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

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| FINANCIAL GUARANTY INSURANCE COMPANY,<br><br>Plaintiff,<br><br>v.<br><br>ALEJANDRO GARCÍA PADILLA et al.,<br><br>Defendants. | CIVIL NO. 16-1095 (JAF) |

**MOTION TO DISMISS**

**TO THE HONORABLE COURT:**

COME NOW, co-defendants Hon. Alejandro García Padilla, Hon. Juan C. Zaragoza Gómez, Hon. Luis Cruz Batista, Hon. Víctor Suárez Meléndez, Hon. César Miranda Rodríguez, Hon. Melba Acosta Febo, solely in her official capacity as member of the Working Group for the Fiscal and Economic Restoration of Puerto Rico, and Hon. Juan Flores Galarza, in their respective official capacities (collectively "defendants"), specially appearing and without submitting to the jurisdiction or venue of this Court, and hereby state and pray as follows:

## I. INTRODUCTION

This matter does not belong in federal court. Plaintiff alleges that it insures bonds (the "Authority Bonds") issued by three Puerto Rican public corporations (the "Authorities") pursuant to enabling statutes. Plaintiff asserts that the Authority Bonds, **which are not public debt backed by the full faith and credit of the Commonwealth**, are supported by revenues that were assigned to the Authorities by the Puerto Rican legislature and subsequently pledged by the Authorities as security. Plaintiff claims that the defendants—individuals sued in their capacity as Puerto Rican government officials—violated Puerto Rico law by withholding the

assigned revenues from the Authorities to pay down public debt in a time of fiscal crisis. According to plaintiff, before taking such action the Government of Puerto Rico must first divert funds from essential services ensuring the safety, health, and welfare of Puerto Ricans. As plaintiff would have it, until the government has shut down completely, it has no authority to use revenues assigned to the Authorities to pay public debt. Plaintiff is wrong, and the defendants have at all times complied with the laws of Puerto Rico.

Regardless, all of plaintiff's contentions turn entirely on the laws of Puerto Rico. 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. Under the Eleventh Amendment, the federal courts have no jurisdiction over such a case. Because there is no federal jurisdiction here, the complaint should be dismissed.

A similar masked collection claim was recently filed by other insurers of the Authority Bonds. See Assured Guaranty Corp. v. García Padilla, Civil No. 16-1037.[1] The only major difference between the Assured action and this case is that here plaintiff alleged that Article VI, Section 8 of the Constitution of Puerto Rico, the enabling act of Puerto Rico's Office of Management and Budget (the "OMB Act") and several Executive Orders issued pursuant to the same are unconstitutional because they are preempted pursuant to 11 U.S.C. §903(1) ("Section 903(1)"). The issue of whether Puerto Rico laws[2] are subject to preemption by Section 903(1) is currently under review by the Supreme Court of the United States in the case of Puerto Rico v. Franklin California Tax-Free Trust, 136 S. Ct. 582 (2015) (No. 15-233).

For a number of reasons detailed below, Section 903(1) is simply inapposite in this case. In the alternative, should this Court harbor any doubts about the applicability of Section 903(1)

[1] Per this Court's Order dated January 22, 2016, the two lawsuits have not been consolidated. Docket No. 23.
[2] In particular, the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the "Recovery Act").

to the relevant constitutional provision, laws and Executive Orders challenged by plaintiff, it should stay its determination on defendant's motion to dismiss plaintiff's first and second causes of action (Docket No. 1 at 46-48) until the Supreme Court decides whether Section 903(1) is even applicable in Puerto Rico.

## II. BACKGROUND

### A. The parties

Plaintiff Financial Guaranty Insurance Company ("FGIC") is a New York-based insurer that purports to insure approximately $1.2 billion in Puerto Rican debt, including Authority Bonds issued by three 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"). See Complaint, Docket No. 1 at ¶¶ 4-5, 33, 37, 40, 43. Plaintiffs seek to nullify two executive orders issued by the Governor of Puerto Rico in the exercise of his police powers in response to Puerto Rico's unprecedented financial crisis, claiming that the orders violate their federal constitutional rights. Id. at ¶ 1.

Defendants are officials in the executive branch of the Government of Puerto Rico, including the Governor, the Secretary and Sub-Secretary of the Treasury, the Director of the Office of Management and Budget, the Secretary of State and the Secretary of Justice, among others. Each is sued in his or her official capacity.

Plaintiffs join neither the issuers of the Authority Bonds, each with independent capacity to sue and be sued,[3] nor the bondholders in this action.

### B. The Executive Orders

Article VI, Section 8 of the Constitution of Puerto Rico provides as follows:

[3] See 9 P.R. Laws Ann §2004(g); 23 P.R. Laws Ann. §6412(b); 3 P.R. Laws Ann. §1906(d).

> In case the available revenues including surplus for any fiscal year are insufficient to meet the appropriations made for that year, interest on the public debt and amortization thereof shall first be paid, and other disbursements shall thereafter be made in accordance with the order of priorities established by law.[4]

This action was filed following the issuance of Executive Order ("EO") 2015-46 by the Governor of Puerto Rico, co-defendant Alejandro García Padilla, and its implementation through EO 2015-49 (collectively, the "Executive Orders"). Docket Nos. 1-22 and 1-23. EO 2015-46 essentially invoked Art. VI, Section 8 of the Constitution of Puerto Rico in light of the island's current fiscal crisis and the fact that the "resources" or "revenues" (as the terms are used in the Constitution) of the Commonwealth of Puerto Rico (the "Commonwealth") are not sufficient to cover all of the appropriations for the current fiscal year. On the other hand, EO 2015-49 delegates on the Office of Management and Budget of the Commonwealth ("OMB") the responsibility to set the priority guidelines for the payment of the Commonwealth's obligations pursuant to Section 4(c) of the OMB Act, Act No. 147 of June 18, 1980, in light of the activation of Art. VI, Section 8 of the Constitution. Docket No. 1-23.[5]

Plaintiff alleges that the Executive Orders "constitute a misappropriation and diversion of secured bondholder collateral," Docket No. 1 at ¶ 7, because they diverted funds pledged (the "Pledged Funds") to secure the Authority Bonds "to other, unconstitutional uses[.]" Id. at ¶ 5. Although FGIC concedes that the revenues assigned to the Authorities may be withheld to repay public debt when necessary, see id. at ¶ 6, 95-102, it nonetheless argues that the Executive Orders violated a debt priority scheme created by Puerto Rico law. Id. at ¶¶ 6, 45-59. Under

[4] "Cuando los recursos disponibles para un año económico no basten para cubrir las asignaciones aprobadas para ese año, se procederá en primer término, al pago de intereses y amortización de la deuda pública, y luego se harán los demás desembolsos de acuerdo con la norma de prioridades que se establezca por ley."

[5] The OMB Act establishes an order of priorities for the payment of Commonwealth expenditures "[i]n tune with Section 8, Article VI of the Constitution of the Commonwealth of Puerto Rico." 23 P.R. Laws Ann. §104(c). Any discussion of this order of priorities, including whether the payment of the Authority Bonds even falls within the scope of this statutory provision, is purely a matter of state law. It is up to the Commonwealth's courts to ensure that Commonwealth officials comply with said order of priorities, to the extent the same is even applicable to the creditor of a public corporation whose debt is not guaranteed by the Commonwealth.

plaintiff's theory, the Governor is powerless to order that revenues assigned to the Authorities be used to pay public debt unless all other available funds—including those necessary to pay the police and firemen, keep open schools and hospitals, and otherwise ensure the welfare of Puerto Rico's citizens—are insufficient to pay public bonds. See, e.g., id. ¶105 ("[T]he public debt could (and should) be paid from the resources used to pay these other 'expenses,' not from the Pledged Funds.").

