

# PUERTO RICO'S MUNICIPAL BOND DILEMMA: IS STATEHOOD THE ONLY VIABLE OPTION?

## ESSAY

CORY HOWARD\*\*

Introduction.....	15
I. Bankruptcy Protection –or lack thereof– for Federal Territories.....	16
II. How Does Statehood Solve Puerto Rico's Debt Issue? .....	17

### INTRODUCTION

PUERTO RICO'S MUNICIPAL BONDS, ONCE CONSIDERED A MUTUAL FUND'S SAFE haven for their relatively low risk, yet high interest returns,<sup>1</sup> are poised to become a serious liability, possibly costing investors hundreds of millions of dollars.<sup>2</sup> *Muni Bond* problems have become relatively common during the aftermath of the most recent economic downturn, as once prosperous municipalities are suffering from population flight, rising pension obligations, and stagnant economies that leave revenue generation short of debt payments.<sup>3</sup> While a number of municipalities, including Detroit, Michigan and Scranton, Pennsylvania, have (or hope to enjoy) protection under bankruptcy law, there are a number of legal complexities about Puerto Rico's situation that could hinder the island's attempt to control its debt problem. Particularly concerning for

---

\* Copyright © 2013-2014. Creative Commons Attribution - Non Commercial - No Derivatives 3.0 Puerto Rico Public License, <http://creativecommons.org/licenses/by-nc-nd/3.0/pr/>.

\*\* J.D. Candidate, 2014 Wake Forest University School of Law; B.A. in International Affairs, 2011, George Washington University.

<sup>1</sup> See Tim McLaughlin, *Puerto Rico Debt Roils U.S. Municipal Bond Market*, REUTERS (September 3, 2013, 11:55 am), <http://www.reuters.com/article/2013/09/03/municipals-puertorico-idUSL2NoGU27P 20130903> (last visited November 1, 2013) (noting that mutual fund investors were drawn to Puerto Rico's municipal bond offerings because of the tax-exempt status and high interest rate).

<sup>2</sup> See Jake Zamansky, *Created by UBS, Muni Bond "Perfect Storm" Now over Island of Puerto Rico*, FORBES (October 7, 2013, 8:44am), <http://www.forbes.com/sites/jakezamansky/2013/10/07/created-by-ubs-muni-bond-perfect-storm-now-over-island-of-puerto-rico/> (last visited November 1, 2013).

<sup>3</sup> See Carla Fried, *Municipal Bonds, Stung Again*, THE NEW YORK TIMES (October 5, 2013), <http://www.nytimes.com/2013/10/06/business/mutfund/municipal-bonds-stung-again.html> (last visited November 1, 2013) (noting that Puerto Rico's revenue projections are not adequate to cover debt payments of its bond obligations); Kelly Nolan, *Muni-Bond Buyers Seeking Safety*, THE WALL STREET JOURNAL (August 9, 2013), <http://stream.wsj.com/story/markets/SS-2-5/SS-2-298590/> (last visited November 1, 2013).

Puerto Rico is investor-flight caused by regulatory concerns and outstanding debt obligations, which has and will continue to hamper efforts to raise debt-based revenue.<sup>4</sup> Since the island has been using revenue from newly issued bonds to finance debt payments on older obligations, flight from the bond market can cause a liquidity shortfall and potential default.<sup>5</sup> Although states and municipalities that face similar problems can seek protection from creditors, constitutional provisions and federal law exemptions place Puerto Rico in a unique position to which there seems to be only one answer: statehood.

### I. BANKRUPTCY PROTECTION –OR LACK THEREOF– FOR FEDERAL TERRITORIES

Chapter Nine of the U.S. Bankruptcy Code provides bankruptcy protection for government entities.<sup>6</sup> The purpose of this section is to give financially distressed municipalities protection from creditors, so that they may renegotiate their debt obligations and implement an approved plan for repayment.<sup>7</sup> However, there are a number of restrictions to municipal bankruptcies,<sup>8</sup> namely, that the bankrupt entity must be a political sub-division of the state, as states themselves are barred from declaring bankruptcy.<sup>9</sup> As a result, full-fledged states and entities closely associated and acting as a state agent, such as pension funds, are not entitled to protection under the Bankruptcy Code.

Puerto Rico is not the first federal territory to suffer from municipal bond created debt issues. In fact, just several years ago the Mariana Islands were in a similar situation, as the government funded pension plan filed for bankruptcy,

---

<sup>4</sup> McLaughlin, *supra* note 1 (noting that investors have been pulling out of the bond market since late Spring and show no sign of re-entering).

<sup>5</sup> See Mary Williams Walsh, *Worsening Debt Crisis Threatens Puerto Rico*, NEW YORK TIMES (October 7, 2013, 8:48 pm), <http://dealbook.nytimes.com/2013/10/07/worsening-debt-crisis-threatens-puerto-rico/> (last visited November 1, 2013) (noting that Puerto Rico has been using new bond revenue to pay existing debt, but since it has been shut out of the bond market has had to resort to high-cost, short-term funding sources).

<sup>6</sup> 11 U.S.C. § 901 (2004 & Supp.2012).

