

Northwestern Journal of International Law & Business

Volume 38

Issue 3 *Spring*

Spring 2018

Collective Action Clauses as a Solution to Holdouts in Puerto Rico's Unique Debt Crisis: Lessons Learned from Argentina

Sumer B. Marquette

Follow this and additional works at: <https://scholarlycommons.law.northwestern.edu/njilb>

Recommended Citation

Sumer B. Marquette, *Collective Action Clauses as a Solution to Holdouts in Puerto Rico's Unique Debt Crisis: Lessons Learned from Argentina*, 38 *Nw. J. INT'L L. & BUS.* (2018).
<https://scholarlycommons.law.northwestern.edu/njilb/vol38/iss3/3>

This Comment is brought to you for free and open access by Northwestern Pritzker School of Law Scholarly Commons. It has been accepted for inclusion in Northwestern Journal of International Law & Business by an authorized editor of Northwestern Pritzker School of Law Scholarly Commons.

Collective Action Clauses as a Solution to Holdouts in Puerto Rico's Unique Debt Crisis: Lessons Learned from Argentina

*Sumer B. Marquette**

Abstract: On June 30, 2016, in a controversial and bipartisan effort, the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) was signed into law to address the Commonwealth of Puerto Rico's fiscal crisis. At the time, Puerto Rico's government and its agencies had \$72 billion in debt. However, Puerto Rico's status as a U.S. territory disqualified the island from filing for court-arranged bankruptcy under the U.S. Bankruptcy Code and from seeking emergency assistance from the International Monetary Fund. As a result, PROMESA was enacted to create a structure for exercising federal oversight over the fiscal affairs of the territory by establishing an Oversight Board, a process for restructuring debt, and expedited procedures for approving critical infrastructure projects. This Note focuses on PROMESA's Title VI retroactive inclusion of collective action clauses (CACs). Following the landmark decision in NML Capital Ltd. v. Republic of Argentina, CACs gained widespread appeal because they effectively safeguard against a perverse holdout incentive in the restructuring process. CACs expedite the restructuring process by allowing a supermajority of bondholders to agree to a debt restructuring that is legally binding on all bondholders. This Note concludes that Title VI's inclusion of CACs is a normatively desirable result. When applied to the Puerto Rican debt crisis, CACs will likely mitigate the risk of holdouts and incentivize vulture funds to come to the bargaining table.

* J.D., Northwestern University Pritzker School of Law, 2018; B.A., University of California, Berkeley, 2014. I would like to thank the staff of the Northwestern Journal of International Law & Business for their editorial assistance and thoughtful contributions to my Note. I also owe a great deal of gratitude to my family and fiancé for their unwavering support in all of my endeavors.

I. Introduction	450
II. Sovereign Debt Contracts.....	453
A. Overview.....	453
B. Types of Sovereign Debt.....	455
C. Holdouts.....	456
D. Vulture Funds.....	456
E. Pari Passu Clause.....	456
F. Collective Action Clauses.....	457
III. NML Capital, Ltd. v. Republic of Argentina.....	458
A. Argentina’s Debt Crisis.....	458
B. The NML Capital Decision.....	459
C. The Aftermath.....	461
IV. Puerto Rican Debt Crisis.....	462
V. Congress Responds by Enacting PROMESA.....	466
A. Overview.....	466
B. CACs in PROMESA – Title VI.....	467
C. Drawbacks to PROMESA.....	468
VI. Effective Restructuring in Puerto Rico through CACs.....	469
A. Overview.....	469
B. Problems with CACs in PROMESA.....	473
VII. Conclusion.....	474

I. INTRODUCTION

Currently, global government debt is over \$57 trillion and every second a government adds debt.¹ This debt is issued by public authorities, cities, states, federal governments, and sovereign states. Although global debt continues to increase, sovereign borrowers have been defaulting on the repayment of their debt for as long as there has been an international banking system.² Yet, there remains no effective procedure for managing sovereign defaults and enforcing the numerous sovereign debt contracts.³ The lack of

¹ The Global Debt Clock, The Economist, http://www.economist.com/content/global_debt_clock (last visited Jan. 13, 2018).

² Clifford Dammers, A Brief History of Sovereign Defaults and Rescheduling, in *Default and Rescheduling: Corporate and Sovereign Borrowers in Difficulty* 77 (David Suratgar ed., 1984).

³ Yuefen Li, Rodrigo Olvares-Caminal, & Ugo Panizza, *Avoiding Avoidable Debt Crisis:*

an international legal structure to deal with sovereign debt defaults is one of the most important aspects of sovereign debt.

When a government defaults on its debt, in addition to the creditors and the economy, the sovereign's residents are also significantly affected. This is due to a redistribution of national wealth, which includes the pensions and public services provided by the government and its instrumentalities.⁴ Some defaults result in the shuttering of public utilities and other government services. The involvement of a government in the issuance of debt introduces a geopolitical dimension into the financial relationship. This further heightens the need for effective restructuring. With market interest in sovereign and territory borrowing continuously increasing and sovereign debt remaining unenforceable by creditors who cannot attach assets located within the borders of the defaulting territory, one can assume more disastrous scenarios are likely right around the corner.

The Commonwealth of Puerto Rico is faced with a startling fiscal and humanitarian crisis. The government and its various agencies owe around \$72 billion in outstanding debt.⁵ On the brink of default because of strained liquidity and virtually depleted resources, Puerto Rico was faced with choosing between paying its bondholders or providing essential services to its residents.⁶ Although the Puerto Rican government introduced several measures to address the deteriorating fiscal situation, the measures were insufficient to stabilize the government's finances.⁷ One effect of the default has been the closing of public utilities and a decrease in government services.

Puerto Rico is a unique example because of its status as a U.S. territory and its convoluted relationship with the United States, which renders it ineligible to file court-arranged bankruptcy. This territorial status is a serious problem. The objective of organized bankruptcy procedures is to assure the protection of the interests of both debtors and creditors. Further, unlike sovereign nations, Puerto Rico cannot seek emergency assistance from the International Monetary Fund ("IMF"). In order to prevent financial crises, the IMF lends to countries to give the country breathing room to restore financial stability.⁸ This lending is often accompanied with a set of corrective

Lessons From Recent Defaults, in SOVEREIGN DEBT AND THE FINANCIAL CRISIS: WILL THIS TIME BE DIFFERENT? 243, 244 (Carlos A. Primo Braga & Gallina A. Vincelette eds., 2011).

⁴ MAURO MEGLIANI, SOVEREIGN DEBT: GENESIS – RESTRUCTURING – LITIGATION 3 (2015).

⁵ *Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"): Overview and Restructuring Issues*, PUERTO RICO REPORT 5 (Aug. 9, 2016), <http://www.puertoricoreport.com/wp-content/uploads/2016/10/57f390ed745f9.pdf>.

⁶ *Id.*

⁷ See ANDREW AUSTIN, CONG. RESEARCH SERV., R44095, PUERTO RICO'S CURRENT FISCAL CHALLENGES 1 (2016).

⁸ IMF Lending, International Monetary Fund, 1 <http://www.imf.org/About/Factsheets/IMF->

policy actions.⁹ However, this support is only available to the one-hundred eighty-nine IMF member countries upon their request.¹⁰

To address the Puerto Rican debt crisis, on June 30, 2016, the U.S. Congress adopted the Puerto Rico Oversight, Management, and Economic Stability Act (“PROMESA”), which President Barack Obama signed into law.¹¹ PROMESA created a structure for exercising federal oversight over Puerto Rico’s fiscal affairs by establishing an Oversight Board with broad budgetary and financial powers over Puerto Rico.¹² Additionally, PROMESA provides the legal basis to adjust the outstanding bonded debt through a court-supervised process. This paper focuses specifically on Title VI, §601 that provides the Oversight Board the authority to retroactively introduce collective action clauses (“CACs”) to individual creditor contracts on Puerto Rico’s outstanding bonded debt.¹³ CACs have been used to expedite the restructuring of sovereign debt by allowing a supermajority of bondholders to agree to a debt restructuring that is legally binding on all bondholders.

