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Puerto Rico: Of Capital Structures, Control Rights, and Liquidity

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Abstract

The on-going financial distress of Puerto Rico seems to be accelerating, with no clear resolution in sight. This essay takes stock of the current situation, and suggests a path forward. It recounts the economic stress the territory has experienced in recent years, and delineates the complex capital structure that has resulted. The essay also argues that the problems that the island faces are as much about control as they are about trimming the current debt stock. The impending lack of liquidity has put Puerto Rico on the brink. It needs Congress to both provide fresh funds while at the same time instituting a mechanism to address the structural issues that beset the territory.

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Writing about the Puerto Rico debt crisis at this time is a bit like writing a news story at the halftime of a soccer match when you know that the piece is going to be published after the match is over. You may be able to analyze how things have gone so far and you certainly can hazard to make predictions about what will come. Your predictions could be wrong, they could be right, but one thing you know is that by the time the article is published much will have changed, quite often in unforeseen ways. Your readers are certainly going to know more than you did. The one difference, however, between my task here and that of the putative soccer analyst is that there is no assurance that the challenges that Puerto Rico faces will have been resolved when this piece sees the light of day, regardless of how long it

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takes to get this essay to press.[1] While things will no doubt have changed, there is no guarantee that a lasting solution to the current travails of the island will have been found let alone implemented.

The debt crisis that is facing Puerto Rico, its citizens and its invertors is daunting by any measure. Puerto Rico, in terms of population, is roughly the size of Iowa, with each jurisdiction claiming a bit more than three million citizens. Whereas Iowa's GSP (Gross State Product) per capita is more than $40,000, Puerto Rico's corresponding figure is less than $30,000. Indeed, Puerto Rico's Gross Domestic Product (GDP) per capita is lower than the GSP per capita of every state in the Union. Not only is the economic situation bad, but it is getting worse. In real terms, the country's economic output is less today than it was at the start of the Twenty-first century.[2] It is an economy that is at best stuck in neutral, but more accurately characterized as going in reverse.

Not surprisingly, Puerto Rico lags on almost every indicator of economic health that one can find. For example, its workforce participation rate is 40%. This compares with a US average of 63%. Forty-six percent of Puerto Rico's citizens live

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[1] In light of this long time horizon, perhaps cricket is the better analogy.
[2] See AO Krueger, R Teja & A Wolfe, *Puerto Rico – A Way Forward* 4 (June 29, 2015).

below the poverty level, as compared with 16% for those living in American states.[3] Whereas many states and countries have recovered from the Great Recession, Puerto Rico has not. Its economic output decreased by 1% last year, and a recent report authored by, among others, the former deputy managing director of the International Monetary Fund, assumes that the economy will continue to contract that at the same rate in the near future.[4]

The signs for the future are ominous. The country is losing population; as American citizens, those living in Puerto Rico have the right to move to the mainland, just as an American in Kansas can move to California.[5] Those living in Puerto Rico who have valuable skills are tempted by the ability to get a higher return should they decamp from Puerto Rico to come to the United States proper. They take away their human capital from the island, but leave behind the economic burdens. The mainland benefits and the island continues in its downward spiral.

One measure on which Puerto Rico excels is in amassing debt. Despite its weak economy, Puerto Rico managed to incur over $70 billion in debt. Only two American states, California (with over 39 million in population) and New York (with

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[3] See United States Government Accountability Office, *Puerto Rico: Information on How Statehood Would Potentially Affect Selected Federal Programs and Revenue Sources* 10 (March 2014).

[4] Krueger, *et al. supra* note 2, at 18.

[5] 8 U.S.C. § 1402 grants citizenship to those in Puerto Rico.

about 20 million), have higher total debt loads. On a per capita basis, Puerto Rico's debt is about three times as high as that of the highest state, Connecticut, and roughly ten times the U.S. average. As dire as this seems, the $70 billion figure actually understates the true extent of Puerto Rico's financial burdens. This staggering figure does not include the $30 billion or so by which its employee and teacher pension funds are underfunded. Taken together, the future debt obligations easily exceed $100 billion.

Given that Puerto Rico is a territory of the United States and not a state, one may ask whether the right benchmark for its debt is the debt levels of other nations rather than those of the subdivisions of the United States. This question of benchmarks is important, as national governments tend to have significantly larger debt burdens than their subunits. To get a sense of this, consider that Puerto Rico's debt totals about 70% of its GDP. This figure is substantially *lower* than that of the United States, which has debt-to-GDP ratio just above 100%. Indeed, Puerto Rico's ratio is well less than half of the debt ratio of Greece. In other words, were Puerto Rico viewed in comparison with the various nations of the world, its debt would not be the outlier that it is when it is viewed in relation to the debt of the states.

On reflection, however, it is clear that Puerto Rico is better viewed as a subnational unit. It often falls to the national authority to provide many of the basics of running the country, such as a military, social programs and infrastructure. These programs are paid for through taxes of various sorts; indeed, these programs comprise the lion's share of a nation's budget, which leaves substantially less for sub-units to both do and tax. Viewed along these lines, Puerto Rico does not have a military; it enjoys the protection of the United States military. It also does not run its own full array of social safety net programs. Puerto Ricans pay some, but not all, of the federal taxes as other American citizens. They pay employment taxes (Social Security and Medicare), but not federal income taxes.

