Can Historical Insolvency Proceedings Help Puerto Rico Get Back on Track?[*]

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I. Introduction

Puerto Rico is saddled with $70 billion in debt and predictions are that the island will default on its obligations.[1] If Puerto Rico defaults on its current bonds, creditors, such as bondholders, retirees, and labor unions may be fighting over a limited number of assets.[2] There has even been a suggestion that the United States government and its taxpayers will have to bail Puerto Rico out of its financial crisis.[3] This article offers a different suggestion—that Puerto Rico's debt might be restructured through the use of an equity receivership, an antiquated federal reorganization tool used by struggling railroads before such reorganizations were permitted under bankruptcy law.

Like the railroads of the late 19th century, bankruptcy laws do not extend to Puerto Rico. The Commonwealth does not have the option of filing bankruptcy under chapter 9, as Detroit did in 2013.[4] Since Puerto Rico is also an unincorporated territory[5] of the United States, it is difficult for creditors to foreclose on whatever collateral may exist. Puerto Rico and its creditors

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[1] Jake Zamansky, *Puerto Rico Investors Bracing for Default*, FORBES (Jan. 20, 2014), http://www.forbes.com/sites/jakezamansky/2014/01/20/puerto-rico-investors-bracing-for-default/.

[2] Charles Tatelbaum, Puerto Rico May be the Next Big Bailout for U.S. Taxpayers, Real Clear Markets (Apr. 10, 2014), http://www.realclearmarkets.com/articles/2014/04/10/puerto_rico_may_be_the_next_big_bailout_for_us_taxpayers__100998.html.

[3] *Id.*

[4] 11 U.S.C. § 101(52) ("The term 'State' includes the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9 of this title.").

[5] *See* Popular Democratic Party v. Com. of Puerto Rico, 24 F.Supp.2d 184, 190-92 (D. P.R. 1998) (discussing Puerto Rico's status as an unicorporated territory and the "Insular Cases" of the United States Supreme Court).

would benefit more from a property restructuring than a recovery and sale of assets, just as the municipal bond debt market would. So that begs the question, could Puerto Rico benefit from the use of an equity receivership?

Equity receiverships offered many benefits to railroads that might be useful to Puerto Rico. For starters, using an equity receivership to restructure at least part of its debt would give Puerto Rico and its creditors the benefit of having its restructuring supervised by a federal judge in one centralized (and local) forum. The filing of a creditor's bill provides the court with exclusive administration of the assets of the country and prevents creditors from attaching an asset or executing upon it.[6] Thus, the receivership offers an "automatic stay" to the extent that Puerto Rico could benefit from one.[7] Access to "DIP financing," such as "receiver certificates,"—notes that are issued to cover expenses incurred during the receivership and are paid back before the other creditors receive anything—means that Puerto Rico would continue to pay its bills.[8]

Through the receivership creditors could form committees and negotiations could begin on the entirety of Puerto Rico's situation—not just one creditor at a time. Perhaps, through this process, the parties could formulate a plan for recapitalizing debt and selling or issuing "new" bond debt. Moreover, because Puerto Rico is an unincorporated territory of the United States, presumably, the court could access all of Puerto Rico's resources and debts worldwide. In order to know whether the financial tool will be effective in the future, it helps to understand how it was used in the past.

II. Equity Receiverships and the American Railroad

[6] Stephen J. Lubben, *Out of the Past: Railroads & Sovereign Debt Restructuring*, 35 GEO. J. INT'L. L. 845, 852 (2004).
[7] F.H. Buckley, *The American Stay*, 3 S. CAL. INTERDISC. L.J. 733, 741 (Summer 1994).
[8] Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV, 1420, 1444 (2004).

Equity receiverships grew out of the need to assist railroads in dealing with their massive debt in the mid- to late 1800s. At that time, railroads were "highly-leveraged capital structures encompassing institutional debt, public bonds, trade payables, and public stockholders."[9] Typically, railroads issued several series of bonds—each secured by a specific section of track and other assets.[10] So a bondholder may be secured by a few feet, a few miles, or a few hundred miles of track in the middle of nowhere and across several states.

The public's need for an efficient railroad system was rising as the country was becoming more dependent upon railroads for moving people and goods over long distances. Investments in and construction of the railroads were also heavily subsidized by the federal government because of the effect on commerce.[11] So much depended on their services that it seemed impossible for railroads to fail but fail they did, in droves. Between 1873 and 1900, roughly one-third of all railroads, or about 700 railroads total, failed.[12] At some point, nearly 20% of the nation's track was insolvent.[13] Failing railroads left everyone in a bind.

