**IN THE UNITED STATES DISTRICT COURT**
**FOR THE DISTRICT OF PUERTO RICO**

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| NATIONAL PUBLIC FINANCE GUARANTEE CORPORATION,<br><br>Plaintiff,<br><br>-against-<br><br>ALEJANDRO GARCÍA PADILLA, JUAN C. ZARAGOZA GÓMEZ, and LUIS F. CRUZ BATISTA,<br><br>Defendants. | Civil No. 16-cv-2101 (FAB)<br><br>**PUBLIC ACT 21-2016; PREEMPTION BY FEDERAL BANKRUPTCY CODE; DECLARATORY JUDGMENT** |

**PLAINTIFF'S REPLY IN SUPPORT OF MOTION FOR PARTIAL SUMMARY JUDGMENT**

**TO THE HONORABLE COURT:**

**COMES NOW** Plaintiff National, by and through its undersigned counsel, and respectfully states and prays as follows:[1]

**PRELIMINARY STATEMENT**

National's Motion demonstrated that the Moratorium Act violates the Supremacy Clause of the United States Constitution because it is preempted by federal law for the same fundamental reason that this Court, the First Circuit, and the United States Supreme Court held the Recovery Act to be preempted: federal law "bars Puerto Rico from enacting its own municipal bankruptcy scheme." *Puerto Rico v. Franklin California Tax-Free Trust*, 136 S. Ct. 1938, 1942 (2016); 11 U.S.C. § 903(1). Defendants' opposition to the Motion [Dkt. No. 35] (the "Opposition") merely confirms that the Moratorium Act is preempted and that the Court should grant partial summary judgment in favor of National immediately. The Opposition does

[1] Capitalized terms not defined herein are defined in Plaintiffs' Motion for Partial Summary Judgment [Dkt. No. 21], filed June 22, 2016 (the "Motion").

not attempt to identify any disputed question of fact or claim that the Motion is premature. Instead, Defendants seek to avoid summary judgment based on a single, fundamentally mistaken premise: that the Moratorium Act escapes preemption because it supposedly does not provide a mechanism for a composition of debt. This core theory fails at every turn.

*First*, as National's Motion demonstrated, Sections 201(a), (b), (d), and (e) of the Moratorium Act *do* provide for compositions of debt and are therefore expressly preempted under the plain terms of Section 903(1) and *Franklin*. (Mot. at 11-16.) A composition is not, as Defendants contend, limited solely to reductions of principal or interest due upon a debt. Rather, as Supreme Court precedent and the legislative history of the Bankruptcy Code confirm, a "composition is a method of adjusting among creditors rights in property in which all are interested." *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 585 (1935) ("*Radford*"). Defendants do not and could not contest that the Moratorium Act adjusts creditor rights.

PROMESA—the federal law enacted after National filed its Motion, but before Defendants' Opposition—confirms that only Congress has the authority to enact bankruptcy laws governing U.S. territories. PROMESA expressly bars any territorial composition of debt *or* moratorium law to the extent it prohibits the payment of principal or interest—as the Moratorium Act does. Additionally, PROMESA *broadens* the scope of express preemption to cover the Moratorium Act's impact on the Commonwealth's general obligation debt. *See infra* Part I.

*Second*, National demonstrated that the Moratorium Act is implicitly preempted because it conflicts with Congress's legislative determinations that i) Puerto Rico cannot pass a binding restructuring law and ii) bankruptcy law should promote equal treatment of creditors.

(Mot. at 17-18.) With respect to the first point, Defendants' only response is the incorrect assertion that the Moratorium Act does not provide a framework for the composition of debts. Defendants ignore, and thus concede, the second point. *See infra* Part II.

*Third*, and finally, National demonstrated that the Moratorium Act is preempted because Congress chose to occupy the field of bankruptcy. (Mot. at 18-20.) Defendants' response—that the Supreme Court supposedly has blessed state restructuring laws—finds no support in the cases they cite. And Defendants have no answer to the (more recent) Supreme Court, First Circuit, and other authorities cited by National showing that "[i]n respect of bankruptcies . . . [t]he national purpose to establish uniformity necessarily excludes state regulation." *Int'l Shoe Co. v. Pinkus*, 278 U.S. 261, 265 (1929). *See infra* Part III.

## ARGUMENT

### I. Federal Law Expressly Preempts The Moratorium Act

#### A. Section 903(1) Of The Bankruptcy Code Expressly Preempts Sections 201(a), (b), (d), And (e) Of The Moratorium Act.