In response to the Southern District of New York’s groundbreaking decision in *NML Capital, Ltd. v. Republic of Argentina* (“*NML Capital*”), CACs became a common feature in sovereign bonds to combat vulture funds that were successfully able to holdout and block effective restructuring during Argentina’s debt crisis.¹⁴ Vulture funds are bondholders who strategically buy sovereign debt at massive discounts when the sovereign is in distress. Once the sovereign defaults, the vulture fund sues to get the full value of the original bond.¹⁵ Holdout bondholders successfully sued Argentina for breach of a *pari passu* covenant and obtained injunctive remedies to enforce judgment against Argentina.¹⁶

The court held that the holdout creditors could access Argentina’s overseas assets because Argentina failed to comply with its promise to treat holders of the defaulted issues equally in repayment with holders of the lat-

Lending?pdf=1.

⁹ *Id.* at 2.

¹⁰ *Id.*; List of Members, International Monetary Fund, (Last updated Mar. 7, 2017) <https://www.imf.org/external/np/sec/memdir/memdate.htm>.

¹¹ PROMESA has been codified in 48 U.S.C. §§ 2101-2241.

¹² *Id.*

¹³ *Id.*

¹⁴ *NML Capital, Ltd. v. Republic of Argentina*, No. 08 Civ. 6978, 2012 WL 5895784 (S.D.N.Y. Nov. 21, 2012).

¹⁵ See Alexandria L. Todd, *Defaulting the Purpose: The Future of Foreign Sovereign Debt Restructuring in the Wake of Argentina’s Debt Crisis*, 81 BROOKLYN L. REV. 269, 274 (2015).

¹⁶ See Tim Samples, *Rogue Trends in Sovereign Debt: Argentina, Vulture Funds, and Pari Passu Under New York Law*, 35 NW. J. INT’L L. & BUS. 49, 76 (2014).

er issues under the *pari passu* clause.¹⁷ The court's holding sent shock waves through the sovereign debt markets and created a perverse holdout incentive by paying holdouts more than cooperators in sovereign debt restructuring.¹⁸

Due to Puerto Rico's minefield of competing interests¹⁹ from various debt issuers backed by different revenue streams and its current defaulting state, CACs are the best option for creditors to receive the most effective modifications to the essential payment terms of Puerto Rico's sovereign bond contracts. PROMESA's retroactive introduction of CACs to individual creditor contracts on Puerto Rico's outstanding bonded debt will safeguard against a perverse holdout incentive in the restructuring process. If correctly utilized, CACs will ensure that the government, the various creditors, and the residents of Puerto Rico reach a favorable outcome in combating the enormous debt crisis.

II. SOVEREIGN DEBT CONTRACTS

A. Overview

Sovereign debt includes debts owed, guaranteed, or secured by a sovereign state or an agency or instrumentality of the state and can originate from various obligations.²⁰ Sovereign debt may be owed to domestic and foreign creditors.²¹ Sovereign loans fall into different categories: direct or indirect; bilateral or multilateral; secured or non-secured; and public or private.²² Sovereign loans are unique due to the parties involved. The parties are among the most sophisticated in the global financial market. They deal in an enormous amount of money and trade on an active secondary market. The final unique feature of sovereign debt is the absence of a meaningful regulatory body.²³

According to Standard & Poor's, default on a debt contract occurs if a payment is not made within any grace period specified in the contract or if debts are rescheduled on terms less favorable than those specified in the

¹⁷ *Id.* at 76-77.

¹⁸ See John A. E. Pottow, *Mitigating the Problem of Vulture Holdout: International Certification Boards for Sovereign-Debt Restructuring*, 49 TEX. INT'L L. J. 221, 230 (2014).

¹⁹ See generally Nick Brown, *Puerto Rico Debt Fix Unlikely to Resemble Detroit's*, REUTERS, (Sept. 5, 2016) available at <http://www.reuters.com/article/us-puertorico-debt-controlboard-analysis-idUSKCN11B2F5>.

²⁰ MEGLIANI, *supra* note 4, at 4.

²¹ *Id.*

²² *Id.* at 55.

²³ Stephen J. Choi & G. Mitu Gulati, *Conference on Sovereign Debt Restructuring: The View from the Legal Academy: Innovation in Boilerplate contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929, 930 (2004).

original contract.²⁴ Most default episodes are triggered by one or more of the following factors:

a worsening of the terms of trade; an increase in international borrowing costs; consistently poor macroeconomic policies, leading to a building up of vulnerabilities; or a crisis in a systemic country that causes contagion across goods and financial markets.²⁵

Sovereign debt restructuring can be defined as an exchange of outstanding sovereign debt instruments, such as loans or bonds, for new debt instruments or cash through a formal process.²⁶ The purpose of the restructuring is to agree on the terms of a debt exchange that will provide some form of debt relief and solve the distressed situation. Ideally, this restructuring would allow the sovereign to return to the international capital market as soon as possible. Generally, there are two types of operations in a debt restructuring: debt rescheduling and debt reduction. Both involve a “hair-cut” in the present value of creditor claims.²⁷ Debt rescheduling is the lengthening of maturity of the old instrument, whereas debt reduction reduces the nominal face value of the old instrument.²⁸

Although sovereign debt restructuring can occur preemptively, before the government misses a payment, most restructuring occurs after a default. The first known instance of sovereign debt restructuring after default can be traced back to the loan made by the Greek sanctuary of Delos in the fourth century BC to States of the Attic League, in which only a small portion of the loan was reimbursed.²⁹

Sovereign debt restructuring is usually very time-consuming and costly. The average sovereign debt restructuring takes, on average, almost a decade for the entire process to conclude.³⁰ The duration of negotiations for foreign creditors often takes much longer than domestic creditors. In addition to the lengthy process, Mark Wright notes that on average, private creditors lose 40% of the value of their claim, and debtor countries exit default as or more highly indebted than when they entered default.³¹

Before the rise of vulture funds, even without a structured way to man-

²⁴ MARK L. J. WRIGHT, *Restructuring Sovereign Debts with Private Sector Creditors: Theory and Practice*, in SOVEREIGN DEBT AND THE FINANCIAL CRISIS: WILL THIS TIME BE DIFFERENT? 295, 297 (Carlos A. Primo Braga & Gallina A. Vincelette eds., 2011).

²⁵ UDAIBIR S. DAS, MICHAEL G. PAPAIOANNOU, & CHRISTOPH TREBESCH, *Restructuring Sovereign Debt: Lessons from Recent History*, in FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND POLICY RESPONSES 593, 596 (Stijn Claessens, et al. eds. 2014).

²⁶ *Id.* at 594 (although there is no universally accepted definition).

²⁷ *Id.*

²⁸ *Id.*

²⁹ MEGLIANI, *supra* note 4, at 9, & n.3.

³⁰ *See* WRIGHT, *supra* note 24, at 295.

³¹ *Id.*

age the defaults, the restructuring process was relatively predictable and fairly stable.³² The sovereign entity would engage in some form of negotiations with its creditors to agree on the terms of a debt exchange. The sovereign entity would usually identify the holders of the claims, initiate a dialogue with them, and the creditors would then decide whether to accept or reject the offer. Before the rise of vulture funds, most creditors accepted the restructuring offer and took a haircut to their claim in order to avoid a sizeable loss from a default.

B. Types of Sovereign Debt

In any restructuring process, the priority rules for payments to creditors are crucial to the market process. However, with sovereign debt there are no formal priority rules that lay out how different types of claims against the distressed sovereign will be treated.³³ External creditors of sovereign debt often include private-sector creditors, other governments, and multi-lateral creditors.³⁴ Domestic creditors of sovereign debt often include domestic banks and pension funds.³⁵

The 1980s saw a dramatic shift from syndicated bank lending to bonds as a source of finance for emerging market sovereigns.³⁶ A syndicated bank loan is a commercial bank loan in which a number of banks participate in lending. A bond is a form of debt issued by national governments and investors can often purchase them through exchange-traded funds.³⁷ A sovereign looking to raise money issues bonds to tap individual private investors or lenders around the world.³⁸ This shift away from syndicated bank loans to bonds resulted in much more diversity among creditors, making coordination more difficult, and has been a barrier to the restructuring process of a sovereign in default. In other words, the absence of a clear priority system for sovereign bonds has led to a highly diverse set of parties engaging in the market each with their own objectives.

³² See e.g. Elisa Beneze, *Stopping the Circling Vultures: Restructuring a Solution to Sovereign Debt Profiteering*, 49 VAND. J. TRANSNAT'L L. 245, 247 (2016).