To be sure, Puerto Rico does not enjoy the exact same benefit from the major American social programs as do citizens in the states. While Social Security applies the same in Puerto Rico as it does in the rest of the United States, the same is not true for Medicare, Medicaid and SSI. Some of the differences are notably large. For example, Puerto Rico receives well less than half of the Medicaid benefits that it would receive if it were a state. The GAO in 2014 issued a report that analyzed how the cash flow between the US and Puerto Rico would change if Puerto Rico were to become a state. While there would be some adjustments – Puerto Ricans would have to pay federal income tax; Puerto Ricans would receive a higher of benefits under some programs – the basic conclusion is that these changes are basically at the margin. Becoming a state would neither be a financial windfall to Puerto Rico nor it would be a significant burden. Puerto Rico would be a very poor state by U.S. standards, and, as such, there would be substantial transfers to it, just as there are to the less well-of states of the Union. On the whole, the clear takeaway is that, by and large, Puerto Rico, in terms of debt, should be compared with the states of the union rather than a country.

How Puerto Rico slid into financial distress is easy to recount. As is often the case with financial distress, there were a myriad of factors that have lead to the current crisis; while different commentators emphasize differing factors, all played a role in creating the current situation. One of the factors, undeniably, is the treatment by the United States. The relationship between the United States and Puerto Rico has been fraught since the beginning.[6]

Congress has used its power to enact laws that have had a negative impact on the Puerto Rican economy. For example, the Jones Act of 1920 requires that all ships traveling between the United States and Puerto Rico be registered in the United States. This law has the effect of raising shipping prices for goods shipped to and from the territory. Congress also requires that the island follow the U.S. minimum wage law. On top of this federal mandate, local Puerto Rico regulations on over time, paid vacation, and dismissal are more stringent than their counterparts on the mainland. Benefits for unemployed citizens, on the other hand, are relatively generous. Indeed, for many Puerto Ricans government benefits may exceed minimum wage employment. The combination of all of these effects has led to an economy with a very low employment rate. It is relatively expensive for employers to take on new employees, and it is relatively less beneficial for those not working to take an entry-level job.

[6] See S Erman, 'Citizens of Empire: Puerto Rico, Status, and Constitutional Change' (2014) 102 Cal. L. Rev. 1181.

Finally, in recent years the changing U.S. tax policy has negatively affected Puerto Rico. For a number of years, the U.S. Tax Code gave favorable treatment to manufacturing investments in Puerto Rico. This benefit provided an incentive for companies to create manufacturing facilities in the republic, an incentive that ended up being attractive to a number of drug companies. This benefit, however, was phased out, ending completely in 2005. The loss of the tax benefit coincided with many manufacturing concerns closing their doors on the island. These closures have contributed to the ongoing decline in the Puerto Rican economy.

To be sure, there are aspects of the relationship with the United States that benefit Puerto Rico. Puerto Ricans enjoy the protection of the U.S. military, they are covered by the main income protection programs of the US – Social Security, Medicare and Medicaid, albeit at reduced levels in some cases, especially for Medicaid. Unlike citizens of the states, however, they do not pay federal income taxes. One should not overestimate this last benefit. Given that wages in Puerto Rico are low, many of the island's citizens would not be effected by having to pay federal income tax. So, while the transfer payments to Puerto Rico from the federal government are lower than they would be if Puerto Rico were a state, so too are the transfer payments to the federal government. The GAO's study trying to specify how the cash flows between the federal government and Puerto Rico should the island become a state lists numbers with broad ranges due to factors that could not be identified with certainty. Still, on balance, it appears that in terms of the basic transfer programs, were Puerto Rico a state it would have roughly the same net cash flow that it does now with regards to the federal government.

In addition to the relationship with the federal government, much of the blame for the current economic situation resides with Puerto Rico's government and a series of decisions made over the years. Few would deem Puerto Rico a haven for entrepreneurs. The World Bank's Doing Business Index places Puerto Rico at 57th in the world, as compared with number seven for the United States.[7]

The combination of high debt and a poorly performing economy has helped fuel another trend. Puerto Rico is losing population; indeed, it is on track to have a lower population in the near future than it had 100 years ago. As mentioned before, Puerto Rico citizens have the right to move to the United States. The combination of the opportunities offered there with the bleak domestic picture has made it even more attractive for those with high levels of human capital to remove to the mainland. While such migration is beneficial for the receiving state, it further depletes the resources that Puerto Rico has to address its problems. It is difficult to foster economic growth in an economy where the population is declining, especially where the decline comes disproportionately from its most productive citizens.

In July 2015, Puerto Rico's governor stated the obvious – there was no way that Puerto Rico could service its debts going forward. Indeed, few serious people

[7] See World Bank, *Doing Business 2016* 5 (2015)

think that, without any changes as to how Puerto Rico operates, it has any hope of repaying its outstanding debts. A blue ribbon panel of experts concluded that, without changes, Puerto Rico's budget deficits over the next decade will range from $3 ½ - 8 ½ billion.[8] Indeed, even with structural reforms that could add a jolt of stimulus to the Puerto Rican economy, it is still hard to see how Puerto Rico could service its debts in the short and medium term. The short term is especially challenging, given that Puerto Rico is close to running out of money. It not only faces the prospect of not paying back what it owes, but it soon may not be able to pay its current expenses.

