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What Should Puerto Rico Offer Its Creditors?

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With this week's certification of the commonwealth's fiscal plan, the oversight board and the new government in San Juan took their first tangible steps toward defining how much aggregate debt service Puerto Rico can afford to pay its creditors over the coming years. Undoubtedly, creditors and other stakeholders will push back on their analysis, and no doubt disputes will arise as to how such surplus should be allocated among the island's various creditor groups. But whatever surplus ultimately emerges as available and no matter how it is allocated, the form and nature of the instruments that will be issued to creditors as part of any restructuring may have more enduring consequences than the ultimate size of the debt haircut agreed to by, or imposed on, creditors, or which creditor groups emerge as the eventual winners or losers in the process. To date, the underlying assumption is that creditors will receive, as part of the restructuring, the instruments they currently own, whether they be general obligation (GO) bonds, special-purpose bonds secured by sales tax revenues, bonds backed by other pledges of revenue streams, or bonds supported solely by appropriations when and if approved by the Puerto Rican Legislature. As creditors (or the courts) get closer to compromising existing claims, we hope and expect those discussions will include a deeper and more thoughtful discussion of the form and nature of the instruments that will be issued. To that end, we offer four recommendations to keep in mind when designing the type of instrument that creditors will receive in a restructuring of Puerto Rico's debt.


Richard J. Cooper


Luke A. Barefoot

Recommendation No. 1: Puerto Rico should offer the bulk of its creditors a single new fixed-pay instrument, issued by a federally validated bonding authority, in exchange for old bonds.

Puerto Rico's debt stock consists of nearly two dozen different bond issuers and over 900 CUSIPs, and over two-thirds of its outstanding bonded debt, or nearly $50 billion, is payable from overlapping sources of revenues that are generated and/or collected by the central government. Replicating this debt structure through one or more debt exchanges perpetuates an unwieldy and opaque capital structure and does a disservice to both Puerto Rico and its creditors.

As the last year and a half has demonstrated, in the fight for a dwindling pool of revenues to pay back debt, bondholders will take to the courts to claim as much of the commonwealth's resources as possible, with each creditor group believing it has priority to its revenue stream and, in some cases, challenging the very validity of other credit instruments. Puerto Rico's court dockets are filled with litigation challenging the allocation of funds among competing needs. In the case of the very public litigation between holders of GO and Puerto Rico Sales Tax Financing Corporation (COFINA) debt, this has devolved into an acrimonious fight over the very legality of the COFINA bond issuances themselves.

The depth and ramifications of this pervasive intercreditor conflict for Puerto Rico and its creditors cannot be understated. Of the over $60 billion of overall bonded debt issued by the commonwealth and its instrumentalities, nearly $50 billion relies, directly or indirectly, on revenues generated and/or collected by the commonwealth's central government, and for over $6 billion of that debt, the underlying revenues are explicitly subject to constitutional clawback in favor of the general obligation debt.[1] Another $17.2 billion issued by COFINA relies on sales and use taxes that GO holders claim should be diverted to pay public debt. And, as between the COFINA senior and subordinated creditors, acceleration, remedies and subordination provisions under the COFINA bonds create dramatically opposite incentives for the two groups. These are but a few of the deep-seated intercreditor conflicts that have already boiled over as the new administration tries to reach agreement with its major creditor classes.[2]

Even if creditors agree on relative haircuts now, creditors will not accept as part of a restructuring the same instruments they currently hold — with the embedded intercreditor conflicts and critical legal issues left unresolved.[3] The GO holders, for example, have already asked for a statutory lien on Puerto Rico's "available revenues," implicitly recognizing the impact of PROMESA on their debt instruments. And as part of the senior COFINA holders' restructuring proposals, the group had included requests for a final judgment upholding the validity of their structure and other assurances regarding language purportedly providing them a statutory lien. It is true that the dispute du jour could be addressed in a Title III proceeding (although with appeals it could take years),[4] but new disputes with different fact patterns could arise in the future. And there are practical disadvantages to giving creditors the same bonds in any debt exchange — for example, constitutional debt limits on the amount and tenor of GO and commonwealth-guaranteed debt may substantially limit the ability of Puerto Rico to issue new public debt as part of or following the restructuring and/or to sculpt a new commonwealth capital structure given its limited debt service capacity.

The alternative is to propose a single instrument issued by a federally authorized "bonding authority".[5] The bonding authority would be created through an amendment to the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) — a draft of the necessary language was circulated prior to PROMESA's enactment — and would basically provide for a new issuer, issuing one or more classes of bonds, to be issued in varying proportions to exchanging creditors after oversight board approval. Although the debt would not be "backed," or in any way supported or guaranteed, by the federal government, as part of the legislation creating a bonding authority, liens would be federally authorized and automatically perfected. In addition, grounding the authority of the new issuer in PROMESA would not only provide a federal imprimatur to the bonding authority and its resulting debt issuances, but also immunize it from potential legal challenges asserted in the future based on Puerto Rican law. Debt issued under this bonding authority, including by virtue of the granting and lien language contained in the federal statute, would be superior from a legal perspective to any of the debt in the existing debt stock of Puerto Rico (and could include whatever enhancements in terms of statutory liens, New York law or forum, collective action provisions, or other protections as the parties may negotiate), as it would no longer be subject to challenge under Puerto Rican law or its constitution. It would, of course, also have the effect of aligning the interests of all creditors and restraining the impulse of some investors to attack their fellow creditors in the future if and when the commonwealth were to experience financial stress.

This is not a new idea nor an unrealistic ask of Congress. It was included in the federal legislation used to help Washington, D.C., with its fiscal crisis in 1995. During the passage of PROMESA last summer, the commonwealth government and the U.S. Treasury sought to incorporate similar language in drafts of PROMESA. Indeed, at that time, most creditors and their advisers agreed with and recognized the benefits of such a bonding authority. And, as per the Congressional Budget Office, the cost of implementing the bonding authority from a U.S. taxpayer perspective would be minimal.

The benefits of collapsing the commonwealth's debt stock into a single issuer or a reduced number of issuers are substantial. Beyond the additional legal certainty and improved security that a bonding authority and a single instrument could provide, creditors and Puerto Rico will also benefit from simplicity: one set of consolidated cash flows for one instrument instead of fractured streams of tax revenues and payment terms for hundreds of distinct CUSIPs. A simplified capital structure will not only help bring more transparency to the market, benefiting stakeholders, rating agencies and other market participants, but also bring greater liquidity to the bonds, which will no longer be divided among 18 different issuers. This means Puerto Rico can also market itself to a broader range of investors, who to date have stayed away from Puerto Rican bonds as an investment, given the complexity of the capital structure and opaque legal issues surrounding each of the various Puerto Rican debt issuances. This in turn will help existing creditors as an expanded market for Puerto Rican debt will provide even greater liquidity and ultimately higher values for restructured debt — a benefit that was confirmed by various investment banks when this issue was first raised as part of the previous administration's restructuring efforts.

Recommendation No. 2: Puerto Rico should offer a contingent value instrument, or "growth bond," alongside the fixed-pay instrument issued by the bonding authority.

A contingent value instrument is an instrument that gives the holder the right to receive additional debt service payments from the debtor in the event that certain growth-linked triggers (such as increases in gross domestic product or government revenues) are met. This type of instrument would be especially apt in Puerto Rico's situation, where sizable haircuts are inevitable given the limited ability of the commonwealth to pay its contracted debt going forward.

The "growth bond" offers an elegant solution to the looming haircuts that would be a win-win for creditors and Puerto Rico alike. For creditors, it offers an instrument that gives them the opportunity to recoup losses due to a haircut on their original principal and allows them to participate in the upside of economic growth and recovery. For Puerto Rico, it allows the island to make significant debt relief more palatable to creditors and create incentives for creditors to be partners in growing the island's economy.

And this too is not a novel strategy — for one, contingent value instruments have been used in several major sovereign restructurings in the recent past: Argentina in 2005, Greece in 2012 and Ukraine in 2015. They have also appeared in municipal restructurings; the city of Stockton, California, used a variant of CVIs in its agreement with one of its bond insurers as part of its 2015 Chapter 9 bankruptcy. Moreover, the concept was included in prior commonwealth restructuring proposals and, in fact, was also something creditors included in various forms in their counterproposals.

For a growth bond to work for Puerto Rico, it needs to be designed to enhance — not jeopardize — the prospects for future economic growth. Accordingly, we suggest that it be structured with these elements in mind: First, before additional payments kick in under the instrument, the commonwealth will need to have created some breathing room to lay the foundation for enduring economic expansion.

Therefore, the instrument should require that no payments should be made until a defined period of time has passed and growth at some minimum agreed level has been achieved. Second, additional payment should be triggered off of an increase in central government cash revenues, as opposed to GDP/gross national product-linked measures (which are difficult to measure for Puerto Rico and are more appropriate in the sovereign context) or other measures that may not correlate with economic growth at all. Third, once additional payments kick in, excess revenues should be shared between payments under the growth bonds and retention by the government so that residents of Puerto Rico can continue to benefit from an improved economy. This could include features such as aggregate caps on amounts paid and trailing calculation periods to even out any irregularities in revenues. And fourth, the instrument should include safety valves to deal with unforeseen events, such as natural disasters or reductions in federal assistance, that would enable Puerto Rico to suspend its obligations under the instrument to mitigate the effects such events have on the economy as a whole.

Recommendation No. 3: Puerto Rico must address the needs of local creditors.

It is estimated that at least $7 billion of Puerto Rico's bonded debt is held on-island. These holders include local mutual funds and financial institutions, individual investors, and investment portfolios for the local credit unions (or cooperativas), in which roughly one-third of Puerto Ricans have deposited their savings. Of these estimated $7 billion, it is further estimated that a sizeable portion of such investments were made in bonds issued by some of the weakest credits on the island, which are expected to suffer the most significant haircuts. The effect of these haircuts on Puerto Rico would be doubly disastrous: hundreds of thousands of Puerto Ricans, including the lower-income and the elderly, could see their retirement funds and savings evaporate, and the local economy would be further crippled, in turn retarding the commonwealth's ability to restore economic growth and repay its creditors.

It is therefore imperative that any restructuring proposal incorporates a restructuring solution that addresses the needs of local holders. Such a solution could take many forms, including: a long-dated instrument that maintains the same par value as the old bonds (but with a lower interest rate and little or no amortizations) for those holders who are focused on capital preservation or estate planning; transferable tax credits for lost principal that offset local taxes owed (calculated to not materially erode in any given year government revenues for such year), which could enable local holders to monetize or offset some of the losses they may experience; options to swap discounted debt for "equity" in new public vehicles set up to hold assets that are expected to be privatized; a government-sponsored support mechanism to protect the viability of local credit unions (cooperativas) and help them offset losses from discounted debt that otherwise might harm some of the most vulnerable residents of Puerto Rico; and/or the establishment in Title III of a convenience class of local individual, retail holders to mitigate their losses up to an agreed maximum amount of discounted debt.

While each of these solutions would need to balance the legitimate concerns that off-island creditors will surely have, the importance of preventing a collapse on the island should be obvious. Indeed, when raised during the previous administration's debt negotiations, off-island creditors seemed understanding of this imperative.

Recommendation No. 4: Puerto Rico, and its creditors, must act fast.

Almost as important as the type of instrument that creditors receive, is the recognition by all parties that they need to move quickly. As we approach the extended PROMESA stay deadline, the economic contraction underway in Puerto Rico worsens with each passing day. And, as one recent analysis points out,[6] unlike a sovereign state that undergoes a similar economic contraction, there is a real risk that the loss of economic power in Puerto Rico over the next several years will be a permanent one, as Puerto Rican residents can easily and cheaply relocate to the United States, where they can find greater employment opportunities and rely on a broader safety net of social- and health-related services and benefits. The accelerating pace of outmigration should concern all creditors, as it translates quite clearly into less revenue for Puerto Rico and less potential surplus available for debt service. The longer the restructuring process takes, the greater the impact this will have and the lower creditor recoveries ultimately will be.

For creditors seeking to litigate their way to better recoveries based on the purported strength of their particular debt instruments, the passage of time will also not prove to be beneficial. The plain truth is that there are no clear winners among the various creditor groups. Every debt instrument has its inherent vulnerabilities, and PROMESA creates new ones — for everyone, from GOs, to credits with dedicated pledged revenue streams, to the weakest appropriations-backed bonds. The incorporation into PROMESA of the Bankruptcy Code's cramdown power, and the power of the oversight board to use a fiscal plan as either a shield or sword to influence creditor behavior and affect judicial outcomes, is significant and affects all credits. As the litigation wears on and the oversight board and the courts tire of the inability to find a consensual solution, these vulnerabilities will become more pronounced and more likely to be exploited.

And then there are the risks of uncertainty, and their impact on creditor recoveries, that arise as the process drags on with no end in sight. The dramatic fiscal cliff due to nonrenewal of Affordable Care Act funding, the running down of pension assets to pay benefits, the high percentage of government revenues dependent, directly and indirectly, on U.S. and Puerto Rican tax policies — these are but a few of the many volatile factors at play. And as the commonwealth's finances only get worse, the commonwealth government may be forced to take even more dramatic actions, including liquidating various instrumentalities and/or expropriating pledged revenue streams. No one can be certain of how these factors will unfold or what responses they may engender, but the longer the restructuring process extends, the more likely these types of risks will materialize and potentially dramatically alter and extend the process, to the detriment of all creditors. None of this will serve the people of Puerto Rico nor aid its government in securing further support from Washington, D.C., support that is necessary to put Puerto Rico on firmer ground to eventually repay its restructured debt. And none of this will serve creditors who, after all, will for decades be completely dependent on a functioning island economy in order to recoup their investments. Time, therefore, is not on anyone's side, and all stakeholders would be well-advised to move toward a compromise that aligns interests and preserves what remains of the commonwealth's ability to eventually repay its debts.

* * *

The recommendations included above are by no means exhaustive; there are many other issues that will need to be addressed as part of any global restructuring. And there is no assurance that they can be achieved, as they depend in part on returning to Congress to amend PROMESA to authorize the establishment of a Puerto Rican bonding authority. However, when Congress helped Washington, D.C., overcome its financial difficulties in the 1990s, Congress (and the federal government) acted more than once when it was clear that their initial efforts would be insufficient. In the case of Puerto Rico, it is clear that further congressional and federal assistance will be required, whether to address the looming health care crisis on the island or the loss of Affordable Care Act funding. Further legislative gaps in PROMESA may also arise as the commonwealth and the oversight board move forward with a restructuring plan.[7] In any event, since the establishment of the bonding authority is a positive for both Puerto Rico and its creditors and will not cost U.S taxpayers anything, we would hope that it would not meet much resistance on Capitol Hill.

—By Richard J. Cooper, Luke A. Barefoot and Jessica McBride, Cleary Gottlieb Steen & Hamilton LLP

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DISCLOSURE: Cleary Gottlieb assisted the commonwealth of Puerto Rico and its instrumentalities with their financial challenges prior to the recent change in government.

[1] That is just the debt that is explicitly subject to clawback. GO bondholders are actively seeking to claw back revenues from issuers that did not issue bonds explicitly covered by the clawback mechanism. If successful, billions more (including the $17.2 billion of COFINA bonds) could be embroiled in an intercreditor conflict with the GO holders.

[2] Aside from the GO challenge to COFINA, the validity of several billions of GO and guaranteed bonds is also susceptible to challenge for failure to comply with Puerto Rican law, including constitutional limitations, as discussed in more depth in the second article in this series, "Issues To Expect In A Title III Puerto Rico Restructuring," published in Law360.

[3] For example, the governing bond documents for COFINA specify that the commonwealth government retains the right to “limit or restrict” the character of the pledged sales and use taxes, which could permit a rescission of the tax and leave holders without recourse.

[4] But not in Title VI, as described in the first article in this series, "Why Puerto Rico Will Likely Rely On PROMESA Title III," published in Law360. PROMESA only gives a judge the jurisdiction to resolve ancillary disputes in a Title III proceeding.

[5] Although a single instrument, this could nonetheless have different series to accommodate varying preferences among creditors, such as long-dated par-preservation instruments or capital appreciation-type bonds.

[6] “Getting Puerto Rico’s Fiscal Baseline Right,” by Brad W. Setser, Mar. 10, 2017, http://blogs.cfr.org/setser/2017/03/10/getting-puerto-ricos-fiscal-baseline-right/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+CFR_BradSetserBlog+%28Brad+Setser%3A+Follow+the+Money%29.

[7] One critical issue that is likely to arise is the preservation of tax-exempt status of the old bonds in a restructuring, for which legislative action could provide certainty of such status and avoid the need for several months of costly, painstaking diligence. Similar to the bonding authority, a draft of the necessary amendments was circulated but never included in the final PROMESA legislation. All parties should be advocating for their inclusion in any subsequent amendments to PROMESA.