³³ Nouriel Roubini & Brad Setser, BAILOUTS OR BAIL-INS: RESPONDING TO FINANCIAL CRISES IN EMERGING MARKETS 249 (2004).

³⁴ *Id.* at 251.

³⁵ *Id.*

³⁶ Alon Seveg, *Investments: When Countries go Bust: Proposals for Debtor and Creditor Resolution*, 3 ASPER REV. INT'L BUS. & TRADE L. 25, 46 (2003).

³⁷ Justin Kuepper, *What are Sovereign Bonds?* Everything you need to know about Sovereign Bonds, BALANCE (Aug. 6, 2016) <https://www.thebalance.com/what-are-sovereign-bonds-1979114>.

³⁸ Seveg, *supra* note 36, at 27.

C. Holdouts

The ability to bind all creditors to an in rem resolution is a key feature to the success of a typical bankruptcy system.³⁹ However, since no international bankruptcy system exists for sovereign debt restructuring, holdouts have been a serious problem in sovereign debt restructuring. This is because in most cases, a successful restructuring requires a minimum level of acceptance by creditors to move forward with the restructuring.⁴⁰ The problem of creditor holdouts is widely seen as the main reason for slow and inefficient debt restructuring. In a holdout scenario, a creditor refuses to participate in a restructuring process to try to enforce better terms, usually by suing the sovereign debt issuer in a court in New York or London.⁴¹

D. Vulture Funds

Vulture funds are private investment funds that acquire defaulted or soon-to-default debt on secondary debt markets.⁴² The world's most heavily indebted poor countries usually issue the targeted debt. Holdouts are commonly vulture funds.⁴³ Vulture funds buy up debts owed by a sovereign in financial difficulty at a deep discount and then try to get full payment on the debt when the country defaults.⁴⁴ Vulture funds block effective restructuring and will typically sue the sovereign issuer in a New York or London court for full payment.⁴⁵ Litigation mostly occurs in New York courts because a large majority of outstanding emerging market bonds are traded on exchanges that are subject to New York law.

E. *Pari Passu* Clause

The *pari passu* clause has become a standard clause in international unsecured debt obligations and means “with equal step.”⁴⁶ It ensures that

³⁹ John A. E. Pottow, *Mitigating the Problem of Vulture Holdout: International Certification Boards for Sovereign-Debt Restructurings*, 49 TEX. INT'L L. J. 221, 222 (2014).

⁴⁰ See DAS, ET AL., *supra* note 25, at 598.

⁴¹ *Id.* at 610.

⁴² James Bai, *Stop Them Circling: Addressing Vulture Funds in Australian Law*, 35 SYDNEY L. 703, 706 (2013) (citing AFDB, *Vulture Funds in the Sovereign Debt Context*, <https://www.afdb.org/en/topics-and-sectors/initiatives-partnerships/african-legal-support-facility/vulture-funds-in-the-sovereign-debt-context/> (last visited Feb. 16 2018)).

⁴³ *Id.*

⁴⁴ Seveg, *supra* note 36, at 38-39.

⁴⁵ *Id.* at 48.

⁴⁶ Natalie Wong, *NML Capital, Ltd. v. Republic of Argentina and the Changing Roles of the Pari Passu and Collective Action Clauses in Sovereign Debt Agreements*, 53 COLUM. J.

bonds within the same issue stand on the same footing without preference or priority among themselves.⁴⁷ The clause has been included in sovereign debt contract for over 140 years.⁴⁸ However, the meaning of the clause remains uncertain and has become quite malleable over the years. Although some sovereigns will respect the clause in sovereign debt contracts, in the absence of a bankruptcy-like regime to oversee creditors' claims, the defaulting sovereign is left to their own devices.⁴⁹

F. Collective Action Clauses

A collective action clause, or CAC, is a provision in a sovereign debt contract that allows for modification of the essential payment terms of the contract through a supermajority vote. The essential payment terms usually include the date of repayment, the amount of the principal, and a coupon.⁵⁰ CACs in sovereign debt contracts aim to address the difficulties inherent in organizing diverse groups of bondholders.⁵¹ Commentators argue that the inclusion of CACs can better facilitate creditor-debtor negotiations in a restructuring situation, by reducing the hurdle of reaching unanimity on an agreement and limiting potential litigation from holdout creditors.⁵²

The primary problem with CACs is that they typically only apply to a single bond issue. Therefore, restructuring requires the activation of a CAC for each individual bond issue and approval by a supermajority of each issue's holders.⁵³ As Jesse Kaplan points out, issuances can be small, making it relatively easy for an investor to buy up a big enough position in a single debt instrument to block a restructuring.⁵⁴ Further, the issuance of multiple rounds of debt makes the potential for a creditor to take a blocking position even more likely.

TRANSNAT'L L. 396, 400 (2015).

⁴⁷ *Id.*

⁴⁸ See Jesse Kaplan, *Collective Action and the Competence of Courts: The Lessons of NML v. Argentina*, 20 STAN. J. L. BUS. & FIN. 1, 13 (2014).

⁴⁹ *Id.* at 14.

⁵⁰ *Id.* at 21.

⁵¹ *Id.*

⁵² DAS, ET AL., *supra* note 25, at 612.

⁵³ See Kaplan, *supra* note 48, at 27.

⁵⁴ *Id.*

III. NML CAPITAL, LTD. V. REPUBLIC OF ARGENTINA

A. Argentina's Debt Crisis

Argentina's history with sovereign debt goes back centuries. It has defaulted on its external debt seven times.⁵⁵ Economic prosperity in Argentina declined significantly since the 1950s, primarily due to a heavily regulated economy.⁵⁶ In order to satisfy various political needs, Argentine authorities continuously spent significantly more than could be raised in taxes.⁵⁷ Once Argentina could no longer tap domestic and international creditors, the recourse, like often, was hyperinflation.⁵⁸ A deep recession followed and inflation wiped out much of the domestic currency debt of the Argentine government, leaving the dollar-denominated external debt at \$80 billion.⁵⁹ The Brady Plan granted the Argentine government access to the international capital markets and allowed foreign bonds to finance future public deficits.⁶⁰

Between 1993–1998, the Argentine economy generally performed well as it received four International Monetary Fund arrangements. An IMF lending arrangement, similar to a line of credit, is issued to support a country's adjustment program. The arrangement requires the country to observe specific terms and is subject to periodic reviews.⁶¹ However, even with the IMF arrangements, Argentina's public-sector debt-to-GDP ratio rose by 12%, indicating an unsustainable fiscal policy.⁶²

By late 2000, the Argentine government was the largest emerging-market borrower on international credit markets.⁶³ Markets deemed Argentina's external debt unsustainable as its debt-to-export ratio increased to 400%.⁶⁴ With the public debt on an unsustainable spiral, the IMF reluctantly granted another credit line to prop up central bank reserves.⁶⁵ When fiscal

⁵⁵ Shane Roming, *Argentina's Long History of Economic Booms and Busts*, WALL STREET J., (July 30, 2014), <http://blogs.wsj.com/moneybeat/2014/07/30/argentinas-long-history-of-economic-booms-and-busts/>.

⁵⁶ JOCHEN ANDRITZKY, SOVEREIGN DEFAULT RISK VALUATION: IMPLICATIONS OF DEBT CRISIS AND BOND RESTRUCTURINGS 36 (2006).

⁵⁷ MICHAEL MUSSA, ARGENTINA AND THE FUND: FROM TRIUMPH TO TRAGEDY 10 (2002).

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ See ANDRITZKY, *supra* note 56, at 36.

⁶¹ See *Argentina: History of Lending Arrangements*, IMF (May 2015), <https://www.imf.org/external/np/fin/tad/extarr2.aspx?memberKey1=30&date1key=2005-05-31>.

⁶² See generally MUSSA, *supra* note 57, at 16 (2002).

⁶³ See *id.* at 27.

⁶⁴ See ANDRITZKY, *supra* note 56, at 37.

⁶⁵ *Id.*

revenues fell without a corresponding reduction in social spending, default became unavoidable on \$100 billion in sovereign bonds.⁶⁶

At the time of its default, Argentina's bonded debt amounted to about half the global indebtedness and was held both by institutional investors and individual holders.⁶⁷ In 2005, 76% of the defaulted foreign debt was exchanged for new restructured bonds worth about twenty-five to twenty-nine cents to every dollar owed to the original bonds.⁶⁸ The second restructuring, which took place in 2010, brought the total percentage of original external bonds that were exchanged for restructured bonds to 91%.⁶⁹ The remaining holdout creditors that refused to accept the restructuring sued Argentina and engaged in over a decade of litigation, which culminated with the *NML Capital* decision.

