Written Testimony of James E. Spiotto[1]
before the
House Committee on Natural Resources
regarding
Amendments to Puerto Rico Oversight Management and Economic Stability Act
of
October 30, 2019

Chairman Grijalva, Ranking Member Bishop and distinguished Members of the Committee, I am honored to address you at this hearing regarding the Discussion Draft of H.R. ______, the Amendments to Puerto Rico Oversight Management and Economic Stability Act of October 30, 2019 ("Proposed Amendments"). The following remarks are based on my experience in refinancings, workouts and restructurings of state and local debt obligations and those of other countries for over forty years, as well as my prior written testimony to House and Senate Committees on Chapter 9 Municipal Bankruptcy and the government finance market including in 1983, 1988, 1992, 1995, 2011, and with respect to Puerto Rico in 2015, 2016 and 2018.

The history of sovereign debt restructurings and past state and local government financial challenges has demonstrated that Puerto Rico should develop a recovery plan that encourages reinvestment in Puerto Rico, providing needed essential services and infrastructure improvements. This plan would stimulate economic development, rebuilding and enhancing infrastructure, motivating those who have left the Island to return, spark expansion of local business, and attract new business thereby creating new, good jobs. This raises the level of employment and labor participation that increases personal, business and tax revenues: the high tide that raises the economic fortunes and health, safety and welfare of Puerto Rico's citizens and provides the creditworthy basis for repaying creditors. There are some serious questions as to whether the Proposed Amendments will accomplish this goal of establishing fiscal responsibility and enhancing access to the capital markets.

<u>The Gathering Storm of Puerto Rico's Financial Distress</u>

Historians may well debate the causes and impact of Puerto Rico's financial and operational distress, but it should be clear that public debt was not the cause of the financial distress of the government. Rather, it is a symptom of a systemic problem. As Puerto Rico has continually and correctly noted, the Merchant Marine Act of 1920 added 10-15% to the price of many goods carried by foreign vessels, and the repeal of Section 936 of the IRS Code (previously Section 931) removed the encouragement to U.S. corporations to invest in Puerto Rico and federal policy created inequities in federal funding and treatment of Medicaid and tax policy for Puerto Rico compared to states. This purportedly has cost Puerto Rico billions annually for decades, and all of these are a fertile ground for blame.

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1 As of January 1, 2014, I retired as a Partner of Chapman and Cutler LLP. I am a Managing Director of Chapman Strategic Advisors, LLC, a consultancy providing educational and strategic insights to market participants concerning finance topics of interest. For further detail, see my resumé attached. The statements expressed in this material are solely those of the author and do not reflect the position, views or opinions of Chapman and Cutler LLP or Chapman Strategic Advisors LLC.

In 1996, Congress repealed (effective 2006) Section 936 of the Internal Revenue Code (previously Section 931) that existed since the 1920's to encourage U.S. corporations to invest in Puerto Rico by providing an exemption from federal taxes. This measure promoted two-thirds of Puerto Rico's GDP, namely, in finance, insurance, real estate (19.6%), and manufacturing mainly in pharmaceuticals and electronics (46.4%).

By 2006, Puerto Rico was in financial distress due at least in part to the effect of the Jones Act, the repeal of Section 936 of the Internal Revenue Code without any replacement, the inequity of federal government funding compared to states costing Puerto Rico billions annually for decades relating to Medicaid, Supplemental Security Income ("SSI"), earned income tax credit ("EITC"), child tax credit ("CTC"), etc. All of this culminated in financial distress. In 2006, Puerto Rico had $40 billion of public debt and public debt per capita of $10,666.66, double the average for state and local governments in the U.S. Also in 2006, Puerto Rico's public debt as a percentage of GDP was 45.82%.

Put another way, by 2006, Puerto Rico, with $40 billion in public debt, chose literally to double down on debt rather than face the then need for financial restructuring or federal government assistance such as oversight and refinancing of debt in 2006 rather than 2016, the ultimate result. Between 2006 and 2015, $40 billion of public debt became $72 billion, the percent of debt to GDP rose from 45.82% to 69.83%, and per capita public debt more than doubled from $10,666.66 to $20,727.38 (the average for state and local government debt in the U.S.A. in 2015 was $5,633.88, one quarter of Puerto Rico's).

The Evolution of PROMESA

In late 2015 and 2016, Congress was presented with the financial problems and debt crisis the Commonwealth of Puerto Rico and its people were suffering. The territory had over $70 billion of public debt and pension liabilities of over $40 billion. The overall debt of Puerto Rico and its instrumentalities debt were viewed as beyond their respective liquidity and the perceived ability to pay as scheduled and created what appeared to be an insurmountable burden to Puerto Rico and its people.

During the first part of 2016, Congress considered what needful rules and regulations would be appropriate. At the same time, the Commonwealth itself enacted in April 2016 the Moratorium Law (Art. No. 21-2016) purporting to suspend payment on the public debt. This caused the expected negative reaction from debtholders and increased the necessity for an effective mechanism for the resolution of the financial crisis. This Committee held hearings and Congress enacted the Puerto Rico Oversight, Management and Economic Stability Act ("PROMESA"), 48 U.S.C. §§ 2101-2241, signed into law by President Obama on June 30, 2016, which created Financial Oversight and Management Board for Puerto Rico (the "Oversight Board" or "FOMB") for supervision and assistance to Puerto Rico. In enacting PROMESA, Congress exercised its power to "make all needful rules and regulations respecting the territory" under the U.S. Constitution (Article IV, §3, cl. 2).

