TESTIMONY

OF

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Hearing To Consider A Bill For The
Puerto Rico Oversight, Management, and Economic Stabilization Act
(PROMESA)

Committee on Natural Resources
Subcommittee on Indian, Insular and Alaska Native Affairs
U.S. House of Representatives

Chairman Bishop, Chairman Young, Ranking Member Ruiz, and members of the Subcommittee:

Thank you for inviting me to testify on the bill proposed by Chairman Bishop for bespoke legislation needed to address Puerto Rico's financial crisis. I am honored to be here.

Background

My name is Susheel Kirpalani. I am the Chairperson of the Bankruptcy and Restructuring Group at the law firm Quinn Emanuel Urquhart & Sullivan, LLP. For more than 20 years, I have practiced exclusively in the area of creditors' rights. Beginning in the late 1990s, I have primarily represented creditors in debt restructurings driven by unanticipated financial collapse, typically as a result of questionable accounting practices, lack of transparency in financial reporting, and over-leveraged balance sheets. These restructurings include: **Enron Corporation**; **Refco Inc.**; and **Lehman Brothers**. In each matter, I represented the statutory committee of unsecured creditors—a fiduciary body appointed by the bankruptcy division of the U.S. Department of Justice to protect creditor rights and priorities. In 2012, I was appointed to serve as the examiner and mediator for stakeholders of **Dynegy Holdings**, the Houston-based energy company that once tried to save Enron, and which filed for Chapter 11 with a "pre-arranged plan" that subverted creditor priorities.

I also have relevant experience from the two largest Chapter 9 bankruptcy cases in history—**Jefferson County, Alabama** and **Detroit, Michigan**. In Jefferson County, I spent over three years working with the largest insurer of sewer system bonds to successfully restructure and reduce the system's overblown debt load to match the ability of the citizens of Jefferson County to repay ballooning debts incurred by corrupt public officials.

With respect to Puerto Rico's financial crisis, for the past 10 months, I have been representing a coalition of creditors made up of retirees and individual investors as well as asset managers GoldenTree Asset Management LP, Merced Capital LP, Tilden Park Capital Management, Whitebox Advisors LLC, and others. These creditors invested primarily, if not exclusively, in the safest and most secure senior bond investment Puerto Rico offered known as COFINA.[1] COFINA is a Spanish-language acronym for the Puerto Rico Sales Tax Financing Corporation created at the outset of Puerto Rico's fiscal crisis in 2006, in the wake of the Commonwealth government's shutdown for two weeks, which left 500,000 school children without a place to study and over 100,000 public employees without pay.[2] COFINA was created to insulate creditors from the lack of transparency and political and

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[1] *See, e.g.,* Janney Fixed Income Strategy, June 29, 2010, *available at* http://www.janney.com/file%20library/muni%20sector%20scorecard/cofina%206-29-10.pdf ("COFINA is the strongest Puerto Rico issuer from a credit standpoint. The sales tax revenue bonds have a secure foundation, based on a broad based sales tax and a strong legal framework").

[2] Puerto Rico Closes Government Offices, Schools Amid Fiscal Crisis, *USA Today,* May 1, 2006, *available at* http://usatoday30.usatoday.com/news/nation/2006-05-01-puertorico_x.htm.

credit risk relating to the Commonwealth's general fund.[3] Similar to other public and private bonds, COFINA is a form of securitization, in which a specific revenue stream is transferred or pledged to support bond issues by a separate legal entity. Securitizations significantly reduce costs of borrowing money by separating a revenue stream from an entity's credit profile. Today, COFINA is the largest debt issuer in Puerto Rico, with approximately $17 billion of secured bonds outstanding, including more than $7 billion of senior bonds and more than $9 billion of subordinated bonds.

COFINA bonds—held by many U.S. retail investors and pension recipients—are supported by a dedicated sales and use tax protected under both the U.S. and Puerto Rico constitutions. Given that the revenues for COFINA are dependent on sales activity on island, COFINA bondholders want to help craft a solution to Puerto Rico's fiscal crisis that helps drive on-island commerce, empowers Puerto Rico's economy, and stops the population flight to the states.

