TESTIMONY

OF

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Subcommittee on Indian, Insular and Alaska Native Affairs

on

The Need for the Establishment of a Puerto Rico
Financial Stability and Economic Growth Authority

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Chairman Young, Ranking Member Ruiz, and members of the subcommittee – thank you for inviting me to testify on the Need for the Establishment of a Puerto Rico Financial Stability and Economic Growth Authority, which I will refer to as an "Authority."

My name is Thomas Moers Mayer.[1] I have spent the better part of a decade working on municipal insolvencies and observing how municipal insolvencies work in and out of bankruptcy, and I have spent the last year examining the Commonwealth's fiscal situation and economy in light of its claim that it cannot pay its bondholders.

I offer that experience and my views today on behalf of my clients, certain funds managed by Franklin Advisers ("Franklin") and by OppenheimerFunds, Inc. ("Oppenheimer") in connection with their investment in approximately $10 billion of bonds issued by the Commonwealth of Puerto Rico and most of its 16 governmental corporations.

Who Invests In Puerto Rico?

Franklin and Oppenheimer have for many years been two of the largest investors in bonds issued by Puerto Rico and its governmental corporations; to the best of my knowledge, my clients collectively constitute the largest holders of Puerto Rico bonds.

Franklin and Oppenheimer are mutual funds who invest on behalf of hundreds of thousands of retail investors. Franklin alone has approximately 200,000 investors in the funds that own bonds issued by Puerto Rico and its government corporations; Oppenheimer has over 400,000 individual investors in its municipal bond funds, most of which hold Puerto Rico bonds.

These bondholders are individual savers who receive tax-exempt income derived from Puerto Rico municipal bond holdings. Most tax returns showing tax-exempt income are filed by taxpayers over 65[2] and most report incomes under $100,000.[3] The average investment in one of Oppenheimer's funds is $50,000.

These people live on Main Street, not Wall Street.[4] These investors are ordinary people who invest for retirement and for their children's education. They are taxpayers who want to buy tax-free bonds. Indeed, about 9.5 million U.S. taxpayers invest in municipal bonds to get tax-free income, either directly or through funds like Franklin's and Oppenheimer's.[5]

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[1] I am a partner and co-chair of the Corporate Restructuring and Bankruptcy Group at Kramer Levin Naftalis & Frankel, LLP. *See* Exhibit A. I am also a member of the National Bankruptcy Conference (the "NBC"), which provided its own statement in support of a predecessor to H.R. 870. I was not a signatory to the NBC's statement and abstained from a vote on it. My testimony today is not on behalf of the NBC, which has not reviewed it.

[2] *Statistics of Income, 2013 Individual Income Tax Returns*, Publ. 1304, U.S. DEP'T OF THE TREASURY, INTERNAL REVENUE SERVICE, Table 1.5 at 81 (2013), https://www.irs.gov/pub/irs-soi/13inalcr.pdf (hereinafter "*IRS Publ. 1304*").

[3] *Id.* Table 1.4 at 43.

[4] The "household sector" held almost 42% of all municipal bonds as of September 30, 2015. *Federal Reserve Statistical Release Z.1, Financial Accounts of the United States, Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Third Quarter 2015*, Bd. of Governors of the Fed. Reserve Sys. 101 (Dec. 10, 2015), http://www.federalreserve.gov/releases/z1/current/z1.pdf. Mutual funds together held an additional 19%. *Id.*

[5] In 2013, 5,987,263 tax returns reported tax exempt income, comprised of 3,556,447 tax returns from married couples filing jointly, or 7,112,894 individuals, and 2,430,817 other individual tax returns, for a total of 9,543,711 individuals. *IRS Publ. 1304*, supra note 2, Table 1.3 at 40.

Puerto Rico is the only large issuer whose bonds are tax-free in every state of the union,[6] and it is likely that most municipal bondholders (or fund holders) hold, directly or indirectly, Puerto Rico bonds.

These investors bought their bonds after Congress expressly excluded Puerto Rico from using chapter 9. My own clients – on behalf of more than half a million investors – bought their bonds in reliance on Puerto Rico's exclusion from chapter 9.

How Congress decides to address Puerto Rico's fiscal situation could directly impact millions of Americans in every state of the Union and the Commonwealth of Puerto Rico. Indeed, it is probable that more citizens invest in Puerto Rico bonds than still live in Puerto Rico.

Finally, it is important to remember that many Puerto Ricans invest in Puerto Rican bonds. We estimate that $15 billion of Puerto Rico bonds were purchased by Puerto Ricans. These are Puerto Rico's own hardworking citizens who pay Puerto Rico taxes[7] – or they are former residents of Puerto Rico who have moved to the mainland and depend on the bonds of their native Commonwealth for income.

These Puerto Rican investors, like mainland investors, bought their bonds after Puerto Rico was excluded from chapter 9.

It is these on-island and mainland investors whose money has gone to build and operate Puerto Rico's firehouses, police stations, schools, sewer and water systems, highways, convention center and electrical plants. It is these investors, on-island and mainland, who have been champions of Puerto Rico and have interests that align with those of the people of Puerto Rico in seeing the Commonwealth thrive over the long-run.

And it is these individual, retail investors who Puerto Rico needs. Puerto Rico needed their investment in the past and Puerto Rico will need their investment in the future. Puerto Rico needs to raise billions of dollars for new electrical plants to meet air pollution regulations, for new water lines to avoid droughts in San Juan, for new sewer lines to meet water quality requirements, for maintenance of highways and bridges, for ordinary short term financing that every government needs to finance expenses between one tax collection cycle and the next.

A municipality that forces a restructuring on its bondholders will be locked out of the market for low-cost investment grade municipal bonds.[8] Thus, harming Puerto Rico's investor base as part of a restructuring will only make Puerto Rico's recovery harder, if not impossible, by shutting Puerto Rico out of the normal low-cost investment grade municipal bond market. It will leave Puerto Rico no recourse except to lenders who charge extraordinarily high rates to compensate for risk, or – in the end – the U.S. Treasury. It will also have a negative effect on the value of the $15 billion in Puerto Rico debt owned by on-island investors, leading to less money spent in the economy.

