PUERTO RICO CHAPTER 9 UNIFORMITY ACT OF 2015

HEARING

BEFORE THE

SUBCOMMITTEE ON
REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

ON

H.R. 870

FEBRUARY 26, 2015

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CONTENTS

FEBRUARY 26, 2015

PUERTO RICO CHAPTER 9 UNIFORMITY ACT OF 2015

THURSDAY, FEBRUARY 26, 2015

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to call, at 11:33 a.m., in room 2237, Rayburn House Office Building, the Honorable Tom Marino (Chairman of the Subcommittee) presiding.

Present: Representatives Marino, Issa, Walters, Bishop, Johnson, Conyers, and Cicilline.

Also Present: Representatives Pierluisi and Gutierrez,

Staff Present: (Majority) Anthony Grossi, Counsel; Andrea Lindsey, Clerk; and (Minority) Susan Jensen, Counsel.

Mr. MARINO. The Subcommittee on Regulatory Reform, Commercial and Antitrust Law will come to order.

Good morning, everyone.

Without objection, the Chair is authorized to declare a recess of the Committee at any time.

We welcome everyone to today's hearing on H.R. 870, the "Puerto Rico Chapter 9 Uniformity Act of 2015."

And now for the record, I am going to recognize myself for an opening statement.

We meet today to evaluate the merits of H.R. 870, the "Puerto Rico Chapter 9 Uniformity Act of 2015." On its face, this legislation is very simple. Existing laws exclude Puerto Rico from allowing its municipalities to restructure under the Federal bankruptcy laws. H.R. 870 removes this exclusion and allows Puerto Rico the ability to utilize Chapter 9 of the bankruptcy code.

To be clear, even if H.R. 870 is enacted into law, Puerto Rico has the ultimate discretion to determine whether to allow its municipalities access to the Federal bankruptcy laws. While this may appear to be a technical fix to the bankruptcy code, much is at stake for both Puerto Rico and investors in its debt.

Despite its relatively small size in terms of population, Puerto Rico ranks among the top municipal bond issuers in the country. Puerto Rico, with its population of approximately 3.5 million people, has over $70 billion in municipal bond debt.

To put that in perspective, in terms of municipal bond debt, Puerto Rico ranks only behind California, which has a population of almost 39 million people, and New York, which has a population of approximately 20 million people. In part due to the amount of debt Puerto Rico has issued and because of its tax attributes, Puerto Rican bonds are held by a diverse array of investors, with bondholders ranging from sophisticated hedge funds to Main Street folks with retirement accounts.

As we evaluate H.R. 870 today, we need to be mindful of its potential broad and wide-ranging impact, particularly on those Main Street investors. A significant portion of Puerto Rico's municipal bonds are issued by various public corporations that provide government services to the Puerto Rican population.

For example, the public corporation facing the most severe financial distress, the Puerto Rico Electric Power Authority, or PREPA, is responsible for providing, as its name implies, electricity to the residents of Puerto Rico. PREPA has approximately $8.6 billion in outstanding municipal bond debt.

The Puerto Rico public corporations that are responsible for, among other things, its highways, ports, and telephone service also each carry billions of dollars in municipal bond debt. These are the types of Puerto Rican public corporations that may have to resort to Chapter 9 if that option is afforded to them.

Due in part to its exclusion from the Federal bankruptcy laws for municipalities, Puerto Rico passed a local law that was similar in many ways to Chapter 9. Three weeks ago, the District Court for the District of Puerto Rico struck down that local law, finding, among other things, that it was preempted by Chapter 9 of the bankruptcy code.

As a result of this decision, upon a default by a Puerto Rican public corporation, the contract governing its bonds is the sole source for methods by which parties can resolve the default. These are the contracts that were in place when the investors purchased the Puerto Rican municipal bonds, and we should be mindful of the potential impacts on their rights when considering H.R. 870, which is proposed to operate retroactively. At the same time, we should also consider whether H.R. 870 would bring greater stability to the broader municipal bond market for the benefit of all investors.

Now this hearing is focused solely on the merits of allowing Puerto Rico the ability to utilize Chapter 9 under H.R. 870. We are not—we are not here today to evaluate the broader topic of Chapter 9, which is beyond the scope of this hearing and an issue on which these witnesses are not prepared to testify.

I look forward to today's testimony on the merits of H.R. 870.

[The bill, H.R. 870, follows:]

I

114TH CONGRESS
1ST SESSION

H. R. 870

To amend title 11 of the United States Code to treat Puerto Rico as a State for purposes of chapter 9 of such title relating to the adjustment of debts of municipalities.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 11, 2015

Mr. PIERLUISI introduced the following bill; which was referred to the Committee on the Judiciary

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A BILL

To amend title 11 of the United States Code to treat Puerto Rico as a State for purposes of chapter 9 of such title relating to the adjustment of debts of municipalities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Puerto Rico Chapter 9 Uniformity Act of 2015".

SEC. 2. AMENDMENT.

Section 101(52) of title 11, United States Code, is amended to read as follows:

"(52) The term 'State' includes Puerto Rico and, except for the purpose of defining who may be a debtor under chapter 9 of this title, includes the District of Columbia.".

SEC. 3. EFFECTIVE DATE; APPLICATION OF AMENDMENT.

(a) EFFECTIVE DATE.—Except as provided in subsection (b), this Act and the amendment made by this Act shall take effect on the date of the enactment of this Act.

(b) APPLICATION OF AMENDMENT.—The amendment made by this Act shall apply with respect to—

(1) cases commenced under title 11 of the United States Code on or after the date of the enactment of this Act, and

(2) debts, claims, and liens created before, on, or after such date.

SEC. 4. SEVERABILITY.

If any provision of this Act, or the application of such provision to any person or circumstance, is found to be unconstitutional, the remainder of this Act, or the application of that provision to other persons or circumstances, shall not be affected.

○

Mr. MARINO. It is now my pleasure to recognize the Ranking Member of the Subcommittee on Regulatory Reform, Commercial and Antitrust Law, Mr. Johnson of Georgia, for his opening statement.

Mr. JOHNSON. Thank you, Mr. Chairman, for holding this important hearing.

I support H.R. 870, the "Puerto Rico Chapter 9 Uniformity Act of 2015," which would provide a vital roadmap for severely distressed Puerto Rican municipalities to restructure their debt in the interest of both the citizens who rely on vital public services and creditors of these corporations.

This bill will close a gap in the bankruptcy code, which excludes Puerto Rico for Chapter 9 municipal bankruptcy for reasons that are, at best, unclear. This legislation is also consistent with the purpose of Chapter 9, which is to provide relief to severely distressed municipalities that have exhausted alternative remedies.

Notwithstanding my support for H.R. 870, I close by noting that the municipal bankruptcy is not a cure-all, and there will be remaining questions concerning the restructuring of Puerto Rico's public debt. I strongly support the right of public workers to receive their healthcare and pension benefits, and I support Ranking Member Conyers' legislative efforts to guarantee this right in municipal bankruptcies.

With that, I yield the remainder of my time to Congressman Pierluisi, who has expertly served as Puerto Rico's sole Member of Congress and resident commissioner since 2009. And I hope I have been correct in my pronunciation.

Thank you, Mr. Pierluisi.

Mr. PIERLUISI. Thank you for yielding, Mr. Johnson.

Chairman Marino and Chairman, actually, Goodlatte, who is not here, I would like to thank both of you for scheduling this hearing.

I want to use my time not to explain this simple bill or to itemize the many reasons why it is good policy, but rather to underscore the broad support it has attained. Among professors and attorneys that specialize in bankruptcy law, support for the legislation is virtually unanimous.

The bill has been endorsed by the National Bankruptcy Conference, which is composed of about 60 top scholars and practitioners, including Mr. Mayer, one of today's witnesses. In addition, some of the most respected subject matter experts in the country have written to this Committee to urge enactment of the bill. This includes James Spiotto, an experienced attorney who has represented bondholders in Chapter 9 proceedings and who has written a tour de force letter in favor of the bill.

In Puerto Rico, where unity is rare, H.R. 870 has virtually unanimous support as well. The current administration will testify for the bill. Senate President Eduardo Bhatia is here today to demonstrate his support for the bill. Former Governor Luis Fortuno has written a letter in support of the bill. The legislative assembly has adopted a joint resolution urging enactment of the bill, and nine former presidents of the Puerto Rico Government Development Bank have sent a letter in support of the bill.

In addition, 13 private sector trade associations on the island have signed a memorandum of agreement endorsing the bill, and the bill is supported by Banco Popular, Puerto Rico's largest bank.

Finally, the bill is supported by the vast majority of Puerto Rico's creditors and other stakeholders in the investment community. For example, a letter in support of the bill has been sent to the Committee on behalf of 32 funds who own billions of dollars in Puerto Rico bonds.

Last week, the head of the municipal bond group at the world's largest asset manager said in an interview that he supported the bill. A respected investment firm surveyed approximately two dozen market participants and found that there is nearly unanimous agreement that application of Chapter 9 to Puerto Rico instrumentalities is a reasonable approach and would not impair the normal functioning of the marketplace. Fitch Ratings has stated that enactment of this bill would be a positive and important development for Puerto Rico and holders of debt of its public utilities and public instrumentalities.

Opposition to this bill comes from a very small number of investment firms. I believe the arguments they have put forward cannot withstand meaningful scrutiny, and I hope that the Committee will not allow these objections to frustrate forward movement on this sensible and broadly supported bill.

I yield back the balance of my time.

Mr. MARINO. Thank you, Mr. Pierluisi.

And thank you, Mr. Johnson, for yielding some of your time to him.

Now the Chair recognizes the gentleman from Michigan, the Ranking Member of the full Committee, Congressman Conyers.

Mr. CONYERS. Thank you, Chairman Marino.

Members of the Committee, we think this is so important. A hearing on H.R. 870, the "Puerto Rico Chapter 9 Uniformity Act of 2015," before this very important Subcommittee.

Inexplicably, the bankruptcy code excludes the Commonwealth of Puerto Rico for the purpose of defining who may be a debtor under Chapter 9. And fortunately, the measure before us—and I welcome the witnesses—takes care of this problem.

Now my source for all information on Puerto Rico stems from the gentleman from Illinois, Chicago, who I am very proud to yield the balance of my time to because of his great contributions to the Judiciary Committee and to the Congress in general.

I want to acknowledge the presence of Senator Eduardo Bhatia, the president of the Senate of the Commonwealth of Puerto Rico, as well. And so, I yield my time to the gentleman from Chicago.

Oh, gosh, Nydia Velazquez is here, too. And Jose Serrano, a former all-star Member of the Congress, is here as well. And so, I am very happy to yield at this point.

Mr. MARINO. We can't forget about Joe. We can't forget about Joe back there. Luis?

Mr. GUTIERREZ. Thank you. Thank you so much.

Thank you, Ranking Member Conyers.

Let me first ask unanimous consent to have Senator Eduardo Bhatia, president of the Senate's statement entered into the record.

We gather here in the Judiciary Committee, we are usually easy to identify by our partisan divisions. But today should not be one of those days.

Today, we are discussing how the Congress of the United States can help millions of U.S. citizens without spending a dime of the taxpayers' money. Can you imagine that?

And all the stakeholders agree the legislation we are discussing is the right course of action. The people who support statehood for Puerto Rico and those who do not, Republicans and Democrats, we are here to discuss a consensus approach, not a contentious approach. This legislation is a wise use of the law, a step we can take now to avoid a bailout or a financial crisis later.

I think the Governor of Puerto Rico has been doing a very good job with a very difficult situation. He has been open and transparent. He has engaged the stakeholders in restructuring the dire financial situation he inherited, which has plagued the Island of Puerto Rico for generations.

He has worked diligently with the public corporations on the island to enlist their help and to encourage them to take the steps necessary to avoid a financial crisis. The Governor is dealing effectively with the situation that was left to him, but we in Congress can do our part to help today.

We can help by passing this legislation that I support and that has been offered for our consideration by the resident commissioner of Puerto Rico, Mr. Pierluisi, and which is supported across the board by the Puerto Ricans in this Congress.

I look forward to the testimony, and I want to thank the Chairman for scheduling this hearing. I also want to say that it is a distinct pleasure to be a Member of the Judiciary Committee with my fine, distinguished colleague from Puerto Rico, Congressman Pierluisi, and to sit here on this dais as two Members.

And I thank all of the Members for allowing the two Members from Puerto Rico, one who actually lives there and one that wants to—— [Laughter.]

Mr. GUTIERREZ [continuing]. To join you here and for allowing us time to express ourselves. And again, it is a joy to be enjoined with the resident commissioner of Puerto Rico, Mr. Pierluisi, in supporting his legislation. Godspeed to your legislation. Anything I can do, please let me know.

Thank you. Thank you so much.

Mr. MARINO. Thank you, Congressman Gutierrez.

Thank you, Congressman Conyers, for affording him the time.

And without objection, other Members' opening statements will be made part of the record. I think you had a document that you asked to be submitted or——

Mr. GUTIERREZ. Yes, I asked——

Mr. ISSA. I would ask unanimous consent that that be placed in the record.

Mr. GUTIERREZ [continuing]. That it be placed in the record.

Mr. MARINO. Without objection. Without objection.

Mr. GUTIERREZ. No objection? Thank you, Mr. Chairman.

[The information referred to follows:]

EDUARDO A. BHATIA
PRESIDENT

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

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

Distinguished Members of the Judiciary Committee:

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

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

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

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

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

The editors of Bloomberg, in an editorial published yesterday, February 25, 2015, forcefully advocated for the approval of this bill, lamenting that "[b]ecause Puerto Rico isn't a state it can't avail itself of the provisions in federal bankruptcy law to restructure its debt in an orderly fashion." From a legal or policy standpoint, there is absolutely no justification for barring Puerto Rico's instrumentalities from having access to Chapter 9, as the Commonwealth's instrumentalities are akin to municipalities in the 50 states. Tellingly, the legislative history surrounding the exclusion of Puerto Rico from Chapter 9 contains none. Puerto Rico is not asking for special treatment: it is requesting parity of treatment with state-side municipalities. The uncertainty created by the absence of an insolvency regime for Puerto Rico's public corporations is hurting the possibilities of recovery for Puerto Rico.

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

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

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

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

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

Thank you.

Mr. MARINO. The Chair is now going to recognize Congressman Issa for a statement.

Mr. ISSA. I thank you, Mr. Chairman.

Recognizing that Mr. Goodlatte is not here, I want to take a liberty and discuss very, very quickly a conversation I had with the Chairman night before last.

This bill appears to be noncontroversial. It appears to be fast-tracked, and the Chairman viewed it that way. But in looking at the legislation and the effect on a nonstate player and having been in my past life the Chairman of the Committee that oversees entities, including cities, counties, territories, and the District of Columbia, there were a number of areas of concern that I hope today we will be addressing.

First of all, retroactivity, contract sanctity. The reality is that a debtor assumes a debt based on a risk factor and is given a rate for that debt based on a risk factor. Those risk factors were based on the law in place. In fact, the absence of an ability to bankrupt under Chapter 9.

Additionally, the District of Columbia is an interesting model for the fact that—and so is the City of New York, historically—when irresponsible behavior, not one crisis, not one event, but irresponsible behavior over a long period of time leads to an entity, a public entity—in this case, the District of Columbia or the City of New York—finding itself in a level of insolvency, there has been a history of control boards, a history of preemption in return for any action by the sovereign body. That is not on the table here today.

The fact is that public corporations in most of America are, in fact, private corporations. A major utility in most places is not owned by a city or a State. There are exceptions. And in fact, they are subject to ordinary bankruptcy. They also have an obligation to be fiscally responsible to their shareholders.

That is not the case in Puerto Rico. Puerto Rico has, in many cases, public entities that may not be wise to continue having. It is not this Committee or, in fact, the Oversight Committee's job to micromanage territories, cities, or the District of Columbia. But it is our obligation to question three things.

One is do we have a constitutional and legitimate role in retroactively changing contracts in place so that a bankruptcy could occur that was not in place at the time those contracts were incurred?

Two, and most importantly, is it wise to provide this even prospectively without a real plan presented from the Commonwealth of Puerto Rico going forward for how they are going to work their way out of an ongoing and systemic pattern?

I have had the honor to serve under multiple, I guess three Representatives from Puerto Rico and now four Governors. I have found each of them decidedly different, each to care greatly about the people of Puerto Rico, each to be a proud American.

But I have found that how they deal with the direction of the territory has been decidedly different. One seems to want to pay back debt. Another seems to want to run it up. Some seem to think that the only way to prosperity is to reduce taxes. Others have incurred tax increases with deficit spending.

That is not uncommon here in government. What is uncommon is to come to the Congress and say after a Federal judge says you don't have a right to do something, ask for a right to do it and have it affect $70 billion-plus worth of contracts in place.

So although I have not made a decision on the bill in its current form, I have serious questions about whether it can become law in its current form. And most importantly, if it does become law in any form, what safeguards will we insist on being in place to prevent this kind of, if you will, crisis in the territory Commonwealth of Puerto Rico or, for that matter, in the other territories, the District of Columbia, or any other holding of the United States?

So I take this, Mr. Chairman, as an extremely important hearing, and I hope that all of us will look at this as a bigger potential challenge to be addressed than just a technical correction of an oversight, which I believe it might have been. But these $70 billion-plus worth of debts are, in fact, based on people who took the law as it was, not as it perhaps should have been.

And I thank the Chairman for his indulgence and yield back.

Mr. MARINO. We have a very distinguished panel before us today. I will begin by swearing in our witnesses before introducing them. Would you please stand and raise your right hand?

Do you swear that the testimony you are about to give is the truth, the whole truth, and nothing but the truth, so help you God?

[Response.]

Mr. MARINO. Okay. Let the record reflect that all witnesses have responded in the affirmative.

Thank you. You may be seated.

I am going to introduce the distinguished panel that we have today. And we will begin with Professor John Pottow. Am I pronouncing that correctly, sir? Good.

Mr. Pottow is a professor at the University of Michigan Law School and is an internationally recognized expert in the field of bankruptcy law. Professor Pottow has published articles in prominent legal journals in the United States and Canada, presented his works at academic conferences around the world, provided frequent commentary for national and international media outlets, and argued bankruptcy cases before the Supreme Court.

Professor Pottow received his bachelor's degree from Harvard College, summa cum laude, and his law degree from Harvard Law School, magna cum laude, where he served as treasurer of the Harvard Law Review.

Welcome, sir.

Mr. POTTOW. Thank you very much, Mr. Chairman.

Mr. MARINO. Our next witness is Ms. Melba Acosta. Ms. Acosta is the president of the Government Development Bank of Puerto Rico, referred to as the GDB, a bank that serves as the fiscal agent and financial adviser for Puerto Rico and all of its instrumentalities.

Prior to appointment as president of the GDB, Ms. Acosta served Puerto Rico in a number of capacities, including as secretary of the Treasury Department, chief public financial officer, director of OMB, and chief information officer. Ms. Acosta is a certified public accountant and attorney.

She received her bachelor's degree in accounting from the School of Business Administration of the University of Puerto Rico, her MBA from the Harvard Graduate School of Business Administration, and her law degree from the School of Law of the University of Puerto Rico.

Welcome.

Our next witness is Mr. Robert Donahue. Mr. Donahue is a managing director at Municipal Market Analytics, known as MMA, an independent research firm servicing the municipal bond industry. Mr. Donahue oversees research for more than 150 bank municipal investment portfolios and is responsible for issues pertaining to Puerto Rico's municipal bond market.

He has nearly 20 years of experience in the field and has worked at leading investment firms, including DWS Investment, Fidelity Investments, and T. Rowe Price Associates.

Mr. Donahue received his bachelor's degree from the College of Holy Cross and a master's of public administration from Syracuse University's Maxwell School of Citizenship and Public Affairs.

Welcome.

Our next witness is Mr. Tom Mayer. Mr. Mayer is a partner at the firm of Kramer Levin, where he is the co-chair of the firm's Corporate Restructuring and Bankruptcy Department. Mr. Mayer has over 30 years of experience as a bankruptcy lawyer, principally representing creditors in large Chapter 11 cases.

He also has substantial experience with municipal bankruptcies, where he has represented creditors in Chapter 9 cases of Jefferson County, Alabama, and Detroit and Michigan—in Michigan, excuse me.

Mr. Mayer received his bachelor's degree, summa cum laude, from Dartmouth College and his law degree, magna cum laude, from Harvard Law School, where he was editor of the Law Review.

And welcome to all.

Each of the witnesses' written statements will be entered into the record in its entirety. I ask that each witness summarize his or her testimony in 5 minutes or less. To help you stay within that time, there is a timing light in front of you. The light will switch from green to yellow, indicating that you have 1 minute to conclude your testimony.

When the light turns red, it indicates that your time has expired. And if that happens, I will politely just give you a little tap to give you an indication and ask you to wrap up quickly.

I am going to start now with Professor Pottow for his opening statement. Sir?

TESTIMONY OF JOHN A. E. POTTOW, ESQ., PROFESSOR OF LAW, UNIVERSITY OF MICHIGAN LAW SCHOOL

Mr. POTTOW. Thank you very much, Mr. Chairman and Ranking Members. And thank you for the opportunity to be able to talk at this hearing today on this important matter.

I think that the comments were well taken that it seems like this is a technical bill, and I think that is why there is unanimous support amongst the bankruptcy community for this correction. But there also are some serious concerns that we should be mindful of in thinking of something of this nature to correct the bankruptcy code.

And so, I would like to touch a little bit about those bankruptcy concerns and then talk, if I don't run out of time, about the experience that Detroit has had with its Chapter 9, its recent Chapter 9 restructuring of that city.

The concerns of the bankruptcy code with regarding, talking about a retroactivity or talking about applying a change to pre-existing debts is one that the Supreme Court has actually had occasion to wrestle with because we have amended the bankruptcy laws several times through this Nation's history. In the 19th century, we had temporary bankruptcy laws that expired. They had to reenact them, and then we had the comprehensive overhaul of 1978.

And what the Supreme Court did was draw a distinction between contract rights and property rights. And basically, in the Moyses case, which is cited in my letter at page 4, it came to the conclusion that because of the bankruptcy clause power that the Congress has, everyone who makes an investment is already on notice that if Congress chooses to exercise its regulatory right in a bankruptcy matter, that a debtor might avail himself to those bankruptcy laws, and so they go in knowing that those laws might change.

And that makes good sense, not just a matter of constitutional law, but as a matter of bankruptcy law as well. Because if you tried to have a restructuring like a Chapter 11 for the private sector or Chapter 9 for the public sector, but only half the debts could be restructured, and the other half couldn't be restructured, you would have this sort of Frankenstein hybrid where some people were making difficult compromises and other people walked in with a straight veto and say, "I don't have to show up at the table."

And that is antithetical to what the idea of a restructuring is. It is to get everyone to come in together, to have the stakeholders come together, everyone makes concessions. And one sign that there has been a good restructuring is that if everyone leaves slightly unhappy, there has probably been a good deal that has been reached by all.

Now with property rights, there is a greater concern because we have the takings clause of the Constitution, and that is something the Supreme Court gets very concerned about is when there is property rights. So, for example, in bankruptcy, a secured creditor would have a property right of sorts by having a lien on collateral.

And there is one provision in the bankruptcy code that I am familiar with, which is Section 522(f), which is pretty much Congress at its most invasive on property rights and bankruptcy. And what 522(f) does is it just erases liens on property. There are certain liens on secondhand consumer goods that basically the Congress thought was extortionate, and so it says those liens are not enforceable in bankruptcy. They can be canceled in bankruptcy.

And when that amendment was passed to the bankruptcy code, it went to the Supreme Court, and the Supreme Court said, well, that is actually taking away a lien. That is just more than a contract investment. That is a property right.

And so, they avoided a difficult constitutional question in the Security Bank case, which is also in my letter at page 4, by saying we are going to interpret 522(f) to apply prospectively only. So this thing that cancels liens, we are not going to apply it to preexisting liens, only if you have a lien that is done after this enactment occurred.

And they cited the old cases on contract law to draw a distinction. They said, by contrast, if this was just an investment, that would be fine, and these sorts of amendments to the bankruptcy code take place all the time.

I do think that it is interesting that Puerto Rico has taken what I consider to be a moderate approach when it tried to pass its Recovery Act. It has been struck down as unconstitutional, and the reason why is they said that is the purview of the Federal Government. So if you want to have a bankruptcy regime, go off and talk to Congress, which was an invitation of the court to do so.

And in that Recovery Act, Puerto Rico chose to apply its version of a Chapter 9 law only to a subset of public entities that otherwise would be available under Federal Chapter 9. So they did not apply it to cities, which they otherwise could.

And that makes sense because you see different States take different approaches about how they want to use Chapter 9. Some States forbid it. Some States allow it. Some are in the middle. Puerto Rico might be in the middle.

I would like to make two quick points about Detroit, if I could. Number one, it was a comprehensive overhaul that had not just financial restructuring and financial pain, but also had operational change.

There has been $1.7 billion of capital investment pursuant to a 10-year plan that was laid out in the disclosure statement that the creditors voted on and supported. The bondholders and the pensioners all got together and supported this plan, recognizing their need to be operational changes and financial oversight.

And some said Chapter 9 is going to kill you. The municipal capital markets will never let you borrow money again, and you are going to lose your credit rating. Well, the financing Detroit got in its Chapter 9 is short term. It is private debt, and it rolls over in 4 months. And they are getting prepared to roll over that debt and go out to the capital markets again.

And what has happened to Detroit as a consequence of its success in Chapter 9 is it is going to get investment grade rating. And so, that capital is going to be priced at a lower level than Detroit has ever been able to have before, and that is part of the success of the Chapter 9 process for the City of Detroit.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Pottow follows:]

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(Non University Business.)

February 24, 2015

The Honorable Bob Goodlatte
Chairman
House Committee on the Judiciary
2138 Rayburn House Office Building
Washington, DC 20515

The Honorable John Conyers, Jr.
Ranking Member
House Committee on the Judiciary
B-351 Rayburn House Office Building
Washington, DC 20515

The Honorable Tom Marino
Chairman
Subcommittee on Regulatory Reform,
Commercial and Antitrust Law
House Committee on the Judiciary
2138 Rayburn House Office Building
Washington, DC 20515

The Honorable Henry C. "Hank" Johnson
Ranking Member
Subcommittee on Regulatory Reform
Commercial and Antitrust Law
House Committee on the Judiciary
B-351 Rayburn House Office Building
Washington, DC 20515

Re: <u>H.R. 870, Puerto Rico Chapter 9 Uniformity Act of 2015 ("HR 870")</u>

Dear Chairman Goodlatte, Ranking Member Conyers, Chairman Marino and Ranking Member Johnson:

Thank you for the opportunity to testify on HR 870. I offer my full support for this long-overdue technical correction to the Bankruptcy Code.

Let me start by emphasizing HR 870's narrow focus. It does not authorize municipalities[1] to file chapter 9 bankruptcies in Puerto Rico. Rather, it confers upon Puerto Rico the decision-making authority already accorded the states to decide whether, and under what conditions, its municipalities can file. Some states forbid their municipalities from filing chapter 9s. *See, e.g.*, GA. CODE ANN. § 36-80-5. Others do not. *See, e.g.*, ALA. CODE § 11-81-3. Many in the middle put strings on the ability to file, such as pre-clearance by financial advisory boards administered under state law. *See, e.g.*, MICH. COMP. LAWS. ANN.

[1] I use the term "municipalities" here to refer not solely to cities but to all public entities as that term is used in the Bankruptcy Code (which is title 11 of the U.S. Code). *See* 11 U.S.C. § 101(40) (defining "municipality" as including political subdivisions, public agencies, or instrumentalities of a State).

§§ 141.1541 *et seq*. Thus, at the risk of being pedantic, I underscore that this is not a vote on whether San Juan can file a chapter 9. The discussion is whether to remove Puerto Rico from the infantilizing no man's land it finds itself in under current bankruptcy law for no apparent reason: unable to authorize its municipalities to file for chapter 9 under the federal Bankruptcy Code, *see* 11 U.S.C. § 101(52), but also impotent to pass its own Commonwealth law analogue to chapter 9 (at least according to the recent invalidation of its attempt to do so, *see Franklin California Tax-Free Trust v. Puerto Rico*, No. 14-1518, 2015 WL 522183 (D. P.R. Feb. 6, 2015) ("District Court Opinion") (striking down The Puerto Rico Public Corporation Debt Enforcement and Recovery Act, Act No. 71 (June 25, 2014) ("Recovery Act")).

According Puerto Rico the status enjoyed by the states to "make the chapter 9 call" for itself seems both sensible and equality-promoting. I am unaware of any bankruptcy scholar who opposes this proposal, and this is not an academic community shy about expressing disagreement.

One reason it makes so much sense to fix the Bankruptcy Code with this amendment is that it is not even clear why Puerto Rico was excluded from the chapter 9 process in the first place. When Congress undertook its comprehensive modernization of the bankruptcy laws culminating in the 1978 Code, there was no exclusion of Puerto Rico from chapter 9 under the Code – because there was no definition of "State."[2] In fact, Puerto Rico probably was eligible to access chapter 9 if one reverts to the preceding bankruptcy law, the Bankruptcy Act of 1898, which included Puerto Rico under the definition of "States." Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544, §1(29) (repealed 1978) ("1898 Act"). Thus, although there is some academic debate on the question, in 1978 Puerto Rico most likely could have authorized its municipalities—or forbidden them – from filing for relief under chapter 9, just as all the other states could. Any misconception of longstanding historical exclusion of Puerto Rico from chapter 9 should be corrected right away.

When Congress began a series of technical corrections to the Code – dating back to legislation being considered as early as 1979 – somehow a new definition of "State" got worked into the Code that eliminated Puerto Rico from chapter 9 only. It is not clear whether this was a "scrivener's error" or other such inadvertence because there is absolutely no legislative history of any debate suggesting Congress made this exclusion intentionally. To describe the legislative history as "complicated" is understatement. The Senate proposed a bill to define "State" to include, inter alia, "the Commonwealth of Puerto Rico," S 658, 96th Cong. (1st Sess. 1979), and explained that Puerto Rico was "inadvertently left out of the definition of 'state' during passage of the [1978 Code]," S. Rep. No. 96-305 (1979), an already-confusing explanation because there was no definition of "State" in the 1978 Code to be corrected! That bill never got enacted, but at some point an amendment came back from the House – over many back and forths on different matters – that has the current definition still in force today,

[2] The 1978 Code also had no definition of "United States," so there is some academic debate about whether the Code initially even applied to Puerto Rico at all, which may have been one of the motivations for the technical corrections to follow. Further complicating the fact is that the 1978 Code's definition of governmental units, *cf.* 11 U.S.C. § 101(27) (current definition, which includes "Territory"), only included "State" and "Commonwealth," which could be used to infer an exclusion of Puerto Rico – unless it was already included by virtue of being a "Commonwealth." Good historical discussion that notes the debate can be found in Stephen J. Lubben, *Puerto Rico and the Bankruptcy Clause*, 88 AM. BANKR. L. J. 553 (2014).

which did not get enacted until 1984. *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (enacting 11 U.S.C. § 101(52)). There is no indication why the House made the change that eventually got into law, and in fact there is indirect evidence Congress was confused as to just what it was doing.[3] Thus, Puerto Rico became stripped of its access to chapter 9 for reasons that are at best mysterious and at worst unintentional.

The matter probably attracted no serious congressional attention because of relatively healthy market conditions during a prosperous run of the U.S. economy. The Great Recession starting in 2008 brought considerable financial distress to light, however, including that plaguing municipalities. Chapter 9 has not just been dusted off but is now being used with greater frequency, such as with the much-vaunted emergence of Detroit from bankruptcy with a confirmed plan of adjustment. *See In re City of Detroit*, 524 B.R. 147 (Bankr. E.D. Mich. 2014) ("Detroit Confirmation Order"). It is thus no surprise that attention is turning to the use of chapter 9 by financially troubled municipalities.

Facing need to deal with financial distress afflicting some of its municipalities and its bizarre exclusion from chapter 9 of the Bankruptcy Code, the Commonwealth chose to pass its own "Recovery Act," which attempted to mimic many of the features of chapter 9. That statute was recently held unconstitutional by the federal district court in Puerto Rico and that judgment is already on appeal (which Puerto Rico has asked the Court of Appeals for the First Circuit to expedite). Had HR 870 been law, it is likely this entire debacle could have been avoided.

While that opinion is on appeal, and while I think there are respectable arguments on both sides regarding the constitutionality of the Recovery Act, I do note one important thing that Act taught us. Puerto Rico, when it had the choice to express its own preferences in enacting the Recovery Act, evinced a desire to have some, but not all, public entities that would qualify as "municipalities" under chapter 9 have access to what it called "public sector obligor" bankruptcy relief. Specifically, while utilities, like the debt-laden Puerto Rico Electric Power Authority ("PREPA"), were included in the definition of eligible debtors, cities and towns were not. *See* Recovery Act § 102(50), (113). While of course Puerto Rico might – like any state can – change its mind to allow fewer or greater entities access to chapter 9, it is informative that left to its own deliberative devices, Puerto Rico took a modest, incremental ground to public debt restructuring: allowing some but not all entities to do so. And indeed, this is somewhat the point of chapter 9's deference to state gatekeeping for eligibility: allowing fifty flowers of different policy approaches to bloom.

Given my support for HR 870, Members of the Committee may want to know if I perceive infirmities in its drafting. I do not. It is cleanly drafted. Short and sweet, it gets into the exclusion of Puerto Rico from the definition of State, puts it back in, and then ends. Best of all, the bill contains a clause making explicit the intent to apply to debts incurred prior to its enactment. *See* HR 870 §3(b)(2). This is a good

[3] A Senate Report accompanying one of the exchanges that dragged out over multiple years repeated the boilerplate explanation that the bill was fixing inadvertent omissions from the 1978 Code, such as an exclusion of Puerto Rico from the definition of "State" (which was actually never defined), even with the current language that carved Puerto Rico out from access to chapter 9 and thus excluded it from the definition of "State." *See* S. Rep. No. 97-150 (1981).

thing. The point of bankruptcy law is to provide comprehensive, final resolution of general financial default. Allowing only some debts (future debts), but not others (pre-existing debts), to be resolved is pointless. There is no such thing (or, more precisely, no such useful thing) as a "half-restructuring."

Some might worry that HR 870 applying "retroactively" to pre-existing debts is somehow unfair or even unconstitutional to the holders of that debt. This concern is mistaken. The Nation has had numerous bankruptcy laws throughout its history, some lasting only temporarily (the first "permanent" one was the previously mentioned Act of 1898). *See, e.g.*, Bankruptcy Act of Apr. 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803). Those laws generally applied to pre-existing debts when enacted, and the Supreme Court confirmed the permissibility of Congress exercising its power under the Bankruptcy Clause in this manner. *See, e.g.*, *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 188 (1902). This of course makes sense, because Congress has authority under the Constitution's Bankruptcy Clause to adjust debts, *see* U.S. CONST. art. I, § 8, cl. 4, putting all on notice that their contractual rights are always subject to adjustment by the Congress should a debtor ever avail itself of bankruptcy relief. (The Constitution's Contracts Clause does not apply to the federal government. *Id.* § 10, cl. 1 ("No State shall . . . pass any . . . law impairing the Obligation of Contracts . . .").[4]

The only time retroactivity is a concern is under the Takings Clause, *id.* § amend. V, and that in turn is only implicated when property rights are impaired. In bankruptcy, such concerns are rare, because the Code – in chapter 9 and throughout – is scrupulous about protecting the property rights of secured creditors, the primary instance in which property rights come into play. Secured creditors hold liens on collateral, and so one could argue that the Bankruptcy Code's invalidation of those property rights might implicate the Takings Clause. I say "might" because the issue has never been definitively resolved by the Supreme Court, and its resolution would involve an interaction between the Bankruptcy Clause and the Takings Clause that would be complex. But it is fair to say that there is "concern" about the retroactive application of bankruptcy laws to eliminate state-created property rights. The most recent pronouncement the Supreme Court had to offer was in the case of *United States v. Security Indus. Bank*, 459 U.S. 70, 82 (1982), in which it held that section 522(f) of the Bankruptcy Code – which cancels liens on certain types of second-hand household property of consumers (and thus does not just impair but destroys those lienholders' property rights) – would apply only prospectively to liens created after its enactment to avoid constitutional difficulties. The Court was unanimous in its opinion. Fortunately, as mentioned above, the Bankruptcy Code is quite protective of the value of secured creditors' liens, assuring them protection in myriad ways. *See, e.g.*, 11 U.S.C. §§ 506(a) (allowing each secured creditor an allowed secured claim for the full value of its collateral), 1129(b)(2)(A) (providing objecting secured

[4] At the risk of inundating the Committee with too much detail, I note the Contracts Clause and retroactivity concerns *did* constrain the enactment of state bankruptcy laws, which actually abounded in the nineteenth century before permanent federal bankruptcy legislation was enacted. *See, e.g.*, Act of March 21, 1788, ch. 92 N.Y. LAWS 823. Due to the Contracts Clause, those laws were valid only if they discharged debt incurred after the dates of their enactment. *See Sturges v. Crowninshield*, 17 U.S. 122 (1819).

creditor minimum entitlement to the value of its allowed secured claim in chapter 11), 1325(a)(5)(B) (same, in chapter 13).[5]

Given the widespread academic support and clean drafting of the bill, do I anticipate any opposition? On grounds of principle – that Puerto Rico should not be considered worthy of making its own decisions on the bankruptcy treatment of its municipalities – I do not anticipate objection. Indeed, I would be hard-pressed even to justify objection. Who even wants to make the argument that the elected representatives of Puerto Rico are somehow less competent or wise on matters of bankruptcy law than their state government analogues? Not any well-socialized bankruptcy scholar, or any scholar, for that matter.

That said, I suppose I could see objection based not on principle of continuing to treat Puerto Rico as unequal to the state governments in terms of chapter 9 decision-making but on a generalized aversion to chapter 9. That is, I can imagine someone saying, "I don't like chapter 9, period, and so the fewer entities that can use it, the better!" If that sort of objection is launched, the Committee should reject it. This is because an objection of this sort is unprincipled unless it is tethered to a specific argument about why drawing a distinction between Puerto Rico and other states is justified. It is fine (although in my view wrong-headed) to object to chapter 9. It is not fine to deploy arbitrary discrimination in access to chapter 9. Imagine a bill proposing to amend the Bankruptcy Code to render ineligible for letting its municipalities use chapter 9 any state beginning with the letter "M." Now imagine a supporter enthusing on the grounds that it's a great idea because chapter 9 is terrible, and so the fewer states that use it, the better. That would not be a morally acceptable legal argument to the people of Michigan, regardless of how deeply held the proponent's objections to chapter 9 were. Rather, principled objection would have to craft an argument explaining why M states were worse decision-makers than other states regarding access to chapter 9. As said, neither I nor any other scholar of whom I am aware can come up with such an argument regarding why Puerto Rico is worse than the fifty state governments that get to make that decision already. Thus, if the Committee gets objections premised on generalized disenchantment with chapter 9, it should resist indulging them.

As said, I believe unhappiness with chapter 9 is wrong-headed. Indeed, allow me to sing the praises of chapter 9, especially in light of our beyond-expectations recent success in Detroit. Chapter 9 – like chapter 11 – allows collective resolution of a municipal debtor's financial distress. In the absence of a collective forum, value-destroying fights with individual creditors will consume what little assets there are for repayment. The orderly resolution of debt in the U.S. chapter 11 bankruptcy system is world-renown and increasingly emulated. *See, e.g.*, Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276 (2000). To be sure, chapter 9 is not the mirror image of chapter 11 because of obvious differences (*e.g.*, no shareholders of a city to wipe out, no liquidation alternative to failure of a plan). But the general construct of consensual debt resolution with super-majoritarian buy-in is critical to solving the destructive influences of holdouts with which bankruptcy law

[5] Note the Takings Clause is concerned not with the property itself but with the value of that property and that it not be taken without paying "just compensation," U.S. CONST. amend. V. Hence the Bankruptcy Code's focus is on protecting the value of the lien and not the collateral itself.

is so fundamentally concerned. To that end, most creditors should welcome the addition of chapter 9. One need not wander very far into the world of sovereign debt – where there is no chapter 11 or 9 system; indeed, there is no "system" – to see the unpalatable alternative. Circumstances have grown so dire in that realm that the United Nations just held meetings on how best to resolve sovereign debt distress given the value-detracting lack of a coherent international system. *See Ad Hoc Committee of the General Assembly on a Legal Framework for Sovereign Debt Restructuring Processes: A First Step in the Right Direction*, Feb. 24, 2015 (U.N. Website Announcement).[6]

Perhaps some of the opposition to chapter 9 more generally arises from a concern that municipalities might "rush into" chapter 9 as a way to evade creditors and not take tougher steps, like cutting expenses or raising revenues. In other words, the fear is that chapter 9 might be a first, and not last, resort. This fear misunderstands chapter 9. Unlike chapter 11, chapter 9 imposes specific eligibility requirements, one of which is demonstration that the debtor has negotiated in good faith with the creditors. *See* 11 U.S.C. § 109(c)(5)(B). Debtors rushing to bankruptcy court will find themselves running straight into this bar. And once in, debtors still have to show that a plan of adjustment is fair and equitable to objecting creditors. *See id.* § 901(a) (incorporating *id.* § 1129(b)(1)). For example, in the Recovery Act litigation, it was alleged that PREPA had not tried to resolve its financial distress because it had not raised rates for decades. *See District Court Opinion* at *24. These sorts of allegations are precisely the sorts of objections that one could bring in a chapter 9 hearing and would receive a judge's careful scrutiny. (In our Detroit case, the bankruptcy court noted how the tax-strapped residents of Detroit no longer had a city that could afford "basic police, fire, and emergency medical services that its residents need for their basic health and safety" in finding the city eligible to file. *See In re City of Detroit*, 504 B.R. 97, 112 (Bankr. E.D. Mich. 2013).) Indeed, so far is chapter 9 from a first resort in Michigan that the previously cited law that restricts access to chapter 9 has multiple steps of financial review boards, emergency financial managers, governor's recommendations and so on, that must be climbed well before a municipality can get anywhere near a bankruptcy courtroom.