The Need For Federal Legislation

Puerto Rico simply cannot pay all of its debts. The crippling debt service Puerto Rico heaped upon itself is suffocating the economy now a decade into recession. Young Puerto Ricans have figured out how to escape the debt burden, and are now migrating to the mainland U.S. in large numbers, accelerating the shrinkage of Puerto Rico's economy, and further concentrating the debt burden on the citizens and businesses that remain on the island. This is now forcing Puerto Rico to take ad hoc and extraordinary actions that abuse creditors' rights. Puerto Rico recently enacted a debt moratorium law that grants its governor absolute power to choose to pay or not pay any public debts. One of the three challenges made to the constitutionality of Puerto Rico's ability to enact restructuring legislation is currently before the U.S. Supreme Court. It can be anticipated that there will also be constitutional challenges to the debt moratorium law. I previously believed that the need for Congress to intervene was already evident, but it has become urgent if there is to be any hope of an orderly process that respects property rights and the rule of law, stems outmigration, restores Puerto Rico to health, and avoids the risk of a taxpayer-funded bailout down the road.

Fair Debt Adjustment Laws

Title III of PROMESA is entitled "Adjustment of Debts." This title designs a set of rules that would apply to any impairment of rights of a creditor of Puerto Rico or any of its instrumentalities. Although not a part of Title 11 of the United States Code (the "Bankruptcy Code"), Title III of PROMESA borrows some battle-tested rules contained in the Bankruptcy Code, which were shaped by over 100 years of U.S. jurisprudence on the constitutional limits of federal power over private rights. As such, these rules form the core of American creditor expectations in the event a borrower becomes unable to repay its debts.

[3] Standard & Poor's, Puerto Rico Sales Tax Fin. Corp.; Sales Tax, May 18, 2009, at 2-3.

The first step of understanding any restructuring regime is to ask which creditor claims will potentially be subject to adjustment. In recognition of the reality that most of the near-term strain on Puerto Rico is at the general fund level, Puerto Rico's own recently passed debt moratorium law applies to all issuers of public debt, including the Commonwealth itself. Moreover, Puerto Rico's general obligations or "GO" bondholders assert a superior right to be paid from resources available to the treasurer of Puerto Rico and maintained in the general fund of Puerto Rico before other public debts of the Commonwealth can be paid.[4] The extent of this priority has never been examined by the Supreme Court of Puerto Rico and resolution of that issue by agreement or adjudication will figure prominently in any adjustment of debts of the Commonwealth. Due to the competing claims of creditors from the same ultimate source of repayment—Puerto Rican taxpayers—any restructuring of Puerto Rico is a zero-sum game because the population's resources are limited and will be further limited if outmigration continues or economic growth does not resume.[5] In my experience representing creditors' committees in the largest Chapter 11 cases in history, and having served as a court-appointed mediator, I believe the only way to build a global consensual compromise free from challenge is for every stakeholder group to roll up their sleeves and participate in good-faith negotiations and, failing a voluntary agreement among all groups, to resolve the priority of competing creditor rights in a judicial proceeding. Artificially excluding significant creditor groups from a restructuring regime will lead to protracted litigation, constitutional challenges, and delays to finding a solution, which would only serve to destroy economic value on the whole, and exacerbate creditor losses.

Fundamental to U.S. creditors' rights law is the provision of a "breathing spell" for the debtor that cannot pay—in the form of an automatic stay of creditor enforcement actions—followed by a "discharge" or "fresh start" while respecting creditor priorities and ensuring property rights are not taken for the greater good without just compensation. In reality, this stay of creditor rights actually may enhance creditor recoveries by (1) removing the ability to race to the courthouse and obtain preferential treatment, which would otherwise favor well-heeled sophisticated institutions to the detriment of individuals and other creditors at large, and (2) allowing the beleaguered borrower to stabilize and rehabilitate its financial condition and future prospects without the resource drain and distraction of a rash of lawsuits. And if the debtor abuses the stay by, for example, failing to negotiate in good faith, creditors can seek to have the stay lifted.