<sup>7</sup> Christopher Smith, *Provisions for Access to Chapter 9 Bankruptcy: Their Flaws and the Inadequacy of Past Reforms*, 14 BANKR. DEV. L.J. 497, 522 (1998).

<sup>8</sup> See 11 U.S.C.A. § 109(c) (2004) (stating the requirements that the debtor or entity must: (1) be a municipality that is (2) generally authorized to be a debtor under state law or an officer or organization empowered to make such a declaration is (3) insolvent, (4) desires to negotiate a plan, and (5)(i) has obtained the agreement of creditors holding at least a majority of the claims, (ii) has negotiated in good faith and failed to obtain the agreement of creditors, (iii) or is unable to negotiate with creditors).

<sup>9</sup> See *id.* § 101(40) (stating that a municipality must be a political subdivision or instrumentality of a state); see also *In re Sullivan County Regional Refuse Disposal Dist.*, 165 B.R. 69, 73 (Bankr. D.N.H. 1994).

citing a lack of government dispersed funds to cover its payment obligations.<sup>10</sup> In *In re Northern Mariana Retirement Fund*, a U.S. District Court in Hawaii relied on the legislative history of section 101(27)<sup>11</sup> and construed a *governmental unit* in the broadest sense, classifying the pension fund as an instrumentality that has an active relationship with the state and carrying out a governmental function.<sup>12</sup> As a result of this decision, specifically the court's broad classification of *governmental unit*, it is unlikely that Puerto Rico, a U.S. commonwealth, will be able to claim bankruptcy protection under Chapter 11.

## II. HOW DOES STATEHOOD SOLVE PUERTO RICO'S DEBT ISSUE?

The push for statehood to solve the municipal bond crisis, quite simply, would not automatically relieve Puerto Rico of its obligations. Because states are not eligible for bankruptcy protection under Chapter 11, as they are not persons, nor under Chapter 9, as their political subdivisions are, the Bankruptcy Code would not confer protection on them from creditors as soon as they entered the union. However, municipal and sovereign debt crises are not limited to Puerto Rico; they have been an issue that has plagued states throughout the country, prompting a Congressional reaction. In fact, several Senators have discussed the possibility of tackling the issue, whether it be by amending the Bankruptcy Code, or instead, establishing an oversight panel for troubled states.<sup>13</sup> Even if no formal legislation is ever introduced or passed, just the threat of Congressional action on the issue could force creditors to the bargaining table, allowing Puerto Rico to renegotiate its short-term budget gaps and devote more attention to structural deficiencies.<sup>14</sup> Statehood would also give Puerto Rico voting representatives who could increase the push for such measures.

Additionally, statehood would bring with it tremendous economic benefits, as it did to Hawaii in 1959.<sup>15</sup> Such benefits could increase revenue sources used to

---

<sup>10</sup> See Caitlin Kenney, *Judge Says Pension Fund Can't Seek Bankruptcy Protection*, (June 5, 2012, 6:00 am), <http://www.npr.org/blogs/money/2012/06/05/154302347/judge-says-pension-fund-cant-see-bankruptcy-protection> (last visited November 1, 2013).

<sup>11</sup> Central to the court's decision was their reliance on the legislative intent embodied in H.R. REP. NO. 95-595, at 311 (1977); S. REP. NO. 95-989, at 24 (1978).

<sup>12</sup> *In re Northern Mariana Islands Retirement Fund*, No. 12-00003, 2012 WL 8654317 (D.N. Mar. 1, June 13, 2012).

<sup>13</sup> See Mary Williams Walsh, *A Path is Sought for States to Escape their Debt Burdens*, THE NEW YORK TIMES (January 20, 2011), <http://www.nytimes.com/2011/01/21/business/economy/21bankruptcy.html?pagewanted=all> (last visited November 1, 2013).

<sup>14</sup> *Id.* (noting that Congressional action on behalf of states could give the states bargaining power over creditors, including employee pension funds).

<sup>15</sup> See Gregg Easterbrook, *Make Puerto Rico a State: It's Good for Business*, REUTERS (June 14, 2011), <http://blogs.reuters.com/gregg-easterbrook/2011/06/14/why-puerto-rico-should-become-the-51st-state-it-would-be-good-for-business/> (last visited November 10, 2013) (noting that once Hawaii

cure both short-term obligations and long-term structural issues. Statehood brings with it political certainty and an increased willingness by corporations to invest in the local economy, as was the case in Hawaii.<sup>16</sup> Simply assuming the name *state* would trigger greater interest and thus, greater *foreign* investment that could be used to alleviate chronic unemployment and raise a struggling gross domestic product (GDP) per capita.<sup>17</sup> Also, statehood would bring an estimated 20 billion dollars a year to the Puerto Rican government in federal funding that would otherwise be unavailable.<sup>18</sup> These additional revenue streams would be instrumental in bridging the structural debt problems that have plagued Puerto Rico, and thus its bonds, since the Island's *golden age* in the 1960's. With additional revenues from corporate investment and federal funds, the 70 billion dollars that Puerto Rico owes on its debts could easily be repaid without issuing additional debt.<sup>19</sup>

Statehood would not come as a climatic change or tremendous shock to the people and institutions of Puerto Rico, as 51% of voters in a 2012 referendum rejected their commonwealth classification and 61% chose statehood as the preferable alternative.<sup>20</sup> In response to the recent ballot initiative, Puerto Rico's resident commissioner proposed the follow-up legislation for Congress to consider the completion of the necessary statehood application procedures.<sup>21</sup> The process

---

earned its statehood, both, the infrastructure and public spending, improved education and gave it a higher GDP per capita (\$49,000) than the continental U.S.).