This brings me to a final point: chapter 9 worked well for Detroit. I do not mean to minimize the hurt felt by pensionholders and other workers – non-uniformed retirees took on average an almost 5% cut to their pensions (on top of healthcare clawbacks, COLA reductions, and the like). *See Detroit Confirmation Order* at 179-85. But it could have been much worse. Bondholders argued strenuously that those concessions were not nearly enough and were showing unfair favoritism; yet even the bondholders came on board and *supported* the plan of adjustment, ultimately arguing the court should approve it. *See id.* at 163. And the transformation to the residents of Detroit cannot be overstated. Street lights are coming back where there was literally darkness before. *See* Matt Helms *et al.*, *Nine Ways Detroit Is Changing After Bankruptcy*, DETROIT FREE PRESS (online ed., Nov. 9, 2014). There are lots of lower-income residents who rely on the public services, such as transportation, who now benefit from the collective sacrifices of pensioners and bondholders alike. Most importantly, the bankruptcy court focused on the "feasibility" of the Detroit plan, to make sure the city maximizes its chances of never falling into financial

[6] Available at: http://www.unctad.info/en/Debt-Portal/News-Archive/Our-News/Ad-hoc-Committee-of-the-GA-on-a-legal-framework-for-sovereign-debt-restructuring-processes-a-first-step-in-the-right-direction.

distress again. *See Detroit Confirmation Order* at 223. Without chapter 9, I am not sure where Detroit would be today.

Detroit's success may provide a path for Puerto Rico's municipalities. Or it may not. The point is, Detroit's access to chapter 9 was something the elected representatives of the State of Michigan decided on. That decision, whatever it may be, should similarly fall on the elected representatives of the Commonwealth of Puerto Rico.

Yours very truly,

John A. E. Pottow
John Philip Dawson Professor of Law,
University of Michigan Law School

Mr. MARINO. Thank you, Professor.
President Acosta, please?

TESTIMONY OF MELBA ACOSTA, ESQ., PRESIDENT, GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

Ms. ACOSTA. Thank you, Chairman Marino, Ranking Member Johnson, and Members of the Subcommittee.

I am the president of the GDB, as we already know, that is known. The GDB and the Commonwealth of Puerto Rico appreciate the opportunity to participate in this hearing.

The fiscal and economic situation in Puerto Rico is critical. Puerto Rico's economy has still not recovered from the financial crisis and the great recession. Unemployment remains double the national average, and the average personal income per capita is approximately $17,000.

Our population is declining, as many talented people move to the mainland United States. Puerto Rico's unprecedented economic difficulties have contributed to rising budget deficits at all levels of government. Today, Puerto Rico has $73 billion in public debt outstanding, with a total population of less than 3.6 million U.S. citizens.

Puerto Rico's Governor, Alejandro Garcia Padilla, took office in 2013 and has forcefully responded to these challenges in an effort to achieve long-term fiscal sustainability. My written testimony highlights these efforts in detail.

One critical component of fiscal sustainability is ensuring that Puerto Rico's public corporations, which are government-owned municipal corporations, become self-sufficient. The public corporations are essential to the well-being of residents because they provide basic public services, including water, sewer, electricity, and transportation.

Puerto Rico's three largest public corporations have $20 billion in debt. Our public corporations are not eligible for Federal bankruptcy protection, and in response, Puerto Rico adopted the Debt Enforcement and Recovery Act last June. The Recovery Act filled a gap in the U.S. bankruptcy code to permit Puerto Rico's public corporations to adjust their debt in an orderly process, much like Chapters 9 and 11 of the bankruptcy code.

A Federal judge, however, recently struck down the Recovery Act, holding that it preempted—that it is prevented by the bankruptcy code. Both the Commonwealth and the GDB disagree with this decision and expect the decision to be reversed on appeal.

We support amending Chapter 9 to permit Puerto Rico to have the same opportunity as the 50 States to determine whether its public corporations should be eligible to utilize Chapter 9. In the event that H.R. 870 is adopted, there will be no need for the Recovery Act.

The practical and unfortunate result of the recent court decision on the Recovery Act and the exclusion of Puerto Rico from Chapter 9 is that there is no currently available legal regime for Puerto Rico's public corporations to restructure their obligations. The lack of clear legal authority has created an environment of uncertainty that makes it difficult to address Puerto Rico's fiscal challenges.

First, the credit markets require a risk premium to compensate for this uncertainty. This, in turn, will make it more expensive for public entities in Puerto Rico to borrow money in the future.

Second, investors may have little appetite for Puerto Rico's upcoming bond issuance, which is essential to provide the central government and GDB with liquidity.

Third, the lack of a clear legal framework to restructure the obligation of our public corporations undermines the central government's objective of making public corporations self-sufficient.

Fourth, the absence of a clear legal framework depresses economic growth, and it makes long-term planning nearly impossible.

Finally, if the public corporations default on their obligations and there is no clear legal regime, creditors may attempt to exercise remedies by appointing a receiver and asking the Energy Commission to raise utility rates. This could trigger years of litigation and create liquidity pressures, exacerbating Puerto Rico's overall fiscal situation.

I would like to stress that no decision has been made as to whether any public corporation intends to file under Chapter 9, should it become available, and the Commonwealth and the GDB see Chapter 9 only as an option of last resort. In any event, Chapter 9 would not apply to debt issued directly by the Commonwealth.

Chapter 9 establishes a legal regime that is already understood by suppliers, creditors, and investors. It would provide an orderly process requiring good faith negotiation under the supervision of an experienced judge.

I would like to thank the Subcommittee for giving me the opportunity to participate in this hearing, and I am looking forward to your questions.

[The prepared statement of Ms. Acosta follows:]

STATEMENT

of

MELBA ACOSTA-FEBO

On behalf of the

GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

Before the

SUBCOMMITTEE ON REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW

Of the

COMMITTEE ON THE JUDICIARY

Of the

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

* * *

FEBRUARY 26, 2015

* * *

H.R. 870

TO AMEND TITLE 11 OF THE UNITED STATES CODE TO TREAT PUERTO RICO AS A STATE FOR PURPOSES OF CHAPTER 9 OF SUCH TITLE RELATING TO THE ADJUSTMENT OF DEBTS OF MUNICIPALITIES

("PUERTO RICO CHAPTER 9 UNIFORMITY ACT OF 2015")

Chairman Marino, Ranking Member Johnson, and members of the subcommittee:

My name is Melba Acosta-Febo, and I am the President of the Government Development Bank for Puerto Rico (the "GDB"). Before assuming this position in October 2014, I was the Secretary of Treasury of the Commonwealth of Puerto Rico.

I want to thank the subcommittee for giving the Commonwealth of Puerto Rico ("Puerto Rico") and the GDB the opportunity to participate in this hearing. The GDB is charged with safeguarding the fiscal stability of Puerto Rico and promoting its economic competitiveness. The GDB is also charged with serving as the fiscal agent and financial advisor for Puerto Rico and all of its instrumentalities. The GDB has a significant interest in the subject matter of this hearing, and along with the Commonwealth and the Governor of Puerto Rico, supports H.R. 870, which would treat Puerto Rico as a "State" for the purposes of Chapter 9 eligibility under the U.S. Bankruptcy Code.

Economic Overview of Puerto Rico

The fiscal and economic situation in Puerto Rico has reached a critical moment. The Legislative Assembly has declared a fiscal emergency in Puerto Rico.

Puerto Rico's economy is closely tied to the United States but was disproportionately and adversely impacted by the U.S. financial crisis and the Great Recession. For example, economic growth in Puerto Rico was negative or weak between 2007 and 2014, which is materially worse than in the rest of the United States during the same period. Growth continues to pose a significant challenge as a result of many factors, including some beyond Puerto Rico's control. An example of this was the repeal and phase-out by Congress of Section 936 of the Internal

Revenue Code, which provided tax benefits for certain businesses (including large pharmaceutical companies) operating in Puerto Rico. The elimination of these tax benefits has led to a significant contraction in employment in Puerto Rico's manufacturing sector, leading to a significant adverse impact on economic growth.

Unemployment has remained at elevated levels, suggesting continued weakness in Puerto Rico's economy, exceeding 15% for many years following the financial crisis. Puerto Rico's unemployment rate was approximately 12.1% as of December 2014, while unemployment in the rest of the United States dropped to 5.6%. Nearly half of all residents in Puerto Rico qualify for low-income health insurance subsidies, and the average personal income per capita, including transfer payments, was approximately $17,000 in fiscal year 2013. Moreover, Puerto Rico's population, unlike the rest of the United States, has declined in each of the last five years resulting in part from migration to the mainland United States.

Puerto Rico's unprecedented economic difficulties have contributed to rising budget deficits at all levels of government, including at Puerto Rico's municipal or "public" corporations. To continue providing essential public services, and to close those deficits, these public corporations routinely accessed the market, or relied on interim financing from the GDB or private sector banks, to finance their budget deficits. Today, Puerto Rico's government, including its public agencies, divisions, instrumentalities and public corporations, has approximately $73 billion in public debt outstanding with a total population of less than 3.6 million residents. In addition, Puerto Rico's public pension funds, although subject to a major overhaul during fiscal year 2014 that reduced future annual cash flow needs, still face significant unfunded actuarial accrued liabilities, which will require increased governmental pension contributions in upcoming years.

Governor Alejandro García Padilla took office in 2013 and has forcefully responded to these unprecedented fiscal challenges in an effort to achieve long-term fiscal sustainability. Within two years of taking office, the administration has materially reduced budget deficits by raising revenues and cutting expenses; has imposed unprecedented cost-control measures at the central government and public corporation levels; has established limits on government payroll (as of November 2014, there were 92,842 government employees paid from the General Fund, compared to 139,640 in 2008); has implemented comprehensive pension reform; has imposed loan origination discipline at the GDB; has completed and is actively exploring public-private partnerships; and has reformed rates at certain public corporations. The federal government has shown continued support for the difficult measures that the Garcia Padilla administration has taken to address long-term fiscal sustainability in Puerto Rico, and we look forward to having continued support from all levels of the federal government as we address many of the remaining challenges that lie ahead.

One critical component of the administration's commitment to fiscal sustainability is ensuring that Puerto Rico's public corporations can become self-sufficient and are no longer dependent on voluntary contributions by the GDB or the central government for their financing needs. The public corporations, which are government-owned municipal instrumentalities, are essential to the wellbeing of residents because they provide basic public services including water and wastewater services, electric power, and transportation. Three of the most critical public corporations in Puerto Rico are: (1) the Puerto Rico Electric Power Authority (often referred to as "PREPA"), which provides substantially all of the electricity to residents and businesses in Puerto Rico; (2) the Puerto Rico Aqueduct and Sewer Authority (often referred to as "PRASA"), which provides 97% of the water and 59% of the wastewater services to residents in Puerto Rico;

and (3) the Puerto Rico Highways and Transportation Authority (often referred to as "PRHTA"), which is responsible for highway construction and maintenance on the island.

The public corporations, like all municipal utilities, charge fees associated with their services. Because Puerto Rico is an island, the cost of providing these services is often much higher than in the mainland United States. In November 2014, for example, utility customers in Puerto Rico paid more than twice the national average per kilowatt hour for electricity. Nonetheless, these public corporations have had chronic budget deficits in recent years resulting, in part, from population and economic decline. In 2012-2013 alone, the combined deficit of PREPA, PRASA, and PRHTA was over $800 million. Public corporations have historically financed their deficits by relying on the central government in Puerto Rico; on loans from GDB or private sector banks; and on capital market financings. These recurring deficits ballooned the debt of these three public corporations. The deficits, when combined with borrowings for infrastructure projects, have left these three public corporations with over $20 billion in debt.

Certain of these public corporations currently lack market access and have been shut out from private bank financing. Neither the central government nor GDB has the liquidity to shore up deficits or finance necessary capital expenditures at these public corporations. Meanwhile, Puerto Rico's infrastructure, including its power generating plants and electricity distribution network, are outdated and inefficient and require substantial capital investment. Addressing fiscal problems associated with Puerto Rico's public corporations is not only a necessity from a public welfare and safety perspective but it is a critical piece of any strategy for long-term economic growth, fiscal sustainability, and prosperity in Puerto Rico. Unlike many island economies, Puerto Rico's manufacturing sector is the largest sector of Puerto Rico's economy. It also pays the highest wages. To retain and grow this sector, Puerto Rico needs to remain competitive including being competitive when it comes to providing basic services such as power, water and transportation. The cost of these essential services are important contributing factors to employers' decisions to come to or remain on the island.

The Debt Enforcement and Recovery Act

Research and experience shows that investors, creditors and others doing business with Puerto Rico and its instrumentalities need to have more certainty in dealing with the island's current financial situation, including the establishment of an orderly and consensus-based process for addressing outstanding debt at the public corporations. Prior to June 2014, there was no legal regime allowing Puerto Rico's public corporations to adjust their debt or handle creditor claims in an orderly manner. Our public corporations are not eligible to reorganize under Chapter 11 of the U.S. Bankruptcy Code because they are governmental instrumentalities, and they are not eligible to adjust their debts under Chapter 9 because Puerto Rico is expressly excluded from the U.S. Bankruptcy Code's definition of "State" for purposes of Chapter 9 eligibility.

In response, the Puerto Rico Legislative Assembly adopted the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (No. 71-2014) (the "Recovery Act") in June 2014 to allow public corporations to address their fiscal problems while protecting the collective interest of all of their constituents, including bondholders and other creditors, as well Puerto Rico's residents and businesses who depend on these corporations for the essential services they provide. The Recovery Act fills a gap left by the U.S. Bankruptcy Code and is designed and intended to permit Puerto Rico's public corporations to adjust their debt in an orderly process—with creditor input and court supervision—much like Chapters 9 and 11 of the U.S. Bankruptcy

Code. The Recovery Act also ensures that provision of essential public services to Puerto Rico's residents will not be interrupted in the event of a fiscal emergency at one of the public corporations. The Recovery Act is designed to protect the collective interests of creditors by including supermajority voting requirements and minimum recovery levels.

Immediately after the passage of the Recovery Act, two groups of PREPA bondholders filed suit, seeking judgments declaring the Recovery Act unconstitutional. On February 6, 2015, the U.S. District Court for the District of Puerto Rico enjoined enforcement of the Recovery Act, holding that the Recovery Act is unconstitutional because it is preempted by section 903 of the U.S. Bankruptcy Code, which the court concluded prevents Puerto Rico from passing a law allowing its public corporations to adjust their debts through a composition. I do not think it is appropriate for me to discuss the specifics of pending litigation, or the reasons for our belief that the Recovery Act is not precluded by section 903 of the U.S. Bankruptcy Code. I note for the record, however, that both the Government of Puerto Rico and the GDB disagree with this decision, which is being appealed to the U.S. Court of Appeals for the First Circuit, and do not agree that section 903 preempts the Recovery Act. Ultimately, we believe we will be successful on appeal, but there would be no need for the Recovery Act if the U.S. Bankruptcy Code is amended so that Chapter 9 applies to Puerto Rico.

In any event, the practical and unfortunate result of the District Court's decision is that there is currently no available legal regime for Puerto Rico's public corporations to adjust their debts through a consensus-based, court-supervised process—either under the U.S. Bankruptcy Code or Puerto Rico law. In this respect, Puerto Rico is treated differently from every state in the United States, each of which may utilize Chapter 9 if the respective state legislature so authorizes. Puerto Rico's exclusion from Chapter 9 is the result of an amendment adopted by

Congress in 1984. There is very little legislative history regarding that amendment and nothing that would suggest an intent to deprive Puerto Rico's public corporations of the ability to reorganize and adjust their debts under court supervision.

Leading bankruptcy academics, such as Professors David Skeel of the University of Pennsylvania and Stephen J. Lubben of Seton Hall University, have noted that there is no justification for this exclusion and have suggested that Congress fill the legislative gap in the U.S. Bankruptcy Code to dispel the uncertainty that Puerto Rico faces by permitting Puerto Rico—like each of the 50 states—to opt into Chapter 9. In fact, Professor Lubben wrote last fall in an American Bankruptcy Law Journal article that: "The logic behind excluding Puerto Rico from chapter 9, to the extent it did, no longer makes sense. In a perfect world, Congress would quickly allow Puerto Rico's public corporations to file chapter 9 bankruptcy petitions."

Consequences of Having No Legal Regime to Adjust Debts

The unavailability of any feasible legislative option other than the Recovery Act to adjust debts of Puerto Rico's public corporations—such as under Chapter 9 of the U.S. Bankruptcy Code—has created an environment of uncertainty that makes it more difficult to address Puerto Rico's fiscal challenges and threatens Puerto Rico's economic future. I would like to share with the subcommittee some of the unfortunate consequences of this predicament.

First, the credit markets require a risk premium to compensate for uncertainty in the market. This in turn will make it more expensive for all Puerto Rico issuers—particularly at the Commonwealth level—to borrow money in the future at a time that Puerto Rico seeks to contain costs and lower expenses (some of Puerto Rico's general obligation bonds currently yield over 10%). This consequence has already been evidenced by credit downgrades that followed the invalidation of the Recovery Act. Standard & Poor's downgraded Puerto Rico's general obligation and appropriation debt to three notches below investment grade (from 'BB' to 'B'), and it downgraded GDB's long- and short-term credit ratings even further into speculative grade territory ('BB-/B' to 'B-/C'). Standard & Poor's also put GDB on negative outlook and even stated in a report published on February 12, 2015 that "Puerto Rico has experienced and will continue to face a major reduction in its ability to obtain external liquidity at a reasonable cost, as evidenced by GO bond yields topping 10%, following a lower court decision invalidating its debt restructuring law. As a result, Puerto Rico's access to cash flow financing necessary for the next fiscal year could be severely constrained in our opinion." Other ratings agencies have followed suit, having recently downgraded various Puerto Rico issuers further into speculative grade territory.

Moreover, and perhaps most critically today, the lack of a clear debt adjustment mechanism negatively affects investor appetite for Puerto Rico's upcoming bond issuance, which the GDB views as necessary to provide the central government and GDB with liquidity. Indeed, the failure to complete a financing transaction could severely impact GDB's ability to support the central government's fiscal adjustment plan and continue acting as its lender of last resort. By way of background, Puerto Rico has not accessed the credit markets for long-term debt in twelve months and will need to do so in the near future. Accordingly, Puerto Rico's Legislative Assembly approved legislation in December 2014 authorizing the Puerto Rico Infrastructure Finance Authority, which is sometimes referred to as "PRIFA," to issue up to $2.95 billion in secured, Commonwealth-guaranteed bonds that would be collateralized by new taxes on oil. The proceeds of that bond issuance would be used, in part, to refinance $2.2 billion that the Puerto Rico Highway Transportation Authority owes to GDB. The invalidation of the Recovery Act may reduce investor appetite for these new bonds or require a risk premium that makes the issuance materially more expensive or prohibitive.

Second, the lack of a clear debt adjustment mechanism undermines the Administration's objective of making public corporations self-sufficient and financially independent from the central government. This objective, which was announced one year ago as part of the administration's plan to promote long-term fiscal sustainability, provided confidence to the capital markets that Puerto Rico had a plan to address the fiscal health of its public corporations while also ensuring investors that the public corporations would not jeopardize the fiscal health of the central government. This policy played an integral role in allowing Puerto Rico to raise $3.5 billion in the capital markets in March 2014. But the GDB has already seen signs that confidence in this objective has begun to erode as bond prices for the public corporations increased and bond prices for Puerto Rico's general obligation bonds decreased upon the invalidation of the Recovery Act.

Third, the lack of a clear adjustment option depresses economic growth in Puerto Rico generally, and it makes long-term investment and capital expenditure plans at the public corporations nearly impossible. In fact, the International Monetary Fund, the World Bank, and the Organisation for Economic Co-operation and Development have acknowledged that insolvency regimes promote financial stability, investment, and growth. In its publication entitled *Orderly & Effective Insolvency Procedures* (1999), the International Monetary Fund articulates that there is no reason to exclude municipalities:

> [I]t is universally recognized that sovereign nations are not subject to any insolvency law, international or national. Local government entities, such as municipalities, may be excluded from the scope of the insolvency law altogether or the law may establish a special regime for them. While the treatment of government-owned entities may also vary, there appears to be no reason why such an enterprise operating in the market place

> as a distinct entity should be excluded from the coverage of the general insolvency law unless the government has extended an explicit guarantee with respect to all its liabilities. [T]he inclusion of a government-owned enterprise within the scope of the insolvency law has the advantage of both subjecting the enterprise to the discipline of the market place and sending a clear signal that government financial support will not be unlimited.

Debt-adjustment tools, like those found in Chapter 9, provide significant economic benefits to public instrumentalities but also to creditors because legal regimes provide predictability. The uncertainty surrounding the high level of debt held by Puerto Rico governmental entities is an impediment to the very sort of economic activity that is fundamental to Puerto Rico's economic recovery, namely private investment. Until a legal regime for adjusting Puerto Rico's debt is available, this uncertainty will loom large and investors will be hesitant to invest capital.

Finally, if the public corporations default on their obligations and there is no clear legal regime, creditors may attempt to engage in a race to the courthouse and exercise remedies that include attempting to appoint a receiver and, in PREPA's case, filing a rate case before Puerto Rico's Energy Commission seeking to raise utility rates beyond their current levels. This could trigger years of litigation, exacerbate liquidity pressures at these public entities and have adverse consequence on economic growth, which only exacerbates Puerto Rico's overall fiscal situation. Creditors would be in a worse position than they would be in under an orderly, consensual process. Suppliers could refuse to deliver critical supplies as a result of the legal uncertainty surrounding a public corporation's default – this is particularly true in the case of PREPA, which relies on fuel as the primary source of energy to generate electricity on the island. This scenario would certainly be value-destructive for all stakeholders, including creditors, the residents of Puerto Rico, and the public corporations themselves.

Extending Chapter 9 to Puerto Rico Will Provide Measured Benefits

I would like to stress to the subcommittee that no decision has been made as to whether any public corporation intends to file under Chapter 9 were it to become available and the Commonwealth of Puerto Rico and the GDB see Chapter 9 only as an option of last resort. In any event, Chapter 9 would not apply to debt issued directly by the Commonwealth of Puerto Rico. This is because "States," which would include Puerto Rico if H.R. 870 passes, are not eligible for protection under Chapter 9.

Chapter 9 establishes a legal regime that is already understood by the capital markets, creditors, prospective lenders, and suppliers. It would provide an orderly process, requires the public corporation to negotiate in good faith, creates an environment to reach consensus and allows the process to be supervised by an experienced court. Chapter 9 has also been tested on many occasions, including in Detroit, Michigan, Stockton, California, and Jefferson County, Alabama, just to name a few. The National Bankruptcy Conference, comprised of leading bankruptcy scholars as well as current and former judges throughout the country, has stated that extending Chapter 9 to Puerto Rico would provide courts and parties with importance guidance. Fitch Rating has said that extending Chapter 9 to Puerto Rico would offer benefits, including the avoidance of protracted litigation and uncertainty, and would put Puerto Rico on equal footing with the 50 states. Legal precedent under Chapter 9 will give debtors and creditors a useful roadmap that offers more certainty as to their substantive rights and expected procedures. Public corporations in Chapter 9 would be permitted to obtain debtor-in-possession financing and use cash collateral under well-tested procedures, permitting the continuation of normal operations and the provision of essential public services to Puerto Rico's residents. Finally, any Chapter 9 proceeding would be overseen by a U.S. Bankruptcy Judge that has expertise in insolvency matters and that would be approached as an independent arbiter to all parties in interest. The virtue of Chapter 9 can be seen in the Chapter 9 cases of Detroit, whose adjustment proceedings lasted less than 18 months, and Stockton, whose adjustment proceedings lasted less than two years.

Accordingly, Commonwealth of Puerto Rico and the GDB believe that passage of H.R. 870 will prove to be a useful tool for Puerto Rico's long-term economic success, whether or not it is actually invoked.

I would like to thank the subcommittee for giving the Commonwealth of Puerto Rico and the GDB the opportunity to participate in this hearing.

Mr. MARINO. Thank you.
Director Donahue?

TESTIMONY OF ROBERT DONAHUE, MANAGING DIRECTOR, MUNICIPAL MARKET ANALYTICS

Mr. DONAHUE. Thank you very much.

I will point out I am the only nonlawyer on this panel today.

VOICE. Your mike is not on. I am sorry.

Mr. ISSA. They won't even turn the mic on if you are not a lawyer in this room. [Laughter.]

Mr. DONAHUE. Might as well just leave now. For the record, I am——

Mr. ISSA. I noticed you didn't go to Harvard Law and do the Review. So, clearly, you have got a problem at the Harvard end of it, too. [Laughter.]

Mr. DONAHUE. Thank you. I am well aware.

But I do have over 15 years of experience covering Puerto Rico, have been down to the island many times. I have worked for three of the largest municipal bond investment management firms, during which time I have approved thousands of securities, made recommendations and analysis to buy billions of dollars of Puerto Rico debt over that time, buy and sell Puerto Rico debt.

I am not going to repeat a lot. I think Melba's testimony, it depicted very fairly the current situation in Puerto Rico. But what I will do is try to talk from the market perspective.

Despite the territory's worsening situation, I have seen an allocation of risk in Puerto Rico bonds in the investor base. Prudent municipal investors, many of our clients, have sold the municipal bonds to reduce—and reduced their exposure. Fitch Research has said that municipal bond mutual funds have declined their exposure to Puerto Rico by 65 percent, and now those funds only earn 33 percent.

Now a large and increasing portion of the island's debt is owned—is held by and its future access to capital is really reliant on a different class of opportunistic investors. Trading in Puerto Rico bonds throughout this process over the last several years of downgrades and bad news headlines, beginning with the Barron's article back in 2013, has remained active, allowing for significant price discovery and trading opportunities as risk averse owners of municipal bonds—you know, folks who own municipal bonds, typically, they put munis just right up with Treasuries and agencies as the most pristine bonds.

And their shareholders expect that, and they have rotated out of these bonds as the situation has devolved. We have seen rises and falls in bond prices, and yields have reached certain levels. But what we recognize is that is the evidence, a common trait of a healthy market.

I am here today to express our opinion, based on my experience in our work with our clients, over 300 clients. We represent the largest dealers and the largest investors and everybody in between, to the retail bondholder in Peoria. We believe that the current framework under which these public corporations can restructure is very uncertain.

Specifically, the trust indenture, which I think we will talk about today, provides an untested and wholly inadequate legal framework that is unsuitable for the highly complex financial restructuring among a diverse group of stakeholders. It is with this backdrop that this legislation is being considered, and we believe that H.R. 870 provides a technical fix to the bankruptcy code. It simply extends the same framework allowed to 50 States to Puerto Rico's governmental instrumentalities.

I want to make a key point here. Puerto Rico itself cannot declare debt. It is the instrumentalities in Puerto Rico.

Number two, it reduces the near-term likelihood that Puerto Rico will request external assistance.

Number three, it sets no adverse precedent from what we can see for the broadening of municipal bankruptcy that may destabilize the municipal bond market, the Nation's best source of efficient, low-cost infrastructure funding. Importantly, and I emphasize this, H.R. 870 opens no doors to State bankruptcy, which we do not support.

Number four, it will not, in and of itself, pose an incremental systemic risk to the broader capital markets.

And number five, it establishes a basis by which the island can finally begin to focus on efforts to foster economic growth for enduring fiscal stability.

We believe Chapter 9 is a high-impact way for Congress to provide Puerto Rico with a standardized, orderly, uniform legal framework guided by an existing body of case law in an appropriate arm's length venue. It amends an existing flaw in the bankruptcy code, as was stated earlier, with no expenditure of fiscal dollars.

This is not a bailout. It is not a panacea. It is not a precedent for further Chapter 9 filings elsewhere. This is merely a technical fix.

Your approval of this bill will not create the perception in a municipal market or among issuers that Puerto Rico's past failings have been absolved. And we can talk about that, and I appreciate your comments earlier and agree with everything you said.

Your approval is not likely to encourage other municipalities to borrow irresponsibly, knowing that they could later restructure their debts in bankruptcy. We point out that Chapter 9 bankruptcies are extremely rare and always a last resort. They are painful for everybody, especially the elected officials, given the high cost and the associated stigma to it.

For citizens of Puerto Rico, it is critical to get this right now. Once granted the right to use Chapter 9, Puerto Rico's leaders, I implore them to use this powerful tool thoughtfully and cautiously. Specifically, the island's leaders must take great care—and Senator Bhatia is here today—in crafting enabling statutes in a fair and equitable manner, with good faith to preserve creditors' rights and the island's long-term need for affordable capital.

MMA, to restate, strongly opposes bankruptcy in any form by a municipality. However, this is the best option among a limited set of unattractive options. We speak to many market participants on a daily basis, and most of these people in the letters that were pointed out earlier agree with our perspective, and the legal scholars that we have spoken with agree with this perspective.

Thank you so much for asking me to testify today, and I look forward to your questions.

[The prepared statement of Mr. Donahue follows:]

Municipal Market Analytics, Inc. (**MMA**)

Written Testimony for the House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law

Presented by Robert Donahue, Managing Director

February 26, 2015

Good morning Chairman Marino, Ranking Member Johnson and members of the Committee. My name is Robert Donahue and I am a Managing Director at Municipal Market Analytics, Inc. (**MMA**). **MMA** is the leading independent research and data-provider for the municipal bond industry whose clients include a broad group of investors, banks, securities dealers, issuers and federal and state regulators. To be clear – **MMA** does not buy, sell or trade municipal bonds – the industry values us for our independent perspective.

Thank you for inviting me to testify before you today to share **MMA**'s opinions on HR 870.

The notion of bankruptcy is a last resort to any government or individual. No government official should consider it lightly—nor does **MMA.** While we do not advocate bankruptcy for any state, locality or municipal agency, **MMA** believes this is the best available option for Puerto Rico and the municipal market at this time.

In my experience of nearly 20 years covering Puerto Rico's credit for three of the largest US institutional investment management firms, there have been few times when I have observed the same level of consensus that exists towards giving the territory this option. Governor Garcia Padilla of the Popular Democratic Party has expressed his support for the bill as firmly as New Progressive Party (NPP) Resident Commissioner and At-Large Representative Pedro Pierluisi. This rare bipartisan moment demonstrates the importance of providing this financially troubled jurisdiction with an orderly framework for debt adjustment that is consistent with the restructuring framework to which all states currently have access.

To summarize we believe that HR 870:

1) Provides a technical fix of the Bankruptcy Code, simply extending the Chapter 9 framework available to the 50 states to Puerto Rico's government instrumentalities;
2) Reduces the near-term likelihood that Puerto Rico will request assistance in order to secure essential services to its citizens;
3) Sets no adverse precedent for the broadening of municipal bankruptcy provisions that may destabilize issuers' access to capital via the municipal bond market, the nation's source of efficient low cost infrastructure funding;

4) Will not, in and of itself, pose any incremental systemic risk to the current lenders or the broader capital markets; and,
5) Establishes a basis by which the island may focus on efforts to foster economic growth for enduring fiscal stability.

Approval of this bill is a technical fix to an oversight that has remained un-remediated since 1984 when the Bankruptcy Amendments and Federal Judgeship Act, a law to correct technical errors in the 1978 Bankruptcy Code, defined "State" to include Puerto Rico (and the District of Columbia), **except for purposes of who may be a debtor under Chapter 9**, a definition that has lasted to this day.

The purpose of this exemption, and original Congressional intent, is vexing to legal scholars. Initially, the Act actually defined a "governmental unit" to include a Territory. Subsequent versions **expressly included** Puerto Rico in the definition of a "State". The record indicates that an amendment introduced by Senator Robert Dole states that Puerto Rico had been "inadvertently left out of the definition of "state' during the passage of the [1978] Reform Act." Inexplicably, the definition of "State" was changed to its current form during the amendment process and remains so to this day.

Chapter 9 provides a standardized, orderly legal framework guided by an existing body of case law in an appropriate arms-length venue. **MMA** believes this is far preferable to a receiver-driven restructuring. A court supervised process would put all vested parties together on a far more even playing field than currently exists. All creditor classes would fully participate, with limited political interference if negotiations break down. Chapter 9 still provides a high degree of stakeholder influence on creditor recoveries and a plan that a US federal court judge will ultimately determine.

A perfect storm has gathered over a long period of time, resulting from years of policies of both political parties. The island's economic deterioration, the accelerating depopulation of Puerto Rico, and persistent budget deficits threaten the provision of basic services, and the ability to meet obligations to bondholders and other financial participants.

Puerto Rico's leadership recognized the immediacy of its crisis and attempted its own fix by passing the Puerto Rico Debt Enforcement and Recovery Act on June 28, 2014. The Act was patterned on Chapter 9, allowing Puerto Rico's public corporations to restructure their debts. This Act was intended to allow the continuation of essential public services while at the same time protecting the interests of creditors. The Act also provided leverage for the commonwealth in negotiations with various creditors who consequently entered into forbearance agreements, which are in place today but expire imminently.

The Act was declared unconstitutional on February 6 by the U.S. District Court. In its motion to appeal to the First Circuit Court of Appeals in Boston, Massachusetts, the commonwealth acknowledged that "the acute fiscal crisis that gave rise to the Recovery Act is still very much a reality, and is just as pressing now as ever." Indeed, as we sit here today, several of the forbearing creditors could potentially trigger actions that could begin a disorderly debt crisis. Puerto Rican officials acknowledged in court papers that Puerto Rico Electric Power Authority (PREPA) bondholders, as soon as March 31, could take unilateral actions against the utility that could "disrupt the provision of essential public services." These include attempts to accelerate PREPA debt payments, suits to increase already high electricity rates, or an appointment of a receiver to take over PREPA's management, all within their rights as stipulated in loan and bond documents. Any of these actions could place an undue burden on Puerto Rican citizens, many of whom are unaware of the complexities of the island's tenuous fiscal conditions.

In the three weeks since, two rating agencies further downgraded the island deeply into junk bond status. S&P dropped the island's bond rating to 'B' on February 12 and Moody's cuts its rating to 'Caa1' one week later, reflecting "very high credit risk." The agencies state that Puerto Rico's current economic and financial trajectory could ultimately impair its ability to fund basic services and its debt commitments. Subsequently, yields on Puerto Rico bonds have ascended above 10%, to levels comparable to deeply distressed sovereigns of Greece and Ukraine, as investors again have sold bonds.

Absent the Chapter 9 framework, the current rules under which public corporations may restructure debts present grave uncertainty. For example, bondholders of PREPA, the most likely initial candidate for debt restructuring, are dependent on the utility's 1974 Trust Agreement, which **MMA** believes provides a wholly inadequate legal framework within which to address PREPA's highly complex financial restructuring needs among a diverse group of stakeholders.

We believe that the superficial process for debt reorganization contained in PREPA's Trust Agreement falls far short of the Chapter 9 process. Section 208 of PREPA's charter provides for the appointment of a receiver vested with vague powers other than to carry on the purposes that are of public good ("utilidad pública") and prohibited from encumbering or dispose of property. Creditor rights are limited, primarily to bringing suit to compel compliance with the Rate Covenant. However, a weak receiver with vaguely defined powers will be hard-pressed to enforce rate increases with PREPA's per kilowatt hour rates over twice the US average costs. Accordingly, PREPA's Trust Agreement states: "Remedies are subject to discretion and delay and may not be readily available or may be limited. Equitable principles may also delay or otherwise adversely affect the enforcement of bondholders' rights." We note that any judicial action regarding the appointment of a receiver must be filed in Puerto Rico court applying Puerto Rico law.

The argument has been made that the extension of Chapter 9 to Puerto Rico at this time is an impairment of existing protections available in the Trust Indenture under which bondholders purchased bonds. **MMA** disagrees. Any investor holding PREPA bonds in August 2013, or thereafter, was forewarned that risks existed. Specifically, the Risk Section of the official statement (OS) dated August 15, 2013 states that;

- For each of the last four fiscal years, the Authority incurred losses, deterioration of its liquidity, pension funding shortfalls, and a decrease in electric energy sales...if (these) trends were to continue, the Authority's ability to fund its operations and finance its capital program could be negatively impacted.

In the March 2014 OS for the Commonwealth's \$3.5B GO offering, dated March 11, 2014, PR officials incorporated a candid 14-page risk section warned that Puerto Rico:

- "may be unable to meet its debt obligations" if market access is lost; that emergency actions, restructuring, moratorium, and alternative courses of action are being evaluated;
- "remedies available to bondholders are potentially subject to substantial discretion and delay."

As the territory's situation has worsened, Puerto Rico's investor base has changed. Municipal bond investors such as mutual funds or retired individuals, the island's traditional lenders, have significantly reduced their ownership of Puerto Rico debt. Fitch Ratings estimates starting in 2Q and 3Q 2013, U.S. mutual funds reduced their Puerto Rico exposure by approximately 65%, on average.[1] Municipal bond funds, once the primary owners of Puerto Rico debt, now own less than one third of the island's debt with holdings concentrated in largely insured, general government issuers.[2]

The result is that the island's current debt, as well as its future access to capital is now held by, and dependent on, alternative investors who demand high costs in return for their investment. Fitch estimated that there are now over 60 alternative fund managers holding more than $16 billion, or 25% of the island's debt.

The rotation away from risk-averse municipal investors to opportunistic buyers is indication that the debt markets are functioning efficiently. Trading in Puerto Rico debt has remain active through downgrades and other negative events, allowing for efficient reallocation of risk, significant price discovery and trading opportunities as risk-averse owners have sold to willing hedge funds and qualified buyers. Bond prices have risen and fallen with evolving investor opinions as occurs in healthy capital markets. The chart, to the **right**, illustrates that PREPA trading volume actually spiked six times the median daily volume during the periods of stress over the past two years.

[1] Big Changes for Puerto Rico Bond Market, Fitch Ratings Fund and Asset Manager Rating Group, August 18, 2014
[2] Ibid

MMA believes that the extension of Chapter 9 to Puerto Rico is not a bailout or panacea, but is a last resort to avert a broader crisis and brings an orderly process to any restructuring of the commonwealth's agencies, while keeping such important decisions within the hands judges and out of the hands of politicians. We believe that this action is not likely to encourage other municipalities to borrow irresponsibly, knowing that they could later restructure their debt in bankruptcy. As witnessed in Detroit, Michigan and Stockton, California, Chapter 9 has a tendency to negatively affect all stakeholders: municipal services are often reduced, employees have faced benefit reductions, and investors experienced deep losses. Bankruptcy judges in both Detroit and Stockton have stated on record that public pensions can be reduced in Chapter 9, even when strong state legal protections exist.

In the absence of a Chapter 9 framework for restructuring and the Recovery Act determined to be unconstitutional, Puerto Rico lacks a powerful, motivating tool to bring all parties into an organized restructuring at the two functionally insolvent public corporations, PREPA and the Highway and Transportation Authority (HTA). Both entities have large outstanding loans due to the Government Development Bank (GDB), which itself faces insolvency if these debts are written down. In turn, the GDB's diminished liquidity and potential loss of funding will preclude its ability to extend emergency short-term credit to the central government as it has in the past. The GDB announced months ago that it would issue a $3 billion bond, backed by a recently increased petroleum products tax, to enhance liquidity and shift large HTA loans off its balance sheet issue. To date, GDB has been unable to execute its plan because certain legislators have blocked key elements of the GDB's plan, concerned about long-term fiscal sustainability and the costs layering more debt.

Chapter 9 is an effective way for Congress to assist Puerto Rico, with no expenditure of taxpayer dollars, and the extension of such to the commonwealth amends an existing flaw in the bankruptcy law. Residents and businesses in Puerto Rico today can access all protections offered through other chapters of the US Bankruptcy Code (i.e., Chapter 13, 12, 11 and 7). Chapter 9 will likely remain a rarely used mechanism that allows a municipality to adjust its debts while continuing to provide public services. This action is neither a bailout nor a precedent for further Chapter 9 actions, merely a fix to clarify Puerto Rico's right to develop a plan of adjustment in an orderly way and begin its path toward recovery. We fully expect that the island's leaders will take great care in crafting enabling statute in fair and equitable manner, assuring that proceeding in good faith will preserve the island's long-term need for affordable capital.

Thank you for asking me to testify today, and I welcome your questions during this session.

Appendix

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Dated January 27, 2014
Through February 9, 2015

February 9, 2015

PUERTO RICO UPDATE: Late Friday, the PR District Court struck down the Recovery Act as unconstitutional, citing PREPA's extant non-impairment, acceleration and receivership provisions. The decision upheld claims of three plaintiffs that the Act violated legal remedies and liens. With the Commonwealth's home-cooked 'Creole bankruptcy' framework now struck down, **MMA** believes a broad, disorderly restructuring is increasingly likely unless Congress moves forward with a chapter 9 extension. **The decision squarely undermines the "ring-fence" strategy of investors who assumed restructuring would be contained within the public corporations. We now believe all PR debt, including GO's, are on the table for potential restructuring and/or claw back.** Hypothetically, PR could begin claim emergency powers (cf. Home Building & Loan Ass'n v. Blaisdell) to protect key assets like the Government Development Bank (GDB), recognizing:

1) *Increasing Lack of Ability*: PR's finances were approaching crisis before this decision. While low oil prices have lessened pressure on PREPA somewhat, the economy and budget stresses have intensified. GDB's funding is at risk and liquidity likely exhausted, facing sizeable outflows by June and beyond (including $437M Note payments, largely to critical local institutions). The $2B+ petroleum tax-backed PRIFA bond deal, a futile, ill-advised attempt that compounds PR's unsustainable debt load, is likely doomed. Without GDB's ability to subsidize deficits, PR's faces threats to public safety and essential services. The Governor's platform for recovery, a sweeping PR tax reform via a Value Added Tax (VAT), is unlikely to take hold for years, the next chapter in which bondholders may be unwilling spectators.

2) *Demonstrated Lack of Willingness*: The Recovery Act, a pivot away from bondholder obligations, cost the island its ratings and market access. The Act, hastily enacted ahead of expiration of PREPA's fuel

financing lines to 1) shield the utility from immediate acceleration; 2) establish a debt restructuring framework for PR public corporations in the absence of chapter 9 recourse; and 3) ensure these public corporations have the ability to continue to provide vital public services. There is little reason to believe this stance has softened. The PDP-AGP friendly daily, El Nueva Dia, wrote last week, "Puerto Rico is Bankrupt" bringing increasing calls for broad debt restructuring and shared pain.

