

# NOTE

## An Arbitral Solution: A Private Law Alternative to Bankruptcy for Puerto Rico, Territories, and Sovereign Nations

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### ABSTRACT

*Puerto Rico is excluded from bankruptcy relief under the U.S. Bankruptcy Code. As a result, Puerto Rico's ability to restructure its debt is severely hindered and almost resulted in a humanitarian crisis in 2016. The problems for Puerto Rico's government, including a scarcity of interim financing and holdout creditor litigation, exacerbated Puerto Rico's dire financial situation while draining funds that could have been used to pay creditors. Although the recent passage of the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA") has temporarily capped some of these issues, PROMESA does not offer full Chapter 9 bankruptcy protection and presents issues for Puerto Rico's long-term debt restructuring and its ability to assert a democratic form of government. This lack of bankruptcy protection is also a problem for U.S. states and territories that lack direct restructuring relief under Chapter 9 or PROMESA. Sovereign nations face similar concerns because there is no international bankruptcy court for nations.*

*This Note offers a private law alternative to bankruptcy that could have empowered Puerto Rico, and other government entities like it, without having to wait on a divided U.S. Congress or international community to act. By borrowing solutions from Chapters 9 and 11 of the U.S. Bankruptcy Code and*

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\* J.D., 2017, The George Washington University Law School. I am grateful to the staff of *The George Washington Law Review* and my Notes Editor, Sandra Praxmarer. I dedicate this Note to my grandmothers, Fevkija Zečević and Sena Hadžiomerović, who taught me the value of kindness, faith, and persistence.

*solutions often proposed in sovereign debt restructuring scholarship, this Note creates a private, contractual framework to help Puerto Rico and other unin-corporated territories restructure their debt while working within the bounda-ries of PROMESA. This Note's proposed framework exports restructuring disputes to arbitration to create mock bankruptcy proceedings for government debtors such as U.S. states and territories. Although this Note concerns Puerto Rico's restructuring crisis, it also explores the greater applicability of its arbi-tral framework to other governmental entities that are not afforded bank-ruptcy protection, such as other U.S. territories, U.S. states, and nations.*

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INTRODUCTION

[P]eople impacted by the water cut-offs . . . say they were given no warning and had no time to fill buckets, sinks and tubs before losing access to water. . . Sick people have been left without running water and working toilets. People recovering from surgery cannot wash and change bandages.<sup>1</sup>

The humanitarian disaster described above brings to mind images of natural disasters that defy human will and instrumentality. This loss of the human right to water, however, was not an unavoidable consequence of an act of God or force majeure, but was rather a consequence of Detroit’s financial crisis.<sup>2</sup> Detroit’s 2013 bankruptcy, and other municipal financial crises like it, indicates that the line separating financial crises and humanitarian disasters is a precarious divide.<sup>3</sup> Indeed, Detroit’s crisis attracted the attention of experts within the Office of the United Nations High Commissioner for Human Rights, which declared the water shutoffs resulting from its default a violation of human rights.<sup>4</sup>

1 THE BLUE PLANET PROJECT, SUBMISSION TO THE SPECIAL RAPPORTEUR ON THE HUMAN RIGHT TO SAFE DRINKING WATER AND SANITATION REGARDING WATER CUT-OFFS IN THE CITY OF DETROIT, MICHIGAN 4 (June 18, 2014), <http://www.blueplanetproject.net/wordpress/wp-content/uploads/Detroit-HRTW-submission-June-18-2014.pdf>.

2 See *id.* at 3–4; cf. Sam Fleming & Eric Platt, *Puerto Rico at Risk of ‘Humanitarian Crisis,’* FIN. TIMES, <http://www.ft.com/intl/cms/s/0/48e7de10-784f-11e5-a95a-27d368e1ddf7.html#axzz3qrqXCSrv> (last updated Oct. 22, 2015, 3:46 PM) (noting that essential services such as “police and fire protection, medical services, and social support” would likely be put at risk because of Puerto Rico’s financial crisis).

3 See THE BLUE PLANET PROJECT, *supra* note 1, at 3; Fleming & Platt, *supra* note 2.

4 Press Release, U.N. Office of the High Comm’r for Human Rights, Detroit: Disconnecting Water from People Who Cannot Pay—An Affront to Human Rights, Say UN Experts (June 25, 2014), <http://www.ohchr.org/EN/NewsEvents/Pages/DisplayNews.aspx?NewsID=14777&LangID=E>.

Despite international recognition, such crises continue to threaten American citizens with potentially devastating effects on public services.<sup>5</sup> The Commonwealth of Puerto Rico, whose inhabitants hold U.S. citizenship,<sup>6</sup> currently faces a deficit estimated at upwards of \$70 billion.<sup>7</sup> When asked about the situation, the counselor to the U.S. Treasury Secretary had this to say: “In the very near future, Puerto Rico will face impossible choices among providing essential public services, delivering promised pension benefits, and paying its debt.”<sup>8</sup>

Puerto Rico’s restructuring crisis is distinct from Detroit’s in two crucial regards. First, while the Detroit crisis was insular, Puerto Rico’s predicament has the potential to inflict significant harm on the U.S. economy.<sup>9</sup> Detroit’s crisis predominantly remained within the borders of the municipality because the City’s debt consisted mainly of employee benefit and pension funds owed to the City’s retirees.<sup>10</sup> In contrast, Puerto Rico’s crisis has the potential to hit households nationwide because so many “regular Americans” own the debt.<sup>11</sup> Presently, over twenty percent of U.S. bond mutual funds hold Puerto Rican bonds, and a substantial amount of Puerto Rico’s remaining debt is owned by U.S. hedge funds.<sup>12</sup>

The second point of distinction is also unsettling. Detroit was able to invoke Chapter 9 bankruptcy protection, thereby obtaining interim financing relief, restructuring its debt, and eventually restoring public services.<sup>13</sup> Although individual American states cannot declare bank-

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<sup>5</sup> See *id.*; Fleming & Platt, *supra* note 2.

<sup>6</sup> See Stephen J. Lubben, *Puerto Rico and the Bankruptcy Clause*, 88 AM. BANKR. L.J. 553, 556 (2014) (“Puerto Ricans acquired American citizenship with the passage of the Jones Act of 1917.”).

<sup>7</sup> See Nick Brown, *Puerto Rico Debt Fix Unlikely to Resemble Detroit’s*, REUTERS (Sept. 5, 2016, 9:01 PM), <http://www.reuters.com/article/us-puertorico-debt-controlboard-analysis-idUSKCN11B2F5>.

<sup>8</sup> Fleming & Platt, *supra* note 2.

<sup>9</sup> See Sam Fleming & Nicole Bullock, *Jack Lew Warns of Puerto Rico Debt Risks to US*, FIN. TIMES (July 29, 2015, 12:07 AM), <http://www.ft.com/intl/cms/s/0/6dbd50b4-3577-11e5-b05b-b01debd57852.html#axzz3qvTxyAke>.

<sup>10</sup> See Brad Plumer, *Detroit’s Pension Problems, in One Chart*, WASH. POST: WONKBLOG (July 19, 2013), [https://www.washingtonpost.com/news/wonk/wp/2013/07/19/detroits-pension-problems-in-one-chart/?utm\\_term=.8041b8d25719](https://www.washingtonpost.com/news/wonk/wp/2013/07/19/detroits-pension-problems-in-one-chart/?utm_term=.8041b8d25719).

<sup>11</sup> Heather Long, *Who Owns Puerto Rico’s Debt?*, CNN MONEY (Aug. 6, 2015, 7:06 PM), <http://money.cnn.com/2015/07/01/investing/puerto-rico-bond-holders/>.

<sup>12</sup> See *id.* (noting that “377 funds out of 1,884 United States bond mutual funds” hold this debt and that American retirees were particularly attracted to Puerto Rican bonds because these bonds are tax exempt).

<sup>13</sup> See Nathan Bomey et al., *Judge OKs Bankruptcy Plan; A ‘Miraculous’ Outcome*, DET. FREE PRESS, <http://www.freep.com/story/news/local/detroit-bankruptcy/2014/11/07/rhodes-bank>

ruptcy, their municipalities may do so under Chapter 9 of the U.S. Bankruptcy Code (“Code”).<sup>14</sup> In this way, bankruptcy has proven to be a critical lifeline for municipalities<sup>15</sup> and the nation’s overall financial stability because it provides an orderly restructuring process that prevents government services from grinding to a halt.<sup>16</sup>

But what recourse is available to Puerto Rico, as well as states and territories like it, which is excluded from the protections of the Code?<sup>17</sup> The answer is deeply unsettling. Without a permanent, orderly restructuring process, Puerto Rico would be left to deal with costly, lengthy, and uncertain restructuring that imperils its ability to provide even the most basic public services.<sup>18</sup> Take, for instance, the narrowly negotiated deal between Puerto Rico and French oil company Total, which was patched together at the last minute in January 2016.<sup>19</sup> Before this eleventh-hour deal was finalized, the Commonwealth’s shortage of liquidity almost put its ambulances, patrol cars, fire trucks, and other public vehicles out of operation due to a lack of fuel.<sup>20</sup> Although the recent passage of the Puerto Rico Oversight, Management, and Economic Stability Act (“PROMESA”)<sup>21</sup> has recently provided some restructuring relief to Puerto Rico, more should be done to prevent future restructuring crises that could have far-

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ruptcy-decision/18648093/ (last updated Nov. 7, 2014, 9:34 PM) (noting that Detroit’s bankruptcy judge approved a restructuring plan that allowed the City to “reinvest . . . in public services and blight removal”).

<sup>14</sup> See Lubben, *supra* note 6, at 559–60 (“Under section 109, governmental units are only eligible to file under chapter 9, and then only if they qualify as municipalities.”); see also Antonio J. Pietrantonio, *Collective Action Clauses for Puerto Rican Bonds: Borrowing Costs, Practical Considerations and Lessons from Sovereign Debt*, 84 REVISTA JURÍDICA U.P.R. 1195, 1199 (2015) (“Unlike individuals and businesses, sovereign nations and American states cannot file for bankruptcy protection.”).

<sup>15</sup> See Bomey et al., *supra* note 13.

<sup>16</sup> See generally Christine Sgarlata Chung, *Municipal Bankruptcy, Essential Municipal Services, And Taxpayers’ Voice*, 24 WIDENER L.J. 43 (2015).

<sup>17</sup> See 11 U.S.C. § 101(52) (2012) (“The term ‘State’ includes the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9 of this title.”). This exclusion is largely arbitrary, and stems from the territory’s historical identity as occupying a limbo space between statehood and sovereignty as an independent country. See Lubben, *supra* note 6, at 556.

<sup>18</sup> See *Puerto Rico Reaches Deal to Keep Ambulances, Fire Trucks on the Road*, SAN DIEGO UNION-TRIB. (Jan. 11, 2016, 2:42 PM), <http://www.sandiegouniontribune.com/hoy-san-diego/sdhoy-puerto-rico-reaches-deal-to-keep-ambulances-fire-2016jan11-story.html>.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), Pub. L. No. 114-187, 130 Stat. 549 (2016).

reaching effects on the U.S. economy<sup>22</sup> because PROMESA does not provide Puerto Rico with a permanent solution.<sup>23</sup>

Further, PROMESA presents certain obstacles to Puerto Rico's long-term debt restructuring and its ability to assert a democratic form of government. First, PROMESA does not offer Puerto Rico the full benefits of a Code amendment incorporating Puerto Rico's municipalities into the Chapter 9 statutory framework. Although there was some support for such a measure in Congress, that proposal was unable to gain traction due to concerns that such an amendment might constitute a bailout similar to the 2008 crisis "handouts."<sup>24</sup> That legislative proposal failed twice when it was presented in 2014 and in 2015.<sup>25</sup> Lastly, Puerto Rico's own legislative attempt to save itself by creating its own bankruptcy-like proceedings failed because of the unconstitutionality of those proceedings and preemption by the Code.<sup>26</sup>

Given these practical impediments to complete bankruptcy protection, Puerto Rico should consider bolstering its bond agreements with additional contractual frameworks that promote more orderly restructuring and reduce the threat of costly holdout creditor litigation in the future.<sup>27</sup> Doing so would prepare Puerto Rico for future crises after the Fiscal Oversight Board ("Oversight Board") that administers PROMESA terminates and would aid the Oversight Board in facilitating voluntary restructurings under PROMESA.<sup>28</sup> This Note proposes a contractual solution by providing an arbitral framework for

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22 See, e.g., Pietrantonì, *supra* note 14, at 1197–98; Long, *supra* note 11.

23 See PROMESA §§ 209, 405(d) (requiring the termination of the Oversight Board of Puerto Rico—which is the only entity authorized to file PROMESA proceedings on behalf of Puerto Rico and its instrumentalities—and the termination of stay protection once certain requirements are met).

24 See Seung Min Kim & Burgess Everett, *Congress Balks at Lifeline for Puerto Rico*, POLITICO (July 8, 2015, 8:24 PM), <http://www.politico.com/story/2015/07/congress-balks-at-lifeline-for-puerto-rico-119876> (describing the Republican position on the Puerto Rican debt crisis and noting the party's concern that assistance could be considered a bailout). Many American politicians recently recognized the crisis as a serious issue and again rallied their fellow representatives to amend the Code for the purposes of providing Puerto Rican municipalities full Chapter 9 relief, but it is unlikely to gain traction in the current political landscape. See *id.*

25 See Puerto Rico Chapter 9 Uniformity Act of 2015, H.R. 870, 114th Cong. (2015), <https://www.congress.gov/114/bills/hr870/BILLS-114hr870ih.pdf>; Puerto Rico Chapter 9 Uniformity Act of 2014, H.R. 5305, 113th Cong. (2014), <https://www.congress.gov/113/bills/hr5305/BILLS-113hr5305ih.pdf>.

