

Puerto Rico Commission for the Comprehensive Audit of the Public Credit

Pre-audit Survey Report

Executive Summary

Law 97 of 2015 created the Commission for the Comprehensive Audit of Puerto Rico's Public Credit ("Commission"). The Commission is comprised of 17 members selected from civil society stakeholders including: elected officials, representatives of financial institutions, credit unions, academics, and organized labor. The Commission requested that the Methodology Committee of the Commission conduct a pre-audit survey to obtain a basic understanding of the debt and the legal norms applicable to Puerto Rico's debt. The Commission also asked it to provide a factual basis for continued study. The scope of this pre-audit report was limited to a review of documentation produced by the Government Development Bank associated with the two most recent full faith and credit debt issues of the Commonwealth; those being the 2014 \$3.5 billion general obligation bond offering and the 2015 issue of tax and revenue anticipation notes, as well as associated independent economic, legal, and accounting research. The review was limited due to the fact that the Commission has yet to receive funds to commence its work.

As a result of this research, the Commission has decided to further study the following questions:

1. Has Puerto Rico violated the constitution's balanced budget requirement by using debt to finance deficits? Puerto Rico issued the 2014 GO bonds in order to finance prior deficits. Puerto Rico's Constitution requires that the Commonwealth maintain a balanced budget, and thus prohibits the government from borrowing to cover budget deficits. Nonetheless, Puerto Rico has borrowed over \$30 billion to finance deficits. Puerto Rico has been borrowing to cover deficits since as early as 1979. If Puerto Rico financed deficits despite being strictly prohibited from doing so by its own Constitution, then a court may rule that Puerto Rico borrowed without authorization to do so, with the consequence that Puerto Rico may be barred from issuing further debt in the future to finance deficits, it may be forced to raise taxes, or alternatively, declare the debt unpayable for lack of authorization.
2. Has Puerto Rico violated the constitutional debt limit? Puerto Rico is spending anywhere between 14% and 25% of internal revenues on debt. Puerto Rico's Constitution states that Puerto Rico cannot take out any debt that would make it spend more than 15% of internal revenues in its Treasury on General Obligation debt. If the audit demonstrates that Puerto Rico has been spending more than 15% of internal revenues on debt, then a court could, under U.S. Supreme Court case precedent, rule that the debt may not be payable. The Commission will have to determine what debt counts toward that limit, and which debt does not, and then determine whether the Commonwealth went over that limit.

3. Does Puerto Rico's use of "scoop and toss" practices violate the Constitution's prohibition against issuing notes lasting, more than 30 years? The Commonwealth has engaged in a long time pattern of "scoop and toss." That means anytime a debt is about to come due, rather than pay it, the Commonwealth took out another loan and refinanced the debt. For example, the 2014 debt repaid a debt from 2003, but that was refinancing a debt from 1987. The Constitution explicitly states that Puerto Rico cannot issue any loans for more than 30 years. While this practice may not be fiscally wise, the Commission will have to determine whether scooping and tossing debt violates the Constitutional prohibition.
4. What effect did the Commonwealth's use of Capital Appreciation Bonds have on the total debt amount? Puerto Rico has approximately \$37 billion in Capital Appreciation Bonds (CAB's) outstanding, of which approximately \$23 billion belong to COFINA. CABs are an unusual type of debt in which the borrower does not pay interest or principal until the bond comes due. Interest continues to accrue even though the borrower does not have to pay until the debt is due. In Puerto Rico's case, one of the bonds that the Commonwealth must pay on July 1, 2016 is a CAB issued in 1998 for \$14 million, and that the Commonwealth must now pay \$38 million on, after adding interest payments.
5. Did the Commonwealth, and or its advisors and underwriters, comply with relevant SEC laws concerning disclosure? SEC Rule 15 c2-12 bars underwriters from selling debt unless they have determined that the issuer will provide to the Municipal Securities Rulemaking Board ("MSRB") annual financial statements or audited financials in a timely manner. The Commonwealth issued the 2014 GO bond on March 17, 2014. However, only six weeks later, on April 30, 2014, the Commonwealth filed a notice that it would miss its continuing disclosure obligation to provide its FY 2013 audited financials. Furthermore, the 2014 bond offering says very little about the fact that Puerto Rico's Constitution prohibits using debt to cover deficits. The Commission plans on investigating whether the underwriters, which used the proceeds from the debt to retire some of its holdings, knew, or should have known, that the Commonwealth would not meet its continuing disclosure requirements six weeks later.
6. At what point did the debt stop being productive and contributing to economic growth? Puerto Rico has a debt to GDP ratio of 96%. Economic literature suggests that borrowing is correlated to possible negative economic growth once the GDP to debt ratio goes over 90%. The Commonwealth has increased debt usage in recent years, but has failed to realize any sustained economic growth in that period. As deficits increased the amount of "unproductive debt," debt used to finance deficits increased and the amount of productive debt decreased. The Commission plans to study the economic impact of Puerto Rico's debt issuances.

TABLE OF CONTENTS

Purpose of the Report	4
Debt Compliance Evaluative Criteria	5
Part 1: Trends and Elements of Commonwealth Debt	7
Part I a. Overview of 2014 GO Bond Offering.....	9
Discussion.....	11
Part Ib. Overview of 2015 Trans Offering.....	14
Part II:Items of Concern emanating from the pre-audit survey.....	16
a. Use of debt for deficit financing.....	16
b. Conformity with constitutional limitations on the maximum duration of long-term debt issued. ..	17
c. Compliance with Federal continuing disclosure requirements.....	18
d. Compliance with Constitutional limitations of the amount of annual debt service in relation to internal Commonwealth revenues.	19
e. Economic Implications.....	21
Part III- Legal Implications.....	23
a. Deficit Financing.....	22
b. 30 Year Limit on Maturity of Notes.....	23
c. Disclosure Issues	24
d. Debt Limit	26
Next Steps.....	30
Conclusion and Recommendations.....	31

Puerto Rico Commission for the Comprehensive Audit of the Public Credit

Pre-audit Survey Report¹

Purpose of the Report

The Commission for the Comprehensive Audit of the Public Credit of Puerto Rico (“Commission”) was formed pursuant to Law 97 of 2015 of the Commonwealth of the Government of Puerto Rico (“Commonwealth”). The Commission is comprised of 17 members selected from civil society stakeholders including elected officials, representatives of financial institutions and credit unions, academics, and organized labor. The members work in committees that are formed from time to time for specific purposes.

The Commission created the Methodology and Planning Committee with the goal of aiding the Commission in the establishment of its formal audit process. Accordingly the Methodology and Planning Committee conducted this pre-audit survey in order to obtain a basic understanding of the Commonwealth’s use of bonded indebtedness, and private placement of notes, to finance government operations and capital improvements.

While the Commission has decided to conduct the audit in accordance with U.S. General Accounting Audit Standards, this pre-audit survey report does not purport to nor is it intended to comply with those standards. Instead this report is prepared solely for the purpose of facilitating and expediting the audit planning efforts.

The scope of the present pre audit survey report was limited to a review of documentation produced by the Government Development Bank associated with the two most recent full faith and credit debt issues of the Commonwealth; those being the 2014 \$3.5 billion general obligation bond offering to the public and the 2015 issue of tax and revenue anticipation notes that were privately placed (“TRANS”).

This limitation upon the research efforts during this pre-audit survey was due to practical considerations of timing and budget. The Commission has yet to attain the funding necessary to

¹ The Methodology Committee consists of professional economists and accountants. They were assisted by volunteers associated with various Commissioners, including a CPA with over 30 years’ experience in performing public sector audits and experienced counsel. The documents reviewed are summarized in Exhibit A1 and A2. Additionally, the team reviewed certain documents associated with the termination of certain interest rate swaps tied with 2014 GO Offering. Members of the Methodology Committee also reviewed relevant economic literature, researched relevant case law, and did a limited review of prior year budgets and debt that was refinanced by the 2014 offering. In doing the Commission members spent approximately over 425 hours of professional time doing the research and writing this report. Using typical legal accounting, and research related professional rates in Puerto Rico, which are well below mainland professional firm rates, this report would have cost \$63,740. Using average mainland legal rates for a lawyer of similar experience and average accounting rates for a CPA/project manager and research analyst of similar experience, the rate comes to \$135,000.

initiate an audit that is comprehensive in scope; yet the Commission has a mandate to provide the legislature with periodic status reports.² The present report aims to fulfill this mandate.

In addition, the Methodology and Planning Committee hopes and expects this first pre-audit survey report can serve to create a consensus amongst Commission members regarding the following project management issues:

- Audit scope and objectives
- Timing and budget
- Audit team organization and resource acquisition

This pre-audit survey report consists of three elements:

- A high level profile of the Commonwealth's debt currently outstanding as represented in the Commonwealth's bond offering documents, and audited financial statements,
- An itemization of concerns that have arisen during the pre-audit survey and specifically in reviewing the 2014 and 2015 debentures, and
- A series of recommendations for moving forward on a comprehensive financial and compliance audit of the Commonwealth's debt as prescribed in the Commission's charter law.

Debt Compliance Evaluative Criteria

The Methodology and Planning Committee understands the following Puerto Rican constitutional provisional apply to debt financing.

