EMERGENCY REFINANCING: PUERTO RICO'S MUNICIPAL BONDS AND THE CONTRACT CLAUSE

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Abstract

This Note examines whether Puerto Rico's Act 91 is constitutional under the Contract Clause. Puerto Rico passed Act 91 to address its massive debt crisis. Specifically, Act 91 established the COFINA corporation to issue COFINA backed bonds to refinance Puerto Rico's outstanding General Obligation bond debt. Initially, this refinancing strategy appeared to work. But then, Puerto Rico's economy further collapsed, which prompted a legal dispute between these two sets of bondholders. The General Obligation bondholders assert, among other things, that Puerto Rico violated the Contract Clause when Puerto Rico established COFINA. This is because Puerto Rico already contractually committed the funds that back the COFINA bonds to the General Obligation bondholders. With this background, this Note makes two modest contributions. First, it seeks to inform legal decisions as to the constitutionality, under the Contract Clause, of the COFINA bonds. Second, because other U.S. municipalities, including Chicago, have established similar legal structures to refinance their outstanding bond debt, this Note will aid professionals who may engage in a similar Contract Clause analysis for another U.S. municipality. In making these two contributions, this Note describes the historical events that led Puerto Rico to amass its current debt and provides an overview of the Supreme Courts' Contract Clause Jurisprudence.

Resumen

Este escrito examina si le Ley 91 de Puerto Rico es constitucional al amparo de la Cláusula de Menoscabo de Obligaciones Contractuales (Cláusula de Menoscabo). Puerto Rico aprobó la Ley 91 para atender su crisis financiera masi-

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va. Específicamente, la Ley 91 establece la corporación COFINA para emitir bonos COFINA para refinanciar la deuda de Puerto Rico con los bonistas de obligación general (GO). Inicialmente, esta estrategia de refinanciamiento pareció funcionar. Pero luego, la economía de Puerto Rico continuó colapsando, lo cual ocasionó una disputa legal entre estos dos tipos de bonista. Los bonistas GO alegan, entre otras cosas, que Puerto Rico violentó la Cláusula de Menoscabo cuando estableció COFINA. Esto porque Puerto Rico había comprometido contractualmente los fondos de COFINA a los bonistas GO. Con este trasfondo, este escrito hace dos contribuciones humildes. Primero, busca informar decisiones legales sobre la constitucionalidad, al amparo de la Cláusula de Menoscabo, de los bonos COFINA. Segundo, porque otras municipalidades de los EE.UU., incluyendo Chicago, han establecido estructuras legales similares para refinanciar sus deudas a bonistas, este escrito ayudará a profesionales que pueden encontrarse en un análisis similar en cuanto a la Cláusula de Menoscabo en otras municipalidades de EE.UU. En hacer estas dos contribuciones, este escrito describe los eventos históricos que llevan a Puerto Rico a acumular su deuda actual y provee un resumen de la jurisprudencia del Tribunal Supremo de Estados Unidos en materia de la Cláusula de Menoscabo.

I. Introduction

Puerto Rico, an island of 3.5 million U.S. citizens, is nearing a humanitarian crisis.[1] This is in part due to its depressed economy and crippling debt,[2] which Hurricane Maria ("Maria") highlighted.[3] In the aftermath of Maria, Puerto Rico faced additional funding issues as the hurricane disrupted the economy, which is predicted to result in a $20- to $40-billion loss in economic output;[4] while "it could take $95 billion . . . to rebuild"[5] the island, as governor Ricardo Rosselló states.

Even before Maria, Puerto Rico's failing economy was evident.[6] Puerto Rico, before Maria, "had a failed economy, severe poverty, and massive debt crisis."[7] For example, Puerto Rico had a 45% poverty rate and an 11% unemployment rate.[8] In addition, more than 60% of its residents are on Medicaid.[9] This economic crisis, however, did not happen overnight.[10]

To meet its economic challenges, which started around 2000, Puerto Rico issued debt in the form of municipal bonds,[11] which led to more than $70 billion in outstanding debt.[12] Puerto Rico has amassed this staggering amount of debt in part

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[1] *See* James H. Carr, *Puerto Rico Deserves U.S. Assistance to Restructure Its Debt and Avoid a Humanitarian Crisis*, FORBES, (Oct. 27, 2017, 7:51 AM), https://www.forbes.com/sites/jameshcarr/2017/10/27/puerto-rico-deserves-u-s-assistance-to-restructure-its-debt-and-avoid-a-humanitarian-crisis/#715ba9441313.

[2] *See Id.*

[3] *See* Daniela Hernandez & Arian Campo-Flores, *Puerto Rican Business Struggle to Restart with Little Power After Hurricane Maria*, WALL ST. J., (Oct. 14, 2017, 7:00 AM), https://www.wsj.com/articles/puerto-rican-businesses-struggle-to-restart-with-little-power-after-hurricane-maria-1507978801.

[4] *See Id.*

[5] *Id.*

[6] *See* Carr, *supra* note 1.

[7] *Id*.

[8] *See* Daniel Bases, *Puerto Rico Creditors Are Open to Mediation in Bankruptcy Court: In re Commonwealth of Puerto Rico*, 14 NO. 2 WESTLAW J. BANKR. 4, 1-2 (2017).

[9] *See* Carr, *supra* note 1.

