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U.S. District Court Holds that Puerto Rico's Recovery Act is Unconstitutional: Cadwalader

On February 6, 2015, Judge Francisco Besosa of the U.S. District Court for the District of Puerto Rico held that the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the "Recovery Act") is expressly preempted by section 903 of the Bankruptcy Code and is therefore unconstitutional. The court also denied the Commonwealth's motion to dismiss the plaintiffs' claims under the Contracts Clause and certain of the plaintiffs' claims under the Takings Clause. The decision is among the first to explicitly hold that section 903 of the Bankruptcy Code preempts the States, including Puerto Rico, from enacting a municipal debt adjustment scheme that results in the discharge of indebtedness. The court's ruling also removes a major leverage point for the Commonwealth and its public agencies attempting to negotiate restructurings with creditors and restores remedies available to bondholders, including the right to appoint a receiver.

Background

On June 25, 2014, Puerto Rico's legislature introduced and approved the Recovery Act. Shortly thereafter, Governor Alejandro Garcia Padilla signed the Recovery Act into law. The Recovery Act permits Puerto Rico's three major public corporations (PREPA, PRHTA, and PRASA)1 to pursue two non-consensual alternatives to a restructuring of their debts. The first alternative, Chapter 2, permits a public corporation to modify, amend, or exchange certain of its debt instruments if (i) at least 50 percent of the debt in a given class votes on whether to accept the changes and (ii) at least 75 percent of participating voters approve the changes to the debt instruments. The second alternative, Chapter 3, is modeled after chapter 9 of the Bankruptcy Code and permits a debtor to propose a plan that adjusts its debts without the consent of all of its creditors. The Chapter 3 plan may be confirmed if at least one class of affected debt has voted to accept the plan by a majority of the votes cast in such class and two-thirds of the aggregate principal amount of affected debt in such class that is voted. In addition, the Recovery Act:

- Eliminated existing statutory remedies for certain secured bondholders, including the right for PREPA bondholders to appoint a receiver;
- Permitted debtors to use cash collateral and obtain DIP financing with a priming lien without providing any adequate protection to prepetition creditors, provided that the use of cash collateral or the DIP financing would be to serve a public function;
- Permitted debtors to sell their assets with court approval; and
- Stayed prepetition creditors from enforcing remedies against the debtor during the pendency of the Chapter 2 or 3 case.

Two groups of creditors filed complaints against the Commonwealth of Puerto Rico and PREPA, seeking a declaration that the Recovery Act is unconstitutional because it infringed on the federal bankruptcy power and a declaration that the Recovery Act is expressly preempted by section 903(1) of the Bankruptcy Code. The plaintiffs also sought declarations that the Recovery Act violated the Takings and Contracts Clauses of the U.S. Constitution and that provisions in the Recovery Act that would stay federal proceedings are unconstitutional. The Commonwealth moved to dismiss these

claims, and the creditors cross-moved for summary judgment.

The Court's Decision

In Franklin California Tax-Free Trust v. Commonwealth of Puerto Rico and Blue Mountain Capital Management LLC v. Governor Alejandro Garcia-Padilla,2 the court first addressed ripeness, concluding that the plaintiffs' preemption and Contracts Clause claims were ripe for review because, among other things, the claims relied on the enactment of the Recovery Act, not on its application. The plaintiffs' claims were not dependent on any hypothetical facts, presented purely legal issues, and also alleged direct injuries to the plaintiffs' interests. Notably, the court observed:

[N]ot having the guarantee of remedial provisions that they were promised affects plaintiffs' day-t--day business as PREPA bondholders, particularly when negotiating with PREPA over remedies and potential restructuring. Indeed, the threat of PREPA's invocation of the Recovery Act hangs over plaintiffs and diminishes their bargaining power as bondholders.

The court also concluded, however, that certain of the plaintiffs' Takings Clause claims and stay of proceedings claims were not ripe for adjudication, because they were contingent on hypothetical events that had not yet occurred. In addition, the court dismissed the plaintiffs' claims against PREPA, as the plaintiffs did not sufficiently allege any injuries that are traceable to an action by PREPA.

1. Preemption

Having determined that the preemption claims were ripe for review, the court held that the plain language of section 903 of the Bankruptcy Code expressly preempted the Recovery Act. "Express preemption" occurs when congressional intent to preempt state law is made explicit in the text of a federal statute. In addition, a state law may be preempted when it conflicts with or frustrates the purpose of a federal statute. The latter type of preemption is known as "conflict preemption."

Section 903 of the Bankruptcy Code provides, in pertinent part, that a "State law prescribing a method of composition of indebtedness by such municipality may not bind any creditor that does not consent to such composition."3 Under the Bankruptcy Code, Puerto Rico is a "State," except for the purposes of who may be a chapter 9 debtor. However, section 903 does not, on its face, apply only to chapter 9 debtors. Further, unlike other provisions in chapter 9, section 903 applies broadly to the term "municipalities," which would include public agencies like PREPA. The court also found that the Recovery Act was a "method of composition" because the law permits the adjustment and discharge of debts. Accordingly, the court concluded that the Recovery Act was preempted by section 903.

