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Filling an Empty Arsenal: Puerto Rico's Bankruptcy, From the Recovery Act to PROMESA

***By Richard J. Cooper and Antonio J. Pietrantoni**[*]*

"Gentlemen, we have run out of money.

"Now we have to think."

– Winston Churchill[1]

On August 25, 2023, the Puerto Rico Electric Power Authority (PREPA), the last major Commonwealth instrumentality with debt restructuring negotiations still ongoing, filed its third amended plan of adjustment and marked what may be the final stretch of a nearly decade-long effort by the Commonwealth of Puerto Rico (the Commonwealth or Puerto Rico) to come to grips with its fiscal and economic challenges, challenges that themselves took years to recognize. While a confirmed plan of adjustment for Puerto Rico's government-owned utility may mean that Puerto Rico can finally fully focus its fiscal and policy efforts on generating growth and prosperity for its residents, the path to addressing its fiscal challenges was hardly a straightforward exercise. Indeed, back in 2014, when its mounting fiscal challenges forced the Commonwealth to accept the fact that market access was not something that could always be counted on, it was only the realization that it lacked the legal tools necessary to obtain debt relief in a fair and orderly manner that propelled it down the road that ultimately led to where it stands today.

Unlike private corporations, American states cannot file for bankruptcy protection under the federal Bankruptcy Code. Their municipalities, however, do have access to bankruptcy relief under Chapter 9 of the Bankruptcy Code. For reasons not addressed by legislative history, Puerto Rico and its municipalities were expressly precluded from being able to file for bankruptcy relief under Chapter 9.[2] As a result, Puerto Rico and its municipalities had no formal

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[1] Quote attributed to Sir Winston Churchill, Prime Minister of the United Kingdom, as well as to New Zealand physicist Ernest Rutherford.

[2] 11 U.S.C. § 101(52) ("The term "State" includes the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9 of this title.").

mechanism to bring its stakeholders to the table and obtain debt relief, and this exclusion ultimately dictated the path that Puerto Rico would have to take to get to where it is today.

Congress made history when it enacted the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) in June 2016.[3] PROMESA provided the Commonwealth with two distinct restructuring tools, (i) Title VI of PROMESA, an out-of-court process that relies on a mechanism to bind creditors similar to collective action clauses in sovereign debt instruments, and (ii) Title III of PROMESA, a court-led restructuring mechanism modeled on Chapter 9 of the Bankruptcy Code. PROMESA also incorporated a short-term stay on creditor remedies[4] and, notably, implemented certain fiscal and economic disciplines and safeguards largely through the establishment of an independent oversight board.

In many ways, PROMESA's enactment represented the culmination of efforts to provide Puerto Rico with a workable solution to address its fiscal and economic challenges. To be sure, PROMESA is far from perfect and there were many compromises included in the law which reduced its effectiveness or resulted in unnecessary delays and increased execution costs. But as the Commonwealth's experience these last few years aptly illustrates, the complexities of its debt stock, the interdependence of many of its credits, the legal uncertainties caused by often opaque and conflicting documentation, laws and Puerto Rican and federal statutes and the U.S. Constitution, and the diversity of its creditor pool would almost certainly prevented Puerto Rico or its creditors from restructuring the Commonwealth's debt (and the debt of the numerous other state-owned public corporations of Puerto Rico) outside the cover of a formal bankruptcy regime.

While the underlying causes of fiscal distress in state and local governments vary on a case-by-case basis, legal issues involving relative priorities, due process, the claw back of recoveries and contractual and property rights, all of which played a critical role in Puerto Rico's path to bankruptcy, generally form a common thread among them. PROMESA's ability to tackle these issues through recognized and tested mechanisms should therefore serve as a potential blueprint to address future fiscal crises.

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[3] Puerto Rico Oversight, Management, and Economic Stability Act, Pub. L. No. 114-187, 130 Stat. 549 (2016).

[4] The short-term stay expired on May 1, 2017. See PROMESA § 405(d).

PUERTO RICO'S SPUTNIK MOMENT

Puerto Rico's fiscal and economic crisis came to head in 2013, but it had been brewing in the background for quite some time. Following decades of chronic fiscal mismanagement, a combination of structural problems, stretched public finances and the phase-out of key federal tax incentives pushed Puerto Rico into an acute fiscal crisis, the likes of which had never been experienced by any state or local government within the United States. As the one-time darling of the municipal debt market,[5] Puerto Rican bonds were a staple to municipal bond portfolios from Wall Street to Tulsa. The market initially turned a blind eye to Puerto Rico's troubling statistics and kept buying Puerto Rican bonds, fueled, in part, by a unique triple tax-exempt status enjoyed by debt issued by the Commonwealth and its instrumentalities.[6] In August 2013, *Barron's* published an article discussing Puerto Rico's looming challenges in light of Detroit's historic bankruptcy filing and, with it, the inevitable Sputnik moment arrived.[7] The market was jolted into realizing that Puerto Rico was in serious trouble. In February 2014, the preeminent credit rating agencies downgraded the Commonwealth and its debt-issuing instrumentalities to below investment grade (i.e., speculative or "junk" status).[8]

These downgrades marked a critical turning point in Puerto Rico's history, foreclosing the Commonwealth's access to its traditional retail investor base and increasing its borrowing costs as it prepared to tap the capital markets in the first quarter of 2014. Sophisticated hedge funds were the ones now sitting across the table, demanding an 8% interest coupon, original issue discount and bond terms that were generally inconsistent with traditional municipal market

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[5] Andrew Bary, Troubling Winds from Puerto Rico, BARRON'S (Aug. 26, 2013), http://online.barrons.com/news/articles/SB50001424052748704719204579022892632785548) ("Puerto Rico's 'triple' tax exemption – federal, state, and local – is rare in the municipal market.").