- 1) Article VI, Sec. 7 of the Commonwealth's Constitution states that "the appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal Year unless the imposition of taxes sufficient to cover said appropriations is provided by law." This provision explicitly prohibits budget deficits. However, our initial review of the 2014 GO Bond Offering suggests that the Government of Puerto Rico engaged in borrowing to cover deficits, a practice known as "deficit financing". For example, on page 8 of the 2014 GO Bond Offering Statement; the Commonwealth admits that it has been borrowing to cover deficits for years. According to our initial estimates, the Commonwealth and its instrumentalities may have borrowed up to \$30 billion in recent years to fund deficits, and has been engaging in deficit financing since as early as 1979, if not possibly earlier.
- 2) Article VI, Sec. 2 of the Commonwealth Constitution states "...and no such bonds or notes issued by the Commonwealth for any purpose other than housing facilities shall

² Art. 2, Sec. 3 of Law 97 of 2015 requires that the Commission issue a preliminary report six months after the passage of the Law. Delays in Commission formation and other factors effectively precluded the Committee from initiating its work until January 2016.

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...” This provision prohibits incurring debts with ever longer maturity dates. While the 2014 GO debt offering included bonds that mature in less than 30 years, the proceeds from the 2014 GO debt offering were used to refund a debt that was issued in 2003 by the Puerto Rico Commonwealth as a public improvement bond; which in turn had been used to refinance a Capital Appreciation Bond (“CAB”) that was originally issued in 1987. Assuming Puerto Rico pays off this bond on time, it will have paid off the 1987 CAB in 2035, almost 50 years from the date the debt was first issued.

Capital Appreciation Bond- A bond in which the borrower pays accrued interest and the entire amount outstanding at maturity.

- 3) Article VI, Sec. 2 of the Constitution states that it shall not have direct obligations that “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.” Recently, the Governor of Puerto Rico issued Executive Order 2015-022. The Governor’s order created a “Working Group for the Fiscal and Economic Recovery of Puerto Rico” to work on a restructuring proposal. On page 17 of its September 2015 report, the group states that Puerto Rico will spend 42% of its “tax backed” revenues on debt in FY 2016, and that it will spend 35% of its “tax backed” revenues in Fiscal Year 2017 on debt service.³

Aside from the Constitutional issues expressed above, the Committee has also found issues that warrant further investigation by the Commission, such as the roles of underwriters and other financial and legal institutions in issuing the 2014 debt. For example, SEC Rule 15c2-12 bars underwriters from selling debt unless it has determined that the issuer will provide to the Municipal Rulemaking Board (“MSRB”) annual financial statements or audited financials in a timely manner. The 2014 GO Offering closed March 17, 2014.

However, only six weeks later, on April 30, 2014, the Commonwealth filed a notice that it would miss its continuing disclosure obligation to provide its FY 2013 audited financials. The Commonwealth filed another notice on April 21, 2015 indicating that it would not meet its continuing disclosure requirement to provide continuing financials of 2013. The Commonwealth eventually filed its FY 2013 financials, but it then missed its self-imposed deadline of July 31, 2015 to file FY 2014 applicable financials. The Commission should investigate and determine whether the underwriters, which used the proceeds from the debt to retire some of its holdings, knew, or should have known, that the Commonwealth would not

³ <http://www.bgfpr.com/documents/PuertoRicoFiscalandEconomicGrowthPlan9.9.15.pdf> at p. 17.

meet its continuing disclosure requirements six weeks later. The Commission has requested information from the Government Development Bank related to the underwriting of this bond in order to determine whether the underwriters complied with this SEC requirement, and is awaiting response.

As a result of the foregoing, the Methodology and Planning Committee believes that there is a strong factual basis for the Commission to continue research into whether the Commonwealth complied with the Constitution in issuing its debt, and whether the underwriters complied with applicable SEC norms.

Part 1: Trends and Elements of Commonwealth Debt

As of June 30, 2014 (the most recent date for which the Commonwealth Government has produced a financial report that appears to conform to generally accepted governmental accounting principles) the Commonwealth Government and its component units were indebted to bondholders in excess of \$72 billion.

Three broad categories of debt exist. These categories and the approximate amount outstanding as of June 30, 2014, in the latest audited financials are:

- Direct obligations of the Commonwealth and those subject to a full faith and credit guarantee – approximately \$17 billion
- Obligations for which payment is contingent upon appropriations from the Commonwealth – approximately \$571,000,000
- Obligations issued by instrumentalities of the Commonwealth which are backed not by a guarantee of the Commonwealth's full faith and credit but with a claim upon specified revenues collected by said instrumentality – Approximately \$54 billion

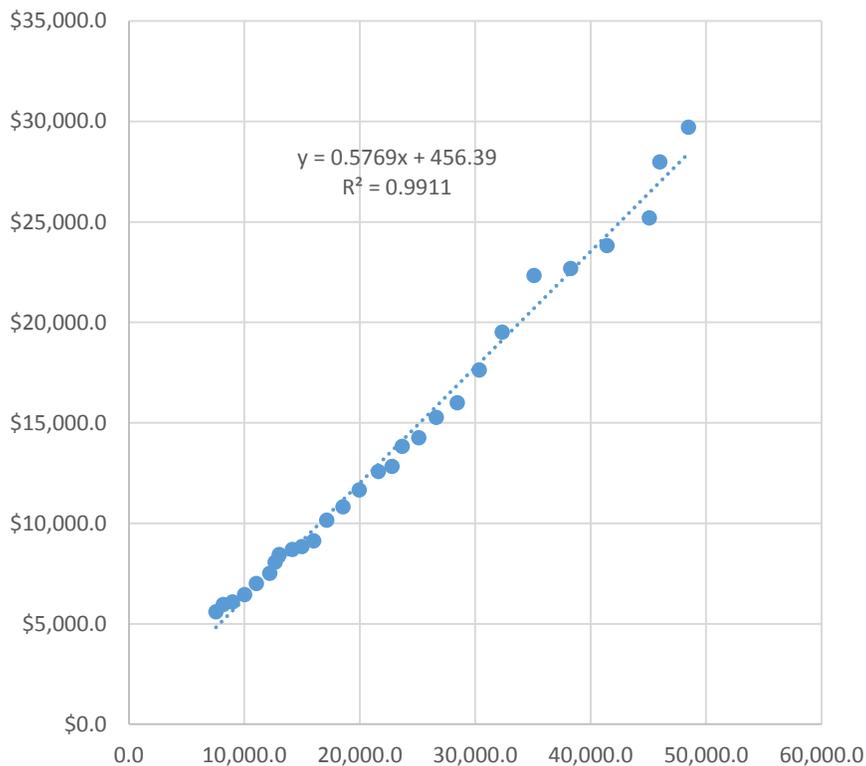
Since 2006 the total public debt of the Commonwealth Government has grown; apparently due to the Commonwealth's need to provide essential public services in the face of a contraction in the economy and a resultant decline in general and special purpose tax revenues. As a case in point, in 2003 the Commonwealth's total public sector debt amounted to just \$29 billion, or less than one half the current amounts. Additionally in 2003 total debt service of the primary government (including the refunding of bonds previously issued) amounted to about \$1.4 billion. By FY 2014 year end, this amount had grown to about \$2.45 billion. According to the Commonwealth's unaudited financial statement attached with the 2014 GO Offering, the Commonwealth has attempted to reduce deficit spending, lowering deficits from \$2.864 billion in FY 2009 to \$1.29 billion in FY 2013.⁴ The true nature of the deficit will have to be determined based on an examination of previously audited financials statements, and the Commission's own work.

⁴ http://www.bgfpr.com/investors_resources/documents/CommonwealthPRGO2014SeriesA-FinalOS.PDF at P. II-10.

Nevertheless, in our estimation, the Commonwealth's overall debt levels have surpassed a point where it is sustainable. Generally speaking governmental debt is sustainable when a government, applying reasonable measures, can attend to the service of the debt. Governments, in most cases, can attend to debt when there is a stable relationship between external debt and gross domestic product, or the ratio between the two is shrinking. Literature on public debt indicates that for most economies there is an "inflexion point" in which the acquisition of more debt does not add to economic growth. For example, Harvard economists Reinhart and Rogoff find that, in advanced economies, a debt to GDP ratio over 90% correlates negatively to economic growth. They find that once an economy is above that threshold, average economic growth falls 1% when compared to countries with less debt.⁵ Later research by Minea and Parent suggests that public debt to GDP ratios between 90%, and less than 115%, are associated negatively with growth.⁶

The trends discussed in the literature have borne out in Puerto Rico. The following chart demonstrates the historical relationship between debt and economic growth.

