



625 S. State Street
ANN ARBOR, MICHIGAN 48109-1215

John A. E. Pottow
John Philip Dawson Collegiate Professor of Law

TELEPHONE: (734) 647-3736
FAX: (734) 647-7349

(Non University Business.)

February 24, 2015

The Honorable Bob Goodlatte
Chairman
House Committee on the Judiciary
2138 Rayburn House Office Building
Washington, DC 20515

The Honorable John Conyers, Jr.
Ranking Member
House Committee on the Judiciary
B-351 Rayburn House Office Building
Washington, DC 20515

The Honorable Tom Marino
Chairman
Subcommittee on Regulatory Reform,
Commercial and Antitrust Law
House Committee on the Judiciary
2138 Rayburn House Office Building
Washington, DC 20515

The Honorable Henry C. "Hank" Johnson
Ranking Member
Subcommittee on Regulatory Reform
Commercial and Antitrust Law
House Committee on the Judiciary
B-351 Rayburn House Office Building
Washington, DC 20515

Re: H.R. 870, Puerto Rico Chapter 9 Uniformity Act of 2015 ("HR 870")

Dear Chairman Goodlatte, Ranking Member Conyers, Chairman Marino and Ranking Member Johnson:

Thank you for the opportunity to testify on HR 870. I offer my full support for this long-overdue technical correction to the Bankruptcy Code.

Let me start by emphasizing HR 870's narrow focus. It does not authorize municipalities¹ to file chapter 9 bankruptcies in Puerto Rico. Rather, it confers upon Puerto Rico the decision-making authority already accorded the states to decide whether, and under what conditions, its municipalities can file. Some states forbid their municipalities from filing chapter 9s. *See, e.g.,* GA. CODE ANN. § 36-80-5. Others do not. *See, e.g.,* ALA. CODE § 11-81-3. Many in the middle put strings on the ability to file, such as pre-clearance by financial advisory boards administered under state law. *See, e.g.,* MICH. COMP. LAWS. ANN.

¹ I use the term "municipalities" here to refer not solely to cities but to all public entities as that term is used in the Bankruptcy Code (which is title 11 of the U.S. Code). *See* 11 U.S.C. § 101(40) (defining "municipality" as including political subdivisions, public agencies, or instrumentalities of a State).

§§ 141.1541 *et seq.* Thus, at the risk of being pedantic, I underscore that this is not a vote on whether San Juan can file a chapter 9. The discussion is whether to remove Puerto Rico from the infantilizing no man's land it finds itself in under current bankruptcy law for no apparent reason: unable to authorize its municipalities to file for chapter 9 under the federal Bankruptcy Code, *see* 11 U.S.C. § 101(52), but also impotent to pass its own Commonwealth law analogue to chapter 9 (at least according to the recent invalidation of its attempt to do so, *see Franklin California Tax-Free Trust v. Puerto Rico*, No. 14-1518, 2015 WL 522183 (D. P.R. Feb. 6, 2015) ("District Court Opinion") (striking down The Puerto Rico Public Corporation Debt Enforcement and Recovery Act, Act No. 71 (June 25, 2014) ("Recovery Act"))).

According to Puerto Rico the status enjoyed by the states to "make the chapter 9 call" for itself seems both sensible and equality-promoting. I am unaware of any bankruptcy scholar who opposes this proposal, and this is not an academic community shy about expressing disagreement.

One reason it makes so much sense to fix the Bankruptcy Code with this amendment is that it is not even clear why Puerto Rico was excluded from the chapter 9 process in the first place. When Congress undertook its comprehensive modernization of the bankruptcy laws culminating in the 1978 Code, there was no exclusion of Puerto Rico from chapter 9 under the Code – because there was no definition of "State."² In fact, Puerto Rico probably was eligible to access chapter 9 if one reverts to the preceding bankruptcy law, the Bankruptcy Act of 1898, which included Puerto Rico under the definition of "States." Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544, §1(29) (repealed 1978) ("1898 Act"). Thus, although there is some academic debate on the question, in 1978 Puerto Rico most likely could have authorized its municipalities—or forbidden them – from filing for relief under chapter 9, just as all the other states could. Any misconception of longstanding historical exclusion of Puerto Rico from chapter 9 should be corrected right away.

