

TESTIMONY OF JAMES E. SPIOTTO¹

REGARDING THE NEED FOR THE ESTABLISHMENT OF A PUERTO RICO FINANCIAL STABILITY AND ECONOMIC GROWTH AUTHORITY

BEFORE THE HOUSE OF REPRESENTATIVES SUBCOMMITTEE ON INDIAN, INSULAR AND ALASKA NATIVE AFFAIRS

FEBRUARY 2, 2016

I am honored to address this Subcommittee regarding the establishment of a Puerto Rico Financial Stability and Economic Growth Authority to assist in the resolution of Puerto Rico's financial challenges.² In my remarks, I will refer to the history of the use of such oversight authorities by a number of States and the lessons to be learned from such precedents. In addition, I will highlight the more successful elements of such authorities to be considered in the development of legislation as evidenced by past experience.

RECOVERY MUST BE THE FOCUS

The United States is not alone in confronting the problem of sovereign debt in crisis. Dealing with the financial distress of a government requires not merely short-term actions to reduce debt obligations, increase tax revenues and lower costs, but also the long-term reinvestment in the government, its economy and its people. The financial challenges, loss of business and jobs resulting in many not being meaningfully employed, the need for economic stimulus and business development, the demands for social programs and governmental services, the level of poverty and financial strain on programs to address human distress have been well documented by Puerto Rico, its community leaders, its creditors and the financial markets. Puerto Rico has over 45% of its residents living at or below poverty level, it has lost over 250,000 jobs since 2006, labor force participation in Puerto Rico is at approximately 40% compared to average of 62.4% in the States, and, most distressing, 58% of its children (its future) are living below the federal poverty level. There should be no debate over whether assistance is needed now, only by whom and what form the assistance will take need to be answered. The experience of other sovereigns is instructive.

¹ As of January 1, 2014, I retired as a Partner of Chapman and Cutler LLP. I am a Managing Director of Chapman Strategic Advisors LLC, a consultancy providing educational and strategic insights to market participants concerning municipal finance topics of interest. The statements expressed in this material are solely those of the author and do not reflect the position, views or opinions of Chapman and Cutler LLP or Chapman Strategic Advisors LLC.

² In December of 2015, I submitted to the United States Committee on the Judiciary written testimony entitled IS CHAPTER 9 BANKRUPTCY THE ULTIMATE REMEDY FOR FINANCIALLY DISTRESSED TERRITORIES AND SOVEREIGNS SUCH AS PUERTO RICO: ARE THERE BETTER RESOLUTION MECHANISMS? (the "*Senate Statement*"). This written testimony and exhibits and appendices provide an explanation of the scope and limitation of the municipal bankruptcy process, the history of the Supreme Court's examination of related legislation and more desirable alternatives to Chapter 9. I am resubmitting these materials to the Subcommittee as resource material.

As a parade of over 600 sovereign debt defaults since 1950 involving 95 countries have demonstrated, there are too many repetitive problems because of a limited focus on reducing external debt without addressing the systemic problem that caused the economic distress. The missing and needed ingredient in these failed sovereign restructurings of debt is the long-term reinvestment in the government and its people to improve and expand governmental services and infrastructure and stimulate business opportunities. This creates growth of new businesses and new jobs resulting in new taxpayers to increase tax revenues that brings about the real recovery for the health, safety and welfare of citizens. Such an approach is likely in the best interests of not only the government but also its citizens and taxpayers, and its creditors, including employees and retirees. It is only through a robust recovery plan that creditors, including employees and retirees, will be paid to the fullest extent possible.

THE USE OF VARIOUS MECHANISMS BY STATES TO PROVIDE FINANCIAL OVERSIGHT AND ASSISTANCE TO MUNICIPALITIES IN DISTRESS TO AVOID THE USE OF CHAPTER 9

Certain States have concluded that mechanisms short of Chapter 9, including a financial authority or control board, assist the recovery process. A brief review of their experience may be of aid to you in your deliberations. The limitation on indebtedness and authorization to issue refunding bonds are the basic tools in the States' arsenal to assist municipalities, and Puerto Rico has likewise provided these limitations for its municipalities. However, in times of financial distress, these basic approaches have been enhanced by additional, more targeted mechanisms. These methods have started with reaffirming statutory requirements to balance budgets and have progressed to greater State assistance and oversight of municipal budgets and finances in times of financial emergency as well as the use of refinance authorities, receivers, financial managers and financial oversight authorities. States have approached the task of supervising and assisting their municipalities in a variety of ways. Although these mechanisms vary by type and degree of supervision and assistance, the widespread development of these mechanisms indicates the growing trend of more active oversight and supervision of municipalities by States in order to build better credibility with citizens and creditors, including the municipal bond market. Over half of States have implemented municipal debt supervision or restructuring mechanisms to aid municipalities. These programs are detailed on pages 24 through 26 in the written testimony submitted to the Senate Judiciary Committee referenced in footnote 2.

FINANCIAL CONTROL BOARDS AND THEIR PROGENY

Today, the laws of Florida, Indiana, Michigan, Nevada, New Jersey, New York, North Carolina, Pennsylvania, and Rhode Island include a variation on a provision allowing for the appointment of a financial control board or commission, emergency managers, receivers, coordinators, or overseers over a troubled unit of local government. The intent of many of these provisions is to identify early signs of financial distress for a city or municipality so that the State may intervene before the city or municipality reaches the level of a municipal crisis. Importantly, such provisions are not just a web of buried State laws never to be used but, rather, are applied where situations call for intervention.