Table 1: Relationship between public debt and nominal GDP: 1976-2004

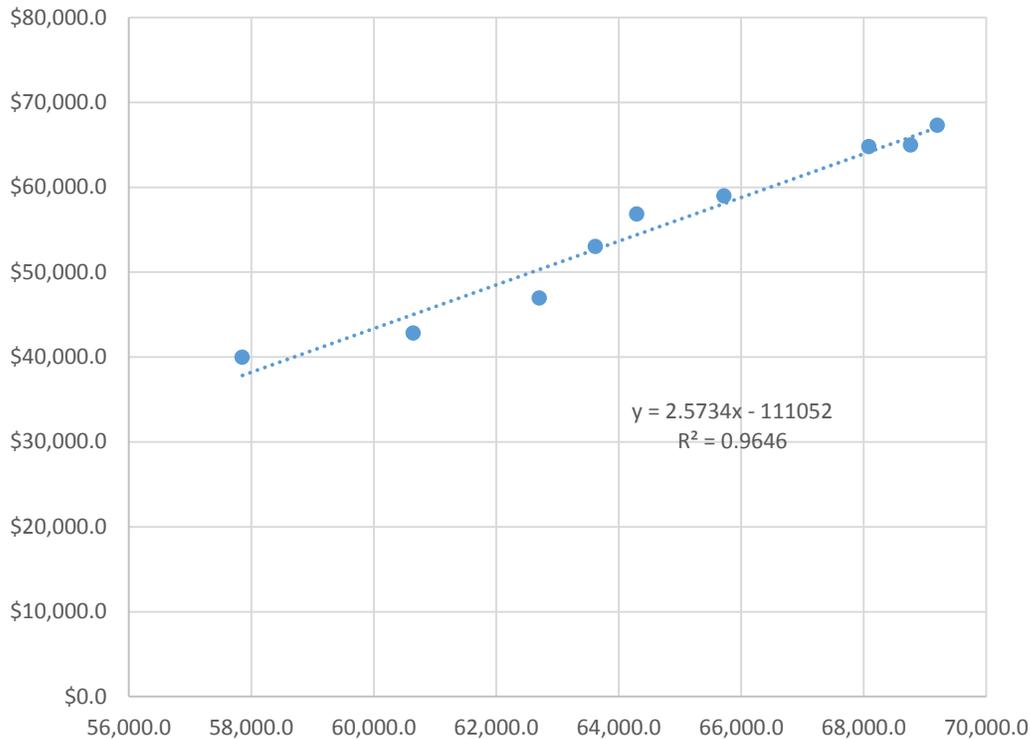


⁵ <http://voxeu.org/article/debt-and-growth-revisited>

⁶ <http://publi.cerdi.org/ed/2012/2012.18.pdf>

Between 1976 and 2004, for each additional \$1 dollar added to Puerto Rico’s GDP, public debt increased by \$0.58 cents. In other words, the addition of debt generally added to the economic well-being of the Commonwealth. However, from 2004 to 2014, for each additional \$1 added to Puerto Rico’s GDP, the Commonwealth added \$2.57 for each dollar of debt as noted in the chart below.

Table 2: Relationship between public debt and nominal GDP : 2004 a 2014



As a result of Puerto Rico’s borrowing, it has a debt to GDP ratio of 96%, and the literature suggests that borrowing is correlated to possible negative economic growth.

Part I a. Overview of 2014 GO Bond Offering

On March 17, 2014, the Government of Puerto Rico, pursuant to Law 34-2014, sold \$3.5 billion dollars of General Obligation (“GO”) debt with an 8% term coupon payment, and an 8.727% yield. The Bonds were to mature in 2035, or 20 years after issuance. Barclays Capital acted as the lead underwriter on the project, as well as Morgan Stanley and RBC Capital Markets. The Government of Puerto Rico engaged several law firms advising on the matter. In addition to the Secretary of Justice, the Commonwealth retained Greenberg Traurig LLP (“Greenberg”) to serve as counsel to the Commonwealth and opined that the bonds were valid,

and exempt from taxation. Both Greenberg and the Secretary of Justice issued a principal opinion and a supplemental opinion. The law firm Pietrantonio, Mendez, and Alvarez LLP (“Pietrantonio”) reviewed the disclosure of the Commonwealth statement to ensure it complied with relevant law. The law firm O’Neil Borges served as counsel to Barclay’s and the underwriters, and in doing so opined that the Commonwealth did not have to register the Offering Statement (“OS”) with the Securities Exchange Commission (“SEC”). Finally, the underwriters retained Sidley and Austin, LLP, to act as co-counsel to O’Neil Borges. Moody’s rated the bond as Ba2, Standard and Poor rated the offering as BB+, and Fitch rated the bonds BB. All three rated the bond below investment grade. As of May 3, 2016, the bonds are selling 65 cents on the dollar, per data from EMMA.⁷

Page 24 of the OS succinctly lays out the use of the bond proceeds.⁸

Principal amount of the Bonds.....	3,500,000,000
Original Issue Discount.....	(245,000,000)
Total Sources.....	3,255,000,000
Uses:	
Repayment of GDB lines of credit and deposit to Redemption Fund.....	1,896,072,196
Repayment of COFINA BANs.....	342,365,760
Refinancing of the Refunded Bonds*	466,574,005
Termination amounts for certain interest rate exchange agreements†	90,417,100
Payment of interest on the Bonds.....	422,749,408
Underwriting discount, legal, printing and other financing expenses.....	36,821,531
Total Uses.....	\$3,255,000,000

⁷ See <http://emma.msrb.org/IssueDetails/Trades/EA350120>.

⁸ See http://www.bgfpr.com/investors_resources/documents/CommonwealthPRGO2014SeriesA-FinalOS.PDF.

Discussion

There are four notable observations to make about the 2014 GO Offering's use of proceeds:

- 1) The Commonwealth is not paying on principal of this bond until 2021, and it is not paying on interest in the first two years out of its own proceeds because the Commonwealth used \$422,749,408 of the bond to pay interest on the same bond for the first two years of this loan, per laws approving the issuance of this debt. The last interest payment using the proceeds from this sale will be on July 1, 2016, when the Commonwealth will pay \$37,500,000 from the proceeds of this bond to pay interest on it. At closing, Barclays wired the proceeds to the redemption fund held at the GDB so that interest payments of \$77,943,832.77 due on June 1, 2014 would be paid.
- 2) The proceeds from this bond sale were used to refinance previous debt issuances that either (a) were not covered by the full faith and credit of the Constitution or (b) refunded lower interest GO debt in exchange for the higher interest cost that was proposed by the new issuance. For example, the Commonwealth used its full faith and credit to pay back \$342,365,760 in COFINA Bond Anticipation Notes ("BAN's"), of which Barclays was the purchaser.⁹ COFINA bond notes were meant to be repaid from the proceeds of a COFINA bond sale that did not occur. Similarly, the Commonwealth paid the GDB \$1,896,072,196.43 to retire several lines of credit that the central government had outstanding. The refinancing mechanism brought debt that was outside the scope of the GO guarantees within it. After the issuance of the debt, Puerto Rico had \$66 million dollars left per year to further pledge toward the repayment of public debt. Act 34 of 2014 authorized the Commonwealth to do this.
- 3) The Commonwealth agreed to apply New York state law to any disputes arising out of the bonds, except for the issue of authorization, which is to be resolved under the laws of Puerto Rico. This is the first time the Commonwealth has allowed a dispute concerning its bonds to be heard in a forum outside of Puerto Rico.
- 4) This issuance also refunded several earlier loans that were left outstanding at higher interest rates than originally taken out. For example, the 2014 GO refunded the

⁹ Id. at p. 24-25.

following bonds. The principal, interest paid at closing, the total paid, and stated interest rate are provided in Table 3.

Table 3. Bonds to be refunded as part of Commonwealth’s 2014 General Obligations Debt Offering¹⁰

Bond Issuance	Principal	Interest	Total	Stated Rate	New Rate
Series 2003C-5-1	\$44,905,000	\$195,027	\$45,100,027	5.50%	8.00%
Series 2003C-5-2	\$188,710,000	\$2,172,957	\$190,882,957	5.00%	8.00%
Series 2003C-6-1	\$98,695,000	\$582,523	\$99,277,523	variable%	8.00%
Series 2003C-6-2	\$98,690,000	709, 968.40	\$99,399,968	variable%	8.00%
Series 2007A-2	\$14,915,000	178, 162.74	\$15,093,163	4.00%	8.00%
Series 2007A-3	\$14,925,000	63, 220.66	\$14,988,221	5.00%	8.00%
Total	\$460,840,000	\$3,723,875	\$464,563,874.23		8.00%

Source: Puerto Rico Government General Obligations Debt Offering 2014 and Offering Statements on Prior Debt, 2008 General Obligation Refunding Bond OS.¹¹

While the 2014 GO offering proceeds were used to refinance debt from 2003, the proceeds of the 2003 offering were being used to refinance and refund debt from 1987. For example, the proceeds for Series 2003C series debt were being used to refinance 1987 GO debt, amongst other things. In turn, the 1987 GO debt was in the form of Capital Appreciation Bonds (“CABs”).¹² Unlike a traditional bond in which a borrower pays bondholders regular interest and principal payments via a coupon, with CABs, the principle and interest are paid in one lump sum on the bond's maturity date.¹³ Also known as zero-coupon bonds,¹⁴ CABs have no impact on the constitutional debt service faced by the Commonwealth during the present fiscal year, as long as they do not mature during the current fiscal year because the Commonwealth would not be forced to use funds to pay it while the CAB was still outstanding. Therefore, as long as the Commonwealth could refinance the CABs, the Commonwealth could accumulate as much debt as needed without impacting the debt service calculated for the purposes of the constitutional debt service limit. The current total debt of Puerto Rico includes the value of the interest currently accrued on those bonds, plus unamortized premiums and interest accreted on capital appreciation bonds, less unaccreted discount and deferred refunding losses.¹⁵ The 2003 bond also refunded certain bonds from 1989 from a 7.5% rate to a 5% rate.

¹⁰ The Audit Commission has not yet received the original interest rate swaps tied to these loans. A list of documents reviewed has been included as Exhibit A, as supplemented by Footnote 1 to this paper.

¹¹ <http://emma.msrb.org/MS272586-MS269425-MD533949.pdf> at p. 38.

¹² See page 6 of http://www.gdb-pur.com/pdfs/public_corp/commonwealth/OSGOREfundingApril2003.pdf.

¹³ See <http://www.msrb.org/Glossary/Definition/CAPITAL-APPRECIATION-BOND- CAB .aspx>.

¹⁴ The attached chart, enclosed herein as Exhibit B, is a Bloomberg report that demonstrates all of the CAB’s outstanding by the Commonwealth.

¹⁵ <http://www.gdbpr.com/documents/2013CommonwealthFS-SecuredVersion.pdf>, at p.136.

