



## **Fitch: Chapter 9 Extension Would Be a Positive for Puerto Rico**

Fitch Ratings-New York-06 August 2014: The extension of Chapter 9 provisions governing the adjustment of municipal debt in Puerto Rico would be a positive and important development for Puerto Rico and holders of debt of its public utilities and public instrumentalities, according to Fitch Ratings.

On July 31, 2014, Puerto Rico's Resident Commissioner and Congressional representative introduced a proposed amendment to the US Bankruptcy Code. The 'Puerto Rico Chapter 9 Uniformity Act of 2014' would amend the US bankruptcy code and extend to Puerto Rico the power to use Chapter 9 proceedings in federal bankruptcy court to adjust debts of its municipalities and public instrumentalities. Corporations in Puerto Rico have access to US Bankruptcy proceedings under Chapters 7 and 11.

From a bankruptcy standpoint, the amendment would place Puerto Rico on an equal footing with the 50 States, who can currently use Chapter 9 to achieve debt adjustment for their municipalities. The amendment, which will be considered by the House judiciary committee, is supported by the National Bankruptcy Conference. Fitch notes the Conference recommends that the amendment be modified to include retroactive application.

The combination of fiscal challenge, weak economic performance and limited market access has led the Commonwealth government to a point where increasingly difficult choices are required. In June the Commonwealth government enacted the Recovery Act. Given the economic and fiscal pressures facing the Commonwealth itself and its need to provide proper service levels for its citizens, its ability to continue to provide meaningful ongoing financial support to its public corporations going forward would be challenging, in Fitch's view.

The Recovery Act is an effort to fill the void resulting from the absence of a federal bankruptcy alternative. The Commonwealth has attempted to forge its own framework for orderly debt restructuring applicable to its public corporations, including the Puerto Rico Electric Power Authority (PREPA; rated 'CC' and on Rating Watch Negative by Fitch) and Puerto Rico Aqueduct and Sewer Authority (PRASA; rated

'B+' and on Rating Watch Negative). While the Recovery Act is intended to restore solvency over the long-term, it entails debt restructuring that would trigger suspension of debt payments and preclude the timely payment of principal and interest during the pendency of the proceedings.

The Recovery Act specifically excluded the Commonwealth's general obligation debt and certain instrumentalities of the Commonwealth, including the Puerto Rico Sales Tax Financing Corporation (COFINA). However, the adoption of the Recovery Act and the absence of any preemptive federal bankruptcy alternative, in Fitch's view suggest a degree of legal uncertainty regarding how the Commonwealth might act at a time of more severe financial stress to extend the same or a similar act to debt obligations of COFINA. This led Fitch to eliminate any distinction between its rating of COFINA debt and the general obligation debt of the Commonwealth ('BB-', Negative Rating Outlook).

The enactment of the Recovery Act signaled a further level of fiscal stress within the Commonwealth and resulted in Fitch rating action on debt obligations of PREPA, PRASA, and COFINA. The adoption of the Recovery Act also spawned litigation and market volatility, potentially increasing the challenge to market access for the Commonwealth and its public corporations. The litigation challenging the Recovery Act will likely be costly to the Commonwealth, a distraction from more important governance activity and will continuously shroud the outcome of any proceedings or agreements entered into under the terms of the Recovery Act with uncertainty.

The Recovery Act has provisions that mimic to a degree those in Chapter 9, but are also different in important ways. The extension of Chapter 9 of the US Code would not of course alleviate the immediate financial stress which PREPA currently faces. However, clarifying the rules for restructuring and aligning them to a federal standard with understandable precedent, albeit limited, and providing a federal forum for the proceeding would benefit bondholders. It would also protect the Commonwealth from claims it is acting unjustly or arbitrarily and contrary to accepted norms.

The range of options available to the Commonwealth and its municipalities and public instrumentalities would be the same as those available in other states. Additionally, the administration of the proceedings and the outcomes would have the same underpinning as the outcomes for other Chapter 9 cases such as Jefferson County in Alabama and Detroit in Michigan, for example. The Recovery Act itself would likely become unnecessary, its provisions for debt restructuring in a Commonwealth court rendered ineffective by the provisions of Chapter 9. Section 903 of the US Code makes any outcome of a composition proceeding like that outlined in the Recovery Act nonbinding on non-consenting creditors and prevents judicial enforcement of the

outcome of such proceedings against such creditors. Fitch would expect the Recovery Act to be withdrawn once Chapter 9 becomes available.

Fitch's recent action aligning the rating on obligations of COFINA to the Commonwealth general obligation debt reflects the more uncertain legal environment that exists in Puerto Rico as long as Chapter 9 of the US Code is inapplicable in Puerto Rico. The passage of the Recovery Act substantially increased Fitch's assessment of the risk that the Commonwealth could take steps to the detriment of COFINA bondholders if the Commonwealth considered that a fiscal emergency and its need to provide essential services required legislative action to allow adjustment of the debt of COFINA to provide breathing space for the Commonwealth.

Fitch believes that the extension of Chapter 9 of the US Code to Puerto Rico would reduce the risk of future actions harmful to COFINA debt holders. As a separately constituted, independent instrumentality of the Commonwealth, COFINA would constitute a 'municipality' under the US Code for purposes of Chapter 9. No alternative proceeding under Commonwealth laws as noted above could be effective to bind bondholders, thus removing the incentive and the option for the Commonwealth to adopt special legislation to adjust the debt of COFINA.

As a municipality COFINA could file under Chapter 9 only if authorized by the Commonwealth and only if it could show that it is "insolvent" and had made a good faith effort to negotiate with its creditors or that such negotiation was not practical. General fiscal distress in the Commonwealth would not support a filing by COFINA. That the conditions for filing have been met independently by COFINA would need to be demonstrated in a neutral federal forum in a US Bankruptcy Court, and not before a Commonwealth tribunal.

The consequent reduction of the legal risk and uncertainty surrounding the Commonwealth's ability to adopt and apply a similar restructuring act to COFINA debt in the event of Commonwealth fiscal distress, and the limited ability of COFINA to file under Chapter 9 would necessarily be factored into Fitch's ratings of COFINA debt obligations. In Fitch's view, the extension of Chapter 9 to the Commonwealth could support ratings of COFINA debt at levels above the Commonwealth general obligation debt. Fitch would need to review COFINA ratings at the time Chapter 9 was amended and the rating outcome would depend upon the credit specifics at that time, including the general health of the Puerto Rican economy.

Contact:

Thomas McCormick

Managing Director

+1 212 908-0235

Fitch Ratings, Inc., 33 Whitehall Street, New York, NY

Dan Champeau

+1-212-908-9188

Managing Director

Richard Raphael

+1-212-908-0506

Managing Director

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: [elizabeth.fogerty@fitchratings.com](mailto:elizabeth.fogerty@fitchratings.com).

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