Because there was no federal bankruptcy statute applicable to railroads, they were vulnerable to disruptive seizure of their assets, which would interrupt commerce across the nation.[14] For example, a railroad might run east to west from New York to California, with a creditor of the railroad holding a security interest in a small section of track in Nebraska. If the creditor were to foreclose on the track in Nebraska, service would be interrupted across the entire continent. Any interruption in service or a liquidation of the railroad as a whole would also

[9] Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Business for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 160-61 (2004).
[10] Stuart Bernstein, et al., *Is Chapter 11 Dead*, 15 FORDHAM J. CORP. & FIN. L. 1, 9-10 (2009), citing Charles Kerr, *The Origin and Development of the Law Merchant*, 15 VA. L. REV. 350, 367 (1929).
[11] Miller & Waisman, *supra* note 9, at 161.
[12] *Id.*
[13] *Id.*
[14] *Id.*

make it harder—if not impossible—to collect on the debt. Thus, the creditor's security interest in particular tracks was essentially worthless if the railroad was not operating.[15]

Needing an alternative to bankruptcy, railroads and their creditors sought to use the equitable powers of the federal courts to form equity receiverships, which would assume control of the defaulting railroad and its assets.[16] Equity receiverships were useful in the restructuring of rail road debt as they "negated state borders and provided a single forum to protect and administer the assets of the distressed railroad."[17] The receiverships set up a basis for creditors to realize the value of their security once the railroad defaulted on a bond.[18]

The process began with the filing of a "creditor's bill," which was a way of formally asking the court to appoint a receiver and acted like an automatic injunction preventing the collection of debt.[19] Then a "foreclosure bill" was filed and asked the court to schedule a sale of property.[20] Generally, railroads did not contest the bills and consented to the relief requested.[21]

Once a receiver was appointed, committees would be formed for each class of security.[22] The railroad's management would then negotiate with the committees to come up with a way to restructure the railroad's debt.[23] The plan usually proposed to recapitalize the railroad into a "new" entity and new securities in that entity would be distributed to investors of the former railroad, pursuant to the plan. Instead of voting on a plan, creditors who wished to participate in the process would deposit their securities with the committee that was negotiating on its behalf.[24] Eventually, the negotiations would conclude with a plan of reorganization and a new

[15] Bernstein, *supra* note 2, at 10.
[16] Miller & Waisman, *supra* note 9, at 161.
[17] *Id.* at 162.
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] Lubben, *supra* note 6, at 849.
[23] Miller & Waisman, *supra* note 9, at 161.
[24] Lubben, *supra* note 6, at 849.

reorganization committee would be formed.[25] Once the plan was finalized and the reorganization committee was formed, the court would schedule a sale, where the committee would credit bid the face value of the securities that had been deposited with the committees.[26] The committee would win the auction and become the new owners of the railroad.[27]

These receiverships began as a creditor's remedy and were not "voluntary."[28] Rather, a corporation would file an application with a federal court to put a company into receivership.[29] The first voluntary equity receivership was that of the Wabash, St. Louise and Pacific Railway in 1884.[30] "In the case of *Wabash*, representatives of the railroad *themselves* sought and obtained judicial authority to commence a receivership *prior* to missing their first interest payment."[31] It was a more common practice to have a friendly contract creditor file a creditor's bill, which the corporation would join.[32] In *In re Reisenberg*, the Supreme Court approved the practice.[33] So long as a debt existed between the railroad and the friendly out-of-state creditor, the Court found that there was a case a controversy despite the fact that the railroad wanted to enter receivership.[34]

Although receiverships could have been brought in state courts, litigants often chose to bring them in federal courts, through the use of diversity jurisdiction.[35] The railroad (or restructuring company) would find a creditor from out of state and the two would agree to the

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[25] *Id.*
[26] Miller & Waisman, *supra* note 9, at 161.
[27] Bernstein, *supra* note 10, at 10.
[28] *Id.*
[29] Henry J. Friendly, *Some Comments on the Corporate Reorganizations Act*, 48 Harv. L. Rev. 39, 41 (1934).
[30] U.S. Trust Co. v. Wabash W. R.R. Co., 150 U.S. 287, 290 (1893) (describing how the railroad filed its own bill of insolvency).
[31] Miller & Waisman, *supra* note 9, at 164.
[32] Friendly, *supra* note 29, at 41.
[33] *In re* Reisenberg, 208 U.S. 90, 111 (1908).
[34] *Id.*
[35] Ralph Brubaker, *On the Nature of Federal Bankruptcy Jurisdiction: A General Statutory and Constitutional Theory*, 41 WM. & MARY L. REV. 833-34 (2000).