The Oversight Board was charged under PROMESA with being the mechanism to achieve fiscal responsibility and economic and operational recovery from the financial distress and debt burdens that Puerto Rico was suffering. PROMESA, as is evident from Congress's hearings in 2015 and 2016 on the Puerto Rico debt crisis, followed the tradition that states and

the federal government have chosen for providing oversight, supervision and an effective mechanism to resolve the grave financial distress of governments such as Puerto Rico and its related governmental entities. The goal of all these legislative efforts is the creation of a mechanism to encourage consensual resolution as in Title VI of PROMESA. PROMESA is structured to foster such consensus and provides a last resort to use a bankruptcy-like process for involuntary resolution, as Title III of PROMESA does, to effectuate resolution of debt issues that cannot effectively be resolved by agreement. PROMESA was intended to provide financial oversight, assistance and supervision for Puerto Rico. To a degree, PROMESA was to be similar to New York City and the Municipal Assistance Corporation ("MAC") in 1975, Philadelphia and Pennsylvania Intergovernmental Cooperation Authority ("PICA") in 1991 and Washington, D.C. and its Financial Control Board ("D.C. Control Board") in 1995, which enhanced needed financial credibility and access to the financial markets. It should be noted in MAC for New York City, PICA for Philadelphia and D.C. Control Board for Washington D.C. there were no public debt restructurings but rather refinancing of public debt. This was due, in part, to the acknowledged need for governments to be able to borrow in the capital markets.

The PROMESA Experience and Recent Approved and Proposed Settlements for Public Debt and Other Creditors

Contrary to the hope for Title VI resolutions in the first three years of PROMESA, the dynamic uncertainty of the situation continued with the litigious response by creditors and the Commonwealth resulting in limited consensual resolution in 2017 and 2018. Over two year ago, the Oversight Board filed for the Commonwealth and some covered entities a Title III bankruptcy proceeding that permits involuntary resolution if consensual agreement is not reached. There have been recent announcements of a settlements with the Commonwealth, Oversight Board, COFINA bondholders and GDB creditors among others.[2] There have been recent efforts by the Title III District Court to stay active litigation for a set period of mediation to attempt to foster consensual resolution and a settlement proposal[3] for the remaining debt

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2 Puerto Rico's approved settlement: There are two settlements of major public debt that have been approved namely: (1) the GDB debt of $4.1 billion with a 55¢ on the dollar recovery and the COFINA settlement of $17.8 billion of debt and private loans with a 93% recovery for senior and 53.5% recovery for subordinated for a blended recovery of 68%. Accordingly, of public debt, 29% of the $73.8 billion public debt and private loans have court approved settlements.

3 Puerto Rico's proposed settlements to public debt and consensual creditors:

- $35 billion of claims: The $35 billion of G.O. bond debt, Public Building Authority obligations and other debt originally supported by $3 billion of public bond debt. The G.O. bond debt has a proposed settlement for the vintage G.O.s (pre-2012) of $6.9 billion with a 64% recovery: the 2012 G.O.s of $2.7 billion with a 45% recovery or litigate: the 2014 G.O.s of $3.6 billion with a 35% recovery or litigate. The Public Building Authority obligations that the FOMB and Commonwealth are now calling debt consist of vintage PBA (pre-2012) of $3.9 billion with a 73% recovery and the 2012 PBA of $0.7 billion with a recovery of 23%. Also, there is other unsecured debt (non-G.O. and non-PBA unsecured creditors) of $16 billion with a recovery of 9%. When you add the $35 billion of proposed settlements to the $21.6 billion of approved settlements for public debt and private loans there are about $56.6 billion of proposed and approved settlements. These proposed settlements have been generally incorporated into a proposed plan of debt adjustment for the Commonwealth and instrumentalities in the Title III proceedings. Virtually all of the $51.461 of bond and private loans contained in the fiscal plan is covered by approved proposed settlements not counting ERS pension liabilities.

followed by a proposed plan of debt adjustment that generally follows the proposed settlement. The employee retirement system obligations to employees and retirees has also been the subject of a proposed settlement.[4] In past resolutions of state and local government debt restructurings like Detroit, Jefferson County, Stockton, San Bernardino and others, there came a time when virtually all creditor constituents, with some reluctance, reached a global agreement and settlement that resolved litigation and provided a path forward. Given the passage of time and the continuing litigious spirit that has prevailed with the absence of a global settlement and general agreement, all creditor constituents' frustrations and fatigue can motivate the desire for drastic approaches. The Discussion Draft appears to be a product of this environment.

Unfortunately, financial challenges and distress were compounded by the natural disasters of Hurricanes Irma and Maria and other ill winds. The resulting broken infrastructure only magnified the distress and human suffering. Such human tragedy may blur legal priorities and, to a degree rightfully so, shift the focus of efforts and attention. Puerto Rico really needs a Marshall Plan to reinvest in Puerto Rico and rebuild its infrastructure and economy. It appears illogical to ask a government to provide its best proposal for repayment of its debts or creditors to expect the best recovery when the engine for payment, the government's infrastructure and economy, is struggling to exist. But, public debt elimination is not the historically best, preferred or economically productive method of resolving Puerto Rico's financial and infrastructure challenges.

The Proposed Legislation and Discharge of Public Debt

The proposed legislation would *inter alia* (a) add some further definition to essential public services and economic growth, (b) require disclosure by professional persons employed by court order, (c) provide for the legislative discharge of unsecured public debt without corresponding discharge or impairment of unsecured debt for goods, services, pensions, other retirement benefits or healthcare benefits of any kind under a newly created Title VIII, and (d) create a Public Credit Comprehensive Audit Commission, Office of Reconstruction Coordinator for Puerto Rico and Revitalization Coordinator for Puerto Rico Power Authority under the proposed new Title IX.