[6] 48 U.S.C. § 745 (2012) ("[Puerto Rican bonds] . . . shall be exempt from taxation by the Government of the United States, or by the Government of Puerto Rico or of any political or municipal subdivision thereof, or by any State, Territory, or possession, or by any county, municipality, or other municipal subdivision of any State").

[7] Bary, supra note 5; see also Puerto Pobre, THE ECONOMIST (Oct. 26, 2013) https://www.economist.com/finance-and-economics/2013/10/26/puerto-pobre.

[8] Press Release, Moody's Investor Services, Rating Action: Moody's downgrades Puerto Rico GO and related bonds to Ba2, notched bonds to Ba3 and COFINA bonds to Baa1, Baa2; outlook negative (Feb. 7, 2014) (on file with authors); Press Release, Standard and Poor's Rating Services, Puerto Rico GO Rating Lowered To 'BB+' Remains On Watch Negative (Feb. 4, 2014) (on file with authors); Press Release, Fitch Ratings, Fitch Downgrades Puerto Rico GO and Related Debt Ratings to 'BB'; Outlook Negative (Feb. 11, 2014) (on file with authors).

borrowings.[9] More so, these bonds included New York choice of law provisions, signaling a negative shift in the market's assessment of the risk of Puerto Rico defaulting on its debt.

The record-breaking March 2014 issuance of new series of general obligations (GO) bonds with an outstanding aggregate principal amount of approximately $3.5 billion, however, provided limited respite. The Commonwealth's public corporations remained unable to refinance short- term obligations coming due later in the year. In particular, PREPA, the government-owned entity responsible for the ownership and operation of the island's electric transmission and distribution system and a fleet of aging thermal generation plants, faced significant debt maturities in the first half of 2014. Paying these maturities at par would have left PREPA unable to purchase the fuel it needed to continue operating Puerto Rico's electrical system and, consequently, collect the revenues needed to continue to provide power to its residents and ultimately repay creditors. In short, Puerto Rico could no longer continue business as usual, dribbling its chances by tapping the municipal markets to fund operating deficits and refinance its ever-increasing debt stock at higher costs. The need to keep lights on and ensure the continuity of essential public services pushed the Commonwealth to act.

THE PREPA EXPERIENCE

From the start, the lack of an adequate restructuring framework severely limited the options available to PREPA. Puerto Rican policymakers needed to act fast and come-up with a solution to avoid the collapse of the island's sole source of electric power.

The existing legal framework was inadequate. PREPA's enabling act contained receivership provisions,[10] but these provisions were archaic, lacking the robust mechanisms needed to restructure operations and implement long-term measures to benefit every stakeholder, including PREPA's creditors. Pursuant to these receivership provisions, upon an event of default under the indenture governing PREPA's bonds, holders of 25% of the aggregate principal amount outstanding could obligate a court to appoint a receiver. This receiver's

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[9] See Jonathan Mahler and Nicholas Confessore, Inside the Billion-Dollar Battle for Puerto Rico's Future, THE NEW YORK TIMES (December 19, 2015), https://www.nytimes.com/2015/12/20/us/politics/puerto-rico-money-debt.html?_r=0.

[10] See Puerto Rico Electric Power Authority Act, P.R. Laws Ann. tit. 22, § 207 (providing for a court-appointed receiver in event of default). A similar construct also appears in Section 154 of the organic act of Puerto Rico Aqueduct and Sewer Authority. See P.R. Laws Ann. tit. 22, § 153.

authority, however, would be strictly limited to operating and maintaining PREPA's business, collecting fees from end-users and paying debt service on PREPA's outstanding debt instruments. PREPA's receivership provisions critically withheld from the receiver the power to address structural and fiscal issues, including by disposing assets or outsourcing operations to private operators, or provided it tools to address serious operational issues. While, technically, the receiver could seek to raise rates, rates were already considerably above the rates charged in the mainland United States and Puerto Rico's economy was already suffering with approximately 40% of the population living below the poverty line. Additionally, there was no assurance such rate increases would ultimately be sufficient to address the magnitude of PREPA's liquidity, solvency and capital needs. Further, the length of the receivership was not subject to any fixed term, therefore presumably keeping PREPA under court supervision until all its debts (many of which went out for decades) were paid in full.