26 See Michael K. Piacentini, Note, *Lights Out for Puerto Rico's Restructuring Law?: Puerto Rico's Municipal Bankruptcy Dilemma*, 80 BROOK. L. REV. 1677, 1692–700 (2015) (noting the ways in which the Puerto Rico Corporation Debt Enforcement and Recovery Act is unconstitutional and preempted).

27 See generally Pietrantonì, *supra* note 14.

28 See PROMESA §§ 104(i), 209.

Puerto Rico to include in all future bond agreements and in existing bond agreements during renegotiations of bond terms.<sup>29</sup> This framework seeks to improve Puerto Rico's future restructurings by borrowing private law solutions to sovereign debt restructuring and the Code.<sup>30</sup> The framework is not limited to Puerto Rico and its instrumentalities; it could be used by states and other U.S. territories not covered by either Chapter 9 of the Code or PROMESA.<sup>31</sup> The framework avoids constitutional violations by removing the procedure to an arbitral forum affecting only prospective bond agreements and consensual amendments.<sup>32</sup> By contracting around the problems caused by the lack of an orderly bankruptcy process, Puerto Rico could further insulate itself from its restructuring crisis and provide a model for similarly situated commonwealths and sovereigns that lack Chapter 9 bankruptcy relief.<sup>33</sup>

Part I of this Note discusses Puerto Rico's unique legal identity and the resulting exclusion of its municipalities from the protections of Chapter 9 of the Code.<sup>34</sup> This Part explains how this exclusion has created restructuring and economic problems in the territory, while simultaneously threatening the financial health of American mutual funds and the American economy.<sup>35</sup> Part II discusses three existing proposals to address these vulnerabilities, including congressional attempts to amend the Code, failed legislative attempts by the Puerto Rican government to enforce its own "bankruptcy" act, and promising contractual solutions that have surfaced in recent scholarship focusing on Puerto Rico's main source of debt: its bond agreements.<sup>36</sup> Part III

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<sup>29</sup> See *infra* Part III.

<sup>30</sup> See *infra* Part III.

<sup>31</sup> Although PROMESA contemplates the addition of other U.S. territories into its framework, PROMESA did not establish such fiscal oversight boards for Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, or the United States Virgin Islands. See Bruce Wilson, *PROMESA and the Future of Puerto Rico: Part 2*, LAW360 (Nov. 16, 2016, 4:25 PM), <https://www.law360.com/articles/863012/promesa-and-the-future-of-puerto-rico-part-2> ("Territories of the United States, other than Puerto Rico and its instrumentalities, are not currently covered by PROMESA."). Further legislative or judicial action would be required to allow for such boards and permit these government entities access to PROMESA's restructuring protections. See *id.*

<sup>32</sup> See *infra* Part III.

<sup>33</sup> See *infra* Part III.

<sup>34</sup> See *infra* Part I.

<sup>35</sup> See *infra* Part I.

<sup>36</sup> See *infra* Part II. Specifically, the note analyzes the use of collective action clauses ("CACs") as a potential solution and decides that although they are a good starting point, more can be done. See *infra* Part II. For an in-depth explanation of CACs and their applicability to Puerto Rican debt, see Pietrantoni, *supra* note 14.

argues for the adoption of a new contractual solution to government bond restructuring problems not yet considered by the current scholarship: an arbitral framework that mimics bankruptcy by including a combination of arbitration clauses and choice-of-law provisions in future bond agreements between Puerto Rico and its bondholders.<sup>37</sup> This Part lists the major elements and the instructions for implementing such a framework in future bond agreements issued by the territory.<sup>38</sup> Part IV addresses potential criticisms, including the practicality of this solution, its constitutionality, and its recognition in foreign courts and the bond markets.<sup>39</sup>

## I. PUERTO RICO IN LIMBO: EXCLUSION FROM BANKRUPTCY

### A. Which Code Provisions Require Puerto Rico's Exclusion?

Puerto Rico's exclusion from bankruptcy protection is intertwined with its identity and historical placement within the American legal system. This identity is the subject of debate, both inside and outside of the courtroom.<sup>40</sup> The Supreme Court first addressed Puerto Rico's state of "constitutional limbo" in the *Insular Cases*, which stand for the proposition that Puerto Rico may not be analyzed under precedent concerning nonstate territories and may even be afforded protections traditionally enjoyed by states.<sup>41</sup> Subsequent federal cases continue along this line of reasoning, whereby Puerto Rico is sometimes treated as a U.S. state, but other times is not.<sup>42</sup> For instance, the First Circuit treats Puerto Rico as a state for sovereign immunity purposes, despite the Eleventh Amendment's express prohibition of actions "against one of the United States."<sup>43</sup> Despite Puerto Rico's complicated legal treatment, there are two principles that have re-

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<sup>37</sup> See *infra* Part III. The solution will borrow contractual provisions used in sovereign debt restructuring, including provisions from Professors Patrick Bolton and David A. Skeel, Jr. See generally Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 763, 803–08 (2004). Although the Note will use the Bolton and Skeel framework, it will also borrow from other theorists who have formulated different rules for an ideal government restructuring, in order to better tailor it to Puerto Rico. See *infra* Part III.

<sup>38</sup> See *infra* Part III. The Note will briefly discuss the applicability of this solution to other unincorporated territories (e.g., Guam), as well as sovereigns hoping to prevent future restructuring crises. See *infra* Part III.

<sup>39</sup> See *infra* Part IV.

<sup>40</sup> See Lubben, *supra* note 6, at 555–57.

<sup>41</sup> *Id.*

<sup>42</sup> See *id.* at 556–57.

<sup>43</sup> *Id.* at 557–58 (discussing the ways in which Puerto Rico enjoys protections and restrictions that apply to states, such as applicability of the Dormant Commerce Clause to Puerto Rico).



mained fairly certain. First, Puerto Rico seems to be bound by some provisions of the U.S. Constitution.<sup>44</sup> Second, although Puerto Rico does not enjoy the full sovereign rights of a foreign nation, it may be occasionally treated as a nonstate entity by Congress.<sup>45</sup>

Puerto Rico's treatment under the Code serves as an example of these two principles. First, Puerto Rico is currently prohibited from legislating its own bankruptcy laws because those laws are preempted by the Code under the authority of the Supremacy Clause.<sup>46</sup> Second, although the Commonwealth is considered a State for most of the provisions of the Code, it is expressly excluded from state treatment for the purposes of Chapter 9 municipal bankruptcy.<sup>47</sup>

Under the Code, Puerto Rico is above all considered a "governmental unit," which is defined to include the following entities: "United States; State; Commonwealth; District; Territory; municipality."<sup>48</sup> For this Note's purposes, it is important to note that states are not allowed to file for bankruptcy relief under Chapter 9.<sup>49</sup> However, these states indirectly benefit from bankruptcy protection because their municipalities may file for bankruptcy under Chapter 9.<sup>50</sup> Under the Code, a municipality is defined as a "political subdivision or public agency or instrumentality of a State."<sup>51</sup>

### B. Puerto Rico's Missing Bankruptcy Protections

A Code amendment would give Puerto Rico access to the numerous benefits of the U.S. bankruptcy process. These benefits include: (1) "the ability to bind all stakeholders to an *in rem* resolution of restructured obligations";<sup>52</sup> (2) eliminating the effects of holdout litigation by consolidating creditor actions and introducing a stay of litigation;<sup>53</sup> and (3) the ability to attract interim financing through

<sup>44</sup> See *id.* at 555–58.

<sup>45</sup> See *id.*

<sup>46</sup> U.S. CONST. art. VI, § 2; see also *Franklin Cal. Tax-Free Tr. v. Puerto Rico*, 805 F.3d 322, 325 (1st Cir. 2015).

<sup>47</sup> 11 U.S.C. § 101(52) (2012) (expressly excluding Puerto Rico from Chapter 9); see also Lubben, *supra* note 6, at 560.

<sup>48</sup> 11 U.S.C. § 101(27); see also *id.* § 101(52) (noting that "State" includes Puerto Rico).

<sup>49</sup> *Id.* § 109(a); see also Lubben, *supra* note 6, at 559–60.

<sup>50</sup> See 11 U.S.C. § 109(c)(1); Lubben, *supra* note 6, at 560.

<sup>51</sup> 11 U.S.C. § 101(40).

<sup>52</sup> John A.E. Pottow, *Mitigating the Problem of Vulture Holdout: International Certification Boards for Sovereign-Debt Restructurings*, 49 TEX. INT'L L.J. 221, 222 (2014). In § 1122(a) of the Code, creditors are grouped into classes of similar claims and vote by supermajority so that the vote is representative of "holders of substantially similar claims." Steven L. Schwarcz, "*Idiot's Guide*" to Sovereign Debt Restructuring, 53 EMORY L.J. 1189, 1198 (2004).

<sup>53</sup> See Schwarcz, *supra* note 52, at 1193 ("Holdouts, however, discourage all creditors—

debtor-in-possession (“DIP”) financing from private creditors, thereby reducing the moral hazard problem of entities being bailed out by multilateral organizations or the federal government.<sup>54</sup>

Taken together, the predictability created by a smooth Chapter 9 restructuring process creates stability for government debtors who must continue to serve the public during the occurrence of a default event.

*C. Resulting Harms to Puerto Rico’s Public and American Investors*

Aside from the harmful consequences to Puerto Rico’s residents, Puerto Rico’s bankruptcy exclusion also has major implications for mainland U.S. investors. Presently, over twenty percent of U.S. bond mutual funds hold Puerto Rican bonds, and a substantial portion of Puerto Rico’s remaining debt is owned by U.S. hedge funds.<sup>55</sup> This interdependency was encouraged by a triple tax incentive (federal, state, and local tax exemptions) for Americans buying Puerto Rican bonds.<sup>56</sup> The resulting flush of financing created a robust incentive for Puerto Rico to borrow using bond agreements and introduced vulnerability into the U.S. economy.<sup>57</sup> Institutional and individual investors across the country have watched helplessly as their Puerto Rican bonds have spiraled into junk ratings.<sup>58</sup>

Puerto Rico’s restructuring problems could have far-reaching effects on the United States and taxpayers. Judicial authorities have made it clear that without an orderly restructuring, Congress may eventually have to provide direct funding to alleviate Puerto Rico’s financial crisis.<sup>59</sup> The First Circuit disagreed with the argument “that preemption [of Puerto Rico’s bankruptcy laws] would leave Puerto

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even those who otherwise wish to reach an agreement—from agreeing to a debt restructuring plan.”).

<sup>54</sup> *Id.* at 1199–200.

<sup>55</sup> Long, *supra* note 11.

<sup>56</sup> Piacentini, *supra* note 26, at 1694.

<sup>57</sup> See Long, *supra* note 11; Matthew Yglesias, *Congress Has a Bipartisan Deal to Save Puerto Rico from Its Debt Crisis*, Vox (May 20, 2016, 8:40 AM), <http://www.vox.com/2016/5/20/11719332/puerto-rico-debt-crisis-deal>.

<sup>58</sup> Long, *supra* note 11 (“Many insurance firms and pensions can’t hold Puerto Rican debt anymore because it has junk status.”).

<sup>59</sup> See Matthew Repetto, *Exposing the Lack of Uniformity in U.S. Bankruptcy Law: Puerto Rico’s Own Municipal Bankruptcy Law Preempted by Chapter 9*, AM. BANKR. INST., [http://www.abi.org/member-resources/blog/exposing-the-lack-of-uniformity-in-us-bankruptcy-law-puerto-rico%E2%80%99s-own#\\_ednref7](http://www.abi.org/member-resources/blog/exposing-the-lack-of-uniformity-in-us-bankruptcy-law-puerto-rico%E2%80%99s-own#_ednref7) [<http://perma.cc/CJX2-CT33>] (last visited May 9, 2017).

Rico with no means of relief.”<sup>60</sup> It “noted that Puerto Rico could, as it had already, seek relief directly from Congress.”<sup>61</sup> This response recognizes that Puerto Rico does not have the sovereign authority to seek financing from non-U.S. government sources, such as the International Monetary Fund (“IMF”).<sup>62</sup> Unlike sovereign nation-states working through the same restructuring issues that Puerto Rico now faces, Puerto Rico lacks the authority to knock on the IMF’s door for financing.<sup>63</sup> PROMESA also fails to provide direct funding to Puerto Rico.<sup>64</sup>

In addition, the remaining U.S. territories—Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the United States Virgin Islands—are also excluded from Chapter 9, but are not covered by PROMESA.<sup>65</sup> Further legislative or judicial action would be necessary in order to provide these entities with protections under PROMESA or Chapter 9.<sup>66</sup> Leaving these territories without an orderly restructuring process could lead to similar financial and humanitarian crises, such as those experienced by Puerto Rico. If no permanent comprehensive actions are taken to create orderly restructuring processes for U.S. territories and states, Congress may eventually have to provide direct economic and humanitarian aid to these government debtors.

## II. EXISTING PROPOSALS TO PREVENT FUTURE CRISES

In the absence of bankruptcy, Puerto Rico is left without a permanent restructuring process, whereby “changes [are made] in the originally envisaged debt service payments, either after a default or under the threat of default.”<sup>67</sup> The goal of any restructuring process is to negotiate “a more manageable liability profile over time or a reduc-

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*; see also *Franklin Cal. Tax-Free Tr. v. Puerto Rico*, 805 F.3d 322, 325 (1st Cir. 2015).