The new Title VIII of PROMESA would authorize Puerto Rico and its instrumentalities to be able to discharge (eliminate so that there is no future liability or obligation to pay), financial obligations (public debt securities and loan financial guarantees and derivative transactions, hereafter "Public Debt") that is unsecured by enacting a resolution that either has been adopted by (a) an affirmative vote of over a majority of the members of each house of the legislature and is signed by the chief executive or (b) an affirmative vote of not less than two-thirds (2/3) of the members of each house of the legislature. As noted above, discharge is limited to unsecured financial obligations/Public Debt and does not include similar ranked and classified unsecured debt related to goods, services, labor, pension, other retirement benefits, healthcare, tax refund or tax credit. Given Puerto Rico's debt per capita outstanding, receipt of disaster relief and emergency assistance and loss of population, there should be no doubt of Puerto Rico's

4 Proposed employees' retirement systems settlement: There is also a proposed settlement of the ERS pension liabilities of about $50 billion that proposes an 8.5% cut in pension benefits over $1.200 a month and that affects about 39% of the retirees. This settlement proposal is supported by the Official Committee of Retired Employees.

ability to qualify for the relief of Title VIII as intended by the proposed legislation. Will a Title VIII discharge resolution supersede and undo approved and proposed settlements for Public Debt? Will current unsecured Public Debt creditors demand secured debt payout for the restructured remaining amount of unsecured debt?

Purportedly, the legislature of Puerto Rico under the proposed Title VIII could discharge secured Public Debt and place the burden on the secured Public Debt holder to bring a declaratory judgment action either in the courts of Puerto Rico or the federal courts in Puerto Rico to have its debt declared secured and determine the extent of the secured status (all or part of the debt). Any pledge of revenue or future tax payments by Puerto Rico or its instrumentalities, which is the essence of revenue bond financing and statutory lien financing, would be terminated as of the date of the legislation effecting the discharge. Virtually all of state and local government financing is based on payment from future revenue and taxes and over half of state and local government financing in the United States is revenue bond financing. This is the financing that provides funding for needed infrastructure, improvements and capital improvements (schools, roads, water, sewer and electrical systems, public buildings, etc.) for state and local government as well as territories of the United States. Such legislation as the Proposed Amendments places a cloud over and threatens the viability of such financing for territories and state and local governments as will be further discussed below.

Once the legislature of Puerto Rico has appropriately adopted a resolution of discharge, the creditor of a financial obligation of Public Debt is stayed and estopped from any action to collect or enforce the discharged debt except for the declaratory judgment action to determine if and to the extent it is secured. It appears that, if a plan of adjustment is not confirmed or the Oversight Board is determined not to be validly appointed, some or all of the $73.8 billion of financial obligations/Public Debt could be subject to Title VIII, including the $21.7 billion of prior court approved COFINA and GDB Public Debt and the Public Debt portion of the proposed $35 billion settlement. There is no exception for prior court approved settlements from discharge or the need for declaratory judgment. If this is not intended, it should be specifically spelled out and excepted. Clearly, $13.2 billion of Puerto Rico's General Obligation Bonds, $4.1 billion of Highway Toll Authority Bonds, $4.0 billion of Public Building Authority Bonds, $4.1 billion of Employee Retirement System Bonds, etc., could, absent a confirmed plan of adjustment and a valid, appointed Board, be at risk of discharge. In addition, Title VIII also provides that financial obligations/Public Debt can be avoided or invalidated under traditional legal theories.

The proposal of a Puerto Rico Public Credit Comprehensive Audit Commission, under Title IX, empowers the Commission to audit Public Debt and the sustainability of outstanding Public Debt and to assess how new rules, policies and controls over Public Debt can be developed or improved and to investigate any irregularities. While these are noble goals, the Oversight Board and others have long been engaged in pursuing this. There already exist suggestions for best practices for governance, management and financing of Puerto Rico and its instrumentalities as have been developed for states and local governments. (*See* Government Finance Officers Association Best Practices available on its website.)

The real question is not what or how much debt can be eliminated but rather how best to obtain a financial recovery for Puerto Rico and its instrumentalities that stimulates economic

growth, creates new, good jobs, encourages those who have left the Island to return (both individuals and businesses), attracts new business to Puerto Rico, funds needed improvements of essential services and infrastructure, and fosters financially sustainable government that is fiscally responsible and enhances access to the capital market (the goal of PROMESA, Section 101).

RECOVERY MUST BE THE FOCUS

The United States is not alone in confronting the problem of sovereign debt in crisis. Dealing with the financial distress of a government requires not merely short-term actions to reduce debt obligations, increase tax revenues and lower costs, but also the long-term reinvestment in the government, its economy and its people. The financial challenges, loss of business and jobs resulting in many not being meaningfully employed, the need for economic stimulus and business development, the demands for social programs and governmental services, the level of poverty and financial strain on programs to address human distress have been well documented by Puerto Rico, its community leaders, its creditors and the financial markets. Puerto Rico has over 45% of its residents living at or below poverty level, it has lost over 250,000 jobs since 2006, labor force participation in Puerto Rico is at approximately 40% compared to average of 62.7% in the States, and, most distressing, 58% of Puerto Rico's children (its future) are living below the federal poverty level. There should be no debate over whether assistance is needed now, only the question of by whom and what form the assistance will take needs to be answered. The experience of other sovereigns is instructive.