The only way to assure the Main Street retail investors who have entrusted their savings to Puerto Rico in the past that they can do so in the future is the creation of a strong, independent and federally appointed Authority.

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[6] *See* 48 U.S.C. § 745.

[7] As discussed below, Puerto Ricans do not pay federal income tax, but they do pay the Federal Insurance Contributions Act tax.

[8] *See, e.g.*, *Ratings Methodology: US Local Government General Obligation Debt*, MOODY'S INVESTORS SERVICE 21 (Jan. 15, 2014) (considering defaults or "government's willingness and/or ability to meet financial obligations" as a factor in methodology for rating U.S. local government general obligation debt).

The Problem to Be Solved

The Commonwealth blames its problems on the individual retail investors who trusted the Commonwealth with their money. We submit that the Commonwealth created its own problems through over-optimistic revenue forecasting when budgeting, an economy with too much government and too little private enterprise, and poor management of public resources.

Consider:

- KPMG, the Commonwealth's own consultant, estimates that the Commonwealth could have obtained an additional $2.5 billion in revenue each year by improving tax collections and simplifying its tax structure.[9] This problem, again, is not new – it was highlighted in a 2006 report by the Brookings Institution.[10]

- KPMG likewise reports that the Commonwealth collects only 56% of its sales and use taxes.[11]

- The Commonwealth's funding gap is in material part due to municipal subsidies. These are required because municipalities base their property taxes on assessed valuations ***from the 1950s***.[12]

- The Commonwealth has failed to file audited financial statements for 2 years.

Similar problems arise at the level of governmental corporations. The Puerto Rico Electric Power Authority, or PREPA, provides the best example.

- PREPA bills governmental corporations for power but historically has not collected what it is owed.[13]

- PREPA allows private customer bills to go unpaid for months before shut-off – and then instantly re-connects on payment without an adequate security deposit, effectively giving its customers months and months of credit. As of January 2015, PREPA suffered a 6% theft rate – the highest of any utility in the United States.[14]

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[9] *See* excerpts from KPMG, *Unified Tax Code of Puerto Rico: Tax Policy Implementation Options Executive Summary* (Oct. 31, 2014), *available at* http://www.hacienda.gobierno.pr/sites/default/files/unified_tax_code_of_pr-_executive_summary_0.pdf (attached hereto as Exhibit B) (hereinafter the "*KPMG Report*").

[10] James Alm, *Assessing Puerto Rico's Fiscal Policies*, in RESTORING GROWTH IN PUERTO RICO: OVERVIEW AND POLICY OPTIONS 71 (Susan M. Collins et al. eds. 2006) (hereinafter "RESTORING GROWTH IN PUERTO RICO").

[11] *See* excerpts from *KPMG Report*, supra note 9 (attached hereto as Exhibit B).

[12] Anne O. Krueger, et al., *Puerto Rico – A Way Forward*, 20 (July 13, 2015), *available at* http://www.bgfpr.com/documents/FinalUpdatedReport7-13-15.pdf (hereinafter "*Krueger Report*").

[13] *Accounts Receivable and CILT Report*, FTI Capital Advisors, LLC, 16 (Nov. 15, 2014), http://www.aeepr.com/Docs/restructuracion/PREPA%20AR%20and%20CILT%20Report%20Final.pdf.

[14] *Id.* at 45, 49; Siemens PTI Report Number R054-15, Integrated Resource Plan, Addendum I: Losses Considerations (July 15, 2015), *available at* http://www.aeepr.com/Docs/Ley57/PREPA%20IRP%20Addendum%20I%20%E2%80%93%20Draft%20for%20PREC%20review%20-%20July%207-2015%20-%20Losses%20Consideration.pdf.

- PREPA's current labor contract allows employees to get a year's pay for nine months of work, and an employee earns overtime for more than 8 hours on any day even if the employee works less than 40 hours a week.[15]

- PREPA's 200 top managers are politically appointed and change with every administration.[16]

- According to publicly-filed contracts, PREPA plans to dramatically over-pay for solar and wind – buying such power at an average cost of about 17 cents per KwH,[17] greatly in excess of PREPA's average cost of producing additional power at 11.33 cents per KwH in 2016[18] and ***double*** the 8.6 cents which Lazard estimates is the levelized cost of utility-scale solar power nationwide.[19]

These facts illuminate why PREPA is a poster child for the creation of a strong Authority. First, a strong authority could provide a credible assessment of PREPA's financial condition that could provide the basis for reforms. Second, a strong authority could enact the reforms that so far the Commonwealth and its municipalities have refused to adopt.

A Strong Authority Can Fix These Problems

In light of the Puerto Rico government's inability to manage its profound fiscal and operational problems, Congress should consider establishing an Authority for Puerto Rico based on what Congress did with a control board for the District of Columbia back in the 1990s, when the District of Columbia had its financial problems. Many observers agree that the control board which Congress created for the District of Columbia was instrumental in the District's dramatic revitalization that is evident today.

Moreover, I would note that, when Congress examined legislative proposals to help the District of Columbia in the 1990s, opting for a control board, it also considered permitting the

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[15] *Krueger Report*, supra note 12, at 18; Collective Bargaining Agreement Between PREPA and the Union of Electrical and Irrigation Industry Workers of Puerto Rico (Aug. 24, 2008), *available at* http://www.utier.org/Contenido/CONVENIOFINALWEB.pdf. Employees receive 30 paid vacation days, 19 paid sick days and 20 paid holidays, for a total of 69 paid days off each year. *Id.* Assuming there are 260 working days in a year, PREPA employees accrue paid time for approximately 25%, or about three months, of each year. Unused vacation days can be carried over for a year; sick days can be accumulated and carried over from year to year without limit. *Id.*

[16] *Hearing Before the Puerto Rico Senate Committee on Energy Matters and Water Resources* (Apr. 14, 2015) (Testimony of Lisa Donahue, Chief Restructuring Officer of PREPA).