When Congress began a series of technical corrections to the Code – dating back to legislation being considered as early as 1979 – somehow a new definition of "State" got worked into the Code that eliminated Puerto Rico from chapter 9 only. It is not clear whether this was a "scrivener's error" or other such inadvertence because there is absolutely no legislative history of any debate suggesting Congress made this exclusion intentionally. To describe the legislative history as "complicated" is understatement. The Senate proposed a bill to define "State" to include, *inter alia*, "the Commonwealth of Puerto Rico," S 658, 96th Cong. (1st Sess. 1979), and explained that Puerto Rico was "inadvertently left out of the definition of 'state' during passage of the [1978 Code]," S. Rep. No. 96-305 (1979), an already-confusing explanation because there was no definition of "State" in the 1978 Code to be corrected! That bill never got enacted, but at some point an amendment came back from the House – over many back and forths on different matters – that has the current definition still in force today,

² The 1978 Code also had no definition of "United States," so there is some academic debate about whether the Code initially even applied to Puerto Rico at all, which may have been one of the motivations for the technical corrections to follow. Further complicating the fact is that the 1978 Code's definition of governmental units, *cf.* 11 U.S.C. § 101(27) (current definition, which includes "Territory"), only included "State" and "Commonwealth," which could be used to infer an exclusion of Puerto Rico – unless it was already included by virtue of being a "Commonwealth." Good historical discussion that notes the debate can be found in Stephen J. Lubben, *Puerto Rico and the Bankruptcy Clause*, 88 AM. BANKR. L. J. 553 (2014).

which did not get enacted until 1984. See Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (enacting 11 U.S.C. § 101(52)). There is no indication why the House made the change that eventually got into law, and in fact there is indirect evidence Congress was confused as to just what it was doing.³ Thus, Puerto Rico became stripped of its access to chapter 9 for reasons that are at best mysterious and at worst unintentional.

The matter probably attracted no serious congressional attention because of relatively healthy market conditions during a prosperous run of the U.S. economy. The Great Recession starting in 2008 brought considerable financial distress to light, however, including that plaguing municipalities. Chapter 9 has not just been dusted off but is now being used with greater frequency, such as with the much-vaunted emergence of Detroit from bankruptcy with a confirmed plan of adjustment. See *In re City of Detroit*, 524 B.R. 147 (Bankr. E.D. Mich. 2014) (“Detroit Confirmation Order”). It is thus no surprise that attention is turning to the use of chapter 9 by financially troubled municipalities.

Facing need to deal with financial distress afflicting some of its municipalities and its bizarre exclusion from chapter 9 of the Bankruptcy Code, the Commonwealth chose to pass its own “Recovery Act,” which attempted to mimic many of the features of chapter 9. That statute was recently held unconstitutional by the federal district court in Puerto Rico and that judgment is already on appeal (which Puerto Rico has asked the Court of Appeals for the First Circuit to expedite). Had HR 870 been law, it is likely this entire debacle could have been avoided.

While that opinion is on appeal, and while I think there are respectable arguments on both sides regarding the constitutionality of the Recovery Act, I do note one important thing that Act taught us. Puerto Rico, when it had the choice to express its own preferences in enacting the Recovery Act, evinced a desire to have some, but not all, public entities that would qualify as “municipalities” under chapter 9 have access to what it called “public sector obligor” bankruptcy relief. Specifically, while utilities, like the debt-laden Puerto Rico Electric Power Authority (“PREPA”), were included in the definition of eligible debtors, cities and towns were not. See Recovery Act § 102(50), (113). While of course Puerto Rico might – like any state can – change its mind to allow fewer or greater entities access to chapter 9, it is informative that left to its own deliberative devices, Puerto Rico took a modest, incremental ground to public debt restructuring: allowing some but not all entities to do so. And indeed, this is somewhat the point of chapter 9’s deference to state gatekeeping for eligibility: allowing fifty flowers of different policy approaches to bloom.