The goals of any fair and effective restructuring regime should be to protect creditor expectations to the greatest extent practicable and to ensure any necessary taking of private property for public purposes is in exchange for just compensation. The means of achieving these goals are as follows: (1) restructure balance sheets and set budgets on a debtor-by-debtor basis; (2) establish classes of creditors in a fair and commonsense manner—in other words, insist that only "substantially similar" claims with similar legal and contractual rights against the same borrower are grouped together, fully recognizing the secured and priority

[4] Puerto Rico Const., Art. VI, § 8.

[5] For a quick thumbnail on the reasons for Puerto Rico's fiscal crisis, see Michelle Kaske and Martin Z. Braun, Puerto Rico's Slide, April 6, 2016, *available at* http://www.bloombergview.com/quicktake/puerto-ricos-slide.

status of some creditors; (3) solicit the votes of creditors in a fair way, consistent with due process of law including by providing adequate information to make a decision about any proposed adjustment; (4) treat each class of creditors according to its members' legal and contractual priorities, as determined by the local law governing the borrower and its relationship with creditors; and (5) ensure that a restructuring is in the "best interests of creditors" by mandating that creditors receive at least as much as they would have received in the absence of federal intervention. Although the Bankruptcy Code has not always accomplished these strict goals, particularly in the context of municipal bankruptcy where the locality retains plenary and exclusive control over its finances and proposing a debt adjustment plan, the provisions of the Bankruptcy Code contain state-of-the-art rules that are the envy of much of the world's less-developed financial markets and legal systems.[6]

Collective Action and the Ability to Bind Holdouts

It is a given that if unanimous consent by all stakeholders were required to confirm a debt adjustment plan, it would be impossible to ever achieve a voluntary compromise. For example, different people have different risk tolerance, a greater or lesser penchant for litigation, and some may prefer an expedient solution that minimizes cost but delivers recovery in the shortest amount of time. Accordingly, even the most "voluntary" of collective action rules recognize the need to bind holdouts who may otherwise seek to extract additional value for themselves even if it means risking value for all. So, it has been a constant feature of restructuring laws in the United States to permit the restructuring of an entire class of debt as long as a majority in number and two-thirds in dollar amount support the deal. This is not "cramdown," and is simply the American style of "collective action" within each specific class. PROMESA has this feature.

But the question occasionally arises when an entire class of creditors seeks to hold out for more than its members are legally entitled, and those creditors' unwillingness to accept their fair share prevents all other classes of creditors from moving forward. This rare scenario is when the "cramdown" rule found in section 1129(b) of the Bankruptcy Code must be invoked. I believe the ability to bind holdouts is a reasonable and necessary component of any effective restructuring authority. In my view, having the ability to bind holdouts if they engage in brinkmanship is the only way to get everyone to the table and have any hope of a voluntary agreement. It also promotes predictable outcomes, which is of paramount importance to creditors. Omitting this critical feature, which protects all other classes of creditors who do wish to voluntarily restructure their debts, would lead to unpredictable behavior and discourage consensual arrangements. It is tantamount, in other words, to handing a gun to junior creditors with which they can hold up senior creditors for value in excess of their legal rights or that which they could hope to achieve under current law. Cramdown is a term of art for ensuring that creditor treatment complies with the

[6] In the aftermath of Dubai's real estate crisis, in 2009, I was retained by the quasi-sovereign entity, Dubai World, to participate in the drafting of Dubai's first-ever restructuring law. Hopeful to restore confidence and credibility, it was the consensus among all involved that United States laws in this area achieved the best outcomes for creditors and, as a result, re-establishment of creditor confidence and market re-entry. Several features of U.S. law were borrowed in the enactment of Decree 57 of Dubai, which paved the way to achieve billions of dollars of relief through voluntary agreements with the backstop of a judicial system, only if needed.