National's Motion demonstrated that Section 903(1) of the Bankruptcy Code expressly preempts Sections 201(a), (b), (d), and (e) of the Moratorium Act because they constitute a state law that "prescrib[es] a method of composition of indebtedness" and binds non-consenting creditors. (Mot. at 11-16); *Franklin*, 136 S. Ct. at 1942 (Section 903(1) "bars Puerto Rico from enacting its own municipal bankruptcy scheme to restructure the debt of its insolvent public utilities companies"). Specifically, the Moratorium Act permits the Commonwealth to unlawfully restructure municipal debts by turning secured debts into unsecured debts and senior debts into junior debts. (Mot. at 13-14.)

Defendants' Opposition does not dispute that the Moratorium Act contains these

features, or that the Governor has already used the Act to, *inter alia*, strip PRHTA bondholders of their collateral and demote general obligation bondholders from senior to junior status. Instead, Defendants assert that the Act falls outside the scope of Section 903(1) because it supposedly does not provide for a composition of debt. Defendants claim a composition occurs *only* when there is "an adjustment of the principal or interest amount due." (Opp. at 5.)

In fact, however, a "composition" of debt has a far broader meaning than the narrow definition Defendants ascribe to it. Indeed, the Supreme Court, in a decision cited by National and ignored by Defendants, has defined a "composition" broadly as "a method of adjusting among creditors rights in property in which all are interested." *Radford*, 295 U.S. at 585; (Mot. at 13). Similarly, the predecessor to the Bankruptcy Code, the Bankruptcy Act, stated that a "plan of composition" "may include provisions *modifying or altering the rights of creditors* generally, or of any class of them . . . and may contain such other provisions and agreements not inconsistent with this chapter as the parties may desire." 11 U.S.C. § 403(a) (repealed) (emphasis added).[2] The legislative history of chapter 9 likewise makes clear that "the primary purpose of chapter 9 is to allow the municipal unit to continue operating while it *adjusts or refinances* creditor claims with minimum *(and in many cases, no) loss* to its creditors."[3]

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[2] Section 903(1) of the Code was derived, with stylistic changes, from section 83 of the prior Act. *See Franklin California Tax-Free Trust v. Puerto Rico,* 805 F.3d 322, 330 (1st Cir. 2015).

[3] H.R. REP. No. 95-595, 95th Cong., 1st Sess. 263 (1977) (emphasis added). *See also* Van Heest, *Relieving Insolvent Municipalities: New York's Emergency Moratorium Act and Federal Bankruptcy Law*, 15 URBAN L. ANNUAL 351, 359 (1978) ("The crux of a composition is that the creditor's rights are impaired."); Note, *Municipal Bankruptcy, the Tenth Amendment and the New Federalism*, 89 HARV. L. REV. 1871, 1899 (1976) ("[I]n all earlier versions of the municipal debt provisions, the term 'plan of composition' was defined broadly to encompass all the forms of relief available to the debtor including, presumably, extension.").

In accordance with these principles, courts have repeatedly held that a state law need not discharge debts to be preempted by federal bankruptcy law: "the presence or absence of a discharge provision is not the sole criterion of the invalidity or validity, respectively, of state legislation in the field presently covered by federal law." *In re Wisconsin Builders Supply Co.*, 239 F.2d 649, 652 (7th Cir. 1956).[4] Defendants' contention that a composition *must* reduce principal or interest flies in the face of these authorities and is wholly unsupported.[5]

Defendants' reliance on *Ropico, Inc. v. City of New York*, 425 F. Supp. 970, 982 (S.D.N.Y. 1976) is misplaced. (Opp. at 1; *id.* at 5.) As the Motion demonstrated—and Defendants ignore—the emergency law at issue in *Ropico* differed materially from the Moratorium Act. (Mot. at 15-16.) Unlike the Moratorium Act, the law at issue in *Ropico* did not seize collateral or adjust creditor priorities. Rather, it provided creditors with an option: exchange their short-term notes for long-term bonds bearing higher interest rates, or receive full payment of interest at the contract rate through the original maturity date and at a lower rate for the remainder of the three-year extension. *See Ropico*, 425 F. Supp. at 975. The court found that the statute was not a law of composition but "merely [a proposal] to postpone payment." *See id.* at 982-

[4] *See also First Nat. Bank v. Robinson*, 107 F.2d 50, 53 (10th Cir. 1939) (holding that New Mexico law was "essentially an insolvency act and covers substantially the same field as the National Bankruptcy Act," even though "the New Mexico act does not make express provision for the discharge of the . . . debtor"); *In re Weedman Stave Co.*, 199 F. 948, 950 (E.D. Ark. 1912) ("A provision for the discharge of the debtor from the unpaid balances of his debts is not essential to make it an insolvency law."); *see also In re Borgelt*, 10 F. Supp. 113, 116 (S.D. Ill. 1935) (referencing compositions that "impair[] the lien of [a] secured creditor").