PREPA could try to negotiate a consensual restructuring with its creditors, but it would enter these negotiations lacking the implicit bargaining leverage provided by potential use of a cram-down that would incentivize constructive discussions. In other words, it would not be able to bind holdout creditors who did not voluntarily participate in any restructuring transaction and could take actions to maximize their own recovery, therefore risking the unwinding of any agreements reached with other creditors. Those creditors willing to provide respite might in turn hold back concessions out of fear that holdouts would get a better deal on account of their willingness to absorb losses. In summary, this option did not guarantee any meaningful debt relief for PREPA absent a strong financial support from the Commonwealth, which was itself facing its own set of fiscal challenges.

Worried about PREPA's inability to stay creditor actions that could lead to a messy default and threaten PREPA's ability to continue providing power to the residents of Puerto Rico, the Commonwealth's Legislative Assembly enacted the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the Recovery Act) in June 2014.[11] The Recovery Act was specifically designed to ensure that Puerto Rico's public corporations could continue delivering essential public services while they pursued formal workouts. It also represented the Commonwealth's intent to provide an orderly restructuring mechanism for its ailing public corporations, while also protecting the Commonwealth's general obligation (GO) credit.[12] In other words, through the Recovery Act, the

[11] Puerto Rico Public Corporation Debt Enforcement and Recovery Act, Act No. 71 of June 28, 2014.

[12] The Recovery Act only allowed certain "public sector obligors" to seek relief and its

Commonwealth attempted to take aim at the fiscal and economic problems that, at the time, were believed to be centralized within public utilities such as PREPA and the Puerto Rico Aqueduct and Sewer Authority and avoid having to restructure the central government's GO debt.

THE RECOVERY ACT, PROMESA'S EARLY BLUEPRINT

The Recovery Act provided qualified "public sector obligors" with two avenues for debt adjustment that largely mirrored those already provided by the federal Bankruptcy Code and which ultimately served as the blueprint for the analogous restructuring mechanisms provided by PROMESA.

- Chapter 2 provided a consensual, voluntary restructuring process, with limited involvement by a court, through a market-based approach relying on the consent of a supermajority of creditors. The mechanism provided by Chapter 2 was similar to a "collective action clause," which has become a staple boilerplate term of sovereign debt instruments since their introduction to the market in the early 2000s, and recently successfully deployed by Ecuador and Argentina during their 2020 debt restructurings. The bedrock principle underpinning Chapter 2 was the need to minimize the disruption that a relatively small number of holdout creditors could cause by allowing the consent of a supermajority of creditors to bind a resisting minority.
- Chapter 3 created a formal court-supervised process similar to the one provided by Chapter 9 of the Bankruptcy Code. In other words, a debtor could initiate a court-led process that would conclude with the approval of a plan of adjustment binding on all creditors. Under Chapter 3, a "petitioner" could propose a debt adjustment plan that had to be approved by at least one class of creditors whose instruments would be impaired by the proposed debt adjustment plan.

Although certain critics opposed the Recovery Act on the grounds that it represented a coercive departure from long-standing market precedent, and argued that the Commonwealth should instead rely on consensual negotiations with its creditors, such arguments generally ignored the fact that the Recovery Act was not an attempt to reinvent the wheel. In fact, the Recovery Act incorporated tried and tested concepts and provisions that borrowed from well-established bankruptcy principles, many of which eventually came up again as key components of PROMESA's restructuring framework, including:

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expressly excluded the Commonwealth, the 78 autonomous municipalities of the Commonwealth and a list of government entities.

- A stay on creditor remedies;
- Providing debtors with the flexibility with respect to the path to restructuring its debt obligations, either through Chapter 2's collective action approach or through Chapter 3's formal court proceeding;
- Creation of an independent court with special subject matter jurisdiction over all matters arising out of the Recovery Act as well as with powers to adjudicate claims and controversies involving the covered entities;
- Giving the court the jurisdiction to adjudicate all matters relating to the debt instruments affected by the Recovery Act, including with respect to issues regarding the validity and constitutionality of outstanding obligations and other intercreditor issues;
- Allowing the court to grant administrative expense treatment to such costs and expenses deemed by the court as necessary to preserving the ongoing operations of the debtor, and in doing so provide critical vendors and suppliers with certainty during the restructuring process;
- Permitting a debtor to reject executory contracts based on its best interests;[13]
- Affording creditors procedural and substantive due process, as well as adequate protection against the diminution of value of collateral;
- Allow for debtor-in-possession financing and the granting of superiority liens to secure temporary financing; and
- Permit the sale or transfer of assets free and clear of security interests and successor liability.

