RESTRUCTURING PUERTO RICO'S GENERAL OBLIGATION DEBT

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INTRODUCTION

A. Current Crisis and Recent Developments

THE COMMONWEALTH OF PUERTO RICO[1] IS CAUGHT IN A GORDIAN KNOT; THE days of twist and shout spending and Mickey Mouse economics are over. Faced with a prolonged recession since 2006, the Commonwealth's[2] credit profile has deteriorated due to a convergence of factors. Recent media coverage has continuously highlighted the problems Puerto Rico faces, specifically noting its high debt burdens. As of May 31, 2014, the Commonwealth had a total of $23.364 billion outstanding aggregate principal amount of bonds and notes payable from Commonwealth general fund appropriations. These appropriations are equivalent to 33% of the Commonwealth's gross national product for 2013, which was $70.740 billion.[3] Debt guaranteed by the Commonwealth's full faith and credit totals approximately $19.018 billion, of which $13.398 billion corresponds to general obligation debt (roughly 18.5% outstanding public sector debt).[4] Various instrumentalities owe an additional $49.238 billion.[5] Together, the $72.602 billion outstanding public sector debt of the Commonwealth accounts for approximately 103% of gross national product;[6] a daunting percentage, to say the least.

Compared with U.S. states and sovereign nations, Puerto Rico is in a very delicate situation. The Island's nominal gross national product for 2012, $69.5 billion, is significantly lower than the U.S. state median, $185 billion.[7] Compared with Latin American sovereign nations, Puerto Rico's gross public sector debt to gross

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1 Throughout this article, Puerto Rico and the Commonwealth will be used interchangeably in reference to the political entity known as the Commonwealth of Puerto Rico.

2 *See generally* QUARTERLY REPORT (COMMONWEALTH OF PUERTO RICO), July 17, 2014, at 3–17 [hereinafter QUARTERLY REPORT], http://www.gdbpr.com/documents/CommonwealthQuarterlyReport71714.pdf (discussing the Commonwealth's challenges).

3 *Id.* at 6.

4 *Id.* at 41.

5 *Id.*

6 *Id.* at 6 (including debt from the Commonwealth general obligation bonds, instrumentalities and municipalities).

7 Lisa Heller, *Weakened Liquidity, Constrained Market Access, and Sluggish Economy Drive Puerto Rico Review for Downgrade*, MOODY'S INVESTOR SERVICES, December 23, 2013, at 7, http://www.gdbpr.com/spa/investors_resources/documents/MoodysReviewforDowngrade12_23_13.pdf.

domestic product ratio is also among the highest.[8] Perennial budget deficits, in addition to unfunded pension liabilities, have strained the Commonwealth's treasury that relies on continuous borrowing to bridge the gap between revenues and expenditures.[9] In addition, the marked decline in population of 2.2% from 2000 to 2010, and 3% from 2010 to 2013, threatens Commonwealth's ability to generate the tax revenues needed to close budget deficits and service outstanding debt.[10] This population drop is serious. The majority of those leaving the Island are working age individuals needed to make the local economy competitive.[11] Moreover, a reversal of the population drop is unlikely. For many years Puerto Rico substantially depended on § 936 of the *Internal Revenue Code* to generate employment.[12] Section 936 was a federal tax code item that allowed firms operating on the Island to report tax-free income while they provided employment to Puerto Rican workers. But the ten year phase-out of § 936 ended in 2006, and available manufacturing jobs on the Island plummeted,[13] wiping out a substantial portion of the Commonwealth's income tax base.

A Puerto Rican economy that spent decades carousing under the influence of artificial stimulation would soon wake up to face its new economic reality. The twentieth century's technicolor dreams of prosperity and abundance were put on hold. The market slowly, but eventually, caught up to Puerto Rico's successful catastrophe. Commentators have painted a dismal picture, notwithstanding aggressive reforms by the last two administrations. An article published in August of 2013, discussed Puerto Rico's predicament in light of Detroit's recent bankruptcy filing.[14] This article ignited a maelstrom of speculation that imploded in February of 2014, when the three preeminent credit rating agencies downgraded the majority of Puerto Rico's outstanding obligations to below 'investment grade' rating or 'junk status'.[15] This downgrade sent jitters throughout the many investors who

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8 Puerto Rico's gross public sector debt as percent of GDP is approximately 71%, a relatively high figure when compared to Latin American countries such as Panamá (35.9%), the Dominican Republic (45.71%) and Argentina (43.2%). *See Government Debt To GDP – By Country,* TRADINGECONOMICS, www.tradingeconomics.com/country-list/government-debt-to-gdp (last visited September 15, 2015).

9 *Puerto Pobre*, THE ECONOMIST (Oct. 26, 2013,), http://www.economist.com/news/finance-and-economics/21588364-heavily-indebted-island-weighs-americas-municipal-bond-market-puerto-po bre; Andrew Bary, *Troubling Winds from Puerto Rico*, BARRON'S (Aug. 26, 2013,), http://online.barrons.com/news/articles/SB50001424052748704719204579022892632785548.

10 QUARTERLY REPORT, *supra* note 2, at 15.

11 *See* Lizette Alvarez, *Economy and Crime Spur New Puerto Rican Exodus*, N.Y. TIMES (Feb. 8, 2014), http://www.nytimes.com/2014/02/09/us/economy-and-crime-spur-new-puerto-rican-exodus.html; *Puerto Pobre*, *supra* note 8; Bary, *supra* note 8; QUARTERLY REPORT, *supra* note 2, at 15.

12 26 U.S.C. § 936 (2005).

13 The estimated drop in available manufacturing jobs was from 160,000 to 75,000. Alvarez, *supra* note 10.

14 *See* Bary, *supra* note 8.

15 Press Release, Fitch Ratings, Fitch Downgrades Puerto Rico GO and Related Debt Ratings to 'BB'; Outlook Negative (February 11, 2014) (on file with author); Press Release, Moody's Investor Service, Rating Action: Moody's downgrades Puerto Rico GO and related bonds to Ba2, notched bonds to

considered Puerto Rico's triple tax-exempt bonds a staple of any municipal bond portfolio.[16] Puerto Rico's borrowing costs dramatically increased. Barring a dramatic turnaround, the prospect of default is alive, urgent, and awaiting engagement.

Neither U.S. states nor sovereign nations are strangers to debt crises and defaults.[17] Given the likelihood of default, the logical step would be to pursue bankruptcy protection. Chapter 9 of the *Bankruptcy Code* is the traditional mechanism municipal issuers would use to resort to bankruptcy protection.[18] However, Chapter 9 is not available to *states*, whose definition includes Puerto Rico,[19] because they are excluded from the definition of *municipalities*.[20] An inability to secure relief under the *Bankruptcy Code* consequently forces Puerto Rico to look elsewhere to address its debt problems.

On June 28, 2014, the Commonwealth Legislature passed the *Puerto Rico Public Corporation Debt Enforcement and Recovery Act* (hereinafter the *Recovery Act*).[21] Generally speaking, the *Recovery Act* represents an attempt to provide an orderly restructuring regime for *certain* debtors, while responding to the imperative that public corporations should be weaned from Commonwealth support.[22] The *Recovery Act* provides qualified debtors two avenues for debt relief, a market led solution or a court-supervised mechanism.[23] Most importantly for the purposes of this Article, the *Recovery Act* specifically excludes the Commonwealth from the debt adjustment mechanisms it provides.[24] Consequently, there is still no orderly debt restructuring mechanism that applies to the roughly $14 billion (as of May 31, 2014) outstanding aggregate principal amount of Commonwealth general obligation bonds.[25]

Ba3 and COFINA bonds to Baa1, Baa2; outlook negative (February 7, 2014) (on file with author); Press Release, Standard and Poor's Ratings Services, Puerto Rico GO Rating Lowered To 'BB+'; Remains On Watch Negative (February. 4, 2014) (on file with author).

16 Bary, *supra* note 8 ("Puerto Rico's 'triple' tax exemption—federal, state, and local—is rare in the municipal market.").

17 *See* B. U. RATCHFORD, AMERICAN STATE DEBTS (1941) (discussing the experience of multiple American states with debt crises); WILLIAM A. SCOTT, THE REPUDIATION OF STATE DEBTS (1893) (discussing the state debt repudiations that occurred throughout the nineteenth century).

18 11 U.S.C. §§ 901-946 (2012).

19 *Id.* at § 101(52) ("The term 'State' includes the District of Columbia and Puerto Rico. . . .").

20 *Id.* at § 101(40) ("'[M]unicipality' means political subdivision or public agency or instrumentality of a State.").

21 Puerto Rico Public Corporation Debt Enforcement and Recovery Act, Act No. 71 of June 28, 2014, http://www.oslpr.org/download/en/2014/A-071-2014.pdf.

22 *See id.* Statement of Motives § A, Current State of Fiscal Emergency.

23 *Id.* at § E, Summary of the Act.

24 *See id.* § 102(50)(a) ("'[P]ublic sector obligor' means a Commonwealth Entity, but excluding: (a) the Commonwealth . . . ."); *id.*, Statement of Purpose, § E ("[F]or the avoidance of doubt, neither the general obligation debt of the Commonwealth, nor any debt guaranteed by the Commonwealth shall be subject to the Act.").

25 QUARTERLY REPORT, *supra* note 2, at 41.

The *Recovery Act* has been legally challenged and sparked an effervescent debate concerning its constitutionality.[26] While this constitutional debate is ongoing, this Article will focus on a different, albeit equally urgent and important one: because the Commonwealth's general obligation debt does not qualify for the debt restructuring mechanism provided by the *Recovery Act* and states remain explicitly ineligible to file for bankruptcy under Chapter 9, the Commonwealth's ability to seek debt relief from its own debts remains an open question.

B. The Road to a Puerto Rican Debt Restructuring

In light of Puerto Rico's precarious fiscal condition and loss of access to traditional sources of financing, relief from general obligation debt burdens may be necessary to ensure the Commonwealth is able to provide essential public services. This Article discusses the legal framework through which Puerto Rico can pursue an out of court bankruptcy solution that would allow it to regain sustainable debt service capacity. Bonds are liquid multi-creditor instruments that inherently create collective action problems; therefore, Puerto Rico's government needs legislation that provides a mechanism that binds every general obligation bondholder after a consent threshold is met and is also tailored to avoid the negative consequences that follow a default. However, such a scheme should be informed by several legal constraints.

The Federal Constitution limits Puerto Rico's room to maneuver. Any mechanism should be evaluated in light of the Contracts Clause for possible impairment of bondholder rights claims and possible invocation of sovereign immunity under the Eleventh Amendment or the common law. Furthermore, the Commonwealth's Constitution imposes constraints through provisions that grant general obligation bondholders strong protection in the event that Puerto Rico faces a default scenario. Because of the need of restructuring debt outside a formal bankruptcy court, Puerto Rico (or any U.S. state, for that matter) would benefit from sovereign debt restructuring models that resorted to debt exchange offers.[27] To this end, this article will discuss the debt restructuring strategies of Argentina, Greece and Uruguay.

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26 *Compare* John Marino, *Legal Challenges Mount Against the Recovery Act*, CARIBBEAN BUSINESS (July 31, 2014), http://www.caribbeanbusinesspr.com/prnt_ed/legal-challenges-mount-against-the-recovery-act-10222.html (discussing legal arguments that the Recovery Act is unconstitutional), *with* David Skeel, *A Puerto Rican Solution for Illinois*, WALL ST. J. (Aug. 3, 2014), http://online.wsj.com/articles/david-skeel-a-puerto-rican-solution-for-illinois-1407099069 ("Puerto Rico's debt-restructuring statute will likely withstand this challenge."). *See also* Franklin California Tax-Free Trust v. Puerto Rico, 805 F.3d 322 (1st Cir. 2015) *cert. granted*, No. 15-233, 2015 WL 5005197 (U.S. Dec. 4, 2015) *and cert. granted sub nom.*, Acosta-Febo v. Franklin California Tax-Free Trust, No. 15-255, 2015 WL 5096465 (U.S. Dec. 4, 2015).

27 *See generally* Adam Feibelman, *American States and Sovereign Debt Restructuring*, *in* WHEN STATES GO BROKE 146 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012) (arguing that states can learn from the experience of sovereign nations).

To summarize, this Article seeks to: (1) discuss and analyze the federal and state legal framework in which a debt restructuring for Commonwealth general obligation bonds would operate, (2) identify part of the contractual frameworks under which a portion of Puerto Rico's general obligation debt is issued, (3) elaborate on past sovereign debt restructurings as possible models to emulate, and (4) draw a general roadmap that the Commonwealth could follow.

C. General Background and Commonwealth Debt Profile

Since 1952, Puerto Rico has been a Commonwealth that shares a common market and currency with the United States.[28] Although the current political status debate is beyond the scope of this writing, the current status has allowed Puerto Rico access to financing that makes its debt obligations uniquely attractive. Pursuant to the *Federal Relations Act*, debt obligations are 'triple tax-exempt' (from federal, state and local taxes).[29] These exemptions opened the floodgates of an unlimited appetite for Puerto Rico's bonds by municipal bonds investors seeking tax-free income.

Puerto Rico historically issues general obligation bonds backed by its faith and credit, or revenue bonds, backed by the revenues of public corporations. A full faith and credit pledge means that these bonds are secured by an issuer's good faith to "use any and all available revenue-producing powers to pay the obligation as it becomes due."[30] In contrast, revenue bonds are issued by instrumentalities pursuant to their enabling statutes and secured by liens on specific revenues or funds.[31] The general obligation bonds discussed in this Article are issued pursuant to Section 2 of Article VI of the Commonwealth's Constitution, which grants the legislature power to authorize debt issuances.[32]

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28 Puerto Rican residents are U.S. citizens, but do not vote in national elections and do not pay most federal taxes.

29 48 U.S.C. § 745 (2012) ("[Puerto Rican bonds] . . . shall be exempt from taxation by the Government of the United States, or by the Government of Puerto Rico or of any political or municipal subdivision thereof, or by any State, Territory, or possession, or by any county, municipality, or other municipal subdivision of any State . . . .").

30 ROBERT S. AMDURSKY *ET AL.*, MUNICIPAL DEBT FINANCE LAW 37 (2d ed. 2013) (*discussing* Flushing Nat'l Bank v. Municipal Assistance Corp., 358 N.E.2d 848 (N.Y. 1976)).

31 *Id.* at 41.

32 P.R. CONST. art. VI, § 2 ("The power of the Commonwealth of Puerto Rico to contract and to authorize the contracting of debts shall be exercised as determined by the Legislative Assembly. . . .").

I. LEGAL FRAMEWORK OF A PUERTO RICAN DEBT RESTRUCTURING

A. The Federal Contracts Clause

The Contracts Clause provides that "[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts . . . ."[33] It also applies to U.S. territories such as Puerto Rico and government entities with the power to enter into, and impair, contractual agreements.[34] Courts assessing whether a party has a claim under the Contracts Clause must apply the following four-step test:

> [F]irst, the court must determine whether the state law would, in fact, impair a contractual relationship; second, if an impairment is found, the court must determine whether the impairment is of constitutional dimension; third, if the state regulation constitutes a substantial impairment, the court must determine whether a significant and legitimate public purpose justifies the regulation; finally, if a significant and legitimate public purpose exists, the court must determine whether the adjustment of the rights and responsibilities of the contracting parties is based upon reasonable conditions and is of a character appropriate to the public purpose justifying the legislation's adoption.[35]

Thus, the Contracts Clause is broadly interpreted to permit a state to impair contracts if a state acts in accordance with the "proper exercise of [its] . . . police powers."[36] In other words, courts have to balance the sanctity of contracts against the state's "authority to safeguard the vital interests of its people."[37] In *U.S. Trust Co. of New York v. New Jersey*, holders of the Port Authority of New York and New Jersey revenue bonds sued New Jersey claiming that a retroactive repeal of a statutory covenant that limited how New York and New Jersey could use certain funds to subsidize commuter railroads amounted to an unconstitutional impairment.[38] The Court did not dwell on whether a contractual relationship between New York, New Jersey and bondholders existed. Instead, the threshold inquiry focused on whether a state has passed a law that effectuated a *substantial* impairment. It quickly glossed over the text of the legislative act authorizing the bond issuance and identified the existence of a contractual obligation.[39]

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33 U.S. CONST. art. I, § 10, cl. 1.

34 Thornberg v. Jorgensen, 60 F.2d 471, 473 (3d Cir. 1932) (holding that the Contract Clause applies to outlying territories); AMDURSKY *ET AL.*, *supra* note 30, at 355-56.

35 Segura v. Frank, 630 So.2d 714, 729 (La. 1994) (summarizing the Contracts Clause test from *Energy Reserves Grp., Inc. v. Kansas Power & Light Co.,* 459 U.S. 400, 410–13 (1983)).

36 Richard M. Hynes, *State Default and Synthetic Bankruptcy*, 87 WASH. L. REV. 657, 680 (2012).

37 *See* Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 434 (1934) (discussing how a state's police power should be *harmonized* with the constitutional prohibition against impairments).

38 *See* U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1 (1977).

39 *Id.* at 17 ("In this case the obligation was itself created by a statute . . . . It is unnecessary, however, to dwell on the criteria for determining whether state legislation gives rise to a contractual obligation.").

Whether a substantial impairment has occurred is predicated on identifying a contractual party's expectations.[40] Courts trying to identify these expectations focus on how parties have specifically agreed to "leave intact a contractual provision . . . and the practical effect . . . [a law may have] on the ability of the issuer to pay the bonds."[41] For example, in *U.S. Trust*, covenants relating to limits on the Port Authority's deficits were not *superfluous* because they protected the general fund used to pay bondholders from depletion.[42] A law unilaterally impairing bond covenants relating to remedies, amendments or payment would therefore easily meet this threshold question. Bondholders can point to these covenants as protecting their right to be repaid and argue that modifying these rights without their consent constitutes a substantial impairment subject to the Contracts Clause.

B. Impairment of Bondholder Rights

Finding a substantial impairment does not mean that a law is automatically unconstitutional. The law can still be a valid exercise of the police power of a state. The Court in *Home Bldg. & Loan Ass'n v. Blaisdell* established a balancing test between the constitutional protection of contracts and the police power of states to protect and promote their citizens' welfare.[43] In the midst of the Great Depression, Minnesota passed a law that impaired mortgage agreements in order to provide credit relief and prevent foreclosures. The court clarified that "[t]he question is not whether the legislative action affects contracts incidentally, or directly or indirectly, but whether the legislation is addressed to a legitimate end and the measures taken are reasonable and appropriate to that end."[44] Decades later, *U.S. Trust* reiterated this test: a state can impair its own financial obligations if it is a *reasonable* and *necessary* exercise of police power that serves an important public purpose.[45]

U.S. Trust warned courts to be wary of how self-interest could lead states to craft improper assessments of reasonableness and necessity.[46] Courts have to conduct their own "inquir[ies] beyond the state legislature's pronounced purpose[]."[47]

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40 *See id.* at 20 n.17.

41 AMDURSKY *ET AL.*, *supra* note 30, at 361.

42 *U.S. Trust Co. of N.Y.*, 431 U.S. at 19 ("As a security provision, the covenant was not superfluous; it limited the Port Authority's deficits and thus protected the general reserve fund from depletion.").

43 *See Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934). *See also* George Triantis, *Bankruptcy For the States and By the States*, *in* WHEN STATES GO BROKE, *supra* note 27, at 249 (discussing *Blaisdell*'s modern test for Contracts Clause claims against states).

44 *Home Bldg. & Loan Ass'n*, 290 U.S. at 438.

45 *U.S. Trust Co. of N.Y.*, 431 U.S. at 25.

46 *See id.* at 25-26 (holding that a complete deference to a state's assessments of reasonableness and necessity is not warranted because they can always find an excuse to need extra money without having to raise taxes).

47 George Triantis, *Bankruptcy For the States and By the States*, *in* WHEN STATES GO BROKE, *supra* note 29, at 250 (discussing *U.S Trust*, 431 U.S. 1 (1977)).

