

James E. Spiotto

111 West Monroe Street
Chicago, Illinois 60603-4080
T 312.845.3763
F 312.516.1900

February 24, 2015

The Honorable Bob Goodlatte
Chairman
House Committee on the Judiciary
2138 Rayburn House Office Building
Washington, DC 20515

The Honorable John Conyers, Jr.
Ranking Member
House Committee on the Judiciary
B-351 Rayburn House Office Building
Washington, DC 20515

The Honorable Tom Marino
Chairman
Subcommittee on Regulatory Reform,
Commercial and Antitrust Law
House Committee on the Judiciary
2138 Rayburn House Office Building
Washington, DC 20515

The Honorable Henry C. "Hank" Johnson
Ranking Member
Subcommittee on Regulatory Reform,
Commercial and Antitrust Law
House Committee on the Judiciary
B-351 Rayburn House Office Building
Washington, DC 20515

Re: HR 870, Puerto Rico
Chapter 9 Uniformity Act of 2015 (the "Bill")

Dear Chairman Goodlatte, Ranking Member Conyers, Chairman Marino and Ranking Member Johnson:

It is a privilege to submit the following letter to the Committee in support of the Bill and provide comments on the legislative history that led to the existing law and the effect the Bill is likely to have on the ability of Puerto Rico's municipalities to obtain access to financing at an acceptable cost. I¹ previously testified before the Committee with respect to the Municipal Bankruptcy Amendments of 1988² that corrected some of the inconsistencies between then existing bankruptcy law and municipal law and financing practices.³

¹ As of January 1, 2014, I retired as a Partner of Chapman and Cutler LLP. I currently 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. I also am co-owner and co-publisher of MuniNetGuide.com, an online resource specializing in municipal research, including public finance. The opinions expressed in this letter are solely those of the author and do not reflect the position of Chapman and Cutler LLP or Chapman Strategic Advisors LLC.

² MUNICIPAL BANKRUPTCY AMENDMENTS, Pub. L. No. 100597 (1988) ("1988 Amendments").

³ The focus of the 1988 Amendments includes assurance that liens on "*special revenues*" not be extinguished, that prepetition payments on bonds and notes be free from the taint of possible preference

Following the adoption of the Bankruptcy Reform Act of 1994,⁴ which clarified the split that had developed in case decisions and provided that municipalities must be specifically authorized by the State in order to be eligible to file for bankruptcy,⁵ I testified regarding the Orange County Bankruptcy and municipal investments before a Subcommittee of the Committee on Banking and Financial Services. More recently, I testified in 2011 regarding the role of public employee pensions in contributing to State's insolvency and the possibility of a State bankruptcy chapter. Accordingly, I hope to provide some context as to the need for the Bill and its importance to Puerto Rico and its municipalities for favorable access to the municipal market.

EXISTING LAW GOVERNING MUNICIPAL BANKRUPTCY IN PUERTO RICO

Chapter 9 currently is not applicable to Puerto Rico. The term "State" is defined in the Bankruptcy Code as including "Puerto Rico, except for the purpose of defining who may be a debtor under Chapter 9 of this title."⁶ As a result, Puerto Rico attempted to construct its own law for dealing with its fiscal problems, the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the "Recovery Act")⁷ for use by the Puerto Rico Electric Power Authority ("PREPA") and a number of other public corporations. The stated purpose of the Recovery Act was to allow public corporations to adjust their debts in the interest of all creditors affected thereby. The Recovery Act was viewed very negatively by the United States municipal bond market.⁸ In particular, the Recovery Act was materially worse for public corporate revenue bondholders (such as PREPA) than Chapter 9 in that it did not incorporate the provisions of the 1988 Amendments to Chapter 9, especially the language assuring the preservation of the pledge and benefit of the bargain regarding "special revenues" for revenue bond financing.⁹ Further, the

attack, and that revenue bonds not be transformed into general obligation bonds. Further, the 1988 Amendments make a general failure to pay debts the criterion for municipal insolvency and eligibility for filing.

⁴ Publ. L. No. 103-394.

