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Issues To Expect In A Title III Puerto Rico Restructuring

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Given the likelihood of a Title III proceeding under the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) for the commonwealth and certain of its instrumentalities in the near future,[1] we thought it useful to outline some, but by no means all, of the key issues that are likely to be raised. The resolution of these issues is impossible to predict today in light of the unprecedented nature of Title III, the departures that PROMESA makes from the statutory text and structure of Chapter 9, and the unique history and legal framework of the commonwealth's debt obligations. However, one thing is certain — the resolution of these issues will significantly affect creditor recoveries, and the nature of the commonwealth's future debt burden, no matter how they are resolved.

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Validity of Debt

A threshold question in any Title III proceeding is whether certain debt issuances were constitutionally valid, given the various restrictions in the Puerto Rico Constitution that limit the amount, duration and purposes of certain debt. These issues — which are distinct from the questions as to whether certain revenue streams should be "clawed back" from various instrumentalities to satisfy general obligation debt — are not only of interest to every resident of Puerto Rico, but will be at the core of the strategy of certain creditor groups in any Title III proceeding.

The commonwealth constitution precludes the issuance of debt backed by the commonwealth's full faith and credit if it would cause future annual debt service to exceed 15 percent of internal revenues averaged over the prior two years (plus amounts paid on account of guaranteed obligations). The method of calculation of this 15 percent cap, however, has not been judicially tested, and the commonwealth does not include every revenue stream that flows through its general fund in calculating the cap. As part of a Title III proceeding, creditors or parties in interest may argue the cap was not adhered to, and/or that certain debt obligations not currently viewed as general obligation debt should be subject to the debt cap calculation. Creditors could also bring alter-ego allegations against issuers such as the Puerto Rico Sales Tax Financing Corporation (COFINA), seeking to include their debt in the calculated limit, which, if successful, could raise questions regarding not only such issuances but also the validity of certain recent general obligation bond issuances.

The commonwealth constitution also restricts issuance of new commonwealth guarantees. However, in contrast to the process for issuance of new general obligation bonds, the debt cap for guarantees does

not take into account future maximum annual guaranteed debt service, and does not create a dollar limit for new guaranteed debt. As a textual matter, if the commonwealth can issue a single dollar of new general obligation debt, it can guarantee an unlimited amount of debt. On this point, creditors or parties in interest may seek to reclassify guaranteed obligations for which there is no independent source of payment as direct debt of the commonwealth. For example, where an issuer such as the Puerto Rico Public Buildings Authority (PBA) is entirely reliant on general fund revenues to fund debt service, then its scheduled debt payments, as well as guaranteed obligations, could arguably be deemed direct obligations of the commonwealth, again raising questions regarding not only such issuances but also the validity of recent general obligation issuances.[2]

Finally, the commonwealth constitution includes limitations on maturity, generally limiting direct obligations backed by the full faith, credit and taxing power of the commonwealth to a 30-year maximum maturity (with certain exceptions). Creditors may argue that some direct general obligation issuances may have, practically or facially, violated this limit. On this point, the pre-audit survey report issued by the recently disbanded Puerto Rico Commission for the Comprehensive Audit of Public Credit concluded that the commonwealth used a "scoop and toss" strategy to refinance maturing debt, refinancing maturing debt with new debt, "effectively creating maturities more than 30 years from initial issuances."[3] The same report noted that certain capital appreciation bonds have facial maturities of greater than 30 years.

Whether or not there are merits to any of these potential challenges, the stakes could not be higher for those holding the challenged debt. Analogous case law on these types of challenges suggests both that (a) there are no time limits on challenges to the validity of debt, and (b) if held invalid, the principal amount of the debt is simply not subject to recovery.

Prospects for Substantive Consolidation of the Commonwealth Issuers or Cramdown Based on a Joint Plan of Adjustment for All Commonwealth Debt

If the validity of various debt issuances is likely to be a threshold substantive issue raised in a Title III proceeding, then the threshold procedural issue is whether a Title III court would substantively consolidate separate commonwealth issuers, or whether a joint plan of adjustment of commonwealth debt can be confirmed based on the approval of one impaired class of creditors of a single commonwealth debtor.[4] The resolution of these issues will not only have far-reaching consequences on the terms and form of any plan of adjustment, but also on the degree of leverage the commonwealth will wield in seeking a resolution of its financial challenges.

At the outset, there is limited First Circuit precedent on the standards for substantive consolidation, particularly for complex entities with publicly issued debt, such as the commonwealth issuers.[5] However, courts generally consider the extent to which creditors relied on the distinct identities of the debtors, or whether their affairs are so intertangled that an effort to segregate them would effectively harm all creditors.

The obligations of the commonwealth issuers are no doubt significantly interrelated. Not only do all commonwealth issuers ultimately rely on a common tax base for their revenues, but the commonwealth's general fund includes substantial appropriations for a number of other instrumentalities, which enables them to make debt service payments. In turn, many of those appropriations are expressly subject to "clawback" to the general fund if revenues prove insufficient, which suggests not only a practical but a legal interrelationship. At the same time, creditors may claim that they relied on the separate identities of the commonwealth issuers, and often received opinions

concerning their separateness in connection with debt issuances. Separate accounting has also generally been maintained.