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Why Puerto Rico Will Likely Rely On PROMESA Title III

Richard J. Cooper

Law360, New York (March 1, 2017, 4:34 PM EST) -- When Congress enacted the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA), it provided the commonwealth of Puerto Rico and its instrumentalities two distinct restructuring tools to address its financial challenges. The first, Title VI of PROMESA, is a largely out-of-court process that focuses exclusively on financial debt and relies on a collective action mechanism to bind dissenting creditors to the agreement of the debtor and a supermajority of its creditors to restructure its debt. The second, Title III of PROMESA, is a broad-based in-court restructuring regime that is modeled on Chapter 9 of the Bankruptcy Code.

Luke A. Barefoot

Both the oversight board and the new commonwealth administration have expressed a strong preference for restructuring the commonwealth's debt through the use of Title VI. However, when it comes to the debt of the commonwealth and those instrumentalities that rely on its taxing power for debt service ("commonwealth debt"), as opposed to the debt of certain of its instrumentalities, such as the Puerto Rico Electric Power Authority (PREPA) or the Puerto Rico Aqueduct and Sewer Authority (PRASA) that have their own independent revenue source and are not subject to the same interdebtor and intercreditor disputes, Title VI is unlikely to provide a realistic path to restructure such debt.[1]

First, unlike Title III, Title VI contains no automatic stay of creditor litigation upon the commencement and during the continuation of the restructuring process. As the current stay is now set to expire in May 2017, with limited options available for a further extension,[2] any attempt to restructure the commonwealth debt through Title VI will likely be complicated when existing litigation resumes and additional litigation is commenced. This issue is not limited to the ongoing dispute between general obligation (GO) and Puerto Rico Sales Tax Financing Corporation (COFINA) creditors concerning whether the commonwealth's sales and use tax represents "available resources" for satisfaction of GO debt,[3] although that is a critical dispute. In addition, creditors already have challenged the invocation of the clawback by the commonwealth, asserted claims against the commonwealth based on violations of statutory impairment provisions, alleged that various property interests have been taken in violation of constitutional protections, and claimed violations of PROMESA and other statutes. Regardless of the validity of these claims, it is clear that they will not all be resolved in the likely time frame that a Title VI process will take, and the outcome of such litigation, as well as other litigation that surely will be commenced upon the expiration of the current stay, could alter or harden the positions of the affected parties and change their willingness to compromise their claims.

Second, Title VI is limited in its scope, as only financial debt can be restructured as part of the process. In the case of the commonwealth, that would mean not only that nonfinancial obligations such as pension or retiree health obligations, contract claims, labor liabilities or impairment claims based on debts of the commonwealth's instrumentalities could not be restructured, but the fact that they would fall outside the scope of the Title VI process will inevitably make financial creditors, who otherwise would be inclined to participate in a financial restructuring, less willing to participate knowing that the commonwealth could be exposed to potentially billions of dollars of contingent liabilities even after completion of a targeted Title VI financial restructuring. This isn't an academic point in the case of the commonwealth, particularly where the oversight board has already called for substantial reductions in the commonwealth's pension liabilities, which will be difficult to achieve absent a Title III process.

In addition, the commonwealth could face billions of dollars in potential statutory and contract impairment claims from creditors who do not consent to a Title VI restructuring and assert claims against the commonwealth for violating numerous nonimpairment covenants that the commonwealth entered into in connection with the financing of certain of its instrumentalities, as well as guarantees of instrumentality debt issued by the commonwealth. Although these nonimpairment claims may ultimately fail, they have been asserted in pending proceedings and additional claims will likely be asserted once the current stay of litigation expires.

Third, unlike Title III, Title VI has a number of procedural and substantive limitations that make it ill-suited to address the interrelated web of tax-supported debt issued by the commonwealth and its instrumentalities. For example, a court in a Title VI process has limited authority under PROMESA when it comes to addressing issues that go beyond approving the specific changes to the terms of the restructured debt. Unlike a Title III court, a Title VI court likely lacks the power to enter an order as broad as what is typically contained in a Chapter 9 confirmation order, addressing and resolving issues between and among debtors and their respective creditors (such as those between GO and COFINA creditors that are at the heart of some, but not all, of the intercreditor disputes that exist today). In addition, Title VI does not provide the district court overseeing the restructuring with jurisdiction to resolve "related to" litigation that could potentially implicate the debtor. Thus, any Title VI process for the commonwealth would likely have to be conditioned on — and therefore the implementation delayed by — the resolution of numerous legal issues that will be decided in separate proceedings conducted outside of the district court approving the restructuring, which with appeals could take years.

In contrast, a Title III court can address "related to" litigation and can take full advantage of its equitable powers to fashion a broad confirmation order that will provide a clear and reliable discharge of all manner of obligations upon confirmation, providing the commonwealth with a true clean slate upon emergence. The value of a broad confirmation order and fresh start cannot be underestimated. In Chapter 9 and Chapter 11 bankruptcy cases, debtors have been able to return to credit markets based in part upon the certainty that a comprehensive discharge provides (even in the face of pending appeals of a bankruptcy court order). Facilitating Puerto Rico's return to the credit markets is not only one of the primary objectives of PROMESA, but its achievement will be an important barometer of the durability of the restructuring once achieved.

Apart from these legal and structural limitations inherent in the Title VI process, there are also substantial practical reasons why the oversight board and the new government are likely to eventually rely on Title III to restructure the commonwealth's tax-supported debt.

First, unlike Title VI, which requires a supermajority of creditors in each pool of claims to consent to the restructuring, Title III incorporates the bankruptcy cramdown power for nonconsenting classes of claims. Although it would be wonderful to believe that multiple pools of creditors across nearly a dozen different debtors holding in excess of $50 billion of debt will agree by supermajority to a consensual restructuring, more than two years of efforts to reach such a consensual solution have shown that result is unlikely to occur in the time frame available (even with new powers afforded to the oversight board and the commonwealth under PROMESA). The cramdown power incorporated in Title III — which would allow a plan of adjustment to be approved (if it meets all other requirements) with the approval of a single impaired class — is a powerful tool that will no doubt influence creditor behavior.

Nor is it likely that the commonwealth and the oversight board can effectively bifurcate the commonwealth credits into a multiple-stage restructuring achieved initially through a Title VI process. Even if the commonwealth and the oversight board were to focus their initial efforts on a consensual Title VI proceeding for the two "senior" commonwealth credits (GO and COFINA), with the remainder addressed in one or more subsequent restructurings, the success of the "first-stage" GO and COFINA restructuring will ultimately be subject to the outcome of the subsequent proceedings and possible claims that may be asserted against the commonwealth as a result.

Moreover, separating the commonwealth credits into two distinct baskets is not as easy as one might think. For example, the commonwealth has guaranteed the debt of certain issuers such as the Puerto Rico Public Buildings Authority (PBA) and PRASA, and has issued more than $4 billion in appropriation debt to the Government Development Bank for Puerto Rico (GDB). Leaving resolution of these material issues to an uncertain stage-two process is unlikely to be accepted by a supermajority of creditors of each of those debtors. In addition, many commonwealth instrumentalities (including the University of Puerto Rico (UPR), the GDB, the Employees Retirement System, and even the Highways and Transportation Authority), depend in whole or in part on appropriations from the commonwealth which would necessarily have to be agreed as part of the fiscal plan approved as part of the stage-one restructuring. Not having UPR creditors present as part of that negotiation of that plan of adjustment, as an example, even though it would establish whether there are sufficient appropriations to provide capacity for debt service at UPR, is not likely to be well-received by UPR creditors, and likely to invoke legal challenges.

This raises the second practical reason why the commonwealth's tax-supported debt will likely need to be restructured as part of an overall commonwealth-wide Title III process: the substantial cross-ownership of debt that exists among the commonwealth and its various instrumentalities by certain institutional investors and insurers. One of the complicating factors in the restructuring efforts to date has been the fact that a number of institutions hold or insure debt not only of the commonwealth but also of one or more of its instrumentalities. Any strategy that depends for its success on the prospect of these institutions accepting an outcome for certain of their Puerto Rican holdings while they roll the dice on the remainder of their commonwealth positions is likely to be challenging to implement, to say the least.

There is also the other practical concern that every debtor including the commonwealth faces — will it have sufficient liquidity to continue operating during the pendency of the restructuring process, which in the commonwealth's case could take years. Title III — in contrast to Title VI — incorporates the Bankruptcy Code's provisions on debtor-in-possession (DIP) financing, providing potential lenders with the certainty and security of a superpriority lien and protections against reversal on appeal. This may be of particular import if Congress fails to maintain current levels of support under the Affordable Care Act or other government programs, and/or if the island's revenues further deteriorate to require financing for essential government services during the course of a restructuring. Additionally, once Title III is filed, secured creditors that do not have "statutory liens" or are not secured by "special revenues," are no longer entitled to a pledge of future revenue streams, which itself could free up additional liquidity.

Finally, perhaps the most compelling reason for a comprehensive commonwealth-wide Title III process relates to what type of capital structure emerges from the restructuring process. Conducting a series of debtor-by-debtor Title VI processes, or a two-stage hybrid process for the commonwealth debt stock, even if achievable, will almost certainly guarantee that the current patchwork of commonwealth debt would remain in place, preserving the same dependency on carving up the commonwealth's revenue stream across different issuers with embedded interdebtor and creditor conflict. This result would be unfortunate for both creditors of the commonwealth and the commonwealth itself and raise the capital costs for the island for decades to come.

For all these reasons, regrettable as it may be given the likely cost and potential timing implications, when it comes to the tax-supported debt of the commonwealth (as opposed to certain of its instrumentalities), we expect Title III to be the restructuring mechanism on which the oversight board and the commonwealth will rely.

—By Richard J. Cooper, Luke A. Barefoot, Jessica McBride and Antonio Pietrantoni, Cleary Gottlieb Steen & Hamilton LLP

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This article is the first installment of a multiple-part weekly series on the Puerto Rico debt crisis.

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[1] For purposes of this article, references to the commonwealth's "debt" or "tax-supported debt" will be used in reference to the debt of those Puerto Rican government issuers that are reliant, either directly or indirectly, on the commonwealth's taxing power for operational expenses and debt service, such as the commonwealth's general obligations, COFINA, HTA, PBA, GDB, ERS, PRIFA, PFC, UPR, CCDA, PRIDCO, but excluding municipalities and those entities that have their own revenue sources and/or are financing vehicles with no recourse to tax revenues — including PREPA, PRASA, HFA and the Children's Trust.

[2] See PROMESA § 405(b)(1)(C). While it is possible that a 60-day extension of the current stay could be granted by the district court upon commencement of a Title VI proceeding, it is unlikely that such a 60-day period would be sufficient to conclude a Title VI proceeding, or that a final order approving a Title VI compromise would effectively preclude all such litigation in the future.

[3] See Lex Claims LLC v. Commonwealth of Puerto Rico, Case No. 16-cv-2374 (FAB) (D.P.R.).

PREPA Restructuring

ABI New York Bankruptcy Conference
May 18, 2017

Richard G. Mason
Brian Bolin

WACHTELL, LIPTON, ROSEN & KATZ

Topics

- Overview of PREPA
- Restructuring Support Agreement
- The Path to Completion of the Restructuring

Overview of PREPA

Background

- Public corporation of the Commonwealth established in 1941 pursuant to the Puerto Rico Electric Power Authority Act, No. 83-1941
- Serves all of Puerto Rico: Generation, transmission and distribution for ~1.5 million customers
- > 50% of electricity generated from oil (compared to < 1% avg. in mainland US)
  - Rates sensitive to oil prices
  - Currently not in compliance with federal Mercury and Air Toxics Standards (MATS)

Source: www.prepa.com; Statement of Motives, Act No. 57-2014

PREPA Capital Structure

- Revenue Bonds (~$8 billion)
  - Issued pursuant to Trust Agreement dated Jan. 1, 1974
  - Secured by pledge of system revenues, net of certain operating expenses

- Fuel Line Credit Facilities ($700 million)
  - $150 million originated by Citibank
  - $550 million originated by syndicate led by Scotiabank de Puerto Rico

Restructuring Support Agreement

Restructuring Support Agreement

- Agreement reached December 2015, with modifications agreed April 2017
  - Creditor groups had been forbearing since August 2014 maturity of Scotiabank fuel line
  - After taking office in January 2017, Governor Rossello's administration negotiated modifications providing additional rate savings over next five years
  - Since August 2014, supporting creditors have provided over $1 billion of liquidity by relending interest and principal when it has come due.
  - Modifications also provide for certain supporting creditors to provide additional liquidity for July 2017 interest and principal payments.

- Supporting creditors
  - Ad Hoc Group of bondholders
  - Monoline bond insurers
  - Fuel line lenders

Restructuring Support Agreement

- Parties agree to work cooperatively to implement Recovery Plan
  - Deadlines for various "milestones" in implementation
  - Upcoming milestones include:
    - **May 15, 2017:** Oversight Board certification of Title VI proceeding
    - **August 1, 2017:** District court order approving Title VI modifications
    - **September 1, 2017:** Outside date for closing

Key Terms of Recovery Plan

- Operational Restructuring
- Securitization
- Debt Restructuring

Key Terms of Recovery Plan (Dec. 2015)

- Operational Restructuring
  - Governance reforms to make PREPA more commercially-oriented
    - PREPA Board:
    - 7 members (5 must be Puerto Rico residents)
    - 5 independent members chosen by Governor from list compiled by independent executive search firm; 2 consumer representatives
  - Operational reforms
    - Resulted in one-time savings of $270 million plus ongoing annual savings of $237 million
  - Infrastructure modernization
    - Transition to natural gas
    - Achieve compliance with environmental regulations
    - Investments to improve plant efficiency

Key Terms of Recovery Plan (Dec. 2015)

- Operational Restructuring (continued)
  - Rate structure
    - Rates to be submitted to Energy Commission for approval every 3 years, with annual interim adjustments
    - Rates must be sufficient to cover debt service and other costs
    - Fuel mark-up eliminated (previously created incentive to purchase expensive fuel)
  - Governance and rate structure reforms enacted through PREPA Revitalization Act, No. 4-2016.
  - Energy Commission approved rate structure, subject to certain modifications, on January 11, 2017.

Key Terms of Recovery Plan (Dec. 2015)

- Securitization
  - Bankruptcy-remote SPV formed for purpose of issuing securitization bonds
  - SPV has statutory property right to impose, bill and collect "Transition Charges" to be included in PREPA bills to fund debt service on securitization bonds
    - Transition charges are uncapped, non-bypassable and are "trued up" periodically to ensure sufficient revenues to service securitization bonds
    - Enacted through PREPA Revitalization Act
    - Energy Commission approval of Transition Charges obtained
  - PREPA engaged as servicer to collect Transition Charges and remit them to trustee for securitization bonds

Key Terms of Recovery Plan (Dec. 2015)

- Securitization (continued)
  - Securitization bonds to be issued to fund distributions to PREPA creditors agreed as part of debt restructuring
  - Subject to certain conditions, additional issuances of securitization bonds, including up to $500 million to fund Aguirre Offshore Gas Port to help PREPA reduce reliance on oil and achieve compliance with MATS, are permitted

Key Terms of Recovery Plan (Dec. 2015)

- Debt Restructuring
  - ***Ad Hoc Group:*** Exchanges PREPA revenue bonds for securitization bonds issued by a new SPV at exchange ratio of 85%
    - No amortization for 5 years
    - Choice of current cash interest bonds (maximum 4.75% interest rate) and bonds that PIK interest for 5 years (maximum 5.50% interest rate)
    - Investment grade rating for securitization bonds required
  - ***Monolines:*** Provide sureties of up to $437 million for securitization bonds' debt service reserve fund (DSRF), and PREPA refinances and/or defeases insured PREPA bonds through issuance by SPV of new "mirror" securitization bonds
  - ***Fuel Line Lenders:*** Option to accept same treatment as AHG or to remain creditors of PREPA by converting debt to 6-year amortizing term loan with fixed below-market interest rate of 5.75%
  - ***Non-Forbearing Bondholders:*** Exchange offer for securitization bonds on same terms as Ad Hoc Group. Minimum participation threshold as closing condition.