When it came to structuring the operative mechanics of the Recovery Act, the Commonwealth was particularly keen on ensuring they would facilitate the expeditious and efficient administration of a debt relief transaction under Chapter 2 or Chapter 3. To that end, the Recovery Act was specifically designed to provide a public sector obligor substantial flexibility in seeking relief under Chapter 2 or Chapter 3, either simultaneously or sequentially. The debt adjustment mechanism under each chapter were not mutually exclusive and could be commenced simultaneously or at different points in time. In doing so,

[13] With respect to the collective bargaining agreements and employee benefit plans, the Recovery Act went beyond language included in the Bankruptcy Code and required that any proposed rejection to be reviewed under a higher- level scrutiny whereby the rejection would only be allowed "if the equities balance in favor of reject[ion] . . . ," in accordance with the Supreme Court's holding in NLRB v. Bildisco, 465 U.S. 513, 525 (1984).

these mechanisms effectively complemented each other. For example, the possibility of a debtor seeking relief under a Chapter 3 court-based proceeding would motivate creditors to proactively participate in a Chapter 2 voluntary process in order to avoid a more coercive Chapter 3 proceeding whereby a single class of creditors could vote in favor of a plan of adjustment and a court would have the final say on the terms of a restructuring.

In any case, the ultimate purpose of the Recovery Act was to provide an orderly framework that would both help the Commonwealth restructure the debt obligations of the eligible obligors with minimal interruption of essential services, while also placing limits on individual creditor enforcement rights, therefore improving the potential recoveries for creditors as a whole. Put another way, the Commonwealth believed that all stakeholders, including creditors, would benefit from some type of formal mechanism that avoided the pitfalls of simply relying on ad-hoc negotiations with creditors and could nonetheless result in a disorderly default with no way to effectively control their run-and-grab instincts.

The ink was barely dry when the Recovery Act's constitutionality was challenged by two groups of PREPA's bondholders alleging, among other things, that it was preempted by the Bankruptcy Code. The federal district court in Puerto Rico enjoined enforcement of the Recovery Act and agreed with the bondholder's preemption argument. The Supreme Court ultimately affirmed the lower court's ruling striking down the Recovery Act on preemption grounds,[14] thus effectively denying Puerto Rico the ability to enact for its public corporations its version of a Chapter 9 bankruptcy.

Some might argue that the enactment of the Recovery Act was a failed strategy given the Supreme Court's eventual holding that it was unconstitutional. Nevertheless, the mere enactment of the Recovery Act gave the Commonwealth the bargaining leverage it urgently needed to bring PREPA's creditors to the negotiating table and therefore effectively mitigated some of the costs of having to address PREPA's fiscal challenges outside a formal bankruptcy framework. Due to these efforts, PREPA was able to negotiate a forbearance agreement with 60% of its creditors that set the stage for the restructuring process under Title III of PROMESA that continues to this day. Absent the Recovery Act, and assuming no federal or third-party bailout, the Commonwealth's public corporations would have likely defaulted on debt service obligations, opening the doors to a negative sum game with years of costly and time-consuming litigation. The structural and substantive similarities between the Recovery Act

[14] Puerto Rico v. Franklin Cal. Tax-Free Tr., 579 U.S. 115 (2016).

and PROMESA are also telling of the strength and legitimacy of the legal mechanisms that the Recovery Act attempted to provide for the Commonwealth.

GDB'S FISCAL PREDICAMENT

Beginning in early 2015, as the Commonwealth's overall liquidity position became more precarious, the Commonwealth and its principal depositary institution, fiscal agent and financial advisory arm, the Government Development Bank for Puerto Rico (GDB), began analyzing potential legislative and financial actions and assistance from the U.S. government, as well as exploring potential self-help remedies through a liability management or tapping new sources of revenue (i.e., new taxes). Motivating these efforts were concerns with GDB's chronic undercapitalization and the risk that GDB's insolvency could paralyze all of the Commonwealth's operations.

As of December 31, 2014, GDB's liquidity stood at approximately $1 billion, but certain debt service payments were due throughout 2015, including a debt service payment amounting to approximately $270 million that was due on December 1, 2015, therefore leaving GDB with a precarious liquidity balance at the start of 2016.[15] Given GDB's critical role as the financial and depositary institution of the central government, public corporation and Puerto Rican municipalities, the liquidity challenges it was facing made it an ideal, if not necessary, candidate for a restructuring.

GDB first began exploring a potential voluntary exchange offer on a stand-alone basis in the spring of 2015. GDB and its advisors developed an exchange proposal involving an exchange of existing GDB bonds for new bonds issued by the Puerto Rico Infrastructure Financing Authority (PRIFA) that would be backed by certain petroleum products taxes and a guaranty by the Commonwealth. Over the course of the summer of 2015, GDB and its advisors engaged in negotiations with an ad hoc group of bondholders (the GDB Ad Hoc Group) regarding the terms of this exchange. However, given the onerous terms proposed by the GDB Ad Hoc Group, as well as the concerns creditors had regarding the Commonwealth's overall fiscal situation, the parties were ultimately unable to arrive at an agreement on terms.