<sup>62</sup> See Robin Wigglesworth, *Puerto Rico Bonds Tumble on Debt Fears*, *FIN. TIMES* (June 29, 2015, 6:36 PM), <http://www.ft.com/intl/cms/s/0/53ca83f6-1e71-11e5-aa5a-398b2169cf79.html#axzz3qrqXCSrv>.

<sup>63</sup> See *id.*; see also *IMF Country Information*, INT’L MONETARY FUND, <http://www.imf.org/external/country/index.htm> [<http://perma.cc/U8TG-6Y5G>] (last visited May 9, 2017) (outlining IMF’s member states, which does not include the Commonwealth of Puerto Rico).

<sup>64</sup> See PROMESA, Pub. L. No. 114-187, § 210, 130 Stat. 549, 576 (2016); D. ANDREW AUSTIN, CONG. RESEARCH SERV., R44532, *THE PUERTO RICO OVERSIGHT, MANAGEMENT, AND ECONOMIC STABILITY ACT (PROMESA)*; H.R. 5278, S. 2328) 35 (2016).

<sup>65</sup> See Wilson, *supra* note 31.

<sup>66</sup> *Id.*

<sup>67</sup> Michael Waibel, *Opening Pandora’s Box: Sovereign Bonds in International Arbitration*, 101 AM. J. INT’L L. 711, 712 n.9 (2007) (quoting FEDERICO STURZENEGGER & JEROMIN ZETTELMEYER, *DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISES* 3 (2006)).

tion in the debt's net present value."<sup>68</sup> Currently, three solutions to Puerto Rico's restructuring problems predominate discussions of the territory's financial future. These are: (1) a congressional amendment that would allow the territory access to the U.S. bankruptcy process, specifically Chapter 9;<sup>69</sup> (2) Puerto Rico's own legislative attempts to create a bankruptcy process;<sup>70</sup> and (3) contractual or "private law" solutions that attempt to create orderly restructuring processes and minimize the harm caused by Puerto Rico's exclusion from Chapter 9.<sup>71</sup>

Considering Puerto Rico's legal identity (which includes characteristics of U.S. statehood as well as nation-state sovereignty),<sup>72</sup> it is appropriate to adopt terminology and concepts from both U.S. bankruptcy law and sovereign debt restructuring literature when discussing various solutions to this problem. This literature is also appropriate in the context of discussing solutions for other U.S. states and territories, given that these entities arguably have more in common with sovereign debtors than private debtors. There are two main approaches to restructuring problems in the context of sovereign debt restructuring: (1) the public law approach (defined as solutions "requiring rules among States")<sup>73</sup> and (2) the private law approach (defined as solutions "not necessarily requiring rules among States," including contractual solutions negotiated between a state and private creditors).<sup>74</sup>

<sup>68</sup> *Id.* at 712.

<sup>69</sup> See Puerto Rico Chapter 9 Uniformity Act of 2015, H.R. 870, 114th Cong. (2015), <https://www.congress.gov/114/bills/hr870/BILLS-114hr870ih.pdf>; Puerto Rico Chapter 9 Uniformity Act of 2014, H.R. 5305, 113th Cong. (2014), <https://www.congress.gov/113/bills/hr5305/BILLS-113hr5305ih.pdf>.

<sup>70</sup> See GOV'T DEV. BANK FOR P.R., THE FACTS ABOUT PUERTO RICO'S PUBLIC CORPORATIONS DEBT ENFORCEMENT AND RECOVERY ACT (2014), <http://www.gdb-pur.com/documents/FactsAboutDebtEnforcementAndRecoveryAct.pdf>.

<sup>71</sup> See Pietrantonio, *supra* note 14, at 1199 (arguing for a contractual solution).

<sup>72</sup> See generally Jason Adolfo Otaño, Note, *Puerto Rico Pandemonium: The Commonwealth Constitution and the Company-Colony Conundrum*, 27 FORDHAM INT'L L.J. 1806 (2003) (revisiting Puerto Rico's history and its status under both U.S. and international law).

<sup>73</sup> Schwarcz, *supra* note 52, at 1190. Examples include: "[T]he sovereign debt restructuring mechanism (SDRM) approach proposed by the International Monetary Fund (IMF) and similar international-treaty or international-convention approaches." *Id.* (footnote omitted).

<sup>74</sup> *Id.* at 1190–91. Other examples of private law solutions include collective action clauses and "bond-exchange offers with exit consents, which attempt to replace a State's existing bonds with bonds permitting supermajority voting to change essential payment terms; and other such approaches." *Id.* (footnote omitted). Another approach might be to advocate for the status quo. See Pottow, *supra* note 52, at 231. As the status quo has already been presented as an option that creates massive restructuring problems, see *id.*, only the above mentioned public and private law solutions are considered here.

### A. *Public Law Approaches: Amending the Code or Validating Puerto Rican Legislation*

Scholars who favor public law approaches attempt to solve restructuring problems through legislative or treaty-based solutions.<sup>75</sup> Advocates of this approach note the benefits that concerted action by governments brings, including the ability to bind all creditors.<sup>76</sup> Such approaches prevent the collective action problem, defined as the inability to gain consensus among creditors during restructuring,<sup>77</sup> which often leads to the problem of holdout creditors filing parallel suits in multiple jurisdictions.<sup>78</sup> These public law scholars find their equivalent in the Puerto Rican restructuring discourse in the past attempts to amend the Code, the recent passage of PROMESA, and Puerto Rico's own legislative attempts to pass bankruptcy-like legislation.

#### 1. *An Amendment to the Code*

An amendment to the Code allowing Puerto Rico's municipalities to file under Chapter 9 would be the ideal solution to Puerto Rico's restructuring problems because it fills in the missing elements discussed in Part I: the lack of absolute priority, the inability to stay creditor litigation, and the lack of interim financing to continue municipal operations.<sup>79</sup> Although a Code amendment is ideal in this author's opinion, it is perhaps not the most realistic solution given the current political environment and Congress's recent approval of PROMESA's restructuring regime.<sup>80</sup>

For instance, a bill was introduced in 2014 by Puerto Rico's non-voting representative in Congress, Resident Commissioner Pedro

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<sup>75</sup> See Schwarcz, *supra* note 52, at 1197.

<sup>76</sup> See *id.* at 1197–98. Professor Schwarcz also quotes Charles Jordan Tabb to emphasize that restructuring agreements outside of bankruptcy often fail because “dissenting creditors cannot be bound to the restructuring agreement.” *Id.* at 1198 n.41 (quoting CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* 7 (1st ed. 1997)).

<sup>77</sup> See *id.* at 1192.

<sup>78</sup> See Pottow, *supra* note 52, at 231.

<sup>79</sup> See *supra* Section I.A.

<sup>80</sup> See Kim & Everett, *supra* note 24. Professor Skeel has argued that amending Chapter 9 to allow Puerto Rico to file for bankruptcy would be an effective solution to Puerto Rico's restructuring process. See David Skeel, *Fixing Puerto Rico's Debt Mess*, WALL ST. J. (Jan. 5, 2016, 7:29 PM), <https://www.wsj.com/articles/fixing-puerto-ricos-debt-mess-1452040144>. However, Professor Skeel further suggested that the Chapter 9 process could be improved upon in general by adding two additional requirements for confirming a municipal restructuring plan. See *id.* (arguing that Congress should enforce its requirement that bankruptcy judges conclude that a municipal restructuring plan does not “discriminate unfairly” and clarify that the “best interests” requirement in the Code “means that the plan ensure as much recovery for creditors as is reasonably possible”).

Pierluisi, that would fix Puerto Rico's restructuring woes by amending the Code.<sup>81</sup> This bill would have amended the Code to allow Puerto Rico's municipalities to declare Chapter 9 bankruptcy like any other municipality within the United States.<sup>82</sup> A nearly identical version of this bill was reintroduced in 2015, but also failed.<sup>83</sup> Although the 2015 bill was favored by many Congressional Democrats and was on the platforms of both leading Democratic presidential candidates in the most recent U.S. presidential election,<sup>84</sup> it did not inspire bipartisan support.<sup>85</sup> A bill proposing a Code amendment is likely to fail again because PROMESA offers at least some restructuring options for Puerto Rico and the idea of amending Chapter 9 is often linked to the concept of a government bailout.<sup>86</sup>

During the finalization of this Note, both Democrats and Republicans proposed draft legislation within weeks of each other to provide Puerto Rico with restructuring relief.<sup>87</sup> The Democrats' draft legislation was distinct from their previous bills because of the plan's prioritization of pension fund debt to "senior secured debt" status.<sup>88</sup> The Republican plan, by contrast, created a federal oversight board with the power to (1) "enact fiscal plans and budgets for Puerto Rico . . . if the local legislature fails to do so"; and (2) authorize a "court-supervised restructuring process" if specified conditions are met.<sup>89</sup> The rhetoric surrounding these plans evinces the steep opposition to the

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<sup>81</sup> Kim & Everett, *supra* note 24; see Puerto Rico Chapter 9 Uniformity Act of 2014, H.R. 5305, 113th Cong. (2014), <https://www.congress.gov/113/bills/hr5305/BILLS-113hr5305ih.pdf>.

<sup>82</sup> Puerto Rico Chapter 9 Uniformity Act of 2014, H.R. 5305, 113th Cong. (2014), <https://www.congress.gov/113/bills/hr5305/BILLS-113hr5305ih.pdf>; Kim & Everett, *supra* note 24.

<sup>83</sup> Compare H.R. 870, 114th Cong. (2015), <https://www.congress.gov/114/bills/hr870/BILLS-114hr870ih.pdf>, with H.R. 5305, 113th Cong. (2014), <https://www.congress.gov/113/bills/hr5305/BILLS-113hr5305ih.pdf>.

<sup>84</sup> Carl Horowitz, *Puerto Rican Bond Default Raises Likelihood of U.S. Bailout*, NAT'L LEGAL & POL'Y CTR. (Aug. 7, 2015), <http://nlpc.org/2015/08/07/puerto-rican-bond-default-raises-likelihood-us-bailout/>.

<sup>85</sup> See *All Bill Information (Except Text) for H.R.870 – Puerto Rico Chapter 9 Uniformity Act of 2015*, CONGRESS.GOV, <https://www.congress.gov/bill/114th-congress/house-bill/870/all-info#cosponsors> (last visited May 9, 2017) (listing the bill's 41 co-sponsors—all of whom are Democrats).

<sup>86</sup> See Kim & Everett, *supra* note 24.

<sup>87</sup> See Nick Timiraos, *House Republicans to Introduce Draft Bill to Rescue Puerto Rico*, WALL ST. J. (Mar. 24, 2016, 7:19 PM), <http://www.wsj.com/articles/house-republicans-to-introduce-draft-bill-to-rescue-puerto-rico-1458861545>; Mary Williams Walsh, *Democrats' Bills to Empower Puerto Rico Face Uphill Battle*, N.Y. TIMES: DEALBOOK (Mar. 13, 2016), [http://www.nytimes.com/2016/03/14/business/dealbook/democrats-bills-to-empower-puerto-rico-face-uphill-battle.html?\\_r=0](http://www.nytimes.com/2016/03/14/business/dealbook/democrats-bills-to-empower-puerto-rico-face-uphill-battle.html?_r=0).

<sup>88</sup> See Walsh, *supra* note 87.

<sup>89</sup> Timiraos, *supra* note 87.

passing of an amendment allowing Puerto Rico to file bankruptcy under Chapter 9 of the Code.<sup>90</sup> However, Congress was able to reach a compromise between these two bills, resulting in the passage of PROMESA on June 30, 2016.<sup>91</sup>

PROMESA—which was signed into law by President Obama just one day before Puerto Rico was set to default on \$1.9 billion worth of debt—provides some of the benefits of, but is not identical to, a bankruptcy proceeding under Chapter 9.<sup>92</sup> The most relevant PROMESA sections for this Note’s purposes are sections 104(i) and 304, which allow the Oversight Board to facilitate voluntary modifications of agreements among bond claim holders,<sup>93</sup> and, in the event the requisite amount of creditors does not agree on the restructuring, allow the Oversight Board to file a case in a federal district court to readjust the debts of Puerto Rico and its instrumentalities.<sup>94</sup> To summarize, PROMESA has many benefits and was arguably one of the only plausible courses of action available at the time because the political climate did not allow for a Code amendment giving Puerto Rico and its instrumentalities full and permanent access to Chapter 9 bankruptcy proceedings.<sup>95</sup>

Despite these advantages, PROMESA is not ideal when compared to the solution of amending the Code. First, while PROMESA does institute an automatic stay of litigation, the Act does not offer the full stay protection offered to the municipalities of states under Chapter 9.<sup>96</sup> Instead, PROMESA’s stay provision contemplates that its stay will expire on February 15, 2017, unless the Oversight Board

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<sup>90</sup> Some Democrats, including Senator Bernie Sanders, condemn the Republican plan as undemocratically overriding Puerto Rico’s budget decisions and the will of its people. *See* Daniel Marans, *Bernie Sanders Says This Puerto Rico Rescue Package Would Just Make Things Worse*, HUFFPOST, [http://www.huffingtonpost.com/entry/bernie-sanders-house-puerto-rico-bill\\_us\\_56fea86ce4b083f5c60791e8](http://www.huffingtonpost.com/entry/bernie-sanders-house-puerto-rico-bill_us_56fea86ce4b083f5c60791e8) (last updated Apr. 1, 2016).

<sup>91</sup> *See* PROMESA, Pub. L. No. 114-187, 130 Stat. 549 (2016).

<sup>92</sup> *See* Brown, *supra* note 7; Wilson, *supra* note 31.