This case is, in essence, a masked collection claim against three separate public corporations regarding defaults or potential defaults on payment obligations. However, instead of bringing a breach of contract or collection action, the bondholders' insurer has chosen to bring what amounts to two purported constitutional claims[6] against the Governor and other officers of the Commonwealth.

Plaintiff essentially seeks a declaration that there are other available resources from which public debt could be paid before using the Pledged Funds for this purpose, and that the order of payment priorities established subsequent to the issuance of the Executive Orders, in particular, the alleged failure to make available the Pledged Funds while making other payments, is at odds with the text of the OMB Act. It seeks a declaration that Art. VI, Section 8 of the Constitution of Puerto Rico has been improperly invoked and implemented, and an injunction prohibiting defendants from taking any action pursuant to the Executive Orders. In other words, plaintiff 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

[6] Plaintiffs' two purported constitutional claims are: (1) a claim for declaratory and injunctive relief for the alleged violation of the Contracts Clause of the Constitution of the United States; (2) a claim for declaratory and injunctive relief for the alleged violation of the Takings, Due Process and Equal Protection Clauses of the Constitution of the United States.

them. This relief is barred by Eleventh Amendment or sovereign immunity and the doctrine set forth in Pennhurst State Sch. & Hosp. v. Halderman, 465 U.S. 89 (1984).

In a desperate attempt to bootstrap federal jurisdiction to a clear state law question, plaintiff has gone as far as to allege that the very statutes on which it bases its claim—that payment of the Authority Bonds is entitled to priority over all government expenditures other than public debt—are, themselves, unconstitutional.

This Court need not heed plaintiff's request that it overhaul the Commonwealth's management of its fiscal affairs, because Section 903(1) is plainly inapplicable in this case.

## III. STANDARD OF REVIEW

Pursuant to Fed.R.Civ.P. 12(b)(1) and (6), in lieu of an answer to a complaint, a party can raise as a defense that the Court lacks subject matter jurisdiction and that plaintiff has failed to state a claim upon which relief can be granted. "Motions brought under Rule 12(b)(1) are subject to the same standard of review as Rule 12(b)(6) motions." Igartua v. United States, 86 F. Supp. 3d 50, 53 (D.P.R. 2015).

Rule 12(b)(1) covers a variety of challenges to subject-matter jurisdiction, including "ripeness, mootness, sovereign immunity, and the existence of federal question jurisdiction." Valentín v. Hosp. Bella Vista, 254 F.3d 358, 363 (1st Cir. 2001). Federal courts are courts of limited jurisdiction, and "the party invoking federal jurisdiction bears the burden of establishing its existence." Steel Co. v. Citizens for a Better Env't, 523 U.S. 83, 104 (1998). The court also has "an obligation to inquire sua sponte into its own subject matter jurisdiction." McCulloch v. Vélez, 364 F.3d 1, 5 (1st Cir. 2004). The question of whether defendants are entitled to Eleventh Amendment or sovereign immunity is hence reviewed under Rule 12(b)(1). Questions regarding the preemptive effect of Section 903(1) are reviewed under Rule 12(b)(6). See Franklin

California Tax-Free Trust v. Puerto Rico, 85 F. Supp. 3d 577, 595 (D.P.R.) aff'd, 805 F.3d 322 (1st Cir. 2015) cert. granted, 136 S. Ct. 582 (2015).

"In deciding a motion to dismiss, the court must 'assume the truth of all well-pleaded facts in the complaint, drawing all reasonable inferences in the plaintiffs' favor." Fitzgerald v. Harris, 549 F.3d 46, 52 (1st Cir. 2008) (citation omitted). However, although it must accept well-pleaded facts as true, the court is not required to accept a plaintiff's legal conclusions. Ashcroft v. Iqbal, 556 U.S. 662, 678 (2009) (noting "the tenet that a court must accept as true all of the allegations contained in a complaint is inapplicable to legal conclusions"); Maldonado v. Fontanes, 568 F.3d 263, 268 (1st Cir. 2009).

A complaint must be dismissed if the facts as pled do not state a claim for relief that is plausible on its face. See, Iqbal, 556 U.S. at 679 ("only a complaint that states a plausible claim for relief survives a motion to dismiss"); Bell Atl. Corp. v. Twombly, 550 U.S. 544, 561-62 (2007) (retiring the prior "unless it appears beyond doubt that the plaintiff can prove no set of facts" standard); Maldonado, 568 F.3d at 268 (quoting Iqbal, *supra*). In Twombly, the Supreme Court emphasized that a complaint "requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do." Twombly, 550 U.S. at 555. Factual allegations in a complaint "must be enough to raise a right to relief above the speculative level on the assumption that all the allegations in the complaint are true (even if doubtful in fact)." Id. (internal citations and emphasis omitted).

## IV. ARGUMENT

### A. Plaintiffs' claims are barred by the Eleventh Amendment and Pennhurst.

The Eleventh Amendment to the Constitution of the United States provides as follows:

> The judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by citizens of another state, or by citizens or subjects of any foreign state.

U.S. Const. amend. XI.

"The eleventh amendment, despite the absence of any express reference, pertains to Puerto Rico in the same manner, and to the same extent, as if Puerto Rico were a State." De León López v. Corporación Insular de Seguros, 931 F.2d 116, 121 (1st Cir. 1991). See also Consejo de Salud de la Comunidad de la Playa de Ponce, Inc. v. González–Feliciano, 695 F.3d 83, 103 n. 15 (1st Cir. 2012) ("This Circuit has consistently recognized that 'Puerto Rico enjoys the same immunity from suit that a State has under the Eleventh Amendment.'").[7]

It is well-settled that, pursuant to the landmark case of Ex parte Young, 209 U.S. 123 (1908), "the Eleventh Amendment does not prevent federal courts from granting prospective injunctive relief [against a state official in his or her official capacity] to prevent a continuing violation of federal law." Green v. Mansour, 474 U.S. 64, 68 (1985). However, in Pennhurst State Sch. & Hosp. v. Halderman, 465 U.S. 89 (1984) the Supreme Court found that the Ex parte Young exception to Eleventh Amendment immunity was inapplicable to suits against state officials on the basis of state law. 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

[7] As are plaintiffs (see Docket No. 1 at 39 n. 2), we are also mindful of the decision of the Supreme Court of Puerto Rico in Pueblo v. Sánchez Valle, 192 P.R. Dec. 594 (2015), and the question pending before the Supreme Court of the United States. See Puerto Rico v. Sánchez Valle, 136 S.Ct. 28 (2015) (No. 15-108). Nevertheless, unless and until the U.S. Supreme Court expresses a different view, the First Circuit cases regarding Eleventh Amendment immunity cited above are binding on this Court. See Díaz Morales v. Commonwealth of Puerto Rico, 2015 WL 4742512 at *11 (D.P.R. Aug. 11, 2015) (Gelpí, J.) ("To begin, the court notes that while the undersigned is mindful of the recent opinion of the Puerto Rico Supreme Court and gives it the utmost respect that it deserves, said court's decision in *Sánchez Valle* is not binding and does not constitute precedent for this court. Even if the court were to agree with that court's conclusion, it is the First Circuit that must revisit the issue and overrule itself, not the Puerto Rico Supreme Court. As such, although Plaintiff's claim—that Puerto Rico lacks the protection of sovereign immunity if it is no longer enjoys the dual sovereignty necessary for the application of the double jeopardy doctrine—is logically sound, the court must adhere to binding First Circuit precedent on this issue."). The appearing parties expressly reserve the right to assert additional rights and defenses, whether under federal or Commonwealth law, as a result of the Supreme Court's ruling in Sánchez Valle.

supreme authority of federal law. On the contrary, it is difficult to think of a greater intrusion on state sovereignty than when a federal court instructs state officials on how to conform their conduct to state law. Such a result conflicts directly with the principles of federalism that underlie the Eleventh Amendment. We conclude that *Young* and *Edelman* are inapplicable in a suit against state officials on the basis of state law."). See also Díaz-Fonseca v. Puerto Rico, 451 F.3d 13, 43 (1st Cir. 2006) ("[The Eleventh Amendment] does not allow injunctive relief against state officials for violation of state law..."); O'Brien v. Mass. Bay Transp. Auth., 162 F.3d 40, 44 (1st Cir. 1998) ("It is not the proper purview of a federal court to supervise state officials' compliance with state law.").