3) *Clock is Ticking*: Weeks before PREPA's March 2nd debt restructuring plan date and the March 31st Forbearance Agreement termination date, the decision deprives PR leverage in negotiations to extend creditor agreements. PR's investor pool—short-play, low-cost-basis hedge funds, ad hoc ring-fencers, long bondholders, bond insurers, fuel financing banks, and fuel suppliers (e.g. troubled Petrobas)—is a tenuous mix of interests and sophistication. The CRO's clout in preventing internecine feuds between creditors groups is now effectively neutered. The trump card is held by GDB, also a forbearance agreement signatory and creditor which can use claw back provisions.

Chapter 9 Prospects Are Likely Improved: While the Recovery Act provided bondholders and the island framework, the specter of a disorderly restructuring may be too be the catalyst to push Congressional action on potential extend of chapter 9 to PR. In fact, Resident Commissioner Pierluisi is refiling last year's bill (H.R. 5305) to amend chapter 9 this Thursday. Reportedly, government officials, Congressional leaders, and key stakeholders (hedge funds and other investors) believe this amendment may get traction as a result of the judge's decision.

January 12, 2015

PUERTO RICO'S 2015 BEGINS THIS WEEK:

· In 2015, PR's credit downside risk is elevated and rising given: 1) execution risk in substantial restructuring/reform efforts and; 2) the possibility of a budget shortfall in the neighborhood of $500 million.

· With media requiems for 2014 written—a year with some successes, but far more failures—2015 now begins in earnest. The island and its lenders are weary after six of years of austerity, no employment growth, and persistent outmigration of jobs, people and investment assets (down 5.5% with UBS losing 19% of its client assets).

· The list of PR issues to monitor this year includes: the gas tax hike and PRIFA bond deal, tax reform, GDB liquidity and solvency, a PREPA restructuring by March, a prospective PRASA bond issue, the economy (and now, Cuba), and ever-fluid political tides. Over the weekend, the resignation of HTA's executive director, Javier Ramos was announced, among several others (generally routine midterm replacements). Ramos' departure is untimely but was not unexpected.

· PR's Legislative session opens today. Central on the agenda is the "crudita", the Petroleum Products Tax bill. After receiving an unacceptable version in late 2014, passed under severe controversy, the Governor has three options: 1) a pocket veto, 2) sign the bill then amend, and 3) request the Legislature to amend the bill itself and then send it back. **MMA** expects the bill will be passed with necessary changes to move forward with the PRIFA bond, given the importance of enhancing GDB liquidity entering a challenging period in 1Q15. Chief of Staff Suarez was actively lobbying Legislators over the break of the stakes. If not amended, GDB would be forced to write off over $2B of PRHTA loans, risking the possibility GDB's auditors could determine the bank insolvent. More importantly, GDB would be unable to cover potential central government and corporations deficits, triggering a potential cash flow crisis.

- **MMA** remains concerned about "surprise" late year budget shortfalls. Through November, the Commonwealth general government has only collected $2.7B of its expected $9.5B annual revenues. When compared to initial projections this is below the $2.9B expected YTD with the "Other" category lagging significantly along with the Corporation and Motor Vehicle taxes. The current shortfall is reported at $32M and $217M (or 2.4%) below last year's levels. Some favorable tailwinds: strong holiday tourism, and the drop in oil prices, both which will benefit Sales and Use Tax collections. The COFINA bucket fills up sometime this month and begin flowing to the general fund, ultimately totaling 8% of revenues.
- PR's most recent disclosure (1/5/15) indicates a slim $23M projected Treasury cash balance at for end of Fiscal Year 2015. The report however sheds little light on spending patterns, and budgeted savings in education and health care (specifically the government health insurance plan) are significant risks to balance. Tax refunds also remain opaque.
- Disclosure also indicates Section 4.15, a "Budgeted Revenues Covenant" of the TRANs agreement apparently sets certain (3% and 5%) thresholds, likely required by lenders. What triggers and how stringent (acceleration, automatic spending cuts, for example) are not specified.
- The wildcard: PR's comprehensive, controversial tax reform will be revealed February 15 to be approved on or before March 31. The transition to a Value Added Tax—the only such tax in the US—is challenging in the best of times, requiring payment throughout the distribution chain. Count us as skeptics given PR's secretiveness to date in disclosing the conceptual basis of the reform, its spotty track record implementing tax changes, the traditional corporate gamesmanship, and a culture of rampant evasion on the island. The island's tenuous liquidity could be devastated by hasty adoption and botched implementation.

December 1, 2014

PUERTO RICO'S NEW DEAL PLACEMENT PROSPECTS ARE GOOD: Puerto Rico is contemplating a multi-billion dollar issuance late this year. Whether or not this actually happens, **MMA** compares market issuance conditions today versus the broadly successful $3.5B GO deal issued in March 2014. Important to note is that PR buyers are no longer typical municipal funds, rather a potential investor base would be composed of cross-overs, corporate high yield funds, and hedge funds. This investor base is dependent not only on municipal market conditions, but also on broader corporate and sovereign bond trends.

Supply: Positive: Corporate supply numbers have dropped significantly since September in response to Treasury and equity volatility, and has not regained its footing despite a resurgent Treasury market.

Demand: Negative: In contrast to the municipal market, corporate fund flows were drastically negative in recent months. The divergence between taxable and tax-exempt markets may cause dysfunctional absorption patterns for a PR issuance. Positive municipal dynamics could be misinterpreted as good for

PR when in fact, the cross-over, taxable investor base has seen massive redemptions and may not have the excess capital to allocate to the municipal market.

Performance in Alternatives: Modest Positive: Corporate high yield spreads have widened considerably since the summer but are still far below long-term averages. In sovereigns, Greece specifically has under-performed the broader market as European deflationary concerns have driven high grade Eurozone yields to extreme lows. Seen in this context, Puerto Rico offers value at tax equivalent yields of +16%.

Performance in Puerto Rico: Negative: Perhaps the most important factor surrounding a potential PR issuance is the performance of the major island credits. As can be seen, the island has seen significant price underperformance this year, specifically PREPA. Additional debt on an overly burdened economy may push prices of alternate credits down even further as cash flows are diverted into an expanding pie.

Overall, the environment is worse for a new PR issuance than it was in March, noting questionable corporate absorption and better value in alternative (competing) investments. However, current PR holders may well see the new issue as a tool for building total return in their investments, and, in general, credit spreads are still tight, yield scarce by historical standards. Our conclusion is that the new loan will be successfully placed, although yields may need to be higher than those for the March issue, all else being equal.

PUERTO RICO TAX HIKE UPDATE: Puerto Rico's governor appears to have persuaded several same-party (PDP) dissidents to support an unpopular 68% gas tax hike and avert a risky transit shutdown. The governor announced Sunday night that he has gained the required 26 votes for approval of the house bill. Last week, the house and senate suspended a controversial special session until today, because they did not have the votes needed to pass the tax hike, known in Spanish as the "crudità". Reportedly, opponents of the bill have not yet declared their support to confirm the governor's assertion. Today's session (beginning shortly) will indicate whether the Governor is bluffing or has necessary votes to move forward with the $2B+ PRIFA bond issue. While **MMA** believes the outcome will likely be approval of the crudità, the Governor has lost considerable political capital and authority. Amidst the above controversy, the GDB announced on Friday that year-over-year gasoline consumption dropped 12%, cement sales down 10%, energy sales down 1.6% and employment down 0.3%. The total EAI decline was 2.2%, the largest decline in the last eight months

November 17, 2014

PUERTO RICO BORROWING PLANS, TAX PLANS: Governor Garcia Padilla was forced to convene a special session when Legislators failed to approve a tax-increase intended to back a $2.9 billion GO-backed deal Puerto Rico Infrastructure Financing Authority (PRIFA) bond deal possibly before the end of the year. This is a blow to the Governor whose approval rating has sunk to 19% according to an El Nuevo Día poll last week.

The Governor met with Legislative leaders over the weekend and again today, and will hold a broader Legislative session on Tuesday. Despite the intense lobbying effort, the bill currently is short by one vote in the House. Resistance to the bill comes from various corners: some lawmakers fear the economic impact of a large hike (some advocate a toll increase instead), others prefer to implement the tax increase in conjunction with the coming tax reform, other insist on a HTA reorganization to cut expenses, and powerful companies (e.g. Puma) are lobbying hard against the oil tax hike. **MMA** believes a heavily amended bill, that includes pre-conditions that HTA will be reorganized to cut costs, will be signed into law by Thanksgiving, if not this week. The Governor simply has no alternative and will reasonably make what concessions are needed.

Enhancing GDB's Liquidity: The bill would enact a petroleum excise tax hike to $15.50 per barrel, of which $8.25 (nearly $180M annually) would cover debt service adequate to service a $2.9B PRIFA bond. The Governor has heavily lobbied lawmakers in his own majority party to approve the tax as an economic stimulus and infrastructure improvement, but the primary purpose is to bolster GDB's liquidity position and allow the bank to refinance outstanding short term obligations maturing in FY2015. The GDB disclosed that its liquidity, and likely solvency, depends on spinning off about $2.2B in HTA credit lines.

The financing scheme is intended to garner investment grade ratings based on: (a) a highly structured, COFINA-like security package, (b) provisions demanded by the market like acceleration, sovereign immunity waiver, choice of venue, guarantees and legal protections similar to the recent GO deal; and (c) assurances PRIFA is permanently barred from restructuring its debts under the Recovery so as to firewall investors from PR-related risk.

The Deal Must Get Done: Commonwealth officials are highly motivated to place this deal by year-end in order to ensure sufficient GDB liquidity prior to a PREPA restructuring that could occur early in 2015 (and push the GDB liquidity problem out beyond reelection in November 8, 2016). Below are demand challenges:

· Accurately forecasting tax revenues and coverage. Reportedly, projected revenue growth after last year's increase have been well below projections.

· Overcoming rating agency reluctance. In the aftermath of the ill-timed Recovery Act, rating agencies cast a broad brush questioning the willingness to pay. We doubt this structure will be so tightly structured as to eliminate concerns that PR's future (and current) leaders could undo the protections.

· Securing credit enhancement **MMA** is skeptical that adequate and material insurance capacity exists.

Attracting alternative investors. PR buyers are no longer typical municipal funds. Investors in the March 2014$3.5B GO deal issued in corporate high yield funds, and hedge funds. Since March, corporate supply numbers have dropped significantly (esp. in September) in response to Treasury and equity volatility.

Despite challenges, **MMA** believes that the PR will place the PRIFA bond deal, albeit at high rates. Alternative PR investors have assessed PR's myriad challenges and asymmetric risks closely in the last six months in contrast to other sovereign and distressed investments. Some have determined to limit exposure. However, the generally favorable conditions for issuance, global demand for yield, and PR's incentive to complete the transaction are overriding factors

November 3, 2014

PUERTO RICO ADVANCES PLANS TO BOLSTER CONFIDENCE: PR GDB's investor call on Thursday was an effort to bolster investor confidence ahead of a return to the capital markets. The commonwealth laid out ambitious plans for both the HTA and sweeping tax reform while intensifying its efforts to inform investors and establish practices consistent with other municipal borrowers. However, municipal bond investors remain unlikely to direct unfettered capital toward the island, being well acquainted with PR's chronic fiscal and economic woes, wary of optimistic fiscal and economic "recovery" plans, and increasingly concerned about willingness to honor obligations after the botched Recovery Act rollout. For its various deficit financing needs, PR remains almost wholly reliant on hedge funds, an investor class easily distracted by other investing opportunities and reasonably worried over a lack of quick profits in PR so far.

In general, **MMA** remains skeptical: 1) that the tax plan will be fully enacted as presented, especially as the island's political cycle ramps up; 2) that various tax adjustments "intended to simplify" will be efficiently imposed and ultimately yield the expected revenue upside; 3) that the substantial new taxes will not damage the weak economy and demographic (i.e. outmigration) situation; and 4) that the island will achieve a cost of borrowing with a rate and structure that is both palatable to local stakeholders and doesn't expose the island to longer term risk.

PR bondholders are exposed to several other principal risks at present, the largest being knock-on trauma from any (hypothetical) triggering of the Recovery Act for PREPA. The investor call featured only two brief slides on PREPA, which is not suggestive of a detailed plan being developed to protect capital market creditors. PREPA's five-year business plan will "serve as baseline for discussions of the Recovery Plan...and require contribution from all stakeholders." Other looming risks include burgeoning FY15 budget shortfalls for the central government (our specific concerns are Mi Salud and education); GDB's liquidity and its impending audit; and various bond rollovers.

HTA: Leaders filed HB 2212 on Thursday which, if approved, will raise fuel taxes (68% from $9.25 to $15.50 per barrel) "at a time when oil prices have decreased significantly." The GDB expects the tax will yield an additional $178 million per year to: 1) finance HTA budget gaps (39%); 2) back up to $2.5B of debt, proceeds of which will liquefy the GDB by refinancing $1.9B HTA loan and take out the August 2013 $400M bond anticipation notes with RBC (53%); and 3) finance a new Mass Transit Authority (8%). This tax will be effective March 2015.

Tax Reform: The government presented a complex project to remove the Sales and Use Tax (IVU) and replace it with a Value Added Tax (VAT) and, among other things, eliminate the payment of taxes for hundreds of thousands of taxpayers who earn less than $50,000. The proposed 15% VAT will be felt broadly as will a likely property tax increase and increase in tax rates to top earners. PR officials state that the tax would be implemented retroactively to January, and must be approved by March.

October 20, 2014

PUERTO RICO LIQUIDITY IS CONCERNING: PR's Government Development Bank (GDB) released a Special Liquidity Update on Friday night, just days after announcement of management changes and a week after placement of $900M of TRANs at 7.75% interest cost. The main takeaway is that GDB's current Ending Liquidity Balance is even more precarious than previously thought, roughly $1.8B*, which is 28% below the $2.3B projected in March, as well as the $3.5B actual liquidity in March and $3.1B in June.

Although GDB's liquidity position "improved significantly in March 2014 as a result of the issuance of the Series 2014 Bonds," the GDB has experienced greater balance sheet deterioration than anticipated, seven months later. The report raises serious concerns regarding further liquidity risks, the GDB's solvency (audit will be released in coming months), its ability to raise additional capital this year, and capacity to provide credible projections.

The decrease in GDB liquidity came from a variety of factors, including the following:

- Deterioration in the bank's funding base. GDB cites "seasonal and cyclical factors" which have inhibited the bank's ability to access fresh capital bringing liquidity to perilously low levels. Cash and deposits totaled $883M in March; by September the amount had dropped to $232M.
- Lower than expected deposit recapture and higher deposit attrition.
- Unanticipated draws. For example there was a $247M lines of credit "reprogramming" to close the fiscal year 2014 budgetary gap totaling. In May 2014, GDB repurchased $200M in HTA VRDNs.
- Various other unplanned obligations including payout of vacation and sick leave at the Department of Education, a loan to the Puerto Rico Industrial Development Company and the PRPA to finance capital expenditures related to Lufthansa Technik's relocation to Puerto Rico.

Risky Outlook. Looking forward, various potential short-term liquidity needs could reduce liquidity further:

- Central government deficits are again likely. The report states that General Fund revenues are approximately $36M below budgeted revenues and "the Commonwealth may have a deficit for fiscal year 2015." How large is the question, and **MMA** projects it will perhaps again be in the $700M range (last year's deficit was $783M). This is a wide estimate which factors: 1) projected $309M of unrealized budget savings with "high implementation risk"; 2) a 2% shortfall revenues would cost about $193M; 3) health insurance and education overspending of about $200M; and 4) unanticipated interest on the TRAN.
- Both GDB and the public corporations have significant short-term funding needs related to obligations that mature, may be accelerated or terminated. GDB faces a $397M note maturity FY 2015 of its medium-term while PREPA, HTA and PRASA short-term obligations at $696M, $ 292M and $ 200M, respectively. Making these payments is critical and the report states that "in the event that the public corporations cannot obtain third party financing, public corporations could take advantage of all legal alternatives available under Puerto Rico law, including seeking relief under the Recovery Act."
- Finally, letters of credit and financial guarantees, termination payment guarantees, and municipal loans pose further risk.

Taken in full perspective, the GDB report highlights the risk the dependencies between the GDB and other entities have broadly across the island. The report states that $1B of loans made to PRHTA by GDB must be refinanced during 2Q2015 from a portion of the proceeds of a long-term bond issued through the Puerto Rico Infrastructure Financing Authority ("PRIFA"). This number contrasts with the publicly reported anticipated $2.5B issuance.

The report highlights the market access risk stating "there is no assurance that the Commonwealth or its instrumentalities will be able to access other sources of financing or funding sufficient at any one time to meet their obligations." Although GDB has assumed that it will not provide financing in excess of that projected, the reader is cautioned that GDB may be forced for public policy reasons to provide such financing in an emergency situation or on a temporary basis and the liquidity position of the GDB could be adversely affected." In short, PR situation is far from resolved with great risk looming in the next several months.

*This number includes the recent $400M reimbursement of GDB's higher than projected TRAN line caused by underperforming revenues.

October 14, 2014

PUERTO RICO TRANs/DORAL: Last Thursday, PR's GDB announced it had successfully placed $900M of TRANs with a syndicate of banks in furtherance of raising $1.2B in near-term liquidity for the commonwealth. EMMA now shows five CUSIPs, four with maturity dates of 6/30/2015 and one on 6/15/2014. Two CUSIPs are variable rate, all are 144A (meaning private placements that ostensibly may be resold to qualified institutional buyers) and two had specific language stating they are "guaranteed by the commonwealth of Puerto Rico." This guaranty—which reportedly had been authorized under Act 24 of December 2013—appears to be another attempt by PR to navigate a short-term predicament by exposing itself to long-term ambiguity. The guaranteed TRANs may well have a better security pledge than the other notes, but how this guaranty stacks up against a full GO pledge may ultimately require judicial interpretation. If the commonwealth's fiscal affairs to continue to deteriorate through the spring, GO bondholders may well need to understand the extent of "claw back-able" resources available. Unfortunately, municipal bondholders are now painfully aware that the commonwealth's own perspective on relative security can vary with situational politics and immediate funding needs.

Doral: For example, the Doral case. In recent financial disclosures, Doral Bank's balance sheet had counted $229M of assets related to an agreement with PR's treasury (under Fortuño) to reduce Doral's tax liability in respect of past tax overpayments. FDIC regulators subsequently questioned the validity of those assets, and in May, treasury secretary Melba Acosta declared the commonwealth's obligation "null and void," arguing that Doral had committed "fraud and irregularities" in restating inflated earnings from 1998 to 2004. Last week, a San Juan superior court judge ruled the Doral agreement with PR's treasury was "valid and effective." In a 48-page ruling, the court ordered the commonwealth to pay out a sum that places further liquidity pressure. The governor has since called this tax deal "immoral".

If the court ruling stands, the Doral payment will be amortized over five years of ~$50M payments: an incremental liquidity burden on the commonwealth and its emerging budget deficit (currently estimated at $500-850M for FY15). However, this ruling also draws more negative attention to PR's management practices and its inconsistent willingness to honor obligations. And the subsequent vitriol between parties further deflects PR's efforts to reverse negative perceptions, particularly among prospective investors. **MMA** also notes the lawsuits filed by several large municipal bond funds and a hedge fund over the Recovery Act that allege, in many ways, similar charges raised in the Doral case.

October 6, 2014

PUERTO RICO TRANS: Puerto Rico Senate President Eduardo Bhatia is expected to bring forward a version of the TRAN bill for a full Senate vote. The House passed its version of the TRAN bill 27-17, along party lines over a week ago. According to President Bhatia, the Senate bill will be materially identical to the bill that passed the House. If the Senate passes it, the bill will move to the Governor's desk. The approval and placement of the TRAN will bring much needed liquidity and relief for the Commonwealth.

The Senate bill provides strong TRAN bondholder protections via a segregated, trustee-held Special Fund, in which "all moneys deposited are hereby irrevocably pledged for the benefit of the holders...and will be dedicated to the payment of principal and redemption premium, if any, and interest until all obligations on the notes have been satisfied. The irrevocable pledge created is automatically perfected without the need for a public document filed or notarized or any other act intended that still is and will be a statutory lien." Rumored buyers are all banks, some on-island banks, along with several traditional bank lenders that have provided GDB capital. It is believed that few, if any, alternative investors will participate.

According to the MSRB EMMA filing on Puerto Rico's upcoming TRANs, it will have four separate CUSIPS as shown in the table below. Noteworthy aspects of the EMMA filing are:

· All notes will mature prior to the June 30 Fiscal Year end. However, the Variable Rate Series B–2B will mature 15 days prior to the three other securities, effectively time-subordinating the three other CUSIP holders;

· Two securities have 9/30/2014 dated and closing dates, prior to the TRAN Bill being enacted into law;

· The principal amount of notes being issued is blank. It has been reported that the size of the note is $900 million with another $300 million purchased by the GDB, but the size could be considerably larger; and,

· There is no Official Statement filed, nor is it expected that such a document will be filed given the nature of the private placement

· The stated issuer for the notes is Puerto Rico Commonwealth Government Development Bank Senior Notes rather than the Commonwealth of Puerto Rico. The security structure has been evolving and MMA understands that the GO guarantee is being applied via the GDB Notes that will wrap the TRANs. This is a unique structure but provides the strong priority that the banks were seeking.

It had been reported that note would not only provide general government liquidity but also provide capital to the GDB, which will require capital to retire maturing senior notes (e.g. a $250M maturity coming due on 2/1/2015) as well as supplement internal liquidity. However, the current issue reportedly does not include additional liquidity for GDB. Future issues are in the works to monetize assets in GDB's balance sheet, specifically with regard to the Highway and Transportation. The legislation transferring the loans and revenues to PRIFA apparently is being debated (specifically regarding the controversial increase in both the petroleum tax and the crude oil tax) and is expected to be refiled for approval soon.

September 29, 2014

PUERTO RICO UPDATES: TRANs: Last week, the commonwealth's house of representatives passed a bill that: 1) creates a more structured and insulated fund segregation for the upcoming tax revenue anticipation notes (TRANs); 2) established NY court jurisdiction for disputes with creditors; and 3) waives the commonwealth's right to sovereign immunity with respect to the 2014-15 notes. There is also word that the ostensible lending group for the transaction has demanded: 4) additional security, including a potential GO pledge (unlikely, in our view) or some form of guaranty. **Even without a GO, this is a different and stronger security than used for past TRANs (which had little protection versus the commonwealth's general obligation claw back) and thus subtly erodes the base of resources available to secure PR general obligation bonds.** While the legislation does protect several other bondholder securities (exempting COFINA revenues, special act 22-2000 deposits on behalf of HTA, crude oil and cigarette excise taxes directed to HTA, and sales and use taxes to be used by the convention center district) from capture by the special TRANs fund, PR is once again drawing resources away from outstanding (GO) bondholders to secure new borrowing access: a trade that is unsustainable in the long term.

Economics: PR's August EAI was disappointing, decreasing 1.11% versus 2013: the biggest drop in four months. A lack of economic growth on the island poses considerable risk to economic forecasts and will reasonably worsen the commonwealth's cash position. Of the four EAI components, only non-agricultural wage employment increased (by 0.4%), the GDB citing construction employment as a particular bright spot (up 6.6%). The other components were all negative: cement sales fell 22.4%; gasoline consumption was 0.3% lower, and electricity generation decreased 4.1%. Continually negative readings underscore the uncertainty of PR's business climate amidst the government's fiscal crisis, the ongoing inability of the public sector to stimulate growth, and the ostensible tightening of bank credit.

Management: It is widely expected that significant changes in Garcia Padilla administration will come this week, following the recent resignation of the chief of staff Ingrid Vila and several others. To an extent, changes like these are consistent with an administration at its midpoint between elections, but turnover of key positions can make already complex financial and stakeholder discussions more difficult. For example, PR management is now working to ensure adequate operating liquidity through a challenging FY2015 budget year, execute future borrowing with the island's alternative lenders, to interface with variously-politicized legislators, implement complex tax reforms and system reforms, and manage public corporation restructurings with hired experts.

September 8, 2014

PREPA RESTRUCTURING ADVANCES: Ahead of today's deadline to appoint a chief restructuring officer, PREPA's governing board on Friday announced the appointment of Lisa Donahue, a turnaround and restructuring expert. Her experience as a consultant in the energy field are impressive, especially her role as chief financial officer at Calpine through its bankruptcy and as a restructuring officer in the oil and gas field. Her appointment appears to have been well received, and she will most likely be "reasonably acceptable" to the bondholders, as required in the forbearance agreements.

As with other distressed municipal situations, however, the honeymoon will be short. Most concerning is the capacity of PREPA's entrenched, labor-influenced board and legislative overseers to swallow the same bitter pill they have long resisted. Count us as skeptics. The governor will be required to show leadership in intervening in disputes between the CRO's nebulous authority and other stakeholders, including impatient investors. Thus far, Garcia Padilla's record of statesmanship has been unconvincing.

Ultimately, the CRO brings much needed credibility and buys time (again) before what we believe is going to be a rocky operational and debt restructuring, despite the ambitious, scripted reform timeframe outlined in the creditor forbearance agreements. PREPA's path to self-sufficiency and lower power costs will require: 1) overhauling its indefensible labor structure; 2) transitioning from the currently unsustainable crude oil power generation to something else; and 3) rationalizing its unwieldy cost structure, which will include a debt restructuring.

August 18, 2014

PREPA, BACK TO THE WALL, FORBEARING AGAIN: Late Thursday, Puerto Rico's GDB reached forbearance agreements with three separate groups: long-term bondholders, fuel-purchase creditors (Citibank/Scotiabank group) and the GDB, all which will last through March 31, 2015.

Given PREPA's precariously low gross liquidity position, now about $382M unrestricted, and creditor's questionable security position, both parties had strong incentives to settle. The agreements allow the supermajority of PREPA insurers (primarily National with $1.3B and Assured with $655M of its $9.3B debt) and bondholders to avoid painful write-downs and live another day. PREPA can preserve cash for critical operations and fuel purchases by delaying payment on credit lines, suspending required Revenue and Sinking Fund transfers, delaying all payments on GDB loans, and using construction funds to pay current expenses and capital improvements (budgeted at $300M this year). PREPA also averts legal actions over technical default, noting the acknowledgement that PREPA "did not make the required monthly Bond Service Account and Redemption Account deposits on July 25, 2014."

Although post-forbearance trading is reflecting price rebounds, we expect to see continued PREPA volatility. The temporary agreements only delay deep bondholder haircuts. The agreement on page 3 cites likelihood for new financing, loan, or "debtor in possession" facility in any proposed recovery program or debt enforcement plan restructuring plan. And the processes by which PREPA will ultimately submit itself, or be forced to, privatize its heavily unionized and politically entrenched operation will be rocky.

What's Next? The conditions included in this agreement are severe. For example, PREPA must use "pursue overdue accounts" (e.g. PREPA's $640M receivable from the PR government), and also record revenue from municipalities and associated receivables as well as Contributions in Lieu of Taxes beginning September 1, 2014. Although PREPA has stipulated to pay all P&I, in advance of the next bond payment on January 1, 2015, creditors demand the transfer of five payment installments ($170M aggregate) to a special Trustee-held defeasance fund "if Reserve Account funds are required." Further anticipating the possibility of disruption, the counterparties have a January 15, 2015 termination option. Creditors also extracted numerous early termination provisions and withdrawal rights (specified for the "Ad Hoc Group") if PREPA fails to deliver throughout the term. For example, the agreement contains an automatic suspension provision if the Recovery Act (or any other action seeking to adjust or challenge the claims of PREPA's creditors) is instituted by or on behalf of PREPA.

The creditors insist on detailed disclosure, including monthly cash reports, weekly updates to the Initial 13-Week Cash Flow Statement and Construction Fund disbursement, and various notices, to "Forbearing Bondholders and/or their advisors who have executed non-disclosure agreements." It is unclear from the document whether non-signatories will be provided access to this information and if these "Forbearing Bondholders" will be restricted from trading on privileged information.

PREPA must also appoint a chief restructuring officer (CRO) by Sept. 8 and a debt restructuring plan by March 2nd, both. It remains unclear how the CRO is appointed, what powers the position holds, and whether PREPA will even cooperate. The agreement also appears to obligate PREPA to hire FTI Consulting to develop a report on "best practices" to be delivered to PREPA no later than November 15, 2014.

The restructuring plan will also require negotiations with PREPA's largest union, UTIER, now the focus of reform efforts. The union, which reportedly barricaded doors outside PREPA headquarters as this agreement was being negotiated, will resist payroll reductions and layoffs.

PREPA's leaders have long resisted reform and this agreement is no panacea. Reducing the cost of energy by diversifying fuel sources will require patient, fresh capital and receptivity toward innovative technologies and approaches. The task at hand and strict conditions detailed above may be more than the utility alternative can reasonably handle. Despite ceding considerable authority via the agreement, PREPA's Board and management team remains intact and, we believe, an obstacle to successful execution of this plan as long as they remain in place.

July 28, 2014

PUERTO RICO TO ROLL OR FILE: PREPA's forbearance agreements with its credit line providers—Citibank ($146 million) and the Scotiabank consortium with Banco Popular and Oriental Bank ($525 million)—expire on Thursday. Reportedly, negotiations were ongoing over the weekend. **MMA** sees another extension as likely via extension of the lines themselves via a DIP structure as provided by PR's Recovery Act. The bank negotiations coincide with PR talks a group of hedge funds currently targeting an entry point for deeper financial involvement in PR's restructuring efforts. In theory, this implies an acceleration of proceedings and lenders considering the lower rungs of PR's capital structure should choose new positions with caution. Also, immediate assistance from traditional municipal managers remains unlikely: there are now two lawsuits against the Recovery Act (the second of which being led by Ted Olson, a high-profile plaintiff's attorney). The Commonwealth has fired back against these suits with its own motion to dismiss stating that the, "US Supreme Court has long rejected the argument that Congress's authority to enact uniform bankruptcy legislation automatically precludes states or territories from passing their own restructuring laws where, as here, there is no conflict between the Act and federal bankruptcy law."

Note the backdrop of Argentina's unfolding default brinksmanship between two sets of investors, both clinging to specific terms (the "Rights Upon Future Offers" or RUFO) that were hammered out in the depths of that crisis years earlier. As with PR, jurisdictional issues over court rulings and populist dynamics are key ingredients. Millstein and Clearly Gottleib certainly will have an eye on Argentina and its implications as they work toward their own client's best outcome.

PREPA INSURED BOND TRADING IS REASONABLE: While uninsured PREPA Cusips have traded down into the low $40s, insured bonds have retained a range of values, indicating market perceptions of the individual insurers' ability to cover their policies. In general, we find these company-by-company opinions to be quite realistic, if not a bit cheap regarding Syncora. We also note differential treatment of these insurers' anticipated recovery values across the curve: virtually all insured, short-maturity bonds trade at or close to par. However, as maturity increases, bonds begin to trade at increasing discounts, reflecting both the uncertainty in long-term PREPA proceedings plus an increasing risk of insurance payment haircuts (**Figure 6**).

The Model: Uninsured PREPAs are now trading in a 43-46 range. Using the worst-case experience of FGIC's rehabilitation (which will pay an estimated future value of 25% of policy claims to FGIC-insured bondholders), the market-implied insured PREPA payout should thus, at a minimum, be 45+25 or 70 cents. We say "at a minimum" because FGIC's experience and losses are very likely to be worse than those of any still existing bond insurer, FGIC being brought down by outsize portfolio risks to damaged structured finance transactions (with no help from JeffCo, Detroit, and some PR). All of the remaining insurers have, by definition, already survived their structured portfolios, meaning their individual worst-case scenarios, if modelled, would reasonably bring bondholders a better total payout.

PREPA's insurers: Insurers wrap approximately $2.9B in PREPA bonds with main insurers including Assured Guaranty ($1.1B), National Public Guaranty ($1.4B), and XLCA ($248M). However, there are four PREPA Cusips secondarily-wrapped by BHAC, which, since its very limited entrance into the municipal market, has been the monoline insurance gold-standard. BHAC-wrapped PREPAs accordingly trade at a premium or at par, depending on their coupon. BHAC thus continues to represent what AAA bond insurance once did—pure credit replacement of the underlying issuer, with little investor thought needed for what is happening below the Berkshire level.

Investors give Assured Guaranty (AGC and AGM) and National policies more modern treatment as credit enhancement, where expected recovery = underlying credit performance + that of the insurer. Among these, short maturity PREPA bonds also continue to trade at par, intermediates at a 5-cent discount (95 cents), and long maturity bonds at a 10-cent discount (90 cents). Thus, bondholders are assuming Assured and National would provide almost twice the bondholder recovery were they to undergo a FGIC-style rehabilitation. This is not an unreasonable assumption. We agree that the risk of either of these companies needing rehabilitation is low (but not zero), and that, even if this were to happen, bondholder payouts should be substantially greater than with FGIC.

By contrast, bonds insured by Syncora (XLCA)—which has the largest proportional exposure to PREPA with $248M out of $348M total—are trading at more significant discounts: short maturity bonds at a 10-cent discount (90 cents) and long maturity bonds at a 25-cent discount (75 cents). Again, this implies that Syncora, were it to undergo rehabilitation, would wind up within 5 points of FGIC. We find this scenario highly unlikely. While Syncora, being in runoff, is a more obvious candidate for rehabilitation than the other two, its portfolio has already survived the collapse in structured finance. It thus should, today, represent an incrementally better risk than did FGIC, meaning Syncora-insured PREPA should be trading at slightly better levels.

PREPA Insured Market Recovery Analysis			
PREPA Assumptions	**Short**	**Intermediate**	**Long**
Par Value	100.00	100.00	100.00
Uninsured Recovery	46.20	43.18	43.12
Market Prices	**Short**	**Intermediate**	**Long**
BHAC	N/A	103.79	108.36
Assured	99.37	94.66	90.67
National	99.34	95.50	88.84
XLCA	90.49	N/A	75.26
Implied Minimum Payout	**Short**	**Intermediate**	**Long**
BHAC Payout	N/A	56.82	56.88
Assured Payout	53.16	51.48	47.55
National Payout	53.14	52.31	45.72
XLCA Payout	44.29	N/A	32.14

July 21, 2014

PUERTO RICO CREDIT UPDATE: Last week, the commonwealth's financing team presented a scripted investor call highlighting "meaningful and decisive actions to protect its fiscal health and establish a foundation for economic growth," followed by the far gloomier Quarterly Report of the GDB. The carefully worded filing generally mirrors much of the previous February 18th Quarterly Report and March 11th POS's 15-page risk section, primarily restating the key point that the Commonwealth "may not be able to honor all of its obligations as they come due if it does not have sufficient access to the capital markets." A statement was released over the weekend seeking to "contextualize" the report stating, "any claim that the government admits in the document that the crisis has worsened in wrong." The report makes a few notable modifications from the prior reports, specifically:

1. *The impact of recent downgrades.* With PR's GO ratings now at B2, BB- and BB, "there may not be sufficient demand... to issue any future bonds or notes." An added sentence in the new report states that, "In addition, changes in the Commonwealth's credit ratings are likely to affect its relationships with creditors and other business counterparties."

2. *A more negative economic outlook.* According to the PR Planning Board, for fiscal years 2014 and 2015, real GNP is projected to increase by only 0.1% and 0.2%, and "more recent data from the GDB suggest even slower growth or possibly a decline." This will have dividends in a commonwealth budget shortfall as revenue models assume positive growth.

3. *A snapshot of GDB's liquidity, improved but not a panacea.* While it is favorable that GDB has increased liquidity by $1.7 billion after the GO bond deal, it is unclear how long its capital will remain adequate. As of June 30, 2014, GDB's cash, bank deposits and investment portfolio at fair market value was $3.2 billion. The Report specifically warns the "delays in the repayment of outstanding GDB lines of credit limit GDB's ability to continue providing liquidity to the Commonwealth."

4. *FY2015 budget execution risk looms*. The report highlights concerns that the Commonwealth will not meet projected FY2015 revenue levels or achieve the required spending cuts for to achieve a balanced General Fund budget. This may require emergency measures "that may include a restructuring, moratorium or other actions affecting creditors' rights." Which creditors' rights are not specified? **MMA** sees this stated contagion risk quite consistent with the rationale cited by all three rating agencies in their recent downgrades.

5. *Spotlight is now on government liquidity*. PR is seeking to access external borrowing to cover critical intra-year cash flow imbalances with TRANs (Tax And Revenue Anticipation Note). Lending under a TRAN line requires considerable faith in budget execution given the need for full TRAN "bullet" payment at maturity. As **MMA** noted in our May ***OUTLOOK***, the various banks that participated are unlikely to renew their commitment for obvious reasons. Given the precarious nature of the FY2015 budget, the appetite for new borrowing is likely limited, heightening the risk of a midyear liquidity event.

Other Developments. The report also adds that:

· FY 2014's $208M budget deficit was covered by a $93M loan from GDB, and $115M in cash management measures. After considering the $575M refunding, the total amount of the fiscal year 2014 budget deficit was $783M. It appears that a good portion of this was closed via one-time transfers of costs and/or revenues between the General Fund and the agencies.

· The $344M of annual interest costs for the last GO deal will require "significant" resources beginning in FY2016.

· Should Doral prevail on its claim against the Commonwealth, the Commonwealth would be required to pay $230 million over a five-year period.

· On May 5, 2014, the Commonwealth was formally notified that the United States Army Corps of Engineers had agreed to waive all cumulative Cerrillos Dam-related penalty interest and fees.

The report acknowledges that PREPA is headed for restructuring. Although "no public corporation has sought relief under the Recovery Act...PREPA may need to seek relief under the Recovery Act." PREPA's two fuel financing lines (totaling $146 million and $550 million as of July 6, 2014) are currently subject to acceleration and the July 31 forbearance deadline approaches. The report states that "over the next few weeks, PREPA expects to continue discussions with the lenders concerning its vision for the future as it evaluates various alternatives to improve its financial situation and operations." The report takes note of a lawsuit filed against PREPA and PR's intent to defend itself vigorously, noting that it "will take time to be ultimately resolved."

Beyond PREPA: We continue to have concerns about all levels of the island's capital structure if a liquidity crisis arises in coming months. We do however believe that PR will be most diligent in attempting to protect its GO securities first and foremost, given the Constitutional protections.

We generally believe that believe COFINA will remain protected as well, but with less conviction. In addition to our ongoing concerns over lack of clear judicial backing of COFINA's claw back-proofed legal framework (among other political considerations), we note last month's passage of Act 72-2014. Act 72 postpones the October 2013 direction of a 0.75% sales tax increment to COFINA until the "fiscal year following the year in which the COFINA bond issue is consummated." The dedication of this increment had been viewed as a credit positive for COFINA's existing bondholders. Thus even this ostensibly lock-solid credit is not entirely safe from a government in need of cash flow.

We also increasingly of the opinion that the Commonwealth will protect the GDB. We see House Bill 2039, recently introduced into the Puerto Rico Legislature, as an attempt to carve out GDB's exposure to Highway and Transportation Authority (HTA). If approved, the bill will transfer HTA's debt, together with the revenues that were enacted last year (Act 30 and 31), to PR Infrastructure Financing Authority (PRIFA). The bill does not explicitly state the HTA will need to be restructured, it does appear that a possible to isolate the GDB from the impact of HTA debt write down if the agency files for protection under the restructuring act.

HB 2039 has received a positive report from the Treasury Commission of the House and a positive recommendation from the GDB. The bill is scheduled to be put to a vote when the Legislature reconvenes in August. It then goes to the Senate and on to the Governor for his signature. As with the Recovery Act, it is unclear whether this legally is possible without violating bondholder covenants, and/or could be voided as an unlawful preferential transfer.

July 7, 2014

SYSTEMIC RISK FROM PUERTO RICO: With the flow of negative news heading into the holiday weekend—particularly concerns that PREPA drew from reserves to make its payment last week—investors continue to re-price the risk in PR securities. This creates concerns that: 1) certain fund complexes heavily concentrated in PR holdings will see large NAV declines, causing outflows and selling pressure, and pushing broad market yields, spreads, and cross-market yield ratios all higher; 2) other issuers will be similarly "disciplined" by the market; and/or 3) there will be negative implications for Congressional support of the tax-exemption. Noting caveats below for affected market sub-sectors.

Broad Market Impacts Should be Manageable but with Caveats: If near-term mutual fund outflows are larger than anticipated AND the taxable bond market begins a bigger struggle against inflation and growth fears, PR could be a contributor or accelerant to market weakness. However, even in a worst case, this is more likely to be a matter of weeks not months, and dozens not scores of basis points. In our view, PR's downgrades and likely restructurings more likely represent an incremental threat to near-term performance, noting mitigants in:

1. The current market context—extreme supply scarcity and persistent rally in yields and spreads. Funds thus should also have access to unspent cash, temporary lines of credit, and reasonably liquid securities (i.e., tobaccos) to afford emergency funding needs. This may weaken somewhat if the prices in USTs continue to reverse, but that does not appear likely.

2. The fact that many portfolio adjustments have already been made—and many headlines already have already been filed—since PR's crisis accelerated last summer. We assume a number of retail clients and their brokers were not up to speed ahead of last week's downgrades, but most institutional investors surely were.

3. The ready capitulation on price by initial sellers of PR securities (via sub-70 cent GO and sub-50 cent utility trades and even the large 2014 GOs lodged only one (1) trade at or above 85 cents on Thursday, having never fallen below 85 cents prior to last week) is likely easing the secondary order flow, although it will magnify the impact on mutual fund NAVs. To the extent PR-heavy funds liquidate non-PR bonds to afford outflows, their internal PR concentration (and thus exposure to falling price evaluations) rises, making continued investors outflows more likely.

Caveat One, Puerto Rico Goes Tribal: We do expect that market sub-sectors related to PR could and likely will be negatively affected in the near term, including generic high yield and, in particular, other US Territory bonds. Should PR's Restructuring Act be validated by the courts, all US Territories—and not just PR—will have effectively been awarded the right to unilaterally adjust their contracts with bondholders in a manner unconnected to Federal legal precedents. In effect, **Territory bonds may need to be treated and priced like Tribal financings** and perhaps ultimately moved away from a traditional, municipal market borrowing context (into emerging markets?). Current holders of Guam and VI paper should strongly consider taking gains (selling their bonds) immediately before there is a greater appreciation of the related risks to their credit profiles.

