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NEWS ALERT - PROMESA LITIGATION UPDATE

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Commonwealth of Puerto Rico files for PROMESA Title III Bankruptcy-like Protection

We are pleased to announce the first note of a series of News Alerts we will prepare for our clients and friends during the litigation arising under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"), 48 U.S.C. §§ 2161, et seq., and any other debt negotiation efforts by the Commonwealth of Puerto Rico.

This information is relevant to businesses serving the Commonwealth and other government entities, as well as their vendors, suppliers, contractors, sureties and guarantors. We will also follow closely any developments on regulations applicable to tax exemptions and decrees as a result of creditor negotiations, and revenue increasing measures taken by the Commonwealth that may affect our clients.

Background

Stuck in recession since 2006, Puerto Rico is at a crossroads, facing the largest public restructuring in U.S. history – over $70 billion in financial debt – and a ballooning operating annual deficit of over $7 billion. This deficit includes the depletion of Affordable Care Act related funds provided under § 2012 of the Health Care and Education Reconciliation Act, Pub. Law. No. 111-152 – which gave Puerto Rico a base grant of $925 million against which it may seek reimbursement for Medicaid expenses and a joint grant of $6.3 billion for the territories – as well as the depletion of the liquid assets of the Employee Retirement System ("ERS"). In addition to ERS, other public pension systems are massively underfunded and face a cumulative deficit of over $49 billion. See, Commonwealth of P.R. Financial Information and Operating Data Report at p. 17 (Dec. 18, 2016).

Some economists expect the economy to further contract in Fiscal Year 2018, which begins on July 1, 2017, by a level of reduction only common to war-torn countries and countries recovering from a major natural disaster. Forecasts by the Commonwealth, supported by the Financial Oversight and Management Board ("FOMB") created under PROMESA § 101, project a fall of 16.2% of GNP. See, Commonwealth of P.R., Revised Baseline Projections at p. 5 (Dec. 20, 2016); FOMB letter to Gov. Ricardo Rosselló dated January 20, 2017 at p. 3, n.1; see also, New York Times, Joseph Stiglitz, the Nobel Laureate, on Saving Puerto Rico at p. A20 (Feb. 27, 2017) ("[A] decline of 16.2 percent of gross national product in the next fiscal year, [is] comparable to the experience of countries in civil wars, and Venezuela in economic crisis in 2016."). As an initial step in managing these challenges, the Commonwealth presented a fiscal plan that the FOMB certified on March 13, 2017, and corrected on April 28, 2017 ("Fiscal Plan"), but we will not see the actual impact of its measures until a draft budget for Fiscal Year 2018 is published. This should occur on or around May 22, 2017, according to the new working schedule established by the FOMB. We will discuss it in a future News Alert. It is worth noting that there are other more favorable economic projections out there, including a more optimistic basis for revenue projections in the Commonwealth's pro-forma cash flows currently assumed by the government and the FOMB in the Fiscal Plan.

In light of this reality, government contractors, vendors and suppliers must be prepared to bring the right claims in the right forum and avoid unfair impairments of their rights. Other entities whose business models depend on concessions, natural monopolies or tax benefits and decrees should also pay close attention to the evolution of the proceedings.

Litigation

As expected, the Commonwealth (central government) filed for the protection of Title III on Wednesday, May 3, 2017. The special public corporation that has a security interest in sales tax revenues, COFINA, also filed for Title III protection, on Friday, May 5, 2017. Many would argue this was a reasonable move, as it made little sense to wait for the accumulation of collection actions without the protections of a federal court and an automatic stay. Other entities that may follow the same route in the near future include the Government Development Bank for Puerto Rico ("GDB") and the Puerto Rico Highway and Transportation Authority ("HTA"). GDB has already stated in its own fiscal plan that it intends to recover around 25 cents on-the-dollar on its assets and liquidate its operations over a ten-year period, and HTA issued draft, unaudited financial statements last week, which, as explained below, is a pre-requisite for filing for Title III protection. As a result of their critical financial condition those two entities were the first ones to become covered by the executive orders under the Emergency Moratorium and Financial Rehabilitation Act, Law No. 21-2016, which suspended debt service since May, 2016. In fact, HTA was operating during the duration of the PROMESA § 405 stay on litigation by redirecting toll revenues to cover operating expenses instead of bondholders. The Puerto Rico Electric Power Authority ("PREPA"), on the other hand, has stated that it expects to complete the implementation of its Restructuring Support Agreement with bondholders through consensual, voluntary negotiations under Title VI of PROMESA. Thus far, the FOMB has certified fiscal plans for PREPA, HTA, and GDB, and revisions were ordered for the Puerto Rico Aqueduct and Sewer Authority's ("PRASA") fiscal plan.

