UNITED STATES DISTRICT COURT
DISTRICT OF PUERTO RICO

FINANCIAL GUARANTY INSURANCE COMPANY, Plaintiff, -against- ALEJANDRO GARCÍA PADILLA, JUAN C. ZARAGOZA GÓMEZ, INGRID RIVERA ROCAFORT, MELBA ACOSTA FEBO, LUIS F. CRUZ BATISTA, VÍCTOR A. SUÁREZ MELÉNDEZ, CÉSAR A. MIRANDA RODRÍGUEZ, JUAN FLORES GALARZA, and JOHN DOES 1-40, Defendants.	No. 16-1095

MEMORANDUM OF LAW IN OPPOSITION
TO DEFENDANTS' MOTION TO DISMISS

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Plaintiff Financial Guaranty Insurance Company ("***Plaintiff***"), by its attorneys Rexach & Picó, CSP and Butler Snow LLP, submits this Memorandum of Law (the "***Memorandum***") in opposition to Defendants' Motion to Dismiss (Dkt. No. 37, and Joinders therein, Dkt. Nos. 39 and 41) (the "***Motion to Dismiss***")[1] the Complaint for Declaratory Judgment and Injunctive Relief[2] [Dkt. # 1] (the "***Complaint***") against defendants Hon. Alejandro García Padilla, Hon. Juan C. Zaragoza Gómez, Hon. Ingrid Rivera Rocafort, Hon. Melba Acosta Febo, Hon. Luis F. Cruz Batista, Hon. Víctor A. Suárez Meléndez, Hon. César A. Miranda Rodríguez, Hon. Juan Flores Galarza, and John Does 1-40 (collectively, "***Defendants***").

INTRODUCTION

By this action, Plaintiff challenges the two Executive Orders (the "***Executive Orders***") issued on November 30, 2015 and December 8, 2015 by The Honorable Governor of the Commonwealth of Puerto Rico (the "***Commonwealth***") by which Defendants purport to divert funds pledged as collateral to bondholders of certain Puerto Rico public corporations on multiple federal constitutional grounds. Specifically, Plaintiff alleges that the two Executive Orders violate the following controlling provisions of the United States Constitution: (1) the Contracts Clause set forth in Article I, Section 10, Clause 1, (2) the Takings Clause of the Fifth Amendment, (3) the Equal Protection Clause of the Fourteenth Amendment, and (4) the Due Process Clauses of the Fifth and Fourteenth Amendments.

Plaintiff's claims under the United States Constitution are based entirely on federal law and seek solely prospective relief. Plaintiff asserts no claims under Commonwealth law.

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[1] Defendant Hon. Melba Acosta Febo, in her official capacity as President of the Government Development Bank for Puerto Rico ("***GDB***"), filed a joinder to the motion to dismiss on February 10, 2016, and also filed an individual motion to dismiss on that same date. The individual motion to dismiss filed by Defendant Acosta Febo, in her capacity as President of the GDB, is addressed in a separate filing by Plaintiff.

[2] Capitalized terms used but not otherwise defined herein shall have the meanings ascribed to them in the Complaint.

Plaintiff further challenges on the bases of express, conflict and field preemption the constitutionality of Section 8 of Article VI of the Constitution of the Commonwealth of Puerto Rico (the "***Constitutional Debt Priority Provision***"), the Management and Budget Office Organic Act, Act No. 147 of June 18, 1980 (the "***OMB Act***"), and the two Executive Orders.[1]

Defendants move to dismiss,

- Plaintiff's third through sixth claims for relief (which assert claims under the United States Constitution) pursuant to Rule 12(b)(1) for lack of subject matter jurisdiction based on sovereign immunity; and
- Plaintiff's first and second claims for relief (which assert claims based on preemption) pursuant to Rule 12(b)(6) for failure to state a claim upon which relief can be granted.

In the context of their preemption argument (only), Defendants also ask this Court to stay this case, which would preclude Plaintiff from proceeding not only on its claim of preemption, but also on its separate constitutional claims. Such a stay is neither supported nor warranted as to any of the claims asserted, and would be particularly inappropriate given Plaintiff's pending constitutional claims.

To date, Plaintiff has been required to make payments in respect of at least $6,393,666 of claims submitted under Plaintiff's insurance policy insuring certain of the defaulted PRIFA Bonds. To stay these proceedings would subject Plaintiff to further irreparable injury as Defendants have indicated their intention to continue diverting PRIFA Pledged Funds.

[1] The Constitutional Debt Priority Provision, the OMB Act and the Executive Orders are hereinafter, collectively, referred to as the "***Restructuring Laws***."

THE ISSUES PRESENTED

Before this Court are two discrete issues:

1. With regard to the third through the sixth claims of the Complaint, do Plaintiff's exclusively federal claims that seek solely prospective relief against state officials for ongoing violations of federal law fall within the exception to sovereign immunity created by *Ex parte Young*, 209 U.S. 123 (1908)?

2. With regard to the first and second claims of the Complaint, are the Constitutional Debt Priority Provision, the OMB Act, and/or the Executive Orders unconstitutional on the basis of preemption?

As discussed more fully below, Plaintiff submits (i) that Plaintiff's federal constitutional claims fall squarely within the exception to sovereign immunity created by *Ex parte Young*, and (ii) that the Constitutional Debt Priority Provision, the OMB Act, and/or the Executive Orders are unconstitutional on the basis of preemption:

First, where (as here) a plaintiff has pleaded solely federal law claims against state officers seeking only prospective injunctive relief, sovereign immunity poses no bar. As stated by the Supreme Court in *Verizon Maryland, Inc. v. Pub. Serv. Comm'n of Maryland*, 535 U.S. 635 (2002):

> In determining whether the doctrine of *Ex parte Young* avoids an Eleventh Amendment bar to suit, a court need only conduct a 'straightforward inquiry into whether [the] complaint alleges an ongoing violation of federal law and seeks relief properly characterized as prospective.'

Id. at 645 (quoting *Coeur d'Alene*, 521 U.S. at 296 (O'Connor, J., concurring)). *See* Point I, below.

Second, Defendants invocation of *Pennhurst State Sch. & Hosp. v. Halderman*, 465 U.S. 89 (1984) is grossly misplaced. As shown below, Plaintiff does not assert any claims under Commonwealth law against Defendants, nor does Plaintiff seek an order compelling Defendants to comply with Commonwealth law. *See* Points II.A and II.B. below.

Further, as this Court recognized in *Center for Disease Detention, LLC v. Rullan*, 288 F. Supp. 2d 136 (D.P.R. 2003) (Fusté, J.), the mere fact that this Court will construe Commonwealth law in connection with the adjudication of Plaintiff's legitimate federal constitutional claims in no way divests the Court of jurisdiction over such federal claims:

> 'While the resolution of these constitutional issues necessarily requires this court to ascertain what state law means, this is a far cry from a prohibited *Pennhurst* type action which seeks injunctive relief on the basis of state law.'

Id. (quoting *Coal. of N.J. Sportsmen v. Whitman*, 44 F. Supp. 2d 666, 672 (D.N.J. 1999)). Numerous other federal courts facing the same issue have reached the identical conclusion. *See* Point II.C, below.

Third, the fact that a defendant's conduct may also give rise to independent claims under state law in no way precludes this Court's consideration of federal constitutional claims arising out of the same events. Bifurcation of federal and state claims is precisely what is required by *Pennhurst*. *See* Point II.D, below.

Fourth, this action neither seeks money damages from the treasury of the Commonwealth such that the Commonwealth is the "real, substantial party in interest", nor touches upon and gives offense to the "dignity and status" of the Commonwealth as a sovereign[1] in a manner that makes *Ex parte Young* inapplicable. *See* Point III, below.

[1] Assuming, *arguendo*, that the Commonwealth is a "sovereign," it should be noted that whatever sovereignty the Commonwealth has was granted by Congress. *Davila-Perez v. Lockheed Martin Corp.*, 202 F.3d 464, 468 (1st Cir. 2000) ("[Puerto Rico] is still subject to the plenary powers of Congress under the territorial clause."). The Commonwealth therefore differs from the States, which had won their independence from England, were sovereign entities before ratifying the Constitution, and "retained 'a residuary and inviolable sovereignty'" after ratification, *see Printz v. United States*, 521 U.S. 898, 918-19 (1997) (quoting The Federalist No. 39 at 245), in that the Commonwealth had no "residuary sovereignty" to retain. *See Examining Bd. of Eng'rs*, 426 U.S. 572, 586 (1976) ("By the Treaty of Paris, 2274 Stat. 1754 (1899), Spain ceded Puerto Rico to the United States."); S. Rep. No. 1779, at 3 (1950) (Under the Treaty of Paris, Congress controls the "the civil rights and political status of the native inhabitants."). Thus, any purported exercise of the police power by the Commonwealth emanates from a grant of ***federal*** power and cannot be offended by federal court examination of the conduct of its officials.

Fifth, the Restructuring Laws are preempted on the bases of express, field and conflict preemption.

The Restructuring Laws are expressly preempted by Section 903(1) of the Bankruptcy Code which prohibits state laws that provide for the adjustment or modification of public debt, using *any method*, without any requirement of consent from the holders of such debt obligations. *See* Point IV, below.

Further, the Restructuring Laws are also preempted on the bases of field and conflict preemption. *See* Point V, below.

Finally, the Defendants' request for a stay of these proceedings is not warranted and should be denied. *See* Point VI, below.

For these reasons, as more fully discussed below, Defendants' Motion to Dismiss should be denied.

FACTUAL BACKGROUND

Plaintiff is a monoline insurer who insures approximately $1.2 billion of the debt of the Commonwealth and its public corporations. (Compl. ¶¶ 5, 9.) Defendants are the Governor of Puerto Rico and various government officials who act at his direction. (*Id.* ¶¶ 11-28.) The dispute arises out of Defendants' unconstitutional diversion of funds pledged to repay bonds (the "***Authority Bonds***") issued by three Puerto Rico public corporations—the Puerto Rico Highways and Transportation Authority ("***PRHTA***"), the Puerto Rico Convention Center District Authority ("***PRCCDA***"), and the Puerto Rico Infrastructure Financing Authority ("***PRIFA***," and together with PRHTA and PRCCDA, the "***Authorities***"). (*Id.* ¶¶ 1-7.) The Authority Bonds are secured by certain tax payments and other revenues (the "***Pledged Funds***"). (*Id.* ¶¶ 4, 36, 39, 42.)

Plaintiff has insured the payment of principal and interest on certain Authority Bonds. (*Id.* ¶¶ 5, 37, 40, 43.)