[5] Defendants cite a number of cases standing for the proposition that a reduction of principal or interest constitutes a composition. (Opp. at 5.) But none of those cases holds that a composition *requires* a reduction of principal or interest. And this Court's decision in *Franklin* offers Defendants no support. (*See id.*) Because the Recovery Act was concededly a restructuring law, the Court had no occasion to define the contours of a composition.

83. The Moratorium Act, on the other hand, offers creditors no such option, expropriates property, seizes collateral, and violates priority rights—in some cases permanently.[6]

**B. PROMESA Confirms Congress's Intention To Preempt State Restructuring Laws.**

Defendants contend that Section 303(1) of PROMESA supports their composition argument by "addressing a 'moratorium' law separately from a 'composition' law."[7] To the contrary, PROMESA confirms that Congress intended federal law to be the exclusive source of authority to restructure municipal and/or territorial debts. PROMESA expressly bars, *inter alia*, (i) "a territory law prescribing a method of composition of indebtedness or a moratorium law . . . to the extent that it prohibits the payment of principal or interest." PROMESA §§ 303(1). It is beyond cavil that the Moratorium Act prohibits principal or interest payments, so to that extent it is expressly preempted by PROMESA § 303(1). This is so regardless whether the Act provides for compositions of debt.

Additionally, as a result of PROMESA, federal law now also expressly preempts the Moratorium Act and executive orders issued thereunder insofar as they affect the

[6] The Motion also noted that numerous provisions of the Moratorium Act mirror the federal Bankruptcy Code—confirming that the Moratorium Act is an unlawful state restructuring scheme. (Mot. at 14-15.) Defendants' only response is that "[n]othing in Section 903(1) remotely purports to preempt any and all state 'restructuring' laws," as supposedly distinct from "composition" laws. (Opp. at 7.) This wordplay is unavailing: "The Federal Bankruptcy Code pre-empts state bankruptcy laws that enable insolvent municipalities to *restructure* their debts over the objections of creditors and instead requires municipalities to *restructure* such debts under Chapter 9 of the Code." *Franklin*, 136 S. Ct. at 1942 (emphasis added).

[7] (Opp. at 6.) Although PROMESA was enacted after National's Motion and eleven days before their Opposition, Defendants elected not to address any other aspect of its express preemption provisions. (*See id.* at 1-2 n.1.) Defendants note that National has not amended its complaint following PROMESA's enactment (*id.*), but they cite no authority requiring a party to amend a pleading to reference new law that is consistent with its existing claims.

Commonwealth's own, general obligation debt, not merely the debt of its instrumentalities. Section 303(1) of PROMESA broadens the scope of preemption by reaching all debts of "a covered territory" (defined to include Puerto Rico, *see id.* § 5(20)), not just debts of a "municipality" (or instrumentality) as in Section 903(1) of the Bankruptcy Code, *see* 11 U.S.C. § 101(40)).[8]

**II. The Moratorium Act Is Implicitly Preempted**

National's Motion also demonstrated that Sections 201(a), (b), (d), and (e) of the Moratorium Act are implicitly preempted because they conflict with Congress's legislative determinations that i) Puerto Rico law cannot bind creditors in a restructuring and ii) bankruptcy law should promote equality among creditors. (Mot. at 17-18.)

Defendants' only response on the first point is that the Moratorium Act does not conflict with any Congressional purpose because it supposedly does not provide for compositions. (Opp. at 7-8.) That is incorrect. *See supra* Part I. Defendants offer no response on the latter point. They thus concede both that the Bankruptcy Code seeks to "ensure fair payment to creditors," *Fustolo v. 50 Thomas Patton Drive, LLC*, 816 F.3d 1, 6 (1st Cir. 2016), and that the Moratorium Act flouts that legislative goal by granting the Governor unfettered discretion to promote the interests of preferred creditors while impairing other creditors. And

[8] PROMESA also expressly preempts "unlawful executive orders that alter, amend, or modify rights of holders of any debt of the territory or territorial instrumentality." PROMESA § 303(3). Under color of the Moratorium Act, the Governor has issued several executive orders that are clearly unlawful because they, among other things, diverted revenues pledged to the repayment of certain secured debts and ordered nonpayment of principal and interest on the Commonwealth's general obligation bonds, in violation of the Commonwealth Constitution's mandate that general obligation debt be paid before any other expenditures. *See* P.R. Const. Art. VI § 8.

that is exactly what the Governor has done. For example, on June 30, 2016, the Governor issued executive orders that suspend payment on PRHTA and general obligation debt, but make a special exception for such debts held by GDB. (Ex. 1, ¶¶ 5, 13; Ex. 2, ¶¶ 1, 8.) This is the antithesis of equality among creditors. Because the Moratorium Act conflicts with Congress's objectives, it is preempted. *See Franklin*, 805 F.3d at 343.