June 30, 2014

PUERTO RICO PREPARES TO RESTRUCTURE PUBLIC CORPORATIONS: PR's Governor Alejandro Garcia Padilla signed the Public Corporations Debt Enforcement and Recovery Act (Recovery Act) into law over the weekend, with limited debate, just days after it was filed. The law is the island's attempt to rectify a long-standing problem: a gap between federal bankruptcy code and the PR law for the island's troubled public corporations. Specifically three entities, the electricity, water, and highway authorities—which collectively have over $20B in debt outstanding—had nowhere to go to in case of financial distress and insolvency. This law advances a framework for relief specifically for public corporations, while explicitly protecting GO COFINA and GDB bondholders, as well as municipalities' debt, among others, in the meantime. In a larger sense, this bill may represent PR's pivot with respect to bondholders: meaning, a transition from describing debt obligations as inviolable to describing the risk if debt payments and bondholder remedies interfere with the corporations' other stakeholders and their critical public missions. That pivot is a critical feature: if this law is ultimately upheld by the courts, bondholders in PR will be uniquely exposed to considerations of willingness to pay.

What it Does: The bill itself allows the public corporations to be restructured on declaration of a financial emergency and with approval of the GDB and/or Commonwealth government. Restructuring can follow two tracks named for their section number. Chapter 2 entails a negotiated restructuring with bondholders, requiring 3/4ths of impaired holders to agree to reduce or extend repayments. Chapter 3 is a court-ordered process built to mimic Chapter 9; however, the bill sets a minimum recovery for each creditor at the sum of: 1) the minimum recovery each creditor would receive were all creditors to exercise their remedies simultaneously, and 2) a pro-rata share of a hope note, secured by 50% of excess cash flow generated by the corporation for ten years following the restructuring.

Prices Affected: We emphasize that NO corporation has filed under this new law yet. But there is widespread speculation that a PREPA filing is close at hand, possibly imminent, accelerating related bond trading at distressed prices. Last week, PREPA-issued securities traded into the mid-40s, as did some PRHTA bonds. Commonwealth GOs traded up—apparently in expectation of the island's improving economic prospects should electric and water rates be lowered through bondholder cramdowns—while COFINAs were off slightly.

Legal Pushback: Investors are challenging the Constitutionality of the Recovery Act. Two large fund groups, Oppenheimer and Franklin, filed suits saying that only Congress can approve bankruptcy laws and that the law violates constitutional protections in that it would allow PREPA to use existing debt as collateral for future loans. Reportedly 23 other fund managers are also filing a lawsuit which states that activation of the restructuring process represents an unconstitutional seizure of the assets of the bondholders, impairment of contracts, and illegal delegation of power to the courts of PR as the law intended to stop and prevent lawsuits against corporations public in federal court. Finally, it is unclear what strategy the Commonwealth would pursue were these plaintiffs to succeed in invalidating the new law. A reasonable scenario in that instance would be disorderly defaults by PREPA and perhaps other public corporations, to the direct detriment of the GDB and thus indirectly impacting the other Commonwealth credits.

PREPA: The power utility is indeed a logical and convenient scapegoat for the island's economic woes. Its high rates combined with other factors are driving businesses away, consuming family budgets, and depressing economic activity. PREPA's entrenched management has been remarkably unresponsive to reform attempts despite repeated assurances that it will diversify power and lower costs. Most immediately, large debt obligations loom as lines of credit expire in the very near term, threatening liquidity. PREPA's director has said publicly that its large fuel financing lines are being called in by two large banks. Lacking sufficient internal resources, PREPA would face an event of default. Using the Recovery Law would allow the entity to continue providing power across the island while it contends with scores of legal challenges.

More broadly, PR's central government simply is out of options to balance its own budget and can no longer afford to support public corporations. The June 30 fiscal year end arrives today, with a large current year gap, and next fiscal year's (2015) balance at best precarious leaving the Governor little option other than to finally choke off the public corporations. This effectively makes bondholders unwitting austerity participants, shouldering the burdens previously borne by central government subsidies. A PREPA debt restructuring provides an expedient way to achieve the budgetary "balance" Governor Garcia Padilla pledged when he presented his FY2015 spending plan. Painful cuts and fiscal emergency laws have failed to ameliorate the downward slide. Facing labor strikes and rapidly declining popularity, the Governor is pivoting to the populist inclinations, forcing to make bondholders share the pain.

The Credibility Gap: Recently, more aggressive PR investors have allocated shareholder dollars to PR issuers based on several key premises. Specifically: 1) the indentures and legal framework protects them. PREPA's 1974 indenture explicitly states that bondholders can name a trustee to run the corporation, under certain conditions; 2) these public corporations are essential service monopolies which will raise rates to manage costs and protect market access; and 3) if all else fails, they can always rely on the longstanding protection of the GDB, the government's fiscal agent. The GDB is now backing away from that implied support and advancing a view of the individual loans as separately supported by their own various sources of revenues and income. It is noteworthy that GDB has considerable loans to these same corporations that it purports to be protecting and expect to hear much more about these potential conflicts of interest. For instance, 15% ($2.1B) of the GDB's loan portfolio is to the PRHTA.

Which is not to say GO and COFINA holders should breathe easily. The potential financial relief and economic benefit restructuring public corporation debt represents is not a panacea, but a step to enable potential relief from one set of shareholders. PR's finances remain in critical condition and it is possible this step may eventually prove to have caused more harm than good. Specifically, the Recovery Act is an attempt to establish a precedent that contemplates bondholder impairment: a door that previously was considered closed. In direct response, S&P has put the GO and COFINA ratings on CreditWatch, speaking to the pivot in willingness mentioned above. Further today's *Caribbean Business* headline "PR Government Eyes $60M Bond Issue," highlights the island's need for continued market access and for capital markets support and trust. It's hard to see the Recovery Act increasing either. And finally, remember that the introduction of this bill and its messaging is occurring during a period of heightened scrutiny of municipal issuers by the SEC. There are also disclosure-related issues—as of this morning, **MMA** found no notice of the new law filed in EMMA and only partial disclosure of the recent rating changes. GDB's own website was carrying incorrect ratings this morning. There are also potential issues for broker dealers recommending PR bonds to retail investors; the evolution in risk has been rapid and sales and marketing material may not be up to date, arousing further regulator concerns.

June 2, 2014

PUERTO RICO'S MARKET RISK IS SMALLER, NOT FORGOTTEN: In **MMA**'s view, PR's systemic impact on the rest of the municipal market has waned, in particular as most large holders have, by now, likely come to grips with the risks in their exposure. But diminished is not eliminated, and there is still latent risk of market disruption, in particular if the Commonwealth's financial and solvency issues become more pressing so soon after completion of their $3.5B in deficit financing bonds. It may simply be that PR leadership has done a poor job managing investor expectations, raising the potential for a larger, unexpected downside. We highlight some of these risks below.

ECONOMIC MALAISE CONTINUES -- The GDB's latest Economic Activity Index (EAI), released Friday, shows that the island's battered economy has registered its 17th consecutive YoY decline with the recession now nearing eight years in duration. The April EAI showed a 1.3% YoY reduction, on the heels of a 1.0% decrease in March 2014. Components of the EAI include non-farm employment, which dropped 1.5% YTD FY2014, electricity generation which was down 3.1%, gasoline consumption which declined 2.1%, and cement sales, which were 14.6% below last year.

While these numbers are concerning, investors may find that the reality is actually worse. Puerto Rico's Planning Board recently acknowledged that "certain significant deficiencies" and unreliable economic statistics have existed for several years. The GDB states that it will be releasing a new seasonal adjustment procedure next month to "allow more reasonable month-over-month comparisons...and further reduce the volatility of the Index."

Regardless of the outcome, PR's worsening economic backdrop and $442M revenue shortfall in April ($380M because of corporate tax underpayments) have heightened focus on the island's near-term liquidity, the FY2015 budget, and further borrowing plans. Key PR financial officials traveled to NYC last week to assuage rating agency concerns as the island enters the last month of the fiscal year. Reportedly PR officials stated that large manufacturing firms were being asked to make advance tax payments to contain the budget gaps and that GDB "is willing to step in with financing to shore up the public coffers."

The Commonwealth's OMB Director stated that emergency cuts would leave the island close to budget for this year, but recent analysis by Sergio Marxuach, director of Public Policy at the Center for New Economy, shows that PR may carry a structural budget gap forward into FY2015 as large as $1B. While the Governor has declared the budget "balanced", **MMA's** view is that this balance is illusory given the island's aggressive revenue estimates (up over $650M resulting from new revenue measures), continued reliance on a handful of corporations, over $500M of non-recurring revenues, speculative proposed budget cuts, questionable savings, and lastly, the effect of the budget on the general economy.

LIQUIDITY REMAINS THE FOCUS – **MMA**'s primary concern remains the island's ability to repay its TRANs on June 30 (see table below) and find willing

participants in next year's TRAN borrowing, where lenders (some of whom face their own fiscal challenges) will be asked to put considerable capital at risk based on a budget that, in the PR OMB Director's own words, "entails complex implementation processes and a high degree of estimation risk."

Issuance	TRAN Series	Amount	Lender	Due Date	Rate
1-Jul-13	Series A	$300,000,000	GDB	30-Jul-14	Greater of (i) prime rate plus 150 basis points or (ii) 6.0%.
16-Jul-13	Series B	$100,000,000	Oriental Bank	30-Jun-14	Base LIBOR plus the applicable margin
23-Jul-13	Series C	$100,000,000	Banco Popular de Puerto Rico	30-Jun-14	Base LIBOR plus the applicable margin
13-Aug-13	Series D	$200,000,000	Banco Santander	30-Jun-14	Base LIBOR plus the applicable margin
22-Aug-13	Series E	$200,000,000	JP Morgan Chase	30-Jun-14	3.25% multiplied by a margin rate factor,
12-Sep-13	Series F	$100,000,000	Scotiabank	30-Jun-14	3% per annum, up to 6% upon a downgrade
Sept/Oct	Series G	$200,000,000	Bank of America	N/A	N/A

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transfer, but according to PREPA's Treasurer, the agency has considerable latitude to pay for capital projects from internally generated funds and replenish these with highly fungible borrowed moneys. According to PREPA's most recent financial report (3/31/14), the agency's (restricted) Construction Fund balance was $433M, assumedly from last year's bond proceeds. Of greater concern is the utility's liquidity, which is operating now with ten days cash. Financial disclosures also show PREPA's widening $1.6B accounts receivable balance, of which $672M is due from government clients and $1.3B accounts payable ($762M for fuel oil). Considering the above, a negative $1B net deficit position (+23% versus last year), and inevitably rising capital costs, PREPA's BBB rating is sorely lacking credibility.

PR's political leaders (particularly Senate President Bhatia) clearly recognize the risks that PREPA poses to the island's economy and bondholder confidence (how a PREPA restructuring would affect other bondholders is a major question). While recent PREPA reform law signed by the Governor is a good first step toward imposing some discipline on PREPA's operations, it may be too late. PREPA's entrenched management team continues to desperately maintain its position stating that its FY2014 recommended budget, to be released today, will reflect "today's realities." PREPA's reality is that it is operating deep in the red, with antiquated technology, high costs and declining sales. All-in debt service costs are $702M for next year, not factoring Scotiabank's $550M Fuel Financing line of credit, expiring on 8/14/14, and a $250M Citi line, expiring 1/9/15, create major liquidity challenges for an entity that already spends much of its $5B on fuels and salaries. And: it was reported last week that 30 agents from the PR Special Investigations Bureau seized documents from the agency's Fuels Purchasing Office. Many on the island have speculated about the possibility of selective power blackouts to manage cash, but this will cause considerable economic and civil disruption, that may entail debt restructuring as well.

May 27, 2014

PR HIGHWAYS DRAWING ON BANK SUPPORT: Last week, Puerto Rico's Highways and Transportation Authority (HTA) filed a notice that: 1) a series of its VRDOs (745190Y77; $200M Series A of 1998) have recently become bank bonds under their LOC; 2) the GDB appears to have stepped in to replace the LOC provider; and 3) HTA and GDB intend to amend the bonds' repayment provisions and the security pledged for repayment. In our view, the first development has been common enough in the last few years not to warrant special consideration. But the second and third—which may imply an extension of maturity or a recast interest rate—is another negative data point for the credit and the related messaging for Puerto Rico in general. In the worst case, developments could warrant HTA's inclusion in our database of defaulted and impaired bonds, reasonably under the "Support" or "Other" categories.

HTA may be headed for our database in any event. There are rising operating subsidy requirements to the Tren Urbano light rail, an underperforming and underutilized asset, which has long been a burden on the overall system. Recent reports also indicate that the system has stopped paying third-party vendors amid mounting cash flow pressures. Finally, HTA will need to access the market in the coming months to repay RBC's $400M loan or face increasingly punitive interest rates. And remember that a quarter of the GDB's own loans are to the HTA: a material weakening in the latter's credit raises the issue of GDB write downs and related knock-on risks across the island. The ongoing $230M Doral Bank dispute has also raised criticisms regarding Puerto Rico's ability and willingness to honor existing bank obligations

May 12, 2014

PUERTO RICO, APRIL SURPRISE: Puerto Rico missed its estimated revenue target April by 26%, or $442M. In dollar terms, PR expected $1.67B this April but only received $1.22B. Year-to-date (July-April) revenues are now below budget estimates by $356M with two months left. The primary cause of the monthly shortfall was the corporate income tax, which was $380M, or 50%, below the $776M estimate. Reportedly, thousands of corporations filed tax returns with applications for extensions, many of which (53%) included no payments. The time extension for corporations is 3 months, ending July 15, 2014. There is much speculation about the causes for the extensions, including that many business owners are deferring payments for purely fiscal reasons. Apparently many companies have opted to ask for the extension without sending an estimated payment, hoping they would be able to negotiate lower payments with Treasury in exchange of not firing people or having to simply shut down or downsize.

The shortfall also underscores a point that **MMA** has focused on for some time—Puerto Rico's skewed reliance on a highly volatile corporate tax. Act 154 excise tax makes up more than 20% of Puerto Rico's General Fund revenue and other business taxes push the total reliance above 40%. The US state average is about 6%.

Implications are broad. A cash flow shortfall would require immediate spending cuts or external borrowing measures to bridge the gap. It is unclear whether the Treasury has requested a line from GDB (yet). The Commonwealth also has roughly $1B of TRANs (intra-year cash flow borrowing, originated before the downgrade) with a variety of banks as well as the GDB. The ability to repay these notes with internal liquidity is a concern, but perhaps as importantly will be the ability to find TRAN lenders next year.

More broadly, the credibility of the Commonwealth's estimates and forecasts are wearing increasingly thin. Recall that FY2014's gross receipts tax proposal was quickly cobbled together after the Center for New Economy stated that the Commonwealth's initial proposals were, "logically incoherent in the best case, and as bordering on economic illiteracy in the worst....we fear that that the end product may be an incoherent jumble of new taxes and exemptions that will significantly increase the complexity of the system, complicate both compliance and enforcement efforts, and fail to generate the expected revenues....in which case a further GO downgrade would be inevitable."

Note that PR's Treasury is again predicting an increase of between $615M and $700M in revenues next year from various other revenue measures as well as rosy economic projections. Last week, a respected PR-based economist estimated that the economy, at best, will shrink by 0.8%, rather than grow by 0.1%, the PR Planning Board estimate upon which the new budget is being based. In a press release entitled, "April Revenues Increase 20%

Year-Over-Year; Year-To-Date Revenues Exceed Last Year Period By $465 Million", the Secretary of the Treasury, Melba Acosta, stated "Certainly, these are not exactly the results we expected." We expect better and again urge the Commonwealth to adopt legislation introduced by Senator Bhatia to create a professional nonpartisan, oversight and analysis body as soon as possible.

April 14, 2014

PUERTO RICO PENSION REFORM AND ECONOMIC DATA ARE INCONCLUSIVE: Late Friday, the Supreme Court of Puerto Rico, declared in a 5-3 decision (Justice Feliberti recused himself) declaring key provisions of Law 160 teacher's pension reform unconstitutional. Specifically, the Court reasoned that aspects of the pension law did not comply with the strict standard of being "reasonable and necessary in furtherance of an important government interest." Several justices stated that the Legislature did not adequately study the legislation's probable effects and that it did not adequately prove that Law 160's solved the problem. According to Politank, a PR-based Government Affairs law firm that has been closely tracking the issue, the Justices factored into their ruling the potentially "disastrous effects" of Law 160 were it to triggering a massive retirement of teachers to avoid the law's cuts. Such premature retirements would potentially consume all retirement system assets in short order. Note that several key components of Law 160 were upheld (eliminating collateral benefits and medicine bonuses, and post-reform reductions) and we believe the island leadership will take action to remedy many of the Court's concerns.

Still, this court ruling appears to undercut assertions that Puerto Rico's judiciary will always defer to "legislative determinations." This claim was cited as an island credit strength on a GDB's October 31 conference call, in response to investors' legal concerns about COFINA and related claw back issues vis-à-vis the GO security's first claim on revenues. **MMA** has long urged the Commonwealth to settle this dispute via a mandamus validation process (common in many US states) where the Supreme Court can rule (or not) whether sales tax revenues constitute "available resources" which, under Puerto Rico's constitution, are dedicated on a first priority basis to the payment of Puerto Rico's "public debt."

Additionally, as the island continues to engage more "restructuring" experts, Justices may also be forced to weigh contractual commitments to bondholders versus Puerto Rico's other stakeholders and economic growth prospects. In our view, the majority's opinion ruling that the ban of impairment/violation of contracts is not absolute keeps a door open in this area, although clearly the standards for such a reversal would need to be high.

The decision is also a blow to Gov. Alejandro García-Padilla (a pro-Commonwealth, strict constructionist attorney) who showcased the teacher pension reform as evidence of his administration's fiscal successes in marketing the large bond deal. The ruling relies on data that conflicts with, and undermines, some of the administration's arguments regarding the system's solvency. Reportedly, the Governor is now hammering the Justices' perceived "free-lancing," saying their court decision could sidetrack his efforts toward fiscal balance and revive the economy.

Economic data remain inconclusive, which is better than clearly negative: On this note, Puerto Rico's economic recovery statistics remain inconclusive and conflicting. Official BLS data show Puerto Rico's payroll employment plunging by more than 25,000 jobs since January 2013, while the Governor continues to cite 45,000 new jobs created by his administration over the same period. Note that the GDB reported that its February 2014 Economic Activity Index dropped another 2.4% YOY as public employment decreased by 3.7% (9,300 jobs) and gasoline consumption dropped 6.4%. It does appear that there has been some recent Puerto Rico private sector job growth (up 1.5% YOY, or 10,300 jobs), specifically in the Professional & Business Services sector as well as in Leisure & Hospitality. It is not clear at this time whether the biotechnology and pharmaceutical companies are driving this growth, or other more diverse job-intensive sectors. These data are important in tracking PR's success in reversing the recent malaise and negative perceptions among residents that beget continued outmigration and brain drain. PR needs an optimistic "buzz."

To this end, Puerto Rico is ramping up efforts to bring in outside companies and investors and will host many in events this week and next. The island's unique territorial ability to make special tax arrangements is a powerful tool that is now being leveraged effectively. Specifically, Act 20 is very appealing for American business owners who can incorporate and operate their business from Puerto Rico at significantly lower effective tax rates that on the mainland. And under Act 22, an American citizen, living and earning Puerto Rican-sourced capital gains and certain interest and dividends income in Puerto Rico pays a zero tax rate. Large multinational corporations continue to benefit from Puerto Rico's Law 154 manufacturing excise levy as a creditable tax against federal income tax. Favorably, the IRS recently confirmed it will not challenge this credit. Additionally, the island will have to manage these incentives carefully so as not to appear to be another Cayman Island-like tax haven that pushes the rising tax burden on other states and municipalities.

The island is also taking decisive action to stimulate sustainable, indigenous economic activity. Going back to Operation Bootstrap (the 1950s industrial transformation) to Section 936 (enacted in 1976) to the triple-tax exemption to Act 154, the island has relied on external measures that have not created adequate job growth and in some cases, exacerbated the island's economic challenges (e.g. increased reliance on debt and a handful of corporations to keep the government going). Puerto Rico has a long history of writing up exciting and detailed economic development plans but these seem to change with through each political transition. Some of the most experienced and respected economists, conservative and liberal, have studied the problem ad nauseam. Yet the political leaders have not been had the decisiveness, wherewithal or luck to convert these plans into results. The GDB must return to its role as long-range, non-political facilitator of long-range economic development. After years of half-measures and quick-fixes, Puerto Rico stands at an economic and financial precipice. Now, as never before, the pressure on the island is intense and it will probably need to cut significant government spending and raise more taxes to balance a large structural deficit in the anticipated FY2015 budget and bring down its debt levels at the same time.

March 17, 2014

PUERTO RICO FOLLOW UP AND RESTRUCTURING BILL: Last week's successful execution of an up-sized PR bond (to $3.5B with $16B in reported subscriptions) is a testament to continuing market demand for exposure to PR debt. In the near-term, this is comforting: the commonwealth's principal credit strength, after all, is its ability to access new capital if needed. But of course the new bond will add some financial pressure to the commonwealth's annual budget (once capitalized interest runs out next year) and could make any future restructuring, if needed, incrementally more difficult to effect. Importantly, we also expect that, with the successful sale that depended largely on hedge funds, Puerto Rico as an investment is continuing to its transition away from the traditional municipal bond market (even if some traditional players have decided to re-engage and speculate on near-term performance of the island's new GOs). This is an important perspective, as it implies a thicker cushion between what happens in PR and the market as a whole. This is not to say that renewed problems would not lead to mutual fund outflows again; they likely would. But this is also increasingly a temporary risk. We find it hard to expect that investors in any mutual fund with material PR exposure now have not effectively re-underwritten their purchases in these funds with that information in mind, meaning preparing themselves for PR-related problems that might occur.

MMA is also following last week's filing of PR Senate Bill 993, the "Public Corporation Restructuring Act", which lays out a process for the restructuring of an insolvent public corporation. The bill is sponsored by Senators Ángel Rosa and José Nadal Power, two committee chairs of the same party as the Governor, both described as "mavericks" who opposed the $3.5B bond deal. This bill portrays a process substantively different from chapter 9. Specifically it allows for: 1) bankruptcy of a Puerto Rican public corporation to be initiated by a creditor not just the issuer, and 2) the standard for eligibility to be as little as liabilities exceeding assets. Also, 3) a plan of adjustment seems to be able to come from creditors, not just the corporation; 4) liquidation of the corporation is possible, under control of the respective judge; 5) there are few carve outs or protections for contracts, pensions, etc.; and it seems that 6) there is no special revenue provision that would protect revenue bonds as in chapter 9. Finally, 7) the Commonwealth Court is in charge, not a federal court.

MMA notes that this is just a draft bill which appears to have been hastily drafted in both English and Spanish without consultation with the GDB, lacking proper governance, legal and financial advice, implying that parts may or may not be consistent with commonwealth and Federal law. The PR Legislature, like the US Congress, files many bills which never find a vote (and Senate President Bhatia has yet to state his position). Also, the GDB has stated that neither it, nor the Governor's Office, participated in the drafting of SB993 and that they have no specific plans in case one or more public corporations were not self-sufficient. "The GDB, as the government's and its instrumentalities' fiscal agent, is evaluating the financial condition of public corporations to assist them in drafting plans to assure their self-sufficiency. No contingency plan, including debt restructuring, has been adopted in case their financial condition doesn't improve." Of course, GDB could also provide much needed guidance to the bill's drafters and flesh out many of its skeletal positions.

But despite its many flaws, there appears to us some compelling logic behind this bill. Specifically, the lack of a clear path for a restructuring is a negative for all stakeholders, with taxpayers, employees, and bondholders forced to operate with some suspension of disbelief that defaults can and might occur. Further, the lack of a restructuring provision has in the past been a major inhibitor to deeper hedge fund involvement in PR agency debt. This bill, were it to provide some clarity on how a restructuring might actually occur, could allow investors to better price speculative positions in agency debt, opening up substantially better liquidity in related blocks of bonds. And finally, this type of bill could be a tool to induce parties to a private restructuring negotiation to reach an agreement or submit themselves to a potentially less "professional" court procedure.

MMA notes several larger block PREPA trades below $70 on Friday (CUSIP 74526QA7), likely related to the bill's filing. Although PREPA is the most obvious target within the bill's rhetoric (which would, incidentally, allow for even COFINA to be drawn in to this process, although we strongly expect that this is an issue with drafting and not intent), no senior level PREPA executive has yet reacted to the bill. A PREPA public interest director did say that PREPA is current in all bond payments and that debt issuance plans are limited. PRASA's Executive Director stated the agency would study the bill carefully, but that the agency will end this fiscal year with no deficit and that PRASA no longer expects to receive General Fund subsidies due to the agency's recent rate hikes. This bill incidentally came on the same day that a measure to create a Public Utilities Regulatory Commission with oversight over PREPA was filed in the House (the Senate filed a similar bill recently). Hindrances to fully monopolistic rate setting by either agency likely increase their medium-term.

March 10, 2014

PUERTO RICO THIS WEEK: PR's issue this week may well be the most scrutinized and eagerly anticipated deal in municipal bond history. Accordingly, the POS provides a candid 14-page depiction of the Commonwealth's myriad risks and contemplates the potential for adverse out-comes. It is of significance that the issuer has now established a new baseline for transparency and disclosure for prospective investors, current bondholders, and regulators—a constructive sign from this issuer. **MMA** finds it particularly noteworthy that:

- PR concedes it has not complied with disclosure requirements in three of the last five years;
- The Commonwealth (finally) acknowledges it has a "very high level of debt" that approaches debt limit capacity;
- Leverage is exacerbated by a complex web of private bank lending arrangements and inter-agency dependencies;
- The Commonwealth explicitly states it "may be unable to meet its debt obligations" if market access is lost;

- Operating requirements and political opposition "from affected constituents" present further risk to bondholders;

- GDB liquidity has dropped by $1.033B this year and, even in the most optimistic scenarios, the bank may end the fiscal year with just $679M in net cash available and probably have to seek loans from private banks or in the public market by the end of FY2015;

- "Claw back protection" is less solid than thought; it is unclear what steps a GO bondholder has to "compel the diversion...to the payment of public debt or how the necessary available Commonwealth resources would be allocated";

- FY2015 budget risk is ~$1.5B (due to cost escalators and revenue assumptions) and further gaps may widen as outmigration, economic deterioration, education and health spending trends are revealed;

- Emergency actions, restructuring, moratorium, and alternative courses of action are being evaluated;

- The GDB has hired a "financial advisory" firm (Millco Advisors) specializing in debt restructurings. GDB states that Millco is NOT advising on restructuring but assisting with "cash flow and projected liquidity." As a result, PR's restructuring risk should temporarily abate with this bond sale; and

- There is no collateral, acceleration, or mortgage lien, and remedies available to bondholders are potentially "subject to substantial discretion and delay." Furthermore, despite efforts of bondholders for venue protection, "there is no assurance that any judgment from a New York court would be given effect by a Puerto Rico court."

Given these risks, the GDB states that this issuance is suitable only for purchasers in $100K denominations and emphasizes buyers are those "who can bear the risks of price declines, limited liquidity and the possible failure to pay debt service." Also, the large lot sizing should aid expected liquidity in the new borrowing, allowing for fewer "odd lot" trades and the gaping price dispersion now plaguing the general PR market.

MMA expects sufficient demand will emerge to take down this issuance; post-sale reports likely will reflect broad-based demand. Potential preliminary structuring entails a $3B, 8% coupon term maturity in 2035 sold to an 8.625-8.875% yield. With sinking funds schedule from 2022 to 2035, callable at par.

How long the bond proceeds will enable PR to bridge itself to a sustainable path is the central question. Hopefully, there will be notable progress before the Commonwealth returns to the market by the end of CY2014. Remember that, even with the new bond proceeds—and under best-case scenarios—PR and its agencies face $2.5B in short term debt obligations through FY2015 and GDB faces large debt maturities in FY2016 as well.

Impact on Ratings: PR's new disclosure of risks does not break new ground for investors already awake to the fragility of Commonwealth finances and the dependence of same on inter-agency liquidity transfers and volatile market access. As noted above, the POS is a positive step toward greater transparency and, more importantly, avoiding action from a recently more restive SEC municipal enforcement division. However, the credit profile depicted in the risks section is also clearly not an investment grade security—nor has it been for some time—despite its being rated as such only one month ago. The new disclosures are thus a reproach to those ratings and the agencies themselves, which all investors should welcome. Although the Commonwealth has hopes of regaining IG (and so traditional municipal investor demand) in the medium-term, this goal is better depicted as an aspiration for the very long term.

February 24, 2014

PUERTO RICO UPDATE: With their extended investor call last week, the Commonwealth has moved closer to executing the planned new loan, now estimated at just shy of $3.0B, to finance immediate and near-term cash flow needs. A bill to authorize up to $3.5B in new borrowings (ostensibly to provide some cushion for an additional loan if needed) is moving through the PR legislature, but media reports this morning (www.noticel.com) that a contemplated waiver of the Commonwealth's sovereign immunity may not have gotten through the Senate. Still, we expect this financing to be completed in the next few weeks, allowing some optimism to return in PR bond pricing (indeed, multiple sources are noting firmness at the end of last week and sub-50 cent odd-lot trading in current interest bonds subsided to ~2% of total PR CIB trades (**Figure 5**). Keep in mind that, should liquidity and prices in PR names continue to improve, we expect more bondholders will choose to exit PR positions, limiting the potential for near-term outperformance in PR.

February 10, 2014

PUERTO RICO DOWNGRADED: Last week's long anticipated double downgrade of Puerto Rico GOs and other credits—S&P's by one notch, Moody's by two—has dominated news flow into this week's open. The island's exhaustive campaign to maintain investment grade ratings was valiant, but inevitably futile. Puerto Rico's persistent economic downturn and unsustainable debt load had simply become too weighty for the agencies to ignore. The agencies simply ran out of methodological exceptions and one-offs for Puerto Rico. The simple truth is that the evident lack of cash (and market access to get more) by definition had made the island's long-term credit rating "speculative" quality months before.

Also, revenue numbers just out this morning were mixed. To the positive, January sales tax collections were their highest ever since inception, completing the transfer of new funds to COFINA bondholders. Negatively, year-to-date general fund net revenue surplus shrunk from $80M to $36M. The December economic index (still not released) will likely be negative as preliminary reports show payroll employment (-2.7%), gasoline consumption (-8.9%), power generation (-3.1%) and cement sales (-18%) are all again down.

The Ratings Contrast. Agency reports were similar in tone, both citing marginal progress despite the outcome. Generally, S&P's report focused on liquidity, while Moody's looked more to the economy and macro-factors. Most importantly, Moody's downgraded both senior-lien (Baa1 from A2) and subordinate (Baa2 from A3) COFINA's bonds. S&P left COFINA untouched, reflecting their view that the dedicated sales tax is "not subject to the prior diversion of revenue for GO debt service payments" (aka "claw back"). Still, Moody's **COFINA action obviously dampens the prospects for a Third Lien bond deal (see below)**. Noteworthy as well, while S&P spared PREPA, Moody's cut the power agency's rating to Ba2. This is an issuer that some believe is politically ripe for restructuring—many blame the power authority for the island's economic woes arising from its high cost structure and intransigent management. Related reform efforts are languishing.

Lack of Transparency Hurt the Island. Experienced municipal investors recognize that constrained liquidity, and consequent reliance on short-term lending rollover, is the tipping point in most municipal crisis. By last week, few took any solace in GDB Chairman David Chafey's verbal insistences that GDB liquidity is "adequate" as a pillar for prudent investment thesis. It was vexing that, Mr. Chafey, an experienced banker and investor, would fail to provide basic quantitative evidence of his assertion of GDB's liquidity. Investors gradually interpreted GDB's extraordinary actions (pulling government deposits at private banks and using the Workers Comp and State Insurance Fund) as an indication that liquidity was probably much lower than represented. Mr. Chafey, appointed by the Governor's, failed to realize that without disclosure, his credibility, and investor patience, would suffer.

In the aftermath of the downgrades, PR leadership has shown resolve in hopes of forestalling more downgrades and maintaining demand for a bond deal. The press release said, "We strongly disagree...and we will not relent in our plans to strengthen our fiscal situation" again maintaining that liquidity is adequate. The Governor offered various budget balancing proposals to cut spending and stimulate economic growth and reportedly will make an speech today at 4:50 PM to talk with "more detail and precision," about proposals that have already been made public. It is stated he will address recent proposal by Senator José Luis Dalmauto remove the sales and use tax (SUT) and restore the general excise tax. The bill states that that the SUT is woefully inefficient, as evasion is 44%, which causes annual losses to the treasury about $900M.

What Next? The oft-cited Chinese character for "crisis" representing both danger and opportunity is one that PR investors are considering:

· Bulls contend downgrades were priced in, evidenced by light trading in the aftermath, and that forced fund selling had been exaggerated. The liquidity impact of the downgrades may have been overstated (with extensions of existing liquidity facilities and forbearance of swap terminations a possibility), while fresh liquidity awaits from hedge-funds, assuming prices are showing satisfactory resilience. The downgrades also present an opportunity for Puerto Rico to adapt to the realities and form new political alliances and enhance fiscal practices.

· Skeptics are less willing to accept rosy narratives. The juxtaposition of the news of downgrades with the announcement of borrowing sends a message that PR is returning to "business as usual" by presenting a last-gasp bonding attempt that puts undue pressure on the market. With deep problems (highlighted in yesterday's sobering, most-emailed *NY Times* article), the attempt to borrow at rates approaching double-digits would, if successful, provides temporary salve but longer term worsens the island's economic and fiscal condition. The issuance would also tap out the Commonwealth's remaining $1.3B of available borrowing capacity, leaving future leaders with no borrowing capacity.

The terms of this proposed debt issuance (currently subject to negotiations between prospective buyers, bankers and GDB's depleted management team) regarding legal protections, requirements, timetables and acceleration provisions will likely be revealed this week. Note a new article showing PR's securing a $2-2.5B "backup" commitment from RBC while negotiating with a Latin American syndicate for another. Reportedly, these would be used should traditional market sources be inadequate. We assume some form of stronger security and high yields, deep discounts would be involved. In the event new borrowing initiatives are unsuccessful, **MMA** notes an increase in legal briefs contemplating the legal consequences of Puerto Rico not paying bondholders, whether Puerto Rico be sued, who can sue as well as complex questions regarding court jurisdiction over a sovereign entity and "forum-scouting."

Stay Tuned. The downgrades have ignited an already fluid situation for investors as well as the people of Puerto Rico's people. Driving Puerto Rico's efforts to maintain the investment grade was a pride and patriotism, now bruised. The loss of investment grade now will chafe among citizens who are paying higher taxes, workers, retirees and local investors who borne financial losses, and leaders who risked political careers to assuage the investor community, which (in their view) prematurely and coldly turned their backs. There have been encouraging signs that PR will rise to the occasion and adapt to the new reality, balancing the demands of bondholders and its economy toward rational outcomes. We expect developments in the next several weeks to carry enormous weight as to how the island's leaders will respond.

BOND INSURANCE AND PUERTO RICO: Despite widespread market commentary and assurances that the bond insurers will ably survive Puerto Rico's current situation, we believe that risks warrant a somewhat more cautious perspective. There are likely severe loss scenarios for PR in which the insurers would be at risk of downgrade or, worse, regulatory intervention. **MMA** thus recommends investors calibrate the size and quality of their insured positions according to their own projections for default and loss severity in PR.

Last week's downgrades do not on their own threaten Assured, National, or Ambac in any material way. The lower ratings do increase the required capital buffer for the companies; however, both Assured and National currently maintain excess capitalization versus their ratings (ratings being lower than existing capital would imply, based on thin market opportunities, agency mistrust of the business model in general, etc.). A more difficult scenario—running to a temporary default on principal and interest—should also be manageable by the insurers, Assured and National/MBIA likely retaining the ability to raise incremental new capital if needed to demonstrate excess solvency to the rating agencies.

However, if some or all of the Commonwealth's issuers ultimately need to reduce their debt loads, things become less predictable. Again, modest or even material haircuts by only one or two of the weaker credits should be reasonably affordable. By statutory guideline, the monolines are only charged with covering the timely payment of principal and interest as originally scheduled. This stops capital from going out the door to cover a single insured bond's acceleration, preserving the monoline's resources to ensure fair treatment of its other contingent liabilities (policies).

Which is exactly the problem for the insurers from a business perspective. If PR's worst case scenario indeed produces the sweeping haircuts current market discounts imply, **MMA** believes there emerges a risk of regulatory intervention (as occurred with Ambac and FGIC) for the companies with large exposures to PR names. In other words, the regulators may choose to intervene in the companies' operation to conserve cash and protect the holders of non-PR insured bonds. This was the case with FGIC, where massive structured finance losses precipitated the monoline's rehabilitation and subsequent capping of policy payments at a fraction of par.

Because regulatory intervention is a major negative for new business generation prospects and ratings, the insurers in a worst case scenario could choose to pro-actively solicit PR policy commutations (the exchange of a policy cancelation for a partial cash payment by the insurer to bondholders). This occurred with many troubled structured finance transactions during the financial crisis, as well as the Las Vegas Monorail bonds. Commutations, if completed smoothly, would reduce the risk of a forced rehabilitation but would likely pose severe damage to ratings and new business generation.

Finally, although BAM has no direct PR exposure, we expect that events similar to the above could do further damage to the bond insurance model generally, undermining the industry's reputational improvements following full payment to holders in JeffCo, Harrisburg, Stockton, and Detroit.

January 27, 2014

PUERTO RICO FAST AND FURIOUS BUT MAYBE NOT ENOUGH OF EITHER: Facing ongoing rating agency pressure, PR Governor Alejandro Garcia Padilla signed a flurry of legislation ahead of his team's visits to the rating agencies in NYC this week. The NYC trip was postponed from last week, presumably as the Legislature took action to roll out a new sales tax backed credit, enhance the COFINA structure, and demonstrate progress in protecting GDB's solvency and liquidity.

The actions failed to sufficiently impress S&P, however, which late Friday placed the Government Development Bank on CreditWatch with negative implications, then followed with a CreditWatch placement of the GO and appropriation debt as well as various other agencies, including the Highway and Transportation Authority. COFINA's ratings were not affected. S&P follows similar Fitch and Moody's actions, all of which certainly will not help PR's ability to place either a sizable COFINA bond issue or a large \$2-\$3 billion private deal (as has been rumored in recent weeks). S&P states that, "GDB's ability to provide liquidity to the commonwealth has become constrained could have limited liquidity by fiscal year-end June 30, 2014 without access to the debt market by either GDB or the commonwealth.' The agency also acted on four private banks stating, the Commonwealth's funding challenges "could hurt the local banking sector through increased loan exposures and reduced deposits from public agencies and local municipalities."

MMA believes that GDB's leadership has done a poor job satisfying investors and rating agencies questions regarding the bank's liquidity position, offering only vague pronouncements of adequacy. The imminent release of GDB's FY2013 financial statements (released in mid-February last year) will provide real numbers and context. S&P states that PR's routine funding needs could be as high as \$1 billion over the next six months; other estimates are twice that level. A downgrade would exacerbate the monetary impact given the cost of interest rate swap agreement collateral postings, termination costs, variable-rate demand obligations liquidity terminations, mandatory tenders, unwinds, etc., not to mention the debilitating impact on the island's economy.

The speculation regarding negotiations for a hedge fund pool loan and PR to raise additional capital is no surprise and is consistent with the island's efforts to provide capital to meet its near term operating and capital needs. **For current investors in PR bonds, the potential for a large cash infusion from hedge funds represents a short-term balm by as it could help patch any unanticipated liquidity shortfalls. However, to the extent the new loan is structured to be senior or effectively senior to outstanding bonds, current holders will see their own security diminished. This is particularly a concern if the Commonwealth does in fact need to move to a restructuring phase over the next several years.**

MMA has reviewed the new PR bills noted above and offers some preliminary analysis:

· Maintain the Sales and Use Tax (SUT) at 7% versus the proposed reduction to 6.5 % The actions will strengthen Corporation Tax Fund (COFINA) coverage by adding 0.5% beyond the 5.5% currently pledged. Of course, there may well be negative economic implications of a higher tax on consumption.

· Create the Municipal Financing Corporation (COFIM) fund into which shall be deposited directly on 1% of the municipal portion of the SUT. COFIM shall have the power to issue bonds to pay or refinance $600 million debt owed to GDB by municipalities. The bill also enhances collections as it makes mandatory that all 78 municipalities municipal charge SUT 1 % to sales of unprocessed foods (17 municipalities had chosen not to implement the tax).

· Strengthen GDB liquidity and impose fiscal discipline measures limiting loans that GDB can issue to government entities. Specifically, Bill 857 requires:

* Government entities generally (with some exemptions) are required to transfer their private bank deposits to GDB, which must offer "competitive market interest rates and minimize the costs of penalties." The House amended the bill stating it will apply to the extent that it doesn't have an adverse effect on its operational income or its capacity to generate revenues necessary to provide financing.

* Government entities formalize, restructure and document their debts with GDB and negotiate repayment plans by July 1, 2016. This bill also prohibits GDB from loaning over $100 million to the General Fund without legislative authorization or extending loans to entities without corresponding increases in tariffs and other fees. GDB, nevertheless, may provide loans not subject to this cap, when needed to honor debt service payments by any government entity or loan to cover required debt service payments or to make emergency loans to avoid the interruption of essential services. Violation will constitute a felony with a maximum three year jail term.

* SB 857 also addresses of $2B in GDB financings that were extended to HTA on or before Dec. 1, 2013. While the original language allowed that, if HTA revenues were insufficient to cover debt service, the Treasury Secretary would be required to transfer available resources from the General Fund to cover such deficiencies, the bill now states that when GDB determines an insufficiency, "the necessary appropriations to cover such deficiencies shall be included in the recommended budget".

Mr. MARINO. Thank you.
Attorney Mayer?

TESTIMONY OF THOMAS MOERS MAYER, ESQ., PARTNER AND CO-CHAIR, CORPORATE RESTRUCTURING AND BANKRUPTCY GROUP, KRAMER LEVIN NAFTALIS AND FRANKEL, LLP

Mr. MAYER. Thank you, Mr. Chairman. Thank you, Chairman Marino, Ranking Member Johnson, Committee Ranking Member Conyers, and Members of the Subcommittee, for inviting me to testify on H.R. 870.