In *U.S. Trust*, the court considered a variety of factors beyond the legislature's stated purposes before it declared that the retroactive repeal of the covenant was neither reasonable nor necessary. After considering whether bondholder's rights were completely or partially destroyed, whether the public was concerned with environmental protection and energy conservation or whether the state needed to divert funds to subsidize commuter railroad expansion, the court was not convinced. The justifications used to repeal the covenant were inadequate.[48] "[L]ess drastic" alternatives were available (i.e., the repeal was not necessary) and the evolving needs of mass transit were foreseeable when the covenant was enacted (i.e., the covenant was not reasonable).[49]

The Supreme Court has rarely addressed claims regarding the impairment of bondholder's contractual rights as a result of acute financial distress. One such case is the oft cited, and much discussed, *Faitoute Iron & Steel Co. v. City of Asbury Park*. In *Faitoute*, the Supreme Court upheld a New Jersey law that created a restructuring mechanism for the debts of one of its own municipalities.[50] The fact that *Faitoute* "validated an extension of maturity and an amendment of payment terms over the objection of minority of creditors" might provide some "solace and frustration" to states seeking to restructure their outstanding public debt.[51] The *Bankruptcy Code* subsequently overruled *Faitoute* when it prohibited a state from passing a law that restructures the debts of its *municipalities* by binding non-consenting creditors.[52] However, since the *Bankruptcy Code* is silent on whether a state can create a bankruptcy mechanism for itself,[53] Justice Frankfurter's reasoning in *Faitoute* may still shed light on how states can adopt a debt-restructuring regime for their *own* debt without offending the Constitution.

The New Jersey statute in *Faitoute* allowed the state to assume control of insolvent municipalities and to impose a debt adjustment plan on non-consenting creditors. State courts would oversee these restructuring efforts. As long as the restructuring scheme received the approval of 85% of creditors and did not reduce any of the outstanding principal amount, a *court* could approve the plan over the objections of a minority of creditors subject to an assessment of the (1) municipality's ability to pay according to the original terms, (2) the adjustment's measurement *vis-à-vis* the municipality's capacity to pay, (3) how the interest of all creditors is served by the adjustment, and (4) how the adjustment is not detrimental

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48 *U.S. Trust Co. of N.Y.,* 431 U.S. at 29.

49 *Id.* at 30-31.

50 Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942).

51 Clayton Gillette, *What States Can Learn from Municipal Insolvency*, *in* WHEN STATES GO BROKE, *supra* note 27, at 111 (arguing that Depression-era cases dealing with contractual impairments provide states with an uncertain legal framework).

52 *Id.* at 111-12 (discussing 11 U.S.C. § 903(1) which states that a "State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition").

53 Hynes, *supra* note 36, at 687.

to other creditors of the municipality.[54] The city initiated an exchange offer pursuant to the state law and was legally challenged by dissenting creditors on two grounds: preemption and impairment of contracts.

Relevant to this analysis is how the Supreme Court disposed of the impairment claim. The Court in *Faitoute* espoused the idea that an impairment implies "refus[ing] to pay an honest debt", not finding alternative ways to pay for it: "[t]he necessity compelled by unexpected financial conditions to modify an original arrangement for discharging a city's debt is implied in every such obligation for the very reason that thereby the obligation is discharged, not impaired."[55] Central to the Court's analysis was how bondholders would have been worse off absent the state's restructuring scheme. The bonds in *Faitoute* were akin to general obligation bonds, the issuer pledged its good faith and credit, and bondholders could recover only by means of a court order that the city raise taxes in order to be able to pay.

Faitoute recognized that taxing has its limits and that "[a] city cannot be taken over and operated for the benefit of its creditors, nor can its creditors take over the taxing power."[56] Even if a court ordered a municipality to levy taxes in order to pay, treasury officials have historically resigned in these situations, instead of levying taxes, leaving bondholders with an "empty right to litigate,"[57] due to the absence of government officials a court could compel to honor outstanding claims. Facing two probable outcomes, one in which bondholders would not get paid under the terms of the old bonds and one in which bondholders would get paid under the terms of the new bonds, the Court saw no reason to strike down New Jersey's restructuring law. Implicit within *Faitoute* is the Court's approval of a good faith effort by the state to restructure the terms of its outstanding obligations in a manner that adequately balanced state and bondholder interests. Thirty years later, *U.S. Trust* reiterated its approval of the restructuring scheme discussed in *Faitoute*.[58] Therefore, outside the contours of Chapter 9 of the *Bankruptcy Code*, *Faitoute* provides structural benchmarks around which a state can design a restructuring regime for its own public debt outside the universe of the federal Bankruptcy Code.[59]

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54 *Faitoute Iron & Steel Co.*, 316 U.S. at 504-05 (summarizing the provisions of N.J. REV. STAT. § 52:27-34—39 (1937)).

55 *Id.* at 511.

56 *Id.* at 509 ("The notion that a city has unlimited taxing power is, of course, an illusion.").

57 AMDURSKY *ET AL.*, *supra* note 30, at 336 (quoting *Faitoute Iron & Steel Co.*, 316 U.S. at 510) (this note discusses in *infra* Part II.D how Eleventh Amendment immunity can further limit the ability of bondholders to recover from states in federal courts).

58 U.S. Trust Co. of New York v. New Jersey, 431 U.S. 1, 27-28 (1977) (discussing *Faitoute Iron & Steel Co.*).

59 Per Professor Hynes claims against state modification of collective bargaining agreements can illustrate how courts can analyze bondholder claims. He identifies six factors the courts are focusing under the *reasonable and necessary* test:

C. Federal and Commonwealth Contract Clause Jurisprudence

Three cases, one from the First Circuit[60] and two from the Puerto Rico Supreme Court, are particularly germane to this discussion.[61] These cases dealt with Contracts Clause claims against laws enacted as part of Puerto Rico's efforts to address the current fiscal crisis.[62] In *United Automobile Workers v. Fortuño*, the First Circuit affirmed a dismissal of a Contracts Clause claim against a law that, among other things, reduced the government payroll by laying-off government employees.[63] In *Trinidad Hernández v. Estado Libre Asociado*, the Supreme Court of Puerto Rico upheld a reform to the Government employees' pension system.[64] In contrast, *Asociación de Maestros v. Sistema de Retiro* struck down the analogous reform to the public school teachers' pension system.[65]

Soon after taking office, former governor Luis Fortuño's administration passed Act No. 7-2009, aptly named Special Act to Declare a State of Fiscal Emergency and to Establish a Comprehensive Fiscal Stabilization Plan to Salvage the Credit of Puerto Rico. Act No. 7-2009 aimed to eliminate a $3.2 billion structural deficit via the reduction of the Government's payroll.[66] In addition to cost-cutting measures, it sought to increase revenues by eliminating tax credits and exemptions, increasing the excise tax on cigarettes and alcohol, and levying new taxes on residential property and financial institutions.[67] Among the complaints lodged against the Government, the plaintiffs argued that Act No. 7-2009 substantially impaired statutory covenants and contractual obligations governing public sector collective bargaining agreements.

> (i) [T]he severity of the government's fiscal emergency, (ii) the foreseeability of the economic problems that created the crisis, (iii) the severity of the impairment of workers' rights, (iv) the availability of alternative courses of actions, (v) whether the impairment acts prospectively or retrospectively, and (vi) whether the financial pain is shared by similarly situated groups.

Hynes, *supra* note 36, at 681 (translation by the author).

61 The U.S. Court of Appeals for the First Circuit has appellate jurisdiction over the District Court for the District of Puerto Rico.

62 In Brau v. ELA, 190 DPR 315 (2014), the Puerto Rico Supreme Court struck down a reform to the pension system of the Commonwealth's judiciary branch. However, because it did so under the separation of powers doctrine, its analysis is not relevant here.

63 United Auto., Aerospace, Agric. Implement Workers of Am. Int'l Union v. Fortuño, 633 F.3d 37 (1st Cir. 2011) [hereinafter *United Workers*].

64 Trinidad Hernández v. ELA, 188 DPR 828 (2013).

65 Asociación de Maestros de PR v. Sistema de Retiro para Maestros de PR, 190 DPR 854 (2014).

66 Special Act to Declare a State of Fiscal Emergency and to Establish a Comprehensive Fiscal Stabilization Plan to Salvage the Credit of Puerto Rico, Act No. 7 of May 9, 2009, 3 LPRA § 8791-8810 (2011).

67 *United Workers*, 633 F.3d at 40.

In *United Workers*, the First Circuit granted Puerto Rico's motion to dismiss because the plaintiffs failed to plead sufficient facts to sustain an inference that Act No. 7-2009 was an unreasonable and unnecessary contractual impairment. The Court recognized that a state's rationale for a law that impairs its own obligations should be afforded deference, specially in regards to economic and social issues.[68] *United Workers* is important, however, because the First Circuit made observations that may help Puerto Rico minimize its exposure to Contracts Clause claims in the future. For example, a plaintiff has the burden of showing that a debt restructuring law passed by the Commonwealth is unreasonable and unnecessary.[69] The First Circuit believed that imposing this burden on plaintiffs helps states be effective when faced with a fiscal crisis that "necessitate[s] decisive and dramatic action."[70] The Commonwealth would otherwise be placed in an "undesirable" situation where it would be discouraged from enacting laws simply because they may "impact[] public contracts."[71] Ergo, the Commonwealth's tools to deal with the fiscal crisis would be restricted.

As a result of the First Circuit's rule, the Commonwealth has tactical advantages to pre-emptively protect a measure from Contracts Clause challenges. Without a doubt, well-articulated justifications, backed with economic figures and independent assessments of debt sustainability projections, can restrict a plaintiff's ability to plead the necessary facts for an impairment claim. The opinion's language further suggests that the Contracts Clause should not by itself be a complete bar to necessary government action. The Commonwealth was given the green light to use its judgment to deal with this fiscal crisis as long as there was no evidence that impairments were unreasonable or unnecessary.

Trinidad Hernández and *Asociación de Maestros* are important not only because they were decided in the backdrop of the current crisis, but also because they illustrate how Puerto Rican courts might not be willing to grant the Government complete deference to adopt measures that impair contracts. The relevance of these two cases further increases in light of the fact that they demonstrate the analysis Commonwealth courts might use for bondholder claims that cannot find their way to federal courts because of Eleventh Amendment sovereign immunity.

In 2013, Puerto Rico enacted a law that increased employee contributions and postponed the retirement date for participants of the Government's pension system.[72] The law's statement of motives justified the pension reform by arguing that not only did it guarantee the survival of the system, but that it was also needed to

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68 *Id.* at 44-45.

69 *Id.* at 43.

70 *Id.*

71 *Id.* The Court also noted that Act No. 7-2009 "spread the burden" of restoring Puerto Rico's fiscal health across different sectors. *Id.* at 47.

72 Statement of Purpose, Employees Retirement System of the Government of the Commonwealth of Puerto Rico Amendment Act, Act No. 3 of April 4, 2013, 2013 LPR 42.

prevent a downgrade of Puerto Rico's credit by the rating agencies.[73] In other words, the law wanted to kill two birds with one stone: provide tangible relief from the pension system's actuarial crisis and ameliorate Puerto Rico's broader credit crunch. Fueled by a highly politicized environment, participants of the pension system sued the Government and claimed that Act No. 3-2013 was unconstitutional under the Federal and Commonwealth Contracts Clauses.[74]

The *Trinidad Hernández* court, in a *per curiam* opinion, recognized that government employees who participate in its retirement plan have a proprietary interest of a contractual nature protected by constitutional guarantees against their impairment.[75] The Court also agreed that Act No. 3-2013 substantially impaired the Government's contractual obligations because it adversely affected any expectation participating employees had regarding their future retirement.[76] But even after qualifying the deference afforded to the state Government with regards to the reform's reasonableness and necessity justifications, the Court held the pension reform constitutional. The Court said that the law's statement of purpose adequately addressed the *reasonableness* and *necessary* prongs. It specifically noted the Government's argument that prior pension reforms failed to fix the problems in the system, and tied these arguments to concerns with exacerbating the crisis by holding otherwise.[77]

Pensioners argued that there were other viable alternatives that could have been employed by the Government. For example, the Government could have adopted revenue-raising measures, such as increasing a variety of taxes, making this reform unnecessary.[78] The Court dismissed these arguments because they failed to present convincing evidence that they were viable or less onerous. In upholding the pension reform, these justices recognized that Puerto Rico is upon a precipice. The pension reform was vital for Puerto Rico to have any chance of reversing its economic decline:

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73 *See id.* at 44.

74 The Commonwealth Constitution's Contracts Clause is analogous to the U.S. Constitution's Contract Clause: "No laws impairing the obligation of contracts shall be enacted." P.R. CONST. art. II, § 7. Puerto Rican courts also use an identical test when evaluating impairment claims under the Commonwealth Constitution. See *Trinidad Hernández v. ELA*, 188 DPR 828 (2013), where the Court stated:

> [I]n assessing state interference with private contracting, you must first determine if there is a contractual relationship and if the modification constitutes a substantial or severe impairment. If there is a substantial or severe impairment, we assess whether the government interference reflects a legitimate interest and if it is rationally related to the objective.

Id. at 834-35 (translation by the author) (citation omitted).

75 *Id.* at 835-36.

76 *Id.* at 837.

77 *See id.* at 837 ("There is certainly an important public interest, therefore, in ensuring the financial solvency of the [pension] system, all participants are benefited and it addresses, in part, the fiscal crisis facing the country thus protecting the welfare of all Puerto Ricans." (translation by the author)).

78 *Id.* at 838.

> [W]e know of the importance that resolving these cases has over the economic situation of the country, particularly, over the national debt that permits access to funds for the development and maintenance of infrastructure and other programs of singular importance to all of us who live in Puerto Rico.[79]

However, it appears that the Puerto Rico Supreme Court that decided *Trinidad Hernández* has become less deferential. In *Asociación de Maestros*, decided a handful of months after *Trinidad Hernández,* the Supreme Court of Puerto Rico struck down as unconstitutional impairments portions of Act No. 160-2013 that reformed the public school teacher's pension system.[80] Relying on the reasonableness of the *U.S. Trust* test, the Court did not to focus on the salient premise of the law. Instead, it zeroed in on its consequences. According to the majority, the Government failed to rebut the evidence that the *structure* of the reform would make the impairment of the pension system unreasonable in light of the reform's purported public interest, to guarantee its solvency.[81] In meeting the *crucial* evidentiary burden under *United Workers*,[82] the plaintiff's empirical evidence convinced the Court that the reform unraveled itself because teachers were now motivated to retire early, retain all their current benefits and avoid the fallout from the law.[83] In other words, an exodus of early retirement would render the impairment counterintuitive because it undercut the statute's purpose. Without the reform in place, the pension system was to become insolvent by 2020. With the reform in place, the pension system could become insolvent by 2018.[84] The Court noted that the Legislature, eager to recess for Christmas, failed to assess how the reform motived teachers to retire early and thus endangered the system's sustainability.[85]

Although not addressed by the majority opinion, the circumstances leading to the pension reform's enactment are relevant. The reform's hurried enactment - only five days transpired between its introduction in the Legislature and the Governor's signing of the bill- was on the heels of the credit rating agencies placing the Commonwealth's credit on a downgrade watch, with special emphasis placed

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79 *Id.* at 831 (translation by the author). The opinion next talks about needing to carefully balance competing rights and interests.

80 *See* Asociación de Maestros de PR v. Sistema de Retiro para Maestros de PR, 190 DPR 854 (2014).

81 *Id.* at 872.

82 *Id.* at 873.

83 *Id.* at 875-76, 903-04.

84 *See id.* at 875-76 (discussing statistical evidence predicting that the pension fund would become insolvent by 2018).

85 *Id.* at 876. The Court noted that:

> On the other hand, it follows from the accelerated legislative process in the rush to legislate before Christmas Eve, that the Legislature did not do a study on the number of teachers who would retire because of the Act No. 160-2013, or how that would affect the solvency of the [teacher's pension system].

Id. (translation by the author).

on this specific pension system's unfunded liabilities.[86] The decision also came out *after* the February 2014 downgrades. Although neither explicitly stated nor implied by the majority opinion, at least one concurring opinion addressed *ex-post* the Commonwealth's failure to avert a downgrade.[87] What could have been a rational 'preemptive' justification for the Court in *Trinidad Hernández* was now a careless attempt to bandage an open wound.

Asociación de Maestros arguably stands for the proposition that a Commonwealth court should carefully scrutinize evidence of (1) how the *effects* of an impairment can render a measure unreasonable and consequently undermine the government interest served by the exercise of its police power, and (2) how the perceived lack of careful consideration of these potential effects could detract from the deference afforded to the Legislature's justifications. Indeed, the Court seems to have implicitly adopted a test very similar to *Faitoute* in which a Contracts Clause review analyzes the practical effects of a given impairment as indicative of its reasonableness.[88] This shift from *Trinidad Hernández*'s substantial deference is important because it means that the Government has less latitude to maneuver, at a time when the fiscal crisis has worsened. After this case, the Commonwealth may need ironclad proof that a restructuring mechanism would "unavoidably"[89] be guaranteed to further the interest of obtaining debt relief in order to ensure that the Government can provide for the health and welfare of Puerto Ricans. In other words, the Commonwealth has to convincingly articulate that a restructuring is both reasonable and necessary and prove that the mechanism would not vitiate itself through self-inflicting wounds.

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86 *See id.* at 860-61 (narrating the sequence of events that lead to Law No. 160-2013's enactment). Prior to the law's enactment, rating agencies warned that failure to reform the teacher's pension could prompt a downgrade. *See* Press Release, Moody's Investor Services, Rating Action: Moody's Places Puerto Rico General Obligation and Related Bonds on Review for Downgrade (Dec. 11, 2013), https://www.moodys.com/research/Moodys-places-Puerto-Rico-general-obligation-and-related-bonds-on--PR_288376; Michael Aneiro, *Fitch Puts Puerto Rico On Watch For Junk Downgrade*, BARRON'S (Nov. 14, 2013), http://blogs.barrons.com/incomeinvesting/2013/11/14/fitch-puts-puerto-rico-on-watch-for-junk-downgrade/.

87 The majority opinion, acknowledged the downgrades without delving on how, or if, it influenced its decision. *Asociación de Maestros de PR*, 190 DPR at 865. But at least one concurring opinion intimated how it might have been a looming consideration. Justice Estrella had scathing remarks about the Commonwealth's desire to placate rating agencies in light of the reform's failure to prevent the "inevitable" downgrade: "In this selfish act, the State ended up being bound by rating agencies with its own rope. It could not avoid the inevitable, much less at the expense of the humblest." *Id.* at 891 (Estrella, J., concurring) (translation by the author).

88 "The question whether the remedy on this contract was impaired materially is affected not only by the precarious character of the plaintiff's right, but by considerations of fact,—of what the remedy amounted to in practice." Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 514 (1942) (citation omitted).

89 We use the Court's own words in *Asociación de Maestros*, 190 DPR at 880 (translation by the author).

D. Sovereign Immunity

i. Eleventh Amendment

The Eleventh Amendment of the United States' Constitution provides that "[t]he Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State."[90] It has been said that "[t]his immunity does not solely protect the State. Rather, since a State only exists through its instrumentalities, Eleventh Amendment immunity also extends to arms or 'alter egos' of the State, which includes the officers acting on behalf of the state."[91]

However, the distinction as to whether a state, or one of its arms, is sued by a bondholder is important. Federal courts cannot entertain cases against a state even if they violate constitutional provisions such as the Contracts Clause.[92] But this protection does not apply when one of its arms is the focus of litigation. A state officer loses sovereign immunity when he or she is acting pursuant to an unconstitutional state law.[93] The presumption is that a state would never pass a law that is unconstitutional, thus the officer is no longer "cloaked with the mantle of the state"[94] needed to invoke the Eleventh Amendment. To be sure, the Contracts Clause would be pointless if there were no way to enforce it. Therefore, a state must take care to ensure that any restructuring mechanism survives constitutional challenges lest it risk being left with no way to fashion an enforceable remedy for relief.