As a parade of over 600 sovereign debt defaults between 1950-2010 involving 95 countries has demonstrated, there are too many repetitive problems because of a limited focus on reducing external debt without addressing the systemic problem that caused the economic distress.[5] The missing and needed ingredient in these failed sovereign restructurings of debt is the long-term reinvestment in the government and its people to improve and expand governmental services and infrastructure and stimulate business opportunities. This creates growth of new businesses and new jobs resulting in new taxpayers to increase tax revenues that brings about the real recovery for the health, safety and welfare of citizens. Such an approach is likely in the best interests of not only the government but also its citizens and taxpayers and its creditors, including employees and retirees. It is only through a robust recovery plan that creditors, including employees and retirees, will be paid to the fullest extent possible.

Concerns and Consequences of the Proposed Legislation

The wholesale discharge or elimination of Public Debt without a reasonable justification will result in higher borrowing costs for Puerto Rico assuming it can achieve market access. A government requires access to borrowing and the capital markets because tax revenues are irregular in timing of payments and amount and needed liquidity literally to keep the lights on requires market financial credibility and access. Financial credibility is premised on the ability and certainty of repayment of the borrowed debt. The past experience of sovereign debt borrowers who default or repudiate debt (discharge by elimination as the legislation proposes) has been to suffer the significant increase in the cost of borrowing or annual interest

5 *See* James E. Spiotto, MUNICIPALITIES IN DISTRESS? (Second Edition) 9-30 (Chapman and Cutler LLP 2016).

cost or yield due to recent failure to pay, especially if there was not complete justification for the total elimination of the debt or a justified inability to pay. For that reason, any sovereign, state or local debt restructuring has been a partial reduction or haircut in principle not a complete discharge or elimination of debt going forward.

It should be noted for Public Debt of state and local governments in the United States there has been a very low default rate and generally a higher recovery rate than for corporate debt. Historically, between 1839 and 1978 the annual default rate is about a .058% or less than 6/100 of one percent for 130 years.

RECORDED DEFAULTS, BY TYPE OF LOCAL GOVERNMENT UNIT
1839-1969

	1839 -49	1850 -59	1860 -69	1870 -79	1880 -89	1890 -99	1900 -09	1910 -19	1920 -29	1930 -39	1940 -49	1950 -59	1960 -69	Total Defaults	Number of Local Governments in 1967[a]	% of Annual Default Rate Over 130 Yrs.[b]
By Type of Units																
Counties and parishes		7	15	57	30	94	43	7	15	417	6	12	24	727	3,049	.183%
Incorp. munics.	4	4	13	50	30	93	51	17	39	1,434	31	31	114	1911	18,048	.081%
Unincorp. munics.		4	9	46	31	50	33	5	10	88	7	4	26	313	17,105	.014%
School districts				4	5	0	11		14	1241	5	23	60	1,272	21,782	.048%
Other districts				2	1	12	11	7	107	1,590	30	42	70	1,872	21,264	.067%
Totals	4	15	37	159	97	258	149	36	185	4,770	79	112	294	6,195	81,248	.058%

a The number of local government units has changed rapidly. For example, in 1932 there were 127,108 school districts, 8,580 other districts, and 175,369 state and local government units.

b The percent of annual default in total defaults by type divided by number of governments divided by 130 (years).

Sources: Default information in *The Daily Bond Buyer, The Commercial and Financial Chronicle* and *The Investment Bankers' Associations Bulletin:* default lists from Federal Deposit Insurance Corporation, Life Insurance Commission, and U.S. Courts; and Albert M. Hillhouse, *Defaulted Municipal Bonds* (Chicago: Municipal Financial Officers Association, 1935). Number of local government units from: U.S. Department of Commerce, Bureau of Census, Census of Governments, 1967, Vol. 1 "Governmental Organization" (Gov't Printing Office, 1969) and ACIR Report Bankruptcy, Defaults and Other Local Government Financial Emergencies U.S. Government 1973.

Since 1970, Moody's reports that for rated state and local government municipal bonds between 1970-2013 there was an average of two rated bond defaults per year with a recovery rate of at least 60% which is higher than the recovery for corporate senior unsecured bonds of 48%. Recoveries in recent Chapter 9 bankruptcies were 80% for sewer bonds in Jefferson County, 100% of principal for special revenue bonds for water and sewer in Vallejo, Stockton and Detroit. There have been 684 Chapter 9 municipal debt adjustments since 1937 the enactment of Chapter 9, 362 Chapter IX between 1937 and 1972 with average recovery of 64.7%, and 18 Chapter IX between 1954-1972 with an average recovery of 73.9%.[6] The default, repudiation and discharge of unsecured Public Debt of Puerto Rico under the proposed Title VIII would be in stark contrast to the historical default rate and recovery rate for state and local governments in

6 Prior to 1978, the roman numeral IX was used to indicate the Chapter on municipal debt adjustment. Under the Federal Bankruptcy Code after 1978, the Arabic number 9 was used.

the United States and the overall percentage of Haircuts (percent reduction of principal amount of debt) for sovereign Public Debt globally.

Without any justification for the reduction of debt based on anticipated revenue and expense and sustainability, the proposed Title VIII legislature resolution would discharge the unsecured Public Debt. This result for sovereign, state and local government restructurings is historically beyond rare and borders on dangerously unique. For the 180 sovereign restructurings between 1978-2010, the estimated Haircut was a mean of 37%, median of 32.1% and standard deviation of 27.3%.[7] The range was generally from a 2% Haircut to 80% Haircut. The potential results for Puerto Rico under proposed Title VIII discharge would produce an extreme Haircut and stigma on the credit worthiness of Puerto Rico that appears not only unprecedented but also unjustified with no rationale for the extreme result.