My name is Thomas Moers Mayer, and I represent funds managed by Franklin Municipal Bond Group and Oppenheimer Funds, Inc. They are not newcomers to Puerto Rico. They are among Puerto Rico's most loyal and largest investors. They are not recent purchasers of this debt.

These funds own approximately $1.6 billion of bonds issued by PREPA, and we oppose H.R. 870. We believe it will cause more harm than good for millions of Americans. About 9.5 million U.S. taxpayers invest in municipal bonds either directly or through funds like Franklin and Oppenheimer. And as noted, Puerto Rico is the third-largest issuer of municipal bonds. This bill would affect $48 billion of bonds.

Notice I said $48 billion. The other $25 billion, to get you to the total $73 billion, that is held by all the funds who support this bill. They want it to apply to everybody other than them.

Puerto Rico bonds are tax exempt in every State of the Union. That is why they are held by men and women nationwide, and they are that way because Congress made them that way. It is probable that more citizens invest in Puerto Rico bonds than live in Puerto Rico.

Most of these investors are individuals over 65. Most have incomes under $100,000. These people live on Main Street, not Wall Street. H.R. 870 hurts these people because Chapter 9 is not good for bondholders.

Exhibit B to my testimony shows how badly Chapter 9 hurt investors in Detroit, Stockton, Valeo, and Jefferson County. I disagree with Professor Pottow's description of Detroit and would be happy to answer questions in connection with that but will not take more time now.

PREPA itself does not need Chapter 9. It can fix itself. It can raise revenues. PREPA has not raised its base rate in 26 years. That is the rate that pays for everything other than fuel and purchase power.

Puerto Ricans pay less for electricity than Hawaiians. They pay less than New Yorkers. PREPA could raise its base rate tomorrow, and consumers would still pay less than they did 6 months ago because fuel costs are down.

PREPA could also collect what it is owed. The Commonwealth and its municipalities owe PREPA more than $828 million, and they have been in arrears for years. PREPA would be self-sufficient if the Commonwealth let it operate as a self-sufficient entity, as opposed to a piggybank for the rest of the island.

Instead of paying for its power, Puerto Rico wants Chapter 9 to force a bailout on the backs of PREPA bondholders, and that is not right. And let me be clear. If you are a taxpayer that owns PREPA bonds, a law that takes your savings to support PREPA is just as much a taxpayer bailout as something that raises your taxes.

Puerto Rican law already provides an alternative to Chapter 9, a receivership. A court in Puerto Rico will pick the receiver and will control the receiver, and the receiver will keep the lights on. But the receiver can also collect from the government and raise rates and run PREPA as a self-sufficient entity.

And I have heard the question why shouldn't Congress give Puerto Rico the same access to Chapter 9 as the States? And there are three reasons.

First, as the panel has already noted, millions of individuals nationwide invested in Puerto Rico bonds after Congress denied Puerto Rico access to Chapter 9. H.R. 870 breaks faith with those men and women.

Second, Congress chose to give Puerto Rico bonds a nationwide tax exemption enjoyed by no State. So Puerto Rico's bonds are overwhelmingly held outside of Puerto Rico. My own clients include funds for taxpayers in California, Georgia, Michigan, New York, Pennsylvania, and Virginia.

Puerto Rico's use of Chapter 9 would damage far more out of Commonwealth investors. That is why Puerto Rico should not have access to Chapter 9.

And finally, Puerto Rico is not a State. Puerto Rico enjoys benefits that no State receives. Its residents do not pay Federal income tax. But out of Commonwealth investors, they do pay Federal income tax. They pay it on everything other than their tax-exempt bonds.

Chapter 9 would expropriate value from taxpaying investors outside of Puerto Rico to benefit nontaxpaying residents inside Puerto Rico. Without changes to Chapter 9, H.R. 870 just hurts millions of investors. We don't think it is sufficient to address the Commonwealth's problems. We think it provides more harm than good.

I am happy to answer any questions the panel may have. Thank you.

[The prepared statement of Mr. Mayer follows:]

TESTIMONY

OF

THOMAS MOERS MAYER

February 26, 2015

Hearing of the House of Representatives' Committee on the Judiciary's Subcommittee on Regulatory Reform, Commercial and Antitrust Law

on

H.R. 870: "Puerto Rico Chapter 9 Uniformity Act of 2015"

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Chairman Marino, Ranking Member Johnson, members of the Sub-Committee – thank you for inviting me to testify on H.R. 870.

My name is Thomas Moers Mayer.[1] I represent certain funds managed by Franklin Municipal Bond Group ("Franklin") and by OppenheimerFunds, Inc. ("Oppenheimer") in connection with their investment in approximately $1.6 billion of bonds issued by the Puerto Rico Electric Power Authority, or "PREPA". Franklin and Oppenheimer have been for many years two of the largest investors in bonds issued by Puerto Rico and its governmental corporations.

We oppose H.R. 870 and the application of Chapter 9 in its current form to Puerto Rico. Use of Chapter 9 by any of Puerto Rico's public corporations will cause more harm than good, for both millions of Americans who invested in Puerto Rico bonds and for the Commonwealth.

About 9.5 million U.S. taxpayers invest in municipal bonds, either directly or through funds like Franklin and Oppenheimer.[2] Franklin alone has approximately 200,000 investors in the funds that own bonds issued by Puerto Rico and its government corporations.[3]

Puerto Rico is the third largest issuer of municipal bonds in the United States. Its bonds are tax exempt in every state of the union and Puerto Rico's instrumentalities borrow to fund almost all the capital needs of the island. Why are they tax exempt in every state? Because

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[1] I am a partner and co-chair of the Corporate Restructuring and Bankruptcy Group at Kramer Levin Naftalis & Frankel, LLP. See Exhibit A. I am also a member of the National Bankruptcy Conference ("NBC"), which last year provided its own statement in support of a predecessor to H.R. 870. I was not a signatory to the NBC's statement and abstained from a vote on it. My testimony today is not on behalf of the NBC, which has not reviewed it.

[2] In 2012, 5,954,819 tax returns reported tax exempt income, comprised of 3,532,100 tax returns from married couples filing jointly, or 7,064,200 individuals, and 2,422,719 other individual tax returns, for a total of 9,486,919 individuals. *Statistics of Income, 2012 Individual Income Tax Returns, Publ. 1304*, U.S. Dep't of the Treasury, Internal Revenue Service, Table 1.3 at 36 (2012), http://www.irs.gov/file_source/pub/irs-soi/12inalcr.pdf [hereinafter "IRS Publ. 1304"].

[3] Oppenheimer has over 400,000 individual investors in all its municipal funds.

Congress made them so. Congress passed legislation granting Puerto Rico this special advantage, to make it easier and less costly to borrow money from men and women in jurisdictions outside Puerto Rico.[4]

Men and women throughout the country own PREPA bonds in their own name or through funds. The funds I represent include funds for taxpayers in California, Georgia, New York, Pennsylvania and Virginia – and all these funds hold PREPA bonds. It is probable that more citizens invest in Puerto Rico bonds than live in Puerto Rico.

These bondholders are individual savers. Most tax returns showing tax-exempt income are filed by taxpayers over 65[5] and most report incomes under $100,000.[6] These people live on Main Street, not Wall Street.[7]

This bill would affect $48 billion of Puerto Rico's municipal bonds[8] owned by millions of investors nationwide – including in Puerto Rico itself.

Puerto Rico enacted its own debt restructuring law, which unfairly sought to strip value from bondholders.[9] That law was terrible. It was much worse than Chapter 9. The U.S. District Court in Puerto Rico struck down that law as unconstitutional.[10]

But Chapter 9 is not much of an improvement. Chapter 9 hurts bondholders. Exhibit B contains a chart showing how badly Chapter 9 hurt bondholders in Detroit, Michigan; Stockton and Vallejo, California; and Jefferson County, Alabama. Chapter 9 is not a good thing for the

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4 48 U.S.C. § 745.

5 IRS Publ. 1304, *supra* note 2, Table 1.5 at 73.

6 *Id.* Table 1.4 at 40.

7 The "household sector" held almost 43% of all municipal bonds as of September 30, 2014. *Federal Reserve Statistical Release Z.1, Financial Accounts of the United States*, Bd. of Governors of the Fed. Reserve Sys. 101 (Dec. 11, 2014), *available at* http://www.federalreserve.gov/releases/z1/current/z1.pdf. Mutual funds together held an additional 25.4%. *Id.*

8 Financial Information and Operating Data Report, Commonwealth of P.R., 88 (Oct. 30, 2014) http://www.gdbpr.com/documents/CommonwealthReport-October302014.pdf.

9 Puerto Rico Public Corporation Debt Enforcement and Recovery Act, Law 71-2014 (June 28, 2014).

10 *Franklin California Tax-Free Trust et al. v. Puerto Rico*, 2015 WL 522183 (D.P.R. Feb. 6, 2015).

municipal bond market,[11] which is why 23 states have not authorized their municipalities to file a Chapter 9 petition and why Georgia and Iowa have affirmatively ***prohibited*** municipalities from filing for Chapter 9.[12]

Puerto Rico's water and sewer agency needs to sell hundreds of millions of bonds in the near future. If Congress extends Chapter 9 to Puerto Rico, we predict that the agency will not be able sell any bonds unless it is ***prohibited*** from seeking Chapter 9 relief or the bonds are guaranteed by the Commonwealth and bear an extortionate interest rate with onerous security features.[13] That will be true for ***every Puerto Rico governmental corporation for the foreseeable future***.

PREPA itself does not need Chapter 9. It can fix itself. It can raise revenues in the same manner as nearly every other municipally owned utility in the United States. PREPA has not raised its "base rate" – the rate that pays for everything other than fuel and purchased power – in nearly 26 years. Every other public utility in the country sets its rates at a level sufficient to service its bonds and cover its other costs.

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[11] Fitch Ratings issued a release on August 6, 2014 titled "Chapter 9 Extension Would be a Positive for Puerto Rico", but a careful reading shows that Fitch wanted Chapter 9 to apply to PREPA and the sewer company because Fitch thought it would be good for ***other*** Puerto Rico bonds – the sales tax bonds – which, in Fitch's view, would not be subject to Chapter 9. *Chapter 9 Extension Would Be a Positive for Puerto Rico*, Fitch Ratings, Inc. (Aug. 6, 2014), *available at* https://www.fitchratings.com/creditdesk/press_releases/detail.cfm?print=1&pr_id=845614. Fitch thus reflects a political reality: the only bondholders who back Chapter 9 are those who believe it will never apply to them, including, in particular, certain holders of general obligation bonds issued by the Commonwealth itself.

[12] The State Role in Local Government Financial Distress, The Pew Charitable Trust, 9-12 (July 2013), *available at* http://www.pewtrusts.org/~/media/Assets/2013/07/23/Pew_State_Role_in_Local_Government_Financial_Distress.pdf.

[13] There are conflicting studies on the effect of Detroit's Chapter 9 filing on the municipal bond market. The Federal Reserve of Chicago purported to show that interest rates on bonds issued in Chapter 9-eligible states did not increase compared to Chapter 9-ineligible states. Gene Amromin & Ben Chabot, *Chicago Fed Letter No. 316: Detroit's Bankruptcy: The Uncharted Waters of Chapter 9*, THE FED. RESERVE BANK OF CHI. (Nov. 2013), *available at* https://www.chicagofed.org/~/media/publications/chicago-fed-letter/2013/cflnovember2013-316-pdf. However, the study does not take into account the dramatic widening of interest rates spreads for Chicago's bonds following Detroit (see Exhibit C).

PREPA could raise its base rate tomorrow, and consumers would still pay less than they did six months ago, because fuel costs are down.

PREPA's own consultants have identified numerous readily obtainable operational improvements and potential efficiency savings that, if implemented, would diminish the base rate increase, providing consumers with further savings.[14]

PREPA could collect what it is owed. The Commonwealth and its various governmental corporations owe PREPA more than $828 million.[15] The governments have been in arrears for years. Puerto Rico's municipalities pay PREPA almost nothing for their power.[16] Puerto Rico wants to use Chapter 9 so its local governments do not have to pay their electric bills.

In sum, Puerto Rico wants to use Chapter 9 to save a few cents per kilowatt hour,[17] to let citizens in Puerto Rico pay less for power than citizens in Hawaii[18] or New York City,[19] by forcing bondholders in the 50 states to shoulder the burden of PREPA's operational failures and Puerto Rico's fiscal irresponsibility.

The contention that only Chapter 9 provides "certainty" is not true.

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[14] Many of these initiatives can be found in the Accounts Receivable and CILT Report prepared by FTI Capital Advisors, LLC. *Accounts Receivable and CILT Report*, FTI Capital Advisors, LLC, 9 (Nov. 15, 2014), http://www.aeepr.com/Docs/restructuracion/PREPA%20AR%20and%20CILT%20Report%20Final.pdf [hereinafter "AR and CILT Report"]. The AR and CILT Report is also on file with the Committee.

[15] *Monthly Report to the Governing Board*, P.R. Elec. Power Auth. (Dec. 31, 2014), *available at* http://www.aeepr.com/INVESTORS/DOCS/Financial%20Information/Monthly%20Reports/2014/December%2020 14.pdf. This is an increase from the $750 million reported by the Commonwealth's own advisor, *see* AR and CILT Report, *supra* note 14, at 9.

[16] In theory, PREPA rebates to Puerto Rican municipalities the cost of their power as a "contribution in lieu of taxes." In fact, no money appears to change hands, and the credit each municipality receives is not related to any calculation of any "taxes." Because municipalities pay almost nothing for power, they waste electricity and enter into agreements that allow private parties to benefit from the municipalities' free power.

[17] PREPA currently charges approximately 23 cents a kilowatt hour (including fuel surcharges). Debt service on PREPA's bonds comprises about 3-1/2 cents of the total.

[18] *Rankings: Average Retail Price of Electricity to Residential Sector*, U.S. Energy Info. Admin. (Nov. 2014), http://www.eia.gov/state/rankings/#/series/31.

[19] Con Edison in New York charges more than 24 cents per kilowatt hour. *See Retail Sales 2013 with Average Res Rates, Electric Power Sales, Revenue, and Energy Efficiency Form EIA-861*, U.S. Energy Info. Admin. (2013), *available at* http://www.eia.gov/ electricity/data/eia861/zip/f8612013.zip; *see also* Bill Sanderson, *Con Ed Seeks To Increase City Residential Electric Rates*, N.Y. Post, Feb. 1, 2015, http://nypost.com/2015/02/01/con-edison-seeks-to-increase-city-residential-electric-rates.

First, Chapter 9 itself does not offer "certainty". Chapter 9 is the Wild West. It is not like Chapter 11. There is no established body of case law and there have been very few cases. The only certainty is that Chapter 9 takes a long time – at least 18 months to three years – and is very expensive. Detroit's Bankruptcy Judge just days ago approved $178 million in fees as "reasonable."[20]

Second, Puerto Rican law already provides an alternative: receivership. A court in Puerto Rico will pick the receiver. A court in Puerto Rico will control the receiver. The receiver will keep the lights on – but the receiver can also collect from the government and raise rates.[21]

I've heard the question, "why shouldn't Congress give Puerto Rico the same access to Chapter 9 as a state?"

After Congress passed a law denying Puerto Rico access to Chapter 9,[22] millions of individuals nationwide invested billions of dollars in reliance on that law. H.R. 870 breaks faith with those millions of men and women.

And there are good reasons why states have access to Chapter 9 and Puerto Rico does not. Congress chose to give Puerto Rico bonds a nationwide tax exemption, enjoyed by no state – and Congress chose to exclude Puerto Rico from Chapter 9. The benefit and the restriction go together.[23]

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[20] *In re City of Detroit*, No. 13-53846, 2015 WL 603888, at *27 (Bankr. E.D. Mich., Feb. 12, 2015).

[21] Bondholders do not need Chapter 9 to protect themselves. Bondholders have rights under their trust agreements and Puerto Rico law, which they relied upon in their investments. Bondholders cannot rely on Chapter 9 to provide any "certainty." Exhibit B and n.26 *infra*. Only holders of bonds not affected by Chapter 9, such as general obligation bonds of the Commonwealth, could make such an argument.

[22] P.L. 98-353, § 421, 98 Stat. 333 (July 10, 1984) (codified at 11 U.S.C. § 101(52)).

[23] Generally, a state's municipal bonds are exempt from state and local tax only in that state. Therefore tax-exempt bonds issued by California municipalities are held primarily by California tax payers, Pennsylvania tax-exempt bonds primarily by Pennsylvania tax payers, etc. When a state authorizes its municipalities to file under Chapter 9, that authorization will affect primarily taxpayers in that state. But Puerto Rico's bonds are tax exempt everywhere and therefore held primarily outside of Puerto Rico. If Congress enacts H.R. 870, Puerto Rico's decision to authorize PREPA (or any other municipality) to file under Chapter 9 will affect primarily individual investors outside of Puerto Rico.

Finally, Puerto Rico is not a state – by Puerto Rico's own choice. Puerto Rico's citizens have repeatedly voted against statehood, in part because Puerto Rico enjoys benefits no state receives. Not only does Puerto Rico have a unique ability to sell tax exempt bonds nationwide, Puerto Ricans do not pay any federal income tax.[24]

Franklin and Oppenheimer would not oppose the application of Chapter 9 to Puerto Rico if Congress made Chapter 9 a fairer statute, which would take only a few changes. For instance, Chapter 9 could require an affirmative bondholder vote before a plan affects the bondholders.[25] That's what the Bankruptcy Act required before 1978.[26]

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[24] Puerto Ricans do not pay federal income tax on income derived from Puerto Rico. 26 U.S.C. § 933.

[25] Chapter 9 should also be amended to provide that only actual and current out-of-pocket expenses necessary to maintain operations (excluding, for example, the municipality's attorneys' fees) may be deducted from revenues pledged to bondholders, with the balance paid currently to bondholders. That is the clear intent of 11 U.S.C. §§ 902 & 928.

[26] Prior to 1978, no municipality could file for relief under the Bankruptcy Act unless the petition was accompanied by a plan accepted, in writing, by creditors owning not less than 51% of the securities affected by the plan. Section 83(a) of the Bankruptcy Act of 1898, *as amended by* The Municipal Bankruptcy Act of 1937, Pub. L. No. 302, 50 Stat. 652 (1937) (codified at 11 U.S.C. § 403(a) (1970)).

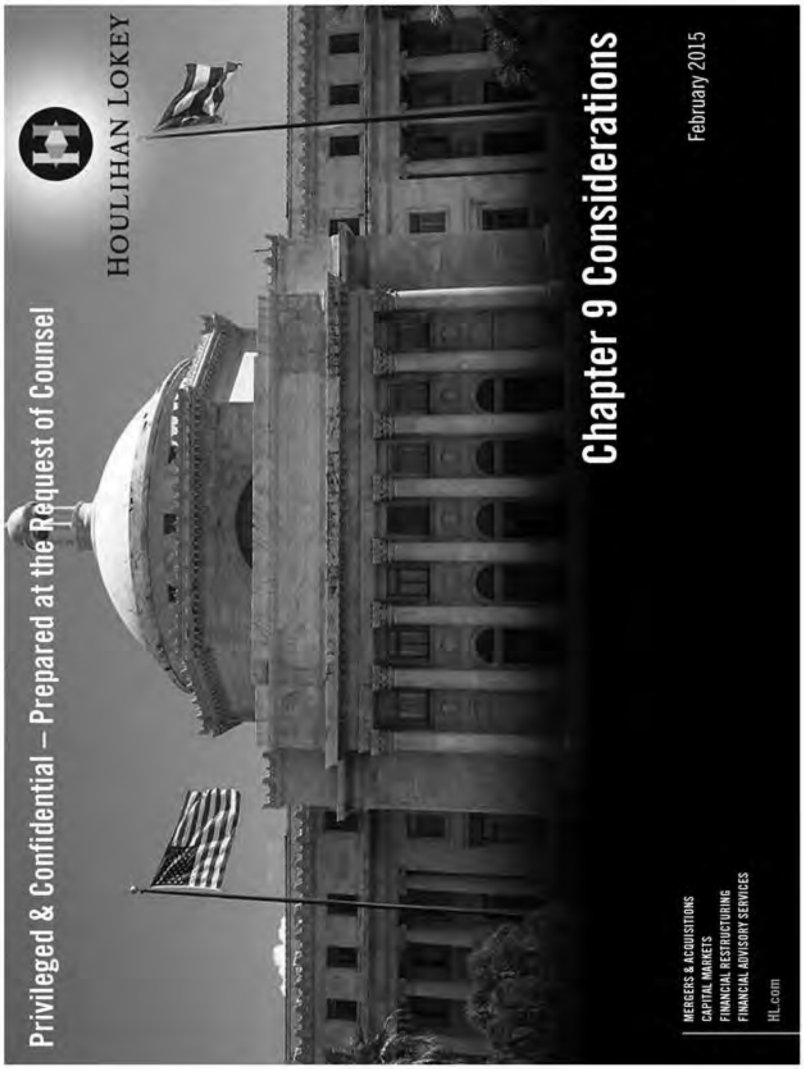
Chapter 9 currently provides for a bondholder vote, but the vote can be meaningless if the bonds are classified with plan-supporting claims, as was the case in City of Stockton. Stockton paid pennies to bond claims but forced them to vote in the same class as vastly larger and more numerous retiree medical claims. The retirees voted "yes" because [a] they could get substitute medical coverage from their current employer, from their spouse's employer, or from the Affordable Care Act, and [b] while their retiree medical claims were receiving pennies, their pension claims were being paid in full. *In re City of Stockton, California*, No. 12-32118-C-9, 2015 WL 515602, at *21-22 (Bankr. E.D. Cal. Feb. 4, 2015).

Chapter 9 also provides that a plan can be confirmed over a dissenting bondholder vote so long as it does not "discriminate unfairly" against the bonds. The City of Detroit gave a group of bondholders their own class, but paid them 13 cents while paying pensioners 59-60 cents. *In re City of Detroit*, 524 B.R. 147, 253-54 (Bankr. E.D. Mich. 2014). Bankruptcy Judge Rhodes held this was not "unfair discrimination" because it did not offend "the judgment of conscience," including "the Court's experience and sense of morality" – a novel standard never before applied to "unfair discrimination" and for which the Court cited no precedent – and therefore the plan could be confirmed irrespective of a bondholder vote. *Id.* at 253, 256. Bondholders withdrew their objection to the plan and changed their vote only after Judge Rhodes made it perfectly clear he was going to rule against them.

The last remaining protection for dissenting bondholders is the requirement that a plan be in the "best interests of creditors." 11 U.S.C. § 943(b)(7). According to the legislative history of this section, the "best interests" test requires the municipality to make a detailed showing that that it has done what it can to pay creditors. 124 Cong. Rec. H11,100 (Sept. 28, 1978); S17,417 (Oct. 6, 1978). However, this requirement was, again, effectively disregarded in Detroit, where Judge Rhodes did not require the city to maximize payments to bondholders because he held that bondholders' remedies outside of Chapter 9 would not yield a better result. *City of Detroit*, 524 B.R. at 213-17. PREPA's secured bondholders, like Jefferson County's secured sewer warrantholders, do have the remedy of a receiver, and Jefferson County's warrantholders did contend that Section 943(b)(7) required Jefferson County to raise sewer rates. The issue settled before trial.

But without changes to Chapter 9, H.R. 870 only hurts millions of investors and, again, the Commonwealth itself. Puerto Rico, its public corporations and municipalities, must borrow billions of dollars, this year and in each year to come. H.R. 870 threatens to limit, if not eliminate, access to the low-cost financing provided by traditional long-term municipal bond buyers. H.R. 870 serves the interests of neither the Commonwealth nor the millions of individuals who invested in the bonds of the Commonwealth's corporations.

ATTACHMENTS



Discriminatory Aspects of Chapter 9

- The comparative lack of creditor protections in Chapter 9 has proven to be uniquely disadvantageous to financial creditors (specifically municipal bond investors) in recent Chapter 9 proceedings
- Pensions in all recent Chapter 9 proceedings have generated significantly higher recoveries on their claims than financial creditors, even in jurisdictions like Detroit, where pension and financial claims were deemed by the bankruptcy court to be pari passu, or of equal standing

City	Recovery	
	Pension	Financial Creditors
Central Falls, RI	75-100%[1]	GO: NA[2]
Detroit, MI[3]	59% - 60%	LTGO: 41% COP: 13%
Jefferson County, AL	N/A	Secured Sewer Bonds: 56%
Stockton, CA	100%	Lease Revenue: 1%+[4]
Vallejo, CA	100%	COP: 53%[5]

(1) Reflects approximate cut in actual retiree pension distributions
(2) State passed legislation specifically elevating the priority of municipal debt obligations before the city filed for chapter 9 bankruptcy protection
(3) Excludes 74% UTGO recovery due to the bonds' secured status relative to LTGO and COP debt
(4) Gen creditors received a 1% recovery on their unsecured claim or a 12% recovery on their secured plus unsecured claim
(5) Reflects estimated NPV reduction of Vallejo's costs with respect to approximately $30 million of COP claims held by Union Bank

Discriminatory Aspects of Chapter 9 (cont.)

- Beyond the objective metrics highlighting vastly divergent pensioner and financial creditor Chapter 9 recovery outcomes, the lack of creditor protections in Chapter 9 has had a negative impact on municipal restructurings in a number of key respects

Restructuring Objective	Outcome
Operational Restructuring Initiatives	■ Despite profound city government dysfunction, no recent Chapter 9 municipal debtors have effected significant operational improvements under Chapter 9 bankruptcy protection ■ According to the court appointed expert in Detroit's bankruptcy, "the majority of the operational restructuring initiatives have been laid in the lap of the mayor and are expected to be executed after the City emerges from bankruptcy" ■ This outcome stands in stark contrast to corporate restructurings, where exigent circumstances are customarily used to effect otherwise challenging institutional changes for the benefit of all stakeholders
Municipal Asset Monetization Strategies	■ Recent Chapter 9 debtors have largely ignored transactional opportunities for City assets as a means of generating capital to catalyze municipal recovery and increase creditor recoveries ■ In unique circumstances such as the partial monetization of Detroit's city-owned art collection, the monetization process was flawed and generated sub-optimal outcomes ■ In the case of Detroit's art collection, the transaction executed in bankruptcy realized a mere $455 million in value for a city asset appraised at $8.1 billion
City / Creditor Recovery Alignment	■ In nearly all recent Chapter 9 bankruptcies, financial creditor losses have been set or crystalized with creditors receiving no contingent value recovery mechanisms to allow for incremental creditor recoveries as the city's financial condition improves ■ The "heads I win, tales you lose" outcome stands in stark contrast to the corporate restructuring model which seeks to align creditor and corporate recovery interests ■ The asymmetric risk dynamic acts as a substantial deterrent to new municipal investment capital from either existing or outside creditors as is the norm in the corporate context

Morgan Stanley Matrix

Analytics

23 February 2015 15:45 GMT http://matrix.ms.com

Chart 1

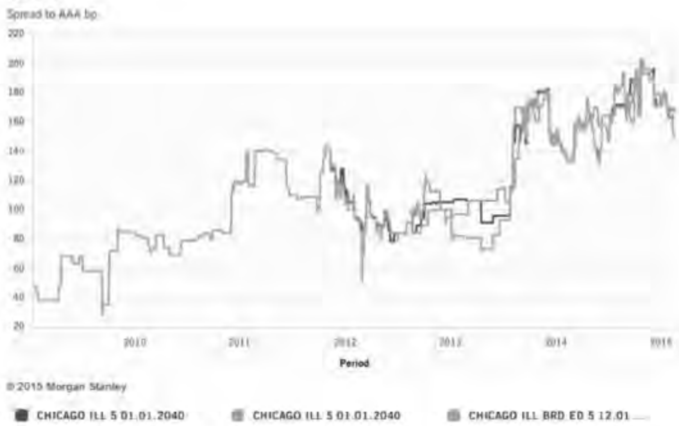


Chart 1

	Average	First	Last	Max	MaxDate	Min	MinDate	Periods	StdDev	ZScore
CHICAGO ILL 5 01.01.2040	130.23	134	168	202	22 Oct 2014	57	02 Mar 2012	817	36.08	1.05
CHICAGO ILL 5 01.01.2040	107.86	48	163	197	07 Nov 2014	28	15 Sep 2009	1522	39.95	1.38
CHICAGO ILL BRD ED 5 12.01.2042	141.87	98	151	203	24 Oct 2014	86	23 Aug 2012	626	33.01	0.28

assumptions will prove to be correct. Morgan Stanley makes no representations as to the accuracy, completeness, usefulness, performance, reliability or relevance of the Functions as a tool for analyzing market data or any information produced by the Functions.

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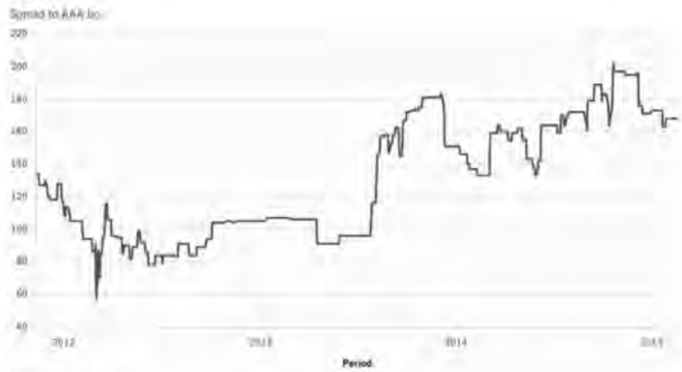
Morgan Stanley Matrix

23 February 2015 18:49 GMT http://matrix.ms.com

Chart 1



■ CHICAGO ILL 5 01.01.2040

Chart 1

	Average	First	Last	Max	MaxDate	Min	MinDate	Periods	StdDev	ZScore
■ **CHICAGO ILL 5 01.01.2040**	130 23	134	168	202	22 Oct 2014	57	02 Mar 2012	817	36.08	1.05

Morgan Stanley Matrix

Analytics

23 February 2015 15:45 GMT

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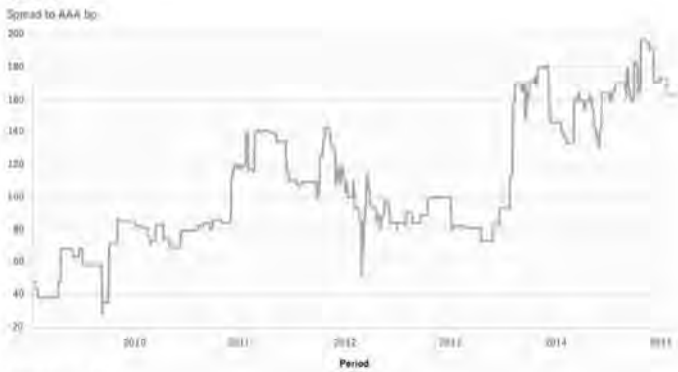
Chart 1



CHICAGO ILL 5 01.01.2040

Chart 1

	Average	First	Last	Max	MaxDate	Min	MinDate	Periods	StdDev	ZScore
CHICAGO ILL 5 01.01.2040	107.86	48	163	197	07 Nov 2014	28	15 Sep 2009	1522	39.95	1.38

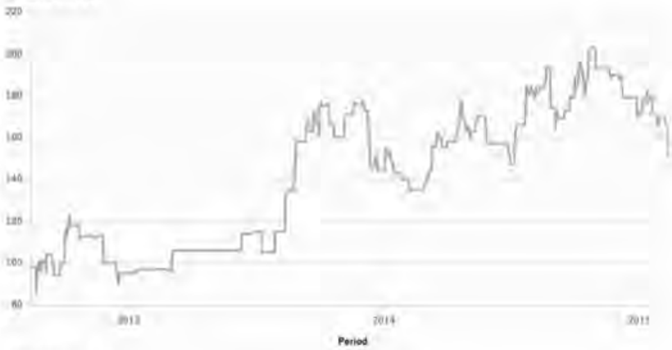
Morgan Stanley Matrix

Analytics

23 February 2015 18:54 GMT http://matrix.ms.com

Chart 1

Spread to AAA bp



CHICAGO ILL BRD ED 5 12.01.2042

Chart 1

	Average	First	Last	Max	MaxDate	Min	MinDate	Periods	StdDev	ZScore
CHICAGO ILL BRD ED 5 12.01.2042	141.87	98	151	203	24 Oct 2014	86	23 Aug 2012	626	33.01	0.28

Mr. MARINO. Thank you.

I am going to start out by asking a couple of questions. I normally don't do this, but I am very much looking forward to what you have to say, each of you. But I want to start with Attorney Mayer.

What is the downside of going into allowing Puerto Rico, if it chooses to go into Chapter 9, would it not financially benefit more, as opposed to going into a traditional bankruptcy, finding out what the assets are, liquidating them—if there is anything to liquidate—and paying off the creditors?

Mr. MAYER. No, Congressman. There is no way to liquidate a municipality or a governmental corporation. The choice of Chapter 9 or not Chapter 9 really does not deal with liquidation or not. It deals with who runs the process.

And what Puerto Rico wants to do is ensure that the Commonwealth runs the PREPA restructuring for the benefit of the Commonwealth to the expense of its investors.

Mr. MARINO. There is something there of worth. Are you—do you not agree with me that there is some entity, some substance there that has a financial value to it?

Mr. MAYER. I am sorry, Congressman. I am not sure I understand the question.

Mr. MARINO. Well, if Puerto Rico chooses to go into a Chapter 9 and into a restructuring, what do you account for or how would you account for any value that the corporations, such as the electric company, may or may not have?

Mr. MAYER. The electric company has value because it collects for electricity it sells to rate payers, and it has pledged those revenues to the investors in its bonds. And it has also agreed, like every other comparable utility, that if the revenues are insufficient, it will raise the rates.

That is the value that is in PREPA right now. It is that is the value, the ability to sell electricity at a rate.

If Chapter 9 happens, the court in Chapter 9 has no power to make PREPA do anything. That is clear from the structure of Chapter 9.

Mr. MARINO. So the only thing the electric company can do is raise rates. It can't sell assets?

Mr. MAYER. The electric company has the ability to sell assets to the extent provided by Puerto Rican law. Chapter 9 doesn't give it any more or less power to sell assets.

Mr. MARINO. Thank you.

President Acosta, could you—do you remember my question? I want to know the difference between financially bankruptcy and allowing Chapter 9?

Ms. ACOSTA. I don't necessarily agree with Mr. Mayer's answer. I mean, Chapter 9 is a process that is known. It is an orderly process, provides predictability, and the community knows that process and is a rule and oversight by the judge, an experienced judge.

In the case of a receiver, which is what we are talking about, the powers are extremely limited. It is just to try to raise the rates. I mean, you have seen certainly the Energy Commission that was recently created around the company. I understand that it doesn't have any right or any power to sell property. If there is any need for entering a financing, for example, a debtor in possession financing to help PREPA move along, this person doesn't have that right.

On the other hand, and certainly, you know, going—using the receivership process, I mean, that could entail a huge amount of litigation from everybody. We could have problems with the entities that actually provide fuel for PREPA, and I think it is a total disorderly process.

Chapter 9 definitely is a much better process than going through the receiver, and it is a process that is known. The receivership process is not known.

Mr. MARINO. Thank you.

Professor Pottow, how do you account for or is there a way to account for the worth of the assets, and I will use that word loosely, compared to a traditional bankruptcy?

Mr. POTTOW. It is a good question. It is an important concern because it highlights basically the difference between Chapter 9 and Chapter 11. Because if we have a traditional company we think of, we could sell off the assets piecemeal. That is what liquidation bankruptcy is. Or we can try to keep it together to keep that going concern value, which is the premium that is basically the sum is—or the whole is greater than the sum of its parts, right? And you are going to forfeit that if it gets busted up and sold out together.

Now with a public debtor, you can't bust up and sell, say, like a city. There is no city to liquidate or sell. You can't really do that. I mean, there is parking garages and stuff that it owns, but you know, there is no sort of going concern.

And so, that is why Chapter 9 has more of a focus on corralling the people together and using the procedural elements of the bankruptcy code, which bankruptcy judges are pretty used to doing, which is getting people together. There was a lot of mediation in the Detroit bankruptcy. And so, it is capturing more of the process value of eventually getting the parties to agree what they are going to do.

Mr. MARINO. Thank you.

My time has expired, and I now yield to the gentleman from Georgia, Mr. Johnson.

Mr. JOHNSON. Thank you.

Professor Pottow, in the absence of Chapter 9, what incentives exist to encourage consensus among various creditors?

Mr. POTTOW. Not much. I mean, it is sort of like a state of nature where, you know, you litigate to try to get what you think you are entitled to under your contract or your bond indenture. And some people can get recovery and some people can't, depending what it is.

It is an atomistic process, and it is sort of basically the principle is why we have bankruptcy systems, why the World Bank, the IMF, all the advice-giving institutions for countries around the world say if you want to foster investment, you have to have a comprehensive debt resolution regime when things go bad.

So we want to have these sorts of bankruptcy regimes to help investors.

Mr. JOHNSON. Yes, Mr. Mayer, you want to respond to that?

Mr. MAYER. Yes. Congressman, there is no possibility the creditors can run in and grab assets and sell them. The law doesn't provide for that under any circumstance.

The only question is, will PREPA maximize its value either by raising rates or by collecting the debts that is owned by the Commonwealth?

Mr. JOHNSON. Well, certainly, under a Chapter 9, in accordance with a plan of reorganization, that collecting accounts receivables, elevating or upping the rate for the service, creating more cost efficiencies, all of those things can be a part of the—or they can be raised as issues by debtors or, excuse me, creditors under a Chapter 9. Is that correct?

Mr. MAYER. No. Actually, Congressman, it isn't. That is one of the problems with Chapter 9.

Mr. JOHNSON. Okay. Well, let me ask Professor Pottow, would you disagree with that?

Mr. POTTOW. I think there is a bit of truth in both of those things. I think that there is no power for a bankruptcy judge to order something like changing the rates, okay, because the Chapter 9 tries to protect this sovereignty of the respective entity. That said, the bankruptcy judge does have the capacity to decide whether there has been negotiation in good faith as a precondition to availing yourselves of the Chapter 9 protection.

And so, if I were a creditor objecting to, say, the utility that was going in, I would say they haven't made a good faith attempt if they haven't raised their rates. Those arguments you can bring to Chapter 9.

Mr. JOHNSON. All right. Thank you, Professor.

And I would love to have this exchange between you both, but I feel compelled to first request unanimous consent to include in today's hearing record a number of documents that we have received from various organizations, academics, investment firms, and businesses, among others.

They include a letter from the National Bankruptcy Conference, expressing support for substantively identical version of H.R. 870 that Mr. Pierluisi introduced in the last Congress; a statement from Ken Klee, professor emeritus at UCLA School of Law; also a letter in support from Jim Spiotto, a well-respected expert on municipal bankruptcy law; and a letter in support from an ad hoc group of 32 financial institutions, for the record. And——

Mr. MARINO. Without objection.*

[A list of the submissions follows:]

***Note:** The material submitted by Mr. Johnson is not printed in this hearing record but is available at the Subcommittee and can also be accessed at:

http://docs.house.gov/Committee/Calendar/ByEvent.aspx?EventID=103021.

Mr. Johnson's Submissions Entered into the Record:

1. National Bankruptcy Conference Letter
2. Statement from Professor Kenneth Klee
3. James Spiotto (Managing Director, Chapman Strategic Advisors) Letter
4. Anthony Princi (Ad Hoc Group of Puerto Rico bondholders) Letter
5. Former Puerto Rico Governor Luis G. Fortuño Letter
6. National Puerto Rican Coalition Letter
7. Professor Stephen Lubben Letter
8. Memorandum Support of H.R. 870, signed by 13 organizations in Puerto Rico
9. Douglas Baird Letter
10. FCO Advisors Letter
11. SAFT(energy company) Letter
12. Melissa Jacoby Letter
13. Carlos Cuevas Letter
14. Banco Popular Letter
15. Hon. Gerardo A. Carlo Altieri Letter
16. The Puerto Rico Manufacturers Association (PRMA) Letter
17. The National Grocers Association Letter
18. Nine former presidents of the Puerto Rico GDB Letter
19. Hon. Jaime Perelló-Borrás Letter
20. Center for a New Economy Letter
21. South Florida Puerto Rican Chamber of Commerce Letter
22. Bloomberg editorial of February 25, 2015
23. Washington Post editorial of February 26, 2015
24. Fitch Ratings Letter
25. Prof. Arturo Porzecanski Letter
26. Manuel Natal Albelo Letter

Mr. JOHNSON. And I will yield the balance of my time to Mr. Pierluisi.

Mr. PIERLUISI. Thank you for yielding.

I will address a couple of the points raised by Mr. Mayer in the time remaining, and perhaps I will have another opportunity later in the hearing.

I noticed that you are appearing not in your personal capacity, but rather as counsel to two investment firms. So I am not surprised that your position is inconsistent with the National Bankruptcy Conference's position on my bill.

But I see a couple of things that are really troubling here in your statements. For example, you state that use of Chapter 9 by any of Puerto Rico's public corporations will cause more harm than good for both millions of Americans invested in Puerto Rico bonds and for the Commonwealth.

Most bondholders and investment experts disagree with your claim that passage of this bill would be bad for holders of Puerto Rico's $70 billion in public debt. And the argument that the bill is bad for Puerto Rico is even more difficult to understand. As we have said, everybody in Puerto Rico is in agreement across party lines. You are basically saying that we are well intentioned, but wrong, that we are not actually acting in Puerto Rico's best interest, but that your clients are. Makes no sense.

Now much of your testimony also deals with Chapter 9, disparaging Chapter 9. But this is not a hearing on Chapter 9, which has been the law of the land for decades. I am sure we could deal with Chapter 9 at any point in time.

Now it is incredible, really, that your clients, Franklin and Oppenheimer, you have stated would not oppose the application of Chapter 9 to Puerto Rico if Congress made Chapter 9 a fairer statute, which would only take a few changes. This is a critical admission. You are basically saying we think the law Congress enacted for the 50 States is imperfect. If it is improved, then and only then we would support its extension to Puerto Rico. That is not persuasive.

My time ran out, but you can—you can comment on my statements.

Mr. MAYER. Yes, Congressman. We do think Chapter 9 is an imperfect bill. We are concerned about the investors in the $48 billion of government debt, who bought it when Chapter 9 was not available. And that is our principal concern.