**III. Congress Has Occupied The Field Of Bankruptcy Law**

Finally, National's Motion demonstrated that the Moratorium Act is independently preempted because federal law fully occupies the field of bankruptcy. (Mot. at 18-20.) Defendants' Opposition nowhere addresses the U.S. Supreme Court and First Circuit authority, cited by National, establishing that "[i]n respect of bankruptcies the intention of Congress is plain. The national purpose to establish uniformity necessarily excludes state regulation." *Int'l Shoe Co.*, 278 U.S. at 265; *In re Bank of New England Corp.*, 364 F.3d 355, 364 (1st Cir. 2004) (similar). Instead, Defendants contend that there is no field preemption because i) the Supreme Court supposedly "has long held" that states may enact restructuring laws and ii) the Bankruptcy Code's express preemption provision supposedly indicates that Congress did not intend to occupy the field. (Opp. at 8-9.) Both arguments are without merit.

First, none of the cases Defendants cite supports their contention that the Supreme Court has endorsed state restructuring laws. Defendants' chief authority, *Stellwagen v. Clum*, 245 U.S. 605, 610-11 & n.1 (1918)—in addition to predating *International Shoe*—merely upheld a state law permitting trustees to avoid preferential transfers. As the U.S. Court of Appeals for the Ninth Circuit subsequently explained, in rejecting another litigant's over-reading of that

decision, *Stellwagen* did not delineate the outer bounds of federal bankruptcy preemption.[9] Defendants' other citations likewise fail to rebut National's showing of field preemption.[10]

Second, the express preemption provisions of the Bankruptcy Code and of PROMESA are perfectly consistent with field preemption. *See*, *e.g.*, *Arizona v. United States*, 132 S. Ct. 2492, 2504-05 (2012) ("[T]he existence of an express pre-emption provision does not bar the ordinary working of conflict pre-emption principles . . . .") (quotations and editing removed); *Nat'l Fed'n of the Blind v. United Airlines Inc.*, 813 F.3d 718, 732 (9th Cir. 2016) (noting that "the same logic [articulated in *Arizona*] applies to the operation of implied *field* preemption principles") (emphasis in original). In fact, Defendants' argument gets it precisely backward: "the pre-emption provision itself reflects a desire to [impose] a single, uniform set of federal . . . standards." *Geier v. Am. Honda Motor Co.*, 529 U.S. 861, 871 (2000).[11]

**CONCLUSION**

**WHEREFORE,** National respectfully requests this court to allow the Motion, deny the

[9] *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1205 (9th Cir. 2005) (while "*Stellwagen* reiterated that a state statute granting a discharge would definitely be preempted, it left open whether other state statutes dealing with the subject of insolvency may also be preempted").

[10] *See Franklin*, 136 S. Ct. at 1944-45 (explaining that the holding of *Faitoute Iron & Steel Co. v. City of Asbury Park, N.J.*, 316 U.S. 502 (1942), "rejecting [the] contention that Congress had occupied the field of municipal bankruptcy law" was overturned by the 1946 amendments to the Bankruptcy Code); *Neblett v. Carpenter*, 305 U.S. 297, 303 (1938) (holding that statute did not impair the obligation of contracts); *Doty v. Love*, 295 U.S. 64, 72 (1935) (addressing only allegations of "a denial of due process or an impairment of contract"); *Sturges v. Crowinshield*, 17 U.S. (4 Wheat.) 122, 196 (1819) (explaining that state powers can be "suspended" by the "actual establishment" of bankruptcy laws, which had not then been enacted).

[11] Defendants note that none of the *Franklin* decisions ruled on field preemption under the Bankruptcy Code. (Opp. at 9.) Because the Recovery Act (like the Moratorium Act) was expressly preempted, there was no need to.

Opposition and consequently grant partial summary judgment to National.

**RESPECTFULLY SUBMITTED**, in San Juan, Puerto Rico, this 18th day of July, 2016.

**WE HEREBY CERTIFY** that on this same date the foregoing motion was filed with the Clerk of Court using the CM/ECF system, which will send notification of such filing to all attorneys of record.

**ADSUAR MUÑIZ GOYCO**
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