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WHAT BANKRUPTCY LAW CAN AND CANNOT DO FOR PUERTO RICO

CONFERENCE*

JOHN A. E. POTTOW**

INTRODUCTION

I AM GOING TO SPEAK AND THEN LEAVE SOME TIME FOR FURTHER DISCUSSION, among other reasons because I will probably speak too quickly for you to understand half of what I'm saying, and because I may get a little bit too excited getting into the weeds of bankruptcy law, which I'm sure will be almost as exciting for you as hearing the former governor talk about the constitutional status of Puerto Rico. And I see I have some colleagues here who can keep me honest if I go astray. So, what I will do is give a general introduction of what the

* Note to the reader: This article is based on a February 2016 keynote address given at the University of Puerto Rico Law Review Symposium *Public Debt and the Future of Puerto Rico*. Thus, much of it remains written in the first person, and so the reader may imagine the joy of being in the audience. Citations and footnotes have been inserted before publication – sidebars that no reasonable person would ever have inflicted upon a live audience, even one interested in bankruptcy law. Rhetorical accuracy thus yields to scholarly pedantics. JAEP.

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Bankruptcy Code does, how it works, and how it might have applicability to what we will refer to as "The Troubles" for Puerto Rico, financially, right now. We will also talk about some of the proposals that are being developed including, if the audience is interested, about the Supreme Court litigation that is unfolding regarding the bankruptcy proposal that Puerto Rico has put forward. To that end, we will talk about bankruptcy law and its constraints, including Chapters 7, 11, and 9 of the U.S. Bankruptcy Code. Then we will look at sovereign debt restructuring, and finally we will turn to Puerto Rico and Detroit.

I. THE BANKRUPTCY CODE

First thing, what is bankruptcy? Bankruptcy is an area of law that allows the adjustment of contractual and other private law relations. Mainly, it's a discharge of debt. Under our federal Constitution in the United States, the Congress has a power to legislate a uniform bankruptcy law under the Bankruptcy Clause,[1] and that means the power to enact legislation that confers discharge of private debt obligations. Colloquially, I will say it allows the ripping up of contracts and that, of course, is disappointing if you are the counterparty of that contract, but that is what the premise of bankruptcy law is.

A. The Constitution: Imposing Constraints on Bankruptcy Laws

We have a few constraints on the use of bankruptcy law powers, and bankruptcy power is not necessarily exclusive to the Federal Government. Indeed, in the early days, the states were heavily involved. We did not have a permanent bankruptcy law in the United States until the *1898 Bankruptcy Act*.[2] Before that, in the 19th century, there was a succession of stop-gap bankruptcy bills that the Federal Congress would pass and then sunset out of existence. The idea was to correspond those to financial crises, so when there was a financial crisis and there was a bunch of debt, Congress would pass a bankruptcy law to address the crisis, but then the law went away when normalcy returned. So some states picked up the slack. Even though lacking a Bankruptcy Clause, they too passed debt relief laws under their general police powers. Thus, the states had residual power to enact their own bankruptcy legislations, and many states did; all sorts of states had all sorts of bankruptcy laws.[3] A couple hundred years ago, however, this need for the states to play back-up functionally fell out of existence once the permanent federal legislation of the *1898 Bankruptcy Act* came into play.

Importantly, the states did not have as much bankruptcy power as the Federal Government. There were specific constraints on the use by the states of their powers to pass bankruptcy laws under the Constitution. The principal historical

1 U.S. CONST. art. I, § 8, cl. 4.

2 Bankruptcy Act of 1898, ch. 541, 30 Stat. 544.

3 *See, e.g.,* Act of March 21, 1788, ch. 92, 1788 N.Y. Laws 823.

constraint on state bankruptcy laws was the Contracts Clause of the Constitution, which applies against the states.[4] The Contracts Clause of the Constitution proscribes governmental impairment of contracts. Remember I said that the whole purpose of bankruptcy law is to rip up contracts. If you have a Contracts Clause cabining the states that prohibits them from ripping up contracts, that makes it an uphill battle for them to enact a meaningful bankruptcy law. The federal Constitution confers on the Congress the power to pass uniform laws on the subject of bankruptcy, which is unfettered by the Contracts Clause. So there is residual space for states to pass bankruptcy laws as well as Congress, but not a lot of space given the Contracts Clause (and absence of a Bankruptcy Clause).

How did the early constitutional jurisprudence on bankruptcy powers treat these state bankruptcy laws, in light of these constraints imposed by the Contract Clause and in light of the inapplicability of the Bankruptcy Clause? In order to simplify it, I am going to say that the Supreme Court's approach to state bankruptcy laws was to say that a state could pass bankruptcy laws under its general police powers, but these could only apply "prospectively," to after-enacted contracts.[5] This means that a state could pass a bankruptcy law, but it could not use that law to abrogate a pre-existing private contract. In other words, New Jersey could pass a bankruptcy act in 2015 and say, "Any contracts entered into 2015 or later are covered by this bankruptcy law of New Jersey." Anything that would have retroactive application to contracts, however, they worried would be an impairment of the contract that was discharged in bankruptcy and so would run afoul the Contracts Clause. That was the only meaningful constraint; you could pass a bankruptcy law for your state as long as it only applied prospectively. Now, I say *only* apply prospectively as if that is a mere tiny wrinkle, but if you have a debt crisis, you probably have a lot of debt built up already, and so solely prospective enactment is going to be cold comfort. Still, that was the lay of the constitutional land.