The Commonwealth is not an obligor on the Authority Bonds. The contracts governing the Authority Bonds, however, incorporate among their terms various statutory provisions containing protections conferred by the Commonwealth's Legislative Assembly in the enabling acts under which the Authority Bonds were issued and related Commonwealth statutes (hereinafter, the "***Enabling Acts***"). The Enabling Acts provide that certain of the Pledged Funds may to be used, or "clawed back," to pay the Commonwealth's public debt in a fiscal year in which available revenues are insufficient to meet appropriations ("***Clawback***"), ***but*** expressly provides that Clawback of the Pledged Funds may occur ***only*** when ***all other*** available resources for the relevant fiscal year are insufficient to pay the public debt. (Compl. ¶ 95.) The Enabling Acts also provide that Pledged Funds that are clawed back may be used ***only*** to pay the public debt, and may ***not*** be used to pay other expenses. (*Id.* ¶ 96.)

In addition, the OMB Act sets forth an order of spending priorities the Governor must follow in the event of a budgetary shortfall in a fiscal year.[1] (Compl. ¶¶ 53-59.) That law provides that, in the event of such a shortfall, payments on the Authority Bonds shall have priority **second only** to payments on the Commonwealth's public debt (*i.e.*, debt backed by the full faith, credit, and taxing power of the Commonwealth). (*Id.* ¶¶ 53-56.)

On November 30, 2015, the Governor issued an executive order (the "***First Executive Order***") requiring Clawback of certain of the Pledged Funds. (Compl. ¶ 103.) The First

[1] The Constitutional Debt Priority Provision of the Puerto Rico Constitution provides that, "[i]n case the available resources including surplus for any fiscal year are insufficient to meet the appropriations made for that year," payments shall first be made on the Commonwealth's public debt, and all other payments "shall thereafter be made ***in accordance with the order of priorities established by law***." P.R. Const. art. VI, § 8 (emphasis added); *see also* Compl. ¶ 53.

Executive Order claimed that Clawback was necessary to make payments on the public debt, but provided that the Commonwealth would continue to make payments on general expenses lower in the statutory order of priorities. (*Id.* ¶¶ 104-105.) In so doing, the Governor eliminated the protections of the Enabling Acts (which are integral terms of the Authority Bonds) and the OMB Act spending priorities, and unlawfully impaired the Authority Bonds and Plaintiff's property rights. (*Id.* ¶ 106.) Specifically, while the Authority Bonds, by their terms, are entitled to be paid from their respective Pledged Funds second only to general obligation bonds, the Governor has put them last, to be paid after all other governmental expenditures.

On December 8, 2015, the Governor issued a second executive order (the "***Second Executive Order***") intended to implement the First Executive Order. (Compl. ¶ 107.) The Second Executive Order set in motion a number of procedures that further modified the protections of the Authority Bonds established by the Enabling Acts and the OMB Act, and unlawfully impaired the Authority Bonds and Plaintiff's property rights.[1]

On January 1, 2016, having been deprived by the Executive Orders of the Pledged Funds necessary to repay its debt, PRIFA defaulted, failing to pay when due approximately $36 million of interest on its bonds. (Compl. ¶¶ 30, 43, 117.) As a consequence of this default, Plaintiff was

[1] Specifically, the Second Executive Order permitted Defendant Cruz Batista, the Director of the Commonwealth's Office of Management and Budget (the "***OMB Director***"), to make budgetary adjustments that would include the Pledged Funds as available revenues despite the fact that the preconditions for Clawback had not been triggered. (Compl. ¶ 108.) It also required the OMB Director to be guided in managing the Commonwealth's cash flow by the "priority guidelines" set forth in the OMB Act, but "with the purpose of maintaining essential services and to ensure the good operation of the Government of the Commonwealth of Puerto Rico," thus effectively modifying the terms of the OMB Act requiring that payment on the Authority Bonds be prioritized over general expenditures. (*Id.* ¶ 75.)

To further implement these provisions, the Second Executive Order authorized the Working Group for the Fiscal and Economic Restoration of Puerto Rico (the "***Working Group***") (which includes Defendants Acosta Febo, Suárez Meléndez and Miranda Rodriguez among its members; *see* Compl. ¶¶ 14, 16, 17), the Secretary of the Treasury (Defendant Zaragoza Gómez), and the heads of the Commonwealth's governmental agencies (the "***Commonwealth Agencies***") to manage the Commonwealth's and the Commonwealth Agencies' cash flows in a manner consistent with the OMB Director's budgetary adjustments (*id.* ¶¶ 110-112), all in derogation of the contractual priority set forth in the Authority Bonds, and all impairing Plaintiff's contract rights and property interests.

required to make payments in respect of at least $6,393,666 of claims submitted under Plaintiff's insurance policy insuring certain of the defaulted PRIFA Bonds. (*Id.* ¶¶ 30, 117.) Defendants' continuing diversion of the Pledged Funds makes further defaults on the Authority Bonds inevitable. (*Id.*)

This lawsuit followed. Plaintiff asserts six claims –

- two seeking an order, pursuant to the federal Declaratory Judgment Act, 28 U.S.C. §§ 2201 and 2202, declaring that the Executive Orders are unconstitutional because they violate the Contracts Clause, Takings Clause, Equal Protection Clause, and Due Process Clauses of the United States Constitution (Compl. ¶¶ 152-155, 162-165),

- two seeking prospective injunctive relief to prevent further violation of Plaintiff's constitutional rights by barring Defendants from enforcing the Executive Orders (*id.* ¶¶ 156-161, 166-170),

- one seeking an order, pursuant to the federal Declaratory Judgment Act, 28 U.S.C. §§ 2201 and 2202, declaring that the Constitutional Debt Priority Provision, the OMB Act, and the Executive Orders are unconstitutional on the bases of express, conflict and field preemption (Compl. ¶¶ 142-145), and

- one seeking prospective injunctive relief to prevent further violation of Plaintiff's constitutional rights by barring Defendants from taking or causing to be taken any action pursuant to the Constitutional Debt Priority Provision, the OMB Act, and the Executive Orders (*id.* ¶¶ 146-151).

ARGUMENT

I. THIS COURT HAS JURISDICTION TO HEAR THIS CASE BECAUSE THE COMPLAINT FALLS SQUARELY WITHIN THE *EX PARTE YOUNG* EXCEPTION TO ELEVENTH AMENDMENT SOVEREIGN IMMUNITY

The Eleventh Amendment[1] protects "the privilege of the sovereign not to be sued without its consent." *Va. Office for Prot. & Advocacy v. Stewart*, 563 U.S. 247, 253 (2011). That privilege, however, is not without exception.

[1] The First Circuit has held that the Eleventh Amendment applies to the Commonwealth. *See, e.g.*, *Maysonet-Robles v. Cabrero*, 323 F.3d 43, 53 (1st Cir. 2003). The Puerto Rico Supreme Court, however, recently held that the Commonwealth is not a sovereign for purposes of the Double Jeopardy Clause of the United States Constitution. *See Pueblo v. Sánchez Valle*, 192 P.R. 594 (Sup. Ct. 2015). That decision is currently under review by the United

In *Ex parte Young*, the United States Supreme Court established a "necessary exception to Eleventh Amendment immunity," *Puerto Rico Aqueduct & Sewer Auth. v. Metcalf & Eddy, Inc.*, 506 U.S. 139, 146 (1993), "which allows a plaintiff to enforce a claim of federal right by obtaining injunctive or declaratory relief against a state officer in the officer's official capacity." *Greenless v. Almond*, 277 F.3d 601, 606-607 (1st Cir. 2002). In *Ex parte Young*, the lower federal court enjoined the Attorney General of the State of Minnesota from enforcing a state statute that allegedly violated the Fourteenth Amendment of the United States Constitution. *Ex parte Young*, 209 U.S. at 149. The Supreme Court held that the Eleventh Amendment did not prohibit this injunction." *Id*. at 155, 168.

The Supreme Court explained that because unconstitutional state action is "void," a state official who undertakes it "comes into conflict with the superior authority of [the] Constitution" and is therefore "stripped of his official or representative character and is subjected in his person to the consequences of his individual conduct." *Id*., 209 U.S. at 159-60.

Subsequently, in *Edelman v. Jordan*, 415 U.S. 651 (1974), the Supreme Court held that in a suit against a state official alleging a violation of federal law, federal courts may award an injunction that governs the official's future conduct, but may not award retroactive monetary relief. *Edelman v. Jordan*, 415 U.S. at 678. In the present action, no monetary relief (prospective or retroactive) is sought. (Compl. ¶¶ 142-170.)

Thus, under *Ex parte Young*, as clarified by *Edelman*, a plaintiff may seek prospective injunctive relief against state officers to remedy violations of federal law. *Ex parte Young*, 209

States Supreme Court, *see Puerto Rico v. Sánchez Valle*, 136 S. Ct. 28 (2015) (No. 15-108), and the United States has taken the position that the Commonwealth is not a sovereign for constitutional purposes, *see* Brief for the United States of America as *Amicus Curiae*, *Puerto Rico v. Sánchez Valle*, No. 15-108 (Dec. 23, 2015). Thus, although this Court is currently constrained by First Circuit precedent to the contrary, it is questionable whether the Eleventh Amendment applies to the Commonwealth, and Plaintiff reserves its right, as it has previously (*see* Compl. ¶ 117 n.1), to assert any and all claims and arguments that may become available following the Supreme Court's ruling in *Sánchez Valle*.

U.S. at 155, 168; *Edelman v. Jordan*, 415 U.S. at 678; *see also Idaho v. Coeur d' Alene Tribe*, 521 U.S. 261 (1997) (O'Connor, J., concurring in part and concurring in the judgment) ("[A] *Young* suit is available where a plaintiff alleges an *ongoing* violation of *federal* law, and where the relief sought is *prospective* rather than *retrospective*."); 521 U.S. at 298 (Souter, J., dissenting) (observing that, given the disposition of the Justices in that case, "Justice O'Connor's view is the controlling one").

The *Ex parte Young* doctrine is "necessary to permit the federal courts to vindicate federal rights." *Pennhurst*, 465 U.S. at 105. To determine whether the *Ex parte Young* exception applies, courts conduct a "straightforward inquiry" into two issues:

(1) whether the complaint "alleges an ongoing violation of federal law;" and

(2) whether the complaint "seeks relief properly characterized as prospective."

Verizon, 535 U.S. at 645 (internal quotation marks and citation omitted). Plaintiff's Complaint easily satisfies both tests.