Modifications to Recovery Plan (2017)

- ***Ad Hoc Group***
  - Maturity of securitization bonds extended to 2047
  - DSRF reduced to 5%
  - Investment grade rating condition waived
  - Maturity extended and interest rate reduced for relending bonds issued to finance interest/principal in 2016
  - Agree to finance portion of July 2017 interest/principal payments

- ***Monolines***
  - Defer $300 million of near-term maturities in next 6 years
  - Maturity extended and interest rate reduced for relending bonds issued to finance interest/principal in 2016
  - Agree to finance portion of July 2017 interest/principal payments

Modifications to Recovery Plan (2017)

- ***Scotiabank***
  - Maturity of term loan extended to 8 years
  - Amortization of term loan in first 5 years reduced from 90% to 25%
  - Interest rate on term loan reduced to 5.25%

- ***Other Fuel Line Lenders***
  - Exchange for securitization bonds at par
  - Provide portion of DSRF

- ***Non-Forbearing Bondholders***
  - Exchange implemented pursuant to Title VI of PROMESA

- ***Other Terms***
  - PREPA board: 3 independent; 3 Governor-appointed; 2 consumer representatives
  - As condition to closing, PREPA must have adequate liquidity, determined based on fiscal plan, which must be reasonably acceptable to supporting creditors

Modifications to Recovery Plan (2017)

	December 2015	April 2017
Securitization Bonds	Maturity: 2043 DSRF: 10%	Maturity: 2047 DSRF: 5%
Investment Grade Rating	Closing condition	Waived
Insured bond near-term maturities	Bonds defeased with mirror bonds and paid on schedule through transition charge	Maturities deferred through monolines' purchase of securitization bonds
Fuel Line Lenders	Choice of term loan (6 years at 5.75%; 90% amortization in first 5 years) or securitization bonds on same terms as ad hoc group	Scotiabank: Term loan (8 years at 5.25%; 25% amortization in first 5 years) Other Fuel Line Lenders: Exchange for securitization bonds at par, provide portion of DSRF
Non-forbearing bondholders	Voluntary exchange with minimum participation condition	Exchange pursuant to Title VI of PROMESA
July 2017 Payments	N/A	Portion financed by monolines and ad hoc group
PREPA Governance	5 independent board members; 2 consumer representatives	3 independent board members; 3 Governor appointees; 2 consumer representatives

The Path to Completion of the Restructuring

Milestones and Closing Conditions

- Enactment of governance reforms and securitization legislation
  - PREPA Revitalization Act enacted February 2016
  - Amendment required to implement PREPA board composition agreed in April 2017
- Energy Commission approval of transition charges and rate structure
  - Transition charges approved June 2016
  - Rate structure approved January 2017
- Completion of Commonwealth court proceedings (including any appeals) regarding validity of securitization bonds and their authorizing legislation
  - Multiple active proceedings
  - Favorable decision obtained in *Union de Trabajadores de la Industria Electrica (UTIER) v. Autoridad de Energia Electrica de Puerto Rico*, K AC2016-0291 (Court of First Instance, San Juan) in December 2016

Milestones and Closing Conditions

- Implementation of restructuring pursuant to Title VI of PROMESA
  - Oversight Board certifies proposed debt modifications consistent with RSA as "preexisting voluntary agreement"
  - Two-thirds of outstanding principal amount votes in favor
  - District court order approving proposed modifications
  - As of April 2017, PREPA analyzing whether to propose implementing through a "hybrid" Title VI/Title III proceeding
- Adequate liquidity of PREPA
  - Determined based on certified fiscal plan, which must be reasonably acceptable to supporting creditors

Upcoming Key Dates

- May 15, 2017: Milestone deadline for Oversight Board certification under Title VI
- June 7, 2017: Milestone deadline for commencement of solicitation of votes under Title VI
- July 1, 2017: principal and interest due on PREPA bonds
  - Certain supporting creditors have agreed to finance a portion to enable PREPA to make payment
- August 1, 2017: Milestone deadline for Title VI order from district court
- September 1, 2017: Outside date for closing of restructuring

AN OVERVIEW OF PROMESA'S MAJOR PROVISIONS & KEY REFINEMENTS

ENFORCEMENT OF FISCAL PLANS:

PROMESA's Fiscal Plans are the cornerstone of the Act. They are the chief enforcement tool for the Oversight Board to ensure accountability in the territory and its institutions. The Oversight Board has exclusive control to ensure the Fiscal Plans are enacted and enforced, and that all necessary reforms are undertaken so the Island **ATTAINS FISCAL SOLVENCY** and **REGAINS ACCESS TO CAPITAL MARKETS**.

OVERSIGHT BOARD ENFORCEMENT:

GOVERNMENT REFORMS:

The Oversight Board has the authority to enforce balanced budgets and government reform if the territory fails to do so. The new PROMESA includes provisions to bolster these authorities including:

→

- The authority to bring about solvency and transparency in government operations.
- The reaffirmation that PROMESA holds supremacy over any territorial law or regulation that is inconsistent with the Act or Fiscal Plans.

FINANCIAL STATEMENTS:

The Oversight Board has the authority to seek audited financial statements from the government of Puerto Rico at all levels. PROMESA includes refinements to improve these authorities including:

→

- The authority to conduct hearings, request information from the territory and issue subpoenas.
- The imposition of criminal penalties for knowingly providing false and misleading information, or refusing or failing to take any action ordered by the Board.

ECONOMIC GROWTH:

The Oversight Board has the authority to enforce actions to promote financial stability and economic growth including:

→

- The authority to prevent the execution of legislative acts, executive orders, regulations, rules and contracts that under cut economic growth initiatives or violate the Act.
- The requirement that the territory score their legislation to estimate costs – an activity not currently performed by the government.

PROTECTING PROPERTY RIGHTS & LAWFUL PRIORITIES:

The new **PROMESA** includes additional language and provisions to further clarify the relative lawful priorities and lawful liens as provided for in the Puerto Rican Constitution and other laws, and to promote voluntary negotiations and further protect property rights.

- Any adjustment of debts must "respect the relative lawful priorities or lawful liens, as may be applicable, in the constitution, other laws, or agreements of a covered territory... in effect prior to the date of enactment of this Act" and must be "in the best interest of the creditors."
- Provisions to reiterate the promotion of voluntary restructuring agreements and explicitly honor voluntary agreements that are already in place.
- New language to prohibit inter-debtor transfers, thereby disallowing the Governor from executing any budgetary adjustment between the enactment of this Act and the appointment of the Oversight Board.
- PROMESA creates a firewall between the constitutionally protected creditor hierarchy and pensions in the development of Fiscal Plans.

ECONOMIC GROWTH AND...

INFRASTRUCTURE:
PROMESA provides for accelerated processes for the review and permitting of infrastructure projects designated as "Critical Projects." In the new PROMESA, additional language has been added to allow Puerto Rican residents to submit comments on energy infrastructure projects.

LABOR REFORM:
PROMESA prevents the U.S. Department of Labor's proposed 113% increase in the individual salary threshold to qualify as exempt from federal overtime pay requirements from impacting Puerto Rico.

MINIMUM WAGE:
PROMESA grants the Governor the authority to designate a time period no greater than four years during which employers may pay employees who are initially employed after the date of enactment of PROMESA a wage that is less than the national minimum wage. The provision will raise the maximum age of applicability from 20 to 25.

PUERTO RICO GROWTH TASKFORCE:
The new PROMESA establishes a bipartisan, bicameral Congressional Task Force to provide a report no later than December 31, 2016 regarding impediments in current Federal law and programs to economic growth in Puerto Rico, recommended changes to Federal law and programs that would spur sustainable, long-term growth, and additional information as deemed necessary.

SMALL BUSINESS:
The new PROMESA requires the Government Accountability Office to conduct a report on the application and utilization of contracting activities of the Small Business Administration related to the HUB Zone program.

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GOVERNMENT OF PUERTO RICO

Puerto Rico Fiscal Agency and Financial Advisory Authority

FISCAL PLAN FOR PUERTO RICO

San Juan, Puerto Rico

March 13, 2017

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Table of Contents

I. INTRODUCTION

What the Government's Proposed Fiscal Plan Seeks to Achieve

Closing the Projected Baseline Fiscal Plan Deficit

- At the direction of the Oversight Board, the Government's new administration has prepared this Fiscal Plan which supersedes the prior administration's December 2016 fiscal plan that was rejected by the Board. From the date the new administration took office, AAFAF and its advisors have earnestly worked in cooperation with the Board's input to put forth a credible and reliable Fiscal Plan that will guide Puerto Rico's fiscal and economic recovery
- **The Fiscal Plan commits to fiscal responsibility and implements specific revenue enhancements and targeted expenditure reductions to return Puerto Rico to fiscal stability and economic growth.** In particular, the Fiscal Plan averts the $67bn fiscal deficit from the prior administration's plan and achieves +$7.9bn in cumulative cash flow available for debt service through the 10 year period

Further Improvement

- The Government fully appreciates that despite fiscal and economic uncertainties, now is the time to set the benchmark for the needed fiscal and economic measures as outlined in the Fiscal Plan. The Government is demonstrating its commitment to correcting the mistakes of the past. The Government is also mindful that in stopping the cycle of deficit spending, it must do so without undermining economic recovery or endangering the health, welfare or safety of the 3.5 million US citizens living in Puerto Rico

Bondholder Negotiations and Consensus

- Per PROMESA Section 2.01(b)(1)(I), the fiscal plan must provide a debt sustainability analysis. The Government's Fiscal Plan consolidates available cash resources that can be made available for debt service payments. The Fiscal Plan as proposed does not presume cash flow for debt service for any particular bondholder constituency, including clawed back cash and special revenues, nor does it take a position with respect to asserted constitutional or contractual rights and remedies, validity of any bond structure, or the dedication or application of tax streams / available resources
- The Government believes that any fiscal plan should reflect commitment to develop and implement operational and structural improvements that demonstrate the Government's willingness to achieve maximum payment of its debt obligations as restructured. However, in achieving debt sustainability, Puerto Rico's bondholders will be called upon to share in the sacrifice needed for a feasible debt restructuring. **The Government believes communication, grounded in fiscal responsibility, can create the opportunity for maximum consensus among stakeholders and pave the way for Puerto Rico's long-term fiscal stability and economic growth**

What the Fiscal Plan does not determine

Major Entities Impacted by the Fiscal Plan

- The Fiscal Plan is for the Government as a covered entity under PROMESA. The Government's various taxes, fees and other revenues are used to fund, subsidize or guarantee payments of the debt of many covered entities by various means. Accordingly, this Fiscal Plan does provide for payment of expenses and capital investments in, among other covered entities: (1) Public Building Authority, (2) PR Sales Tax Financing Corporation ("COFINA"), (3) PR Highways and Transportation Authority ("HTA"), (4) PR Convention Center District Authority ("PRCCDA"), (5) PR Infrastructure Finance Authority ("PRIFA"), (6) Employees' Retirement System ("ERS"), (7) University of Puerto Rico ("UPR"), (8) Puerto Rico Industrial Development Company ("PRIDCO"), and (9) Government Development Bank ("GDB")

Major Entities Not Covered by the Fiscal Plan

- There are four entities whose revenues and expenses are not included in this Fiscal Plan: (1) Puerto Rico Electric Power Authority ("PREPA"), (2) Puerto Rico Aqueduct and Sewer Authority ("PRASA"), (3) The Children's Trust Fund and (4) Puerto Rico Housing Finance Authority ("PRHFA"). As a result, this Fiscal Plan does not take a position with respect to these entities' financial prospects or the debt sustainability of such entities

Legal & contractual issues not determined by the Fiscal Plan

The Fiscal Plan does not attempt to resolve, among others, the following issues:

- The mechanisms by which projected cash flow available for debt service should be allocated to different debt instruments
- What is an essential service for purposes of the exercise of the Government's police power
- The scope, timing or specific use of revenues to be frozen or redirected as 'claw back' revenue
- The value, validity and /or perfection of pledges
- Whether any particular bond or debt issuance may have been improvidently issued
- What the Government is permitted to accomplish through the increase or decrease of dedicated taxes, fees, tolls or other revenue sources

II. FINANCIAL PROJECTIONS

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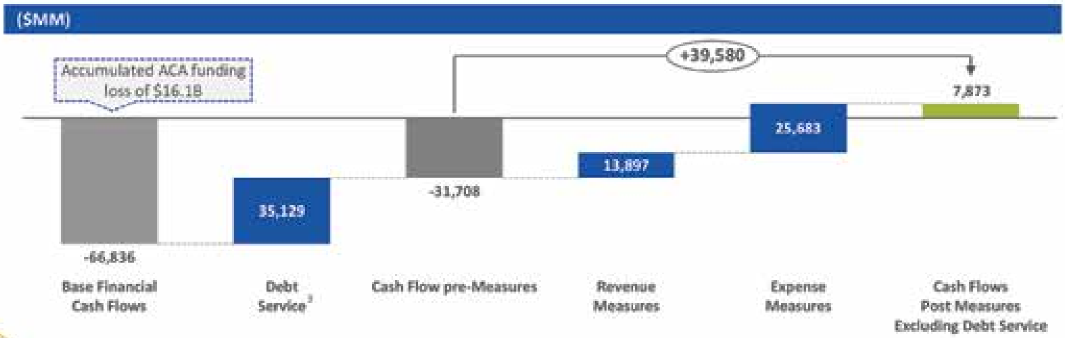
FINANCIAL PROJECTIONS

The Government will undertake fiscal measures that will reduce the fiscal gap by $39.6B, and create a 10 year cash flow surplus of $7.9B

- Based on the currently stated debt obligations, the 10-year budget gap is expected to reach $66.9B
  - ~$35.1B of expected principal and interest payments during the forecast period
- The Fiscal Plan estimates cash flows available for debt service. The chart below shows the key components of the forecast, including:
  - Base fiscal gap of $66.8B which includes full cost of debt service and does not include the impact of revenue and expense measures
  - Revenue and expense measures of $13.9B and $25.7B[1]
    - Revenue Measures: stabilizing corporate tax revenue through tax reform positively affects cash flows by $7.9B
    - Expense Measures: $19.2B of $25.7B (79%) due to Government right-sizing initiatives[2]



[1] See Section IV, Fiscal Reform Measures for full detail
[2] See government right-sizing section
[3] Includes $1,415 of past due P&I (Aug 1, 2015 to July 1, 2016), and $277 in Other Adjustments.

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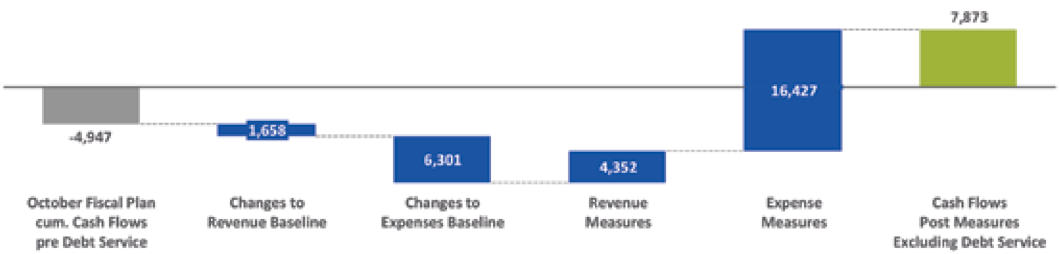
FINANCIAL PROJECTIONS

The current fiscal plan is a significant departure from the version presented in October, as it commits to higher revenue and expense measures of $4.4B and $16.4 B, respectively

- The October proposed Fiscal Plan estimated negative cumulative cash flows pre-debt service over the projection period ('17-'26) of ($4.9B) vs. the Current Fiscal Plan projections estimating positive cumulative cash flows pre-debt service of $7.92B. The change is comprised primarily of:
  - Negative net impact on cash flows available for debt service, pre-Measures of -$8.0B
    - Decrease in total revenues of $1.7B
    - Decreased expenses of $6.3B
  - Enhanced revenue measures of $4.4B
  - Additional savings from Expense Measures of $16.4B

($MM)



FINANCIAL PROJECTIONS

A summary of financials for the 10-year projection period shows positive cash flows post-measures, before debt service of $7.9B

($MM)

Fiscal year ending June 30 ($ in millions)	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	'17 - '26 total
PR Nominal GNP Growth	*(2.2%)*	*(2.8%)*	*(2.4%)*	*(0.5%)*	*(0.4%)*	*0.3%*	*1.0%*	*1.6%*	*2.1%*	*2.6%*	
Revenues before Measures [1]	**$18,952**	**$17,511**	**$16,407**	**$16,434**	**$16,494**	**$16,590**	**$16,746**	**$16,953**	**$17,204**	**$17,509**	**$170,799**
Noninterest Exp. before Measures [1]	**($17,872)**	**($18,981)**	**($19,233)**	**($19,512)**	**($19,950)**	**($20,477)**	**($20,884)**	**($21,310)**	**($21,973)**	**($22,316)**	**($202,507)**
Cash flows pre-Measures	**$1,080**	**($1,470)**	**($2,826)**	**($3,077)**	**($3,456)**	**($3,886)**	**($4,139)**	**($4,357)**	**($4,769)**	**($4,807)**	**($31,708)**
Measures											
Revenue measures	--	924	1,381	1,384	1,531	1,633	1,740	1,752	1,766	1,785	13,897.1
Expense measures	--	951	2,012	2,415	2,983	3,156	3,255	3,357	3,724	3,830	25,683.3
Net impact of measures	**--**	**1,875**	**3,393**	**3,799**	**4,515**	**4,789**	**4,995**	**5,108**	**5,491**	**5,615**	**39,580**
Cash flows post-Measures, before Debt Service	**$1,080**	**$404**	**$567**	**$722**	**$1,059**	**$903**	**$857**	**$751**	**$722**	**$808**	**$7,873**

Cash flows post-measures, before debt service trends:

- FY 2017 estimate of $1.1B, declining to a low of $0.4B in FY 2018, driven by GNP contraction and ERS Paygo contributions of $1.0B in FY 2018
- Forecast peaks at $1.1B in FY 2021 before declining to $0.8B by FY 2026. Decline is primarily driven by Affordable Care Act ("ACA") funding expiration that increase steadily from ~$0.9B in FY 2018 to ~$2.4B in FY 2026
- Expense measures include $1.3B in supplier payment pay downs through the projection period

1 Full details in Appendix

2 This addback is illustrative, and is not reflected in the amounts available for debt service elswhere in this Plan

FINANCIAL PROJECTIONS

Revenues Before Measures

($MM)