The second restriction under the Constitution on bankruptcy powers, and this applies to the Federal Government as well, is the property rights protection under the Takings Clause.[6] The constraints that the Takings Clause imposes on the Federal Government in the bankruptcy realm have not been definitively resolved by the Supreme Court. However, we have some pretty juicy dictum, and I'm going to tell you what it is. First of all, let me explain what the conceptual issue is. I say bankruptcy law allows you to "rip up" contracts. I am being somewhat glib in my exposition; it technically allows you to "reject" contracts, and then the aggrieved counterparty gets to file a claim in your bankruptcy estate as a creditor.[7] If your bankruptcy estate pays five cents on the dollar, the counterparty gets five cents on the dollar for the breach damages. On the whole, I think

4 U.S. CONST. art. I, § 8, cl. 4.

5 Sturges v. Crowninshield, 17 U.S. 122 (1819).

6 U.S. CONST. amends. V, XIV.

7 11 U.S.C. § 365 (2014).

for simplicity, it's fair to call it ripping up a contract. But can bankruptcy allow "ripping up" property rights?

Well, sort of, yes. The Bankruptcy Code even allows for the variation of property rights, which gets into more sensitive constitutional territory given the Takings Clause. For example, the United States Bankruptcy Code, under Section 522(f), actually takes certain liens -bona fide property interests- that the Congress finds offensive as a policy matter and just erases them.[8] It says, in effect, you may very well have a lien on that household couch under state law, but we think it's predatory for you to take liens on household furniture when it's exempt from involuntary seizure. So if you have a non-purchase-money lien on certain types of exempt property, it just goes away by order of federal bankruptcy law. Making the lien go away -at least from the lienholder's perspective- is literally a taking of property.

There were no such aggressive lien-invalidation provisions in the *1898 Bankruptcy Act*. Perhaps unsurprisingly, when these provisions were added to the 1978 Bankruptcy Code -which is about eighty percent of what we are using today- consumer lenders challenged them as unconstitutional, claiming that taking away their liens amounted to an impermissible taking under the Constitution. In 1982, the Supreme Court decided *United States v. Security Bank*.[9] In this case, the Supreme Court did not decide whether Congress, exercising its powers under the Bankruptcy Clause, could invalidate liens or whether the Bankruptcy Clause had to be subordinate to the Takings Clause. (Consider that there is no intrinsic textual reason why one clause is better than another. You could go in alphabetical order, you could have policy considerations and say "we think one clause captures more of our principles; we want to have that clause trump the other.") The Supreme Court ducked the issue, leaving the interaction of the Bankruptcy Clause and the Takings Clause unclear.

What did the Supreme Court say? Essentially, the Supreme Court said that removing pre-existing liens sounds like a taking of property, and that it would expect an awfully clear statement from Congress if that's what it wanted to do. Hence, since the 1978 Bankruptcy Code did not have any applicable provisions regarding timing, the Supreme Court decided to interpret the statute as meaning that only liens that were created after 1978, prospectively, could be invalidated, but not pre-existing ones. In sum, the Supreme Court has never decided whether Congress can invalidate property rights with its bankruptcy powers, but it has offered some pretty juicy dicta suggesting that it could create serious constitutional problems to do so, even in the exercise of bankruptcy authority.

That is a contested position, by the way. Academics, because this is what we do for a living, fight over whether that is right or wrong. We go through the history of the Bankruptcy Clause, we go through the history of the Takings Clause, we go through the history of any other clause for good measure. Nevertheless,

8 *Id.* § 522(f).

9 *See* United States v. Sec. Indus. Bank, 459 U.S. 70 (1982).

there is some suggestion from academics who have done some serious historical work, and Professor Charles J. Tabb is one of them, that it is not at all clear whether the Takings Clause constrains the Bankruptcy Clause.[10] If the government is exercising good faith authority to pass a bankruptcy discharge law, then there's a decent argument that there may not even be a just compensation requirement for a taking (there might be a due process constraint, of course, but that's a separate question).

Those are basically the only constraints of importance. There are others, such as Uniformity,[11] but they are too technical for us to worry about today. As you can see, while there are some constraints, they are not very strong. The Federal Congress can do a lot with those Bankruptcy Clause powers, -indeed it has- and even the states can take some lesser measures if they want, which is what Puerto Rico tried to do last year, taking a page from history.