A. Plaintiff Alleges an Ongoing Violation of Federal Law

Plaintiff's third through sixth claims in the Complaint seek declaratory and injunctive relief based exclusively on ongoing violations of federal Constitutional law. (Compl. ¶¶ 120-141, 152-170.) Thus, federal jurisdiction over these claims "is based on the existence of a federal question, not on principles of pendent jurisdiction or state law." *Ctr. for Disease Det.*, 288 F. Supp. 2d at 142 (emphasis added). *See also Coal. of N.J. Sportsmen*, 44 F. Supp. 2d at 673 (suit is not foreclosed by *Pennhurst* where "[e]very count of plaintiffs' complaint alleges violations under the United States Constitution"); *Everett v. Schramm*, 772 F.2d 1114 (3d Cir. 1985) (federal jurisdiction over Section 1983 claim for violations of federal law by state officers "was based on the existence of a federal question, not, as in *Pennhurst II*, on principles of

pendent jurisdiction"). Further, the Executive Orders remain in effect, and Defendants' continuing diversion of the Pledged Funds makes further defaults on the Authority Bonds inevitable. (Compl. ¶¶ 30, 117.)

B. Plaintiff Seeks Prospective Relief Only

The Complaint seeks only prospective declaratory and injunctive relief under the Federal Declaratory Judgment Act, 28 U.S.C. §§ 2201-2202, as permitted by *Ex parte Young* and its progeny. (Compl. ¶ 29, 152-170.) Specifically, Plaintiff requests that the Court enter judgment declaring the Executive Orders unconstitutional and enjoining their ongoing enforcement and implementation.

Notably, Plaintiff is *not* seeking damages for the injuries already caused by the Defendants' purported "clawback." *See Edelman,* 415 U.S. at 663-64 (suit barred to the extent the suit sought "the award of an *accrued* monetary liability…" which represented "retroactive payments" (emphasis added)). On the other hand, the Eleventh Amendment does not bar prospective relief seeking to remedy a present violation of federal law even though accompanied by an ancillary effect on the state treasury. *Id.*, 415 at 667-68; *see also Milliken* v. *Bradley*, 433 U.S. 267, 289-90 (1977).

Here, Plaintiff simply asks this Court for an injunction that *prospectively* prevents the Defendants from continuing to violate federal constitutional law by the further diversion of additional funds pledged as collateral to bondholders of the Authorities. Such claims fall squarely within the exception to sovereign immunity under *Ex parte Young*.

II. THE *PENNHURST* RULE, WHICH BARS FEDERAL COURTS FROM AWARDING INJUNCTIVE RELIEF AGAINST STATE OFFICERS ON THE BASIS OF STATE LAW CLAIMS, IS NOT IMPLICATED HERE

A. Plaintiff Asserts Exclusively Federal Claims Against Defendants. No Pendent Claims Under Commonwealth Law are Brought.

Defendants repeatedly mischaracterize the Complaint as seeking relief under Commonwealth law.[1] It does not. As discussed above, the Complaint alleges that the Executive Orders and Defendants' implementation of the terms of the Executive Orders violate various provisions of the United States Constitution. (Compl. ¶¶ 120-141.) No claims are asserted under Commonwealth law (or the law of any state).

Stated simply, there is nothing in the Complaint that runs afoul of *Pennhurst*. To the contrary, in *Pennhurst* the Supreme Court recognized that a suit challenging under federal law the constitutionality of a state official's conduct is not a suit against the state for purposes of the Eleventh Amendment. *Pennhurst*, 465 U.S. at 102. Indeed, consistent with this understanding, the Supreme Court in *Pennhurst* reversed the Third Circuit's affirmance of injunctive relief awarded solely under state law, and remanded the case to the lower courts to determine whether the same injunctive relief could be imposed under plaintiffs' claims brought under federal law. *Id*., 465 U.S. at 125.

Pennhurst was a class action brought by a resident of an "institution for the care of the mentally retarded." *Pennhurst*, 465 U.S. at 92. Plaintiff sued the institution, institution officials,

[1] *See, e.g.*, Defs.' Br. at 1-2 ("Plaintiff claims that the defendants . . . violated Puerto Rico law . . . [but] the defendants have at all times complied with the laws of Puerto Rico."); *id.* at 2 ("Plaintiff seeks, in essence, a declaration that the defendants have violated Puerto Rico law and an injunction forcing the government to comply with their incorrect interpretation of that law."); *id.* at 5 ("This case is, in essence, a masked collection claim . . . ."); *id.* at 5-6 ("[P]laintiff is asking this Federal Court to interpret the Constitution and laws of the Commonwealth and to enjoin state officers from acting in a manner that, according to plaintiff, is at odds with the them."); *id.* at 10 ("The award plaintiff really seeks here is a declaration that the Executive Orders violate Puerto Rico law, and enjoining the defendants from taking action in compliance with those orders."); *id.* at 18 ("What plaintiff seeks, improperly, is a ruling from a federal court that Puerto Rican officials have acted contrary to Puerto Rico law."); *id.* at 19 ("[W]hat plaintiff is requesting is clearly an injunction requiring state officials to comply with state law.").

and various state and county officials, alleging that conditions at the institution violated the class members' rights both under the United States Constitution and federal statutory law, and also under state law, specifically the Pennsylvania Mental Health and Mental Retardation Act of 1966. *Id.* The district court ruled for the plaintiffs on both federal and state law grounds, issuing an injunction that "established detailed procedures for determining the proper residential placement for each patient." *Id.* at 94. The Court of Appeals affirmed the sweeping and detailed injunction, but did so solely on state law grounds. The Court of Appeals found it unnecessary to reach the federal constitutional questions. *Id*. at 124.

The Supreme Court reversed. The Court recognized that the *Ex parte Young* doctrine "has been accepted as necessary to permit the federal courts to vindicate federal rights and hold state officials responsible to 'the supreme authority of the United States'." *Id*. at 105 (citing *Ex parte Young*, 209 U.S. at 160). In contrast, however, the Court found that the *state law* claim at issue did not implicate the same competing interests between state sovereignty and federal law as the supreme law of the land. *Id*. at 106 ("A federal court's grant of relief against state officials on the basis of state law, whether prospective or retroactive, does not vindicate the supreme authority of federal law"). The Supreme Court then held that the assertion of pendent jurisdiction over state law claims does not displace the Eleventh Amendment. *Id*. at 121.

While the Court determined that the Eleventh Amendment barred consideration by the federal courts of the plaintiff's *state law* claims, the Supreme Court did not direct that the case be dismissed. Rather, the Court remanded the case for further proceedings to determine whether the judgment could be sustained **on *federal* constitutional or statutory bases** which had been asserted. *Pennhurst*, 465 U.S. at 125 ("The District Court also rested its decision on the Eighth and Fourteenth Amendments and § 504 of the Rehabilitation Act of 1973. See *supra*, at 93. On

remand the Court of Appeals may consider to what extent, if any, the judgment may be sustained on these bases. The court also may consider whether relief may be granted to respondents under the Developmentally Disabled Assistance and Bill of Rights Act, 42 U. S. C. §§ 6011, 6063 (1976 ed. and Supp. V)").

In the present case, Plaintiff has asserted no pendent claims under Commonwealth law (or under any state's law). (Compl. ¶¶ 152-170.) Indeed, there is no request here for relief under Commonwealth (or state) law of any kind. *Id.* Because the only claims asserted are federal constitutional claims, nothing in *Pennhurst* supports Defendants' argument that these purely federal claims are not properly before this Court.

B. Plaintiff Does Not Seek an Order Instructing Defendants to Comply With Commonwealth Law

Defendants next argue that the relief sought by Plaintiff is an injunction requiring Defendants to comply with Commonwealth law. (*See, e.g.*, Defs.' Br. at 19 ("[W]hat plaintiff is requesting is clearly an injunction requiring state officials to comply with state law").) As shown, this is not correct; the Complaint contains no such request. Further, on review it is clear that (in contrast to the present case) each of the cases cited by Defendants in support of sovereign immunity involved a request for declaratory or injunctive relief to redress ***an alleged violation of state law***.[1] (*See* Defs.' Br. at 8-11.) Again, the relief sought herein by Plaintiff is not based on

[1] *See Diaz-Fonseca v. Puerto Rico*, 451 F.3d 16, 42-43 (1st Cir. 2006) (declining request for declaratory judgment that "defendants' system of provision of physical therapy . . . violates Puerto Rico law"); *O'Brien v. Mass. Bay Transp. Auth.*, 162 F.3d 40, 44 (1st Cir. 1998) (affirming dissolution of preliminary injunction against state officials to remedy alleged violation of Massachusetts Declaration of Rights); *S. Union Co. v. Lynch*, 321 F. Supp. 2d 328, 333-34 (D.R.I. 2004) (declining to grant declaratory judgment that Rhode Island's Public Utilities Commission Act preempted Rhode Island's Pipefitters Act); *Tolman v. Finneran*, 171 F. Supp. 2d 31, 38 (D. Mass. 2001) (declining request for declaratory and injunctive relief for violations of Massachusetts Constitution and Massachusetts Declaration of Rights); *Benning v. Bd. of Regents of Regency Univs.*, 928 F.2d 775, 778 (7th Cir. 1991) (declining request for declaratory judgment that state officials violated Illinois tort law). Notably, in several of these cases, despite disclaiming jurisdiction to entertain claims seeking relief under ***state*** law, the courts reached the merits of the ***federal*** claims alleged. *See S. Union*, 321 F. Supp. 2d at 334-342 (granting declaratory judgment that state law was preempted by federal law); *Diaz-Fonseca*, 451 F.3d at 42-43 (dismissing federal claims against state officials on the

state law, but seeks to redress Defendants' continuing violation of Plaintiff's federal rights under the United States Constitution.

The relief sought by Plaintiff would simply say that the Executive Orders are unconstitutional and that Defendants therefore may not act to implement them. It would say nothing about what kind of conduct would pass muster under Commonwealth law (or, for that matter, federal law). There is an elementary difference between telling someone to stop doing what they are currently doing, on the one hand, and telling someone what they must do, on the other. The former is all that Plaintiff seeks here, and this raises no *Pennhurst* problem.