[17] C. Kunkel et al., *Opportunity for a New Direction for Puerto Rico's Electric System*, INSTITUTE FOR ENERGY ECONOMICS AND FINANCIAL ANALYSIS (Sept. 10, 2015), *available at* http://ieefa.org/wp-content/uploads/2015/09/Opportunity-for-A-New-Direction-for-Puerto-Ricos-Electric-System-Sept-10-2015.pdf.

[18] *See* PREPA, *PREPA's Transformation: A Path to Sustainability*, 9, as set forth in *PREPA Public Disclosure* (July 22, 2015), *available at* http://emma.msrb.org/ER906457-ER708173-ER1109700.pdf. PREPA's July 2015 report estimated the 11.33 cents cost of buying additional power based on current and currently-projected natural gas and oil prices. The IEEFA's September 2015 Report, although issued two months later, used 2014 natural gas and oil prices (more than twice as high) to support IEEFA's conclusion that renewable power is cheaper than conventional power.

[19] LAZARD, *Levelized Cost of Energy Analysis – Version 8.0,* 2 (2014), available at www.lazard.com/media/1777/levelized_cost_of_energy_-_version_80.pdf.

District of Columbia to access chapter 9 – but it expressly rejected that option because it found that:

> **[T]he Bankruptcy Code as it stands is neither intended to nor designed to promote judicial restructuring of a municipal government that suffers chronic, structural budget deficits. . . . Unlike a Control Board, the [Bankruptcy] Court provides no mechanism for acquiring independent financial expertise services. Nor can it provide legally binding guidance to the debtor on administrative or structural reform.**[20]

If Congress were to create an Authority for Puerto Rico and also grant chapter 9 for Puerto Rico, chapter 9 would not only: (1) undermine the rule of law and result in a bailout of Puerto Rico on the backs of well over a million U.S. taxpayers throughout the mainland (and Puerto Rico) who are retail investors in Puerto Rico bonds, but also (2) undermine the reforms hoped to be achieved through an Authority, as Puerto Rico could simply repudiate its debts through bankruptcy, thereby alleviating the political imperative to implement tough reforms recommended by the Authority.

A strong Authority provides the best chance to fix the problems of Puerto Rico and its governmental corporations. The Authority should have a small number of board members – I suggest 5 – because the smaller the board the stronger it will be.

A strong Authority must have board members from both Puerto Rico and the mainland that are acceptable to both Congress and Puerto Rico. The board should be bipartisan, appointed by the President and confirmed by the Senate, have experience in municipal finance and inspire the trust and confidence of Puerto Rico's creditors.

The board members will be asked to work long and hard on the problems of Puerto Rico. Their terms should be several years because Puerto Rico's problems will not be solved quickly. Further, board members should be compensated so that the Authority obtains the committed service of the most serious, experienced and best people – and Congress should seek out members who are preferably fluent in Puerto Rico's two official languages, English and Spanish, to help ensure effective communication with both Congress and the people of Puerto Rico.

The Authority should retain an executive director of unquestioned competence, stature and dedication, and the Authority should have the resources to hire committed, experienced, knowledgeable and bilingual financial professionals.

The powers of the Authority should be broad and must include the power of the purse, but they need not trespass on the sovereignty of the Commonwealth.

The United States Treasury already funds billions of dollars to Puerto Rico every year and the Commonwealth is asking for more – more Medicaid and federal credit support. The continuation of, or increase in, any support from the federal government can be conditioned on the Authority's approval of the Commonwealth's budget on a yearly basis – just as the District of Columbia Control Board's approval was required for the District to have access to federal funding.

With respect to the Commonwealth's government corporations, the Authority should have the same power that Michigan had over Detroit and has over its other cities: the

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[20] *District of Columbia Financial Responsibility and Management Assistance Act of 1995*, H.R. Rep. No. 104-96, at 17 (1995).

appointment of a manager with power to hire, fire, reject and renegotiate contracts, revise work rules, and restructure pensions.[21]

A strong Authority can bring expenditures under control. I cite the financial problems and recovery of New York City in the mid to late 1970s as the largest example. New York's budget had ballooned in the 1960s and 1970s as government grew bigger and bigger.[22]

Only outside intervention brought New York City's budget under control. Everyone remembers New York State's imposition of the Municipal Assistance Corporation, which to this day ensures that the City keeps its books in accordance with Governmental Accounting Standards. Fewer people remember that the U.S. Treasury also exercised oversight over New York – there was a special office created in Washington to deal with New York City.[23]

The oversight was effective, its results well known. New York City brought its labor costs under control, cut the size of its government and set the stage for an economic recovery.

More recently, the District of Columbia Control Board, with Anthony Williams as chief financial officer and later mayor, brought the District from deficit and fiscal crisis to surplus in less than two years.[24]

The Authority's role should not be permanent. Just as with the District of Columbia Control Board, the Authority's control should expire upon a congressionally approved determination of success, which should include, among other factors, access to short and long term capital markets at reasonable rates, a balanced budget for a few years in a row, and audited, credible financial statements.

Only after maximum operational changes have been made and maximum operational savings have been achieved, and only if debt restructuring is still necessary, the manager could then have the power to negotiate and implement a restructuring with the vote of two-thirds of the debt to be restructured.

Finally, it is critical that neither the Authority nor Puerto Rico have the authority to authorize chapter 9 filings because chapter 9 in its current form allows municipal debtors to do as little possible by paying creditors as little as possible.

Chapter 9 used to give creditors a vote – indeed, prior to 1978, it required agreement by a majority of bonds to even begin a case[25] – but the 1978 statute reduced the vote to a formality. So long as a chapter 9 plan has been accepted by one class of creditors, no matter how small, it can be confirmed over the objection of all other creditors, no matter how large or how many.[26]

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21 *See generally* 2012 Mich. Pub. Act 436, the Local Financial Stability and Choice Act.

22 *See* Exhibit C.

23 MARTIN SHEFTER, POLITICAL CRISIS FISCAL CRISIS: THE COLLAPSE AND REVIVAL OF NEW YORK CITY 134, 151 (Columbia Univ. Press Morningside ed. 1992).

