

Testimony of Kenneth N. Klee<sup>1</sup> Before the Subcommittee on Regulatory Reform,  
Commercial and Antitrust Law, House Committee on the Judiciary, Regarding H.R. 870,  
the *Puerto Rico Chapter 9 Uniformity Act of 2015*

February 26, 2015

Chairman Marino, Ranking Member Johnson, and Members of the Subcommittee, thank you for the opportunity to testify about H.R. 870, the *Puerto Rico Chapter 9 Uniformity Act of 2015*. Forty years ago I had the privilege of serving as associate counsel to the House Judiciary Committee working on Chapter IX bankruptcy reform, and later on the 1978 Bankruptcy Code, including the codification of its chapter 9, Adjustment of Debts of a Municipality. I have welcomed the opportunity to testify before Judiciary subcommittees on many occasions, sometimes in an official capacity. This current testimony is not made in any official or representative capacity, but as the personal views of a private citizen.

H.R. 870 is urgently needed to enable municipalities located in the territory of Puerto Rico to gain access to chapter 9, should the Puerto Rican legislature specifically so authorize. By amending the Bankruptcy Code to make Puerto Rico a “State” for purposes of chapter 9, Congress will give Puerto Rico the same power and responsibility that the 50 states have to determine whether and when to grant some or all of their municipalities access to chapter 9. Although it might have been a reasonable policy choice in 1984<sup>2</sup> to reserve this decision to Congress in the exercise of its power to govern territories under Article IV of the Constitution, it is impractical for Congress to consider and determine whether to specifically authorize a particular Puerto Rican municipality to seek chapter 9 relief. Rather, the decision should be delegated to the Puerto Rican government, which has local knowledge of the political and financial issues and, therefore, is in a better position than Congress to address the specific needs of Puerto Rico's municipalities.

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<sup>2</sup> Section 421(j) of the Bankruptcy Amendments and Federal Judgeship Act of 1984 enacted 11 U.S.C. § 101(44) to clarify that the term "State" includes Puerto Rico and the District of Columbia except for the purpose of defining who may be a debtor under chapter 9. This definition was redesignated § 101(46) by section 251 of The Bankruptcy Act of 1986 and § 101(48) by Pub. L. No. 101-311 (June 25, 1990). On November 29, 1990, Pub. L. No. 101-467 redesignated the definition to its current location in § 101(52) of title 11. There is no legislative history explaining the purpose or rationale of the initial 1984 amendment.

H.R. 870 accomplishes its objective elegantly by amending the definition of "State" in section 101(52) of the Bankruptcy Code to override the chapter 9 exception in the 1984 amendment with respect to Puerto Rico. See H.R. 870, § 2.<sup>3</sup> Therefore, Congress retains power to decide whether a municipality in the District of Columbia (and presumably other territories such as Guam, the Virgin Islands, and the Northern Marianas) may file for chapter 9 relief; but will have delegate to the government of Puerto Rico the decision whether to specifically authorize any or all of its municipalities to be eligible to file a petition under chapter 9 of the Bankruptcy Code.

Section 3 of H.R. 870 wisely makes the amendment effective in cases filed on or after the date of enactment of the Act, but applicable to debts, claims, and liens created before, on, or after the date of enactment. H.R. 870 would do little good if it did not apply expansively to debts, claims, and liens created before, on, or after the date of enactment. Existing municipalities would not be able to have meaningful plans of adjustment if existing debts or liens were excluded.

Critics might question the constitutionality of retroactive relief. The arguments should fail for many reasons. First, at least since the 1978 Bankruptcy Code enacted chapter 9, Congress has had the power to authorize the filing of a chapter 9 petition for Puerto Rican municipalities. All debts, claims, and liens created on or after October 1, 1979 have always been subject to modification in such event. All H.R. 870 does is change the body politic that authorizes the municipality to file, not the substance of the applicable bankruptcy law. Second, ever since the Supreme Court decided the *Bekins* case<sup>4</sup> in 1938, there has been no constitutional impediment to the modification of unsecured debts or other contractual rights in chapter 9. The Contracts Clause of the United States Constitution<sup>5</sup> binds only the States, not Congress, and the Supreme Court has made clear that a State's authorization of its municipalities to file chapter 9 does not transgress the Contracts Clause.<sup>6</sup> Third, retroactive application of chapter 9 does not violate the Fifth Amendment as a matter of either due process or takings.<sup>7</sup> Chapter 9 provides sufficient safeguards for a secured creditor's rights, both in the form of the fair

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<sup>3</sup> Section 2 of H.R. 870 provides: "(52) 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."

<sup>4</sup> *United States v. Bekins*, 304 U.S. 27 (1938).

<sup>5</sup> U.S. Const., art. I, § 10.

<sup>6</sup> See *Bekins*, note 4 *supra*, 304 U.S. at 54 (noting that the municipal bankruptcy act "invites the intervention of the bankruptcy power to save its [municipality] which the State itself is powerless to rescue").

<sup>7</sup> See *id.* ("As the bankruptcy power may be exerted to give effect to a plan for the composition of debts of an insolvent debtor, we find no merit in . . . objections under the Fifth Amendment." (citations omitted)). See also Kenneth N. Klee & Whitman L. Holt, *BANKRUPTCY AND THE SUPREME COURT: 1801-2014* at 114-15 & 348 (West Academic 2015) (discussing holding and significance of *Bekins* opinion).

and equitable test<sup>8</sup> and the general best interests of creditors test.<sup>9</sup> To the extent there is any taking, it is justly compensated by giving the secured creditor deferred payments of a present value at least equal to the value of its collateral;<sup>10</sup> there is no constitutional claim of the secured creditor to more than that.<sup>11</sup> As the Court has so aptly observed, "Property rights do not gain any absolute inviolability in the bankruptcy court because created and protected by state law. Most property rights are so created and protected. But if Congress is acting within its bankruptcy power, it may authorize the bankruptcy court to affect these property rights, provided the limits of the due process clause are observed."<sup>12</sup>

In the event a court nevertheless finds retroactive application of H.R. 870 to be unconstitutional as applied to a particular debt, which it should not, Section 4 of H.R. 870 contains a severability clause. This clause should preserve the balance of the legislation to be applied to the greatest extent permitted by the Constitution.

In conclusion, H.R. 870 is thoughtful legislation, carefully drafted to accomplish a limited but important purpose. It is in the best interests of the United States and the Territory of Puerto Rico that it be enacted into law as soon as is practicable.

I welcome the opportunity to answer and questions you or your staff may have, and I regret that my teaching obligations at the UCLA School of Law did not permit me to testify in person before you.

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<sup>8</sup> See 11 U.S.C. §§ 901, 943(b)(1), & 1129(b)(1), (2)(A) & (B).

<sup>9</sup> See 11 U.S.C. § 943(b)(7).

<sup>10</sup> See *id.* § 1129(b)(2)(A)(i)-(iii).

<sup>11</sup> See *Wright v. Union Central Life Ins. Co.*, 311 U.S. 273, 278 (1940).

<sup>12</sup> See *Wright v. Union Central Life Ins. Co.*, 304 U.S. 502, 518 (1938). See also Kenneth N. Klee & Whitman L. Holt, *BANKRUPTCY AND THE SUPREME COURT: 1801-2014* at 101-06 (West Academic 2015) (discussing Supreme Court's Takings Clause jurisprudence as applied in the bankruptcy context).