

FIRST CIRCUIT INVALIDATES OVERSIGHT BOARD APPOINTMENTS, REFUSES TO DISMISS TITLE III PROCEEDINGS

On February 15, 2019, exactly one week prior to this conference, the First Circuit Court of Appeals held that the appointment of all members of the Financial Oversight and Management Board was unconstitutional. However, the Court stopped short of dismissing the Title III cases and gave 90 days for the Oversight Board to be reappointed or reconstituted in accordance with constitutional requirements.

Background

The First Circuit's decision arose out of a motion to dismiss the Title III proceedings filed several affiliates of Aurelius Capital Management (collectively, "Aurelius") which hold substantial interests in bonds issued by the Commonwealth and the Puerto Rico Highways and Transportation Authority. Aurelius argued that the Oversight Board lacked authority to initiate the Title III proceedings because its members were appointed in violation of the Appointments Clause, which requires certain presidential appointments to be made "by and with the advice and consent of the Senate." The district court, however, disagreed and held the Appointments Clause did not apply.

First Circuit Analysis

On appeal, the First Circuit applied a three step analysis to reverse the district court and hold that the Appointments Clause applied to the Oversight Board. First, it analyzed whether the Constitution's Territorial Clause, which grants Congress plenary power over U.S. territories, displaces the requirements of the Appointments Clause in unincorporated territories such as Puerto Rico. The district court had held this grant of plenary power obviated the need to comply with the requirements of the Appointments Clause, but the First Circuit disagreed. Applying the canon of legal interpretation "specific governs the general", the Court held that the Territorial Clause's general grant of authority over territories does not "extend to areas where the Constitution explicitly contemplates a particular subject, such as the appointment of federal officers. Nowhere does the Territorial Clause reference the subject matter of federal appointments or the process to effectuate them. On the other hand, federal officer appointments is the *raison d'être* of the Appointments Clause."

Second, the First Circuit found that Oversight Board members are "Officers of the United States" subject to the Appointments Clause by applying a three part test established by the Supreme Court. That test asks whether: (1) the appointee occupies a "continuing" position established by

federal law; (2) the appointee exercises significant authority; and (3) the significant authority is exercised pursuant to the laws of the United States.

The First Circuit held the Oversight Board members readily met these requirements. First, Oversight Board members occupy “continuing positions” under federal law, as PROMESA provides that their terms can extend beyond the initial three year appointments, and members can only be removed by the President for cause. Second, PROMESA grants Oversight Board members significant authority, including the right to initiate and prosecute the largest bankruptcy in the history of the U.S. municipal bond markets, the power to veto, rescind or revise Commonwealth laws deemed inconsistent with PROMESA (including the right to reject budgets) and their investigatory and enforcement powers exceed or are at least equal to judicial officers found to be “Officers of the United States” in Supreme Court precedent. Third, because Oversight Board members trace their authority directly and exclusively to a federal law, PROMESA, their authority is exercised “pursuant to the laws of the United States.”

The First Circuit then concluded that, because only the President can remove an Oversight Board member, Oversight Board members are “principal” officers of the United States whose appointment must be made by the President by and with the advice and consent of the Senate in accordance with the Appointments Clause.

First Circuit’s Remedy; Refusal to Dismiss Title III Proceedings

Despite invalidating the appointment of the Oversight Board members, the First Circuit stopped short of invalidating all of the Oversight Board’s actions to date and dismissing the Title III proceedings. The Court invoked the de factor officer doctrine, which “confers validity upon acts performed by a person acting under the color of official title even though it is later discovered that the legality of that person’s appointment to office is deficient,” and granted 90 days to allow the President and the Senate to validate the currently defective appointments or reconstitute the Oversight Board in accordance with the Appointments Clause, during which time the Oversight Board may continue operating as until now. In fashioning its remedy, the First Circuit noted that invalidating the Oversight Board’s actions would negatively impact the many, if not thousands, innocent third parties who have relied on the Oversight Board’s actions to now, as well as introducing additional delays into a restructuring process already impeded by the hurricanes that hit Puerto Rico in September 2017 and nullifying any progress made towards PROMESA’s aim of helping Puerto Rico “achieve fiscal responsibility and access to capital markets.”

OVERVIEW OF PROCEDURES GOVERNING THE CHALLENGED GO BOND OBJECTION

This piece provides an overview of the procedures that will be used to resolve an objection to more than \$6 billion dollars in general obligation bond claims against the Commonwealth based upon constitutional infirmities in the issuance of those bonds. Given the vast sums of money at stake and the thousands of claimants subject to the objection—none of whom were required to file a proof of claim—the debate over the scope of the objection procedures was particularly contentious. After motion practice and extensive negotiations among various stakeholders, the Court entered a procedures order that reflects the attempt to strike a balance between the twin goals of judicial economy and protection of due process rights.