The New York Experience. Perhaps the most well-known appointment of a financial commission was the implementation of the New York City Financial Control Board in 1975. In the spring of 1975, New York City was unable to market its debt because the bond market had

discovered that, for more than ten years, New York City had been using questionable accounting and borrowing practices to eliminate its annual budget deficits. Banks refused to renew short-term loans that were maturing or to loan additional cash to the city, and only State cash advances were keeping the city afloat. The city's spending for operating purposes exceeded operating revenues over several years, and the accumulated fund deficit could be resolved only by increasing amounts of short-term borrowing. New York City itself had no funds to meet its short-term obligations. New York City nearly defaulted on the payment of its notes in October 1975, and it was predicted that a default was likely in December absent federal aid. In response, the State Municipal Assistance Corporation, or MAC, issued a series of securities on behalf of the city and a financial control board was appointed.

The New York City Financial Control Board was given the power and responsibility to review and provide oversight with respect to the financial management of New York City's government. Among other things, the act establishing the board required the city to prepare and submit a "rolling" four-year financial plan to the Financial Control Board prior to the beginning of each city fiscal year.

The Pennsylvania Experience. Similar to the New York experience, Pennsylvania has implemented a series of provisions to aid ailing cities. Pennsylvania law contains the Financially Distressed Municipalities Act, which applies to any county, borough, incorporated town, township, or home-rule municipality (Act 47). 53 Pa. Stat. §§ 11701.101-11701.501. Under these provisions, if the State's Department of Community Affairs determines that a municipality is financially distressed based on certain triggering events, the department may appoint a coordinator to guide the municipality in getting its financial affairs in order. Since 1987, there have been only 29 municipalities that have chosen to involve the Act 47 declaration of and determination of financial distress and only 10 so far have had the determination rescinded.

In addition to the Financially Distressed Municipalities Act, Pennsylvania law contains the Intergovernmental Cooperation Authority Act, or PICA, which was created in 1991 to deal with insolvency issues faced by Philadelphia. The act created a five-member authority with authorization to enter into intergovernmental cooperation agreements with cities, and these agreements were preconditions to the issuance of any obligations by the authority. Among other things, the authority could issue bonds and the city and the authority were required to work together to develop a five-year recovery financial plan.

The District of Columbia. The structure of oversight and assistance of the New York MAC and the Pennsylvania PICA was the basis for the U.S. Congress passing the District of Columbia Responsibility and Management Assistance Act of 1995. Pub. L. No. 104-8, 109 Stat. 97. This legislation, signed by the President on April 17, 1995, created an oversight authority known as the District of Columbia Financial Responsibility and Management Assistance Authority ("*D.C. Control Board*"), a five member body appointed by the President in consultation with the respective chairs of the Appropriations and Oversight Committees of the House of Representatives, the chairs of the Appropriations and Governmental Affairs Committees of the Senate and Delegate to the House of Representatives of the District of Columbia. The District of Columbia Financial Control Board was to oversee the finances of the District of Columbia and was to approve the budget and financial operation of Washington, D.C. This Board superseded and had the power to override any decision of the District of Columbia's mayor and city council. The Board continued in existence until September 30, 2001 when, as set

forth in the legislation, the District of Columbia achieved its fourth consecutive balanced budget. The Board's operation and power were similar in structure to MAC and PICA, but the use of an executive director was an added instrument of oversight and control.

The Michigan Experience. Likewise, the State of Michigan, under its former Local Government Fiscal Responsibility Act, has taken over the Detroit Public Schools, the City of Pontiac, the City of Ecorse, the Village of Three Oaks, the City of Hamtramck, the City of Highland Park, and the City of Flint. Former Mich. Comp. Laws. § 141.2802 (this provision has been replaced by the Local Government and School District Fiscal Accountability Act). *See also* Eric Scorsone, Local Government Financial Emergencies and Municipal Bankruptcy, Michigan Senate Fiscal Agency Issue Paper; Available at <http://www.senate.michigan.gov/sfa/publications/issues/localgovfin/localgovfin.pdf>. These provisions were subsequently replaced by the Local Government and School District Fiscal Accountability Act. Mich. Comp. Laws §§ 141.1501-141.1531 (2011). Under this act, if a school district or municipality was in a perilous financial situation, the governor of Michigan could declare a financial emergency. Should the municipality or school district enter into a financial emergency and an emergency manager be appointed, the emergency manager had broad powers to operate and restructure the municipality, including the ability to reject, modify, or renegotiate contractual obligations. Mich. Comp. Laws. § 141.1519 (2011). As a last resort, this emergency manager could file a Chapter 9 municipal bankruptcy petition on behalf of the municipality. Mich. Comp. Laws. § 141.1523 (2011). This Public Act 4 of 2011 provided for a Michigan emergency manager with extraordinary power. The act was very controversial, especially to local government bodies and elected officials. A referendum placed on the November 6, 2012, ballot defeated Public Act 4 of 2011, the Michigan Emergency Manager Law.

On December 27, 2012, the governor of Michigan signed into law the Local Financial Stability and Choice Act, which replaced the defeated Public Act 4. Local Financial Stability and Choice Act, Mich. Pub. Act 436 of 2012, Mich. Comp. Laws, § 141.1541 *et seq.* Also, in 2012, Indiana passed legislation allowing its Distressed Political Subdivisions Appeal Board to appoint an emergency manager for its distressed subdivisions on grounds and with powers similar to the Michigan emergency manager. Ind. Code § 6.1.1-20.3 *et seq.* (2012).

