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Alert

Supreme Court Holds Puerto Rico Recovery Act Preempted by Bankruptcy Code

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"Puerto Rico's Recovery Act is barred by § 903(1) … of the Bankruptcy Code," held the U.S. Supreme Court on June 13, 2016. *Commonwealth of Puerto Rico v. Franklin California Tax-Free Trust*, 2016 WL 3221517, *11 (U.S. June 13, 2016) (5-2). Affirming the First Circuit, the court reasoned that Code § 903(i) "preempts state bankruptcy laws [enabling] insolvent municipalities to restructure their debts over the objections of creditors [and] instead requires municipalities to restructure [their] debts under Chapter 9 of the Code." *Id.*, at *2. According to the court, "Puerto Rico is a 'State' for purposes of this preemption provision." *Id.*

The court also rejected Puerto Rico's argument that "Chapter 9 no longer applies to it" because of a 1984 Congressional Amendment to Code § 101(52) excluding Puerto Rico "for the purpose of defining who may be a debtor under Chapter 9." *Id.* In the court's view, "Puerto Rico remains a 'State' for other purposes related to Chapter 9, including that chapter's preemption provision," barring the Commonwealth "from enacting its own municipal bankruptcy scheme … ." *Id.*

Relevance
Puerto Rico is a U.S. "territory" that retains some level of self-governance. Its legislature may pass laws that govern the island without Congressional approval. To go further, however, it must become a State or independent nation. Article IV of the U.S. Constitution provides that a "territory" such as Puerto Rico is subject to the "power [of Congress] to … make all needful Rules and Regulations respecting the Territory … belonging to the United States." U.S. Const., Art. IV, Sec. 3. In a sense, therefore, a territory such as Puerto Rico is "property" of the federal government. *Id.*

Puerto Rico's legislature decided to act on its own two years ago by passing a debt-recovery law that would provide alternative ways for its local public utilities to restructure their debt so as to allow them to continue operating. Bondholders of the territory's electric utility, however, dissatisfied with the new legislation, sued, arguing that the legislation conflicted directly with a provision of Chapter 9 that limits how local government agencies can deal with creditors.

Facts
Puerto Rico has more than $20 billion of debt shared by three "government-owned public utility companies." *Id.* at *3. The Commonwealth's government-owned bank had provided financing "to enable utilities to continue operating without defaulting on their debt obligations," but became unable to continue funding the more than $800 million of operating losses sustained by the utilities in 2013.

In addition, Puerto Rico's "access to capital markets [had] also been severely compromised [when] ratings agencies downgraded Puerto Rican bonds, including the utilities, to non-investment grade in 2014." *Id.*

Puerto Rico "responded to the fiscal crisis by enacting" a so-called "Recovery Act" in 2014, enabling its "public utilities to implement a recovery or restructuring plan for their debt." *Id.* Essentially, "Chapter 3 of the Recovery Act … mirrors Chapters 9 and 11 of the … Code by creating a court-supervised restructuring process intended to offer the best solution for the broadest group of creditors…. Creditors holding two-thirds of an affected class of debt must participate in the vote to approve the restructuring plan, and half of those participants must agree to the plan." *Id.* "The debt modification [would thus] bind … all creditors …" *Id.*

The Lower Courts

A group of investment funds sued Puerto Rico and various government officials to enjoin enforcement of the Recovery Act. They alleged, among other things, "that the … Code prohibited Puerto Rico from implementing its own municipal bankruptcy scheme." *Id.* The district court and First Circuit "concluded that the preemption provision in [Code § 903(1)] precluded Puerto Rico from implementing the Recovery Act and enjoined its enforcement." *Id.* at *4. According to the First Circuit, "it was up to Congress, not Puerto Rico, to decide when the government-owned companies could seek bankruptcy relief." *Id*.

The Supreme Court

The Statutory Text. The court first analyzed three relevant provisions of the Code. The so-called "gateway" provision, § 109(c) (2), requires a Chapter 9 debtor to be an insolvent municipality that is "specifically authorized" by a State "to be a debtor." The applicable preemption provision, § 903(1), bars States from enacting municipal bankruptcy laws. Finally, Code § 101(52) defines State, as amended in 1984, to include "… Puerto Rico, except for the purpose of defining who may be a debtor under Chapter 9." The federal bankruptcy power is based on Act I, § 8, cl. 4 of the U.S. Constitution, which "empowers Congress to establish 'uniform laws on the subject of Bankruptcies throughout the United States.'"

Puerto Rico, reasoned the court, "is not a 'State' for purposes of the gateway provision, so it cannot perform the single function of the 'State[s]' under that provision: to 'specifically authorize' municipalities to seek Chapter 9 relief." *Id.* at *7. Thus, "Puerto Rico's municipalities cannot satisfy the requirements of Chapter 9's gateway provision until Congress intervenes." *Id.* The "amended definition of 'State' unequivocally excludes Puerto Rico as a 'State' for purposes of the gateway provision." *Id.* at *8.