As of today, attorneys for several creditors and parties in interest have already filed notices of appearance in the Commonwealth's case, including a supplier, a contractor, the University of Puerto Rico, the ERS, unionized public workers affiliated to the AFSCME, and an ad hoc retiree committee.

The Framework

Under PROMESA § 206, the requirements for a Title III filing include: (i) a showing that the entity made good faith efforts to negotiate with creditors, (ii) the entity has adopted procedures to deliver timely audited financial statements and made public draft financial statements and other information sufficient for any interested person to make an informed decision with respect to a possible restructuring, (iii) the entity is either a covered territory or instrumentality that has adopted a Fiscal Plan certified by the FOMB, (iv) there is no pending consensual deal under Title VI, or if such deal has been approved the entity cannot make its debt payments, and (v) 5 out of the 7 members of the FOMB have approved a restructuring certification. In the two cases filed so far, the FOMB voted unanimously to support the court-supervised proceedings. Additionally, Title III of PROMESA establishes in § 302 that, in order to be a debtor in Title III, a territory must be under the supervision of a FOMB and an entity must be a "covered territorial instrumentality" under PROMESA, have a restructuring certification approved under § 206(b), and the entity desires to effect a plan to adjust its debts. A case may then commence under § 304 by the FOMB with the filing of a petition with the district court. The parties then have 120 days to object to the petition. This applies to the cases filed on Wednesday and Friday.

Substantial litigation in this front is expected as creditors are already challenging the Fiscal Plan's compliance with the 14 criteria listed in PROMESA § 201(b)(1), particularly the requirements in § 201(b)(1)(m) and (n), which preclude the transfer of assets from one territorial instrumentality to another, and requires compliance with the relative lawful priorities or lawful liens applicable under the Constitution and statutes of the Commonwealth, respectively. Presumably, the FOMB will defend the Fiscal Plan arguing that its certification decisions are not subject to judicial review under PROMESA § 106(e), and will ask for any Plan of Adjustment under Title III to be consistent with the Fiscal Plan. PROMESA § 314(B)(7) ("[The Court shall confirm a plan if] the plan is consistent with the applicable Fiscal Plan certified by the Oversight Board under Title II"). For the first case filed, District Judge Laura Taylor Swain of the S.D.N.Y was designated by the Chief Justice of the United States. We are still awaiting a judge designation for the COFINA case. Although the Commonwealth and COFINA cases were filed in the U.S. District Court of the District of Puerto Rico, venue is proper in the districts in which the FOMB has an office. PROMESA § 307(b)(1). The FOMB announced on May 2, 2017, that it leased office space in Manhattan.

Like Chapter 9 of the Bankruptcy Code, the purpose of Title III is to provide a financially-distressed instrumentality (or the central government) protection from its creditors while it develops and negotiates a plan for adjusting its debts. Reorganization of the debts of a municipality in Chapter 9 is typically accomplished either by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan. Stakeholders will argue that the results of a Plan of Adjustment should leave financial creditors recovering an amount very close to the $787 million total that the Fiscal Plan allows for its first Fiscal Year, simply because higher debt service payments would further push the Commonwealth down a death spiral, and a Plan of Adjustment must be in the best interest of creditors in order to be approved by the court, which should also consider the available remedies out of bankruptcy. PROMESA § 314(b)(6). In that regard, the debtor entity and unimpaired creditors will likely argue that it is in the best interest of impaired creditors to receive a small payment on debt service in order to guarantee operations in the long run, rather than agreeing to a self-defeating higher payment upfront at the expense of lower long-run aggregate recoveries. Creditors should seek to collect on any increase in revenues by requesting a "growth bond" or other similar guarantees.

Commonwealth officials have stated publicly that their legal powers to continue operating the Puerto Rico Treasury and issuing payments arise from §§ 303 and 305 of PROMESA, which expressly allow for the debtor to retain its governmental powers. See, 48 U.S.C. § 303 ("[T]his title does not limit or impair the power of a covered territory to control, by legislation or otherwise, the territory or any territorial instrumentality thereof in the exercise of the political or government powers … including expenditures for such exercise."); 48 U.S.C. § 305 ("Subject to the limitations set forth in titles I and II of this Act, notwithstanding any power of the court, unless the Oversight Board consents or the plan so provides, the court my not by any stay, order or decree in the case or otherwise, interfere with any political or governmental power [], any of the property of the debtor, or the use or enjoyment by the debtor of any income producing property."). For these reasons, it is expected that, for the time being, the government will continue paying vendors and suppliers in the ordinary course without seeking specific court authorization.