Defendants also seek to support their position with regard to sovereign immunity by arguing that they have not violated the law. *See, e.g.*, Defs.' Br. at 20-22. This argument (which is mistaken in any event) is not properly made at this stage. The merits of a plaintiff's claim are ***not*** considered when a defendant challenges subject matter jurisdiction on the ground of sovereign immunity. *See Verizon*, 535 U.S. at 646 ("[T]he inquiry into whether suit lies under *Ex parte Young* does not include an analysis of the merits of the claim. See *Coeur d'Alene*, *supra*, 521 U.S. at 281 ('An *allegation* of an ongoing violation of federal law . . . is ordinarily sufficient' (emphasis added)).")[1]

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merits); *O'Brien*, 162 F.3d at 44 (holding that the challenged federal law expressly preempted state law). These cases support, rather than refute, this Court's jurisdiction here.

Certain cases cited by Defendants do not even decide issues of sovereign immunity and thus can be disregarded. *See Gully v. First Nat'l Bank*, 299 U.S. 109, 114-17 (1936) (Defs.' Br. at 22) (finding no removal jurisdiction where federal question did not appear on face of complaint, plaintiff did not rely upon federal rights in support of his claims, and defendant's suggestion that hypothesized violations of federal law were "lurking in the background" was rejected as "conjectural" and insufficient to give rise to federal jurisdiction); *Neo Gen Screening, Inc. v. New England Newborn Screening Program*, 187 F.3d 24, 28-29 (1st Cir. 1999) (Defs.' Br. at 22) (Sherman Act does not apply to actions by states).

[1] Defendants further question Plaintiff's standing to sue (*see, e.g.*, Defs.' Br. at 11), but do not seek dismissal on that basis. In any event, the Complaint adequately alleges injury-in-fact in the form of (1) Plaintiff's having already made payments in respect of over $6 million in policy claims incurred as a result of Defendants' constitutional violations, and (2) Defendants' substantial impairment of the collateral securing the bonds at issue.

C. The Need to Interpret Commonwealth Law when Deciding Federal Constitutional Claims Is No Bar to Federal Jurisdiction

Defendants argue that Plaintiff's claims are barred by *Pennhurst* because they require interpretation of Commonwealth law. (*See, e.g.*, Defs.' Br. at 5 ("plaintiff is asking this Federal Court to interpret the Constitution and laws of the Commonwealth").) But federal courts have repeatedly held that sovereign immunity does not bar a suit merely because federal claims require interpretation of state law.

For example, in *Center for Disease Detention*, the plaintiff sued the Commonwealth's Secretary of Health, seeking a declaratory judgment that a Commonwealth clinical laboratory licensing statute and a regulation promulgated thereunder either did not apply to the plaintiff, or were unconstitutional under the Dormant Commerce Clause of the United States Constitution. 288 F. Supp. 2d at 137. The defendant argued that the suit was barred by the Eleventh Amendment as interpreted in *Pennhurst*. *Id*. at 139. This Court rejected the argument, holding that, unlike in *Pennhurst*, the complaint was "based on the existence of a federal question, not on principles of pendent jurisdiction or state law." *Id.* at 142.

This Court also found no *Pennhurst* problem in the fact that, when resolving the plaintiff's federal constitutional claims, the Court would have to determine the meaning of the Commonwealth's clinical licensing statute. *See id.* ("'The ascertainment of state law is an everyday function of the federal court.'" (*quoting Everett*, 772 F.2d at 1119)). This Court entertained the federal claims and issued a declaratory judgment that the Commonwealth statute at issue was applicable only to laboratories operating in Puerto Rico, and therefore did not run afoul of the Dormant Commerce Clause. *Id.* at 148.

In *Everett v. Schramm*, the Third Circuit similarly rejected a defendant's attempt to invoke *Pennhurst* because of the need to construe state law when resolving federal claims,[1] and explained that it was not "troubled by the fact that in this case compelling compliance with federal law may incidentally require compliance with state law." 772 F.2d at 1115, 1119.

Numerous other federal courts have reached the same conclusion. *See, e.g.*,

- *Lewis v. Rendell*, 501 F. Supp. 2d 671, 690 (E.D. Pa. 2007) ("Although *Pennhurst* prevents this Court from ordering relief on the basis of [a state statute], it does not bar the Court from construing these [statutory] provisions for the purposes of ruling upon their constitutionality under the U.S. Constitution").

- *Smolow v. Hafer*, 353 F. Supp. 2d 561, 570 (E.D. Pa. 2005) (federal claims alleging that defendants' violation of state statute also violated the United States Constitution not barred by *Pennhurst*).

- *Henrietta D. v. Giuliani*, 81 F. Supp. 2d 425, 430 n.14 (E.D.N.Y. 2000) ("Plaintiffs may use state law, and evidence of State defendant's liability under it, to prove that State defendant is in violation of federal law. Where plaintiffs use non-compliance with state laws to demonstrate non-compliance with federal statutes, such as the ADA, the Eleventh Amendment is not implicated").

- *Coal. of N.J. Sportsmen*, 44 F. Supp. 2d at 673 ("While the resolution of these constitutional issues necessarily requires this court to ascertain what state law means, this is a far cry from a prohibited *Pennhurst* . . . action which seeks injunctive relief on the basis of state law").

- *Piecknick v. Pennsylvania*, 36 F.3d 1250, 1255 n.7 (3d Cir. 1994) ("The fact that the federal due process right hinges upon a property or liberty interest created in part by a state regulation or policy statement does not make the cause of action any less federal in nature").

Further, Defendants do not cite **a single case** (and Plaintiff is aware of none) in which a federal claim was dismissed because its resolution would require the court to construe state law.

[1] The plaintiff claimed that state officials in Delaware had violated the federal Social Security Act in their administration of a state family aid program. 772 F.2d at 1115, 1119. As here, the defendants in that case argued that, under *Pennhurst*, "the district court lacked jurisdiction to award prospective relief on the basis of a violation of a state statute." *Id.* at 1119. The Third Circuit, however, held that, "[t]hough it is true that this [case] required the district court to *ascertain* what the standard of need was under Delaware law, ascertaining state law is a far cry from compelling state officials to comply with it." *Id.* (emphasis in original).

D. The Potential Existence of Independent Causes of Action Under Commonwealth Law Does Not Preclude the Vindication of Federal Rights in Federal Court

Defendants finally suggest that because Plaintiff may assert causes of action for breach of contract under Commonwealth law, Plaintiff is somehow precluded from asserting federal claims in federal court arising out of the same course of events.[1] This is plainly not the law.

To be clear, the Complaint does *not* allege that Defendants have failed to perform a contractual obligation -- which makes sense, because Defendants are not parties to any of the relevant contracts. Rather, the Complaint alleges that the Defendants are violating Plaintiff's constitutional rights by diverting funds that are pledged as collateral to bondholders of the Authorities and otherwise implementing the Executive Orders.[2] Indeed, Defendants concede that they are not referring here to potential contract claims by Plaintiff against the Defendants, but rather to potential contract claims against separate entities, specifically the Authorities. *See* Defs.' Br. at 20.

Whatever the merits of Plaintiff's possible contract claims against the Authorities, the existence of such claims in no way forecloses Plaintiff's legitimate constitutional claims against the Defendants. Further, even if Plaintiff could proceed directly against Defendants under Commonwealth law for breach of contract or for violation of the Commonwealth Constitution (and, to be clear, Plaintiff reserves its right to do so) this would not divest this Court of jurisdiction to decide Plaintiff's federal constitutional claims asserted herein.

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[1] *See* Defs.' Br. at 5 (complaining that "instead of bringing a breach of contract or collection action, [Plaintiff] has chosen to bring . . . two purported constitutional claims"); *id.* at 18 ("Rather than bringing a breach of contract claim, plaintiff instead couched its grievance in federal constitutional terms . . . .").

[2] Defendants' reliance on *Ex parte Ayers*, 23 U.S. 443 (1887) (Defs.' Br. at 11), is unavailing, as Plaintiff here does not seek an injunction "forbidding all those acts and doings which . . . would constitute breaches of the contract," *id.* at 502.

It is well recognized that bifurcation of federal and state claims is precisely what is required by *Pennhurst*. Indeed, the Supreme Court in *Pennhurst* recognized such bifurcation of claims as "not uncommon". *Pennhurst*, 465 U.S. at 122; *see also Deakins v. Monaghan*, 484 U.S. 193, 203-04 (1988) (while petitioners are free to argue that *Pennhurst* warrants dismissal of respondents' state law trespass, conversion, and tort claims, respondents' well-pleaded Section 1983 claims justify federal jurisdiction).

The First Circuit has also recognized that a plaintiff is not estopped by the existence of potential state law claims from proceeding with his federal claims in a federal forum, and that the federal courts have a duty to hear the federal claims. *See, e.g., Planned Parenthood League v. Bellotti*, 868 F.2d 459, 467 (1st Cir. 1989) (recognizing plaintiff's right to "bifurcate state and federal claims in order to preserve a federal forum for federal claims as envisioned by *Pennhurst*"); *Cuesnongle v. Ramos*, 835 F.2d 1486, 1497 (1st Cir. 1987) ("If the plaintiff wishes the federal court to address the federal claims, bifurcation will be the only option"). *See also S. Union Co. v. Lynch*, 321 F. Supp. 2d 328, 335 (D.R.I. 2004) (dismissing state claims and noting plaintiff's "'post-*Pennhurst*' choice to have this Court proceed to consider its federal question claim on the merits").

It is settled law -- and, indeed, the accepted practice -- that a plaintiff in a federal action pursuing a claim that state officials are violating federal law need not assert pendent state law claims, and that those state law claims, should they exist, may be reserved for a later day or concurrently pursued in a separate action in the state courts without compromising the federal court's jurisdiction to decide the federal claims.

In short, there is no authority for the proposition that the existence of potential causes of action arising under state law *precludes* the assertion in a federal forum of federal constitutional claims arising out of the same events.

III. PLAINTIFF'S FEDERAL CONSTITUTIONAL CLAIMS DO NOT IMPLICATE "SPECIAL" SOVEREIGNTY INTERESTS

Although not specifically asserted as a ground for dismissal, Defendants' closing paragraph of their sovereign immunity argument requires a brief response. Specifically, in that paragraph, Defendants state:

> Plaintiff goes as far as arguing that the Commonwealth should raise taxes (Docket No. 1 at ¶ 130), improve revenue collections (id. at ¶ 131) or reduce costs (id. at ¶ 132) before taking any measures pursuant to the Executive Orders. These actions lie at the core of a sovereign's powers and any federal court injunction interfering with the same would be tantamount to an impermissible and unconstitutional intrusion by the federal courts into matters of state governance.

(Defs.' Br. at 21.)[1] To the extent that Defendants are asserting that Plaintiff seeks an order from this Court directing the Commonwealth to do any of these things, they are wrong. Plaintiff does not.