It has been held that the Pennhurst rationale applies equally to actions seeking injunctive as well as declaratory relief. S. Union Co. v. Lynch, 321 F. Supp. 2d 328, 334 (D.R.I. 2004); Tolman v. Finneran, 171 F.Supp.2d 31, 38 (D.Mass. 2001); Benning v. Bd. of Regents of Regency Universities, 928 F.2d 775, 778 (7th Cir. 1991) (holding that a declaratory judgment by a federal court based on state law would constitute "an end-run around *Pennhurst* that is equally forbidden by the Eleventh Amendment.").

Plaintiff alleges that it has a right to or property interest in certain revenues (the "Pledged Funds") pledged to secure the payment of the Authority Bonds. Plaintiff claims that the Executive Orders impair plaintiff's contractual rights to the Pledged Funds and/or they constitute a misappropriation or taking of plaintiff's property in violation of its constitutional rights. See Docket No. 1 at ¶¶ 4-7.

Plaintiff's attempt to shoehorn its suit into the narrow Ex Parte Young exception fails. While plaintiff has couched its allegations in federal terms, whether a claim is barred by the Eleventh Amendment does not turn on a plaintiff's ability to artfully frame it in constitutional

language. See Idaho v. Coeur d'Alene Tribe of Idaho, 521 U.S. 261, 270 (1997) ("The real interests served by the Eleventh Amendment are not to be sacrificed to elementary mechanics of captions and pleading."). Instead, "[t]he nature of a suit . . . is to be determined by the essential nature and effect of the proceeding." Id. at 277 (quoting Ford Motor Co. v. Dep't of Treasury of Ind., 323 U.S. 459, 464 (1945)). This Court should determine the "essential nature and effect" of the case by "judg[ing] the award actually [sought] in this case[.]" Coeur d'Alene, 521 U.S. at 278.

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. See Díaz-Fonseca v. Puerto Rico, 451 F.3d 13, 43 (1sr Cir. 2006) (holding that the Eleventh Amendment "does not allow injunctive relief against state officials for violation of *state law*"). Plaintiff's Complaint contains a detailed discussion of the statutory structure establishing the Authorities and assigning revenues to them. See Docket No. 1 at ¶¶ 35-36, 38-39, 41-42. It then proceeds to a lengthy, flawed interpretation of the Commonwealth Constitution, the OMB Act, and the statutes permitting the use of revenues assigned to the Authorities to pay public debt, which plaintiff wrongly insists together establish an "Authority Bond Priority" second only to public debt. Id. at ¶¶ 45-59; 94-102. Plaintiff's Complaint is mostly devoted to challenging the Executive Orders as violations of the "Authority Bond Priority" plaintiff incorrectly derives from Puerto Rican law. The complaint thus makes clear that this is a suit "against [Commonwealth] officials on the basis of [Commonwealth] law." Pennhurst, 465 U.S. at 106.

The Eleventh Amendment bars suit where, as here, a plaintiff asks "the federal court to make pronouncements on the lawfulness of the Commonwealth and its officials' conduct with

respect to the Commonwealth's own law" or asks "a federal court to direct Commonwealth officials to comply with that law." Díaz-Fonseca, 451 F.3d at 43. Recognition of the defendants' sovereign immunity under the Eleventh Amendment is particularly important here, where the suit seeks an "injunction, indirectly, to compel the specific performance of [a] contract, by forbidding all those acts and doings which [the plaintiff alleges] would constitute breaches of the contract[.]" Ex parte Ayers, 123 U.S. 443, 502 (1887).

As a threshold matter, and as a matter of law, two things must be noted. First, the relevant bonds do not constitute general obligations of the Commonwealth. In other words, the Commonwealth is not plaintiff's debtor (assuming plaintiff has any standing, which is denied). On the other hand, pursuant to the express terms of the enabling acts that empowered the Authorities to issue bonds, payment of said bonds is subject to the availability of resources pursuant to Art. VI, Section 8 of the Constitution of Puerto Rico.

**1. PRHTA**

Plaintiff alleges that PRHTA issued certain bonds (the "PRHTA Bonds") pursuant to PRHTA's Enabling Act (see 9 P.R. Laws Ann. §2004(l)) and certain Resolutions (the "PRHTA Resolutions") executed in 1968 and 1998. Docket No. 1 at ¶ 34. As of the filing of the Complaint, PRHTA had not defaulted in the payment of principal or interest on the PRHTA Bonds, and there is no allegation in this regard in the Complaint. Plaintiff alleges that it has suffered an injury in fact because, pursuant to the Executive Orders, pledged funds that serve as security for the relevant bonds were allegedly diverted to other uses. Docket No. 1 at ¶ 30. Plaintiff admits that, to date, the only payment default that has taken place involves PRIFA, not the PRHTA. Id. In other words, plaintiff's claim involving the PRHTA bonds revolves around

the possibility that there may be a default in the payment of said bonds and that said default may be insured by it.

Plaintiff alleges that the PRHTA bonds are secured by liens on revenues derived from tolls and excise taxes collected pursuant to PR Act 34-1997, Act 1-2011 and Act 1-2015; and from vehicle license fees imposed under Act 22-2000. Regardless of whether plaintiff has a property interest in these funds, the availability of the same is expressly subject to the availability of funds pursuant to Art. VI, Section 8 of the Constitution Puerto Rico.

PRHTA is empowered to issue bonds pursuant to its enabling act, PR Act 74-1965. Section 12 of said Act provides in its relevant part as follows: "The bonds issued by the Authority under this provision shall not encumber its credit margin nor constitute a debt of the Commonwealth of Puerto Rico, nor of any of its political subdivisions, which shall not be liable therefor." 9 P.R. Laws Ann. §2012. In other words, any bonds issued by PRHTA are not general obligations of the Commonwealth and the Commonwealth is not liable for any default of PRHTA.

In its Complaint, plaintiff relies on Section 19 of Act 74-1965 in support of its claims. Docket No. 1 at ¶36. Said section provides in its entirety as follows:

> The Commonwealth Government does hereby pledge to, and agree with, any person, firm or corporation, or any federal, commonwealth or state agency, subscribing to or acquiring bonds of the Authority to finance in whole or in part any traffic facilities or any part thereof, that it will not limit or restrict the rights or powers hereby vested in the Authority until all such bonds at any time issued, together with the interest thereon, are fully met and discharged.

9 P.R. Laws Ann. §2019.

The statute cited above does not create a payment obligation on the part of the Commonwealth. Such a conclusion would be at odds with Section 12 of PRHTA's enabling act, *supra*. It must also be read in conjunction with other statutes cited below, which subject any

Pledged Funds to availability pursuant to the Constitution of Puerto Rico. The Commonwealth has not amended or repealed any of the statutes regarding the Pledged Funds or the capacity of PRHTA to issue bonds. There has been absolutely no legislative action on the part of the Commonwealth regarding the Pledged Funds and no action has been taken that could be at odds with the statutory provision cited above. EO 2015-46, challenged by plaintiff, simply declares that at present there are not enough resources to satisfy the Commonwealth's obligations, as per Art. VI, Section 8 of the Constitution. Assuming for purposes of this motion that plaintiff has a right or interest in the Pledged Funds, the statutes purportedly creating such a right remain intact. The issue is simply one of availability of funds pursuant to state law. The same holds true with regards to the PRCCDA and PRIFA Bonds, whose enabling acts contain similar provisions. See 23 P.R. Laws Ann. §6450 and 3 P.R. Laws Ann. §1913, respectively.