For example, a Commonwealth officer could be presumptively enjoined from "acting" pursuant to an unconstitutional restructuring law,[95] leaving Puerto Rico with no way to reap its benefits. Lifting the cloak of Eleventh Amendment immunity, however, does not mean creditors can automatically compel states to honor their obligations through its officers. Subsequent interpretations have expanded the scope of this protection by granting sovereign immunity when the state is the real, substantial party in interest of an action seeking damages for breach.[96] While

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90 U.S. CONST. amend. XI.

91 Padilla Román v. Hernández Pérez, 381 F.Supp.2d 17, 24 (D.P.R. 2005).

92 Hans v. Louisiana, 134 U.S. 1, 10 (1890).

93 *See, e.g.*, *Ex parte* Young, 209 U.S. 123 (1908).

94 Hynes, *supra* note 36, at 677.

95 *See* Hubbell v. Leonard, 6 F.Supp. 145 (E.D. Ark. 1934) (enjoining an Arkansas state officer from diverting pledged tax proceeds to pay interest and principal on highway revenue bonds).

96 Ford Motor Co. v. Dep't of Treasury of Indiana, 323 U.S. 459, 464 (1945) ("And when the action is in essence one for the recovery of money from the state, the state is the real, substantial party in interest and is entitled to invoke its sovereign immunity from suit even though individual officials are nominal defendants.") (citation omitted).

federal courts can still order injunctions or a writ of *mandamus* against Commonwealth officers in charge of general obligation debt service, even these remedies may be somewhat limited when they involve relief in the form of money payment.

The amendment essentially functions as a broad bar from *monetary recovery* against states in *federal* courts.[97] The Supreme Court has interpreted the amendment to proscribe "federal court[s] from awarding retroactive relief -damages to compensate for past injuries- when those damages will be paid from the state treasury"[98], and even if an injunction requires future compliance by a state officer, the Court drew the line to prohibit an injunction that requires the payment of "previously owed sums."[99] The Supreme Court also rejected a remedy, such as a *mandamus*, that would essentially allow the judiciary to *supervise* the executive power of a state to levy and collect taxes to pay bond proceeds.[100] While a court may certainly strike down a debt restructuring law as unconstitutional, and enjoin state officers from executing it, this result may not fully appease the ultimate interest of bondholders to be repaid. There isn't much a federal court could technically do if a state defaults and refuses to honor its debt obligations.[101]

The Commonwealth general obligation bonds presumably fit comfortably within the legal framework discussed above because they are payable from "any funds available to the Commonwealth."[102] Even if a debt restructuring law is determined to be unconstitutional, federal courts may be uncomfortable compelling a Commonwealth officer to divert appropriations and revenues to pay bondholders because it may be perceived as a federal judiciary takeover of the Commonwealth government. Important for the purposes of this analysis is the notion that

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97 *See* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 208-09 (4th ed. 2011) (discussing how the Eleventh Amendment prevents federal courts from ordering remedies requiring monetary compensation from states).

98 *See id.* at 210 (discussing Edelman v. Jordan, 415 U.S. 651 (1974), and *Ford Motor Co.*, 323 U.S. 459).

99 *Id.*

100 *See* SCOTT, *supra* note 17, at 20-21 (quoting Louisiana *ex rel.* Elliot v. Jumel, 107 U.S. 711, 727-28 (1883)).

101 *See* John J. Gibbons, *The Eleventh Amendment and State Sovereign Immunity: A Reinterpretation*, 83 COLUM. L. REV. 1889, 2004 (1983) ("Yet under current eleventh amendment doctrine, federal courts would not be able to hear suits by bondholders against the states. No amount of arid theorizing on the nature of state sovereignty or the amenability of enforcements against state treasuries could justify such a catastrophic result." (note omitted)); Gillette, *What States Can Learn from Municipal Insolvency*, *in* WHEN STATES GO BROKE, *supra* note 27, at 112 (arguing that states can recreate a *functional* equivalent of bankruptcy because creditors have limited recovery options in federal courts). *See also* SCOTT, *supra* note 17, at 30 ("The general conclusion is that our States are practically free to pay their debts or to repudiate them as they see fit.").

102 *See* The Commonwealth of Puerto Rico, Official Statement: $2,318,190,000 Public Improvement Refunding Bonds (General Obligation Bonds) Series 2012-A, at 12 (Mar. 7, 2012), http://www.bgfpr.com/investors_resources/documents/PRCommonwealth01a-FIN.pdf.

a state can contractually waive sovereign immunity. Courts have no qualms enforcing these waivers.[103] Some courts believe that the waiver needs to be clearly expressed in contractual or statutory language in order to be enforceable.[104] Regardless, the Eleventh Amendment does not prohibit *state* courts from hearing claims against states.[105] As discussed in the next section, states retain some measure of common law sovereign immunity independent from the Eleventh Amendment.

Doubts about Puerto Rico's Eleventh Amendment immunity and whether this immunity has been waived are important. Without immunity, bondholders could effectively turn to federal courts to recover from Puerto Rico in the event of a default or a successful challenge to a debt restructuring law. The Supreme Court has not ruled on whether Puerto Rico has Eleventh Amendment sovereign immunity, but the First Circuit has consistently held that it is "settled" that Puerto Rico enjoys Eleventh Amendment immunity.[106] Whether this reading of the Eleventh Amendment is valid is beyond the scope of this Article.[107] For this Article, I will assume that the Commonwealth enjoys sovereign immunity rights under the Eleventh Amendment.

ii. Common Law

A state's common law sovereign immunity derives from its inherent character as a sovereign entity, not from the Constitution.[108] Outside the fabric of the Eleventh Amendment, states retain the residual power to behave as sovereigns within the spheres they control, i.e., state courts and state laws. In other words, the federal Government may remove a state's common law immunity (because it is a superior sovereign entity) and subject it to claims in federal court under Federal Law, but the state may not be subject to lawsuits in its own state courts under state

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103 *See* Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy"*, 59 UCLA L. REV. 322, 334 (2011) ("it appears settled that a waiver by a state of its Eleventh Amendment immunity would be enforceable").

104 *See* Quern v. Jordan, 440 U.S. 332, 345 (1978) ("[Section] 1983 does not explicitly and by clear language indicate on its face an intent to sweep away the immunity of the States; nor does it have a history which focuses directly on the question of state liability and which shows that Congress considered and firmly decided to abrogate the Eleventh Amendment immunity of the States").

105 Gillette, *What States Can Learn from Municipal Insolvency*, *in* WHEN STATES GO BROKE, *supra* note 27, at 113 (arguing that even if the Eleventh Amendment allows suing states in their own courts, access to state courts is subject to the "vagaries of state law.").

106 *See* Metcalf & Eddy, Inc. v. P.R. Aqueduct & Sewer Auth., 945 F.2d 10, 11 n.1 (1st Cir. 1991) ("It is settled that Puerto Rico is to be treated as a state for Eleventh Amendment purposes."), *rev'd on other grounds*, 506 U.S. 139 (1993), *remanded*, 991 F.2d 935, 939 n.3 (1st Cir. 1993) ("We have consistently treated Puerto Rico as if it were a state for Eleventh Amendment purposes.").

107 *See* Adam D. Chandler, *Puerto Rico's Eleventh Amendment Status Anxiety*, 120 YALE L.J. 2183 (2011) (arguing that the First Circuit might have erred on Puerto Rico's Eleventh Amendment immunity).

108 *See* Alden v. Maine, 527 U.S. 706, 713 (1999) ("the States' immunity from suit is a fundamental aspect of the sovereignty which the States enjoyed before the ratification of the Constitution").

laws without its consent.[109] There are no serious debates surrounding Puerto Rico's inherent common law sovereign immunity, but whether the Commonwealth chose to retain it *vis-à-vis* general obligation bondholders is a different matter.[110]

It appears that the Commonwealth completely waived its common law immunity when it explicitly allowed general obligation bondholders to ask a court to honor a priority scheme that gives bondholders a first lien on Commonwealth revenues. Not only does a facial reading of the wording of section 2 of article VI of the Commonwealth Constitution indicate that bondholders have been provided with a constitutionally protected right to pursue legal action, but Governor Muñoz Marín's speech to the state legislature introducing the 1961 amendment to the Commonwealth Constitution explicitly referred to the purpose of the language as a waiver of immunity: "[the Commonwealth's bondholders] would be entitled to enter legal action against the Secretary of the Treasury without the prior consent of the State in the event of default."[111] The Puerto Rican Senate report restates Governor Muñoz Marín's comments by noting that the legal right of action language was intended to be a waiver of immunity, allowing general obligation bondholders to sue Puerto Rico in case of a default.[112]

iii. Implications of Sovereign Immunity

Sovereign immunity yields insight into how parties may react to a state default or restructuring. A bondholder is likely to sue in federal court for fear that state courts would be partial to a state's circumstances.[113] Even if a state has waived its sovereign immunity rights for the purposes of public debt issuances, bondholders will still face numerous obstacles. A state, unlike a corporation, cannot be easily

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109 *See* Ngiraingas v. Sánchez, 495 U.S. 182, 205 (1990) (Brennan, J., dissenting). *See also* Puerto Rico v. Shell Co., 302 U.S. 253, 262 (1937) ("The effect [of Puerto Rico's organic statutes] was to confer upon the territory many of the attributes of *quasi*-sovereignty possessed by the states—as, for example, immunity from suit without their consent.").

110 The Supreme Court held that Congress intended to grant Puerto Rico a government similar to the states through the early organic acts. Porto Rico v. Rosaly y Castillo, 227 U.S. 270, 273 (1913) ("It is not open to controversy that . . . the government which the organic act established in Porto Rico is of such nature as to come within the general rule exempting a government sovereign in its attributes from being sued without its consent.").

111 Luis Muñoz Marín, Governor of the Commonwealth of Puerto Rico, Address to the Puerto Rico Legislative Assembly on Puerto Rico's Debt Ceiling (Aug. 16, 1961) (on file with author). *See also* discussion *infra* Part II.E(1) regarding section 2 of article VI.

112 *See* INFORME DE COMISIÓN ESPECIAL DESIGNADA PARA ESTUDIAR Y CONSIDERAR LA R. CONC. DEL S. 3 DE FEBRERO DE 1961, at 14 DIARIO DE SESIONES DE LA ASAMBLEA LEGISLATIVA 220-22, Núm. 27 (1961).

113 *See* William B. English, *Understanding the Costs of Sovereign Default: American State Debts in the 1840's*, 86 AM. ECON. REV. 259 (1996) (discussing how these suits involve complicated questions of jurisdiction over states that might dissuade bondholders from pursuing them); *see also* Hynes, *supra* note 36, at 678 n.110 ("One could argue for personal jurisdiction in a state where a debtor-state marketed its bonds. However, this strategy may be difficult if the debt at issue is owed to current or former workers.").

valued or liquidated.[114] The majority of state assets like schools, hospitals and highways are exempt from attachment.[115] In either case, a federal or Commonwealth court adjudicating bondholder claims against a Puerto Rico in the middle of dire fiscal crisis also will have to confront the elephant in the room: the fact that granting bondholders remedies might imply substantial social and economic costs.[116] Perhaps, one might argue, even worsen the fiscal crisis at hand.

The extent of a state's insulation from monetary claims have led some legal scholars to conclude that sovereign immunity allows states to create what amounts to a *functional equivalent* of an out of court bankruptcy process.[117] The fact that "many of the immunity issues implicated by a default or restructuring of a state bonds have not been aggressively tested under current law"[118] might motivate both parties to avoid engaging in unpredictable litigation. As mentioned before, regardless of whether a restructuring regime adopted is constitutional, Puerto Rico can simply refuse to pay bondholders. This decision may lead to a stalemate with damaging economic and reputational consequences. A need to access the capital markets will pressure Puerto Rico to avoid prolonging this situation altogether. Puerto Rico will be motivated to "repay its debt to develop a reputation for honoring its commitments."[119] Thus, notwithstanding its potential insulating strength, sovereign immunity can nonetheless bring both a debt-laden borrower and its aggrieved creditors to the negotiating table. Arkansas, the only state to default during the twentieth century, is a case in point.

Arkansas needed to finance a rapidly expanding highway system that relied on revenue bonds secured by highway revenues to pay for their construction and maintenance.[120] The Great Depression rolled in and revenues decreased to a point where they could no longer provide the state with enough money to comply with debt service requirements.[121] Arkansas soon found itself in a situation reminiscent to that of Greece during its recent debt crisis: "they could not raise taxes to pay off their debts as their economies shrank, not in the sense that they could not reach a political agreement to do so but in the sense that you cannot get blood from a

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114 Schwarcz, *supra* note 103, at 335 ("As a political if not constitutional matter, states cannot be liquidated.").

115 Hynes, *supra* note 36, at 678.

116 *See* Gillette, *What States Can Learn from Municipal Insolvency, in* WHEN STATES GO BROKE, *supra* note 27, at 114 (discussing where a court was concerned with the implications of mandating an issuer to honor its debts).

117 *See id*. at 112; *see* also Schwarcz, *supra* note 103, at 333-35; Hynes, *supra* note 36, at 675- 679.

118 Feibelman, *American States and Sovereign Debt Restructuring*, *in* WHEN STATES GO BROKE, *supra* note 27, at 155 n.41.

119 Hynes, *supra* note 36, at 673.

120 *See* RATCHFORD, *supra* note 17, at 393.

121 *Id.*

stone."[122] Prior to defaulting in 1933, the state began considering ways to enact "refunding"[123] laws to "reduce the heavy burdens of indebtedness."[124] In 1933, the state passed the *Ellis Refunding Act*. The act provided for the refunding of all highway revenue bonds, with a first lien on highway revenues, by issuing new general obligation bonds with lower interest rates and extended maturity schedules.[125] In *Leonard v. Hubbell*, bondholders asked the federal district court to enjoin the state treasurer from diverting originally pledged revenues for alternative uses.[126]

The district court granted the injunction and held that the state treasurer could not assert Eleventh Amendment immunity because he was acting pursuant to an unconstitutional law.[127] The Court did not expand into why the act was unconstitutional, but it seems that it believed that this was an impairment disallowed by the Constitution.[128] Lack of sovereign immunity for the state officer foreclosed Arkansas's ability to unilaterally restructure its debt because state officers could be enjoined from diverting pledged revenues for other uses. The Court, however, could not force Arkansas to pay bondholders. The state and its treasury still enjoyed sovereign immunity. Arkansas, still overwhelmed by unsustainable debt, was forced to recall the legislature and enact a second refunding act.[129] This time around, the state sat down with a committee of bondholders and negotiated a mutually agreeable debt restructuring that was upheld by the Arkansas Supreme Court.[130] As a result, Arkansas's ordeal illustrates how the Eleventh Amendment can lead to the negotiating table where bondholders recognized that a negotiated restructuring was the only way to overcome this impasse. Bondholders "understood that [to keep seeking judicial remedies] . . . would be futile in a context in which Arkansas' economy had essentially collapsed."[131]

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122 *See* Damon A. Silvers, *Obligations Without the Power to Fund Them*, *in* WHEN STATES GO BROKE, *supra* note 27, at 46 (discussing how states like Arkansas were in conditions similar to Greece on the eve of its restructuring).

123 Although not precisely clarified by the literature available to us, it seems that what Arkansas meant by "refunding" was essentially a unilateral debt restructuring involving the issuance of new bonds.

124 Lee Reaves, *Highway Bond Refunding in Arkansas*, 2 ARK. HIST. Q. 316, 318 (1943).

125 *See* RATCHFORD, *supra* note 17, at 396 (summarizing the mechanism of the refunding law).

126 *See* Hubbell v. Leonard, 6 F.Supp. 145, 150 (E.D. Ark. 1934) (discussing the refunding law and bondholders objections to it).

127 *Id.* Arkansas argued that the court should have ignored the constitutional question because sovereign immunity prevented the federal court from entertaining this lawsuit. The court, however, considered the immunity issue *with reference to* the impairment claim.

128 *See* Silvers, *Obligations Without the Power to Fund Them*, *in* WHEN STATES GO BROKE, *supra* note 27, at 43.

129 *See* RATCHFORD, *supra* note 17, at 398.

130 *See* Reaves, *supra* note 124, at 320-21 (discussing how some accused the legislature of "selling the state down the river." But the legislature nevertheless negotiated a settlement because it was the "only recourse at the time."); *see also* RATCHFORD, *supra* note 17, at 398.

131 Silvers, *Obligations Without the Power to Fund Them*, *in* WHEN STATES GO BROKE, *supra* note 27, at 47.

The Commonwealth has acknowledged the importance of the sovereign immunity issue. In its recent Series 2014A general obligation bonds, the Commonwealth agreed to a limited waiver of sovereign immunity and consented to jurisdiction before the state and federal courts of Puerto Rico and New York City, covenants conspicuously absent in prior issuances.[132] Such a clear and express waiver in favor of an arguably more bondholder-friendly New York City federal court might induce the Commonwealth to avoid including this issuance in any binding restructuring mechanism it might adopt in the future.[133] This waiver was not present in the 2012 bond resolution. Sovereign immunity, however, still provides Puerto Rico some strategic advantages. Selectively defaulting on issuances that retained sovereign immunity might buy some time for Puerto Rico to carefully consider options and ensure the continued debt service of those issuances that would otherwise be exposed to lawsuits.[134] Without a doubt, doing so would raise questions of fairness and equity. A preferable alternative would be to use sovereign immunity as implicit leverage over bondholders while negotiating an appropriate debt settlement in the best interests of both.

E. Puerto Rico's Constitution

The desire to attract investors has led some states to adopt constitutional provisions providing bondholders with additional assurances that they will be repaid.[135] Puerto Rico is no exception. The Commonwealth Constitution specifically addresses general obligation debt, beyond having its own Contracts Clause.[136] These provisions have not been tested nor aggressively scrutinized by federal or Commonwealth courts. Nevertheless, the reach of these provisions depends on how "court[s] exercising equitable powers during a time of extreme fiscal need would mandate the payment of funds to bondholders."[137]

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132 Commonwealth of P.R., Bond Resolution $3,500,000,000 General Obligation Bonds of Series 2014-A, § 38 (Mar. 11, 2014) [hereinafter 2014 Bond Resolution], http://www.gdb-pur.com/investors_resources/documents/BondResolutionFinal-Mar112014.pdf ("the Commonwealth waives immunity from the jurisdiction of any of the applicable courts only in a suit brought to compel the Secretary to comply with the provisions of Sections 2 and 8 of Article VI of the Constitution with respect to its obligations on the Bonds").

133 Felix Salmon, *Why Puerto Rico's Bonds are Moving to New York*, REUTERS (Mar. 3, 2014), http://blogs.reuters.com/felix-salmon/2014/03/03/why-puerto-ricos-bonds-are-moving-to-new-york/.

134 Ernest A. Young, *Its Hour Come Round At Last? State Sovereign Immunity and the Great State Debt Crisis of the Early Twenty-First Century*, 35 HARV. J.L. & PUB. POL'Y 593, 620 (2012) ("Immunity serves the public interest by providing public officials with breathing space in which to adjust the government's financial obligations to private individuals while considering competing demands . . . .").

135 AMDURSKY *ET AL.*, *supra* note 30, at 414-16.

136 P.R. CONST. art. II, § 7.

137 AMDURSKY *ET AL.*, *supra* note 30, at 416.

i. Constitutional Debt Priority Provisions

The Commonwealth's constitutional guarantees relating to its general obligation debt have been traditionally perceived to place strong protective barriers around bondholders.[138] Section 8 of article VI (hereinafter section 8) provides that if available revenues are insufficient to meet *appropriations* for that year, interest on the public debt and amortization thereof shall receive first priority in the order of disbursements established by law.[139] In 1980, the Puerto Rico Legislature passed the most recent codification of this priority scheme to apply "when the available funds for a specific fiscal year are not sufficient to cover the appropriations for that year."[140] In the event that section 8 is triggered, section 2 of article VI (hereinafter section 2) stipulates that the Secretary of the Treasury *may be required* by a court acting at the behest of a bondholder to apply any available revenues towards the payment of interest and amortization of the public debt.[141]

Section 2 and section 8 essentially give general obligation bonds the first claim in Commonwealth's revenues if available revenues are insufficient to meet *appropriations* to cover debt service *for that year*, and they provide bondholders a cause of action to compel the Secretary of the Treasury to allocate funds to honor section 8's priority provision. Together, these sections have been labeled the "Constitutional Debt Priority Provisions."[142]

Section 8's grant of first priority to general obligation bonds, whose inclusion was debated during the drafting of the Commonwealth Constitution,[143] had its origins in the *Jones-Shafroth Act of 1917* (hereinafter *Jones Act*).[144] The *Jones Act* represented Congress' attempt to formalize a more permanent relationship between the United States and Puerto Rico (at the time a recently acquired bounty of war

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138 *See, e.g.*, Mary Williams Walsh & Michael Corkery, *Puerto Rico Wants to Incur More Debt to Regain Financial Footing*, DEALBOOK (February 18, 2014), http://dealbook.nytimes.com/2014/02/18/puerto-rico-wants-to-incur-more-debt-to-regain-financial-footing/?_r=0; John Marino *et. al.*, *Prepa is the Problem*, CARIBBEAN BUSINESS (July 10, 2014), http://caribbeanbusinesspr.com/prnt_ed/prepa-is-the-problem-10138.html.