In the two passages of the Complaint immediately preceding the passages cited by Defendants (Compl. ¶¶ 128-129), Plaintiff alleges that Defendants' confiscation of Plaintiff's collateral "is not a necessary or reasonable means of serving an important public purpose, because less drastic alternatives were available", and that "the Commonwealth has many more reasonable tools at its disposal to address its fiscal and economic challenges." *Id.* The subsequent passages cited by Defendants (*id.* ¶¶ 130-131) are merely illustrative examples of

[1] *See also* Defs.' Br. at 2 (falsely suggesting that the relief would force the Commonwealth to "divert funds from essential services ensuring the safety, health, and welfare of Puerto Ricans"), and at 4-5 (falsely suggesting that relief sought would render the Governor "powerless . . . to pay the police and firemen, keep open schools and hospitals, and otherwise ensure the welfare of Puerto Rico's citizens").

areas in which third parties have observed that the Commonwealth's fiscal performance might be improved. They are *not* part of the relief requested.

Further, these allegations are included in the Complaint to support Plaintiff's allegation that the Executive Orders are not reasonable or necessary to serve an important public purpose (*id*. ¶ 128) -- one of the *elements* of a claim under the Contracts Clause.

Finally, this action neither seeks money damages from the treasury of the Commonwealth such that the Commonwealth is the "real, substantial party in interest", *Ford Motor Co. v. Dept. of Treasury*, 323 U.S. 459, 464 (1944), nor touches upon and gives offense to the "dignity and status" of the Commonwealth as a sovereign[1] in a manner that makes *Ex parte Young* inapplicable. *See Coeur d'Alene*, 521 U.S. at 287-88.[2]

Coeur d'Alene was a case in which five Justices, including the opinion's author, agreed that the relief requested was in essence an action to quiet title to land that would have a direct effect upon the State of Idaho, divesting it of substantial real property. *Coeur d'Alene*, 521 U.S.

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[1] Assuming, *arguendo*, that the Commonwealth is a "sovereign," it should be noted that whatever sovereignty the Commonwealth has was granted by Congress. *Davila-Perez v. Lockheed Martin Corp.*, 202 F.3d 464, 468 (1st Cir. 2000) ("[Puerto Rico] is still subject to the plenary powers of Congress under the territorial clause."). The Commonwealth therefore differs from the States, which had won their independence from England, were sovereign entities before ratifying the Constitution, and "retained 'a residuary and inviolable sovereignty'" after ratification, *see Printz v. United States*, 521 U.S. 898, 918-19 (1997) (quoting The Federalist No. 39 at 245), in that the Commonwealth had no "residuary sovereignty" to retain. *See Examining Bd. of Eng'rs*, 426 U.S. 572, 586 (1976) ("By the Treaty of Paris, 2274 Stat. 1754 (1899), Spain ceded Puerto Rico to the United States."); S. Rep. No. 1779, at 3 (1950) (Under the Treaty of Paris, Congress controls the "the civil rights and political status of the native inhabitants."). Thus, any purported exercise of the police power by the Commonwealth emanates from a grant of ***federal*** power and cannot be offended by federal court examination of the conduct of its officials.

[2] The concept that there are "special" sovereignty interests that touch upon "the dignity and status of . . . statehood" and must be balanced against the *Ex parte Young* exception finds support in *Coeur d'Alene* solely in those portions of the opinion (521 U.S. at 277-80, 287-88) that were subscribed to by only two justices (Kennedy, J. and Rehnquist, C.J.). In fact, those portions of the opinion of the Court were ***rejected by seven justices in that case***. *See id.* at 296-97 (O'Connor, J., concurring, joined by Scalia and Thomas, JJ.) (finding *Ex parte Young* inapplicable because the relief sought by the plaintiff was not prospective, but rather was in the nature of an action to quiet title); *id*. at 297-98 (Souter, J., dissenting, joined by Stevens, Ginsburg, and Breyer, JJ.) ("there is reason for great satisfaction that Justice O'Connor's view is the controlling one"). This notion of a case-by-case balancing of "special" sovereignty interests against *Ex parte Young* advocated by two justices in *Coeur d'Alene* appears to have been repudiated in *Verizon*, 535 U.S. at 645, and that repudiation was seemingly acknowledged as such in Justice Kennedy's concurrence in *Verizon*, *id*. at 648-49.

at 281-282; *id*. at 291 ("Here, the Tribe seeks a declaration not only that the State does not own the bed of Lake Coeur d'Alene, but also that the lands are not within the State's sovereign jurisdiction") (O'Connor, J., concurring). As such, the action, even though state officials were named, was viewed as a suit against the State itself. *Coeur d'Alene*, 521 U.S. at 282; *id*. at 296 ("[I]t simply cannot be said that the suit is not a suit against the State.") (O'Connor, J., concurring).

Consistent with other decisions in which immunity was upheld in a suit against the State, the five justices in the *Coeur d'Alene* majority found such relief inconsistent with the *Ex parte Young* exception. *Coeur d'Alene* is therefore viewed as having created a limited exception to *Ex parte Young* for suits to quiet title to submerged lands. *See* Erwin Chemerinsky, *Federal Jurisdiction*, 436 (4th ed. 2003) ("In *Idaho v. Coeur d'Alene Tribe*, the Court carved a new, quite narrow exception to *Ex parte Young*: state officers cannot be sued to quiet title to submerged lands").

In sharp contrast, it is clear that the relief requested in the present Complaint would not result in the transfer of title to, or control over, Commonwealth land. Nor does Plaintiff request relief that would interfere with the powers of the Commonwealth to manage its affairs. Again, claims three through six of the Complaint do ***not*** request in any way that this Court interfere with the Commonwealth's management of taxes, revenue collections, or costs, much less request that this Court issue specific direction to Defendants as to how they should address any of these matters when discharging their official functions. Plaintiff's third through sixth claims in the Complaint merely seek an injunction on federal constitutional grounds barring Defendants from continuing to violate Plaintiff's constitutional rights by diverting more of Plaintiff's collateral, the Pledged Funds, and otherwise implementing the Executive Orders. Nothing more.

Finally, although Defendants cite *Coeur d'Alene* (Defs.' Br. at 10), nowhere do Defendants contend that the opinion of the Court in *Coeur d'Alene* calls for dismissal here; rather, their sovereign immunity argument is premised entirely on *Pennhurst*.

In sum, neither Defendants' mischaracterization of Plaintiff's Complaint nor *Coeur d'Alene* provides a basis to avoid the application of *Ex parte Young*, and this Court's adjudication of Plaintiff's claims. *See Neo Gen Screening, Inc. v. New England Newborn Screening Program*, 187 F.3d 24, 28 (1st Cir. 1999) ("It is quite true that *Ex Parte Young* avoids the *Eleventh Amendment* defense where prospective injunctive relief, not involving damages or property transfer, is sought against named state officials for a violation of federal law. *See Coeur d'Alene Tribe*, 521 U.S. at 276-77").

IV. THE CONSTITUTIONAL DEBT PRIORITY PROVISION, THE OMB ACT AND THE EXECUTIVE ORDERS ARE EXPRESSLY PREEMPTED BY THE BANKRUPTCY CLAUSE AND THE BANKRUPTCY CODE

The Complaint alleges the Restructuring Laws are preempted on the bases of express, field and conflict preemption. As Defendants address only Plaintiff's express preemption claim, Defendants impliedly concede Plaintiff's field and conflict preemption claims for purposes of the Motion to Dismiss. Nevertheless, Plaintiff's field and conflict preemption claims are addressed briefly in Section V, below.

Congress has, in its judgment, expressly prohibited state laws that provide for the adjustment or modification of public debt, using *any method*, without any requirement of consent of the holders of such debt obligations. The Restructuring Laws purportedly authorize the Defendants to adjust or modify debt obligations without obtaining consent from any holders of such debt obligations. As a result, the Restructuring Laws are expressly preempted by Section 903(1) of the Bankruptcy Code. In response, Defendants allege that Plaintiff is attempting to

"invalidate, in one fell swoop, the whole system through which the Commonwealth manages its budget and fiscal affairs, in turn annulling the very same statutes on which [P]laintiff relies in support of its claim." (Defs.' Br. at 31) This is simply not true.

First, this Court may "enjoin only the unconstitutional applications of a statute while leaving other applications in force" or "sever its problematic portions while leaving the remainder intact." *Ayotte v. Planned Parenthood*, 546 U.S. 320, 329 (2006). Therefore, to the extent provisions of the Restructuring Laws do not violate Section 903(1) of the Bankruptcy Code or are not otherwise preempted under principles of conflict and field preemption, those portions of the Restructuring Laws may be left undisturbed.

Second, Defendants are attempting to use the Restructuring Laws to do precisely that which the First Circuit Court of Appeals in *Franklin Cal. Tax-Free Trust v. Puerto Rico*, 805 F.3d 322 (1st Cir. 2015) held the Commonwealth could not do under the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the "***Recovery Act***"). *Id*. at 601.

Though the Recovery Act and the Restructuring Laws are different laws requiring different analyses, they are both expressly preempted by Section 903(1) and by field and conflict preemption. Thus, Defendants' real complaint does not concern the preemption of Restructuring Laws or that Congress has made the Commonwealth subject to the same prohibition as the States—namely, Section 903(1)'s ban on the enactment of State municipal restructuring laws—but rather that Congress has excluded the Commonwealth from Chapter 9 and reserved to itself the right to decide whether and to what extent it should authorize a framework for restructuring municipal debt for the Commonwealth and its instrumentalities. Accordingly, it is to Congress

that the Commonwealth must turn if it desires authority to restructure its debts or those of its instrumentalities. And, in fact, Congress presently appears to be considering these matters.[1]

Finally, Defendants offer policy arguments to paint a picture of chaos, a dismantling of the Commonwealth's ability to operate or manage its fiscal affairs. Despite the irrelevance of such policy arguments in the face of constitutional violations,[2] the Restructuring Laws (or, as applicable, those specific portions therein) stand in stark contrast to the Commonwealth's general budgetary and fiscal management laws and regulations. The preempted provisions of the Restructuring Laws are all conditioned on the insolvency of the Commonwealth and/or its instrumentalities and allow for the nonconsensual adjustment and modification of municipal debt—and in this respect, they stand alone. Therefore, should the Court ultimately find for Plaintiff in this case, such a ruling would not affect other laws or regulations providing for the ordinary, day-to-day management and governance of the Commonwealth.