B. Chapter 7 of the Bankruptcy Code: Liquidation and Discharge

Now let us talk about bankruptcy law under the 1978 Bankruptcy Code. The primordial chapter of bankruptcy law is Chapter 7.[12] Chapter 7 provides the traditional liquidation and discharge of debt. There are two fundamental principles upon which a bankruptcy law like this is passed, a law which is replicated in many systems around the world. One is that when a debtor is bankrupt, all the creditors are corralled into accepting equal treatment. All the creditors have to share equally, which is the principle of *pari passu* distribution. Now, I should drop a big footnote here and say, like in *Animal Farm*, some creditors are more equal than others.[13] But the aspiration of the bankruptcy system is for equal sharing of the pain and obligations when there is insufficient money to go around. This is important because bankruptcy has a very powerful collectivization force to it.

Most principally, there is something called the *automatic stay* of bankruptcy.[14] What the automatic stay does is invalidate and freeze any attempt by any creditor anywhere to collect money from the debtor on his or her own account. As you can imagine, if you are a particularly aggressive creditor, and you are first off the mark and think you can shake the debtor down really well, you become disappointed when a bankruptcy court says you have to stop – and not only do you have to stop, you have to stop for the benefit of him over there, the lazy fellow creditor who has not done anything yet because you are all going to share together. Aggressive creditors thus dislike bankruptcy, although that may be a

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10 Charles J. Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, 2015 U. ILL. L. REV. 765 (2015).

11 U.S. CONST. art. I, § 8, cl. 1.

12 11 U.S.C. §§ 701-784.

13 GEORGE ORWELL, ANIMAL FARM (1946). *Cf.* 11 U.S.C. § 507 (ranking priority of certain creditors).

14 11 U.S.C. § 362.

social welfare wash, because I suppose slow creditors like bankruptcy equally and oppositely. We can debate that if inclined.

The second thing bankruptcy does in Chapter 7 liquidation is allow for a discharge of indebtedness.[15] This discharge of indebtedness is the canonical "fresh start" of bankruptcy. The idea is that you have a moment of clarity, a moment of realization of financial insolvency. You get all the creditors in the room, the debtor gives all of its non-exempt assets up,[16] and the creditors take everything else to share *pro rata* as they discharge the debtor and book a loss. People then move on. That is Chapter 7 bankruptcy.

Importantly, there is no discharge for businesses.[17] Humans need a fresh start. Corporations do not. Bankruptcy's discharge is about individuals; individuals need fresh starts. Business entities can just fail and expire.

C. Chapter 11 of the Bankruptcy Code: Consensual Reorganization of Corporate Debts

We also have something called Chapter 11, which is where businesses come in.[18] Chapter 11 has worked out pretty well for us. It is not flawless, but it has worked out pretty well and has been replicated in other insolvency systems around the world.

The premise of Chapter 11 is that some businesses might be worth saving and may need some sort of fresh start. Similar to Chapter 7, in Chapter 11 debtors still have the automatic stay; creditors cannot collect anything on their own outside the bankruptcy court proceedings. However, unlike Chapter 7 bankruptcy - where a debtor just comes in, files a petition, and gets her discharge- Chapter 11 is a consensual, vote-driven regime where the creditors vote on a plan of how (and whether) to restructure the debts of the debtor. And "restructure" the debts in regular words means "cutting." So the plan might be to cut twenty percent of the principal of all the debt. In Chapter 11, the creditors vote on that. Now, why would a creditor vote to reduce the money that's owed? Because the creditor will look at the alternative, and the alternative is you cut the debtor up and divide the assets that you can sell in an auction, which usually doesn't fetch a lot of money. If a debtor has going-concern value, *i.e.*, if the whole is greater than the sum of its parts, then finding some way to keep that debtor alive and whole is valuable, even if it means conceding to a partial loss on your principal.

Different creditors have different conceptions of how to do that, of course, and that is why they have elections and vote. It's financial democracy. The idea is that if the majority of creditors -it is actually a supermajority of a two-thirds vot-

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15 *Id.* §§ 523(a), 727(a).

16 Consumer creditors have certain exempt assets which are not part of the bankruptcy estate, but everything that has got value and can be liquidated, goes to the creditors. 11 U.S.C. §522.

17 11 U.S.C. § 727(a)(1).

18 *Id.* §§ 1101-1174.

ing system in bankruptcy- think it is a fair plan and good plan, then it votes for this plan.[19] And the majority gets to bind dissident minorities. The most important power of Chapter 11 of the Bankruptcy Code is the power to bind the hold-out who does not want to cut his or her debt. When they are dragged into Chapter 11, creditors vote, and if a supermajority says that it is a good plan and that creditors should restructure, it does not matter if you, yourself, do not vote in favor. If you are out-voted, you lose and you are bound by the plan.[20]

