Why Chapter 9 for Puerto Rico is a bad idea

By Arturo C. Porzecanski, April 8, 2015

The economic and financial situation in Puerto Rico continues to worsen, and the weakest link in the debtor chain is the island's electric company, a state-owned monopoly known by the acronym PREPA which owes mainland bondholders and bank creditors over $9 billion. The Commonwealth and its representative in Congress, Resident Commissioner Pedro Pierluisi, have been making the case on Capitol Hill that state enterprises like PREPA cannot possibly resolve their financial problems under the applicable indentures and laws of Puerto Rico. If creditors are not reined in by a federal bankruptcy court, "it will be a big mess" and there will be endless and disorderly litigation, power outages, and the utility "will teeter on the verge of collapse."

Therefore, Pierluisi and government representatives have been lobbying members of the Judiciary Committee's Subcommittee on Regulatory Reform, Commercial and Antitrust Law, which is chaired by Rep. Bob Goodlatte (R-Va.), to mark-up H.R. 870, a bill which would amend Title 11 of the United States Code to define Puerto Rico as a "state" for purposes of Chapter 9. The idea is to allow entities such as PREPA and other public utilities and agencies to restructure their debts under the supervision of a federal bankruptcy judge.

The good news is that the company has been negotiating constructively with its creditors, and the financial press has reported that major bondholders have offered the utility $2 billion in new financing in return for constructive steps to enhance revenues and cut costs. This is precisely the kind of face-to-face, give-and-take that the dire circumstances warrant, but the Commonwealth has every incentive to spurn offers of financing in exchange for reforms as long as there is a chance that Congress will provide the Chapter 9 option.

The irony is that Congress decided long ago to give Puerto Rico a nationwide tax exemption on its debt enjoyed by no state, an exemption that allowed the Commonwealth to become the third-largest issuer of municipal bonds in the United States. Under H.R. 870, Congress would now bestow on the island the benefit of a federal workout mechanism – as if the territory were a state. If the bill were to pass, it would set a precedent for privileged double-dipping.

H.R. 870 is warmly supported by the Democrats in the committee, who view the bill as a cost-free lifeline they can throw to the island's Popular Democratic Party administration, whose voters have an affinity with mainland Democrats. They are also currying favor with the government's base of support among the labor unions of Puerto Rico, who feel threatened by the prospect of belt-tightening and reform in the island's bloated and inefficient public sector.

However, H.R. 870 should be rejected for several reasons. First, the bill's passage would change the rules of the game with retroactive effect for the millions of investors throughout the United States who – like me – bought Puerto Rican bonds because of the Commonwealth's solemn pledge that they would be serviced in accordance with the creditor-friendly laws in place.

It is one thing to alter the rules of a game for those who may want to play it, but it is entirely another to put someone involuntarily into a game they were assured they would never have to play. Let's not help turn Puerto Rico into an Argentina or Venezuela, where investor rights have been trampled, the ensuing losses have been enormous, and confidence has been shattered.

A Chapter 9 escape clause is a costly, and by no means a costless, solution. It would render a myriad of mainland investors vulnerable to potentially inordinate losses in multiple court-supervised workouts. Taxpaying bondholders from the fifty true states have already suffered major mark-to-market pain on their investments in Puerto Rico bonds. The availability of a Chapter 9 bankruptcy option for the Commonwealth would weaken the bargaining position of bondholders and open them up to enduring permanent losses – a gift to the islanders, who under H.R. 870 would remain exempt from paying their fair share of federal income taxes.

Moreover, H.R. 870 is unnecessary to deal with the financial problems of state-owned entities in Puerto Rico. Their enabling acts contemplate the court appointment of a receiver should the entities find themselves facing liquidity or solvency problems that they and their creditors were unable to resolve. The receiver would then take over management of these entities and apply operating revenues in the manner ordered by the courts, with a view to preventing or overcoming any debt-servicing difficulties.

Finally, H.R. 870 represents a misallocation of congressional effort, which would be better spent establishing a Financial Control Board capable of addressing the root causes of Puerto Rico's urgent economic, financial, and leadership problems. With the benefit of hindsight, it is painfully clear that the Commonwealth of Puerto Rico took excessive advantage of its privilege to issue bonds paying tax-exempt interest throughout the United States.

Rather than compounding the mistake, Congress should be focusing on establishing a federal oversight board to manage the Commonwealth's grave fiscal situation – much like it did for the District of Columbia in the mid-1990s. Puerto Rico is arguably in worse shape: the Commonwealth and its companies and agencies have already been downgraded below the levels reached by the District in 1995, and the island's authorities appear unable to overcome their economic and financial emergency, at least not on their own.

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