There is no obvious solution to the crisis facing Puerto Rico. The remainder of this essay outlines these challenges along three dimensions – the lack of a coherent capital structure, the lack of control rights vested in an entity that can make necessary structural changes, and the lack of liquidity. While the island does not have the resources to solve these problems on its own, the federal government can provide a mechanism that would address all three concerns.

I. The Lack of a Coherent Capital Structure

Adding to the bleak fiscal picture confronting Puerto Rico is the unwieldy nature of the country's debt stock. It is not as if Puerto Rico owes $72 billion and all

[8] See Krueger, *et al.*, *supra* note 2, at 15.

its creditors stand on equal footing. In such a scenario, there would be difficult conversations about the appropriate financial restructuring, but all of the creditors would have, at least as a starting point, the same economic interests.[9] They would share and share alike in any reduction of the island's debt, and would benefit ratably should the Puerto Rican economy turn around. The focus in such a discussion would be on the relationship between the creditors and the debtor, and what a sustainable level of debt would be for the country.

Matters, however, are more complicated. Unlike the other, the other high profile sovereign distress of recent times – Greece – Puerto Rico's debt is not all issued directly by the government. Rather, the debt has been issued by a number of different entities. Even the bonds that the government itself has issued directly come in different flavors, with different types of bonds looking towards differing sources of government revenues for repayment. The varying claims that creditors hold could well lead to sustained disagreement, as differing groups of creditors each claim that they are entitled to first dibs on a given source of revenue. Moreover, the

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[9] These interests can, however, diverge. To the extent that an investor has purchased more credit protection than it has in outstanding debt, it could be net short and actually benefit from a default. For a discussion of this dynamic, see DG Baird & RK Rasmussen, 'Antibankruptcy' (2010) 119 Yale L.J. 648, 677-87. The common wisdom in the bankruptcy community is that the ability to in effect purchase a short position has made restructurings more difficult.

differing classifications allow any group of creditors to assert that it is some other group that needs to have its holdings pared back for the common good.

There are at least 17 different flavors of Puerto Rican debt. The issues are, not surprisingly, in widely differing amounts. Perhaps at the top of the hierarchy are the country's general obligation bonds.[10] The Constitution of Puerto Rico provides that these obligations take precedence over all others. Specifically, Article VI, Section 8 of the Constitution provides:

> "In case the available revenues including surplus for any fiscal year are insufficient to meet the appropriations made for that year, interest on the public debt and amortization thereof shall first be paid, and other

[10] The general obligation bonds have been issued by the Government Development Bank. The GDB was founded in 1945 to assist with financing development in Puerto Rico. In 1972, it issued its first bonds. Today it is the fiscal agent for the island. It not only issues the general obligation bonds, but it also is responsible for making the payments as they become due. For a history of the GDB, see http://www.bgfpr.com/about-gdb/history_01.html. The coffers of the GDB are almost dry, which runs the substantial risk of triggering a liquidity crisis. Given how intertwined the GDB is in handling Puerto Rico's fiscal affairs, any restructuring of the debt stock (some of which is held by the GDB) would most likely require a recapitalization of the Bank.

disbursements shall thereafter be made in accordance with the order of priorities established by law."

In other words, the monies due and owing on the public debt have to be paid before the country meets any other of its obligations. Most observers, and certainly the debt markets, view these as the most secure of Puerto Rico's many debt issues. Currently, there are about $14 billion in these bonds outstanding.

But even within general obligation bonds, there are important differences and these differences complicate the rescue effort. Most notably, in 2014 the government issued $3.5 billion in general obligation bonds, paying interest at 8%. These bonds, unlike their predecessors, allow for suit to be filed in New York. In prior issues, the government only consented to be sued in Puerto Rico.[11] Thus, it is easy to imagine those holding the 2014 general obligation bonds would bring an enforcement action in the New York courts, whereas the holders of such bonds that were issued earlier would turn to the Puerto Rican courts for their remedy. The possibility of suits in differing jurisdictions raises the specter of conflicting interpretations of the relevant laws. Especially problematic would be differing rulings on the relationship between the general obligation bonds and the other bonds issued by the federal government.

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[11] That Puerto Rico enjoys sovereign immunity has been the law for over 100 years. See Porto Rico v Rosaly v Castiallo, 227 U.S. 270 (1913).

Perhaps the group of bonds issued by the federal government that come next in the pecking order are the COFINA bonds.[12] In 2006, Puerto Rico enacted a sales tax. The legislation provided that one half of the revenue stream was pledged to repay the newly issue COFINA bonds, with the other half going into the general fund. How could this be, given the Constitution's grant of priority to the general obligation bonds? How could part of the tax stream go first to the holders of COFINA bonds, thus bypassing those who hold general obligation paper? The argument is that the funds from the sales tax, since they are pledged, are not "available revenue" as that term is used in the Puerto Rican constitution. While there is some precedent in other states that supports this argument, it has yet to be put to the test in the Puerto Rican (or New York) courts. It does not take much creative work to craft an argument that the dedication of the tax revenues to the COFINA bonds runs afoul of the Puerto Rican Constitution. Indeed, the entire reason behind the creation of the COFINA bonds was precisely to evade the demands of the Constitution. Given the unpredictability of sovereign debt litigation in the past, it would be foolhardy to deem the allocation of sale tax revenue between COFINAs and general obligation bonds as being definitively settled.[13] There is about $16 billion in CONFINA bonds

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[12] COFINA is "attached" to the GDB, but not a subsidiary of it. Rather, it is independent. See http://www.bgfpr.com/affiliates/sales-tax-financing-corporation.html.