⁵ 1994 Bill at Section 402.

⁶ 11 U.S.C. §101 (52).

⁷ Puerto Rico Act No. 71 of June 28, 2014.

⁸ Reuters, "U.S. BOND FUNDS SUE PUERTO RICO, WORRIED ABOUT BANKRUPTCY THREAT," June 30, 2014, available at www.reuters.com/assets/USL2NOPBOLG20140630.

⁹ As you may recall, one of the reasons for the 1988 Amendments was to provide a means of financings for financially distressed municipalities when they need financing the most. This arose out of the problem of Cleveland in 1978. Cleveland's lack of cash revenues could not be addressed through revenue bond financings from a profitable municipal electric utility since the municipal market feared that any pledge of

Recovery Act authorized a restructuring of PREPA secured bonds which could be contrary to the terms of the bond documents. Bondholders sued alleging the Recovery Act was preempted by Section 903 of the Federal Bankruptcy Code and therefore void pursuant to the supremacy clause of the United States Constitution. The United States District Court for the District of Puerto Rico agreed and held the law unconstitutional, noting that it was “not a close case.”¹⁰ The court found that Section 903 of the United States Bankruptcy Code, which provides that a State may not enact a law that prescribes a method for dealing with a municipality’s indebtedness that binds non-consenting creditors, clearly evidenced an intent to preempt laws such as the Recovery Act. Unless the ruling on the Recovery Act is reversed on reconsideration or appeal, Puerto Rico will have no statutory basis under which to restructure the debt of public corporations or municipalities and to resolve its financial problems. This is a matter of great concern. Since the mid-1800’s, it has been recognized that the financial distress of a Territory or a State, including repudiation of its debt, can have an adverse effect on the municipal market generally and the cost of financing to state and local governments. Accordingly, the Puerto Rico problem is of importance to the Federal Government. (See Exhibit A).

THE BILL

The Bill is aimed at ameliorating this situation and providing a last resort remedy for municipalities in Puerto Rico, assuming Puerto Rico authorizes its municipalities to file for bankruptcy. The Bill is thus consistent with the original purpose of Chapter 9. Chapter 9 was the last resort for municipalities that were suffering severe financial distress and, for the most part, had exhausted other available, less drastic methods of resolution. The Bill amends Section 101(52) of the Bankruptcy Code so that it provides “The term “State” includes Puerto Rico and, except for the purpose of defining who may be a debtor under Chapter 9 of this title, includes the District of Columbia.” Thus, the Bill has a narrow, simple and straightforward purpose: to permit Puerto Rico, if it so chooses, to authorize its municipalities to file for Chapter 9. I would submit that this legislation conforms with the purposes of Chapter 9 of the Bankruptcy Code and federal policy regarding the treatment of municipal bond creditors.

revenues would be voided in a subsequent bankruptcy proceeding, nullifying the pledged revenue source of payment. The 1988 Amendments created this “safety net” providing municipalities in financial distress with the ability to obtain financing. The concept of a pledge of “special revenues” that survived a Chapter 9 filing was codified in § 922(d) and § 928 of the Bankruptcy Code assuring the benefit of the bargain and terms of the contract could not be avoided in a Chapter 9 and must be unimpaired. *See* H.R. No. 100-1011, September 14, 1988, available at 1988 WL 169907 (“*House Report*”).

¹⁰ *Franklin California Tax-Free Trust et al. v. Commonwealth of Puerto Rico et al.*, 2015 WL 522183 (D. Puerto Rico Feb. 6, 2015) (hereinafter “*Franklin Trust*”).

THE BILL IS CONSISTENT WITH THE PURPOSE OF CHAPTER 9 AND FEDERAL POLICY

During the period of 1929 through 1937, there were 4,700 defaults by U.S. governmental bodies in the payment of their obligations, which resulted in a plethora of continuous and unproductive litigation.¹¹ The response by Congress was the enactment of the Bankruptcy Act of 1934, which ultimately was superseded by the Bankruptcy Act of 1937.¹² This legislation reflected a recognition that municipalities required a mechanism that would stay the annihilating litigation arising from defaults and provide a fresh start through the allowance of municipal debt adjustment to what is sustainable and affordable. In this way, creditors of the distressed municipality could be paid as much as possible without crowding out essential governmental services.