The Massachusetts Ad Hoc Experience. Similar to the laws of States establishing specific authority for financial control boards or similar commissions, Massachusetts has typically employed a system of implementing legislation on an ad hoc basis to create a financial control board or overseers for municipalities in severe financial distress.

The California Experience: Neutral Evaluator. California also has experimented with the concept of introducing a third party to assist in the resolution of municipal financial difficulties. California recently enacted a provision restricting the ability of its municipalities to file petitions to institute Chapter 9 proceedings. Cal. Gov't Code §§ 53760; 53760.1; 53760.3; 53760.5; and 53760.7 (as amended and added by Cal. A.B. 506; signed into law on October 9, 2011). The thrust of the legislation is to provide a period of objective and dedicated negotiation and resolution of issues affecting major creditors or financial problems. The legislation provides for a neutral evaluation process, otherwise known as mediation, for major creditors and parties to the financial problems. The neutral evaluator process provides a professional, independent, neutral advisor to serve as the supervising adult, which is the essence of a neutral evaluator. The

neutral evaluator can foster negotiations among the municipality and representatives of major creditor constituencies, including workers and union representatives, vendors, contract suppliers, holders of major claims including bondholders, judgment creditors, or others whose interests could affect the financial fate of the municipality. The neutral evaluator process may not last more than 60 days from the date the evaluator is chosen unless the municipality or a majority of participating interested parties elect to extend the process up to an additional 30 days. The neutral evaluator procedure is intended to be an expedited process and cannot last more than 90 days from the date of the selection of the neutral evaluator.

North Carolina Experience. Due to a significant number of local government defaults during the Great Depression, North Carolina created the Local Government Finance Commission as part of the North Carolina Department of the State Treasurer. The Commission provides oversight and assistance to North Carolina local governments. No debt can be incurred by any local government in North Carolina without the supervision and assistance of that Commission and the oversight continues as to annual financial reporting and accounting of the fiscal health of the local governmental offering broad assistance in financial administration. This is supervision of debt incurrence from cradle to payment in full.

Even if Congress concludes Chapter 9 should be available to the municipalities of Puerto Rico, the passage of such legislation should not preclude Congress from providing financial oversight and technical assistance to the Commonwealth and its governmental bodies similar to what States have provided with the goal to avoid financial meltdown and use of a Chapter 9 filing to rescue their financially challenged municipalities. As will be described below, financial oversight authority for the Commonwealth of Puerto Rico or territories can be enhanced by authorizing under the Bankruptcy Clause in the legislation for such authorities the ability to approve debt adjustments. This authority would arise when consensual agreement has failed and there are insufficient funds to pay for needed essential services and infrastructure and for creditor claims to be made whole.

These alternatives to Chapter 9 that certain States have provided to avoid the cost and stigma of Chapter 9 have been well-accepted and appreciated by the municipal market. For this reason, every State provides for some form of refinancing of municipal obligations and some States provide various forms of oversight, supervision and financial support to the distressed municipality. The ability to file Chapter 9 does not prevent as an alternative the oversight, supervision and refinancing of the debt of a financially challenged municipality as was done with New York City in 1975 with MAC that helped supervise the financial recovery of the City and refinance its debt or similar assistance by Ohio to Cleveland in 1978 or by Pennsylvania to Philadelphia in 1991 with PICA or by Congress to Washington, D.C. in 1995 with the creation of the D.C. Control Board. Further, the passage of the Bill would not preclude the oversight and supervision, budget commission or determination of what is sustainable and affordable and what is not such as authorized by recent legislation in Rhode Island or the use of an emergency manager as permitted by legislation in Michigan and Indiana or financial control boards in New York State or Act 47 used in Pennsylvania.

**DEVELOPMENT OF THE FINANCIAL OVERSIGHT AND RECOVERY AUTHORITY FOR
TERRITORIES INCLUDING THE COMMONWEALTH OF PUERTO RICO AND ITS MUNICIPALITIES,
PUBLIC CORPORATIONS AND RELATED GOVERNMENTAL BODIES**

Financial Oversight is Needed Assistance Not a Bailout. The establishment of a financial oversight authority does not constitute a bailout. Rather, as has been the experience in a number of States, the introduction of financial oversight is not only more appropriate than rushing into Chapter 9 but also more effective.

Under consideration by some States is the use of a government protection authority utilizing some of the best aspects from the mediation process of the neutral evaluator and the oversight and supervision of financial control boards and financial management. This concept could be implemented for Puerto Rico and for any United States Territory in financial distress. Under this government debt resolution mechanism, Congress under the Territorial Clause and Bankruptcy Clause would establish an entity that would have a quasi-judicial function and power similar to a commission or special master appointed by a court. Such an authority would approve budgets, assure transparent financial information, require funding of essential services and needed infrastructure improvements, and if mediation supervised by the authority and mutual agreement with creditors fail, then approve debt adjustment as needed to be sustainable and affordable. The members of the authority would be independent, experienced experts in governmental operation or finance as well as in mediation and debt resolution techniques, including bankruptcy. The authority would start with legislation for the authority that would encourage the Commonwealth and its governmental bodies as well as their creditors to accept and join in as an opportunity for an integrated holistic approach to addressing their concerns. The structure of the authority would assure all parties of a fair, impartial process designed to foster consensual resolution of issues. The procedures of the authority would require transparent financial information that is vetted and determined to be accurate and the basis of sustainable and affordable budgets and financial proposals. Consideration must be given to financial goals and triggers to ensure balanced budgets, oversight and assistance to prevent further financial erosion. Such oversight and assistance would address the financial and operational problems as well as social programs to ensure adequate funding of essential services, infrastructure, stimulate economic development and promote financial credibility in dealing with creditors and citizens.