[13] Indeed, a proposal to have the United States Treasury collect the taxes for Puerto Rico encountered opposition in part because financial players holding general obligation bonds worried that having the money go to the U.S. Treasury would allow

outstanding. Thus, in total, over 40% of Puerto Rico's debt is comprised of general obligation and COFINA bonds.

Other large chunks of debt have not been issued directly by the government, but rather by three public corporations established by the Puerto Rican government. The three largest public entities– power (PREPA), water (PRASA), highways (HTA) – have outstanding debt in the neighborhood of $30 billion. While there is currently a tentative deal in place that would reduce PREPA's debt by 15%, the agreement also requires that the government enact legislation which some view as opening up the utility to privatization in the future. Assuming that the current agreement is finalized (and deadlines keep being pushed back), if there is a default on the new obligations, it may well lead to a movement to privatize the utility companies. Should that occur and the companies convert to private ownership, the holders of the debt would be well positioned to become the new owners of the utility.[14]

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for the argument that the funds were no longer available resources and hence they would lose their priority position. See M Corkery & MW Walsh, 'Treasury Considers Plan to Help Puerto Rico' http://www.nytimes.com/2015/10/15/business/dealbook/treasury-considers-plan-to-help-puerto-rico.html?smtyp=cur

[14] The "loan to own" strategy is well known in the context of lending to corporations. See DA Skeel, Jr., 'Creditors' Ball: The "New" New Corporate Governance in Chapter 11' (2003) 152 U. Pa. L. Rev. 917.

The remaining obligations, roughly $10 billion or so, consists of a variety of differing bonds. Various municipal governments have issued debt totaling roughly $4 billion dollars. Another $4 billion in debt represents so-called "appropriation" debt. The Government Development Bank created a subsidiary, the Public Finance Corporation for the purpose of issuing debt. The funds raised by the PFC were used to build things like schools and landfills. The understanding was that the debt was to repaid through the legislature enacting laws transferring funds to the PFC. Because there is no express promise to make such an allocation, however, the government takes the position that these funds are only "moral" obligations, under which the holders have no right to compel payment. The bonds did have a guarantee by the Government Development Bank, but the value of the guarantee is uncertain. Puerto Rico missed a payment on these bonds in August.[15]

In addition to multiple classes of debt, the problem of lowering Puerto Rico's debt level is complicated even further by the way in which that debt is held. Some of the debt is held by individual investors, the bulk of whom live in Puerto Rico and in the United States mainland. The problem with this part of the debt is that without a mechanism to bind all holders to a new arrangement, it is difficult to get these disparate bondholders to work in concert. In the corporate context, the governing

[15] See Mary Williams Walsh, *Puerto Rico Defaults on Bond Payment, http://www.nytimes.com/2015/08/04/business/dealbook/puerto-rico-decides-to-skip-bond-payment.html?_r=0*

wisdom is that the more the debt is widely held, the more difficult it is to reorganize outside of a bankruptcy proceeding.[16] The same is likely true here as well.

Added to the individual investors are institutions of various stripes. Some of these are standard mutual funds that hold municipal debt. Indeed, one estimate suggests that 85% of mutual bond funds include some Puerto Rican debt in their holdings. The widespread holding of Puerto Rican debt by American mutual funds is due to the fact that interest payments on the debt are exempt from federal, state and local taxes. Given that these tax advantages flow to all Puerto Rican debt, the funds themselves tend to hold various issues of debt. For example, the Oppenhiemer and Franklin Funds combined held roughly $7 billion in Puerto Rican debt (Oppenhiemer held a total of $4.6 billion and Franklin held $2.3 billion). When Puerto Rico tried to pass an insolvency regime that would allow its public corporations to overhaul their debts, these two funds challenged the law on preemption grounds. As part of the suit, they represented that they held more than $1.5 billion in PREPA debt, implying that they held roughly $5.5 billion in other Puerto Rican obligations.

In addition to the bond funds that hold Puerto Rico's debt, the other major group of debt holders are hedge funds. Indeed, hedge funds were the prime

[16] See RH Gertner & D Scharfstein, 'A Theory of Workouts and the Effects of Reorganization Law' (1991) 46 J. Fin. 1189.

architects of the recent issuance of $3 billion in general obligation bonds.[17] There are, of course, a large number of hedge funds and an almost equally large number of strategies that they follow. One class of hedge funds, relevant to Puerto Rico, specializes in distressed debt. These funds are generally known for their aggressiveness in pursuing their goals. They often buy into debt that is trading at a discount, looking for a way to increase the value of the instrument quickly and reaping a substantial return. By and large, they are not in it for the long haul.[18]

As the numbers of players holding differing types of instruments multiplies, it becomes increasingly difficult to arrange a consensual restructuring. Even if there is agreement in the abstract that something has to be done, the parties can be expected to diverge on who should bear the brunt of the restructuring. One source claims that $11.3 billion is held by mutual bond funds, $15 billion by hedge funds, and the rest by individuals, mostly in Puerto Rico and the mainland.[19]

This chaotic dispersion of Puerto Rico's debt suggests that there would be substantial hurdles to trying to resolve matters amicably. The hurdles are of at least two types. The first is that, within any given class of bonds, the holders may disagree

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[17] See J Mahler & N Confessore, 'Inside the Billion-Dollar Battle for Puerto Rico's Future' http://www.nytimes.com/2015/12/20/us/politics/puerto-rico-money-debt.html?emc=edit_th_20151220&nl=todaysheadlines&nlid=43250620

[18] See Skeel, *supra* note 14; Baird & Rasmussen, *supra* note 9.