filing of the creditor's bill.[36] Once diversity jurisdiction was established, ancillary jurisdiction enabled the courts to consider claims of the remaining creditor as well as proceedings brought by the receiver to recover assets.[37]

The idea of using a federal equity receivership to restructure debt quickly spread from railroads to other business entities. This was the favored procedural device for any company hoping to have a judicial reorganization. From the mid-1800s until the mid-1930s, receiverships were the preferred option for an American corporation looking for a judicially supervised reorganization.[38]

III. The Decline of Receiverships in Federal Court

After the depression, however, receiverships started to fall out of favor. The general opinion at the time was that receiverships were inadequate to meet the needs of a reorganizing company—at least a company that was not a railroad. The major investment bank firms that were involved in most of the receiverships were seen a pariahs who took advantage of the railroads, made a successful reorganizations impossible and engaged in self-dealing. Others criticized the use of the receiverships for thwarting state law and avoiding state and federal regulations. Still others believed that the federal government's exercise of its equity jurisdiction had grown too large.

The "waxing doubt" of the device can be traced to dicta in *Harkin v. Brundage*, wherein the Court uttered the "true rule" of receiverships: that only a judgment creditor may bring a creditor's bill after the return of "nulla bonda" on execution.[39] Around that same time, the jurisdiction of the federal courts was being examined. For a large part of the time that courts

[36] *Id.*
[37] *Id.*
[38] Lubben, *supra* note 6, at 845.
[39] Harkin v. Brundage, 276 U.S. 36, 52 (1928); *see also* Sidney Post Simpson, *Fifty Years of American Equity*, 50 HARV. L. REV. 171, 190 n.125 (1936) (citing several cases that have also called this practice into question).

were overseeing equity receiverships, the *Erie* doctrine had not yet been molded by federal courts.[40]

In 1938, the Supreme Court drastically changed federal practice by declaring that in cases where federal jurisdiction is based on diversity of citizenship, the courts should apply state substantive law.[41] Prior to *Erie, Swift v. Tyson* was the law of the land.[42] Swift permitted federal courts to develop federal common law in diversity cases so long as a state's legislature had not specifically addressed the issue. And so for many decades, federal courts relied on this case and developed a wide array of federal common law, including in cases of equity receiverships. *Erie*, however, questioned the legitimacy of federal common law.

To add to this already dwindling acceptance of receiverships, the Chandler Act was passed in 1938, which brought railroads under the wing of the Bankruptcy Act for the first time and provided both railroads and corporations with a more formalized process for reorganizing.[43] The reform of corporate bankruptcy law was related to broader changes occurring in the United States as part of the New Deal and in response to the Great Depression. The Chandler Act followed other major acts such as the Securities Act of 1933, the Securities Exchange Act of 1934, and the Glass-Steagall Act of 1933.[44] With the passing of the Chandler Act, the reign of equity receiverships as a business reorganization tool had come to an end.

IV. Receiverships Today

[40] *Equitable Remedy of Receivership—State Law in the Federal Courts*, 10 Stan. L. Rev 361, 366 (1958) (discussing how the Erie doctrine may be applied to federal equity receiverships).
[41] Erie R. Co. V. Tompkins, 304 U.S. 64, 79-80 (1938).
[42] Swift v. Tyson, 41 U.S. 1 (1842).
[43] David A. Skeel, Jr., *An Evolutionary Theory of Corporate An Law and Corporate Bankruptcy*, 51 Vand. L. Rev. 1325, 1358-1365 (1998).
[44] *Id*. at 1364.