"absolute priority" rule, a legal concept that has been a critical part of U.S. restructuring jurisprudence since at least the 1898 Bankruptcy Act. When used properly and in accordance with strict Congressional mandates, cramdown ensures the fairness of the restructuring process.

The National Bankruptcy Conference, a non-partisan organization of 60 of the nation's leading bankruptcy scholars, recently had this to say about the "Discussion Draft" of PROMESA:

> The Conference believes that granting a Title III debtor the power to confirm a plan of adjustment over the rejection of the plan by an impaired class of creditors-including one comprising holders of bond debt-is critical to the success of a Title III case. ***Without cramdown, Title III would provide a dissenting class with absolute veto power over a plan of adjustment.*** The various protections afforded nonconsenting classes such as the prohibition against unfair discrimination as well as the incorporation of the absolute priority rule in sections 1129(b)(2)(A) and 1129(b)(2)(B), level the negotiation playing field, and should serve to encourage both sides to reach agreement, which is a stated goal of the House Committee on Natural Resources.[7]

The Perils of Chapter 9 and the Myth of "Super Chapter 9"

Select bond investors have lobbied hard against PROMESA, including through the placement of targeted advertisements in members' districts, suggesting it is some form of "Super Chapter 9" because it incorporates provisions of the Bankruptcy Code. This is misleading and misguided. PROMESA is not an amendment to the Bankruptcy Code, and in fact implements significant changes from Chapter 9 that are specifically designed to ensure federal oversight and the fair treatment of creditors. Nor could PROMESA's territory-specific provisions ever be "contagious" to the states. The reason is the Tenth Amendment of the U.S. Constitution. The Tenth Amendment is a recognition of our dual sovereign form of government—that it is the various states that created the federal government. By contrast, under the Territories Clause of the U.S. Constitution, the federal government has plenary authority to enact needful rules and regulations respecting the unincorporated territories.

Chapter 9 has led to failed creditor expectations because local, elected officials remain in control and can lawfully use the stay to prevent creditor enforcement while retaining discretion as to which debts to honor during the bankruptcy case. Moreover, the elected officials have exclusive authority to formulate a plan and could use that authority to favor local interests.[8] By the time the plan is presented to creditors, bondholders may have

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[7] Comments on the Discussion Draft of an Act Entitled "Puerto Rico Oversight, Management, and Economic Stability Act", *available at* http://newnbc.wpengine.com/wp-content/uploads/2015/07/2016-April-8-NBC-Statement-on-PROMESA.pdf (emphasis added).

[8] *See* Recent Municipal Bankruptcies Provide Greater Clarity on Outcomes for Investors, *Moody's Investor Services, Sector-In-Depth*, Feb. 25, 2016 ("Given the choice between cutting retiree liabilities

no choice but to cry uncle because they have no ability to force repayment and no recourse to an impartial decision-making body. All they can do at that late stage is object to the plan, vote against it, and hope the bankruptcy judge forces the debtor to go back to the drawing board. The inherent unfairness in that process is the necessary byproduct of balancing state sovereignty with the desire for federal legislation to restructure a municipality's debts. The initial version of bankruptcy law designed by Congress for state municipalities in 1934 was held unconstitutional two years later as violating the Tenth Amendment.[9] The "sweeping character of the holding of the Supreme Court" called for a far lighter touch—one that offers debt adjustment tools to a municipality upon election by the state but on the condition that the state retained full control over all its municipality's political or governmental powers, and the federal court was unable to interfere with a municipality's property and revenues. The revised statute was upheld by the Supreme Court[10] and is the predecessor to modern-day Chapter 9.

In stark contrast, PROMESA does not leave unfettered control over fiscal matters to the Governor and Legislative Assembly in Puerto Rico. Unconstrained by the Tenth Amendment because Puerto Rico is not a state, pursuant to the Territories Clause, PROMESA would install a non-political oversight board—which Congress will play a significant role in selecting—to ensure that local interests are not favored over long-distance creditors, and that decisions on issues of greatest concern to creditors are overseen and approved by a dispassionate, disinterested board. Significantly, only the oversight board would be able to propose a plan of adjustment for creditor vote and judicial approval. This is a profound difference with Chapter 9, in which it is the debtor that determines when to file.