[19] http://money.cnn.com/2015/07/01/investing/puerto-rico-bond-holders/

as to the appropriate outcome. It is easy to imagine hedge funds taking a different route than bond funds, which in turn may see things differently than individual investors. The bonds here were issued under Puerto Rican law, and thus they are exempt from registration under the Securities Act of 1933, and correspondingly, the Trust Indenture Act. While the TIA's prohibition on terms that allow the reduction of principle without the consent of the bondholder does not apply, the bonds as issued do not contain such clauses. Thus, there is no mechanism within the bonds themselves to allow for the majority to bind the minority to a write down of debt. In theory, Puerto Rico could attempt to amends its laws to allow for such collective action clauses, as Greece did, but there has no attempt made along those lines.[20] To be sure, holders of extant bonds could have argued that the Contracts Clause of the United States Constitution bars such amendments,[21] though the resolution of any such challenge was far from certain.

Even if the holders of each debt class could speak with one voice, it would still be challenging to find a solution to the current crisis under the current legal regime. In addition to the inability to bind members within a class of bondholders,

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[20] On the ability of Greece to amend local law to retroactively insert collective action clauses into its bonds, see J Zettelmeyer, C Trebesch & M Gulati, 'The Greek Debt Restructuring: An Autopsy' (2013) working paper.

[21] See U.S. Const., Art. I, Sec. 10, Clause 1. ("No State shall * * * pass any * * * Law impairing the Obligation of Contracts * * *.")

there is no mechanism to bind the various classes to the same arrangement.[22] For example, one can easily imagine disputes among the holders of general obligation bonds and COFINAs as to which group has first dibs on the revenues generate by Puerto Rico's sales tax.[23] Those holding general obligation debt could well argue that they have priority over all the tax revenues, whereas those holding COFINA bonds assert that they are entitled to half of the stream from the sales tax. By the same token, the holders of the debt of the utilities may differ radically in their preferred outcome.

This chaotic capital structure suggests that there may be no deal that can win the agreement of all the parties. Any coalition that forms could collapses as some defect to a new coalition in which they are better off. In the language of game theory, there is no core solution. Indeed, one of the often overlooked benefits of Chapter 11

[22] On the twin hurdles of getting agreement among class members and between classes, see LC Buchheit & M Gulati, 'Sovereign Bonds and the Collective Will' (2002) 51 Emory LJ 1317.

[23] The opinion letter accompanying the issue of COFINA bonds in 2011 stated its conclusion that diverting the tax revenues to the bonds did not run afoul of the Constitution. It was careful to note, however, "The outcome of any challenge to this transaction cannot be predicted with certainty. It is of significance that there are at present no Puerto Rico precedents controlling or directly on point. * * * Thus, different conclusions could be reached by a court and would not necessarily constitute reversible error." Nixon Peabody letter at 10.

is that, by assigning to the debtor the right to propose a plan of reorganization, it can overcome the problem of an empty core.[24]

Indeed, to date there have been various attempts to reach agreement on restructuring various aspects of the debt. While there have been some areas of agreement, none of these attempts has come to fruition. For example, a group of more than three dozen hedge funds holding over $5 billion in debt had been meeting since February 2015 in hopes of finding a solution. These funds held primarily general obligation bonds and COFINA bonds. They were exploring ways to fund new debt, but the alliance fell apart in mid-September.[25]

The negotiations that have proceeded the farthest involve the power company. There is a tentative agreement among some of the bondholders of PREPA. The basic terms are a 15% haircut, coupled with minimal cash requirements for the first few years. Some of the new bonds pay interest only for the first five years. Others make no payments at all for the first five years. Of course, while this deal would drastically reduce PREPRA's cash obligations over the next five years, it is by no means assured that, five years hence, the problems that confront the utility will have been solved.

[24] See Baird & Rasmussen, *supra* note 9, at 687-98.

[25] See Laura J. Keller, Puerto Rico's Biggest Hedge-Fund Coalition Said to Disband, http://www.bloomberg.com/news/articles/2015-09-24/puerto-rico-s-biggest-hedge-fund-creditor-group-said-to-disband

Recent action by the United States Supreme Court has added even more uncertainty to the situation. As the United States Bankruptcy Code is currently written, Puerto Rico and its municipalities cannot take advantage of its provisions. Puerto Rico attempted to resolve the financial distress plaguing its municipal corporations by enacting its own bankruptcy law. In June 2014, Puerto Rico passed the Puerto Rico Public Corporation Debt Enforcement and Recovery Act.[26] This law would have allowed the utility companies and other government agencies to restructure its debt and, subject to certain conditions being met, bind those who did not agree to the terms of the deal. The federal district court and the court of appeals, however, both concluded that this law was preempted by federal bankruptcy law.[27] Most commentators agree with this analysis. Nevertheless, the Supreme Court recently agreed to hear the case.[28] While most view the chances of Puerto Rico winning as something of a long shot, the possibility that the law may be valid could

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[26] See Puerto Rico Public Corporations Debt Enforcement and Recovery Act, Act 71-2014.