All of the alleged PRHTA Pledged Funds are subject to availability, as per the very statutes relied on by plaintiff. PR Act 34-1997, cited in plaintiff' Complaint, amended Section 2084 of Puerto Rico's Internal Revenue Code of 1994, Act 120-1994. In 2011 the Commonwealth enacted the current Internal Revenue Code of Puerto Rico, Act 1-2011, which in effect repealed Act 120-1994 and hence Act. 34-1997. See 13 P.R. Laws Ann §9084.

Section 3060.11(a)(1)(C) of Puerto Rico's Internal Revenue Code, Act 1-2011, which in part substituted Section 2084 of the previous version of the Code, *supra*, provides in its relevant part as follows:

> The Highways and Transportation Authority is hereby authorized to commit or pledge the proceeds of the collection thus received on gasoline and the tax of four cents (4¢) on gas oil or diesel oil fixed in § 31626 of this title and the amount appropriated by virtue of this Subtitle of the excise tax on crude oil, partially finished and finished oil by-products, and any other mixture of hydrocarbons fixed in § 31627 of this title, for the payment of the principal and the interest on bonds or other obligations or for any other legal purpose of the Authority. **Said**

> **commitment or pledge shall be subject to the provisions of Section 8 of Item VI of the Constitution of the Commonwealth of Puerto Rico**.

13 P.R. Laws Ann. §31751(a)(1)(C) (emphasis added).

Act 1-2015 amended Section 3060.11 of the PR Internal Revenue Code, but left intact the provision cited above. Other statutory provisions in Section 3060.11 also make express reference to Article VI, Section 8 of the Constitution of Puerto Rico. See 13 P.R. Laws Ann. §31751(a)(1)(E)-(G).

Section 24.01 of Act 22-2000 provides in its relevant part as follows:

> The Authority is hereby authorized to commit or pledge the product of the collection received for the payment of the principal and interest on bonds or other obligations or for any other lawful purpose of the Authority. **Said commitment or pledge shall be subject to the provisions of Section 8 of Article VI of the Constitution of Puerto Rico**. The product of said collection shall be used solely for the payment of the interest and amortization of the public debt, as provided in said Section 8 of Article VI of the Constitution, until the other available resources referred to in said section are insufficient for such a purpose. Otherwise, the product of such a collection, in the amount that may be necessary, shall be used solely to pay the principal and interest on the bonds and other obligations of the Authority and to comply with any other stipulations agreed to by the latter with the holders of said bonds or other obligations.

9 P.R. Laws Ann. §5681 (emphasis added).

Finally, Section 3 of PR Act 9-1982 provides as follows:

> The total proceeds of the fifteen-dollar ($15) increase in the fees to be paid for public and private automobile licenses shall be covered into a Special Deposit in behalf and for the benefit of the Highways and Transportation Authority of Puerto Rico, to be used by the Authority for its corporate purposes. Said Authority is hereby authorized to pledge or pignorate the proceeds of the collection thus received, to the payment of the principal and interest on bonds and other obligations of the Authority, or for any other legal purpose of the Authority; and said pledge or pignoration **shall be subject to the provisions of § 8 of Article VI of the Constitution of Puerto Rico**…

9 P.R. Laws Ann. §2021 (emphasis added).

**2. PRCCDA**

Plaintiff alleges that PRCCDA issued certain bonds (the "PRCCDA Bonds") pursuant to PRCCDA's Enabling Act (see 23 P.R. Laws Ann. §2004(l)) and a Trust Agreement dated March 24, 2006 (the "PRCCDA Trust Agreement"). Docket No. 1 at ¶ 38. As in the case of the PRHTA Bonds, plaintiff has not alleged that PRCCDA has incurred in a payment default and its standing is allegedly premised on third-party beneficiary rights. Plaintiff's claim involving the PRCCDA bonds revolves around the possibility that there may be a default in the payment of said bonds and that said default may be insured by it.

Plaintiff alleges that the PRCCDA bonds are secured by a lien on certain hotel occupancy taxes imposed by the Commonwealth and collected by the Puerto Rico Tourism Company pursuant to the Hotel Tax Act, PR Act 272-2003. Docket No. 1 at ¶ 39. As in the case of PRHTA, with regards to the PRCCDA Bonds and the alleged Pledged Funds securing the same: (1) the Commonwealth is not the bondholders' debtor and does not guarantee the relevant bonds; and (2) the availability of the alleged Pledged Funds is expressly subject to the availability of funds pursuant to Art. VI, Section 8 of the Constitution of Puerto Rico.

Section 5.06 of PR Act 351-2000 provides as follows:

> The bonds issued by the Authority do not constitute a debt of the Government of the Commonwealth of Puerto Rico or any of its political subdivisions, and neither the Government of the Commonwealth of Puerto Rico nor any of its political subdivisions shall be liable for them, and said bonds shall be payable solely from those funds that have been set aside for their payment.
>
> The Authority shall not be deemed to be acting on behalf of, or that it has incurred any obligation to holders of any debt of the Government of the Commonwealth of Puerto Rico.

23 P.R. Laws Ann. §6446.

On the other hand, section 31(a)(4) of Act 272-2003 provides in its relevant part as follows:

> The Authority is hereby authorized, with the prior written consent of the Company, to pledge or otherwise encumber the revenues product of the fixed tax collected which is to be deposited in a special account as required by the first paragraph of this subsection, as security for the payment of the principal and interest on the bonds, notes or other obligations issued, assumed or incurred by the Authority, as described in the first paragraph of this subsection, or for the payment of its obligations under any bond related financing agreement, as described in said paragraph. **Such a pledge or obligation shall be subject to the provisions of Section 8 of Article VI of the Constitution of the Commonwealth of Puerto Rico**.

12 P.R. Laws Ann. §2271 (emphasis added).

**3. PRIFA**

Plaintiff alleges that PRIFA issued certain bonds (the "PRIFA Bonds") pursuant to PRIFA's Enabling Act (see 3 P.R. Laws Ann. §1906(l)) and a Trust Agreement dated October 1, 1988 (the "PRIFA Trust Agreement"). Docket No. 1 at ¶ 41. Plaintiff alleges that on January 1, 2016 it paid at least $6,393,666 of claims submitted under FGIC's insurance policy insuring certain of the defaulted PRIFA Bonds. Docket No. 1 at ¶ 43. However, plaintiff has not brought a collection action against PRIFA.

Plaintiff alleges that the PRIFA bonds are secured by a portion of a federal excise tax imposed on rum and other items produced in the Commonwealth and sold in the United States. Docket No. 1 at ¶ 42. As in the case of PRHTA and PRCCDA, with regards to the PRIFA Bonds and the alleged Pledged Funds securing the same: (1) the Commonwealth is not the bondholders' debtor and does not guarantee the relevant bonds; and (2) the availability of the alleged Pledged Funds is expressly subject to the availability of funds pursuant to Art. VI, Section 8 of the Constitution of Puerto Rico.

Section 11 of Act 44-1988 provides as follows:

> The bonds issued by the Authority shall not constitute an indebtedness of the Commonwealth nor of any of its political subdivisions, and neither the Commonwealth nor any of its political subdivisions shall be liable therefor, and such bonds shall be payable solely out of those funds pledged for the payment thereof.
>
> The Authority shall not be deemed to be acting on behalf of or to have incurred any obligation to the holders of any indebtedness of the Commonwealth or any benefited entity or to third parties, even when the Authority has taken any action under this chapter which affects such benefited entity.