[10] *See generally* Christopher K Odinet, *Of Progressive Property and Public Debt*, 51 WAKE FOREST L. REV. 1101, 1110-18 (2016).

[11] *See* Scott M. Christman*, Puerto Rican Debt Legislation: Is the Territory Better Off Restructuring Municipal Debt Under PROMESA*, 8 UPR BUS. L.J. 87, 90-94 (2017) (explaining that from 2000 to 2015 Puerto Rico's Bond Debt went from $30 to 70 billion to meet the economic challenges caused by (1) the expiration of the IRC 936, which led many of Puerto Rico's largest employers to leave the island, (2) the significant amount of its citizen's moving to the mainland U.S., and (3) the Great Recession). *See also* Mary Williams Walsh, *How Puerto Rico is Grappling with a Debt Crisis*, N.Y. TIMES, (May 16, 2017), https://www.nytimes.com/interactive/2017/business/dealbook/puerto-rico-debt-bankruptcy.html ("In 1996, Washington started phasing out a tax break for American companies with subsidiaries on the island, removing a significant driver of economic growth.").

[12] *See* Heather Gillers, *Puerto Rico Bonds Slide as Trump Says 'Goodbye' to Territory's Debt*, WALL ST. J., (Oct. 4, 2017, 5:39 AM), https://www.wsj.com/articles/puerto-rico-bonds-slide-as-trump-says-goodbye-to-territorys-debt-1507126128. *See also* Christman, *supra* note 11, at 91.

because of its depressed economy, coupled by its government spending more than it had for many years.[13] The current state of Puerto Rico's municipal bond debt raises the following question: how did Puerto Rico obtain so much debt?

The answer to that question may be that investors, even after Puerto Rico's economy began to struggle, continued pouring money into Puerto Rico by purchasing its municipal bonds.[14] There are legal structures in place that have motivated investors to purchase these municipal bonds.[15] For example, Puerto Rico's municipal bonds receive a triple income tax exempt status, and Puerto Rico is unable to declare bankruptcy.[16]

In regards to the tax exemptions, Puerto Rico's municipal bonds, unlike other states that issue municipal bonds, are exempt from local, state, and federal tax even for investors that do not live in Puerto Rico.[17] To realize this triple tax exemption when purchasing other states' municipal bonds, an investor would have to live in the state that the municipal bond was issued in.[18] Moreover, Puerto Rico cannot declare bankruptcy because Congress passed a law denying Puerto Rico access to Chapter 9.[19] After Congress passed this law, "millions of individuals nationwide invested billions of dollars in reliance on that law."[20] Yet, Congress recently enacted the *Puerto Rico Oversight, Management, and Economic Stability Act* ("PROMESA").[21]

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[13] *See* Walsh, *supra* note 11. *See also* Carlos A. Rodriguez Vidal, *A Tale of Two "Municipalities" (Detroit and Puerto Rico): Legal and Practical Issues Facing a Financially distressed "Municipality*," AMERICAN BAR 12 (April 2016), https://www.americanbar.org/content/dam/aba/administrative/state_local_government/BinderTaleofTwoMunicipalities4116.authcheckdam.pdf ("Puerto Rico is currently facing a singularly debilitating fiscal crisis. This crisis is centered on a public debt of more than $70 billion, an amount that exceeds that of all but two States of the United States and almost equal to its Gross National Product."). *See also* Mary Williams Walsh, *The Bonds That Broke Puerto Rico*, N.Y. TIMES (June 30, 2015), https://www.nytimes.com/2015/07/01/business/dealbook/the-bonds-that-broke-puerto-rico.html ("Puerto Rico has about 15 times the median bond debt of the 50 states, according to Moody's Investors Service.").

[14] *See* Christman, *supra* note 11, at 91.

[15] *See Id.* at 91-92.

[16] *See Id.*

[17] *See Id.*

[18] *See Id.* at 91.

[19] 11 U.S.C.A. § 903 (West 2018); 11 U.S.C.A. § 101(West 2018) (stating that Puerto Rico is not a State for purposes of who can become a chapter 9 debtor). *See also* Christman, *supra* note 11, at 92.

[20] Christman, *supra* note 11, at 92 (quoting Puerto Rico Chapter 9 Uniformity Act of 2015: H.R. 870 Before the H. Comm. on the Judiciary, 114th Cong. 88 (2015) (written testimony of Thomas Moers Mayer, Esq., Partner and Co-Chair, Corporate Restructuring and Bankruptcy Group, Kramer Levin Naftalis and Frankel, LLP)).

[21] 48 U.S.C. § 2121 (2016). *See also* Martin Guzman, *Puerto Rico's Debt Crisis is a Wake-Up Call. It Could Be Crushed Like Greece*, THE GUARDIAN, (May 8, 2017), https://www.theguardian.com/commentisfree/2017/may/08/puerto-ricos-debt-crisis-greece (explaining that PROMESA is a federal law that Congress created to aid Puerto Rico with its debt crisis).