<sup>93</sup> PROMESA § 104(i); *see* AUSTIN, *supra* note 64, at 9.

<sup>94</sup> PROMESA § 304; *see* AUSTIN, *supra* note 64, at 16.

<sup>95</sup> *See, e.g.*, 162 CONG. REC. H3601 (daily ed. June 9, 2016) (statement of Rep. Grijalva) (“When measured against a perfect bill, this legislation is inadequate. When measured against the worsening crisis in Puerto Rico, this legislation is vitally necessary.”).

<sup>96</sup> 11 U.S.C. §§ 901(a), 922 (2012) (applying the stay provisions of § 362 of the Code to municipal bankruptcies under Chapter 9); *see also id.* § 362(c) (“[T]he stay of an act against property of the estate under subsection (a) of this section continues until such property is no longer property of the estate; (2) the stay of any other act under subsection (a) of this section continues until the earliest of—(A) the time the case is closed; (B) the time the case is dismissed; or (C) if the case is a case under chapter 7 of this title concerning an individual or a case under chapter 9, 11, 12, or 13 of this title, the time a discharge is granted or denied . . .”).

extends the stay by seventy-five days or a district court with jurisdiction under PROMESA decides that an additional sixty days are needed to complete a voluntary process under Title VI of the Act.<sup>97</sup> The stay did in fact expire on May 1, 2017, following an extension.<sup>98</sup> Thereafter, creditor litigation began and Puerto Rico's central government filed for restructuring under Title III on May 3, 2017 (thereby invoking a stay of litigation concerning \$18 billion in general obligation debt).<sup>99</sup> COFINA followed suit and filed on May 5 (invoking a stay for another \$17 billion or so of debt).<sup>100</sup> Second, the creation of the Oversight Board has been referred to as an antidemocratic institution and an affront to the self-governance of Puerto Rico's people, as articulated by representatives in the legislative history of PROMESA's passing.<sup>101</sup> Although PROMESA incorporates many important sections of Chapter 9,<sup>102</sup> these notable differences illustrate that PROMESA does not offer the full and permanent proceedings available to state municipalities under Chapter 9 of the Code.

## 2. *The Recovery Act: Puerto Rico's Legislative Approach to Restructuring Problems*

When it became clear that Congress was not going to provide a timely amendment to the Code and that restructuring was going to be "legally and politically messy, given the complexity of the debts,"<sup>103</sup> Puerto Rico attempted to establish its own bankruptcy process by passing the Public Corporations Debt Enforcement and Recovery Act ("Recovery Act").<sup>104</sup> This Act would have provided bankruptcy relief

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<sup>97</sup> PROMESA, Pub. L. No. 114-187, § 405(d), 130 Stat. 549, 588 (2016).

<sup>98</sup> Nick Brown, *Puerto Rico Board Extends Key Deadlines on Turnaround Plan*, REUTERS (Jan. 28, 2017, 11:59 AM) <http://www.reuters.com/article/us-puertorico-debt-oversightboard-idUSKBN15C0FV>.

<sup>99</sup> Daniel Bases, *Puerto Rico Seeks Title III Bankruptcy Protection for COFINA Debt*, REUTERS (May 5, 2017, 8:35 PM), <http://www.reuters.com/article/us-puertorico-debt-cofina-idUSKBN18200O>.

<sup>100</sup> *Id.*

<sup>101</sup> See 162 CONG. REC. H3601 (daily ed. June 9, 2016) (statement of Rep. Grijalva) ("The oversight board . . . is yet another infringement of the sovereignty of the people of Puerto Rico, and they have a right to find it offensive."); *id.* at H3602 (statement of Rep. Young) ("That does not mean that this is a perfect bill. It is not even close. . . . It is offensive that Puerto Rico must foot a \$370 million price tag for an oversight board its residents do not want."). Although Representatives Grijalva and Young argued that PROMESA is not an ideal solution, they advocated for it as the only politically feasible measure available to fix an impending humanitarian and fiscal crisis. See *id.* at H3601, H3602.

<sup>102</sup> PROMESA § 301 (applying certain provisions of Chapter 9 to Puerto Rico).

<sup>103</sup> Wigglesworth, *supra* note 62.

<sup>104</sup> See GOV'T DEV. BANK FOR P.R., *supra* note 70.



to Puerto Rico's municipal entities, in part by mimicking the U.S. bankruptcy process.<sup>105</sup> The government of Puerto Rico views the exclusion of its municipal entities from the U.S. bankruptcy process as an oversight; it passed the Act "to fill the gap in the restructuring law and ensure that no critical services are jeopardized."<sup>106</sup>

Like the Code, the Recovery Act expressly excludes Puerto Rico—in its functions as a quasi-state—from the protections of the Act while providing relief to its municipal entities (specifically, municipal corporations),<sup>107</sup> such as the Puerto Rico Electric Power Authority ("PREPA") and the Puerto Rico Highways and Transportation Authority ("PRHTA").<sup>108</sup> These municipal corporations issued billions of dollars of municipal bonds that constitute a substantial portion of Puerto Rico's overall debt.<sup>109</sup> Their eligibility under the Recovery Act is partly in keeping with the Code because the Code does not protect individual U.S. states.<sup>110</sup> The Recovery Act allows such municipal corporation bankruptcies by virtue of two of its chapters: Chapter 2, which allows for the solicitation of consensual debt relief with creditors, and Chapter 3, which provides for a nonconsensual process in the event that Chapter 2 is exhausted.<sup>111</sup>

Both of these chapters are patterned after the Code.<sup>112</sup> For instance, Chapter 2 requires initiation by the municipal corporation, with an automatic stay of litigation for "at least 270 days," during which the corporation negotiates "structural and operating changes" in order to refinance its debts.<sup>113</sup> This provision reveals an attempt to mimic the Code in that the automatic stay is considered to be "a principal feature" of the U.S. system.<sup>114</sup> Additionally, Chapter 3, which

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<sup>105</sup> See Piacentini, *supra* note 26, at 1685–87.

<sup>106</sup> GOV'T DEV. BANK FOR P.R., *supra* note 70.

<sup>107</sup> See Piacentini, *supra* note 26, at 1686. For an extensive overview of the Recovery Act, as well an argument that the Act is constitutional because of Puerto Rico's unique legal history and exclusion from bankruptcy protection, see Lubben, *supra* note 6.

<sup>108</sup> See Lubben, *supra* note 6, at 553, 560.

<sup>109</sup> See *id.* at 553 (noting that Puerto Rico's municipal corporations were responsible for \$24.8 billion out of the \$72.6 billion in outstanding debt).

<sup>110</sup> See Piacentini, *supra* note 26, at 1685–87; see also 11 U.S.C. § 109(c) (2012).

<sup>111</sup> See Piacentini, *supra* note 26, at 1686–87.

<sup>112</sup> *Id.* at 1687.

<sup>113</sup> *Id.* at 1686.

<sup>114</sup> *Id.* at 1686–87. The Recovery Act does differ, however, with regard to the duration of the stay. Under the U.S. system, the stay is not lifted until the resolution of the bankruptcy case. *Id.* (noting that the shortened time frame recognizes the virtues of efficiency and expediency and empowers creditors by allowing them to approve extensions in increments of ninety-day periods beyond the initial stay with support of at least 20% of the creditor class). Additionally, the Recovery Act would have required at least 50% of the holders of the debt to participate in a

may only be invoked where the municipal corporation is insolvent, mimics Chapter 11 of the Code in that it may be used to force restructuring upon unwilling creditors.<sup>115</sup>

Unfortunately, the Recovery Act raises a laundry list of constitutional concerns, including “federal preemption due to Congress’s heavy legislation in the area, issues with the automatic stay, impairment of contracts under Article I, Section 10 of the Constitution, and unconstitutional takings claims under the Fifth Amendment.”<sup>116</sup> Indeed, the First Circuit removed almost all doubt that the Recovery Act was not a viable solution to Puerto Rico’s restructuring woes by declaring that § 903(1) of the Code preempts the Recovery Act.<sup>117</sup> In its opinion, the court explained that the legislative history of the section (specifically, its predecessor section 83(1)) “clearly barred Puerto Rico (and all the other territories) from enacting their own versions of Chapter 9.”<sup>118</sup> At the time of the writing of this Note, the Supreme Court delivered its decision affirming the First Circuit’s holding.<sup>119</sup> Although the Recovery Act would have provided ample relief and would have even allowed for the restructuring of Puerto Rico’s past bond agreements, the First Circuit made it clear that the Recovery Act was preempted and that attempts to create a Puerto Rican bankruptcy code would similarly fail.<sup>120</sup> PROMESA would also arguably prohibit such attempts while the Oversight Board remains in force, given the Oversight Board’s broad restructuring and budgetary powers under the Act.<sup>121</sup>

### *B. Collective Action Clauses: The Starting Point for Private Law Solutions*

Considering these substantial barriers to realizing public law solutions, why has Puerto Rico not turned to a private law solution to ameliorate its restructuring crisis? The reasons for this may be addressed by looking at the criticisms traditionally aimed at contractual solutions. Advocates of public law solutions argue that there are two

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vote to the final municipal restructuring plan, and 75% of these voters must approve the plan for it to pass. *Id.* at 1687.

<sup>115</sup> *Id.* at 1687.

<sup>116</sup> *Id.* at 1692.

<sup>117</sup> *Franklin Cal. Tax-Free Tr. v. Puerto Rico*, 805 F.3d 322, 336 (1st Cir. 2015).

<sup>118</sup> Rafael Porrata-Doria, Jr., *First Circuit Bars Puerto Rico’s Municipal Debtors from Bankruptcy Court*, TEMPLE 10-Q (Oct. 13, 2015), <http://www2.law.temple.edu/10q/first-circuit-bars-puerto-ricos-municipal-debtors-from-bankruptcy-court/>.

<sup>119</sup> *Puerto Rico v. Franklin Cal. Tax-Free Tr.*, 136 S. Ct. 1938 (2016).

<sup>120</sup> *See Franklin Cal. Tax-Free Tr.*, 805 F.3d at 336–37.

<sup>121</sup> *See PROMESA*, Pub. L. No. 114-187, § 104, 130 Stat. 549, 558 (2016).

main shortcomings in private law solutions.<sup>122</sup> First, such approaches are often limited to prospective bond debts because they are contractually based and “cannot bind noncontracting parties in order to solve the collective action problem.”<sup>123</sup> Thus, any bondholders with agreements not containing these provisions would have to “agree, *ex post*, to include those provisions in their bond indentures” through “[b]ond exchange offers with exit consents.”<sup>124</sup> Creditors may find such *ex ante* negotiations unpalatable, and, as public law advocates argue, such exit consents “are of limited utility, . . . are extremely costly,” and may encourage coercive attempts in negotiation.<sup>125</sup> Public law scholars further argue that contractual provisions may not sit well with some creditors, as some creditors might refuse to agree to the terms of these contracts or fail to attract the attention of sovereigns that fear increasing lending costs and, thus, the likelihood of default.<sup>126</sup>

In addition to the common criticisms levied at public law solutions, the difficulty of achieving the legislative consensus necessary for a Code amendment makes it unlikely that such a solution will come to pass before the next restructuring crisis hits Puerto Rico or another U.S. government entity not covered by the Code. Instead, Puerto Rico and these other government entities should also consider private law solutions to halt the damage of disorderly restructuring and ensure future bond sales will not exacerbate existing financial weaknesses.<sup>127</sup> PROMESA would not automatically or necessarily prohibit a contractual framework so long as the Oversight Board reviews and approves those contracts.<sup>128</sup> Further, after the Oversight Board’s eventual termination, these contracts could be executed by Puerto Rico and its instrumentalities without prior Oversight Board approval.<sup>129</sup> By utilizing a private law solution, Puerto Rico and its creditors could better organize complex, costly negotiations and more easily coordinate vol-

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<sup>122</sup> See Schwarcz, *supra* note 52, at 1203.

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> See *id.* at 1204 & n.69.

<sup>127</sup> See Pietrantonio, *supra* note 14, at 1199. Pietrantonio notes that the absence of congressional action requires Puerto Rico to “rely on *ad hoc* debt restructurings outside the protection of a formal bankruptcy mechanism” and that “the success of a restructuring depends on carefully navigating the treacherous debt markets.” *Id.*

<sup>128</sup> PROMESA, Pub. L. No. 114-187, § 207, 130 Stat. 549, 575 (2016) (“For so long as the Oversight Board remains in operation, no territorial government may, without the prior approval of the Oversight Board, issue debt or guarantee, exchange, modify, repurchase, redeem, or enter into similar transactions with respect to its debt.”).

<sup>129</sup> See *id.* § 209.

untary restructurings authorized by Title VI of PROMESA<sup>130</sup> before the Oversight Board is forced to exercise its authority under § 206 and § 304 to file for court proceedings.<sup>131</sup>

One prospective private law solution has already been suggested for Puerto Rico: the inclusion of collective action clauses (“CACs”) in every future bond agreement between Puerto Rico and its creditors.<sup>132</sup> These clauses go to the heart of the problem by focusing on one of the major sources of private government debt: the ability to raise money by issuing government bonds to investors.<sup>133</sup> CACs work by allowing the parties to modify the bond terms following a majority or supermajority vote of bondholders, thereby modifying terms “such as interest, maturity and principal amount—under the guise of a democratic framework that incentivizes debtors to engage creditors in a diplomatic matter.”<sup>134</sup> CACs are effective in simple restructurings and have proven successful in reducing holdout creditor litigation, and its resulting frustration of the restructuring process, by binding holdouts to renegotiated terms.<sup>135</sup> Although CACs may increase short-term borrowing costs by encouraging creditors to charge a premium for agreements that include these new clauses, some scholars argue that such costs are “worth the hassle down the road” given the ease of administering the debt workouts that would otherwise require unanimity and individualized negotiation.<sup>136</sup> Further, their increasing popularity in the sovereign debt market indicates that creditors and bond issuers alike are beginning to prefer CACs to the status quo.<sup>137</sup> More than ninety percent of newly issued sovereign bonds contain CACs.<sup>138</sup>

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<sup>130</sup> *Id.* §§ 401–413.

