



Bankruptcy Department

June 14, 2016

NOTICE TO CLIENTS AND FRIENDS

Puerto Rico Debt-Restructuring Law Voided by U.S. Supreme Court

On June 13, 2016, the U.S. Supreme Court ruled 5-2 decision in the case of *Puerto Rico v. Franklin California Tax-Free Trust et al.*, 579 U.S. ____ (2016), that Section 903(a) of the Bankruptcy Code preempts Puerto Rico’s Public Corporation Debt Enforcement and Recovery Act (the “Recovery Act”). The Bankruptcy Code pre-empts state bankruptcy laws that enable insolvent municipalities to restructure their debts over the objections of creditors and instead requires municipalities to restructure such debts under Chapter 9 of the Code. The question before the court was whether Puerto Rico is a “state” for purposes of the preemption provision. Justice Clarence Thomas, writing for the Supreme Court, held that Puerto Rico is not considered a U.S. state in one part of bankruptcy law, meaning it cannot authorize its municipal agencies to restructure debt. In so holding, Justice Thomas emphasized that the constitutional structure “...does not permit this court to rewrite the statute that Congress enacted.”

The Bankruptcy Code included Puerto Rico as a “State,” but in 1984, Congress amended the definition of “State” to exclude Puerto Rico “for the purpose of defining who may be a debtor under chapter 9.” As a result, the Puerto Rico government argued that as a result of the amended definition, Chapter 9 no longer applies to it, so it is no longer a “State” for purposes of Chapter 9’s pre-emption provision. Under this interpretation, the pre-emption provision does not apply to them, and Puerto Rico could enact its own municipal bankruptcy scheme. The Respondents, on the other hand, read the amended definition narrowly. They argued that “the definition precludes Puerto Rico from ‘specifically authoriz[ing]’ its municipalities to seek relief... but that Puerto Rico is no less a ‘State’ for purposes of the pre-emption provision than the other ‘state[s],’ as that term is defined in the Code.” Under this narrow interpretation, pre-emption would still apply to Puerto Rico and bar it from enacting the Recovery Act.

After analyzing the text and history of the provisions in the Bankruptcy Code, the Court concluded that Puerto Rico is still a “State” for purposes of the pre-emption provision and held that the provision pre-empts the Recovery Act. The Supreme Court specifically stated that the “1984 amendments precludes Puerto Rico from authorizing its municipalities to seek relief under Chapter 9, but it does not remove Puerto Rico from the reach of Chapter 9’s pre-emption provision.” The amended definition excludes Puerto Rico “for the single ‘purpose of defining who may be a debtor under chapter 9’ of the Bankruptcy Code, and but does not extend any further. “Had Congress intended to alter th[is] fundamental detai[l]’ of municipal bankruptcy, we would expect the text of the amended definition to say so... Congress ‘does not, one might say, hide elephants in mouseholes.’” *Id.*, at 11 (citing *Whitman v. American Trucking Assns., Inc.*, 531 U.S. 457, 468 (2001)).

The Court's rejection particularly highlights Section 903 (1) of the Bankruptcy Code, which pre-emptly Puerto Rico's attempt at a recovery act by their own maneuvers. The Court's decision focused mainly on federal law that bars non-States, such as Puerto Rico and the District of Columbia, from doing what defined "States" are entitled to do: authorize bankruptcy filings by public utilities and other municipalities. Puerto Rico sought to get around that provision in 2014 by passing a local law that offered an option similar to bankruptcy. As a result of the decision, it is now up to Congress to place the island's finances under federal oversight, including the development of options for debt settlement.

Only seven justices considered the case because Justice Samuel Alito recused himself and Justice Antonin Scalia, who died in February, has not yet been replaced.

In the dissent, Justice Sonia Sotomayor was joined by Justice Ruth Bader Ginsburg, who both acknowledge the severity of the current situation and its consequences on the island, with a possible humanitarian crisis underway if the fiscal crisis is not attended to. Currently, there are several projects being developed in Congress that are aiming to give relief to Puerto Rico's outstanding debt, and will serve to restructure the financial abyss that amasses the island's economy.

Because of the general nature of this newsletter, nothing herein should be considered as legal advice or a legal opinion. For further information about the contents of this newsletter, or should you need further assistance in connection with these matters, please contact the firm's Bankruptcy Department.

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