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Why Puerto Rico Will Likely Rely On PROMESA Title III

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When Congress enacted the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA), it provided the commonwealth of Puerto Rico and its instrumentalities two distinct restructuring tools to address its financial challenges. The first, Title VI of PROMESA, is a largely out-of-court process that focuses exclusively on financial debt and relies on a collective action mechanism to bind dissenting creditors to the agreement of the debtor and a supermajority of its creditors to restructure its debt. The second, Title III of PROMESA, is a broad-based in-court restructuring regime that is modeled on Chapter 9 of the Bankruptcy Code.

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Both the oversight board and the new commonwealth administration have expressed a strong preference for restructuring the commonwealth's debt through the use of Title VI. However, when it comes to the debt of the commonwealth and those instrumentalities that rely on its taxing power for debt service ("commonwealth debt"), as opposed to the debt of certain of its instrumentalities, such as the Puerto Rico Electric Power Authority (PREPA) or the Puerto Rico Aqueduct and Sewer Authority (PRASA) that have their own independent revenue source and are not subject to the same interdebtor and intercreditor disputes, Title VI is unlikely to provide a realistic path to restructure such debt.[1]

First, unlike Title III, Title VI contains no automatic stay of creditor litigation upon the commencement and during the continuation of the restructuring process. As the current stay is now set to expire in May 2017, with limited options available for a further extension,[2] any attempt to restructure the commonwealth debt through Title VI will likely be complicated when existing litigation resumes and additional litigation is commenced. This issue is not limited to the ongoing dispute between general obligation (GO) and Puerto Rico Sales Tax Financing Corporation (COFINA) creditors concerning whether the commonwealth's sales and use tax represents "available resources" for satisfaction of GO debt,[3] although that is a critical dispute. In addition, creditors already have challenged the invocation of the clawback by the commonwealth, asserted claims against the commonwealth based on violations of statutory impairment provisions, alleged that various property interests have been taken in violation of constitutional protections, and claimed violations of PROMESA and other statutes. Regardless of the validity of these claims, it is clear that they will not all be resolved in the likely time frame that a Title VI process will take, and the outcome of such litigation, as well as other litigation that surely will be commenced upon the expiration of the current stay, could alter or harden the positions of the affected parties and change their willingness to compromise their claims.

Second, Title VI is limited in its scope, as only financial debt can be restructured as part of the process. In the case of the commonwealth, that would mean not only that nonfinancial obligations such as pension or retiree health obligations, contract claims, labor liabilities or impairment claims based on debts of the commonwealth's instrumentalities could not be restructured, but the fact that they would fall outside the scope of the Title VI process will inevitably make financial creditors, who otherwise would be inclined to participate in a financial restructuring, less willing to participate knowing that the commonwealth could be exposed to potentially billions of dollars of contingent liabilities even after completion of a targeted Title VI financial restructuring. This isn't an academic point in the case of the commonwealth, particularly where the oversight board has already called for substantial reductions in the commonwealth's pension liabilities, which will be difficult to achieve absent a Title III process.

In addition, the commonwealth could face billions of dollars in potential statutory and contract impairment claims from creditors who do not consent to a Title VI restructuring and assert claims against the commonwealth for violating numerous nonimpairment covenants that the commonwealth entered into in connection with the financing of certain of its instrumentalities, as well as guarantees of instrumentality debt issued by the commonwealth. Although these nonimpairment claims may ultimately fail, they have been asserted in pending proceedings and additional claims will likely be asserted once the current stay of litigation expires.

Third, unlike Title III, Title VI has a number of procedural and substantive limitations that make it ill-suited to address the interrelated web of tax-supported debt issued by the commonwealth and its instrumentalities. For example, a court in a Title VI process has limited authority under PROMESA when it comes to addressing issues that go beyond approving the specific changes to the terms of the restructured debt. Unlike a Title III court, a Title VI court likely lacks the power to enter an order as broad as what is typically contained in a Chapter 9 confirmation order, addressing and resolving issues between and among debtors and their respective creditors (such as those between GO and COFINA creditors that are at the heart of some, but not all, of the intercreditor disputes that exist today). In addition, Title VI does not provide the district court overseeing the restructuring with jurisdiction to resolve "related to" litigation that could potentially implicate the debtor. Thus, any Title VI process for the commonwealth would likely have to be conditioned on — and therefore the implementation delayed by — the resolution of numerous legal issues that will be decided in separate proceedings conducted outside of the district court approving the restructuring, which with appeals could take years.

In contrast, a Title III court can address "related to" litigation and can take full advantage of its equitable powers to fashion a broad confirmation order that will provide a clear and reliable discharge of all manner of obligations upon confirmation, providing the commonwealth with a true clean slate upon emergence. The value of a broad confirmation order and fresh start cannot be underestimated. In Chapter 9 and Chapter 11 bankruptcy cases, debtors have been able to return to credit markets based in part upon the certainty that a comprehensive discharge provides (even in the face of pending appeals of a bankruptcy court order). Facilitating Puerto Rico's return to the credit markets is not only one of the primary objectives of PROMESA, but its achievement will be an important barometer of the durability of the restructuring once achieved.

Apart from these legal and structural limitations inherent in the Title VI process, there are also substantial practical reasons why the oversight board and the new government are likely to eventually rely on Title III to restructure the commonwealth's tax-supported debt.