In parallel, efforts by the Commonwealth, GDB and their advisors to facilitate a federally- sponsored solution focused on seeking financial assistance

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[15] See Mary Williams Walsh, Puerto Rico Begins Choosing Which Debt Payments to Make, THE NEW YORK TIMES (December 1, 2015), https://www.nytimes.com/2015/12/02/business/dealbook/puerto-rico-government-debt-bond-payment.html; see also Megan Davies and Nick Brown, Puerto Rico Makes Dec 1 Debt Payment, REUTERS (December 1, 2015), https://www.reuters.com/article/uk-usa-puertorico-senate/puerto-rico-makes-dec-1-debt-payment-idUKKBN0TK53Z20151201.

from the U.S. Department of the Treasury (UST) and later lobbying Congress to grant the Commonwealth and its instrumentalities access to a restructuring regime – either through Chapter 9 of the Bankruptcy Code, which would have been unable to address certain issuers with material debt obligations (i.e., the Commonwealth itself), or through an expanded variant of Chapter 9 permitting both the Commonwealth and its instrumentalities access to restructuring tools. These efforts were coupled with analysis of, and subsequent discussion with members of the UST regarding, various liquidity options for the Commonwealth that could potentially be put in place in the immediate term through existing federal mechanisms.

Unfortunately, the Commonwealth was unable to obtain a formal commitment from the federal government and, in light of the Recovery Act litigation, it was hesitant to pursue another statutory solution for GDB that would likely end up challenged in court. The Commonwealth therefore resorted to extraordinary revenue-raising liquidity measures in order to buy time,[16] as well signal to the market its commitment to honor its senior debt service obligations. In addition, the Puerto Rico Public Finance Corporation defaulted on certain "moral obligation bonds" during the summer of 2015,[17] followed by the governor's issuance of an executive order December 1, 2015 ordering the "claw back" of certain taxes and fees pledged by certain public corporations for the payment of debt service on their bonds.[18] Nevertheless, these measures were not sufficient and given the need to tackle the worsening fiscal panorama, the Commonwealth was left with no other alternative than to try to bring its creditors to the negotiating table and pursue a consensual solution to avoid a default.

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[16] For example, the Commonwealth's liquidity preservation and cash management measures included, among others, the enactment of additional taxes on tobacco and crude oil products, an increase and in the Sales and Use Tax from 7% to 11.% and the delay of tax refunds and payments owed to private sector vendors and suppliers.

[17] The Public Finance Corporation (PFC) was a GDB subsidiary that issued bonds payable solely from the principal of and interest on promissory note issued by the certain government agencies, which promissory notes were in turn payable from budgetary appropriations made by the Legislative Assembly. See Aaron Kuriloff, Puerto Rico Defaults on Most of $58 Million Debt Payment, WALL ST. J. (Aug. 3, 2015), https://www.wsj.com/articles/puerto-rico-misses-most-of-58-million-debt-payment-1438633822.

[18] Pursuant to the statutes authorizing the bonds issued by PRIFA, the Puerto Rich Highways and Transportation Authority, and the Puerto Rico Convention Center District Authority, taxes and fees pledged for the repayment of their outstanding bonds were explicitly conditioned on such revenues not being necessary for the repayment of the Commonwealth's public debt. See also Executive Order 2015-46, December 1, 2015 (activating Article VI of Section 2 of the Commonwealth's Constitution).

THE VOLUNTARY EXCHANGE OFFER AND INITIAL RESTRUCTURING PROPOSALS

Beginning in the spring of 2015, the Commonwealth and its advisors engaged in a comprehensive assessment of the fiscal situation of the Commonwealth as a whole. The Commonwealth hired three former economists from the International Monetary Fund and the World Bank, Dr. Anne O. Krueger, Dr. Ranjit S. Teja and Dr. Andrew Wolfe, and on June 29, 2015, Governor García Padilla made public a report (the Krueger Report) on the Commonwealth's economic and financial stability and growth prospects prepared by these former IMF economists.[19] The Krueger Report essentially concluded that Puerto Rico's public debt was unsustainable and could not be made sustainable without growth. Further, the Krueger Report also concluded that addressing Puerto Rico's fiscal and economic crisis required necessary structural reforms to right size government spending, as well as substantial and comprehensive debt relief. Noting that "there is no US precedent for anything of this scale,"[20] the Krueger Report acknowledged that restructuring Puerto Rico's debt obligations would be unlike anything the US capital markets had ever seen. However, for the team that prepared the Krueger Report, the economics were clear and "the issue could no longer be avoided."[21]

The Krueger Report clearly laid out how the Commonwealth had very little room to maneuver and had to act swiftly to avoid a disorderly default. By looking at the Commonwealth's revenues and expenses from a holistic perspective, instead of parceling out instrumentalities that were nominally independent but, in fact, reliant on general fund appropriations, the Commonwealth also hoped that the Krueger Report would help creditors and leaders in Washington understand the true magnitude of Puerto Rico's crisis. In late June 2015, the Commonwealth government decided to pursue a comprehensive restructuring through voluntary negotiations with its creditors. In particular, the Commonwealth began to structure a proposal to obtain debt relief through a voluntary exchange offer (the VEO) involving debt issued by GDB, the Commonwealth and other credits whose cash flows were linked to the Commonwealth's general fund. The purpose of the VEO was to reprofile the terms of the Commonwealth's outstanding debt instruments and put them on sustainable terms. The Commonwealth also hoped to secure short-term cash

[19] Anne Krueger, Ranjit Teja and Andrew Wolfe, "Puerto Rico – A Way Forward," http://www.gdb-pur.com/documents/PuertoRicoAWayForward.pdf.