The extension of the benefits of Chapter 9 to the public corporations and municipalities of Puerto Rico is consistent with the policy of Chapter 9 to permit troubled municipalities to remain in existence by allowing municipalities to adjust their debts to what is sustainable and affordable.¹³ Putting aside questions of the constitutionality of the Recovery Act, the Chapter 9 approach embodied in the Bill is far more desirable than the one-off legislation by Puerto Rico represented by the Recovery Act. The existing Chapter 9, especially since the enactment of the 1988 Amendments, results in a treatment of municipal bonds in bankruptcy that should be uniform throughout the United States and that is in accord with well established principles of municipal finance. Existing Chapter 9 has provided clarity to the \$3.7 trillion U.S. municipal market, and the expectations of the market have been further refined with the case law that has been developed interpreting the provisions of Chapter 9.¹⁴ Under Chapter 9, general obligation and special revenue bonds have relative rights and priorities that are understood by the market. Applying the familiar Chapter 9 provisions to Puerto Rico would provide more certitude in the market as to the expected treatment of bonds issued by the public corporations of Puerto Rico in the event of financial distress. The capital markets have difficulty dealing with unpredictability. The Recovery Act and any other efforts of Puerto Rico to provide a one-off, singular substitute

¹¹ See discussion at p. 3 in James E. Spiotto, PRIMER ON MUNICIPAL DEBT ADJUSTMENT, published by Chapman and Cutler LLP and available upon request from Chapman and Cutler LLP.

¹² *Id.* at p. 5. The 1937 Legislation was upheld by the Supreme Court in *United States v. Bekins*, 304 US 27 (1938).

¹³ See House Report and S. Rep. No. 100-506 (1988).

¹⁴ Revenue bond financing has been the major source of financing for the world-class infrastructure of the U.S. state and local governments and has been available in the municipal market to Puerto Rico. It will be necessary to protect and preserve that type of financing for the over \$3.6 trillion of improvements that are estimated to be needed over the next five years. Am. Soc’y of Civil Engineers, 2013 Report Card for America’s Infrastructure, <http://www.infrastructurereportcard.org/a/documents/2013-Report-Card.pdf>.

to Chapter 9 for its municipalities inevitably will lead to increased anxiety in the market over an untested and unique approach. Allowing Puerto Rico to authorize its municipalities to file for Chapter 9 will reduce, if not eliminate, the unhealthy cloud of uncertainty that can lead to restriction of access to the municipal market and an increased cost of borrowing. The reduction in legal uncertainty likely will be greeted positively by the municipal market.¹⁵

THE EXTENSION OF CHAPTER 9 TO PUERTO RICO DOES NOT REPRESENT A RETREAT FROM FEDERAL POLICY

Puerto Rico is a Territory of the United States, not a co-sovereign, but directly overseen by the United States federal government. As noted by the court in voiding the Recovery Act, in approving Puerto Rico's constitution in 1952, Congress did not provide Puerto Rico a power to enact its own municipal bankruptcy laws that Congress had explicitly denied to the states.¹⁶ Given the power of the federal government over its territories, the possibility that Chapter 9 could be extended to Puerto Rico is not unexpected. What the municipal market *did expect* in extending credit to Puerto Rican municipalities including public corporations was that the federal policies regarding municipal debt obligations embodied in the 1988 Amendments and Bankruptcy Reform Act of 1994 would be observed in Puerto Rico. The Bill will help ensure that outcome so there will be no conflict between the Puerto Rico legislation and the federal policy and protection provided in Chapter 9.

