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Puerto Rico Files Bankruptcy, Puts Congress' Promesa Act to the Test

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As a firm founded in Detroit, Butzel Long sympathizes with the people of the Commonwealth of Puerto Rico as they embark upon the uncertain path of governmental bankruptcy. By commencing its proceedings with an estimated $123 Billion in debt ($49 Billion in pension debt and $74 Billion in bond and other claims), Puerto easily surpassed Detroit as the largest ever United States governmental bankruptcy. Puerto Rico's approximately 3.5 million citizens each carry an unsustainable pro rata debt burden of $35,125 (not including their share of the United States' national budget deficit), and Puerto Rico's government has not been able to provide adequate services to its people because of its debt load.

As a firm with hard-won experience representing various parties in Detroit's bankruptcy, Butzel Long is well-qualified to assist in various aspects of the Puerto Rican insolvency.

Puerto Rico's bankruptcy causes concerns for those supplying goods and services to Puerto Rico, parties involved in infrastructure projects in Puerto Rico, Bondholders and Banks, those who are planning to travel to Puerto Rico, as well as anyone interested in how future governmental debt crises (such as the State of Illinois) might be handled.

For trade suppliers, the situation with respect to pre-Bankruptcy claims appears disheartening, with unsecured creditors unlikely to receive full payment and facing possible preference claims.

Those involved in infrastructure projects have better prospects, at least if the project is continuing, as Puerto Rico may want to assume their contracts and continue the projects (leading to payment in full). In addition, many construction suppliers may have bond claims.

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Bondholders and Banks each face significant issues relating to the priority and repayment of their claims, which are beyond the scope of this alert.

Travelers to Puerto Rico should maintain their plans, at least as long as the government is able to maintain at least existing levels of service. As we saw with Detroit, the situation post-bankruptcy often improves, as the government is able to provide additional funding for services that was otherwise being consumed by interest payments on debt. Moreover, vacationing in Puerto Rico is likely the single biggest contribution anyone could make to resolving the debt crisis (and might be a bargain under the present conditions).

As for future municipal bankruptcies, at this point, predictions are difficult. The State of Illinois has a well-publicized debt crisis and currently no bankruptcy options. Both Connecticut and New Jersey, as well as other states, have unfunded pension liabilities and structural debt issues that are not as severe as those of either Puerto Rico or Illinois, but that might come to the forefront in the near future. So it may be worth paying attention to Puerto Rico's issues, even if you have no direct connection with Puerto Rico.

The PROMESA Act:

Chapter 9 of the United States Bankruptcy Code, the provisions used by the City of Detroit and a (relative) few other communities only applies to political subdivisions of a State and specifically did not apply to Puerto Rico. Accordingly, until 2016, there was no judicial process available to Puerto Rico to address its debt crisis. In 2016, Congress passed, and President Obama signed, the PROMESA Act which appointed a Financial Oversight and Management Board for Puerto Rico, and provided for a Bankruptcy Code that would apply to certain U.S. territories (Puerto Rico, Guam, American Samoa, the Northern Mariana Islands and the U.S. Virgin Islands). However, the fact that name of the Act means promise in Spanish, as well as the Bill being named the Puerto Rico Oversight, Management, and Economic Stability Act hints that Congress did not have Guam or American Samoa in mind when the law was passed.

Under the PROMESA Act, the seven person Financial Oversight and Management Board is entirely independent of the government of Puerto Rico and has the authority to, among other things to:

- review and approve any budget or fiscal plan proposed by the Puerto Rican government,
- ensure compliance with any budget, or alter the budget as needed,
- enforce certain laws enacted by Puerto Rico independent of the government,
- override or force modification of any legislation that would increase Puerto Rico's deficit or financial stability,
- sue any party on behalf of Puerto Rico,
- file bankruptcy under the PROMESA Act on behalf of Puerto Rico,
- serve as the Trustee in Puerto Rico's bankruptcy, and

- be the sole party that may propose a Plan of Adjustment for Puerto Rico.

As a result of Puerto Rico's defaults on its debt obligations, a number of parties sued to enforce debt instruments and, at the request of the Governor and the approval of the Financial Oversight and Management Board, Puerto Rico filed bankruptcy on Wednesday, May 3, 2017.