Today, equity receiverships are most often used in regulatory enforcement of securities and commodities trading laws.[45] And there remains authority for appointing receivers even where there is no explicit statute on point.[46] Instead receiverships are governed almost entirely by federal common law.[47] "They are procedural shells into which federal and state claims and defenses fit; they do not confer any substantive rights on receivers that were not exercisable by the entities in whose shoes the receiver stands."[48]

The statutes that provide authority for federal equity receiverships are broad, leaving plenty of wiggle room. For example, Federal Rule of Civil Procedure 66 states: "These rules govern an action in which the appointment of a receiver is sought or a receiver sues or is sued. But the practice in administering an estate by a receiver or a similar court-appointed officer must accord with the historical practice in federal courts or with a local rule. An action in which a receiver has been appointed may be dismissed only by court order."[49]

Despite the growing dissatisfaction with the use of equity receiverships, the device has left a strong mark on the insolvency community. Corporate reorganizations were added to the Bankruptcy Act in 1934.[50] In 1938, when Congress enacted the Chandler Act, it grafted many of the receivership's tools into corporate bankruptcy law. For example, the "debtor-in-possession" concept that is so much a part of modern chapter 11 practice was born from equity receiverships. As was the plan of reorganization, the committee of creditors, and the absolute priority rule, among other important reorganization concepts.

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[45] Jared A. Wilerson, *In Whose Shoes?: Third-Party Standing and "Binding Arbitration Clauses in Securities Fraud Receiverships*, 8 J.L. Econ. & Pol'y 45, 49-50 (2011).
[46] S.E.C. v. Am. Bd. Trade, Inc., 830 F.2d 431, 436 (2d Cir. 1987) ("Although neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 explicitly vests district courts with the power to appoint trustees or receivers, courts have consistently held that such power exist.").
[47] Wilerson, *supra* note 45, at 50.
[48] *Id.* at 50-51.
[49] Fed. R. Civ. P. 66.
[50] Friendly, *supra* note 29, at 39 n.3.

V. Can an Equity Receivership Help Puerto Rico?

This brings us back to the initial question. Could the use of an equity receivership help the creditors of Puerto Rico in its current financial crisis? Let's start by assessing where Puerto Rico stands today. The island nation is saddled with $70 billion in debt.[51] In 2009, the governor of Puerto Rico signed the "Law Declaring a Fiscal State of Emergency and Establishing a Comprehensive Fiscal Stabilization Plan to Save Puerto Rico Credit" into law, which implemented cost-saving measures aimed at addressing the deficit.[52] And more measures are being introduced all the time.[53]

And yet, today the unemployment rate is near 15.4%.[54] There has been a mass exodus of professionals and middle-class residents from the island to the main land.[55] Those leaving are trying to escape the increased cost of living, high crime rates, tax hikes, failing small businesses, and declining schools.[56] Puerto Rico's municipal bond rating has been cut to junk-bond status.[57] This change in rating reflects a worry that Puerto Rico has a limited ability to sell more debt and that the island faced possible cash shortages.[58] The low rating could subject the island to collateral demands and note accelerations, which could make an already bad situation worse.[59]

Having friendly creditors file an equity receivership against Puerto Rico to restructure these debts would be very useful. First, filing for an equity receivership in federal court

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[51] Lizette Alvarez, *Economy and Crime Spur New Puerto Rican Exodus*, N.Y. TIMES (Feb. 8, 2014), *available at* http://www.nytimes.com/2014/02/09/us/economy-and-crime-spur-new-puerto-rican-exodus.html; *UPDATE: 3-Fed's Dudley sounds alarm over Puerto Rico's High Debt Load*, REUTERS (June 24, 2014 5:23 PM), http://www.reuters.com/article/2014/06/24/usa-puertorico-dudley-idUSL2N0P519Q20140624.
[52] *See* UAW v. Fortuna, 633 F.3d 37, 39 (1st Cir. 2011).
[53] Maria Chutchian, *Puerto Rico Proposes Debt Restructuring for Agencies*, LAW360 (June 25, 2014 6:30 PM EST).
[54] Alvarez, *supra* note 51.
[55] *Id.*
[56] *Id.*
[57] *S&P cuts Puerto Rico's General Obligation Debt Ratings to Junk*, REUTERS (Feb. 4, 2014 3:36 PM), http://www.cnbc.com/id/101359301.
[58] *Id.*
[59] *Id.*

establishes of a single collective forum for parties to work toward a plan of reorganization.[60] In *Fortuna*, First Circuit appears to have already paved the way for Puerto Rico to restructure its relationship with public employees.[61] In that case, Puerto Rico's legislation that violated collective bargaining agreements and providing for salary and benefit freezes, layoffs, and furloughs was upheld as valid despite a constitutional challenge that such a law violated the Contracts Clause of the Constitution.[62] The decision implies that public employees will be expected to "sacrifice" when a state faces a financial crisis like the one affecting Puerto Rico now.[63]

This case provides Puerto Rico with strong bargaining power over its public employees and might make them more eager to come to the negotiation table. Having these creditors "on board" may make the process run more smoothly and can help to induce other creditors, such as bond holders, to participate in the process. When all creditors and other parties in interest are steered in the same direction, the collective interests of the group can be assessed and an appropriate course of action mapped out.[64] Filing for an equity receivership in federal court establishes of a single collective forum for parties to work toward a plan of reorganization.[65] The presence of a federal judge will also help keep negotiations on track.

