Statement to the Judiciary Committee, Sub-Committee on Regulatory Reform, Commercial and Antitrust Law of the United States House of Representatives in support of H.R. 870, a bill to amend title 11 of the United States Code to treat Puerto Rico as a State for purposes of Chapter 9 of such title relating to the adjustment of debts of municipalities.

Senator Eduardo Bhatia
President
Senate
Commonwealth of Puerto Rico
February 26, 2015

Distinguished Members of the Judiciary Committee:

As President of the Senate of the Commonwealth of Puerto Rico, I fully support H.R. 870, a bill to amend title 11 of the United States Code to treat Puerto Rico as a State for purposes of Chapter 9 of such title relating to the adjustment of debts of municipalities. Both the Chairman Tom Marino and Mr. Pedro Pierluisi from Puerto Puerto Rico should be commended for this effort and the expeditious nature of this hearing. I would like to share three observations:

First, I would like to announce that with bipartisan local support, just this week both the Senate and the House of Representatives of Puerto Rico approved Joint Resolution 41 in support of H.R. 870 and to request the U.S. Congress and the President its expedited approval. The Federal government must pay attention to the current economic situation in Puerto Rico and offer real, effective and timely assistance. To a great extent the Island faces today difficult economic challenges that could have been avoided by sound federal policies in the 1990's and early 2000's. A toxic combination of local and federal policies in the 1990's poisoned the well of Puerto Rico's economy. Without any regard for decades of carefully crafting and building the private economy of the Island around high end manufacturing

assisted by sound federal tax policy, and at the bizarre urging of the then Governor of Puerto Rico, President Clinton and the US Congress repealed Section 936 of the U.S. IRC, over a 10 year phase-out period. The result: many companies left to go to Singapore, India and Ireland, directly causing Puerto Rico's current economic recession lasting already close to 120 months. In the process, the cornerstone of the manufacturing economy of Puerto Rico was shaken with a direct impact to the middle class. Tens of thousands of good paid industrial engineers, chemists, accountants and other professionals have since left the Island. This was the turning point creating a spiraling fall.

Second, I believe that there is one fundamental reason why the Federal Bankruptcy Law should be immediately amended to include Puerto Rico under Chapter 9: as one of the largest issuers of municipal bonds in the United States, with an outstanding debt of over $70 billion, Puerto Rico finds itself today in a quagmire. On the one hand, all the operable Federal laws and regulations governing the issuance of securities by municipalities and state instrumentalities in the United States apply in Puerto Rico. On the other hand, unlike their counterparts in the 50 states, purchasers and issuers of those bonds have no legal mechanism to address the undesirable scenario of insolvency by the issuer of such securities. The result is a legal limbo that critically undermines the ability to effectively manage severely indebted, cash strapped government entities, many of which provide essential public services to U.S. citizens living in Puerto Rico.

In 2014, ratings on Puerto Rico's bonds were lowered to non-investment or speculative grade ("junk bonds") by Standard & Poor's, Moody's and Fitch. Most of the top mutual funds, as well as millions of United States citizens in the $3.7 trillion municipal bond market own Puerto Rico securities, making the Island's financial woes of concern to the Nation as a whole. Although no one desires to have the need to file for bankruptcy, and certainly not a state instrumentality, Congress and the market understand it is a necessary and time-tested tool to reorganize and turn-around insolvent corporations and government entities.

The editors of Bloomberg, in an editorial published yesterday, February 25, 2015, forcefully advocated for the approval of this bill, lamenting that "[b]ecause Puerto Rico isn't a state it can't avail itself of the provisions in federal bankruptcy law to restructure its debt in an orderly fashion." From a legal or policy standpoint, there is absolutely no justification for barring Puerto Rico's instrumentalities from having access to Chapter 9, as the Commonwealth's instrumentalities are akin to municipalities in the 50 states. Tellingly, the legislative history surrounding the

exclusion of Puerto Rico from Chapter 9 contains none. Puerto Rico is not asking for special treatment: it is requesting parity of treatment with state-side municipalities. The uncertainty created by the absence of an insolvency regime for Puerto Rico's public corporations is hurting the possibilities of recovery for Puerto Rico.

Puerto Rico needs a partner in this Congress. The Executive and Legislative Branches in Puerto Rico have taken bold steps towards an austere, fiscally responsible local government since January 2013. The current Administration has sought to address, one by one, the multiple challenges faced by a broken fiscal system. In what amounts to open heart surgery on Commonwealth finances, in 24 months we have cut spending and raised revenues to close a $2.3 billion operating budget deficit, ended budgetary gimmicks such as failing to budget for full debt service payments, pension benefits were reformed to address the severe underfunding of the island's public pension plans; injected more than $1 billion into the Commonwealth's debt ridden Ports Authority through the first FAA-approved airport administration public private partnership in the history of the United States; shored-up the chronically underfunded Highways Authority through a special petroleum products tax and the financially strained Aqueduct and Sewer Authority through a review of its rate structure; embarked in the most comprehensive energy reform since the 1940's in an effort to jumpstart the island's economy. In fact, audited general fund expenses for FY 2012 reflect that Puerto Rico's government spent $11.96 billion. For FY 2013 the General Fund expenses were cut to $8.94 billion. In terms of government employees paid for by the general fund, Puerto Rico had 139,640 in 2008; today there are 89,576 employees, a reduction 34% in the Commonwealth's payroll.

These actions, although unprecedented, have unfortunately been insufficient to address all our fiscal and financial headwinds. Much work still needs to be done, and the possibility of insolvency is real.

Third, under Federal law, to seek protection under Chapter 9, the state has to specifically authorize its municipalities to file. Recent actions taken by the Puerto Rico Legislature support my belief that the state authorization necessary to file under federal law would be granted to those entities in need access to Chapter 9. In June 2014, for example, Puerto Rico enacted the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (2014 PR Laws Act No. 71), also known as the Recovery Act, to develop a local insolvency regime patterned after Chapter 9. Earlier this month, the U.S. Federal District Court of Puerto Rico held the Recovery Act to be unconstitutional due to it being preempted by Section 903 of the U.S.

Bankruptcy Code, a decision that is currently being appealed to the U.S. Courts of Appeal for the First Circuit. This absurd conclusion seems to suggest that states, territories and the Commonwealth of Puerto Rico have no right to develop public policies at the local level in the absence of Congressional action, a view inconsistent with the basic tenets of federalism in the United States and the policies underlying the U.S. Bankruptcy Code. But the Recovery Act's passage was a clear message by the Commonwealth of unwavering support for the adoption of insolvency regimes to address the financial challenges by certain state instrumentalities in Puerto Rico.

Puerto Rico will ultimately need robust economic growth to escape its current fiscal and financial situation. Sound federal tax policy that allows the island to take advantage of the Island's biotech and manufacturing infrastructure to re-energize the local economy should be part of Puerto Rico's road to recovery. More short term, however, Puerto Rican instrumentalities must have access to a forum that allows them to re-negotiate the terms of debt instruments with their creditors for the benefit of all stakeholders, a forum that avoids potential disorderly defaults that threaten the provisions of public services to U.S. citizens living in Puerto Rico. Amending the U.S. Bankruptcy Code to extend application of Chapter 9 to Puerto Rico would provide a proven mechanism to accomplish this important goal.

Thank you.