<sup>131</sup> *Id.* §§ 206, 304.

<sup>132</sup> See Pietrantonì, *supra* note 14, at 1200–01.

<sup>133</sup> See *id.* at 1201–03.

<sup>134</sup> See *id.* at 1199–200.

<sup>135</sup> See *id.* at 1200–01, 1203.

<sup>136</sup> *Id.* at 1201. But see Barry Eichengreen & Ashoka Mody, *Would Collective Action Clauses Raise Borrowing Costs?* 4–5 (Nat’l Bureau of Econ. Research, Working Paper No. 7458, 2000), <http://www.nber.org/papers/w7458.pdf> (finding that CACs would likely reduce borrowing costs for credit-worthy sovereigns).

<sup>137</sup> See Pietrantonì, *supra* note 14, at 1224, 1232. Take, for example, the use of CACs in Greece’s restructuring. See Pottow, *supra* note 52, at 224 (citing INT’L MONETARY FUND, SOVEREIGN DEBT RESTRUCTURING—RECENT DEVELOPMENTS AND IMPLICATIONS FOR THE FUND’S LEGAL AND POLICY FRAMEWORK 28 (2013), <https://www.imf.org/external/np/pp/eng/2013/042613.pdf>).

<sup>138</sup> Alison Wirtz, *Bilateral Investment Treaties, Holdout Investors, and Their Impact on Grenada’s Sovereign Debt Crisis*, 16 CHI. J. INT’L L. 249, 258 (2015).

Indeed, the Eurozone requires CACs in “all Eurozone government securities with a maturity of more than one year.”<sup>139</sup>

There are, however, serious criticisms that have been raised against the CAC solution. These may be grouped into two categories: (1) criticisms that may have been remedied with the passage of time, and (2) criticisms that indicate serious, irreconcilable shortcomings of CACs. The latter criticisms suggest CACs may not solve the collective action problem entirely, and recent cases show they have failed to prevent holdouts in the past, such as in Greece’s recent restructuring.<sup>140</sup>

The first set of criticisms includes the argument that CACs cannot solve holdouts because of the absence of “jurisprudence clarifying the rights and responsibilities of creditor groups in restructurings.”<sup>141</sup> This lack of precedent, the argument goes, has made it more difficult to thwart holdout litigation.<sup>142</sup> Additionally, “vulture funds . . . may easily be able to marshal [CAC] blocking positions,” and thus fail to reach a restructuring agreement outside of judicial action, “especially when a sovereign has issued multiple rounds of debt.”<sup>143</sup> This creates a “zero-sum theoretical fight between [creditor] consensus and holdout potential” because “the tougher one wants to make it to acquire a blocking position, the less consensus one must tolerate for the restructuring (because the voting threshold must be lowered).”<sup>144</sup>

It is up for debate whether the first set of these criticisms continues to hold water, as the passage of time may have clarified creditor rights and responsibilities. Additionally, although the zero-sum tension mentioned above is a significant challenge for drafters, one wonders whether this tension translates into problems for market participants, given that the same tension has not altered the popularity of majority voting in successful models such as the Code voting thresholds for DIP financing discussed in Part I.

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<sup>139</sup> W. Mark C. Weidemaier & Mitu Gulati, *A People’s History of Collective Action Clauses*, 54 VA. J. INT’L L. 51, 81 (2013).

<sup>140</sup> Pottow, *supra* note 52, at 223–24 (“Greece presents a stark, recent example where CACs did not prevent holdouts.”).

<sup>141</sup> Jill E. Fisch & Caroline M. Gentile, *Vultures or Vanguard?: The Role of Litigation in Sovereign Debt Restructuring*, 53 EMORY L.J. 1043, 1095 (2004).

<sup>142</sup> *See id.*

<sup>143</sup> Pottow, *supra* note 52, at 224; *see* Fisch & Gentile, *supra* note 141, at 1045 n.1, 1098 (“The term ‘vulture funds’ generally refers to investment funds, particularly hedge funds and mutual funds, that purchase the debt of countries, or companies, that are in financial distress. These funds thus become creditors of the countries, or companies, through purchases of debt in the secondary market, rather than as primary lenders.”).

<sup>144</sup> Pottow, *supra* note 52, at 224.

The second set of CAC criticisms proves difficult, if not impossible, to reconcile. First, these clauses do not work for complicated debt portfolios.<sup>145</sup> Additionally, there is no absolute priority rule that attaches to CACs; i.e., there is no efficient system by which to prioritize different types of creditors and debts.<sup>146</sup> Although CACs may have been successful in dissuading holdout litigation in simple debt portfolios, they do not provide a “bankruptcy-like stay” of litigation for all creditors and thus cannot entirely solve the problem of consolidating creditor actions.<sup>147</sup> Lastly, CACs do not address the problem of interim financing.<sup>148</sup> Even in a situation where a CAC is perfectly executed, disagreement among creditors will occur over whether to allow the debtor to take out new loans necessary to continuing its operations.<sup>149</sup> This is likely due to the perception that new creditors are being allowed to access funds that belong to the older bondholders.<sup>150</sup> These criticisms suggest that—although CACs help to alleviate restructuring issues—additional tools to alleviate restructuring issues are warranted.

### III. PROPOSED SOLUTION: AN ARBITRAL FRAMEWORK

Considering the inadequacies of the existing solutions to Puerto Rico’s restructuring woes, the benefits of adopting new contractual frameworks become clear. Such modifications could be used under PROMESA with the approval of the Oversight Board to promote sound renegotiations of existing claims while the Oversight Board remains in existence and after it terminates.<sup>151</sup> The proposed solution to Puerto Rico’s future restructurings is to rewrite and issue future bond agreements that include a combination of arbitral and other contractual provisions that give Puerto Rico’s restructuring process the added benefit of consolidating creditor actions before the Oversight Board has to initiate court proceedings. This solution could also be included

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<sup>145</sup> See David A. Skeel, Jr., *Can Majority Voting Provisions Do It All?*, 52 EMORY L.J. 417, 422–23 (2003).

<sup>146</sup> See *id.* at 424–25.

<sup>147</sup> Pottow, *supra* note 52, at 224 n.14; see Weidemaier & Gulati, *supra* note 139, at 62 (noting that CACs “have never been viewed as . . . a panacea for the macroeconomic problems arising from sovereign financial distress”).

<sup>148</sup> See Skeel, *supra* note 145, at 424.

<sup>149</sup> See *id.* at 424–25.

<sup>150</sup> See *id.*

<sup>151</sup> PROMESA, Pub. L. No. 114-187, § 207, 130 Stat. 549, 575 (2016) (“For so long as the Oversight Board remains in operation, no territorial government may, without the prior approval of the Oversight Board, issue debt or guarantee, exchange, modify, repurchase, redeem, or enter into similar transactions with respect to its debt.”).

in existing bond agreements when renegotiating the debt. Doing so is important because the stay provided by PROMESA is more precarious than the stay provided under the Code; PROMESA's limited stay risks reintroducing the collective action problem back into Puerto Rico's restructuring processes.<sup>152</sup> This Note's solution is not limited to aiding Puerto Rico and its instrumentalities. This solution could help U.S. states and territories that—unlike state municipalities—are not afforded bankruptcy relief by providing states with mock-bankruptcy proceedings in arbitration.

One of the central features of this framework is the relocation of the forum of the dispute resolution to private arbitration and away from litigation. This change in forum benefits both the governmental debtor in question, as well as sovereign creditors, because the “legal remedies” available to “sovereign creditors are generally ineffective.”<sup>153</sup> For instance, national courts often block litigation in sovereign bond debt because of “sovereign immunity from enforcement, coupled with a limited pool of attachable assets abroad.”<sup>154</sup> The creditors could ensure an effective remedy, however, by requiring Puerto Rico, U.S. states, and other U.S. territories to waive sovereign immunity and consent to arbitration. Puerto Rico's implementation of the arbitration would likely be useful to Puerto Rico only after the Oversight Board (along with its power to bind holdout creditors and bring bankruptcy-like proceedings under PROMESA) has terminated. However, many of the provisions contemplated in the arbitral framework could still be of use to the Oversight Board now as they undergo the important work of modifying existing bond agreements and negotiating voluntary restructurings.<sup>155</sup>

This arbitral framework provides two overarching advantages for government debtors that do not have access to bankruptcy proceedings, including U.S. states and territories. First, arbitration empowers government debtors by removing the uncertainty of waiting for legislators to reach consensus on the provision of full bankruptcy protection to government debtors. If the limited stay extensions afforded under PROMESA prove insufficient, these debtors will need to request a PROMESA amendment or other act of Congress to provide them with the full stay protection otherwise available under Chapter 9 of the Code. Second, the time and cost efficiencies of arbitration are

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<sup>152</sup> See *infra* text accompanying notes 170–71.

<sup>153</sup> Waibel, *supra* note 67, at 711, 713.

<sup>154</sup> *Id.* at 713.

<sup>155</sup> See PROMESA, Pub. L. No. 114-187, § 104(i)–(j), 130 Stat. 549, 559–61 (2016).

considerable.<sup>156</sup> The latter efficiency should not be easily discounted because the proceedings at issue here stem from the debtors' lack of sufficient funds.

A. *Inspiration for the Framework: Borrowing Lessons from Sovereign Debt Restructuring Mechanisms and U.S. Bankruptcy Law*

The inspiration behind the proposed framework derives partially from Professor Bolton and Professor Skeel's Sovereign Debt Restructuring Mechanism ("SDRM").<sup>157</sup> These scholars created one of the existing proposals for how an international mechanism could be used by courts to adjudicate sovereign debt restructuring disputes.<sup>158</sup> This approach constituted a fundamental departure from mechanisms previously contemplated by scholars in that previous models called for what can be (most simply) characterized as an international bankruptcy court for nations.<sup>159</sup>

Although no international restructuring mechanism has come into existence, the SDRM proposals in the literature give considerable insight into how a governmental unit (such as a U.S. state or territory) could restructure its debts. This Note differs from the Bolton and Skeel SDRM model by contemplating an arbitral, rather than judicial, framework in the context of commonwealth and territory restructurings. This Note chooses to abandon some of the elements of the Bolton and Skeel model in favor of borrowing elements from the IMF's SDRM model that are better suited for U.S. territories and states. Lastly, because this Note discusses private restructuring, rather than state-to-state or state-to-international organization restructuring, it departs from previous sovereign debt scholarship to analyze disputes solely between private parties and governments.

Although there are multiple SDRM models, the Bolton and Skeel model is one of the first to separate a SDRM framework from the requirement of having a single brick-and-mortar court adjudicate international restructurings.<sup>160</sup> Traditional SDRMs contemplate a set

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<sup>156</sup> See Joseph T. McLaughlin & Laurie Genevro, *Enforcement of Arbitral Awards Under the New York Convention—Practice in U.S. Courts*, 3 INT'L TAX & BUS. LAW. 249, 249–50 (1986).

<sup>157</sup> See Bolton & Skeel, *supra* note 37, at 767–68.

<sup>158</sup> See *id.*

<sup>159</sup> See *id.* at 768–69, 809.

<sup>160</sup> See *id.* at 768–69. Although the idea of removing the SDRM from one court to many courts which could “export” the legal rules of Bolton and Skeel's model is novel, the idea of incorporating a set of ready-made rules is commonplace in international arbitration, especially



of rules that would be implemented by a single international tribunal comprised of specially elected judges whose appointments would be inevitably politicized.<sup>161</sup> The Bolton and Skeel model, however, would allow any bankruptcy or insolvency court to use its rules to adjudicate restructurings concerning sovereign debt, thereby allowing existing courts to do something about the restructuring problems they are called upon to resolve.<sup>162</sup>

A bankruptcy court under this model does not have to wait for an international bankruptcy tribunal to come into being to take meaningful action.<sup>163</sup> Instead, courts can use Professor Bolton and Professor Skeel's "ready-made" rules to resolve the dispute in a manner that creates a uniform body of international sovereign debt restructuring law and recognizes the idiosyncrasies that make sovereign debt distinct from any other bond debt. For this Note's purposes, the exportation of this model (or at least some of its elements) to private arbitration could lead to better recognition and adoption of uniform international restructuring rules both with regard to sovereign debt restructurings and the restructurings of entities such as commonwealths and territories.<sup>164</sup>

Further, the arbitral framework proposed by this Note goes beyond the provisions discussed by CACs and the Bolton and Skeel model to address what is lacking in the current restructuring process in arbitration. To reiterate, the missing elements in the status quo include: 1) the binding of stakeholders in an in rem resolution; 2) eliminating the harmful effects of holdout litigation by consolidating creditor actions and introducing a stay of litigation that could last until the end of the restructuring; and 3) the ability to attract interim financing through DIP financing from private creditors.<sup>165</sup> With these problems in mind, this Note presents the following elements for an arbitral restructuring framework in bond agreements that alleviates

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when the investment is already contemplated in an international investment treaty. See Note, *Mediation of Investor-State Conflicts*, 127 HARV. L. REV. 2543, 2545 (2014) ("Many treaties allow parties to organize an arbitral panel under different sets of arbitration rules and procedures, most commonly those published by the International Centre for Settlement of Investment Disputes (ICSID) and the United Nations Commission on International Trade Law (UNCITRAL).").