B. The *NML Capital* Decision

The District Court for the Southern District of New York's decision in *NML Capital*⁷⁰ sent shockwaves through sovereign debt markets. Holdout creditors that fell into the definition of vulture funds, sued to collect the full value of the original bonds that Argentina defaulted on.⁷¹ The plaintiffs, several vulture hedge funds led by NML Capital, Ltd., included Blue Angel Capital, Aurelius Capital Management, Dart Management, Bracebridge Capital, Olifant Fund, and Montreux Partners.⁷² The bonds contained a provision that they were governed by the laws of New York and subject to any state or federal court in New York City.⁷³ The bonds also contained a *pari passu* clause, which guaranteed bondholders that all claims would be ranked equally with all other present and future external indebtedness of Argentina.⁷⁴

The crux of the plaintiffs' argument was that Argentina violated the *pari passu* clause by paying the creditors who agreed to the restructuring without paying the holdout creditors. The court agreed with the plaintiffs and held that due to the *pari passu* clause, if Argentina did not pay the

⁶⁶ Samples, *supra* note 16, at 52.

⁶⁷ See MEGLIANI, *supra* note 4, at 37.

⁶⁸ Todd, *supra* note 15, at 273-74.

⁶⁹ *Id.* at 274.

⁷⁰ See *NML Capital, Ltd. v. Republic of Argentina*, No. 08 Civ. 6978, 2012 WL 5895784 (S.D.N.Y. Nov. 21, 2012).

⁷¹ See Todd, *supra* note 15, at 274.

⁷² Martin Guzman, *Wall Street's Worst Vulture Hedge Funds are Making a Killing by Undermining the Global Economy*, QUARTZ, (June 17, 2016), <https://qz.com/707165/wall-streets-vulture-hedge-funds-are-making-a-killing-by-undermining-the-global-economy/>.

⁷³ See Todd, *supra* note 15, at 275.

⁷⁴ *Id.*

plaintiffs it could not pay any of the other creditors because of the equal ranking obligation.⁷⁵ The court issued an injunction against Argentina.⁷⁶ The district court's narrow application of the *pari passu* clause in *NML Capital* made sovereign restructuring much more difficult under New York law as it incentivized creditors to holdout in the restructuring process for more money.⁷⁷

The U.S. Court of Appeals for the Second Circuit also found for the plaintiffs in upholding the district court's ruling.⁷⁸ In its decision, the court noted that the universal inclusion of collective action clauses would reduce the apparent harshness of the District Court's ratable interpretation of the *pari passu* clause in the future.⁷⁹ The U.S. Supreme Court denied Argentina's petition for review of the Second Circuit's interpretation of Argentina's obligations.⁸⁰ As a result, Argentina could not engage in the international credit market as it was effectively shut out.

On February 29, 2016, with a new government in office, Argentina agreed to pay the holdout creditors in *NML Capital* \$4.65 billion to settle the claims and return to the international credit market.⁸¹ Most commentators thought Argentina would never pay the holdout creditors after the fifteen years of contentious litigation. However, when Mauricio Macri succeeded Christina Fernandez de Kirchner as President of Argentina on December 10, 2015, President Macri pledged to return Argentina to credit markets by resolving the disputes with the holdout bondholders.⁸² Argentina's Congress approved the settlement on March 16, 2016 ending the debt battle in a 54-16 vote.⁸³ *NML Capital*'s original principal amount in claims was \$617 million but under the settlement *NML Capital* received \$2.28 billion, about a 370% return.⁸⁴

⁷⁵ See Kaplan, *supra* note 48, at 7.

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ See generally *NML Capital, Ltd. v. Argentina*, 699 F.3d 246, 252 (2d Cir. 2013).

⁷⁹ *Id.*

⁸⁰ See *NML Capital, Ltd. v. Argentina*, 134 S. Ct. 2819 (2014).

⁸¹ Patrick Gillespie, *This Fund Made an 800% Return on Argentina Debt*, CNN MONEY (Mar. 2, 2016), <http://money.cnn.com/2016/03/02/news/economy/hedge-funds-argentina-debt/>.

⁸² *Sovereign Debt Update*, JONES DAY, (June 1, 2016), <http://www.lexology.com/library/detail.aspx?g=4cca27f7-00eb-4258-988c-ec51eb2986ed>.

⁸³ *Argentina's Congress Oks Payments to Holdout Creditors*, AGENCIA EFE (Mar. 31, 2016) <http://www.efe.com/efe/english/business/argentina-s-congress-oks-payments-to-holdout-creditors/50000265-2883159>.

⁸⁴ *Argentine Sovereign Debt: Exhibit 1*, SHEARMAN & STERLING LLP, <http://argentine.shearman.com/sitefiles/11592/doc%20904-3.pdf> (last visited Feb. 10, 2017).

C. The Aftermath

In reaction to *NML Capital*, players in the international credit market responded with numerous devices to avoid a similar outcome. Since no regime exists for insolvent sovereigns, many market players have advocated for Chapter Nine of the U.S. Bankruptcy Code to serve as a model for a global sovereign bankruptcy regime.⁸⁵ The prevailing argument is that adjudication under a predetermined set of rules by an independent forum will produce a much fairer, more certain, and predictable outcome than the unpredictable ad hoc negotiations that currently resolve these issues.⁸⁶

Alternatively, the IMF proposed the Sovereign Debt Restructuring Mechanism (“SDRM”) initiative in 2002. Many lawyers, fund managers, and policy makers advocated for this mechanism in order to curtail another debt crisis.⁸⁷ SDRM sought to provide a framework to reinforce incentives for a distressed sovereign and its creditors to reach a quick restructuring agreement.⁸⁸ The distressed sovereign would activate the SDRM and facilitate a quick restructuring agreement.⁸⁹

Ultimately, even though more than 70% of IMF members supported the proposal in 2003, leading shareholder countries rejected it.⁹⁰ The IMF has now become reluctant to take the lead on the creation of a sovereign bankruptcy regime unless it can convince the leading shareholder countries of its efficacy.⁹¹ It is unlikely that the United States will back the regime, as the United States believes that some of the SDRM provisions would interfere with the contractual claims of U.S. investors.⁹²

As an alternative to an international bankruptcy regime following the *NML Capital* decision, major banks and banking industry associations proposed the mandatory inclusion of collective action clauses in all sovereign bond documents.⁹³ If included, it would mean that creditors agree in advance to accept the determination of a majority of them, usually a super-

⁸⁵ Ross P. Buckley, *The Bankruptcy of Nations: An Idea Whose Time Has Come*, 43.3 INT’L LAW. 1899, 1203 (2009).

⁸⁶ *Id.* at 1207.

⁸⁷ Alan Beattie & Robin Wigglesworth, *Bankruptcy Regime for Countries Urged Amid Argentina Debt Battle*, FINANCIAL TIMES, (Jan. 7, 2013), <http://go.galegroup.com.turing.library.northwestern.edu/ps/i.do?&id=GALE|A314088107&v=2.1&u=northwestern&it=r&p=AONE&sw=w&authCount=1>.

⁸⁸ Molly Ryan, *Sovereign Bankruptcy: Why Now and Why not in the IMF*, 82 FORDHAM L. REV. 2473, 2511 (2014).

⁸⁹ *Id.*

⁹⁰ *Id.* at 2512.

⁹¹ Beattie & Wigglesworth, *supra* note 87.

⁹² Ryan, *supra* note 88, at 2512.

⁹³ See Buckley, *supra* note 85, at 1208.

majority of 75% of creditors, as to any variation of the terms of the debt.⁹⁴ This clause is an inverse of a *pari passu* clause, which requires that creditors be treated equally and repaid pro rata after a sovereign entity becomes insolvent.⁹⁵ CACs effectively weaken a holdout creditor's position and act to streamline the entire debt restructuring process.⁹⁶

The Global Committee of Argentina Bondholders ("GCAB"), a representative bondholder group formed during Argentina's restructuring process, is an example of collective action benefitting a group of creditors. GCAB claimed to represent more than 50% of the outstanding private bonds of Argentina in their restructuring.⁹⁷ GCAB gave 450,000 small bondholders some influence in the negotiation process by agreeing to negotiate as a single creditor.⁹⁸ However, because the other 50% of bondholders did not agree to act collectively, the group was limited in its success.