Finally, the Commonwealth used \$90,417,100 of the proceeds to pay off the termination fees associated with interest rate swaps, as well as the fee for the swap advisor. An interest rate swap (IRS) is a liquid financial derivative instrument in which two parties agree to exchange interest rate cash flows, based on a specified notional amount from a fixed rate to a floating rate (or vice versa) or from one floating rate to another. Governments tend to use them in order to stabilize interest rate risks associated with a variable rate debt instrument that they issue. Interest rate swaps can be used for both hedging and speculating, and have been the subject of much litigation.

For example, during the Detroit bankruptcy Judge Rhodes rejected two settlements between the City and its swap counterparties because they were unfair to Detroit. After a credit downgrade, the City of Detroit owed \$288 million in termination fees to its swap counterparties. However, Judge Rhodes rejected two earlier offers, one for \$230 million dollars, and one for \$165 million. The swap counterparties ultimately accepted \$88 million in termination payments, or 30% of the original face value of the amount outstanding.¹⁶

In comparison, the Government of Puerto Rico ended up paying approximately 94% of termination fees it owed on these instruments. Puerto Rico ended up owing termination fees because the credit downgrade caused it to be in a state of technical default, and therefore caused rates to accelerate to default rates. At that time Puerto Rico could pay either a termination fee, or continue going under default terms. The 2003 Series C-5-1 and 5-2 bonds that the Commonwealth refunded were bonds that had an interest rate swap agreement with the Bank of New York Mellon serving as the counterparty. According to summaries prepared by the swaps advisor, the Commonwealth was paying 3.7658% interest semiannually, which it was receiving in return .67% of the 1 Month Libor rate, which averaged 0.089% in 2014, or about .534% every six months. The Commonwealth received less than a 10% discount on the swap termination fees.¹⁷

The Commission has not received information yet concerning how much it was losing each month, but clearly the Commonwealth was paying more to the Bank of New York Mellon as counterparty than it was getting back in return. The Commonwealth faced a similar situation with FMS Wertmanagement and Merrill Lynch as well. When the Commission receives the original agreements it will provide greater detail regarding these deals.

Due partially to the credit downgrade by the rating agencies, the Commonwealth's 2014 GO offering contained over thirteen pages of discussion regarding risk factors related to the bonds. First and foremost, the Commonwealth alerted bondholders that it may not be able to pay back the bonds because of financial headwinds. It also alerted bondholders that it may institute a

¹⁶ <http://www.reuters.com/article/usa-detroit-bankruptcy-idUSL2N0N30WY20140411>

¹⁷ The Commission received and reviewed the swap termination agreements, but has not been able to review the original underlying swap agreements that the proceeds of the 2014 debt issuance went to pay for.

moratorium on debt repayment, and that it may not be able to cure 2014 fiscal deficits, or balance its budget for fiscal year 2015, and that the economy of Puerto Rico may not grow fast enough to support the debt it is carrying. The Commonwealth also discussed that it may not have sufficient borrowing authority to go to market.

Part Ib. Overview of 2015 Trans Offering

On October 10, 2014, the Government Development Bank (“GDB”) closed a \$1.2 billion issuance of Tax Refund Anticipation Notes (“TRANS”), \$900,000,000 in Series B, and \$300,000,000 in Series C, to a syndicate of banks led by J.P. Morgan (“syndicate”). The syndicate also included DNT Asset Trust (a wholly owned subsidiary of J.P. Morgan, Morgan Stanley, Amalgamated Bank, Merrill Lynch, and Banco Popular. The law firm of Squire, Patton, and Boggs served as bond counsel. The Secretary of Justice served as legal counsel to the Commonwealth. The law firm of Pietrantonio, Mendez, and Alvarez advised the Government Development Bank. All of the firms opined that the deal was validly entered into. Each received \$235,000 in legal fees, with the GDB receiving \$1.5 million in advisory fees for consummating the transaction.

In structuring this transaction, the GDB first lent the Commonwealth money, and then sold its interest in the notes to the syndicate. The debt was issued by the GDB pursuant to Law 12 of 1975 (“Guaranty Act”) as amended by Law 24 of 2014. The resolution authorizing the issuance of the TRANS makes clear that the notes are not obligations of the Commonwealth, but of the GDB with repayment guaranteed by the Commonwealth.

The TRANS were issued pursuant to Law 1 of 1987. That law states that TRANS shall not be considered debt for purposes of the constitutional debt limit. It also provides the Commonwealth with the authority to take out 18% of internal revenues. It was later amended by Law 39 of 2005 to increase the limit on TRANS to \$1.5 million or 18%, whichever is less. That law states, in Sec. 4 that the Commonwealth did not pledge its full faith. It also states that TRANS debt shall not be counted toward the debt limit because they are considered revenue bonds. It was not until Law 1 of 2014 that the Commonwealth legislature pledged its good faith and credit toward repayment of TRANS.

The TRANS loans were first issued in Series A, which consisted of the original note to the Commonwealth. That note was cancelled, and then the GDB sold \$900,000,000 of Series B consisting of \$250,000 notes. Those notes were subject to mandatory redemption, meaning that the Commonwealth had to pay the amounts due every fifteen days starting April 16, 2015 until maturity on June 30, 2015. The interest rate on Series B-1A and B-1B notes was 7.75%. The spread on Series B-1B and B-2-B was 7.55%. The syndicate was entitled to a 10 basis point penalty if the Commonwealth made payment between 1-5 days late and 50 basis points if the Commonwealth made payment 6-10 days after the appointed redemption date. Series C consisted of the extension of a revolving line of credit by the syndicate to the Commonwealth for

up to \$300,000,000. The Series C notes are subordinate to the Series B notes. Moody's rated the loans as B2 negative, S&P rated the transaction as BB negative, and Fitch rated the transaction as BB- negative.

These grades are speculative or junk ratings. The GDB did not produce a liquidity statement to the syndicate. Instead, the GDB covenanted to produce a liquidity report after closing, and it did so, producing a fiscal update on October 30, 2014.

The 2015 TRANS agreement contained five noteworthy clauses:

- 1) It required that New York law govern the agreement, like the 2014 GO offering.
- 2) It required that the GDB create a new sinking fund at Banco Popular to ensure prompt repayment of the loan.
- 3) Article VI(e) of the Note Purchase, Revolving Credit, and Term Loan Agreement contains a "pari passu" clause. This clause caused problems for Argentina when it attempted to restructure its debt because it gave holdout bondholders a mechanism to compel more favorable terms for a minority of them. See generally NML Capital v. Republic of Argentina, 134 S. Ct. 2250 (2014).¹⁸ The *pari passu* clause states that GDB shall comply with all of the requirements of the Guaranty Act in order to secure repayment of the Notes by the Commonwealth on parity with other general obligation indebtedness of the Commonwealth secured by the full faith, credit and taxing power of the Commonwealth. This clause led to trouble Argentina when it began to default on its loans, and provided bondholders with reason to continue to holdout in restructuring negotiations because the holdout creditors insisted that they receive full value on their original loans.¹⁹
- 4) Furthermore, the agreement also requires that the GDB oppose any legislation to repeal the Guaranty Act or to lower the ceiling of the aggregate principal amount of indebtedness the Commonwealth may guaranty with a pledge of its full faith, credit and taxing power, except for such legislation that will have a prospective effect and will not affect the validity or enforceability of the guaranty by the Commonwealth pursuant to the Guaranty Act as in effect on the Effective Date.
- 5) Finally, the Agreement allows for the Commonwealth to secure payment of the note using any sources available, including sales taxes currently collected by the Puerto Rico Sales Tax Financing Authority, known by its Spanish acronym COFINA. The TRANS documents remain subordinate to other general obligation bonds in

¹⁸ See http://jtl.columbia.edu/wp-content/uploads/sites/4/2015/04/Wong-Note_53-CJTL-396.pdf .

¹⁹ See <http://www.financierworldwide.com/the-pari-passu-clause-as-applied-in-argentina-sovereign-bonds-litigation/#.Vyp11YOrLIU>.

compliance with the Commonwealth Covenant Agreement, Indebtedness where the principal of and interest thereon, or any required payment with respect thereto, is not payable during the fiscal year ending 2015 (excluding interest that is capitalized and payable from the proceeds of related Indebtedness).

The TRANS agreement also contained several clauses in which the Commonwealth assured the syndicate that it had complete authority to enter into the transaction, including multiple assurances that the Commonwealth was not violating any debt limits that were applicable, including the Constitution and the Guaranty Act. Unlike other TRANS issuances with banks, the Government Development Bank did not post this transaction or its documents on its websites because the deal was classified as a private transaction. The GDB has published TRANS documents for other offerings.²⁰

The Commonwealth fully repaid the TRANS ahead of the redemption date.

Part II: Items of Concern emanating from the pre-audit survey.

The Methodology and Planning Committee would like to bring to the Commission some areas of concern for the Commission to further study, based on our initial overview of various materials.

These concerns are expressed as follows:

a. Use of debt for deficit financing.

Article VI, Sec. 2 of the Commonwealth Constitution contains what is commonly referred to as a balanced budget clause; one that requires that the Commonwealth raise taxes to close deficits, and by implication prohibits borrowing to finance operating deficits.²¹ However, the March 2014 General Obligation Bond offering includes a representation that the proceeds of bond offering would be used in part to cover deficits that had accumulated in fiscal years and that were expected to occur in the year of the offering.²² In researching the FY 2014 bond offering document we observed no writings which would either constitute a certification of compliance with the Constitutional prohibition against deficit financing, or which would describe the circumstances under which deficit financing is indeed permissible. In fact, the Commonwealth financial report attached to the 2014 GO asserts that Puerto Rico amassed \$10.9 in general fund deficits between 2009 and 2013.²³ We reviewed earlier reports from the Office

²⁰ See e.g., http://www.gdb-pur.com/pdfs/public_corp/commonwealth/2008-11-07-PRCommonwealth-887MM-OS.pdf.

