

FULL FAITH BONDS AND REVENUE BONDS IN PUERTO RICO

ARTICLE

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INTRODUCTION**

PUBLIC FINANCING MAY HAVE ITS ORIGINS BACK IN THE EARLY ITALIAN REPUBLICS, at the dusk of the Middle Ages. In the early fifteenth century, the Republic of Genoa faced a dire financial crisis. Most government revenue was needed to pay public debts. Its creditors, worried about imminent bankruptcy, founded a private organization called *San Giorgio* by which they would exchange the Republic's debt for equity shares in the new institution, acquiring in return a right to collect taxes and operate some of the Republic's profitable businesses.¹

Modern government financing has its beginnings in the nineteenth century, when New York issued some bonds in order to finance public infrastructure projects, such as river canals and bridges.² Rapidly, other states started issuing bonds to pay for public construction works and projects.³

State financing permits governments to obtain a project's social and economic benefit without having to pay for it at once. Instead, the government borrows money in order to achieve the intended goal and, in turn, commits itself to future payment on the loans. This scheme greatly resembles any other type of loan: debtor obtains money advancements and, in turn, commits to pay principal plus interests on a future and determined date. As any other debtor, if government does not comply with the terms, its credit ratings will probably decrease and future credit capabilities will be diminished. In case of default, creditors may not be available to advance future loans. Thus, public debtors are greatly motivated to pay their debts as due and, sometimes, even offer alternate means to comply with loan or bond issuance terms.

The government of the Commonwealth of Puerto Rico is constitutionally authorized to raise funds through public debt issuances. The Constitution also

** This article tries to examine the general relations between government debtor and its bondholder creditors. In particular, we will try to analyze the Commonwealth's legal framework for public debt financing and debt issuances, examining also the practical meaning of the full faith and credit pledge. There are some who think that Commonwealth's creditors may have lien rights on public property and in case of government default, may even execute said properties for payment on the debts. We will try to show that general obligation (G.O.) creditors of the Commonwealth do not have the right and may not be able to seize Puerto Rico's properties in case of government default, but instead that the full faith pledge actually implies a real and *good faith* commitment to timely pay every debt as they come due and that, ordinarily, state power cannot be invoked to impair said obligation commitments. We will also examine revenue bonds issued by some public entities in Puerto Rico, as well as the differences and similarities between general obligations and revenue bonds. We also point out that at the time this article was written and edited Puerto Rico maintains a clean payment record on its public debt, but recently some questions have emerged regarding its short and mid-term credit capabilities.

¹ Clayton P. Gillette, *Can Public Debt Enhance Democracy?*, 50 WM. & MARY L. REV. 937, 939 (2008).

² Richard M. Jones, *The Future of Moral Obligation Bonds as a Method of Government Finance in Texas*, 54 TEX. L. REV. 314, 315 (1976).

³ *Id.*

provides that Puerto Rico's legislature shall have the power to fix limits of public debt issuance by the municipalities:

The power of the Commonwealth of Puerto Rico to impose and collect taxes and to authorize their imposition and collection by municipalities shall be exercised as determined by the Legislative Assembly and shall never be surrendered or suspended. The power of the Commonwealth of Puerto Rico to contract and to authorize the contracting of debts shall be exercised as determined by the Legislative Assembly, but no direct obligations of the Commonwealth for money borrowed directly by the Commonwealth evidenced by bonds or notes for the payment of which the full faith, credit and taxing power of the Commonwealth shall be pledged shall be issued by the Commonwealth if the total of (i) the amount of principal of and interest on such bonds and notes, together with the amount of principal of and interest on all such bonds and notes theretofore issued by the Commonwealth and then outstanding, payable in any fiscal year and (ii) any amounts paid by the Commonwealth in the fiscal year next preceding the then current fiscal year for principal or interest on account of any outstanding obligations evidenced by bonds or notes guaranteed by the Commonwealth, shall exceed 15 percent of the average of the total amount of the annual revenues raised under the provisions of Commonwealth legislation and covered into the Treasury of Puerto Rico in the two fiscal years next preceding the then current fiscal year; and no such bonds or notes issued by the Commonwealth for any purpose other than housing facilities shall mature later than 30 years from their date and no bonds or notes issued for housing facilities shall mature later than 40 years from their date; and the Commonwealth shall not guarantee any obligations evidenced by bonds or notes if the total of the amount payable in any fiscal year on account of principal of and interest on all the direct obligations referred to above theretofore issued by the Commonwealth and then outstanding and the amounts referred to in item (ii) above shall exceed 15 percent of the average of the total amount of such annual revenues.⁴

The Constitution authorizes Puerto Rico's municipalities to pledge their full faith and credit on any obligation, bond or IOU directly issued by said municipalities. It also provides certain limitations for these debts.⁵

Since no bondholder suit has been presented claiming payment of Puerto Rico's general obligations (G.O.), and Puerto Rico has never defaulted on its

⁴ P.R. CONST. art. VI, § (emphasis added).

⁵ *Id.* The Constitution establishes that no full faith and credit obligation shall be issued by the municipalities when:

[T]ogether with the amount of all such bonds and notes theretofore issued by such municipality and then outstanding, shall exceed the percentage determined by the Legislative Assembly, which shall be not less than five per centum (5%) nor more than ten per centum (10%) of the aggregate tax valuation of the property within such municipality.

Id.

public debt,⁶ a question arises as to what section two, article six of the Constitution of Puerto Rico actually means. This article will try to establish that Puerto Rico's full faith and credit obligations, as well as its revenue bonds, are unsecured debts and that the Constitution does not concede any security interest or seizing rights to creditors; but also that these debts do not amount to mere moral promises of future payment.⁷

We will also try to establish that the government bears a high burden of proof against impairing its public debt obligations. In fact, Puerto Rico's full faith and credit pledge must be interpreted as a *good faith* promise to pay every public debt as they come due and that, in need of revenues, the Commonwealth pledges that taxes may be raised and collected in order to pay every obligation as due, in accordance with the established terms.