Enhance Financial Credibility Through Accurate and Public Financial Information and Budgeting. The first step is to make sure that accurate financial information is available to all so that interim and long term budgets and any necessary financing to ensure liquidity and funding is available during the process. The purpose of this first step is to ensure that human suffering from inadequate services and infrastructure is reduced or eliminated and dealing with creditors is not complicated with financial illiquidity so there is no time for rational thought and discussion. The more expedited the agreement of the Commonwealth and its creditors on the basic financial numbers and the extent of the financial crisis, the quicker and better the resolution for all. Without this process, the past obstacles of dueling financial numbers and debate over whether payment can be made or not will lead to financial meltdown. This process is aimed at reducing or eliminating unprofitable debate by either having everyone agree to the financial numbers or having the authority, through a vetting process with the input from all parties, to determine what is sustainable and affordable what is not.

Resolution of Creditor Disputes. Once the critical budgeting and financial transparency is accomplished, the concurrent steps of discussion, mediation and resolution of financial issues and creditor disputes can be effectively addressed and resolved. The goal is consensual agreement by the Commonwealth and the affected creditor constituencies. However, participation by the authority may be voluntary by acceptance by the Commonwealth and other affected constituencies or otherwise mandated by the financial emergency. Negotiation, mediation and discussion of positions are strictly confidential. Laws establishing the authority include an exception to any open meetings and freedom of information laws to allow for open discussion of any sensitive and confidential topics. If additional tax revenues or loans or grants from the Commonwealth or financing are needed, recommendations to the Commonwealth by the authority may be made. The authority may be empowered to recommend increased taxes or other actions. Specified time periods for resolution will be set forth and, if the voluntary process is not successful, the second phase may be requested or may be required if the authority so determines.

Power to Approve and Enforce Adjustments of Debt, If Necessary. In the second phase, if consensual agreement is not reached, the authority and its designated members turn into a quasi-judicial panel, and the Commonwealth is required to set forth the steps to be taken to address its specific financial problems (recovery plan). If there are insufficient projected revenues to fund the recovery plan, including essential services and economic development and payment of creditors in full, then the Commonwealth, for its debts and its other governmental bodies for their debts will propose appropriate adjustments so that the recovery plan is sustainable and affordable. Creditors, workers, and taxpayers will have the ability to comment and to attempt, through negotiation, to modify the recovery plan within a set period of time. Then, the recovery plan (with the proposed adjustment of debts) is presented to the members of the authority for determination of the plan's feasibility and whether it is reasonably fair to creditors' interests in relation to the requirement that, under all circumstances, essential governmental services, at least at an established necessary level, must be maintained for the reasonable future. The authority will assure creditors are paid as much as can be afforded while maintaining the sustainability of the recovery plan. In addition, the recovery plan should examine existing legislation that could be modified to assist Puerto Rico in its effort to resolve its financial crisis. The Commonwealth and others have pointed out a needed review of federal law, rules, regulations and policy to ensure appropriate fairness compared to the treatment of States and others. Puerto Rico contends it has lost billions of dollars due to unequal treatment under Medicaid and Medicare for 50 years, under Supplemental Security Income ("SSI"), Earned Income Tax Credit ("EITC") programs for over 40 years and under the Child Tax Credit ("CTC") program for nearly 20 years. The lack of a stimulus for economic and business development in Puerto Rico following the repeal of Section 936 tax exemption for U.S. companies, the claimed disproportionate burden of Medicaid and social programs, the need for effective tax reform and efficient collection methods suggest the consideration of review and, where needed, modification of existing laws that have impeded Puerto Rico's economy.

Initiation and Buy-In of the Authority Process. One of the triggers for the authority's action is the petition of the Commonwealth with the possible support of its workers, taxpayers or creditors that a governmental function emergency exists or creditor litigation or action threaten a fair resolution of open issues for all creditors and the Commonwealth and therefore the assistance of the authority is needed. The petition should state what essential services as to the health, safety, and welfare of its residents are being threatened or threatened creditor action and

that the forced reduction in services, given the government's financial condition and its revenues, impairs the health, safety, and general welfare of its residents so that there is need of the authority's services. In this way the Commonwealth and legislature will demonstrate buy-in to the authority process. The authority, after hearing all sides (government, workers, taxpayers, affected creditors), will determine: what the extent of the stay of actions should be; what is sustainable and affordable; what the government can afford; and what adjustments must be made to the recovery plan, including as to debt obligations, to allow the Commonwealth to continue to provide essential governmental services to its residents at established mandated levels to preserve the health, safety, and welfare of its residents and to pay what is feasible to its creditors, including workers' wages and pensions. As part of the process, there would be a general stay of creditor litigation or efforts outside of the jurisdiction of the authority by any party to seek a preference of its position over other creditors of the Commonwealth through litigation or otherwise.