3 P.R. Laws Ann. §1910.

On the other hand, Section 8(a) of Act 44-1988, as amended, provides in part as follows:

> The bonds issued by the Authority may be payable from all or any part of the gross or net revenues and other income derived by the Authority which, **subject to the provisions of § 8 of Article VI of the Constitution of the Commonwealth of Puerto Rico**, may include the proceeds of any tax or other funds which may be made available to the Authority by the Commonwealth as provided in the trust agreement or resolution whereby the bonds are issued. The principal of, and interest on, the bonds issued by the Authority may be secured by a pledge of all or part of any of its revenues which, **subject to the provisions of § 8 of Article VI of the Constitution of the Commonwealth of Puerto Rico**, may include the proceeds of any tax or other funds which may be made available to the Authority by the Commonwealth, all as provided in the trust agreement or resolution under which the bonds are issued.

3 P.R. Laws Ann §1907 (emphasis added).

Plaintiff alleges that PRIFA has defaulted on its bonds by missing approximately $36 million in interest payments, which in turn required plaintiffs to pay at least $6,393,666 in claims to PRIFA bondholders. Docket No. 1 at ¶117. Plaintiff alleges no other defaults on any Authority Bonds, although it speculates that further defaults are "inevitable." Id.

Plaintiff does not name PRIFA as a defendant. If it did, it would be required to sue in Commonwealth court. See, e.g., PRIFA 2006 special tax revenue bond at p.p. 27-28, available at http://www.bgfpr.com/pdfs/affiliates/PRIFA-OS-Sept192006.pdf (requiring that suit on disclosure covenants be instituted in a Commonwealth court in San Juan). Moreover, the named

defendants are immune from any such claim for breach. See, e.g., Puerto Rico Infrastructure Financing Act, 3 P.R. Laws Ann. § 1910.

This is an action concerning a breach of contract where neither party to the contract is involved in the suit. Rather than bringing a breach of contract claim, plaintiff instead couched its grievance in federal constitutional terms, asserting causes of action under the Contract, Takings, Due Process and Equal Protection Clauses of the United States Constitution. Notwithstanding the Complaint's federal veneer, this case is in fact about the proper interpretation of the laws of Puerto Rico. What plaintiff seeks, improperly, is a ruling from a federal court that Puerto Rican officials have acted contrary to Puerto Rico law. Under the Eleventh Amendment a federal court cannot issue such a ruling.

**B. Plaintiff's request for declaratory and injunctive relief involves an order requiring state officials to comply with state law.**

In its Complaint, plaintiff admits that the availability of the Pledged Funds is subject to the provisions of Art. VI, Section 8 of the Constitution of Puerto Rico, which, according to plaintiff itself, establishes a priority for the payment of public debt when there is a shortfall for a fiscal year. See Docket No. 1 at ¶¶ 6 and 51. As shown above, it is clear, as a matter of law, that the Authority Bonds are not public debt or an obligation of the Commonwealth.

As per plaintiff's own Complaint, the Constitution of Puerto Rico requires that, once Article VI, Section 8 is invoked and the public debt is paid, all other disbursements be paid "in accordance with the order of priorities established by law." Id. at ¶ 52. Said order of priorities is set forth in Section 4(c) of the OMB Act, 23 P.R. Laws Ann. §104(c). Plaintiff alleges that pursuant to the Commonwealth Constitution, the OMB Act and the laws under which the Authority Bonds have been issued, the Commonwealth is required to pay the Authorities'

bondholders prior to paying all other Commonwealth general expenditures. See Docket No. 1 at ¶¶ 59 and 97.

Plaintiff argues that since the projected resources available for the current fiscal year (approximately $9.0 billion according to plaintiff) vastly exceed debt service on the public debt ($1.87 billion according to plaintiff) there are clearly enough resources to pay the Authority Bonds, which according to plaintiff enjoy a second order of priority after the payment of public debt. Docket No. 1 at ¶ 134. Plaintiff claims that in making budgetary adjustments "the Governor should have complied with the 'priority guidelines' set forth in Section 4(c) of the OMB Act by first reducing the amounts allocated to the lowest priority items, such as commitments contracted by the Commonwealth under special appropriations and the construction of capital works." Id. at ¶133. In other words, plaintiff is claiming that the Governor of Puerto Rico has failed to comply with Puerto Rico law by failing to pay the bondholders before making other disbursements, and is requesting that the Governor and other government officials be enjoined from proceeding in such a manner in conducting the Commonwealth's affairs. Regardless of the merits of these legal arguments, which the appearing defendants reserve the right to contest, what plaintiff is requesting is clearly an injunction requiring state officials to comply with state law. This is precisely the relief barred by Pennhurst.[8]

In order to avoid this result and bootstrap federal jurisdiction where there is none, plaintiff has alleged that it has a right or property interest in the Pledged Funds and that the Commonwealth's actions, **in alleged violation of Commonwealth law**, have deprived plaintiff of these rights. However, assuming for purposes of this motion that plaintiff has such a right or

[8] Notably, if plaintiff were to be correct in its interpretation of Commonwealth law, its own argument negates the existence of any irreparable harm or any urgency in the resolution of this matter. If every single cent in the Commonwealth's coffers not destined for the payment of public debt should inure to the benefit of the Authorities' bondholders prior to the payment of any other Commonwealth expenditures, then in any fiscal year there will always be funds available for debt service on the Authority Bonds.

property interest, which the appearing defendants reserve the right to contest, no state action has been taken in violation of such purported rights. The issue in this case is simply one of priority of payment under Commonwealth law, as plaintiff concedes that the availability of the Pledged Funds is subject to the availability of resources pursuant to Art. VI, Section 8 of the Constitution of Puerto Rico.

To date there has been no legislative action taken regarding the Authority Bonds, the enabling acts empowering the Authorities to issue the same, or the statutes providing the amount or scope of Pledged Funds that allegedly serve as collateral for said bonds. See, for example, Futura Dev. of Puerto Rico v. Estado Libre Asociado De Puerto Rico, 276 F. Supp. 2d 228, 241 (D.P.R. 2003) ("The Contract Clause prevents the impairment of obligations only by legislative action.") (citing Rooker v. Fidelity Trust Co., 261 U.S. 114, 118, 43 S.Ct. 288, 67 L.Ed. 556 (1923)). To the extent plaintiff has a right to the Pledged Funds (which is denied) said right is still intact.

The agreements and resolutions providing for the issuance and payment of the relevant bonds have not been altered, modified or amended. To the extent plaintiff has standing to seek enforcement of the relevant agreements (which is denied), it is free to commence judicial proceedings against the Authorities for breach of contract in the event there is any default or breach of the same. But a suit to enforce payment on the bonds would be a quintessential state law claim for damages, barred by the Eleventh Amendment if asserted in federal court. See, e.g., Papasan v. Allain, 478 U.S. 265, 278-79 (1986). This is simply not a scenario involving a claim under the Takings Clause. See, for example, Consumers Energy Co. v. United States, 84 Fed. Cl. 152, 155 (2008) ("where plaintiffs retain the full range of remedies associated with a cause of action for breach of contract, any breach of contract does not constitute a taking") (quoting

Castle v. United States, 301 F.3d 1328, 1342 (Fed.Cir. 2002) ("We agree with the Court of Federal Claims that the plaintiffs retained the full range of remedies associated with any contractual property right they possessed. Consequently, we hold that even assuming the enactment and enforcement of FIRREA breached a contract the government had with Castle and Harlan, it did not constitute a taking of the contract.").

