

Supreme Court nixes Puerto Rico insolvency law, but Congress legislates new path

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Introduction

On July 13 2016, the US Supreme Court issued its ruling in *Puerto Rico v Franklin California Tax-Free Trust*. Affirming the decision of the court of appeals, the Supreme Court ruled by a vote of five to two that the US Bankruptcy Code pre-empts the Recovery Act, which Puerto Rico enacted in 2014 to address its mounting debt crisis.

The code expressly prevents Puerto Rico from authorising its municipalities and public utilities to pursue bankruptcy relief under Chapter 9, which provides for the adjustment of municipal debt.⁽¹⁾ The question before the Supreme Court was whether the pre-emption provision contained in Chapter 9 nevertheless applies to bar Puerto Rico from enacting its own bankruptcy scheme for restructuring the debts of its municipalities and public utilities.⁽²⁾

Decision

In an opinion authored by Justice Clarence Thomas, the court held that even though the municipalities and public utilities of Puerto Rico are ineligible for relief under Chapter 9, its pre-emption provision renders the Recovery Act invalid. In dissent, Justices Sonia Sotomayor and Ruth Bader Ginsburg took the position that, when read contextually, the exclusion of Puerto Rican entities from the federal municipal bankruptcy scheme renders inapplicable the pre-emption provision of Chapter 9. The majority, however, reasoned to the contrary that the "plain text of the Bankruptcy Code begins and ends our analysis". The court found that the amended definition of 'state' excludes Puerto Rico for the single purpose of defining who may be a debtor under Chapter 9, but that the "text of the definition extends no further". Thus, Puerto Rico is "no less a 'State' for purposes of the pre-emption provision than it was before Congress amended the definition" in 1984.

New legislation

The Supreme Court's decision exacerbated Puerto Rico's dilemma since it left the territory in a legal no-man's land – unable to authorise its municipalities and utilities to file under Chapter 9 and unable to pass its own legislation to address the debt crisis. On June 29, however, Congress passed the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) and President Barack Obama signed the bill into law on June 30, one day before Puerto Rico was expected to default on a \$2 billion payment. Immediately after Obama signed the law, Puerto Rico's governor issued an executive order suspending authorisation of payments on its debt obligations that were due the following day, July 1. Thus, despite the timely legislation, Puerto Rico still defaulted on \$779 million in general obligation bonds.

PROMESA establishes a federally appointed oversight board to restrain Puerto Rico's public spending and to put its fiscal affairs in order.⁽³⁾ As in bankruptcy, the new law imposes a stay on collection actions and other efforts to enforce creditors' rights, giving Puerto Rico and its municipalities the

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breathing space to negotiate deals with creditors.(4) Additionally, PROMESA establishes a process to work out consensual debt restructurings with bondholders, called 'qualifying modifications'.(5) The terms of those restructurings can be imposed on dissenting bondholders if the required supermajority of bondholders in each pool vote to accept the proposed restructuring and if other statutory requirements are met.(6) If a consensual restructuring cannot be reached despite good-faith efforts, the oversight board is authorised to commence adjustment-of-debt cases for Puerto Rico and its municipalities. In this event, numerous sections of the code would apply – virtually the same sections that govern a regular Chapter 9 municipality case.(7) These sections would include those providing for the automatic stay, avoidance powers and cramdown of a plan of adjustment over the objections of dissenting creditors.(8)

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Endnotes

(1) Chapter 11 permits municipalities of a 'state' to petition for bankruptcy relief under Chapter 9 of the code. However, Chapter 11 defines 'state' to include "[t]he District of Columbia and Puerto Rico, **except** for the purpose of defining who may be a debtor under chapter 9" of the code. 11 USC § 101 (52). Thus, Puerto Rico may not authorise its municipalities to pursue relief under Chapter 9.

(2) The pre-emption provision states that "a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition". 11 USC § 903(1).

(3) PROMESA, Pub L No 114-187, 130 Stat 549, § 101 (June 30 2016).

(4) *Id* § 405.

(5) *Id* § 601(g).

(6) *Id* § 601(j), (m).

(7) *Id* §§ 206, 301.

(8) *Id*.

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