A. The Tenth Amendment Does not Apply to the Commonwealth. As a Territory, the Commonwealth's Management of Its Fiscal Affairs are Subject to Congress's Plenary Power under the Territorial Clause

The Tenth Amendment does not apply to the Commonwealth because the Commonwealth is a Territory, not a State. *See Franklin*, 805 F.3d at 344-345 ("The limits of the Tenth Amendment do not apply to Puerto Rico, which is constitutionally a territory, because Puerto Rico's powers are not those reserved to the States but those specifically granted to it by

[1] *See e.g.*, United States House of Representatives Committee on Financial Services, February 25, 2016, Subcommittee on Oversight and Investigations hearing entitled "Puerto Rico's Debt Crisis and its Impact on the Bond Market" at *http://financialservices.house.gov/uploadedfiles/022516_oi_memo.pdf*. (February 19, 2016).

[2] That the Restructuring Laws may be important is not relevant in a preemption analysis. *See Free v. Bland*, 369 U.S. 663, 666 (1962) ("The relative importance to the State of its own law is not material when there is a conflict with a valid federal law, for the Framers of our Constitution provided that the federal law must prevail."). The Commonwealth's sole remedy, therefore, lies with Congress. *See also Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) ("where Bankruptcy Code's "language is plain, the sole function of the courts -- at least where the disposition required by the text is not absurd -- is to enforce it according to its terms.") (citations and quotations omitted).

Congress under its constitution. Accordingly, that § 903(1) expressly preempts a Puerto Rico law does not implicate these Tenth Amendment concerns.") (citations and quotations omitted).

The Commonwealth's constitutional status as a Territory, and not a State, is a critical distinction in this case. As a Territory of the United States, the Commonwealth is subject to Congress's plenary power. *See* U.S. Const. art. IV, cl. 2 (the "***Territorial Clause***") ("Congress shall have Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States…."). Under the Territorial Clause, "Congress may not only abrogate laws of the territorial legislatures, *but it may itself legislate directly for the local government*. It may make a void act of the territorial legislature valid, and a valid act void. In other words, it has full and complete legislative authority over the people of the Territories…." *Nat'l Bank v. County of Yankton*, 101 U.S. 129, 133 (1880) (emphasis supplied).

The territorial status of the Commonwealth augments the preemptive effect of Section 903(1). As a Territory, Section 903(1) not only restricts the Commonwealth's municipalities from utilizing Chapter 9, it also deprived "Puerto Rico of a fundamental and inherently managerial function over its municipalities…[i.e.,] the power to control, manage, and regulate the local financial affairs of [its] municipalities" if such powers purported to effectuate procedures to adjust or modify obligations of creditors without their consent. *Franklin*, 805 F.3d at 350-51 (J. Torruella concurring). In this way, Congress's relationship with the Commonwealth under Chapter 9 functions much like a State's legislature does with that State's political subdivisions, public agencies or public corporations. *See Yankton*, 101 U.S. at 133 ("**The Territories are but political subdivisions of the outlying dominion of the United States. Their relation to the general government is much the same as that which counties**

bear to the respective States, and Congress may legislate for them as a State does for its municipal organizations.") (emphasis supplied).

Thus, when Congress re-introduced the definition of "State" to the Bankruptcy Code in 1984 to include "Puerto Rico, except for the purpose of defining who may be a debtor" under Chapter 9 of the Bankruptcy Code, 11 U.S.C. § 101(52), Congress expressly prohibited the Commonwealth *and* its municipalities from utilizing Chapter 9 and from enacting laws for the nonconsensual adjustment or modification of debt obligations. In effect, Congress legislated "for [the Commonwealth] as a State does for its municipal organizations", just as many States have done with their own municipalities concerning the availability of Chapter 9 relief. *Yankton*, 101 U.S. at 133.

This result is supported by the First Circuit's analysis in *Franklin*. Under the Territorial Clause, in conjunction with the Bankruptcy Clause, Congress may "adopt other – and possibly better – options to address the insolvency of Puerto Rico municipalities that are not available to it when addressing similar problems in the States." *Franklin*, 805 F.3d at 336. *See also*, *id*. at 337 ("Because of the different constitutional status, the limitations on Congress's ability to address municipal insolvency in the states…are not directly applicable to Puerto Rico."). Accordingly, it is to Congress that the Commonwealth must turn if it desires to obtain the authority to restructure its debts or those of its instrumentalities.

Defendants' arguments that the Restructuring Laws "are absolutely necessary and intrinsically tied to the management of the Commonwealth's fiscal affairs" are unavailing. (Defs.' Br. at 27) As here, "where 'Congress' power in the area…is plenary, its judgment must be respected whatever policy objections there may be…." *Franklin*, 805 F.3d at 337 (*citing Guss*

v. Utah Labor Relations Board, 353 U.S. 1, 11 (1957)).[1] And, in its judgment, Congress enacted Section 903(1) and the 1984 Amendments to the Bankruptcy Code to "preempt state laws that prescribe a method of composition of municipal indebtedness that binds nonconsenting creditors and to include Puerto Rico laws in this preempted arena." *Franklin Cal. Tax-Free Trust v. Puerto Rico*, 85 F. Supp. 3d 577, 601 (D.P.R. 2015).

B. The Restructuring Laws Prescribe a Method of Composition of Indebtedness in Violation of Section 903(1) of the Bankruptcy Code

Since 1946, Congress has expressly barred States from enacting nonconsensual restructuring laws for their municipalities. *See* Act of July 1, 1946, Pub. L. No. 79-481, sec. 1, § 83(i), 60 Stat. 409, 415 ("***Section 83(i)***"). This prohibition applied to the Commonwealth from the outset because the term "States" included "Territories and possessions." *See* Act of June 22, 1938, Pub. L. No. 75-696, sec. 1, § 1(29), 52 Stat. 840, 842. Congress incorporated Section 83(i)'s prohibition into the modern Bankruptcy Code "with stylistic changes" only, and thus the provision, re-codified as Section 903(1), continued to prevent "States [from] enact[ing] their own versions of Chapter 9 and thereby "frustrat[ing] the constitutional mandate of uniform bankruptcy laws." S. Rep. No. 95-989, at 110 (1978) (internal quotation marks omitted).

Section 83(i) (and later, Section 903(1)) was drafted so as not to interfere with the inherent sovereign powers of the States. However, while States have "inherent" powers (U.S. Const. amend. X), the Commonwealth does not. The Commonwealth has only those powers delegated by Congress under the Puerto Rican Federal Relations Act, 48 U.S.C. §§ 731 *et seq*. By passage of Public Law No. 447, 66 Stat. 327—approving the Commonwealth Constitution—Congress did not in 1952 provide the Commonwealth a power to enact laws for the nonconsensual adjustment or modification of debt obligations that Congress had explicitly

[1] *See* fn. 18, *supra.*

denied to the States under Section 83(i) only six years earlier, in 1946. To the contrary, any powers delegated to the Commonwealth in 1952 were made subject to Section 83(i). *See* 48 U.S.C. § 734 ("The statutory laws of the United States not locally inapplicable, except as…otherwise provided, shall have the same force and effect in Puerto Rico as in the United States….").[1]

1. The Historical Context of Section 903(1)

The legislative history and congressional intent behind the language of Section 903(1) are essential in determining the existence and range of an express preemption provision. As stated by the First Circuit, "Congressional intent is the principal resource to be used in defining the scope and extent of an express preemption clause. In this endeavor, we look to both the text and context of the particular clause. We also may consider the clause's purpose and history, as well as the structure of the statutory scheme in which it is housed." *Brown v. United Airlines, Inc*., 720 F.3d 60, 63 (1st Cir. 2013) (citations omitted).

Section 903 of the Bankruptcy Code provides, in relevant part:

> This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but—
>
> (1) a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition….

[1] *Cf. Perez v. Campbell*, 402 U.S. 637, 654-656 (1971) ("It is asserted that 'Congress must have regarded the two statutes as consistent and compatible,' post, at 665, but such an argument assumes a modicum of legislative attention to the question of consistency. Had Congress focused on the interaction between this minor subsection of the rather lengthy financial responsibility act and the discharge provision of the Bankruptcy Act, it would have been immediately apparent to the legislators that the only constitutional method for so defining the scope and effect of a discharge in bankruptcy was by amendment of the Bankruptcy Act, which by its terms is a uniform statute applicable in the States, Territories, and the District of Columbia.").

11 U.S.C. § 903(1). Section 101(40), in turn, provides: "The term 'municipality' means political subdivision or public agency or instrumentality of a State." Further, Section 101(52) defines the term "State" to include "Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9 of this title."

In 1934, the Bankruptcy Act of 1898 (as amended, the "***Bankruptcy Act***") was amended to include Chapter IX, "Provisions for the Emergency Temporary Aid of Insolvent Public Debtors" (the "***Original Chapter IX***"). *See* Act of May 24, 1934, 48 Stat. 798. In 1936, the Supreme Court held the Original Chapter IX was invalid because it might materially restrict a State from exercising control of the fiscal affairs of its political subdivisions. *See Ashton v. Cameron County Water Improvement Dist*., 298 U.S. 513 (U.S. 1936). In response, Congress enacted what was then Chapter X of the Bankruptcy Act on August 16, 1937 (the "***Original Chapter X***"), and included a provision requiring the consent of the State as a condition for a municipality to seek relief under the Bankruptcy Act. *See* Act of August 16, 1937, 50 Stat. 653. In 1938, the Supreme Court upheld the Original Chapter X as it was "carefully drawn so as not to impinge upon the sovereignty of the State." *United States v. Bekins*, 304 U.S. 27, 51 (1938). In 1938, Congress amended the Bankruptcy Act by adding the Original Chapter X into the Original Chapter IX to form a single chapter ("***Chapter IX***"). *See* Act of June 22, 1938, 50 Stat. 840.

Congress's stated policy behind enacting the Original Chapter IX (and later, the Original Chapter X) was the pronouncement of "**a national emergency** caused by increasing financial difficulties of many local government units, which render[ed] imperative the further exercise of the bankruptcy powers of the Congress of the United States." *See* Act of May 24, 1934, 48 Stat. 798 (emphasis supplied). Indeed, as stated by the Supreme Court, "similar conditions existed in

other parts of the country and it was this serious situation which led the Congress to enact Chapter IX and later Chapter X." *Bekins*, 304 U.S. at 48-9. The foregoing illustrates that Congress's motive in enacting municipal bankruptcy laws was to provide a single statutory mechanism under federal law to aid States and their instrumentalities in times of financial crisis.