24 *See* ALICE RIVLIN, ET AL., BUILDING THE BEST CAPITAL CITY IN THE WORLD, A REPORT BY DC APPLESEED AND OUR NATION'S CAPITAL 109 (2008), http://www.brookings.edu/~/media/Research/Files/Reports/2008/12/18-dc-revitalization-garrison-rivlin/appendix.PDF (hereinafter the "BROOKINGS REPORT") (attached hereto as Exhibit D).

25 Section 83(a) of the Bankruptcy Act of 1898, *as amended by* The Municipal Bankruptcy Act of 1937, Pub. L. No. 302, 50 Stat. 652 (1937) (codified at 11 U.S.C. § 403(a) (1970)).

26 11 U.S.C. § 901(a) (incorporating § 1129(a)(10)). Chapter 9 also allows debtors to classify disparate creditors together, even if the results will be inequitable. In Stockton's bankruptcy case, unsecured bond claims were classified with the much larger retiree medical claims, even though retiree medical claimants could also look to a spouse's insurance, the Affordable Care Act, and their pension claims, which were being paid in full. *See* In re City of Stockton, Cal., 526 B.R. 35, 62 (Bankr. E.D. Cal. 2015) *aff'd in part, dismissed in part*, 542 B.R. 261 (B.A.P. 9th Cir. 2015).

Chapter 9's other requirements – that the plan be "fair and equitable," "not discriminate unfairly" and be "in the best interests of creditors" – provide little protection to creditors,[27] who do not even have the ability to propose their own plan.[28]

Once in chapter 9, the Bankruptcy Code bars the court from ordering the municipality to do anything[29] – the municipality cannot be compelled to cut its costs, raise its revenues, collect its taxes, renegotiate its contracts, restructure its pensions, reform its budgets, anything. The only thing a court can do is dismiss the case.

So the argument often heard, that chapter 9 "builds consensus," is fake. A municipality is free to make minimal operational changes, cut a deal with one favored class of creditors, and tell all other classes that their votes mean nothing. The only remedy that creditors have in chapter 9, and the only power a court has with respect to the municipal debtor, is to get out of chapter 9.

No matter how strong the Authority or its emergency managers, the availability of chapter 9 or any compulsory debt restructuring reduces the incentive of any government to enact real reforms, will cut access to the capital markets and inevitably lead the Commonwealth and its governmental corporations returning to Congress for financial support.[30]

Chapter 9 Would Hinder, Not Help, The Authority

A comparison of the District of Columbia (which had a control board but no access to bankruptcy via chapter 9), with Jefferson County, Alabama (chapter 9, no control board) and the City of Detroit (chapter 9, 18-month emergency manager[31]) shows why a strong control board is required and why chapter 9 is an impediment to required reform.

The District of Columbia Control Board closed D.C. General Hospital over the objections of the D.C. City Council because the District had to cover deficits of $90 million – and because a local system of clinics and hospitals could provide better and less expensive medical care for residents.

By contrast, there was no control board for Jefferson County, Alabama. Jefferson County's Cooper-Green Medical Center was costing the county $10 million a year to employ

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[27] In Detroit's bankruptcy case, *In re City of Detroit, Mich.*, 524 B.R. 147 (Bankr. E.D. Mich. 2014), Bankruptcy Judge Rhodes held that paying one group of bondholders 13 cents while pensioners received 59-60 cents was not "unfair discrimination" because it did not offend "the judgment of conscience," including "the Court's experience and sense of morality." This standard – which had never before been applied to "unfair discrimination" – allowed the court to confirm the plan irrespective of the bondholder vote. *Id.* at 253, 256-58.

The "best interests of creditors" test also does little to protect creditors. In the Detroit case, Judge Rhodes further held that the plan was in the best interests of creditors because bondholder remedies would not yield a better result outside of bankruptcy. *City of Detroit*, 524 B.R. at 213-17. Precedent under old Chapter IX required a municipality to do what it could to pay creditors. *See Fano v. Newport Heights Irrigation District*, 114 F.2d 563, 565-66 (9th Cir. 1940).

[28] 11 U.S.C. § 941.

[29] 11 U.S.C. §§ 903-904.

[30] Some witnesses have predicted that governmental corporations can obtain "debtor in possession" or "DIP" financing in a chapter 9 bankruptcy case. There is no basis for this prediction. No private sector lender makes a DIP unless secured by a first lien on collateral. The government corporations cannot grant such a lien because most of them have already pledged all their collateral to existing bondholders. Therefore, if Puerto Rico's government corporations were given access to chapter 9, any bankruptcy case would be like General Motors and Chrysler – the only entity that would provide DIP financing would be the United States Government.

[31] The statute providing for the appointment of Detroit's emergency manager gave the manager a term of 18 months.

over 528 staff with fewer than 38 patients, even though it had 100 available beds.[32] The world-class University of Alabama/Birmingham Hospital is literally across the street with capacity to take Cooper-Green's patients. It took years – including two years in chapter 9 – for the County Commissioners to transition Cooper Green to an urgent care clinic.[33]

Detroit had similar problems when it resorted to chapter 9.

Kevyn Orr, the emergency manager appointed by Governor Snyder, had an 18-month term to solve a range of problems.[34] Orr cut debt service and moved retiree medical benefits off the City's budget and onto the federal government through the Affordable Care Act, but he made minimal cuts to pension – zero reduction in current benefits for police and fire,[35] a 4.5 percent cut for general employees,[36] and he allowed the City to adopt some of the same questionable practices that led to pension underfunding in the first place.

Detroit's pension problems are far from solved. Detroit's plan put in place a ten-year moratorium on pension funding, but Detroit must make yearly payments thereafter. Recent projections show that the balloon payment due in 2024 has risen to $195 million, approximately 71% higher than the $114 million originally projected.[37] Even former Bankruptcy Judge Rhodes, now a consultant to the Puerto Rico government, who confirmed the City's plan of adjustment, has admitted that Detroit's bankruptcy was a "missed opportunity" for greater pension reform.[38]

Lingering pension issues are one of many reasons that even now, over a year after Detroit emerged from bankruptcy, Detroit has no access to the low-cost ordinary municipal market. Detroit as an issuer still has a junk credit rating. Its new unsecured notes, issued under its bankruptcy plan, trade at around 23 cents on the dollar. Following its bankruptcy, Detroit has been able to access the credit markets only through secured debt issued by a State of Michigan entity secured by income tax revenues that the City never touches.[39] Puerto Rico has no entity to enable it to access the credit markets other than the United States Treasury.