IV. PUERTO RICAN DEBT CRISIS

The government of Puerto Rico is facing a severe fiscal crisis. The island's economy has been in a steady decline for over a decade.⁹⁹ Forty-five percent of Puerto Ricans live below the federal poverty level, compared to the United States national average of 16%.¹⁰⁰ As a result, residents are bolting to the mainland United States taking with them valuable jobs and income from the island. Indeed, the statistics from the past ten years reflect the greater pattern of brain drain, 300,000 people have fled the island, including 84,000 in 2014 alone.¹⁰¹

Additionally, the remaining population is increasingly older and not actively seeking employment.¹⁰² The labor force participation in Puerto Rico is about 40%, substantially below the United States average of about 62%.¹⁰³ In the last decade, Puerto Rico has experienced declines in both GDP output and employment.¹⁰⁴ Puerto Rico's pension system is also at se-

⁹⁴ *Id.* at 1209.

⁹⁵ Bai, *supra* note 42, at 712.

⁹⁶ *Id.*

⁹⁷ See DAS, ET AL., *supra* note 25, at 605.

⁹⁸ See *Argentine Bondholders of the World, Unite*, MERCOPRESS, (Jan. 13, 2004), <http://en.mercopress.com/2004/01/13/argentine-bondholders-of-the-world-unite>.

⁹⁹ Douglas Holtz-Eakin, *The Budgetary and Economic Outlook for Puerto Rico*: Testimony to the Senate Finance Committee, 1 (2015).

¹⁰⁰ *Puerto Rico's Economic and Fiscal Crisis*, Treasury.gov, at 1, https://www.treasury.gov/connect/blog/Documents/Puerto_Ricos_fiscal_challenges.pdf. (last visited Nov. 10, 2016).

¹⁰¹ *See id.*

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

rious risk and its funds will soon be depleted.¹⁰⁵ At the end of the 2014 fiscal year, Puerto Rico's three public pension funds held just \$2 billion in net assets against a combined estimated personal liability of \$46 billion.¹⁰⁶

Puerto Rico's government currently has over \$72 billion in debt.¹⁰⁷ This debt represents nearly 70% of the island's gross domestic product ("GDP"), in comparison to the average debt-to-GDP ratio for states in the United States at 17%.¹⁰⁸ In February 2014, Puerto Rico's public debt was downgraded by the three major credit ratings agencies to below investment grade.¹⁰⁹ The debt was subsequently downgraded two more times.¹¹⁰ The first downgrade was in June 2014 after the government sought to establish a restructuring process for debt issued by the island's public corporations.¹¹¹ The public debt was downgraded again in June 2015 after Puerto Rico's Governor Garcia Padilla declared that the island's debt was unpayable.¹¹² This led to an inevitable default by the Puerto Rican government of its debt. A bright-line rule for identifying a distressed sovereign is when its interest on outstanding debt exceeds 10% of its GDP.¹¹³ Puerto Rico reached this level in March 2015.¹¹⁴

For decades, there has been an impassioned debate over Puerto Rico's territory status and, as a result, Puerto Rico has never enjoyed full-fledged sovereign status. Unlike U.S. cities and states, like Detroit, Puerto Rico cannot file for court-arranged bankruptcy reorganization under the United States Bankruptcy Code because of its territory status. Furthermore, unlike sovereign nations, such as Argentina, Puerto Rico cannot seek emergency assistance from the International Monetary Fund. The indeterminate nature of Puerto Rico has exacerbated its dire fiscal situation.¹¹⁵ Further complicating matters, Puerto Ricans lack voting rights at the federal level and are rep-

¹⁰⁵ *Id.* at 6.

¹⁰⁶ *Id.*

¹⁰⁷ Javier Ortiz, *The Human Impact of the Puerto Rico Debt Crisis*, THE HILL (Dec. 9, 2015), <http://thehill.com/blogs/congress-blog/economy-budget/262512-the-human-impact-of-the-puerto-rico-debt-crisis>.

¹⁰⁸ Greg DePersio, *The Origins of the Puerto Rican Debt Crisis*, INVESTOPEDIA (May 31, 2017), <http://www.investopedia.com/articles/investing/090915/origins-puerto-rican-debt-crisis.asp>.

¹⁰⁹ *Commonwealth of Puerto Rico: Basic Financial Statements and Required Supplementary Information for FY2013*, P.R. DEP'T TREASURY 230-231 (Jun. 30, 2013), http://www.hacienda.gobierno.pr/downloads/pdf/cafr/FINANCIAL_REPORT_2013.pdf.

¹¹⁰ *Id.*

¹¹¹ See AUSTIN, *supra* note 7, at 4.

¹¹² *Id.*

¹¹³ Holtz-Eakin, *The Budgetary and Economic Outlook for Puerto Rico*, *supra* note 99, at 9.

¹¹⁴ *Id.*

¹¹⁵ See Diane Lourdes Dick, *Tax Imperialism in Puerto Rico*, 65 AM. U.L. REV. 1, 5 (2015).

resented by only one non-voting Resident Commissioner in the U.S. House of Representatives.¹¹⁶

In 2016, United States Supreme Court reaffirmed Puerto Rico's territorial status when it held that Puerto Rico would only be able to restructure its debt through consensual agreements among the parties or through an Act of Congress. The Court's decision invalidated the Puerto Rico Corporation Debt Enforcement and Recovery Act ("PR Recovery Act") that was passed in 2014.¹¹⁷ Puerto Rico's government passed the PR Recovery Act to enable certain Puerto Rican instrumentalities to adopt a restructuring plan for their debt.¹¹⁸ However, in *Puerto Rico v. Franklin Cal. Tax-Free Trust*, the United States Supreme Court held that the PR Recovery Act was invalid because it is preempted by a provision in the United States Bankruptcy Code, which prohibits states from enacting their own bankruptcy legislation.¹¹⁹ This left many creditors unsure of the state of repayment as Puerto Rico was defaulting on substantial payment obligations.

Complicating matters more, unlike other high-profile distressed sovereigns, like Greece, Puerto Rico's debt is not all issued directly by the government.¹²⁰ Much of the island's debt is municipal bonds that were issued by the government and its various agencies and utilities to help cover revenue shortfalls.¹²¹ Each obligor represents varying risk factors for creditors.¹²² This debt is backed by various revenue streams, as well as \$8 billion in general obligation debt backed by the "full faith and credit" of the territory's government, resulting in a complex array of competing interests.¹²³ The number of other entities that have issued debt makes the situation much more complicated because the creditors do not share the same economic interest like the reduction of the island's debt. As a result, Morningstar urges investors not to treat all Puerto Rican municipal debtors monolithic.¹²⁴

The Puerto Rico Electric Power Authority ("PREPA") is the primary power utility in Puerto Rico and one of the governmental entities that has

¹¹⁶ *Id.* at 5-6.

¹¹⁷ *Puerto Rico v. Franklin Cal. Tax-Free Tr.*, 136 S.Ct. 1938 (2016).

¹¹⁸ See Michael K. Piacentini, *Lights Out for Puerto Rico's Restructuring Law? Puerto Rico's Municipal Bankruptcy Dilemma*, 80 BROOK. L. REV. 1677, 1679 (2015).

¹¹⁹ See *Franklin Cal. Tax-Free Trust*, 136 S. Ct. at 1938.

¹²⁰ Robert K. Rasmussen, *Puerto Rico: of Capital Structures, Control Rights and Liquidity*, 11 CAP. MKT. L.J. 228, 232 (2016).

¹²¹ See Piacentini, *supra* note 118, at 1678.

¹²² See CANDICE LEE, *State of the Territory*, in MORNINGSTAR SPECIAL REPORT PUERTO RICO FISCAL STRAIN: IMPLICATIONS FOR INVESTORS 5 (2013), http://www.fidelity.com/binpublic/060_www_fidelity_com/documents/PuertoRico_SpecialReport_10-16-13.pdf.

¹²³ See generally Brown, *supra* note 19.