Currently, using PROMESA as the vehicle, Puerto Rico is in the midst of restructuring its municipal bond debt.[22] This restructuring has spurred a legal battle between the General Obligation bond holders and Puerto Rico's Sales and Use Tax Corporation ("COFINA") bond holders.[23] These two classes of bondholders are fighting over who will be entitled to the $400 million in funds held by the sales-tax bond trustee.[24] Already, more than 20 lawsuits have been filed.[25] And the U.S. Bankruptcy Court in San Juan will be involved in deciding who is entitled to these funds.[26]

This article will address the legal dispute between the General Obligation bondholders and the COFINA bondholders. Specifically, it will address whether Act 91, which established COFINA, unconstitutionally violated the Contract Clause. The answer to this inquiry is largely dependent on two factors: (1) the jurisprudence a court uses to determine if Act 91 violated the contract clause; and (2) whether COFINA is a separate entity from the Puerto Rico Common Wealth Fund. The analysis that follows, however, will focus on the Contract Clause jurisprudence and its application to the Act 91. Part II of this article will address the historical background leading up to this issue and the details regarding the General Obligation and COFINA bonds. Part III will illustrate the development of the Contract Clause jurisprudence and highlight the relevant tests and factors in deciding if a statute violates the Contract Clause. Part IV will analyze whether Act 91 impermissibly violates the Contract Clause, taking into consideration the circumstances surrounding Puerto Rico passing Act 91 and the specifics of Act 91. Part V will serve as this article's conclusion.

II. Background

A. Brief History Illustrating How Puerto Rico Amassed Its Debt

Congress, in 1917, passed the Jones-Shafroth Act. ("Jones Act").[27]Among other things, the Jones Act granted American citizenship to Puerto Ricans[28] and allowed

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[22] *See* Bases, *supra* note 8, at 1.

[23] *See* Cate Long, *Developing: Puerto Rico Enters Bankruptcy on May 3: Faithful to PROMESA and Congressional Intent?*, 36 AM. BANKR. INST. J. 12, 85-87 (2017). COFINA is short for *Corporación del Fondo de Interés Apremiante*.

[24] *See* Michelle Kaske & Steven Church, *Puerto Rico Warns It May Grab Sales-Taxes Claimed by Bondholders*, BLOOMBERG MARKETS, (June 10, 2017, 4:34 PM), https://www.bloomberg.com/news/articles/2017-06-10/puerto-rico-warns-it-may-grab-sales-taxes-claimed-by-bondholders.

[25] *See* Guzman, *supra* note 21.

[26] *See* Kaske & Church, *supra* note 24.

[27] MARC D. JOFFE & JESS MARTINEZ, ORIGINS OF THE PUERTO RICO FISCAL CRISIS 5 (2016).

[28] 64 Cong. Ch. 145 § 5 ("[A]ll citizens of [Puerto] Rico . . . are hereby declared, and shall be deemed and held to be, citizens of the United States . . . .").

Puerto Rican issued bonds to be exempt from local, state, and federal tax.[29] In effect, the Jones Act made Puerto Rican issued bonds attractive to investors around the country.[30] Although this act attracted investors to Puerto Rican issued municipal bonds, it provided mechanisms to limit the amount of debt Puerto Rico could incur: (1) Puerto Rico could borrow only up "to 7 percentum of the aggregate tax valuation of its property,"[31] and (2) the act contained a balanced budget clause.[32]

This limitation on borrowing, over time, eroded.[33] For instance, in 1961, Congress removed the percentage limitation on borrowing and Puerto Rico adopted its own,[34] which allowed Puerto Rican *municipalities* to "borrow between 5 percent and 10 percent of assessed value on their own, without including commonwealth debt in the calculation."[35] By not including debt in its calculation, it increased the assessed value, which in turn permitted Puerto Rico to issue more debt.[36]

Moreover, Puerto Rico eliminated the percentage-based assessed valuation limitation on the Puerto Rican *commonwealth*; instead, Puerto Rico limited the commonwealth's borrowing to 15% of its tax revenues.[37] Due to this, Puerto Rico could increase the amount it borrowed if it increased the amount of tax revenues, which was previously barred.[38] The borrowing limitation on the commonwealth,

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[29] *See Id.* at § 3 ("[A]ll bonds issued by the government of Porto Rico, or by its authority, shall be exempt from taxation by the Government of the United States, or by the government of Porto Rico or of any political or municipal subdivision thereof, or by any State, or by any county, municipality, or other municipal subdivision of any State or Territory of the United States, or by the District of Columbia.").

[30] *See* Joffe & Martinez, *supra* note 27, at 6.

[31] 64 Cong. Ch. 145 § 3.

[32] *Id.* ("In computing the indebtedness of the people of [Puerto Rico], bonds issued by the people of [Puerto] Rico secured by an equivalent amount of bonds of municipal corporations or school boards of [Puerto] Rico shall not be counted.").

[33] *See, generally,* Joffe & Martinez, *supra* note 27, at 9-16.

[34] PL 87-121.

[35] *See* Joffe & Martinez, *supra* note 27, at 13 (*citing* P.R. CONST. art. VI, § 2).

[36] *See Id.* at 12-13.

[37] P.R. CONST. art. VI, § 2:

> [B]onds or notes for the payment of which the full faith credit and taxing power of the Commonwealth shall be pledged shall be issued by the Commonwealth if the total of (i) the amount of principal of and interest on such bonds and notes, together with the amount of principal of and interest on all such bonds and notes theretofore issued by the Commonwealth and then outstanding, payable in any fiscal year and (ii) any amounts paid by the Commonwealth in the fiscal year next preceding the then current fiscal year for principal or interest on account of any outstanding obligations evidenced by bonds or notes guaranteed by the Commonwealth, shall exceed 15% of the average of the total amount of the annual revenues raised under the provisions of Commonwealth legislation and covered into the Treasury of Puerto Rico in the two fiscal years next preceding the then current fiscal year . . . . (official translation).