[27] See Franklin Cal. Tax-Free Trust v. Puerto Rico, No. 14-

1518, 2015 WL 574008, at *1 (D.P.R. Feb. 10, 2015); Franklin Cal. Tax-Free Trust v. Puerto Rico, No. 15-1218 (1st Cir. July 6, 2015).

[28] Commonwealth of Puerto Rico v. Franklin California Tax-Free Trust, No. 15-255 (Dec. 4, 2015).

well affect negotiations. The threat of worse treatment under that law should it take effect may induce some creditors to soften their stand in ongoing negotiations.

On final player deserves mention: the United States government. Its mere presence makes finding a solution in the current environment even more difficult. It is not that the US has taken steps to impede resolution of the crisis. Far from it. There have been various proposals for action that would help alleviate the crisis, including one put forward by the Obama Administration. But that is the problem. There is belief in some quarters that should things deteriorate enough, the federal government will come in and rescue Puerto Rico. Given the dire situation that American citizens in Puerto Rico would face in the event of the local government running out of funds, that Congress would take some action to address the current situation is not idle speculation.

Not surprisingly, the politicians early on by and large were adamant that there will be no bailout for Puerto Rico. It is easy to see why this was the case. Even if public officials harbor private sympathy for the plight of those in Puerto Rico, there is little incentive to express it publicly or even privately. The federal government would, all things being equal, prefer the loss fall on the investors in the bonds rather than the public fisc. Any indication that the government will arrive at the last minute could lead investors to hesitate in agreeing to any but the modest amount of haircuts. As the situation in Puerto Rico has deteriorated, more legislators are willing to publicly float the idea that some sort of action needs to take place.

Until it is clear precisely what action the federal government will or will not take, the possibility that it may intervene is another complicating factor. Until the government acts, or convinces the various holders of Puerto Rico's debt that it will not act, it is unlikely that a deal will occur. Indeed, for reasons discussed below, it is difficult to imagine a way out of the current morass without federal intervention.

II. The Problem of Control

As challenging as it is to find ways to restructure Puerto Rico's extant debt, in some ways that is the least of the worries. Many of the causes of the debt crisis are structural. This is not a situation where a sovereign's debt has grown to an extent that it cannot be fully serviced, but the underlying operations of the economy are sound. Were that the case, once the debt is restructured so that it can be serviced, the government can continue on the path that it was on. The only problem that needs to be addressed is the entity's balance sheet; its core operations do not need to be adjusted.

That, alas, does not describe Puerto Rico's plight. Puerto Rico is bearing the brunt of decisions that have been made over the years, both by the island's government and by the federal government. Even if the territory could evade the current crisis, it has little hope of returning to robust economic health without systemic changes in its economy. Puerto Rico has a high cost of doing business, low domestic demand for its goods and services, and an economy that is contracting. Paring the debt down to more modest levels is not a long-term fix for the problems that ail the Puerto Rican economy. To the extent that Puerto Rico needs to change course as well as trim its debt stock, this is a question of making systemic changes to the way that the country operates.

The power to make changes in the current state of affairs rests with the elected politicians. They exercise control over the island's policies.[29] Yet it is often the case that politicians are unable to implement the policies that are needed, even when they have a sense of what needs to be done. Unlike the CEO of a company who only needs to retain the confidence of the Board (and in times of financial distress the senior lenders), government officials face the electorate at regular intervals. When a government runs into financial distress, it places the officials in a difficult position. They are often elected with the assistance of groups that could see their incomes hurt in a restructuring. Indeed, it may even be the case that the reason the government is in financial distress is because politicians over the years gave in to the temptation of making promises that they knew or at least should have known

[29] One the central role that control rights play in the reorganization of private firms, see DG Baird & RK Rasmussen, 'Private Debt and the Missing Lever of Corporate Governance' (2006) 154 Pa. L. Rev. 1209.

that they could not keep. The short time horizon of elected officials creates the incentive to give benefits today while pushing costs off into the future. The future, however, inevitably arrives, and the structure of the government may make it ill equipped to take necessary action.[30]

To give one example of this dynamic, one option to a government facing distress is to increase the efficacy of its tax system – either through raising rates or improving collection efforts. The porous nature of the extant system develops with at least the tacit approval of the government, which is turn supported by the electorate. Aligning facts on the ground with the law on the books is no easy task. It is almost universally the case that citizens tend to resist paying more, especially at a time when services are being reduced. Politicians wishing to stay in office may reasonably drag their feet in terms of upping collection efforts. Indeed, in Puerto Rico's case, all see to agree that one thing that needs to be fixed is the tax collection system. As we have seen in Greece, however, it is one thing to observe that a tax regime is not collecting all that it is owed, it is quite another to reorient the system.