Moreover, while Chapter 9 led to failed creditor expectations in the case of Detroit, commentators have correctly observed that the fault was not with the rules of the Bankruptcy Code as much as with the bankruptcy judge who generously interpreted its flexibility.[11] If applied correctly, the Bankruptcy Code "removes the risk that a debtor will pick and choose which obligations to pay, and it ensures that creditors' priorities will be honored."[12] The practicalities of Chapter 9—including the sovereignty point just

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(pensions and OPEBs) and [bond] debt, local governments may choose to impair debt more severely than pensions and OPEBs.").

[9] *See Ashton v. Cameron County*, 298 U.S. 513, 536 (1936) ("If obligations of States or their political subdivisions may be subjected to the interference here attempted, they are no longer free to manage their own affairs; the will of Congress prevails over them . . . . And really the sovereignty of the State, so often declared necessary to the federal system, does not exist.) (citing *McCulloch v. Maryland,* 4 Wheat. 316, 430).

[10] *See United States v. Bekins*, 304 U.S. 27, 51 (1938) ("The [revised] statute is carefully drawn so as not to impinge upon the sovereignty of the State. The State retains control of its fiscal affairs.").

[11] David Skeel, Fixing Puerto Rico's Debt Mess, *The Wall St. Journal*, Jan. 5, 2016 ("[T]he rule of law took a beating in the Detroit bankruptcy. . . . Steven Rhodes, the federal bankruptcy judge in the Detroit case, instead concluded that the requirement was met as long as the plan satisfied his conscience").

[12] *Id.*

discussed—make it inappropriate for Puerto Rico, particularly given the heavy interest of distant, state-side investors in Puerto Rican debt.

It is unclear whether PROMESA utilizes the federal Bankruptcy Court system. There is a reference in section 306 of the bill to 28 U.S.C. § 157, which permits the District Courts to refer matters to bankruptcy judges, and in section 309 to 28 U.S.C. § 158(a), which governs appeals from Bankruptcy Courts. Bankruptcy judges serve for 14-year terms and derive their power from Article I of the Constitution. As such, they do not have life tenure and cannot without consent of the parties exercise the judicial power of the United States, except for certain "core bankruptcy" areas. Congress may want to consider whether an event as significant as a territorial restructuring, pursuant to the Territories Clause, should be heard by the federal District Courts which exercise the judicial power of the United States pursuant to Article III of the Constitution. There may be issues that arise in a territorial restructuring that some creditors may challenge the Bankruptcy Court's power to hear and determine. Requiring that cases under Title III of PROMESA be heard in the District Court would further distinguish the regime from Chapter 9.

Unlike Chapter 9, the oversight board has authority to move the venue to a district outside the affected region if necessary.

Provisions to Further Protect Creditor Expectations and Respect Territorial Law

The rules for classifying only "substantially similar" claims together and ensuring a plan treats creditors "fairly and equitably" and does not "discriminate unfairly" are bedrock principles of American law. Given the potential for creative interpretation of those phrases, however, Congress should consider giving stricter definitional certainty to protect creditor expectations that the laws and agreements governing their claims will be respected and not tossed aside based on one judge's views of what is fair at the time. Imposing stricter definitional certainty would, with respect to Puerto Rico, make it impossible to classify GO bonds with inferior unsecured claims, such as pension claims or bonds that are subject to clawback, or to lump COFINA senior bonds together with contractually subordinate bonds. By setting the classification rules properly, only creditors with the same rights against the same issuer can be counted together and receive the same treatment. Further, especially given the lesson of Detroit, judicial restraint can be imposed by further defining the concepts of "fair and equitable" and whether discrimination is "unfair" based on creditor priorities found in the law or by agreement, not in the personal views of the jurist.