We do believe that it will prove shortsighted for Puerto Rico to use Chapter 9, if given. You are correct that Puerto Rico wants to use Chapter 9. Chapter 9 is a value transfer mechanism. It transfers value from bondholders to municipalities.

It is, therefore, not surprising to me that Puerto Rico is in favor of using Chapter 9.

Mr. MARINO. Thank you.

The Chair now recognizes the gentleman from California, Congressman Issa.

Mr. ISSA. Mr. Mayer, I just want to make sure I understand the effect of if we grant retroactively Chapter 9 to Puerto Rico. One, you mentioned that $25 billion or so, a subset of the $73 billion, would not be covered. So, by definition, those would be paid in full with no concessions. Is that correct?

Mr. MAYER. If Puerto Rico had the resources to pay them, yes, that is correct.

Mr. ISSA. Well, if they don't have to pay $40 billion in full, they would, by definition, potentially be better off financially?

Mr. MAYER. Puerto Rico believes, clearly, that it would be better off if it did not have to—if its instrumentalities did not have to pay that $48 billion.

Mr. ISSA. Right. So if they don't have to pay the $48 billion, two things happen. One, they don't have to change the institutions that have been artificially subsidizing, if you will, electricity and other utilities. And the quality of the bonds remaining would go up, right?

Mr. MAYER. Yes, the holders of those bonds——

Mr. ISSA. Okay. So there is winners and losers, and Mr. Donahue, you mentioned, you know, that there was some people had speculated. But there are speculators who will win if we grant this, in addition to speculators who may or may not win.

So leaving the speculation aside, I am just going to ask a couple of easy tough questions. If we treat Puerto Rico like a State and say go ahead and tell your municipalities that you can do this, aren't some of those, if you will, municipalities effectively state entities, which in most States would have the full faith of the State?

In other words, in California, some of this debt would be State debt. But aren't we saying to all the States, structure your debt so that all your debt can be covered by Chapter 9 if possible? People were saying there was no effect on the States, but some is bankruptable. Some is nonbankruptable. In a sense, what we are really saying is encourage, if you will, States to do the same thing Puerto Rico has done.

Mr. DONAHUE. Well, I think in my testimony——

Mr. ISSA. Because these are—this is not a State, and some of these assets are not municipal assets. They are Puerto Rican assets, and so they are a subset. But they are not really a political subset in the sense of a city, right?

Mr. DONAHUE. No. I just think when Puerto Rico gets this right—if Puerto Rico gets this right, it is going to craft an enabling statute, and that is going to define who is within and who is without.

Mr. ISSA. Okay. Well, let us just assume for a moment that Puerto Rico will broadly do it in order to get the greatest relief because I suspect in their own best interests, they will do that.

Let me just ask a question, Professor Pottow. Okay. Since you are the Harvard, you know, scholar here, if I understand correctly, Puerto Rico has two ways in which they could cure this by their own vote today. They could ask for and vote for statehood, in which they would be covered by Chapter 9, or they could ask for and vote to become independent, in which case they would have the right to do this on their own as an independent Nation. Is that correct in simplistic terms?

Mr. POTTOW. Well, we are getting to the margins of my knowledge as a bankruptcy expert. But if——

Mr. ISSA. Well, if they were an independent country, they are not covered by our laws, and if they are a State, they would be covered by State law that already effects Chapter 9, right?

Mr. POTTOW. The international law of secession is very complicated about what the obligation—if they had preexisting obligations and they became a separate sovereign state, it is not clear that they could walk away from those obligations. That is a touchy area.

But the other point you make——

Mr. ISSA. Well, we will ask Fidel about it. So we will change that for a second, and we will just assume that if they become a State, they would be covered by 9. They have that ability——

Mr. POTTOW. If they are a sovereign unit——

Mr. ISSA. They have repeatedly done it.

Mr. Mayer, I am going to focus really on something straightforward. The District of Columbia went into a form of receivership. The Congress looked and said we will do a lot of things for you, but you are going to have to straighten out your act, and they did over a period of time.

Bankruptcy does not do that. Why should we look at pervasive problems and allow them to be bankrupted out from underneath without the reforms that would prevent it from happening in the future, separate from the question of some of your citizens in my State and the Chairman's State, in the Ranking Member's State, obviously could be big losers?

Mr. MAYER. It is a very good question, Congressman. And here, there is an interesting distinction between Puerto Rico and every other municipality, which is if you take Detroit as an example, or New York or the District of Columbia, each of those insolvency situations, whether a bankruptcy or not, they featured a form of oversight from a governing body.

The State of Michigan imposed an oversight board on Detroit. New York went through its own financial emergency oversight board. D.C. has the same. There is no comparable mechanism for Puerto Rico, and none is contemplated.

Mr. ISSA. Thank you.

Thank you, Mr. Chairman.

Mr. MARINO. Thank you.

The Chair now recognizes the gentleman from Michigan, the Ranking Member of the full Committee, Congressman Conyers.

Mr. CONYERS. Thank you, Mr. Chairman.

I appreciate the presence of Jose Serrano of New York, who has been following this very carefully, and the gentleman from Puerto Rico, Mr. Pierluisi, who has introduced this bill before. This is not new. And I would just like to welcome especially our professor of law from the University of Michigan, Professor Pottow.

Now let me start off with you, Professor. What would happen if H.R. 870 isn't enacted? What would be the likely result, especially for the electric company, PREPA, but for others in general?

Mr. POTTOW. Sorry, I didn't hear the critical part. Did you say if it was or was not enacted?

Mr. CONYERS. If it was not enacted.

Mr. POTTOW. If it is not enacted, then we will, I predict—I don't follow it as closely—these people will have a default at some point that they will not be able to service the debt. And then it is at a certain point, you can't draw blood from a stone. So you can't get—you can wave a contract and say, "I have an entitlement to be paid." But if they can't pay you, they can't pay you.

And that is why we have restructuring systems like bankruptcy to decide what concession is and what debt service is available. And I will say this for the financial oversight boards, which Puerto Rico apparently doesn't have right now, there is a circularity because Michigan has the financial oversight boards as one of the preconditions before you are allowed to file for Chapter 9.

So I could conjecture that if Puerto Rico were allowed access to Chapter 9, it might set up some sort of financial oversight board system, too, that creates those steps.

Mr. CONYERS. Thank you.

Now Mr. Mayer claims that Chapter 9 doesn't offer a certainty and, matter of fact, it is the wild west. Are you prepared to make any comment or observation about that?

Mr. POTTOW. Well, I am not sure I would call it the wild west or even the wild Midwest. I think it is a fair observation that Chapter 9 is a more fluid process with less structure than a Chapter 11 precisely because we don't have that liquidation scenario and alternative.

But to describe it as the wild west really depends on what your reference point is. And if you think about sovereign debt defaults, right, where there is no bankruptcy system, there is nothing even approaching Chapter 9, that is a relatively chaotic environment with litigation all over the place, legal uncertainty, bond premiums pricing in that risk, and this has risen to the level of the United Nations saying we have a dysfunctional system. We have to try to do something.

So compared to that, Chapter 9 would be seen as like sort of a stately, you know, game of bridge or something like that, compared to the wild west. [Laughter.]

Mr. CONYERS. Thank you so much.

I would like now to yield to the gentleman from Puerto Rico, our very excellent colleague, Mr. Pierluisi himself, for the balance of my time.

Mr. PIERLUISI. Thank you, Mr. Ranking Member.

I have to say something for the record. This hearing is not about political status. Mr. Mayer, you wrote that Puerto Rico's citizens have repeatedly voted against statehood.

In 2012, in fact, the American citizens of Puerto Rico voted to reject their current status, and more voters favored statehood than any other status option. That was just 2 1/2 years ago.

I have a separate bill, actually, pending before Congress that would provide for Puerto Rico's admission as a State. The two main political parties in Puerto Rico may disagree on the status issue, but we are united in support of this bill, which is about bankruptcy access.

Now having said that, it is hard for me to understand where your clients are coming from. Because—and I suspect that it has to do with the fact that they have not only stakes in the Puerto Rico power authority, but there are ongoing conversations, negotiations, and perhaps what they are doing is trying to buy some time here.

Because, frankly, if what you are saying is that it is better to simply rely on the trust indenture agreement that was used when the bonds were issued, I cannot see how that is better than Chapter 9, even taking at face value all your criticisms of Chapter 9.

And let me explain a bit of this. I am not a bankruptcy scholar or expert, but I am a litigator. If you use that trust indenture agreement, all you will be doing is actually suing for collection, getting a receiver appointed, but you are not going to be stopping a wide range of collection litigation from other stakeholders. Could be suppliers, employees, pension holders, the entity itself. The debtor which owes the money might end up not paying you anything at all.

Chapter 9 provides a structured, orderly process in which your clients could participate and have a say. In fact, the requirements of Chapter 9, as you well know, make it so that the power authority would have to even negotiate in good faith with the creditors, your clients, among others, show that it is insolvent, and so on and on and on.

So, again, it is hard for me to understand any principled basis for objecting access to Puerto Rico to the law of the land in America. This is a U.S. territory after all. This is not a foreign country.

So those are my statements. I am sorry I ran out of the time, and but if the Chairman allows it, I would like Mr. Mayer to respond.

Mr. MAYER. May I respond, Mr. Chair?

Mr. MARINO. Yes.

Mr. MAYER. Through 2013, the Commonwealth repeatedly denied that it would ever seek access for itself or for any of its instrumentalities the recourse of a bankruptcy or similar court. It said it was committed to paying its debts. And on that basis, my clients bought and continue to hold billions of dollars of debt. We believe that PREPA can, in fact, pay its debts.

And with respect to your other comments and with respect to certainty of Chapter 9, let me briefly summarize Detroit from a bondholder's perspective, and you will understand why we are so concerned that it not apply in Puerto Rico. You had mentioned other stakeholders.

In Detroit, as Professor Pottow noted, the pensioners got 95 percent. The general obligation bonds, which had never before been touched in 70 years since the Great Depression, they got cut by 25 percent. My clients, who had loaned the money necessary to pay the pensioners, we got paid 13 percent.

So before people fall in love with certainty and how Chapter 9 really provides bondholders with a say, the recent experience is to the contrary.

Mr. MARINO. Thank you.

The Chair now recognizes the gentleman from Rhode Island, Congressman Cicilline.

Mr. CICILLINE. Thank you, Mr. Chairman.

Mr. Mayer, I know that you said in your written testimony that there were good reasons why Puerto Rico was excluded, the bonds were given nationwide exemption. And I know that you, Professor

Pottow, if I am pronouncing that correctly, say it is not even clear why the exemption was granted. So I would like to sort of hear more from you on that because it seems to be one of the central bases of the argument made by Mr. Mayer what the context was for that distinction?

Mr. POTTOW. Yes, I think it is an interesting theory. So, academically, I would say that to suggest that the exclusion was intentional because of the special tax exempt treatment for Puerto Rican bonds, I think it is an unlikely explanation because the tax exemption has existed for it since the early part of the 19th century. I think going back to around 1917, and this was an amendment in 1984.

So during the intervening half century, Puerto Rico had been eligible, as far as we can best figure out, to use Chapter 9. So that is probably not it.

And in terms of the how widely held Puerto Rican debt is around the country, our experience in Detroit was that there was a lot of creditors from a lot around the country as well for Detroit bonds. It wasn't just Michigan investors.

So I would give creativity points, but I don't think that is probably what was going on. [Laughter.]

Mr. CICILLINE. Thank you.

Mr. Donahue, Mr. Mayer says also that PREPA does not need Chapter 9, that it can be fixed itself, and sort of made some suggestions to Ms. Acosta about things that could be taken. Do you share that view that this is something that could be responded to internally by actions taken by PREPA that would make bankruptcy unnecessary?

Mr. DONAHUE. I have looked at the trust indenture, you know, and I am an investor. I have been an investor, and you know, what do we really look at? We don't really factor bankruptcy eligibility. You know, we are muni investors.

Bankruptcy is so rare and so isolated. So it is when I am looking at an investment, I am not factoring what State is eligible versus what State is not eligible.

When it comes to PREPA, I have gone through and looked at their trust indenture, which dates back to 1974, and you know, you pull out this old copy, and you look through it for the word "receiver." And the word "receiver" is mentioned twice in there, and it is not very clear.

And so, the untested aspect of this, I would argue that going the route of opposing Chapter 9 and going into what I think is really the wild west is going through the provisions of the trust indenture. It is completely inadequate, and I think it is going to result in a race to the courthouse. We have these forbearing credit agreements that are expiring next month, and that could happen as soon as then.

So I think that the immediacy of this is right in front of us and that that trust indenture, it is untested. I don't think it was built for this type of a circumstance. They didn't know PREPA was going to have over—close to $10 billion in debt.

So I think it is wholly inadequate, and I think it exposes the market. Contrary to what Mr. Mayer says, I think it exposes the market to more risk than less risk.

Mr. CICILLINE. Thank you.

And I yield the balance of my time to Mr. Pierluisi.

Mr. PIERLUISI. And adding to this, and I would like Mr. Pottow to comment further—I think it is. Let me get closer to the mike.

There was a statement made here before that this is all about who runs the process. Well, not really, actually. When you look at Chapter 9, you have a Federal bankruptcy judge in charge. You have the bankruptcy court actually ensuring that whatever plan, reorganization plan is issued is fair and equitable to all the interested parties.

And but, of course, sometimes on a case-by-case basis, particular stakeholders might do better than others. But the one running the process is the bankruptcy court itself. The debtor submits the plan but is subject to a wide range of requirements and regulations.

Now so let me make that clear here. Apart from that, I would like for the professor to deal with this issue about Chapter 9 versus receivership under the trust indenture agreement in Puerto Rico when there is no case law on it and there is no automatic stay, which you have in bankruptcy court. I would like you to comment further.

Mr. POTTOW. I think that for the reasons Mr. Donahue said, I think that the pricing of that, there would be concern with the risk of the uncertainty of the receivership process. The lack of a discharged power of also central oversight power by a Federal judge would be troubling as well.

And I also want to underscore the point of consensus in the Chapter 9 process. It is the data that was suggested here said, look, these creditors only got 13 percent in the Detroit hearing, the certificate of the COP creditors—and the workers got 95 percent.

Well, that is—first of all, that was supported by the funds themselves. They voted for the plan. And second of all, the 13 percent was because there was serious allegation that the debt was illegally issued, that they might have gotten zero on the dollar. So 13 percent, if you think you are going to lose that case, is pretty darned good.

Every different case is going to have different factors. Every debtor is going to have different factors, and you are trying to consider, you know, what happens if the PREPA receivership and this indenture act from 1974 can do that? The question right now, as I understand it, as you are citing, should Puerto Rico be able to access the Chapter 9 system with whatever strings it wants to put on for whatever entities are in Puerto Rico for an individual?

And that, from the general bankruptcy perspective is, I think, there is a straightforward answer.

Mr. PIERLUISI. Thank you. I ran out of time.

Mr. MARINO. All right. The gentleman's time has expired.

And this will conclude today's hearing. I want to thank all of the witnesses for attending.

And without objection, all Members will have 5 legislative days to submit additional written questions for the witnesses or additional materials for the record.

This hearing is adjourned.

[Whereupon, at 12:53 p.m., the Subcommittee was adjourned.]

A P P E N D I X

Material Submitted for the Hearing Record

Non-University Business

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H.R. 870 Pottow Follow-up Questions

Questions submitted for the Record from Subcommittee Chairman Marino

1. Mr. Mayer argues that Puerto Rico bondholders purchased their bonds, in part, on a reliance that chapter 9 was not an option. Why should we retroactively affect their rights and is there any reason why we cannot rely on the resolution process provided for under the bondholder contracts?

I reject the premise that the bondholders purchased their bonds with a legitimate expectation that there would be no changes to the Bankruptcy Code over the course of the life of their bonds. The Bankruptcy Code changes all the time. Congress can change the bankruptcy laws whenever it wants, and well-established Supreme Court precedent dictates that those changes can apply to pre-issued debt – i.e., the changes apply "retroactively," so to speak. *See, e.g.*, *Wright v. Vinton Branch of Mountain Trust Bank of Roanoke*, 300 U.S. 440, 470 (1937); *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 188 (1902). The suggestion that sophisticated financial investors – like the funds Mr. Mayer represents – are unaware of this legal rule is difficult to accept.

Moreover, anytime a substantive provision of the Bankruptcy Code changes for the benefit of one party, another party necessarily suffers a detriment – all "retroactively." Consider, just for example, the massive expansion of the bankruptcy safe harbors (i.e., favorable creditor treatment) for certain financial instruments, *see, e.g.*, 11 U.S.C. §§ 362(b)(17), 365, 546(g) (2006).[1] When those financial creditors were awarded special treatment in bankruptcy, all other creditors (e.g., general bondholders) were necessarily disadvantaged. Those bondholders were perhaps disappointed, but they had no legal claim that their "rights" were being unfairly changed in frustration of their "expectations" – because their expectations necessarily subsumed the possibility of bankruptcy law change. In law, we have a concept called "assumption of risk," and those principles apply here. When

[1] Similar in spirit is the extraordinary protection accorded shopping center lessor-creditors under 11 U.S.C. § 365(b)(3), added in 1984, doubtless to the disappointment of other pre-existing creditors and investors of shopping center lessee-debtors.

investors buy bonds currently exempt from bankruptcy treatment, built into that price is a risk that the Congress might amend the bankruptcy laws and bring the bonds within the scope of bankruptcy's reach.

Matters might be different if *property rights* were destroyed by changes in the bankruptcy laws made to apply to property acquired before those changes (as I will discuss more below), but H.R. 870 does not seek to so affect property rights.

As for the resolution process under the bond contracts, I believe that applies principally to "PERPA" (the Puerto Rican utility company). Thus, the short answer is that the bond contract procedures can only – by definition – be of assistance to the subset of public debtors in Puerto Rico that have such provisions. H.R. 870 is supposed to be a law of general applicability, however, so the ability of *one* debtor to sort out its own troubles should not block a bill designed to help *all* debtors.

The longer answer is that some are skeptical that that bond contract process (involving the appointment of a receiver and/or possible litigation before the Energy Commission for a rate increase) would work well because it is untested and uncertain. In all candor to the subcommittee, I do not have strong feelings about the viability of a receiver. Maybe it would work, maybe it wouldn't. The key point for me is that it is indeed uncertain and untested. Just to give one example, I am not sure whether the receiver would have the authority to consider the interests of any other creditors beyond the bondholders. If not, then there could only be a partial and not total resolution of debts, undermining the purpose of bankruptcy law. Worse, if the receiver's scope of authority is ambiguous, that will lead to litigation and delay – more disasters for bankruptcy. Thus, I cannot say that a receiver would be useless – it might well be better than nothing – but I have serious doubt that a receiver could provide the certainty and market-calming effects of a judge-supervised bankruptcy case.

2. Do you believe that affording Puerto Rico the option to utilize chapter 9 may lessen the potential for Puerto Rico to require future federal financial assistance?

Yes – or, more accurately, Qualified Yes. I think we can safely say as a general proposition of reorganization law the following: if an entity is sufficiently large that it becomes "too big to fail" (defining "big," however one wants – politically, economically, etc.), then if the private parties cannot work out a restructuring on their own, there will be overwhelming pressure on the government to bail it out. Allowing Puerto Rico access to chapter 9 and the bankruptcy courts the power to shepherd the private parties through a debt restructuring substantially increases the probability that a consensual agreement will emerge. Indeed, that is what chapter 9 (and chapter 11) is all about. The reason I give only a "qualified" yes is because whether any of Puerto Rico's public entities are too big to fail is a question on which I think in all honesty the members of the subcommittee have better insight than I. For what it's worth, my hunch is that a major provider of necessary services to the Puerto Rican people would be awfully hard to let fail, so I have substantial concerns that the lack of a chapter 9 path for Puerto Rico's public entities would put considerable pressure on Congress to spend funds from the public fisc for a bailout.

3. Is the retroactive application of H.R. 870 unprecedented? Would the retroactive application constitute a "taking" under the "Takings Clause" of the Fifth Amendment to the Constitution?

No, as discussed above, when Congress amends the bankruptcy laws, it routinely does so "retroactively" – i.e., the revisions apply to debts incurred before the date of the amendments. The Supreme Court has held no constitutional infirmity with such an approach. The only time a "Takings" concern arises is when a property right is implicated, such as when a lien held by a secured creditor is avoided (i.e., stripped off the collateral by operation of bankruptcy law). The Supreme Court "hinted" in a case called *United States v. Security Industrial Bank*, 459 U.S. 70 (1982), that that retroactive application of such a lien-stripping law might violate the Takings Clause because the lender has a property right in the collateral that cannot be retroactively taken. *See id.* at 78. But garden-variety application of the bankruptcy laws "retroactively" to contractual debts (like bonds) raises no constitutional problems.

Let me assure members of the subcommittee that Congress's powers under the Bankruptcy Clause are quite broad. The reason I said the Supreme Court "hinted" that retroactive application of a lien-stripping law might run afoul the Takings Clause is that the Court never actually held to that effect. Specifically, in *Security Industrial Bank*, the Supreme Court interpreted a lien-stripping provision of the Bankruptcy Code, 11 U.S.C. § 522(f), to apply prospectively only because the retroactive application of such a property-taking provision could raise serious constitutional concerns. Thus, the Court used a doctrine called "avoidance" to *avoid* a possibly difficult constitutional question. To avoid having to address the constitutionality of retroactively invalidating a property right, the Court interpreted the statute's text (which was silent on timing) only to apply prospectively, i.e., to liens created after its date of enactment. Ducking the question, it never had occasion to hold that retroactive application to invalidate pre-existing liens would, in fact, be unconstitutional under the Takings Clause.

Under the circumstances, I think "hinted" is a fair description of the Court's views, but even the Court itself would admit the issue was still open, had not been fully briefed and decided, etc. Indeed, I have had the recent pleasure of reading a well-researched article by Professor Charles Tabb that presents a careful historical analysis of the interaction between the Bankruptcy Clause and the Fifth Amendment (which contains the Takings Clause). *See* Charles J. Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, 2015 U. ILL. L. REV. 765. (Professor Tabb argues over the course of this article that the Fifth Amendment is probably not an independent constraint on the Bankruptcy Clause, and so long as Congress has a valid bankruptcy purpose in enacting a bankruptcy law, and so long as it properly comports with notions of due process, it can interfere with a secured creditor's lien on collateral without violating the Constitution. Tabb's view seems consistent with an under-appreciated Supreme Court precedent, *Continental Illinois Nt'l Bank & Trust Co. v. Chicago, Rock Island & Pac. Rwy. Co.*, 294 U.S. 648 (1935), and he does important work in drawing this case to policymakers' attention; surely this will be relied upon if and when the Court ever takes up the constitutional question.) In any event, these Takings concerns risk, dare I say, unduly venturing into the "academic," because H.R. 870 does not purport to extinguish any rights of secured creditors "retroactively." Secured creditors, as in chapter 11, are protected by having the value of their liens preserved in chapter 9.

Questions submitted for the Record from Representative John Conyers, Jr. and Representative Henry C. "Hank" Johnson, Jr.

1. Mr. Mayer states that he "would not oppose the application of Chapter 9 to Puerto Rico if Congress made Chapter 9 a fairer statute" by which he means, for example, that Chapter 9 "require an affirmative bondholder vote before a plan affects the bondholders." What is your response?

I went back and re-read footnote 26 to Mr. Mayer's testimony to understand what he means by "an affirmative bondholder vote." His argument is that bondholders should have a special veto in chapter 9 and should have to approve (by 51% vote of the bondholders) any chapter 9 plan of adjustment before it can be confirmed – even if *every other creditor* of the debtor supports the plan. I do not share his view that this would make chapter 9 more fair. On the contrary, I think it would make chapter 9 less fair. Why should bondholders have a veto? I can imagine others who think pension holders should have a veto. Or workers. Or taxpayers. Etc. No, I think the best – and fairest – path is the one Congress has taken: treat all creditors equally.

Chapter 9 – which follows the law of well-respected voting rules of chapter 11 – provides that you vote based on how much debt you have outstanding. The more you are owed by the debtor, the more your vote counts. While the debtor can put creditors into different classes for voting purposes, the Code prohibits the debtor from stuffing dissimilarly situated creditors into the same voting class (say, putting secured and unsecured creditors in the same class to vote). *See* 11 U.S.C. § 1122(a) (incorporated into chapter 9 by § 901). There is no "unfairness" at being outvoted, just disappointment. Mr. Mayer admits as much in his footnote's second paragraph but then complains that in the recent *Stockton* case the judge made a bad decision in rejecting a vote classification objection. That is not an indictment of the voting rules of chapter 9 (which mirror chapter 11); it is a critique of the judge's order. Franklin, Mr. Mayer's client, is indeed appealing that *Stockton* ruling and appellate briefing is under way. In my respectful opinion, a law is not "unfair" simply because you lost a case in which it was applied.

2. As you know, H.R. 870 would apply to debt obligations created prior to the legislation date of enactment. Does this provision present any constitutionality concerns?

No. (For a fuller discussion, please see my responses above to learn more about the contours of bankruptcy legislation and constitutional constraints). H.R. 870 is nowhere close to being unconstitutional. The bill is so far back from the constitutional line, it can't even see the line – the line is in a different room!

3. In an attachment to Mr. Mayer's testimony is an analysis that purports to show the discriminatory aspects of Chapter 9. Specifically, it claims that pensions have received "significantly higher recoveries on their claims than financial creditors." What is your response?

Page 14 of the attachment has a chart seeking to show the "discriminatory aspects of chapter 9." It picks only five chapter 9 cases, although it is unclear by which selection criteria. These data do not prove much of anything. For example, in one of the five cases (presumably 20% of the statistical population), the bondholders actually did *better* than the pensioners (Central Falls) due to local legislation favoring bondholders. In another, there was no pension debt, and so the comparison is "N/A" (Jefferson County). So only in three, not even five, cases did Mr. Mayer's consultants find pension holders having a higher distribution than bondholders. This is hardly a devastating finding. (You can probably find three examples of anything if you want.) In fact, one of these three remaining examples is not even finalized yet. It (Stockton) is in the middle of being appealed for the very reason Mr. Mayer raises: that it discriminates unfairly against the bondholders for CalPERS to have blocked any cuts whatsoever. Another one of the three (Vallejo) is an older case from California that thought the pensions could not be compromised under Californian law – an issue that the *Stockton* appeal will now resolve. That leaves only *one* case (Detroit) in which there is a true grievance of differential distribution, and there the differential dividend can be explained by an external injection of funds earmarked to pensioners. (Nothing in the Bankruptcy Code can force third-party benefactors to favor all creditors; if they want to favor workers about to lose their pensions, so be it.) In sum, nothing in this attachment suggests, let alone demonstrates, any "discriminatory aspects" of chapter 9.

Moreover, it is worth noting in Detroit that the bondholders eventually withdrew their objections to support the plan. So they can't complain they were discriminated against unfairly if they supported the plan (unlike their objecting counterparts in Stockton). And there are many reasons why different creditors might accept a lower dividend. For example, an investor who is challenged by the debtor for having received an illegal payment may well settle for a lower distribution in exchange for having the debtor abandon that legal challenge. (In Detroit, the defendant-COP creditors settled for 13% according to the attachment.) The data provided in the attachment tell us nothing about the strength of the underlying claims.

Finally, to the extent that pension holders received a different (higher) distribution than bondholders, I would not find that outcome intrinsically troubling. To start, pension holders cannot insure their pensions the way bondholders can diversify their portfolios and purchase credit default coverage. In fact, private pension holders have a partial form of compulsory government insurance through the Pension Benefit Guaranty Corporation. Public municipal workers – those implicated in chapter 9 proceedings – are exempted from this scheme and so are especially vulnerable as creditors. The suggestion that pensioners are somehow making out like bandits in chapter 9 is not just exaggerated but unfair. In fact, the subcommittee might reflect upon how vociferously in the unions *fought* Detroit's eligibility for chapter 9. More importantly, however, it could be that the chapter 9 plans offered different distributions to pensioners because there were strategic reasons of workplace morale, etc., requiring current workers to see their future pensions would be minimally impaired. Bondholders are not necessarily repeat players: they take their losses and move on. By contrast, a city could be devastated if there were large-scale walkouts by their labor force. To be clear, I am not making comments on any specific chapter 9 case or endorsing any position; I am just clarifying that I can well imagine why there might be good reasons for a differential distribution that favors pension holders. Put another way, "discrimination" does not necessarily mean "unfair discrimination" in bankruptcy.

4. Last month, the U.S. District Court for the District of Puerto Rico held that the Puerto Rico Public Corporation Debt Enforcement and Recovery Act is expressly preempted by section 903 of the Bankruptcy Code and is therefore unconstitutional. Section 903 of the Bankruptcy Code, in substance, provides that a state law prescribing a method of composition of indebtedness for a municipality may not bind any creditor that does not consent to such composition. What is your explanation for why section 903 was enacted?

Section 903 of the Bankruptcy Code in part addresses federalism concerns and in part addresses Bankruptcy Clause preemption concerns. To sketch the history in very broad strokes, when Congress passed a prior version of chapter 9, the Supreme Court struck it down as violating the Tenth Amendment (which reserves to the States residual rights and powers). *See Ashton v. Cameron Cnty. Water Imp. Dist. No. 1*, 298 U.S. 513, 531 (1936). The gist of the Tenth Amendment federalism concerns are that because municipalities are creatures of state law, it is invasive for a federal court (namely, a bankruptcy court) to dictate the terms of a financial restructuring. Congress responded by making fixes to chapter 9 to allow the States more power, which the Supreme Court subsequently blessed. *See United States v. Bekins*, 304 U.S. 27 (1938). For example, States must now authorize their public entities to use chapter 9. *See* 11 U.S.C. § 109(c)(2). This requirement of state consent was designed to address the constitutional concern that the federal government was somehow imposing intrusively on States in violation of the Tenth Amendment in enacting chapter 9.

There are offsetting Bankruptcy Clause concerns, however, also reflected in section 903, specifically in the "proviso" subsections (1) and (2) of section 903. Those provisions claw back the general declaration of state autonomy found in the main paragraph of section 903 by clarifying that the states *cannot* pass their own "mini-chapter 9s" – in the words of the statute, "a State law prescribing a method of composition of indebtedness of such municipality." *Id.* at 903(1). Why is this so? Certainly States could pass bankruptcy laws and indeed did so in the earlier days of the Republic. *See Ogden v. Saunders*, 25 U.S. 213 (1827).[2]

Probably the best explanation of the insertion of the claw-back provisos is that they were Congress's attempt to reverse the Supreme Court's holding in *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942).[3] That case upheld the constitutionality of a New Jersey restructuring statute that allowed extension of debts. In adding the claw-back "provisos" to now-section 903 in its comprehensive overhaul of the Bankruptcy Code in 1978, the Senate Report explained: "The proviso . . . prohibit[s] State composition procedures for municipalities . . . . Deletion of the provision would permit all States to enact their own versions of Chapter [9], which would frustrate the constitutional mandate of uniform bankruptcy laws." S. REP. 95-989, 110, 1978 U.S.C.C.A.N. 5787, 5896 (internal quotation marks omitted).

It is conceivable Congress wanted to maximize central control over bankruptcy procedures under the new Code and did not want States "competing" with chapter 9. But the Tenth Amendment foundations to section 109(c)(2) – the provision that accords States a veto over access to chapter 9 for their municipalities – render the scope of the proviso uncertain. Recall that some States forbid their public entities to use chapter 9. *See, e.g.*, GA. CODE ANN. 36-80-5. We can call these "opt out" States. Others allow chapter 9, sometimes unconditionally, *see, e.g.*, ALA. CODE 11-81-3, and sometimes with conditions, *see, e.g.*, MICH. COMP. LAWS ANN. §§ 141.1541 *et seq.* We can call these others "chapter 9" States. There is thus a scholarly debate over the scope of section 903's provisos: do they apply to all States (chapter 9 and opt-out States), or do they apply only to chapter 9 States? (A good summary of this debate is fleshed out in Stephen J. Lubben, *Puerto Rico and the Bankruptcy Clause*, 88 AM. BANKR. L. J. 553 (2014).)

On the one hand, you can argue the proviso applies *broadly* to all States, because it sounds in mandatory language ("a State law . . . may not bind any creditor"). On the other, you can argue the proviso applies *narrowly* only to States that use chapter 9 in the first place, because if a State opts out of Chapter 9, it must be left with the autonomy to design its own debt resolution scheme. Proponents of this narrow view note that it makes no sense to read a provision in a part of the statute

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[2] Due to Contracts Clause concerns, such state laws could only apply to debts incurred after their enactment. *See Sturges v. Crowninshield*, 17 U.S. 122 (1819).
[3] Probably too wonkish, I fear, but in service of being comprehensive, I note that Congress may not have succeeded completely in overruling *Asbury Park* due to the technical difference between a "composition" and an "extension."

specifically concerned with Tenth Amendment issues broadly to maximize the federal government's incursion into state legislative autonomy. They also note that a broad reading has a coercive effect of "forcing" States to accede to chapter 9 (i.e., it's chapter 9 or nothing), a curious intent for a chapter highly conscious of state sovereignty. The better read, they argue, is that the proviso does not apply to opt-out states, only states who opt into the chapter 9 system. If they opt in and consent to their municipalities using chapter 9, they can't speak out of the other side of their mouths and enact a rival chapter 9 state law.

This debate is significant for Puerto Rico. Puerto Rico is an "involuntary" opter-out because its municipalities cannot use chapter 9 for the very reason H.R. 870 is being considered to fix. As such, a broad reading of the section 903 provisos would say Puerto Rico is just stuck: no chapter 9 *and* no state law analogue. A narrow read of the provisos, however, would allow the new Recovery Act to stand. Obviously, the District Court went with the broader read and struck down the Act. Given the uncertainty of the constitutional question, it is not surprising that decision is being appealed.

5. What are some of the benefits of Chapter 9 over a receivership?

The benefits of chapter 9 over a receivership are numerous. To list just a few: chapter 9 is a legal proceeding in which a judge presides over the case and keeps order over the negotiations. For example, a judge can order parties into mediation. Second, chapter 9 covers all creditors and so allows a comprehensive plan of adjustment to be voted on and implemented. A receiver may not be able to bind absent parties. Third, chapter 9 is a judicial process. A receiver is at best quasi-judicial. A judge will be trained in law and attuned to other considerations (e.g., whether a constitutional argument can be launched at some aspect of the plan); a receiver might have no such expertise. Relatedly, a judge has judicial power, *e.g.*, to sanction disruptive litigants. A receiver has no such authority. Perhaps most importantly, a judge follows precedent and can apply bankruptcy case law. It is true that chapter 9 has a thin precedent book due to its infrequent use. But that is better than no precedent book! In sum, chapter 9 brings certainty and order that a receivership would be unable to guaranty.

6. In the absence of Chapter 9, what incentives exist to encourage consensus among various creditors?

None. One of the key theoretical foundations of a bankruptcy reorganization system (chapter 9, chapter 11, or anything else) is that there is a "coordination failure" when atomistic creditors try to go after the debtor individually. A mad rush to dismember the carcass destroys value. A state-controlled, compulsory proceeding is necessary to prevent these ironically self-destructive impulses. A common metaphor for this "common pool" problem is over-fishing in a situation of scarcity. If it's first come, first served, everyone rushes and fishes the pond to extinction. If the putative fisherman are stayed and corralled into a courtroom to share the fish pro rata (a) everyone gets a fair share, not just the fastest/pushiest (who get fastest and pushiest when they panic there's not enough fish to go 'round), and (b) the fishing stock might be given time to repopulate, allowing an even greater share for all. I'll leave the subcommittee with that image as an appropriate conclusion to my thoughts.

John A. E. Pottow

<u>RESPONSES OF MELBA ACOSTA-FEBO</u>

QUESTIONS SUBMITTED FOR THE RECORD FROM SUBCOMMITTEE CHAIRMAN MARINO

1. **Is it correct that the Government Development Bank ("GDB") is a significant creditor to many of Puerto Rico's public corporations that may be eligible to file for chapter 9? Would the GDB's role as a creditor to a Puerto Rico public corporation in a chapter 9 case present a conflict with its role as a financial advisor to Puerto Rico?**

Response:

In limited circumstances, GDB has extended financing and other forms of liquidity to certain of Puerto Rico's public corporations. Consequently, if the U.S. Bankruptcy Code were amended as contemplated by H.R. 870, and Puerto Rico enacted an enabling statute, it is possible that GDB would be a creditor of a public corporation that seeks relief under Chapter 9. In the event that a public corporation files for relief under Chapter 9, and GDB is a creditor of that entity, however, we do not believe that there would be a per se *conflict of interest if GDB continues to serve as a financial advisor to Puerto Rico.*

GDB as a creditor would have an inherent interest in maximizing creditor recoveries. As a financial advisor to Puerto Rico, GDB would have an inherent interest in maximizing creditor recoveries and supporting a Chapter 9 process that provides predictability and fairness to all creditors, which will ultimately provide a better environment for capital investment.

Moreover, any Chapter 9 case would be overseen by an experienced federal bankruptcy judge. The judge can approve a Chapter 9 plan only if the substantive and procedural protections of the U.S. Bankruptcy Code are followed. These protections ensure that the process is fair to all parties involved, including creditors, employees, and the public corporation(s). For example, in order to approve the plan of adjustment, the bankruptcy judge must find that the plan is in the best interest of creditors and that the plan was proposed in good faith.

2. **Do you believe that affording Puerto Rico the option to utilize chapter 9 may lessen the potential for Puerto Rico to require future federal financial assistance?**

Response:

I do not think affording Puerto Rico the option to utilize Chapter 9 for its municipalities will increase or lessen the potential for Puerto Rico to require future federal financial assistance. A state's access to Chapter 9 is neither a *precondition nor a disqualification from receiving federal financial assistance as far as I know, and the same would be true for Puerto Rico. Having said that, I believe that if the U.S. Bankruptcy Code were amended to permit Puerto Rico to authorize certain of its public corporations to seek Chapter 9 relief, such corporations would be less likely to seek financial assistance from the central government of Puerto Rico or the GDB, which in turn will benefit the central government's financial situation.*

3. **Do you believe that allowing Puerto Rico to utilize chapter 9, by itself, is a solution to Puerto Rico's financial issues?**

Response:

No. Amending the U.S. Bankruptcy Code as contemplated by H.R. 870, in and of itself, would not solve Puerto Rico's financial issues. It would complement many of the actions already taken by the current administration to achieve fiscal sustainability, which includes reducing budget deficits, imposing cost-control measures at multiple levels of government, limiting government payroll, implementing pension reform, imposing loan origination discipline at GDB, completing public-private partnerships, and reforming utility rates, among others.

4. **Mr. Mayer argues that chapter 9 is unnecessary and that the Puerto Rico public corporations can take other actions to address their financial distress. How do you respond to that argument?**

Response:

We respectfully disagree. It is important to emphasize for the record that Mr. Mayer is a lawyer for PREPA bondholders who have a specific objective to maximize their investment on their particular bonds. In his advocacy role, Mr. Mayer has asserted that several alternatives to Chapter 9—namely, placing public corporations into receiverships, raising utility rates, and collecting outstanding receivables—are sufficient to address the fiscal problems that Puerto Rico's public corporations currently face. Mr. Mayer is also on record as having stated that Chapter 9 is imperfect, implying that if it were drafted to be fairer for his clients, he would not have any objection to it.

The GDB and the government of Puerto Rico respectfully submit that the better view—a view that is held by nearly every restructuring professional that has weighed in on this issue, as well as nearly every major international organization charged with economic growth and prosperity—is that extending a restructuring regime to entities like Puerto Rico's public corporations is sound public policy. Nonetheless, I would like to explain why the alternatives offered by Mr. Mayer are inadequate for PREPA and Puerto Rico.

First, the receivership that Mr. Mayer contemplates is far inferior to Chapter 9. Puerto Rico's receivership laws are vague and untested. Unlike Chapter 9, they do not contemplate any creditor input or creditor voting or any framework for protecting the interests of all stakeholders. As noted by Mr. Robert Donahue of Municipal Market Analytics (MMA), the remedy contained in the PREPA bond documents (that is, a court-appointed receiver) is "wholly inadequate legal framework within which to address PREPA's highly complex financial restructuring needs among a diverse group of stakeholders."[1] Specifically, a receivership could literally take decades to complete and give rise to endless litigation. Perhaps most importantly, a receivership could cause suppliers to refuse to deliver fuel on reasonable terms and ultimately threaten PREPA's ability to provide electricity to the people and businesses of Puerto Rico. This is because the current receivership framework does not contemplate the concept of "debtor-in-possession" financing, which allows debtors to obtain financing with enhanced priority rights while operating under the U.S. Bankruptcy Code.

Second, we often hear from investors that the solution to PREPA's problem is simply to raise "base rates" because the cost of electricity in Puerto Rico has not increased in decades. This suggestion seems attractive at first blush, but unfortunately mischaracterizes the real issue. To be clear, the "base rate" that is charged to consumers is just one component of the "all-in" rate that consumers pay for electricity. The all-in rate includes in the cost of purchasing fuel, transportation of fuel, and other fuel-related expenses, which are substantial given that Puerto Rico is an island. While it is true that the "base rate" has not increased in many years, the "all-in" rate—which is the only rate to which Puerto Rico's consumers are sensitive—is more than twice the average rate in the continental United States. Given that Puerto Rico has one of the highest unemployment rates and lowest per capita income levels in the United States, its consumers are particularly sensitive to rate increases. Regardless, PREPA cannot unilateral raise rates because any rate adjustment requires approval from the Puerto Rico Energy Commission, which may or may not approve an increase. Finally, raising utility rates could have the opposite result—that is, decreasing revenues because consumers cannot afford to pay the rates.

Third, we agree that PREPA should collect from its creditors, and PREPA's financial advisors agree that this must happen immediately. That being said, it is worth emphasizing that collecting from PREPA's creditors is not a solution to PREPA's overall financial situation. Many of PREPA's largest creditors are municipalities and other governmental instrumentalities in Puerto Rico, which

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[1] See Testimony of Robert Donahue, Managing Director, Municipal Market Analytics, Inc. (MMA), before the House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law (February 26, 2015).

are experiencing their own financial distress, making collecting from them in the short term very challenging.

Finally, as for Puerto Rico generally, and as stated in my testimony, the lack of a clear restructuring option—either under Chapter 9, or under Puerto Rico law - has unfortunate and real consequences for the entire island, none of which factors into Mr. Mayer's criticisms, which focus solely only on his clients' interests.