By contrast, the D.C. Control Board was able to restore the District's access to the markets. By 2001, all three major rating agencies deemed the District's bonds investment

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[32] *See* Barnett Wright, *Dr. Sandral Hullett of Cooper Green Hospital, Among 210 Who Received Lay Off Notices*, THE BIRMINGHAM NEWS (Dec. 20, 2012), http:/blog.al.com/spotnews/2012/dr_sandral_hullett_ceo_of_coop.html; B. Wright, *Cooper Green Ending Inpatient, Emergency Room Services*, THE BIRMINGHAM NEWS (Dec. 12, 2012), http://blog.al.com/spotnews/2012/12cooper_green_mercy_hospital_to_2.html.

[33] *Id.*

[34] Mr. Orr ended up serving as Detroit's emergency manager from his appointment on March 2013 until Detroit emerged from bankruptcy in December 2014. Della Cassia, *Emergency Manager Kevyn Orr Steps Down as Detroit Emerges From Bankruptcy*, PBS Newshour (Dec. 12, 2014), http://www.pbs.org/newshour/rundown/emergency-manager-kevyn-orr-steps-detroit-emerges-bankruptcy.

[35] The cost of living adjustment was eliminated for police and fire retirees.

[36] Chris Christoff, *Detroit Pension Cuts from Bankruptcy Prompt Cries of Betrayal*, BLOOMBERG (Feb. 2, 2015), http://www.bloomberg.com/news/articles/2015-02-05/detroit-pension-cuts-from-bankruptcy-prompt-cries-of-betrayal.

[37] *See* Matthew Dolan et al., *$195M pension payment might derail Detroit's Recovery*, DETROIT FREE PRESS (Nov. 15, 2015), http://www.freep.com/story/news/local/detroit-bankruptcy/2015/11/14/detroit-pension-balloon-payment-estimated-195m/75657200.

[38] *Id.*

[39] *See* Michigan Finance Authority Offering Memorandum for Local Government Loan Program Revenue Bonds, Series 2014F (City of Detroit Financial Recovery Income Tax Revenue and Refunding Local Project Bonds) (Dec. 10, 2014).

grade.[40] One of my clients, Franklin Advisers, was an early investor in bonds issued by the District under the Control Board. Standard & Poor's now rates the District at AA – several notches above investment grade.

Orr made no structural changes to the Detroit government. The City exited chapter 9 with the same 28 government agencies it had when it entered bankruptcy.[41] Note that Puerto Rico has at least 120 government agencies and 78 municipalities for an island with 3.5 million people.[42]

By contrast, Mayor Anthony Williams and the D.C. Control Board focused on reducing government, collecting (not raising) taxes and attracting private sector employers to the District. The comparison of the District of Columbia with Puerto Rico is instructive. Puerto Rico's collection rates are extremely low:

> Some analysts estimate that uncollected personal income taxes amounted to 29.7 percent of actual income tax revenues in 1987 and 24.9 percent of tax revenues in 1992.[43]

The District recognized the importance of improving collections as a fundamental part of its turnaround:

> In addition to strictly managing expenditures, the District's growth in revenue generation since FY1997 is a striking success. Total tax revenue grew by 92% and gross revenues increased almost 53% from FY 1997 to 2007. The District took three important steps to make this possible: (1) D.C. made improvements to its current revenue collection capacity; (2) it improved its overall financial health, and, thus, its capacity to generate revenue, especially through the real estate market; and (3) it developed cautious estimates of future revenues.[44]

The contrasting experiences of Detroit and D.C. provide valuable instruction on the benefits of employing a strong control board to address the Commonwealth's problem and the dangers of resorting to chapter 9.

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[40] D.C.'s general obligation bonds were rated below investment grade in 1995; starting in 1998, as a result of the District's financial turnaround, the rating agencies began steadily increasing the ratings. *See* U.S. General Accounting Office, Testimony Before the Subcommittee on the District of Columbia, Committee on Government Reform, House of Representatives and Subcommittee on Oversight of Government Management, Restructuring and the District of Columbia, Committee on Governmental Affairs, U.S. Senate, "District of Columbia: Oversight in the Post-Control Board Period" 6 (June 8, 2001), http://www.gao.gov/assets/110/108870.pdf.

[41] *City of Detroit – Expert Witness Report of Stephen J. Spencer* (July 2014).

[42] *Annual Estimates of the Resident Population: April 1, 2010 to July 1, 2015*, U.S. CENSUS BUREAU (Jan. 22, 2016, 10:15 PM), http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=PEP_2014_PEPANNRES&src=pt; *Agency Directory*, PR.GOV (Jan. 24, 2016, 12:30 PM), http://www2.pr.gov/Directorios/Pages/DirectoriodeAgencias.aspx; Steven J. Davis & Luis A. Rivera-Batiz, *The Climate for Business Development and Employment Growth*, *in* RESTORING GROWTH IN PUERTO RICO, supra note 10, at 57.

[43] James Alm, *Assessing Puerto Rico's Fiscal Policies*, in RESTORING GROWTH IN PUERTO RICO, supra note 10, at 71.

[44] THE BROOKINGS REPORT, supra note 24, at 113.

CONCLUSION

Puerto Rico's problem in a nutshell is that its private sector employs too low a percentage of working-age citizens, its public resources are mismanaged and its government employs too great a percentage of its working-age citizens. The Commonwealth's cry of "humanitarian crisis" is nothing more than a plea for third parties – bondholders through cuts to debt service, the federal government through loans, grants or subsidies – to maintain the size of an un-maintainable and poorly managed government, to fund the patient's illness, not to cure it.