139 P.R. CONST. art. VI, § 8.

140 Management and Budget Office Organic Act, Act No. 147 of June 18, 1980, 23 LPRA § 104(c) (2014).

141 P.R. CONST. art. VI, § 2. (this constitutional provision may be construed as a waiver of sovereign immunity).

142 Legal Opinion from Pietrantoni, Méndez & Álvarez LLC, Underwriter's Counsel to the Puerto Rico Sales Tax Financing Authority (COFINA), Sales Tax Revenue Bonds Senior Series 2011C and Senior Series 2011D (Dec. 13, 2011), http://www.gdb-pur.com/investors_resources/documents/PMACOFINAOpinionreDecember132011.pdf (discussing the treatment of the pledged sales tax under the Commonwealth Constitution).

143 *See* discussion *infra* Part II.E(2).

144 ANTONIO FERNÓS-ISERN, ORIGINAL INTENT IN THE CONSTITUTION OF PUERTO RICO: NOTES AND COMMENTS SUBMITTED TO THE CONGRESS OF THE UNITED STATES 104 (2d ed. 2002) (reprint of NOTES AND COMMENTS ON THE CONSTITUTION OF THE COMMONWEALTH OF PUERTO RICO (1952)) [hereinafter NOTES AND COMMENTS] (discussing the Jones Act, ch. 145, § 34, 39 Stat. 951, 960 (1917)).

from the Spanish-American War of 1898) by, among other things, delegating some limited autonomy to the local legislature and granting American citizenship to Puerto Ricans. Introduced in January 1916, the original version of the *Jones Act* adopted by the U.S. House of Representatives did not include language analogous to a first lien on Puerto Rico's revenues.[145] The first lien language was instead introduced as a subsequent amendment to the Senate version of the *Jones Act*.[146] This amendment was part of a series of provisions that imposed *orderly and proper* directives on the Legislature's day-to-day operations.[147] The amendment survived into the legislation signed by President Woodrow Wilson.

In any event, this debt priority provision appears to have lacked teeth. The *Jones Act* granted the insular Governor appointed by the President[148] discretionary power to overrule it:

> In case the available revenues of P[ue]rto Rico for any fiscal year, including available surplus in the Insular Treasury, are insufficient to meet all the appropriations made by the Legislature of such year, such appropriations shall be paid in the following order, *unless otherwise directed by the Governor* . . . First class—The ordinary expenses of the legislative, executive, and judicial departments of the State government, and interest on any public debt, shall first be paid in full. . . .[149]

Section II.E(2) discusses how the Commonwealth's Constitutional Convention subsequently decided to retain a modified version of this language as part of its attempt to protect the good credit of the Commonwealth's bonds.[150] But it is worth noting that the Commonwealth Constitution completely eschewed gubernatorial discretion and, in doing so, placed in *absolute terms* the priority granted to the payment of interest and amortization of the Commonwealth's general obligation bonds.[151]

In contrast, the current wording of section 2, providing for the full faith and credit pledge and a legal cause of action for bondholders, is not a direct product

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145 *See* H.R. Res. 9533, 64th Cong. (1916) (enacted) (as introduced to the United States H.R. on Jan. 20, 1916).

146 *See* S. Rep. No. 579, at 4-5 (1916) (discussing proposed amendment to Section 34 of the Jones Act incorporating a first lien provision subject to the Governor's discretion).

147 *Id*. at 5 ("The above amendments are recommended as necessary for orderly and proper procedure in the legislature. The paragraphs prescribing the forms to be observed in the various stages of the bill's enactment are those which are generally in effect in the State legislatures of the United States and which have proved their excellence through years of their usage. So also the provisions related to appropriation bills . . . experience has shown their wisdom and necessity.").

148 Jones Act, ch. 145, § 12, 39 Stat. 951, 955 (1917) (providing that the Governor would be appointed by the President), *amended by*, ch. 490, § 1, 61 Stat. 770 (1947) (providing for the democratic election of Puerto Rican governor's beginning in 1948), *repealed by* ch. 446, § 5(2), 64 Stat. 320 (1950) (eff. July 25, 1952).

149 Jones Act, ch. 145, § 34, 39 Stat. 951, 960 (1917) (*emphasis added*).

150 3 JOSÉ TRÍAS MONGE, HISTORIA CONSTITUCIONAL DE PUERTO RICO 225 (1982) [hereinafter 3 TRÍAS MONGE].

151 *Id.*

of the organic acts that existed prior to the Commonwealth Constitution's adoption or even the Commonwealth Constitution itself. This language originated as a result of a renegotiation of the relationship between the federal government and Puerto Rico, *after* the Commonwealth Constitution was adopted. Section 3 of the Puerto Rico *Federal Relations Act*, the federal counterpart to the Commonwealth Constitution, initially imposed a debt ceiling on the Commonwealth's borrowing capacity.[152] This ceiling was set at 10% of the Island's aggregate property tax valuation and purposely mirrored the debt limitations found within the prior organic acts governing Puerto Rico's relationship with the federal government.[153] Faced with the possibility of exhaustion by 1962, and needing to expand the Commonwealth's borrowing capacity in order to continue implementing a rapidly successful economic development plan, Governor Luis Muñoz Marín's administration lobbied Congress to allow Puerto Rico to design its own debt limitations outside the purview of federal law.[154] Congress unanimously adopted a joint resolution in 1961 striking down the federal limitation contingent upon the results of a local referendum whereby Commonwealth voters would approve the amendment to the Constitution to impose their own debt ceiling.[155]

Muñoz Marín subsequently introduced legislation to amend the Constitution on August 16, 1961.[156] In a speech before the Puerto Rican Legislature, Muñoz Marín described as one of the core principles of the amendment the right of bondholders to pursue legal action to compel the Secretary of the Treasury to honor the first lien provision without prior consent of the state.[157] Although floor debates mainly wrangled over the debt-ceiling formula, the attention given to the provision giving bondholders a cause of action -and waiving sovereign immunity- leaves no doubt that it was understood as a guarantee of the Commonwealth's

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152 *See* 48 U.S.C. § 745 (*amended by* Pub. L. No. 87-121, § 1, 75 Stat. 245 (1961)).

153 *See* Jones Act, ch. 145, § 3, 39 Stat. 951, 953 (1917) ("no public indebtedness of P[ue]rto Rico . . . shall be . . . allowed in excess of seven per centum of the aggregate tax valuation of its property"); Foraker Act, ch. 191, § 38, 31 Stat. 86 (1900) ("no public indebtedness of P[ue]rto Rico . . . shall be authorized or allowed in excess of seven per centum of the aggregate tax valuation of its property").

154 *See, e.g.*, H.R.J. Res. 681, 85th Cong. (1958) (introducing legislation to remove the debt limitations from the Jones Act); *A Bill to Provide for the Amendment of the Compact Between the People of Puerto Rico and the United States, and Related Legislation: Hearing on H.R. 9234 Before the Subcomm. on Territorial & Insular Affairs of the H. Comm. Interior & Insular Affairs*, 86th Cong. 59-65 (1959) (statement of Rafael Picó, President, Gov't Dev. Bank of P.R.) (arguing that Puerto Rico would benefit from removing the federally imposed debt limitation in order to continue implementing economic development initiatives known as Operation Bootstrap).

155 *See* Pub. L. No. 87-121, § 1, 75 Stat. 245 (1961).

156 *See* R. Conc. del S. 3 of September 4, 1961, Ses. Extra. at Vol. 14, No. 27, *Diario de Sesiones de la Asamblea Legislativa* 220-22 (Extraordinaria) (1961) (adopting the proposed language that would be voted on by referendum to amend Section 2 of Article VI of the Commonwealth Constitution); Act No. 1 of September 29, 1961, 1961 LPR 401-446 (providing the electoral procedure to carry out the constitutional amendment referendum).

157 *See* Governor Muñoz Marín, Address on Puerto Rico's Debt Ceiling, *supra* note 111.

creditworthiness.[158] The Puerto Rican Senate report discussed the cause of action and waiver of immunity as directly complementing section 8 by strengthening the first lien with an enforcement mechanism.[159] The Senate report also revealed that other state constitutions, particularly New York's, inspired this language.

Section 2 of article VIII and section 16 of article VII of the New York Constitution similarly provide holders of municipal and state debt, respectively, with a constitutional first lien on revenues. In fact, the language of these two sections is almost identical to the one the Commonwealth Constitution employs. Upon a failure to make appropriations to cover bond indebtedness, relevant authorities *may be required* by a court to apply the first revenues towards repayment at the suit of any bondholder.[160] However, the little interpretation these provisions received does not indicate that they had been afforded a single conclusive meaning on which Commonwealth policymakers would have relied.[161]

Prior to the Puerto Rican referendum held in December 1961, New York state courts interpreted these provisions twice and reached divergent conclusions. In one case, a trial court read the New York Constitution's 'may be required' language as granting a discretionary *mandamus* remedy "[w]here requiring a duty to be performed would result in great hardship to the municipality and its inhabitants".[162]

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158 *See generally* Vol. 14, No. 27, *Diario de Sesiones de la Asamblea Legislativa* 221-222 (1961) (indicating that Commonwealth legislators understood the proposed debt guarantees to be credit enhancers).

159 *See* S. Report on R. Conc. del S. 3 (1961), *id.* at 222 ("This disposition gives teeth to what is provided by Section 8 of Article VI that commits the Government's revenues towards the preferential payment of capital and interest of public debt.") (translation by author).

160 *See* N.Y. CONST. art. VIII, § 2. Upon failure to make the necessary appropriations, the New York Constitution states:

> If at any time the respective appropriating authorities shall fail to make such appropriations, a sufficient sum shall be set apart from the first revenues thereafter received and shall be applied to such purposes. The fiscal officer of any county, city, town, village or school district may be required to set apart and apply such revenues as aforesaid at the suit of any holder of obligations issued for any such indebtedness.

Id.; Article VII of New York Constitution adds that:

> If at any time the legislature shall fail to make any such appropriation, the comptroller shall set apart from the first revenues thereafter received, applicable to the general fund of the state, a sum sufficient to pay such interest, installments of principal, or contributions to such sinking fund . . . . The comptroller may be required to set aside and apply such revenues as aforesaid, at the suit of any holder of such bonds.

Id. art. VII, § 16.

161 Ropico, Inc. v. City of New York, 415 F.Supp. 577, 584 (S.D.N.Y. 1976) ("it is very difficult to say definitively that these provisions of the state constitution are not 'susceptible' to a certain reading by the state courts").

162 Van Derzee v. City of Long Beach, 31 N.Y.S.2d 359, 361 (N.Y. Sup. Ct. 1941). The Court also added that:

> For the court to direct that the first revenues received after the docketing of the judgment to the exclusion of all other expenses be used by the fiscal authorities to liquidate or discharge such money judgment could well deprive the municipality for a long period of the funds required by it, to remove and dispose of the refuse, to extinguish fires, to furnish police

The trial court found that given the discretionary nature of a writ of *mandamus* it could "temper its direction" and rule against bondholders when honoring the constitutional first lien provision endangered the municipality's ability to provide essential public services.[163] But a related case reached a different conclusion. The trial court resisted this reading and acknowledged that the purpose of the first lien was to preserve a *sound credit*, the same policy guiding the Commonwealth's amendment. The reviewing appeals court agreed and went further to read the *may be required* language as constituting a mandatory obligation to pay notwithstanding a claim of hardship.[164]

After the 1961 referendum, New York courts had another opportunity to interpret these provisions when the country's largest city was on the verge of collapse.[165] In *Flushing v. Municipal Assistance Corp.*, a case involving New York City's historic fiscal crisis discussed later in this article, New York's highest court interpreted the *may be required* language narrowly. It concluded that the language did not leave the matter of enforcement to a court's discretion when read alongside section 2 of article VIII's requirement, so the municipality had to set apart first revenues to honor debt obligations upon a failure to make sufficient appropriations to cover debt service.[166] A Commonwealth court could reasonably reach the same conclusion given the interaction between section 2 (providing a cause of action when section 8 is triggered) and section 8 (requiring first revenues to be used towards honoring debt obligations). Ironically and most importantly, however, even after it deemed the language of New York's Constitution as prescribing mandatory enforcement, the *Flushing* court did indeed exercise some discretion in explicitly refusing to order New York City to pay and push it further into bankruptcy.

Whether the drafters of Puerto Rico's amendment were aware of the different interpretations of New York's constitutional first lien is unclear, but both constitutions included the language as part of an effort to protect the state's creditworthiness. As a matter of public policy, whether the protection of creditworthiness should override an ability to provide essential services in the midst of a fiscal crisis would push courts to grapple with skittish existential questions. Should the credit-enhancing purpose be given weight in the event of the Commonwealth's credit

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> protection and to carry on other essential activities. . . . The adoption of the amendment was not intended to give to a bondholder-judgment creditor the absolute power to paralyze a municipality . . . .

Id. at 362.

163 *Id.* at 361.

164 Van Derzee v. City of Long Beach, 32 N.Y.S.2d 954, 955 (N.Y. Sup. Ct. 1942) *aff'd*, 39 N.Y.S.2d 401, 403 (N.Y. App. Div. 1943).

165 See discussion *infra* Part II.E(2) for more details on this important development.

166 *See* Flushing Nat'l Bank v. Mun. Assistance Corp. for City of New York, 358 N.E.2d 848, 853 (N.Y. 1976) ("The matter is not left to discretion, for the section goes on to provide that the fiscal officer of the municipality 'may be required to set apart and apply such revenues [] at the suit of any holder of obligations.'").

already collapsing with no improvement in sight? Should a Constitution, a document whose main purpose is to provide for the continuity of government, be allowed to unravel the sovereign it purports to create? In addition, notwithstanding their seemingly ironclad stipulations, the literal text of the constitutional debt priority provisions and their reading in light of other constitutional provisions, as well as the Constitutional Convention's floor discussions about them, might provide the avenue through which a court can be persuaded to uphold the validity of a restructuring mechanism under the Commonwealth Constitution.

Section 8's trigger upon an inability to meet appropriations for a given year might be relevant if the Commonwealth decides to restructure its debt in a preemptive fashion to avoid a default. Without a doubt, lack of revenues to meet budgeted appropriations may lead to a default. However, a preemptive debt restructuring might not necessarily have anything to do with the "appropriations made for that year."[167] Appropriations are a legislative exercise in budgeting, usually once a year, to earmark revenues and assign expenses.[168] A preemptive restructuring can materialize even when available resources destined to meet appropriations for a given year are sufficient. This suggests that the Commonwealth Constitutional Debt Priority Provisions are not triggered as long as the Commonwealth continues to have enough resources to cover debt service, and to be safe, continues to make sufficient appropriations to service its debt obligations. Therefore, a preemptive restructuring *to avoid a default* might be the surest way to obtain debt relief without the interruption of the Commonwealth's ability to continue safeguarding essential public services due to the potential activation of the debt priority scheme.

To be fair, this is an untested argument; courts have never interpreted these constitutional provisions in a restructuring context because Puerto Rico has never defaulted on its general obligation debt. However, *dicta* by Justice Anabelle Rodríguez of the Commonwealth Supreme Court may support this idea. Justice Rodríguez analyzed these provisions in light of a budgetary deadlock between the executive and legislative branch. In *Aponte Hernández v. Acevedo Vilá*,[169] because a struggle regarding the Commonwealth's budget was resolved during the pendency of the case, the majority declared the controversy moot. Justice Rodríguez dissented from the court's decision to declare the controversy moot, believing that the parties' conduct could be repeated.[170] In her dissent, Justice Rodríguez analyzed the operation of section 7 of article VI (hereinafter section 7), requiring the

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167 P.R. CONST. art. VI, § 8.

168 *See id*. art. III, § 17; *id.* art. VI, § 6; *see also* BLACK'S LAW DICTIONARY 117-18 (9th ed. 2009) (defining "appropriation" as "[a] legislative body's act of setting aside a sum of money for a public purpose.").

169 Aponte Hernández v. Acevedo Vilá, 167 DPR 149 (2006).

170 It was, after all, a budget deadlock. *See Aponte Hernández*, 167 DPR at 164-200 (Rodríguez Rodríguez, J., dissenting) (arguing that an exception to the doctrine of mootness applied because the conduct of the parties could be replicated in the future).

adoption of balanced budgets,[171] and section 8 in a chronological manner. She recognized that section 7 prescribed "precaution" *at the outset* of the fiscal year by mandating that "appropriations" cannot exceed *estimated* revenues.[172] In turn, she read section 8 to normally operate *at the end* of the fiscal year in case *available* revenues failed to meet appropriations made per section 7: "[I]t is at [the end of the fiscal year] when it is known whether total available revenues are sufficient to meet approved appropriations."[173]

The critical question, however, is whether the mere existence of a constitutional entitlement complicates the collective action problems the Commonwealth has to surmount. Having a first lien on revenues enshrined in a constitution might incentivize bondholders to strategically resist a restructuring since a subsequent triggering of the first lien provision presumably improves their chances of being repaid in full. To avoid this potential deadlock, the Commonwealth needs to resort to a binding legal mechanism that is capable of being imposed on potential holdouts. To enhance this mechanism's chances of surviving judicial review, the Government might need to rely on other constitutional provisions relating to the exercise of its police powers, invoked as part of its desire to protect public welfare in addition to ensuring that it survives a constitutional impairment challenge.

Ultimately, a court can acknowledge the constitutional priority mandate while upholding remedial measures adopted on equitable grounds. The General Obligation Series 2014-A bond documentation specifically mentioned how judicial discretion might limit bondholder remedies.[174] This language is noticeably absent in the 2012 bond documents; they only provided an almost verbatim iteration of the Constitution's language. This priority structure may simply require that payments "go first to bonds, not that the principal amount of the bonds be untouched."[175] Moreover, the Commonwealth Bill of Rights and debates from the Puerto Rico Constitutional Convention may further influence how a court interprets the provisions that appear to impose an absolute obligation to pay.

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171 P.R. CONST. art. VI, § 7 ("The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal year unless the imposition of taxes sufficient to cover said appropriations is provided by law.").

172 *Aponte Hernández*, 167 DPR at 185.

173 *Id.* (translation by the author). Justice Rodríguez Rodríguez recognized that the legislature could trigger this provision whenever it is in session if it fails to approve revenue-raising measures consonant with budgetary shortfalls that may arise. *Id*. at 186.

174 The Commonwealth of Puerto Rico, Official Statement: $3,500,000,000 General Obligation Bonds of 2014, Series A, at 5-18 (Mar. 11, 2014), http://www.gdbpr.com/investors_resources/documents/CommonwealthPRGO2014SeriesA-FinalOS.PDF.

