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Puerto Rico Adopts a Debt Recovery Act for Its Public Corporations

*Lorraine S. McGowen**

The Commonwealth of Puerto Rico has adopted the Puerto Rico Corporations Debt Enforcement & Recovery Act, enabling certain Commonwealth public corporations in financial distress to restructure their debt obligations. The author of this article explains the new law and the challenges to the constitutionality of the act that have already been commenced.

On June 28, 2014, the Commonwealth of Puerto Rico adopted the Puerto Rico Corporations Debt Enforcement & Recovery Act¹ (the “Debt Recovery Act”), enabling certain Commonwealth public corporations in financial distress to restructure their debt obligations. The Debt Recovery Act purports to establish a debt enforcement, recovery, and restructuring regime for public corporations and other instrumentalities of the Commonwealth during an economic emergency. The goal of the new law is to balance the interests of creditors and other stakeholders with the interest of the Commonwealth to protect its citizens and to enable the financially distressed public corporations to continue to provide essential government services such as the delivery of electricity, gas, and clean water.

The Debt Recovery Act, though, is not limited to restructuring and enforcement of debt obligations or securities. If you lent money or extended other forms of credit, or provided goods or services, to a public corporation of the Commonwealth of Puerto Rico, this new law may affect you.

Many were caught by surprise by the speed at which the Debt Recovery Act became law. Without much fanfare or prior public hearings, in a matter of a few days in late June, 2014, the Debt Recovery Act was approved by the Commonwealth’s Senate and House of Representatives and signed by the Governor of the Commonwealth.² Section 401 provides that the Debt Recovery Act became effective immediately and will expire on December 31, 2016 unless its effectiveness is extended by law. As described below, challenges to the constitutionality of the act have already been commenced, and more challenges undoubtedly will be filed if and when a distressed public corporation avails itself of the procedures available under the Debt Recovery Act. Because of the speed at which the law was adopted, creditors may challenge the constitutionality of the new law on the ground that the Commonwealth failed to consider less burdensome alternatives.

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¹ Act 71-2014.

² The Commonwealth of Puerto Rico is a self-governing commonwealth of the United States.

EXCLUDED ENTITIES

The Debt Recovery Act provides a framework for restructuring the obligations of certain eligible public corporations, including the Puerto Rico Electric Power Authority (“PREPA”), the Puerto Rico Aqueduct and Sewer Authority (“PRASA”) and the Puerto Rico Highways and Transportation Authority (“PRHTA”). A number of entities are expressly excluded from the scope of the Debt Recovery Act, including the Commonwealth of Puerto Rico itself, its 78 municipal governments, the Government Development Bank of Puerto Rico (“GDB”), the Puerto Rico Sales Tax Financing Corporation (“COFINA”), the Puerto Rico Infrastructure Finance Authority (“PRIFA”) and the Puerto Rico Industrial Development Company, among others.

SUMMARY OF THE FORMS OF RELIEF

Under the Debt Recovery Act, an eligible public corporation, subject to the consent of the GDB, may commence a consensual debt modification procedure under Chapter 2 or a court-supervised proceeding under Chapter 3 that would culminate in an orderly debt enforcement plan. The Debt Recovery Act provides two types of procedures to address an eligible public corporation’s debt burden. Under Chapter 2 of the Act, an eligible public corporation can seek a consensual debt modification procedure that will culminate in a recovery program. Alternatively, the public corporation could seek a court-supervised procedure that would culminate in an orderly debt enforcement plan. The eligible public corporation can seek relief under either Chapter 2 or Chapter 3 either simultaneously or sequentially.³ If the eligible public corporation does not itself seek relief, the GDB, at the Governor’s request, may seek relief under the Debt Recovery Act. The Senate bill indicates that eligible entities are expected to try Chapter 2 before turning to Chapter 3, but the Debt Recovery Act does not contain such admonition. No other party may commence an involuntary proceeding against an eligible public corporation under the Debt Recovery Act.

CONSENSUAL DEBT RELIEF (CHAPTER 2 PROCEEDING)

The objective of a Chapter 2 proceeding is to obtain acceptance of a consensual workout by holders of affected debt instruments that culminates in a recovery program. Amendments to the debt instruments may include interest rate adjustments, maturity extensions, debt relief or other revisions. In exchange for the consensual modifications to the debt instruments, the distressed public corporation will formulate and commit to a recovery program that provides financial and operational adjustments necessary to allow the entity to become financially self-sustaining.