QUESTIONS SUBMITTED FOR THE RECORD FROM REPRESENTATIVE JOHN CONYERS, JR. AND REPRESENTATIVE HENRY C. "HANK" JOHNSON, JR.

1. **I note that you previously were the Secretary of Treasury for the Commonwealth of Puerto Rico in addition to your current position as President of the Government Development Bank for Puerto Rico. Based on your experience in both capacities, how would H.R. 870 benefit Puerto Rico?**

Response:

My experiences as both Secretary of Treasury for the Commonwealth of Puerto Rico and as President of GDB have given me unique insight into the benefits that H.R. 870 would provide Puerto Rico. First and foremost, passing H.R. 870 would further the administration's objective of making Puerto Rico's public corporations self-sufficient such that they will no longer need to rely on the central government or GDB for financial assistance. This is an integral part of achieving long-term fiscal sustainability on the island as a whole.

In addition, H.R. 870 will have many measured benefits. First, H.R. 870 will provide certainty to the market, which will decrease the cost of borrowing at all Puerto Rico issuers. Second, H.R. 870 will allow many issuers that have been closed out of the credit markets to access them again. Third, H.R. 870 will actually increase economic growth by providing stability and facilitating long-term capital investment and expenditure plans. Finally, H.R. 870 provides creditors with a clear roadmap—in terms of substantive rights and expected procedures—that is far better than the receivership provisions under current law.

2. **Mr. Mayer argues that H.R. 870 "serves the interests of neither the Commonwealth nor the millions of individuals who invested in the bonds of the Commonwealth's corporations." What is your response?**

Response:

The GDB and the government of Puerto Rico respectfully disagree. Adoption of H.R. 870 would give Puerto Rico the opportunity to access a well-tested regime for public corporations to adjust debts in a manner that requires creditor input and participation, as well as good-faith negotiation, under the supervision of an experienced bankruptcy judge. It would provide a recognized framework that balances the interests of all stakeholders. Mr. Mayer represents a handful of sophisticated financial investors—many of which purchased their PREPA bonds on the secondary market at a discount after PREPA's financial challenges became well known—that object to Chapter 9 itself. Criticisms of Chapter 9 are irrelevant to whether Puerto Rico should have the same opportunity as the 50 *states to authorize its public corporations to invoke Chapter 9. The states have this opportunity, and there is no reason to deprive the Commonwealth of this same opportunity, especially given the fiscal emergency facing Puerto Rico's public corporations.*

3. **Some argue, such as Mr. Mayer, that PREPA could do much to improve its bottom line such as increasing its base rates, collecting its accounts receivable, and improving the efficiency of its employees; among other measures. What is your response?**

Response:

I would like to respond separately to the suggestion that (i) increasing base rates, (ii) collecting account receivables, and (iii) improving efficiencies of employees will improve PREPA's bottom line.

Raising Rates

As I noted above, investors often say that the solution to PREPA's problem is simply to raise "base rates" because the cost of electricity in Puerto Rico has not increased in decades. This suggestion mischaracterizes the real issue because the "base rate" that is charged to consumers is just one component of the "all-in" rate that consumers pay for electricity. The all-in rate includes in the cost of purchasing fuel, transportation of fuel and other fuel-related expenses that are substantial given that Puerto Rico is an island. While it is true that the "base rate" has not increased in many years, the "all-in" rate—which is the only rate to which Puerto Rico's consumers are sensitive—is more than twice the average rate in the continental United States. Given that Puerto Rico has one of the highest unemployment rates and lowest per capita income levels in the United States, it is particularly sensitive to rate increases. Regardless, PREPA cannot unilateral raise rates because any rate adjustment requires approval from the Puerto Rico Energy Commission, which may or may not approve an increase.

Collecting Accounts Receivable

As I noted above, we agree that PREPA should collect from its creditors, and PREPA's financial advisors agree that this must happen immediately. That being said, it is worth emphasizing that collecting from PREPA's creditors is not a solution to PREPA's overall financial situation. Many of PREPA's largest creditors are municipalities and other governmental instrumentalities in Puerto Rico, which are experiencing their own financial distress, making collecting from them in the short term very challenging.

<u>Efficiencies of Employees</u>

We agree that improvements can be made with respect to employee efficiencies, but employee-related costs are only a small component of PREPA's budget. The most significant costs are related to fuel and inefficient generation facilities. It will take a significant amount of time and new capital to address these long-term problems.

4. **If legislation such as H.R. 870 is not enacted, what is likely to be the result for such public corporations as PREPA?**

Response:

The current administration remains committed to making Puerto Rico's public corporations self-sufficient such that they do not require financial assistance from the central government or the GDB regardless of whether H.R. 870 is enacted. However, if H.R. 870 is not enacted, achieving this objective will be more difficult.

First, if H.R. 870 is not enacted, Puerto Rico will continue to defend the constitutionality of the Puerto Rico Debt Enforcement and Recovery Act (the "<u>Recovery Act</u>"), which would allow the public corporations to adjust their debts under Puerto Rico law. We remain steadfast in the belief that the Recovery Act—which is modeled in part after the Bankruptcy Code—is constitutional and appropriately balances the interests of the public, the public corporations, and creditors.

Second, if there were no legal mechanism to adjust debt, there could be substantial negative consequences on Puerto Rico and public corporation creditors. As everyone knows, virtually the entire population of Puerto Rico relies on PREPA for electricity, which includes for medical care, light, communication and running water. If PREPA cannot adjust its debt in an organized and timely way, it may not be able to purchase fuel, pay employees, maintain its plants, comply with environmental regulations, operate its transmission and distribution lines, and serve customers. In a crisis situation, PREPA could be forced to ration electricity and employ rolling blackouts, which would unquestionably threaten public health, safety and welfare, and may even cause chaos. This would undoubtedly lead to a further deterioration to the economy and more Puerto Rico residents moving to the mainland United States.

Beyond the risks to the health, safety, and welfare of Puerto Rico's residents, there is also a risk that (i) Puerto Rico's public corporations will be shut out of the capital markets for the foreseeable future, and to the extent access becomes available, it will be on terms that are cost prohibitive, (ii) it will be more difficult *to make long-term investment and capital expenditure plans, (iii) suppliers and venders may require immediate cash payments for their services, which could cause immediate and widespread liquidity events in Puerto Rico, and (iv) creditors may race to the courthouse to exercise remedies such as seeking the appointment of a receiver pursuant to untested procedures that do not balance the interests of all stakeholders or even require creditor input or participation.*

Municipal Market Analytics, Inc. (MMA)

Written Responses to Member Questions
Hearing on H.R. 870, the "Puerto Rico Chapter 9 Uniformity Act of 2015".
House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law

Presented by Robert Donahue, Managing Director

May 1, 2015

Table of Contents

QUESTIONS SUBMITTED FOR THE RECORD FROM CHAIRMAN MARINO

1. Would the enactment of H.R. 870 have an impact on the stability of the Puerto Rican bond market, or the broader municipal bond market? Is there a risk for market contagion if chapter 9 is not available to Puerto Rico?

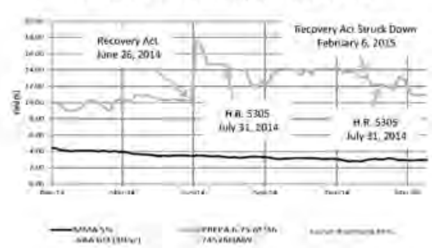
State's Municipal Legal Protections Vary Widely

MMA believes enactment of HR 870 will have limited impact on the stability of Puerto Rican markets or the broader municipal bond market. Municipal bond investors are well acquainted with the risks of chapter 9. The chart (**right**) shows that state municipal legal protections, including chapter 9 authority, vary widely among states. States enjoy access to the municipal market regardless of their position on chapter 9, or level of oversight.

Puerto Rican investors are also well aware of bankruptcy risks. Residents and businesses in Puerto Rico today can access all protections offered through other chapters of the US Bankruptcy Code (i.e., Chapter 13, 12, 11 and 7).

The surprise passage of the Puerto Rico Debt Enforcement and Recovery Act ("Recovery Act") on June 28, 2014 resulted in yield spikes and wide bond price declines (**see graph below**). Since this time, two bills allowing PR access to Ch. 9 have been presented (H.R. 5305 – July 31, 2014 and H.R. 870 – February 11, 2015). The graph illustrates that there was no perceptible negative market impact on bonds issued by PREPA (the most likely candidate for Ch. 9).

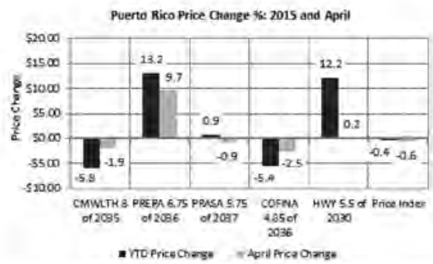
PREPA vs. MMA: Weekly Yields: 2014-2015



Investors have had several years to absorb Puerto Rico rating agency downgrades and widespread negative headlines broadcasting that the Commonwealths debt levels have become unsustainable given its shrinking economy and volatile financial structure.

Rating agencies had been very forward at each stage, giving investors ample time to exit their Puerto Rico positions. There have consistently been bids available. Investors have been aware of risks and many added to positions as credit weakened.

There has been market liquidity as well; sellers have been able to execute trades in a timely manner, although not necessarily at favorable levels. The graph (**below**) illustrates that market participants are differentiating between the various island credits in trading levels, the sign of an efficient, functioning market.



If Congressional authority is granted, and the tool of chapter 9 becomes available to Puerto Rico, this it does not necessarily mean it will be used. Puerto Rico will be required to pass an enabling act detailing the scope of authority that will be granted. **MMA** believes it is possible that, if done appropriately, this action may stabilize markets, especially over the longer term.

Enactment could create time for some Puerto Rican credits, such as General Obligation bonds, to stabilize and perhaps to issue again. On the other hand, the island's public corporations (for whom chapter 9 is targeted) may have a longer path to stability. Importantly, in either case the ability to use chapter 9 will provide a powerful negotiating tool, enable an orderly process for a default workout, and ultimately build a path toward long term stability.

2. Do you believe that affording Puerto Rico the option to utilize chapter 9 may lessen the potential for Puerto Rico to require future federal financial assistance?

The argument that extending chapter 9 to Puerto Rico will necessarily lead to future financial assistance, or a "bailout", is specious. The federal government has a long avoided intervention in state/local financial crisis, and only taken action in cases *in extremis*. In certain rare circumstance, there is precedent for a federal guarantee of a public entity facing serious financial difficulties but these actions have limited federal financial assistance and required considerable loss of operational autonomy.

For example, in the case of Washington DC, Congress has invoked its constitutional mandate to oversee the operations of the seat of the federal government. In this situation, intervention materialized only after it was evident that failure to intervene would likely have an adverse effect on the operations of the federal government.[i]

In 1978, the federal government intervened New York City's fiscal crisis only after foreign governments expressed their concerns regarding the potential global economic fallout of a bankruptcy. In response, Congress passed and President Carter signed, the New York City Loan Guarantee Act, a response to the city's severe fiscal crisis at the time. The Act required the city to submit to the Secretary of the Treasury a plan for balancing its budget within roughly four years and mandated that an independent fiscal monitor "demonstrate to the satisfaction of the secretary that it has the authority to control the city's fiscal affairs during the entire period in which federal guarantees are outstanding."

Without a framework to restructure some of its debts, the Commonwealth is vulnerable to unforeseen risks. Chapter 9 provides a standardized, orderly legal framework guided by an existing body of case law in an appropriate arms-length venue. **MMA** believes this far preferable to a receiver-driven restructuring. A court supervised process would put all vested parties together on a far more even playing field than any that currently exists. In the near term, however, **MMA** believes that the option to utilize chapter 9 is a best available, highest impact step that will stabilize the situation and allow breathing room.

The only parties that benefit in the event of a long protracted workout are attorneys. **MMA** believes it is best in all circumstances to quickly settle insolvency and move forward so that resources are allocated to constituents and stakeholders rather than to workouts.

Ultimately Puerto Rico's political system may simply be unable to resolving the current financial crisis without some type of receivership. Many, including **MMA**, believe a federal intervention of some form is increasingly likely, perhaps inevitable. Under the broad powers granted to it under the Territorial Clause of the United States Constitution, Congress has broad powers legislate to impose federal control over the island's finances.[ii] Whether this occurs remains to be seen.

3. Do you believe that allowing Puerto Rico to utilize chapter 9, by itself, is a solution to Puerto Rico's financial issues?

No. Chapter 9 is a last resort to avert a broader crisis, and not a panacea. Chapter 9 is merely a first safety net option if the Commonwealth lacks the political will to address its issues and a crisis deepens, threaten the public safety. Also chapter 9 would allow the Commonwealth to maintain essential operations which would be essential to an orderly workout process.

Chapter 9, in our view, provides the best available process to enable, if necessary, to provide an orderly restructuring of the commonwealth's agencies/corporations, keeping such important decisions within the hands of impartial judges and out of the hands of politicians.

4. Your firm represents a wide-range of municipal bond investors. Do you believe there is a consensus among the municipal bond investment community regarding allowing Puerto Rico to utilize chapter 9?

In weighing the decision to testify on behalf of H.R. 870 before the Subcommittee, **MMA** spoke with a variety of traditional municipal investors to assess municipal market support for an extension of chapter 9 to Puerto Rico. We found a diversity of opinions on the topic.

Some expressed support for H.R. 870 in the context of allowing bankruptcy as a last resort, only to be used when all other options have been exhausted. We recognize that many expressed support H.R. 870 largely based on its consistency with their investment strategy – for example, to buy GO and COFINA bonds and restructure public corporation bonds – also known as the "ring-fence" strategy coined after the passage of the Recovery Act.

Some investors conditionally support chapter 9, believing it is a half-measure which must be accompanied by stronger federal oversight.

Other investors oppose H.R. 870 as an attempt to resurrect the "ring-fence" strategy and viewed enactment of chapter 9 as a distraction from the island's core issues. Some of these firms stated that Congress would be unwise to sanction the current bill because it would appear to be favoring a "winning" investor group.

Finally, there are investors that oppose in all forms because they own debt across the whole complex. The firms have been active in publicly opposing H.R. 870.

On this note: some firms supportive of H.R. 870 have been reluctant to publicly express their position out of concern this could possibly be perceived as "supporting" a bill that allows a large, disruptive chapter 9 bankruptcy.

5. There are a number of states that either prohibit or do not authorize chapter 9 for their municipalities. From an investment perspective, why is Puerto Rico any different than these states?

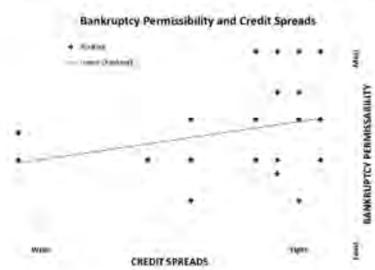
This question assumes that there are common characteristic among US states that authorize, prohibit or limit chapter 9. However, state approaches to chapter 9 authorization vary widely. **MMA**'s analysis of state authorization reveals no geographic, regional or political relationship or conclusions that may be drawn (map right).

Taking a step further, **MMA** reviewed the relationship between state General Obligation ratings and bankruptcy authorization to assess whether rating agencies factor this issue into their assessments of state creditworthiness. The table below indicates that there is little perceivable relationship.

State Chapter 9 Authority Relationship to Ratings				
	Chapter 9 Status			
Ratings	No	Yes	Conditional	Limited
AAA	9	3	2	
High AA	3	6	1	1
Mid AA	5		5	
Low AA/A			3	1
Grand Total	**17**	**9**	**11**	**2**

*Note that not all states have General Obligation ratings, therefore the total is less than 50.

Finally, because ratings do not always reflect the bond market's view on state credit, **MMA** assessed the relationship between credit spreads and bankruptcy authorization. The graph below indicates that there too is little relationship between state municipal bonds trading levels (spreads which reflect high risk when "wide", and lower risk when "tight").



QUESTIONS SUBMITTED FOR THE RECORD FROM REPRESENTATIVE JOHN CONYERS, JR. AND REPRESENTATIVE HENRY C. "HANK" JOHNSON, JR.

1. Mr. Mayer warns that "[i]f Congress extends Chapter 9 to Puerto Rico," the Commonwealth's water and sewer agency "will not be able to sell any bonds." What is your response?

MMA refrains from speculative statements of this nature. Making market predictions, whether forecasting interest rates or projecting whether a specific issuer may, or may not, access the market at what interest rate, is presumptuous. While enactment of chapter 9 certainly does not help the water and sewer agency PRASA, or any Puerto Rico public corporation, to place debt in the future it is not clear that this issuer, or any, cannot sell bonds at the right price.

2. Mr. Mayer says that "PREPA itself does not need Chapter 9. It can fix itself." What is your response?

If PREPA could "fix itself", it probably would have done so by now. The utility is essential to the people, businesses, and economy of Puerto Rico. High costs have worsened the island's longstanding recession. The potential for an interruption of power supply, sparked by labor disruption, fuel supply disruption or other causes, pose significant risks to the island's recovery. Most likely PREPA lacks the willingness or incentive to fix itself.

PREPA's challenges are significant, resulting from decades of mismanagement and political interference. PREPA has had years to "fix itself" but the problems have only deepened. Ongoing reports by qualified, experienced engineering firms have detailed a set of monumental challenges. In written testimony to PR's Energy Affairs and Water Resources Commission Senate of Puerto Rico, Chief Restructuring Officer Lisa Donahue provided a list of the challenges facing the utility, including:

- a board and management structure susceptible to political influence and corruption;
- a lack of institutionalized processes and procedures;
- outdated systems and information technology;
- high employee turnover;
- unreliable and outdated billing systems causing low collection rates;
- high levels of power theft;
- an antiquated and deteriorating generation infrastructure systems causing unusually high rate afforded outages;
- a technically obsolete vehicle fleet; and
- serious safety issues which have resulted in three fatalities and numerous accidents.

PREPA's Chief Restructuring Officer (CRO) has, for nearly one year, been working to develop a comprehensive recovery plan to transform PREPA into a modem and self-sustaining utility, and reduce the all-in rate charged to consumers over time." MMA supports this process. However, is uncertain that ability of an appointed official with limited time and authority can effectively broker a viable plan amidst a complex, diverse group of stakeholders including creditors, employees, unions, legislators, regulators, consumers and other stakeholders.

Our concerns have increased in recent weeks based upon our review of news reports and discussions with PR officials indicate that stakeholder resistance to the plan could block implementation. It is our understanding that creditors remain determined to receive high recovery levels, assigning much of the burden on rate payers and other stakeholders.

While MMA does not have access to information regarding the negotiations, advisors to the Ad Hoc Group of PREPA Bondholders presented a high level restructuring proposal March 26, 2015. A subsequent Creditor Proposal Review released on April 23, 2015 from PREPA rejected the Ad Hoc Group's proposal on the grounds that the Proposal underestimated future costs of implementation by at least $3.1 B, included inaccurate or aggressive assumptions, incomplete data/information, and inconsistencies with underlying data. PREPA emphasized that the Proposal would require the rate charged to PREPA's customers to be raised materially in the near term, assuming no change in existing debt service and meeting all costs. PREPA concluded that "a successful restructuring of PREPA must be based on an executable plan that rightly balances the contribution of PREPA's stakeholders."

While we are hopeful, over many years we have witnessed the failure of plans to achieve consensus. Our belief is that any successful PREPA restructuring has to be considered in the context of the long term economic and political sustainability. A plan that is diluted for expediency will only result in deeper problems. Consequently we see the ability for Puerto Rico to use chapter 9 as an insurance policy or backstop.

3. What are the ramifications if a receiver is appointed for PREPA?

PREPA's bond covenants empower bondholders to seek a court-ordered receivership in the event of a utility default. Section 208 of PREPA's charter provides for the appointment of a receiver vested with limited powers other than to carry on the purposes that are of public good ("utilidad pública") and prohibited from encumbering or dispose of property.

Creditor rights are limited, primarily to bringing suit to compel compliance with the Rate Covenant. MMA believes that a weak receiver with vaguely defined powers will be hard-pressed to enforce rate increases with PREPA's per kilowatt hour rates over twice the US average cut costs. The Jefferson County AL sewer debt crisis provides a recent case study regarding the ability to enforce such covenants.

PREPA's Trust Agreement states: "Remedies are subject to discretion and delay and may not be readily available or may be limited. Equitable principles may also delay or otherwise adversely affect the enforcement of bondholders' rights." We note that any judicial action regarding the appointment of a receiver must be filed in Puerto Rico court applying Puerto Rico law.

We believe that the receivership procedures laid out in PREPA bond documents are impractical. We believe the provisions in the 1974 Trust Agreement provide an inadequate framework which fails to address PREPA's highly complex financial restructuring needs among a diverse group of stakeholders and turning around and improving PREPA.

Finally, as stated earlier, we are concerned that the potential of unilateral actions by a receiver could disrupt the provision of essential public services. Any of these actions could place an undue burden on Puerto Rican citizens, many of whom are unaware of the complexities of the island's tenuous fiscal conditions.

3. You state that H.R. 870 "sets no adverse precedent for the broadening of municipal bankruptcy provisions that may destabilize issuers' access to capital via the municipal bond market." Mr. Mayer, on the other hand, appears to have a completely different view of what the bill's impact may have on the financial marketplace and Puerto Rico. What is your explanation for such very divergent views?

MMA's research and analysis indicates that municipal bond investors such as mutual funds or retired individuals, the island's traditional lender, have significantly reduced ownership of Puerto Rico debt and therefore systemic risk to the municipal market has been greatly reduced. Fitch Ratings estimates starting in 2Q and 3Q 2013, U.S. mutual fund reduced their PR exposure by approximately 65%, on average. Municipal bond funds, once the primary owners of Puerto Rico debt, now own less than one third of the island's debt concentrated in largely insured, general government issuers.

The result is that the island's current debt, as well as its future access to capital is now held by, and dependent on, alternative investors who demands high costs in return for their investment. Fitch estimated that there are now over 60 alternative fund managers holding more than $16 billion, or 25% of the island's debt.

The divergent views are perhaps indicative of the differing perspectives and objectives between MMA and Mr. Mayer. MMA is an independent firm with over 300 clients representing a broad spectrum of the market. MMA clients pay annual subscription fees to receive value-added strategic research and analysis. MMA does not advocate policy positions, provide expert testimony, or represent firms or governments in restructuring proceedings. MMA is not a broker dealer nor does it have any interest or stake in holding bonds. MMA was not paid to appear before the House Subcommittee.

Beyond providing our expertise and education to core clients, MMA's mission to maintain the efficient operation of the municipal bond market as the primary vehicle for US infrastructure finance.

Like you, we are concerned about endorsing an action that could enable a large municipal bankruptcy that would, if taken, impose steep losses on a wide range of investors. As witnessed in Detroit, Michigan and Stockton, California, Chapter 9 has a tendency to negatively affect all stakeholders. No government official should it lightly—nor does MMA. While we do not advocate bankruptcy for any state, locality or municipal agency, MMA believes this is the best option for Puerto Rico and the municipal market.

4. Some argue that H.R. 870 will further undermine investor confidence in Puerto Rico's ability and willingness to service its debt obligations. What is your response?

Investor confidence has reached extremely low levels not only because the island has shown that it is incapable of solving its financial problems but also because heightened uncertainty regarding how bondholders will be treated in the event of a default.

As of this writing, Puerto Rico's investor confidence has eroded to unseen levels. On April 30, the legislature failed to approve a critical tax reform which was central to its proposed $2.9 billion PRIFA bond deal and fiscal 2016 budget. Consequently, Puerto Rico's 8% coupon GO bonds maturing in 2035, rated Caa1/CCC+, were trading in the range of 10.81%-10.42% ($79.75-$77.13 dollar price) compared to yesterday's levels between 10.37%-10.31% ($80.50-$80.13 dollar price).

The lack of an adequate framework is one factor among many (e.g. sagging economy, too much debt, poor financial practices, lack of leadership and lack of trust/confidence in PRs government) that have led to the deteriorating bond prices.

It is our belief that H.R. 870 could actually being the process of restoring confidence and provide stability. Investors will likely favor the increased certainty that a federally supervised chapter 9 process provides.

5. Some say that H.R. 870 is a bailout for Puerto Rico and its government-owned corporations. What is your response?

We do not agree. As stated earlier, we believe that H.R. 870 averts the likelihood of a federal bailout.

We do understand the perspective that restructuring is an indirect bailout imposed on mainland bondholders if Congressional approves of this bill. However, we believe that losses will be shared across stakeholders This court supervised process would put all vested parties together on a far more even playing field than currently exists. All creditor classes fully participate, with limited political interference if negotiations break down. Chapter 9 still a high degree of stakeholder influence on creditor recoveries and a plan that a US federal court judge will ultimately determine.

We do agree that ultimately, chapter 9 alone won't be enough to solve the central government's problems. The question for Congress is it wants to do it in the format as proposed by this bill or in another more comprehensive manner.

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[i] Municipal Fiscal Crises in the United States: Lessons and Policy Recommendations for Puerto Rico, Center for the New Economy, April, 28, 2006

[ii] Article IV, section 3, clause 2 of the U.S. Constitution states that "the Congress shall have Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States..."

Thomas Moers Mayer's Responses to

Questions for the Record

Hearing of the House of Representatives' Committee on the Judiciary's Subcommittee on Regulatory Reform, Commercial and Antitrust Law
on
H.R. 870: "Puerto Rico Chapter 9 Uniformity Act of 2015"

1. "Supporters of H.R. 870 have described an insolvency process that relies on the bondholder contracts as unpredictable and likely to yield years of litigation. How do you respond to that characterization?"

The characterization is wrong; it does not take account of applicable Puerto Rican law and the financial and operating realities of PREPA and the other governmental institutions.

To the extent this question reflects the concerns that the bondholders' right to increase electricity rates under Section 502 of the Trust Agreement would lead to "years of litigation" by customers, there is no basis for such a fear.

The bondholders cannot impose new electricity rates on ratepayers – they, like PREPA, can only ask the Energy Commission to do so under Puerto Rico's Act 57, enacted in 2014. Act 57 also created an Independent Consumer Protection Office to "[d]efend and advocate for the interests of customers in all matters before the Energy Commission . . . with regard to electric power rates and charges . . . ." Act 57 § 6.44(c). There is no reason to believe that rates proposed by a receiver and approved by the Energy Commission's board after review and intervention by the Independent Consumer Protection Office would be met with "years of litigation" by customers.

This is especially true in the current economic situation, where noteholders have proposed restructured rates that are actually lower than the rates paid by Puerto Ricans as recently as last August, and much more stable than they have been for the past few years.

In addition, there is no basis for the concern that appointment of a receiver would prompt litigation from other stakeholders such as suppliers, employees or pensioners. These people will be paid without litigation: The Trust Agreement itself provides that current expenses – that is, payments to suppliers, employees, pensioners – must be paid before bondholders are paid.

Your question also asks whether a restructuring process that relies on "bondholder contracts" is "unpredictable". The short answer is "no"; such a process is not unpredictable and relies on more than "bondholder contracts". Bondholders have the right to a receiver not just under their Trust Agreement but also under section 207 of the Puerto Rico Electric Power Authority Act (Act 83 of 1941 § 17). That section specifies the powers of a receiver in relevant part as follows:

> (b) The receiver so appointed shall forthwith, directly or by his agents and attorneys, enter into and upon and take possession of such undertakings and each and every party thereof, and may exclude the Authority, its Board, officers, agents and employees and all persons claiming under them, wholly therefrom and shall have, hold, use, operate, manage, and control the same and each and every part thereof, and in the name of the Authority or otherwise, as the receiver may deem best, shall exercise all the rights and powers of the Authority with respect to such undertakings as the Authority itself might do. Such receiver shall maintain, restore, insure, and keep insured, such undertakings and from time to time shall make all such necessary or proper repairs as such receiver may deem expedient, shall establish, levy, maintain and collect such rates, fees, rentals, and other charges in connection with such undertakings as such receiver may deem necessary, proper and reasonable, and shall collect and receive all income and revenues and deposit the same in a separate account and apply the income and revenues so collected and received in such manner as the court shall direct.
>
> * * *
>
> (d) Such receiver shall act, in the performance of the powers hereinabove conferred upon him, under the direction and supervision of the court and shall at all times be subject to the order and decrees of the court and may be removed thereby. Nothing herein contained shall limit or restrict the jurisdiction of the court to enter such other and further orders and decrees as such court may deem necessary or appropriate for the exercise by the receiver of any function specifically set forth in §§ 191-217 of this title.
>
> (e) Notwithstanding anything in this section to the contrary, such receiver shall have no power to sell, assign, mortgage, or otherwise dispose of any assets of whatever kind or character belonging to the Authority and useful for such undertakings, but the powers of any such receiver shall be limited to the operation and maintenance of such undertakings, and the collection and application of the income and revenues therefrom, and the tribunal shall not have jurisdiction to enter any order or decree requiring or permitting said receiver to sell, mortgage or otherwise dispose of any such assets.

This lengthy provision rebuts witness Robert Donahue's statement that the word 'receiver' is mentioned only twice in the trust indenture "and is not very clear".[1] The powers of the receiver are carefully set forth and limited, and the receiver is always subject to the control and jurisdiction of a court in Puerto Rico.

I disagree with the suggestion that a receivership involves more litigation than a Chapter 9 bankruptcy. The City of Vallejo spent 41 months in bankruptcy court. The City of Stockton and Jefferson County each spent over two years in bankruptcy court, and their plans are still being appealed. The City of San Bernardino filed for Chapter 9 in July 2012 and has yet to emerge. Detroit took a relatively short 17 months – but only because Governor Snyder had

[1] February 26, 2015 Hearing Transcript at p. 60.

appointed an emergency manager whose tenure, by statute, was limited to 18 months, a factor not present in Puerto Rico.[2]

Finally, your question refers to an "insolvency process". The phrase should not have any application to PREPA – under Puerto Rican law PREPA is not, nor can it be, insolvent. Section 2.8 of Act 57 requires the Puerto Rican Energy Commission to set rates that are sufficient to cover the costs of PREPA's operations, costs that are spelled out in detail and include "the payment of principal and interest of the bonds and other financial obligations of the Authority [PREPA]". There are no commercial impediments to PREPA in charging rates that are adequate to satisfy its financial obligations. There is no economic impediment today in that PREPA's current rates are approximately 21 cents per kilowatt-hour, down over 30% from a 31 cents per-kilowatt-hour high in 2013. As I indicated in my testimony, PREPA is therefore in the enviable position of being able to solve its own financial problems; any "insolvency" is created by PREPA's own reluctance to do so.

2. <u>"As a bankruptcy practitioner, on balance, which do you believe is more predictable: a restructuring under bondholder contracts or a chapter 9 bankruptcy process?"</u>

As a bankruptcy practitioner who has represented major bondholder groups in two Chapter 9 cases – Jefferson County, Alabama and City of Detroit, Michigan – I believe a restructuring under bondholder contracts and applicable state law is more predictable than a Chapter 9 bankruptcy process because a Chapter 9 process is not predictable at all. In the words of witness Professor John Pottow, Chapter 9 is "an unknown, uncharted and unpredictable process". See <u>Exhibit A</u> (which includes similar statements by, among others, the Federal Reserve Bank of Chicago, Letter, *Detroit's Bankruptcy: The Uncharted Waters of Chapter 9* (Oct. 4, 2013)).

Restructuring under bond documents and applicable state law offers bondholders greater certainty because Article I §10 of the United States Constitution, which bars a state from impairing contracts, essentially compels distressed municipalities to fix their operational problems before they cut their bonds.

Receiverships, emergency managers and financial control boards focus on fixing the operations and current expenses of the municipality – they tend to effectuate more lasting structural and operational fixes to their financial problems. The District of Columbia is a good example. When the District had a financial crisis, Congress considered and rejected Chapter 9 as a solution and instead installed an essentially independent Chief Financial Officer who balanced the district budget and was instrumental to its financial recovery. More recently, in the wake of

[2] Detroit filed its plan and commenced the confirmation hearing before the emergency manager's tenure ended in September 2014. Judge Rhodes strongly encouraged the City of Detroit to keep the emergency manager and his team involved in the case until the confirmation order was entered in December 2014.

Harrisburg's Chapter 9 petition being rejected, the City installed a receiver to cut costs, monetize assets, and achieve structural reforms that have bolstered the City's finances and put the City on a path to full financial recovery.

Therefore outside of Chapter 9, the municipality will fix – under the Constitution, must fix – its operational problems rather than cut payments to bondholders. Inside Chapter 9, the reverse is true – the focus of Chapter 9 is on debt adjustment.[3] Under Chapter 9, the municipal government retains control – which enables the political factions who created the insolvency to retain their influence and prevents structural reform, and results only in the discharge of debt and not the structural reforms necessary for the long-term revival of the municipality. For example, in the Chapter 9 cases of Vallejo and Stockton, those municipalities cut their bonds – indeed, cut everything – rather than reduce the structural costs that were a principal cause of their financial collapse. The result: a few short years after Vallejo emerged from bankruptcy, it is back in financial crisis. See Exhibit B.

PREPA's own situation shows that a non-political receiver would be far superior to the maintenance of PREPA's current politicized management in Chapter 9. As PREPA's chief restructuring officer, Lisa Donahue, recently testified:

> For many years, PREPA has been run by successive Boards of Directors and senior management teams *that have been subject to changing direction and policies of different administrations. Management and other strategic decisions, including staffing and capital investment, too often have been based on political consideration rather than best practices or sound business judgment* . . . .
>
> Once a crown jewel of the island, PREPA's situation has deteriorated over the years to become one of the island's most challenged public corporations. These challenges include a lack of institutionalized processes and procedures, outdated systems and information technology[], *and frequent changes of employee positions and responsibilities with each electoral cycle. Staffing decision are made often without regard for prior experience or expertise given the nature of PREPA's role in the political process. This pattern has made it difficult for PREPA to tackle critical multi-year projects such as environmental compliance and capital investment. In the past, scarce capital has been spent on multi-year expensive projects that later administrations have determined not to pursue* . . . .[4]

(Emphasis added).

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[3] *See Report of the House Committee on Government Reform and Oversight to Accompany H.R. 1345, District of Columbia Financial Responsibility and Management Assistance Act*, H.R. Rep. No. 104-96, at 16-17 (1995) (declining to authorize Chapter 9 for the District of Columbia because relief under Chapter 9 is limited to debt adjustment, and instead imposing an emergency financial control board). The same report recommended against a federal receivership on the ground that it would invade the District's sovereignty – a concern not raised with PREPA, given the oversight of the Energy Commission. *Id.* at 17-18.

[4] Prepared Statement of Lisa Donahue in connection with her testimony before the Energy Affairs and Water Resources Commission on April 14, 2015 at 3-4, available at http://www.aeepr.com/Docs/Lisa%20Donahue%20PR%20Senate%20Statement%204-14-15.pdf.

The PREPA board's composition makes it subject to political pressure. Prior to the enactment of a new law in 2014, six of the nine members of the PREPA board were appointed by the Governor (with the advice and consent of the Senate), and the seventh member was the Secretary of Transportation and Public Works – also a Governor appointee. Under current law, the nine-member PREPA board includes four members appointed by the Governor with the advice and consent of the Senate and, as *ex oficio* members, the Secretaries of Transportation and Public Works and of the Department of Economic Development and Commerce, both appointed by the Governor.[5] The political manipulation of the Board described by Ms. Donahue has, in fact, worsened during the past two years. Less than 30 days after the current Commonwealth administration came into power, it submitted House Bill 715, which subsequently became Law 29 of 2013, which essentially ousted the PREPA board members before their fixed terms were over. This unprecedented law has removed virtually all political and operational autonomy that PREPA may have ever had.

Therefore, Ms. Donahue's own efforts to fix these problems are, by definition, subject to the political winds of the next election.

A receiver can implement operational fixes without regard to the political winds, subject to court review in a public process where all stakeholders can seek relief. By contrast, Chapter 9 bankruptcy would ensure the continuation of political influence over PREPA, because Section 904 of the Bankruptcy Code prohibits the bankruptcy court from ordering PREPA (or any other municipality) to do anything. As Professor John Pottow effectively admitted at the February 26 hearing, the only remedy bondholders have in a Chapter 9 case is to persuade the bankruptcy court to dismiss the Chapter 9 petition.[6]

Detroit's plan and confirmation decision show how little "certainty" is offered by Chapter 9. Dissentors argued that the plan contained "unfair discrimination" against classes of creditors under the Bankruptcy Code, because certain unsecured creditors would receive a recovery of as little as 13%, while other unsecured creditors received more than 59-60%.[7] Judge Rhodes (in a decision without precedent) held that "unfair discrimination" depended on the "conscience of the court" as informed by his own "personal experience."[8] Detroit thus shows that an unsecured creditor's recovery in Chapter 9 can depend on the personal whim of the presiding bankruptcy judge, without anchor to any rule of law.

Finally, I do not agree that receivership is a novel or untested proceeding. At least 20 municipalities (or political subdivisions, like school districts) have gone through receiverships or "emergency manager" proceedings (the Michigan statute specifically states that the emergency

[5] See 22 L.P.R. § 194, as amended by Act 57 of 2014.
[6] February 26, 2015 Hearing Transcript at p. 45.
[7] *In re City of Detroit*, 524 B.R. 147, 253-54 (Bankr. E.D. Mich. 2014).
[8] *In re City of Detroit*, 524 B.R. 147, 253-56 (Bankr. E.D. Mich. 2014).

manager has "broad powers in receivership");[9] at least 20 more have had financial advisory boards managing their finances. Jefferson County, Alabama's sewer system is most comparable to PREPA. Like PREPA, Jefferson County's sewer system was badly run, had issued billions of dollars in bonds, and had not raised rates for years. When the bonds defaulted, bondholders obtained a receiver who was granted plenary powers to run the sewer system. In less than a year, the receiver developed a plan involving operational and capital improvements, rate increases and debt adjustments. The County filed for Chapter 9 after a settlement fell through that would have allowed the receiver to fix the sewer system's problems and raise rates.[10] In the end, Chapter 9 merely added two years of litigation before the bankruptcy court approved a plan substantially similar to the receiver's plan – the validity of the rates is still being challenged on appeal.[11]

What PREPA needs is to improve efficiency and cut unnecessary operational costs, which are excessive compare to comparable utilities.

To summarize, restructuring under bondholder documents and applicable state law (such as the PREPA receivership statute) offers bondholders the certainty that the municipality will cut their payments only to the *least extent necessary*. Restructuring under Chapter 9 offers the certainty that the municipality will cut bondholder payments to the *greatest extent possible*.

I therefore conclude, as a bankruptcy practitioner, that restructuring under bond documents and applicable state law offers bondholders substantially greater certainty than a restructuring under Chapter 9.

[9] Mich. Comp. Laws § 141.1549 (2012).
[10] *See In re Jefferson County*, 474 B.R. 228, 244 (Bankr. N.D. Al. 2012).
[11] The receiver's plan would have provided $2.05 billion to redeem $3.136 billion of sewer warrants – a 65.4% recovery for sewer warrantholders – and proposed sewer rate increases of 8.2% for each of the first three years and projected future increases thereafter of no more than 3.25%. Jefferson County's confirmed plan of adjustment provided 65% recoveries for sewer warrantholders who did not make a commutation election (80% for those who did) and required sewer rate increases of 7.89% for the first four years and 3.49% for the remaining life of the sewer warrants.

EXHIBIT A

ESSAYS ON ISSUES | THE FEDERAL RESERVE BANK OF CHICAGO | NOVEMBER 2013 NUMBER 316

Chicago Fed Letter

Detroit's bankruptcy: The uncharted waters of Chapter 9

by Gene Amromin, senior financial economist, and Ben Chabot, financial economist

On July 18, 2013, Detroit became the largest municipality to seek protection under Chapter 9 of the U.S. Bankruptcy Code. This article describes several ways in which Detroit's bankruptcy filing has the potential to alter some of the key assumptions of municipal bond (muni) finance, and examines the market reaction to date.

> To date, Detroit's bankruptcy filing has had little impact on the cost of municipal financing outside of Michigan, but it has the potential to set a number of precedents with far-reaching consequences.

Chapter 9 provides financially distressed local governments, such as the City of Detroit, protection from creditor claims in the federal bankruptcy courts, subject to a number of state-level restrictions.[1] Michigan is one of 24 states that allow their municipalities to seek Chapter 9 protection. Although the federal requirements for bankruptcy are explicit,[2] the paucity of Chapter 9 filings and the variability in state legal environments effectively make every new case a complex and protracted matter. This holds particularly true for Detroit's filing, which is notable for its sheer size, the multitude of competing claims, and the historical and economic contexts in which the bankruptcy is playing out. Indeed, the intensity of media coverage surrounding Detroit indicates the extent to which the bankruptcy filing of the once-thriving industrial icon has resonated with the American public. In this *Chicago Fed Letter*, we describe how municipal bankruptcy unfolds in Michigan, how Detroit's filing has the potential to change some of the key assumptions of municipal bond finance, and what the market reaction has been thus far.

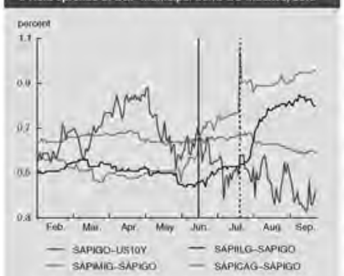
Municipal bankruptcy in Michigan

A unique feature of Michigan law is the ability of the governor to appoint an emergency manager (EM) to take over operations of financially distressed units of local governments, ranging from school districts to entire municipalities. Shortly after the state's February declaration that the City of Detroit was in a financial emergency, Governor Rick Snyder appointed Kevyn Orr as Detroit's EM. Under new legislation that went into effect on March 28, 2013, governor-appointed EMs are allowed to take extraordinary measures, including modifying or terminating collective bargaining agreements and recommending that the municipality enter Chapter 9 bankruptcy.[3] When Chapter 9 protection is sought, the EM has the sole power to propose a restructuring plan to the bankruptcy court.

