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Puerto Rico Financial Oversight Law Enacted

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Overview

On June 30, President Obama signed the ''Puerto Rico Oversight, Management, and Economic Stability Act ('Promesa')'', which is intended to address Puerto Rico's municipal debt crisis. Promesa, which is the Spanish word for ''promise,'' was signed the day before Puerto Rico had approximately $2 billion in bond payments due, which it failed to make. But one of the key elements of Promesa is an automatic stay of all litigation against Puerto Rico, so bondholders must now continue the ongoing debt negotiations without the ability to commence or continue litigation if the talks fail.

Promesa establishes a fiscal oversight board (the ''Oversight Board'') to oversee Puerto Rico's finances. The primary responsibilities of the Oversight Board are to develop and approve budgets for the territory of Puerto Rico and its many governmental agencies that have issued municipal bonds (the ''Municipal Issuers''). The Oversight Board also has the responsibility to approve voluntary debt restructurings for Puerto Rico and the Municipal Issuers, or to use the federal court system to impose restructurings where the parties have been unable to agree. The Constitutional authority for Promesa is Article IV, which gives Congress full legislative authority over areas that would otherwise be exercised by a state. The Oversight Board is unpopular with some Puerto Ricans, who argue that its extensive budget powers re-impose colonialism. But Promesa's supporters argue that the establishment of the Oversight Board is the only remedy that can address Puerto Rico's long history of failed budgets.

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During the debate over Promesa some argued that Puerto Rico and its Municipal Issuers needed access to the municipal bankruptcy provisions of Chapter 9 of the federal Bankruptcy Code. But many Puerto Rico bondholders opposed allowing access to Chapter 9, with some opponents voicing a fear that bankruptcy courts would effectively subordinate bondholder claims to Puerto Rico's pension claimants, which is what they contend occurred in Detroit's Chapter 9 case. Other bondholders argued that Puerto Rico has the ability to satisfy its municipal bond indebtedness in full, and that a combination of tax increases and cuts in social service spending are the only actions that are necessary. Puerto Rico and its Municipal Issuers have argued that they cannot pay their debts in full, and that debt relief is required.

Promesa is a compromise; instead of granting Puerto Rico and the Municipal Issuers access to Chapter 9, it contemplates first allowing the bondholders and Puerto Rico and each Municipal Issuer to reach consensual restructurings where possible. But if agreements cannot be reached, it provides for a federal district court to oversee a judicial reorganization, which is modeled on Chapter 9.

Puerto Rico's Economic Problems

While Promesa acknowledges the enormous economic challenges posed by Puerto Rico's deteriorating

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economy, it provides for no direct federal aid, so it is not a bailout bill. Congressional Republicans were opposed to using any federal funds to rescue what they viewed as a profligate and undisciplined government. But Promesa does little to address the difficult problems Puerto Rico's economy faces, and the law also fails to satisfy those who sought more direct aid to Puerto Rico, and a guarantee of debt relief. Nor, however, does it satisfy the bondholders who sought protection from being required to take any haircuts. Rather, Promesa encourages voluntary debt restructurings, but in the event that voluntary agreements cannot be reached, creates a debt restructuring procedure modeled on Chapter 9 of the Bankruptcy Code for implementing nonconsensual restructurings.

The impetus for Promesa comes from two related problems: Puerto Rico's massive financial problems, including its $71 billion in municipal bond debt and $43 billion in pension liabilities, amounts which Puerto Rico and the Municipal Issuers say they cannot pay in full, and Puerto Rico's collapsing economy, which has been mired in recession for the last 10 years. Puerto Rico faces some of the same weaknesses in its economy as Detroit: large job and population losses, leading to an erosion in its tax base and economic stagnation.

Puerto Rico's Municipal Bonds and Pension Liabilities

Puerto Rico has approximately $71 billion in outstanding municipal bonds, including $15.2 billion in sales tax revenue bonds, $12.6 billion in special obligation bonds, $8.1 billion in bonds issued by the Puerto Rico Electric Power Authority, $4.6 million in bonds issued by the Puerto Rico Highways & Transportation Authority, and approximately $4 billion issued by each of the Aqueduct & Sewer Authority, the Government Development Bank and the Public Buildings Authority. Despite having a population roughly equivalent to Connecticut, Puerto Rico has more municipal bond debt than any state except New York and California.

On May 1, 2016, Puerto Rico failed to make a $400 million payment on Government Development Bank debt. On July 1, 2016, Puerto Rico failed to make additional payments due of approximately $2 billion, including more than $800 million in general obligation bonds. Its default on its general obligation bonds, represented the first default by a state-level borrower since Arkansas missed payments in 1933.