175 David A. Skeel Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 696 n.81 (2012) (discussing California's Constitution).

ii. Bill of Rights and the Commonwealth Constitutional Convention

Section 19 of the Commonwealth Bill of Rights allows the Legislature to abrogate rights when faced with situations that imperil the welfare of the Commonwealth:

> The foregoing enumeration of rights shall not be construed restrictively nor does it contemplate the exclusion of other rights not specifically mentioned which belong to the people in a democracy. *The power of the Legislative Assembly to enact laws for the protection of the life, health and general welfare of the people shall likewise not be construed restrictively*.[176]

According to Trías Monge, the first sentence of this provision was modeled after the Tenth Amendment of the Federal Constitution and embraced a liberal notion of reserved rights beyond those specifically enumerated.[177] The second sentence, however, sought to serve as the countervailing 'balancer' against the first, giving the Commonwealth's government a likewise unrestricted power to legislate in economic and social affairs in the furtherance of protecting general welfare.[178]

The Puerto Rican Legislature has already successfully invoked this provision to deal with similar legal challenges with respect to the current financial crisis.[179] It stands to reason that the Commonwealth might be able to successfully invoke it again when designing a restructuring mechanism, but this strategy could be met with herculean resistance. The fact that the Constitution provides bondholders with payment guarantees should not be lightly dismissed. The current fiscal crisis is arguably the exact situation the Constitutional Debt Priority Provisions sought to address. The appropriate legal question is thus to what extent the Commonwealth could harmonize them with a need to enact emergency measures to address a fiscal crisis.

The importance of the Commonwealth's credit reputation was imbedded in the minds of the delegates tasked with drafting the Puerto Rican Constitution. The Puerto Rico of the 1950s was a nascent, agrarian economy that needed to borrow in order to achieve economic development. The delegates believed that by constitutionalizing a notion that the payment of general obligation debt was a priority, they would provide "guarantees to maintain [a strong] public credit, so necessary to the economic improvement of the people."[180] An interesting interaction took place regarding possible amendments to what is now section 8. Delegate

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176 P.R. CONST. art. II, § 19 (emphasis added).

177 *See* 3 TRÍAS MONGE, *supra* note 150, at 208-209; FERNÓS-ISERN, *supra* note 144, at 47.

178 *See* 3 TRÍAS MONGE, *supra* note 148, at 209; FERNÓS-ISERN, *supra* note 144, at 47.

179 *See* Special Act Declaring a State of Fiscal Emergency and Establishing a Comprehensive Fiscal Stabilization Plan to Salvage the Credit of Puerto Rico, Act No. 7 of May 9, 2009, 3 LPRA §§ 8791-8810 (2011). *See also* United Auto., Aerospace, Agric. Implement Workers of Am. Int'l Union v. Fortuño, 633 F.3d 37 (1st Cir. 2011) (upholding the validity of Act No. 7-2009 under the federal Contracts Clause).

180 4 DIARIO DE SESIONES DE LA CONVENCIÓN CONSTITUYENTE DE PUERTO RICO 3202-03 (1961), http://www.oslpr.org/PDFS/DiarioConvencionConstituyente.pdf (translation by author).

Gelpí proposed adding a sentence to read: "The Legislative Assembly can decree, in the case of a national or insular emergency, a moratorium in regards to the payment and collection of any type of tax and to prohibit the collection of particular obligations, via judicial recourses, during the onset of said emergency."[181] Delegate Gutiérrez Franqui, speaking for the Drafting and Style Committee, objected to his proposal because it was "clearly and dangerously prejudicial to the [public] credit of the new state [they were] organizing."[182]

Delegate Gelpí responded by reminding the Convention of a devastating hurricane that forced the Island's territorial government to impose a moratorium of all debts and tax collection. Gutiérrez Franqui agreed with Gelpí's premise, but argued that adopting his proposal would be unwise. Moreover, Gutiérrez Franqui believed that Gelpí's proposal referred to an already *inherent* power of the legislature:

> Simply because we understand that this is an inherent power of the Legislative Assembly, I believe that we should not place this red flag on our constitution, the instrument that is examined and analyzed in relation to our public credit. The Legislative Assembly, even if not stated in the Constitution, will always have this faculty.[183]

Other delegates suggested that federal constitutional pre-emption eliminated the need for this amendment because federal bankruptcy law already allowed debtors to secure relief.[184] The delegates ultimately defeated the proposed amendment, convinced that it was unnecessary because the legislature had inherent powers to use its police powers to tackle emergency challenges.[185]

Given the mention of federal bankruptcy law, the reference to the legislature's inherent powers to impose a debt payment moratorium may refer to private obligations, not the public debts of the Commonwealth. However, this debate sheds light on the clear intent by some delegates to clarify the faculties granted to the Commonwealth Legislature to fashion relief to deal with an unforeseen emergency. Put simply, these floor discussions suggest the following: the Commonwealth Constitution was not going to irresponsibly flaunt the Legislature's ability to adopt emergency measures that might deter investors because the Commonwealth Constitution was concerned with protecting Puerto Rico's reputable credit unless exigent conditions required otherwise.

The floor discussions and section 19 of article II can together be read to invite the Legislature to engage in a balancing of priorities during economic emergencies. In passing laws to address the current fiscal crisis, the importance of Puerto Rico's credit, as incarnated by the debt priority guarantees, is to be weighed

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181 *Id.* at 2442.

182 *Id.* at 2443.

183 *Id.* (translation by the author).

184 *Id.* at 2444 (discussing the existence of an *arrangement* option under federal bankruptcy law).

185 *Id.* at 2446 (only six delegates voted in favor of the amendment).

against the legislature's need to enact laws to protect the public. While the Puerto Rico Supreme Court has recently exhibited at least some willingness to defer to the Legislature's articulated justifications for laws addressing the current fiscal crisis, Commonwealth courts have yet to interpret the applicability of a provision as specific as the debt priority provisions in light of Puerto Rico's new economic reality; a reality where the protection of the Commonwealth's credit is not much of an option to the extent there is no credit to rely on and market access has all but dissipated.

Some commentators note that *Trinidad Hernández* shows how this deference can turn out to be a "double-edged sword" for bondholders.[186] The Puerto Rico Supreme Court has already been protective of the island's credit and upheld contractual impairments against *select* constituencies (public sector employees) in order to benefit Puerto Rico as a *whole*. The same court "may be no more protective of Puerto Rico's contractual obligations to mutual funds and other bond investors," an analogous *select* constituency, if an effort to deal with this fiscal crisis involves a debt restructuring adopted to benefit Puerto Rico *and* bondholders as a *whole*.[187] However, *Asociación de Maestros* suggests a modified deference requiring that the government be certain that these measures will be effective.

Nevertheless, the lack of clear judicial precedent interpreting the Constitutional Debt Priority Provisions leaves room for normative questions. Sovereign immunity's protection of state funds may well be outcome determinative.[188] Because the New York Constitution has similar provisions regarding New York City general obligation debt, the experience of New York City's fiscal crisis during the 1970s might illustrate how the Commonwealth's constitutional first lien can shape a potential restructuring.

iii. Full Faith and Credit Pledge

Years of mismanagement and dependence on short-term debt to finance chronic budget deficits left New York City with an operating deficit of $2.2 billion by the mid-1970s.[189] The city saw itself losing market access due to low investor demand and the high interest rates it had to pay.[190] By April of 1975, the city was on the verge of default and the state had to intervene.[191] The state legislature en-

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186 Len Weiser-Varon & Bill Kannel, *Puerto Rico Supreme Court's Deference to Legislature's Determinations: A Double-Edged Sword for Puerto Rico Bondholders?*, PUBLIC FINANCE MATTERS (Nov. 13, 2013), http://www.publicfinancematters.com/2013/11/puerto-rico-supreme-courts-deference-to-legislatures-determinations-a-double-edged-sword-for-puerto-rico-bondholders/.

187 *Id.*

188 *See generally id.*

189 *See* Roger Dunstan, *Overview of New York City's Fiscal Crisis*, 3 CAL. RESEARCH BUREAU NOTE, no. 1, 1995, at 1.

190 *Id.* at 1.

191 *Id.* at 3.

acted two statutes to address the situation, the *New York State Financial Emergency Act for the City of New York* and the *New York State Emergency Moratorium Act for the City of New York* (hereinafter *Moratorium Act*).[192] The *Moratorium Act*, in particular, imposed a 6% interest rate and a three-year moratorium on enforcement actions by the holders of short-term obligations that declined to participate in a debt exchange offer.[193] Had they participated, they would have received new long-term bonds with an equal principal amount.[194] In other words, this backdoor coercion applied to those who declined to exchange short-term notes for long-term notes of the same value, with an adjusted interest payment schedule that would grant the city some respite. The new bonds were issued by the Municipal Assistance Corporation (M.A.C.) pursuant to an exchange offer and were secured by tax revenues, as opposed to the full faith and credit of the city.[195] Bondholders then challenged the *Moratorium Act* as offending New York's constitutional guarantees.

In *Flushing v. Municipal Assistance Corporation*, New York's highest Court sided with the bondholders and struck down the *Moratorium Act*.[196] The *Flushing* Court concluded that a constitutional requirement to issue the city's debt under a pledge of full faith and credit, in addition to ancillary provisions allowing tax limitation to be exceeded in order to garner funds to pay debt obligations, meant that the New York Constitution requires the "debt obligations [of the city to] . . . be paid, even if tax limits must be exceeded."[197] In other words, the state constitution required the city "to pay and *in good faith* use its revenue powers" to secure the money needed to honor its obligations.[198] The Court believed that the city's invocation of the state constitution's emergency clause was misplaced,[199] suggesting that its language bespoke of an intent to provide for government continuity in the

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192 *See* Flushing Nat'l Bank v. Mun. Assistance Corp. for City of New York, 358 N.E.2d 848 (N.Y. 1976).

193 *Id.* at 850.

194 *Id.*

195 *Id.*

196 *Id.* at 848.

197 *Id.* at 852.

198 Triantis, *Bankruptcy For the States and By the States*, *in* WHEN STATES GO BROKE, *supra* note 27, at 247.

199 The New York Constitution emergency clause states:

> Notwithstanding any other provision of this constitution, the legislature, in order to insure continuity of state and local governmental operations in periods of emergency caused by enemy attack or by disasters (natural or otherwise), shall have the power and the immediate duty (1) to provide for prompt and temporary succession to the powers and duties of public offices, of whatever nature and whether filled by election or appointment, the incumbents of which may become unavailable for carrying on the powers and duties of such offices, and (2) to adopt such other measures as may be necessary and proper for insuring the continuity of governmental operations.

N.Y. CONST. art. III, § 25.

face of something similar to nuclear annihilation.[200] The argument that the act was a constitutionally valid exercise of police powers under emergency conditions was nothing more than a "fugitive recourse" to thrust upon short-term bondholders the burden of resolving the city's debt woes.[201] Notwithstanding the fiscal emergency gripping the city, the police powers of the state could not be allowed to so easily subvert a clear constitutional mandate to pay bondholders and use revenue-raising capacity to meet obligations.[202] However, as professor Clayton Gillette posits, the holding in *Flushing* is not necessarily a grant of absolute power to bondholders.[203]

Recognizing that New York City faced "grave fiscal and economic problems,"[204] the Court restrained itself from ordering it to pay. "It would serve neither plaintiff nor the people of the City of New York precipitately to invoke instant judicial remedies which might give the city no choice except to proceed into bankruptcy."[205] Professor Gillette sees this as an articulation of "a clear entitlement in favor of creditors."[206] One could say that the ruling interprets this constitutional provision as a push, of sorts, toward the negotiation table. The clause's sole "office" was to be enforceable precisely at times when it was inconvenient;[207] it was not boilerplate language to be glossed over. This entitlement should be the focus around which debt relief is negotiated. Gillette believes that this might be the functional equivalent to bondholders being asked to absorb the "appropriate level of losses" without causing a country's debt burden to be "nonsustainable".[208] In other words, *Flushing* does not facially prohibit the restructuring of outstanding general obligation bonds. It instead clarifies the extent to which bondholder rights should be preserved through statutory design.[209]

A lingering question remains as to whether a mechanism could be used to cram down on dissenting bondholders. Perhaps this could be achieved with a sufficiently high consent threshold that responds to the composition of the Commonwealth's bondholder pool, coupled with an explicit requirement to negotiate

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200 *See Flushing Nat'l Bank*, 358 N.E.2d at 854, where the Court of Appeals stated that "[i]ts history and language bespeak the frigid years of the Cold War and the threat of nuclear decimation".

201 Triantis, *Bankruptcy For the States and By the States*, *in* WHEN STATES GO BROKE, *supra* note 27, at 248 (quoting *Flushing Nat'l Bank*, 358 N.E.2d at 853).

202 *Flushing Nat'l Bank*, 358 N.E.2d at 855.

203 *See* Clayton P. Gillette, *Bondholders and Financially Stressed Municipalities*, 39 FORDHAM URB. L.J. 639, 648 (2012) ("What the Court of Appeals gave with one hand, however, it withdrew with the other.").

204 *Flushing*, 358 N.E.2d at 855.

205 *Id.*

206 Gillette, *supra* note 203, at 648.

207 *Flushing*, 358 N.E.2d at 855.

208 Gillette, *supra* note 203, at 648.

209 The Court specifically noted that the New York state legislature would soon reconvene and instructed it to seek debt relief under the auspices of its holding. *Flushing*, 358 N.E.2d at 855.

with bondholders and an independent third party demonstrating that tax increases would erode the tax base. This erosion would undermine the security represented by the bondholder's right to tax revenues, which would address *Flushing*'s concept of a qualified remedy. The notion that tax rates have a direct effect on taxpayer behavior is undisputed. It is a basic canon of tax policy that increasing tax rates beyond a certain point can be inefficient to the extent that it leads to diminishing returns due to a shrinking tax base.[210]

A colorable argument could also be made that structural differences between the New York and Puerto Rico constitutional emergency clauses support this approach. The New York Constitution crudely emphasizes the continuity of government while the Commonwealth Constitution emphasizes a rejection of a restrictive interpretation that undermines the ability of the legislature to protect life, health and general welfare.[211] Given New York's seemingly difficult emergency invocation thresholds, the *Flushing* Court easily interpreted a requirement to pledge the city's full faith and credit as a sacrosanct right to be paid notwithstanding the limits of taxation. In contrast, the analogous emergency language of the Commonwealth Constitution might persuade to hold otherwise. Allowing bondholders to enjoy their priority status in the face of an acute crisis would benefit neither the Commonwealth nor its bondholders and the situation might warrant invoking the emergency clause's desire to give the government substantial leeway in implementing economic legislation needed to protect general welfare.[212] To be sure, *Flushing*'s restraint in the face of the city's imminent bankruptcy is telling. Courts can tilt the balance in favor of general obligation bondholders without getting rid of the balance altogether. A strict *Flushing*-like interpretation of the Commonwealth Constitution in the face of impending fiscal paralysis can still lead to a debt restructuring mechanism being adopted, albeit, through a negotiation table with bondholders holding most, but not all, of the cards.

II. CONTRACTUAL FRAMEWORK OF THE COMMONWEALTH'S GENERAL OBLIGATION DEBT

Bondholders and the Commonwealth will not always have congruent interests. The Commonwealth responds to the interest of its constituents in using resources in a way that furthers their welfare, health and safety. Bondholders will desire that these resources be used towards repaying debt.[213] These interests will

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210 *See, e.g.*, Arthur B. Laffer, *The Laffer Curve: Past, Present, and Future,* THE HERITAGE FOUNDATION (June 1, 2004), www.heritage.org/research/reports/2004/06/the-laffer-curve-past-present-and-future (describing the relatively undisputed canon of tax policy of how tax rates impact taxpayer behavior).

211 *Compare* N.Y. CONST. art. III, § 25 ("in order to insure continuity of state and local governmental operations in periods of emergency caused by enemy attack or by disasters (natural or otherwise)"), *with* P.R. CONST. art. II, § 19 ("The power of the Legislative Assembly to enact laws for the protection of the life, health and general welfare of the people shall likewise not be construed restrictively.").

212 *See* discussion on Section 19 of Article II of the Commonwealth Constitution, *supra* Part II.E(2).

213 *See generally* AMDURSKY ET AL., *supra* note 30, § 5.1, at 317.

collide when "the issuer defaults or threatens to default under the bond resolution"[214] and bond terms will be the lynchpin bondholders use to assert their rights. An impairment claim could technically arise from laws that modify or eliminate bond terms.[215] This section is merely a cursory survey of relevant provisions in two of the Commonwealth's recent general obligation issuances.

The Commonwealth Legislature has the power to enact laws that authorize the Secretary of the Treasury to issue general obligation bonds and to pledge the Commonwealth's full faith and credit, subject to approval by the Governor.[216] The Treasury then proceeds to adopt a governing resolution laying out the terms of each issuance. Generally speaking, it appears that these resolutions are almost exactly identical. However, the bond resolutions of the recent issuance of General Obligation Bond Series 2014-A contained sections that were different from the previous 2012 issuance. These changes likely respond to a dramatically different market demanding more bondholder-friendly covenants from the Commonwealth.[217] The 2012 and 2014 resolutions contain pledges of the Commonwealth's full faith and credit.[218] The authorizing resolution for the 2012 general obligation bonds does not define an event of default and limits the language of its pledge to a description of how the Secretary of the Treasury is "authorized and directed" to pay principal and interest when it comes due.[219] But the analogous provision for the Series 2014-A bonds changes the language somewhat. It acknowledges the constitutional provisions that protect the bonds and that "the Secretary [of the Treasury] is authorized and directed to pay the principal of and the interest . . . from any funds in the Treasury . . . available for such purpose *in the fiscal year* for which said payment is required."[220] In light of the attention given to this particular issuance, the drafters seem to clarify the scope of the priority provisions along the same line as was previously discussed in this Article.

Although not labeled an event of default, going instead for "non-payment", the 2014 resolution has a clause that states that bondholders can only initiate actions when obligations are not paid "when due."[221] This same clause also refers to section 2 and section 8 and any equitable remedies under a pledge of full faith and credit as providing the *exclusive* bondholder remedies available after a default. What the 2014 resolution does, that the 2012 bond documents do not is cabin the

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214 *Id*. at 333, § 5.3.

215 *See supra* Part II.A-C.

216 P.R. CONST. art. VI, § 2.

217 Salmon, *supra* note 133.

218 *See* The Commonwealth of P.R., Bond Resolution $2,318,190,000 Public Improvement Refunding Bonds (General Obligation Bonds) Series 2012-A, § 19 (Mar. 7, 2012) [hereinafter 2012 Bond Resolution], http://www.gdb-pur.com/investors_resources/documents/BondResolution2012A-Mar72012.pdf; 2014 Bond Resolution, *supra* note 132, § 19.

219 *Id.* at § 19.

220 2014 Bond Resolution, *supra* note 132, § 19 (emphasis added).

221 *Id.* § 20.

debt priority provisions as subject to judicial discretion. In the event that the Commonwealth does not pay when due, bondholders under the 2014 resolution cannot accelerate outstanding principal and interest.[222]

Neither the 2012 nor the 2014 resolutions include provisions for amending the payment terms of the bonds. Commonwealth law governs the 2012 bonds.[223] In contrast, New York law governs the 2014 general obligation bonds.[224] The noticeable difference between both resolutions is how the 2014 resolution *irrevocably* submits to the jurisdiction of the New York state courts, the federal court in New York City and any state or federal court in Puerto Rico. In addition, it waves sovereign immunity in any applicable court "only in a suit brought to compel the Secretary to comply with the provisions of Sections 2 and 8 of Article VI" with respect to those bonds.[225] Because this waiver is explicit, it is likely to be upheld by a federal court. However, this resolution waived sovereign immunity only for the 2014 bonds and was a discrete attempt to placate a market openly skeptical about the Commonwealth's prospects at the time. The 2012 bonds do not include language remotely similar to the 2014 resolution.

III. SOVEREIGN DEBT RESTRUCTURING AS MODELS TO FOLLOW

A. Implications of a Sovereign Debt Restructuring Solution

Because states have very little debt restructuring experiences to drawn on, the experiences of sovereign governments provide models for states crafting strategies to deal with their own debt crises.[226] Das, Papaioannou & Trebesch define a sovereign debt restructuring as "an exchange of outstanding sovereign debt instruments, such as loans or bonds, for new debt instruments or cash through a legal process."[227] These restructurings are usually achieved through an exchange offer where holders of outstanding debt are invited to tender (or exchange) *original* debt instruments for *new* debt instruments with different terms.[228] Successful exchange offers can provide debt relief by extending bond maturities, reducing par

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222 *Id.* (there is no explicit reference to acceleration rights in the 2012 Bond Resolution).