Actions for a Higher Public Purpose and Adjustment of Debt. The authority would act as an "honest broker" to review budgets, operation efficiency and financial plans and to approve or make recommendations so that good decisions are recognized and supported and questionable ones are vetted so that bad decisions are avoided. To the extent justified by financial analysis, the authority may recommend increases in taxes, where necessary; increases in contributions or concessions by the various interested parties who agree, if necessary; or reduction, delay, or stretching out of payments to creditors if legally permitted and necessary. Any reduction to payment to creditors would be made, if necessary to preserve the public health, safety, and welfare of the Commonwealth's residents and for a higher public purpose. The authority will have the power to recommend and approve adjustments of debt pursuant to Congress' authorization under the Bankruptcy Clause as a bankruptcy remedy for Territories. The reason why the Authority should be vested with Bankruptcy Clause powers to adjust unaffordable unsustainable debt if the Commonwealth and its creditors cannot consensually agree is because, without the assurance of a definitive resolution, nothing may be accomplished. Creditors need to know if they agree to a deal it will be enforced and it is final. Without that finality, creditors may refuse to negotiate and not present their best offer for resolution. Further, those creditors who desire to hold out unreasonably will recognize if they do not negotiate with the Commonwealth, the recovery plan will proceed and provide treatment by the Commonwealth, subject to the modification after hearing, based upon what the authority determines is appropriate and fair. As noted below, this may all be reviewed and affirmed by a Federal District Court to be enforceable and final.

Implementation of Recovery Plan and Debt Adjustment. Under this process, a government that underestimates in its recovery plan its ability to pay creditors or for services will have necessary increases recommended and found by the authority to be required for the benefits of the workers, citizens and the creditors. A government that overestimates its ability to pay or makes promises that are not sustainable and affordable will be subject to the recommendation of the authority that payments available to creditors be reduced or taxes possibly increased. The findings of the authority will specify if they are final and enforceable by the parties or specify if further negotiations or proceedings are necessary. The authority will be charged to make sure that the Commonwealth and its governmental bodies maintain access to the financial markets, and the ability to borrow will be protected to the fullest extent possible. This authority process should help protect all parties, workers, vendors, creditors, the taxpayers and the government so they will have needed means of continued financing that can be accomplished based upon

maintaining market credibility. The authority may enforce its jurisdiction and may authorize the Commonwealth or its municipalities to enforce its findings in a Federal District Court as an exercise of the Bankruptcy Clause power. This would include a stay similar to an automatic stay in a bankruptcy proceeding if needed to prevent precipitous creditor action that would be adverse to the interests of other creditors and the Commonwealth. As noted above, this process of using a Financial Oversight and Recovery Assistance Authority would be available to all territories as approved by Congress as a uniform law for territories under the Bankruptcy Clause and an exercise of the Territorial Clause. The findings, determinations, and rulings of the authority can have the force of law as a final court order by providing that the Federal District Court reaffirms them. Such means of reinforcement can including have the recovery plan as approved or revised by the authority approved by the Federal Court like a pre-negotiated or “pre-packaged” Chapter 9 plan. The authority could be allowed by the legislation to authorize municipalities, public corporations and related governmental bodies to file for a Chapter 9 proceeding but only after the “second look” by the Commonwealth and authority. The purpose of the “second look” is to assure Chapter 9 is the last resort and every effort has been made to use the mediation and determination of what is sustainable and affordable available through the authority to avoid any unnecessary use of Chapter 9. The use of the oversight authority with bankruptcy powers as outlined above is more effective than Chapter 9, and for the Commonwealth and its issues of sovereignty, avoids overcoming questions and arguments that Chapter 9 was only designed for sub-sovereigns of states as noted on pages 10 through 14 of the Senate Statement. Historically and practically, Chapter 9 debt adjustment should be the last resort after all other alternatives have been unsuccessful (See Senate Statement, p. 3). Many States have provided assistance, refinancing, oversight and other mechanisms to help local government avoid Chapter 9 if it is at all possible. The authorization of a government to file Chapter 9 should not be interpreted as precluding such efforts such as financial oversight, technical assistance and guidance. Further, the proposal of expanding the Bankruptcy Clause legislation to a vehicle for territories to be able to adjust unaffordable and unsustainable debt as necessary will not lead others to request similar provisions such as states since states are co-sovereigns of the Federal Government cannot be subject to Federal Bankruptcy (See p. 17 Senate Statement). Further, Puerto Rico is a territory subject to the principles of the U.S. Constitution including the Supremacy, Territorial and Bankruptcy clauses.

This Financial Oversight and Recovery Assistance Authority should not be subject to adverse municipal market reaction. Rather, the reaction should be favorable because the financial oversight is to provide assurance of a fair and impartial process consistent with government finance traditions and adjustments only when necessary to allow the government to continue affordable operations for the best interest of all. This authority process encourages affordability and sustainability as well as the payment of all that can realistically be paid to creditors. Further, the resolution for affected workers and creditors can be hard-wired for a payment source of dedicated taxes for assured payment of wages, benefits, and creditor claims rather than the speculative hope of future payment at the willingness of future legislative actions.

THE STRUCTURE FOR OVERSIGHT AND EMERGENCY FINANCING

Local governments that have encountered financial distress have resorted to financing and oversight authorities (such as New York City and Philadelphia). This approach can involve various degrees of formal oversight and control. In the beginning, it can be as simple and benign

as a “commission” or “authority” that reviews the city budget and makes recommendations based on new revenue sources. If necessary, the authority can develop into a refinancing authority with full power to refinance existing debt of the Commonwealth purportedly at a lower interest rate given the assured payment and to authorize collection of new revenue sources or withdraw use of new revenue sources if budget recommendations are not followed or met. Further, the authority could assist the Commonwealth with exchange or tender offers to purchase debt at current market discounts. There are two basic advantages to this approach:

- The new independent conduit issuer can have financial credibility and, therefore, access to borrowing in the capital marketplace if it has an assured source of revenue to pay debt service that is isolated from the bankruptcy and other legal risks; and
- An independent authority can use various tools to enforce fiscal discipline on the government because it can be removed from political pressures.