First, unlike Title VI, which requires a supermajority of creditors in each pool of claims to consent to the

restructuring, Title III incorporates the bankruptcy cramdown power for nonconsenting classes of claims. Although it would be wonderful to believe that multiple pools of creditors across nearly a dozen different debtors holding in excess of $50 billion of debt will agree by supermajority to a consensual restructuring, more than two years of efforts to reach such a consensual solution have shown that result is unlikely to occur in the time frame available (even with new powers afforded to the oversight board and the commonwealth under PROMESA). The cramdown power incorporated in Title III — which would allow a plan of adjustment to be approved (if it meets all other requirements) with the approval of a single impaired class — is a powerful tool that will no doubt influence creditor behavior.

Nor is it likely that the commonwealth and the oversight board can effectively bifurcate the commonwealth credits into a multiple-stage restructuring achieved initially through a Title VI process. Even if the commonwealth and the oversight board were to focus their initial efforts on a consensual Title VI proceeding for the two "senior" commonwealth credits (GO and COFINA), with the remainder addressed in one or more subsequent restructurings, the success of the "first-stage" GO and COFINA restructuring will ultimately be subject to the outcome of the subsequent proceedings and possible claims that may be asserted against the commonwealth as a result.

Moreover, separating the commonwealth credits into two distinct baskets is not as easy as one might think. For example, the commonwealth has guaranteed the debt of certain issuers such as the Puerto Rico Public Buildings Authority (PBA) and PRASA, and has issued more than $4 billion in appropriation debt to the Government Development Bank for Puerto Rico (GDB). Leaving resolution of these material issues to an uncertain stage-two process is unlikely to be accepted by a supermajority of creditors of each of those debtors. In addition, many commonwealth instrumentalities (including the University of Puerto Rico (UPR), the GDB, the Employees Retirement System, and even the Highways and Transportation Authority), depend in whole or in part on appropriations from the commonwealth which would necessarily have to be agreed as part of the fiscal plan approved as part of the stage-one restructuring. Not having UPR creditors present as part of that negotiation of that plan of adjustment, as an example, even though it would establish whether there are sufficient appropriations to provide capacity for debt service at UPR, is not likely to be well-received by UPR creditors, and likely to invoke legal challenges.

This raises the second practical reason why the commonwealth's tax-supported debt will likely need to be restructured as part of an overall commonwealth-wide Title III process: the substantial cross-ownership of debt that exists among the commonwealth and its various instrumentalities by certain institutional investors and insurers. One of the complicating factors in the restructuring efforts to date has been the fact that a number of institutions hold or insure debt not only of the commonwealth but also of one or more of its instrumentalities. Any strategy that depends for its success on the prospect of these institutions accepting an outcome for certain of their Puerto Rican holdings while they roll the dice on the remainder of their commonwealth positions is likely to be challenging to implement, to say the least.

There is also the other practical concern that every debtor including the commonwealth faces — will it have sufficient liquidity to continue operating during the pendency of the restructuring process, which in the commonwealth's case could take years. Title III — in contrast to Title VI — incorporates the Bankruptcy Code's provisions on debtor-in-possession (DIP) financing, providing potential lenders with the certainty and security of a superpriority lien and protections against reversal on appeal. This may be of particular import if Congress fails to maintain current levels of support under the Affordable Care Act or other government programs, and/or if the island's revenues further deteriorate to require financing for essential government services during the course of a restructuring. Additionally, once Title III is filed, secured creditors that do not have "statutory liens" or are not secured by "special revenues," are no longer entitled to a pledge of future revenue streams, which itself could free up additional liquidity.

Finally, perhaps the most compelling reason for a comprehensive commonwealth-wide Title III process relates to what type of capital structure emerges from the restructuring process. Conducting a series of debtor-by-debtor Title VI processes, or a two-stage hybrid process for the commonwealth debt stock, even if achievable, will almost certainly guarantee that the current patchwork of commonwealth debt would remain in place, preserving the same dependency on carving up the commonwealth's revenue stream across different issuers with embedded interdebtor and creditor conflict. This result would be unfortunate for both creditors of the commonwealth and the commonwealth itself and raise the capital costs for the island for decades to come.

For all these reasons, regrettable as it may be given the likely cost and potential timing implications, when it comes to the tax-supported debt of the commonwealth (as opposed to certain of its instrumentalities), we expect Title III to be the restructuring mechanism on which the oversight board and the commonwealth will rely.

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DISCLOSURE: Cleary Gottlieb assisted the commonwealth of Puerto Rico and its instrumentalities with their financial challenges prior to the recent change in government.

This article is the first installment of a multiple-part weekly series on the Puerto Rico debt crisis.

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[1] For purposes of this article, references to the commonwealth's "debt" or "tax-supported debt" will be used in reference to the debt of those Puerto Rican government issuers that are reliant, either directly or indirectly, on the commonwealth's taxing power for operational expenses and debt service, such as the commonwealth's general obligations, COFINA, HTA, PBA, GDB, ERS, PRIFA, PFC, UPR, CCDA, PRIDCO, but excluding municipalities and those entities that have their own revenue sources and/or are financing vehicles with no recourse to tax revenues — including PREPA, PRASA, HFA and the Children's Trust.

[2] See PROMESA § 405(b)(1)(C). While it is possible that a 60-day extension of the current stay could be granted by the district court upon commencement of a Title VI proceeding, it is unlikely that such a 60-day period would be sufficient to conclude a Title VI proceeding, or that a final order approving a Title VI compromise would effectively preclude all such litigation in the future.

[3] See Lex Claims LLC v. Commonwealth of Puerto Rico, Case No. 16-cv-2374 (FAB) (D.P.R.).

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