Fiscal year ending June 30 ($ in millions)	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	'17 - '26 total
PR Nominal GNP Growth	*(2.2%)*	*(2.8%)*	*(2.4%)*	*(0.5%)*	*(0.4%)*	*0.3%*	*1.0%*	*1.6%*	*2.1%*	*2.6%*	
Revenues											
General Fund Revenues:											
Individual Income Taxes	$1,892	$1,760	$1,718	$1,709	$1,703	$1,708	$1,725	$1,752	$1,789	$1,836	$17,592
Corporate Income Taxes	1,515	1,473	1,437	1,430	1,424	1,429	1,443	1,466	1,497	1,536	14,649
Non-Resident Withholdings	685	666	650	647	644	646	652	663	677	694	6,624
Alcoholic Beverages	268	260	254	253	252	253	255	259	265	272	2,591
Cigarettes	112	109	106	106	105	106	107	108	111	114	1,083
Motor Vehicles	330	321	313	311	310	311	314	319	326	335	3,191
Excises on Off-Shore Shipment Rum	206	173	175	176	178	179	180	182	183	184	1,816
Other General Fund Revenue	391	386	377	375	373	374	378	384	392	402	3,833
Total	**5,399**	**5,148**	**5,030**	**5,007**	**4,989**	**5,005**	**5,055**	**5,134**	**5,239**	**5,372**	**51,378**
General Fund Portion of SUT (10.5%)	1,718	1,655	1,596	1,553	1,511	1,484	1,472	1,474	1,487	1,512	15,463
Net Act 154	2,075	1,556	1,038	1,038	1,038	1,038	1,038	1,038	1,038	1,038	11,931
General Fund Revenue	**$9,192**	**$8,360**	**$7,664**	**$7,598**	**$7,538**	**$7,527**	**$7,565**	**$7,646**	**$7,764**	**$7,921**	**$78,773**
Additional SUT (COFINA, FAM & Cine)	850	877	906	936	968	1,003	1,039	1,078	1,118	1,161	9,936
Other Tax Revenues	1,337	1,396	1,401	1,411	1,423	1,429	1,436	1,445	1,455	1,467	14,199
Other Non-Tax Revenues	579	576	582	594	622	630	635	642	649	666	6,174
Adj. Revenue before Measures	**$11,958**	**$11,208**	**$10,552**	**$10,539**	**$10,550**	**$10,588**	**$10,675**	**$10,810**	**$10,986**	**$11,215**	**$109,082**
Federal Transfers	6,994	7,168	7,372	7,477	7,623	7,835	8,023	8,212	8,469	8,675	77,847
Loss of Affordable Care Act ("ACA") Funding	--	(865)	(1,516)	(1,582)	(1,680)	(1,833)	(1,953)	(2,069)	(2,251)	(2,382)	(16,130)
Revenues before Measures	**$18,952**	**$17,511**	**$16,407**	**$16,434**	**$16,494**	**$16,590**	**$16,746**	**$16,953**	**$17,204**	**$17,509**	**$170,799**

FINANCIAL PROJECTIONS

Non-Interest Expenses Before Measures

($MM)

Fiscal year ending June 30 ($ in millions)	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	'17 - '26 total
Expenses											
General Fund Expenditures:											
Direct Payroll	($3,271)	($3,309)	($3,342)	($3,375)	($3,413)	($3,458)	($3,509)	($3,563)	($3,619)	($3,675)	($34,532)
Direct Operational Expenses	(907)	(918)	(926)	(936)	(946)	(959)	(973)	(988)	(1,003)	(1,019)	(9,574)
Utilities	(260)	(332)	(352)	(360)	(373)	(372)	(369)	(374)	(387)	(395)	(3,575)
Special Appropriations	(3,890)	(4,037)	(4,068)	(4,068)	(4,209)	(4,140)	(4,143)	(4,136)	(4,250)	(4,147)	(41,087)
General Fund Expenses	**(8,329)**	**(8,596)**	**(8,688)**	**(8,738)**	**(8,941)**	**(8,929)**	**(8,993)**	**(9,060)**	**(9,259)**	**(9,236)**	**(88,768)**
Other:											
Paygo Contributions in Excess of Asset Balance	--	(989)	(1,014)	(985)	(964)	(1,151)	(1,177)	(1,217)	(1,251)	(1,278)	(10,026)
Run-Rate Capital Expenditures	(283)	(400)	(407)	(415)	(422)	(429)	(437)	(445)	(453)	(462)	(4,154)
Total other	**(283)**	**(1,389)**	**(1,421)**	**(1,400)**	**(1,386)**	**(1,581)**	**(1,614)**	**(1,662)**	**(1,704)**	**(1,739)**	**(14,180)**
Component Units, Non-GF Funds and Ent. Funds:											
Net Deficit of Special Revenue Funds	(110)	(130)	(146)	(154)	(162)	(169)	(173)	(176)	(176)	(174)	(1,571)
Independently Forecasted Non-Enterprise CUs	(452)	(380)	(433)	(558)	(639)	(752)	(859)	(963)	(1,109)	(1,210)	(7,356)
HTA Operational Expenses	(246)	(234)	(236)	(238)	(239)	(243)	(246)	(250)	(254)	(258)	(2,444)
Other	(44)	(41)	(30)	(30)	(30)	(31)	(31)	(32)	(32)	(33)	(335)
Total	**(853)**	**(785)**	**(845)**	**(980)**	**(1,071)**	**(1,194)**	**(1,310)**	**(1,420)**	**(1,572)**	**(1,675)**	**(11,705)**
Disbur. of Tax Revenues to Entities Outside Plan	(335)	(302)	(304)	(307)	(313)	(314)	(316)	(319)	(322)	(334)	(3,168)
Adj. Expenses before Measures	**($9,800)**	**($11,071)**	**($11,259)**	**($11,425)**	**($11,712)**	**($12,018)**	**($12,234)**	**($12,461)**	**($12,857)**	**($12,984)**	**($117,822)**
Federal Programs	(6,994)	(7,168)	(7,372)	(7,477)	(7,623)	(7,835)	(8,023)	(8,212)	(8,469)	(8,675)	(77,847)
Reconciliation Adjustment	(585)	(592)	(598)	(604)	(610)	(618)	(627)	(637)	(647)	(657)	(6,175)
Other non-recurring	(493)	(150)	(5)	(5)	(5)	(5)	--	--	--	--	(663)
Total	**(8,072)**	**(7,910)**	**(7,975)**	**(8,086)**	**(8,238)**	**(8,458)**	**(8,650)**	**(8,849)**	**(9,116)**	**(9,332)**	**(84,685)**
Noninterest Exp. before Measures	**($17,872)**	**($18,981)**	**($19,233)**	**($19,512)**	**($19,950)**	**($20,477)**	**($20,884)**	**($21,310)**	**($21,973)**	**($22,316)**	**($202,507)**

FINANCIAL PROJECTIONS

Assumptions and Methodology: Revenue

Category	Description	'17 Revenue $MM	'26 Revenue $MM	2017 – 2026 Growth Methodology
1 Taxes	• Individual Income Taxes • Corporate Income Taxes	3,407	3,371	• Grows with PR Nominal GNP Growth Factor • Excludes corporate tax reform and compliance impact which is included within fiscal measure reform analyses
2 Other General Fund Revenue	• General Fund	391	402	• Grows with PR Nominal GNP Growth Factor
3 Act 154	• Act 154 • Act 154 / Foreign Company Tax Losses	2,075	1,038	• Act 154 revenue is sustained at 2017 levels until 2026 • Losses equal (519) in 2018, double in 2019, and sustained at 2019 levels
4 SUT	• General Fund Portion of SUT (10.5%) • Additional SUT (COFINA, FAM, & Cine)	2,568	2,673	• Total SUT grown at PR Nominal GNP growth • Allocation proportions grow at historical levels
5 ACA Loss	• Loss of Affordable Care Act ("ACA") Funding	0	-2,382	• Initial decrease from (865) in 2018 to (1,516) in 2019 • Annual growth in loss of 6.7% from 2019 to 2026
6 Component Units	• Other Tax Revenues • Other Non-Tax Revenues	1,916	2,132	• Grows with PR Nominal GNP Growth Factor & Elasticity

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FINANCIAL PROJECTIONS

Assumptions and Methodology: Expenses (1/2)

Category	Description	2017 $MM	2026 $MM	2017 – 2016 Growth Methodology
1 Direct Payroll	• Payroll and Operational Expenses • Education Payroll • Police Payroll	-3,271	-3,675	• Growth based on previous year multiplied by PR Inflation and Inflation pass-through to payroll
2 Direct Operational Expenses	• Legislature • Department of Education • Other Agencies	-907	-1,019	• Growth based on previous year multiplied by PR Inflation and Inflation pass-through to payroll
3 Utilities	• Power and Water • PBA Operating Subsidy (Rent) • Insurance Premiums	-260	-396	• PBA Operating Subsidy maintains • Power and water have initial increase due to subsidy reduction with steady year-over-year growth until 2026
4 Special Appropriations	• UPR • Judicial and Municipalities • Retirement Systems • Health Insurance	-3,890	-4,147	• UPR, Judicial and Municipalities increase in 2018, maintain steady-state following initial growth
5 Paygo Contributions in Excess of Asset Balance	• Required Pay-go contribution: ERS, TRS and JRS	0	-1,278	• Paygo program for ERS, TRS and JRS is initiated in 2018 with initial expenses of $989MM • Steady growth in expenses starting in 2020
6 Run-Rate Capital Expenditures	• Non-Growth Capital Expenditures in the Base (Run-Rate) • Growth Capex	-284	-462	• Initial increase in 2018 to $400MM and steady growth in following years based on previous year multiplied by PR Inflation following

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FINANCIAL PROJECTIONS

Assumptions and Methodology: Expenses (2/2)

Category	Description	2017 $MM	2026 $MM	2017 – 2026 Growth Methodology
7 Reconciliation Adjustment	• Reconciliation Adjustment	-585	-657	• Initial increase in 2018 to $592MM with steady increase until 2026 • Reconciliation adjustment based on midrange estimate provided by E&Y analysis and audit
8 Other Non-Recurring	• Payment of Past-Due Tax Refunds • Transition and restructuring costs	-493	0	• Initial decline in tax refunds in 2018 from $493MM to $150MM, decline in 2019 from $150MM to $5MM, and elimination of non-recurring expenses in 2023 • Costs to implement restructuring ($370MM over 10 years)
9 Component Units	• Net Deficit of Special Revenue Funds • Independently forecasted non-enterprise • HTA Operational Expenses	-853	-1,675	• Net Deficit of Special Revenue Funds growth is based on previous year multiplied by PR Inflation • Non-enterprise expenses include ASEM, ASES, ADEA, PRCCDA, PRIDCO, PRITA, Tourism, and UPR deficits • PBA and the Port Authority run a surplus in 2017 that transitions towards deficit beginning in 2018 • Initial HTA decline in expenses due to a reduction in Past Due AP costs

FINANCIAL PROJECTIONS

Assumptions and Methodology: Macroeconomic Factors

Category	Description, %	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2017 – 2026 Growth Methodology
1 PR Nominal GNP Growth Factor		-2.2	-2.8	-2.4	-0.5	-0.4	0.3	1.0	1.6	2.1	2.6	• Initial decrease to 97.2% in 2019 • Increase in 2020 to 99.5% • Steady, minimal growth until 2026
2 PR Inflation		-0.2	1.2	1.0	1.0	1.1	1.3	1.5	1.5	1.6	1.6	• Initial negative inflation of -0.2% in 2017 increasing to 1.2% in 2018, 1.0% in 2019 with steady, minimal growth in Inflation until 2026
3 PR Population Growth Factor		-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	• Maintenance of 2017 PR Population Growth Factor of 99.8%
4 US Population Growth		0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.7	0.7	0.7	• Maintenance of 2017 US Population Growth of 100.8% until 2024, where it drops to 100.7%

III. FISCAL REFORM MEASURES

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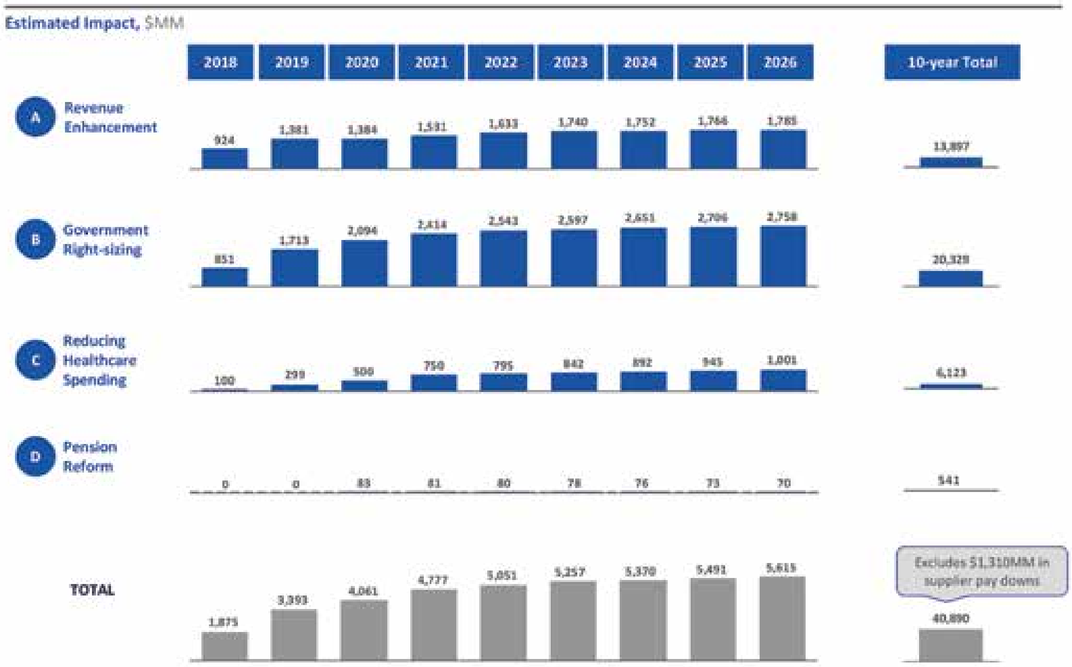
FISCAL REFORM MEASURES

Fiscal Reform measures reduce the 10-year financing gap by $39.6B



Note: Values may not add up due to rounding; Excludes expenditures related to rehabilitation of trade terms with local suppliers

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REVENUE ENHANCEMENT

Hacienda will embark in a multi-year transformation process to reduce leakage, improve revenue collections and adjust fees

Revenue Enhancement Measures, $MM

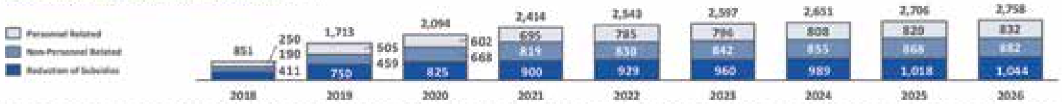
Reform Measures	Description	2018 Impact
Corporate Tax Reform	• The Government will use the breathing room provided by the extension of Act 154 to seek a more stable, consistent corporate tax policy that implements a broad-based regime with fewer exemptions by no later than January 2019	$519MM
Tax Compliance	• Reduce leakage by increasing electronic SUT tax collections at the point of sale, including internet sales • Improve revenue collections by using advanced analytics, expanding capacity and conducting targeted interventions	$150MM
Adjust Taxes and Fees	• Increase tobacco-related products excise tax and implement new property tax regime • Revise fees including licenses, traffic fines, insurance fees and other charges for services to keep up with market trends	$255MM

Note: To meet fiscal plan objectives, the Government may consider additional measures.