If Puerto Rico is to survive and flourish, it must create an island economy where the private sector generates income for its citizens and supports its own government. Supporting or increasing government expenditures will not work. Cutting debt service to maintain government spending will not work. A strong Authority which reduces government, enhances management of public resources and supports the private sector has a chance of doing so – as it did in D.C. and New York City. Any other solution leads the Commonwealth, as it led General Motors and Chrysler, back to the federal government for cash the private markets will no longer supply. In addition to eliminating access to private markets, access to chapter 9 would hurt individual investors – the very people who were willing to invest in Puerto Rico's infrastructure and development in the first place.

Exhibit A

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Thomas Moers Mayer is co-chair of Kramer Levin's 45-attorney Corporate Restructuring and Bankruptcy Department.

Mr. Mayer has represented Official Committees of Unsecured Creditors in some of the largest cases in history, including General Motors, Chrysler, Capmark, Smurfit-Stone and Dana Corporation. Mr. Mayer has also played major roles in the largest municipal insolvencies, representing holders of $900 million in secured sewer warrants of Jefferson County, Alabama in that County's chapter 9 case and $1 billion in Certificates of Participation in the Detroit chapter 9. Mr. Mayer leads the Kramer Levin team focused on heavily indebted Puerto Rico and its instrumentalities. He currently assists Amy Caton in her representation of $2.4 billion of secured bonds issued by the Puerto Rico Electric Power Authority.

Mr. Mayer has also represented investors in financially distressed companies. His transactions include the 1991 acquisition of Wheeling-Pittsburgh Steel Corporation and the 2006 hostile takeover of WCI Steel Corporation, both through chapter 11 plans supported by the United Steelworkers of America. He is the leading scholar on trading claims and taking control of corporations in chapter 11, having authored or co-authored (with Chaim J. Fortgang) five published articles and the *Collier Bankruptcy Manual* chapter on the topic.

Chief Justice John Roberts of the United States Supreme Court appointed Mr. Mayer to the United States Judicial Conference Advisory Committee on Bankruptcy Rules for a three-year term starting October 1, 2014. Mr. Mayer is a member of the National Bankruptcy Conference, a non-partisan organization of approximately 60 leading lawyers, law professors and bankruptcy judges which provides bankruptcy advice to Congress. He is also a Fellow of the American College of Bankruptcy, an honorary association of approximately 800 leading senior insolvency professionals.

Honors and Distinctions

- Listed in *Benchmark Litigation*, 2015
- Included in *The Best Lawyers in America*, 2015
- Recognized in *Chambers Global*, 2014
- Included in *Legal 500 US*, 2014
- Included in New York *Super Lawyers*, 2014
- Adjunct Professor, Cardozo Law School (1998)

Thomas Moers Mayer
Continued

Professional Affiliations

- Member, Association of the Bar of the City of New York

Education

- J.D., *magna cum laude*, Harvard Law School, 1981
  Editor, *Harvard Law Review*
- A.B., *summa cum laude*, Phi Beta Kappa, Dartmouth College, 1977

Bar Admission

- New York, 1982

Clerkships

- Judge J. Edward Lumbard, U.S. Court of Appeals for the 2nd Circuit, 1981-1982

Exhibit B

Commonwealth of Puerto Rico

Tax Reform Assessment Project

Unified Tax Code of Puerto Rico:

Tax Policy Implementation Options

Executive Summary

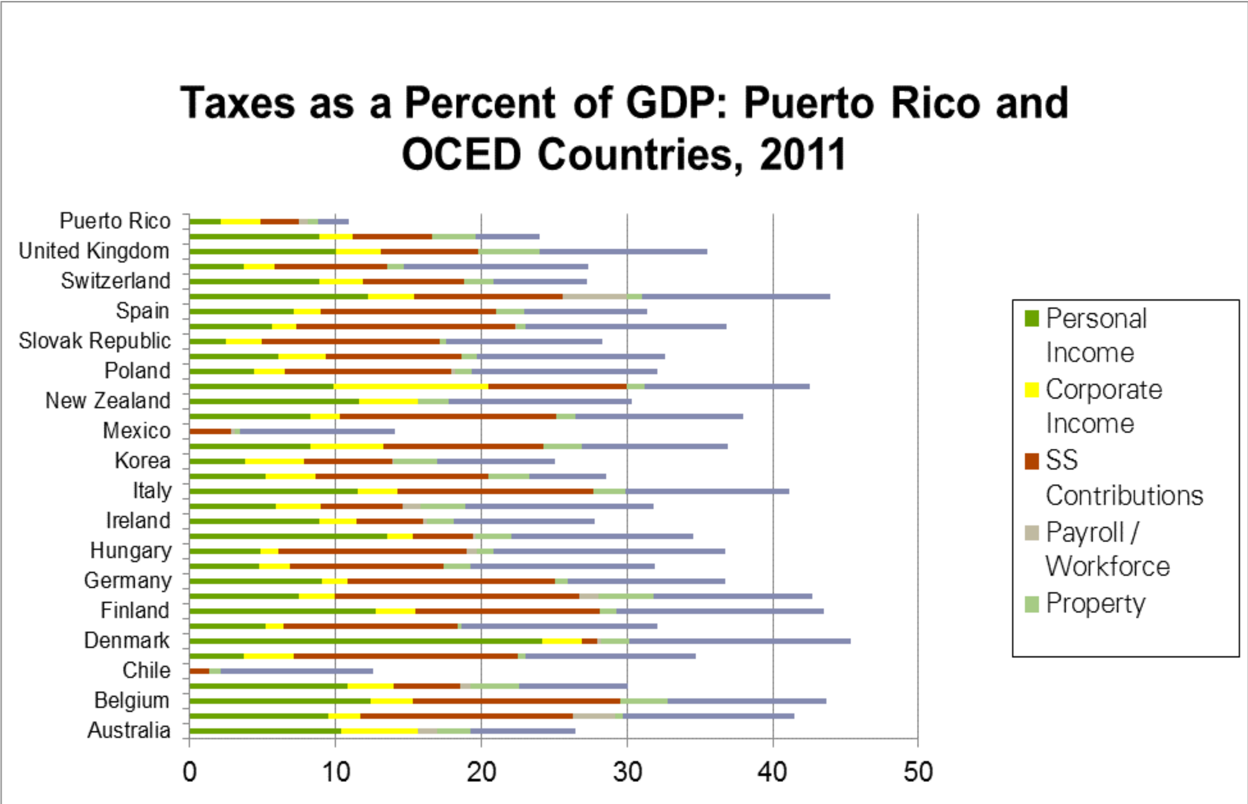
October 31, 2014

1.3 Summary of Principal Findings

1.3.1 High Level Observations

The current income and consumption tax structures are inordinately complex, due principally to a plethora of special provisions that for the most part were adopted in a haphazard manner over time generally to provide incentives for particular forms of economic activity. These special provisions have never been subjected to a cost benefit analysis. As shown in Tables 1 and 2, revenue from consumption and income taxes are below peer jurisdictions.