Another "must have" feature of any federal law that prevents or otherwise impairs creditor rights is to ensure that—when all is said and done—every creditor fares no worse than they would have under current law, had the federal case never been commenced or were it to be dismissed. This is known as the "best interests of creditors" test and is one of the requirements to confirm a plan of adjustment under PROMESA. The "best interests" test also comes out of bankruptcy case law, and specifically ensures that the federal government will not be liable in eminent domain for "taking" property without just compensation because the creditor's recovery must be, by definition, at least as much as the creditor would have received had federal legislation never intervened.[13] Greater definitional

13 *See Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 515-16 (1942).

certainty could be included in PROMESA, again to make it more protective of individual creditors and to prevent courts from merely rubber stamping a proposed plan just because it is supported by the requisite majorities.

Finally, federal courts overseeing bankruptcy cases are routinely called upon to address issues of state or territorial law, because it is those laws, not federal, that defines property interests.[14] The uncertain determination of key issues affecting creditor recoveries is often a cause for concern among participants in a bankruptcy case. Any doubt over whether the federal judge retains discretion to attempt to divine issues of first impression of Puerto Rican law bearing on constitutional or property interests of creditors should be removed under PROMESA. The law should require direct certification of such issues to the territorial high court, namely, the Supreme Court of Puerto Rico. This feature would not only promote and protect creditor expectations, which were set by local law, but would reduce the risk of undue federal interference with insular territorial law and is consistent with U.S. Supreme Court jurisprudence.[15] The bill in its current form does not have any type of federal court abstention, not even the type contained in 28 U.S.C. § 1334, which applies to bankruptcy cases. The original "discussion draft" contained an appropriate provision to require expedited determination by the territorial high court of issues of first impression under the territory's laws.

Collective Action Clauses

I have been analyzing whether "Collective Action Clauses" or "CACs" could work for Puerto Rico. To be clear, CACs would *retroactively* change individual creditor rights, without judicial supervision and accepted notions of due process of law, so this raises many of the same constitutional concerns as bankruptcy without any precedent on which to rely. Special care must be taken to ensure any proposed modification is consistent with contractual and property rights among the competing creditors. While these types of provisions have been introduced in the Euro-Zone, they have never been a part of the fabric of American creditors' rights and they were not developed from the "takings" jurisprudence of the United States.[16] Title VI of the bill contains a mechanism for retroactively changing

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14 *Butner v. United States*, 440 U.S. 48 (1979) ("Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'") (citation omitted).

15 Manuel Del Valle, Puerto Rico Before The United States Supreme Court, 19 Rev. Juridica U. Inter. P.R 13 (1984) ("In the case of Puerto Rico, its economic, social and cultural development has been intimately associated with its legal development and ability to exercise insular sovereignty over matters of local concern.") (collecting SCOTUS cases that reversed the First Circuit Court of Appeals in deference to the Supreme Court of Puerto Rico on issues of Puerto Rican law).

16 S*ee* Collective Action Clauses No Panacea for Sovereign Debt Restructurings, *available at* https://www.pimco.com/insights/viewpoints/viewpoints/collective-action-clauses-no-panacea-for-sovereign-debt-restructurings ("German Chancellor Angela Merkel and French President Nicolas Sarkozy, meeting in the French seaside resort of Deauville amid the escalating eurozone debt crisis in 2010, agreed to make them *de rigeuer* for sovereign bonds European countries issue under U.K. law from 2013.").

contract rights of bondholders through votes by two-thirds in amount of bonds in a given "pool." The bill thoughtfully includes careful classification rules and also ensures any modification meets the "best interests of creditors" test, both of which are critical. To be clear, these features are the minimum floor of creditors' rights, and additional features to protect against unfair results or improper motivations of creditors in overlapping pools may be appropriate. The CAC concept in Title VI, moreover, is only applicable to bond debt, which raises questions about overall fairness if only bonds will be subjected to compromise, and not other liabilities of Puerto Rico.

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