¹²⁴ LEE, *supra* note 122, at 2.

issued a significant amount of debt.¹²⁵ In large part, PREPA drives Puerto Rico's debt portfolio as it is responsible for an estimated \$9 billion of the island's overall debt of \$72 billion.¹²⁶ Around December 2015, PREPA reached a Restructuring Support Agreement ("RSA") with a group of private creditors in an attempt to avert default.¹²⁷ Under the deal, the creditors would accept a 15% haircut to repayments in exchange for higher-rated bonds and certain structural reforms within PREPA.¹²⁸ Puerto Rico's legislature passed the deal but the future of the agreement is unclear as it has been extended fifteen times since it was agreed to.¹²⁹

Additionally, Puerto Rico was faced with a financing gap of over \$64 billion over the next ten years.¹³⁰ For many years, debt in Puerto Rico was tax-exempt for investors throughout the United States and paid higher yields than average sovereign debt. This made Puerto Rican debt extremely attractive to scores of bond mutual funds.¹³¹ Bond investors across the United States have taken advantage of these benefits by purchasing Puerto Rico's bonds. In the face of high demand, the Puerto Rican government issued too much bond debt and started relying on borrowed funds to balance its unstable budget.¹³²

Additionally, the types of creditors holding the differing instruments are incredibly varied. It has been claimed that \$11.3 billion is held by mutual bond funds, \$15 billion held by hedge funds, and the rest by individuals.¹³³ Among the largest funds that hold Puerto Rico's debt are Oppenheimer Funds Inc. and Franklin Templeton Investments.¹³⁴ Once credit rating

¹²⁵ See Piacentini, *supra* note 118, at 1678.

¹²⁶ *PREPA and Creditors Reach Preliminary Agreement*, CENTER FOR PUERTO RICAN STUDIES, <https://centopr.hunter.cuny.edu/events-news/puerto-rico-news/debt-restructuring/prepa-and-creditors-reach-preliminary-agreement>.

¹²⁷ *Id.*; see Stephen Kim Park & Tim R. Samples, *Puerto Rico's Debt Dilemma and Pathways Toward Sovereign Solvency*, 54 AM. BUS. L.J. 9,12 (2017); Executed Version, Restructuring Support Agreement, http://www.gdb-pur.com/investors_resources/documents/PREPA-RSA-RestructuringSupportAgreement-FullyExecuted.pdf.

¹²⁸ Subcommittee on Indian, Insular and Alaska Native, Oversight Hearing on "The Status of the Puerto Rico Electric Power Authority (PREPA) Restructuring Support Agreement, 3 (Mar. 20, 2017) https://naturalresources.house.gov/uploadedfiles/hearing_memo_-_ov_hrg_03.22.17.pdf.

¹²⁹ *Id.* at 1.

¹³⁰ Holtz-Eakin, *The Budgetary and Economic Outlook for Puerto Rico*, *supra* note 99, at 12-13.

¹³¹ See generally DePersio, *supra* note 108.

¹³² *Id.*

¹³³ Heather Long, *Who Owns Puerto Rico's Debt?*, CNN MONEY, (Aug. 6, 2015), <http://money.cnn.com/2015/07/01/investing/puerto-rico-bond-holders/>.

¹³⁴ *Id.*

agencies began downgrading the Puerto Rican debt, benchmark bonds began to trade as low as thirty cents on the dollar.¹³⁵ Similar to the situation in Argentina, vulture funds began to buy debt on the active secondary market with hopes of obtaining a complete dollar repayment plus interest, like the *NML Capital* holdouts were successfully able to accomplish.

V. CONGRESS RESPONDS BY ENACTING PROMESA

A. Overview

PROMESA means “promise” in Spanish. In a controversial, bipartisan Congressional effort, the Puerto Rico Oversight, Management, and Economic Stability Act, was signed and enacted into law by former U.S. President Barack Obama on June 30, 2016. PROMESA established an Oversight Board with broad powers of budgetary and financial control over Puerto Rico’s financial situation.¹³⁶ The Oversight Board includes seven members designated by Congress and the President.¹³⁷ PROMESA gives the Oversight Board power to enact procedures for adjusting debts.¹³⁸

The Act contains seven sections. The establishment and organization of the Oversight Board is laid out in Title I.¹³⁹ Title II further defines the responsibilities of the Oversight Board.¹⁴⁰ Title III of the Act creates provisions for Puerto Rico or an instrumentality to file a case to reorganize their debts.¹⁴¹ This section incorporates numerous provisions of the U.S. Bankruptcy Code, including many from Chapter Nine. Title IV contains miscellaneous provisions, which include establishing the first minimum wage in Puerto Rico and an automatic stay on the enforcement of creditor rights on financial debt until February 15, 2017.¹⁴² Title V outlines the steps the Oversight Board will take regarding Puerto Rico’s infrastructure revitalization.¹⁴³ This includes expediting approval of key energy projects and other critical projects, as defined by the Act, in Puerto Rico to spur economic growth.

¹³⁵ David Dayen, *How Hedge Funds Deepen Puerto Rico’s Debt Crisis*, AM. PROSPECT, (Dec. 11, 2015), <http://prospect.org/article/how-hedge-funds-are-pillaging-puerto-rico>.

¹³⁶ See generally Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), Pub. L. 114-187, § 101, 130 Stat. 549, 553-57 (2016) [hereinafter PROMESA].

¹³⁷ *Id.* at § 101(e).

¹³⁸ *Id.* at § 104.

¹³⁹ *Id.* at §§ 101-09.

¹⁴⁰ *Id.* at §§ 201-12.

¹⁴¹ *Id.* at §§ 301-17.

¹⁴² *Id.* at §§ 401-13.

¹⁴³ *Id.* at §§ 501-07.

This paper focuses on Title VI, which allows for the collective action clause and is discussed in detail below.¹⁴⁴ Title VII's brief section expresses the desire of Congress that any durable solution "should include permanent, pro-growth fiscal reforms that feature, among other elements, a free flow of capital between possession of the United States and the rest of the United States."¹⁴⁵ In sum, PROMESA provides two mechanisms to address Puerto Rico's debt crisis: (1) through Title III's bankruptcy like procedure; and (2) Title VI's collective action mechanism to create negotiated agreements among Puerto Rico and its creditors. This second mechanism, on the focus of this paper, is largely an out of court process.

B. CACs in PROMESA—Title VI

Under Title VI, §601 of PROMESA, the Oversight Board will borrow the collective action clause model and apply it towards Puerto Rico's outstanding bonded debt.¹⁴⁶ This is a method adopted to effectuate an overall bond restructuring of Puerto Rico or an instrumentality as an alternative to the debt adjustment provisions under Title III. Modifications to a bond financing can be proposed by the bond issuer, Puerto Rico or one of its instrumentalities, or by bondholders.¹⁴⁷ This section of PROMESA is unique as it is the first law in U.S. history that carves out a period outside of bankruptcy for bondholders to negotiate terms of a restructuring.¹⁴⁸

Title VI, §601(j) addresses how bondholders can agree to modify their own bond terms in an attempt to circumvent extensive holdout creditor litigation.¹⁴⁹ It states that a qualified modification can be binding on all bondholders in the applicable pool of bondholders if:

(i) holders of at least two-thirds of the pool's principal who vote approve the modification; and (ii) holders of at least 50% of the total principal outstanding in the pool vote to approve the modification; and finally (iii) the modification is approved by the Oversight Board.¹⁵⁰

The inclusion of the CACs provision in Title VI is significant because normally the Trust Indenture Act applies to bonds and requires 100% of bondholders to agree to the changes on the bond.¹⁵¹ However, in the case of

¹⁴⁴ *Id.* at §§ 601-02.

¹⁴⁵ *Id.* at § 701.

¹⁴⁶ *Id.* at § 601.

¹⁴⁷ *Id.* at § 601(i).

¹⁴⁸ Robert Slavin, *How PROMESA Breaks from Muni Traditions on Collective Actions*, BOND BUYER, (Aug. 9, 2016), <http://www.bondbuyer.com/news/regionalnews/how-promesa-breaks-from-muni-traditions-on-collective-action-1110556-1.html>.

¹⁴⁹ PROMESA, *supra* note 136, at § 601(j).

¹⁵⁰ *Id.*

¹⁵¹ *See* Slavin, *supra* note 148.

Puerto Rico, PROMESA states that: “provisions of this Act shall prevail over any general or specific provisions of territory law, State law, or regulation that is inconsistent with this Act.”¹⁵²

In addition, Title VI, §602 states that the process will be governed by U.S. law, without regard to any foreign or international law,¹⁵³ meaning that the *NML Capital* decision will likely apply since most clearing houses are governed by New York law. If the CACs fail, the Oversight Board may request that a court modify the bond terms in a bankruptcy proceeding, similar to the U.S. Bankruptcy Code process.