²¹ https://en.wikisource.org/wiki/Constitution_of_the_Commonwealth_of_Puerto_Rico

²² http://www.bgfpr.com/investors_resources/documents/CommonwealthPRGO2014SeriesA-FinalOS.PDF at p. 8.

²³ http://www.gdbpr.com/investors_resources/documents/CommonwealthPRGO2014SeriesA-FinalOS.PDF at p. II-10 (page 106 of PDF).

of Management and Budget that suggest that the Commonwealth has been engaging in deficit financing since 1979.²⁴

Additionally, in examining the official statements associated with prior general obligation bond offerings in previous years, we observed what appeared to be an express acknowledgement by the Commonwealth of the prohibition against deficit financing. The 2000 and 2007 public improvement bond offerings²⁵ provide an extensive discussion of the systems and procedures in place to ensure compliance with the balanced budget clause.²⁶ In fact, the 2000 offering mentions the balanced budget amendment right up front on page 4, and contains over seven pages on the topic in the attached financial statement.²⁷ However the extensive verbiage was not present in the 2014 offering.

b. Conformity with constitutional limitations on the maximum duration of long-term debt issued.

Article VI, Sec. 2 of the Commonwealth constitution contains an express prohibition against issuing debt that is scheduled to mature beyond 30 years for debt, other than that which is to be used to finance the construction of public facilities.

In reviewing the 2014 General Obligation bond offering, we noted that approximately \$466 million of the \$3.255 billion in bond proceeds (net of an original issue discount of \$245 million) was used to refund a series of public improvement bonds that were issued during calendar years 2003 and 200. Additionally, we discovered that the public improvement bonds which were issued during 2003 through 2007 also constituted refundings of previously issued debt, including debt from 1987. The use of new borrowings to pay off maturing debt is known as “scoop and toss.”²⁸ Exhibit B also contains examples of maturities lasting more than 30 years on CABs.

The Constitution appears to be silent as to whether or not it is permissible to effectively extend the maturity of bonds issued and outstanding by way of advance refunding said bonds.²⁹ The Constitution does not appear to indicate under which conditions such refundings are permissible. While the authorization law for issuing the 2014 GO’s allow the Commonwealth to refund bonds, the issue here is not a statutory one, but a constitutional one. The legislature’s actions must comport to the Constitution.

²⁴ <http://www2.pr.gov/presupuestos/presupuestosanteriores/af99/ingles/serdeuda/capdeud2.htm>

²⁵ http://www.gdbpr.com/pdfs/public_corp/commonwealth/2007-09-17-OS-PRCommonwealthGOs408MM.pdf at p. I-64-71.

²⁶ http://www.gdbpr.com/pdfs/public_corp/commonwealth/PRCommonwealth3-OS.pdf at p. I-73 (page 125 of PDF).

²⁷ http://www.gdbpr.com/investors_resources/documents/2012-06-13-PRCommonwealthPubImpRef2000.pdf at p. 4, see also I-41-47.

²⁸ See <http://www.wsj.com/articles/SB10001424052702304579404579234441072889918>.

²⁹ Based upon discussions with various representatives of the Commonwealth we understand the refinancing of debt has been commonplace in recent years as a way of helping manage the deficit of the General Fund and is referred to as “scoop and toss”.

Based upon conversations with a former director of the Office of Management and Budget it is our understanding that the refunding of bonds has been a standard practice of the Commonwealth as a means of balancing the General Fund budget since 2006, and that the Commonwealth may have had budget deficit starting in the late 1970's.

In examining the 2014 General Obligation bond offering we obtained and reviewed the opinions of bond counsel and of the Department of Justice. We also obtained and reviewed various certifications provided by Hacienda and the Government Development Bank which pertained to certain key compliance issues such as conformity with IRS Arbitrage rebate regulations and limitations on annual debt service. None of these documents we reviewed spoke directly to the issue of whether refunding of bonds, much less the refunding of refunded bonds, was permissible.

The economic substance of the Commonwealth's admittedly extensive use of bond refundings (as well as the refunding of bonds previously refunded) is arguably tantamount to issuing debentures of unlimited duration. In examining the debt the Commission should look at the extent to which bonds were refunded, especially to less favorable terms for the Commonwealth.

c. Compliance with Federal continuing disclosure requirements.

The 2014 Bond offering document acknowledges the Commonwealth's duty to conform to US Securities and Exchange Commission Rule 15c 2-12. In Puerto Rico's case, the Commonwealth agreed to provide audited financial statements within 305 days of the end of the fiscal year. The 2014 Bond OS also contained an acknowledgement of the Commonwealth's repeated failure to adhere to its continuing disclosure duties in recent years.³⁰

To rectify past financial reporting lapses, the Commonwealth represented to have undertaken the following corrective actions to ensure future compliance:

- (i) The assignment of additional resources from local and national audit firms to those component units whose financial statements have not been provided in a timely manner to the Commonwealth;
- (ii) The assignment of dedicated external and internal resources to assist the Central Accounting Division at Hacienda in the preparation of complex financial information that has historically delayed the audit;
- (iii) Regular meetings between Hacienda and GDB personnel in order to track the progress of all component unit financial statements and provide assistance, when necessary, to ensure timely filing of the financial statements;

³⁰ http://www.gdbpr.com/investors_resources/documents/CommonwealthPRGO2014SeriesA-FinalOS.PDF at p. 42.

- (iv) As necessary, regular meetings between Hacienda, GDB and component unit personnel to ascertain progress and compliance with the completion deadlines.³¹

The Commonwealth failed, despite those efforts to ensure timely compliance, to produce timely financial reports in two consecutive years following the issue of the 2014 General Obligation bond offering. The 2014 GO Offering closed March 17, 2014. However, only six weeks later, on April 30, 2014, the Commonwealth filed a notice that it would miss its continuing disclosure obligation to provide its FY 2013 audited financials.³² The Commonwealth eventually filed its FY 2013 audited financials. However, the Commonwealth filed another notice on April 21, 2015 indicating that it would not meet its continuing disclosure requirement to provide continuing financials FY 2014.³³ The Commonwealth also missed its self-imposed deadline of July 31, 2015 to file applicable financials. The Commonwealth also filed another notice indicating that it missed yet another deadline to file its continuing disclosure on April 29, 2016.³⁴

d. Compliance with Constitutional limitations of the amount of annual debt service in relation to internal Commonwealth revenues.

Section 2 of Article VI of the Commonwealth Constitution provides that direct obligations of the Commonwealth evidenced by full faith and credit bonds or notes shall not be issued if the amount of the principal of, and interest on, such bonds and notes and on all such bonds and notes theretofore issued that is payable in any fiscal year, together with any amount paid by the Commonwealth in the fiscal year preceding the fiscal year of such proposed issuance on account of bonds or notes guaranteed by the Commonwealth, exceed 15% of the average annual revenues raised under the provisions of Commonwealth legislation and deposited into the treasury (referred to as “internal revenues”) in the two fiscal years preceding the fiscal year of such proposed issuance.

Internal revenues consist of sales taxes (other than that pledged to COFINA), property taxes, income taxes and various miscellaneous sources of revenue. In the case of the 2014 offering internal revenues amounted to approximately \$8 billion thus providing for a maximum debt service of about \$1.2 billion.

Our review of the 2014 GO Bond offering included an examination of the Government Development Bank’s certification of compliance with the constitutional limitation on a prospective basis, and in anticipation of the issuance of an additional the \$3.5 billion in full faith and credit debentures to be issued.

³¹ Id.

³² <http://emma.msrb.org/EP810191-EP627521-EP1029300.pdf>

³³ <http://emma.msrb.org/ER887429-ER693281-ER1094859.pdf>

³⁴ <http://emma.msrb.org/ES785073-ES617350-ES1013051.pdf>

The computational methods used by GDB appeared to be arithmetically correct, performed in a manner consistent with protocol employed in years past, and supported by the opinion of outside bond counsel.

However, certain transactions of economic substance appear to have been excluded from consideration in the 2014 offering. As a case in point, we noted that the FY 2014 draft financial statements included recognition of a liability under guaranteed debt in the amount of \$224 million. Since this \$224 million liability was not identified on the Commonwealth's FY 2013 audited financials it is presumably an expense that was incurred contemporaneously with the 2014 General Obligation Bond offering. Depending on the timing of when that expense was incurred, it should have been taken into account in the debt limit calculation.

The computation of margin of available debt service computed after giving effect to the \$3.5 billion March 2014 general obligation bond offering was just \$66 million. Hence, had the \$224 million liability been included in the GDB's debt limit, the bond may not have been issued in compliance, depending on the timing of the \$224 million expense.³⁵

Additionally, during FY 2014 approximately \$2 billion in General Fund expenditures, or roughly 25% of internal revenues were expended for the purpose of debt service. However only about \$1.2 billion or about 15% of such expenditures were recognized for the purpose of certifying compliance with the Commonwealth's constitutional debt limit.

We note that in years past, the Commonwealth's independent auditors have consistently opined that the Commonwealth has been in conformity with the debt limit. However, an opinion has yet to be rendered with respect to this issue in the audit for fiscal year ending June 30, 2014, which is the fiscal year in which the bond offering the Commission examined, was issued.³⁶

During this phase the Commission learned that the information used by GDB to prepare the debt certification comes from Hacienda and the Office of Management and Budget ("OGP"). Hence, upon the initiation of the comprehensive audit, follow up inquiries with those agencies will be necessary.