The court also found that the legislative history of section 903 evidenced Congress's intent to preempt state municipal debt adjustment laws. Specifically, the House Report to section 903's predecessor, section 83(i) of chapter IX, stated:

An amendment to section 83(i) provides that State legislation dealing with compositions of municipal indebtedness shall not be binding on non-consenting creditors. State adjustment acts have been held to be valid, but a bankruptcy law under which bondholders of a municipality are required to surrender or cancel their obligations should be uniform throughout the 48 States, as the bonds of almost every municipality are widely held. Only under a Federal law should a creditor be forced to accept such an adjustment without his consent.5

According to the court, the legislative history of section 903 evidenced a clear intent to reserve the

power to adjust municipal debts for the federal government. The court concluded that the Recovery Act stood as an obstacle to section 903's stated purpose to permit nonconsensual adjustments of municipal debt under a uniform federal law.

In so holding, the court rejected several of the Commonwealth's defenses. First, the Commonwealth argued that section 903 could not apply to it because Puerto Rico's municipalities are ineligible for chapter 9 relief. The court reasoned, however, that the plain language of the Bankruptcy Code only exempts Puerto Rico from the term "State" in one limited circumstance: chapter 9 eligibility. It does not, on its face, exempt Puerto Rico from the term State in all of chapter 9.

Second, the Commonwealth argued that it would be nonsensical to read the Bankruptcy Code as precluding Puerto Rican municipalities from filing for chapter 9 relief, but simultaneously preempting Puerto Rican laws that govern municipal debt adjustments. However, the court found:

"Congress's decision not to permit Puerto Rico's municipalities to be Chapter 9 debtors…reflects its considered judgment to retain control over any restructuring of municipal debt in Puerto Rico. Congress, of course, has the power to treat Puerto Rico differently than it treats the fifty states."

Third, the Commonwealth contended that section 903 could only apply to states whose municipalities are eligible for chapter 9 relief. The court, though, found nothing in section 903's text or legislative history to suggest that Congress intended section 903 to apply only to states whose municipalities are eligible to be chapter 9 debtors.

Finally, the court rejected the Commonwealth's argument that section 903 could not apply because Puerto Rico's bondholders could not qualify as "creditors," as such term is defined in the Bankruptcy Code. Specifically, the Commonwealth maintained that the term "creditor" is limited to those who hold claims against a "debtor." Because the Commonwealth's public agencies cannot be chapter 9 debtors, the Commonwealth reasoned that section 903 could not apply because the Commonwealth's bondholders are not "creditors." However, the court found that the Commonwealth's interpretation was strained and that nothing in the Bankruptcy Code's definition of "creditor" suggested that the term was limited to claims against a debtor that is eligible for bankruptcy relief.

The court ultimately concluded that this was "not a close case," even though federal preemption is a "strong medicine." According to the court, section 903 of the Bankruptcy Code and its legislative history "provide direct evidence of Congress's clear and manifest purpose to preempt state laws that prescribe a method of composition of municipal indebtedness that binds nonconsenting creditors…and to include Puerto Rico laws in this preempted arena." Accordingly, having found that the Recovery Act is expressly preempted by section 903 of the Bankruptcy Code, the Court held that the Recovery Act is unconstitutional under the Supremacy Clause.

2. The Contracts Clause

The Contracts Clause of the U.S. Constitution prohibits states from impairing their own contracts. To validly state a claim under the Contracts Clause, a plaintiff must demonstrate that (i) the state law operates as a "substantial impairment" of a contractual relationship and (ii) that such impairment is not a reasonable or necessary means to serve an important government interest.

First, the court found that the plaintiffs adequately alleged that the Recovery Act substantially impaired contractual relations. Both the PREPA Trust Agreement and the PREPA Enabling Act created a contractual relationship between PREPA, its bondholders, and the Commonwealth. The plaintiffs alleged that the Recovery Act substantially impaired that contractual relationship by (i) permitting PREPA to modify its debts without creditor consent in a manner that is inconsistent with

the PREPA Trust Agreement; (ii) permitting PREPA to grant priming liens on prepetition collateral, notwithstanding prohibitions on such liens in the PREPA Trust Agreement; (iii) permitting PREPA to sell its assets with court approval; (iv) rendering the PREPA Trust Agreement's ipso facto clause unenforceable; (v) limiting PREPA bondholders' rights to enforce Trust Agreement remedies during a Chapter 2 or 3 proceeding; and (vi) eliminating the PREPA bondholders' right to seek the appointment of a receiver.