223 2012 Bond Resolution, *supra* note 218, at B-10.

224 2014 Bond Resolution, *supra* note 132, § 37.

225 *Id.* § 38.

226 *See* Feibelman, *supra* note 27, at 158 (arguing that states can learn from sovereign debt restructurings). *See also* FEDERICO STURZENEGGER & JEROMIN ZETTELMEYER, DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISES 3-29 (2006) (summarizing sovereign debt crises).

227 Udaibir S. Das, Michael G. Papaioannou & Christoph Trebesch, *Sovereign Debt Restructurings 1950-2010: Literature Survey, Data, and Stylized Facts* 7 (IMF, Working Paper No. 12/203, 2012) [hereinafter Das, Papaioannou & Trebesch], http://www.imf.org/external/pubs/ft/wp/2012/wp12203.pdf.

228 RODRIGO OLIVARES-CAMINAL *ET AL.*, DEBT RESTRUCTURING 382 (2011).

value and lowering interest rates in addition to amending non-financial bond terms such as provisions related to the debt instrument's governing law.[229]

For professor Adam Feibelman, the fact that sovereigns have achieved debt relief outside of a formal bankruptcy proceeding should provide solace to states.[230] These sovereigns generally relied on a market-oriented approach to restructuring their debts. This same approach may be what the federal and Commonwealth legal framework prescribes for Puerto Rico. The caveat is that these restructurings can be "messy, costly and contentious affairs . . . predicated on the debtor facing acute financial crisis."[231] A central premise of professor Feibelman's argument is that states and sovereigns are very similar when it comes to structural financial constraints,[232] notwithstanding some differences of immunity and monetary pressure.[233]

Feibelman nevertheless identifies lessons states can extrapolate from sovereigns. Most successful sovereign restructurings are done in the middle of "clear and acute" crisis where debt levels were unsustainable or there was a liquidity crunch.[234] Debt exchanges must be "minimally" appealing to encourage voluntary participation while still "stacking the deck" in their favor by threatening default, amending bond terms, and so forth.[235] However, as previously discussed, the existence of constitutional guarantees may complicate or hinder a state's ability to benefit from this lesson. Sovereign debt restructurings also revolve around the composition of both instruments and creditors, with special care being taken to minimize local banking exposures.[236] In addition, an external "official" sector entity has had a role in these restructurings, suggesting the possibility that the Federal Government might need to get involved if a state seeks this solution.[237] Finally, states should recognize that "unpleasant policy adjustment will be part of any approach to resolving a crisis" since creditors will demand policy changes before voluntarily participating in a restructuring.[238]

A sovereign makes an assessment of the level of debt relief it needs before a restructuring is proposed. This relief is otherwise known as the *haircut* that bondholders need to accept in order to restore debt service sustainability.[239] These are

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229 *Id.*

230 Feibelman, *American States and Sovereign Debt Restructuring*, *in* WHEN STATES GO BROKE, *supra* note 27, at 147.

231 *Id.*

232 *Id.* at 150-52 (for example, borrowing needs, sources of revenue for debt service, causes of fiscal distress, etc.).

233 *Id.* at 153-56.

234 *Id.* at 173.

235 *Id.* at 174.

236 *Id.*

237 *Id.* at 175.

238 *Id.* at 176.

239 Das, Papaioannou & Trebesch, *supra* note 227, at 9 (discussing the concept of *haircuts*).

complex mathematical assessments, often involving calculations of the present value of the new bonds and the face value of the old bonds.[240] Three types of debt restructuring transactions are particularly prominent: debt rescheduling, debt reduction and, to a lesser extent, debt buybacks.[241] For debt exchange offers to be successful there needs to be a minimum threshold of tendering bondholders.[242] In fact, one of the key objectives behind the design of an exchange offer is to achieve the highest participation possible.[243] Nevertheless, even the most emollient debt restructuring transaction can encounter its fair share costs. Some bondholders can holdout while they wait to see if the sovereign improves the terms of the offer or agrees to pay them back in full.[244]

To incentivize bondholder participation, an issuer needs to offer both *carrots* and *sticks*.[245] *Carrots* might include better legal covenants in the new bonds, a 'menu' option of new instruments to choose from and cash payments; *sticks* diminish the value of the old bonds and try to coerce bondholders to tender.[246] One of the *sticks* used in exchange offers are exit consents. Exit consents use existing bond amendment clauses by requiring tendering bondholders to consent to modifying the non-financial terms of the old bonds (i.e., governing law, acceleration, negative pledge clauses) and make them less attractive.[247] But exit consents do not harbor from holdouts that resist, such as so-called 'vulture' funds that specialize in distressed debt, and which have the ability to launch damaging litigations.[248]

Sovereigns can eschew exit consents, and minimize the problems posed by holdout creditors, by using collective action clauses. These clauses allow a majority of bondholders to accept the terms of a debt restructuring that binds every holder, even those who vote against it, after the requisite consent threshold is met. They are a relatively recent phenomenon for sovereign bonds issued under New York law and only Belize has benefitted from using them.[249] Nevertheless, they

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240 *Id.* at 9-11 (describing various computational alternatives for calculating *haircuts*).

241 *Id.* at 7 (debt rescheduling refers to lengthening maturities and lowering interest rates; debt reduction refers to the reduction of the face value; and debt buybacks refers to exchanging outstanding bonds for cash).

242 Das, Papaioannou & Trebesch, *supra* note 227, at 13.

243 *Id.* at 22.

244 *See* Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59, 64-65 (2000).

245 Das, Papaioannou & Trebesch, *supra* note 227, at 21-23.

246 *Id.*

247 *See* Buchheit & Gulati, *supra* note 244 (discussing how exit consents work).

248 For more information on this, see Jonathan Blackman & Rahul Mukhi, *The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos, and Other Legal Fauna*, 73 LAW & CONTEMP. PROBS. 47 (2010) and Samuel E. Goldman, *Mavericks in the Market: The Emerging Problem of Hold-Outs in Sovereign Debt Restructuring*, 5 UCLA J. INT'L L. & FOREIGN AFF. 159 (2000).

249 For summaries of Belize's restructurings, see Tamon Asonuma et al., *Sovereign Debt Restructurings in Belize: Achievements and Challenges Ahead* (IMF, Working Paper No. 14/132, July 2014),

have become a staple term ever since Mexico included a collective action clause in a 2003 debt issuance.[250] In an ideal world, these clauses are included within issuances as a contractual term *ex-ante* to fiscal crises, serving as an insurance policy against the bondholder coordination problem.[251] Unfortunately, these clauses are relatively absent from the municipal debt market in which the Commonwealth's debt trades.

The following subsections will briefly describe the debt restructuring experience of three sovereign debtors who had starkly different approaches to the same problems the Commonwealth currently faces, or may likely face in the future. They also illustrate the good, the bad and the ugly aspects of negotiating debt relief.

B. Argentina

Argentina's debt crisis originated from a confluence of factors and its eventual default involved more than $100 billion owed to private and bilateral lenders.[252] To counteract inflation, Argentina's government adopted a *convertibility plan* that pegged its *peso* to the Dollar.[253] But developments abroad, such as the Brazilian currency devaluation and commodity price collapse, disrupted the balance of payments and increased spending on debt service.[254] A recession in 2001 was the tipping point, and the unrest that followed toppled the government, which led Argentina to declare a "temporary moratorium" on debt service.[255] The country was then forced to devaluate its currency, which caused debt to grow from 47.5% to 166.3% (as of percent of GDP) in 2002.[256] At the time, Argentina had 152 outstanding bonds, under the laws of eight nations, denominated in seven different currencies.[257] Its government was initially reticent to admit that a restructuring was necessary,[258] but things changed as the economic situation worsened. The government argued that bondholders had a moral duty to "*share in the misery*" afflicting

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https://www.imf.org/external/pubs/ft/wp/2014/wp14132.pdf and__Lee C. Buchheit & Elizabeth Karpinski, *Belize's Innovations*, 5 BUTTERWORTHS J. INT'L BANKING & FIN. L. 278 (2007).

250 *See generally* Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1320-23 (2002) (providing an overview of the history of CACs).

251 *See generally* Mark L. J. Wright, *Sovereign Debt Restructuring: Problems and Prospects*, 2 HARV. BUS. L. REV. 153 (2012) (discussing the bondholder coordination problems).

252 J.F. HORNBECK, CONG. RESEARCH SERV., R41029, ARGENTINA'S DEFAULTED SOVEREIGN DEBT: DEALING WITH THE "HOLDOUTS" 2 (2013).

253 *Id.*; STURZENEGGER & ZETTELMEYER, *supra* note 226, at 165.

254 STURZENEGGER & ZETTELMEYER, *supra* note 226, at 168.

255 NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246, 251 (2d Cir. 2012) (discussing Argentina's measures prior to defaulting).

256 DEALING WITH THE HOLDOUTS, *supra* note 248, at 3.

257 HORNBECK, *supra* note 252, at 6.

258 *See* STURZENEGGER & ZETTELMEYER, *supra* note 226, at 173-74 (describing Argentina's initial posture).

the whole country.[259] Argentina thereafter embraced a hard line against creditors with the passing of a *Lock Law* that prohibited the government from reopening offers and suspending debt payment to those who chose not to participate.[260] The law strategically wanted to assure tendering bondholders that subsequent offers would not be made on better terms and thus scare potential holdouts into participating due to this being a one-shot deal.[261]

To entice creditors, tendering bondholders had a menu of new securities to choose from: par bonds with no face value reduction, discount bonds with a high face value reduction and *quasi-par* bonds with characteristics from both.[262] These new instruments achieved substantial *haircuts* (between 71% to 75%) by extending maturities and lowering interest rates and principal.[263] GDP-linked warrants, promising to distribute 5% of the excess of projected GDP growth towards bond buy backs and an additional 5% towards increased coupon payments, were attached to all the new instruments.[264] The new instruments had a number of *novel* features: a most favored creditor clause giving tendering bondholders the right to participate in future exchange offers (i.e., in case better deals were offered), collective action clauses that permitted amending bond terms with the consent of 75% of the aggregate principal amount, and aggregation clauses that allowed 85% of the aggregate principal amounts of all issues to amend the payment terms of all outstanding bonds (as long as two-thirds of each issue consented).[265]

After three years of negotiations, Argentina launched an exchange offer in 2005 for $81.8 billion of its outstanding privately held debt that succeeded in exchanging $62.3 billion.[266] A follow-up exchange offer was conducted in 2010 where Argentina offered similar terms and succeeded in getting another $12.4 billion exchanged.[267] Together, the two exchange offers obtained a 91.3% participation rate.[268] For those who did not participate, Argentina declared that it had no intention to pay them.[269] This repudiation led to the holdout litigation that Argentina continues to be famous for.[270]

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259 HORNBECK, *supra* note 252, at 4.

260 DEALING WITH THE HOLDOUTS, *supra* note 252, at 5.

261 *Id.*

262 HORNBECK, *supra* note 252, at 9-10.

263 *See* FEIBELMAN, *supra* note 27, at 166 (discussing Argentina's exchange offers).

264 These were meant to compensate for accrued interest / principal since the default. *See* HORNBECK, *supra* note 257, at 10; STURZENEGGER & ZETTELMEYER, *supra* note 226, at 190-91.

265 STURZENEGGER & ZETTELMEYER, *supra* note 226, at 191.

266 HORNBECK, *supra* note 257, at 5.

267 *Id.* at 7.

268 *Id.*

269 *See* NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246, 255-56 (2d Cir. 2012)

270 The Second Circuit upheld an interpretation of the *pari passu* clause to mean that Argentina could not subordinate holdout creditors. *Id.*

C. Greece

The Greek debt crisis began in 2009 when the Greek government announced that the country had "understated its debt and deficit figures for years."[271] As it worsened, European governments were concerned with its possible ramifications, especially the possibility of Greece exiting the Eurozone. Greece was subsequently forced to negotiate for a bailout by a German-led European Union that demanded austerity measures as a condition for receiving these loans.[272] Many Greeks resisted, leading to unrest and riots in the country. Talks on restructuring Greek debt gained traction once President Sarkozy of France and Chancellor Merkel of Germany publicly acknowledged the need for an "arrangement" that included private sector participation.[273] This acknowledgement heralded the largest debt restructuring in history.

Greece's restructuring was largely facilitated by the formation of creditor committees. It was relatively easy to organize these committees because Greek debt was held mostly in hands of large financial institutions.[274] Moreover, the majority of Greek debt was governed by Greek law, which made it easier for Greece to restructure within its own legal framework.[275] In February 2012, Greece and the creditor committee announced an agreement on the terms of a restructuring of €195.7 billion of Greece's privately held debt. The Greek Legislature then enacted the *Greek Bondholder Act* permitting Greece to restructure "with the consent of a qualified majority, based on a quorum of votes representing 50 per cent face value and a consent threshold of two-thirds of the face-value taking part in the vote."[276] This amounted to a collective action clause being legislated into the bond covenants that made it harder for dissenting bondholders to block an exchange offer because it would require that they expend more resources to amass enough holdings to effectively block a restructuring.[277] In other words, bondholders would feel greater pressure to subscribe to the offer.

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271 Jeromin Zettelmeyer et al., *The Greek Debt Restructuring: An Autopsy* 4 (Peterson Inst. for Int'l Econ., Working Paper No. 13-8, 2013), http://www.iie.com/publications/wp/wp13-8.pdf.

272 *Id.*

273 *Id.* at 4-5 (discussing Sarkozy and Merkel's statements signaling EU approval of a restructuring involving private creditor haircuts).

274 *Id.* at 9 (explaining how having few retail bondholders made it easier to organize creditor committees).

275 Lee C. Buchheit & G. Mitu Gulati, *How to Restructure Greek Debt* 10-13 (Duke Law Working Papers, Paper No. 47, 2010), http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2959&context=faculty_scholarship.

276 Zettelmeyer et al., *supra* note 271 (discussing the Greek Bondholder Act, 4050/2012). *See also* Press Release, Ministry of Fin. of the Hellenic Rep. of Greece, Feb. 24, 2012, http://www.tovima.gr/files/1/2012/02/24/https___www.bondcompro.com_greeceexchange_pdfs_Greek.Min-Fin-Press_Release_Feb.24-2012.pdf (announcing the exchange offer and mechanics of the statutory collective action clauses).

277 Zettelmeyer et al., *supra* note 271, at 11-12 (describing the *retrofit* collective action clauses legislated into the Greek law bonds).

Greece's offer included cash payments, short-term notes worth 15% of the old debt's value, the issuance of twenty new bonds under English law worth 31.5% of the old value, with annual coupon payments of 2%-4.3%, GDP-linked securities that would pay 1% of the new bond's face value if Greece exceeded IMF growth projections, and compensation for accrued interest from the old bonds guaranteed by an external European entity.[278] Greece never defaulted and continued debt service throughout this process.[279] However, Greece employed some coercive measures to incentivize participation. Because Greece legislated *retrofit* collective action clauses into its outstanding Greek-law bonds, Greece used *consent solicitations* (similar to exit consents). In order to receive the new bonds, bondholders had to approve an amendment (proposed through the consent solicitations) that permitted the government to redeem the old bonds for the new instruments.[280] Once the consent threshold of the collective action clauses was met, the amendment would become binding on all bondholders. Greek authorities also set a 90% minimum participation threshold for the exchange offer to proceed.[281]

The restructuring was arguably a success. Greece restructured 96.9% of its outstanding obligations, a total €199.2 billion of the outstanding face value: "[h]ence, the face value of Greece's debt declined by about €107 billion as a result of the exchange, or 52 percent of the eligible debt."[282] In contrast to Argentina, Greece never repudiated its debt and continued servicing holdout claims after the exchange.[283] Greece amply succeeded in preemptively gaming the holdout problem as much as possible by using its own legal framework to its advantage (enacting a law to allow amendments), offering a bundle of carrots (such as cash *sweeteners*, English-law bonds, and negative pledges) that addressed fears that Greece might still collapse, even after an exchange, and using an external co-financing entity to provide additional security.[284] Nevertheless, Greek debt woes persist to this day as the country continues to feel pressure from debt service obligations owed to its official sector creditors, the infamous "troika" of lenders, whose obligations were not part of the restructuring transaction discussed above that focused on Greece's private sector creditors.

D. Uruguay

Unlike most, Uruguay's exchange offer was "fast and smooth . . . [and] permitted its re-access to the markets within a month and without applying a penalty

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278 *Id.* at 9-11 (summarizing the *consideration* issued pursuant to the terms of the Greek debt exchange).

279 *Id.* at 10.

280 *Id.* at 11 (describing how Greece used consent solicitations).

281 *Id.* at 12.

282 *Id.* at 13.

283 *Id.* at 14.

284 *Id.* at 26-27.

interest rate."[285] Due to contagion from Argentina's financial crisis, Uruguay witnessed a run against its bank deposits because of fear that Uruguay would follow Argentina and impose capital controls.[286] Bank deposits, including those of the Uruguayan Central Bank, began to deplete and Uruguay's debt was downgraded to junk rating due to liquidity concerns.[287] As a result, the government decided to devalue the Uruguayan currency; a decision that caused the debt to GDP ratio to skyrocket from 54% in 2001 to 92% in 2002.[288] Authorities knew that significant debt service was coming due in the short-term and decided to act preemptively in order to avoid economic collapse.[289]

Uruguay's total external debt stood at $5.3 billion and included nineteen bonds issued under English and New York law, denominated in various currencies, and held by both retail and domestic investors.[290] Uruguayan authorities determined that they needed debt service relief through debt re-profiling, not reduction, and delineated two strategic objectives. They wanted to *minimize reputational impact* in order to return to investment grade quickly and they recognized that insufficient participation might worsen the banking sector's health.[291] As a result, Uruguay engaged creditors in *extensive* consultations and publicly reiterated that any exchange offer would reflect these negotiations.[292] Uruguay then "portrayed its offer as a pre-emptive step to deal with a serious liquidity problem before the situation would deteriorate into a full-fledged default."[293] The exchange achieved a 93% participation rate.[294]

Uruguay's success is notable because it was achieved through a measure that was clearly marketed as a preemptive attempt to avert a default.[295] The two new instruments offered by Uruguay reflected its re-profiling goal: a bond with the same interest rate but a 5-year maturity extension and benchmark bonds with liquidity enhancing features attractive to particular investors (i.e., floating rate bonds).[296] Uruguay used exit consents only as a *defensive* measure to prevent holdout litigation and not destroy the value of the old bonds by proposing to remove

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285 OLIVARES-CAMINAL *ET AL.*, *supra* note 228, at 454.

286 *See* Nicolás Piaggio, *Lessons for Europe: The Preemptive Restructuring of Uruguay*, *in* SOVEREIGN DEBT AND DEBT RESTRUCTURING 201, 201 (Eugenio Andrea Bruno ed., 2013).

287 *See* FEIBELMAN, *supra* note 27, at 166.

288 Piaggio, *in* SOVEREIGN DEBT AND DEBT RESTRUCTURING, *supra* note 286, at 201-202.

289 STURZENEGGER & ZETTELMEYER, *supra* note 226, at 216.

290 OLIVARES-CAMINAL *ET AL.*, *supra* note 228, at 454.

291 STURZENEGGER & ZETTELMEYER, *supra* note 226, at 216.

292 OLIVARES-CAMINAL *ET AL.*, *supra* note 228, at 454.

293 *Id.* (*citing* Lee C. Buchheit & Jeremiah Pam, *Uruguay's Innovations*, 19 J. INT'L BANKING L. & REG. 28 (2004)).

294 *Id.*

295 *See id.* (citing Buchheit & Pam, *supra* note 293).