C. Drawbacks to PROMESA

While PROMESA is an innovative solution to Puerto Rico’s debt crisis, the Act has a pretext of colonization. In other words, PROMESA is quite paternalistic. Many people have argued that Puerto Rico’s debt crisis and long history of economic struggles are a direct result of its inability to tackle the problem adequately due to its territorial status and colonial relationship with the United States.¹⁵⁴ PROMESA likely increases Puerto Ricans’ mistrust of the U.S. government, as some view it as an opaque, undemocratic, form of colonial control.¹⁵⁵ To many people, PROMESA is a harsh reminder that Puerto Rico remains subject to the territorial clause under the U.S. Constitution.

Furthermore, the Oversight Board does not provide a seat for any Puerto Rican elected officials. As the recent shutdowns of Puerto Rican schools and hospitals have demonstrated, the debt crisis is an issue of utmost national importance to Puerto Rico. The fact that many of the systemic issues which led to the debt crisis can be blamed on the United States highlights these colonial comparisons. When enacting such a paternalistic statutory regime, Congress has an obligation to bring transparency to the process.

¹⁵² PROMESA, *supra* note 136, at § 4.

¹⁵³ *Id.* at § 602.

¹⁵⁴ Dialogo-El Vocero, *Protests Against ‘Colonial’ PROMESA Debt Plan Rock Puerto Rico*, TELESUR, (Sept. 1, 2016), <http://www.telesurtv.net/english/news/Protests-Against-Colonial-PROMESA-Debt-Plan-Rock-Puerto-Rico-20160901-0015.html>.

¹⁵⁵ 162 Cong. Rec. H5100 (daily ed. Sept. 7, 2016) (statement of Mr. Gutierrez).

VI. EFFECTIVE RESTRUCTURING IN PUERTO RICO THROUGH CACS

A. Overview

PROMESA's inclusion of Title VI is a relatively economically efficient solution to Puerto Rico's debt crisis. Title VI is economically efficient if the benefit of solving the collective action problem is greater than the cost of free riders that result from the implementation of CACs. This section addresses the cost and benefits of Title VI's inclusion of CACs. I conclude that collective bargaining costs are greater than the cost from free riding. Therefore, Title VI is a workable solution for Puerto Rico and future sovereign debt crises.

As previously discussed, PROMESA provides the Commonwealth of Puerto Rico and its instrumentalities with two restructuring mechanisms that are overseen by the Oversight Board. First, Title III §§ 301-317 provides for a bankruptcy proceeding modeled after Chapter Nine of the U.S. Bankruptcy Code. Second, Title VI §§ 601-602 CACs allows for an agreement between Puerto Rico and a majority of creditors that binds dissenting creditors. Some people have argued that Title III will mainly be relied on instead of Title VI.¹⁵⁶ While it is true that in May 2017 the Commonwealth of Puerto Rico, which covers only the central government agencies, received Board approval to file under Title III,¹⁵⁷ Title VI is still relevant as it will likely be used by other debtors on the island.

For instance, in May 2017, the Government Development Bank of Puerto Rico ("GDB") and a majority of its creditors negotiated terms for a Restructuring Support Agreement under Title VI provisions.¹⁵⁸ The Restructuring Support Agreement was approved by the Oversight Board on July 12, 2017.¹⁵⁹ Once approved by the requisite number of creditors, the creditors will be able to exchange their bond claims against GDB through a

¹⁵⁶ Richard J. Cooper, et al., *Why Puerto Rico Will Likely Rely on PROMESA Title III*, LAW360, Mar. 1, 2017, <https://ssrn.com/abstract=2938608> (arguing Puerto Rico will likely rely on Title III because Title VI: (1) contains no automatic stay on creditor litigation upon the commencement and during the continuation of the restructuring process; (2) applies only to financial debt; and (3) procedural and substantive limitations might be unable to address some tax-supported debt issues).

¹⁵⁷ Financial Oversight and Management Board for Puerto Rico, *Unanimous Written Consent Approving and Issuing Certifications Pursuant to Sections 104 and 206 of PROMESA for the Commonwealth of Puerto Rico*, May 3, 2017.

¹⁵⁸ Financial Oversight and Management Board for Puerto Rico, *Unanimous Written Consent Approving Authorization of Certification of Restructuring Support Agreement Pursuant to Title VI of PROMESA*, July 12, 2017.

¹⁵⁹ *Id.*

menu approach of three tranches of bonds.¹⁶⁰ Indeed, the use of Title VI by the GDB indicates that Title III is not the only avenue by which Puerto Rico's restructuring will happen.

The wide spread and varying claims that Puerto Rico's creditors hold will inevitably lead to serious disagreement between creditors. Each will claim they are entitled to seniority of a given revenue in the restructuring process. Because Puerto Rico is a territory, it is unable to access Chapter Nine of the U.S. Bankruptcy Code or seek IMF assistance, thereby adding an additional layer of confusion for the parties involved.¹⁶¹ Since much of Puerto Rico's debt portfolio consists of its instrumentalities issuing bonds, the challenge of restructuring is rendered even more complex.¹⁶² Title VI of PROMESA tries to address these complexities with a streamlined process of restructuring through a consensual agreement process. This differs from a judicially administrated process that would result from a Title III process.

The inclusion of CACs in Puerto Rico's bonds benefits most creditors and potentially the market as a whole. Under the provision, bonds are grouped together according to legal seniority, and any restructuring agreement will require a two-third majority.¹⁶³ In the restructuring process, creditors are generally willing to renegotiate the terms with the distressed sovereign and each take haircuts in order to facilitate some return on their investment. For the most part, it is only the vulture funds who are not willing to renegotiate the terms. This is a classic holdout problem. Indeed, the *NML Capital* case incentivizes holdouts. The retroactive inclusion of CACs in Puerto Rico's debt contracts attempts to directly address this collective action problem. In other words, the CACs directly target holdouts and force them to renegotiate with the sovereign or in this case, the territory.

The introduction of CACs into Puerto Rico's public debt contracts puts the creditors in the best position to agree to acceptable renegotiated terms on their own before judicial interventions. The Act was thoughtfully drafted with careful classification rules to ensure that modification meets the best interest of creditors test.¹⁶⁴ Additionally, CACs act as the functional equivalent of a negotiation forum and incentivizes sovereign debtors to engage

¹⁶⁰ Financial Oversight and Management Board for Puerto Rico, *Fact Sheet Regarding GDB Restructuring Support Agreement ("RSA")*, July 17, 2017.

¹⁶¹ See Dick, *supra* note 115, at 5.

¹⁶² See Rasmussen, *supra* note 120, at 232.

¹⁶³ See Principles Consultative Group, *Principles for Stable Capital Flows and Fair Debt Restructuring: Report on Implementation by the Principles Consultative Group*, INSTITUTE OF INTERNATIONAL FINANCE 11 (Oct. 2016).

¹⁶⁴ *Bill for The Puerto Rico Oversight, Management, and Economic Stabilization Act (PROMESA): Hearing Before the H. Comm. on Natural Resources 10 (2016)*(statement of Susheel Kirpalani, Chair of Bankruptcy and Restructuring Group, Quinn Emanuel Urquhart & Sullivan, LLP).

their creditors in a diplomatic matter. The inclusion of CACs can significantly streamline the intense negotiations between the defaulter and the creditors that often occurs when debt restructuring requires unanimous consent. Thus, CACs offer several clear benefits. First, they create and force a negotiation forum. Second, they palliate the issue of holdouts. Finally, CACs streamline the often lengthy and expensive restructuring process.