There are other Commonwealth debt obligations. Puerto Rico also issues *revenue bonds*. These bonds are typically issued by a public corporation or a separate public entity and are commonly payable from a direct source; usually revenues to be raised by a public project. For these revenue bonds, the Commonwealth may not pledge its full faith and credit because revenue bond creditors have direct interests upon incomes raised by bond issuer.⁸ The Commonwealth also issues other debt obligations by concept of notes or tax and revenue anticipation notes. These may be considered as a type of general obligation debt, but may not be guaranteed by the full faith and credit and the power to raise taxes.⁹ Under federal law, Puerto Rico's public debt enjoys a triple tax-exemption; thus, Commonwealth debt is usually very attractive to investors.¹⁰

⁶ Government Development Bank of Puerto Rico (G.D.B.), *Introduction: Debt Payment Record*, http://www.gdb-pur.com/investors_resources/introduction.html (last visited May 21, 2012).

⁷ There are some that tend to believe that the Commonwealth Constitution gives Puerto Rico's general obligation (G.O.) creditors security interests or liens over Commonwealth properties or public funds that could, in case of default, be executed, sold or levied by creditors to obtain payment. Also, there are some who think that revenue bondholders may be able to seize or attach public properties in order to obtain payment on these bonds. This article will try to argue and demonstrate that such is not the case in Puerto Rico and that at least some bond creditors cannot seize, levy or attach Commonwealth properties to obtain payment. Nonetheless, these types of debts are not mere moral obligations.

⁸ The Commonwealth Constitution does not explicitly provide for revenue bonds issuances by public utilities, but said obligations are quite common in Puerto Rico. Public corporations issue them somewhat regularly and according to legislation. *E.g.*, Puerto Rico Aqueduct and Sewer Authority (P.R.A.S.A.) and Puerto Rico Electric Power Authority (P.R.E.P.A.). *See also* Government Development Bank of Puerto Rico (G.D.B.), *Tax Exempt Securities*, http://www.gdb-pur.com/investors_resources/exempt-securities.html (last visited May 21, 2012), for a list of all local bond issuers.

⁹ *See* Government Development Bank, *Investor Resources*, http://www.gdb-pur.com/investors_resources/commonwealth.html (last visited May 21, 2012).

¹⁰ Puerto Rican Federal Relations Act, 48 U.S.C.A. § 745 (West 2012). The Puerto Rican Federal Relations Act states that Commonwealth bonds are exempt from federal, state and Commonwealth taxes:

All bonds issued by the Government of Puerto Rico, or by its authority, shall be exempt from taxation by the Government of the United States, or by the Government of Puerto Rico or of any political or municipal subdivision thereof, or by any State, Territory,

I. CONSTITUTION AND STATUTES: GENERAL OBLIGATION BONDS AND REVENUE BONDS

Section two, article six of the Constitution of Puerto Rico authorizes public debt issuances according to legislative disposition. For its general obligation (G.O.) bond issuances, Puerto Rico pledges its full faith, credit and taxing powers. Commonwealth direct debt, i.e., general obligations, is issued according to state legislation. Municipality debts are issued according to municipal ordinances. Public corporation debts are issued according to the particular statutes of the issuing entity. The Government Development Bank (G.D.B.), which acts as the government's fiscal agent in every debt transaction, must supervise and approve all bond issuances.¹¹

A full faith and credit general obligation stands as a different type of public debt compared to revenue bonds. G.O.s are *pledged* debts, which means that the full taxing power of the state or municipality is invoked in order to pay the obligation.¹² However, payment on *revenue obligation bonds* (revenue bonds) is limited to revenues pledged from a determined and designated income source or fund.¹³

The full faith pledge in a G.O. implies that the government assumes an irrevocable obligation to use and apply, in good faith, its authorized revenue sources and taxing powers for full and proper payment of principal and interest on the debt as the obligation comes due.¹⁴ Said *good faith promise* implies that the state or municipality will use its general revenue powers to raise sufficient funds for payment.¹⁵ These pledged G.O.s are backed by an "unlimited taxing power on the residents, taxpayers and property owners within the jurisdictional boundaries of the [state or municipal] borrower."¹⁶

A. General Obligations

Puerto Rico issues G.O.s consistently. Every such issuance requires specific legislative authorization. Any issuance must be individually and independently understood, but the general work frame does not vary greatly.

or possession, or by any county, municipality, or other municipal subdivision of any State, Territory, or possession of the United States, or by the District of Columbia.

Id.

¹¹ See P.R. LAWS ANN. tit. 7, § 552 (2006 & Supp. 2012). See also Government Development Bank, *Public Debt*, http://www.gdb-pur.com/investors_resources/public-debt.html (last visited May 21, 2012).

¹² 1 M. DAVID GELFAND ET AL., *STATE AND LOCAL GOVERNMENT DEBT FINANCING* § 1:7 (2nd ed. 2012).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.* at 2 § 14:3.

In 2008 the Commonwealth issued \$250 million as general obligation bonds for public improvement works.¹⁷ This issuance was carried out pursuant to Act No. 243 of August 9, 2008.¹⁸ The Official Statement provides that Act No. 243 pledged the “good faith, credit and taxing power of the Commonwealth”¹⁹ for prompt payment of the principal and interest of said bonds. The Statement also provides that since the G.O.s are pledged, they are payable from Commonwealth general revenues and that some government incomes do not qualify as general revenues for said purposes.²⁰

The Commonwealth also issues some G.O.s by the name of Public Improvement Refunding Bonds.²¹ The Official Statement for said issuance states that these debts are general obligation bonds and that the Commonwealth irrevocably pledges its faith, credit and taxing power for full and prompt payment.²² The Statement also provides that this issuance was done pursuant to Act No. 33 of December 7, 1942 and a Resolution passed on March 7, 2012 adopted in accordance with said Act.²³

The G.O. issuer is the Commonwealth of Puerto Rico *per se*, and not any other government subdivision. In a 2007 issuance valued at more than \$400 million, pursuant to Act No. 74 of July 23, 2007, the Commonwealth *irrevocably* pledged its faith, credit and taxing power for prompt payment on the bonds.²⁴