Another impediment is that many wealthy Puerto Ricans own the government's debt. They would have little enthusiasm for measures that drastically write down the territory's bonds. They may well attempt to use their influence to

[30] For an excellent analysis of the political dynamics in municipal bankruptcies, see CP Gillette and DA Skeel, Jr., 'Governance Reform and the Judicial Role in Municipal Bankruptcy' 9 (forthcoming) Yale L.J.

impede efforts that would benefit the economy as a whole but impair their own wealth.

Also, for decades the relationship between Puerto Rico and the United States has been contentious among the citizens of the island. Some favor Puerto Rico becoming a state; others prefer the current arrangement. Attempts to work with the federal government in addressing the current problems will be viewed against this backdrop. For example, were Puerto Rico allowed to use Chapter 9, this could be seen domestically as an attempt to closer align Puerto Rico with a state.

The solution to the paralysis that local officials encounter in times of financial distress is for control rights to shift from the elected officials to another group that faces fewer electoral constraints. It is one thing to recognize that control has to shift to a group that does not have to face the wrath of the public; it is another to actually ensure that it happens when it is necessary to do so. Few people who exercise control are willing to give it up, whether they are in the public or private sector. In the private sector, senior creditors have devised ways to ensure that control rights are exercised in a way that does not impair their interests. The lenders through various means have been able to obtain input in the executive suite. They can encourage the company to hire a chief restructuring officer. Indeed, the person selected will often have the blessing of the lenders. In the extreme, in some cases the senior lenders end up owning the company. Short of this, they can make sure that the debtor does not take action that would threaten their interests. While there is a vigorous debate over the merits of this development, it is clear the lenders can often cajole the debtor to reorienting its operations more so that it is more in line with the lenders' thinking.

Things are much more complicated in the public sphere. Private lenders lack the levers of control that they have in the private sector. The debt instruments that they hold do not contain the type of provisions that are seen in private debt. Indeed, in the case of Puerto Rico, the territory's assets cannot be seized. To the extent that control rights need to be shifted to an entity that does not face the constraints that politicians do, the lenders are ill-equipped to trigger such a switch.

When we look at the resolution of sovereign distress in other situations, it is almost always the case that control rights shift so that the necessary structural reforms can take place. In the case of state sovereigns, such changes are done through the International Monetary Fund. The IMF plays two crucial roles in addressing a country's fiscal woes. The first is the determination of sustainability. By its charter, the IMF will only lend when the resulting debt load is sustainable. But sustainability is partly a concept of what sacrifices the citizens of a country should expect to bear. Sustainability analysis addresses the question of the extent to which a country's debt burden should be adjusted.

The IMF, however, also exercises control rights. The agency imposes structural changes through the nature of its lending. The principle is called "conditionality." The funds that the IMF loans come with strings attached. The access to them is conditioned on the borrower enacting a set of policies that the IMF staff negotiates with the debtor nation. This involvement of the IMF provides cover to the local politicians. They can kick and scream while they implement the needed reforms, pointing fingers and shaking their fists at the IMF. The IMF can insist on actions that an elected government would never voluntarily undertake.

Sustainability analysis and conditionality work in tandem. If the IMF through conditionality can induce the sovereign to implement policies that can lead to economic improvement, then the sovereign, in theory, could service a larger debt load. Conversely, if the debt level is stabilized, this stability can further enhance economic growth. While these changes thus help the country flourish in the long run, there is often austerity in the short run. Given political realities, it is difficult to imagine the politicians enacting the necessary reforms without the coaxing of the IMF.[31]

A similar dynamic of having outsiders direct necessary changes to the way in which the government operates is at work in the United States. In the American domestic context, states and the bankruptcy judge play the role of exercising control rights to restructure the governmental entity. Chapter 9 does not give municipalities an unfettered right to file for bankruptcy. Rather, Chapter 9 is only open to

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[31] The role of the IMF in this regard has been challenged, most notably by Joseph Stiglitz. See Joseph E. Stiglitz, Globalization and its Discontents (W.W. Norton 2002).

municipalities where states have authorized the municipality to take advantages of its provisions. This gives the state some measure of control over the municipality. The recent bankruptcy of Detroit shows how powerful this control can be. State law allowed the governor to appoint an emergency manager with extensive control over the city's finances. The governor exercised this power, placing a restructuring expert in change of the city's fiscal operations. After the appointment, the manager recommended to the governor that Detroit file for Chapter 9 bankruptcy. The governor approved this recommendation. The manager, working with the bankruptcy judge, found a way to reduce Detroit's debt stock and to launch efforts to revitalize the city. The manager was able to make hard choices that may have been well beyond the stomach of local politicians.

Two other experiences in the United States combined debt relief with the imposition of oversight by an outside entity. The first involved New York City. In the 1970's, New York City faced financial distress. The state of New York put the Emergency Financial Control Board in place in 1975. The City had only two votes on the seven-member board. Congress, after the Board was in place, eventually extended a loan to the City, but as with the IMF and its lending practices, strings were attached. The City had to hike fees, cut services and raise additional taxes. The First Deputy Mayor, the Deputy Mayor for Finance and the city's budget director all had to resign and be replaced. New York returned to financial health, due in large part to measures that the Board put in place.

Along the same lines, when the city of Washington, D.C. faced a fiscal crisis, Congress in 1995 established the District of Columbia Financial Control Board. The Board had the power to override decisions made by the Mayor and the city council. The Board stayed in place until September, 2001, when the District achieved its fourth consecutive balanced budget. As was the case in New York City, shifting control away from elected officials facilitated necessary structural changes.