[20] Krueger Report, page 21.

[21] Id.

flow release, crucial to funding government operations as it implemented much needed structural and fiscal reform measures. The success of the VEO, however, relied on the participation of a significant portion of bondholders in order to make the resulting debt stock sustainable.

Unlike modern day bonds issued by sovereign nations, municipal bonds do not contain collective action clauses that facilitate a coordinated workout of debt instruments with a diverse pool of creditors.[22] The Commonwealth was no exception. Amending the payment terms of the Commonwealth's outstanding debt instruments (i.e., to change their principal and interest terms, amortization schedules, events of defaults, etc.) required the consent of each affected bondholder. To incentivize the voluntary participation of creditors and minimize the risk of holdouts, the Commonwealth had to carefully put together a transaction whereby creditors were to be offered a package of "carrots" and "sticks" to sweeten the deal and incentivize participation.

Carrots would consist of measures to encourage bondholder participation, such as offering cash payments, new debt instruments that contained enhanced security interests, additional guarantees, New York choice of law and venue, robust disclosure requirements, as well as adopting at the government-level mechanisms to ensure the Commonwealth's fiscal discipline, among others. Besides the implicit threat of having to default absent some form of debt reprofiling, the Commonwealth would need to rely on exit consents as a stick to discourage bondholders from holding out from participating in the VEO. In general terms, through the use of exit consents, an issuer would ask bondholders to, as a condition of receiving the new instruments offered through the exchange offer, vote in favor of stripping terms and conditions of the bonds that did not require unanimous consent – i.e., terms covering governing law, forum selection, sinking fund protections, asset transfers, among others – with a view to make the legacy bonds less desirable than the offered instruments. Exit consents have been commonly used in exchange offers involving corporate debt and have been upheld by courts in prior out-of- court restructurings.[23]

The planning phase in anticipation of the VEO largely consisted of identifying the key structural reforms that the Commonwealth would have to undertake to encourage bondholders to participate in the VEO, modeling

[22] Collective action clauses represent a contractual response to the inherent coordination problems that bonds pose as multi-creditor debt instruments.

[23] See Katz v. Oak Indus. Inc., 508 A.2d 873 (Del. Ch. 1986) (upholding the use of exit consents as a restructuring mechanism in the corporate context); but see Marblegate Asset Management, LLC v. Education Management Corp., 846 F.3d 1 (2d Cir. 2017) (implying that the use of exit consents would be unduly coercive in certain contexts).

future cash flows based on the projected economic performance of the island as a whole and designing a restructuring currency that would be sufficiently attractive to creditors while keeping Puerto Rico economically viable. In tandem, GDB and its advisors worked on the development and enactment of the Organic Act for the Fiscal Oversight & Economic Recovery Board, Act 208-2015[24] (the Commonwealth's local fiscal oversight board legislation) and the development and publication of the Commonwealth's Fiscal and Economic Growth Plan in September 2015 (along with subsequent updates in 2016). To be sure, these two measures would later become the key hallmarks for PROMESA's fiscal oversight mechanism.

Throughout the first half of fiscal year 2015-2016, Commonwealth representatives and their advisors led a due diligence process for bondholders and bond insurers, including extensive presentations and meetings with Commonwealth representatives. These efforts culminated in the development of an initial restructuring proposal made public on February 1, 2016. The Commonwealth's initial proposal sought to exchange $49.2 billion of tax-supported debt into (i) $26.5 billion of fixed-rate bonds, and (i) $22.7 billion in variable payment bonds (i.e., a contingent value instrument, or CVI). The proposal contemplated no interest payments until fiscal year 2018, no principal payments until fiscal year 2021, maximum annual debt service of $1.7 billion starting fiscal year 2021 and a final maturity in fiscal year 2051.

By consolidating the credits into a single, new fixed-pay instrument nicknamed the "Superbond," the Commonwealth's proposal was tackling head-on one of the gating issues that made restructuring Puerto Rico's debt stock particularly challenging – over two-thirds of its bonds had been issued by more than twenty different issuers and they all relied on overlapping revenues sourced, one way or another, by or through the central government.[25] This muddled capital structure sparked a number questions on the validity of certain credits and set the stage for heated intercreditor conflicts. As evinced by the GO-COFINA litigation and the PROMESA Oversight Board's ultra vires investigation, both of which dealt with issues that arose during the Commonwealth's pre-PROMESA restructuring efforts and continued to impact the Title III approval process, intercreditor issues were too imbedded into the Common-

[24] The Organic Act for the Fiscal Oversight & Economic Recovery Board, Act No. 208 of December 8, 2015.

[25] For more information, see David Skeel, "After Debt: A Path Forward for Puerto Rico" ("Not even the island's largest creditors know exactly which parts of the Commonwealth are responsible for which debts, and Puerto Rico has complicated matters further by using funds appropriated to various government agencies to pay its guaranteed GO debt.").

wealth's debt stock and could not be ignored. To avoid making the same mistake twice, any long-term solution needed to simplify the outstanding debt structure in a way that clearly laid out relative priorities and collateral rights.