The Discharge of Public Debt under Proposed Title VIII Would Increase the Perception of Risk and Cost of Borrowing for Puerto Rico

As noted above, the ability of government to borrow funds in the capital market is critical to its long-term financial survival. Any increased perception of risk from a high default rate and low recovery rate of past government borrowing will increase the annual interest rate which reflects the risk of repayment to the lenders.

Access to the market at a low cost of borrowing is desired by all government borrowers. *Access and the cost of borrowing is a reflection of the perceived risk of the government credit:* Fiscal distress for government begets a higher cost of borrowing and even loss of access to the market. On March 2, 2012, Greece had a ten-year bond annual yield of 37.1% and in July, 2015, after the third attempted bailout and austerity package being implemented, Greece's annual yield is still over 10.5% with a 52-week range of 5.5% and 19.5%. Greece has defaulted on its sovereign debt since 1826 at least five times prior to its recent financial crisis (1826, 1843, 1860, 1894 and 1932). Brazil, a large developing economy which defaulted or restructured its sovereign debt eleven times since 1826, the last time 1990, had an average ten-year bond annual yield between 2006 and 2015 of approximately 12.3% with an all-time high of 17.91% in October, 2008. Puerto Rico, given its recent financial distress experience, had yields on its ten-year G.O. bonds exceeding 10% in February, 2014. At the same time, other sovereigns experienced usually low bond annual yields of 2.27% for U.S.A., 1.52% for Canada, .74% for Germany and 1.03% France. A review of selected sovereigns that have defaulted since 1998 demonstrates default does result in a time out or lack of access to the international bond market.

7 Sebastian Edwards, *Sovereign Default, Debt Restructuring, and Recovery Rates: Was the Argentinean "Haircut" Excessive?* NATIONAL BUREAU OF ECONOMIC RESEARCH (Feb. 2015), http:// https://www.nber.org/papers/w20964, *see also* Maximiliano A. Dvorkin, Juan M. Sánchez, Horacio Sapriza and Emircan Yurdagul, *Sovereign Debt Restructurings*, FEDERAL RESERVE BANK OF ST. LOUIS (August 2019), https://doi.org/10.20955/wp.2018.013.

Analysis of Recent Sovereign Restructurings 1998-2010					
Country	Default Date	Time to Competion (quarters)	Haircut (%)	First Issuance to International Bond Market (quarters after completion)	Participation (%)
Russia	08/1998	8	(40,75)	10	(75-99)
Pakistan	05/1999	11	(29,32)	18	99
Ukraine	08/1998	12	(5-5.92)	16	(82-100)
Ecuador	09/1999	5	(9-47)	24	98
Argentina	06/2001	12	(25-82)	19	(50-76)
Domininican Republic	12/2004	3	(1-2)	4	97
Serbia	12/2000	20	62	Not Yet	
Dominica	12/2003	2	50	-	78.5
Belize	12/2006	2	(1-28)	Not Yet	98
Grenada	01/2004	3	(40-50)	Not Yet	91
Jamaica	02/2010	-	20	4	99
(Federal Reserve Bank of Dallas, Global and Monetary Policy Institute Working Paper No. 143, Aitor Erce, April 2013)					

In the Detroit Chapter 9 municipal bankruptcy, the emergency manager's unjustified attack on Unlimited Tax General Obligation Bonds (ULTGOs) raised the perception of risk and increased annual interest rates. The filing of the Detroit Chapter 9 proceedings and the Emergency Manager's unwarranted attack on ULTGOs caused other municipalities in Michigan, like school districts, to experience approximately 100 basis points increase in the annual interest rate, the cost of borrowing, on ULTGOs due to the Detroit contagion. In California, the Detroit fall out cost school districts a 50-100 basis point increase, which was historically unjustified given the Chapter 9 experience of *San Jose School District* and *Sierra King Health Care District* cases. California response through the efforts of CDIAC was to attempt to clarify the intended low risk of California ULTGO by passing SB 222 to reconfirm that California state law provides a statutory lien intended to be unimpaired and paid in a Chapter 9.

There is a 200-300 basis point spread between strong and weak credits. Traditionally the spread in the state and local government municipal market between strong credits (top investment grade) and significantly weak credit (lower non-investment grade) was 200-300 basis points.[8]

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8 Traditionally the spread in the municipal market between strong credits (top investment grade) and significantly weak credits (lower non-investment grade) was 200-300 basis points (*See e.g.,* approximate 200 basis point trading spread between Detroit sewer and water with and without Chapter 9 threat and Chicago sale tax securitization approximate 275 basis point lower than similar Chicago maturities. https://fixedincome.fidelity.com/ftgw/fi/FINewsArticle?id=201801251903SM______BNDBYER_00000161-2a4f-dad2-a779-ff4fc963_110.1. Even if weaker creditor or past defaulters suffer only a 200 to 300 basis point rise in annual interest expense, that is 60% to 90% more payment of principal over 30-year period. (Spread

Being classified as a weaker credit increases the cost of the borrowing by 25% or more of the face amount of debt and should be avoided if possible. To a state or local government or territory like Puerto Rico, a 200 point per year or 2% more interest cost a year on a 20-year bond with a bullet maturity would be 40% more of the principal amount paid as interest over 20 years. Put another way, on a billion dollar debt issue with a twenty year maturity and a bullet payment of principal at maturity, a 2% additional interest cost per annum would be a present value at a 5% discount of about $250 million or 25% of the face amount. That is $250 million not available to a state, local or territory government to pay needed infrastructure improvements, public services, worker salaries, retiree benefits or tax relief to its citizens. These are funds desperately needed by Puerto Rico for reinvestment into Puerto Rico.