Why is that so important? Why is that the conceptual lynchpin of Chapter 11? It is so important because consider if I had all you guys in the room, and I had a hundred people that I had to negotiate with, and I said: "I don't think I can pay all of you." I would start with the friendliest-looking person right in the front and say: "Will you take a fifteen percent haircut?" And he says: "sure." Then I go to the next-friendliest person and say: "So, you know, there is talk about a fifteen percent haircut, are you on board?" And she says: "Sure." I go all the way through the room. Then I get to person Number Ninety-nine, and I say; "Ninety-nine, will you take a fifteen percent haircut?" And Ninety-nine says: "Well, is someone else taking that?" And I say: "Yeah, everyone is, so are you going to go along?" Ninety-nine thinks, stares back at me icily, and says: "No." Flumoxed, I plead: "Will you take a fourteen percent haircut, at least?" The recalcitrance continues: "No." "Will you take any haircut?" "No, get lost." Now, I am stuck. But here is what is worse. Number One, my erstwhile friend, gets wind of it, and says: "Wait a minute, wait, Ninety-nine's taking no haircut and I'm a *schmuck* taking fifteen percent? That's not fair! I change my mind; I am not taking a fifteen percent haircut." And as soon as Number One bails, Number Two will back out, and so on as the deal dies.

That is the collective action problem with holdouts. That is why bankruptcy laws are necessary to bind creditors, because in bankruptcy I can now get to Ninety-nine and say: "I don't care anymore about you. We are going to get a fifteen percent haircut, and I have the votes to get that plan passed, so be as recalcitrant as you like!" There is no incentive to hold out. That is what Chapter 11 bankruptcy does.

Although there are complex voting rules, classes, and all sorts of fun stuff that are crammed down under certain circumstances, the general principle is that it is a consensual voting system.[21] Cannot confirm a plan? Cannot come out with a plan that your creditors like? You do not get to reorganize. You are done: you liquidate.[22] Off to Chapter 7 with you. That's Chapter 11 of the American bankruptcy system and, as I said, it has attracted some attention around the world. Many companies have reorganized through the Chapter 11 process, and I'm relatively confident I flew on one of them on my way down to San Juan.

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19 *Id.* §§ 1126(c), 1129(a)(8).

20 *Id.* § 1141 (a).

21 *See, e.g.*, *id.* § 1129(b)

22 *Id.* § 1112(b)(2)(A).

D. Chapter 9: Restructuring the Public Debts of the State Subdivisions

What is Chapter 9? This exotic little beast occupies four poorly visited pages of the United States Code.[23] Chapter 9 is a "Chapter-11-voting-kind-of-system" for public entities that go bankrupt, like cities or subdivisions of a state. Not the state itself -the state, under our dual sovereignty system, is sovereign and cannot be put into a federal bankruptcy proceeding. More precisely, Congress has not passed legislation to that effect. I do not think there is any constitutional constraint on allowing a state to go through a bankruptcy system if it wants to, but it cannot be forced.

The first section of Chapter 9, Section 901 of the Bankruptcy Code, just copies out about three quarters of Chapter 11 and announces that all those provisions apply in Chapter 9, such as dividing creditors into classes, having them vote on a plan, and so on.[24] There are a couple of special rules in Chapter 9, however, that are sensitive to its public origins and to constitutional concerns. I feel the need for a little constitutional digression again, for which I apologize. When the first version of Chapter 9 was passed, during the Depression, the Supreme Court struck it down it as unconstitutional.[25] Why did the Supreme Court strike down a part of the Bankruptcy Code as unconstitutional? It had nothing to do with the Contracts Clause and nothing to do with the Takings Clause, which we discussed earlier. The problem here was that Initial Chapter 9 was perceived to infringe upon the Tenth and Eleventh Amendments.[26] The idea of allowing a state's entities, like its cities, to use the federal bankruptcy court system to restructure its debts was seen as too invasive by the Federal Government on the prerogatives of the sovereign states to manage their own affairs, namely, the financial problems of their subdivisions.

After the Supreme Court struck down Initial Chapter 9, Congress (back when it was more functional) responded by amending the law to comport with the Supreme Court's holding. However, it did not radically rewrite Chapter 9. It merely injected a few, albeit significant, changes. Specifically, relevant for the constitutional infirmities first identified by the Supreme Court, the Chapter 9 bankruptcy rules were redesigned to include certain "eligibility screens" that must be satisfied before a Chapter 9 bankruptcy proceeding can be opened.[27] A Chapter 9 would-be debtor has to have the consent of its state to file. This consent requirement vitiates the constitutional concerns about the Federal Government being too "pushy," because if a state thinks the Feds are getting to be too

23 *Id.* §§ 901-946.

24 *Id.* § 901.