The express prohibition of State laws that prescribe a "method of composition of indebtedness" was introduced in 1946 when Congress amended Chapter IX to include Section 83(i). Congress re-enacted Section 83(i) in 1976 and again in 1978, each time for the express purpose of ensuring that "**[o]nly under a Federal law should a creditor be forced to accept such an adjustment without his consent.**" H.R. Rep. No. 79-2246, at 4 (1946) (emphasis added); *see also* H.R. Rep. No. 94-686, at 19 (1975); S. Rep. No. 95-989, at 110 (1978). Those provisions are now codified in Chapter 9 of the Bankruptcy Code, 11 U.S.C. §§ 901 et seq., titled "Adjustment of Debts of a Municipality."

2. In Municipal Bankruptcy, A "Composition" is Any Procedure that Modifies or Alters a Creditor's Rights in Any Way

In a municipal bankruptcy context, the term "compositions" was first used in the Original Chapter X of the Bankruptcy Act. Section 83(a) of the Original Chapter X defined a "'plan of composition', **within the meaning of this chapter**, [to] include provisions **modifying or altering the rights of creditors generally**, or of any class of them, secured or unsecured, either through the issuance of new securities of any character, **or otherwise**…." 50 Stat. at 655 (emphasis supplied). From the very beginning, Congress made it clear that the term "composition" was broadly defined in a municipal bankruptcy context to include any procedure that modified or altered the rights of municipal creditors or particular classes or types of municipal creditors. *See* Rosalynn Van Heest, *Municipal Affairs—Relieving Insolvent Municipalities: New York's Emergency Moratorium Act and Federal Bankruptcy Law*, 15 Urb.

L. Ann. 351, 352 n. 6 (1978) ("The term ['plan of composition'] therefore refers to both plans which contemplate reductions in payment and those plans, called 'extensions,' that provide for payment in full at a later time.").

While Defendants may argue the Restructuring Laws do not establish a method of composition of indebtedness, "[p]re-emption is not a matter of semantics." *Wos v. E.M.A.*, 133 S. Ct. 1391, 1398 (2013). Defendants "may not evade the pre-emptive force of federal law by resorting to creative statutory interpretation or description at odds with the statute's intended operation and effect." *Id.* Indeed, "[i]n a pre-emption case…a proper analysis requires consideration of what the state law in fact does, not how the litigant might choose to describe it." *Id.*

The Restructuring Laws are insolvency laws because they are conditioned entirely on "revenues including surplus for any fiscal year" as being "insufficient to meet the appropriations" made for that year. *See* P.R. Const. art. VI, § 8. The term "revenues" includes "the General Fund, the Special Funds, the grants from the United States Government, bond issues and loans, the public corporations' own revenues, and any other sources of income" that can be appropriated for the satisfaction of payment obligations of the Commonwealth and its instrumentalities. In other words, the Restructuring Laws are operative only if the Commonwealth or its instrumentalities are in a "financial condition such that [the Commonwealth or instrumentality] is unable to pay its debts as they become due." *See* 11 U.S.C. § 101(32)(c).

Once insolvent, the plain language of the Restructuring Laws purports to allow the Governor to adjust or modify the obligations of the Commonwealth and its instrumentalities by seizing any and all revenues (regardless of any conflicting contractual obligations or consent of

creditors) and to distribute such revenues in accordance with the priorities set by the Restructuring Laws or as the Governor so desires. *See e.g.* 23 L.P.R.A. § 104(c)-(e). There is no provision in the Restructuring Laws that requires the consent of a creditor prior to adjustment or modification of a debt obligation. The Defendants do not dispute the foregoing. Defendants only dispute the extent of the modification or adjustment that may be implemented pursuant to the Restructuring Laws.

But the Restructuring Laws ostensibly authorize much more than unilateral extension of maturity deadlines or deferral of payment obligations. For example, Section 104(e)(5) of the OMB Act states the Governor may "restrict the funds available to the agencies, in whatever way he deems pertinent, when, in the execution and control of the budget, he considers it necessary regardless of the circumstances established in subsections (c) and (d) of this section." In addition, nothing in the Restructuring Laws appears to limit the deferral of payment obligations in time or amount. The Commonwealth could, conceivably, defer payment obligations indefinitely or as long as the Commonwealth or an instrumentality remained insolvent. An indefinite extension or cessation of a payment obligation is a discharge by a different name.

Further, Defendants concede the Restructuring Laws purportedly authorize the Commonwealth to unilaterally defer payment obligations and/or to extend maturity deadlines without consent.[1] This falls squarely within the original concept of a "composition" as described in Chapter IX of the Bankruptcy Act, *i.e.*, any arrangement that modifies or alters the rights of creditors.

Deferral of payment obligations and maturity extensions are also methods of composing indebtedness under the rulings of the courts in *Franklin*. In *Franklin*, the district court

[1] Specifically, Defendants admit that, "[a]t most, the only potential result of the invocation and implementation of the Commonwealth Laws…is a delay in the availability of the Pledged Funds due to the shortfall in the current fiscal year." (Defs. Br. at 28)

determined that Chapters 2 and 3 of the Recovery Act "prescribed a method of composition of indebtedness" because they "adjust or discharge their obligations to creditors" through "any combination of amendments, modifications, waivers or exchanges, which may include **interest rate adjustments, maturity extensions, debt relief, or other revisions to affected debt instruments**" and "permit an eligible public corporation to **defer debt repayment** and to decrease principal owed to creditors." *Franklin*, 85 F. Supp. 3d at 597 (emphasis supplied).

In accordance with the district court's analysis in *Franklin*, a "method of composition of indebtedness" is any procedure in which a debt instrument is modified, amended, or adjusted, including interest rate adjustments, maturity extensions and deferral of debt repayment. Defendants freely admit the Restructuring Laws purportedly authorize the Commonwealth to take these exact actions. (*See* Defs.' Br. at 28)

3. *Ropico, Inc. v. New York* is Not Applicable to This Case

In *Ropico, Inc. v. New York*, 425 F. Supp. 970 (S.D.N.Y. 1976), the court's statutory analysis of the precursor of Section 903(1) (Section 83(i)) is inconsistent with the express terms and legislative history of the Bankruptcy Act.

In *Ropico*, a New York state law that modified certain payment obligations of bondholders (the "***Moratorium Act***") was challenged, in relevant part, on the basis that it constituted a State law "prescribing a method of composition of indebtedness" in violation of Section 83(i) of Chapter IX of the Bankruptcy Act. The Moratorium Act generally provided for a maturity extension and deferral of payment obligations concerning bonds issued by the City of New York.

The district court held that the Moratorium Act was an extension, not a composition, and therefore did not run afoul of the prohibition in Section 83(i).[1] *But see* Rosalynn Van Heest, *Municipal Affairs—Relieving Insolvent Municipalities: New York's Emergency Moratorium Act and Federal Bankruptcy Law*, 15 Urb. L. Ann. 351, 359 (1978) ("The court noted that the [Moratorium Act] did not impair prematurity interest, yet this is not a compelling distinction. The crux of a composition is that the creditors' rights are impaired. The fact that full interest is paid until maturity of the note does not seem to be a practical distinction since creditors can lose as much in interest reduction after maturity as before maturity").

The district court's analysis in *Ropico* relied, in large part, on *Perry v. Commerce Loan Co.*, 383 U.S. 392 (1966). The primary issue in *Perry* concerned the prohibition of multiple discharges when an individual debtor filed a "wage-earner extension plan" after a previous "wage-earner plan by way of composition" under Chapter XIII. Chapter XIII was uniquely tailored for individual debtors. *See Perry*, 383 U.S. at 394 ("Chapter XIII provides a highly desirable method for dealing with the financial difficulties of individuals"); *see also id.* at 395 ("In designing a remedy for the dilemma facing a debtor seeking to repay, rather than avoid, his obligations, the Congress settled upon the wage-earner extension-of-time procedures of Chapter XIII").

In this way, the distinction made in *Perry* concerning "wage earner extension plans" and "wage earner composition plans" is limited to Chapter XIII. *See id*. at 402-03. ("We emphasize that our construction of [Chapter XIII] does not preclude application of § 14 (c)(5) to confirmations of general arrangements under Chapter XI or to real property arrangements under Chapter XII.…The relief afforded in those chapters…represents a wholly different statutory

[1] The Moratorium Act was later held to be in violation of the New York State Constitution in denying full faith and credit to the city's notes. *See Flushing Nat'l Bank v. Municipal Assistance Corp.*, 40 N.Y.2d 731 (1976).

scheme from wage-earners' extensions, and the restrictive provisions are not, therefore, in *pari materia*."); *see also* 52 Stat. 840, 930 (Section 601 of Chapter XIII stated, "The provisions of this chapter shall apply exclusively to proceedings under this chapter."). *See also* Section IV(B)(4), below.

In addition, *Ropico* is inapplicable because its holding is based in large part on issues of State sovereignty under the Tenth Amendment. *See Ropico*, 425 F. Supp. at 983 ("A federal court decision that the federal Bankruptcy Act precludes the New York State legislature from implementing this emergency measure aimed at dealing with a fiscal crisis of unprecedented proportions affecting its largest city would raise very serious questions about the right of a state effectively to govern its political subdivisions."). As discussed in Section IV(A), above, the Tenth Amendment is not applicable to the Commonwealth. Further, Congress's power under the Territorial Clause is plenary, such that the Commonwealth's "relation to [Congress] is much the same as that which counties bear to the respective States, and Congress may legislate for them as a State does for its municipal organizations." *Yankton*, 101 U.S. at 133.

Finally, the Moratorium Act extended the City of New York's payment obligations for a set three year period. *See Ropico*, 425 F. Supp. at 972.[1] In sharp contrast, in this case the Restructuring Laws do not prevent Defendants from indefinitely deferring payment obligations or extending maturity deadlines for so long as the Commonwealth or instrumentalities are insolvent. More, for the term of the Moratorium Act, the bondholders in *Ropico* were to receive the full amount of interest due on the notes, notwithstanding the suspension of payment of principal for the three year period. *Id.* Again in contrast, under the Restructuring Laws

[1] *See also id*. at 983 ("Under these circumstances, so long as the contract rate of interest on the notes is paid until the original maturity date, the fact that the Moratorium Act provides for payment at a lower rate of interest after that date does not render that Act a law of composition.").

Defendants may purportedly elect to defer all payment obligations or extend the maturity of debts of the Commonwealth or its instrumentalities without paying any outstanding interest on the underlying debt instruments during such time.