But the "exception [in Code § 109(c)] excludes Puerto Rico only for purposes of the gateway provision." *Id.* Indeed, "Puerto Rico is no less a 'State' for purposes of the preemption provision than it was before Congress amended the definition." *Id.* Thus, by enacting the preemption provision in § 903(1), Congress "prohibited States and Territories defined as 'States' from enacting their own municipal bankruptcy schemes … ." Nothing "in the text of the amended definition" of Code § 109(c) suggests otherwise. *Id.*

The court rejected Puerto Rico's argument that it would be essentially excluded from Chapter 9 and barred from passing its own restructuring law. In other words, Puerto Rico argued that it was in a "no man's land," with its only remaining option to persuade Congress to make Chapter 9 available to it. The court accepted the plaintiff bondholders' narrower reading that the Code's gateway provision only

precludes Puerto Rico from authorizing its municipalities to seek Chapter 9 relief and that the other provisions of Chapter 9 still apply. "A State's only role under the gateway provision [§ 109(c)(2)] is to provide that 'authoriz[ation]' to file." *Id.*, at *9.

The "preemption provision then imposes an additional requirement: The States may not enact their own municipal bankruptcy schemes. A State that chooses not to authorize its municipalities to seek Chapter 9 relief under the gateway provision is no less bound by that preemption provision." *Id.* at *9. Indeed, "if it were Congress' intent to also exclude Puerto Rico as a 'State' for purposes of that pre-emption provision, it would have said so." *Id.*

The court rejected the dissent's "faulty assumption that Puerto Rico is 'by definition' excluded from Chapter 9." *Id.* at *10. Although Puerto Rico may not authorize its municipalities to seek Chapter 9 relief, it is still "a 'State' for purposes of § 903's introductory clause and its proviso," which "are neither 'irrelevant nor meaningless,'" as the dissent argued. *Id.* In short, the Code may "preclude … Puerto Rico from authorizing its municipalities to seek relief under Chapter 9," but "it does not remove Puerto Rico from the scope of Chapter 9's preemption provision. Federal law, therefore, preempts the [Puerto Rico] Recovery Act." *Id.* at *11.

The Dissent

The dissent reasoned that "[b]ecause Puerto Rican municipalities cannot access Chapter 9's federal bankruptcy process, … a non-federal bankruptcy solution is not merely a parallel option; it is the only existing legal option for Puerto Rico to restructure debts that could cripple its citizens." *Id.* at *11. Accordingly, it reasoned that "a preemption provision in Chapter 9 should not apply to Puerto Rico." *Id.* In short, argued the dissent, "Congress excluded Puerto Rico from Chapter 9 for all purposes – it shut the gate and barred it tight." *Id.* at *16. In the dissent's view, Code "§ 903 is directed to states that can approve their municipalities for Chapter 9 bankruptcy." *Id.* at *16.

Comment

The court's majority relied on the Constitution's "Supremacy Clause," contained in Article 6, Clause 2 of the U.S. Constitution, making federal law supreme and preempting state law. A dominant federal interest in debt restructuring precludes the enforcement of any state law on the same subject.

Until 1984, Puerto Rico, like the states, could authorize municipalities to obtain federal bankruptcy relief. In 1984, however, Congress amended § 101(52), defining state to include Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9. According to the court's majority in *Franklin*, however, the Code's definitional change was not meant to transform the force of Code § 903(1), which expressly preempts the Puerto Rican Recovery Act. *See MSR Exploration, Ltd. v. Meridian Oil, Inc.*, 74 F.3d 910, 913 (9th Cir. 1996) ("… adjustment of rights and duties within the bankruptcy process itself is uniquely and exclusively federal. It is very unlikely that Congress intended to permit the super-imposition of state remedies on the many activities that might be undertaken in … the management of the bankruptcy process." *Id.* at 914). *See generally National Hockey League v. Moyes*, 2015 U.S. Dist. LEXIS 153262, *12-*16 (D. Ariz. 2015) ("to the extent that the [plaintiff] alleges that the [defendants] aided and abetted a breach of fiduciary duty by causing the debtors to file bankruptcy, the claim is preempted."); *In re Astor Holdings, Inc. v. Roski*, 325 F. Supp. 2d 251, 262 (S.D.N.Y. 2003) (when plaintiff sued defendant for aiding and abetting breach of fiduciary duty, alleging that defendant "induced a third party to file for bankruptcy, harming the plaintiff," *held*, any misuse of bankruptcy process "governed exclusively" by Bankruptcy Code.).

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