25 U.S. CONST. amends. X, XI.

26 Ashton v. Cameron Cty. Water Imp. Dist. No. 1, 298 U.S. 513, 532 (1936).

27 Municipal Bankruptcy Act of 1937, Pub. L. No. 75-302, 50 Stat. 653 (1937) (adopting modern Chapter 9).

pushy, the state can just say no.[28] Some states, for example, Georgia, do not allow its entities to file Chapter 9; Atlanta cannot file a Chapter 9 proceeding.[29] Many states, like Michigan, have conditional requirements. For example, they require that the entity go through an emergency procedure with a financial manager.[30] The financial manager has to find that the entity's prospects are hopeless and then make a recommendation of filing for Chapter 9 relief. The Governor also has to sign off on the filing.[31]

Those are the eligibility requirements of Chapter 9. I will make a prediction for you right now, which is a prediction of general litigation and dilatory tactics. Remember I noted the idea that fast, aggressive creditors do not like bankruptcy? If Chapter 9 is ever extended to Puerto Rico or its sub-entities, I guarantee you that the parties that seem to have an appetite for litigation will be in there robustly contending that there is no eligibility for filing for Chapter 9 even if it is made available. They will protest and say that it has not been properly authorized, or that there have not been good-faith negotiations.[32] Perhaps even -which would be jaw-dropping, but it was claimed in Detroit- they may claim that the debtor is not insolvent. Those are all requirements to file a Chapter 9 bankruptcy proceeding.[33]

What are other unique rules in Chapter 9? There is an express proscription on federal bankruptcy judges getting involved in the political affairs of the debtor.[34] For example, let us presume that a bankruptcy judge finds that elections are too expensive for an over-indebted city and that they should be cancelled. That is not allowed under the Bankruptcy Code in Section 903. Also, of particular importance to this crowd, Section 903 includes an explicit preemption provision that precludes states from passing their own versions of Chapter 9.[35]

I can give you historical background of where that pre-emptive provision came from. Remember I noted that, historically, there were temporary laws that sunset out of existence to respond to discrete perceived problems and crises? Scholars who have done good historical digging, like Professor Stephen J. Lubben, have found that when Chapter 9 was first enacted, it was one of those crisis laws. It was supposed to exist for a small period of time and then go away. The preemption provision was passed in that context.[36] In other words, while this

28 United States v. Bekins, 304 U.S. 27, 54 (1938) (holding the consent requirement solved the constitutional concerns).

29 GA CODE ANN. § 36-80-5 (West 2016).

30 MICH COMP. LAWS ANN. §141.1541 (West Supp. 2014).

31 *Id.*

32 11 U.S.C. § 109(c)(5)(B) (2014).

33 *Id.* § 109(c). *See In re* City of Detroit, Michigan, 504 B.R. 97 (Bankr. E.D. Mich. 2013). (finding Detroit eligible to file Chapter 9 after lengthy eligibility litigation).

34 11 U.S.C. § 904(1).

35 *Id.* § 903(1).

36 *See* Stephen J. Lubben, *Puerto Rico and the Bankruptcy Clause*, 88 AM. BANKR. L.J. 553 (2014).

short-term law was in place, Congress did not want the states passing their own competing laws. I suppose the good news is that, if you take the petitioner's position in the Supreme Court litigation currently unfolding, Puerto Rico is excused from that preemptive provision, because, of course, Chapter 9 does not apply to Puerto Rico.[37]

Other than that, the provisions of Chapter 9 that are specific to Chapter 9 and not Chapter 11 are quite technical. Perhaps the most important for the financial straits of this jurisdiction is that there is a "super protection" for what I would call "revenue bonds."[38] Why? Under Chapter 11, these liens would be deemed invalid as impermissible encumbrances on prospective revenues streams that would get in the way of the redevelopment of the debtor and be disallowed.[39] They are protected, however, in Chapter 9. As for secured credit more generally, the bankruptcy rules in Chapter 11 provide protection for the collateral of secured lenders.[40] This means that if I lend you money, and I have a mortgage on your house, when we go into bankruptcy courts my mortgage is protected up to the value of the house. I don't have to share it with other creditors. That is how secured lenders get collateral; they take mortgages.

Municipalities generally do not pledge real estate collateral as a way to finance debt. What municipalities like to do is pledge what are, basically, receivables. Instead of offering real assets as collateral, they pledge future tax revenue streams. Essentially, they offer "first dibs" on the revenues that come in. Under bankruptcy law in Chapter 9, whether these priorities are protected as secured debt is contested. This uncertainty of course makes some creditors anxious, but that's the nature of the beast.

In sum, Chapter 9 is a consensual voting system modeled on Chapter 11, with a few special tweaks. Like Chapter 11, it gets the creditors together and forces them to vote on a restructuring plan.

II. SOVEREIGN DEBT RESTRUCTURINGS

Now I want to talk briefly about the sovereign debt system, which is relevant when independent countries go broke. Before the International Monetary Fund (IMF), there was the *Paris Club,* which was a consortium of developed countries who lent to developing countries. Nowadays, the sovereign debt market is much more complex. We have publicly traded bonds, often scooped up by specialty investors. Today, the IMF is also around and comes in as the lender of last resort. The lender of last resort's job is to provide financing to countries that have lost their access to the debt markets. The traditional way developing countries deal with deficits, as you guys may know very well here, is that when you have financ-

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37 11 U.S.C. § 101(52).

38 *Id.* §§ 902-903.

39 *Id.* §552(a).