<sup>161</sup> See Bolton & Skeel, *supra* note 37, at 768–69, 810–12.

<sup>162</sup> See *id.* at 812–14.

<sup>163</sup> See *id.* at 813.

<sup>164</sup> See Alice de Jonge, *What Are the Principles of International Law Applicable to the Resolution of Sovereign Debt Crises?*, 32 POLISH Y.B. INT'L L. 129, 130 (2012).

<sup>165</sup> See *supra* Section I.A.

some of the problems caused by the lack of permanent restructuring procedures for U.S. territories and states.

### *B. The Elements of the Arbitral Debt Restructuring Framework*

The first element of the arbitral framework is a choice-of-forum arbitration clause in lieu of a clause that selects a specific national court to adjudicate its disputes, as is typical of most SDRMs and bond agreements.<sup>166</sup> Again, this clause is consistent with the concept of exporting SDRM rules from a single brick-and-mortar court to multiple forums, as proposed by Professors Bolton and Skeel.<sup>167</sup> It deviates from previous models, however, by advocating for nonjudicial, arbitral forums chosen by the creditors and government debtor. The additional elements in this framework will be discussed in significant detail below and include: (1) a Hotchpot rule with a clawback provision; (2) a provision dividing creditors into distinct voting classes; (3) a first-in-time priority rule; (4) a provision that would allow creditors to vote on the debtor's ability to take on new debt (DIP financing); and (5) the incorporation of § 904 and § 903 of the Code to ensure vital Commonwealth services and operations.

#### *1. The Hotchpot Rule and the Clawback Provision*

As identified earlier, one problem of the status quo is the potential for holdout litigation. Indeed, some hedge funds have already begun the race to the courts to recover their losses by freezing Puerto Rico's assets.<sup>168</sup> Prior to the passing of PROMESA, the Commonwealth of Puerto Rico and its instrumentalities could not create a property-based bankruptcy estate and did not have access to an automatic stay of litigation.<sup>169</sup> PROMESA, however, now allows for the creation of an estate (if the Oversight Board so chooses) and allows for a time-limited stay of litigation.<sup>170</sup>

But Puerto Rico's attempts to bring all creditors to the negotiating table or a single restructuring could still be undermined by holdout

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<sup>166</sup> See Bolton & Skeel, *supra* note 37, at 768–69; Pottow, *supra* note 52, at 242.

<sup>167</sup> See Bolton & Skeel, *supra* note 37, at 768–69.

<sup>168</sup> See Nick Brown, *Creditors Sue to Block Puerto Rico Development Bank Withdrawals*, REUTERS (Apr. 4, 2016, 4:22 PM), <http://www.reuters.com/article/us-puertorico-debt-lawsuit-idUSKCN0X120N> (noting that hedge funds, including Brigade Capital Management and Claren Road Asset Management, filed a suit requesting that a federal court in San Juan freeze the assets of Puerto Rico's Government Development Bank).

<sup>169</sup> See Lubben, *supra* note 6, at 560.

<sup>170</sup> See PROMESA, Pub. L. No. 114-187, §§ 207, 301(a), 301(c), 405(d), 130 Stat. 549, 575, 577–78, 588 (2016).

creditors after the termination of the Oversight Board or the expiration of the PROMESA stay.<sup>171</sup> Such holdout creditors will prefer to litigate separately in a court of law where the Commonwealth might be ordered to pay the creditor's full claim.<sup>172</sup> But Puerto Rico could easily recreate the *effects* of a stay it desires without congressional action by including the Hotchpot rule (as advocated in the IMF's SDRM proposal) and a clawback provision in its bond or other creditor agreements.<sup>173</sup>

The Hotchpot rule operates by offsetting any damages awarded to the creditor in litigation "against the [creditor's] claim in the restructuring agreement" so that any funds it received in litigation are subtracted from any funds it would have received in a restructuring.<sup>174</sup> The clawback provision kicks in after the Hotchpot rule and operates by disgorging the funds of a creditor who receives more damages from litigation than it would have been entitled to under the restructuring agreement.<sup>175</sup> These two elements could be very beneficial to Puerto Rico's bond and restructuring agreements.

This combination of provisions provides the same disincentive that a stay of litigation in bankruptcy creates: it discourages creditors from litigating their claims because doing so would be futile in light of the clawback provision and the costs of bringing their claims in court.<sup>176</sup> Professors Bolton and Skeel critique this combination and ultimately decide to use a modified version of an automatic stay in their SDRM proposal.<sup>177</sup> They argue that the Hotchpot-clawback combination does not completely stay litigation and does not address the ability of creditors to use the threat of litigation as a bargaining chip or "delaying tactic."<sup>178</sup> That aside, given Puerto Rico's lack of access to a full Chapter 9 bankruptcy stay, this rule is an effective deterrent for holdout litigators and could consolidate restructurings into a single arbitration.<sup>179</sup> Further, a court reviewing this framework's choice-of-forum clause would immediately send these types of claims to

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<sup>171</sup> See *id.* §§ 209, 405(d).

<sup>172</sup> See Wirtz, *supra* note 138, at 268 ("[J]udgment creditors may find it profitable to assert claims regarding *pari passu* and negative pledges in a later lawsuit, because doing so provides them two bites at the apple.").

<sup>173</sup> See Bolton & Skeel, *supra* note 37, at 777.

<sup>174</sup> *Id.*

<sup>175</sup> See *id.*

<sup>176</sup> See *id.*

<sup>177</sup> See *id.* at 768, 777.

<sup>178</sup> *Id.* at 777.

<sup>179</sup> See Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, 36 GEO. J. INT'L L. 299, 367 (2005) (noting that the Hotchpot rule ensures "creditors would have some

arbitration and out of the courtroom. This further creates *ex ante* incentives for creditors to submit to arbitration rather than litigation.

## 2. *Classification of Creditors and Majority Voting Requirements*

The arbitral framework next includes a provision separating the voters into separate classes based on priority (as determined by the bond agreements and the negotiating power of the parties at the time the bond was created) and any “distinctive common interest (like trade credit).”<sup>180</sup> These classes would then vote on what they would believe to be a reasonable reduction of the government’s total debt.<sup>181</sup> This voting element would help solve the collective action problems that Puerto Rico faces because of its lack of permanent bankruptcy protection.<sup>182</sup>

These classes would then vote to renegotiate certain matters such as “maturity dates, interest rates, amortization schedules and principal amount” in the style of traditional CACs.<sup>183</sup> CACs are effective because investors agree to be bound without their consent only in the event that a certain “threshold” of voters in their class agrees to amend the terms of the agreements and the necessary quorum of voters is present.<sup>184</sup> This threshold is usually set at seventy-five percent<sup>185</sup> to reflect a supermajority voting requirement. The significance of this consensus indicates that seventy-five percent tends to be the optimal collection action clause threshold; it is neither so high that the impact of the CAC is too weak nor so low that it dissuades bondholders from accepting these clauses “for fear of the ease with which other bondholders could approve changes to the terms of the bonds.”<sup>186</sup>

These provisions find their parallel in Chapter 11 of the Code. Under Chapter 11, a majority of each voting class must approve the

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assurance that their forbearance through the negotiating process would not be abused by an aggressive litigant”).

<sup>180</sup> Bolton & Skeel, *supra* note 37, at 796.

<sup>181</sup> *Id.*

<sup>182</sup> See Pietrantonì, *supra* note 14, at 1203.

<sup>183</sup> *Id.*

<sup>184</sup> See *id.*

<sup>185</sup> See Bolton & Skeel, *supra* note 37, at 779 (noting the IMF’s proposal, requiring a 75% vote for bondholders to amend their agreements to allow the sovereign to permit the debtor to seek interim financing); see also Pietrantonì, *supra* note 14, at 1203 (discussing a wide array of voting threshold options, including a 66.67% requirement for all Eurozone bonds, but noting that the “typical requirement tends to be 75%”).

<sup>186</sup> Pietrantonì, *supra* note 14, at 1203–04 (quoting David Billington, *European Collective Action Clauses*, in *SOVEREIGN DEBT MANAGEMENT* 406 (Rosa M. Lastra & Lee Buchheit eds., 2014)).

overall reduction in debt, whereby each class has veto power in order to ensure that there is equality among “all creditors.”<sup>187</sup> That veto power, however, does not upend the entire restructuring process because courts are allowed to approve the restructuring against the objection of a class where the court determines the reduction to be “fair and equitable” in that it “satisf[ies] the absolute priority rule with respect to any dissenting class.”<sup>188</sup> This function, known as a “cramdown,”<sup>189</sup> could be simply exported to arbitration, whereby the arbitrator makes a determination that the overall debt reduction is fair and equitable. Should the parties disagree with the arbitrator, this Note contemplates that the parties could only be allowed to challenge the arbitrator’s decision in extraordinary circumstances where the arbitrator made a substantial procedural error that would not be reviewable on the merits.<sup>190</sup> This last feature would add much needed finality to the proceedings.<sup>191</sup>

The benefit of these voting provisions is that they determine an overall reduction of debt using the consent of creditors.<sup>192</sup> This voting provision also preserves the Code’s concept of absolute priority, in that different classes will be paid out first depending on their priority.<sup>193</sup> This model could also be bolstered by giving priority status to any restructured debt in order to prevent certain classes of creditors

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<sup>187</sup> Bolton & Skeel, *supra* note 37, at 794–95 & n.75.

<sup>188</sup> *Id.* at 795.

<sup>189</sup> *Id.* at 794–95 & n.76.

<sup>190</sup> See Waibel, *supra* note 67, at 715 (discussing the efficiencies of arbitration and that arbitration awards issued by the ICSID are not subject to judicial review on the merits).

<sup>191</sup> Another option would be to increase the strength of this proposal by adopting the voting provisions in the Bolton and Skeel model. See Bolton & Skeel, *supra* note 37, at 796–97. This model would allow the debtor to first suggest “an overall debt reduction proposal to a vote of all creditors in a *single* class, voting in proportion to their individual debt holdings,” and then in the second stage would allow for the class voting contemplated by Chapter 11 as described above with the caveat that, if a class vetoes the proposal, the arbitrator could invoke the cramdown rule. *Id.* at 796–97 (emphasis added). The proposition that only the debtor (municipality), not any creditor or third party, may initiate or propose the restructuring plan is a central feature in Chapter 9 of the Code provided by § 941. See 11 U.S.C. § 941 (2012) (“The *debtor* shall file a plan for the adjustment of the debtor’s debts. If such a plan is not filed with the petition, the debtor shall file such a plan at such later time as the court fixes.” (emphasis added)); see also *Chapter 9—Bankruptcy Basics*, U.S. COURTS, <http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics> (last visited May 10, 2017) (“This limitation is required by the Supreme Court’s pronouncements in *Ashton*, 298 U.S. at 528, and *Bekins*, 304 U.S. at 51, which interpreted the Tenth Amendment as requiring that a municipality be left in control of its governmental affairs during a chapter 9 case.” (emphasis corrected)). This power follows from the Code’s respect for the governmental operations provided in Chapter 9. See 11 U.S.C. § 904.

<sup>192</sup> See Bolton & Skeel, *supra* note 37, at 794–95.

<sup>193</sup> See *id.*

from banding together and rejecting the reduction outright.<sup>194</sup> In the event that a restructuring plan contemplates a reduction that is too draconian, the creditors could simply reject it in order to incentivize debtors to come to the table with a more palatable offer of reduction.<sup>195</sup> In the extreme event that a second or third proposal fails, the arbitrator could invoke the cramdown provision, whereby the arbitrator chooses among the three plans.

These class voting provisions would primarily aid U.S. states and non-PROMESA covered territories that do not have access to the provisions of Chapter 11. Puerto Rico and its instrumentalities are currently afforded access to these Chapter 11 provisions, as well as class voting options for voluntary restructurings under section 104(i) of PROMESA.<sup>196</sup> Following the termination of Puerto Rico's Oversight Board, Puerto Rico could benefit from these arbitral provisions should it face another restructuring crisis in the future.

### 3. *Priority Classes: How to Prioritize Debt*

As already discussed, CACs do nothing to address the problem of absolute priority in restructuring where there is a limited amount of resources available and a surplus of creditor claims. The fundamental question becomes, who gets paid first? Under Chapter 9 and PROMESA's temporary framework, secured debt is paid first.<sup>197</sup> When applied to bonds, this means that special revenue bonds are treated as secured and continually paid out while the Chapter 9 case is pending.<sup>198</sup> Thus, if revenues are available, special revenue bonds will be paid first.<sup>199</sup> If funds are left over, unsecured debt is paid.<sup>200</sup> When applied to bonds, general obligation bonds will be treated as general unsecured debt, and the municipality will not be "required to make payments of either principal or interest on account of such bonds."<sup>201</sup> The simple incorporation of these bankruptcy rules by reference in a choice-of-law provision would preserve this order of priority in Puerto Rico's arbitral restructuring.

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<sup>194</sup> See *id.* at 797–98.

<sup>195</sup> See *id.* at 796–97.

<sup>196</sup> PROMESA, Pub. L. No. 114-187, §§ 104(i)(2)(B), 301(a), 130 Stat. 549, 560, 577 (2016).

<sup>197</sup> See *id.* § 301(a); Jeffrey B. Ellman & Daniel J. Merrett, *Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?*, 27 EMORY BANKR. DEV. J. 365, 399–400 (2011).