By the same token, this is not a scenario involving the Due Process Clause, since plaintiff, to the extent it has standing and a property interest in the Pledged Funds (which is denied), has an adequate post-deprivation remedy, to wit, a breach of contract action. See Lujan v. G & G Fire Sprinklers, Inc., 532 U.S. 189, 196-197 (2001) (…respondent has not been denied any present entitlement. G & G has been deprived of payment that it contends it is owed under a contract, based on the State's determination that G & G failed to comply with the contract's terms. G & G has only a claim that it did comply with those terms and therefore that it is entitled to be paid in full. Though we assume for purposes of decision here that G & G has a property interest in its claim for payment, see supra, at 1450, it is an interest, unlike the interests discussed above, that can be fully protected by an ordinary breach-of-contract suit… **We hold that if California makes ordinary judicial process available to respondent for resolving its contractual dispute, that process is due process**.") (emphasis added). See also Ramírez v. Arlequín, 447 F.3d 19, 25 (1st Cir. 2006) ("A claim of breach of contract by a state actor without 'any indication or allegation that the state would refuse to remedy the plaintiffs' grievance should they demonstrate a breach of contract under state law," *Casey v. Depetrillo*, 697 F.2d 22, 23 (1st Cir.1983) (per curiam), does not state a claim for violation of the plaintiffs' right of procedural due process.").[9]

[9] It is unclear whether plaintiffs are attempting to state a procedural or a substantive due process claim. To the extent plaintiffs are attempting to make a substantive due process claim, such claim is subsumed by their takings claim. See

This is also clearly not a case involving Equal Protection concerns, which do not apply to individual determinations regarding government contracts. See, for example, Rivera Díaz v. Puerto Rico Tel. Co., 724 F. Supp. 1069, 1072 (D.P.R. 1989) (dismissing a claim that a government contract was terminated in violation of the Equal Protection Clause) ("The function of the equal protection clause 'is to measure the validity of classifications created by state laws'. *Parham v. Hughes*, 441 U.S. 347, 358, 99 S.Ct. 1742, 1749, 60 L.Ed.2d 269 (1979). The equal protection clause applies only to the making of classifications, not to the adjudication of individual situations. Nowak, Rotunda & Young, *Handbook on Constitutional Law*, West Publishing, 3d Ed., 1986 at p. 519. Plaintiff's equal protection challenge can succeed only if he shows the existence of a legislative classification not rationally related to a legitimate public end. *Murillo v. Bambrick*, 681 F.2d 898, 901 (3rd Cir.1982), *cert. denied*, 459 U.S. 1017, 103 S.Ct. 378, 74 L.Ed.2d 511 (1982). Plaintiff has failed to so state or allege and, consequently, no claim under the 14th Amendment has been stated. Therefore, said claim must be dismissed.").

Labels aside, there is no real federal issue here. See Gully v. First Nat'l Bank, 299 U.S. 109, 117 (1936) (finding no federal issue where "a finding upon evidence that the [state] law has been obeyed may compose the controversy altogether, leaving no room for a contention that the federal law has been infringed"). Federal jurisdiction is therefore lacking. Neo Gen Screening, Inc. v. New England Newborn Screening Program, 187 F.3d 24, 29 (1st Cir. 1999) (refusing to allow federal antitrust claims against state agency where the claim was that "the state official or agency was acting in excess of his (or its) authority under state law" because "the Supreme Court

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Graham v. Connor, 490 U.S. 386, 395 (1989); Parella v. Ret. Bd. of Rhode Island Employees' Ret. Sys., 173 F.3d 46, 58 (1st Cir. 1999); S. Cty. Sand & Gravel Co. v. Town of S. Kingstown, 160 F.3d 834, 835 (1st Cir. 1998) ("Because SCS's lament, at bottom, is a garden-variety regulatory takings claim, the Takings Clause, not substantive due process, would seem to supply the proper decisional framework.").

has made clear that the Eleventh Amendment is not to be avoided under *Ex Parte Young* merely to enforce state law").

In sum, plaintiff's stated constitutional claims are a pretext, and an excuse to attempt to bring a case to federal court when there is clearly no federal jurisdiction. Its request for injunctive relief is at its core a request for an order requiring the Government of Puerto Rico to comply with what plaintiff believes is the correct order of priority in the payment of Commonwealth expenditures. 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.

**C. Plaintiff's claims based on preemption fail as a matter of law**

Plaintiff argues that Article VI, Section 8 of the Constitution of Puerto Rico and the provisions of the OMB Act establishing an order of priorities in the payment of Commonwealth expenditures "when the available funds for a specific fiscal year are not sufficient to cover the appropriations approved for that year," 23 P.R. Laws Ann. §104(c) (collectively, the "Commonwealth Laws"), are unconstitutional because they are preempted by Section 903(1) of the Bankruptcy Code. In turn, plaintiff claims that the Executive Orders, which essentially invoke and implement the Commonwealth Laws, are unconstitutional and preempted as well.

The question of whether Section 903(1) may have preemptive effect on Puerto Rico laws is currently before the Supreme Court of the United States in the case of Puerto Rico v. Franklin California Tax-Free Trust, 136 S. Ct. 582 (2015) (No. 15-233). The Supreme Court has issued a

writ of *certiorari* to review a decision of the First Circuit Court of Appeals that held that Puerto Rico's Recovery Act, approved in June of 2014, was preempted by Section 903(1). See Franklin California Tax-Free Trust v. Puerto Rico, 805 F.3d 322, 325 (1st Cir.) cert. granted, 136 S. Ct. 582 (2015). In that case, there was no dispute about the fact that the Recovery Act came within the ambit of Section 903(1), inasmuch as it prescribed a nonconsensual method of composition of indebtedness of public corporations. The issue was whether Section 903(1) had any preemptive effect on Puerto Rico laws, given that Puerto Rico municipalities and public corporations are not afforded the protections of Chapter 9 of the Bankruptcy Code. See 11 U.S.C. §101(52). The First Circuit concluded that although Puerto Rico municipalities are "expressly (though indirectly) forbidden from filing under Chapter 9 absent further congressional action," Franklin, 805 F.3d at 331, Puerto Rico may not enact its own laws involving the nonconsensual composition of indebtedness of its municipalities. Id. at 334.

The appearing defendants, some of whom are parties in the Franklin case, respectfully disagree with the conclusion of the First Circuit, and incorporate by reference the arguments raised before the Supreme Court in Case No. 15-233, as if fully stated herein.[10] Since that case is *sub judice* and the final determination of the Supreme Court will be binding on the parties and this Court, it is unnecessary to overburden the Court by reiterating all of the arguments raised before the High Court. In any event, as will be shown below, even if Section 903(1) applies in Puerto Rico, it simply does not apply in this case.

**1. Section 903(1) does not apply to a State's management of its own fiscal affairs.**

Section 903 of the Bankruptcy Code provides as follows:

[10] See http://www.americanbar.org/content/dam/aba/publications/supreme_court_preview/briefs_2015_2016/15-233_pet2.authcheckdam.pdf

> 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; and
> (2) a judgment entered under such a law may not bind a creditor that does not consent to such composition.

11 U.S.C. §903.

Assuming for purposes of this argument that Section 903(1) may preempt Puerto Rican laws (which is denied), said preemptive effect is limited to "a State law prescribing a method of composition of indebtedness of [a] municipality." 11 U.S.C. §903(1). Section 903(1) says nothing about a State's management of its **own** finances. Nor could it; otherwise, it would intrude into matters of a State's sovereignty. See, e.g., In re Cty. of Orange, 179 B.R. 185, 191 n. 11 (Bankr. C.D. Cal. 1995) ("The purpose of this provision is to remove any inference that Chapter 9 does anything more than provide a method for municipalities to adjust their indebtedness.").

A State itself, as opposed to its municipalities, is not covered by Chapter 9 of the Bankruptcy Code. States themselves cannot be debtors under Chapter 9 of the Code and are not subject to its provisions. See, for example, 11 U.S.C. §109(c)(1); see also 11 U.S.C. §101(40) (defining "municipality" as a "political subdivision or public agency or instrumentality of a State."). Plaintiff does not deny this reality. See Docket No. 1 at ¶70 ("Only a 'municipality,' as defined by the Bankruptcy Code, may be a debtor under Chapter 9"). Any contrary result would raise serious questions about the constitutionality of Section 903. Against this backdrop, any action of the Commonwealth pursuant to the Commonwealth Laws involves the

Commonwealth's management of its own finances and is not preempted by Section 903(1), regardless of whether said statutory provision applies in Puerto Rico.