Again, said bonds are payable, according to the Statement, from Commonwealth general revenues, i.e., all central government revenue, minus monies raised by public corporations (which may issue bonds payable from their own revenues).²⁵ This means that general obligations are payable from all Commonwealth central government income, i.e., “payable from any funds available for such purpose at the Department of the Treasury in the fiscal year in which such payment is due.”²⁶ This includes, but is not limited to, personal and property taxes, other special taxes and any new tax the Commonwealth deems necessary for prompt and full payment of its debts.²⁷ The Statement also provides that, according to section two, article six of the Constitution of Puerto Rico, G.O.s are

¹⁷ Government Development Bank, *Commonwealth of Puerto Rico Public Improvement Bonds of 2008, Series A: Introductory Statement*, http://www.gdb-pur.com/pdfs/public_corp/commonwealth/PR_Commonwealth_250MGO_OS.pdf (last visited May 22, 2012).

¹⁸ *Id.*

¹⁹ *Id.* at 10.

²⁰ *Id.* at 104.

²¹ Government Development Bank, *Commonwealth of Puerto Rico Public Improvement Refunding Bonds, Series 2012B*, www.gdb-pur.com/investors_resources/documents/PRCommonwealth02a-FIN.pdf (last visited May 22, 2012).

²² *Id.*

²³ *Id.* at 1.

²⁴ Government Development Bank, *Commonwealth of Puerto Rico Public Improvement Bonds of 2007, Series A*, http://www.gdb-pur.com/pdfs/public_corp/commonwealth/2007-09-17-OS-PRCommonwealthGOS408MM.pdf (last visited May 23, 2012).

²⁵ *Id.* at 1-33.

²⁶ *Id.* at 10.

²⁷ *Id.* at 11.

payable from *internal revenues*, which include income and property taxes and excise taxes on goods and commodities, but does not include other special contributions, such as tobacco and alcohol taxes.²⁸

Note that every Commonwealth G.O. issuance must be statutorily authorized by Puerto Rico's legislature and that every issuance explicitly provides whether the particular bonds are *pledged* or not. This, of course, is part of the constitutional provisions concerning public debt issuance by the Commonwealth.²⁹

II. REVENUE BONDS

The other main type of Commonwealth public debt are *revenue bonds*, which are debts payable to bondholders – and according to the statute authorizing their issuance – only from a designated *special fund* or a specified revenue source.³⁰ Some revenue bonds are payable from special fees or charges paid by users of a public utility or public service system (such as tolls or power utility bills). Some of these obligations specifically provide for fee raises or rate increases on the public utility in order to obtain sufficient funds to amortize these debts. In case of default, revenue bondholders may seek a writ of mandamus requiring debtor to raise or levy proper rates or fees in order to pay in full.³¹

However, it should not be understood that bondholders, either G.O. creditors or revenue bond creditors, have security interests over government properties. Such obligations are “not secured by any real or personal property held as collateral . . . [r]ather, they represent claims on pieces of the borrower's cash flow.”³²

A. Commonwealth Revenue Bonds

The Puerto Rico Electric Power Authority (P.R.E.P.A.) is a Commonwealth public corporation. It is owner of the Island's power utilities and sole provider of electrical services. P.R.E.P.A. boasts that it supplies 99% of all power consumed in Puerto Rico.³³ As such, it is authorized by its governing statutes to issue its own debt. P.R.E.P.A. revenue bonds are not pledged G.O.s. These revenue bonds are payable from the corporation's net revenues, derived from rates and charges

²⁸ *Id.* at 11-12.

²⁹ P.R. CONST. art. VI, § 2.

³⁰ GELFAND, *supra* note 12, at 2 § 14:3.

³¹ *Id.*

³² *Id.* Government may also issue debts in which mortgages or other types of security interests over real property are conceded. Such debts may be known as *conduit* bonds, but this article will not presently examine those. *See id.*

³³ Government Development Bank, *Tax-Exempt Securities: Puerto Rico Electric Power Authority (PREPA)* http://www.gdb-pur.com/investors_resources/prepa.html (last visited May 22, 2012).

for its utility services.³⁴ Payment on these revenue bonds is also guaranteed by P.R.E.P.A.'s reserve funds.³⁵

P.R.E.P.A.'s \$650 million revenue bond issuance in 2012 provides that said bonds are not part of Commonwealth public debt, nor municipalities' debts, and that no one, except the corporation, shall be liable for their payment.³⁶ The Official Statement provides that these bonds are only payable from the identified payment source, i.e., revenues of the system after expenses.³⁷ Accordingly, it must be understood that *system* refers to all properties owned and operated by P.R.E.P.A., while *revenue* means all monies received by the corporation as the result of operating its system, after expenses.³⁸

The Puerto Rico Aqueduct and Sewer Authority (P.R.A.S.A.) is another revenue bond issuer. P.R.A.S.A. is Puerto Rico's sole water and wastewater owner and service operator, boasting service to 97% of the Commonwealth's population. In a February 12, 2012 issuance for more than \$295 million, this public entity pledged its revenues from water services for payment of the bonds.³⁹ These bonds are payable solely from and secured by a gross lien on its revenues, but they also concede a first claim right on such revenues.⁴⁰

The 2012 Statement for this issuance provides that P.R.A.S.A., an independent legal entity, will not be stripped of its powers or authority in any way that could impair bondholders' rights.⁴¹ Accordingly, it also provides that, pursuant to the applicable statutes, the G.D.B. acted as financial advisor for this transaction.⁴²

The Puerto Rico Highway & Transportation Authority (P.R.H.T.A.) constructs, maintains and operates Puerto Rico's highway network. Its revenue bonds are payable solely from special gas and fuel taxes, highway tolls and some license fees. In a 2010 bond issuance and refunding, valued at more than \$297 million, the Official Statement provides that these bonds are payable from and

³⁴ *Id.*

³⁵ *Id.*

³⁶ Government Development Bank, *Puerto Rico Electric Power Authority Power Revenue Bonds, Series 2012 A and Power Revenue Refunding Bonds, Series 2012B*, http://www.gdb-pur.com/investors_resources/documents/2012-04-23-PreElectricPowerAuthoia-FIN.pdf (last visited May 12, 2012).