The problems of Puerto Rico's public pension liabilities are also dire. Its Teachers Retirement System and Employees Retirement System together cover approximately 330,000 workers and retirees. Their combined benefit liability is estimated at approximately $43.2 billion, and is backed by just $1.8 billion in assets, meaning that they are 96% underfunded. The funds are already paying out more in benefits than they receive in income each year, forcing them to liquidate assets to continue paying benefits at current levels. According to an actuarial report prepared for the pension plans, unless Puerto Rico modifies the benefits it pays to retirees, its pension plans will run out of money entirely by 2019.

The Fiscal Oversight Board

The central premise of Promesa is that the establishment and operation of the Oversight Board will enable Puerto Rico to ''achieve fiscal responsibility and access to capital markets.'' To achieve these goals, Promesa grants the Oversight Board broad power to set budgets for the territory of Puerto Rico, (the ''Territory'') the Municipal Issuers, and to take further actions, such as reducing non-debt service expenditures to the extent necessary to bring such parties into compliance with their budgets. In short, Promesa gives the Oversight Board the power to override the budget choices of Puerto Rico's elected legislators for the purpose of requiring those entities to make their scheduled debt service payments.

Structure of the Board; Powers

The Oversight Board will consist of seven members who will be appointed by the President, although Congressional Republicans will control the appointments because two members will come from a list proposed by Speaker of the House Paul Ryan and two come from a list proposed by Senate Majority Leader Mitch McConnell. Members of the Oversight Board are required to have experience in finance, management, law, or the operation of business or government; no prior experience in, or knowledge of Puerto Rico is required, although at least one member of the Oversight Board must have a primary residence in or have his or her principal business in Puerto Rico. The initial term of board members is for three years (and board members may be re-appointed), and the President may only remove a member for cause. The Oversight Board will remain in place until Puerto Rico has balanced its territorial budget for four consecutive years and regained the ability to have regular access to the public capital markets, as determined by the Oversight Board.

Although the House Committee stated in its legislative summary of Promesa that the Oversight Board will act ''in the most efficient and equitable manner that is respectful of the rule of law, self-governance and all interested parties and creditors,'' the actions of the Oversight Board are immune from review by the government of Puerto Rico, including its courts.

The Oversight Board has broad authority to take actions necessary to implement its powers. It can, and is expected to, hire a permanent staff, and it may also retain professionals. As part of its budget authority, it can allocate to itself an annual budget (which is not subject to any review or approval by the Territory), which must be fully funded as part of the Territory's budget. The Oversight Board can also issue bonds backed by the full faith and credit of the Territory to finance its operations. The Congressional Budget Office has estimated the cost of the Oversight Board will amount to $570 million over five years.

The Oversight Board is authorized to ''conduct necessary investigations'' into the government of the Territory or any user agency or instrumentality. The Oversight Board may conduct audits, hold hearings, obtain government records, demand evidence, take testimony under oath, and subpoena witnesses. Failure to comply with the Oversight Board's investigatory powers is subject to various sanctions, including contempt of court and criminal and civil penalties.

Budget Controls

Promesa's budget process allows the Territory and its Municipal Issuers to propose their own respective bud-

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gets, but gives the Oversight Board the ability to control the process if inadequate budgets are submitted or the Territory or its Municipal Budgets cannot meet their budgets. The enactment of Promesa reflects Congress's view that the Territory and its Municipal Issuers have failed to control their respective budgets and to make adequate provisions for the payment of debt service and other obligations. Promesa requires Puerto Rico's governor (the ''Governor'') to prepare and submit to the Oversight Board a five-year fiscal plan (the ''Fiscal Plan''), which is intended as an overall strategy for restoring Puerto Rico's solvency. The Oversight Board may approve the Fiscal Plan, or it can send it back to the Governor with changes. But in the event of a disagreement, the Oversight Board may prepare its own Fiscal Plan and submit it to the Governor and the legislature, in which case the Governor will be deemed to have approved it.

The Fiscal Plan is required to have the following elements:

- Estimates of revenues and expenditures of the Territory and its subsidiary agencies
- Provide for the funding of essential public services
- Provide adequate funding for public pension systems
- Provide for the elimination of budget gaps
- Ensure that the Territory's debt burden is sustainable
- Improve the Territory's fiscal governance
- Provide a means for achieving fiscal targets
- Creates credible and independent forecasts of governmental revenues

Although Promesa provides that each Fiscal Plan shall provide for adequate funding of public pension systems, the House Report on Promesa acknowledged the statute's ambiguity regarding pensions and noted that ''[t]his language should not be interpreted to reprioritize pension liabilities ahead of the lawful priorities or liens of bondholders.'' Given the substantial underfunding of Puerto Rico's public pension plans, it is difficult to foresee how the Territory can satisfy Promesa's other statutory mandates without reducing and restructuring its pension obligations, and nothing in Promesa expressly bars such a result. But given that the Territory has not run a balanced budget for several years, the legislation is silent on how the Territory is to achieve these goals, some of which may be in conflict. In the debate surrounding Promesa's enactment, some argued that the Territory needed to drastically reduce its benefits and services. Others argued that implementing such steps would only accelerate the population losses Puerto Rico has experienced in recent years, and that growth in the economy is the only solution. But the legislation does not directly address either argument, leaving it to the Oversight Board to develop a strategy.