[38] *See* Joffe & Martinez, *supra* note 27, at 13.

however, "only applied to 'bonds or notes for the payment of which the full faith and credit and taxing power of the Commonwealth shall be pledged. . . '."[39] this language contributed to the issue at hand as Puerto Rico used this language to create COFINA.

Additionally, a step towards a looser limitation on borrowing involved the interpretation of the following language in the 1917 Jones Act: "[n]o appropriation shall be made, nor any expenditure authorized by the legislature, whereby the expenditure of the Government of Puerto Rico during any fiscal year shall exceed the *total revenue* then provided for by law and applicable for such appropriation or expenditure . . . ."[40] Specifically, the phrase "total revenue" is translated in Spanish as "total resources," which could—and did—lead to a broader interpretation.[41]

At the Puerto Rican Constitutional Convention, taking place from 1951 through 1952, delegates argued that the phrase "total resources" did not mean the same thing as it did when Congress passed the Jones Act, and the phrase should now include revenues from "funds obtained from the sale of bonds." [42] The broader interpretation prevailed, which effectively destroyed the balanced budget clause in the Jones Act, allowing the proceeds from Puerto Rico's municipal bonds to be considered when balancing Puerto Rico's budget,[43] and "opened the door to recurring operating deficits."[44]

B. Puerto Rico's General Obligation and COFINA Bonds

The General Obligation bonds are backed by the Puerto Rican Constitution.[45] Specifically, Article VI, Section 2 states that Puerto Rico has the power to issue municipal bond debt and that such debt will be backed by "the full faith and credit and taxing power of the Commonwealth . . . ."[46] Moreover, the Puerto Rican Constitution explains that to pay back the municipal debt issued, the Secretary of the Treasury may be required to use available revenues.[47]

But, as stated above, there is a limitation on the amount of debt Puerto Rico could issue; in 2007, Puerto Rico could not issue any more General Obligation bonds because it had reached its debt ceiling imposed by the borrowing

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[39] *See* P.R. CONST. art. VI, § 2. *See also* Joffe & Martinez, *supra* note 27, at 13.

[40] 64 Cong. Ch. 145 § 34 (emphasis added).

[41] *See* Joffe & Martinez, *supra* note 27, at 11.

[42] *See Id.*

[43] *See Id.*

[44] *Id.*

[45] *See* P.R. CONST. art. VI, § 2.

[46] *Id.*(official translation).

[47] *See Id.*

limitation.[48] Yet, Puerto Rico, to continue to borrow, found a way around its debt ceiling.[49] Specifically, Puerto Rico passed a law, Act 91, to create a sales and use tax corporation known as COFINA, which is a self-proclaimed separate entity.[50] The legislature created COFINA to issue sales and use tax backed bonds.[51] Initially, Puerto Rico issued these COFINA bonds at an A+ rating, "which was five levels higher than Puerto Rico's General Obligation bonds at the time."[52] Due to the better credit rating given to the COFINA bonds, Puerto Rico was able to borrow at a cheaper rate.

Puerto Rico was able to issue the COFINA bonds at significantly higher credit rating because the sales and use tax revenue that secured these bonds was claimed to be separate from the funds used to back the bonds issued to the General Obligation bondholders.[53] As briefly mentioned before, the General Obligation bondholders are to be paid, as stated by the Puerto Rican Constitution, from the "available resources" of Puerto Rico's Commonwealth; however, Act 91 deemed the sales and use tax revenues that secured the COFINA bonds to be separate from the available resources of the Commonwealth.[54] Act 91 specifically states that the sales and use tax resources dedicated to COFINA "shall not constitute available resources of the commonwealth of Puerto Rico for any purpose, including for the purpose of Section 8 of Article VI of the Constitution."[55]

i. COFINA Bonds in Detail.

COFINA creates a priority interest in the commonwealth's sales and use tax for COFINA bondholders.[56] Act 91, which creates this priority interest for COFINA bondholders, states that 5.5% of the commonwealth's sales and use tax will go directly to "COFINA until a guaranteed base amount of tax collections is met."[57]

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[48] *See* Christman, *supra* note 11, at 93. *See also* P.R. CONST. art. VI, § 2 (stating that Puerto Rico can issue bonds and notes if such issuances do not exceed 15% of Puerto Rico's average total tax revenues).

[49] *See* Christman, *supra* note 11, at 93.

[50] *See* Martin Z. Braun, *Bondholders Fret as Alchemy Turns Chicago's Junk to Gold*, BLOOMBERG MARKETS, (November 10, 2017, 7:30 AM), https://www.bloomberg.com/news/articles/2017-11-10/bondholders-fret-over-alchemy-that-turns-chicago-s-junk-to-gold.

[51] *See Id.*

[52] *Id.*

[53] *See* Odinet, *supra* note 10, at 1143.

[54] *See Id.*

[55] *Id.*

[56] *See* Horacio Aldrete-Sanchez, *Puerto Rico Sales Tax Financing Corp.: Sales Tax*, STANDARD & POORS, (June 28, 2007), http://www.gdb.pr.gov/investors_resources/documents/COFINA08x2007SP.pdf.