Given my support for HR 870, Members of the Committee may want to know if I perceive infirmities in its drafting. I do not. It is cleanly drafted. Short and sweet, it gets into the exclusion of Puerto Rico from the definition of State, puts it back in, and then ends. Best of all, the bill contains a clause making explicit the intent to apply to debts incurred prior to its enactment. See HR 870 §3(b)(2). This is a good

³ A Senate Report accompanying one of the exchanges that dragged out over multiple years repeated the boilerplate explanation that the bill was fixing inadvertent omissions from the 1978 Code, such as an exclusion of Puerto Rico from the definition of “State” (which was actually never defined), even with the current language that carved Puerto Rico out from access to chapter 9 and thus excluded it from the definition of “State.” See S. Rep. No. 97-150 (1981).

thing. The point of bankruptcy law is to provide comprehensive, final resolution of general financial default. Allowing only some debts (future debts), but not others (pre-existing debts), to be resolved is pointless. There is no such thing (or, more precisely, no such useful thing) as a “half-restructuring.”

Some might worry that HR 870 applying “retroactively” to pre-existing debts is somehow unfair or even unconstitutional to the holders of that debt. This concern is mistaken. The Nation has had numerous bankruptcy laws throughout its history, some lasting only temporarily (the first “permanent” one was the previously mentioned Act of 1898). *See, e.g.*, Bankruptcy Act of Apr. 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803). Those laws generally applied to pre-existing debts when enacted, and the Supreme Court confirmed the permissibility of Congress exercising its power under the Bankruptcy Clause in this manner. *See, e.g., Hanover Nat’l Bank v. Moyses*, 186 U.S. 181, 188 (1902). This of course makes sense, because Congress has authority under the Constitution’s Bankruptcy Clause to adjust debts, *see* U.S. CONST. art. I, § 8, cl. 4, putting all on notice that their contractual rights are always subject to adjustment by the Congress should a debtor ever avail itself of bankruptcy relief. (The Constitution’s Contracts Clause does not apply to the federal government. *Id.* § 10, cl. 1 (“No State shall . . . pass any . . . law impairing the Obligation of Contracts . . .”).⁴

The only time retroactivity is a concern is under the Takings Clause, *id.* § amend. V, and that in turn is only implicated when property rights are impaired. In bankruptcy, such concerns are rare, because the Code – in chapter 9 and throughout – is scrupulous about protecting the property rights of secured creditors, the primary instance in which property rights come into play. Secured creditors hold liens on collateral, and so one could argue that the Bankruptcy Code’s invalidation of those property rights might implicate the Takings Clause. I say “might” because the issue has never been definitively resolved by the Supreme Court, and its resolution would involve an interaction between the Bankruptcy Clause and the Takings Clause that would be complex. But it is fair to say that there is “concern” about the retroactive application of bankruptcy laws to eliminate state-created property rights. The most recent pronouncement the Supreme Court had to offer was in the case of *United States v. Security Indus. Bank*, 459 U.S. 70, 82 (1982), in which it held that section 522(f) of the Bankruptcy Code – which cancels liens on certain types of second-hand household property of consumers (and thus does not just impair but destroys those lienholders’ property rights) – would apply only prospectively to liens created after its enactment to avoid constitutional difficulties. The Court was unanimous in its opinion. Fortunately, as mentioned above, the Bankruptcy Code is quite protective of the value of secured creditors’ liens, assuring them protection in myriad ways. *See, e.g.*, 11 U.S.C. §§ 506(a) (allowing each secured creditor an allowed secured claim for the full value of its collateral), 1129(b)(2)(A) (providing objecting secured