296 OLIVARES-CAMINAL *ET AL.*, *supra* note 228, at 455; STURZENEGGER & ZETTELMEYER, *supra* note 226, at 217-18.

cross-default clauses, de-list the bonds and amend the waiver of immunity (old holders could not attach payments of the new bonds).[297] These consents invited a *consensual* agreement through a *check-the-box* strategy for each amendment proposed.[298] The new bonds incorporated collective action clauses (75% of the aggregate principal amount needed to amend payment terms), aggregation clauses (85% of the aggregate principal amount of every series combined and roughly two-thirds of each individual issuance), and a promise to not use exit consents to offer future securities on better terms than the ones bondholders were then receiving, among other covenants.[299]

Although Uruguay's exchange offer achieved relatively small haircuts (between 5% to 20%), it is important to remember that Uruguay was seeking short-term relief, not substantial debt reduction.[300] Fortunately, its gamble paid off. Once the dust settled, the country's economy started to grow, rapidly removing the need for future restructurings.[301]

IV. ROADMAP TO A PUERTO RICAN DEBT RESTRUCTURING

A. Preliminary Considerations: To Default or not to Default?

A decision by the Commonwealth to restructure its outstanding general obligation debt has to be made carefully, with two key considerations: the potential socioeconomic implications of a restructuring and the legal and contractual framework under which it would operate. As a threshold matter, the Commonwealth has to determine if it should suspend debt service or if it should enact a law that permits a preemptive debt restructuring. In other words, the Commonwealth has two options: it can default or it can preemptively restructure its debt to avoid a default. A preemptive restructuring is beneficial only to the extent that bondholders do not successfully challenge the mechanism as an unlawful impairment. A post-default restructuring has short-term and long-term costs that it has to modulate. In any case, the reputational damage the Commonwealth may incur stemming solely from a decision to restructure will intuitively have some effects on its ability to tap the bond markets for future financing.

As a political matter, Commonwealth policymakers will also need to balance costs involved in a restructuring with the uncertainty of implementing further fiscal reforms. Prolonged debt crises may affect trade and manufacturing. The *size* of haircuts, for instance, influences short-term borrowing costs and the length of

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297 OLIVARES-CAMINAL *ET AL.*, *supra* note 228, at 456; STURZENEGGER & ZETTELMEYER, *supra* note 226, at 218.

298 OLIVARES-CAMINAL *ET AL.*, *supra* note 228, at 455.

299 *See id.* at 456-57 (describing the covenants and strategies used by Uruguay).

300 STURZENEGGER & ZETTELMEYER, *supra* note 226, at 219.

301 *Id.* at 225-26; OLIVARES-CAMINAL *ET AL.*, *supra* note 228, at 467.

time the issuer will be excluded from the capital markets. Haircuts might themselves threaten the local financial sector, especially if local banks are exposed to considerable government debt and are therefore vulnerable to haircuts to inflict balance sheet trauma. A protracted battle with creditors might stymie investment and dissipate investor confidence while a restructuring transaction imposes its share of costs derived from the services of financial and legal advisors.[302]

Nevertheless, some argue that a restructuring's ultimate impact on a debtor (i.e., market exclusion or increased borrowing costs) is a delicate matter that depends on its particular circumstances. Focusing solely on the potential negative consequences of a restructuring would irresponsibly simplify its ramifications, ignore its potential benefits and, in any case, evidence suggests they should not be the reason for delay.[303] In other words, once restructuring becomes a viable alternative for the short, medium and long-term health of a debtor government, policymakers should avoid being distracted by swaggering moralizing arguments that focus solely on the integrity of the balance sheet and not the long-term benefit of every stakeholder. The overall effects of a restructuring cannot be simplified to mere numerical formulas. Many of the benefits a restructuring could provide can easily elude the four corners of a term sheet. For example, a restructuring may grant a government greater flexibility to use tax policy towards more economically competitive goals, such as lowering income tax rates in order to stem the population exodus and incentivize working-age Puerto Ricans to stay (or return). This would also, potentially, increase future tax revenue collections.

A default would automatically trigger rights and remedies provided in the terms of outstanding bonds. For example, even if the majority of the Commonwealth's general obligation debt enjoys sovereign immunity in federal courts, a default triggers the untested Constitutional Debt Priority Provisions and full faith and credit pledge. It is possible that a court might refuse to order the Commonwealth to engage in cost cutting exercises, levy taxes or channel available resources in a way that further burdens the Puerto Rican population. However, the uncertain rights of both parties in a default scenario, in addition to the potential reputational damages, make it an unattractive option. The Commonwealth may be able to selectively default on those issuances that have sovereign immunity and continue debt service on those that do not. While this strategy buys time, the reputational damage would still cripple its ability to borrow. In the end, as the Arkansas experience illustrates, sovereign immunity has its practical limits and the

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302 Das, Papaioannou & Trebesch, *supra* note 227, at 66 fig. 5 (summarizing the normative costs of restructurings and defaults).

303 Odette Lienau, *The Longer-Term Consequences of Sovereign Debt Restructuring*, *in* SOVEREIGN DEBT MANAGEMENT 99-100 (Rosa M. Lastra & Lee Buchheit eds., 2014) [hereinafter SOVEREIGN DEBT MANAGEMENT] ("[E]mphasizing that restructuring has drastic negative effects is overly simplistic in light of the evidence. The empirical nature agrees on the existence of some costs, but hardly speaks with a single voice on whether those costs are especially severe or long lasting . . . framing the ramifications of debt restructuring too bluntly may well lead to greater avoidance and delay that is warranted.").

eventual need to return to the bond markets will push the government to negotiate with bondholders.[304] The posture adopted by policymakers in justifying the default will be an important factor in determining how bondholders accept any haircuts. To the extent that bondholders consent to the terms of a restructuring, it will be less likely that they will challenge such a remedy as an unconstitutional impairment. Argentina, a country that defaulted prior to restructuring and adopted a hard line negotiating with bondholders, has been subject to messy litigation as a result of such a course of action.[305]

Experience suggests that pre-emptive restructurings avoid many of the crippling effects of defaulting. Unlike Argentina, countries like Uruguay and Greece trod down this path. Based on the participation rate during their exchange offers alone, one can argue that preemptive debt restructuring has its merits.[306] By avoiding the economic, and maybe even the emotional shock of a default, bondholders might be better able to internalize the costs of potential losses and become gradually receptive to the issuer's precarious fiscal condition. Continuing debt service while negotiating debt relief might also be perceived as a sign of an issuer's good faith and willingness to honor its contractual commitments. However, the ultimate barometer for a successful debt restructuring is the tangible debt relief that a sovereign obtains. On this score, Argentina obtained the largest debt relief from its restructured bonds.[307] On the other hand, Greece and Uruguay, while securing considerably less debt relief than Argentina, were able to access the markets not long after their debt crises.[308]

A preemptive restructuring, adequately positioned to prevent a default, can potentially survive the scrutiny of courts. This type of impairment requires that

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304 *See supra* Part II.D(3).

305 The ongoing Argentina bondholder's litigation is still wrought with debate about the legal and moral merits of the holdout claims. *Compare* Doug Bandow, *Supreme Court Moves Us Closer To Holding Deadbeat Argentina Accountable*, FORBES (Oct. 21, 2013), http://www.forbes.com/sites/dougbandow/2013/10/21/supreme-court-moves-us-closer-to-holding-deadbeat-argentina-accountable/ ("The Argentine people essentially had a wild party and woke up with a hangover. Naturally, their first reaction was to stiff the fools who had extended credit."), *with* Cecilia Nahón, *The Real Facts On Argentina's Sovereign Debt Restructuring: A Rebuttal*, FORBES (Dec. 19, 2013), http://www.forbes.com/sites/realspin/2013/12/19/the-real-facts-on-argentinas-sovereign-debt-restructuring-a-rebuttal/ ("Pretending that 'the Argentine people essentially had a wild party and woke up with a hangover' reflects utmost disrespect for the suffering of the Argentine people as well as an astounding lack of knowledge about what really occurred in my country.").

306 Argentina's participation rate was 91.3%, Greece's was 96.9%, and Uruguay's was 93%. *See* HORNBECK, *supra* note 257, at 7 (discussing Argentina); Zettelmeyer *et al.*, *supra* note 271, at 13 (discussing Greece); OLIVARES-CAMINAL *ET AL.*, *supra* note 228, at 454 (discussing Uruguay).

307 Argentina achieved haircuts between 71% to 75%, Greece achieved 52%, and Uruguay achieved between 5% to 20%. *See* FEIBELMAN, *supra* note 27, at 166 (discussing Argentina); Zettelmeyer *et al.*, *supra* note 271, at 13 (discussing Greece); STURZENEGGER & ZETTELMEYER, *supra* note 226, at 219 (discussing Uruguay).

308 Uruguay consistently tapped the markets and Greece announced its first post-restructuring debut issuance on April 2014. *See Greece Returns to Debt Markets with Five-year Bond*, BBC (Apr. 9, 2014), http://www.bbc.com/news/business-26955983.

the legislature convincingly articulate the dangers posed by an impending default, how a challenged impairment will likely avert a default, and how all alternative means to avoid a default have been exhausted. To strengthen these justifications, the Commonwealth should consider having reputable independent third parties analyze its finances and proceed with a preemptive restructuring once their conclusions confirm that the Commonwealth will be unable to service its general obligation debt in the near future. Perhaps the fundamental benefit of a preemptive restructuring may be that it avoids triggering the legally untested, and potentially problematic, Constitutional Debt Priority Provisions.[309] A conflict between a constitutional first lien guarantee and an inability to honor them would have courts grapple with difficult considerations whose outcome in litigation is uncertain.[310] A court might determine that ordering the Commonwealth to pay, or to raise sufficient revenues, would be counterintuitive to the bondholder interests because such remedies would further erode the Commonwealth's ability to honor its debts.[311]

Notwithstanding the dichotomy between choosing to default and pursuing a preemptive restructuring, a debtor may be forced to default by circumstances beyond its control. Say, a natural disaster or an unexpected loss of market access. These involuntary defaults may have powerful implications for justifying a post-default debt restructuring remedy. Their occurrence might be a strong element guiding a favorable *U.S. Trust* assessment of a restructuring remedy because the public interest served by a post-involuntary default debt restructuring can be broad.[312] In justifying this impairment, the Commonwealth would have to articulate how no other measure is reasonable to allow it to resume debt service and how it is necessary to attain debt relief in order to restore the Commonwealth's ability to provide essential services, bolster debt servicing capacity, and honor its *honest* debts.[313] Regardless, the ultimate danger of risking for an involuntary default to happen lies in triggering the Constitutional Debt Priority Provisions: an involuntary default may arise from budgetary pressures due to revenues not being sufficient to meet appropriations for a given year.[314] In other words, while the

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309 *Id.*

310 *See* Flushing Nat'l Bank v. Mun. Assistance Corp. for City of New York, 358 N.E.2d 848 (N.Y. 1976). *See also* Skeel, *supra* note 172, at 697 (arguing that state constitutional provisions guaranteeing pension payments might pose difficult questions for courts when a state has no ability to pay).

311 *See Flushing*, 358 N.E.2d 848. *See generally supra* note 307, Part II (discussing how courts are concerned with the practical effects of ordering an issuer to pay, which may imply adverse consequences to the issuer, bondholders and constituents).

312 An inevitable default may help justify a restructuring that would restore a sustainable debt service capacity, allow the government to provide essential public services, etc. Some argue that there is empirical evidence that "excusable" defaults engender fewer costs. *See* Lienau, *in* SOVEREIGN DEBT MANAGEMENT, *supra* note 303, at 94 ("There is some empirical support for this idea, in particular in finding that countries that return to the capital markets faster than the expected baseline if a default is precipitated by unexpected and uncontrollable factors such as natural disasters.").

313 *See supra* Part II.A-C.

314 *See supra* Part II.E.

Commonwealth may still be justified to pursue a restructuring after being forced to default, Puerto Rico may face a tougher legal battle than it would under a preemptive restructuring.

Overall, case law suggests that the broader a justification, the more likely a court defers to a state's judgment. Debt relief cannot respond to a preference by the legislature to promote citizens' welfare; debt relief has to be a necessary condition for the Commonwealth to be able to protect citizen's welfare at all.[315] Because contract rights are property rights under the Fourteenth Amendment, the consideration bondholders receive under a restructuring will also have to amount to *fair compensation* for the property right taken away.[316] However, courts might be unwilling to go deep into such an analysis. Securities such as bonds are subject to fluctuating market prices and factors unrelated to the impairment may have influenced the price.[317] In light of the difficulties of loss valuation, courts might make a general assessment of the broad circumstances leading to the new bonds being issued as consideration for the old bonds and evaluate for fairness by balancing the needed debt relief with the economic losses sustained by bondholders. Consequently, the structure of a debt restructuring will play a significant role in a court's assessment of potential constitutional claims beyond the Contracts Clause. Because of the concern for a state's self-interest, this mechanism should actively engage bondholders and seek their voluntarily participation as proof that this is not an abuse of state police power.[318]

All things being equal, the Commonwealth should pursue a debt restructuring solution that avoids the need to default. Given the legal framework described in this article, it should wait until short-term debt service requirements are unsustainable, a default is extremely likely, and viable alternatives are exhausted. Simply and plainly, the Commonwealth has to be up against the wall and be ready to "demonstrate that the impairing law was enacted to resolve a broad, generalized economic and social problem, that the conditions the law imposes are reasonable, and that [the legislature's] decision to enact the law can pass a test of stringent scrutiny with little deference to the legislative decision."[319]

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315 In *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1, 29 (1977), the Court set a high bar for a state to justify that an impairment served the public good and held that "a [s]tate cannot refuse to meet its legitimate financial obligations simply because it would prefer to spend the money to promote the public good rather than the private welfare of its creditors."

316 U.S. CONST. art. 1, § 10, cl. 1, *amended by* U.S. CONST. amend. XIV. *See U.S. Trust*, 431 U.S. at 19, n.16 ("Contract rights are a form of property and as such may be taken for a public purpose provided that just compensation is paid.").

317 *See id.* ("[N]o one can be sure precisely how much financial loss the bondholders suffered. Factors unrelated to repeal may have influenced price . . . the market may not have reacted fully . . . because of the pending litigation and the possibility that the repeal would be nullified by the courts . . . .").

318 *See supra* Part II.A-C.

319 AMDURSKY *ET AL.*, *supra* note 30, at 287.

B. Potential Mechanism: A General Obligation Debt Sustainability Act

"Many forests have died over the past few years so that law professors could write articles addressing the question of state bankruptcy."[320] Some scholars argue that Congress should extend bankruptcy protection, or some variant of it, to states.[321] Because this hasn't been the case, arguments discussing how a state can obtain debt relief outside formal bankruptcy are more relevant for our purposes. Even if questions about *Faitoute*'s current validity abound, Justice Frankfurter's reasoning addressed common sense principles applicable to the realities of a complex economy: "[t]o call a law so beneficent in its consequences on behalf of the creditor . . . an impairment of the obligation of contract is indeed to make of the Constitution a code of lifeless forms instead of an enduring framework of government for a dynamic society."[322] If every possible alternative involving monumental public and private sector sacrifices to avert a default is exhausted, it would be the folly of fools for a court not to uphold a state's reasonable solution that guarantees creditors some degree of payment.

Professor David Skeel believes that states crafting their own bankruptcy regime should keep several considerations in mind. First, states should recognize and preserve property rights and priorities, such as liens and senior-subordinated indebtedness. Second, bondholders that are similarly situated should receive the same treatment, otherwise they might resist a restructuring and label it unfair. Third, a state should be given express power to impair contracts. Fourth, any restructuring should incorporate a binding majority vote of bondholders over the potential dissent of a minority. Finally, any restructuring should be a firm and final discharge from old obligations.[323] The best way for Puerto Rico to accommodate these considerations is by following a modified version of the Greek model.

i. Greece in the Caribbean

A hypothetical Puerto Rico General Obligation Debt Sustainability Act (hereinafter the *Debt Sustainability Act*) should allow the Commonwealth to insert collective action clauses (CACs) permitting amendments of any bond terms, including those that force holders to redeem old bonds for new bonds after a consent threshold is met. Such a mechanism addresses Professor Skeel's belief that a binding voting mechanism minimizes collective action problems.[324] Professor Steven

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320 E-mail from Clayton Gillette, Max E. Greenberg Professor of Contract Law, N.Y.U. School of Law, to author (Feb. 23, 2014, at 8:02 PM) (on file with author).

321 *See* Skeel, *supra* note 175; Schwarzc, *supra* note 103 (proposing a *minimalist* approach to state bankruptcy).

322 Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 516 (1942).

323 Skeel, *supra* note 175, at 197-200 (discussing what states should consider when creating bankruptcy regimes).

324 *Id.* at 199.

Schwarcz believes implementing this solution might be problematic, and rightfully so.[325] Collective action clauses do not provide a foolproof guarantee against collective action problems, or holdout creditors, which could otherwise undermine the success of a restructuring. However, in proposing a statutory approach through a *minimalist* bankruptcy framework under federal law as a better alternative, he does not discuss how retroactively inserted CACs may address some of the constitutional concerns surrounding the impairments they themselves create.[326] This procedure would force the Commonwealth to engage its general obligation bondholders in a diplomatic manner, under the cover of a framework that evokes principles of democracy and intercreditor equity. On top of that, a *Debt Sustainability Act* can provide additional procedural guarantees that can further minimize concerns about its constitutional validity. In fact, the contractual and market-oriented approach enshrined by a CAC was the U.S. Treasury's favored approach towards standardizing sovereign debt restructurings.[327]

A Puerto Rican debt restructuring should generally begin by policymakers recognizing that a default may be imminent. The medium and long-term burdens imposed by general obligation debt must become unsustainable. Independent third parties should confirm this conclusion by making assessments of their own and provide feedback to policymakers about ways to prevent a default. Armed with these assessments, the Legislature should then proceed to enact a *Debt Sustainability Act* that (1) inserts CACs into the resolutions of every general obligation bond governed by Commonwealth law, (2) requires the Commonwealth to negotiate with bondholder committees in good faith the extent of debt relief it will receive in the form of new instruments, and (3) requires the Commonwealth to consult an independent third-party for permission to initiate an exchange offer that will require a tendering bondholder's approval of modification terms of the old bonds (through the CAC) as prerequisite to receiving any new consideration.

The Greek strategy discussed in Part IV.C of this article lends itself as a model for the Commonwealth to follow. The fact that that the laws of Puerto Rico appear to govern most of the outstanding general obligation bonds will make this process somewhat easier.[328] The Commonwealth could make a generalized argument along the lines that by buying bonds governed by Commonwealth law, bondholders implicitly agreed to the fact that applicable laws could be amended in ways that affect their bundle of rights. But this argument provides only a limited safe

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325 Schwarzc, *supra* note 103, at 330 ("Although states responding to a financial crisis could try to insert CACs into their bond indentures, doing so could be difficult."). *See also* Steven L. Schwarcz, *"Idiot's Guide" to Sovereign Debt Restructuring*, 53 EMORY L.J. 1189, 1203-06 (2004) (discussing the problems with a contractual approach).

326 Schwarzc, *supra* note 103, at 330.

327 *See* Sean Hagan, *Designing A Legal Framework to Restructure Sovereign Debt*, 36 GEO. J. INT'L L. 299, 390-94 (2005) (discussing the U.S Treasury's opposition to the mechanism proposed by the International Monetary Fund).

328 *See supra* Part III; Buchheit & Gulati, *supra* note 275, at 5-6 (arguing that because the majority of Greek bonds were governed by Greek law the country was in an advantageous position to change the governing law of the bonds).

harbor because Commonwealth laws are still subject to federal and Commonwealth constitutional provisions that cannot be easily tinkered with. Like the old Greek-law bonds, Commonwealth-law general obligation bonds are also silent when it comes to amending their terms, which "in theory, [means] that these bonds could be restructured only with the unanimous consent of all bondholders."[329] At this juncture, collective action problems and constitutional questions may begin to pose challenges.

The *Debt Sustainability Act* should provide that once 80% to 90% of the aggregate principal amount of a 50% quorum of bondholders agree to an amendment of any of the bond terms, the amendment would be binding to all holders of the specific bond issue.[330] Greece opted for a slightly different, more aggressive, approach. The Greek CAC's threshold was measured as the whole of *all outstanding bonds*, unlike an individual bond-by-bond threshold. This *aggregation* strategy appears to have been the *pivotal* feature that secured the restructuring of 100% of the Greek law bonds (86% of Greece's outstanding debt) and the overall success of the debt restructuring.[331] However, the specter of the Contracts Clause does not hover over Greece as it does over Puerto Rico. The more 'democratic' and bondholder friendly, issue-specific, CAC may have a better chance of survival under a Contracts Clause analysis. Nevertheless, a court may view the danger that some bondholders may extract better terms than others (by rejecting a collective action proposal) as justifying a more aggressive approach, such as aggregation across *all* bond issuances.