As alleged by plaintiff itself, Article VI, Section 8 of the Constitution of Puerto Rico provides that if revenues are insufficient in a fiscal year, **the Commonwealth** is required to pay the public debt first (Docket No. 1 at ¶51) and then **the Commonwealth** is required to make other disbursements "in accordance with the order of priorities established by law." Id. at ¶52. The order of priorities to be followed by the Commonwealth in the event of a shortfall in a fiscal year is prescribed by Section 4(c) of the OMB Act. Id. at ¶53.

Section 4(c) of the OMB Act provides in part as follows: "In tune with Section 8, Article VI of the Constitution of the Commonwealth of Puerto Rico, [the Governor] shall act according to the following priority guidelines for the disbursement of public funds, when the available funds for a specific fiscal year are not sufficient to cover the appropriations approved for that year." 23 P.R. Laws Ann. §104(c). As per their express terms, the Commonwealth Laws provide an order or priority of payment **by the Commonwealth** of its own debts in the event of a shortfall in the budget of a particular fiscal year. In other words, the Commonwealth Laws address the Commonwealth's management of its own finances, not a method of composition of indebtedness of a municipality or public corporation. As such, the Commonwealth Laws are not within the purview of Section 903(1).

Hence, in this case there is not only no field or express preemption, but also no conflict preemption, inasmuch as a State statute that deals with a State's management of its own finances is expressly excluded from the preemptive effect of Section 903(1). See United States v. Bekins, 304 U.S. 27, 51 (1938) (discussing the precursor to Section 903(1)) ("The statute is carefully drawn so as not to impinge upon the sovereignty of the State. The State retains control of its

fiscal affairs."). The subject Commonwealth Laws do nothing more than address the order of priority of Commonwealth expenditures in the event of a shortfall in a given fiscal year. They are absolutely necessary and intrinsically tied to the management of the Commonwealth's fiscal affairs. They are clearly not preempted by Section 903(1), regardless of the applicability of said statutory provision in Puerto Rico.

**2. The Commonwealth Laws are not a "method of composition of indebtedness."**

Section 903(1) preempts "a State law prescribing a method of composition of indebtedness of [a] municipality" when the creditor does not consent to such composition. "Composition" is a term that has existed for decades, even prior to the enactment of bankruptcy law. "Under non-bankruptcy law, a debtor could agree with some (at least two) or all of her creditors to pay less than all of her debt in satisfaction of her full indebtedness. This was the common law composition under which the agreement of the other creditors to take less than owed was the consideration for each creditor's releasing the debtor for less than payment in full." Richard E. Coulson, Consumer Abuse of Bankruptcy: An Evolving Philosophy of Debtor Qualification for Bankruptcy Discharge, 62 Alb. L. Rev. 467, 487 (1998). In Franklin, relied on by plaintiff, this Court defined a "composition" as an "agreement between a debtor and two or more creditors for the adjustment or discharge of an obligation for some lesser amount." Franklin, 85 F. Supp. at 597; Docket No. 1 at ¶ 78. See also Fed. Deposit Ins. Corp. v. Juron, 713 F. Supp. 1116, 1120 (N.D. Ill. 1989) ("A composition is an agreement between a debtor and several of his creditors in which the creditors agree to accept payment of a sum less than the debts owing to them in full settlement of their respective claims.").

Regardless of the applicability of Section 903(1) in Puerto Rico, the Commonwealth Laws do not establish a method of composition of indebtedness. Art. VI, Section 8 of the

Constitution of Puerto Rico simply sets forth that in the event of a shortfall in a fiscal year public debt is to be paid first and the remaining disbursements shall be made in accordance with the order of priorities established by law. See Docket No. 1 at ¶¶50-51. Said order of priority of payments is contained in Section 4(c) of the OMB Act, 23 P.R. Laws Ann. 104(c).

As explained above, plaintiff's complaint boils down to a disagreement as to the order in which the Commonwealth should pay its expenditures. The Executive Orders do not revoke or abridge any right plaintiff might have to the Pledged Funds. They simply invoke and implement the Constitution of Puerto Rico in the way prescribed by Puerto Rico law. Whether the order of payments provided by Puerto Rico law is being correctly implemented is purely a question of Puerto Rico law. Regardless of plaintiff's place in said order of payments (if it figures at all, which is denied), nothing in the OMB Act operates as "discharge" or a reduction in the payment of the Authority Bonds, nor does it relieve the Authorities of their payment obligations. Plaintiff's contract claims against the Authorities remain intact and they are free to file an action against the Authorities in the Commonwealth Courts. At most, the only potential result of the invocation and implementation of the Commonwealth Laws, through the Executive Orders, is a delay in the availability of the Pledged Funds due to the shortfall in the current fiscal year.

Plaintiff's Complaint alleges too much. In order to make it seem as if the Commonwealth Laws somehow create a "discharge" akin to a composition in a bankruptcy proceeding, plaintiff cites to portions of Section 4(d) of the OMB Act which state that "obligations corresponding to the postponed works shall be canceled for the purposes of the year which has been adjusted." Docket No. 1 at ¶ 58 (quoting 23 P.R. Laws Ann. §104(d)). The word "works" in this context ("obras" in the Spanish official text), clearly refers to postponed capital works and other improvements and not to cash or availability of funds. See, for example, 23 P.R. Laws Ann.

§104(c)(4). In any event, assuming the Pledged Funds are "works" for purposes of Section 104(d) of the OMB Act, the remainder of said section (as admitted by plaintiff) states that the postponed works "shall be entered into the books of the Secretary of the Treasury against the funds available for appropriation in subsequent years, through the corresponding warrant of appropriations." 23 P.R. Laws Ann. §104(d); Docket No. 1 at ¶ 58. Clearly, as plead by plaintiff itself, the implementation of the order of payment priorities established in the OMB Act does not operate as a composition or discharge of all or part of the Authorities' debts, but at most as a postponement or moratorium in the payment of those debts.

In Ropico, Inc. v. City of New York, 425 F. Supp. 970 (S.D.N.Y. 1976), New York City holders of the city's full faith and credit short-term notes challenged the New York State Emergency Moratorium Act for the City of New York. The Moratorium Act suspended payment of principal on notes coming due in 1975 and 1976 for three years and reduced the interest rate after maturity to six percent. The noteholders claimed, among other things, that the Moratorium Act constituted a "composition of indebtedness" pursuant to Section 83(i) of Chapter IX of the Bankruptcy Act, 11 U.S.C. §403(i), a precursor to the current Section 903(1). Id. at 978.

In rejecting this argument, the court in Ropico looked to bankruptcy jurisprudence distinguishing between a method of composition and an extension. In particular, the court relied on the Supreme Court case of Perry v. Commerce Loan Co., 383 U.S. 392 (1966), which expressly distinguished compositions from extensions in the following manner:

> Extension plans, therefore, differ materially from straight bankruptcy arrangements under Chapters XI and XII, and wage-earner plans by way of composition, all of which contemplate only a partial payment of the wage earner's debts. Indeed, under an extension plan, the wage earner who makes the required payments will have paid his debts in full and will not need a discharge, even though the Act provides for a formal one.

Id. at 398-399 (quoted in Ropico, 425 F.Supp. at 982).

The Ropico court held that the Moratorium Act did not violate the precursor to Section 903(1) by prescribing a state method of composition of indebtedness, since the statute merely provided for an extension. Ropico, 425 F.Supp. at 983. In concluding its opinion, the court in Ropico noted the serious constitutional implications of applying Section 903(1)'s precursor in a way that could infringe upon a State's sovereignty:

> In the area of municipal reorganizations the thin line between the federal bankruptcy power and state sovereignty has been particularly difficult to draw. Both Congress and the Supreme Court have thus been careful to stress that the federal municipal Bankruptcy Act is not in any way intended to infringe on the sovereign power of a state to control its political subdivisions; for as the Supreme Court held in the *Ashton* and *Bekins* cases, to the extent that the federal Bankruptcy Act does infringe on a state or a municipality's function it is unconstitutional.
>
> This challenge to the Moratorium Act in these cases raises significant problems in this respect. 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.