The basic idea is that the Commonwealth requests needed financing that is approved by the authority. Congress in its legislation may authorize the authority to be a conduit borrower with the ability to structure financial assurance to creditors by means of a revenue source that is irrevocably dedicated to be used to pay the debt in order to lower future borrowing costs. The authority then borrows and assigns the revenue source to pay debt service on the debt to creditors. The authority makes the bond proceeds available to the Commonwealth to refinance expensive debt, pay its expenses, retire its deficit and provide funds for necessary infrastructure enhancement to foster improved economic growth. A basic legislative choice is whether the local government levies the new taxes and pledges the proceeds to the authority or the authority is the taxing body authorized to levy taxes. In addition, the government’s ability to levy new taxes may be conditioned on a balanced budget or approval of the authority. *The New York Times* has favorably reported on this concept of an authority as a structure to assist troubled cities deal with their problems, including issues of pension and debt obligations. See Walsh, Mary Williams. “Stepping Up with a Plan to Save American Cities.” *New York Times*, 12 Nov. 2013, NY ed: F16.

RESPECTING TRADITIONS AND PRINCIPLES OF GOVERNMENT FINANCING IS ESSENTIAL TO A SUCCESSFUL RECOVERY PLAN

Our Founding Fathers recognized the importance of financial credibility to a country long term and success as a government that provides for the health, safety, welfare and prosperity of its citizens. As George Washington stated over 220 years ago in his State of the Union Address of December 3, 1793:

“No pecuniary consideration is more urgent than the regular redemption and discharge of public debt. On none can delay be more injurious or economy of time more valuable.”

These words were referencing the debts of the Revolutionary War incurred by the States that were assumed by the federal government to insure continued market credibility for the newborn nation and its States. Washington and Hamilton were instrumental in having the federal government assume the former colonies’ (States’) debt from the Revolutionary War since

some States were balking at paying such debt which they believed was a financial game, and they feared their taxes would go to pay northern speculators or debt or States who incurred large war debts like Massachusetts and South Carolina. Washington and Hamilton knew the progress of a new nation could be no swifter than its financial credibility. For this reason, the assured payment of the revolutionary war debt through assumption by the federal government began the long, proud history of payment of State and local government debt to insure market credibility. Hamilton at the same time announced his principle of the “immortality of public debt” namely a government, federal, State or local, should not incur debt unless at the same time it dedicates a revenue source sufficient to pay and thereby assuring payment without fear of change of circumstances, means or payment of the debt.

Special Revenues and Statutory Liens. As recognized in the 1988 Amendments to the Bankruptcy Code and the Senate Report on that legislation traditions of government financing must be recognized and protected in any bankruptcy or restructuring law. “Special Revenues” are tax revenues that the government specifically pledged and dedicated to the payment of the associated financing debt and must be paid as bargained for without impairment to the creditors contractual rights. This respect for Special Revenues is so that government can continue to have access to the capital markets and be able to borrow at a low cost. (See §§ 902(2), 922(d) and 928 of the Bankruptcy Code). The Senate Report for the 1988 Amendments, Senate Report No. 100-506, 100th Cong., 2d Session (1988). Accordingly, Special Revenues should be so respected in any oversight or financial restructuring of the Commonwealth and its related governments and public corporation debts. Likewise statutory liens that are created and arise from a governmental statute or constitutional provisions must be honored and not impaired, delayed or interfered with. This follows from the principles articulated by the United States Supreme Court as to State control over a municipalities’ exercise of governmental powers cannot be impaired or limited as required by Sections 903 and 904 of the Bankruptcy Code.

Follow Government Financing Tradition for Future Financing at as Low a Cost as Possible. Failure to follow these principles will only make the restructuring process and recovery more difficult if not impossible but also may cause future necessary borrowing cost to be too expensive for long term financial survival. Government Operations and Creditor Protections

Need for Continued Government Operations at an Acceptable Level and Business Development. Whether in an oversight, restructuring process or a Chapter 9 proceeding, the government will still have to function as a government. Depending upon the constitutional or statutory mission of the government, there are certain necessary and basic government services that must be provided, such as public safety (police and fire), public health and welfare (education and health, transportation, building and zoning and, under certain instances, sewer, water and electrical services). History has shown that governments in financial distress need a recovery plan that stimulates economic activity in the government and encourages business to locate or expand there. This business expansion typically creates new, good jobs that increase tax revenues that lead to the recovery and the solution of financial distress. Also, in order to effectuate a recovery plan, which is necessary for a turnaround, and to prevent future financial distress, there must be funding of essential government services. This will produce a stimulation of the economy and encourage growth of the municipality which will attract new businesses and new citizens. This economic growth will create needed jobs, especially for younger workers who will in turn become taxpayers and which will result in increased tax revenues and recovery.

CONCLUSION

Puerto Rico Needs A Permanent Fix and Not Band-Aids. As the Commonwealth of Puerto Rico in the various reports it and its representatives have issued and as other observers, legislators and members of the administration have agreed, Puerto Rico's financial distress must be addressed now and its economic recovery must be efficiently and effectively implemented. At the same time, one of the ugly and unfortunate facts of economic distress is that it adversely affects financial credibility in the market so that access to needed liquidity and cost of borrowing become more expensive exactly when a borrower can least afford the increased cost and burden. What is needed is a financial oversight authority and the development of a detailed Recovery Plan that takes a holistic approach and fosters financial credibility in the market by: (a) determining what is sustainable and affordable and what is not, (b) allowing for development of accurate, transparent and mutually agreed-upon financial statements and projections, (c) assuring appropriate funds for needed governmental services and infrastructure improvements, (d) authorizing, to the extent necessary, restructuring of debt consistent with government financing law through the new authority for Territories with bankruptcy powers and (e) providing for economic stimulus and business development in order to expand business and attract new business activities that create good new jobs for a high percentage of those desiring to be meaningfully employed.