It is also important to note that the debt limit is difficult to calculate because the Commonwealth uses taxes to support the debt of both its "blended component units" and "discretely presented units."³⁷ Blended component units are those units that, while legally are independent, meet certain blending criteria under government accounting rules. In the words of

³⁵ See statement of net position

http://www.hacienda.gobierno.pr/sites/default/files/draft_unaudited_financial_statements_dated_2_16_2016_0.pdf at p.24.

³⁶ See

http://www.hacienda.gobierno.pr/sites/default/files/draft_unaudited_financial_statements_dated_2_16_2016_0.pdf at p. 30.

³⁷ See

http://www.hacienda.gobierno.pr/sites/default/files/draft_unaudited_financial_statements_dated_2_16_2016_0.pdf at p. 81.

the Government Accounting Standards Boards (“GASB”), “some component units, despite being legally separate from the primary government, are so intertwined with the primary government that they are, in substance, the same as the primary government and should be reported as part of the primary government. That is, the component unit's balances and transactions should be reported in a manner similar to the balances and transactions of the primary government itself. This method of inclusion is known as blending.”³⁸ The Commonwealth has several blended component units including the Puerto Rico Infrastructure Financing Authority (“PRIFA”), the Puerto Rico Sales Tax Corporation (“COFINA”), and the Puerto Rico Building Authority (“PBA”).³⁹ In this case, the Commission may want to examine whether the income and debt of various component units should have been counted in the debt limit calculation, or should continue to be excluded.

e. Economic Implications

As noted in the overview, the GDP to debt ratio of Puerto Rico is currently at 96%. During Fiscal Year 2015, the ratio was 98%, however as a result of lack of further access to financial markets that ratio has fallen to 96.6%. At this point, the debt appears unproductive, and used to maintain liquidity rather than generate new growth. Page 24 of the OS for the 2014 GO Offering, which contains the Use of Proceeds, makes clear that the offering is for refinancing the Government Development Bank, but it is not for new capital financing. This chart sets out clearly the ratio of productive debt to less productive debt.

From that perspective, the debt appears to be unproductive because it is no longer being obtained to improve capital, but to pay for normal operating costs.

Part III- Legal Implications

The concerns outlined above implicate a host of legal concerns. This section of the pre-audit survey is not a full survey or analysis of the laws that apply to Puerto Rico’s debt, or a legal opinion of any sort. Rather, this section provides an overview of some of the laws that the Commission should test to determine compliance against. This discussion is meant to set out an understanding of the legal consequences that come with failing to comply with the relevant provisions in Puerto Rico’s Constitution and certain securities laws. If the Constitution of Puerto Rico does not authorize a debt issuance, then such an action would be *ultra vires*, or without authority.

Per Law 97, the debt audit must examine debt that has been issued over the last 30 years. The Supreme Court of Puerto Rico has made clear that, should a contract be left null and void,

³⁸ <http://www.gasb.org/st/summary/gstsm14.html>

³⁹ http://www.hacienda.gobierno.pr/sites/default/files/draft_unaudited_financial_statements_dated_2_16_2016_0.pdf
at p. 42.

that contract is not subject to a statute of limitations defense. In other words, the Supreme Court of Puerto Rico could hold that a debt that was issued 30 years ago could be set aside as being unpayable because the statute of limitations does not apply to public or private contracts that are *nolo ab initio* since they were without legal effect in the first instance. See Rios v. Municipio de Santa Isabela, 159 D.P.R. at 849 (holding that actions to set aside public contracts as *nolo ab initio* are not subject to statute of limitations); see also Guzmán Rodríguez v. Guzmán Rodríguez, 78 D.P.R. 673 (P.R. 1955) (holding that the statute of limitations only limits suits on private voidable contracts, not contracts that *nolo ab initio*).

The Commission, and its internal audit team once funded, must test compliance, and whether the Commonwealth acted without authority in issuing certain debt. The four points of concern set out above where a) deficit financing, b) the prohibition on notes maturing 30 years or more past issue date, c) meeting continuing disclosure obligations, and d) debt limit compliance. They will be reviewed in order.

a. Deficit Financing

Article VI, Sec. 7 states:

The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal Year unless the imposition of taxes sufficient to cover said appropriations is provided by law.

This article is commonly known as a balanced budget clause. The Supreme Court of Puerto Rico has never ruled on the meaning or applicability of this section. Similarly, it does not appear as if the Secretary of Justice has provided an opinion concerning whether this provision prohibits the Commonwealth from taking out debt to pay for appropriations.

Nonetheless, courts in two states have dealt with the effect of balance budget laws squarely, New Jersey and Pennsylvania. In Lance v. McGreevey, 180 N.J. 590 (2004), the Supreme Court of New Jersey held that borrowed funds did not constitute revenue within the meaning of the State Constitution's requirement of a balanced budget. Therefore, the court said, the funds could not be used to pay general operating expenses, although the state may continue to borrow for capital projects. Because the court was ruling for the first time on the meaning of the word "revenue," it said its decision would apply only to future budgets.

Similarly, in Hopewell School District, 59 Pa. D. & C. 249 (Pa. Ct. Common Pleas 1947), the court rejected a petition filed, at the request of the professional employees of the district, seeking a declaratory decree on whether the professional employee were entitled to an increase in their salary due to the high cost of living. In the alternative, the school district sought a declaration of whether the high cost of living was an emergency within the meaning of section 563 of the School Code of May 18, 1911. The court found that if the school district increased the salary of the professional employees, the increase would cause the total appropriations contained

in the budget for the current fiscal year to be exceeded. The court stated that the school district could not grant the increase in salary because it was contrary to the statute. The court stated that there was no authority for the school district to make any additional appropriations because there was no anticipated revenue from any source that could be floated to raise revenue for such a purpose. Furthermore, the court stated that the present high cost of living was not an emergency. Even though the case did not deal directly with the implications of a balanced budget amendment, it did make clear that district could not float any more debt through a temporary loan or move appropriations around when the statute required a balanced budget.

There is a dearth of case law regarding the substance of this issue because courts have applied a number of decision avoidance mechanisms to avoid reaching a decision on the merits. Furthermore, states have used a number of budget gimmicks to get around their balanced budget amendments.⁴⁰ Nonetheless, the Commission needs to further investigate whether Puerto Rico used deficit financing in a way that violated its balanced budget amendment, and if the Commission did do so, then the Commission needs to examine with precision how much of the debt was taken to finance deficits, and/or how much the Commonwealth would have had to increase taxes to balance the budget.

b. 30 Year Limit on Maturity of Notes

Article VI, Sec. 2 of the Commonwealth Constitution states “...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...” Puerto Rico’s Supreme Court has not issued a ruling on this issue, nor has the Secretary of Justice published any opinion regarding whether the rollover of maturing debt violates the Constitution. Interestingly enough, a fifty-state Lexis search regarding this issue turned up no case law on the matter, at least as applied to municipal issuers.

The Constitution of Puerto Rico seems pretty clear regarding this point. The Commonwealth cannot issue public debt, as defined by the Constitution, with a maturity of more than 30 years, unless it is for financing the construction of housing.

Once the Commission hires legal counsel, they will need to develop an interpretation of this section of the Constitution, despite the paucity of law on this point, in order for the auditors to test compliance with this provision. The Wall St. Journal noted that Puerto Rico and Chicago are avid users of “scoop and toss”, the practice of refinancing maturing debt with new debt.⁴¹ The question for the audit team to resolve is whether this practice violated the letter of the Constitution, or simply the spirit of the Constitution, and to determine how much debt did this practice add to the total debt load the Commonwealth currently has.

⁴⁰ See generally, Caught Off-Balance: How implementing structural changes to state balanced budget amendment requirements can foster fiscal responsibility and promote long term-economic health., 56 B.C. L. Rev. 351 (2015).

⁴¹ <http://www.wsj.com/articles/SB10001424052702304579404579234441072889918>, dated Dec. 2, 2013.

The audit team will most definitely work with appropriate legal counsel to resolve this issue as the Committee learned that some of Puerto Rico's debt consists of CABs that mature well over 30 years after issuance and in some cases almost 50 years after issuance.⁴² In fact, as noted in Exhibit B to this report, the Commonwealth may have up to \$38 billion dollars outstanding as CABs, and no idea how that is included in the Commonwealth's pro-forma debt report. This report mentions the CABs here because the proceeds from the 2014 GO offering were used to refund a debt offering that was issued in 2003, and that had refinanced a Capital Appreciation Bond ("CAB") that was originally issued in 1987. Assuming Puerto Rico pays off this bond on time, it will have paid off the 1987 CAB in 2035, almost 50 years from the date the debt was first issued.

c. Disclosure Issues

In general, underwriters have to undertake certain obligations related to the marketing of the 2014 GO offering. It is worth quoting Securities and Exchange Commission Rule 15c2-12, codified as 17 C.F.R. 240.15c2-12 at length:

- (a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer (a "Participating Underwriter" when used in connection with an Offering) to act as an underwriter in a primary offering of municipal securities with an aggregate principal amount of \$1,000,000 or more (an "Offering") unless the Participating Underwriter complies with the requirements of this section or is exempted from the provisions of this section.⁴³

(b)(5)(i)

...Participating Underwriter shall not purchase or sell municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined that an issuer of municipal securities, or an obligated person for whom financial or operating data is presented in the final official statement has undertaken, either individually or in combination with other issuers of such municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such securities, to provide the following to the Municipal Securities Rulemaking Board in an electronic format as prescribed by the Municipal Securities Rulemaking Board, either directly or indirectly through an indenture trustee or a designated agent:

⁴² See Exhibit summary of all Capital Appreciation Bonds taken out by the Commonwealth.