[57] *Id.*

Moreover, the bonds are security backed.[58] This is because the statute grants a statutory lien to bondholders on the commonwealth's sales and use tax revenues once any bonds are issued.[59] Due to this lien, the COFINA bonds are non-recourse and are payable only from the pledged property, 5.5% of the commonwealth's sales and use tax.[60]

Furthermore, similar to Puerto Rico's General Obligation bonds, COFINA cannot voluntarily file for or be involuntarily forced into bankruptcy.[61] And, particularly important to the analysis in this note, Act 91 sought to transfer the revenues of the sales and use tax to the separate entity called COFINA.[62] This separation was done to exclude the sales and use tax revenues from the constitutional provision of Puerto Rico that grants the General Obligation bondholders "first lien claim on all available" revenues.[63] This provision is otherwise known as the General Obligation bondholder's constitutionally backed claw-back provision.[64]

COFINA claims to be a separate and independent corporate and political entity from the commonwealth of Puerto Rico, which may allow it to take funds from the sales and use tax and use such funds to back COFINA bonds.[65] One reason Puerto Rico codified this separate entity was to refinance all or part of the extra-constitutional debt it had from issuing the General Obligation bonds.[66] Moreover, to be able to refinance the extra-constitutional debt, Act 91 established the Dedicated Sales Tax Fund, which is called the *Fondo de Interés Apremiante* ("FIA").[67] FIA is funded with the first 5.5% of revenue collected by the entire sales and use tax.[68] And these revenues are given to COFINA before any amount can be used to satisfy Puerto Rico's obligation to its General Obligation bondholders.[69]

ii. Who Holds the Bonds?

A diverse group holds the municipal bonds issued by Puerto Rico.[70] For instance, some bondholders consist of hedge funds, including vulture funds.[71] Vulture funds

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[58] *See Id.*
[59] *See Id.*
[60] *See Id. See also nonrecourse*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining non-recourse as "an obligation that can be satisfied only out of the collateral securing the obligation and not out of the debtor's other assets").
[61] *See* Adrete-Sanchez, *supra* note 56.
[62] *See Id.*
[63] *See Id.*
[64] *See Id.*
[65] *See Id.*
[66] *See Id.*
[67] *See Id.*
[68] *See Id.*
[69] *See Id.*
[70] *See* Odinet, *supra* note 10, at 1129-30.
[71] *See Id.* at 1130.

get their name from buying debt from struggling municipalities for deep discounts in the hopes of significant profits later on.[72] The vulture hedge funds own roughly 35% of all Puerto Rico's outstanding debt.[73] Additionally, mutual funds own a significant amount of the debt, 15%.[74] Also, unlike the vulture hedge funds that prey upon struggling municipalities for a big payday, the mutual funds, which have significant exposure in regards to owning Puerto Rico's outstanding debt, hold money for everyday Americans.[75] Notably, the mutual funds hold money for retirees, "seniors saving for retirement, working Americans, and for those saving for college . . . ."[76] Lastly, the remainder of the bondholders consist of individual investors, who reside across the United States, including Puerto Rico.[77]

III. Overview of the Contract Clause and its Cases

A. Overview of the Contract Clause

The Contract Clause states that "[n]o State . . . shall pass any . . . Law impairing the Obligation of Contracts . . . ."[78] Despite the facially absolute language in the Contract Clause, "its prohibition must be accommodated to the inherent police power of the State 'to safeguard the vital interests of its people.'"[79] Because "literalism in the construction of the contract clause . . . would make it destructive of the public interest by depriving the State of its prerogative of self-protection," the language is not interpreted as absolute.[80] Additionally, the police power is the "sovereign right of the Government to protect the lives, health, morals, comfort and general welfare of the people, and is paramount to any rights under contracts between individuals."[81]

Before the United States passed the 14th Amendment, the Contract Clause was arguably the strongest constitutional limitation on state law.[82] Yet, since those early years, the Contract Clause has "receded into comparative desuetude with the

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[72] *See Id.* at 1127.

[73] *See Id.* at 1128.

[74] *See Id.* at 1129.

[75] *See Id.*

[76] *Id.*

[77] *See Id.*

[78] U.S. CONST. art. 1, § 10, cl. 1.

[79] Energy Reserves Grp., Inc. v. Kan. Power & Light Co., 459 U.S. 400, 410 (1983) (quoting Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 434 (1934)).

[80] Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 240 (1978) (*citing* W.B. Worthen Co. v. Thomas, 292 U.S. 426, 433 (1934)).

[81] *Spannaus*, 438 U.S. at 241 (quoting Manigault v. Springs, 199 U.S. 473, 480 (1905)).

[82] *See Spannaus*, 438 U.S. at 241.

adoption of the Fourteenth Amendment, and particularly with the development of the large body of jurisprudence under the Due Process Clause of that Amendment in modern Constitutional history."[83] But even though the Contract Clause has diminished in importance under current constitutional jurisprudence, "it must be understood to impose some limits upon the police power of a State to abridge existing contractual relationships, even in the exercise of its otherwise legitimate police power."[84] The Court outlined the limits the Contract Clause imposes on the police power where the Court presided over cases in which States passed laws to meet the challenges of economic emergencies.[85]