GOVERNMENT RIGHT-SIZING

The Government must embark on a transformative journey in order to provide core services to citizens in an efficient and fiscally responsible manner

Government Right-Sizing Measures[1], $MM



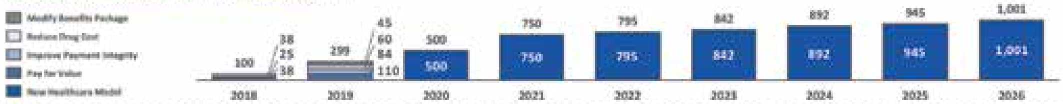
Reform Measures	Description	2018 Impact
Personnel Related	• Freeze on payroll increases for fiscal years 2018 to 2020 • Improve employee mobilization across government, uniform fringe benefits and eliminate vacation and sick day liquidations to produce higher attrition rates or other payroll-related savings	$250MM
Non-Personnel Related	• Freeze on operational cost increases for fiscal years 2018 to 2020 • Re-design the way the Government works by reducing non-core expenses, externalizing services to private entities, centralizing services to eliminate duplication, achieve procurement savings or other cost-cutting measures	$190MM
Reduction of Subsidies	• Gradually reduce general fund subsidies to the University of Puerto Rico, municipalities and other direct subsidies to the private sector • Proactively engage with the University of Puerto Rico, municipalities, as well as industry partners, to mitigate the economic development impact of subsidy removal	$411MM

Note: To meet fiscal plan objectives, the Government may consider additional measures.
1) Post 2018, the relative distribution of savings between personnel and non-personnel related expenses will be decided as part of updates to the Fiscal Plan and the annual budget

REDUCING HEALTHCARE SPENDING

The Government will focus on improving efficiencies, adjusting benefits and developing a new healthcare model in order to achieve savings in healthcare spend

Reducing Healthcare Spending Measures, $MM



Reform Measures	Description	2018 Impact
Pay for Value	• Establish uniformed fee schedules and limit reimbursement rates for providers • Replace current profit sharing arrangement with MCOs and replace with a Medical Loss Ratio	$38MM
Improve Payment Integrity	• Establish partnerships to increase the scrutiny of premium payments for beneficiaries that have left the system or have another health insurance plan • Establish Medicaid Fraud Control Unit and implement the Medicaid Management Information System to reduce waste, fraud and abuse	$25MM
Reduce Drug Cost	• Reduce outpatient drug spending by increase pharmacy discounts on branded drugs, enforce mandatory dispensing of generic drugs, updating the preferred formulary and establishing shared-savings initiatives	$38MM
Modify Benefits Package	• Evaluate services that could be capped and/or eliminated from the current benefit package without adversely affecting access for Mi Salud beneficiaries	$0
New Healthcare Model	• Develop a new healthcare model in which the Government pays for basic, less costly benefits and the patient pays for premium services selected resulting in cost reductions attributed to greater competition along with the capped PMPM amount	$0

Note: To meet fiscal plan objectives, the Government may consider additional measures.

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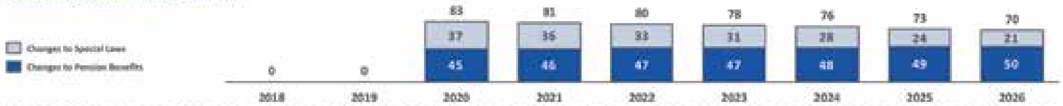
PENSION REFORM

Segmentation of the defined contribution structure will protect the retirement savings of government employees

Pension Reform Measures, $MM



Reform Measures	Initiative	2018 Impact
Contribution Segregation and New Benefit Plans	• Switch to pay-as-you-go model, segregate prospective employee contributions, facilitate Social Security enrollment and improve investment alternatives	$0
Adjust Retirement Benefits	• Protect benefits for lowest pension income earners. Progressive strategy to reduce retirement benefit costs including other post-employment benefits.	$0

Note: To meet fiscal plan objectives, the Government may consider additional measures.

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IV. STRUCTURAL REFORMS

STRUCTURAL REFORM MEASURES

Implementing the package of structural reforms will provide a cumulative 2.0% increase in GNP growth

1 Improve Ease of Business Activity

1a Increase Labor Participation

- Institute public policy measures aimed to attract new businesses, create new employment opportunities, and foster private sector employment growth to increase labor demand
- Change welfare and labor incentives to encourage greater sector participation thus increasing labor supply

1b Permitting Process Reform

- Centralize, streamline, and modernize and expedite permitting processes; increase business friendly environmental and economic growth

1c Tax Reform

- Lower marginal tax rates and broaden the tax base; simplify and optimize the existing tax code to achieve gains in efficiency, ease of doing business and reducing tax evasion

1d Regulatory Reform

- Reduce unnecessary regulatory burdens to reduce the drag of government on the private sector

2 Improve Capital Efficiency

2a Infrastructure Reform

- Augmenting competitiveness by investing in critical infrastructure and quality of public services in roads, ports, telecommunications, water and waste, knowledge services, and other strategically important sectors

2b Public-Private Partnerships

- Leverage key public assets through long term concessions to optimize quality of public infrastructure, services to public and sustainable operations and maintenance

2c Critical Projects

- Implement management system to boost development of critical projects through expedited processes

3 Energy Reform

3a Energy Reform

- Leverage and facilitate expedited private sector investments in modern, cost-efficient, and environmentally compliant energy infrastructure; reform PREPA operations and services to clients; and allow for greater competition in energy generation

4 Promoting Economic Development

4a Enterprise Puerto Rico

- Promote productivity growth, attract FDI & incentivize investments in technology through collaboration with the private sector

4b Destination Marketing Organization

- Externalize the overseeing of marketing efforts & continuity under a single brand and as a unified front representing all of Puerto Rico's tourism components

INFRASTRUCTURE / P3 REFORM – P3 Program

The initial stage of the P3 program includes launching of ~$5B of projects during the 2017-2019 calendar years that have been identified and are in project preparation

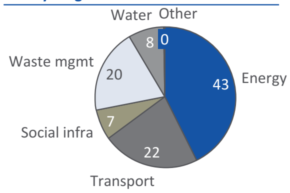
P3 Project Identification

- Identified initial list of priority projects with P3 potential
- Assessed project business cases and impacts on priority infrastructure needs, the economy, and efficient delivery of public services
- Split into 3 groups based on projected sequencing, **designed to launch in 2017, 2018 and 2019**

Key Considerations in the Overall P3 Implementation

- Project sequencing is designed to **effectively progress the advancement of projects and avoid major obstacles in the shortest timeline possible** (i.e., progression from easily executable/advanced permitting to more difficult/less advanced projects)
- Need to **promote and improve funding models to use private funds**, where relevant, as leverage to maximize the unused federal funds current available

P3 Key Target Areas %



10-Year Impact → **Capital Improvement Investment: ~$5B | Jobs Created: ~100,000**

	2017 (Q-17 – Q4-17)	2018 (Q1-18 – Q4-18)	2019 (Q1-19 – Q4-19)
Group 1 Projects	• Launch Group 1 Projects • Estimated value ~$1B		
Group 2 Projects	• Invest in preparing Group 2 • Data gathering, due diligence, etc.	• Launch Group 2 Projects • Estimated value ~$2B	
Group 3 Projects	• Invest heavily in preparing Group 3 • Data gathering, due diligence, etc.	• Invest heavily in preparing Group 3 • Data gathering, due diligence, etc.	• Launch Group 3 Projects • Estimated value $2B

(Project timeline includes P3 concessions included in Externalization measures)

V. DEBT SUSTAINABILITY ANALYSIS

DEBT SUSTAINABILITY

Debt summary

- Below is a summary of the debt (excluding pension liabilities) considered in the fiscal plan
- Note: Amounts are estimated as of February 2017 and based upon preliminary unaudited numbers provided to AAFAF by issuer agencies and from publicly available information. On behalf of the Board, Ernst & Young is conducting an assessment of the debt outstanding to confirm these figures. Estimated amounts are subject to further review and may change

Summary of debt outstanding as of February 2017 ($MM)

Issuers included in Fiscal Plan	Bond principal	CAB	Unpaid P&I[1]	Private Loans	Total Bonds & Private loans	*Loans from GDB/MFA Entities*	*Total Debt Service FY 17-19*	*DSRF Balance*
GO	$12,013	$84	$1,146	$24	$13,267	*$169*	$3,284	--
COFINA	11,425	6,155	--	--	17,580	--	*2,121*	--
HTA[2]	3,983	135	6	--	4,124	*1,734*	*997*	*101*
PBA	3,980	--	117	--	4,097	*182*	*782*	*6*
GDB[3, 4]	3,182	--	742	203	4,126	--	*1,863*	--
ERS	2,658	498	--	--	3,156	--	*500*	*44*
PRIFA[5]	1,566	409	232	--	2,207	*49*	*464*	*2*
PFC	1,025	--	172	--	1,197	--	*257*	--
UPR[6]	496	--	--	0	496	*76*	*145*	*61*
PRCCDA	386	--	--	--	386	*145*	*91*	*9*
PRIDCO	145	11	--	--	156	*78*	*54*	*19*
AMA	--	--	--	28	28	--	--	--
Other Central Gov't Entities	197	--	29	413	639	*3,975*	--	--
Total	**$41,056**	**$7,293**	**$2,444**	**$668**	**$51,461**	**$6,409**	**$10,558**	**$242**
Debt Issuers not incl. in Fiscal Plan								
PREPA	8,259	--	--	697	8,956	*36*	*2,775*	*6*
PRASA[7]	3,943	28	13	584	4,568	*229*	*995*	*93*
Children's Trust	847	613	--	--	1,460	--	*140*	*85*
HFA	542	--	--	--	542	*85*	*134*	*33*
PRIICO	--	--	--	98	98	--	--	--
Municipality Related Debt[8]	556	--	--	1,140	1,696	*2,036*	*n.a.*	*59*
Total	**$14,147**	**$641**	**$13**	**$2,520**	**$17,320**	**$2,386**	**$4,044**	**$276**
Total	**$55,203**	**$7,933**	**$2,457**	**$3,188**	**$68,781**	**$8,795**	**$14,602**	**$518**
Less: GDB Bonds (excl. TDF)					(3,766)			
Plus: Loans from GDB/MFA Entities					8,795			
Public Sector Debt					**$73,810**			

Notes:
1) Unpaid principal and interest includes debt service that has been paid by insurers and is owed by the government
2) HTA includes Teodoro Moscoso bonds
3) GDB private loans includes Tourism Development Fund ("TDF") guarantees
4) Includes GDB Senior Guaranteed Notes Series 2013-B1 ("CFSE")
5) PRIFA includes PRIFA Rum bonds, PRIFA Petroleum Products Excise Tax BANs, PRIFA Port Authority bonds and $34.9m of PRIFA ASSMCA bonds
6) UPR includes $64.2m of AFICA Desarrollos Universitarios University Plaza Project bonds
7) PRASA bonds includes Revenue Bonds, Rural Development Bonds, Guaranteed 2008 Ref Bonds
8) Municipality Related Debt includes AFICA Guyanabo Municipal Government Center and Guaynabo Warehouse for Emergencies bonds

DEBT SUSTAINABILITY

Debt Service Schedule

The table below summarizes the annual debt service through FY 2026 for all issuers included in the fiscal plan

FY 2017 – FY 2026 debt service ($MM)

Fiscal year ending June 30,	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Cash Interest										
GO	$733	$714	$699	$680	$658	$641	$621	$597	$571	$545
PBA	186	186	183	179	175	169	163	157	151	145
COFINA	686	685	684	697	709	703	696	688	680	671
HTA[1]	206	201	194	188	182	175	167	160	153	145
PRIFA[2]	86	80	77	75	72	69	65	61	57	53
PRCCDA	19	18	17	17	16	15	15	14	13	12
PFC	56	55	54	53	51	50	48	47	44	42
UPR[3]	25	24	22	21	20	18	17	15	14	12
ERS	167	167	167	167	167	164	159	155	154	152
GDB	163	142	125	79	55	46	43	18	16	11
PRIDCO	8	8	7	7	6	5	5	4	3	2
Total	**$2,333**	**$2,279**	**$2,229**	**$2,161**	**$2,109**	**$2,054**	**$1,999**	**$1,916**	**$1,857**	**$1,790**
Principal										
GO	$395	$351	$392	$439	$334	$358	$378	$402	$428	$454
PBA	91	66	70	74	100	102	96	103	107	100
COFINA	0	19	48	78	98	120	159	203	248	294
HTA[1]	131	140	126	136	142	150	146	155	164	169
PRIFA[2]	124	48	50	51	54	62	86	64	72	74
PRCCDA	12	12	13	14	14	15	16	17	17	18
PFC	29	30	32	33	34	36	37	39	41	43
UPR[3]	23	25	26	27	29	30	31	33	35	24
ERS	(0)	0	--	0	50	70	80	19	22	29
GDB	309	277	848	432	434	143	47	541	--	248
PRIDCO	10	10	11	11	11	13	13	14	15	16
Total	**$1,124**	**$979**	**$1,614**	**$1,296**	**$1,299**	**$1,097**	**$1,091**	**$1,590**	**$1,149**	**$1,470**
Total debt service										
GO	$1,128	$1,066	$1,090	$1,118	$991	$999	$999	$999	$999	$999
PBA	277	253	252	253	274	270	259	260	258	245
COFINA	686	704	732	776	807	823	855	891	928	965
HTA[1]	337	340	320	324	324	325	314	315	317	314
PRIFA[2]	210	127	127	126	126	130	151	125	130	127
PRCCDA	30	30	30	30	30	30	30	30	30	30
PFC	86	86	86	85	85	85	85	86	86	85
UPR[3]	48	48	48	48	48	48	48	48	48	36
ERS	167	167	167	167	217	234	239	174	176	181
GDB	472	419	973	512	488	189	91	559	16	259
PRIDCO	18	18	18	18	16	18	18	18	18	18
Total	**$3,457**	**$3,257**	**$3,843**	**$3,457**	**$3,408**	**$3,152**	**$3,090**	**$3,506**	**$3,006**	**$3,261**

1 HTA includes Teodoro Moscoso Bridge
2 PRIFA includes PRIFA BANs
3 UPR includes AFICA UPP

Debt sustainability

The table below summarizes the annual cash flow available for debt service, and calculates implied debt capacity based on a range of interest rates and coverage ratios assuming an illustrative 35 year term

- Cash flow available for debt service incorporates (i) the payment of essential services, (ii) benefit of clawback revenues and (iii) a prudent contingency reserve
- In the Fiscal Plan summarized below, the cash flow after Measures but before Debt Service averages $787m per year during the period 2017 - 2026

Debt sustainability sensitivity analysis ($MM)

Fiscal year ending June 30 ($ in millions)	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	'17 - '26 total
Baseline Projections											
Revenues	$18,952	$17,511	$16,407	$16,434	$16,494	$16,590	$16,746	$16,953	$17,204	$17,509	$170,799
Expenses	(17,872)	(18,981)	(19,233)	(19,512)	(19,950)	(20,477)	(20,884)	(21,310)	(21,973)	(22,316)	(202,507)
Cash Flow Excl. Debt Service & Measures	**1,080**	**(1,470)**	**(2,826)**	**(3,077)**	**(3,456)**	**(3,886)**	**(4,139)**	**(4,357)**	**(4,769)**	**(4,808)**	**(31,708)**
Impact of Measures											
Revenue Measures	--	924	1,381	1,384	1,531	1,633	1,740	1,752	1,766	1,785	13,897
Expense Measures	--	951	2,012	2,415	2,983	3,156	3,255	3,357	3,724	3,830	25,683
Total Measures	**--**	**1,875**	**3,393**	**3,799**	**4,515**	**4,789**	**4,995**	**5,108**	**5,491**	**5,615**	**39,580**
Cash Flow Available for Debt Service	**$1,080**	**$404**	**$567**	**$722**	**$1,059**	**$903**	**$857**	**$751**	**$722**	**$808**	**$7,873**

Illustrative Sustainable Debt Capacity Sizing Analysis

		Sensitivity Analysis: Implied Debt Capacity at 10% Contingency								
Illustrative Cash Flow Available		**$700**	**$750**	**$800**	**$850**	**$900**	**$950**	**$1,000**	**$1,050**	**$1,100**
	3.5%	12,600	13,500	14,400	15,301	16,201	17,101	18,001	18,901	19,801
Sensitivity Analysis: PV Rate %	*4.0%*	11,759	12,599	13,439	14,278	15,118	15,958	16,798	17,638	18,478
	4.5%	11,000	11,786	12,572	13,358	14,143	14,929	15,715	16,501	17,286

		Sensitivity Analysis: Implied Debt Capacity at 4% PV Rate								
Illustrative Cash Flow Available		**$700**	**$750**	**$800**	**$850**	**$900**	**$950**	**$1,000**	**$1,050**	**$1,100**
	5.0%	12,412	13,299	14,185	15,072	15,958	16,845	17,731	18,618	19,505
Sensitivity Analysis: % Contingency	*10.0%*	11,759	12,599	13,439	14,278	15,118	15,958	16,798	17,638	18,478
	15.0%	11,105	11,899	12,692	13,485	14,278	15,072	15,865	16,658	17,451