40 *Id.* § 506(a).

ing problems with your deficit, instead of solving them, you go and borrow more money to plug budget holes. You turn to the bond markets. When you cannot access those markets anymore because they've finally had enough, you need to find a way to get money, because someone has to pay for the essential public services to be provided. This is when the IMF intervenes with developing countries. The *quid pro quo* that the IMF gives them is something called "conditionality."[41] When the IMF comes -and this is why it is often hated- it offers to give you some money, but you have to show that you are making structural governance reforms to have a path to fiscal reform. The IMF establishes certain criteria that have to be met before releasing the next extension of cash.

Conditionality is a repeated pattern that is deployed throughout the world and is happening with Greece as well. Thus, when the IMF does come in and provide financing to broke countries that have huge debt overhang, there is a great sacrifice of autonomy and sovereignty, which, as you might imagine, is a very sensitive political issue. But this means that the IMF is good at measuring financial sustainability to decide when that overhang requires the IMF to help. It has rules of thumb, like: the ratio of the interest you are paying on your debt compared to your nominal Gross Domestic Product (GDP), proportionally, should not exceed a certain level. The IMF performs an analysis where it calculates the amount of debt that you will never be able to pay off, even after assuming that you fix your governance problems and are running a primary surplus and have balanced your budget. This is what is often referred to as *unsustainable* debt. You have to get rid of it. Thus, the IMF restructures this overhanging debt. There is no bankruptcy court, so it cannot order the restructuring to take place, and there is no voting system, but the IMF can basically cajole the lenders into taking concessions because the debt is unsustainable and will never be repaid. That is how sovereign debt is often restructured for deeply insolvent nation-debtors.

III. PUERTO RICO'S DEBTS

As mentioned, the IMF is pretty good at measuring unsustainability. Why does that matter? It matters because on many measures by the IMF's criteria, Puerto Rico has unsustainable debt and is in the same league as many developing countries. It has a debt that has tripled in the past decade-plus and would flunk most of the IMF's criteria of sustainable debt. The Krueger report, written by former IMF economist Anne O. Krueger, goes through all the relevant ratios and provides a pretty good analysis of the unsustainability of Puerto Rico's debt.[42]

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41 Factsheet, IMF Conditionality, INTERNATIONAL MONETARY FUND (March 24, 2016), https://www.imf.org/external/np/exr/facts/conditio.htm (last visited May 13, 2016).

42 ANNE O. KRUEGER *ET AL.*, PUERTO RICO - A WAY FORWARD (2015), http://www.gdbpr.com/documents/PuertoRicoAWayForward.pdf.

At seventy-two billion dollars' worth of debt -not even getting into the forty billion dollars of unfunded pension liabilities- you have a debt-to-GDP ratio in Puerto Rico that's over a hundred percent.[43] That is not going to get paid off. You can tighten all the belts you want -you can tighten two belts and a pair of suspenders- but you are not going to pay that off. You are going to need to have some debt relief of the same sort that the IMF would facilitate. However, the IMF will not come in to a sub-national political subdivision, like Puerto Rico. I guess that's too bad under the circumstances. Fortunately, we have the Chapter 9 system, which is supposed to deal with such sub-national public financial restructurings in the United States. Unfortunately, it does not apply to Puerto Rico, and it does not apply in two ways.

First, Chapter 9 does not apply legislatively. Political subdivisions of Puerto Rico, such as the Puerto Rico Electric Power Authority (PREPA) and the city of San Juan, cannot file for Chapter 9.[44] That is a technical error in the Bankruptcy Code. I testified a year ago urging Congress to fix it, but for mysterious reasons it has not yet done so despite long-pending legislation.[45] As expected, the aggressive investors who think that they would lose money if they have to participate in a bankruptcy proceeding and share with others have been fighting the correction. Now that they have found the loophole, the loophole is very important to them. For demoralizing reasons, they have turned it into a political issue that has divided the parties along straight partisan lines. I have no idea how, but now it has become a democrat/republican issue. The democrats are in favor of fixing the loophole and the republicans are against it. If you do not pay attention to the Bankruptcy Code -which I suspect is the case for ninety percent of Congress- as soon as you hear it is a political issue, and you have a primary campaign, you'll say, "Oh, I'm with the republicans," or "I'm with the democrats," depending on your party. So I have a cynical prognosis on that being fixed anytime soon, at least before primary season.

The second legislative barrier that Puerto Rico has for Chapter 9 is the territorial debt, which would be exempt even if Chapter 9 applied. There is a lot of debt at the Commonwealth level. That debt cannot be filed under Chapter 9 for the same reason that Illinois cannot file for Chapter 9. Chapter 9 only applies to subdivisions, not states. I believe the Commonwealth debt is also unsustainable and needs to be restructured. You can try a contractual negotiation -*à la* sovereign debt per the IMF- and maybe that would work. Indeed, the Governor here has thrown down the first salvo with a proposed forty-six percent haircut.[46] So

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43 *Id.*

44 11 U.S.C. 101 (52).

45 *Puerto Rico Chapter 9 Uniformity Act of the 2015: Hearing Before the Committee on the Judiciary, Subcommittee Regulatory Reform, Commercial and Antitrust Law on H.R. 870*, 114th Cong. 1 (2015) (statement of Prof. Pottow, University of Michigan Law School).