Table 1: Taxes as a Percentage of GDP in Puerto Rico Compared to Selected Jurisdictions[4]



[4] (*) While Table 1 uses GDP as the measure of comparison across countries, the results are similar when using GNP as the measure of comparison. Puerto Rico taxes as a percentage of GNP is closer to 15% but still substantially lower than the tax liability of the peer countries shown.

Table 2: Tax Collections as Percent of GDP -- Comparison of Puerto Rico to OECD Countries

	Puerto Rico	Average	Range
Personal Income	2.2%	8.3%	2.2 - 24.2%
Corporate Income	2.7%	3.0%	1.2 - 10.70%
SS Contributions	2.75%	9.00%	0.00 - 16.70%
Payroll/Workforce	0.21%	0.41%	0.00 - 4.44%
Property	0.75%	1.76%	0.29 - 4.16%
Goods/Services	2.216%	10.77%	2.06 - 15.91%
Total	10.66%	33.19%	

Table 3 presents data on the distribution of income and tax liability and shows that less than 10 percent of filers are responsible for almost 78 percent of income tax receipts.

Table 3: 2013 Income Tax Liability by Income Class (In Millions of USD)[5]

Income Level	Filers	Tax Liability (Excluding SS & Medicare)	Share of Tax (Excluding SS & Medicare)	Tax Liability (Including Social Security and Medicare)	Share of Tax (Including Social Security and Medicare)
Less than $20,000	538,026	$4	.2%	$368	9.6%
Between $19,999 and $40,000	319,108	$191	9.2%	$791	20.6%
Between $39,999 and $60,000	107,107	$270	13.0%	$604	15.7%
Greater than $59,999	89,459	$1,614	**77.6%**	$2,079	54.1%
Total	**1,053,700**	**$2,079**	**100.0%**	$3,842	**100.0%**

[5] Distributional analysis based on 2012 individual tax returns provided by Department of Treasury.

Commonwealth of Puerto Rico
Tax Reform Assessment Project

Unified Tax Code of Puerto Rico:

Tax Policy Implementation Options

General Explanation of Principal Options

October 31, 2014

A credit system for goods acquired for resale requires the carrying forward of credits, which can create cashflow burdens. Further, the discretionary power in the Secretary to refund tax where merchants can demonstrate they will be in a regular refund position creates uncertainty.

The existing system is overly burdensome for taxpayers. It is estimated that the sales tax compliance rate is in the neighborhood of 56%, an obviously unacceptable number. While the elimination of the requirement to file sales and use tax returns by location rather than by entity has simplified the compliance process to a certain extent, the requirement to file separate municipality returns and use tax returns for imports imposes significant compliance costs. The inconsistency between the municipalities in the administration of the tax, combined with a lack of information sharing between the municipalities and Department of Treasury, hampers decision making and gives rise to differences in interpretation of legislation. For example, there are inconsistencies in determining the point in time a merchant is considered to have commenced trading – upon first sale, first payment of payroll, or upon laying the first stone of the establishment.

2.1.3 Descriptions of Options

The existing consumption tax structure could be replaced by a broad-based single rate Goods and Services Tax ("GST") with regressivity relief accomplished through direct transfer payments. Financial services, residential housing, water and electricity would be exempt. Certain goods and services subject to excise tax could also be exempt. (See excise tax discussion below.) Businesses below a certain level of receipts, for example $75,000, would not be required to register. Regressivity relief would be calculated to assure that households below a specified income level would not incur any additional tax burden under the new system. All consumption taxes would be collected and administered at the Commonwealth level and proceeds distributed to the municipalities from a dedicated fund pursuant to a revenue sharing formula

2.1.4 Analysis

GST, also known as Value Added Tax ("VAT"), is recognized as the most efficient consumption tax both in terms of revenue for governments and neutrality towards domestic and international trade. It is the most common consumption tax utilized today. Over 150 countries and 33 of the 34 OECD countries have implemented some form of GST.[12] Its recognized capacity to raise revenue in a neutral and transparent manner has contributed to its virtually universal adoption.

A broad based GST with a single rate minimizes compliance cost and, from an economic perspective, is the best policy choice.[13] From an efficiency perspective, a moderate GST rate with a broad base and few exemptions is preferable to a higher rate with exemptions.

The move to a GST would lead to enhanced compliance and revenue when compared to current law. The tax rate would be a function both of revenue needs and the desirability of using consumption tax revenues to reduce the tax burden in other areas, particularly the individual income tax, or to replace revenues lost through repeal of existing provisions, such as the Patente Nacional.

[12] OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 28.

[13] OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 73.