³ The Puerto Rico Corporations Debt Enforcement and Recovery Act, Act 71-2014; references in this article are to Commonwealth S. 1164 dated June 25, 2014 (Debt Recovery Act) (English Text) at 158 and Section 112.

To initiate a Chapter 2 proceeding, an eligible public corporation files a notice of “suspension period” on its Web site. The notice will state which obligations are the subject of the Chapter 2 proceeding (the “affected debt instruments”). A holder of an affected debt instrument will be stayed from exercising any of its remedies or taking any enforcement action. The suspension period may last for a period of 270 days or longer depending upon how long it takes for an order approving the consensual debt transaction to become final and nonappealable.⁴ Under Section 205 of the Debt Recovery Act, the suspension period will end on the earlier of:

- 270 days after commencement of suspension period, but may be extended for one additional period of 90 days if the public corporation and holders of at least 20 percent of the aggregate amount of the affected debt instruments in at least one class of affected debt instruments consent to the extension,
- 60 days after denial of consensual debt relief transaction, unless otherwise provided for in the order denying the application for an approval order, or
- the date the approval order becomes final and nonappealable.

The consensual debt relief transaction in a Chapter 2 proceeding may be approved by the court only where at least 50 percent of the amount of the affected debt in the particular class participates in a vote or consent solicitation and, of those who cast a vote, at least 75 percent of the amount of the affected debt approves the proposed debt relief transaction. If so approved by the consenting creditors and the court, under the Debt Recovery Act, the debt relief transaction will bind all affected creditors within the applicable class.

The standard for court approval of a debt relief transaction is very narrow. The court will enter an approval order approving the debt relief transaction, which will become effective immediately, if the court determines that:

- the proposed amendments, modifications, waivers or exchanges proposed in the debt relief transaction are consistent with the objectives of Chapter 2, and
- the voting procedure was conducted in a manner consistent with Chapter 2.

The Senate bill indicates that the consensual debt relief transaction is “designed to be efficient and expedient in light of the consensual nature of the transaction.”⁵

JUDICIAL DEBT ENFORCEMENT PROCEEDING (CHAPTER 3 PROCEEDING)

The second avenue for debt relief (a Chapter 3 proceeding) involves the commencement of a judicial debt enforcement proceeding. The eligible public

⁴ Of course, the suspension period could be much shorter as well, if the Chapter 2 proceeding is dismissed, or the parties are able to quickly reach an agreement on the terms of the debt relief transaction. As this is a new law with no comparable precedent, it is difficult to estimate how long such a proceeding will last.

⁵ The Puerto Rico Corporations Debt Enforcement and Recovery Act, Act 71-2014; Commonwealth S. 1164 dated June 25, 2014 at 162.

corporation, with the approval of the GDB, may file a petition with the court seeking to formulate an orderly debt enforcement plan that will “maximize distributions to creditors consistent with the execution of vital public functions.”⁶ In a Chapter 3 proceeding, the eligible public corporation will be able “to defer debt repayment and to decrease interest and principal to the extent necessary to enable [it] to continue to fulfill its vital public functions.”⁷ Collective bargaining agreements may be modified or rejected and trade debt may be reduced if necessary. The Senate bill indicates that:

[T]he underlying premise of chapter 3 is that it must serve as an orderly debt enforcement mechanism that makes creditors better off than they would be if they all simultaneously enforced their claims immediately.⁸

In order to file a Chapter 3 petition, the public corporation must satisfy certain eligibility requirements:

- it must be insolvent defined as currently unable to pay valid debts as they mature while continuing to perform public functions or at serious risk of being unable, without further legislative acts and without financial assistance from the Commonwealth or the GDB, to pay valid debts as they mature while continuing to perform public functions;
- it must be ineligible for relief under the Bankruptcy Code, Title 11 U.S.C. (the “Bankruptcy Code”), because it is not a “municipality” eligible to file under Chapter 9; and
- it must be a government unit ineligible to file under Chapter 11 of the Bankruptcy Code.