³⁷ *Id.* at 32.

³⁸ *Id.*

³⁹ Government Development Bank, *Puerto Rico Aqueduct and Sewer Authority Revenue Bonds, Series 2012B*, www.gdb-pur.com/investors_resources/documents/PRAqueductSewerAuthoia-FIN-295MM.pdf (last visited May 12, 2012).

⁴⁰ *Id.* Note that they do not concede liens or a right to seize P.R.A.S.A.'s properties in case of default. Instead, creditors have a right to obtain payment from the first revenues that enter P.R.A.S.A.'s fund, i.e., first claim rights or priority in the order of payment.

⁴¹ *Id.* at 72.

⁴² *Id.*

secured by P.R.H.T.A. revenues.⁴³ It also provides that an insurance policy guarantees their full payment.⁴⁴

The aforementioned public entities represent only a small portion of Puerto Rico's revenue bond issuers. Other such issuers include the Puerto Rico Public Employment Retirement System (E.R.S.), the Convention District Center (P.R.C.D.A.), and the Industrial Development Company (P.R.I.D.C.O.), among several others.⁴⁵ Their revenue bonds are usually payable only from issuer's income, as identified by the act, resolution or ordinance authorizing issuance. Commonwealth funds or state general revenues are not payment sources for these revenue bonds.

B. Bondholder's Claims on Revenue Bonds

What happens if a revenue bond issuer defaults? What recourse does a bondholder have to obtain payment on these revenue bonds? Can a defaulted revenue bondholder seize, attach or levy upon issuer's properties to satisfy the debt? If neither a lien nor a security interest is conceded, what can creditors do to obtain payment?

Most revenue bonds cannot be accelerated in case of default. Of course, that would depend on the specific statute, ordinance, resolution or covenant authorizing such issuance.⁴⁶ Some revenue bond covenants may provide that in case of default, issuer may be required to raise its service rates or charges so they are sufficient for payment of bond's principal and interest.⁴⁷ In such circumstances, bondholders may be able to seek a court order or mandamus requiring debtor to raise fees or levy higher service rates.⁴⁸ If the bond covenant does not provide any mortgage or security interest as collateral, revenue bondholders may only claim from the issuer's cash funds, after issuer's expenses, and cannot seize debtor's property or bank accounts.⁴⁹

Thus, revenue bonds are payable from incomes generated by issuer's activities,⁵⁰ or from special taxes designated as payment source.⁵¹ Bondholders of these types of debt cannot claim payment from Commonwealth general taxes or gen-

⁴³ Government Development Bank, *Puerto Rico Highways and Transportation Authority Highway Revenue Refunding Bonds, Series AA and Transportation Revenue Refunding Bonds, Series H*, www.gdb-pur.com/investors_resources/documents/PRHighwayaFIN_000.pdf (last visited May 22, 2012).

⁴⁴ *Id.* at 12.

⁴⁵ See generally Government Development Bank, *Tax Exempt Securities*, http://www.gdb-pur.com/investors_resources/exempt-securities.html (last visited May 22, 2012), for a list of all bond issuers in the Commonwealth.

⁴⁶ GELFAND, *supra* note 12, at 2 § 14:3.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *See id.*

⁵⁰ *E.g.*, (1) Power utility service rates and charges; (2) Toll charges; (3) etcetera.

⁵¹ GELFAND, *supra* note 12, at 1 § 10:21.

eral funds; but only from those funds and sources designated as such by the covenant, ordinance, statute or resolution authorizing the particular debt issuance.⁵²

III. DEFAULT ON PLEDGED G.O. BONDS

The main tools of public financing in Puerto Rico have been explained: (a) pledged or full faith and credit general obligations and (b) non-pledged, non-full faith revenue bonds. They are easily identified according to their sources of payment. Pledged G.O.s are payable from Commonwealth general funds, whereas revenue bonds are payable from an identified and specific income source, such as P.R.E.P.A.'s utility charges, P.R.A.S.A.'s water services rates or P.R.H.T.A.'s toll incomes.

A. Bondholder's Claim on Full Faith and Credit Bonds

Puerto Rico's payment record shows that it has never defaulted on any of its obligations. Moreover, Puerto Rico has never reached the constitutional limit on its public debt.⁵³ This, added to the fact that Commonwealth G.O.s enjoy a triple tax exemption,⁵⁴ makes Puerto Rico's public debt very attractive to investors. Since no claim has ever been initiated to obtain payment on Puerto Rico's G.O.s, it begs to question, what can G.O. bondholders do in a default scenario? How may they be protected? As we will see, the Constitution of Puerto Rico already provides a system for creditor assurance.

Puerto Rico's Constitution explicitly permits bondholders to bring court claims for payment on general obligations. Article six states that the Secretary of the Treasury may be required to allocate available funds for amortization of Commonwealth's debts in case creditors claim payment on the pledged bonds.⁵⁵ The Constitution also provides that in a default scenario, where available re-

⁵² *Id.*

⁵³ See Government Development Bank, *Investor Resources: Commonwealth of Puerto Rico*, http://www.gdb-pur.com/investors_resources/commonwealth.html (last visited May 23, 2012). See also P.R. CONST. art. VI, § 2. The Commonwealth Constitution establishes that no pledged bonds shall be issued if:

(ii) any amounts paid by the Commonwealth in the fiscal year next preceding the then current fiscal year for principal or interest on account of any outstanding obligations evidenced by bonds or notes guaranteed by the Commonwealth, shall exceed 15% of the average of the total amount of the annual revenues raised under the provisions of Commonwealth legislation and covered into the Treasury of Puerto Rico in the two fiscal years next preceding the then current fiscal year

P.R. CONST. art. VI, § 2.

⁵⁴ Puerto Rican Federal Relations Act, 48 U.S.C.A. § 745 (West 2012).