THE PASSAGE OF THE BILL DOES NOT RETROACTIVELY DEPRIVE ANY CONSTITUENT OF ITS RIGHTS AS A MUNICIPALITY, CREDITOR OR TAXPAYER

As noted, the purpose of Chapter 9 is to result in a sustainable municipal entity that can continue to provide needed governmental services to its citizens. In the context of a municipal utility, Chapter 9 is intended to preserve the continued operation of the utility and its services for the benefit of the municipality, its creditors and citizens. Without its continued operation and the adjustment of its debt, if needed, there would be no utility operating as a source of payment and services and all would lose. While a debt adjustment may be perceived as modifying the originally scheduled payments, it is the practical reality of the circumstances and the terms of the benefit of bargain are not violated but rather preserved to the extent possible. No municipality can pay more than what it actually receives in revenues and to attempt differently will not lead to a greater payment to creditors, but rather, to an unaffordable and unsustainable enterprise. While Chapter 9 protects net revenues (net of current operating and maintenance costs) of a utility to be paid to special revenue bondholders, it also assures that operation and maintenance costs for

¹⁵ See Fitch Ratings, "CHAPTER 9 EXTENSION WOULD BE A POSITIVE FOR PUERTO RICO," August 6, 2014.

¹⁶ *Franklin Trust* at p.16.

continued operations will be paid (See Sections 922(d) and 928). If the practical reality is that changes in rates charged to customers and debt service are required because net revenues, after any appropriate rate adjustments, are less than required to pay the original obligation as scheduled, then the revenue bondholders receive all that they practically can receive and the pledge continues until they are paid

THE PASSAGE OF THE BILL SHOULD NOT MEAN A FLOOD OF CHAPTER 9'S

Chapter 9 provides that a State must specifically authorize its municipalities to file for Chapter 9.¹⁷ The Bill merely modifies the existing law to include Puerto Rico within the definition of State for this purpose. If the Bill becomes law, it will be up to Puerto Rico to specifically authorize its municipalities, including public corporations, to file for Chapter 9. Traditionally, Chapter 9 has been viewed as a last resort, utilized primarily by small municipalities and special tax districts.¹⁸ Total Chapter 9 filings since 1937 have been 661, and only 316 Chapter 9 filings have been made during the last 60 years (1954) of which 189 (60%) have been municipal utilities and special districts. Moreover, only 12 States specifically authorize a municipal bankruptcy filing, another 12 States have conditional authorization, normally a “second look” by means of approval by a state elected official, agency or neutral evaluator, 3 States have limited authorization, 2 States generally prohibit a municipal filing and the remaining 21 States provide no authorization at this time.¹⁹

The passage of the Bill should not preclude Puerto Rico from taking the action other States have chosen short of a Chapter 9 filing to rescue their financially challenged municipalities.²⁰ 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 obligation 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

¹⁷ 11 U.S.C. § 109(c)(2).

¹⁸ See discussion at page 5 in *MUNICIPALITIES IN DISTRESS?* published by Chapman and Cutler LLP, which is available from Chapman and Cutler LLP or on Amazon.com (“*MUNICIPALITIES IN DISTRESS?*”).

¹⁹ *MUNICIPALITIES IN DISTRESS*, pp. 51 and 52 lists those States.

²⁰ These alternative debt resolution mechanisms consistent with Section 903 of the Bankruptcy Code are described in detail in Chapter IV of *Municipalities in Distress*. See also *James E. Spiotto, “The Role of the State in Supervising and Assisting Municipalities in Times of Financial Distress,”* 33 *MUNICIPAL FINANCE JOURNAL*, (2013); *The Pew Charitable Trusts, THE STATE ROLE IN LOCAL GOVERNMENT FINANCIAL DISTRESS*, July 2013.

oversight, supervision and refinancing of the debt of a financially challenged municipality as was done with New York City in 1975 and the formation by New York State legislation of a Municipal Assistance Corporation that helped supervise the financial recovery of the City and refinanced its debt or similar assistance by Ohio to Cleveland in 1978 or by Pennsylvania to Philadelphia in 1991 with the passage of the Pennsylvania Inter-Governmental Cooperation Act. Further, the passage of the Bill would not preclude the oversight and supervision of overseer, budget commission or receiver 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.²¹

History has shown that municipalities in financial distress need a recovery plan that stimulates economic activity in the municipality 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.

