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McV ALERT

Federal Court Declares Debt Restructuring Act for Puerto Rico Public Corporations Unconstitutional; Permanently Enjoins Government From Enforcing It

On Friday, February 6, 2015, the U.S. District Court for the District of Puerto Rico held that Puerto Rico's debt restructuring statute for public corporations, officially known as the Puerto Rico Public Corporation Debt Enforcement and Recovery Act ("the Act"), was unconstitutional.

The federal Court declared that the Act is preempted by the U.S. Bankruptcy Code and is therefore void pursuant to the Supremacy Clause of the U.S. Constitution. The ruling also states that the Act also runs afoul the federal Constitution's "Contracts Clause" and "Takings Clause." Federal courts have the power to invalidate laws that are in conflict with the Constitution.

The ruling has the effect of striking down a statute that, according to statements made by government officials when it was enacted in June of 2014, was critical to help public corporations address their financial difficulties without jeopardizing the Commonwealth's ability to pay for its general obligations or compromising essential services provided by these corporations. One of the Act's main purposes was to protect the Commonwealth's coffers (and the Government Development Bank), because neither is in the position to subsidize or bail out public corporations as has been done in the past.

The Act would have allowed public corporations a way to restructure their debts to help them become financially self-sufficient, and avoid the prospect of creditors exercising legal remedies against public corporations in a disorderly fashion.

Public corporations such as the Puerto Rico Electric Power Authority (PREPA), Puerto Rico Highway and Transportation Authority (HTA) and Puerto Rico Aqueduct & Sewer Authority (PRASA) are mentioned in the Act's statement of motives as the prime candidates in need of the Act's protection.

But now the federal Court has ordered that: "The Commonwealth defendants, and their successors in office, are permanently enjoined from enforcing" the Act.

The Court ruled that the Act was a "state" statute prescribing a method of composition or reduction of municipal indebtedness capable of binding nonconsenting creditors and, as such, it is precluded by Section 903 of the U.S. Bankruptcy Code. Therefore, under the doctrines of "express preemption" and "conflict preemption," the Act was superseded by the Supremacy Clause of the U.S. Constitution.

In so ruling, the Court expressed that Congress did not intend to exempt Puerto Rico from Section 903. The Court recognized that the Commonwealth, its municipalities and its instrumentalities cannot seek federal bankruptcy protection under the U.S. Bankruptcy Code. But the Court said Congress apparently wanted to retain control over any restructuring of municipal debt on the Island, and that it had the power to treat Puerto Rico differently.

In rejecting the government's argument that the dispute concerning the Act was not yet ripe for adjudication, because no local court procedure under the Act has been initiated, the Court ruled that the mere approval of the Act eliminated numerous contractual security provisions and remedies belonging to the plaintiffs, as bondholders, under the Trust Agreement. The Court ruled that the Act "completely extinguishes all of them," and thus the impairment caused by the Act is "substantial." As such, the Court ruled that plaintiffs state a plausible claim under the "Contracts Clause" of the U.S. and P.R. Constitutions. The Court likewise concluded that the Act's approval constituted an unconstitutional "taking" of such contractual rights without any means for just compensation.

The Secretary of Justice of Puerto Rico has issued a statement saying that the government will consider its next steps after careful review and analysis of the Court's decision.

You may access the Court's opinion [here](#).

For further information on these matters, you may contact any of the attorneys listed below:

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