After the Fiscal Plans have been approved, the Oversight Board sets a schedule for the preparation and approval of budgets for the Territory and the Municipal Issuers. The initial proposed budgets are prepared by the Territory and the Municipal Issuers and submitted to the Oversight Board for review. The Oversight Board can approve the budgets or recommend changes. If the Territory or any Municipal Issuer fails to adopt the Oversight Board's changes, the Oversight Board has the power to adopt its budget for the Territory or Municipal Issuer.

The Governor is required to report quarterly to the Oversight Board on budget compliance. If there are adverse variances, the Governor can propose corrective action, subject to the approval of the Oversight Board. If the Governor fails to act, the Oversight Board must make ''appropriate reductions in non-debt expenditures'' to ensure compliance. Notably, there is no limiting language on the Oversight Board's authority in exercising these powers. This combination of quarterly review, coupled with the power to reduce non-debt expenditures, is what gives the Oversight Board true power over Puerto Rico's finances. But at the same time it is this provision that most chafes the critics of Promesa because it authorizes the Oversight Board to supervene the expressed will of Puerto Rico's elected government.

Title III Debt Restructuring Proceedings

Title III of Promesa establishes a debt-adjustment scheme for the Territory and its Municipal Issuers that is based upon Chapter 9 of the Bankruptcy Code. But unlike Chapter 9, where an eligible municipality can commence a proceeding for debt relief, under Promesa only the Oversight Board can initiate a Title III proceeding. Under Promesa, exclusive jurisdiction for a Title III proceedings is in the District Court where the Territory or Municipal Issuer is located. Chief Justice John Roberts will designate the district court judge to preside in any case involving the Territory; in the case of a Municipal Issuer, the designation of a judge will be handled by the chief judge of the Court of Appeals for the First Circuit. Any appeals from decisions of the District Court will be handled by the First Circuit.

The commencement of a Title III proceeding establishes a reorganization proceeding that is designed to lead to approval of a plan of adjustment, which is similar to a plan of reorganization in a Chapter 11 case. Once approved by the court, a plan of adjustment specifies how the claims against the Territory or Municipal Issuer will be restructured. In the case of Municipal Issuers, it is likely that only the municipal bond debt will be adjusted; in the event that the Territory becomes a debtor in a Title III proceeding, the claims against it will be broader, and may include pension obligations, labor contracts and leases and other executory contracts. In cases where there are multiple tranches of debt, Promesa requires that the priorities and liens of any existing claims be respected. A strength of Title III is that it authorizes the cramdown of non-consenting debt holders where consensual restructurings fail.

Promesa incorporates many provisions of Chapter 9 directly, including the automatic stay, financing, majority voting rules, cramdown, discharge, and the discharge injunction. The key difference is the control by the Oversight Board. In a Title III proceeding, only the Oversight Board may file or modify a plan of adjustment. Critically, the standards for approval of a plan of adjustment track the provisions applicable to Chapter 9 cases, including the feasibility and fair and equitable requirements. Given the extent to which Title III proceedings adopt Chapter 9, one might ask why Congress didn't simply fold Promesa into Chapter 9. The answer is bound up in the politics of the law. Many bondholders believe that in the City of Detroit Chapter 9 case, the claims of bondholders had been unfairly treated relative to the claims of union employees and retirees. For that reason, they lobbied to have Title III proceedings heard in district courts, rather than bankruptcy courts, which they viewed as biased in favor of employee and pension claims.

Automatic Stay

Promesa provides for an automatic stay of all litigation against the Territory and its Municipal Issuers. The stay commences upon the enactment of Promesa and continues until the later of six months of enactment of Promesa or February 15, 2017, and may be extended for 75 days by the Oversight Board. The federal court for the District of Puerto Rico also has the authority to extend the automatic stay for 60 days. Thus Promesa, like the Bankruptcy Code, gives the Oversight Board, the Territory, and the Municipal Issuers breathing space to develop new restructuring proposals without having to respond to ongoing litigation.

Minimum Wage; Labor Laws

Section 403 of Promesa authorizes the Governor of Puerto Rico, with the approval of the Oversight Board, to lower the minimum wage for workers under the age of 25 to $4.25 per hour for up to four years. The law would not lower wages for any existing employees; it only applies to employees hired after Promesa's enactment. Section 404 of Promesa exempts employees in Puerto Rico from the revised overtime regulations promulgated by the Department of Labor in July 2015. The effect of the Promesa's exemption of Puerto Rican employees is to reinstate the pre-2015 rules for such employees.

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