<sup>198</sup> 11 U.S.C. § 928 (2012); see *Chapter 9*, *supra* note 191 (noting that, even during an ongoing Chapter 9 case, "[s]pecial revenue bonds . . . will continue to be secured and serviced").

<sup>199</sup> See *Chapter 9*, *supra* note 191.

<sup>200</sup> See Ellman & Merrett, *supra* note 197, at 399–400.

<sup>201</sup> See *Chapter 9*, *supra* note 191.

#### 4. *Interim Financing Provisions*

A crucial benefit that Puerto Rico is missing is the assurance that it can seek interim financing, or DIP financing, while it undergoes restructuring.<sup>202</sup> DIP financing is contemplated in § 364 of the Code, which allows for free-market sources of interim financing by giving priority to nongovernment, DIP creditors.<sup>203</sup> PROMESA incorporates § 364.<sup>204</sup> Interim financing is also contemplated for covered entities under § 904 which “makes it clear that the debtor’s day-to-day activities are not subject to court approval and that the debtor may borrow money without court authority.”<sup>205</sup>

Although allowing priority for interim financiers would seem to raise concerns about harming existing creditors and future bond sales, that harm would likely be minimal. The scholarship on sovereign debt restructuring suggests that the use of priority lending is relatively innocuous.<sup>206</sup> This is because bond ratings are not determined by the amount that creditors expect to recover following a default, but rather by the likelihood that the debtor will default.<sup>207</sup> Interim financing, then, functions “to create value for unsecured creditors,” despite subordinating existing claims, because the financing “increases a debtor’s liquidity, thereby reducing its risk of failure and increasing the expected value of unsecured claims [and] . . . reduc[ing] the risk of economic failure.”<sup>208</sup>

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<sup>202</sup> See Bolton & Skeel, *supra* note 37, at 802–04. Such interim financing contemplates that the new loans will help the reorganizing entity eventually become profitable and return more than in a liquidation, while requiring that the financing be necessary for the continued operation of the debtors’ businesses. See *id.*

<sup>203</sup> See Chapter 9, *supra* note 191; see also Schwarcz, *supra* note 52, at 1199 (“Section 364 of the Bankruptcy Code, however, sets out a mechanism, commonly referred to as debtor-in-possession (DIP) financing, to avoid these problems by enabling a debtor firm to obtain financing for its reorganization *from private, free-market—as opposed to governmental—sources of funds.*”).

<sup>204</sup> PROMESA, Pub. L. No. 114-187, § 301(a), 130 Stat. 549, 577 (2016); see also Lorraine S. McGowen, *The Impact of the New Restructuring Law on Puerto Rico Creditors*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Aug. 20, 2016), <https://corpgov.law.harvard.edu/2016/08/20/the-impact-of-the-new-restructuring-law-on-puerto-rico-creditors/>.

<sup>205</sup> See Chapter 9, *supra* note 191 (“This limitation is required by the Supreme Court’s pronouncements in *Ashton*, 298 U.S. at 528, and *Bekins*, 304 U.S. at 51, which interpreted the Tenth Amendment as requiring that a municipality be left in control of its governmental affairs during a chapter 9 case.” (emphasis corrected)).

<sup>206</sup> See Schwarcz, *supra* note 52, at 1201–02 & n.57 (paraphrasing a telephone interview between Joanne W. Rose, Senior Managing Director, General Counsel, and Chair of the Ratings Policy Board, Standard & Poor’s Ratings Services, and Professor Schwarcz).

<sup>207</sup> *Id.*

<sup>208</sup> *Id.* at 1202 (quoting Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 425 (1997)).

The arbitral framework could either incorporate § 364 or § 904. Allowing for limited DIP financing based on creditor approval, as contemplated by § 364, will likely be more attractive for creditors given their ability to veto DIP financing that they perceive as unnecessary or an attempt to ignore the Commonwealth's obligation to repay its existing debts. This is desirable because PROMESA is not a permanent solution and is predicated on the existence of a temporary Oversight Board to file on behalf of Puerto Rico and its instrumentalities.<sup>209</sup> Such bridge financing (to satisfy short-term liquidity needs) is usually provided for in sovereign debt restructurings by international bodies.<sup>210</sup> These provisions should also be utilized by U.S. states and territories not covered by PROMESA.<sup>211</sup>

### 5. *Protections for Government Assets: The Incorporation of Sections 904 and 903 of the Code*

One of the principal elements of this framework is that it incorporates sections of the Code by reference. One section that is essential is § 904:

[U]nless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—(1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property.<sup>212</sup>

The arbitral framework in this Note incorporates these portions of the Code under a choice-of-law provision that references § 904.<sup>213</sup> The purpose of this provision would be to prevent future restructuring from interfering with the political and governmental powers of the Commonwealth in the future and other government debtors not covered by the Code, much in the way that such powers of U.S. munici-

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<sup>209</sup> PROMESA § 209.

<sup>210</sup> See Schwarcz, *supra* note 52, at 1195; see also PROMESA § 210 ("The full faith and credit of the United States is not pledged for the payment of any principal of or interest on any bond, note, or other obligation issued by a covered territory or covered territorial instrumentality. . . . No Federal funds shall be authorized by this Act for the payment of any liability of the territory or territorial instrumentality.").

<sup>211</sup> Direct federal support has not been extended to Puerto Rico and its instrumentalities under PROMESA. PROMESA § 210(c); AUSTIN, *supra* note 64, at 35 (explaining that Congress rejected a bill introduced by Senator Hatch (S. 2381 § 501) that would have provided for funding).

<sup>212</sup> 11 U.S.C. § 904 (2012).

<sup>213</sup> The choice-of-law provision would also incorporate § 941. See *supra* Section III.B.2.



palities are currently protected under the Code.<sup>214</sup> The importance of this provision is highlighted by the fact that Congress included an almost identical provision in PROMESA.<sup>215</sup>

The second section that would be incorporated by a choice-of-law provision is § 903: “[C]hapter [9] does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise.”<sup>216</sup> There are two reservations to this protection: (1) the debtor cannot create a state law that binds nonconsenting creditors by “prescribing a method of composition of municipal debt” and (2) the state cannot use its courts to enforce legislation that erases its debts at whim.<sup>217</sup>

Incorporating § 903 and § 904 in the arbitral framework ensures the protection of vital government operations and services to the public, while ensuring that government debtors not covered by the Code would treat creditors fairly in the restructuring process. By limiting a government debtor’s ability to legislate its way out of its debts, the incorporation of § 904 ensures the preservation of creditor rights and reasonable expectations.<sup>218</sup> These provisions should be utilized by U.S. states and territories not covered by PROMESA.

#### IV. CRITICISMS AND COUNTERARGUMENTS

##### A. *Criticisms: Keeping the Status Quo and the Fear of Market Acceptance*

There are a number of potential concerns and criticisms usually associated with private law solutions, especially when such solutions contemplate arbitration. The first of these is that arbitration is not necessary to bind holdout creditors and that there is no collective action problem for states because sovereign immunity bars holdout litigation.<sup>219</sup> However, “relying on sovereign immunity, instead of C.A.C.s, to bind dissenting bondholders underestimate[s] the benefit of a higher likelihood of averting a default” in arbitration.<sup>220</sup> The stag-

<sup>214</sup> See Chapter 9, *supra* note 191.

<sup>215</sup> PROMESA § 305.

<sup>216</sup> 11 U.S.C. § 903.

<sup>217</sup> See Chapter 9, *supra* note 191.

<sup>218</sup> See Wirtz, *supra* note 138, at 256–57 (noting the importance of good faith and balancing reasonable expectations in government restructurings within the context of exchange offers).

<sup>219</sup> See Pietrantonio, *supra* note 14, at 1211–14.

<sup>220</sup> *Id.* at 1214. Sovereign immunity in U.S. courts favors the restrictive theory of sovereign immunity, wherein a sovereign is granted immunity for its “sovereign or public acts” but is *not* immune for “strictly commercial acts.” Ronald J. Silverman & Mark W. Deveno, *Distressed*

gering cost and confusion inherent in litigating sovereign immunity issues is in and of itself a good reason to consider another solution.<sup>221</sup> Further, not giving bondholders relief or an opportunity to be heard because of sovereign immunity could hamper the market's appetite for government bonds.<sup>222</sup>

Another criticism in opposition to contractual solutions and bond exchanges is that the market will not accept these solutions because they are unfair and unattractive to creditors. The proposed arbitration framework, so the argument would go, lets Puerto Rico and other government entities escape their debt obligations by staying litigation and allowing for interim financing. The market will simply reject this by refusing to buy future instruments from Puerto Rico. This argument is oftentimes appended with the fact that—aside from the exception of Brazil's bonds, which have featured UNCITRAL arbitration clauses—most sovereign bonds do not include arbitration clauses.<sup>223</sup> Scholars often cite two main reasons for the lack of implementation: (1) the suggestion of arbitration in the bond agreement “could implicitly recognize the possibility of eventual default and thereby negatively affect their marketability,” and (2) the status quo is often promoted because of a perception that “sovereign bonds are ‘conservative’ financial instruments whose contractual terms display tremendous inertia against change.”<sup>224</sup>

More recently, however, CACs have experienced substantial market success.<sup>225</sup> If the market has changed its often stagnant status quo to embrace this feature of private law, then including an arbitral contractual framework may not prompt the mass market outrage and re-

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*Sovereign Debt: A Creditor's Perspective*, 11 AM. BANKR. INST. L. REV. 179, 185–86 (2003) (noting that this theory was further codified in U.S. law through the Foreign Sovereign Immunities Act (“FSIA”)). In terms of foreign sovereign immunity, the FSIA is “the ‘sole basis’ for obtaining jurisdiction over a foreign state in a United States court.” *Id.* at 186 (quoting *Saudi Arabia v. Nelson*, 507 U.S. 349, 355 (1993)).

<sup>221</sup> The issue of Puerto Rico's sovereign immunity could lead to extensive, protracted litigation. Despite the First Circuit's recognition of Puerto Rico's Eleventh Amendment sovereign immunity, the Supreme Court has not yet ruled on this issue despite opportunities to do so. *See* Adam D. Chandler, Comment, *Puerto Rico's Eleventh Amendment Status Anxiety*, 120 YALE L.J. 2183, 2183, 2188–89 (2011). From the uncertainty of the law surrounding Puerto Rico's sovereign immunity, it is fair to assume the resolution of these issues will require extensive litigation. *See id.* at 2197 (noting the uncertainty of the status of Puerto Rico's sovereign immunity).

<sup>222</sup> *See* Waibel, *supra* note 67, at 758.

<sup>223</sup> *See id.* at 732 & n.131.

<sup>224</sup> *Id.* at 732 n.131.

<sup>225</sup> *See* Pietrantonio, *supra* note 14, at 1219–20 (“Mexico's adoption of C.A.C.s proved to be a positive signaling event that eliminated the prisoner's dilemma among sovereign issuers, and opened the floodgates for wider C.A.C. acceptance in the sovereign debt markets.”).

jection that public law advocates often stress. In fact, there are economic incentives for adopting such a provision, just as there were market incentives for adopting CACs. First, arbitration is much quicker than litigation and often more cost effective.<sup>226</sup> Any money used to resolve issues in court drains the funds available to Puerto Rico's creditors.<sup>227</sup> As Puerto Rican Governor Alejandro García Padilla noted: "Our Department of Justice is trying to anticipate any lawsuit we will have . . . . It will be very costly—that litigation, for the commonwealth and our creditors . . . . Every dollar used to pay lawyers will be a dollar . . . not available to pay creditors."<sup>228</sup>

The increased enforcement of awards might also make such an arbitral solution more desirable. An arbitral framework could increase enforcement by giving bondholders a "valuable bargaining chip" through the possession of an arbitration award in their favor and would limit the substantive review of the dispute by a court.<sup>229</sup>

*B. Fear of Legal Recognition: Expropriation, Coercion, Discrimination, Due Process, and Good Faith*

Another potential line of criticism is that foreign courts would not recognize these arbitration clauses because they are unfair to bondholders and violate various legal doctrines. This Part analyzes these criticisms and tests the strength of the arbitral framework by looking at counterarguments brought forward during bondholder disputes at the International Centre for Settlement of Investment Disputes ("ICSID"). ICSID settles disputes between investors and sovereigns.<sup>230</sup> Although ICSID could not serve as a forum for Puerto Rico because the Commonwealth is not a sovereign nation, ICSID precedent offers a useful model for exploring the legality of Puerto

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<sup>226</sup> See generally James Thuo Gathii, *The Sanctity of Sovereign Loan Contracts and Its Origins in Enforcement Litigation*, 38 GEO. WASH. INT'L L. REV. 251, 323 (2006); Matthew Rasmussen, Note, *Overextending Immunity: Arbitral Institutional Liability in the United States, England, and France*, 26 FORDHAM INT'L L.J. 1824, 1835 n.64 (2003).

<sup>227</sup> David Gaffen & Megan Davies, *Puerto Rico Governor Says Preparing for Legal Action from Creditors*, REUTERS (Jan. 4, 2016, 2:34 PM), <http://www.reuters.com/article/usa-puertorico-default-idUSL1N1401H420160104>.

<sup>228</sup> *Id.*

<sup>229</sup> See Waibel, *supra* note 67, at 715. Arbitrations of sovereign investments, such as disputes between nation-states and investors in the ICSID, are also not subject to substantive review. *Id.*

<sup>230</sup> Julian Davis Mortenson, *The Meaning of "Investment": ICSID's Travaux and the Domain of International Investment Law*, 51 HARV. INT'L L.J. 257, 263–64 (2010). "The ICSID Convention created a facility for arbitration between signatory states and individual investors. It enabled individuals to seek *direct* redress from sovereign countries before an institutionalized international forum . . . ." *Id.* at 264 (footnote omitted).