46 *Puerto Rico Proposes 46 Percent Debt Cut in Creditor Plan*, REUTERS (Feb. 1, 2016), http://www.reuters.com/article/usa-puertorico-restructuring-idUSN9N10U020 (last visist May 21, 2016).

how about a forty-six percent haircut? I think it is fair to characterize that as having received a cool reception thus far.

There is, however, finally starting significant discussion of a comprehensive solution to the debt problems here. Since there is already talk of extending Chapter 9 to PREPA, it has been suggested that it would be even more preferable to have a full comprehensive restructuring of the Commonwealth debt at the same time, *i.e.*, extending Chapter 9 to apply to state-level debt. On that subject, I must add that Puerto Rico's debt structure can hold its own against any multinational corporation's in terms of complexity. There are layers upon layers of debt. For example, there are the general obligation bonds that have a 2014 constitutional amendment that is supposed to prioritize them.[47] There is the *Corporación del Fondo de Interés Apremiante de Puerto Rico* (COFINA) structure,[48] which nominally segregates out sales-tax revenue that may or not may be "*clawback-able*."[49] Some of the highway bonds may be "*clawback-able*", others not. Then there is the general unsecured debt. It gives me a headache, and I do this for a living. The idea of trying to do *ad hoc* contractual negotiations, one by one, with about a thousand guys in a room is daunting. That is why attention is now turning to a comprehensive solution, perhaps this so-called "Super Chapter 9," that would allow the Commonwealth's debt to be subject to Chapter 9 procedures as well.

"Super Chapter 9" scares the pants off some people, who see it as the camel's nose under the tent to extending Chapter 9 to state debts. If you guys think you have a problem in Puerto Rico, you should take a trip to Illinois. They have problems, too, and Congress does not want to extend Chapter 9 to the states yet. Fortunately, there is a way out of that: Congress can use the Territorial Clause and say that it is just managing its territories.[50] After all, it has done it so well in the past. So you could get some Chapter 9-like relief through that Clause, which would be a good way to make it a one-off and ensure that the floodgates would stay closed without having to extend relief to the states (that is what I predict will happen). Limiting a relief bill to territories thus gives some political cover to legislators who are skeptical and anxious of extending Chapter 9.

Make no mistake, something will eventually pass. It is inconceivable that this debt will not be restructured and have substantial reductions in principal. These creditors are not going to get paid in full. What Chapter 9 recognizes is that, unlike in Chapter 11, where you can decide just to liquidate the debtor entity, have an auction, sell it off, and wipe-out all the shareholders, you cannot do that with a city or political subdivision of a state. San Juan has no shareholders. There is no wiping-out-of-the-shareholders possible. PREPA, for example, exists

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47 *See* P.R. CONST. art. VI, § 8.

48 *See* P.R. LAWS ANN. tit. 13, §§ 11a-16 (2015).

49 The term "*clawback-able*" refers to the susceptibility of the pledged collateral to be redirected to make interest or principal payments on general obligation bonds which the Puerto Rico Constitution prioritizes over other disbursements. *See* P.R. CONST. art. IV, § 8.

50 U.S. CONST. art. IV., § 3, cl. 2.

as a public entity that provides public services. So it is not viable to say that you will liquidate it and not run power, or to say that you will fire the police force so San Juan will not have to pay for police salaries. We will have "pitchfork costs," for economists, if that happens: we will have riots in the streets. The IMF gets this, and the situation here is analogous. Thus, there is a minimum of sustainable services that have to be provided. Of course, people wrangle over that. If I have invested in a city's bond portfolio, I would say: "What do you want all those expensive police officers for? One or two are fine, make them work overtime." If you are a resident of the city, however, maybe you have a different perspective. That is why we have a litigation system in bankruptcy court. The bankruptcy judge does not tell you what to do, but he or she corrals people together to negotiate. And that is what happened in Detroit, the final topic to which we will now turn.

IV. Lessons from Detroit's debt restructuring

Detroit's Chapter 9 was successful, but I would not call it pretty. Like all bankruptcies, it had some good things and bad things happen. Most importantly, creditors took concessions. People who had pensions did not get their full pensions. They took haircuts. People who had bonds as investments also took haircuts as well. The bond investors took greater haircuts than the pensioners, not because of the Bankruptcy Code, but because there was an external funding source that came in and said, "We will provide some money to the city, but we are not going to let it go to the bondholders when it can go to the pensioners." In addition, Detroit used some of the powers in bankruptcy to make politically unpopular decisions. Chiefly on my mind are labor rights. They have very strong labor rights in Detroit, and those got altered in bankruptcy. I do not know whether those would have been politically alterable outside bankruptcy. It is easier to alter well entrenched labor rights in a bankruptcy system (blame the "bad guy," *i.e.*, the financial manager).