B. Blaisdell and its Progeny

"While emergency does not create power, emergency may furnish the occasion for the exercise of power."[86] In *Home Building & Loan Association v. Blaisdell* (1934), the court reviewed whether a mortgage moratorium law, which the Minnesota legislature passed, during a declared economic emergency, to provide relief for homeowners threatened with foreclosure, violated the Contract Clause.[87] Specifically, Minnesota's law stated that through an authorized judicial proceeding, the court could "extend the period of redemption from foreclosure sales 'for such additional time as the court may deem just and equitable . . . .'"[88] But the Minnesota law limited the court's discretion in regards to the extension period because the courts could only extend the period of the redemption for the duration of the emergency.[89] And during the court-granted extension, the mortgagor was to pay the mortgagee "the reasonable rental value of the property."[90]

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[83] *Id. See also* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW, 647 (4th Ed. 2013) (finding that because the Supreme Court, under the Fifth and Fourteenth Amendments, protects the freedom of contract under the Due Process Clause, the Contract Clause is significantly less important as a limitation on state law).

[84] *See Spannaus*, 438 U.S. at 241.

[85] *See Id.* at 242 ("The existence and nature of those limits were clearly indicated in a series of cases in this Court arising from the efforts of the States to deal with the unprecedented emergencies brought on by the severe economic depression of the early 1930's.").

[86] Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 426 (1934).

[87] *See Id.* at 416. *See also* Samuel R. Olken, CHARLES EVANS HUGHES AND THE BLAISDELL DECISION: A HISTORICAL STUDY OF THE CONTRACT CLAUSE JURISPRUDENCE, 72 OR. L. REV. 513, 568-74 (1993) (explaining that Minnesota passed the moratorium law during the Great Depression, which caused "an exponential increase in the number of foreclosure sales," resulting in protests, riots, and civil unrest).

[88] *Blaisdell*, 290 U.S. at 426.

[89] *See Id.*

[90] *Id.* at 416-17. *See also* Olken, *supra* note 87, at 570 (stating that "[b]y 1933, most property mortgaged in Minnesota was worth only one quarter of its value before the advent of the Depression"). Given the sharp decline in property value, a reasonable rental value was materially more affordable for the mortgagor.

In addition, and notably, this law applied retrospectively.[91]

Due to the circumstances and the specifics of Minnesota's law, the Court held that the law did not violate the Contract Clause.[92] The Court came to this conclusion, despite Minnesota's law infringing upon the mortgagee's foreclosure and possession rights, "to safeguard the vital interests of the people."[93]

In short, the Court recognized the need for a balancing test between individual rights and public welfare.[94] With this balancing test, the Court found the following five factors significant to its decision: (1) there was an economic emergency in Minnesota, "which furnished the proper occasion for the exercise of the reserved power of the state to protect the vital interests of the community"; (2) Minnesota enacted the law to protect the society at large, and not a favored group; (3) Minnesota tailored the law to the challenges of the emergency at hand; (4) the conditions of Minnesota's law were reasonable; and (5) Minnesota's law was temporary in operation as it was limited to the duration of the declared economic emergency.[95] Significantly, subsequent opinions from the Court have interpreted *Blaisdell* to imply that Minnesota's law would have violated the Contract Clause if one of these five characteristics did not exist.[96]

Dissimilar to *Blaisdell*, in *W.B. Worthen Company v. Thomas* (1934), the Court found that an Arkansas law violated the Contract Clause.[97] Applying retrospectively, the Arkansas law in *Thomas* barred creditors from collecting any amount given to the debtor from his life insurance policy.[98] The Arkansas legislature justified the law because of the economic emergency.[99] Yet, the Arkansas law did not have any conditions equitably related to the exigency nor did it limit the law to the duration of the emergency.[100] The Court, recognizing that it upheld the law at issue in *Blaisdell*

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[91] *See Blaisdell*, 290 U.S. at 416. *See* Olken, *supra* note 87, at 571-72 ("Though the United States Supreme Court had consistently invalidated retroactive mortgagor relief legislation under the Contract Clause, it had yet to assess the constitutionality of a moratorium law enacted during the Depression.").

[92] *See Blaisdell*, 290 U.S. at 448.

[93] *Id.* at 434. *See also* Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 242 (1978) (explaining that the States retain the residual authority to guard the vital interests of the people).

[94] *See Blaisdell*, 290 U.S. at 442.

[95] *Id.* at 444-48.

[96] *See, e.g.*, *Spannaus*, 438 U.S. at 242 ("The *Blaisdell* opinion thus clearly implied that if the Minnesota legislation had not possessed the characteristics attributed to it by the Court, it would have been invalid under the Contract Clause . . . .").

[97] *See* W.B. Worthen Co. v. Thomas, 292 U.S. 426, 434 (1934).

[98] *See Id.* at 430-31.

[99] *See Id.* at 432. *See also* MICHAEL E. PARISH, THE HUGHES COURT: JUSTICES, RULINGS, AND LEGACY 150 (2002) (explaining that Arkansas and its economy were suffering because of the collapse of the cotton economy and the Dust Bowl).