Rico's potential bond arbitrations because ICSID arbitrates disputes between governments (nation-states) and private parties (such as bond buyers who qualify as investors).<sup>231</sup> Among the criticisms likely to be raised are the following: (1) that arbitration clauses constitute expropriation; (2) de facto stays of litigation are coercive and discriminatory; (3) arbitration limits creditor due process rights because bondholders should have their day in court; and (4) such agreements are void for lack of good faith.<sup>232</sup> These criticisms, as well as responses to each, are addressed in turn below.

*Expropriation.* First, one might attack the legality of the arbitral framework by arguing that it constitutes expropriation.<sup>233</sup> The haircuts contemplated by the framework after supermajority votes, the argument might go, reflect a loss of property in the form of a contractual right to collect debt. This is possible, and some scholars argue that it is theoretically plausible that certain defaults and restructurings could be considered direct or indirect expropriation in international law, whereby the sovereign must issue compensation for the taking.<sup>234</sup>

Although it is possible that contractual rights may be considered property, scholars disagree over whether debt falls into the category of contractual rights capable of expropriation.<sup>235</sup> One line of thinking is that, even though tangibility is not a dispositive factor, debts nonetheless fail to fall into the definition of property rights subject to expropriation.<sup>236</sup> This is because they are not associated with a commercial undertaking or business venture, in contrast to the bundle of rights created by a contract such as a contract for public works or concessions.<sup>237</sup> Thus, criticisms that sovereigns and other governmental units using such an arbitral framework are expropriating debt face an insurmountable logical flaw: the assumption that debt (like con-

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<sup>231</sup> See *id.*; see also Convention on the Settlement of Investment Disputes Between States and Nationals of Other States art. 25 ¶ 1, *opened for signature* Mar. 18, 1965, 575 U.N.T.S. 159 (entered into force Oct. 14, 1966) ("The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment, between a Contracting State . . . and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre.").

<sup>232</sup> See Waibel, *supra* note 67, at 748.

<sup>233</sup> See Mortenson, *supra* note 230, at 263. Expropriation is also commonly referred to as the power of eminent domain. Charles Noble Gregory, *Expropriation by International Arbitration*, 21 HARV. L. REV. 23, 23 (1907-1908).

<sup>234</sup> See Waibel, *supra* note 67, at 744.

<sup>235</sup> See *id.*

<sup>236</sup> See *id.*

<sup>237</sup> See *id.*

tractual rights associated with commercial undertakings) may be expropriated under international law.<sup>238</sup>

*Coercive or discriminatory effect.* An additional criticism is that the de facto stay of litigation that this arbitration framework contemplates through its Hotchpot-clawback provisions is coercive and discriminatory. The question of coercion is crucial in private debt restructurings because such restructurings depend on the ability of sovereigns to use incentives when encouraging creditors to choose collaboration over a holdout strategy.<sup>239</sup> Answering the question of whether the “incentive devices” are coercive requires analyzing the “limited possibilities of enforcement against sovereigns, as well as the absence of restructuring alternatives for countries.”<sup>240</sup> For instance, consider the typical hypothetical of a state enacting coercive legislation that requires the nonpayment of a particular series of bonds.<sup>241</sup> Such legislation would certainly limit enforcement—it would completely eclipse it—and would give the state multiple alternatives to restructuring including the ability to renege on its payment obligation.

This prototypical example of coercion stands in stark contrast to a contractual provision that both the sovereign and its creditors agree to, because the latter asks for the consent of bondholders. Such a solution does not limit enforcement. Instead, it allows for multiple levels of enforcement by adding arbitration to the mix with the safety provision of judicial review in the event of a coercive or other procedural issue with the arbitrator’s decision.

Arbitration also would not run afoul of fairness concerns because investors have a right to bargain their litigation rights for more efficient, quicker solutions. These are voluntary contracts: if the investor thinks the deal is better elsewhere, then the investor can choose not to invest in these bonds.<sup>242</sup> Further, while international investment law recognizes the need for the protection of legitimate expectations, such protection is limited by reasonableness of the expectations in the context of market conditions:

[B]ondholders, like other creditors, cannot expect to be isolated from financial crises and subsequent sovereign debt

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<sup>238</sup> See *id.*

<sup>239</sup> See *id.* at 747 n.206.

<sup>240</sup> *Id.*

<sup>241</sup> See *id.* at 747.

<sup>242</sup> See *id.* at 755 & n.254 (discussing the *Kearney* case before the U.S.-Mexican General Claims Commission, which emphasized the claimant’s freedom to enter into an agreement with Mexico and full awareness of the country’s capacity to pay and noting that even international treaty law “does not seek to protect inexperienced . . . investors”).

restructurings. The reasonable bondholder would have contemplated a full range of possible states of the world. In some, she is going to pocket a sizable profit, in others a small loss, and in some a substantial loss.<sup>243</sup>

Actual legislation by sovereigns that imposes restructuring limitations has not risen to an illegal degree of discrimination even though it has called for unequal treatment of different series of bondholders.<sup>244</sup> Take for example Argentina's "Ley 26017, which prohibits reopening the debt restructuring."<sup>245</sup> Although this law "certainly . . . interfered with existing contractual rights" and discriminated against a particular type of bondholders (specifically holdout creditors), this discrimination was not illegal because there is likely no "general equal treatment obligation" preventing discrimination and it was not based on the nationality of the creditors.<sup>246</sup>

Even the newer "fair and equitable treatment" provisions in bilateral investments are not dependent upon comparison to the actions of other sovereigns, and so discrimination cannot serve as a "precondition for breach."<sup>247</sup> Considering that "[b]ond exchanges are unlikely to violate that [fair and equitable] standard . . . unless [they are] clearly coercive,"<sup>248</sup> it would be difficult for a bond exchange featuring this arbitral framework to be declared coercive.

*Due process.* A third criticism is that such an arbitral framework would limit creditor due process rights because bondholders should have their day in court. A due process violation in this context, however, is unlikely because a violation "requires that investors' legitimate expectations with respect to the restructuring be disappointed" and this concern is usually eased by a mere attempt on the government's part to restructure "consensually and in good faith with a majority of bondholders."<sup>249</sup> Second, most of this litigation is brought by a minority of creditors (i.e., holdouts), who, unlike the majority of bondholders, seek to be fully paid.<sup>250</sup>

This lack of restriction on minority-driven litigation should not be lauded as a protection of due process. Rather, it can be seen as a detriment and strain on a majority of creditors who would otherwise coop-

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<sup>243</sup> *Id.* at 755.

<sup>244</sup> *See id.* at 747.

<sup>245</sup> *Id.* at 746.

<sup>246</sup> *Id.* at 746-47.

<sup>247</sup> *Id.* at 748.

<sup>248</sup> *Id.* at 752.

<sup>249</sup> *Id.* at 753.

<sup>250</sup> *See id.* at 713.

erate and get a better recoupment of losses than they would receive after holdout litigation.<sup>251</sup> Further, the government's distress, as well as the anonymity and wide disbursement of bondholders, makes a finding of a due process violation more unlikely given the undue burden it could impose on the sovereign.<sup>252</sup>

*Bad faith.* Lastly, the argument could be made that certain governments utilizing the arbitral framework could undertake these agreements in bad faith. An assessment of whether a restructuring is done in good faith "is complex and requires a detailed examination of the country's payment capacity."<sup>253</sup> Two conclusions follow from this requirement. First, a forum is necessary to determine payment capacity.<sup>254</sup> Although it is perhaps less conventional than the proposition of a tribunal or the ICSID in the mind of international investors, an arbitration forum would allow for this type of examination. Second, the claimant would have to prove the bad faith was rooted in the government's desire to avoid payment, rather than the inability to do so.<sup>255</sup> Thus, the framework here does not inherently allow for bad faith. It does exactly the opposite by providing a forum that can quickly and cost-effectively quell states' attempts to avoid financial obligations by allowing bondholders to bring these violations to the attention of an independent arbitrator.

### C. *Who Bears the Burden? Analyzing the Fairness of Restructuring to Balance Creditor and Government Debtor Interests*

Considering the makeup of holders of Puerto Rican debt, it is important to consider who should bear the burden of default. This question often lingers in the background of restructuring debates.<sup>256</sup> Given that most of the creditors are American investors (including individuals and institutional investors),<sup>257</sup> commentators may question whether it is fair for these investors to bear the burdens of a commonwealth that does not pay American income taxes.<sup>258</sup> Another criticism

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<sup>251</sup> *See id.*

<sup>252</sup> *See id.* at 753.

<sup>253</sup> *Id.*

<sup>254</sup> *See id.*

<sup>255</sup> *See id.*

<sup>256</sup> *See, e.g.,* REBECCA M. NELSON, CONG. RESEARCH SERV., R41838, SOVEREIGN DEBT IN ADVANCED ECONOMIES: OVERVIEW AND ISSUES FOR CONGRESS 13–14 (2013) (explaining the two opposing sides of the restructuring debates regarding who should bear the burden of default).

<sup>257</sup> *See Long, supra* note 11.

<sup>258</sup> Johnny Smith, Note, *Commonwealth Status: A Good Deal for Puerto Rico?*, 10 HARV. LATINO L. REV. 263, 276 (2007).

might be that investors who were promised a certain return are now forced to take on massive losses.<sup>259</sup> Lastly, related to the idea that governments bear a responsibility to honor the promises they made to the public and the international or federal community, some commentators may feel the government should simply accept its obligations instead of fleeing to arbitration.<sup>260</sup>

These criticisms assume that governments seeking restructuring have the ability to pay their debts. Considering the staggering reputational costs and severe financing droughts caused by poor bond ratings following a default event, these questions fail to contemplate the reality that governments would rather pay their debts than face the consequences of a default, including the inability to obtain future financing or skyrocketing borrowing costs.<sup>261</sup>

Most importantly, a solution for restructuring issues must keep a balance between sovereigns and borrowers, not solely focusing on creditor protections to the detriment of the “resolution of future sovereign debt crises” and “the interests of the creditor majority and also the international community as a whole.”<sup>262</sup> Arbitration does not necessarily favor sovereigns over creditors but simply gives these parties a forum to effectively and realistically work out their differences with an impartial arbitrator.<sup>263</sup> Arbitration is still an opportunity to be heard and has enhanced efficiencies,<sup>264</sup> particularly in comparison to litigation.<sup>265</sup>

#### *D. Counterarguments Pertaining to Other Government Entities and Sovereigns*

The criticisms outlined above are also relevant in the application of this solution to other territories, states, and sovereign nations. Therefore, some of the counterarguments addressed above also apply to these entities. As discussed, the advantage of the proposed solution is that it removes the disputes from judicial forums. International

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<sup>259</sup> See Jonathan Goren, Note, *State-to-State Debts: Sovereign Immunity and the “Vulture” Hunt*, 41 GEO. WASH. INT’L L. REV. 681, 690 (2010) (discussing the potential for distressed investor sympathy where a sovereign debtor has shown opportunistic behavior regarding default, such as in the instance of Argentina’s most recent default).

<sup>260</sup> See *id.* at 690–91 (noting the case of Argentina’s most recent restructuring wherein scholars identified a moral hazard problem on the part of Argentina, which seemed to renege on its obligations through a conscious decision to default).

<sup>261</sup> See Bolton & Skeel, *supra* note 37, at 766.

<sup>262</sup> Waibel, *supra* note 67, at 759.

<sup>263</sup> See *id.* at 715.

<sup>264</sup> *Id.*

<sup>265</sup> See McLaughlin & Genevros, *supra* note 156, at 249–50.



commercial arbitration is known to be more time and cost efficient than litigation.<sup>266</sup> There are also comity issues that inevitably arise when foreign courts are called upon by foreign plaintiffs to decide the fate of a sovereign's financial health.<sup>267</sup> A foreign court should not decide another nation's disbursement of pensions or be able to trigger austerity measures because this allows a lower foreign court to substantially impact another nation's political and legislative powers.

Further, arbitration awards are more likely to be enforced than foreign judgments because of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, more commonly referred to as the New York Convention.<sup>268</sup> For instance, noncompliance with an arbitration award by ICSID is an "international—and very public—breach" that has "higher reputation costs than ignoring a national court judgment" and that compromises a sovereign's ability to obtain future financing.<sup>269</sup>

#### CONCLUSION

This Note provides an arbitral, contractual framework for resolving future Puerto Rican bond crises not covered by PROMESA in order to prevent future bond holdout problems and halt the spread of collective action problems in restructuring. Given Puerto Rico's fragile economy and the perverse tax incentives that have added a flush of available financing for Puerto Rico, it is crucial to provide Puerto Rico (and other government debtors like it) with a private law solution that will provide for future defaults. By taking action, Puerto Rico can protect its public while restoring order to its bond sales. In doing so, Puerto Rico could set the trend for U.S. states and territories that are excluded from the Code and innovate for the greater health of the U.S. bond market.

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<sup>266</sup> See *id.*

<sup>267</sup> See Pottow, *supra* note 52, at 236–39 (suggesting a recommendation from a nonbinding sovereign restructuring board would be a plausible model to avoid political issues and promote the spirit of comity when deciding the fate of a distressed sovereign).

<sup>268</sup> See McLaughlin & Geneviro, *supra* note 156, at 249–50.

<sup>269</sup> Waibel, *supra* note 67, at 758 & n.263 ("In general, municipal judgments have no binding force outside the forum's jurisdiction. They require recognition. Under the ICSID Convention Art. 53, such recognition is automatic, without possibility of substantial review." (citation omitted)).