The CVIs included as part of the initial restructuring proposal, then dubbed as the "growth bonds," would be payable only in the event the Commonwealth outperformed certain revenue projections. Given the haircuts it was asking bondholders to absorb, the Commonwealth believed CVIs to be a practical way to allow creditors to recover their losses in a way that would not necessarily harm its own economic prospects. To be sure, similar instruments had previously been used in several sovereign debt restructurings, as well as in the Chapter 9 bankruptcy proceeding for Stockton, California.[26] In the case of Puerto Rico, tying the CVI payment trigger to metrics such gross national product or gross domestic product would be difficult, largely due to Puerto Rico's unique territorial status within the United States and its economy. Therefore, the Commonwealth government had proposed tying the payment trigger to government cash revenues and included certain caps to make sure that Puerto Rico's residents would, too, be able to enjoy any windfall from the island's economic turnaround. The Commonwealth's plan of adjustment approved by the Title III court in January 2022 incorporated CVIs, with payment obligations triggers similarly tied to revenue collections, as part of the consideration package certain bondholders would receive.[27]

The Commonwealth's initial proposal met with resistance from the majority of its creditors, particularly from holders of its GO and COFINA bonds who believed their contractual rights warranted a larger recovery on their investment.[28] Certain creditors also questioned the Commonwealth's baseline assumptions and argued that the Commonwealth was facing a liquidity problem, as opposed to a growth problem, therefore minimizing the need for them to concede haircuts as part of a negotiated deal. Following two additional rounds of

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[26] During their debt restructuring in the 1980's, countries such as Nigeria, Mexico and Venezuela issued warrants linked to the price of oil (a proxy for their ability to secure foreign currency needed for debt service payments). More recently, Greece, Argentina and Ukraine offered creditors GDP-linked warrants as part of their restructuring consideration. For more information, see https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2020/11/13/The-Role-of-State-Contingent-Debt-Instruments-in-Sovereign-Debt-Restructurings-49732.

[27] See Michelle Kaske and Jim Wyss, Puerto Rico is Out of Bankruptcy After a $22 Billion Debt Exchange, BLOOMBERG (March 14, 2022), https://www.bloomberg.com/news/articles/2022-03-15/puerto-rico-bankruptcy-set-to-end-with-22-billion-debt-exchange.

[28] Andrew Bary, "Puerto Rico Faces Hurdles Seeking a 46% Cut in Debt," Barron's, February 1, 2016, available at https://www.barrons.com/articles/puerto-rico-faces-hurdles-seeking-a-46-cut-in-debt-1454361125.

proposals through June 2016,[29] negotiations with creditors stalled as the federal government edged closer to the enactment of the fiscal oversight legislation that would come to be known as PROMESA.

THE EMERGENCY MORATORIUM ACT

Because of the Commonwealth's inability to agree on the terms of a consensual debt restructuring with its creditors, and given that certain material debt service payments were coming due in May and July of 2016,[30] on April 6, 2016, the Commonwealth's legislative assembly enacted the Puerto Rico Emergency Moratorium and Financial Rehabilitation Act, Act No. 21- 2016 (the Moratorium Act). Generally speaking, the Moratorium Act gave the Governor authority to declare a moratorium and stay creditor remedies with respect to the debt obligations of government entities declared to be in state of emergency. The Moratorium Act also incorporated provisions modeled on federal banking laws catered to the GDB and its unique role as the principal depositary institution for the Commonwealth and its instrumentalities, including provisions that modernized GDB's outdated receivership mechanism and allowed for the creation of a temporary bridge bank. The Moratorium Act was not intended to be the final, definitive solution for the Commonwealth's debt woes – it specifically provided for its expiration on January 31, 2017, subject to a two-month extension by the governor.

The Moratorium Act was the Commonwealth's last resort for navigating its liquidity crunch as it confronted debt maturities that it simply could not pay or otherwise restructure absent a formal restructuring framework. It was designed to procedurally enable government officials to implement extraordinary cash management measures to avoid the interruption of essential public services. For example, it would permit the governor to impose a freeze or conditions on the withdrawal of deposits at GDB. More importantly, however, it was intended to provide the Commonwealth with additional time, leverage

[29] The final proposal from the Commonwealth, made public on June 21, 2016, shortly before the enactment of PROMESA, provided an incremental $52.7 billion of mandatorily payable debt service to creditors as compared to the Commonwealth's February 1, 2016 offer. The proposal contemplated cash flow relief during the first four years, but increased cash interest payments during such period and added a non-cash interest portion (payable-in-kind). Maximum annual debt service was set at $2.05 billion starting in fiscal year 2031, with a final maturity in fiscal year 2071.