[100] *See Thomas*, 292 U.S. at 432.

because of the law's temporary and equitable conditional relief, found that the Arkansas law violated the Contract Clause because the Arkansas law was neither temporary nor conditional.[101] Specifically, the Court in *Thomas* stated that "[i]n placing insurance moneys beyond the reach of existing creditors, the Act contains no limitations as to time, amount, circumstances, or need."[102]

Also, dissimilar to *Blaisdell*, in *W.B. Worthen Co. v. Kavanaugh* (1935), the Court found three of Arkansas' laws, which the Arkansas Legislature passed in 1933, in violation of the Contract Clause.[103] In *Kavanaugh*, Arkansas passed a law that allowed Arkansas' municipalities to issue bonds, which were secured by the mortgage benefit assessments.[104] Subsequently, in March 1933, Arkansas passed three laws, which applied retrospectively, that altered the terms of the bonds previously issued.[105] The changes that the March 1933 laws instituted resulted in the bondholders having to wait a minimum of six and a half years "without an effective remedy."[106] Importantly, as the Court recognizes, the changes made by the March 1933 laws were "an oppressive and unnecessary destruction of nearly all the incidents that give attractiveness and value to collateral security."[107] And the Court reasoned that even though there was an economic emergency at hand,[108] the March 1933 laws were not limited to the duration of the emergency and did not impose conditions equitably related to the exigency.[109] Thus, unlike the law *Blaisdell*, the March 1933 laws unconstitutionally impaired the obligation of the contract that the bondholders were party to.[110]

C. The Supreme Court's Modern Contract Clause Jurisprudence

Although the more modern Supreme Court Contract Clause cases still recognize the importance of *Blaisdell*,[111] the framework that guides the Contract Clause

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[101] *See Id.* at 434.

[102] *Id.*

[103] *See* W.B. Worthen Co. v. Kavanaugh, 295 U.S. 56, 63 (1935).

[104] *See Id.* at 57 (explaining that Arkansas municipalities could issue bonds that would be funded by property owners' assessment payments to the municipality, and if the owner was delinquent in making such payments, then the bondholder could foreclose on a delinquent owner's property to satisfy the municipality's outstanding obligation to the bondholders).

[105] *See Id.* at 58-59.

[106] *See Id.* at 61.

[107] *Id.* at 62. *See* Parish, *supra* note 99, at 150 (explaining that Arkansas and its economy were suffering because of the collapse of the cotton economy and the Dust Bowl).

[108] *See Kavanaugh*, 295 U.S. at 60.

[109] *Id.* at 62–63.

[110] *See Id.* at 63.

[111] U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 15 (1977).

analysis has changed.[112] In *U.S. Trust Co. of New York* ("U.S. Trust"), for example, necessity and reasonableness of the law guided the Court's inquiry.[113] With this framework, the Court held, in *U.S. Trust*, that the retroactive application of the legislation violated the Contract Clause.[114]

Both New York and New Jersey, in *U.S. Trust*, through bi-state legislation, established the Port Authority to promote and coordinate transportation between the two states.[115] To finance the transportation infrastructure, the Port Authority, in 1952, issued bonds that were "secured by a pledge of the general reserve fund."[116] Thereafter, in 1962, through bi-state legislation, New York and New Jersey passed a covenant.[117] This covenant stated, in part, that New York and New Jersey cannot take any of the stated revenues pledged to the bondholders, except for the listed "permitted purposes."[118] Additionally, the covenant provided that these permitted purposes "would not produce deficits in excess of permitted deficits . . . ."[119] But, in 1974, New York and New Jersey retroactively appealed the covenant.[120] Yet the retroactive appeal occurred when "a national energy crisis was developing."[121] In fact, Congress found that the developing energy crisis threatened "the public health, safety, and welfare."[122]

To start, the Court first established that the 1962 covenant created an obligation and a contract between the states, New York and New Jersey, and the bondholders.[123] The Court found that there was a contract because the States received financing and the bondholders received "constitutional protection of the Contract Clause as security against repeal" of the covenant.[124] In addition, the Court found that the states impaired the contract because, although the effect on the value of the bonds was disputed, the states' "outright repeal totally eliminated an important security provision . . . ."[125] Once the Court established that the states impaired their contrac-

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[112] *See, e.g.*, *Id.* at 14-32. *See also* Robert A. Graham, *The Constitution, The Legislature, And Unfair Surprise: Toward A Reliance-Based Approach to the Contract Clause*, 92 MICH. L. REV. 398, 409-10 (1993).

[113] *See, generally, U.S. Trust Co. of N.Y.*, 431 U.S. at 14-32.

[114] *See Id.* at 32.

[115] *See Id.* at 4.

[116] *Id.* at 7.

[117] *See Id.* at 9-12.

[118] *See Id.* at 10.

[119] *Id.* at 10-11 (stating that the permitted deficit "could not exceed one-tenth of the general reserve fund, or 1% of the Port Authority's total bonded debt").

[120] *See Id.* at 13-14.

[121] *Id.*

[122] *Id.* at 14.

[123] *See Id.* at 17.

[124] *Id.* at 18 (finding that there was a contract because consideration was given).

[125] *Id.* at 19.

tual obligation, it considered whether the retroactive repeal of the covenant violated the Contract Clause.[126]

Having determined that this case did not fall under the reserved powers doctrine,[127] the Court applied the following standard to determine whether the retroactive repeal unconstitutionally impaired the obligation of the contract: "an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose."[128] The courts should analyze whether the impairment is necessary through two different lenses: (1) whether a less drastic modification could have achieved the same goals and (2) whether the state could achieve its goals through an alternative measure.[129] Importantly, when applying this standard, the Court noted that it would not give complete deference to the legislature because the states were a party to the contract and thus, self-interested.[130]

First, the Court determined that the law served an important public purpose.[131] Specifically, it recognized that the law sought to realize the states' goals of "mass transportation, energy conservation, and environmental protection," which are "important and of legitimate public concern."[132] But the Court found the law unnecessary.[133] In *U.S. Trust*, unlike *El Paso v. Simmons*, where the Court found the impairment "quite clearly necessary," the states failed to show that the impairment "was similarly necessary."[134] This is because a less drastic modification would have

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[126] *See Id.* at 21.