Finally, which I think is perhaps the most encouraging development of Detroit's bankruptcy, is that Detroit cleaned up its financial mess and now has meaningful access to the municipal leading markets. A lot of the terror stories bond investors will tell you say: "If you file for Chapter 9, you will never get credit again. The market will not trust you anymore." That's hogwash. First of all, the market can price anything it wants. The market prices Puerto Rico's debt. I can get a general obligation bond for around seventy to eighty cents on the dollar. Heck, I can get the unsecured debt for thirty cents on the dollar, and that is junk territory. Basically, the market will buy anything. So what did the market do after Detroit emerged from bankruptcy? Unsurprisingly, the market for new debt was pretty pumped. The investors basically figured that with a clean balance sheet for the borrower, they should buy bonds from the City, which now had great ability to repay. It is the same reason why consumer debtors, when they rip up their credit cards after they get through a Chapter 7 proceeding and have a fresh start, find themselves subject to a deluge of direct offerings from credit-card companies happy to lend to people who have discharged all their old debt.[51] They have good cash-flow to pay off this new credit-card debt. Thus, I predict that, if there is a restructuring of Puerto Rico's debt, there will be credit in the future that will be plentifully available.

Guess what happened in Detroit? Detroit had, quaintly for you guys, what we thought was the worst bankruptcy problem ever in Chapter 9. It had a twenty-billion-dollar debt problem, unheard of for the scope of Chapter 9. But the city ran through its Chapter 9 proceeding in about a little over a year. It was incredibly well executed for two reasons. First, there was a judge who was very good at pushing things along. He figured that it is just bankruptcy, it is just zeros and people fighting over money, so he decided to run things like a Chapter 11 proceeding. The parties had to negotiate, to mediate, and cut a deal. That is what happened. The Detroit plan was a consensual plan that creditor classes voted on and passed. That requires pressure. You have to have pressure for people to settle.

Secondly, Detroit had a financial manager, who was basically a dictator who got to make decisions on behalf of the City. That is offensive to notions of popular democracy. I understand it, but it does make negotiations happen a lot more expeditiously. You do not have to schedule a city council meeting and get to debate and talk about things. It is like having a CEO of a company to whom you can ask: "Do we cut this deal or not?" You get an answer. But the dictatorship cannot be permanent. We have had a successful regime change in Detroit. There is no financial manager anymore. We have a very active mayor who liaised well and had a smooth hand-off from the financial manager. We still have a financial oversight board in Detroit, and I know that that is not a popular thing, but I think that it is going to be a necessary component for any resolution to this crisis.

CONCLUSION

So that is what bankruptcy can do. The last thing I want to say is what it cannot do. What it cannot do is perform fundamental changes to the structure of how you run the government in Puerto Rico and, more importantly, how you focus your policies on economic growth. Did bankruptcy save the Big Three car companies by shedding their excessive debt? Well, it certainly helped relieve debt overhang, to be sure, but bankruptcy alone cannot make cars that people want to buy. Bankruptcy cannot make jobs in Puerto Rico. That is a matter of economic policy. That is why we have an elected government, and you have to figure out what is the best for you guys. But what bankruptcy can do is get rid of the debt overhang, so you do not squander thirty percent of your budget to paying interest on unsustainable past debt, which is what you are doing right now.

51 Katherine Porter, *Bankrupt Profits: The Credit Industry's Business Model for Postbankruptcy Lending*, 93 IOWA L. REV. 1369, 1391 (2008) ("Credit solicitation of recent bankruptcy debtors is rampant.").

Bankruptcy gets rid of the old debt. But the future, the development, whether this is going to be a place where people want to live, or whether it is going to have jobs, is not up to the bankruptcy court. That is up to the elected officials and the future.

As for Puerto Rico, there are two prongs to what is needed for bipartisan debt relief. Number one is going to be a cancellation of debt or reduction of principal: debt relief the "IMF/Chapter 9" kind of way. Talk of avoiding the need for restructuring is nonsense. It is going to happen, and Congress will get it sooner or later. Number two is going to be external oversight. I understand that the Governor wants to keep it internal, but my experience is that, for the same reason that Detroit had to have an external oversight board, there is enough water under the bridge of distrust with the financial management here, that the creditor community now -and the prospective future creditor community that's going to be lending here- is going to want to have some cleaning of the house and some external third-party oversight. The Detroit board goes away after a few years. After "x" years of surpluses, it winds itself out of existence. The same such thing can readily be set up here. This means that an oversight board need not entail some sort of permanent underclass situation to financial overlords. I do think, however, it is a necessary political expedient and, by the way, probably good from a fiscal policy perspective as well. External oversight and debt relief capability are needed and will happen. I do not know how long it will take Congress to figure that out, but I hope it is soon.

Thus, in the end, bankruptcy law can do a lot for Puerto Rico: it can shed unsustainable debt by corralling creditors into a consensual, super-majoritarian vote-driven restructuring system that can bind dissident holdouts. It will not be pretty, and it will require a lot of sacrifice from all constituents. But what it cannot do (at least directly) is create jobs, economic growth, or entrepreneurial creativity. That is up to the people of Puerto Rico, and I have no doubt based on my brief trip here that you will succeed. Thank you.