The issue of control looms large in Puerto Rico. Puerto Rico needs more than debt relief; it needs restructuring of some of its basic operations. Simply allowing the government to file for Chapter 9, as some have suggested, would not necessarily have the safeguard of vesting control in a third party immune from local political pressure. It is because of this that there have been calls for the establishment of a board to oversee the restructuring efforts, but it is unclear the extent to which the board would have sufficient control rights to restructure Puerto Rico's operations.[32] Not surprisingly, the government of Puerto Rico has suggested that it establish the board that will oversee the restructuring of the island's operations. Equally not surprising, this proposal has garnered little support or enthusiasm in the creditor community. Who has the power to appoint the board obviously matters.

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[32] Kruger, et al. call for such a board, *supra* note 2, at 22, though the report does not specify the extent of the board's powers. Puerto Rico's governor subsequently called for the establishment of such a board, though that proposal did not go forward.

III. The Problem (or Benefit?) of Liquidity

Why would politicians ever cede control to an outside entity? They run for elected office in order to put their hands on the levers of powers. Having in many cases worked all of their lives to ascend to the top, all things being equal they would rather remain in charge. But not all things are equal. It is often the need for cash that induces the elected officials to transfer some measure of control to a third party. The lack of liquidity can often force the issue.

Few entities, whether private or public, end up in financial distress holding an excess of cash. Debtors in both the private and public sector tend to borrow as much as they can in an effort to stave off the day of reckoning.[33] When the time for restructuring arrives, there is often insufficient funds available to keep operations running which the restructuring takes place. Chapter 11 of the American Bankruptcy Code addresses this problem by allowing companies that file for bankruptcy to borrow funds on a priority basis.[34] Similarly, in the sovereign debt context, the International Monetary Fund lends money that it expects to get paid back first.

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[33] On the incentives to delay the filing for bankruptcy in the private sector, see RK Rasmussen, 'The Ex Ante Effects of Bankruptcy Reform on Investment Incentives' (1994) Wash. U.L.Q. 1159.

[34] See 11 U.S.C. 364.

It is the need for liquidity that often induces elected officials to cede control rights in varying measures to a third party. In the case of nation states, the lender of last resort is the IMF. They turn to the agency when they have no other sources of credit available. It is only the possibility of getting funds from the IMF that stands between them and fiscal collapse. At this point, the IMF has tremendous leverage. It can dictate in significant ways the terms of the restructuring. A country facing a crisis of liquidity agrees to the conditions set forth by the IMF in order to get the funds that it needs in order maintain its basic operations.

Puerto Rico is no different in this regard than other financially embarrassed sovereign. It is has depleted most of its cash. The question has moved from whether Puerto Rico will miss a debt payment to when will Puerto Rico miss a debt payment. Unlike corporations under Chapter 11 or countries working with the IMF, Puerto Rico does not have a mechanism by which it can borrow funds to see it through the restructuring process. By statute, it is not allowed to seek protection under the Bankruptcy Code, and the IMF does not extend credit to distressed territories. Given the overhang of existing debt, Puerto Rico can only attract new financing if it can assure the new lender that its obligations will have priority over existing debt. Yet, there is no route by which it can meaningfully promise new lenders that they will be repaid in full.[35]

[35] It is an interesting question whether, had Puerto Rico had access to a restructuring mechanism, it would have invoked it prior to running low on cash and needing fresh funds. Put more broadly, is the ability to award priority debt an

The lack of a coherent capital structure, control rights vested in those who can use them boldly and the evaporation of the government's remaining cash reserves leaves Puerto Rico in a bleak situation. Yet, it is the need for cash that may ultimately bring matters to a head. When a corporation runs out of cash, people lose their jobs. When a sovereign runs out of funds, many do not get paid and the entire economy grinds to a halt. The dire situation that results when a government cannot pay its builds creates an environment where politicians will cede control, and the electorate will support the decision. Moreover, the plight that those in Puerto Rico face may well provide the necessary crisis for Congress to act.

Conclusion

In the end, the broad outlines of what has to happen in Puerto Rico are fairly clear. The territory's debt obligations need to be pared back. The stark reality is that it cannot service its existing debt stock. Structural changes need to be implemented as well. Puerto Rico (and the United States) needs to enact and enforce policies that will start the economy moving in the right direction. Without an entity that has the

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unavoidable feature of a regime that allows for the restructuring of sovereign debt. For thoughts on how to structure a mechanism for resolving the fiscal distress of sovereigns, see P. Bolton & D. Skeel, Jr., "Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?" (2004) Emory LJ 763.

right to force the solution, however, it is fraught as to how things will proceed. In the current environment, only the United States has the ability to overcome the hurdles that lay in the path of a successful resolution to the current crisis. While there is the power, however, it is unclear what the path will be ultimately taken. Possibilites include access to Chapter 9 of the Bankruptcy Code for some (or all) of the entities that have issued debt; a bailout of some sort, presumably in exchange for some structural reforms; or perhaps a new procedure designed specifically for the situation at hand. Lurking in the background is what will the precedential effect of the action be as it relates to some of the fiscal problems that are facing a few of the states.[36]

[36] The state with the worse financial situation currently is Illinois. See http://mercatus.org/statefiscalrankings/illinois