The passage of the Bill should not preclude either Federal or Commonwealth legislation that could increase business activity such as the equivalent of reinstatement of Section 936 of the IRS Code²² for favorable tax treatment of business income, resolve unfavorable treatment of imports under the Merchant Marine Act of 1920 that prohibits use of foreign ships when transporting goods between two points in the United States even if this is more affordable than using a U.S. vessel,²³ or any perceived unfair treatment of Puerto Rico by the Federal Government.

Creative financing techniques could be explored that are geared to lowering the borrowing cost of the distressed local government body while enhancing the market acceptance of the restructured debt such as credit enhancement, moral obligation pledges or the creation of the equivalent of Brady Bonds, collateralized by U.S. Treasury zero coupon bonds, used with Latin American countries and financially challenged governments to refinance or restructure debt at a lower cost with greater market acceptance. Also, the oversight and assistance that the Federal Government provided to the District of Columbia²⁴ still could be provided to Puerto Rico if the Bill is passed. Accordingly, all other options of the Federal Government and Puerto Rico are preserved with the passage of the Bill.

²¹ The Financially Distressed Municipalities Act, Pa. Act of 1987, P.L. 246, No. 47.

²² 26 U.S. Code §936.

²³ P.L. 66-261; *See Federal Reserve Bank of New York, REPORT ON THE COMPETITIVENESS OF PUERTO RICO'S ECONOMY*, June 29, 2012.

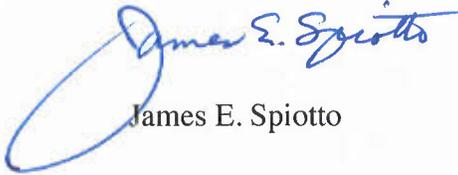
²⁴ The creation of the District of Columbia Financial Responsibility and Management Assistance Authority in 1995. Pub. L. No. 104-8.

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If you have any questions regarding the matters set forth in this letter or if I can be of further assistance to your consideration of this please do not hesitate to contact me.

Very truly yours,

A handwritten signature in blue ink, reading "James E. Spiotto". The signature is written in a cursive style with a large, looping initial "J".

James E. Spiotto

EXHIBIT A

THE HISTORICAL PRICE OF REPUDIATION AND DEFAULT OF THE OBLIGATION TO PAY DEBTS TIMELY FOR STATES AND TERRITORIES

Between 1841 and 1843, eight states and one territory (now a state) repudiated their debt, and seven states between 1843 and 1848 resumed payment. While some attribute the repudiation to the aftermath of the Panic of 1837, the real reason lies in developing states borrowing money to pay for needed transportation improvements given the success of the Erie Canal or for needed banking services in the state. By 1844, nineteen states and two territories had borrowed money for needed economic growth. The inflationary boon of 1834-39 with the accompanying Panic of 1837 came to end by 1841, and there was a tightening of credit that put pressure on incomplete construction projects for transportation improvements in the North (Pennsylvania, Maryland, Indiana, Illinois and Michigan) and lack of credit for banks in the South (Arkansas, Louisiana, Mississippi and Florida Territory). All but the Florida Territory and Mississippi resumed payment by 1848. The reason was the cost of default including denial to the market of access or increase in cost of borrowing. Those that repudiated and had not yet resumed payment experienced borrowing yields to complete projects of 32% until they resumed payment and then paid 4% above market to borrow. Mississippi and Florida Territory lacked access to then public market for almost over a decade. Florida as a territory had its access to the market practically restricted until it became a state.*

*

See English, William B. UNDERSTANDING THE COSTS OF SOVEREIGN DEFAULT: AMERICAN STATE DEBT IN 1840's. Electronic copy available at www.jstor.org/stable/2118266, 1996; Wallis, J., R. Sylla and A. Grinath. SOVEREIGN DEBT AND REPUDIATION: THE ENERGIZING MARKET DEBT CRISIS IN THE U.S., 1839-1843, NBER Working Paper Series (Working Paper 10753) (2004); Sturzenegger, F. and J. Zettelmeyer. DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISIS. Boston: MIT Press (2007).