The collective action problem that CACs seek to solve can become very costly and time consuming for creditors. By replacing the unanimous consent required under the Trust Indenture Act and allowing the lesser consent requirement laid out in §601(j), the restructuring process is streamlined and more cost effective.¹⁶⁵ The CAC provision will be triggered to a voting pool by a two-thirds vote of the eligible debt, in which holders of at least half of the eligible debt participate.¹⁶⁶ Ideally, CACs will prevent another fifteen-year litigation like the one in *NML Capital*.¹⁶⁷ They also offer an incentive for actors in the sovereign debt space to avoid vulture fund-like actions. While this seriously hampers funds that operate in distressed assets, the overall social utility that results from a restructuring agreement greatly exceeds the benefits of vulture fund-like behavior.¹⁶⁸

Title VI of PROMESA also has the binding effect of a non-consenting pools provision.¹⁶⁹ All creditors in a consenting pool, including those that did not vote or voted against it, are bound to the modification that was agreed to by the necessary votes in that pool.¹⁷⁰ While minority creditors may have concern, the ability to bind all the creditors in the pool is a necessary component of any effective restructuring authority. It is likely that this framework is the only way to bring everyone to the table for any hope of a voluntary agreement.¹⁷¹ However, this provision does create a free rider problem. With this framework, creditors are incentivized to let others do the work required to reach an agreement. Because they are bound by a super-majority decision, creditors may free ride on the negotiations which could result in a less favorable settlement or smaller settlement than if the creditors were vigorously involved.

Arguably, this free rider problem would result in both under-negotiation or over-negotiation by the parties. I suspect that the potential for over or under negotiation would not affect Puerto Rico negatively or result in negative re-

¹⁶⁵ PROMESA, *supra* note 136, at § 601(j).

¹⁶⁶ *Id.*

¹⁶⁷ *See generally* Slavin, *supra* note 148.

¹⁶⁸ There is greater social utility from restoring basic services to a territorial population than the potentially high returns issued by a Vulture Fund. This line of reasoning assumes we attach a high social utility value to basic human life and decency.

¹⁶⁹ PROMESA, *supra* note 136, § 601(m).

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

sults for the creditors. This free rider problem contrasts with the classic public good example of air pollution. In this case, the negative externality that might result because of the use of CACs would be a possible decrease in number of lenders or bond issuers in the market. In other words, the use of the CACs and the subsequent free riding that occurs might result in a contraction of the bond market with issuers leaving the market. But, this potential cost must be weighed against the social utility achieved vis a vie the implementation of the CACs. I conclude that the social utility generated from the use of the CACs is likely higher than the long-term cost to Puerto Rico and the contraction of the bond market.

Another concern that is addressed by the drafting of Title VI is that the Oversight Board must also approve the modifications to creditors' claims. The fear is that holdout creditors will aggregate a pool, rendering CACs toothless. These bondholders might organize to ensure that bondholders in the other classes provide a similar or greater haircut to their own. Although the CAC provision in Title VI does not prevent this aggregation from occurring, the Oversight Board's check on any pool's modifications may be useful in combatting this potential problem. The Oversight Board must ensure that any modification meets the "best interests of creditors' test" prior to approving any modification to a pool of creditors.¹⁷² This is an important mechanism that decreases transaction costs for the sovereign and disincentives creditors from creating holdout pools. It is a powerful tool that further decreases the possibility of holdouts. But, this provision does raise costs for creditors. It forces creditors to negotiate with one another instead of using capital to buy out other creditors. I suspect that these transaction costs are significantly lower than the potential cost of holdouts. Indeed, it is difficult to imagine a situation where a holdout is less costly than an inter-creditor negotiated agreement.

CACs concurrently protect and constrain the interests of both creditors and debtors. Furthermore, with all things being equal, a creditor should prefer the contractual framework created by the retroactive introduction of the CACs into the bond contracts over the uncertainty relating to how the insolvent territory will secure relief. The inclusion of the collective action clauses is likely in the best interest of all parties, except the potential holdout creditors or vulture funds, because it solves the market failure created by vulture funds holding out.

There is a strong moral argument against rewarding so-called vulture funds. Economics aside, vulture funds are profiting and preying on the woes of a sovereign nation. In the case of Puerto Rico, it is essentially an American state. Arguably, this makes the vulture funds conduct even worse because they are holding a state hostage and preventing them from participat-

¹⁷² PROMESA, *supra* note 136, § 601(g)(B).

ing in the bond market. The practical effects of the holdout include unpaid workers, limited access to public utilities and blackouts across Puerto Rico. The flip side of this argument is that the vulture funds are serving as a warning to irresponsible borrowers. But, with an understanding of how the United States borrows capital, I think this is a weak argument.

B. Problems with CACs in PROMESA

Professor Deborah Berman-Santana argues that the passage of PROMESA actually puts Wall Street vulture funds in control of most of the outstanding debt.¹⁷³ This has yet to be seen, but the CACs do give the creditors more control over the process than a court-run bankruptcy. In addition, because CACs would be retroactively introduced to change individual creditor rights without judicial supervision or accepted notions of due process of law, this likely raises some constitutional concerns.¹⁷⁴ The Oversight Board therefore must take extreme caution to protect the competing creditors' contractual rights to their best ability. To refine Santana's point, it is likely that large debt holders will have more negotiating power than small creditors. If the larger debt holders are vulture funds, then perhaps they will actually have more control; without vulture funds holding most of Puerto Rico's sovereign debt, Santana's argument is overstated. Further, while CACs limit the ability for creditors to holdout for full payment, they might also exacerbate the incentives for bondholders to free ride on negotiation costs.¹⁷⁵

Furthermore, Title VI of PROMESA only applies to bond debt, which may mean that other liabilities will not be treated in this same way of striving to achieve compromise.¹⁷⁶ Additionally, due to the Act's requirement for each pool of bonds to vote for the modification, and the numerous types of pools intertwined in Puerto Rico's debt, it could be difficult to affect the overall process of the restructuring of Puerto Rico's debt if multiple pools fail to come to an agreement. This is the larger problem that is created because unlike Section 1129(b) of the U.S. Bankruptcy Code, Puerto Rico must make good-faith efforts toward a cooperative deal before initiating a cram-down provision.

Essentially, an entire voting pool could holdout and prevent all other creditors from moving forward. However, if they do fail to come to an agreement, the process resorts back to the Act's Title III pseudo-bankruptcy

¹⁷³ See Michael Nevradakis, *Transcript: Interview with Deborah Berman-Santana on Crisis in Puerto Rico and Greece* (Sept. 30, 2016), <http://99getsmart.com/tag/transcript-interview-with-deborah-berman-santana-on-crises-in-puerto-rico-and-greece/>.

¹⁷⁴ *Id.* at 9.

¹⁷⁵ See WRIGHT, *supra* note 24, at 308.

¹⁷⁶ *Id.* at 10.

regime through a court process that will impose modifications on the pool's claims. Furthermore, Title VI of PROMESA also only applies to bond debt, which may mean that other liabilities will not be treated in this same way.

A final argument against the inclusion of CACs is that vulture funds do not represent a market failure, but rather they are an expression of the markets efficiency. At its core, this argument is entwined with libertarian or free market economics. Indeed, it is a weak argument. When a firm takes advantage of a loophole and subsequently litigates on that issue for fifteen years, in the case of Argentina, it is anything but efficient.

VII. CONCLUSION

Although PROMESA has been heavily criticized, the Title VI provision, which retroactively introduces collective action clauses to sovereign debt bond contracts, may effectively combat the vulture funds that were able to successfully holdout and block effective restructuring in *NML Capital, Ltd. v. Republic of Argentina*. Due to Puerto Rico's immense, varied, and competing interests from debt issuers backed by different revenue streams and its current defaulting state, CACs are the best option for creditors to receive effective modifications to the essential payment terms of Puerto Rico's sovereign bond contracts.¹⁷⁷ Ultimately, combatting vulture funds is better for non-holdout sovereign bond creditors who each agree to give up a little in order to reach a restructuring agreement. This is especially true when an issuer, like Puerto Rico, is in extreme distress.

The purpose of the sovereign restructuring process is to agree on the terms of a debt exchange that will provide some form of debt relief and solve the debt crisis so that the sovereign state can return to the international capital market as soon as possible. In other words, the purpose of the sovereign debt restructuring process is not to make creditors extremely wealthy – it is to come to an agreement about how much *less* the sovereign will pay its creditors. However, a successful restructuring requires a specific minimum threshold of acceptance by creditors to move forward.¹⁷⁸ While controversial, the inclusion of Title VI's collective action clause in Puerto Rico's sovereign bond contracts will not only benefit Puerto Rico in streamlining their financial woes, but it will also benefit most creditors. Vulture funds that took risks on the Puerto Rican debt crisis are most likely to be negatively affected by PROMESA's inclusion of CACs.

¹⁷⁷ See generally Brown, *supra* note 19.

¹⁷⁸ See DAS, ET AL., *supra* note 25, at 598.