The availability of substantive consolidation is further complicated by the text of PROMESA itself. On the one hand, Title III incorporates Section 105 of the Bankruptcy Code, on which courts generally rely to permit substantive consolidation. In addition, PROMESA authorizes both joint plans and the novel concept of "joint petitions," which does not have precedent in Chapter 11 or Chapter 9 practice. Finally, PROMESA expressly permits the commonwealth to adopt a fiscal plan that incorporates the fiscal plans of other instrumentalities, and it is possible that the oversight board, whose determinations are nonreviewable (as discussed below), may approve a fiscal plan that effectively treats the commonwealth and other commonwealth issuers as substantively consolidated.

However, PROMESA also includes language providing that "nothing in this title shall be construed as authorizing substantive consolidation of the cases of affiliated debtors." Opponents of substantive consolidation will certainly argue that this language evidences an intent not to authorize consolidation. That said, even this disclaimer language provides fodder for litigation, as Section 105 is not itself contained in PROMESA's title, and thus arguably falls outside of the scope of the proviso.

Even if substantive consolidation proves unavailable, the oversight board or the commonwealth may still seek to confirm a joint plan of adjustment for the commonwealth and related issuers of commonwealth debt by using PROMESA's incorporated cramdown power, arguing that it can be imposed on all holders of commonwealth debt so long as one impaired class of creditors of a single commonwealth issuer votes to approve the plan. Specifically, PROMESA incorporates Section 1129(a)(10) of the Bankruptcy Code, which requires, among other things, that at least one impaired class of creditors has voted to accept the plan. Courts are divided on whether this must be determined on a debtor-by-debtor basis, or whether one accepting impaired creditor class within a joint plan suffices for all affiliated debtors.

While no courts within the First Circuit have addressed this issue, many commonwealth issuers have no operations and thus are unlikely to have many classes of claims. For a debtor with numerous types of obligations — financial indebtedness, employee claims, vendor claims, etc. — there are simply more available classes that can provide the requisite acceptance to satisfy Section 1129(a)(10). By contrast, where a debtor is a special-purpose debt-issuing entity, without meaningful operations, it may only have a single class of claims to vote on the plan. The ability to nonetheless cram down a plan over the votes of that creditor class, based on acceptance of the joint plan by other issuers' creditors, would provide the commonwealth with tremendous leverage. Particularly given the difficulty in negotiating a plan that satisfies all creditor constituencies, and the absence of appellate precedent on point, a Title III court in a commonwealth proceeding will likely be forced to confront this open question.

All Liens Are Not Created Equal: Statutory Liens and Special Revenues

One of the issues that will perhaps most affect the treatment and negotiating leverage of various creditors in the ensuing Title III process is the determination of the type of security interest and collateral by which their bonds are secured. In particular, whether a creditor has a valid lien under local law, whether that lien constitutes a statutory lien, and whether that lien is secured by special revenues are key issues that will determine the pecking order in any plan of adjustment. Holders of bonds secured by statutory liens or secured by special revenues are entitled to greatly enhanced treatment. Specifically, bonds secured by statutory liens will continue to have their liens attach to revenues and property acquired by the debtor after the petition date (unlike debt secured merely by contractual liens). Holders of special revenue bonds will also see their liens attach to post-petition property, and will

not be barred by the automatic stay from securing or collecting such revenues, subject only to the payment of the debtor's "necessary operating expenses."[6]

Given the extensive variety of debt instruments and pledged property supporting the commonwealth issuer's various obligations and the paucity of case law articulating the relevant standards, determining statutory lien and special revenue status will provide fertile ground for litigation in Title III.

The limited case law on determining whether a particular lien constitutes a statutory lien consists almost entirely of two contradictory decisions from the Orange County proceedings. The Orange County bankruptcy court adopted a restrictive view of statutory liens, reasoning that because the authorizing statute at issue was permissive (providing that funds "may" be pledged), the lien was not automatically effectuated by statute, and instead required the consent of the county and acceptance by the bondholders to become effective. On this basis, the bankruptcy court found that agreements between the parties, rather than the statute itself, created the pledge, such that no statutory lien existed.[7] The Orange County district court, however, adopted a far broader interpretation, focusing on the fact that the authorizing statute provided for mandatory perfection of a first lien for any debt issued. Under this rationale, it was irrelevant whether the municipality chose what property to pledge, so long as the authorizing statute itself imposes the pledge upon borrowing, without further action by the issuer.[8] No other courts have meaningfully addressed this issue,[9] and the variety of authorizing statutes and resolutions across the commonwealth issuers' debt instruments provides ample basis for arguments on the scope of statutory liens. In addition, those opposing a statutory lien will likely contrast the commonwealth structures with recent legislation in other states that was expressly designed to create a statutory lien.[10]