Time Has Come for a Financial Oversight and Recovery Authority for Territories. Accordingly, for the Commonwealth of Puerto Rico, Congress should consider establishing a Financial Oversight and Recovery Assistance Authority to (a) help Puerto Rico help itself to develop the necessary Recovery Plan, (b) provide necessary oversight of financial information, operation and credibility, (c) encourage and foster buy-in and constructive participation by creditors and others through an impartial and fair process that will bring all required parties to the table and provide all the best results possible, (d) if necessary, determine what is sustainable and affordable and resolve issues with the input from all parties, with impartial and fair respect for their respective rights for the best interest of all. Congress, under the Territorial and Bankruptcy Clauses of the U.S. Constitution, has the mandate, mission and ability to provide needed rules and regulations. The federal government is the governmental parent of Puerto Rico. It is a Commonwealth and still a territory and therefore the federal government is not a mere spectator but an interested party with the ability to effect and play a role in the solution.

Members of the U.S. House and Senate have proposed possible legislative solutions and the Department of Treasury has issued a report with a proposed solution. The beauty of the legislative process is the benefit of exchange of ideas, discussion and debate that should demonstrate the capacity for growth and change with a resulting evolved legislation that is, as Aristotle said of "virtue" nothing in excess; not too weak and not too strong but just right to accomplish the intended mission of helping Puerto Rico help itself and achieve financial recovery.



James E. Spiotto
Managing Director

312.845.3763
312.516.1900 (Fax)
spiotto@chapmanstrategicadvisors.com

James E. Spiotto is a Managing Director of Chapman Strategic Advisors LLC, the consulting subsidiary of Chapman and Cutler LLP. In this role, he is engaged in strategic and advocacy initiatives on topics of high interest to municipal market participants and the presentation of educational forums on issues impacting the financial services industry. He is also the co-owner and co-publisher of MuniNetGuide.com, an online resource specializing in municipal-related research and information concerning state and local government, including public finance, infrastructure, job market data and economic statistics and analysis. He is also a member of the Board of Directors of Retirement Security Initiative, a national, bipartisan, non-for-profit advocacy organization focused on protecting and ensuring the fairness and solvency of public sector retirement plans.

Prior to joining Chapman Strategic Advisors LLC, Mr. Spiotto was a partner in the law firm of Chapman and Cutler LLP where he represented issuers, indenture trustees, bondholders, banks, insurance companies, institutional investors and funds in litigation, bankruptcy or workouts of more than 400 troubled debt financings in more than 35 different states and in foreign countries as well. Over the last thirty years, Mr. Spiotto represented clients in the resolution of troubled state and local debt financings, most recently in the *Sierra Kings Health Care District*, *Jefferson County, Alabama* and *Mendocino Coast Health Care District* Chapter 9 cases and has testified before the United States Senate and House Judiciary Committees in conjunction with the amendments to the Bankruptcy Code involving municipal bankruptcy.

Also a significant part of Mr. Spiotto's practice included the representation of indenture trustees facing defaulted securities, troubled securitizations, workouts, debt restructurings, exchange offers, refinancings, insolvencies, pre-packaged plans and all stages of related financial litigation. He has lectured before various academic institutions and professional associations regarding the rights and remedies of indenture trustees and bondholders in defaulted debt securities. From 1980 through 1995, he chaired the annual Practising Law Institute Program on Defaults and Remedies for indenture trustees and their counsel. Also during that time he lectured at the ABA Corporate Trust Workshop and Cannon Financial Institute on the role of the indenture trustee in defaults and remedies. He authored the treatise Defaulted Securities: The Prudent Indenture Trustee's Guide in conjunction with the American Bankers Association.

Education

- University of Chicago Law School
JD, 1972
- St. Mary of the Lake Seminary
BA, 1968

Professional Affiliations

- American Bar Association
- Economic Club of Chicago
- Law Club of Chicago
- Society of Municipal Analysts
(Past President)
- The Civic Federation of
Chicago

Awards

- National Federation of
Municipal Analysts' Municipal
Industry Contribution Award
- National Association of Bond
Lawyers' Carlson Prize for the
best Scholarly Article

Among his many professional accomplishments, Mr. Spiotto is a past President of the Society of Municipal Analysts, was awarded the National Federation of Municipal Analysts' Municipal Industry Contribution Award in both 1992 and 2014, and was presented with the National Association of Bond Lawyers' Carlson Prize for the best scholarly article in recognition of his presentation on Municipal Defaults and Bankruptcy to the United States House of Representatives Subcommittee Hearing on the Orange County Crisis.

He has written numerous books and articles on municipal defaults and bankruptcy including the article entitled "Municipal Bonds: Defaults and Remedies" that appeared in Resources in Review, published by the Government Finance Research Center of the Municipal Finance Officers Association. He is a co-author of the volume The Law of State and Local Government Debt Financing (Thompson West). He authored chapters on municipal defaults and bankruptcy in The Handbook of Municipal Bonds, Sylvan Feldstein and Frank Fabozzi, editors, published by John Wiley & Sons, Inc., an article on "Municipal Finance and Chapter 9 Bankruptcy," published in the Municipal Finance Journal, and a chapter on Financial Emergencies: Default and Bankruptcy in the Oxford Handbook of State and Local Government Finance, Robert D. Ebel and John E. Peterson, editors. He also wrote the article, "The Renewed Battle Over Tax Exemption of Interest on State and Local Government Debt Obligations," published in the Government Finance Review. His article "The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress") was recently published in the Municipal Finance Journal. He also is the author of Municipalities in Distress? published by Chapman and Cutler LLP and available from Amazon.com and Primer on Municipal Debt Adjustment, published by Chapman and Cutler LLP and available upon request from the firm. His most recent article, "How Cities in Financial Distress Should Deal With Unfunded Pension Obligations and Appropriate Funding of Essential Services" appeared in the Summer 2015 edition of The Willamette Law Review.