⁴ At the risk of inundating the Committee with too much detail, I note the Contracts Clause and retroactivity concerns *did* constrain the enactment of state bankruptcy laws, which actually abounded in the nineteenth century before permanent federal bankruptcy legislation was enacted. *See, e.g.*, Act of March 21, 1788, ch. 92 N.Y. LAWS 823. Due to the Contracts Clause, those laws were valid only if they discharged debt incurred after the dates of their enactment. *See Sturges v. Crowninshield*, 17 U.S. 122 (1819).

creditor minimum entitlement to the value of its allowed secured claim in chapter 11), 1325(a)(5)(B) (same, in chapter 13).⁵

Given the widespread academic support and clean drafting of the bill, do I anticipate any opposition? On grounds of principle – that Puerto Rico should not be considered worthy of making its own decisions on the bankruptcy treatment of its municipalities – I do not anticipate objection. Indeed, I would be hard-pressed even to justify objection. Who even wants to make the argument that the elected representatives of Puerto Rico are somehow less competent or wise on matters of bankruptcy law than their state government analogues? Not any well-socialized bankruptcy scholar, or any scholar, for that matter.

That said, I suppose I could see objection based not on principle of continuing to treat Puerto Rico as unequal to the state governments in terms of chapter 9 decision-making but on a generalized aversion to chapter 9. That is, I can imagine someone saying, “I don’t like chapter 9, period, and so the fewer entities that can use it, the better!” If that sort of objection is launched, the Committee should reject it. This is because an objection of this sort is unprincipled unless it is tethered to a specific argument about why drawing a distinction between Puerto Rico and other states is justified. It is fine (although in my view wrong-headed) to object to chapter 9. It is not fine to deploy arbitrary discrimination in access to chapter 9. Imagine a bill proposing to amend the Bankruptcy Code to render ineligible for letting its municipalities use chapter 9 any state beginning with the letter “M.” Now imagine a supporter enthusing on the grounds that it’s a great idea because chapter 9 is terrible, and so the fewer states that use it, the better. That would not be a morally acceptable legal argument to the people of Michigan, regardless of how deeply held the proponent’s objections to chapter 9 were. Rather, principled objection would have to craft an argument explaining why M states were worse decision-makers than other states regarding access to chapter 9. As said, neither I nor any other scholar of whom I am aware can come up with such an argument regarding why Puerto Rico is worse than the fifty state governments that get to make that decision already. Thus, if the Committee gets objections premised on generalized disenchantment with chapter 9, it should resist indulging them.

As said, I believe unhappiness with chapter 9 is wrong-headed. Indeed, allow me to sing the praises of chapter 9, especially in light of our beyond-expectations recent success in Detroit. Chapter 9 – like chapter 11 – allows collective resolution of a municipal debtor’s financial distress. In the absence of a collective forum, value-destroying fights with individual creditors will consume what little assets there are for repayment. The orderly resolution of debt in the U.S. chapter 11 bankruptcy system is world-renown and increasingly emulated. *See, e.g.,* Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276 (2000). To be sure, chapter 9 is not the mirror image of chapter 11 because of obvious differences (*e.g.,* no shareholders of a city to wipe out, no liquidation alternative to failure of a plan). But the general construct of consensual debt resolution with super-majoritarian buy-in is critical to solving the destructive influences of holdouts with which bankruptcy law

⁵ Note the Takings Clause is concerned not with the property itself but with the value of that property and that it not be taken without paying “just compensation,” U.S. CONST. amend. V. Hence the Bankruptcy Code’s focus is on protecting the value of the lien and not the collateral itself.