Background

On January 14, 2019, the Financial Oversight and Management Board, acting through its Special Claims Committee, and the Official Committee of Unsecured Creditors of all Puerto Rico Title III Debtors (other than COFINA) (together, the “Objectors”) filed an objection to all claims that have been or may be asserted against the Title III debtors on account of general obligation bonds issued by the Commonwealth in or after March 2012 (“Challenged GO Bonds”), arguing that the Challenged GO Bonds were issued in violation of the Commonwealth’s constitutional debt service limit and that certain of the claims improperly contain unamortized original issue discount (the “Objection”). On that same day, the Objectors also filed a procedures motion “seeking to establish an orderly and efficient process for resolving” the Objection (the “Procedures Motion”).

Several objections to the Procedures Motion were filed by Challenged GO Bond claimholders, arguing that, among other things, (i) the noticing procedures in the Procedures Motion violated minimum due process standards and Bankruptcy Rule 3007, (ii) the Procedures Motion sought unnecessary information in violation of Bankruptcy Rule 2019 and improperly required Challenged GO Bond claimholders to disclose their substantive arguments against the Objection in order to opt into the claims objection process, (iii) the Procedures Motion improperly sought to treat Challenged GO Bond claimants differently based on whether they were listed in Appendix I to the Objection, (iv) the Procedures Motion improperly compelled respondents to the Objection to cooperate in drafting joint briefs on the merits and (v) the Procedures Motion improperly reserved the right of the Objectors to bring additional objections against the Challenged GO Bond claimholders.

Procedures Order

Following multiple objections, a reply brief from the Objectors, a hearing on the substance of the Procedures Motion and extensive post-hearing negotiations, the Court entered an order approving a negotiated set of procedures for resolving the Objection (such order, the “Procedures Order”). The procedures in the Procedures Order reflect the stakeholders’ and Court’s attempt to strike a balance between the twin goals of judicial economy and protection of due process rights and contain, among others, the following terms:

- *Notice.* Within 7 business days following entry of the Procedures Order, the claims agent will notify all beneficial holders of Challenged GO Bonds of the Objection and the objection procedures.
- *Challenged GO Bond Claimholders Must Opt-In to Objection Litigation.*
 - Within 60 days from entry of the Procedures Order (the “Participation Deadline”), any person holding a Challenged GO Bond that wishes to participate in the litigation of the Objection must serve by email and file a notice of intent to participate in such litigation (a “Notice of Participation”).
 - Notices of Participation shall: (a) indicate whether the person who filed the notice (a “Participant”) supports or opposes the Objection; (b) provide contact information for the Participant and its counsel; and (c) identify whether some or all of that Participant’s Challenged GO Bonds were purchased on the secondary market and, to the best of such Participant’s knowledge, the CUSIP numbers for the Challenged GO Bonds. Notices of Participation may also be filed by *ad hoc* groups and entitle each member of such *ad hoc* group to participate.
- *Effect of Failing to Opt-In.* Parties who do not file a Notice of Participation will not receive notices related to the litigation and may not be allowed to substantively participate in the litigation absent permission granted by the Court upon a showing of good cause. If the Court grants the Objection in whole or in part, recoveries on account of Challenged GO Bonds will be eliminated in whole or in part, and the holders of those claims will be forever barred from asserting claims against the Commonwealth, voting on any plan of adjustment filed in the Title III Case and from participating in any distribution in the Title III Case on claims arising from the Challenged Go Bonds.
- *Litigation Procedures.*
 - 21 days after the Participation Deadline (the “Initial Proposal Exchange Deadline”), the Participants supporting the Objection and the Participants opposing the Objection (the “Respondents”) will exchange proposals by

email setting forth the procedures that will govern litigation of the Objection.

- During the 21 days following the Initial Proposal Exchange Deadline, the Objectors and the Participants shall meet and confer and use reasonable efforts to develop a fully consensual recommendation with respect the Objection litigation procedures.
- 21 days following the Initial Proposal Exchange Deadline, the Objectors shall cause to be filed with the Court a recommendation concerning the Objection litigation procedures. The Objectors shall email a copy of such recommendation to the Participants at least 5 business prior to filing, and Respondents will have 7 days after the filing of the recommendation to file responses.
- *Litigant Coordination.* To the extent the Court determines that joint briefs can and should be submitted, the Respondents shall cooperate in good faith to file joint papers with respect to the litigation of the Objection and shall file separate papers only to the extent necessary to present or discuss issues, positions or arguments upon which they are unable to agree in good faith.
- *Reservation of Right to Bring Additional Claims.* The fact that the Objectors have objected to the Challenged GO Bond claims shall not preclude (i) the Objectors or any other party in interest from objecting to a Challenged GO Bond claim on any basis set forth in the Objection or to any other claim asserted by the Challenged GO Bond bondholder unrelated to the Challenged GO Bonds or (ii) a Title III Party from asserting additional grounds for objecting to the Challenged GO Bond claims pursuant to a Notice of Participation.