Puerto Rico Poised to Enact Bankruptcy-Like Legislation for Certain Revenue Bond Issuers

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Puerto Rico's Governor Alejandro Garcia Padilla today introduced debt restructuring legislation which, upon enactment, would provide a judicial debt relief process in Puerto Rico's courts for certain 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"). Despite a semantic effort at today's press conference by the Governor and in the legislative preamble to distinguish the proposed legislation from "bankruptcy" legislation, the legislation is modeled on Chapter 9 and Chapter 11 of the U.S. Bankruptcy Code (with some significant distinctions) and is in all practical respects a non-federal bankruptcy statute. The Governor urged Puerto Rico's legislature to adopt the proposed legislation by June 30, and enactment is considered a virtual certainty.

Under the proposed legislation, entitled "The Puerto Rico Public Corporation Debt Enforcement and Recovery Act," an eligible public corporation may pursue either or both of two alternatives, simultaneously or sequentially. The first is a "consensual debt relief transaction" (which can be analogized to a "prepack" and will likely be known as a "Chapter 2" proceeding.) To initiate a Chapter 2 proceeding, an eligible entity files a notice of "suspension period" on its website, which notice stays any remedial action by any creditor identified in such notice for a period of up to 360 days if the entity does not seek court approval of specified debt relief, or, if such approval is requested, until the final unappealable approval of such relief or 60 days following denial of such relief.

The applicable consensual debt relief in a Chapter 2 proceeding may only be approved by the court if at least 50% of the amount of debt within a class of substantially similar debt identified by the issuer participates in a vote or consent solicitation relating to the proposed amendments, modifications, waivers or debt exchanges relating to the applicable debt, and at least 75% of the amount of debt in such class that so participates approves the proposed relief. If so approved, the applicable debt relief is purportedly binding on all creditors within the applicable class.

The second avenue for debt relief (which will likely be known as a Chapter 3 proceeding) involves the filing of a petition with the court by, or on behalf of, an eligible public corporation, which filing triggers an automatic stay protecting the applicable public corporation from remedial efforts by creditors. Chapter 3 provides for judicial confirmation of a debt adjustment 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.

Under the proposed legislation, all impaired creditors in a Chapter 3 proceeding must receive payments and/or property having a present value of at least the amount the claims in the applicable class would have received if all creditors had been allowed to enforce their claims on the date the issuer's petition for relief was filed. In addition, every such impaired creditor must also receive its pro rata share of 50% of the issuer's positive free cash flow, if any, after payment of operating expenses, capital expenditures, taxes, debt service, reserves, changes in working capital, cash payments of other liabilities and extraordinary items, during a period of 10 full fiscal years following the first anniversary of the plan's effective date. Such recovery is capped at the amount necessary, together with the present value payment described above, to provide for repayment of the applicable creditor's full claim on the petition date, with any excess reallocated among remaining impaired creditors.

If enacted, attacks on the legislation's constitutionality and on the constitutionality of particular provisions are inevitable. Because the legislation would not be enacted pursuant to the U.S. Constitution's bankruptcy power, it would have no federal constitutional protection from other provisions of the U.S. Constitution, including those protecting contracts from impairment by state action (which for this purpose would include action by the territory of Puerto Rico.)

The legislative preamble devotes significant attention and argument to the proposition that the legislation is constitutional. However, the legislation also includes a provision stating that if a contractual 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 issuer (or the Government Development Bank ("GDB"), acting on its behalf) 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." This statutory description, which loosely parallels the federal judiciary's interpretation of the circumstances under which contract impairments are permitted notwithstanding the "contracts clause" of the U.S. Constitution, fails to mention a key element of that judicial test, namely the requirement that the government establish that no less burdensome alternatives exist for achieving the legitimate government interest.

Another consequence of the legislation being non-federal is that Puerto Rico cannot avail itself of the far-reaching jurisdictional provisions of the federal Bankruptcy Code. This may permit some creditors to assert jurisdictional challenges to the binding nature of any proceeding conducted in the Court of First Instance, San Juan Part, as the bill requires. The bill provides for appeals to the Puerto Rico Supreme Court.

Eligibility for the relief provided in the proposed legislation is limited to specific public corporations. Such corporations may file their own Chapter 3 petitions or GDB, acting at the Governor's request, may do so on their behalf; any Chapter 2 debt relief must be approved by GDB. As noted, eligible corporations include (among others) PREPA, PRASA and PRHTA, and the legislative preamble specifically catalogues their financial difficulties in justifying the need for a debt relief mechanism. In addition, to be eligible to file a Chapter 3 petition, a public corporation must be "insolvent" and must be ineligible for relief under the U.S. Bankruptcy Code because it is not a "municipality" eligible to file under Chapter 9 and is a "government unit" ineligible to file under Chapter 11.

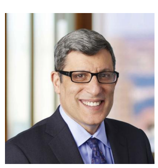
The bill defines "insolvent" as "currently unable to pay valid debts as they mature while continuing to perform public functions" or "at serious risk of being unable, without further legislative acts and without financial assistance from the Commonwealth or GDB, to pay valid debts as they mature while continuing to perform public functions."

Certain entities are expressly excluded from filing under the proposed statute, including (among others) the Commonwealth of Puerto Rico, Puerto Rico's municipalities, the GDB and its subsidiaries and affiliates, the Puerto Rico Sales Tax Financing Corporation (COFINA), the Municipal Finance Agency, the Municipal Finance Corporation, the Puerto Rico Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority and the Puerto Rico Infrastructure Financing Authority.

Certain classes of creditors and claims are expressly protected from impairment under a Chapter 3 plan. Such protected claims include employee claims for wages, salaries, commissions, vacation, severance and sick leave pay, and similar employment benefits, unless such claims arise under a collective bargaining agreement or retirement or post-employment benefit plan.

Much remains to be said and analyzed on this legislation. At first blush, however, the legislation (if enacted and determined to be constitutional) would, in some cases, provide more favorable treatment to Puerto Rico's eligible revenue bond issuers, and less favorable treatment to their creditors, than would Chapter 9 of the United States Bankruptcy Code. For example, the special revenue provisions of Chapter 9 appear absent from the Puerto Rico legislation, though it is focused on revenue bond issuers.

Authors



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