VI. TSA LIQUIDITY

TSA LIQUIDITY

Weekly cash flow forecast through 2017FY

	Cash Flows Before Cliffs, Measures and Debt *(figures in $mm)*	Fcst - 1 3/17	Fcst - 2 3/24	Fcst - 3 3/31	Fcst - 4 4/7	Fcst - 5 4/14	Fcst - 6 4/21	Fcst - 7 4/28	Fcst - 8 5/5	Fcst - 9 5/12	Fcst - 10 5/19	Fcst - 11 5/26	Fcst - 12 6/2	Fcst - 13 6/9	Fcst - 14 6/16	Fcst - 15 6/23	Fcst - 16 6/30
1	General Collections	$349	$254	$58	$71	$66	$760	$186	$63	$66	$334	$60	$44	$59	$134	$520	$57
2	Sales and Use Tax	18	13	146	5	17	14	163	5	18	5	167	4	5	18	14	171
3	Excise Tax through Banco Popular	64	–	–	–	77	–	–	–	–	68	–	–	–	57	–	–
4	Rum Tax	–	10	–	–	–	11	–	–	–	18	–	–	–	–	22	–
5	Electronic Lottery	–	–	–	–	–	–	–	–	–	–	–	–	–	–	14	37
6	Subtotal	$432	$277	$204	$76	$161	$784	$349	$68	$84	$424	$227	$48	$64	$210	$570	$265
7	Employee/Judiciary Retirement Admin.	–	–	–	–	56	–	–	–	56	–	–	–	–	56	–	–
8	Teachers Retirement System	–	–	–	–	70	–	–	–	–	–	–	–	–	–	–	–
9	Retirement System Transfers	–	–	–	–	$127	–	–	–	$56	–	–	–	–	$56	–	–
10	Federal Funds	93	110	83	123	95	119	123	95	126	93	123	49	99	107	107	121
11	Other Inflows	9	–	11	–	–	9	11	–	–	–	–	11	–	–	–	11
12	Tax Revenue Anticipation Notes	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
13	**Total Inflows**	**$534**	**$388**	**$298**	**$199**	**$382**	**$912**	**$483**	**$163**	**$267**	**$517**	**$350**	**$108**	**$163**	**$373**	**$677**	**$397**
14	Payroll and Related Costs	(18)	(51)	(120)	(23)	(95)	(62)	(101)	(35)	(90)	(65)	(96)	(18)	(22)	(95)	(56)	(106)
15	Pension Benefits	–	–	(87)	–	(82)	–	(87)	–	(82)	–	(87)	–	–	(82)	–	(87)
16	Health Insurance Administration - ASES	(53)	(53)	(55)	(53)	(53)	(53)	(60)	(53)	(53)	(53)	(53)	(7)	(53)	(53)	(53)	(55)
17	University of Puerto Rico - UPR	(18)	(18)	(24)	(18)	(18)	(18)	(24)	(18)	(18)	(18)	(18)	(6)	–	(36)	(18)	(24)
18	Muni. Revenue Collection Center - CRIM	(21)	(8)	(8)	(8)	(8)	(8)	(8)	(8)	(8)	(8)	(8)	–	–	(15)	(8)	(26)
19	Highway Transportation Authority - HTA	–	–	(16)	–	–	–	(16)	–	(19)	–	–	(19)	–	–	(19)	(19)
20	Public Building Authority - PBA / AEP	(9)	(4)	(4)	(4)	(4)	(4)	(4)	(4)	(4)	(4)	–	(4)	(4)	(4)	(4)	(4)
21	Other Governmental Entities	(20)	(9)	(54)	25	(20)	(9)	(54)	25	(20)	(9)	(12)	(18)	(3)	(20)	(9)	(63)
22	Subtotal - Government Entity Transfers	($120)	($92)	($160)	($57)	($103)	($92)	($165)	($57)	($122)	($92)	($90)	($54)	($59)	($128)	($111)	($191)
23	Supplier Payments	(57)	(57)	(58)	(86)	(86)	(86)	(87)	(68)	(68)	(68)	(68)	(53)	(65)	(65)	(65)	(66)
24	Other Legislative Appropriations	(24)	(14)	(5)	(2)	–	(38)	(5)	(6)	(22)	(10)	(5)	(4)	–	(16)	(22)	(5)
25	Tax Refunds	(12)	(13)	(4)	(1)	(6)	(39)	(4)	(7)	(4)	(4)	(31)	(3)	(1)	(4)	(6)	(41)
26	Nutrition Assistance Program	(30)	(70)	(22)	(35)	(40)	(54)	(36)	(22)	(43)	(56)	(36)	(16)	(37)	(30)	(70)	(20)
27	Other Disbursements	–	–	–	–	–	–	–	–	–	–	–	(4)	–	–	–	(4)
28	Contingency	(16)	(16)	(16)	(29)	(29)	(29)	(29)	(29)	(29)	(29)	(29)	(23)	(23)	(23)	(23)	(23)
29	Tax Revenue Anticipation Notes	–	–	–	–	–	–	(152)	–	–	–	–	(137)	–	–	–	(135)
30	**Total Outflows**	**($277)**	**($313)**	**($472)**	**($233)**	**($440)**	**($399)**	**($665)**	**($223)**	**($459)**	**($324)**	**($442)**	**($312)**	**($208)**	**($443)**	**($353)**	**($676)**
31	**Net Cash Flows Excluding Debt Service, Fiscal Cliffs and Measures**	**$257**	**$75**	**($174)**	**($34)**	**($58)**	**$513**	**($182)**	**($60)**	**($193)**	**$194**	**($92)**	**($204)**	**($44)**	**($70)**	**$324**	**($279)**
32	Bank Cash Position, Beginning (a)	$319	$576	$650	$477	$442	$384	$897	$716	$655	$462	$656	$564	$360	$316	$246	$570
33	**Bank Cash Position, Ending (a)**	**$576**	**$650**	**$477**	**$442**	**$384**	**$897**	**$716**	**$655**	**$462**	**$656**	**$564**	**$360**	**$316**	**$246**	**$570**	**$291**

(a) Excludes clawback account.

TSA LIQUIDITY

Liquidity Principles for FY 2018

- No external short-term financing
- Rollout of Disbursement Authorization Group in order to enforce priority of payments through defined critical services (see Section VII)
- Consolidate dispersed treasury functions and put in place oversight over accounts not centrally managed
- Refine and regularly update 13 week cash analysis with detailed forecasting of cash receipts and disbursements
- Provide detailed daily performance projections, results, and variances

1 Cash management authority is granted to AAFAF under Act 5-2017 and other relevant legislation

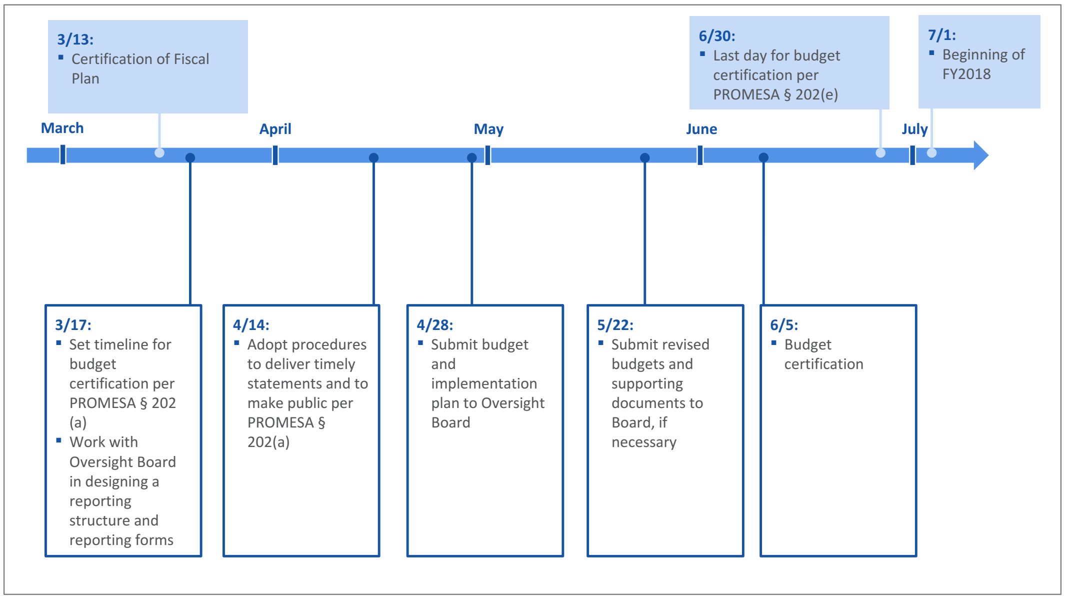
VII. FINANCIAL CONTROL REFORM

Current state of financial controls

- Cash is not centrally managed
  - No central office has visibility across all spending
  - Procurement agencies do not actively enforce terms and specifications
  - Limited coordinated effort to eliminate major cash outlays
  - Limited sweep of cash into general fund accounts
  - Cash disbursements is a manual and subjective process handled at Hacienda
  - No formal structure for reporting and release of audited financials
- Target is to improve level of detail on forecasting and specificity around assumptions
  - "Top-down" approach, based on prior year's Budget
  - Bank-to-book reconciliations are not often prepared in a timely manner
  - No tracking mechanisms exist to measure intra-year actual expenditures vs. budget on an accrual basis

FINANCIAL CONTROLS

Budget certification per PROMESA § 202



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FINANCIAL CONTROLS

Quarterly budget compliance process per PROMESA § 203

Quarterly Action	PROMESA section	Description	Proposed dates (mm/dd/yy)
Reporting[1]	§ 203 (a)	Governor to submit a report describing: (1) the actual cash revenues, expenditures, and flows and (2) any other information requested by the Board	Q1: 10/15/17[1] Q2: 1/16/18 Q3: 4/16/18 Q4: 7/16/18
External auditing	§ 203 (b)	Oversight Board to communicate the result of external auditing report to the government and identify any inconsistencies with the projected revenues, expenditures, or cash flows set forth in the certified Budget for such quarter	Q1: 11/10/17 Q2: 2/12/18 Q3: 5/10/18 Q4: 8/10/18
Correction of variance	§ 203 (b)	Government to provide additional information regarding any inconsistencies with the certified budget and implement remedial action to correct variances	Q1: 11/20/17 Q2: 2/20/18 Q3: 5/21/18 Q4: 8/20/18
Certification of variance / or Budget reductions by Board	§ 203 (c) and (d)	Board to certify that the government is at variance with the applicable certified Budget, and that the Government has initiated such measures as the Board considers sufficient to correct it If the variances are not corrected, the Board shall make appropriate reductions in nondebt expenditures and may institute automatic hiring freezes in instrumentalities and prohibit them from entering in any contract in excess of $100,000	Q1: 12/11/17 Q2: 3/12/18 Q3: 6/11/18 Q4: 9/10/18
Termination of budget reductions	§ 203 (e)	The Board should decide whether the government or instrumentality has made the appropriate measures to reduce expenditures or increase revenues and cancel the reductions	Ongoing

1 Per PROMESA, these dates must be 15 days after end of each quarter

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FINANCIAL CONTROLS

Budget and Forecasting process

Define a timeline for each quarter's budget	▪ Certification process must adhere to PROMESA requirements ▪ Should include, but not be limited to: – Certification process according to PROMESA requirements – Reporting, external auditing, and variance certifications
Set guiding principles for budget and forecasting	▪ Budget should be prepared… – Within the **confines of the overall fiscal plan** – As a **positive cash balance** with sufficient safety margin, due to lack of access to capital markets
Set, update, and track targets every quarter	▪ Use performance metrics, e.g.,: – Status? On track / Delayed / Completed – Reached target? – Above / below past instances? ▪ Implement measures to correct variances from budget

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FINANCIAL CONTROLS

Disbursement process

Define disbursement process	▪ Set guidelines and principles ▪ Work to match budget to disbursement authorizations ▪ Identify an effective, centralized, and time-sensitive disbursement process that involves the adequate authorities – Incorporate a mechanism that confirms alignment between revenues and expenses
Implement a centralized disbursement digital database	▪ Centralize into a single Treasury account with a corresponding database ▪ Update and review periodically ▪ Set a minimum available liquidity threshold and an alert-system
Set, update, and track metrics every quarter	▪ Establish preventive measures ▪ Implement detective procedures to correct problems before they arise ▪ Design a process to correct variances from budget mid-year

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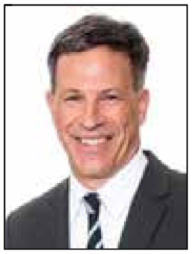
Disarming Puerto Rico's Pension Time Bomb

By **Richard Cooper, Luke Barefoot, Daniel Soltman and Antonio Pietrantoni, Cleary Gottlieb Steen & Hamilton LLP**


Richard Cooper


Luke Barefoot

Law360, New York (April 19, 2017, 3:58 PM EDT) -- With the long-delayed commencement of negotiations between the new government of Puerto Rico and its financial creditors finally underway, and the expiration of the existing stay on creditor actions looming, much of the financial press' attention over the next several weeks will undoubtedly be focused on whether the government of Puerto Rico can reach an out-of-court settlement with its financial creditors. One issue that has received less attention in the financial press, but which is of paramount importance to a financially secure local economy, is the challenge Puerto Rico confronts in reforming its multiple pension systems. Like many other state and municipal governments, Puerto Rico faces difficult choices regarding how to address the substantial cost and massive underfunding of its public pension systems, calculated by analysts to exceed $48 billion.[1] In the recently certified fiscal plan, the federal oversight board has offered guidance toward both reducing the liabilities of the pension systems and adding structural reforms to improve its ongoing funding. In particular, the oversight board has suggested progressive reductions of aggregate pension outlays by more than 10 percent by fiscal year 2020, funding existing benefits on a pay-go basis and moving existing and all new active members into defined contribution accounts that segregate and protect contributions to pay future benefits.

While the current administration has expressed reservations regarding these suggested actions, it has agreed to work with the oversight board on a plan to implement pension reform by June 30 of this year. This article identifies the two legal mechanisms available to the commonwealth government to reform its public pension systems — namely, legislative action or implementation of reforms through one or more Title III proceeding(s) under the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA). Focusing on the central government's Employee Retirement System (ERS), which is the largest of the commonwealth's public pension systems, we analyze the key considerations that will undoubtedly influence the decision of how to proceed. Not surprisingly, the more likely that a Title III proceeding will be needed to adjust the commonwealth's tax-supported debt, the more inevitable it is that pension reform will also come from one or more Title III processes rather than through legislative measures.

ERS, Historical Reform Efforts and Pensions Under Puerto Rico's Constitution

ERS is a statutory trust created to provide pension and other post-employment benefits (OPEB) to former employees of the commonwealth itself, as well as to former employees of more than 200 other governmental employers, including central government agencies, as well as public corporations and municipalities.[2] Aside from the proceeds of bond issuances, ERS is funded primarily by contributions from participating employers (the "employer contributions") and participating employees (the "employee contributions"). Nevertheless, ERS is catastrophically underfunded, and its net assets were exhausted as of fiscal year 2014-2015.[3]

To be sure, the commonwealth has the ability to enact legislative measures to reform its pension systems. Indeed, like many other governments and municipalities facing fiscal difficulties relating to pension obligations,[4] the commonwealth has previously undertaken various reform measures aimed at increasing the employer and employee contributions, most notably under the previous García Padilla administration. However, such reforms met with mixed results. The growing fiscal crisis gripping the commonwealth made it difficult to marshal additional financial resources to address years of underfunding of the public pensions. Further, judicial decisions held that Puerto Rico's Constitution limits the Legislature's ability to impair vested pension obligations.[5]

Under commonwealth law, pension obligations are generally understood to be contractual obligations that can only be impaired prior to the beneficiary's retirement (if such impairment is reasonable and necessary to further the actuarial solvency of the pension system), as opposed to after retirement.[6] Case law since the onset of Puerto Rico's fiscal crisis has generally upheld this principle. In Trinidad Hernández v. Estado Libre Asociado, 188 D.P.R. 828 (2013), the Supreme Court of Puerto Rico (PRSC) considered the constitutionality, under the contracts clause of Puerto Rico's Constitution, of 2013 reforms to ERS that increased both the employee contributions and the minimum retirement age for participants. In upholding the constitutionality of such reforms, the PRSC found the reforms reasonable in light of the compelling need to (1) guarantee the survival of ERS and prevent credit downgrades for the commonwealth and its instrumentalities and (2) address the fiscal crisis.

However, only several months later, in Asociación de Maestros v. Sistema de Retiro, 190 D.P.R. 854 (2014), the same court considered, also under the contracts clause of Puerto Rico's Constitution, the legality of 2014 reforms to the Teachers' Retirement System (TRS) that largely tracked the analogous reforms to ERS described above, and reached an opposite conclusion. In finding the TRS reforms unconstitutional, the PRSC focused on evidence that the proposed reforms would have in fact incentivized early retirement to retain benefits, thus accelerating the insolvency of the TRS. Accordingly, the PRSC found that the measures were not reasonable and necessary to further the solvency of the TRS.

Regardless of how one interprets the differing PRSC decisions on ERS and TRS reforms, what appears clear is that, as a matter of commonwealth law, while the Legislature can reasonably and necessarily alter the rights and benefits of active employees, it faces significant barriers before it can impair vested benefits for current retirees.

The Commonwealth's Options, Chapter 9 Precedents and Expected Treatment Under Title III

Against the backdrop of PROMESA, the commonwealth is effectively left with two options for modifying its public pensions in accordance with the approved fiscal plan: (1) through legislative measures or (2) through a Title III proceeding under PROMESA.[7] While legislative reforms might be an option, and theoretically could be crafted to adjust each of the island's public pensions systems in one measure, given recent decisions by the PRSC, any such measures will be susceptible to challenge under commonwealth law and will be limited in adjusting vested pension benefits. Instead, the commonwealth and the oversight board may consider a Title III proceeding a more attractive option given the ability of a Title III court to exercise the authority bestowed upon it by the federal Constitution's bankruptcy power to modify even vested benefits. Moreover, there may be strategic reasons unrelated to pension reform that favor effecting pension adjustments through one or more Title III proceedings, not the least of which is the possibility of identifying and securing the support of an impaired class of creditors to assist it in imposing an adjustment plan through the cramdown powers of Section 1129(b) of the Bankruptcy Code.[8]

Historical Treatment of Pensions Under Chapter 9

Although PROMESA is untested, state municipalities have long used Chapter 9 of the

Bankruptcy Code to adjust their debts, including pension obligations, in a way that they could not outside of bankruptcy. Importantly, state constitutional protections analogous to those under Puerto Rico's Constitution are generally understood (both by scholars and as interpreted by courts) to be unenforceable in Chapter 9 proceedings pursuant to the federal supremacy clause. The issue of whether pensions can be impaired in Chapter 9 proceedings irrespective of local law protections has been squarely before courts in two recent Chapter 9 cases.