Exhibit C

POLITICAL CRISIS

FISCAL CRISIS

The Collapse and Revival of New York City

MARTIN SHEFTER

Columbia University Press New York

TABLE 5.2

New York City Operating Expenditures by Object: Percentage Increase and Proportion of Total Increase, 1961–75

	Expenditures in Millions		Percentage Increase 1961–75	Proportion of Total Increase 1961–75
	1961	1975		
Wages, Pensions, and Fringe Benefits	$1,334.7	$5,520.6	313.6%	45.1%
Social Welfare	303.9	2,822.0	828.6	27.1
Hospitals	159.4	631.5	296.1	5.1
Debt Service	386.7	1,383.5	257.7	10.7
Contracts, Supplies, Equipment, Other	180.2	1,296.7	619.6	12.0
TOTAL	$2,364.9	$11,654.3	392.7	100.0

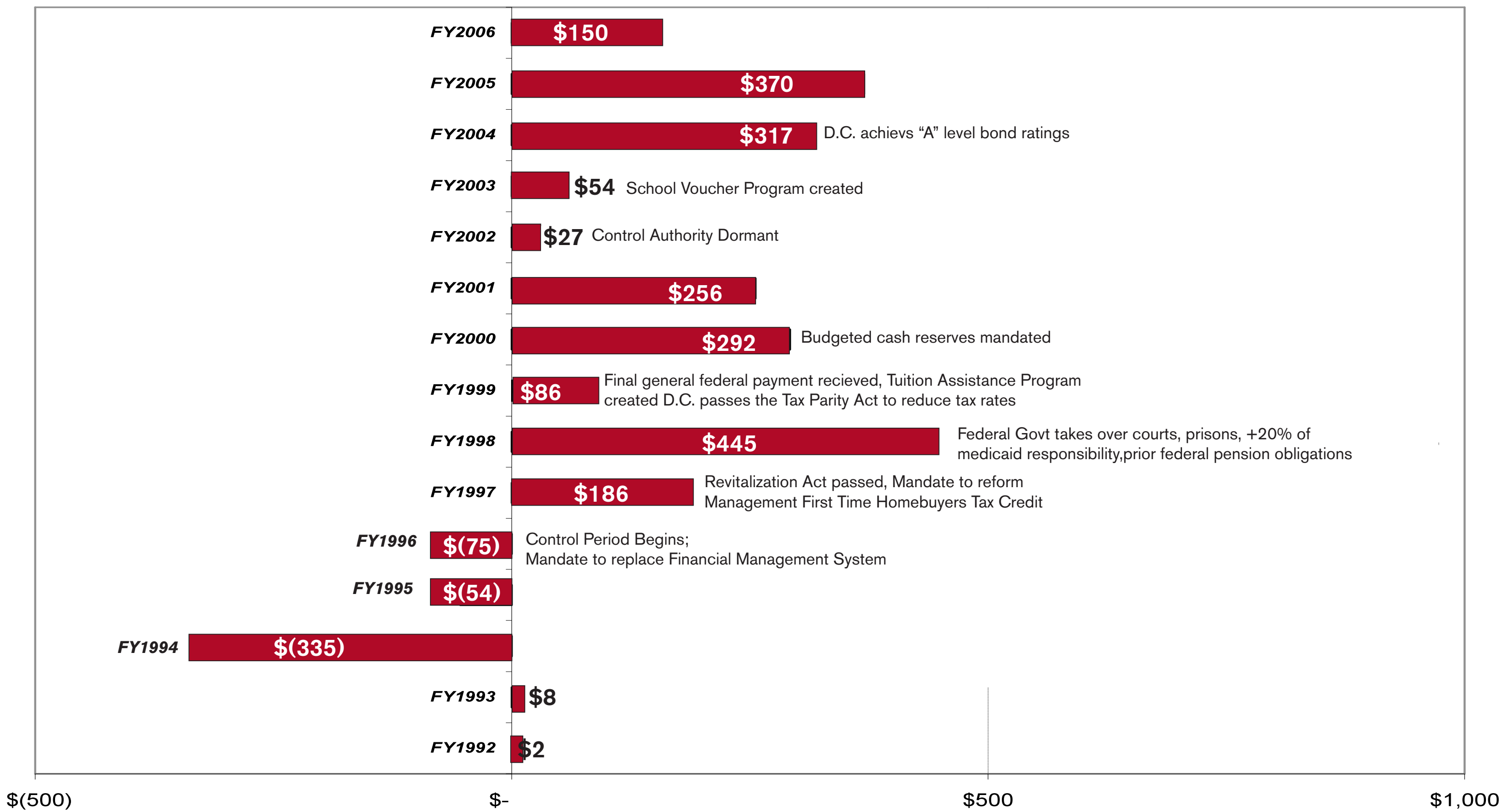
SOURCES: City of New York, *Annual Report of the Comptroller*, 1960–61 and 1974–75; Temporary Commission on City Finances, *The City in Transition*, Appendix III, table 4.

Exhibit D

APPENDIX TWO:

THE FISCAL COMEBACK OF THE DISTRICT OF COLUMBIA

District of Columbia, Year-end Operating Budget Balance, $M, FY1992-FY20006
Significant Federal Actions



repaid all advances made by the U.S. Treasury during the early Control Period years.[300] This financial progress enabled the Control Board to dissolve a year earlier than scheduled.

Since regaining Home Rule autonomy, the city has balanced its operating budget every year, replacing the deficit it once accumulated with annual budget surpluses, as shown in the table below. As a result of on-going annual surpluses, the District now has a sizeable balance in the General Fund of $1.494 billion at the end of FY2007. The General Fund balance is the cumulative sum of all annual surpluses and deficits beginning with Home Rule.

Fiscal Discipline to Prevent Overspending

Over the past decade, the District's spending has been strictly disciplined. The District's local anti-deficiency law, enacted after the Control Period, prevents agency heads from overspending a current budget, and its violation could result in termination or even more severe actions. The District's lawmakers have clearly affirmed the intent to stay within spending authorities.
Indeed, the city only achieved its impressive string of eleven balanced budgets because it was willing to make some very difficult decisions in order to maintain its fiscal health. Perhaps one of the most painful decisions came in FY2000, when the city chose to close D.C. General Hospital, the city's only full-service public hospital. Many residents used D.C. General for primary and routine care, as well as for emergency and hospital care. Yet with the hospital's expenditures exceeding budgeted revenues by as much as $90 million a year, there was no way to keep the hospital open without risking the District's newly-found financial stability.

The city continued to make hard choices in order to balance the budget for the next

Source: Alice Rivlin, et al., Building the Best Capital City in the World,
A Report by DC Appleseed and Our Nation's Capital, Appendix II (December 2008).