is so fundamentally concerned. To that end, most creditors should welcome the addition of chapter 9. One need not wander very far into the world of sovereign debt – where there is no chapter 11 or 9 system; indeed, there is no “system” – to see the unpalatable alternative. Circumstances have grown so dire in that realm that the United Nations just held meetings on how best to resolve sovereign debt distress given the value-detracting lack of a coherent international system. *See Ad Hoc Committee of the General Assembly on a Legal Framework for Sovereign Debt Restructuring Processes: A First Step in the Right Direction*, Feb. 24, 2015 (U.N. Website Announcement).⁶

Perhaps some of the opposition to chapter 9 more generally arises from a concern that municipalities might “rush into” chapter 9 as a way to evade creditors and not take tougher steps, like cutting expenses or raising revenues. In other words, the fear is that chapter 9 might be a first, and not last, resort. This fear misunderstands chapter 9. Unlike chapter 11, chapter 9 imposes specific eligibility requirements, one of which is demonstration that the debtor has negotiated in good faith with the creditors. *See* 11 U.S.C. § 109(c)(5)(B). Debtors rushing to bankruptcy court will find themselves running straight into this bar. And once in, debtors still have to show that a plan of adjustment is fair and equitable to objecting creditors. *See id.* § 901(a) (incorporating *id.* § 1129(b)(1)). For example, in the Recovery Act litigation, it was alleged that PREPA had not tried to resolve its financial distress because it had not raised rates for decades. *See District Court Opinion* at *24. These sorts of allegations are precisely the sorts of objections that one could bring in a chapter 9 hearing and would receive a judge’s careful scrutiny. (In our Detroit case, the bankruptcy court noted how the tax-strapped residents of Detroit no longer had a city that could afford “basic police, fire, and emergency medical services that its residents need for their basic health and safety” in finding the city eligible to file. *See In re City of Detroit*, 504 B.R. 97, 112 (Bankr. E.D. Mich. 2013).) Indeed, so far is chapter 9 from a first resort in Michigan that the previously cited law that restricts access to chapter 9 has multiple steps of financial review boards, emergency financial managers, governor’s recommendations and so on, that must be climbed well before a municipality can get anywhere near a bankruptcy courtroom.

This brings me to a final point: chapter 9 worked well for Detroit. I do not mean to minimize the hurt felt by pensionholders and other workers – non-uniformed retirees took on average an almost 5% cut to their pensions (on top of healthcare clawbacks, COLA reductions, and the like). *See Detroit Confirmation Order* at 179-85. But it could have been much worse. Bondholders argued strenuously that those concessions were not nearly enough and were showing unfair favoritism; yet even the bondholders came on board and *supported* the plan of adjustment, ultimately arguing the court should approve it. *See id.* at 163. And the transformation to the residents of Detroit cannot be overstated. Street lights are coming back where there was literally darkness before. *See Matt Helms et al., Nine Ways Detroit Is Changing After Bankruptcy*, DETROIT FREE PRESS (online ed., Nov. 9, 2014). There are lots of lower-income residents who rely on the public services, such as transportation, who now benefit from the collective sacrifices of pensioners and bondholders alike. Most importantly, the bankruptcy court focused on the “feasibility” of the Detroit plan, to make sure the city maximizes its chances of never falling into financial

⁶ Available at: <http://www.unctad.info/en/Debt-Portal/News-Archive/Our-News/Ad-hoc-Committee-of-the-GA-on-a-legal-framework-for-sovereign-debt-restructuring-processes-a-first-step-in-the-right-direction>.

distress again. *See Detroit Confirmation Order* at 223. Without chapter 9, I am not sure where Detroit would be today.

Detroit's success may provide a path for Puerto Rico's municipalities. Or it may not. The point is, Detroit's access to chapter 9 was something the elected representatives of the State of Michigan decided on. That decision, whatever it may be, should similarly fall on the elected representatives of the Commonwealth of Puerto Rico.

Yours very truly,



John A. E. Pottow
John Philip Dawson Professor of Law,
University of Michigan Law School