First, in Detroit's Chapter 9 bankruptcy, the court considered whether the contracts clauses of the U.S. and Michigan Constitutions, as well as an additional prohibition against impairing pension benefits under the Michigan Constitution, prevented the impairment of pension benefits as part of a plan of adjustment. In holding that pensions could be impaired in Detroit's Chapter 9 bankruptcy, the court stated emphatically that "[t]he Bankruptcy Clause of the United States Constitution, and the bankruptcy code enacted pursuant thereto, explicitly empower the bankruptcy court to impair contracts and to impair contractual rights relating to accrued vested pension benefits." In re City of Detroit, 504 B.R. 97, 150 (Bankr. E.D. Mich. 2013). Ultimately, notwithstanding the ability to impair its pension claims, Detroit provided substantial recoveries on its pension claims (in substantial part aided by the so-called "grand bargain," which involved contributions made to the system by private third parties). Pensioners who were paid from the general pension system received 95.5 percent of their pensions (though their cost of living adjustment (COLA) was eliminated) and pensioners who were paid from the police and fire pension fund received 100 percent of their pensions (while keeping 45 percent of their COLA). However, both sets of retirees experienced substantial reductions to OPEB.

Second, and more recently, pension impairment issues arose in Stockton, California's Chapter 9 bankruptcy, albeit in a slightly different context. In Stockton's bankruptcy, the California Public Employees Retirement System (CalPERS) argued that its contract with Stockton could not be rejected or impaired, pursuant to protections under California state law. Though raised in a different procedural posture than Detroit, the California court similarly held that the CalPERS contract could be impaired in Stockton's Chapter 9 proceeding, noting that "[t]o honor [prohibition on impairment of CalPERS contracts] would amount to permitting a state to usurp the exclusive power of Congress to legislate uniform laws on the subject of bankruptcy." In re City of Stockton, 526 B.R. 35, 57 (Bankr. E.D. Cal. 2015). Notwithstanding the court's holding in Stockton, the city ultimately chose to assume the CalPERS contract and not impair its pension claims (although as noted below, Stockton retirees also experienced substantial OPEB cuts).

Generally speaking, the approach in Stockton and Detroit of providing high pension recoveries while substantially impairing other claims (including OPEB) is typical in recent large Chapter 9 proceedings.[9] A chart showing pension and OPEB recoveries (and approximate prepetition pension funding amounts) in a few recent major Chapter 9 bankruptcies is set forth here:

	Prepetition pension funding amount	Pension recovery in bankruptcy	Retiree OPEB (i.e., health care) recovery in bankruptcy
	85-90 percent	100 percent	1 percent

Stockton, California			
Detroit (Police & Fire)	89.3 percent	100 percent of pension; 45 percent of COLA	10-13 percent
Detroit (General)	70 percent	95.5 percent of pension; 0 percent COLA	1 percent
San Bernardino, Calif.	74 percent	100 percent	1 percent

Likely Issues to Arise on the Treatment of Public Pensions in a Title III Proceeding

Generally speaking, the analysis of pension and OPEB claims in a Title III proceeding under PROMESA is the same as under Chapter 9, with one notable exception. PROMESA provides that any approved fiscal plan must, inter alia, "provide adequate funding for public pension systems" and in turn provides that any approved plan of adjustment must be "consistent with the applicable Fiscal Plan certified by the Oversight Board." See PROMESA §§ 201(b)(1)(C), 314(b)(7).[10] The text and legislative record regarding this language creates some ambiguity over the meaning of "adequate funding for public pension systems," but given the oversight board's certification of the commonwealth's fiscal plan and its suggestions to reform the government's public pension systems, the oversight board seems to have interpreted "adequate funding" to simply mean that the budget must reflect adequate funding for the pensions on the terms set forth in the approved fiscal plan. Notwithstanding that PROMESA states that "[t]here shall be no jurisdiction in any United States district court to review challenges to the Oversight Board's certification determinations under this Act," see PROMESA § 106(e), certain representatives of pensioners have sought to challenge the fiscal plan as certified on the basis of its treatment of pension claims.[11]

The existing clear authority in various Chapter 9 cases overriding state constitutional limitations to adjust pension obligations will clearly be an important factor when the commonwealth considers how to effect pension reform in Puerto Rico. However, using Title III does have some drawbacks. First, it presupposes the use of Title III itself, something that both the oversight board and the current administration in San Juan have stated they wish to avoid if at all possible. Second, it seems clear that not all pension systems could be modified as part of one proceeding. For example, PREPA's pension plan, which is a defined benefit plan and provides greater benefits to retirees than other public pension plans in Puerto Rico, could only be modified in Title III as part of a Title III proceeding for PREPA (something the administration and PREPA creditors have steadfastly sought to avoid).[12] Third, the practical ability to modify pension obligations as part of a Title III proceeding will depend upon the facts and circumstances of each Title III proceeding and thus may be difficult to predict or control. Ultimately, however, as it seems likely that the commonwealth will need to resort to Title III to address its tax-supported debt,[13] we expect that the commonwealth will employ Title III to adjust the pension obligations of the central government rather than use legislative channels.

Adjusting ERS Obligations as Part of a Title III Plan

What would a Title III proceeding seeking to modify ERS pension obligations look like? Although it is clear that ERS pension obligations could be modified in a Title III proceeding, difficult strategic choices and various complexities will invariably arise.

First, as a threshold matter, the oversight board and the commonwealth will need to determine whether to modify ERS pension obligations as part of a stand-alone ERS Title III proceeding or as part of a commonwealth-wide plan to address all tax-supported debt and the pension and other obligations of all central government public pension systems (or at least those included in the certified fiscal plan). The fiscal plan that has been certified by the oversight board would seem to permit either choice. However, given the limited number of potential classes of creditors at ERS, the oversight board and the commonwealth may determine they are better off seeking to adjust ERS pension obligations in a jointly administered proceeding to adjust central government liabilities and functions. Because ERS does not itself have operations that would give rise to a broad swath of trade, employee and other creditors, whose claims could represent an impaired accepting class at ERS itself, the commonwealth may seek to look to creditors of other issuers within a joint plan to find an impaired accepting class to permit a nonconsensual cramdown under Section 1129(b). The oversight board and the commonwealth could, as part of a joint plan, seek to find creditors willing to be an impaired accepting class among creditors of other issuers whose debt is reflected in the certified commonwealth fiscal plan. In addition, as not all courts have held that such "jointly administered" creditor votes at another debtor qualify as an impaired accepting class, the commonwealth may seek to substantively consolidate ERS with other commonwealth debtors. The availability of these remedies will not only be hotly contested, but will put pressure on undersecured ERS bondholders to avoid a cramdown scenario.[14]

Second, complicated issues could arise with respect to ERS' ability to (and the extent to which it can) impair its bondholders in a Title III proceeding (and thus divert more recoveries to pension claimants). While ERS bondholders may have a lien on the employer contributions and certain other collateral,[15] ultimately the extent to which ERS bondholders can be impaired will be a function of whether (to the extent they are secured at all) ERS bondholders are secured through a statutory lien or their collateral constitutes special revenues. Indeed, as the statutory language authorizing the ERS to issue bonds does not contain any lien-creating language, very good arguments exist that ERS bondholders do not have a statutory lien. See 3 L.P.R.A. § 779(d).

Moreover, although a slightly more difficult question on the margins, strong arguments also exist that the employer contributions are not special revenues, because the employer contributions are not system or project revenues of the ERS in the same sense that, for example, toll revenues are of the Puerto Rico Highways and Transportation Authority. See 11 U.S.C. § 902(2). While ERS operates a "pension system," it is difficult to argue this constitutes the type of system "primarily used or intended to be used primarily ... to provide ... services" that Congress intended to fall within the scope of Section 902(2). If ERS bondholders have neither a statutory lien nor special revenues collateral, the liens of ERS bondholders will not continue post-filing, and ERS bondholders may be more inclined to reach an overall consensual deal in order to avoid having the unsecured portion of their claims substantially impaired.[16]

Third, ERS' status as a trust could also present complicated issues if ERS does not file for a Title III proceeding prior to the time that the Title IV stay under PROMESA expires (May 1, 2017 unless extended).[17] Under Puerto Rico trust law, the ERS trustee can bring actions against employers to enforce the terms of the trust, and where the ERS trustee does not do so, employees may have such rights as well under the terms of the applicable collective bargaining agreements.[18] If a gap exists between the end of the Title IV stay and the beginning of the Title III stay, there may be a proliferation of lawsuits against various defendants, some of whom may already be or ultimately will be Title III debtors, and some of whom may not.[19]

Fourth, as a general consideration, the complications in any of the scenarios discussed above may be further exacerbated if a single retiree worked for multiple employers (some of which may be ERS contributors, some of which may be Title III debtors, and others of which may not). The multiple employer issue may be particularly complicated at the plan confirmation stage if releases cannot be extended to nondebtor third parties. Indeed, bankruptcy courts have split on whether and under what circumstances nondebtors can be released as part of a plan of reorganization in the Chapter 11 context, and even those circuits that have restricted third-party releases in Chapter 11 plans acknowledge that the analysis differs under Chapter 9. [20] We are not aware of any Chapter 9 court to have considered this issue in the context of pension beneficiaries' claims against municipal employers, and inclusion of such release in a proposed plan of adjustment will certainly provide fodder for litigation.

Conclusion

The more likely it is that a Title III proceeding will take place in order to adjust the commonwealth's tax-supported debt, the more likely it is that Title III will also be the mechanism by which Puerto Rico will adjust its public pension obligations as provided for in the certified fiscal plan. Though Puerto Rico's public pension systems are exceedingly complex and a Title III adjustment to Puerto Rico's public pensions will raise novel legal issues, Title III is likely the best option available to the commonwealth to adjust its public pension obligations as part of the larger effort to address its current fiscal crisis. Through a Title III proceeding, pension and other retirement benefits (vested and unvested) can be adjusted to reflect the commonwealth's economic realities, and appropriate structural changes can be made to pension systems to ensure their continued viability. It may also be possible as part of a Title III adjustment plan to identify assets that can be contributed to public pension systems in order to improve their long-term viability, such as interests in public entities that are expected to be privatized (or even to issue growth bonds or contingent value rights to such systems that could ultimately help fund future incremental benefits). Further, there may be strategic reasons to seek to impair pension benefits as part of a Title III proceeding as it may provide the commonwealth and the oversight board with leverage over certain financial creditors as it negotiates a broader Title III adjustment plan. Ultimately, how Puerto Rico's pension crisis is addressed may have wider repercussions as well, serving as a possible blueprint to other municipalities that may themselves be struggling with similar fiscal reform and pension challenges. Whatever path Puerto Rico takes, you can be sure that other municipalities will be paying close attention.

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DISCLOSURE: Cleary Gottlieb assisted the commonwealth of Puerto Rico and its instrumentalities with their financial challenges prior to the recent change in government. The firm also currently represents the Government Development Bank

for Puerto Rico on a legacy matter.

This article is the fourth installment of a series on the Puerto Rico debt crisis. Read the first article here, the second article here and the third article here.

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[1] Figure is in USD and includes net estimated pension liabilities as of June 30, 2015, for the three public pensions included in the fiscal plan: the Employee Retirement System (ERS), the Teachers' Retirement System (TRS) and the Judiciary Retirement System (JRS). See Government Development Bank for Puerto Rico, Commonwealth of Puerto Rico Financial Information and Operating Data Report at 17 (Dec. 18, 2016). Because the commonwealth report has not been updated, more recent figures as calculated by the commonwealth and its actuaries are not available.

[2] As noted above, the approved fiscal plan includes three of Puerto Rico's public pension systems: ERS, TRS and JRS. The commonwealth also has two other public retirement systems — the Electric and Power Authority Retirement System (for PREPA) and the University of Puerto Rico Retirement System. To date, the restructuring support agreement negotiated by PREPA and its financial creditors has not required modifications to PREPA's pension plan, which is significantly underfunded (though substantially less underfunded than the ERS).

[3] See Milliman Inc., Puerto Rico Government Employees Retirement System: Actuarial Valuation Report at 14 (June 30, 2014).

[4] Growing concerns over pension obligations are not unique to the commonwealth. Over the last several years, state courts have weighed in on proposed pension reforms, sometimes with different results. For example, the New Jersey Supreme Court has twice upheld proposed pension reforms that impair benefits. See Burgos v. State of New Jersey, 222 N.J. 175 (2015) (state not contractually obligated to fund pensions on legislatively established contribution schedule because promise to do so was in violation of the New Jersey Constitution's debt limitation and appropriations clause); Berg v. Christie, 225 N.J. 245 (2016) (suspension of COLAs did not constitute contracts clause violation because the state Legislature did not unequivocally create right to COLAs). In contrast, the Supreme Court of Illinois recently held that certain proposed pension reforms were unconstitutional based on Illinois state constitutional protections for pensions. See Jones v. Mun. Emps.' Annuity & Benefit Fund, 2016 Ill. 119618 (2016).

[5] Following the appointment of the oversight board, the ability to enact legislative measures to address the commonwealth's public pensions is now subject to oversight board approval. See PROMESA § 204(a).

[6] See Bayron Toro v. Serra, No. RE-85-568, 1987 WL 448265, 19 P.R. Offic. Trans. 646, 660 (P.R. Nov. 18, 1987) ("When the employee retires, once he has met all retirement conditions, his pension is not subject to changes or reductions. However, prior to the employee's retirement, the government may amend the terms and conditions of the retirement, if such amendments are reasonable and further seek the actuarial solvency of the system.") (internal citations omitted).

[7] A Title VI proceeding under PROMESA could not be used to adjust pension obligations, because such pension obligations are not "bond claims." In addition, while a consensual amendment with pensioners is technically an option, it may be logistically impractical given practical collective action obstacles and the unlikelihood that pensioners would agree to voluntary cuts.

[8] See Richard J. Cooper, Luke A. Barefoot, Jessica E. McBride and Antonio J. Pietrantoni,

"Why Puerto Rico Will Likely Rely On PROMESA Title III," Law360 (Mar. 1, 2017).

[9] One notable exception to the general trend of high pension recoveries is Central Falls, Rhode Island's bankruptcy, in which the majority of pensioners recovered no more than 45 percent of their claims, while bondholders were paid 100 percent. However, Central Falls is generally understood to be an outlier for a variety of reasons, see David A. Skeel Jr., "What is a Lien? Lessons from Municipal Bankruptcy" at 676, 687-88, Penn Law Faculty Scholarship Paper 1387 (2015), including that its retiree class included less than sixty (60) people.

[10] Given existing case law from the PRSC, pensioners may also argue that the requirement that any approved fiscal plan "respect the relative lawful priorities ... in the constitution, other laws, or agreements ... in effect prior to the date of enactment of this Act" requires better treatment for pensioners relative to other constituencies. See PROMESA § 201(b)(1)(N).

[11] See Servidores Públicos Unidos de P.R. v. Fin. Oversight and Mgmt. Bd., No. 17-1483 (D.P.R. 2017), where plaintiffs have sought a temporary restraining order and preliminary injunction against, inter alia, implementation of the certified fiscal plan. In support of their motion, plaintiffs lodged contracts clause, takings and due process claims under both the U.S. and Puerto Rico Constitutions, and also called attention to alleged procedural illegalities in connection with the certification of the fiscal plan. As of the time of publication of this article, such requests for injunctive relief have been denied. Neither the moving papers nor the court's orders to date address the jurisdictional issue presented by § 106(e) of PROMESA.

[12] As with ERS, PREPA's pensions could also be modified consensually (which would require cooperation of the union appointees to the PREPA retirement system board) or legislatively (which would subject any modifications to the same legal challenges discussed elsewhere herein with respect to pension reform and which would require approval of the Legislature that has historically resisted such changes).

[13] See Cooper, Barefoot, McBride & Pietrantoni, supra note 8.

[14] Lack of third-party creditors means that TRS and JRS would also likely be resolved as part of a commonwealth-wide plan.

[15] Though the official statements for the ERS bonds provide that "[t]he Bonds are limited, non-recourse obligations of the System, payable solely from and secured solely by a pledge of Employer Contributions ..." we do not here take a view on the existence or validity of a lien as a matter of Puerto Rico law.

[16] Indeed, to the extent that ERS bondholders have neither a statutory lien nor collateral that is special revenues, the current arrangements in place between ERS and certain of its bondholders, pursuant to which ERS has agreed to use segregated employer contributions to make ERS bond interest payments, may change if ERS files a Title III proceeding.

[17] The original stay termination deadline was Feb. 15, 2017, and was extended 75 days (until May 1, 2017) on Jan. 28, 2017. As PROMESA does not provide further options for extensions of the Title IV stay, absent legislative change, an extension beyond May 1, 2017, is unlikely. See PROMESA § 405(d).