The second benefit to using an equity receivership is that the court has the power to issue an injunction akin to the automatic stay. Such an injunction prevents the disbanding of debtor's assets. It also prevents the largest or loudest creditor from claiming the lion's share of assets and

[60] Miller and Waisman, *supra* note 9, at 197.
[61] *Fortuna*, 633 F.3d at 46.
[62] *Id.* at 39-40, 47.
[63] *Id.* at 46 ("'It should not be wholly unexpected, therefore, that these public servants might well be called upon to sacrifice first when the public interest demands sacrifice.'") (quoting and citing Balt. Teachers Union v. Mayor of Balt., 6 F.3d 1012, 1021 (4th Cir. 1993)).
[64] *Id.*
[65] Miller and Waisman, *supra* note 9, at 197.

leaving the remaining creditors to share the scraps. The stay is also an effective tool in persuading an otherwise obstinate party to approach to the negotiating table.

The third benefit of an equity receivership is for the parties to emerge from the proceeding with an agreed upon plan of reorganization and the belief that financial stability in the region is more valuable than a hasty fire sale of assets. When focus is places entirely on repaying debts at any cost, the big picture is often case aside. For this reason, business reorganizations under chapter 11 are often touted as better for the economy in the long run because the Bankruptcy Code emphasizes reviving companies and making them into viable businesses.[66]

This philosophy is also relevant to the restructuring of sovereign debts. Financial decisions can be shortsighted in the midst of a crisis. For example, Puerto Rico increased taxes in recent years in an effort to raise revenues and that increase has been blamed for causing small and medium businesses to close.[67] In effect, the higher rate of tax might actually have made it more difficult to collect tax revenue.[68] Instead of "quick-fix" revenue increases, perhaps the commonwealth should focus its energy more broadly on a reorganization effort aimed at creating a stable and viable commonwealth.

This is not to say that a receivership is a perfect solution. The first hurdle that will need to be overcome by any creditor attempting to file a receivership against Puerto Rico would be to determine whether a sovereign immunity defense could or would be claimed by the commonwealth.[69] Presumably, Puerto Rico would agree to waive such a claim in favor of

[66] Kim Gerard, *How Chapter 11 Saved the US Economy, Working Knowledge*, (Harv. Bus. School Newsletter? Mar. 25, 2013), http://hbswk.hbs.edu/item/6945.html.
[67] Alvarez, *supra* note 50.
[68] *Id.*
[69] Frensenius Medical Care Cardivascular Resources, Inc. v. Puerto Rice and Caribbean Cardiovascular Center Corp., 322 F.3d 56, 60 (1st Cir. 2003) ("The Commonwealth of Puerto Rico is treated as a state for Eleventh

having its debts restructured in its federal courts.[70] Additionally, use of an equity receiverships often resulted in a high rate of recidivism.[71] And receiverships can last longer than bankruptcy reorganizations and be "unnecessarily complicated and costly."[72]

These drawbacks are minor compared to the alternatives, and the equity receivership may provide the political cover needed to successfully reorganize massive debt spread among many creditors. The receivership could prove to be an important instrument for an organized debt restructuring in Puerto Rico.

Amendment purposes."); *see also id.* at 64 ("In Puerto Rico, a breach of contract action against the Commonwealth is capped at $75,000") (citing 32 P.R. Laws Ann. § 3077(c) (2001)).

[70] Puerto Rico Ports Authority v. M/V Manhattan Prince, 897 F.2d 1, 9 (1st Cir. 1990) ("Absent abrogation by Congress or waiver by the state, the eleventh amendment insulates states from damage suits in federal court.")

[71] *See* Lubben, *supra* note 6, at 856; *see also* Lubben, *supra* note 8, at 1466.

[72] Simpson, *supra* note 39, at 192.