While the determination of "special revenues" status under Section 902(2) of the Bankruptcy Code is perhaps less potentially contentious given the more fulsome definition and legislative history, there is virtually no relevant precedent in a contested proceeding. The statute provides for five categories of pledged property entitled to special revenues protection, including "special excise taxes imposed on particular activities or transactions" and receipts of projects or systems providing transportation, utility or other services. The legislative history provides nonexhaustive examples of the revenue streams that Congress attempted to capture, such as receipts from operations of "water, sewage, waste or electric systems." For the commonwealth issuers, while certain pledged property appears to fall neatly inside the bounds of both the statute and congressional intent (e.g., PRASA or PREPA revenues), creditors will likely assert creative arguments about what constitutes a "project or system," or an expansive scope of "excise taxes" in efforts to obtain special revenues protection for all manner of secured debt. This issue will be important to many Puerto Rican instrumentalities, but it will be of particular import for COFINA, as COFINA's debt obligations are secured by a substantial revenue stream. If COFINA holders have neither statutory liens nor are secured by special revenues, their security interest would not attach to these post-petition funds used to keep their bonds current.

Determining Plan Confirmation — Court or Oversight Board?

Another issue that is sure to prompt litigation as part of any Title III process is whether the unique confirmation requirements for a plan of adjustment under PROMESA have been satisfied, particularly given the task of satisfying each of those requirements given the severity of the commonwealth's financial challenges. PROMESA's unique structure also raises potential tension between the roles of the oversight board and the court in deciding that question. While PROMESA includes a broad list of 14 requirements that the fiscal plan must satisfy, the determination of whether these requirements are met is trusted to the oversight board's discretion, and the oversight board's certification of a fiscal plan

is nonreviewable. This is of particular importance where many of PROMESA's requirements for a fiscal plan are in tension with one another given competition for scarce resources (for example, elimination of structural deficits vs. providing for capital expenditures to promote growth). Beyond this, partly as a result of the negotiations that led to PROMESA's passage, many of these 14 requirements are themselves ambiguous, and the legislative history of changes to certain of these requirements may invite conflicting interpretations.[11]

At the same time, PROMESA requires the Title III court to itself determine, as a predicate to confirmation, that the plan of adjustment is consistent with the fiscal plan certified by the oversight board. This requirement creates tension with the nonreviewability of the oversight board's certification, and provides grounds for litigation for creditors who may question the plan of adjustment's faithfulness to the fiscal plan. This is particularly the case where, unlike other executive agency determinations to which courts defer, the oversight board's certifications are not subject to a notice and comment procedure, nor are oversight board members subject to confirmation by the Legislature.

Stay Tuned

Although these are but a few of the many issues that will ultimately drive negotiations among the parties and affect creditor recoveries in any commonwealth Title III proceeding, the plain truth is that there is enough uncertainty as to the outcome of these issues that one can only hope that all parties will see the wisdom of reaching a consensual agreement regarding a Title III plan of adjustment, given the uncertainty and destruction in overall value that a prolonged contested proceeding will entail.

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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.

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[1] See Law360, "Why Puerto Rico Will Likely Rely On PROMESA Title III," March 1, 2017.

[2] Cf. Ayer v. Commissioner of Admin., 340 Mass. 586 (1960).

[3] While the commonwealth constitution precludes appropriations that exceed estimated revenues for the year, the same report suggested that the commonwealth has engaged in deficit financing since 1979. Cf. Lance v. McGreevey, 180 N.J. 590, 597 (2004) (debt used to fund appropriations cannot be counted as revenue).

[4] For purposes of this article, references to the commowealth's "debt" or "debt obligations" will refer 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.

[5] Although we focus on First Circuit authority given that venue for a commonwealth proceeding would lie in San Juan, PROMESA does provide for the possibility of an alternative venue for a Title III proceeding, at the oversight board's discretion, in any district where the oversight board may establish an office.

[6] The scope of "necessary operating expenses" is itself likely to be litigated. Although there is very little case law on the subject, its determination may differ under PROMESA, where the debtor may argue with some force that any payments contemplated by the fiscal plan are per se "necessary operating expenses" paid ahead of the secured claim, as PROMESA requires that any plan of adjustment be consistent with the fiscal plan. This has the potential to shift the dispute from a contested matter to an unreviewable decision made at the oversight board's discretion.

[7] See In re Cty. of Orange, 179 B.R. 185 (Bankr. C.D. Cal. 1995).

[8] See In re Cty. of Orange, 199 B.R. 499 (C.D. Cal. 1995)

[9] See In re Ravenna Metro. Dist., 522 B.R. 656 (Bankr. D. Colo. 2014) (noting in dicta that "[b]y pledging the revenues from its mill levy, the Bonds are secured pursuant to a statutory lien"); In re Badger Mountain Irrigation Dist., 885 F.2d 606 (9th Cir. 1989) (noting in dicta the bankruptcy court's uncontested conclusion that Washington statute created statutory liens).

[10] See, e.g., Cal. Gov't Code § 53515 (2015) (as amended by SB 222, July 13, 2015); R.I. Gen. Laws Ann. § 45-12-1 (2015).

[11] For example, a fiscal plan need only provide "adequate funding for public pension systems," leaving open to debate what is adequate and what benefit levels those systems must provide. Similarly, a fiscal plan need only "respect" the relative priorities and lawful liens under the commonwealth constitution and agreements with creditors.

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