

Bond Case Briefs

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First Circuit Provides ‘Guidance’ on Challenging Puerto Rico’s Debt Restructuring Statute: Nelson Mullins

At the very end of a recent opinion, the First Circuit seemingly provided guidance on how bondholders can attack the constitutionality of Puerto Rico’s debt restricting act, PROMESA (The Puerto Rico Oversight, Management, and Economic Stability Act). However, the apparent guidance offered by the First Circuit may only be fool’s gold.

PROMESA was adopted by Congress in 2016 in response to a Supreme Court ruling that Puerto Rico’s instrumentalities were ineligible for municipal debt adjustment under chapter 9 of the United States Bankruptcy Code (“Bankruptcy Code”); PROMESA in turn provides statutory municipal debt provisions similar to chapter 9.

The First Circuit case began when guarantors of certain highway bonds filed suit in a special Puerto Rico District Court for PROMESA proceedings (the “PROMESA Court”), essentially challenging the constitutionality of PROMESA and attempting to undo the diversion of pledged oil and tax revenue that would have otherwise been paid to the highway bondholders. PROMESA allowed Puerto Rico to divert the pledged revenues to the payment of general obligation bonds if other revenue sources were insufficient to cover the general bonds. The PROMESA Court dismissed the bondholders’ case, and the First Circuit affirmed.

The First Circuit first held that the constitutionality of PROMESA could not be attacked in the PROMESA Court. However, the First Circuit went on to state that the bondholders could attempt to obtain the same relief through two separate alternatives. First, they could seek relief from the automatic stay from the PROMESA Court under PROMESA provisions similar to Section 362 of the Bankruptcy Code, and then begin a separate proceeding in another court. Second, and similarly, they could initiate separate lawsuit in “regular” district court.

Legal scholars doubt that the bondholders would be successful under either alternative offered by the First Circuit, as the bondholders are not being deprived of their right to payment permanently, and therefore it’s unlikely a court would find a violation of the bondholders’ constitutional rights. Also, courts within the First Circuit have already rejected attempts by other bondholders to evade the requirements of PROMESA and obtain payment of diverted funds.

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