Obtaining bankruptcy protection is far from straightforward, however. Although Michigan permitted Detroit to seek bankruptcy protection, the bankruptcy judge must determine whether the city is insolvent and can adjust its debts. The judge must also determine whether Detroit, as represented by the EM, had negotiated in good faith with its creditors and had failed to obtain an agreement outside of court. Moreover, the court must rule on a number of legal objections to Detroit's Chapter 9 eligibility—which range from whether Chapter 9 is itself constitutional to whether the state authorization for the city's bankruptcy filing is invalid in light of Michigan's state constitutional protection of pensions.

If the bankruptcy court upholds Detroit's eligibility for Chapter 9 protection, the

1. Yield spreads of S&P municipal bond GO indexes, 2013



Notes: The plots are the spreads between the yields of Standard & Poor's (S&P) municipal bond general obligation (GO) indexes (or those of an S&P index and ten-year U.S. Treasury bonds). SAPIGO indicates the nationwide S&P Municipal Bond General Obligation Index. US10Y indicates ten-year U.S. Treasury bonds. SAPIMIG indicates the S&P Municipal Bond Michigan General Obligation Index. SAPIILG indicates the S&P Municipal Bond Illinois General Obligation Index. SAPICAG indicates the S&P Municipal Bond California General Obligation Index. The solid vertical line indicates the first trading day (June 17) after the Detroit emergency manager's proposal to creditors. The dashed vertical line indicates the first trading day (July 19) after Detroit's bankruptcy filing.
Source: Authors' calculations based on data from Standard & Poor's.

city will file its restructuring plan (i.e., its "plan for adjustment of debts"), which will outline proposed payments to different types of creditors. Unlike corporate bankruptcy, there is no provision in Chapter 9 allowing creditors to file their own plan. Moreover, the court can force the acceptance of the city plan as long as a majority of *any* class of the impaired creditors accepts the proposal. As a result, creditors have few opportunities to challenge restructuring in Chapter 9.

Much of the market commentary and news coverage to date has centered on the EM restructuring proposal, presented to creditors on June 14, 2013.[4] Although the EM proposal is in no way binding and may end up being quite different from the final plan for adjustment of debts, it provides a basis for the expected treatment of various types of debt. As such, the proposal created considerable controversy, since it ignored several conventional approaches to prioritizing and valuing liabilities of a bankrupt municipality.

Unique aspects of the EM proposal

To understand the unorthodox nature of the EM plan, one needs to decompose Detroit's liabilities into specific categories. Detroit's largest single obligation is the approximately $6 billion in water and sewer bonds that are backed by the specific pledge of revenues from the city's utility system. Detroit also has about $1 billion in outstanding general obligation (GO) debt. GO debt is typically paid out of the overall tax revenues and does not have a dedicated repayment source. However, Detroit's GO debt comes in a number of different flavors. Some GO debt, known as unlimited tax general obligation (UTGO) bonds, was issued with explicit voter approval that commits the city to levy unlimited taxes for repayment. Other GO debt, known as limited tax general obligation (LTGO) bonds, was issued directly by the city and can only be paid from general funds. Moreover, some of the UTGO and LTGO bonds have separate streams of committed revenues coming from the state and are, therefore, referred to as "double-barreled" bonds. These distinctions highlight the fact that various GO bonds can enjoy different forms of legal protection and can count on different sources of revenues for their repayment.

In addition to bonded debt, Detroit's liabilities comprise outstanding pension and other post-employment benefit (OPEB) obligations, mainly for medical insurance coverage, to both current and retired city workers, police, and firefighters. The pension and OPEB obligations have been valued in the EM plan at $3.5 billion and $5.7 billion, respectively. The remaining components of Detroit's liabilities are two sets of financial securities closely related to its pension obligations—pension obligation certificates (POCs) and the associated swap contracts that convert variable-interest payments on POCs into fixed-rate obligations. The POCs and associated swaps have been valued in the EM plan at $1.5 billion and $0.8 billion, respectively.

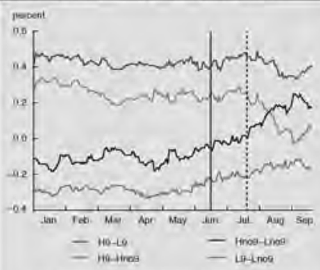
Chapter 9 bankruptcy grants senior status to debts secured by the pledge of specific revenues (e.g., the water and sewer system bonds secured by utility bill payments). All other debts are treated as equally unsecured under the law. As senior debt is repaid first, all other debts can be repaid only from the revenues that are left over. Put differently, every dollar of debt that is regarded as being secured diminishes the pool of money available for repaying unsecured claims. Theoretically, this suggests that all unsecured debt is impaired (i.e., repaid less than fully) in bankruptcy. The exact degree of impairment of each type of unsecured debt is determined during the bankruptcy process.

In practice, however, municipalities seeking Chapter 9 protection have previously treated GO debt as senior to other unsecured claims such as pensions in their debt adjustment plans. This meant that GO bondholders were typically repaid in full, even as some pension and OPEB obligations were diminished. In fact, between 1970 and 2011 (when Jefferson County, Alabama, filed for bankruptcy), no GO bond in the Moody's credit rating universe was impaired in a Chapter 9 bankruptcy.

Yet, the EM proposal called for steep cuts in payments to most bondholders, as well as to pensions being received by retirees, pension and OPEB obligations owed to current employees, and POCs held by pension creditors. Only the water and sewer system bonds and double-barreled UTGO and LTGO bonds were regarded as secured and thus subject to repayment in full. On average, the unsecured creditors were offered about ten cents on each dollar in claims they held.

The EM's proposed placement of some GO bonds on the same footing as retirement and employment obligations surprised market participants. It triggered extensive commentary on the need for investors to rethink their assumptions about recovery values of GO debt in bankruptcy. Although Detroit's combination

2. Yield spreads of municipal bond portfolios, 2013



Notes: The sample of 92 bonds was selected by choosing at most two bonds from each issuer from the set of uninsured fixed-rate general obligation bonds issued by the cities included in Pew Charitable Trusts (2013). When multiple bonds from the same issuer met these criteria, the two with a maturity closest to ten years were selected. H9 is a portfolio of bonds issued by cities with high per capita pension and other post-employment benefit (OPEB) obligations located in Chapter 9 states. L9 is a portfolio of bonds issued by cities with low per capita pension and OPEB obligations located in Chapter 9 states. Hno9 is a portfolio of bonds issued by cities with high per capita pension and OPEB obligations located in non-Chapter 9 states. Lno9 is a portfolio of bonds issued by cities with low per capita pension and OPEB obligations located in non-Chapter 9 states. "High" and "low" obligations are defined as above and below the median, respectively. The plots are the spreads between the weighted average yields of the portfolios. The solid vertical line indicates the first trading day (June 17) after the Detroit emergency manager's proposal to creditors. The dashed vertical line indicates the first trading day (July 19) after Detroit's bankruptcy filing.

Source: Authors' calculations based on data from Bloomberg and Pew Charitable Trusts (2013).

of financial woes and structural economic problems is unique, a substantial number of local governments nationwide face large pension and OPEB obligations. For these governments and their creditors, Detroit's case is a potential bellwether.

Another surprising aspect of the EM proposal was its failure to differentiate between debt backed by the unlimited tax pledge and debt lacking such a pledge. UTGO debt is typically repaid from a special property levy that has no limit and, as such, relies on revenues that are entirely separate from those used to cover general-fund operations.[5] This feature of UTGO debt makes it quite similar to other secured debt, contrary to the EM's statements implying that none of the GO bonds have legal security. This issue will be ultimately settled by the court, and it might have wide-reaching consequences for the pricing of voter-approved GO debt.

Implications for municipal bonds

In the preceding section, we touched on the potential market ramifications of legal rulings with respect to the treatment of pension and OPEB obligations, as well as GO debt backed by unlimited tax pledges. The standing of pension obligations relative to other municipal liabilities is particularly important to bondholders and the broader public given the multitude of well-publicized funding shortfalls in a great number of American cities. For example, data from a recent Pew Charitable Trusts study of large cities indicate that they have funded only 57.5% of the $511.2 billion of retirement benefits promised to their employees.[6]

There is a conflict between state and federal laws as to whether pension obligations can be impaired by a federal bankruptcy court. Michigan's state constitution prohibits reductions of promised pension benefits, but Detroit's EM argues that Michigan law allows for pension cuts in federal bankruptcy court. Pension funds have challenged the EM's interpretation on the grounds that it violates both the Tenth Amendment to the U.S. Constitution and state law. To date there is no jurisprudence addressing the question of whether a municipality can diminish pension obligations protected by a state constitution. If the court agrees with pension creditors that state protections hold supreme, this could change market expectations with respect to the relative standing of municipal debt issued by cities located in states with such protections (e.g., Chicago, Los Angeles, and New York City). Furthermore, any precedent that makes pension obligations senior to municipal bonds on broad Tenth Amendment grounds could have a material effect on the pricing of municipal debt for any city with large underfunded pension obligations.

How have the markets reacted thus far?

Apart from Michigan municipalities, the market reaction to the Detroit bankruptcy filing has been negligible. In the week following the EM's June 14, 2013, proposal to subordinate GO bonds, the difference (spread) between the yield on the nationwide Standard & Poor's (S&P) Municipal Bond General Obligation Index (SAPIGO) and the yield on ten-year U.S. Treasury bonds declined 8 basis points (figure 1). The SAPIGO–ten-year U.S. Treasury bond yield spread did increase by 9 basis points the day after Detroit's Chapter 9 filing on July 18 but quickly returned to its pre-bankruptcy level. In contrast, the spread between the yield on the S&P Municipal Bond Michigan General Obligation Index (SAPIMIG) and the yield on SAPIGO increased 14 basis points following the EM proposal. The spread further jumped by 29 basis points on the day after Detroit's bankruptcy filing and has remained elevated since, suggesting that the filing has had a material impact on borrowing costs of Michigan municipal issuers.

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Although the market penalized Michigan municipal issuers, there was little immediate price impact in municipalities with large unfunded pension obligations located in other states. Figure 1 graphs the yield spread between S&P municipal bond GO indexes for California (SAPICAG), Illinois (SAPIILG), and Michigan and the nationwide SAPIGO. Illinois debt issuers, in particular, have faced recent credit downgrades because of unfunded pension obligations and legislative stalemate in addressing this issue, so the SAPIILG–SAPIGO yield spread increased noticeably in August.

Did the muni market start demanding a larger risk premium for issuers with large pension and OPEB liabilities in the wake of Detroit's bankruptcy filing? To answer this question, we selected 92 bonds issued by cities in Pew Charitable Trusts (2013) and sorted these bonds into four equal-duration portfolios based on issuers' per capita pension and OPEB obligations and whether the issuer was located in a Chapter 9-eligible state. The yield spreads between these bond portfolios are graphed in figure 2. The baseline series labeled (H9–L9) depicts the difference in yields on bonds issued by cities with high obligations located in Chapter 9 states and bonds issued by cities with low obligations located in Chapter 9 states. The H9–L9 yield spread is remarkably stable around the dates of the EM proposal (June 14) and Detroit's bankruptcy filing (July 18). Market participants appear to require no more compensation to hold bonds issued by cities with obligations that are subject to Chapter 9. In fact, the yield spread between bonds from high-obligation issuers located in Chapter 9 states (H9) and those from similar issuers located in non-Chapter 9 states (Hno9) declined approximately 20 basis points in the month after Detroit's bankruptcy filing. Over the same period, the yield spread between bonds issued by high- and low-obligation cities located in non-Chapter 9 states (Hno9–Lno9) increased. This evidence suggests the absence of any systematic discrimination against issuers located in Chapter 9 states or issuers with high per capita pension and OPEB obligations following Detroit's bankruptcy filing.

Conclusion

As of this point, Detroit's bankruptcy filing has had little impact on the cost of municipal financing outside of Michigan. Nonetheless, Detroit's case has the potential to set a number of precedents with far-reaching consequences, such as the treatment of pension and OPEB obligations vis-à-vis bonded debt, the degree of protection afforded by state constitutions, and the value of the unlimited tax pledges approved by the electorate. The resolution of these issues in court will change the shape of municipal financial markets for years to come.

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[1] For details, see Gene Amromin and Anna Paulson, 2011, "Tempestuous municipal debt markets: Oxymoron or new reality?," *Chicago Fed Letter*, Federal Reserve Bank of Chicago, No. 291, October.

[2] Section 109(c) of the U.S. Bankruptcy Code sets forth the eligibility requirements for Chapter 9.

[3] The new EM law (Public Act 436) was passed after Michigan voters had repealed the previous version of the law (Public Act 4) in a November 2012 referendum. Both of the EM laws are subject to several lawsuits challenging their constitutionality.

[4] The EM plan is available at www.freep.com/assets/freep/pdf/C4206913614.PDF.

[5] The official statement for 2008 UTGO bonds states: "In accordance with State law, the City is obligated to levy and collect taxes without regard to any constitutional, statutory or Charter tax rate limitations for payment of such obligations," quoted on p. 15 of www.scribd.com/doc/159347508/Barclays-Municipal-Research-Detroit-Chapter-9-Begins.

[6] Authors' calculations based on data from Pew Charitable Trusts, 2013, "A widening gap in cities: Shortfalls in funding for pensions and retiree health care," report, Washington, DC, January, exhibit 1, p. 3.

Detroit Free Press (Michigan)

December 9, 2012 Sunday

SECTION: FRONT PAGE

LENGTH: 2848 words

HEADLINE: Detroit bankruptcy would be long, painful

BYLINE: By, Matt Helms

BODY:

Free Press Staff Writer

Detroit's seemingly intractable financial crisis is bringing to the fore talk about Detroit becoming America's largest city to go bankrupt.

But Detroit filing for Chapter 9 municipal bankruptcy protection would be a drastic last option, one that would ignite a costly battle with lawyers representing creditors, city worker unions and retirees that could last for years, bankruptcy experts say.

Detroit could end up with legal bills in the hundreds of millions of dollars and far more cuts in its already-meager public services, meaning potentially fewer cops and firefighters and more city departments privatized or eliminated outright. Workers could be terminated, and those who stay would face deep pay and benefits cuts. A federal bankruptcy judge could allow the city -- or the state, through an emergency financial manager -- to rewrite labor contracts or toss them out altogether. The city could find itself proposing the sale of major city assets to pay down its enormous debts.

"It's a situation of 'Be careful what you wish for.' " said John Pottow, a University of Michigan Law School professor whose expertise is in bankruptcy law.

Those who think it would be better to move the battle over Detroit's financial future out of political deadlock in the corridors of City Hall and the state Capitol and into a federal courtroom might be surprised at what Pottow calls "a new normal." He sees federal bankruptcy judges becoming much more aggressive in forcing change on distressed local governments.

"The judges are much more involved," Pottow said. "They're reflecting an amenability to serious labor cuts, and I think that's surprising to a lot of people who didn't think they'd do much in bankruptcy. We are in a new era of Chapter 9 and using it in new ways. It's an unknown, uncharted and unpredictable process."

To be sure, Detroit Mayor Dave Bing and Gov. Rick Snyder say they want to avoid a bankruptcy filing for Michigan's largest city.

That wish was underscored last week with Treasurer Andy Dillon's blunt warning that unless Detroit can manage a seemingly impossible amount of change in the next five weeks -- including the City Council approving crucial contracts on Tuesday aimed at restructuring city government -- the state will be left with little choice but to appoint an emergency financial manager. Dillon said the 30-day review process to install a manager will begin this week.

But given the slow pace of reform and the political clash over how to get there, it's becoming increasingly unlikely Detroit can remain solvent. Snyder told the Free Press last week that his staff has begun reviewing municipal bankruptcies in other states, and the picture is not one they want to replicate in Michigan.

One high-ranking city official, speaking on condition of anonymity, confirmed that Dillon told city officials the state has begun preliminary discussions about the level of losses the state might ask the city's major creditors to take in case bankruptcy can't be avoided. The Bing administration insists it's working on a turnaround and not bankruptcy. But on Friday, Bing acknowledged it's a possibility that he's working strenuously to avoid.

Douglas Bernstein, who leads the banking, bankruptcy and creditors' rights practice at Plunkett Cooney law firm in Bloomfield Hills, said that although he couldn't comment directly on what's happening in Lansing with Detroit's crisis, "such preparations are prudent because there's contingency planning that has to be done."

"Ideally, you hope to do a restructuring outside of bankruptcy -- bankruptcy being the last resort," Bernstein said Friday. "That being said, you should have a contingency plan in the event you're unable to do it."

'It's going to be hard'

Bing and his staff had hoped for more time for Detroit's financial stability agreement to extract reforms through pay cuts to city workers and reductions in pension and health care benefits. City officials say the cuts could save Detroit more than $100 million a year, and the savings will begin to bear fruit in early 2013.

Unlike a federal bankruptcy judge who may have little or no ties to Detroit, the joint city-state financial advisory board that has major sway over the city's finances has considered both the urgent need to fix Detroit's budget crises and the need to maintain crucial public services, said William (Kriss) Andrews, the program management director overseeing Detroit's reform agenda.

"They've taken a wise and broad view, an enlightened view, of its charter to do both things," Andrews said. "We fully intend to be successful. It's going to be hard, and we recognize that."

Andrews was adamant that the city does not want to file for Chapter 9 and is not working on preparations for it or exploring the potential impact.

"There could be all sorts of implications, and trying to sort them all out right now is premature and inappropriate," Andrews said. "Right now, we're trying to implement the reform agenda, and that's what we're working on."

Council action

The council is scheduled to vote Tuesday on new contracts for auditing firms to review fraud in the city's workers compensation claims and in health care dependency eligibility, and another to review how Detroit collects property taxes.

The council also will revisit a controversial $300,000 contract for the Miller Canfield law firm, which Bing hired to advise him on the city's consent agreement. The council previously rejected the contract, saying the law firm has conflicts of interest because it helped write the state's now-repealed emergency manager law, as well as the financial stability agreement that so far has failed to fix Detroit's fiscal mess.

Those contracts are among several goals Bing and the state agreed to meet in order for the state Treasury to release $30 million in bond proceeds to keep the city afloat. Bing warned city employees that there will be widespread furloughs beginning in January and layoffs as soon as he can negotiate them with city unions -- even if the city gets the $30 million.

The deadlock was underscored when Moody's Investors Service downgraded Detroit's bond rating deeper into junk status. Moody's cited uncertainty after the repeal Nov. 6 of Public Act 4, the emergency manager law, as weakening state oversight of Detroit and raising the risk of a city bankruptcy or default in the next 12-24 months.

Bing's administration says the city will be able to make payroll through the end of the year, but the city is on track to be $47 million in the hole by June 30 without an influx of cash from the $137-million bond sale that was intended to keep Detroit solvent while it restructures.

Andrews said Detroit is not now at risk of missing debt payments, and he and Bing's office said they believed the city will be able to manage the cash crisis with furloughs and other cuts yet unidentified. Union officials, however, question whether the savings from furloughs outweigh the disruption to city services.

But absent the ability of the city to significantly modify collective-bargaining agreements -- a power that died with Public Act 4 -- "I think it ends up being inevitable" that Detroit will file for bankruptcy, Bernstein said.

"At some point, the city is going to be at the brink where it can no longer afford to negotiate and it has to move forward with a plan," Bernstein said. "I don't know right now what that point is or what date."

About the process

A bankruptcy filing would be a complicated, painful process that could stretch out for years, lengthened in no small part by political divisions and opposition from city unions and creditors.

Bernstein noted that without appointment of an emergency financial manager, there could be a legal battle between Bing and the council over who represents the city in bankruptcy court, and legal challenges from retirees and creditors over whether Detroit qualifies for bankruptcy protection.

To qualify for bankruptcy protection, Detroit would have to prove:

· It is unable to pay bills as they come in.

· It wants to create a plan to fix its financial problems.

· It has either reached agreement with a majority of its creditors or negotiated in good faith with creditors but has been unable to reach a resolution.

That area of law is one of the main drawbacks to a bankruptcy filing, spurring costly, time-consuming battles as creditors "fight like banshees over the efficacy of the petition, whether the petition should be filed," said Andrews, who before being hired by Bing worked as an executive for a company that filed Chapter 11 bankruptcy in February and ended up laying off 300 employees. "And months go by with you only paying professionals to argue about whether you have the right to file in the first place."

Andrews wouldn't speculate on what sorts of cuts the city might seek, but the stakes are clear. Detroit's long-term debt alone exceeds $12 billion in retiree pension and benefits costs and bonds. That would make it by far the largest U.S. municipal bankruptcy ever. Detroit, with about 700,000 residents, also would be the largest city by population to have filed for Chapter 9.

'A stigma attached'

Despite recent high-profile bankruptcy filings, Chapter 9 occurs infrequently compared with corporate or personal bankruptcies, with fewer than 700 filed since the 1930s, experts say. A Detroit bankruptcy would put the city in company with a growing number of municipalities across the country that ran into deep trouble amid the Great Recession and its housing crash. That recession was exacerbated in the Motor City by rapid depopulation, high poverty rates, blight and loss of manufacturing jobs.

Detroit's debts dwarf the more than $4.2-billion bankruptcy filing in 2011 of Jefferson County, Ala., with Birmingham as its county seat. That bankruptcy was triggered largely over a sewer bond debt.

The largest U.S. city to file for Chapter 9 was Stockton, Calif., population 300,000, with $700 million in bond debt and nearly $150 million in unfunded pension obligations. That city east of San Francisco filed for bankruptcy protection in June, followed just weeks later by the smaller San Bernardino, east of Los Angeles, with $1 billion in debt.

Part of what has kept municipal bankruptcies low compared with corporate or personal bankruptcies is the badge of shame associated with it, Bernstein said.

"From a city standpoint, right or wrong, there's still a stigma attached," he said. "In the old days, it was perceived that if you filed for bankruptcy protection, you'd failed. In my practice, the stigma is reduced, but in certain circumstances, it's still there."

Bernstein argues that there's an optimistic side to bankruptcy, giving cities the chance to clear out debt, reduce legacy costs and restructure government with a "clean sheet going forward."

But it's a painful process to get there. Municipal bankruptcies can result in reduced public services, further work force cuts, consolidation or elimination of some departments and drastic reductions to pay and benefits for workers who keep their jobs. Current workers and retirees could lose health care benefits outright or see them significantly scaled back. Those are among the costs strangling Detroit, which already has reduced health care and pension benefits for current city workers and trimmed health care for retirees.

It also could mean new taxes on residents, workers and businesses to boost the city's revenue, although hefty increases aren't likely, Pottow said.

"Substantial tax increases to raise revenue is not viable for a city as economically fragile as Detroit," Pottow said. "Creditors aren't stupid. They know that."

'Bankruptcy hangover'

Vallejo, Calif., is still recovering from three years in Chapter 9, a year after it emerged from bankruptcy, having spent $12 million in legal fees alone.

The shipyard town filed for bankruptcy in May 2008, buried under what City Manager Daniel Keen said were generous pay and benefits packages the town northeast of San Francisco could no longer afford.

Today, Vallejo operates on a comparative shoestring. Before bankruptcy, the city of 115,000 residents had 148 police officers; it's now down to 93. The city said it had no choice but to close several fire stations. Every department in the city took at least a 25% cut in staffing. Vallejo stopped street maintenance for several years. It whittled previously generous health care benefits for most employees to what Keen said is now a minimal plan. And a bankruptcy judge approved dissolving some employee union contracts and restructuring others.

Keen said the city's work force of about 500 now is "a bare-bones of staff doing the same work required to serve a city of 115,000 people."

"The public safety needs didn't go away. We didn't have fewer police situations. We didn't have fewer fires. We didn't have fewer street problems," Keen said. "It's been a real challenge."

But worse, he said, is the perception of financial failure. Keen said he's working to give people confidence that Vallejo is a city that works within its means to grow its economy.

"The decision to go into bankruptcy has changed the relationship of the city to its residents, and the stigma of going into bankruptcy is not something I would wish on anyone," Keen said. "Time will tell how long it takes to get rid of that reputation. We're going to be dealing with the bankruptcy hangover for a long time."

Detroit council President Charles Pugh acknowledges that his city faces those same prospects, despite its often acrimonious efforts to reduce costs and cut wages and benefits to avoid deeper state intervention.

"It's frustrating and scary at the same time," said Pugh, who still considers Chapter 9 a last resort.

"We can't keep spending money we don't have, either," he said. "At some point, we have to come to a resolution. Plans on paper are only as good as their execution. The reality is, it would be painful."

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More Details: Q+A about bankruptcy

How would Chapter 9 bankruptcy affect the residents of Detroit? Here are some answers to common questions.

QUESTION: Might city services be cut more?

ANSWER: It would certainly be an option. Detroit Mayor Dave Bing and the City Council already have worked to transfer the city's health and human services departments to private nonprofit entities, for example, and Bing privatized management of the Detroit Department of Transportation. City officials or an emergency financial manager could propose more of the same in other departments.

Q: As a resident, would my taxes go up?

A: Quite possibly. The city could choose from a variety of taxes to raise, although experts say steep increases aren't likely because residents and businesses already are highly taxed, and more taxes could hurt an already fragile city.

Q: Could Detroit be forced to sell off assets?

A: Under the federal bankruptcy code, creditors and judges can't force the city to do so, but the city or an emergency financial manager could propose selling assets to pay debts - provided that wouldn't adversely affect crucial public services or violate the city charter.

Q: Can union contracts be terminated?

A: Yes. The city or an emergency financial manager could propose hig changes or dissolve them altogether, provided the judge sees it as legal and the best way forward.

Q: What about my pension?

A: If you're already retired and collecting a pension, that benefit is pretty much untouchable. But pension benefits for current workers could be significantly reduced or restructured.

Q: What about health care benefits?

A: They could be cut drastically or eliminated, for both retirees and active city workers, if the city seeks that option and a bankruptcy judge approves it.

What happens under Chapter 9

· Under current state law - which could change if the Legislature and Gov. Rick Snyder approve a new emergency manager law this week - the only person who can request a municipal bankruptcy is an emergency financial manager appointed by the state.

· That manager would recommend bankruptcy to the local emergency financial assistance loan board, a committee of gubernatorial appointees who could either accept or reject it.

· Voters repealed Public Act 4 in November, and although the governor and state Attorney General Bill Schuette say the state reverts to its previous law - Public Act 72 - that's being challenged in court by unions. If not an emergency financial manager, it's not clear whom the city might select to handle a potential Chapter 9 filing, or whether Mayor Dave Bing and the City Council could agree on one candidate.

· If Snyder's board were to approve a bankruptcy filing, the chief judge of the Cincinnati-based U.S. 6th Circuit Court of Appeals would appoint a judge to handle the case. Creditors, unions and others fearful of losing money or benefits could mount a lengthy challenge on whether the city qualifies for Chapter 9 under the federal bankruptcy code. Given the stakes and the amount of Detroit's debts, the entire process could drag out for years and cost the city hundreds of millions of dollars in legal fees.

LOAD-DATE: December 11, 2012

theguardian

The Guardian (London) - Final Edition

July 19, 2013 Friday

SECTION: GUARDIAN FINANCIAL PAGES; Pg. 30

LENGTH: 681 words

HEADLINE: Detroit on brink of $20bn record bankruptcy: City's emergency manager struggles to strike deal Pension funds fight plan to restructure massive debt

BYLINE: Dominic Rushe in New York

BODY:

Detroit, a city now as famous for its collapse as its car industry, appears to be days away from becoming the biggest municipal bankruptcy in history.

Kevyn Orr, the city's emergency manager, is trying to restructure $20bn (£13bn)in long-term debt and is struggling to broker a deal between the city's bondholders and its pension funds.

If no agreement can be reached, the city may file for a Chapter 9 bankruptcy, which allows municipal bodies to reorganise their debts. Such an outcome would dwarf the previous record filings by Jefferson County, Alabama and Stockton, California. Jefferson was the previous record municipal bankruptcy, when it went bust in 2011 owing $3bn.

Pension funds objecting to Orr's plan have taken legal action this week in a bid to stop him from making the historic move.

Other big cities have teetered on the edge of bankruptcy - New York City in 1975, Cleveland in 1978 and Philadelphia in 1991. But all eventually brokered deals rather than face the dire consequences of going bust.

"Detroit has severe difficulties but this would be an extraordinary event," said James Spiotto, a Chapter 9 expert and head of the bankruptcy unit at Chicago's Chapman & Cutler.

A third of Detroit's population of 700,000 live below the poverty line. The city would be even more stigmatised by a filing and its cost of borrowing would soar. Officials could spend years battling in the court over who is owed what. "Chapter 9 is time-consuming, expensive and uncertain," Spiotto said.

Orr, too, has said bankruptcy is not his preferred option. But he may have no choice. Detroit has been hit by a declining population and 40,000 buildings and parcels of land in the city are vacant, according to the Wall Street Journal. The tax take has fallen and spending has been $100m a year more than the amount raised for the past five years.

His plan to avoid plunging the city into bankruptcy is to slash benefits to retired people, including pensions and health-care, and cut already minimal services to the bone. Police officers and firefighters who retire before the age of 55, for example, would get no healthcare under one proposal. Retirement benefits for municipal workers could be just 10% of what they should be due to receive.

Municipal bonds have traditionally been viewed as among the safest available investments but Detroit bondholders will receive just cents for every dollar in debt they hold.

When Central Falls in Rhode Island went bust in 2011, the state passed a law giving bondholders priority over other creditors. Detroit's investors must now be wondering whether bankruptcy would give them a better deal.

Neither side is happy with Orr's plan but they do not seem willing to negotiate a settlement.

The city's two pension boards - the General Retirement System and the Police and Fire Retirement System - sued Orr and Michigan's governor Rick Snyder this week in an attempt to block a bankruptcy.

Orr, a lawyer, was appointed in March after Snyder declared a financial emergency. He previously helped steer Chrysler out of bankruptcy but this is a dilemma of a different magnitude.

Even after years of decline, Detroit remains the US's 18th biggest city. Its finances may have hit an all-time low but its business is bouncing back. The car firms that made the city are back in rude health and downtown Detroit is being revitalised by new businesses.

Some local business leaders believe the city has already hit rock bottom and that a stronger Detroit is already emerging.

Dan Gilbert, founder of the Quicken Loans insurer, has been rebuilding downtown and encouraging new businesses to come and old ones to move back into the city. In a recent interview with the Guardian, he backed Orr's tough financial plans: "He is finally going to do what needed to be done if not in the last several years then in the past decades. It's essentially good news for the city because it means this period is coming to an end."

Captions:

A vacant home in a once thriving neighbourhood on the east side of Detroit, where municipal finances have hit an all-time low Photograph: Rebecca Cook/Reuters

LOAD-DATE: July 19, 2013

NEWSWIRES
Dow Jones News Service

November 23, 2011 Wednesday 10:03 PM GMT

LENGTH: 810 words

HEADLINE: UPDATE: Judge Tosses Harrisburg, Pa., Bankruptcy Case

BODY:

--Governor, unions, bondholders challenged Harrisburg case

--Harrisburg to continue down path toward state receivership

--Harrisburg struggles under $300M in trash incinerator debt

(Updates with market reaction, background throughout.)

By Katy Stech
Of DOW JONES DAILY BANKRUPTCY REVIEW

A bankruptcy judge threw out Harrisburg's controversial Chapter 9 bankruptcy case, putting Pennsylvania's capital city on the path to rehabilitate its financial troubles under the state's control.

Judge Mary France of the U.S. Bankruptcy Court in Harrisburg determined Wednesday that a band of city councilors failed to follow the state's well-defined procedures for distressed municipalities when they put the city of roughly 49,000 residents under bankruptcy protection last month.

"For Chapter 9 bankruptcy to work, all of the branches of a municipality must be on the same page," France said at a court hearing.

State leaders, bondholders and even the city's own mayor had challenged the validity of the city's bankruptcy petition, which was filed Oct. 11 with the signature of city councilor Susan Brown-Wilson. Earlier this year, the state passed an anti-bankruptcy law that discouraged smaller, distressed municipalities from filing for protection--against the threat of losing state aid.

Harrisburg's finances have strained against $300 million in growing debt from an expensive trash incinerator project that was meant to turn the city's waste into energy.

The dismissal leaves the state to move forward on its takeover of the city's finances. Earlier this month, a state agency under the direction of Gov. Tom Corbett asked a state judge to appoint bond attorney David Unkovic as the city's receiver.

The court is expected to give that request a first look on Dec. 1.

Attorney Mark Schwartz, who fought for Harrisburg's petition on behalf of city councilors, criticized the judge for focusing too narrowly on grammatical issues.

"This is the ideal case to end up at the United States Supreme Court," said Schwartz, declining to say whether he would appeal the ruling. "I think she was nervous about declaring a state statue as unconstitutional."

The dismissal should come as a relief to municipal bond market participants, who don't like the unknowns that come with Chapter 9 bankruptcy. Filings are relatively rare from local governments, and there is very little case law that establishes how the process unfolds.

The $2.9 trillion muni market shrugged after news of the dismissal late Wednesday with trading desks thin ahead of Thanksgiving. Still, muni-bond buyers should view the move as a positive, something that could be reflected in prices after the holiday.

"It would be nice if all municipalities and government could survive on tax dollars alone, but the reality is government needs to borrow money in many forms and in so doing it is necessary to respect the criteria and expectations of the financial community," said Neal Colton, who spoke on behalf of the state during the hearing.

Harrisburg's dismissal marks the 82nd municipal bankruptcy since 1980 case that's been thrown out of court shortly after it was filed, according to Jim Spiotto, a partner at the Chapman and Cutler LLC law firm in Chicago who specializes in laws affecting financially troubled municipalities. That's nearly a third of all 261 municipal bankruptcy cases filed since that time.

Nearly half of U.S. states, which are each required to lay out their own rules for how municipalities file for bankruptcy, either prohibit or don't expressively authorize local municipalities to file Chapter 9 protection. Many other set strong limitations on those types of filings.

With such strict and varying rules, the issue of whether a city has the authority to file has become a common and often contentious issue that arises is such cases.

Spiotto said that diplomacy is an often cheaper method of solving problems for cash-strapped cities.

"If we allow a misperception about the creditworthiness of our municipalities, they'll have to pay more in the market which means we'll have to pay more as taxpayers," he said in an interview that took place before the hearing.

Earlier this year, the Chapter 9 case filed by Boise County, Idaho, case was thrown out after it was determined that the county wasn't insolvent even though it faced a multimillion-dollar legal judgment.

The Chapter 9 case filed by Jefferson County, Ala., became the largest municipal bankruptcy in U.S. history when it was filed on Nov. 9, breaking records set by Orange County, Calif., when it sought protection in 1994 with roughly $2 billion in obligations.

(Dow Jones Daily Bankruptcy Review covers news about distressed companies and those under bankruptcy protection.)

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-Kelly Nolan contributed to this article. [11-23-11 1703ET]

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HEADLINE: Rolling the Dice on Municipal Bankruptcies -- WSJ Blog

BYLINE: By Mike Cherney

BODY:

Want to gamble but can't make it to Vegas? Then buy bonds from an ailing municipality.

The amount of money that bond investors get back in municipal bankruptcies varies widely -- even among creditors who own debt with similar characteristics, Moody's Investors Service said this week.

The commentary is timely given the ongoing drama in Puerto Rico, which has about $70 billion in outstanding debt that is widely owned among U.S. investors. The commonwealth has been downgraded to junk recently by two major rating firms, Moody's Investors Service on Friday and Standard & Poor's Ratings Services earlier this week.

Puerto Rico, which has faced a struggling economy in recent years, is not eligible for Chapter 9 municipal bankruptcy, but it is unclear how bond investors would fare if the island could not pay back its debt. Island officials say they are working to improve the commonwealth's finances and have assured investors they will get their money back.

Moody's analysts noted that in the bankruptcy case of Jefferson County, Ala., which was weighed down by more than $3 billion in sewer debt, investors who owned sewer bonds got back 54.1% of their money. However, J.P. Morgan Chase ended up with a recovery closer to 30%. (Moody's did not include in its calculations a fine that J.P. Morgan paid related to a bribery investigation connected to the sewer bonds.) Other creditors got as much as 80%, Moody's said.

Meanwhile, investors who owned general-obligation bonds issued by Central Falls, R.I., made it out of bankruptcy with a 100% recovery. In Vallejo, Calif., investors who owned debt tied to the city's general fund made a recovery of 60% to 75%. In Stockton, Calif., the city wants investment firm Franklin Advisers to accept a 1% recovery rate, while some other investors are getting 100%, Moody's said.

In Detroit, which filed the largest municipal bankruptcy ever last summer, officials are still negotiating with creditors. Still, the city's original proposal included a potential plan for water and sewer bondholders to take a cut. The end result for Detroit bondholders remains uncertain--and the previous cases are unlikely to offer much guidance.

"Recent outcomes in Chapter 9 bankruptcies are distinguished by the circumstances of the particular cases, and therefore do not set broadly applicable precedents," the Moody's analysts wrote.

The data could be skewed by the small number of municipal bankruptcies. From 1980 to 2010, there were just 239 municipal filings, according to the American Bankruptcy Institute. In contrast, there were nearly 44,000 commercial bankruptcy filings in 2013 alone, according to Epiq Systems.

But if you're a betting man, you still might want to wager on municipal bonds than other types of debt. Moody's has said that the ultimate recovery for defaulted municipal debt from 1970 to 2012 was about 60%, compared to 49% for senior unsecured corporate bonds from 1987 to 2012.

More at The Wall Street Journal's MoneyBeat blog, http://blogs.wsj.com/moneybeat/

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REFILE-Two years after bankruptcy, California city again mired in pension debt

* Vallejo struggling to pay pension costs

* Pension fund, city's biggest creditor, only one not touched in bankruptcy

* City's plight a lesson to Detroit, other cities in bankruptcy

By Tim Reid

Oct 1(Reuters) - Less than two years after exiting bankruptcy, the city of Vallejo, California, is again facing a budget crisis as soaring pension costs, which were left untouched in the bankruptcy reorganization, eat up an ever-growing share of tax revenues.

Vallejo's plight, so soon after bankruptcy, is an object lesson for three U.S. cities going through that process today - Detroit, Stockton and San Bernardino, California - because it shows the importance of dealing with pension obligations as part of a financial restructuring, experts say.

The Vallejo experience may be particularly relevant to Stockton, which is further along in its bankruptcy case than Detroit and San Bernardino and has signaled its intention to leave pension payments intact.

All three current bankruptcies are considered test cases in the titanic battle between Wall Street and public pension funds over whether municipal bondholders or current and retired employees should absorb most of the pain when a state or local government goes broke.

"Any municipal bankruptcy that doesn't restructure pension obligations is going to be a failure because pension obligations are the largest debt a city has," said Karol Denniston, a municipal bankruptcy attorney in San Francisco.

"A city like Vallejo can be reasonably managed but it is still going to be flooded out because it cannot be expected to keep up with its pension obligations."

Calpers, the retirement system for California public employees, said it had "reached out" to Vallejo to discuss concerns. "Employers looking to cut costs have some options that can make benefits easier to manage in the near term, some of which Vallejo has already taken," Calpers said in a statement. "We are pleased Vallejo has remained committed to delivering on the pension promises it made to its employees."

Calpers is the largest pension system in the United States and serves many California cities and counties. It has long argued that it has a much wider responsibility than managing pensions for individual cities. It says state law mandates that it is the custodian of the entire fund, and as such is unable to renegotiate pension rates that cities have agreed to with their workers.

Vallejo, a port city of 115,000 near San Francisco that was staggered by the closure of a local naval base and the housing market meltdown, filed for Chapter 9 bankruptcy protection in 2008 with an $18 million deficit.

During its three-and-half year bankruptcy, the city slashed costs, including police and firefighter numbers, retiree health benefits, payments to bondholders and other city services.

The only major expense the city did not touch was its payments to the $260 billion California Public Employees Retirement System.

"We realized we did not have the time or the money to take on a giant behemoth like Calpers," said Stephanie Gomes, Vallejo's vice mayor.

Now city leaders say that growing, and unexpected, costs to Calpers are putting its post-bankruptcy budget under enormous strain. The city budget shows a deficit of $5.2

million for this fiscal year, and that is set to rise to $8.9 million next year unless significant cost savings can be found.

When Vallejo entered bankruptcy in 2008, its annual employer payments to Calpers were $8.82 million, or 11 percent of the city's general fund, according to the city's finance department.

When it exited bankruptcy at the beginning of 2011, the payments to Calpers were just over $11 million, or 14 percent of the fund. The latest budget pegs those payments at $15 million, or 18 percent of the general fund.

The increase comes largely from the recent decision by Calpers to lower its projected investment return rate, from 7.75 percent to 7.5 percent, and to change the way it calculates long-term pension maturity dates.

Those changes mean cities, state agencies and counties must pay rate increases of up to 50 percent over the next decade. Vallejo expects an increase in pension contribution rates of 33 to 42 percent over the next five years.

"Our five-year business plan was based on things we knew," said Deborah Lauchner, the city's finance director.

"Now we have to figure out a way to pay for these new Calpers rates. Every time we react to the last rate change they impose, they come up with another one. I understand they want to improve their funding status, but it's on the backs of the cities."

David Skeel, a bankruptcy law professor at the University of Pennsylvania Law School, said: "Vallejo made a conscious decision under enormous pressure not to mess with Calpers. That is a decision coming home to roost."

Marc Levinson, of the law firm Orrick, Herrington & Sutcliffe, was the lead attorney for Vallejo in its bankruptcy and has the same role for Stockton. He says his clients would welcome pension reform in California, and he is the first to say that contributions to Calpers are a big problem for cities.

http://www.reuters.com/article/2013/10/01/usa-municipality-vallejo-idUSL2N0HM05C20131001

But, Levinson said, dealing with the issue is no simple matter.

"How does a city start a new pension plan when it can't pay its bills?", Levinson said. "How can a city break away from Calpers and still retain employees when other jurisdictions have a pension plan?"

Vallejo has met in full its annual payments to Calpers since exiting bankruptcy, and even accurately projected them.

"But just because a cost is projected does not make it sustainable," said Lauchner, the finance manager.

Dan Keen, Vallejo's city manager, said the only way for the city to meet growing pension costs is to get more concessions from city unions - contract negotiations are underway - and to cut services further.

Keen said options were to slow or freeze hiring and make other cost cuts, for example, at the city marina. But he added: "The reality is we don't have anywhere else to cut."

Gomes, the city's vice mayor, said of Calpers: "It's the biggest part of my city's problem. I don't know any city that can afford it."

http://www.reuters.com/article/2013/10/01/usa-municipality-vallejo-idUSL2N0HM05C20131001