<sup>16</sup> Lawrence A. Hunter, *Leave No State or Territory Behind: Formulating a Pro-Growth Economic Strategy for Puerto Rico*, POL'Y REP. 177, INST. POL'Y INNOVATION (2003), <http://www.ipi.org/docLib/PR177-PREconomicsV10-4.pdf-OpenElement.pdf>.

<sup>17</sup> See Laura Matthews, *Puerto Rico Statehood: Bad Business for the U.S. or the Next Swing State?*, INTERNATIONAL BUSINESS TIMES (August 23, 2012), <http://www.ibtimes.com/puerto-rico-statehood-bad-business-us-or-next-swing-state-754173> (last visited November 10, 2013) (noting that a new state would instantly, if inexplicably, garner increased attention and investment from the American business community).

<sup>18</sup> See Danica Coto, *Puerto Rico Considers Statehood*, THE HUFFINGTON POST (November 4, 2012), [http://www.huffingtonpost.com/2012/11/04/puerto-rico-statehood\\_n\\_2072532.html](http://www.huffingtonpost.com/2012/11/04/puerto-rico-statehood_n_2072532.html) (last visited November 10, 2013).

<sup>19</sup> See Mike Cherney, *Puerto Rico Debt Troubles Regulators*, THE WALL STREET JOURNAL (October 6, 2013), <http://online.wsj.com/article/SB10001424052702304441404579119251798925192.html> (last visited November 10, 2013).

<sup>20</sup> Mariano Castillo, *Puerto Ricans Favor Statehood for First Time*, CNN (November 8, 2012), <http://www.cnn.com/2012/11/07/politics/election-puerto-rico/index.html> (last visited November 10, 2013).

<sup>21</sup> Pete Kasperowicz, *Puerto Rico Statehood Bill Tops GOP's 'Citizen Cosponsor' List*, THE HILL (June 10, 2013), <http://thehill.com/blogs/floor-action/house/304499-puerto-rico-statehood-bill-tops-gops-citizen-cosponsor-list> (last visited November 10, 2013) (noting that H.R. 2000 would allow Congress to take up the issue of Puerto Rico's statehood); see also Arian Campo-Flores, *Puerto Rico Statehood Bid Gets New Push*, THE WALL STREET JOURNAL (May 23, 2013), [http://online.wsj.com/article/SB100014241278873234637-04578493124\\_250050966.html](http://online.wsj.com/article/SB100014241278873234637-04578493124_250050966.html) (last visited November 10, 2013) (explaining that H.R. 2000 would require a plebiscite on the island and if a majority of the people voted Yes, the

of statehood would also give Puerto Rico an additional, yet unintentional, protection from creditors, as it is not usual for Congress to issue admission resolutions that impose or permit additional requirements on territories seeking to become states.<sup>22</sup> Currently, Puerto Rico's Constitution requires that general bond obligations be given first-priority status on all the revenue the island collects,<sup>23</sup> a unique constitutional feature that is, in part, responsible for the heavy collection of Puerto Rican bonds that mutual funds have accumulated. Therefore, statehood would give Puerto Rico the opportunity to reform their Constitution to remove such a provision, or at least present a credible enough threat that bondholders could be forced to settle to reduce the island's public debt.

Puerto Rico has found itself in a troubling position with regards to the debt it has incurred by issuing municipal bonds. As investors pull out of the bond market and the island's bond status gets continually downgraded, the once *golden child* of investors will, and has, found itself struggling to repay debt obligations. Although statehood will not carry with it the protection of the Bankruptcy Code, the economic and legal benefits appear to be one of the few viable ways to achieve the necessary short-term funding, and close the long-term structural gaps that have plagued the island for decades.

---

Citation: Cory Howard, *Puerto Rico's Municipal Bond Dilemma: Is Statehood the Only Viable Option?*, 83 REV. JUR. DIG. UPR 15 (2013-2014), <http://www.revistajuridicaupr.org/wp-content/uploads/2013/12/83-REV-JUR-DIG-UPR-15-.pdf>

---

president would be required to submit the issue to Congress, who has ultimate authority to approve statehood via a majority vote).

<sup>22</sup> Ralph H. Brock, *The Ultimate Gerrymander: Dividing Texas Into Four New States*, 6 CARDOZO PUB. L. POL'Y & ETHICS J. 651, 661 n.46 (2008)(noting that this occurred in the case of Arizona's quest for statehood and the requirements imposed included re-surveying boundaries and re-drafting its proposed state constitution).

<sup>23</sup> PR CONST. art. VI, § 8.