Puerto Rico's bankruptcy is not only the largest municipal bankruptcy in US history, but it is also the first under the new act. While the PROMESA Act's bankruptcy provisions are similar to Chapter 9 of the Bankruptcy Code, there are some important differences, including the following:

- The Financial Oversight and Management Board is the Trustee and the representative of the Debtor. The Puerto Rican government either will not be a party to the case, or will only be a party to the extent permitted by the Financial Oversight and Management Board,
- Only Puerto Rico may file a Plan of Adjustment, and that Plan of Adjustment must be approved and certified by the Financial Oversight and Management Board,
- The Plan must ensure funding of essential public services and provide adequate funding for public pension systems, as well as provide for the elimination of structural deficits, sufficient capital expenditures to promote economic growth and provide for a debt burden that is sustainable.
- The Bankruptcy will be heard by a District Court Judge, not a Bankruptcy Judge. Chief Justice Roberts has appointed Judge Laura Taylor Swain of the Southern District of New York, who appears very well qualified, as she is a former Bankruptcy Judge who has handled complex financial matters.
- There are no set Court Rules for the Case.
- There is no binding precedent for any matter in connection with the case (although there is persuasive precedent related to Chapter 9 of the Bankruptcy Code).
- As in Chapter 9, parties may object to Puerto Rico's eligibility to file, or otherwise seek dismissal of the case. However, such a hearing will not occur for at least 120 days after filing. Further, if Puerto Rico is found to be eligible to file, and the Court does not dismiss the Petition, there will be no stay pending appeal. Therefore, any party objecting to Puerto Rico's bankruptcy will have to seek an emergency appeal, or risk a finding that their appeal is equitably moot.

What Comes Next:

The filing of Puerto Rico's bankruptcy imposes an automatic stay against any actions against it. However, there may be significant litigation about matters related to the stay, in particular involving setoffs. According to Supreme Court precedent, any party who owes Puerto Rico money but that has an offsetting claim against Puerto Rico can withhold the amount that they owe pending judicial resolution. This may become an issue with respect to Puerto Rico's bank accounts, among other things.

If Puerto Rico's revenues are not sufficient to pay its operating expenses plus any necessary capital improvements, Puerto Rico may need to obtain post-bankruptcy financing in an atmosphere where Wall Street may be substantially hostile to Puerto Rico. Puerto Rico's ability to react to any emergency (for example, a hurricane) will be seriously impaired without Federal assistance.

In approximately 120 days, there will be a hearing on whether the bankruptcy should be dismissed. However, the PROMESA Act does not set any specific standard for dismissal, other than that "the Petition does not meet the requirements of [the Act]". Unlike the City of Detroit and Chapter 9, the PROMESA Act does not have a requirement that there have been negotiations in advance or event that Puerto Rico or the Financial Oversight and Management Board have acted it good faith. Therefore, it seems dismissal is unlikely.

Assuming the case is not dismissed, a schedule will be set by the Court and the parties will commence negotiations and/or litigation, primarily over Puerto Rico's resolution of its pension and bond debt. Puerto Rico also may commence suit against any parties deemed responsible for its financial crisis. The amount of time involved cannot be determined with any certainty at this point. A short schedule (as in the Detroit case) encourages settlement and reduces expensive litigation. However, Puerto Rico's situation appears more complex than Detroit's, and is likely to require a longer period of time.

President Trump has stated that there will be no federal assistance to Puerto Rico. It is a fair assumption that this statement is going to be tested.

Parties doing business with Puerto Rico may continue to do business, and the priority of their claims, as well as the likelihood of being paid, is enhanced post-bankruptcy. Nevertheless, parties may wish to consider COD terms and/or Cash in Advance Terms.

Already, Puerto Rico is taking painful actions to reduce expenses, including the closing of 184 public schools (almost 15% of the total number of schools). It is likely that this will get more painful before it gets better.

Finally, the PROMESA Act provides that Puerto Rico's Plan of Adjustment must both ensure the funding of essential public services and "adequate funding for public pension systems" [whether that means payment in full or not]. It does not require payment for bonds. Therefore, it seems likely that the compromise of bond claims, as well as the priority of certain bond claimants is going to be the focus of the case.

The Future of Puerto Rico's Relationship With the United States

As is often said in Washington, all options remain on the table, including statehood, independence and the maintenance of territorial status. It is likely, however, that the PROMESA process, which fundamentally overrides the powers of the Puerto Rican government, may become unpopular (even if Wall Street is likely even less popular), and that the next several years will bring substantial demands for a changed relationship.

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