Puerto Rico's Historical and Constitutional Treatment of Public Debt Is Turned on Its Head and Is Contrary to Proposed Title VIII Discharge

The Treaty of Paris ending the Spanish-American War of 1898 resulted in control of Cuba, Puerto Rico, Guam and The Philippine Islands being given to the United States. Cuba in 1902 and The Philippines in 1946 were given independence. Puerto Rico and Guam remain territories of the United State. In recent years, Puerto Rico as a Commonwealth flirted with independence or statehood with no clear decision.

Puerto Rico was founded on the principles that Public Debt has a first priority of payment upon default (along with expense of insular government) embodied in Section 34 of the 1917 Jones Act, which governed Puerto Rico prior the Commonwealth's Constitution in 1952. The inclusion of Article VI, § 8 in the 1952 Puerto Rico Constitution continued this policy providing constitutional Public Debt, upon insufficient funds to pay expenses, was first to receive payment from "available resources." The statute and constitution mandate that upon insufficient funds and default on general obligation bonds first available funds are to pay Public Debt general obligation bonds. When faced with the 2006 financial crisis, Puerto Rico, with $40 billion of Public Debt outstanding, chose to borrow more rather than restructure its debt. Puerto Rico used additional general obligation bonds and the COFINA securitization structure to add another $17 billion of Public Debt by 2015 that purportedly was not limited by the constitutional debt limit, resulting in Public Debt of Puerto Rico totaling over $72 billion. Both the constitutional priority of general obligation bonds and COFINA securitization bond structure were market accepted and tested financing that enhanced repayment as well be discussed below.

Generally, the Puerto Rico Public Debt structure has followed the traditional structure used by U.S. states and local governments. Puerto Rico's over $13 billion of General Obligation Bonds follow the constitutional priority for payment of G.O. bond debt found in the constitutions and statutes of U.S. states like New York. The financial distress case of New York City in 1975 demonstrates the effectiveness of this constitutional provision that was found to be binding and

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between AAA and BBB can vary 100 to 150 basis points. Baird Fixed Income Study, 4/7/14, p. 8.) February 28, 2018, S&P Municipal Bond Index AAA (average duration 4.9 years) to B (average duration 6.08 years) on average 230 basis point yield difference. Bloomberg Barclay BVAL scale 10 years AAA rated bond to BBB rated bond, a difference of 97 basis points in yield (March 21, 2018). That additional cost could have been used to reduce taxes, pay for needed infrastructure or services or pay unfunded pension obligations. In the near term spread may widen thereby increasing the cost of borrowing for weaker credits.

enforceable to end the moratorium on payment of bond debt that mandated a refinancing rather than a Chapter 9 bankruptcy for New York City as the *Flushing National Bank* case, 40 N.Y.2d 731 (1976) described. The New York highest court found that this constitutional provision in the New York Constitution, which is similar to the Puerto Rico constitutional provision that followed New York's model, mandates the government to make payment of first available funds to the Public Debt general obligation bonds and delay or non-payment were not to be tolerated if funds were so available. Likewise, the COFINA securitization structure is intended to be similar to New York City's Sales Tax Receivable Corporation and not included in constitutional debt limits or offensive to the rights of outstanding G.O. debt as the Court of Appeals (the highest court in New York) ruled in 1977 in the case of *Quirk v. MAC for City of NY*, 41 N.Y.2d 644 (1977). The passage of the proposed Title VIII for discharge of unsecured Public Debt of Puerto Rico like general obligation bonds would raise not only constitutional challenges but be contrary to the provision of PROMESA that creditor rights were to be honored consistent with Puerto Rico's constitutional and statutory provisions. Any unjustified discharge of Public Debt would further enflame litigation that is already overloaded with issues and disputes.

The United States' Tradition of Honoring Public Debt Obligation

Early in our country's history, the importance of honoring Public Debt obligations was declared as the prudent and sound path to take as a developing country. It should be remembered that "No pecuniary consideration is more urgent than the regular redemption and discharge [payment] of Public Debt. On none can delay be more injurious or an economy of time more valuable." These were the words of George Washington, over 220 years ago, in his State of the Union address on December 3, 1793. Washington and Hamilton were instrumental in having the Federal Government assume the states' debt from the Revolutionary War since some states were balking at paying such debt. Those states feared their good tax dollars would go to pay Northern speculators (who purchased the debt at a discount) or the debt of other states who were big borrowers. Washington and Hamilton knew that the progress of the nation could be no swifter than its financial credibility. The Federal Government assumed the states' Revolutionary War debt to avoid repudiation and to assure financial credibility on the federal and state level. Now, there are echoes of this same debate over 225 years later. Will there be the same result?

In the aftermath of the Panic of 1837 and the need for states to borrow to pay for transportation improvements in the North (given the success of the Erie Canal) and for banking services in the South, 19 out of 26 states and two territories borrowed money for economic growth. By the 1840's, eight states and one territory defaulted on those borrowings and repudiated those debt obligations. Those issuers that repudiated the debt then experienced either an inability to borrow additional funds or, if they could obtain financing for needed governmental improvements and services, suffered the imposition of a 32%+ yield. By the late 1840's, seven of the eight states had renounced their repudiation and resumed payment on the debt in order to obtain market access at a lower cost. The state and one territory that were left repudiating their debt struggled for over a decade to obtain funds, let alone at a reasonable cost.

After the Civil War, in response to suggestions that the government should discount the cost of war debt by paying it in greenbacks as a devalued currency, President Grant, in the spirit of Washington and Hamilton eighty years earlier, chose to protect national honor. He stated every dollar of the government indebtedness should be paid in gold. Unfortunately, such was not

the fate of the failed confederate government's war debt. By means of the 14th Amendment, debt incurred in aid of insurrection was deemed illegal and void. Since the late 1880's, no state has defaulted on its general obligation bonds except Arkansas in 1933 which was quickly refinanced and paid.