In terms of the continuing creditor negotiations, creditors should consider numerous incentives and interests, including their needs to access prompt liquidity on their holdings over their considerations for total returns. Creditors, the FOMB, and the court could eventually seek the convenience of hearing all restructuring cases at once, rather than at a piecemeal basis. There are 14 issuers of debt whose main source of revenues is the Commonwealth's taxing power, and there are obvious challenges to treating those revenues as separate pools of funds to cover each entities' debts, especially when considering that the revenues pledged to some of those debts are "clawbackable" to cover other debts. Additionally, there are large institutional creditors holding claims across several issuers that will ask for certain treatment in one class of holdings before consenting to a treatment on another claim. Creditors are also paying attention to the securities being proposed for an exchange and their taxability.

For purposes of Title III, the FOMB may take any action necessary on behalf of the debtor to prosecute the case of the debtor including, filing a petition, submitting or modifying a Plan of Adjustment or submitting filings in relation to the case with the court. PROMESA § 315. Immediately after filing, a debtor is covered by the automatic stay of 11 U.S.C. § 362 which is incorporated by reference under PROMESA § 301(a). Creditors must now file their proof of claims as in a regular bankruptcy case pursuant to § 501 of the Bankruptcy Code, unless their claims are already listed by the debtor under §§ 924 and 925 of the Bankruptcy Code. The Commonwealth has already listed in the initial filing its top 20 unsecured creditors. The Federal Rules of Bankruptcy Procedure apply to cases under Title III.

First Hearing and Motions

The first hearing on First Day Orders has been set for May 17, 2017 at 9:30 am in courtroom 3 of the U.S. District Court for the District of Puerto Rico. The FOMB has filed several motions on behalf of the Commonwealth seeking approval of the following: (i) joint administration of the Title III cases and related relief regarding the other case pending at this time where the debtor is COFINA, (ii) manner of publication and service of notice of commencement of the case, (iii) nunc pro tunc employment of Prime Clerk as notification, notice and claims agent, (iv) leave to file creditor matrix by June 30, 2017 and creditor list by August 30, 2017, and (v) a proposed case management order, which we will discuss in detail in a future News Alert once approved by the Court.

Tax Abatements

PROMESA § 208(b) required that the Commonwealth provide a report on discretionary tax abatement agreements to which the government or an instrumentality of the Commonwealth is a party within 6 months after its enactment. The Commonwealth has not issued said report and the Fiscal Plan assumes that the government will keep in place its existing tax exemption decrees and relief programs without seeking adjustments to existing contracts and grants under Title III. PROMESA allows the Commonwealth to continue using its fiscal policy to attract businesses. Id. ("[N]othing in this Act shall be interpreted to limit the power of the territorial government or any territorial instrumentality to execute or modify discretionary tax abatement or similar tax relief agreements, or to enforce compliance with the terms and conditions of any discretionary tax abatement or similar tax relief agreement.…").

The Commonwealth did make changes to its tax credit concession and claim policies as a cash management strategy. Pursuant to its authority under Law No. 2-2017, on March 7, 2017, the Puerto Rico Fiscal Agency & Financial Advisory Authority ("AAFAF") issued administrative order OA-2017-01, which freezes all special revenue funds of the Commonwealth and establishes a new process to claim tax credits and negotiate tax decrees. See, http://bgfpr.com/documents/CommonwealthofPuertoRicoFinancialInfoFY201612-18-16.pdf ("Special Revenue Funds are funds separate from the General Fund that are created by law, are not subject to annual appropriation and have specific uses established by their respective enabling legislation. As such, in contrast to expenditures from the General Fund, Special Revenue Fund expenditures do not require annual legislative action because their disbursement is pre-authorized by the applicable fund's enabling legislation, which governs until revised by new legislative action."). For a list of credits and tax benefits now subject to the new approval and claim process, see, http://www.aafaf.pr.gov/assets/aafafoa-2017-01-executed.pdf.

If you have any questions about the matters addressed in this News Alert, please contact Delgado | Fernández, LLC's litigation department or your regular Delgado | Fernández, LLC contact.

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