⁵⁵ P.R. CONST. art. VI, § 2.

sources are insufficient for the fiscal year, the order of payment first requires disbursement for public debt amortization.⁵⁶

We have already seen that bondholders do not have a right to seize or levy upon Commonwealth property and that pledged G.O.s are only payable from government general funds. What other recourse may bondholders have? What if debtor simply denies payment when asked?

1. *Faitoute* and State Power

In *Faitoute Iron & Steel Co. v. City of Asbury*,⁵⁷ Asbury, a New Jersey city, had issued large amounts of public debt by way of general obligation bonds. Foreseeing that default was imminent, bondholders asked that Asbury be put under a special state finance commission. State law provided a special receivership could be established in order to accomplish the ordered payment of claims brought against public debtor.

Pursuant to said statute, Asbury was placed under control of the special state commission, which in turn devised a scheme for refunding the defaulted bonds. However, some Asbury bondholders did not approve the refunding plan and initiated suits based on a contract impairment theory, claiming face value on the G.O.s.

In dismissing these claims, the U.S. Supreme Court stated that the devised refunding scheme was not an impairment of obligations under the federal Contract Clause. It added that the taxing power of the municipality could not be distributed or surrendered to bondholders in order to obtain payment on the G.O.s.⁵⁸ The Court stated that:

An unsecured municipal security is therefore merely a draft on the good faith of a municipality in exercising its taxing power. The notion that a city has unlimited taxing power is, of course, an illusion. A city cannot be taken over and operated for the benefit of its creditors, nor can its creditors take over the taxing power.⁵⁹

The Court recognized that the only remedy for enforcement of the bond claim was a writ of mandamus compelling the levy of new city taxes, but that

⁵⁶ *Id.* § 8.

⁵⁷ *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942).

⁵⁸ *Id.* at 509.

⁵⁹ *Id.* It also stated that:

A municipal corporation . . . is a representative not only of the State, but is a portion of its governmental power. . . . The State may withdraw these local powers of government at pleasure, and may, through its legislature or other appointed channels, govern the local territory as it governs the State at large. It may enlarge or contract its powers or destroy its existence.

Id. (citations omitted).

such remedy was just the equivalent of “the empty right to litigate.”⁶⁰ The Court explained that every time state courts had issued such orders, their intent was easily frustrated by resignation of the government official required to levy the tax.⁶¹

The Court concluded that the refunding scheme devised by the special state commission, pursuant to New Jersey law, was precisely what defaulted bondholders needed to assure payment of their unsecured G.O.s. The New Jersey statute provided that approval of the debt adjustment scheme required agreement by 85% of creditors.⁶² Since no other reasonable remedy was possible and the refunding scheme only modified the general obligations, the Court found no contract impairment.⁶³

2. Flushing Nat. Bank: Full Faith Pledge Implications

Several decades after *Faitoute*, New York state courts appeared to digress from the *Faitoute* holding. In *Flushing Nat. Bank v. MAC for City of N.Y.*,⁶⁴ a New York City note holder brought suit asking that a New York law that declared a moratorium on said notes be declared unconstitutional. Since the State constitution prohibited the city from issuing public debts without pledging the full faith and credit, the court held the Moratorium Act, in denying creditors any judicial remedies for a three year period, rendered “meaningless” the faith and credit pledge.⁶⁵

The New York Moratorium Act provided that during a period of three years no action or court claim could be brought against any state entity seeking to enforce any order or judgment for payment on city bonds, regardless whether any payment was due during that period.⁶⁶ The statute also provided that during the three-year span no action or court proceeding claiming short-term city notes could be initiated.⁶⁷

In declaring the Act unconstitutional, the New York court stated that the faith and credit pledge was to be regarded as an obligation to pay debts and a commitment of the city’s taxing powers to generate sufficient revenues for said payments. However, the court stated that the pledge did not create a lien or security interest upon debtor’s revenue. Instead, it should be interpreted as an

⁶⁰ *Id.* at 510.

⁶¹ *Id.* at 511. The Opinion narrates that some state officials had run for office on a platform of willingness to be held in contempt of court rather than complying with such court orders. *Id.* at 511.

⁶² *Id.* at 504.

⁶³ *Id.* at 515-16. However, the Court narrowed its holding and stated that it was not concerned over secured bond claims, i.e., debts in which a security interest is present as payment assurance.

⁶⁴ *Flushing Nat. Bank v. Municipal Assistance Corp.*, 40 N.Y.2d 731 (1976).

⁶⁵ *Id.* at 732.

⁶⁶ *Id.* at 733-34.

⁶⁷ *Id.* at 734.

acknowledgment of indebtedness, which in turn would be “enforceable in an ordinary action” if the obligation failed.⁶⁸

The New York court found that:

A faith and credit obligation is, therefore, entirely different from a revenue obligation, which is limited to a pledge of revenues from a designated source or fund . . . [i]t is also in contrast to a moral obligation, which is backed not by a legally enforceable promise to pay but only by a moral commitment.⁶⁹

Thus, it held that since state constitution required New York City to pledge its indebtedness with the full faith and credit, the Moratorium Act would enable debtor to ignore its pledge, thus contradicting constitutional requirements.⁷⁰ Since the constitutional pledge served as creditor protection against state police powers being construed to waive payment on public debts, the statute was contrary to constitutional purposes.

The *Flushing* court also stated that the full faith pledge made it “imperative [to pay debt obligations] even if tax limits be exceeded.”⁷¹ In fact, New York’s Constitution provided that a municipal officer could be required to allocate sufficient funds for payment of debts if a bondholder suit arose claiming due obligations and, in a default scenario, sufficient funds be set apart from first incoming revenues for prompt payment.⁷² Lastly, the *Flushing* court majority refused the dissent’s argument that the state police powers could not be invoked in dire financial circumstances to avoid payment of public debts. Thus, the court held that a constitutional interpretation of state powers being applied to suspend or delay prompt payment on the bonds was impermissible.