The Lack of a Rationale for the Extent of Discharge Contradicts the Purpose of PROMESA

As noted above, sovereign debt restructurings and Chapter 9 municipal debt adjustments are not efforts in debt elimination without a justification for the wholesale elimination of Public Debt but were efforts to provide a "fresh start" by reducing debt to an affordable and sustainable level and discharging only that which is incapable of being repaid due to the dire financial circumstances of the government based on an established rationale or justification for the amount of debt eliminated or discharged. As noted above, of the 600 plus sovereign debt restructurings since 1950, there are no examples of a legislative discharge like proposed Title VIII that eliminates all unsecured Public Debt as of the legislative action and leaves unimpaired trade creditors, public workers, pension and other retirement benefits and tax refunds and credits,. The extreme and discriminatory discharge of Public Debt appears to have no justification or basis for the extent of discharge. Chapter 9 municipal debt adjustment that PROMESA incorporates in part in Title III of PROMESA specifically provides the adjustment of debt is for the "best interests of creditors" (Section 314(b)(6) of PROMESA), to the extent necessary to be "feasible" and is to be "fair and equitable", (Section 314(c)(3) of PROMESA). These standards are not *per se* attributable to the blanket discharge of unsecured Public Debt under the proposed Title VIII. Further, PROMESA was premised on not altering of "pre-existing priorities of creditors in a manner outside the ordinary course of business or inconsistent with territory's constitution or laws of the territory as of, in the case of Puerto Rico May 4, 2016 … [Section 204(c)(3)(ii) of PROMESA. For example, the discharge of unsecured general obligation bonds while paying in full trade vendors for goods and services, public workers, pension and other retirement benefits, healthcare benefits and tax refunds and tax credits purportedly in full from "available revenues" is a violation of and contrary to the purpose and intent of Article VI, Section 8 of Puerto Rico's Constitution that, as noted above, similar to New York and other states, provides a priority of payment to "unsecured general obligation bonds" where there are insufficient funds to pay all liabilities.

Proposed Title VIII Would Violate Existing Rights of Secured Creditors

The requirement in proposed Title VIII that a secured creditor would not be secured by a pledge, dedication or mandate after the date of the discharge legislation and future revenues would no longer be paid to and be security for the secured debt violates the continuing lien and pledge of special revenues which the District Court in the Title III proceeding and the U.S. Court of Appeals for the First Circuit have ruled is effective and valid and not terminated. *Assured Guaranty Corp., et al. v. The Financial Oversight and Management Board for Puerto Rico, et al.*, 919 F.3d 121 (1st Cir. 2019). Further, statutory liens purportedly granted by legislation of Puerto Rico mandate the payment for such bonds as COFINA [P.R. LAWS ANN. tit. 1399 11a-16] and PROMESA is not to rewrite prior existing laws of Puerto Rico and creditor rights given the required compliance with constitutional laws. Further, this restriction reducing or eliminating the security for secured debt on pledged, dedicated, "secured" tax revenues after the discharge

legislation date raises the issues of taking property (secured interest) without just compensation in violation of the Fifth Amendment.

The Proposed Title VIII Legislation Discharge of Unsecured Public Debt Is a Prohibited Legislative Punishment Without Trial and Lacks Due Process

The proposed Title VIII legislative discharge of unsecured Public Debt provides no ability to contest, appeal or have the benefits of a trial or due process. This amounts to a legislative punishment of unsecured Public Debt holders without a trial equivalent to a bill of attainder prohibited by Article I, Section 9, Clause 3 of the U.S. Constitution. The holders of unsecured Public Debt are summarily estopped and stayed from any further legal remedies or enforcement of their debt and in effect barred from legal redress to the courts. This threatens the traditional notion of due process and the limits of the power of the legislature to punish without trial. [*U.S. v. Lovett*, 328 U.S. 303 (1946)]

The Proposed Title VIII Unfairly and Inequitably Discriminates Against Holders of Unsecured Public Debt

As noted above, without trial, rational standard for the extent of discharge or reasonable justification to limit discharge to unsecured Public Debt, the proposed Title VIII authorizes discharge of financial obligations/Public Debt but does not deal with and leaves unimpaired debt for goods, services, pension and other retirement benefits, health care benefits, tax refunds and tax credits that are also unsecured and of equal priority and standing. Such invidious discrimination among creditors would not be tolerated, especially without due process and trial in any Chapters 7, 11 or 9 bankruptcy proceeding. The lack of uniformity and the failure to provide for fair and equitable treatment of all creditors cannot be the basis for an appropriate amendment to PROMESA.

There Are Systematic Causes of Puerto Rico's Financial Distress Separate and Apart from the Devastation Caused by Hurricane Maria that PROMESA and Any Recovery Plan Must Address

Counter past economic downturn with economic stimulation and development. With the repeal of Section 936 and exit of corporate and individual taxpayers, with the accompanying loss of tax revenues, there has been no real replacement or long-term economic development strategy to expand business in Puerto Rico. Key to recovery is attracting new business to Puerto Rico, thereby providing new, good jobs for Puerto Rico's population, and attracting a significant increase in population and taxpayers.