The court found that Faitoute Iron & Steel Co. v. Asbury Park,6 the principal authority relied on by the Commonwealth, was misplaced. In Asbury Park, the New Jersey statute barred the reduction of principal, affected only unsecured bonds that had no real remedy, and only provided for an extension of the maturity on the bonds and a reduction in the coupon. In contrast, the Recovery Act affects secured bonds that have meaningful remedies, permits the reduction in principal amount on those bonds, and permits modifications to debt obligations that extend beyond the amendments in Asbury Park.

Likewise, the court rejected the Commonwealth's argument that it would be difficult at this juncture to determine whether any contractual relationships are substantially impaired as a result of the Recovery Act. According to the Commonwealth, one cannot make such a determination until a restructuring occurs under the Recovery Act. The court found this argument unpersuasive. Rather, the court held that when a state law authorizes a party to do something that a contract prohibits it from doing, or when a state law prohibits a party from exercising rights or remedies under a contract, the state law itself impairs the contractual relationship, independent of how a party acts pursuant to that law.

The court further found that the right to receive payment and certain covenants and remedies under the Trust Agreement likely induced bondholders to purchase PREPA's bonds. In particular, the court noted that the Recovery Act did not merely modify existing rights and replace them with comparable security provisions, but rather "it completely extinguishes all of them." Because the Recovery Act eliminated such rights, covenants, and remedies that are central to the Trust Agreement, the court concluded that the plaintiffs adequately alleged that the Recovery Act substantially impairs a contractual relationship.

Second, the court held that the plaintiffs adequately alleged that the Recovery Act was not a reasonable and necessary means to serve an important government purpose. Alternatives to the Recovery Act, identified by the plaintiffs included: (i) PREPA could raise its rates; (ii) PREPA could collect overdue accounts from the Commonwealth and other public agencies; (iii) PREPA could reform the manner in which municipalities are charged and eliminate subsidies; (iv) PREPA could correct inefficiencies with its management; and (v) PREPA could negotiate with its creditors to restructure its debts in a consensual manner. The court inferred from these allegations that the Recovery Act imposed a drastic impairment when more moderate courses were available. Thus, the court concluded that the plaintiffs adequately stated a claim under the Contracts Clause and therefore denied the Commonwealth's motion to dismiss.

3. The Takings Clause

The Takings Clause of the U.S. Constitution provides that private property may not be taken for public use without just compensation. Here, the plaintiffs claimed that the Recovery Act violates the Takings Clause because (i) it eliminates plaintiffs' right to appoint a receiver and (ii) permits public corporations to grant priming liens.

The court determined that plaintiffs stated plausible claims that the Recovery Act's elimination of plaintiffs' right to appoint a receiver violated the Takings Clause. According to the court, the

Recovery Act provides no compensation for eliminating bondholders' contractual rights, and therefore, may qualify as an impermissible taking. Furthermore, the court concluded that the plaintiffs' claims based on the elimination of the receiver remedy are facial takings claims, and therefore are ripe for review.

The court rejected the Commonwealth's defenses. For example, the Commonwealth argued that the receivership remedy did not even exist because PREPA had not yet defaulted on its obligations. Thus, the Commonwealth argued, there was no contractual right for the Commonwealth to take. However, the court found that even though the right to appoint a receiver is contingent on a default, the right nevertheless currently existed under terms of PREPA Enabling Act and PREPA Trust Agreement.

By contrast, the court concluded that plaintiffs' claims that the Recovery Act constitutes a taking on plaintiffs' liens on PREPA's revenues were not ripe for review, because the claims were "as applied" claims that were contingent on events that not yet occurred (i.e., a Commonwealth court's approval of the priming lien pursuant to section 322 of the Recovery Act).

Conclusion

The decision in Franklin California Tax-Free Trust v. Commonwealth of Puerto Rico is significant because it reaffirms the principle that only the federal government may pass bankruptcy laws. The decision also clarifies that Puerto Rico remains subject to Congress's plenary powers. Where, as in the case of Puerto Rico, a state passes a law that allows states or municipalities to adjust and discharge debts, that law would likely be unconstitutional and preempted by section 903 of the Bankruptcy Code.

Footnotes

1 The full names of these public corporations are: the Puerto Rico Electric Power Authority, the Puerto Rico Highways and Transportation Authority, and the Puerto Rico Aqueduct and Sewer Authority.

2 Civ. Nos. 14-1518 and 14-1569 (ECF No. 119), available at http://cases.justia.com/federal/district-courts/puerto-rico/prdce/3:2014cv01518/111423/119/0.pdf?ts=1423304308

3 11 U.S.C.§ 903(1).

4 11 U.S.C. § 101(52).

5 H.R. Rep. No. 2246, 79th Cong., 2d Sess. 4 (1946) (emphasis added).

6 316 U.S. 502 (1942)

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