Upon the filing of the petition, an automatic stay is imposed which prevents creditors from taking or continuing any action against the distressed public corporation or its property to create, perfect or enforce liens or to collect debts. Chapter 3 provides for judicial approval of a debt enforcement plan if at least one class of impaired debt has voted to accept the plan by a majority of all votes cast in such class and if two-thirds of the aggregate amount of impaired debt in such class is voted. In this regard, the voting for approval of a debt enforcement plan mirrors the voting requirements for approval of a plan under Chapter 11 of the Bankruptcy Code.

Unlike a Chapter 2 consensual debt relief transaction, the court will appoint a statutory creditors’ committee in a Chapter 3 debt enforcement proceeding to represent the interest of the affected creditors. The role and powers of the creditor’s committee are more constrained than the role and powers of a committee in a

⁶ The Puerto Rico Corporations Debt Enforcement and Recovery Act, Act 71-2014; Commonwealth S. 1164 dated June 25, 2014 at 165.

⁷ The Puerto Rico Corporations Debt Enforcement and Recovery Act, Act 71-2014; Commonwealth S. 1164 dated June 25, 2014 at 163.

⁸ The Puerto Rico Corporations Debt Enforcement and Recovery Act, Act 71-2014; Commonwealth S. 1164 dated June 25, 2014 at 164.

Chapter 9 or Chapter 11 case under the Bankruptcy Code. Under Chapter 3 of the Debt Recovery Act, a committee may appear and be heard on any issue relating to:

- eligibility;
- adequate protection;
- new borrowing by the petitioner;
- transfer of assets or allocation of proceeds of transfer;
- the plan, but only as to matters regarding how the plan affects the committee's constituents

While the committee may conduct a reasonable investigation into the petitioner's legal and financial ability to increase distributions under the plan for the committee's constituents, the committee does not have standing to commence an action either directly on its own behalf or derivatively on behalf of the petitioner or its creditors.

A Chapter 3 debt enforcement proceeding enables the public corporation to modify its debt obligations, as follows:

- collective bargaining agreements may be modified or rejected under certain circumstances;
- trade debt can be reduced when necessary;
- pledged revenues can be used to sustain the public corporation, and need not be turned over to creditors if necessary to increase the future revenues to pay creditors;
- secured claims can be modified over the objection of the holders of the affected debt if the plan provides that holders of affected secured claims will retain the liens securing their claims to the extent of the allowed amount of such claims; and either
 - (a) the holder receives on account of its secured claim immediate or deferred cash payments totaling at least the value of its interest in the collateral; or
 - (b) the plan provides for the transfer of any property that is subject to liens, free and clear of liens, with such liens attaching to the net proceeds of such transfer;
- unsecured claims (including deficiency claims of affected secured debt) can be restructured over the objection of holders of the affected debt if the plan is in the best interest of creditors and maximizes the amounts distributable to unsecured creditors to the extent practicable, subject to the petitioner's obligations to fulfill its public functions.

Under the Debt Recovery Act, certain classes of creditors and claims are expressly protected from impairment under a Chapter 3 plan. These include:

- allowed and unavoidable unsecured claims of individuals for prepetition wages, salaries or commissions, vacation, severance, and sick leave pay or other similar employee benefits (except to the extent the claims arise out of

a transaction that is avoidable as a fraudulent conveyance under Section 131 of the Debt Recovery Act);

- certain critical vendor debt;
- amounts owed for goods received by, or services rendered to, the petitioner within 30 days before the filing of a petition under Chapter 3;
- noncontingent, undisputed, matured claims not scheduled on the list of affected debt;
- claims owed to another public corporation (if claims are for goods or services provided by the public corporation to the petitioner);
- claims of a Commonwealth entity for money loaned, or other financial support, to the petitioner during the 60 days before the petition or claims of the GDB for reimbursement under Section 134 of the Debt Recovery Act;
- debts owing to the United States of America;
- any credit incurred or debt issued by a public sector obligor between the commencement of the suspension period and the filing of the Chapter 3 petition, if the Chapter 3 petition is filed up to six months after the suspension period has elapsed;
- administrative expenses accruing prior to the effective date of the plan.

Additionally, assets backing employee retirement or post-employment benefits remain inviolable under Chapter 3.