Correction of adverse federal policies that cost Puerto Rico billions such as the permanent repeal of the Jones Act, elimination of any inequalities in Medicare, Medicaid, SSI, EITC and CTC. Congress should examine existing legislation that could be modified to assist Puerto Rico in its effort to resolve its financial and infrastructure crisis. The Jones Act that requires foreign flag vessels that stop in the U.S.A. continental ports and Puerto Rico to pay a tariff increasing the cost of goods for Puerto Rico should be repealed for Puerto Rico's case permanently. Federal assistance in programs to develop new commerce and economic stimulation (such as encouraging increased business activity and supporting manufacturing

opportunities, high tech, green tech, creation of new energy generation and strategy for the short- and long-range economic development by Puerto Rico that its creditors can buy into).

Solving the tax collection problem through identification and implementation of new or increased tax sources along with increasing collection efficiency. The exploration of new tax policies that would stimulate economic development, and new tax sources that do not adversely affect such economic development efforts should be explored. Dealing with deficiencies in tax collection methods are problems that can be solved or at least greatly reduced, which would bring in additional revenues even without adding new or higher taxes

Reverse the stigma of financial distress by improving financial creditability in the capital markets. It would be counter-productive to have the result of any recovery plan be less access and increased borrowing cost for Puerto Rico. Accordingly, steps should be taken to assure that the recovery plan will increase market access and lower cost of borrowing both short-term and long-term. This can be done by following established, best practices of government accounting, administrative budgeting and financing to the extent they have not already been adopted.

Treatment of outstanding Public Debt by PROMESA process must be perceived by the market as fair. As a result of the widespread devastation of the island caused by Hurricane Maria, holders of the Public Debt of the Commonwealth and other related issuers are faced with an inability to pay situation. While federal assistance to the island will be forthcoming, this assistance will not take the form of a bailout of outstanding Public Debt. However, it will be important that the ultimate resolution of the outstanding Public Debt be perceived as fair to all parties, including the citizens of Puerto Rico and creditors including Public Debt and not arbitrary under the circumstances.

Proposed Further Response to the Financial Crisis and Hurricane Maria to Address the Need to Rebuild Puerto Rico's Infrastructure and Stimulate Its Economy

First stop human suffering and develop a Marshall-type plan for Puerto Rico's governmental services and infrastructure. The first immediate action is to assure the health, safety and welfare of the citizens of Puerto Rico with provision of food, water, medical services, governmental service and infrastructure all to a level deemed acceptable. This is a Marshall-type plan for Puerto Rico for services and infrastructure (roads, water, sewer, electricity, etc.) at a level that can attract remaining and new citizens and businesses that want to be there and expand their businesses in Puerto Rico. This will create new, good jobs that produce additional tax revenues needed for a recovery. The technical and financial assistance can be provided not only by emergency relief but also other federal agencies with established expertise DOE (electricity), EPA (clean water) and HUD (housing), etc.

Develop a long-range economic development strategy for Puerto Rico to elevate Puerto Rico's business opportunities and roles in the Caribbean. There should be a long-range economic recovery plan for Puerto Rico which is implemented at the same time or in coordination with the Marshall-type plan that establishes viable and desirable services and infrastructure at the appropriate level as noted above. This economic development plan should provide assured liquidity for continued uninterrupted governmental operations and any necessary bridge financing in coordination with the implementation of the "Marshall-type plan." The

economic recovery plan should consider making Puerto Rico (which means Rich Port) the key point of commerce for the Caribbean. Numerous islands have been continuously affected by the hurricanes in the Caribbean, and Puerto Rico could be the port and the location where all relief and all commercial activity is focused as the staging and coordinating center. This allows a coordinated effort and allows Puerto Rico to be elevated to a key role for the Caribbean. Part of this would include establishing Puerto Rico as the center of commerce for the Caribbean for banking, shipping and processing assembly of goods from foreign manufacturers for distribution in the Caribbean and possibly Central American and other locations.

Also, legislation by Congress and the Commonwealth could provide for financial banking services to be the U.S.A. equivalent of the Cayman Islands for specialty financings and investment vehicles. This would facilitate Puerto Rico's becoming the banking center for the Caribbean like London has been for Europe. There already exist programs for high income persons to obtain tax benefits from a Puerto Rico residence and investment in Puerto Rico, and this would be a further expansion. Puerto Rico Laws Act 20 (Export Service Act) and Act 22 (Individual Investors Act). Also, as part of the economic recovery plan, the whole island of Puerto Rico should become a foreign trade zone (a free trade zone) where equipment, goods and parts manufactured in foreign countries can be shipped to Puerto Rico duty-free and processed, assembled or manufactured with only limited duties on the finished product. Such actions would stimulate additional business activity and the benefits of new financial, shipping and manufacturing jobs [direct (the new jobs created by the economic policy), indirect (jobs created for good and services to support the direct job) and induced (jobs created by salaries spent for goods and services by those with the direct and indirect jobs)]. Historically, Puerto Rico had 46% of its GDP attributed to manufacturing.

The Path Forward for Puerto Rico, Its Citizens, Businesses and Creditors

Citizens, taxpayers, business interests, and creditors of Puerto Rico should support the above proposal for an economic recovery plan, since it is the economic growth and success of Puerto Rico that is the means by which additional tax revenues will be raised, providing the funds to pay debt and other obligations, and to fund governmental services and infrastructure at the acceptable level. There is no substitute for the practical ability to be paid from a recovery plan that maximizes value and recovery to the extent reasonable and reinvests in Puerto Rico to ensure continued operations and sufficient tax revenues to pay off its creditors based on what can be paid. If there is no money, there is no payment no matter the rights or priorities. All the rights legally possible do not necessarily translate into payment of Public Debt or assurance of funding of essential services and needed infrastructure if an entire tax-base, *i.e.,* U.S. citizens, are left with nothing to rebuild and no opportunity to recover.