CACs represent a contractual response to the inherent coordination problems that bonds pose as multi-creditor debt instruments.[332] Throughout the Contracts Clause jurisprudence discussed in this Article, courts exhibited concern with ensuring that the contractual impairment is reasonably effective in achieving its remedial goal. Aggregated CACs may therefore be used to temper these concerns. Aggregation both protects and constrains bondholder rights in multiple ways. For example, aggregated CACs minimize the free rider problem where one set of bondholders will not grant the Commonwealth relief after another set already voted in favor of a restructuring. The underlying tension arising out of the fact that the Commonwealth would presumably lose some bargaining leverage against a given set of free-riding, holdout bondholders on account of another set of bondholders who agreed to the terms of a deal and, in doing so, freed up some cash flow at their expense. Aggregated CACs can also promote allocative efficiency and minimize transaction costs in so far as the entirety of the bondholder pool is organized into one negotiation framework, and each issuance, depending on their outstanding principal and maturity, is given proper barging leverage *vis-à-vis* their

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329 Jeromin Zettelmeyer, Christoph Trebesch & G. Mitu Gulati, *Managing Holdouts: The Case of the 2012 Greek Exchange*, *in* SOVEREIGN DEBT MANAGEMENT, *supra* note 303, at 28.

330 This is an assumption of what might be a proper majority threshold based on *Faitoute* and the restructurings in *supra* Part IV.B-D.

331 *See supra* note 312, at 34.

332 *See* Buchheit *et al.*, *supra* note 250.

particular standing amongst the Commonwealth's outstanding obligations. In the absence of an aggregation mechanism, the particular incentives and motivations of each discrete pool of bondholders could eventually unravel the whole restructuring. A mechanism that cabins these incentives might be critical to ensure that the contractual impairment is certain to reach its intended result.

Once the *Debt Sustainability Act* is invoked, the Commonwealth can commence negotiations with bondholder committees to craft the legal and payment terms of a package of new instruments to be offered in exchange for the old bonds. The composition of these bondholder committees should largely depend on the identity of the pool of bondholders. The more heterogeneous bondholders are, the harder it is for them to successfully coordinate amongst themselves and coalesce under a single representative body. For Greece, the process of forming creditor committees was facilitated because Greek debt was held, mostly, by a concentrated group of banks.[333] While Commonwealth bondholders were traditionally retail investors, recent evidence sheds light on a new reality where bonds are increasingly owned by a concentrated group of hedge funds that specialize on distressed debt investments.[334] Perhaps to account for the uncertainty inherent to issuing liquid multi-creditor debt instruments, the law could set out basic parameters, such as requiring that the largest individual holder of each instrument be tasked with representing the interest of his fellow issuance-holders or having each individual issuance vote for a negotiation leader through a majority vote. If bondholders failed to collectively organize, a court may be given the option to appoint an independent trustee as the default representative.

Once an agreement is reached, an independent third party can confirm that these new instruments ensure that the Commonwealth regains sustainable debt service capacity (i.e., represents adequate debt relief) and grant permission to initiate an exchange offer. The exchange offer would be the means through which the Commonwealth deploys the new statutory CACs and procures bondholder consent to amending the terms of the old bonds. To secure the requisite consent thresholds, the Commonwealth should use consent solicitations, or some variant of them. These consent solicitations should state that as a requirement for participating in an exchange offer, and receiving any new instrument, bondholders have to consent to an amendment (pursuant to the statutory CACs) allowing the Commonwealth to force the redemption of all outstanding bonds of a given issuance in exchange for new instruments.

This mechanism would work because, by obtaining the bondholder's consent to *amend* the old bonds, they should also be required to *vote in favor* of making redemption mandatory for all bondholders. It is also possible that this mechanism

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333 *See* Zettelmeyer *et al.*, *supra* note 271, at 9.

334 *See, e.g.*, Eva Laureano, *P.R. en la mesa con los "buitres", la nueva realidad política*, NOTICEL (Jan. 6, 2015), http://www.noticel.com/noticia/170291/p-r-en-la-mesa-con-los-buitres-la-nueva-realidad-politica.html; José L. Carmona, *Hedge-fund Investors To Square Off Against Traditional P.R. Bondholders*, CARIBBEAN BUSINESS (Mar. 11, 2014), http://www.caribbeanbusinesspr.com/prnt_ed/hedge-fund-investors-to-square-off-against-traditional-p.r.-bondholders-9619.html.

avoids triggering the untested Constitutional Debt Priority Provisions if the Commonwealth retains the ability to service its debt on every outstanding obligation, including general obligation bonds, until enough holders consent to making redemption of the old bonds mandatory for the rest. Nevertheless, and as mentioned before, collective action problems may be augmented by the mere presence of a priority guarantee enshrined in the Constitution. To curb potential bondholder incentives to trigger the priority provisions, it is critical that any restructuring law imposes something akin to an obligation for bondholders to negotiate in good faith and an ability to cram down the terms of a negotiated solution on a discrete and insular resisting minority.

ii. Practical and Constitutional Considerations

The underlying notion behind any constitutional analysis will be the reality that prior to a debt restructuring, the Commonwealth's citizens "will have borne the pain of an economic collapse accompanied by a heavy dose of fiscal adjustment and austerity."[335] Puerto Rico's conspicuous experience these last few years, from a continuous recession to painful austerity measures and a dramatic population decline, attest to this reality.

The biggest hurdle the Commonwealth needs to overcome is the set of constitutional provisions giving general obligation bondholders a first lien on revenues. Ignoring what appears to be a specific trigger based on adequate budget appropriations, bondholders will nevertheless argue that the whole purpose of these guarantees was for them to be enforceable in exactly the fiscal quagmire the Commonwealth currently faces and that these rights were the product of a fair *ex-ante* bargain. The Commonwealth can make several counterarguments. First, the legislative history of these provisions reveals that their purpose was to protect and enhance the Puerto Rico's credit *in order to promote economic development and benefit the public's welfare*. In circumstances where said credit has essentially evaporated (i.e., the Commonwealth could no longer access the capital markets), it would be anomalous for these provisions to inflict damage on the same economic development and welfare they sought to protect. As mentioned before, the purpose of a Constitution is to provide for an enduring framework of government, not the means of its liquidation.

Second, the *Debt Sustainably Act's* focus on a CAC mechanism does not by itself constitute a complete rejection of the constitutional priorities. If anything, the Commonwealth could argue that in providing an orderly mechanism for negotiation, it seeks to reinforce these priorities by helping to prevent a default and giving bondholders substantial bargaining leverage. A majority of bondholders could still draw the line, reject any proposals they deem unfair, and force the Commonwealth back to the negotiation table. Binding a minority of dissenting holdouts also reinforces the constitutional priorities by apportioning losses equitably.

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335 Lee C. Buchheit & Elena L. Daly, *Minimizing Holdout Creditors: Carrots, in* SOVEREIGN DEBT MANAGEMENT, *supra* note 303, at 13.

Otherwise, the threat of opportunistic holdouts extracting better terms would discourage a majority from granting the Commonwealth the relief necessary to continue functioning as a going concern, from which a payment stream could be secured.

Third, circumstances may be such that further fiscal sacrifices by the Commonwealth dangerously erode the pledge securing general obligation bonds: the ability to raise tax revenues. Raising taxes beyond a certain threshold may lead to inefficient results that shrink the tax base. For example, tax increases could worsen the rate of emigration of citizens seeking a better life elsewhere. In light of the above, it would surely be reasonable to read the Constitutional Debt Priority Provisions as empowering courts to provide bondholders with remedies acknowledging their absolute right to be paid when the Commonwealth still retains some control over its fiscal destiny (i.e., a budget impasse due to trifling political conflicts). But it would be *unreasonable* to espouse the same reading when the Commonwealth can barely limp from fiscal quarter to fiscal quarter, with a delicate ability to continue providing essential services and no way to stop the death spiral of distress (i.e., population exodus, increased borrowing costs and service delivery insolvency). It can further strengthen this argument by invoking its constitutional emergency clause. This clause was purposely drawn to give lawmakers an explicit ability to fashion relief attendant to social and economic needs as long as such legislation is carefully balanced to preserve as much as possible the other rights outlined in the Commonwealth Constitution.

Furthermore, a *Debt Sustainability Act* that inserts CACs into outstanding general obligation bonds, which could be used by the Commonwealth to coerce bondholders to sustain losses, also needs to survive constitutional challenges invoking the federal Contract Clause. From the outset, the reasonableness of a *Debt Sustainability Act's* components -collective action mechanism, neutral third party involvement and good faith standard- needs to be emphasized as a whole bundle of provisions that seek to protect the interests of bondholders. Dissenters can argue that the retroactive insertion of a clause that permits a binding vote abrogates their substantive rights under the terms of the original bonds that did not have CACs or any provision for amending the terms of the bonds. This law should articulate strong justifications that a binding majority voting mechanism is reasonable because it weaves in elements of democratic participation, bondholders have the option to decline to participate in the exchange offer (equivalent to voting against the CAC's redemption provision), and that the danger of minority disruption of the majority's negotiated solution, that could entail pushing the Commonwealth into a costly and chaotic default, merits an orderly mechanism that protects the collective will of a majority wishing that the Commonwealth retain some ability to pay. The other alternative is to unilaterally change payment terms without inviting bondholder feedback, or worse, declare a moratorium.

Opponents will also argue that the use of CACs by the Commonwealth to force general obligation bondholders to redeem their bonds is unnecessary in light of less coercive mechanisms that could still procure enough bondholder participation to make the exchange offer successful. However, the Commonwealth

should be able to argue that the reality of having bonds in the hands of dispersed bondholders, the possibility that some would not participate in the offer out of fear that others might get a better deal by holding out, and the likelihood that opportunistic holdouts might hinder relief, justify making the binding mechanism a necessary impairment. Holdouts can undermine the success of a restructuring by threatening inter-creditor equity, generating damaging publicity and launching costly, time-consuming lawsuits.[336] In addition, some investors may willingly or unwillingly ignore the macroeconomic consequences of holding out against an exchange offer.

The CAC's binding vote promotes fairness by apportioning these losses equitably upon all bondholders while not entirely destroying their bargaining leverage. The *Faitoute* Court recognized that the failure to bind dissenting creditors to the terms of an adjustment might render it ineffective and could not ensure that further restructurings would not occur in the future.[337] Finality and futility are elements that might persuade courts to recognize the crucial role this impairment would have in helping the Commonwealth address a pressing need while concurrently attempting to honor bondholder guarantees.

To increase the law's ability to survive judicial scrutiny in light of the fact that a debt restructuring strategy involves the Commonwealth's self-interest, the mechanism adopted by New Jersey and upheld by *Faitoute* can provide a model to follow.[338] Requiring the Commonwealth to petition an independent third party to grant permission to initiate an exchange offer might decrease judicial concerns that the state is abusing its police power. This third party should be someone representing the public sector (a bankruptcy judge or an officer from the federal treasury) or a committee of experts in the field of public finance and bankruptcy. The law should provide that certain elements must be met prior to granting the Commonwealth permission. For example, the third party should make another assessment of the risk of default and subsequently confirm that the new instrument package product of Commonwealth-bondholder committee negotiations results in a sustainable debt service capacity.

Requiring the Commonwealth to engage a committee of bondholders and negotiate with them in good faith the terms of a restructuring further ensures the

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336 *See* Lee C. Buchheit & Elena L. Daly, *Minimizing Holdout Creditors: Sticks*, *in* SOVEREIGN DEBT MANAGEMENT, *supra* note 303, at 15-17 (discussing holdouts).

337 The Court considered the majority consent of creditors for restructuring:

> [O]n the basis of the recommendations of its expert advisers, the New Jersey legislature was entitled to find that in order to keep its insolvent municipalities going, and at the same time fructify their languishing sources of revenue and thus avoid repudiation, fair and just arrangements by way of compositions, scrutinized and authorized by a court, might be necessary, and that to be efficacious such a composition must bind all, after 85 per cent of the creditors assent, in order to prevent unreasonable minority obstruction.

Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 512-13 (1942).

338 *See id.* at 504-507 (discussing the mechanics of the New Jersey law). A similar thought appears in *Asociación de Maestros* when the majority discusses the reform's incentives for pensioners to retire early and undermine solvency. *See also, supra* Part II.C.

Debt Sustainability Act's practical and constitutional palatability. The experience of Greece and Uruguay illustrates that candid, continuous disclosure of information, as well as avoiding hard lines and accusatory discourses, may engender bondholder support for restructuring. In particular, a *consultative* process helped Uruguay to play a variation of the prisoner's dilemma by portraying itself as the borrower trying in earnest to honor its obligations without unduly imposing losses on its creditors.[339] Uruguay's bondholders were able to internalize the stark fact that they had everything to lose if Uruguay did not succeed in its endeavor.

In addition, a requirement to negotiate with creditors in good faith can strengthen the reasonableness of this law. Duties of good faith and fair dealing are not alien to bankruptcy law and jurisprudence and courts would be able to police the Commonwealth's behavior under this statutory mandate. To make negotiations worthwhile, the Commonwealth needs to approach these negotiations with an adequate balance of sweeteners and sticks calibrated to the extent of haircuts it needs bondholders to accept.[340] Ultimately, these negotiations should lay the groundwork for an agreed upon package of new instruments to be offered in exchange for the old bonds.

The composition of any new instruments depends on the debt relief the Commonwealth needs. To the extent that bondholders cling to the Constitutional Debt Priority Provisions, haircuts imposed on bondholders should be a minimal threshold to allow the Commonwealth to regain sustainable debt servicing capacity. Nevertheless, if a contractual impairment challenge were to hinge on the consideration bondholders are given via the restructuring, salient concerns with making sure that the impairment is effective might exert pressure on the calculation of debt relief.[341] If short-term liquidity is the immediate concern, re-profiling debt through the extension of maturity and interest without lowering principal, similar to Uruguay's strategy, might be beneficial. From a legal standpoint, this would protect the Commonwealth from allegations that alternative haircuts would have been less onerous. From a practical standpoint, minimal haircuts may also encourage bondholder participation by minimizing losses and emphasizing that the Commonwealth wants to respect the integrity of the old bond terms as much as possible; Uruguay successfully followed this path.

There are other ways the Commonwealth can attempt to incentivize bondholder participation in an exchange offer. Proposing a menu of options, catered to specific investment portfolios, gives bondholders another incentive to participate in an exchange offer.[342] The Commonwealth should be prepared to accept demands for explicit waivers of sovereign immunity and agree to have New York law

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339 *See* Carlos Steneri, *Uruguay Debt Reprofiling: Lessons from Experience*, 35 GEO. J. INT'L L. 731, 741-44 (2004) (discussing how Uruguay reached out to bondholder creditors).

340 *See* Das *et al.*, *supra* note 227, at 21-23.

341 Per the approach in *Asociación de Maestros* and *Faitoute*.

342 Because the attractiveness of Commonwealth debt emanates from the triple exemption from local, state and federal income taxes, these new bonds should be carefully structured to qualify for these exemptions.

govern any newly issued bonds.[343] Another possible sweetener that might incentivize bondholders is the use of something akin to GDP-linked warrants.[344] Through these warrants, also known as *value recovery rights*, the Commonwealth can promise to pay additional principal or cash if the Commonwealth economy begins to grow above *baseline projections*.[345] It is plausible that a court can be convinced that this makes the impairment all the more reasonable because it illustrates the Commonwealth's palpable desire to achieve an outcome that benefits both parties. Puerto Rico would be promising to compensate bondholders if, as a result of the losses they suffered at its expense, the economic situation drastically improves. In turn, bondholders would buy into the Commonwealth's use of the relief afforded by restructuring to secure medium to long-term economic recovery and growth.

CONCLUSION

Hovering behind a government's decision to borrow other people's money is an indelible moral component. The structure of debt issuances, where a debtor receives instant financial gratification in exchange of a promise to pay at some future date, fundamentally pawns the livelihood of the debtor's future stakeholders. With respect to Puerto Rico, these stakeholders are future generations of taxpaying citizens. Unfortunately, under the mantra of public expenditures that may respond to immediate electoral considerations, government officials may forget the *heavy fiduciary responsibility* that they hold, invisible to the eyes of those focused solely on the present.[346] This responsibility is held towards the future generations that will have to stomach the "distasteful residuum of [debt]—the need to pay it back."[347] Whether or not Commonwealth officials of yore failed to balance a practical need to borrow with a thoughtful recognition that increasingly unsustainable debt loads were being piled upon future Puerto Ricans is a debate for tomorrow's historians; mulling over decades of mismanagement will not solve the current predicament.

What is certain, however, is that at the heart of good governance lies proper debt management. In turn, proper debt management must be accommodating to

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343 The Series 2014-A General Obligation Bonds waived Puerto Rico's immunity in favor of New York state and federal courts and agreed to have New York law be the governing law over the terms of the bond resolutions.

344 Argentina, Greece and Uruguay used them. *See supra* Part IV. They do not necessarily have to be GDP-related; the Commonwealth can promise to set aside a portion of the revenue generated from the sale of state-owned property for the payment of these warrants.

345 *See* Lee C. Buchheit & Elena L. Daly, *Minimizing Holdout Creditors: Carrots*, *in* SOVEREIGN DEBT MANAGEMENT, *supra* note 303, at 10-11 (discussing the mechanics behind value recovery rights).

346 *See* Lee C. Buchheit, *Sovereign Debt in the Light of Eternity*, *in* SOVEREIGN DEBT MANAGEMENT, *supra* note 303, at 463 (discussing how the "legacy" of debt incurrence should prompt decision makers to evaluate their decisions to borrow through moral, legal, financial and political elements beyond immediate financial benefits).

347 *Id.* at 464.

a securities market that lives by a Law of the Jungle, as old and as true as the sky: a debtor's behavior is tied to its long-term survival. Debtors and creditors must acknowledge that economic rehabilitation entails sacrifices by both. Failure to do so will not restore a borrower's financial stability and will not ensure that a creditor receives the money that it is owed. Thorough this article, I have attempted to show that the Commonwealth, if it ever finds itself in this situation with respect to its general obligation debt, can structure a binding mechanism that addresses constitutional impairment concerns by neutralizing each side's incentives to unfairly shift the burdens of recovery on to the other, while still acknowledging the priority granted to them by the Commonwealth Constitution.

As this article emphasizes time and again, the fiscal crisis enveloping Puerto Rico is neither new nor unknown. Remedial measures adopted by various administrations failed to prevent the widespread market skepticism that threatens Puerto Rico's access to financing and could lead to a disastrous default. Debt restructuring entails economic, legal, and reputational costs. However, a concerted strategy can minimize these costs, and perhaps even justify them in the medium to long-term timeframe, if such a strategy is if it is catered to avoid a default, addresses the legal and contractual framework of the Commonwealth's general obligation debt, and achieves adequate debt relief.

It is reasonable to believe that in a critical juncture, where all other alternatives are exhausted, federal and Puerto Rican courts will allow Puerto Rico to seek relief under such a mechanism. Admittedly, the extent and structure of this relief might be subject to whether a court believes it merits legislative deference or that bondholders have compelling evidence undermining the Government's justifications.

The Puerto Rico forged from the white heat of this economic crisis will, undeniably, emerge radically different. If anything, I hope the contents of this article show that despite the seemingly insurmountable difficulties that surround a potential restructuring of the Commonwealth's general obligation debt, a legal solution can be designed to pave the way out of this crisis if relief from general obligation debt service requirements were ever needed. Obtaining debt relief from the Commonwealth's general obligation debt may be necessary to ensure that bondholders are effectively repaid, alleviate liquidity concerns, and allow Puerto Rico to concentrate its resources to the pressing task at hand: fostering economic growth.