3. U.S. Trust Co. of N.Y. and the Federal Contract Clause

In *U.S. Trust Co. of New York v. New Jersey*,⁷³ New York and New Jersey had jointly established the Port Authority as an independent legal entity with large private capital investment, broad powers to administrate its holdings and authority to pledge its revenues securing payment of debts. When the Oil Crisis erupted in the early 70s, New York and New Jersey tried to retroactively repeal the Port Authority covenant, reducing Port Authority powers in order to cut large state deficits and use some of the newly available funds for other public policy purposes. Bondholders brought suit claiming that such repeal of the covenant amounted to impairment of their credit holdings on the Port Authority.

⁶⁸ *Id.* at 735.

⁶⁹ *Id.*

⁷⁰ *Id.* at 736.

⁷¹ *Id.* at 737.

⁷² *Id.* at 738. *See also* N.Y. CONST. art. VIII, § 2. Said clause requires that sufficient funds be set aside from first revenues and applied for payment.

⁷³ *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1 (1977).

The U.S. Supreme Court found that, as a matter of law, New York and New Jersey had contracted debt obligations with Port Authority revenue bondholders. Since the referred covenant repeal authorized lower borrowing margins and greater deficits on Port Authority finances, such repeal would reduce available revenues for payment of the bonds.⁷⁴ The Court stated that the federal Contract Clause was not to be interpreted as an absolute prohibition of contract modifications, nor that it should be literally read. Instead, the Contract Clause should be balanced against state police powers, depending on the circumstances at issue.⁷⁵

The Court determined that, since states could enter contracts and bind in financial obligations, their spending powers could be *relinquished* and state-taxing authority could be exercised for payment of public debts.⁷⁶ The Court stated that the *Faitoute* holding was the only recent instance in which it had sustained a bond contract “alteration.”⁷⁷ Since in *Faitoute*, Asbury City could not have paid its debts according to the original terms, the state refunding plan allowed an effective compliance with debt obligations. Differentiating *Faitoute*, the Court found that the Port Authority case presented “a much more serious impairment”⁷⁸ which was not sustainable by previous holdings.

It then determined that a “[s]tate cannot refuse to meet its legitimate financial obligations simply because it would prefer to spend money promoting the public good rather than the private welfare of its creditors.”⁷⁹ In rejecting states’ claim, the Court found that repeal of the Port Authority covenant was neither necessary nor reasonable to achieve the asserted public purposes. It then declared that less drastic means would have been available and that a “[s]tate is not free to impose a drastic impairment when an evident and more moderate course would serve its purposes equally well.”⁸⁰ The covenant repeal was found contrary to the federal Contract Clause.⁸¹

4. Development of Bondholders’ Suits and Other Recourses

Neither a pledge of full faith and credit nor a revenue pledge of direct income sources may be understood as absolute payment security.⁸² However,

⁷⁴ *Id.* at 20-21.

⁷⁵ *Id.* at 21.

⁷⁶ *Id.* at 24.

⁷⁷ *Id.* at 27.

⁷⁸ *Id.* at 28.

⁷⁹ *Id.* at 29.

⁸⁰ *Id.* at 31.

⁸¹ Chief Justice Burger stated in his concurrence that the states had not demonstrated that the impairment was essential to achieve the advanced public policy purposes. The three dissenting Justices argued that although states should not be able to freely impair their obligations, the Contract Clause could not be used to create a safe haven for private rights and that states had properly acted in accordance to their financial welfare.

⁸² Kenneth W. Bond, *Enhancing the Security Behind Municipal Obligations: Flushing and U.S. Trust Lead the Way*, 6 FORDHAM URB. L. J. 1, 2 (1977).

Flushing and *U.S. Trust* present some limitations on government powers.⁸³ These cases suggest that states have a substantial burden in proving that a possible impairment of public debt obligations is a necessary and reasonable measure. Before *U.S. Trust*, some cases had already suggested that when states contracted public debt obligations they could not impair creditors' rights afterwards.⁸⁴

The above-mentioned cases point out that pledged G.O.s impose a trust on public debtors to hold and protect such obligations, and that state legislation cannot impair debt terms subsequently.⁸⁵ Read together, *U.S. Trust* and *Flushing* suggest that even a slight modification of debt terms might be impermissible. Such modifications might turn into a *slippery slope* scenario, where small alterations pave the way for substantial impairments, until no creditor protection remains whatsoever.⁸⁶ *U.S. Trust* suggests that both pledged G.O.s and revenue bond obligations have to remain unchanged throughout their outstanding period.⁸⁷

However, *Faitoute* remains good law after *U.S. Trust*. Some distinctions are necessary. (1) *Faitoute* was examined in absence of federal bankruptcy laws.⁸⁸ The case was decided under New Jersey law, which provided a debt adjustment scheme for distressed public debtors. (2) The *Faitoute* refunding plan required a high percentage of approval by G.O. bondholders, which meant that most creditors agreed to the plan. Thus, they were arguably estopped from any impairment claim.⁸⁹ (3) In *Faitoute*, Asbury City seemed to assert a very serious financial crisis, which in turn allowed state police powers to be exercised. (4) Finally, the refunding scheme only substituted old bonds with new ones that had longer due periods, but were equally pledged.⁹⁰

Furthermore, the Supreme Court's reasoning in *U.S. Trust* and New York's state court rationale in *Flushing* suggest that *financial embarrassment* is not enough to permit states to invoke their police powers in the ways ascertained.⁹¹ The facts suggested that the Port Authority in *U.S. Trust* and New York City in *Flushing* had either self-inflicted their poor fiscal status, or had alternate means to raise new revenues.⁹² The *Faitoute* case stands as approving public debt term alterations, but it may seem that *Flushing* and *U.S. Trust* effectively saved distressed issuers from self-inflicting damage. A contrary result in *Flushing* and *U.S. Trust* may have had negative consequences in the long run. Municipalities or

83 *Id.* at 10.

84 *Id.* at 14.

85 *Id.* at 15.

86 *Id.* at 15-16.

87 *Id.* at 17.

