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More Cautionary Tales in Puerto Rico's Restructuring

*By Laura E. Appleby, James Heiser, and Aaron M. Krieger**

This article discusses a recent district court decision finding that bondholders holding approximately \$2.9 billion in debt issued by the Employees Retirement System of the Government of the Commonwealth of Puerto Rico were rendered unsecured due to inadequate financing statements.

A recent decision by the court overseeing the Commonwealth of Puerto Rico's bankruptcy-like Title III proceeding has reiterated what every secured creditor understands—perfection matters.¹ Due to perfection issues, the court found that bondholders holding approximately \$2.9 billion in debt issued by the Employees Retirement System of the Government of the Commonwealth of Puerto Rico (the “ERS”) were rendered unsecured due to inadequate financing statements. This case should be a lesson to secured creditors to ensure that their financing statements conform to the requirements of the Uniform Commercial Code (“UCC”). Step one for secured lenders should be to review their collateral package to ensure that all collateral is properly perfected and adequately described according to applicable law.

In the decision, the district court addressed the validity of the security for bonds issued by the ERS (the “ERS Bonds”) to find that the holders of the ERS Bonds (the “ERS Bondholders”) may in fact be unsecured, as the UCC financing statements and related continuation statements associated with the transaction did not contain a sufficient collateral description, the correct debtor name, and other relevant information, and therefore failed to perfect the ERS Bondholders' security interest.²

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¹ *In re Fin. Oversight & Mgmt. Bd. for Puerto Rico*, No. 17 BK 3283-LTS (D.P.R. Aug. 17, 2018) (the “ERS Security Decision”).

² By finding that the ERS Bondholders were unsecured creditors, the court may have limited the impact of a July 2018 decision by the U.S. Court of Federal Claims, which left open the

PUERTO RICO'S DEBT RESTRUCTURING PROCESS

Due to a serious and ongoing fiscal emergency in the Commonwealth, in 2016, Congress enacted PROMESA. In addition to establishing the Title III proceeding for the Commonwealth and its instrumentalities, PROMESA also required that an oversight board (the "Oversight Board") be established to develop a method for the Commonwealth to achieve fiscal responsibility and regain access to the capital markets. Among other things, PROMESA requires the Oversight Board to certify a fiscal plan for the Commonwealth and its instrumentalities.

On May 3, 2017, the Oversight Board commenced a debt restructuring proceeding on behalf of the Commonwealth by filing a petition in the district court under Title III of PROMESA. Shortly thereafter, the Oversight Board commenced Title III proceedings on behalf of certain Puerto Rican government instrumentalities, including ERS and PREPA.

THE DISTRICT COURT DECISION

In the decision, the court ruled in favor of ERS, and found that the ERS Bondholders' security interest was not properly perfected. At issue in the case was the application of the UCC. Under Puerto Rico law, the ERS Bondholders' security interest was required to be perfected by filing a financing statement under the Uniform Commercial Code on the secured transactions registry maintained in Puerto Rico.³ There were six relevant security filings—two in 2008 that utilized a basic UCC 1 financing statement form, and four amendments in 2015 and 2016.

The two financing statements filed in 2008 (the "2008 Financing Statements"), according to the court, failed to provide an adequate collateral description, and thus were insufficient to perfect the ERS Bondholders' interests. Specifically, the 2008 Financing Statements attached the bond resolution, which incorporated by reference the defined term "Pledged Property" from the underlying security agreement. The security agreement, however, was not attached to the 2008

potential that actions by the Oversight Board, as an entity of the federal government, to deprive secured creditors of their property interests under the Fifth Amendment of the U.S. Constitution could entitle those secured creditors to just compensation for the taking of their property by the Oversight Board. *Altair Global Credit Opportunities Fund (A), LLC, et al. v. The United States*, 138 Fed. Cl. 742 (Fed. Cl. July 13, 2018).

³ The Puerto Rico UCC does not except governmental units from its perfection provisions, unless the Puerto Rico constitution or a Puerto Rico statute expressly governs the creation, perfection, priority, or enforcement of a security interest. 19 L.P.R.A. § 2219(c).

Financing Statement. Due to this failure, the court found that the 2008 Financing Statements failed to perfect the ERS Bondholders' security interest when they were filed because the 2008 Financing Statements did not include the definition of "Pledged Property."

The court then determined that the amendments to the 2008 Financing Statements filed in 2015 and 2016 (the "Amendments") were also insufficient to perfect the ERS Bondholders' security interest. Although the Amendments potentially could have cured the defective collateral description contained in the 2008 Financing Statements, the Amendments failed to include the debtor's official name, which had been changed in 2013.

Thus, the district court found in favor of ERS, holding that none of these filings were sufficient to perfect the ERS Bondholders' claimed security interest because: (i) the original filings did not adequately describe the collateral as the nature of the collateral was not described in any part of the filing, and the filed material did not point to any other materials on file with the Department of State that identified the collateral (stating only that it was undefined "Pledged Property"),⁴ and (ii) the later UCC-3 amendment filings were insufficient to cure the defects in the 2008 UCC-1 filings because the later filings did not reference the official legal name of the debtor entity, which had been changed in the interim.⁵

Through the adversary proceeding, ERS invoked Section 544(a) of the Bankruptcy Code, incorporated by Section 301 of PROMESA, which renders invalid and unenforceable an unperfected security interest. The district court specifically found that the requirements of Section 544 were satisfied because a hypothetical judgment lien creditor could have obtained a lien on ERS's assets as of the petition date, even if a creditor could not compel payment from ERS under Puerto Rico law.⁶ Thus, the ERS Bondholders were rendered unsecured creditors of ERS.

CONCLUSION

Taken as a whole, the ERS Security Decision serves as a cautionary tale to all secured lenders, and particularly those holding secured municipal debt, that they should consult counsel and confirm perfection at the first signs of distress. As noted by the court, to properly perfect a security interest, a financing

⁴ ERS Security Decision, *supra* note 1.

⁵ *Id.*

⁶ *Id.*

statement must include an adequate description of the property pledged and the legal name of the borrower.