⁴³ <https://www.law.cornell.edu/cfr/text/17/240.15c2-12>

(A) Annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final official statement, except that, in the case of pooled obligations, the undertaking shall specify such objective criteria;

(B) If not submitted as part of the annual financial information, then when and if available, audited financial statements for each obligated person covered by paragraph (b)(5)(i)(A) of this section;...

Taken together, these rules bar municipal underwriters from selling bonds unless they can reasonably ascertain that municipal issuers can actually comply with their continuing disclosure obligations. The obligation to determine whether an issuer will reasonably meet its continuing obligation disclosure at the time of issuance rests on the underwriter, though an agent acting on behalf of an issuer may, by contract be responsible for providing the disclosure to the market.⁴⁴ In this case, the Commission will have to review the documents provided to the underwriters to determine if they reasonably investigated the ability of the Commonwealth to make its continuing disclosure obligations. Since the Commission has not received those documents yet from the GDB, it is too premature to arrive at any opinion.

While the SEC places certain obligations on the underwriter, issuers are not absolved from all responsibility under current SEC law. Even though municipal issuers like Puerto Rico are exempted from many SEC requirements, municipal issuers are subject to the antifraud provisions of section 10(b) of the Exchange Act,⁴⁵ and Rule 10b-5.⁴⁶ Rule 10b-5 makes clear that it is unlawful for any person to defraud or make untrue statements, or omit material facts. In appropriate circumstances, and usually upon complaint, the SEC will investigate a municipal issuer's Offering Statements to determine if the issuer was acting in a false and misleading manner. The SEC's enforcement actions against Miami and Greater Wenatchee Regional Events Center are illustrative.

In re City of Miami, Florida,⁴⁷ the SEC issued a cease-and-desist order against the City of Miami for preparing official statements which contained false financial information about the city's actual finances at the time of the bond sales. Specifically, the SEC faulted Miami for including a summary of finances that demonstrated that the city's budget was balanced, even though in the next fiscal year the city's operating budget exceed the budgeted operating revenues by millions of dollars. The SEC also found that Miami's use of bond proceeds to fund

⁴⁴ <http://www.msrb.org/Market-Transparency/Continuing-Disclosure.aspx>

⁴⁵ See <https://www.law.cornell.edu/uscode/text/15/78j>, 15 U.S.C. Sec. 78j.

⁴⁶ See <https://www.law.cornell.edu/cfr/text/17/240.10b-5>, 17 C.F.R. Sec. 240.10b-5.

⁴⁷ See <https://www.sec.gov/litigation/opinions/33-8213.htm>.

operational expenses demonstrated the gravity of its cash flow deficit. As a result, the SEC felt that the City needed to make these facts clear to investors.

In Greater Wenatchee Regional Events Center Public Facilities District et al, the SEC held that the Official Statement of bonds that were going to be used to purchase a hockey rink mislead investors because the projections contained were too optimistic. Specifically, the SEC found that the Mayor and developer went out of their way to reject the more sober assessment of potential ticket revenue put forth by an independent consultant. Furthermore, the Commission felt that the City of Wenatchee, WA's ability to support the bonds was limited by its own debt load.⁴⁸

In the case of Puerto Rico, the Audit Commission will have to study whether Puerto Rico's disclosures concerning its debt sufficed to meet relevant SEC standards, and whether its underwriters met their disclosure obligations. While a violation of these standards would not necessarily render any prior debt issuances ultra-vires, the market may want to have the Commission take an independent look at the adequacy of the disclosures put out by Puerto Rico, and the underwriters selling its debt.

d. Debt Limit

If the audit concludes that Puerto Rico issued debt over and above its debt limit, such a finding could have significant legal implications. The Supreme Court of the United States has held that a government that exceeds its debt limit can repudiate debt that is above its legal borrowing limits. In Buchanan v. City of Litchfield, 102 U.S. 278, (1880)⁴⁹ the City of Litchfield, IL borrowed money to fund a set of water works. The city did so even though it had already reached the limit set out under Illinois law. The lender brought suit seeking repayment after the city refused to pay. The United States Supreme Court held that the plaintiff could not recover against the city because the contract was void as the city did not have the legal authority to issue the debt. Id. at 292. In fact, five years later, the Supreme Court once again rejected the plaintiff's attempt to recover for his loss, this time by seeking to take control of the waterworks that the plaintiff's funds were used to purchase. See City of Litchfield v. Ballou, 114 U.S. 190 (1885).⁵⁰

The Litchfield case is not the only case in which this result has been reached. Other cases have also invalidated debt that exceeded the debt limit established by a governmental entity. For example, in Eaton v. Shiawassee County, 218 F. 588, 592-93 (6th Cir. Mich. 1914), the Sixth Circuit held that a debt a bondholder made to a county in excess of borrowing limits set out by the state of Michigan was null and unenforceable. Alabama's courts have also voided debt that

⁴⁸ See <https://www.sec.gov/litigation/admin/2013/33-9471.pdf>.

⁴⁹ See <https://supreme.justia.com/cases/federal/us/102/278/case.html>.

⁵⁰ See <https://www.law.cornell.edu/supremecourt/text/114/190>.

was taken out against its debt limit. See e.g. Eagerton v. Second Econ. Dev. Coop. Dist., 909 So. 2d 783, 796 (Ala. 2005) (taxpayer brought successful suit voiding debt taken out in excess of Alabama constitutional debt limit). In one case, the Supreme Court of Nevada held that the state had invalidly classified certain bonds as being exempt from the constitutional debt limit, and held that if certain bonds to build a cultural center were issued, the amount would have to comply with the Nevada constitution's debt limit. See Brewery Cultural Arts Center v. State Board of Examiners, 108 Nev. 1050, 1056 (Nev. 1992); see also Ferrar v. Britton Independent School District, 72 S.D. 226, 234 (S.D. 1948) (enjoining sale of bonds by taxpayer because issuance would have violated the debt limit).

Other courts have also held that one cannot recover on a contract what a state statute has already deemed void. See e.g. Zane v. Hamilton County, 189 U.S. 370, 381-82 (1903) (holding that bonds that had been invalidated by state statute not subject to recovery); Lewis v. Pima County, 155 U.S. 54, 57-58 (1890) (holding that county's bonds issued for benefit of railroad not recoverable when issued against state law debt authorization); Reynolds v. Waterville, 92 Me. 292, 312-313 (Me. 1898) (invalidating contract over Maine debt limit for cities).

One important exercise that the Commission will have to undertake is determining whether a bond is truly a GO bond, a revenue bond, or a moral bond, as different legal regimes apply to each. In determining which debt is GO debt, and which should not be, some courts have looked behind the labels given to the debt by issuers. A handful of state courts have given greater weight to practical effects in assessing whether an obligation is "debt" within the meaning of a state's constitution. See State ex rel. Ohio Funds Mgmt. Bd. v. Walker, 561 N.E.2d 927, 932 (Ohio 1990) (noting obligation to be considered "not only for what it purports to be, but what it actually is"); Winkler v. Sch. Bldg. Auth., 434 S.E.2d 420, 433, 435 (W. Va. 1993) (noting that the court was un-willing to "abandon . . . logic and common sense" and finding that "where the only source of funds for revenue bonds was general appropriations, it defied logic to say that the legislature had no obligation to fund such bonds.").

This approach was also used in Detroit to a certain extent, and it bears retelling. On January 31, 2014, the City of Detroit brought suit against the Detroit General Retirement Corporation and the Detroit Retirement Systems Funding Trust 2005 and 2006 seeking to invalidate about \$1.5 billion in debt.⁵¹ At that time, the City of Detroit retirement systems for both its employees and public safety officers (collectively "retirement plans") had threatened to file a lawsuit against the City of Detroit for failing to adequately fund them. Detroit could not make the payments because it lacked the \$1.7 billion needed to do so.

⁵¹ See Complaint for Declaratory and Injunctive Relief.

[http://www.drinkerbiddle.com/Templates/media/files/Service%20Pages/City%20of%20Detroit%20COPs%20Holders/Complaint%20for%20Declaratory%20and%20Injunctive%20Relief%20filed%20Jan_%2031%2C%202014%20\(with%20exhibits\).pdf](http://www.drinkerbiddle.com/Templates/media/files/Service%20Pages/City%20of%20Detroit%20COPs%20Holders/Complaint%20for%20Declaratory%20and%20Injunctive%20Relief%20filed%20Jan_%2031%2C%202014%20(with%20exhibits).pdf)

Detroit could not borrow any more money either. Under the Michigan Home Rule City Act (“HRCA”), MCLA § 117.4a, the maximum indebtedness a city could incur was the greater of (1) ten percent of the assessed value of all real and personal property in the city; or (2) fifteen percent of the assessed value of all the real and personal property in the city if that portion of the total amount of indebtedness incurred which exceeded ten percent was or had been used solely for the construction or renovation of hospital facilities. The Constitution of Puerto Rico contains similar language for its municipalities. See Art. VI, Sec. 2. According to Detroit’s Finance Department, the City only had \$600 million remaining under its debt limit as of May 2, 2005. This fact was made known publicly.

