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First Circuit Holds that Fifth Amendment Takings Claims Must be Paid in Full: Dechert

The U.S. Court of Appeals for the First Circuit recently ruled in the Puerto Rico bankruptcy case that Fifth Amendment takings claims cannot be discharged or impaired by a bankruptcy plan. As a matter of first impression in that circuit, the Court disagreed with the Ninth Circuit and held that former property owners affected by prepetition takings must be paid in full.

In re Fin. Oversight & Mgmt. Bd., 41 F.4th 29 (1st Cir. 2022)

The Puerto Rico restructuring is one of the largest and longest-running public bankruptcy cases. After nearly five years of litigation, the Financial Oversight and Management Board of Puerto Rico (the "**Board**") secured the confirmation of a plan of adjustment (the "**Plan**") for the Commonwealth of Puerto Rico (the "**Commonwealth**") under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA).

In confirming the Plan, however, the District Court for the District of Puerto Rico ruled against the Board in holding that prepetition claims arising under the Takings Clause of the United States Constitution cannot be impaired or discharged. The Board appealed that ruling. On July 18, 2022, as a matter of first impression, the First Circuit affirmed.

Background

Former property owners filed proofs of claim in Puerto Rico's bankruptcy cases seeking just compensation for prepetition takings of their private property (the "**Takings Claimants**"). Some of those claims arose from proceedings under the Commonwealth's "quick take" eminent domain statute, which allows the Commonwealth to acquire private property by depositing the estimated compensation amount in a Puerto Rican local court and permits the former property owner to sue for additional compensation. Other claims arose from the Commonwealth's takings made without a deposit.

In its plan, the Board proposed to treat Takings Claims as general unsecured claims. Claims for which the Commonwealth had made a prepetition deposit would be considered secured up to the amount of the deposit and entitled to full recovery of that amount. Any difference between the deposited amount and the yet-to-be-determined just compensation would be considered unsecured.

The Takings Claimants objected to that construct, and the District Court held that their treatment in the Plan violated the Takings Clause. The Court ruled that the Takings Clause creates an "irreducible entitlement to just compensation," and thus the impairment of prepetition takings claims was impermissible.

The Board amended the Plan to comply with the District Court's ruling, while preserving its right to appeal the confirmation order on the grounds that prepetition takings claims may be impaired and discharged.

The First Circuit denied the Board's appeal, holding that just compensation guaranteed by the Takings Clause may not be adjusted by a bankruptcy plan.

The Court noted that the Takings Clause itself establishes the quantum of compensation that must be provided in the event of a taking. It referenced Supreme Court cases holding that "just compensation" means the "the full monetary equivalent of the property taken" to "put [the owner] in the same position monetarily as he would have occupied if his property had not been taken." The Court held that this constitutional guarantee of "the full monetary equivalent" cannot be altered in bankruptcy.

The First Circuit rejected the Board's argument that takings claims may be impaired because the ability of a debtor in bankruptcy to restructure its debts itself has a constitutional basis, flowing from the Bankruptcy Clause of the Constitution. The Court explained that most laws are passed by Congress pursuant to some constitutional authority, but this does not authorize acts of congress to trump other constitutional provisions. The Court held that "[t]he bankruptcy laws are subordinate to the Takings Clause," and the express constitutional authority to enact uniform laws on the subject of bankruptcies cannot overcome the requirements of the Fifth Amendment.

The Court also rejected the Board's arguments that payment of just compensation is a mere monetary remedy for a constitutional violation, similar to any other monetary award given as compensation for constitutional violations and, thus, subject to adjustment. Unlike with other constitutional violations for which compensation may be an appropriate remedy, "in the case of the Takings Clause, the Constitution clearly spells out both a monetary remedy and even the necessary quantum of compensation due. Accordingly, the denial of adequate (read: just) compensation for a taking is itself constitutionally prohibited."

Accordingly, the First Circuit declined to follow the majority opinion in *In re City of Stockton*, 909 F.3d 1256 (9th Cir. 2018), where the Ninth Circuit held that takings claims are not different to other claims arising from constitutional violations that are routinely adjusted in bankruptcy proceedings. The First Circuit found Judge Friendad's dissent in *City of Stockton* more persuasive. Judge Friendad concluded that the Takings Clause afforded just compensation special protection, such that "claims for just compensation should be excepted from discharge, so that they survive any bankruptcy intact."

The First Circuit also rejected the Board's arguments that takings claims may be modified by operation of law in other ways, as when they are judged to be time-barred or are waived or settled, all without violating the Fifth Amendment. The Court clarified that the enforcement of a statute of limitations and the settlement or waiver of claims are litigation decisions under the control of the takings claims holder. The same cannot be said for bankruptcy impairment or discharge. In addition, the Court explained that the Board was conflating what makes the denial of just compensation substantively unlawful with what may make a claim unavailable for procedural reasons.

The Court also refused to accept the Board thesis that a payment-in-full rule would pose significant challenges for future municipal bankruptcies. The Court reasoned, to the contrary, that allowing the impairment or discharge of takings claims, would create a perverse incentive for municipalities or the government to take private property and then restructure the related claims.

What's Next?

The First Circuit may not have had the last word. Given the split between the First and Ninth Circuits' decisions, the Board recently announced its intention to file a petition for writ of certiorari to the United States Supreme Court.

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