88 *Id.* at 18. The federal Municipal Bankruptcy Act was struck down in 1936. The refunding scheme in *Faitoute* was approved in 1937, when no Bankruptcy Act existed.

89 *Id.*

90 *Id.* at 19.

91 *Id.* at 21.

92 *Id.* N.Y. City had alleged serious financial deficit in *Flushing*. While the Court found in *U.S. Trust* that the Port Authority had alternate means to raise revenues from its services and rates.

other public debt issuers would be frequently tempted to impair bond terms, which would pave the way for higher borrowing costs in the future and render their debt a less attractive investment.⁹³

IV. THE PUERTO RICO SCENARIO

A. Impairment of Contracts

It has been established that public debt, both full faith and credit G.O.s and revenue bonds, cannot, ordinarily, be impaired. *Flushing*⁹⁴ points out that when the full faith, credit and taxing powers pledge is a constitutional provision, which debt issuer is required to comply with, the state may not approve legislation that suspends or blocks bondholders' rights, i.e., creditors' claims on a due debt or the right to seek judicial remedies by virtue of debt terms, even when the state asserts negative financial balances. Such suspension or foreclosure of creditors' rights to claim, even when temporary, seems contrary to a constitutional full faith pledge. In other words, when the state constitution requires debt issuers to pledge their faith and credit, issuers are committed to full and prompt payment on the debt as due and no statute can materially impair said commitment by temporarily suspending or foreclosing creditors' rights.

*U.S. Trust*⁹⁵ stands for the proposition that a revenue bond issuer may not substantially deplete its pledged revenues, even when it asserts a necessity to do so based on public policy preferences. Such depletion of revenue may imply impermissible contract impairment when alternate means were available to achieve the preferred policies. However, *Faitoute* still holds that if a G.O. issuer finds itself in a serious and very negative financial crisis, its public debt terms may be modified. For instance, the *Faitoute* Court noted that New Jersey had implemented legislation to protect its subdivision's welfare by creating a special commission that would organize claims presented against distressed public debtors.

In *Faitoute*, the Court pointed to state rules providing that the bond-refunding scheme required approval by a very high percentage of creditors.⁹⁶ It was also noted that the refunding plan did not block creditors' remedies.⁹⁷ In-

⁹³ See *id.* at 24-27. *Faitoute* has recently been called into doubt by lower courts. See *In re Jefferson County*, 465 B.R. 243, 293 (Bkrcty. N.D. Ala. 2012), where a Bankruptcy Court declared in *dicta* that only *Faitoute* had sustained alterations to bond contracts outside bankruptcy proceedings and that only dubious value remained in it. See also *George D. Hardin, Inc. v. Village of Mount Prospect*, 99 Ill.2d 96, 104 (1983), where the Illinois Supreme Court stated that only *Faitoute* stood as upholding alterations to bondholders' rights. However, *Faitoute* is still very much good law and we do not think it should be otherwise. The alleged dubious value of *Faitoute* is not widespread; in fact, the contrary may be true and it seems to be a commonly cited reference in federal and state courts.

⁹⁴ *Flushing Nat. Bank v. Municipal Assistance Corp.*, 40 N.Y.2d 731 (1976).

⁹⁵ *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1 (1977).

⁹⁶ In fact, 85% of creditors were required to approve the refunding plan in *Faitoute*.

⁹⁷ Contrary to what had happened in *Flushing*, in which the struck statute blocked any creditor claim for a three-year period.

stead, the plan only exchanged defaulted bonds for newly issued ones with longer due periods, but the same pledge remained in place. It should be noted that the New Jersey Supreme Court had judicially sanctioned the refunding scheme, and plan approval required a prior judicial determination as to whether:

(1) [T]he municipality is unable to pay in full according to their terms the claims proposed to be adjusted or composed, and perform its public functions and preserve the value of property subject to taxation, (2) the adjustment or composition is substantially measured by the capacity of the municipality to pay, (3) it is in the interest of all the creditors affected thereby, and (4) that it is not detrimental to other creditors of the municipality.⁹⁸

The debtor in *Faitoute* seemed to positively demonstrate its need for an emergency plan in view of its heavy amounts of debt, the financial crises of the period and the widespread high levels of deficit at the time.⁹⁹

Since no bondholder suit has been initiated for payment on Puerto Rico's G.O.s, no case has judicially construed article six, section two of the Constitution of Puerto Rico. There are no judicial determinations as to whether the Constitution requires every Commonwealth G.O. to be pledged with the full faith and credit or whether said pledge is only permissive and activated by legislative provisions authorizing the particular bond issuance. New York's Constitution states that: "[n]o indebtedness shall be contracted by any county, city, town, village or school district unless such . . . shall have pledged its faith and credit for the payment of the principal thereof and the interest thereon."¹⁰⁰ Thus, it seems clear that New York's Constitution prohibits some G.O. debt issuances, unless debtor pledges its faith and credit.

The Constitution of the Commonwealth of Puerto Rico provides that:

The power of the Commonwealth to contract and to authorize the contracting of debts shall be exercised as determined by the Legislative Assembly, but no direct obligations of the Commonwealth for money borrowed directly by the Commonwealth evidenced by bonds or notes for the payment of which the full faith credit and taxing power of the Commonwealth shall be pledged shall be issued by the Commonwealth . . .¹⁰¹

The Commonwealth's full faith pledge, it seems, may only be activated by legislative prevision.

⁹⁸ *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 504 (1942).

⁹⁹ It must be remembered that *Faitoute* was resolved in 1942, just as World War II and the Great Depression were on their way, and the defaulted G.O. bonds in question dated back to the prosperous Roaring Twenties era.

¹⁰⁰ N.Y. CONST. art. VIII, § 2.

¹⁰¹ P.R. CONST. art. VI, § 2.