Since Detroit could not issue traditional bonds without going over the debt limit, the City instead embarked on building a creative financing mechanism to get around the debt limit. Specifically, the City created two shell entities called “Service Corporations.” The board of directors of the Service Corporations consisted of City of Detroit officials. The Service Corporations then established a special trust to sell “Certificates of Participation” (“COP’s) to investors in the market instead of bonds. The COP’s represented an undivided proportionate interest in the funding trust’s right to receive payments from the City of Detroit under the Service Contract.⁵²

The Service Corporations and trusts were then required to remit the proceeds from the sale of COP’s to the retirement systems. The Service Corporations would also pay the trust money to service the interest and principal of the COP’s under a service contract with the City of Detroit. The City claimed, pursuant to advice of counsel, that the payments it made to the Service Corporations were contractual obligations, and not debt as defined under the HRCA. However, the Service Corporations irrevocably transferred their right to receive payments from the City to the trust, and the trust would then pay back the COP’s to investors and ceased to be anything more than a shell entity.⁵³ The trusts, with U.S. Bank as Trustee, would continue to service the COP’s.

As a result of the above, the City of Detroit sought a declaration seeking to invalidate the \$1.45 billion debt for violating the Home Rule City Act. The City argued that the Service Contractors were sham entities created for the purposes of evading the debt limit contained in the Home Rule City Act, and that the contracts were void ab initio.

The defendants sought to dismiss the suit on the basis that the City of Detroit lacked standing because the City was essentially suing itself and that there was no case or controversy at

⁵² Id. at Exhibit 1.

⁵³ Id., see GRS Service Contract between City and Service Corporations 2005.

play.⁵⁴ Shortly after the suit was filed, many creditors and bond insurers sought to intervene in the proceedings because they would lose significant money if the debt was set aside as illegal.

The judge refused to dismiss the lawsuit.⁵⁵ The judge first held that the City properly alleged that the COP's created a real financial obligation for the City, and that there was a real dispute between the parties. The judge also found that the City was not suing itself, but a third party with interests adverse to the City. The judge also granted the creditors' motion to intervene with the limitation that the Interveners could not file a third party complaint or counterclaim against anyone else. *See In re City of Detroit*, 13-53846, Adv. Pro. No. 14-04112-SWR (Bankr. E.D. Mich. June 30, 2014)(Decision by J. Rhodes).

The defendants in the Detroit case raised the following defenses:

1. The suit was brought too long after the debt was incurred under the statute of limitations.
2. The City of Detroit already had the benefit of using the funds and it would be unfair to allow them to not to pay them back.
3. The City represented to investors it had the legal authority to issue COP's and circumvent the debt limit.⁵⁶

The third party intervening creditors brought forward the following counterclaims:

1. They sought a declaration holding that setting aside the debt would violate the Contracts Clause of the U.S. Constitution.
2. The City fraudulently induced investors into buying COP's.
3. The City was unjustly enriched by the sale of the COP's.⁵⁷

⁵⁴ [See Service Corporations' Motion to Dismiss Complaint, dated April 10, 2014,](http://www.drinkerbiddle.com/Templates/media/files/Service%20Pages/City%20of%20Detroit%20COPs%20Holders/Service%20Corporations%20Motion%20to%20Dismiss%20Complaint%2C%20dated%20April%2010%2C%202014.pdf)

<http://www.drinkerbiddle.com/Templates/media/files/Service%20Pages/City%20of%20Detroit%20COPs%20Holders/Service%20Corporations%20Motion%20to%20Dismiss%20Complaint%2C%20dated%20April%2010%2C%202014.pdf>

⁵⁵ [See Opinion and Order \(1\) Denying Motion to Dismiss by Service Corps and \(2\) Granting Motions to Intervene, June 30, 2014](http://www.drinkerbiddle.com/Templates/media/files/publications/2014/Opinion%20and%20Order%20(1)%20Denying%20Motion%20to%20Dismiss%20by%20Service%20Corps%20and%20(2)%20Granting%20Motions%20to%20Intervene%2C%20June%2030%2C%202014.pdf)

[http://www.drinkerbiddle.com/Templates/media/files/publications/2014/Opinion%20and%20Order%20\(1\)%20Denying%20Motion%20to%20Dismiss%20by%20Service%20Corps%20and%20\(2\)%20Granting%20Motions%20to%20Intervene%2C%20June%2030%2C%202014.pdf](http://www.drinkerbiddle.com/Templates/media/files/publications/2014/Opinion%20and%20Order%20(1)%20Denying%20Motion%20to%20Dismiss%20by%20Service%20Corps%20and%20(2)%20Granting%20Motions%20to%20Intervene%2C%20June%2030%2C%202014.pdf)

⁵⁶ [See e.g. Answer with Affirmative Defenses and Counterclaims filed by Wilmington Trust, National Association as Trustee for the Two Funding Trusts, March 17, 2014](http://www.drinkerbiddle.com/Templates/media/files/Service%20Pages/City%20of%20Detroit%20COPs%20Holders/Answer%20with%20Affirmative%20Defenses%20and%20Counterclaims.PDF)

<http://www.drinkerbiddle.com/Templates/media/files/Service%20Pages/City%20of%20Detroit%20COPs%20Holders/Answer%20with%20Affirmative%20Defenses%20and%20Counterclaims.PDF>

⁵⁷ [See e.g. Joint Motion of Certificate Holders to Intervene, dated 3/17/2014 at](http://www.drinkerbiddle.com/Templates/media/files/Service%20Pages/City%20of%20Detroit%20COPs%20Holders/Motion%20of%20Certain%20COPs%20Holders%20to%20Intervene%2C%20etc_%20dated%20March%2017%2C%202014.PDF)

http://www.drinkerbiddle.com/Templates/media/files/Service%20Pages/City%20of%20Detroit%20COPs%20Holders/Motion%20of%20Certain%20COPs%20Holders%20to%20Intervene%2C%20etc_%20dated%20March%2017%2C%202014.PDF

As the proceedings continued, the creditors brought forth many claims for why the COP debt is enforceable as a matter of law. While the judge never explicitly ruled on these issues, both parties briefed these matters fully and such briefing is believed to have played a role in the judge's refusal to accept a final settlement of Detroit's debt on two different occasions, finding on both occasions that the creditors were seeking too much given the weakness of their claims.

In the end, Detroit sought to invalidate \$1.45 billion in COP's, and succeeded in having the court invalidate 87% of the debt that was outstanding on the COP's. In approving the settlement, the judge noted that the outcome of the litigation would have been unclear. Nonetheless, he stated that the City of Detroit's argument that the deal violated the debt limit had "substantial merit" and that the suit would have had a "reasonable likelihood of success. See In re City of Detroit, 524 B.R. 147, 193, 13-53846 (Bankr. E.D. Mich. Dec. 31 2014) (Supplemental Opinion Regarding Plan Confirmation, Approving Settlements, and Approving Exit Financing). He noted that since the Service Corporations did not render any real services to the City, the City acted as the ultimate payor on the COP's. He did note that there were several defenses and counterclaims that various parties could raise, but that the settlement was acceptable.

It is the experience in Detroit, combined with the observations that were observed in the finances of Puerto Rico that lead the Methodology and Planning Committee to recommend further investigation of this matter to the Commission. This means that the Government could act on the findings of this Commission, should it find that the Commonwealth's debt limits were violated. The audit team will most definitely need a group of lawyers to help it resolve this issue before the audit can start. In testing this hypothesis, the Commission would have to decide which debt is included in its limit calculation, and which debt is not in order to arrive at the correct income numerator and denominator for calculating compliance with the 15% debt limit. It is important for the Commission to obtain a thorough sense of how, and why, each debt or revenue stream was included in the calculation of the debt limit.

Next Steps

There are two further inquiries that the Audit Commission can undertake.

First, the Audit Commission could continue examining the role which the certain parties marketed, shaped or in any other way designed a secondary market for the 2014 GO bond offering; the Commonwealth's participation in this process; and any accompanying representations made to secondary market participants. For example, the SEC brought an enforcement action against several broker dealer for improperly selling the 2014 GO bonds in denominations of \$5000 instead of \$100,000, even though MSRB Rule G-15(f) and Section

15B(c)(1) of the Securities Exchange Act of 1934 makes it illegal to do so.⁵⁸ The sellers were fined. This ruling indicates that the SEC found reason to believe that the broker-dealers it monitors engaged in improper sales in the secondary market.

GDB management provided copies of some materials for the 2014 GO bond offering, but no glossary or explanation has been provided that would allow our volunteers to ascertain the meaning of the jargon employed in the marketing campaign for these bonds. Further study of these materials would also require an examination of the Underwriters' communications with the Commonwealth, Bond Counsel, Disclosure Counsel and Tax Counsel, as well as any other material communications that would shed light on the internal controls employed to ensure compliance with federal and Commonwealth laws and regulations.

Second, the Commission should continue its work along the lines it started, by examining debt from the most recent offerings to the oldest offering covered by Law 97. According to data available on the GDB website, the next issuance for review would be a 2013 offering of the Puerto Rico Electric Power Authority (“PREPA”) for \$673,145,000 at 7%.⁵⁹

Conclusion and Recommendations

As a result of the following, the Methodology and Planning Committee recommends that the Commission hire staff and obtain the financial resources necessary to review the matters raised in this pre-audit report carefully, and in compliance with U.S. GAO audit standards. The Commission should also remember that the issues contained herein may not be the only issues that arise; these are simply the ones the Methodology Committee identified in its review of a limited portion of Puerto Rico’s total outstanding debt.

⁵⁸ <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543350368>

⁵⁹ http://www.gdb-pur.com/investors_resources/documents/2013-08-19-OSSeries2013-A-Agosto2013-FINAL.pdf