Thus, even if *Ropico*'s holding were valid (which it is not), the limited and defined terms of the Moratorium Act approved in *Ropico* differ substantially from the undefined powers to adjust and modify debt obligations that are purportedly granted to Defendants under the Restructuring Laws.

4. Extension of Time for Payment is a Method of Composition of Indebtedness

The corporate bankruptcy statutes set forth in Chapters X and XI are more appropriate reference points for analyzing the meaning of a "composition" under Chapter IX of the Bankruptcy Act. *See* Rosalynn Van Heest, *Municipal Affairs—Relieving Insolvent Municipalities: New York's Emergency Moratorium Act and Federal Bankruptcy Law*, 15 Urb. L. Ann. 351, 356 n. 32 (1978) (stating Congress utilized "Chapters X and XI as models for amendments to the Municipal Bankruptcy Act in 1976").

Chapter X was "adapted to the reorganization of corporations with complicated debt structures and many stockholders….[with] [t]he basic assumption…that the investing public dissociated from control or active participation in the management, needs impartial and expert administrative assistance in the ascertainment of facts, in the detection of fraud, and in the understanding of complex financial problems." *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434, 447-50 (1940).

Chapter XI, on the other hand, "provide[d] a summary procedure whereby judicial confirmation is obtained on a plan that has been formulated and accepted with only a bare minimum of independent control or supervision." *SEC v. American Trailer Rentals Co.*, 379 U.S.

594, 606 (1965). The basic purpose of Chapter XI was "to provide a quick and economical means of facilitating simple compositions among general creditors who have been deemed by Congress to need only the minimal disinterested protection provided by that Chapter." *Id.* at 606-07.

Under Chapter XI, a debtor could utilize "simple compositions," which included extensions of payment obligations. As stated by the Supreme Court, "'Simple' compositions are still to be effected under Chapter XI…where, although the public investors are greater in number, the adjustment of their debt is relatively minor, consisting, for example, **of a short extension of time for payment**." *American Trailer*, 379 U.S. at 614 (emphasis supplied). As opposed to individual, wage earner proceedings under Chapter XIII, corporate bankruptcy proceedings under Chapter XI contemplated compositions that provided for an "extension of time for payment." *Id.* *See also General Stores Corp. v. Shlensky*, 350 U.S. 462, 466 (U.S. 1956) ("A large company with publicly held securities may have as much need for a simple composition of unsecured debts as a smaller company.").

Further, "simple compositions" have been recognized by the First Circuit after the holding in *Ropico*. *See In re Continental Inv. Corp.*, 586 F.2d 241, 245-46 (1st Cir. 1978) (stating that, in addition to extensions of time for payment, "[t]he Court has not excluded the possibility that there may be other situations in which the rights of public investor creditors can be adjusted in Chapter XI. We conclude, however, that any such situations would have to fall within the definition of 'simple composition'.").

The term "composition," therefore, has a different meaning for corporate debtors, whether public or private. As a result, *Ropico*'s reliance on *Perry* for its analysis of Chapter XIII provisions undermines the legitimacy of *Ropico*'s analysis of Section 83(i). Chapter XIII was

simply not analogous or sufficiently similar to Chapter IX for any comparison, just like the modern Chapter 13 would be an unsuitable reference for interpreting Chapter 9 today. Indeed, when Congress enacted the Bankruptcy Code in 1978, Chapter 9 was drafted to incorporate many provisions from the newly created Chapter 11—Chapter 9 does not incorporate any provisions of Chapter 13. Presumably, this was because the statutory mechanisms used to address corporate bankruptcies are similar to, if not substantially the same as, those needed for municipal bankruptcy proceedings.

To the extent necessary, this Court should look to the holdings of the Supreme Court and the First Circuit interpreting "compositions" in corporate bankruptcy proceedings under Chapters X and XI of the Bankruptcy Act. As stated in those holdings, an extension of time for payment—which the Defendants admit is purportedly authorized under the Restructuring Laws—is a method of composition of indebtedness.

C. Adjustment and Modification of Municipal Debt Under the Restructuring Laws Impermissibly Do Not Require the Consent of Creditors

The preemptive scope of Section 903(1) encompasses laws "prescribing a method of composition of indebtedness of…Puerto Rico municipalities that **may** bind said municipalities creditors without those creditors' consent." *Franklin*, 805 F.3d at 334 (internal quotations omitted). Therefore, if a state or territory's law (a) authorizes adjustment or modification of public debt and (b) does not include a statutory requirement of consent from the affected creditors, then such a law is expressly preempted by Section 903(1).

The Restructuring Laws purportedly provide that, upon the Commonwealth's or instrumentality's inability to pay debts as they become due, Defendants (a) may adjust or modify obligations to creditors by using any and all revenues otherwise pledged to such creditors and (b) may do so without consent from the such creditors. There simply is no provision in the

Restructuring Laws that requires the Commonwealth to obtain the consent of creditors prior to the Commonwealth adjusting or modifying corresponding debt obligations.

Factual considerations are irrelevant in determining whether Section 903(1) expressly preempts the Restructuring Laws. Indeed, Section 83(i) was originally enacted to overrule a Supreme Court case upholding a state law permitting the adjustment of municipal debt if the city and 85% of creditors agreed.[1] Despite at least 85% of creditors consenting to the arrangement in that case, the state law was still invalidated by Congress's enactment of Section 83(i) because the law, on its face, did not require consent of all creditors. Thus, whether or not creditors consent to a municipal debt adjustment does not somehow save an otherwise expressly preempted law. The inquiry focuses on whether the composition procedures facially require "unanimous creditor consent." If they do not, such procedures would bind nonconsenting creditors in violation of Section 903(1). *Franklin*, 85 F. Supp. at 598.

V. THE RESTRUCTURING LAWS ARE PREEMPTED ON THE BASES OF FIELD AND CONFLICT PREEMPTION BY THE BANKRUPTCY CLAUSE AND THE BANKRUPTCY CODE

Even if the Restructuring Laws were not expressly preempted by Section 903(1), the Restructuring Laws are preempted on the basis of field and conflict preemption. *See e.g.*, *Int'l Shoe Co. v. Pinkus*, 278 U.S. 261, 265 (1929) ("States may not pass or enforce laws to interfere with or complement the Bankruptcy Act or to provide additional or auxiliary regulations"). Defendants do not provide any legal basis or authority for disputing Plaintiff's field and conflict preemption claims. Indeed, by Congress doing so, Congress has prohibited the Commonwealth from "imposing any additional or different--**even if non-conflicting**--requirements that fall

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

within the scope" of the Bankruptcy Code or that concern the subject of bankruptcies. *Nat'l Meat Ass'n v. Harris*, 132 S. Ct. 965, 970 (2012) (emphasis supplied).

The Restructuring Laws are also preempted because they conflict with the Bankruptcy Code and frustrate the express purpose of Congress. *See Franklin*, 805 F. 3d at 343 ("Conflict preemption applies here because…all of the relevant authority shows that Congress quite plainly wanted a single federal law to be the sole source of authority if municipal bondholders were to have their rights altered without their consent"); s*ee also, e.g., Chi. Title & Trust Co. v. Forty-One Thirty-Six Wilcox Bldg. Corp*., 302 U.S. 120, 126 (1937) ("state laws in conflict with the laws of Congress on the subject of bankruptcies are suspended . . . to the extent of actual conflict with the system provided by" federal bankruptcy law (citation omitted)); *Pinkus*, 278 U.S. at 263-64 ("A state is without power to make or enforce any law governing bankruptcies that impairs the obligation of contracts or extends to persons or property outside its jurisdiction or conflicts with the national bankruptcy laws"); *Sturges v. Crowninshield*, 17 U.S. 122, 195-97 (1819).

As described above, the Restructuring Laws are insolvency laws that purportedly authorize Defendants to adjust or modify the debt of Puerto Rico or its instrumentalities without consent of creditors. As a result, the Restructuring Laws are clearly preempted because they operate in a field exclusively occupied by Congress and because they conflict with the Bankruptcy Code and frustrate the express purpose of Congress.

VI. The Defendants' Request for a Stay Should be Denied Because Defendants Did Not Satisfy Their Burden of Proof

While "the power to stay proceedings is incidental to the power inherent in every court to control the disposition of the causes on its docket with economy of time and effort for itself, for counsel, and for litigants", *Landis v. N. Am. Co.*, 299 U.S. 248, 254 (1936), the requesting party

"for a stay must make out a clear case of hardship or inequity in being required to go forward, if there is even a fair possibility that the stay for which he prays will work damage to someone else." *Id.* As noted by the Supreme Court, "Only in rare circumstances will a litigant in one cause be compelled to stand aside while a litigant in another settles the rule of law that will define the rights of both." *Id.*

Plaintiff has sought injunctive relief for the prevention of ongoing and future violations of Plaintiff's constitutional rights. Indeed, the core rationale of prospective relief sought by Plaintiff herein is to avoid damages that are sure to come. To be clear, Defendants do not suggest that they will not continue to wrongfully divert more of Plaintiff's collateral during such a stay. Thus, a stay of these proceedings would moot the very purpose of this case, result in further significant damage to Plaintiff, and effectively operate as a final judgment in favor of Defendants.

Accordingly, Defendants were required to establish a "clear case of hardship or inequity" to support their motion for a stay of these proceedings. The Defendants, however, do not provide any reason or basis (other than a blank assertion that *Franklin* will be decided "no later than the end of June") for such a severe and prejudicial restriction on Plaintiff's right to seek relief from this Court to remedy ongoing violations of Plaintiff's constitutional rights. Defendants, therefore, have failed to meet their burden, and their request for a stay should be denied.

CONCLUSION

Under established principles of law, this Court's exercise of jurisdiction over Plaintiff's third through sixth claims is entirely proper. Each of these federal constitutional law claims fall

squarely within the *Ex parte Young* exception to sovereign immunity, and *Pennhurst* in no way bars their consideration.

Further, the first and second claims set forth in the Complaint which address preemption are valid and may be adjudicated by this Court. And Defendants' request for a stay is neither supported or warranted, and should properly be denied.

For these reasons, Defendants' Motion to Dismiss should be denied in its entirety.

Dated: February 29, 2016

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CERTIFICATE OF SERVICE

I hereby certify that, on February 29, 2016, I electronically filed the foregoing pleading with the Clerk for the United States District Court for the District of Puerto Rico using the Court's CM/ECF system. Participants in this case who are registered CM/ECF users will be served by the CM/ECF system.

Dated: February 29, 2016

Respectfully submitted,

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