1. The Constitutional Amendment of 1961

In 1961 Congress passed a Joint Resolution amending article three of the Puerto Rico Federal Relations Act,¹⁰² providing that said Resolution take effect upon approval by a majority of the Puerto Rican electorate in a referendum amending the Commonwealth's Constitution.¹⁰³ The Commonwealth Legislature accordingly approved a Resolution in September 29, 1961 providing for the holding of said referendum, which in turn passed by majority of the popular vote on December 10, 1961.¹⁰⁴ This referendum added some provisions to the Commonwealth Constitution and substituted the wording in the Puerto Rico Federal Relations Act that limited the Commonwealth's debt-incurring powers.¹⁰⁵ This amendment added the full faith and credit pledge wording to the public debt provisions in the Commonwealth Constitution, which were not in its original language of 1952.¹⁰⁶

Said pledge has full constitutional force, and, as we have seen, may not be statutorily impaired. Thus, the *Flushing* case is illustrative here and *U.S. Trust* remains very relevant. Of course, these interpretations have substantial caveats, i.e., the *Faitoute* case, and the fact that no Puerto Rican court has judicially construed these constitutional provisions.

B. Full Faith and Credit Bondholders' Remedies

We have seen that a state may not, ordinarily, impair its debt obligations; whether they are G.O.s or revenue bonds. But what happens if creditors claim payment as due and debtor only alleges that there are no funds available?

As we have stated, G.O. bondholders may bring suit in state court claiming face value on the bonds, as the Commonwealth Constitution provides.¹⁰⁷ Furthermore, the Constitution provides that in such circumstances Puerto Rico's Secretary of the Treasury may be required to allocate available funds for payment on the claimed debts¹⁰⁸ and in a default scenario the Constitution requires that creditors be paid first.¹⁰⁹

G.O. bondholders cannot seize Commonwealth property. Accordingly, they cannot obtain court orders seizing government revenues. This is equally true for revenue bond creditors. These creditors cannot seize revenue bond issuer's properties, nor can they seize issuer's bank accounts. When the full faith and credit are pledged in G.O. debts, said pledge is to be understood as a commit-

¹⁰² Puerto Rican Federal Relations Act, 48 U.S.C.A. § 745 (West 2012).

¹⁰³ Act of Aug. 3, 1961, Pub. L. No. 87-121, § 1, 75 Stat. 245 (1961).

¹⁰⁴ 48 U.S.C.A. § 745.

¹⁰⁵ *Id.*

¹⁰⁶ See P.R. CONST. art. VI, § 2.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* § 8.

ment to pay when such debt becomes due and a commitment to raise the necessary revenues for prompt payment. Ordinarily, state police powers cannot be construed to impair debt terms in a way that would affect creditors' rights.

In revenue bond obligations, issuers may not deplete or deliberately diminish revenues pledged for payment. Also, states may not strip revenue bond issuers from their revenue collecting authority or taxing powers. Said authority stripping by the state could amount to an impermissible impairment of contract obligations because revenue bond issuer has been denied the powers it had asserted as payment capability. In fact, some Puerto Rican revenue bond issuers have provisions in their enacting statutes that guarantee the issuer will not act in ways that would impair its debt obligations.¹¹⁰ These statutes may also provide a pledge stating that the revenue bond issuer will not be stripped of its granted powers until its debts are fully paid and discharged.¹¹¹

Thus, we have seen that G.O.s are the equivalent of a non-securitized debt. "Apart from these procedural safeguards, there is nothing inherent in a general obligation to make it more than unsecured debt."¹¹² Since the full faith pledge in G.O.s does not imply any security interest or lien upon Puerto Rico's properties or funds, creditors may not be able to attach Commonwealth funds or monies.¹¹³ But Puerto Rico gives first-claim right, or first-revenue right, from which creditors may obtain payment in case state revenues are not sufficient to cover all public expenses in a given fiscal year.¹¹⁴ Accordingly, revenue bond creditors may have somewhat more leeway in claiming payment. Their available remedies depend on the particular statutes, regulations or covenants of the pertinent revenue bond issuer, but, ordinarily, they do not have security interests or lien rights over issuer's properties.

CONCLUSION

Commonwealth G.O.s should be understood as full faith debts. Thus, they may be regarded as unsecured obligations. Revenue bonds are also unsecured debts. Creditor assurance rests not on a possible attachment of Commonwealth property, but on other means. As we have seen, state police powers are generally not to be construed in ways that would block compliance with bond terms.

Assurance also rests in part on the fact that rating agencies, such as Moody's, Standard & Poor's and Fitch's continually examine and rate Puerto Rico's finances.¹¹⁵ In addition, Puerto Rico's Constitution provides *self-limitations* on the level

¹¹⁰ See, e.g., P.R. LAWS ANN. tit. 22, § 200 (2009).

¹¹¹ See *id.* § 215.

¹¹² 1 ROBERT A. FIPPINGER, THE SECURITIES LAW OF PUBLIC FINANCE 66-68 (2011).

¹¹³ See *id.*

¹¹⁴ P.R. CONST. art. VI, § 8.

¹¹⁵ See Government Development Bank, *Investor Resources: Commonwealth of Puerto Rico*, http://www.gdb-pur.com/investors_resources/commonwealth.html (last visited May 29, 2012).

of public debt percentages allowed in relation to available state resources.¹¹⁶ Federal law and securities regulations require continual disclosure on financial information, and, of course, poor fiscal responsibility or poor payment performance can increase loan rates in the future, which in turn jeopardize new possibilities to obtain credit.

The Commonwealth of Puerto Rico may not impair its debt obligations to materially jeopardize creditors' rights. Instead, it is evident that although creditors do not have any security interest over state revenues, it is in debtor's best interest, both present and future, to pay said debts as due.

Contract impairment by use of state police powers is generally negative for economic welfare. Due payment, financial transparency and long-run investments tend to be positive values. Of course, these goals must be pursued with great restraint. In truth, it has been suggested that, if public financing is used properly and effectively, it can greatly contribute to economic and political success.¹¹⁷ Accountability, commitment, fiscal responsibility and political transparency may be greatly enhanced by good financial practices. The responsibility to honor contracts and administer public monies wisely is an essential component for successful public financing, but also for political and general economic welfare.

¹¹⁶ P.R. CONST. art. VI, § 2.

¹¹⁷ Gillette, *supra* note 1.