Id. at 983-984.

*A fortiori*, if the Moratorium Act, which suspended the payment of principal for three years and reduced the post-maturity interest rate was seen as an extension or moratorium and not as a composition, the fact that the disbursement of Pledged Funds may be delayed in light of a shortfall in the current fiscal year clearly is not the type of debt restructuring preempted by Section 903(1).

Moreover, plaintiff's theory—that any priority in the order of payment of Commonwealth expenditures is a composition—would do away with (1) the priority enjoyed by the Commonwealth's bondholders pursuant to the Constitution of Puerto Rico; (2) essential portions of the OMB Act ensuring the effective management and administration of the Government in a

time of fiscal crisis; and, perhaps most tellingly, (3) the very same statutes on which plaintiff relies to attempt to establish its own priority vis-a-vis other creditors of the Commonwealth and its instrumentalities. The Commonwealth Laws (i.e., the Constitution of Puerto Rico and the OMB Act) pre-date not only the bonds issued and purchased by some of plaintiff's insureds, but also some of the enabling acts of the issuing Authorities. This Court cannot indulge plaintiff's attempt 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 plaintiff relies in support of its claim. If plaintiff had its way, and this Court held that any law setting a priority of payment of government expenditures is a composition, there would be no priority at all, and no statute to guide the discretion of the Government in the payment of its expenditures. Such an overhaul of the Commonwealth's management of its affairs is impermissible and would result in an undue intrusion into Puerto Rico's sovereignty.

As an example, plaintiff's Complaint quotes several statutes in support of the argument that the Authority bondholders enjoy a super-priority second only to the payment of public debt. See Docket No. 1 at ¶ 98. Plaintiff claims that the statutes under which the Authority Bonds were issued create an "Authority Bond Priority" (id.), which allegedly is also reaffirmed in the disclosure documents issued by the Authorities as well as the offering documents for the Commonwealth's public debt. See id. at ¶¶ 99-100. If Art. VI, Section 8 of the Constitution of Puerto Rico, which establishes a priority in favor of public debt and mandates that other payments be made in accordance to law, and the OMB Act, which further establishes said constitutionally mandated order of expenditures, are both preempted by Section 903(1) and hence unconstitutional, then so are the statutes of the Authorities allegedly creating an

"Authority Bond Priority," and any bond document purportedly creating such a priority would be illegal, null and void.

**3. To the extent the Commonwealth Laws prescribe a preempted method of composition (which is denied), as a matter of law and plaintiff's own allegations, the bondholders consented to such composition.**

Assuming that Section 903(1) is somehow applicable to the relevant legal provisions involved in this case (which is denied), and that the same prescribe "a method of composition of indebtedness of [a] municipality" (which is denied), such a method of composition "may not bind any creditor **that does not consent to such composition**." 11 U.S.C. § 903(1) (emphasis added). However, in this case, to the extent any payment priorities established by the Commonwealth Laws are considered a composition, plaintiff's insureds consented to the same as a matter of law.

As detailed above, all of the statutes that enable the Authorities to issue bonds condition the issuance and payment of said bonds to the provisions of Article VI, Section 8 of the Constitution of Puerto Rico. See, for example, 13 P.R. Laws Ann. §31751(a)(1)(C); 13 P.R. Laws Ann. §31751(a)(1)(E)-(G); 9 P.R. Laws Ann. §5681; 9 P.R. Laws Ann. §2021; 23 P.R. Laws Ann. §6446; 12 P.R. Laws Ann. §2271; 3 P.R. Laws Ann §1907. Hence, to the extent the Puerto Rico Constitution establishes a method of composition that could conceivably be preempted by Section 903(1) (which is denied) plaintiff's insureds consented to the same.

As also noted above, the bond documents relied on by plaintiff itself in support of its Complaint expressly condition the availability of the Pledged Funds to the availability of resources pursuant to the Constitution of Puerto Rico. See Docket No. 1 at ¶¶ 99-100. Even if they did not make such an express reference, any agreement between the Authority bondholders and the Authorities must be subject to the enabling acts of the Authorities and the statutes cited

above. Otherwise, the same would be null and void pursuant to Puerto Rico law. See Art. 1207 of the Civil Code of Puerto Rico, 31 P.R. Laws Ann. §3372 ("The contracting parties may make the agreement and establish the clauses and conditions which they may deem advisable, provided they are not in contravention of law, morals, or public order.").

Any investment comes with risks, and the Authority bondholders' investments is, as a matter of law, clearly subject to the availability of funds or resources pursuant to Art. VI, Section 8 of the Constitution of Puerto Rico and the Commonwealth laws enacted pursuant to that section. Hence, even if said constitutional provision establishes a method of composition, the same was consented to by plaintiff's purported insureds and is not preempted.

Art. VI, Section 8 of the Constitution of Puerto Rico expressly refers to Puerto Rico law (the OMB Act) for its implementation. The subject Executive Orders invoke the relevant constitutional provision and implement the same through the OMB Act. This statutory scheme was consented to by plaintiff's purported insureds. Once again, the issue here is about a disagreement as to how this statutory scheme is being implemented, not about the legality of the statutes providing for the same. This is purely a matter of state law and not a preemption issue. Plaintiff cannot simply ignore that its insureds purchased bonds whose source of repayment was expressly conditioned to the availability of funds or resources pursuant to the Commonwealth Laws.

**4. In the alternative, this Court should stay its decision regarding plaintiff's preemption claims until the resolution of the case of Puerto Rico v. Franklin California Tax-Free Trust, 136 S. Ct. 582 (2015) (No. 15-233), pending before the Supreme Court.**

Finally, if this Court were to harbor any doubt on any of the foregoing preemption issues, the proper course would be to wait until the Supreme Court decides the pending Franklin

California case, which is scheduled for oral argument on March 22, and should be decided no later than the end of June.

Indeed, "[a] district court ordinarily has discretion to delay proceedings when a higher court will issue a decision that may affect the outcome of the pending case." White v. Ally Fin. Inc., 969 F. Supp. 2d 451, 461-62 (S.D.W. Va. 2013) (citations omitted). See also Hickey v. Baxter, 833 F.2d 1005 (4th Cir. 1987) (unpublished table decision) ("We find that the district court acted within its discretion in staying proceedings while awaiting guidance from the Supreme Court in a case that could decide relevant issues."); Kelley v. Metro. Cnty. Bd. of Educ., 436 F.2d 856, 863 (6th Cir.1970) (Celebrezze, J. concurring in part and dissenting in part).

**WHEREFORE**, the appearing defendants respectfully request that the Court dismiss plaintiff's Complaint. In the alternative, the appearing defendants request that the Court dismiss plaintiff's third through sixth alleged causes of action (Docket No. 1 at 48-51) and postpone resolution of the remainder of the action until the final disposition of the case of Puerto Rico v. Franklin California Tax-Free Trust, 136 S. Ct. 582 (2015) (No. 15-233), pending before the Supreme Court.

**RESPECTFULLY SUBMITTED.**

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

In San Juan, Puerto Rico, this 10th day of February, 2016.

**ANTONETTI MONTALVO & RAMIREZ COLL**
P.O. Box 13128
San Juan, PR 00908
Tel: (787) 977-0303
Fax: (787) 977-0323

**s/ Salvador Antonetti-Zequeira**
SALVADOR ANTONETTI-ZEQUEIRA
USDC-PR No. 113910
santonet@amrclaw.com

**s/ José L. Ramírez-Coll**
JOSÉ L. RAMÍREZ-COLL
USDC-PR No. 221702
jramirez@amrclaw.com