

## PUERTO RICO DEBT RECOVERY ACT RULED UNCONSTITUTIONAL<sup>1</sup>

On Friday February 6, the Puerto Rico Federal District Court ruled the Debt Enforcement and Recovery Act (the “Recovery Act”) unconstitutional. [Franklin Calif. Tax-Free Trust, et al. v. Comm. Of Puerto Rico et al., \(D.P.R., Feb. 6, 2015\)\(Case No. 3:14-cv-01518-FAB\)](#).

The opinion is extensive and addresses each of the constitutional challenges raised by both Blue Mountain and the Franklin/Oppenheimer plaintiffs, and the Commonwealth’s request that the bondholder complaints be dismissed as being “unripe”, among other defenses. The Court confirmed federal jurisdiction and ripeness of the bondholders’ claims of preemption, impairment of contracts and certain of the taking clause claims. The Court said that those claims became ripe immediately upon adoption of the Recovery Act. Most importantly, the Court has ruled that the entire act is preempted expressly by the federal Bankruptcy Code and is therefore void pursuant to the Supremacy Clause of the United States Constitution. The Court further ruled that the Commonwealth is permanently enjoined from enforcing the Recovery Act.

A summary of the key findings by the Court is provided below. The Court also dismissed the claims against PREPA. The Court held that the mere fact that PREPA may commence an action under the Recovery Act at some future time is not sufficient to assert claims against PREPA. The Court noted that “if PREPA’s filing for debt relief pursuant to the Recovery Act were imminent, this could be a sufficient injury traceable to PREPA.” (Decision at 26-27).

### Preemption

As noted above, the Court held that the federal Bankruptcy Code preempts the Recovery Act expressly. 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 Court noted

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that 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. 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. While recognizing that “State” is defined in 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]”, the Court held that 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. The Court held that “Congress’s decision not to permit Puerto Rico municipalities to be Chapter 9 debtors reflects its considered judgment to retain control over any restructuring of municipal debt in Puerto Rico.” (Decision at 39) The Court held that the Recovery Act is a law that binds non-consenting creditors and therefore is unconstitutional pursuant to the supremacy clause of the US Constitution.

### **Impairment Of Contracts**

The Court denied the Commonwealth’s motion to dismiss the impairment of contracts claims in the complaint, finding that the Recovery Act may impair the contractual relationships and obligations under the PREPA enabling act and the Trust Agreement. 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 unequivocal language, this constitutional provision “does not make unlawful every state law that conflicts with any contract. . . .” Instead, the Court noted that 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. 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.

- The Court stated that because the Recovery Act totally extinguishes significant and numerous obligations, rights and remedies, the Court easily concludes that the impairment caused by the Recovery Act is substantial. (Decision at 60). Among the rights the Court found were extinguished by the Recovery Act are the following:
  - Right to a senior lien on revenues
  - Prohibition on PREPA selling its electrical-power system
  - An ipso facto clause triggering default remedies
  - Right to bring an action to compel PREPA to set and collect rates
  - Right to accelerate payments
  - Right to sue to enforce remedies
  - Right to seek appointment of a receiver
- After finding that the impairment was substantial, the Court then considered whether the impairment is “reasonable and necessary to serve an important government purpose”. Recognizing that the Commonwealth enacted the Recovery Act to address Puerto Rico’s current state of fiscal emergency, the Court stated that “even when acting to serve an important government purpose, the Commonwealth can impair contractual relationships only through reasonable and necessary measures.” (Decision at 64). Accepting the bondholders’ factual allegations as true for the moment,



the Court held that the bondholders state a plausible claim under the Contract Clause to withstand the Commonwealth's motion to dismiss at this early stage of the litigation. (Decision at 65.)

- Among the other moderate choices the Commonwealth could have adopted the bondholders asserted include (Decision at 64)
  - PREPA could modestly raise its rates
  - PREPA could collect the \$640.83 million currently owed to it by the Commonwealth
  - PREPA could reduce the amount of funds diverted to municipalities and subsidies
  - PREPA could cut costs and correct inefficiencies in its management
  - PREPA could improve its standing the global capital markets
  - PREPA could negotiate with creditors to restructure its debts on a voluntary basis

### **Unconstitutional Taking**

The Court held that the Commonwealth appropriated the bondholders' contractual right to seek the appointment of a receiver, which violated the "Takings Clause" of the Constitution, and denied the Commonwealth's motion to dismiss the Takings Clause Claims as to the bondholders' right to seek the appointment of a receiver. The Court granted the Commonwealth's motion to dismiss the Takings Clause claims of the bondholders as to their lien on PREPA revenues. (Decision at 74.) The Fifth Amendment to the United States Constitution provides that "private property [shall not] be taken for public use, without just compensation" (the "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. The Court held that the bondholders' claims that the public corporation might invoke the Recovery Act in order to prime their liens is not ripe for the Court's determination.

On February 10, 2015, the Commonwealth filed a notice of appeal of the Court's ruling.