Testimony Before United States Congressional Committees

During his legal career, Jim provided testimony before or written statements to US Congressional committees on a number of important bankruptcy issues:

- United States Senate Committee on the Judiciary regarding Puerto Rico's Fiscal Problems: Examining the Source and Exploring the Solution, December 1, 2015
- United States House of Representatives Judiciary Committee Subcommittee on Regulatory Reform, Commercial and Antitrust Laws regarding HR 870, Puerto Rico Chapter 9 Uniformity Act of 2015, February 2015
- United States House of Representatives, House Judiciary Committee's Subcommittee on Courts, Commercial and Administrative Law, regarding the role of public employee pension in contributing to state's insolvency and the possibility of a state bankruptcy chapter, February 2011
- United States House of Representatives, Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, July 1995, regarding debt issuance and investment practices of state and local government
- United States House of Representatives, Subcommittee on Economic and Commercial Law Regarding H.R. 3949, August 1992, regarding amendments to the Bankruptcy Code
- United States House of Representatives, Subcommittee on Monopolies and Commercial Law, September 1988, regarding the amendments to the Bankruptcy Code
- United States Senate Judiciary Committee Subcommittee on Courts and Administrative Practice, June 1988, regarding the amendments to the Bankruptcy Code
- United States House of Representatives, Subcommittee on Energy Conservation and Power of the Committee on Energy and Commerce, September 1983, regarding the Washington Public Power Supply System
- United States House of Representatives, Subcommittee on Mining, Forest Management and the Bonneville Power Administration, June 1983, regarding the Washington Public Power Supply System

Publications

- Is Chapter 9 Bankruptcy the Ultimate Remedy for Financially Distressed Territories and Sovereigns Such as Puerto Rico: Are There Better Resolution Mechanisms? *Written Statement to the U.S. Senate Committee on the Judiciary Hearing on Puerto Rico's Fiscal Problems: Examining the Source and Exploring the Solution*, December 1, 2015
- Congress's Role in Saving Puerto Rico from Financial Meltdown and Imminent Bankruptcy, *MuniNet Guide*, December 1, 2015

- Reducing Risk to Payment of State and Local Government Debt Obligations, Statutory Liens from Rhode Island to California SB222, *MuniNet Guide*, July 28, 2015
- Chapter 9 and Alternatives - Part Three: Competing Forces in Chapter 9 and Bondholders' Rights, *MuniNet Guide*, May 7, 2015
- Chapter 9 and Alternatives - Part Two: State Programs to Assist Municipalities in Times of Fiscal Crisis, *MuniNet Guide*, April 30, 2015
- Chapter 9 and Alternatives - Part One: Lessons Learned: An Update on the Municipal Bankruptcy Experience, *MuniNet Guide*, April 23, 2015
- The History of Payment of State and Local Government Debt in the United States, *MuniNet Guide*, March 19, 2015
- Should Congress Pass H.R. 870 Allowing Puerto Rico to Authorize Its Municipalities to File Chapter 9?, *MuniNet Guide*, February 25, 2015
- How Municipalities in Financial Distress Should Deal with Unfunded Pension Obligations and Appropriate Funding of Essential Services, *The Willamette Law Review*, Winter 2014
- "The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress," *Municipal Finance Journal*, Spring 2013
- "The Renewed Battle Over Tax Exemption of Interest on State and Local Government Debt Obligations," *Government Finance Review*, February 2013
- *Municipalities in Distress? How States and Investors Deal with Local Government Financial Emergencies*, Chapman and Cutler LLP 2012

Recent Presentations

- The Myth and Reality of Statutory Liens and Special Revenues Treatment in Chapter 9, A Focus on Evolving Issues in Municipal Credit, Kroll Bond Rating Agency and Chapman Strategic Advisors LLC, October 7, 2015
- The Impact of Global Events on U.S. Debt Markets, Women in Public Finance, September 16, 2015
- Municipal Bankruptcy: Is Your Hometown or School District the Next Detroit? Better Government Association, June 3, 2015
- Lessons from Municipal Debt Restructuring, New Rules for Global Finance, May 19, 2015
- Pension Crisis and Municipalities in Distress, Federal Reserve Bank of New York, the Volcker Alliance, and George Mason University, April 14, 2015

Recent Interviews

- Detroit Free Press, Shouting, Reflection Mark First Year Free of Bankruptcy, December 10, 2015
- The Bond Buyer, Supreme Court to Review Ruling on Puerto Rico Restructuring Law, December 4, 2015
- Bloomberg, Memo to Puerto Rico: Alabama County Shows Limits of Bankruptcy, December 3, 2015
- The Bond Buyer, Connecticut Scrambles for Pension Fix, November 20, 2015
- The Bond Buyer, Market Doesn't Like Chicago's Odds in Pension Case, November 19, 2015
- The Bond Buyer, Puerto Rico May Not Get Supreme Court to Take Up Restructuring Case, August 24, 2015
- The Telegraph, Century City Files for Bankruptcy After Large Jury Verdict, August 21, 2015