CONSTITUTIONAL CHALLENGES TO THE DEBT RECOVERY ACT

The Commonwealth of Puerto Rico clearly recognized and anticipated that the Debt Recovery Act would face many challenges. In that regard, the Commonwealth provided its arguments on the constitutionality of the Debt Recovery Act. The Senate bill states that the Commonwealth has the police power to enact orderly debt enforcement and recovery statutes when facing an economic emergency, based on the power conferred on the Commonwealth under the Commonwealth's constitution and enabling statutes. The Commonwealth asserts that it may enact its own laws, as long as the law does not conflict with the Commonwealth's constitution, the constitution of the United States or applicable federal law. The Commonwealth asserts that the Debt Recovery Act is constitutional because the United States Supreme Court has held that States may enact their own laws for entities Congress has not rendered eligible under applicable federal law. The Debt Recovery Act provides that if an affected creditor demonstrates that its contractual rights are substantially impaired by a Chapter 2 or Chapter 3 proceeding, the impairment shall be allowed only if the petitioner demonstrates that the impairment is a reasonable and necessary means to advance a legitimate government interest, and the creditor "fails to carry the burden of persuasion to the contrary."⁹

⁹ The Puerto Rico Corporations Debt Enforcement and Recovery Act, Act 71-2014, Section 128.

The Commonwealth anticipated that constitutional challenges would be asserted against the enforceability of the Debt Recovery Act on the grounds of:

- *Preemption:* Article I, Section 8 of the United States Constitution provides that “Congress shall have the power . . . [to] establish . . . uniform laws on the subject of Bankruptcies throughout the United States. . . .”; The United States Congress has established uniform laws of bankruptcy by its enactment of the Bankruptcy Code and the Bankruptcy Code applies in the Commonwealth.¹⁰ Chapter 9 of the Bankruptcy Code governs the filing of bankruptcy petitions by “municipalities.” Section 101(40) of the Bankruptcy Code defines a “municipality” as a political subdivision or public agency or instrumentality of a State.¹¹ “State” is defined in Section 101(52) of the Bankruptcy Code to include Puerto Rico “except for the purpose of defining who may be a debtor under chapter 9 of [the Bankruptcy Code].”¹² The Bankruptcy Code’s definition of “person” excludes governmental units.¹³ Under the Bankruptcy Code, governmental units include a “department, agency or instrumentality of . . . a State.”¹⁴

As noted above, the term “State” is defined in the Bankruptcy Code to include Puerto Rico (except with respect to eligibility for filing under Chapter 9 of the Bankruptcy Code). Only a “person” is eligible to be a “debtor” under Chapter 7 or Chapter 11 of the Bankruptcy Code.¹⁵ Because the term “person” does not include a “governmental unit,” public corporations are not eligible to file a voluntary bankruptcy case under Chapter 7 or Chapter 11 of the Bankruptcy Code. Section 903 of the Bankruptcy Code provides that a State (which for these purposes includes Puerto Rico) may not enact a state law prescribing a method of composition of indebtedness of a municipality that is binding on any creditor that does not consent to the composition. (For this reason, the Senate bill endeavors to assert that the Debt Enforcement Act is not a bankruptcy act.)¹⁶

- *Impairment of Contracts:* Article I, Section 10 of the United States Constitution provides that “No State shall . . . pass any . . . Law impairing the Obligation of Contracts. . . .” (the “Contract Clause”). Despite its un-

¹⁰ All federal laws have the same force and effect in the Commonwealth of Puerto Rico as in the 50 States. 48 U.S.C. § 734. (The statutory laws of the United States not locally inapplicable . . . shall have the same force and effect in the United States. . . .”)

¹¹ 11 U.S.C. § 101(40).

¹² 11 U.S.C. § 101(52).

¹³ 11 U.S.C. § 101(41).

¹⁴ 11 U.S.C. § 101(27).

¹⁵ See 11 U.S.C. § 109.