[18] Applicable collective bargaining agreements may also provide individual retirees with independent rights to pursue claims for benefits.

[19] Though in some circumstances the Bankruptcy Code's automatic stay may be extended to nondebtors (e.g., to directors and officers so as to minimize distractions or to avoid collateral estoppel for co-liable third parties), in this context it is unlikely that the same arguments would exist for extending the stay to employers not in Title III proceedings.

[20] A split of authority exists as to whether and under what circumstances nondebtor releases are permissible as part of a Chapter 11 plan of reorganization. Compare, e.g., In re Vitro SAB

de CV, 701 F.3d 1031, 1061(5th Cir. 2012) (noting that "prior rulings from [the Fifth Circuit] ... seem broadly to foreclose non-consensual non-debtor releases and permanent injunctions") (internal citations and quotations omitted), with, e.g., In re Metromedia Fiber Network Inc., 416 F.3d 136, 141 (2d Cir. 2005) (noting that "[w]e have previously held that in bankruptcy cases, a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan") (internal citations and quotations omitted). We are not aware of any cases in the First Circuit to address the issue, nor have those courts that restrict third-party releases ruled on the issue in the unique context of Chapter 9. See, e.g., Deocampo v. Potts, 836 F.3d 1134, 1143-44 (9th Cir. 2016) (declining to reach the unsettled issue of third-party releases in a Chapter 9 plan of adjustment); In re City of Detroit, 524 B.R. 147, 265 (Bankr. E.D. Mich. 2014) (approving releases of the state of Michigan and related nondebtor entities as necessary to implementation of the plan of adjustment).

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Issues To Expect In A Title III Puerto Rico Restructuring

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Law360, New York (March 8, 2017, 11:07 AM EST) -- Given the likelihood of a Title III proceeding under the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) for the commonwealth and certain of its instrumentalities in the near future,[1] we thought it useful to outline some, but by no means all, of the key issues that are likely to be raised. The resolution of these issues is impossible to predict today in light of the unprecedented nature of Title III, the departures that PROMESA makes from the statutory text and structure of Chapter 9, and the unique history and legal framework of the commonwealth's debt obligations. However, one thing is certain — the resolution of these issues will significantly affect creditor recoveries, and the nature of the commonwealth's future debt burden, no matter how they are resolved.

Validity of Debt

A threshold question in any Title III proceeding is whether certain debt issuances were constitutionally valid, given the various restrictions in the Puerto Rico Constitution that limit the amount, duration and purposes of certain debt. These issues — which are distinct from the questions as to whether certain revenue streams should be "clawed back" from various instrumentalities to satisfy general obligation debt — are not only of interest to every resident of Puerto Rico, but will be at the core of the strategy of certain creditor groups in any Title III proceeding.

The commonwealth constitution precludes the issuance of debt backed by the commonwealth's full faith and credit if it would cause future annual debt service to exceed 15 percent of internal revenues averaged over the prior two years (plus amounts paid on account of guaranteed obligations). The method of calculation of this 15 percent cap, however, has not been judicially tested, and the commonwealth does not include every revenue stream that flows through its general fund in calculating the cap. As part of a Title

III proceeding, creditors or parties in interest may argue the cap was not adhered to, and/or that certain debt obligations not currently viewed as general obligation debt should be subject to the debt cap calculation. Creditors could also bring alter-ego allegations against issuers such as the Puerto Rico Sales Tax Financing Corporation (COFINA), seeking to include their debt in the calculated limit, which, if successful, could raise questions regarding not only such issuances but also the validity of certain recent general obligation bond issuances.

The commonwealth constitution also restricts issuance of new commonwealth guarantees. However, in contrast to the process for issuance of new general obligation bonds, the debt cap for guarantees does not take into account future maximum annual guaranteed debt service, and does not create a dollar limit for new guaranteed debt. As a textual matter, if the commonwealth can issue a single dollar of new general obligation debt, it can guarantee an unlimited amount of debt. On this point, creditors or parties in interest may seek to reclassify guaranteed obligations for which there is no independent source of payment as direct debt of the commonwealth. For example, where an issuer such as the Puerto Rico Public Buildings Authority (PBA) is entirely reliant on general fund revenues to fund debt service, then its scheduled debt payments, as well as guaranteed obligations, could arguably be deemed direct obligations of the commonwealth, again raising questions regarding not only such issuances but also the validity of recent general obligation issuances.[2]

Finally, the commonwealth constitution includes limitations on maturity, generally limiting direct obligations backed by the full faith, credit and taxing power of the commonwealth to a 30-year maximum maturity (with certain exceptions). Creditors may argue that some direct general obligation issuances may have, practically or facially, violated this limit. On this point, the pre-audit survey report issued by the recently disbanded Puerto Rico Commission for the Comprehensive Audit of Public Credit concluded that the commonwealth used a “scoop and toss” strategy to refinance maturing debt, refinancing maturing debt with new debt, “effectively creating maturities more than 30 years from initial issuances.”[3] The same report noted that certain capital appreciation bonds have facial maturities of greater than 30 years.

Whether or not there are merits to any of these potential challenges, the stakes could not be higher for those holding the challenged debt. Analogous case law on these types of challenges suggests both that (a) there are no time limits on challenges to the validity of debt, and (b) if held invalid, the principal amount of the debt is simply not subject to recovery.

Prospects for Substantive Consolidation of the Commonwealth Issuers or Cramdown Based on a Joint Plan of Adjustment for All Commonwealth Debt

If the validity of various debt issuances is likely to be a threshold substantive issue raised in a Title III proceeding, then the threshold procedural issue is whether a Title III court would substantively consolidate separate commonwealth issuers, or whether a joint plan of adjustment of commonwealth debt can be confirmed based on the approval of one impaired class of creditors of a single commonwealth debtor.[4] The resolution of these issues will not only have far-reaching consequences on the terms and form of any plan of adjustment, but also on the degree of leverage the commonwealth will wield in seeking a resolution of its financial challenges.

At the outset, there is limited First Circuit precedent on the standards for substantive consolidation, particularly for complex entities with publicly issued debt, such as the commonwealth issuers.[5] However, courts generally consider the extent to which creditors relied on the distinct identities of the debtors, or whether their affairs are so intertangled that an effort to segregate them would effectively harm all creditors.

The obligations of the commonwealth issuers are no doubt significantly interrelated. Not only do all commonwealth issuers ultimately rely on a common tax base for their revenues, but the commonwealth's general fund includes substantial appropriations for a number of other instrumentalities, which enables them to make debt service payments. In turn, many of those appropriations are expressly subject to "clawback" to the general fund if revenues prove insufficient, which suggests not only a practical but a legal interrelationship. At the same time, creditors may claim that they relied on the separate identities of the commonwealth issuers, and often received opinions concerning their separateness in connection with debt issuances. Separate accounting has also generally been maintained.

The availability of substantive consolidation is further complicated by the text of PROMESA itself. On the one hand, Title III incorporates Section 105 of the Bankruptcy Code, on which courts generally rely to permit substantive consolidation. In addition, PROMESA authorizes both joint plans and the novel concept of "joint petitions," which does not have precedent in Chapter 11 or Chapter 9 practice. Finally, PROMESA expressly permits the commonwealth to adopt a fiscal plan that incorporates the fiscal plans of other instrumentalities, and it is possible that the oversight board, whose determinations are nonreviewable (as discussed below), may approve a fiscal plan that effectively treats the commonwealth and other commonwealth issuers as substantively consolidated.

However, PROMESA also includes language providing that “nothing in this title shall be construed as authorizing substantive consolidation of the cases of affiliated debtors.” Opponents of substantive consolidation will certainly argue that this language evidences an intent not to authorize consolidation. That said, even this disclaimer language provides fodder for litigation, as Section 105 is not itself contained in PROMESA’s title, and thus arguably falls outside of the scope of the proviso.

Even if substantive consolidation proves unavailable, the oversight board or the commonwealth may still seek to confirm a joint plan of adjustment for the commonwealth and related issuers of commonwealth debt by using PROMESA’s incorporated cramdown power, arguing that it can be imposed on all holders of commonwealth debt so long as one impaired class of creditors of a single commonwealth issuer votes to approve the plan. Specifically, PROMESA incorporates Section 1129(a)(10) of the Bankruptcy Code, which requires, among other things, that at least one impaired class of creditors has voted to accept the plan. Courts are divided on whether this must be determined on a debtor-by-debtor basis, or whether one accepting impaired creditor class within a joint plan suffices for all affiliated debtors.

While no courts within the First Circuit have addressed this issue, many commonwealth issuers have no operations and thus are unlikely to have many classes of claims. For a debtor with numerous types of obligations — financial indebtedness, employee claims, vendor claims, etc. — there are simply more available classes that can provide the requisite acceptance to satisfy Section 1129(a)(10). By contrast, where a debtor is a special-purpose debt-issuing entity, without meaningful operations, it may only have a single class of claims to vote on the plan. The ability to nonetheless cram down a plan over the votes of that creditor class, based on acceptance of the joint plan by other issuers’ creditors, would provide the commonwealth with tremendous leverage. Particularly given the difficulty in negotiating a plan that satisfies all creditor constituencies, and the absence of appellate precedent on point, a Title III court in a commonwealth proceeding will likely be forced to confront this open question.

All Liens Are Not Created Equal: Statutory Liens and Special Revenues

One of the issues that will perhaps most affect the treatment and negotiating leverage of various creditors in the ensuing Title III process is the determination of the type of security interest and collateral by which their bonds are secured. In particular, whether a creditor has a valid lien under local law, whether that lien constitutes a statutory lien, and whether that lien is secured by special revenues are key issues that will determine the pecking order in any plan of adjustment. Holders of bonds secured by statutory liens or secured by special revenues are entitled to greatly enhanced treatment. Specifically, bonds secured by statutory liens will continue to have their liens attach to revenues and property acquired by the debtor after the petition date (unlike debt secured merely by contractual liens). Holders of special revenue bonds will also see their liens attach to post-petition property, and will not be barred by the automatic stay from securing or collecting such revenues, subject only to the payment of the debtor's "necessary operating expenses."[6]

Given the extensive variety of debt instruments and pledged property supporting the commonwealth issuer's various obligations and the paucity of case law articulating the relevant standards, determining statutory lien and special revenue status will provide fertile ground for litigation in Title III.

The limited case law on determining whether a particular lien constitutes a statutory lien consists almost entirely of two contradictory decisions from the Orange County proceedings. The Orange County bankruptcy court adopted a restrictive view of statutory liens, reasoning that because the authorizing statute at issue was permissive (providing that funds "may" be pledged), the lien was not automatically effectuated by statute, and instead required the consent of the county and acceptance by the bondholders to become effective. On this basis, the bankruptcy court found that agreements between the parties, rather than the statute itself, created the pledge, such that no statutory lien existed.[7] The Orange County district court, however, adopted a far broader interpretation, focusing on the fact that the authorizing statute provided for mandatory perfection of a first lien for any debt issued. Under this rationale, it was irrelevant whether the municipality chose what property to pledge, so long as the authorizing statute itself imposes the pledge upon borrowing, without further action by the issuer.[8] No other courts have meaningfully addressed this issue,[9] and the variety of authorizing statutes and resolutions across the commonwealth issuers' debt instruments provides ample basis for arguments on the scope of statutory liens. In addition, those opposing a statutory lien will likely contrast the commonwealth structures with recent legislation in other states that was expressly designed to create a statutory lien.[10]

While the determination of “special revenues” status under Section 902(2) of the Bankruptcy Code is perhaps less potentially contentious given the more fulsome definition and legislative history, there is virtually no relevant precedent in a contested proceeding. The statute provides for five categories of pledged property entitled to special revenues protection, including “special excise taxes imposed on particular activities or transactions” and receipts of projects or systems providing transportation, utility or other services. The legislative history provides nonexhaustive examples of the revenue streams that Congress attempted to capture, such as receipts from operations of “water, sewage, waste or electric systems.” For the commonwealth issuers, while certain pledged property appears to fall neatly inside the bounds of both the statute and congressional intent (e.g., PRASA or PREPA revenues), creditors will likely assert creative arguments about what constitutes a “project or system,” or an expansive scope of “excise taxes” in efforts to obtain special revenues protection for all manner of secured debt. This issue will be important to many Puerto Rican instrumentalities, but it will be of particular import for COFINA, as COFINA’s debt obligations are secured by a substantial revenue stream. If COFINA holders have neither statutory liens nor are secured by special revenues, their security interest would not attach to these post-petition funds used to keep their bonds current.

Determining Plan Confirmation — Court or Oversight Board?

Another issue that is sure to prompt litigation as part of any Title III process is whether the unique confirmation requirements for a plan of adjustment under PROMESA have been satisfied, particularly given the task of satisfying each of those requirements given the severity of the commonwealth’s financial challenges. PROMESA’s unique structure also raises potential tension between the roles of the oversight board and the court in deciding that question. While PROMESA includes a broad list of 14 requirements that the fiscal plan must satisfy, the determination of whether these requirements are met is trusted to the oversight board’s discretion, and the oversight board’s certification of a fiscal plan is nonreviewable. This is of particular importance where many of PROMESA’s requirements for a fiscal plan are in tension with one another given competition for scarce resources (for example, elimination of structural deficits vs. providing for capital expenditures to promote growth). Beyond this, partly as a result of the negotiations that led to PROMESA’s passage, many of these 14 requirements are themselves ambiguous, and the legislative history of changes to certain of these requirements may invite conflicting interpretations.[11]

At the same time, PROMESA requires the Title III court to itself determine, as a predicate to confirmation, that the plan of adjustment is consistent with the fiscal plan certified by the oversight board. This requirement creates tension with the nonreviewability of the oversight board's certification, and provides grounds for litigation for creditors who may question the plan of adjustment's faithfulness to the fiscal plan. This is particularly the case where, unlike other executive agency determinations to which courts defer, the oversight board's certifications are not subject to a notice and comment procedure, nor are oversight board members subject to confirmation by the Legislature.

Stay Tuned

Although these are but a few of the many issues that will ultimately drive negotiations among the parties and affect creditor recoveries in any commonwealth Title III proceeding, the plain truth is that there is enough uncertainty as to the outcome of these issues that one can only hope that all parties will see the wisdom of reaching a consensual agreement regarding a Title III plan of adjustment, given the uncertainty and destruction in overall value that a prolonged contested proceeding will entail.

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[1] See Law360, "Why Puerto Rico Will Likely Rely On PROMESA Title III," March 1, 2017.

[2] Cf. Ayer v. Commissioner of Admin., 340 Mass. 586 (1960).

[3] While the commonwealth constitution precludes appropriations that exceed estimated revenues for the year, the same report suggested that the commonwealth has engaged in deficit financing since 1979. Cf. Lance v. McGreevey, 180 N.J. 590, 597 (2004) (debt used to fund appropriations cannot be counted as revenue).

[4] For purposes of this article, references to the commowealth's "debt" or "debt obligations" will refer to the debt of those Puerto Rican government issuers that are reliant, either directly or indirectly, on the commonwealth's taxing power for operational expenses and debt service, such as the commonwealth's general obligations, COFINA, HTA, PBA, GDB, ERS, PRIFA, PFC, UPR, CCDA, PRIDCO, but excluding municipalities and those entities that have their own revenue sources and/or are financing vehicles with no recourse to tax revenues — including PREPA, PRASA, HFA and the Children's Trust.

[5] Although we focus on First Circuit authority given that venue for a commonwealth proceeding would lie in San Juan, PROMESA does provide for the possibility of an alternative venue for a Title III proceeding, at the oversight board's discretion, in any district where the oversight board may establish an office.

[6] The scope of "necessary operating expenses" is itself likely to be litigated. Although there is very little case law on the subject, its determination may differ under PROMESA, where the debtor may argue with some force that any payments contemplated by the fiscal plan are per se "necessary operating expenses" paid ahead of the secured claim, as PROMESA requires that any plan of adjustment be consistent with the fiscal plan. This has the potential to shift the dispute from a contested matter to an unreviewable decision made at the oversight board's discretion.

[7] See In re Cty. of Orange, 179 B.R. 185 (Bankr. C.D. Cal. 1995).

[8] See In re Cty. of Orange, 199 B.R. 499 (C.D. Cal. 1995)

[9] See In re Ravenna Metro. Dist., 522 B.R. 656 (Bankr. D. Colo. 2014) (noting in dicta that "[b]y pledging the revenues from its mill levy, the Bonds are secured pursuant to a statutory lien"); In re Badger Mountain Irrigation Dist., 885 F.2d 606 (9th Cir. 1989) (noting in dicta the bankruptcy court's uncontested conclusion that Washington statute created statutory liens).

[10] See, e.g., Cal. Gov't Code § 53515 (2015) (as amended by SB 222, July 13, 2015); R.I. Gen. Laws Ann. § 45-12-1 (2015).

[11] For example, a fiscal plan need only provide "adequate funding for public pension systems," leaving open to debate what is adequate and what benefit levels those systems must provide. Similarly, a fiscal plan need only "respect" the relative priorities and lawful liens under the commonwealth constitution and agreements with creditors.