[30] GDB notes had principal maturities of approximately $400 million due on May 1, 2016, but its available cash as of April 1, 2016, was approximately $562 million. In addition, the Commonwealth faced upcoming general obligation debt service payments of approximately $780 million.

and breathing room to complete a negotiated restructuring or wait for Congress to enact a legal solution. As a result, it succeeded in giving policymakers a framework that averted a collapse of the Puerto Rican government. Without a doubt, the Moratorium Act was single-handedly responsible for clearing the runway for PROMESA's orderly implementation. Puerto Rico's lights never went out, its schools never closed, and its hospitals remained open during the months it took to establish an operational Oversight Board under PROMESA.

PROMESA AND POTENTIAL LESSONS FOR AMERICAN STATES

The bill that would eventually become PROMESA was the product of months of tense negotiations between the Obama administration and the Commonwealth and its advisors on the one hand, and the Republican-led Congress (under the leadership of Speaker Paul Ryan) and various creditor groups on the other hand. During the process leading up to PROMESA's enactment, both sides of the aisle were forced to compromise and certain proposed mechanisms and safeguards that might have facilitated a more expedited and less costly process never made it to the final product. While no doubt each participant in those negotiations would have its own list of items that it wanted included in the legislation, three items that the Commonwealth lobbied for but did not get included were the following:

- *Bonding Authority* – A bonding authority that would have allowed a newly-created Puerto Rico government entity (and not a federal government agency) to issue debt approved by the PROMESA Oversight Board. These particular debt instruments would have been an attractive restructuring currency to provide to creditors given their built-in protections, such as the fact that they were issued under the cover of a *federal* law that explicitly permitted the granting of super priority liens and therefore would have avoided legality and priority issues arising under the Puerto Rico constitution, as well as questions regarding the validity or perfection of security interests.
- *Reimbursement of Professional Fees* – Provisions dealing with the reimbursement of professional expenses in connection with a Title III proceeding whereby the relevant debtor would only be responsible for the fees and expenses of *one* official creditor committee. While PROMESA followed the Chapter 11 and Chapter 9 model with respect to the payment of professional fees and expenses, certain foreign bankruptcy regimes have adopted less generous constructs that limit the debtor's exposure to unrestrained professional fees and expenses incurred by multiple interested parties. The amount of professional expenses incurred in connection with Puerto Rico's various restructur-

ings has dwarfed those of any other municipal, sovereign or private restructuring, and their accrual continues to this day.

- *Debtor's Title III Involvement* – Pursuant to Section 315 of PROMESA, the Oversight Board is the debtor's representative throughout the duration of a Title III proceeding. During the negotiation of PROMESA, the Commonwealth argued that relegating the relevant debtor to a secondary back-up role while the Oversight Board takes the lead with the Title III process would ultimately undermine the process. The language that would eventually be codified in Section 315 of PROMESA was the product of creditor lobbying efforts that sought to weaken the debtor's position in light of their experience during the Detroit bankruptcy. However, in accepting such proposal, PROMESA's drafters turned the Oversight Board into an actor and advocate, instead of keeping it as a neutral umpire with the credibility to function as an effective referee in skirmishes with and among creditors. It also put the Oversight Board in the position of having to choose winners and losers among the Commonwealth's various debtors, and certainly among creditors, which tension played itself out most notably in the restructuring of COFINA, the first Commonwealth instrumentality to be restructured under PROMESA.

In the end, PROMESA served its purpose, but while many might disagree with the advantages or disadvantages of the particular items listed above, few would argue that, like any other legislation, improvements could be made.

In any case, Puerto Rico's experience during the past decade will, without a doubt, serve as an important lesson for states and local governments facing fiscal distress. From the use of their inherent police powers to the enactment of legislative measures, state and local governments are, under normal circumstances, comfortably equipped with the tools necessary to protect the health, safety and welfare of their constituents and promote the growth and development of their economies. These tools, however, necessarily require that state and local governments have access to sufficient monetary resources to fund their operations. So long as traditional sources of financing are steady and secure, governments are able to postpone the politically unpalatable decisions needed to balance budgetary aspirations with fiscal realities. However, state and local governments are not immune from the effects of shifting economic fortunes and, like ordinary individuals, they, too, may someday have to make tough decisions on how to prioritize expenses when faced with a cash crunch.

Irrespective of any moral judgment one could pass on the prior actions and policies of government officials that set the stage for a fiscal and economic crisis, the fact remains that state and local governments play a critical role in the

day-to-day functioning of society that cannot be easily put on hold or otherwise replaced by private sector institutions. Unlike private corporations, state and local government, and the assets and essential public services that they administer, such as schools, hospitals and critical transportation infrastructure, cannot be liquidated without risking the health, safety and welfare of private citizens. However, like private corporations, they too are largely subject to the practical constraints of revenue collection and the management of costs and expenses. With its tried and tested mechanisms, and its ability to induce optimal outcomes, bankruptcy law should be put on the table as a potential solution.

If one key lesson can be gleaned from Puerto Rico's experience, it is that when it comes to state and local governments facing acute fiscal distress, it is imperative for them to have access to the tools offered by a rules-based, formal bankruptcy framework. Such tools have been shown to reduce transaction costs and, more importantly, allow for the orderly implementation of a solution that, in the long run, will benefit *every* stakeholder, from ordinary citizens to financial creditors.