¹⁶ The Puerto Rico Corporations Debt Enforcement and Recovery Act, Act 71-2014; Commonwealth S. 1164 dated June 25, 2014 at 153 (“This is not a bankruptcy act, but an orderly debt enforcement for the eligible public corporations”).

equivocal language, this constitutional provision “does not make unlawful every state law that conflicts with any contract. . . .”¹⁷ Instead, Contract Clause claims are analyzed under a two-pronged test. The first question is “whether the state law has . . . operated as a substantial impairment of a contractual relationship.”¹⁸ If the contract was substantially impaired, the court next turns to the second question and asks whether the impairment was reasonable and necessary to serve an important government purpose.¹⁹

- *Unconstitutional Taking*: The Fifth Amendment to the United States Constitution provides that “private property [shall not] be taken for public use, without just compensation” (“Takings Clause”). The Takings Clause applies to the States, and to the Commonwealth of Puerto Rico, by virtue of Section 1 of the Fourteenth Amendment. Creditors are likely to assert that the public corporation’s use of cash collateral (including revenues) amount to a taking without just cause.

Indeed, certain creditors who allege that they are holders of bonds issued by PREPA, have already commenced litigation in federal court in the Commonwealth of Puerto Rico in actions styled *Franklin California Tax-Free Trust (for the Franklin California Intermediate-Term Tax Free Income Fund, et al. v. The Commonwealth of Puerto Rico*,²⁰ and *BlueMountain Capital Management, LLC v. Alejandro J. Garcia Padilla, in his official capacity as Governor of Puerto Rico*.²¹ Additional litigation in federal and state court, both in the Commonwealth and off-island will likely ensue.

DEBT RECOVERY ACT IS SUBSTANTIVELY DIFFERENT FROM THE BANKRUPTCY CODE

The Senate bill for the Debt Recovery Act indicates that the act is modeled on Chapters 9 and 11 of the Bankruptcy Code, and admonishes stakeholders to refer to case-law interpreting the provisions of Chapters 9 and 11 of the Bankruptcy Code, to the extent applicable, for the purpose of interpreting the provisions of Chapter 3 of the Debt Recovery Act.

If the intent was to “provide stakeholders with familiarity in a process wrought with uncertainty,”²² the Commonwealth of Puerto Rico failed miserably. While

¹⁷ *Local Div. 589, Amalgamated Transit Union v. Massachusetts*, 666 F.2d 618, 638 (1st Cir. 1981); and see *United Auto., Aerospace, Agric. Implement Workers v. Fortuño*, 633 F.3d 37 (1st Cir. 2011).

¹⁸ *Energy Reserves Grp., Inv. v. Kan. Power & Light Co.*, 459 U.S. 400, 410 (1983).

¹⁹ *U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 20 (1977); and see *Houlton Citizens’ Coal. V. Town of Houlton*, 175 F.3d 178, 191 (1st Cir. 1999) (dividing the second inquiry into two subparts: whether there is a legitimate public purpose for the state action and whether the adjustment of contractual obligations is reasonable and necessary to accomplishing that purpose).

²⁰ Case No. 14-1518.

²¹ Case No. 14-1569.

²² The Puerto Rico Corporations Debt Enforcement and Recovery Act, Act 71-2014; Commonwealth S. 1164 dated June 25, 2014 at 163.

adopting certain provisions from the Bankruptcy Code, the Debt Recovery Act omits several key provisions that are favorable and protective of creditors' rights. These rights ensure that the burdens of a restructuring are shared amongst all stakeholders including the distressed public corporation, its creditors and other parties. Thus, the Debt Recovery Act creates even more instability and uncertainty for creditors and stakeholders. The consequence of this uncertainty will result in significant litigation, which will only add to the cost and create delays in resolving the financial distress of these public corporations.

Examples of just a few of the provisions in the Debt Recovery Act that are materially different than those under the federal Bankruptcy Code include the following:

- *No Safe Harbor Protection for Derivative Contracts* (Sections 205(c), 325(a)). The Bankruptcy Code provides special protection to parties that have entered into swap agreements, repurchase agreements and other derivative contracts, including the ability to terminate the derivative contract based on the insolvency, bankruptcy or financial condition of a debtor (these provisions are commonly referred to as "ipso facto clauses"). Under the Debt Recovery Act, however, there is no exception permitting a counterparty to terminate a derivative contract based on the public corporation's insolvency, financial condition or the commencement of a proceeding under the Debt Recovery Act. Additionally, under Section 365 of the Bankruptcy Code, a debtor is only able to assume or reject contracts that are "executory" (defined generally as contracts for which performance remains due by both parties). Under the Debt Enforcement Act, however, the public corporation may reject any contract, whether or not it is executory.
- *Limited protection Against Dissipation of Cash Collateral* (pledged revenues) (Sections 129, 207, 323, 324). Under the Bankruptcy Code, a debtor may not use cash collateral without the consent of the secured party or court order, and the court may condition the debtor's use of cash collateral on providing the secured creditor with adequate protection. The Bankruptcy Code provides special protections to creditors who hold liens on "special revenues" in assets involving Chapter 9 municipalities. Under Chapter 9 of the Bankruptcy Code, special revenues received by a Chapter 9 debtor after the commencement of a Chapter 9 case remain subject to a prepetition pledge. Additionally, the filing of a Chapter 9 petition does not operate to stay the application of pledged special revenues to bondholders holding liens on the pledged revenues. Thus, an indenture trustee or other paying agent may apply pledged revenues to payments coming due or distribute the pledged revenues to bondholders without violating the automatic stay. Under the Debt Recovery Act, however, distressed public corporation may use property, including cash collateral (such as revenues) as necessary to perform public functions. The Debt Recovery Act contains the following provisions:
 - a) The court may approve the use or transfer of property without providing adequate protection of an entity's interest in the property if

and when the police power justifies and authorizes the temporary or permanent use or transfer of property without adequate protection.

- b) Adequate protection of a secured creditor's interest in revenues is not required if the pledge of revenues is a "net pledge" (Section 207(b)), if the pledge provides that current expenses or operating expenses may be paid prior to the payment of principal, interest or other amounts owed to a creditor. The distressed public corporation will not be required to provide adequate protection to the extent that sufficient revenues are unavailable for payment of such principal, interest or other amounts after full payment of the current expenses or operating expenses
- *Right to Prime Existing Lien on Collateral* (Sections 206, 322). Under the Bankruptcy Code, a debtor is able to obtain credit secured with a lien equal or senior to an existing lien only if the existing lien holder receives adequate protection. Under the Debt Recovery Act, a public corporation may obtain credit during the Chapter 2 or Chapter 3 proceeding secured by a lien equal or senior to existing liens (a "priming lien") without providing adequate protection to the entity with an interest in the collateral if the credit is necessary to perform public functions.
 - *Right to Sur-Charge Collateral* (Section 129(c)). Under the Bankruptcy Code, a debtor is able to recover from a secured creditor the costs actually incurred to preserve, maintain or dispose of property, but only if the expense is for the benefit of the secured creditor. Under the Debt Recovery Act, a distressed public corporation may recover from or use collateral for the reasonable, necessary costs and expenses of preserving, or disposing of, property, including payment of expenses incurred by the distressed public corporation *pursuant to or in furtherance of* the Debt Recovery Act. The sur-charge does not appear to be limited to actual, reasonable costs incurred to preserve, maintain, or dispose of collateral.

If the goal of the Debt Recovery Act, in part, was to stabilize the capital markets and insulate the Commonwealth of Puerto Rico's general obligation and COFINA bonds from the financial distress of certain of the Commonwealth's public corporations, that goal has failed. In fact, the rating agencies have downgraded the securities issued by the Commonwealth and the public corporations, in part, because the adoption of the new law made a restructuring or default more likely.

CONCLUSION

In summary, the Debt Recovery Act attempts to balance the obligations of its financially distressed public corporations to repay its creditors against those corporations' obligations to provide public services. Because these entities are not eligible to restructure their obligations under Chapter 9 or Chapter 11 of the Bankruptcy Code, the Commonwealth of Puerto Rico's attempted to develop a mechanism as a matter of "local" or "Commonwealth" law. Despite its efforts, bondholders and other

creditors will not draw comfort from their familiarity or experience with the Bankruptcy Code. While some concepts may have been drawn from the Bankruptcy Code, the law is significantly different than that which exists under the Bankruptcy Code. Over the next few weeks and months, such bondholders and others will be poring over this novel and unfamiliar act to understand how the Debt Recovery Act will affect its rights. Ultimately, the courts will interpret and determine the validity of the act.