[127] Before determining whether the retroactive appeal was necessary and reasonable, the Court first considered this case under the reserved powers doctrine. *Id.* at 23. This doctrine states that a state cannot contract away its policy power. *Id.* at 24. Therefore, under the reserved powers doctrine, a state contract is invalid ab initio if it "bargains away the police power of [the] State." *Id.* at 24. (quoting Stone v. Mississippi, 101 U.S. 814, 817 (1880)) (holding that a law invalidating a lottery charter did not violate the contract clause because "the legislature cannot bargain away the police power of a State")). The Court found that this case did not fall under the reserved powers doctrine. *U.S. Trust Co. of N.Y.*, 431 U.S. at 24. This is because, in addition to the Court recognizing that states are generally held to their bond contracts, the covenant was a purely financial promise. *Id.* at 25. The covenant was characterized as a purely financial promise because "[t]he States promised that revenues and reserves securing the bonds would not be depleted by the Port Authority's operation of deficit-producing passenger railroads beyond the level of 'permitted deficits.'" *Id.*

[128] *Id.* at 25.

[129] *See Id.* at 29-30.

[130] *See Id.* at 25-26.

[131] *See Id.* at 28-29.

[132] *See Id.* at 28.

[133] *Id.* at 31.

[134] *Id.* (*citing Simmons*, 379 U.S. 497, 515-16 (1965)). In *Simmons*, the Texas legislature, in an effort to raise money for public schools, passed a law authorizing the sale of public lands. Simmons, 379 U.S. at 509-10. Further, this law allowed a delinquent purchaser of such land to redeem the land at any time if he repaid the amount due. *Id.* At the time purchasers bought such land, the land was believed to be worthless. Note, *Revival of the Contract Clause: Allied Structural Steel Co. v. Spannaus and*

achieved the same result, and the states, without modifying the covenant, could have used alternative measures to achieve the same ends.[135]

Lastly, the Court found the impairment unreasonable.[136] Again, to come to its conclusion, the Court distinguished *U.S. Trust* from *Simmons* and *Faitoute Iron & Steel Co. v. City of Asbury Park* ("Faitoute") (1942).[137] Specifically, the Court noted that, in *Simmons*, the statute at issue had "unforeseen and unintended" effects.[138] And, in *Faitoute*, which was "[t]he only time in this century that alteration of a municipal bond contract has been sustained by this Court,"[139] the impairment was necessary because the state experienced "unexpected financial conditions."[140] Conversely, the Court, in *U.S. Trust*, in coming to its conclusion, found that the concerns that led to the impairment were known at the time the states made a contract with the bondholders via the covenant, and the changes from the time the states enacted the covenant to the retroactive repeal of the covenant were changes "of degree and not of kind."[141] Thus, the retroactive impairment to address an emergency was unreasonable and unconstitutionally impaired the obligation of the contract.[142]

Unlike *U.S. Trust* where the court analyzed whether a law impaired the obligation of a state contract, *Spannaus* concerns Minnesota passing a law that unconstitutionally impaired the obligation of a private contract.[143] In *Spannaus*, Allied Structural Steel Company, in 1963, voluntarily created a pension plan.[144] Then, in April 1974, Minnesota passed the law at issue in *Spannaus*, which provided that if a

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United States Trust Co. v. New Jersey, 65 VA. L. REV. 377, 386 (1979). But, thereafter, oil and gas deposits were discovered, prompting delinquent purchasers to pay the amount they owed to the State and redeem their land. *See Simmons*, 379 U.S. at 510. This led to speculation, uncertainty in land titles, massive title litigation, and material costs on the school fund and development of land use. *Id.* at 512, 516. To prevent speculation and safeguard Texas' vital interest, Texas passed another law ("statue of repose"), which in effect stated that a purchaser can only exercise his right to redeem within 5 years of forfeiture. *Id.* at 511. The Court found, in its Contract Clause analysis, that given the aim of the statue of repose and the problems posed with a timeless redemption period, the "statute of repose was quite clearly necessary." *Id.* at 516.

[135] *See U.S. Trust Co. of N.Y.*, 431 U.S. at 30-31.

[136] *See Id.* at 31.

[137] *See Id.* at 27-32.

[138] *Id.* at 31 (*citing Simmons*, 397 U.S. at 515).

[139] U.S. Trust Co. of N.Y., 431 U.S. at 27 (*citing* Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 516 (1942)).

[140] *U.S. Trust Co. of N.Y.*, 431 U.S. at 28 (*citing* Faitoute Iron & Steel Co., 316 U.S. at 511).

[141] *See U.S. Trust Co. of N.Y.*, 431 U.S. at 32.

[142] *Id.* at 32.

[143] *See, generally,* Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 236–40 (1978).

[144] *Id.* at 238. The details of the plan can be summarized as follows: "an employee who did not die, did not quit, and was not discharged before meeting one of the requirements of the plan would receive a fixed pension at age 65 if the company remained in business and elected to continue the pension plan in essentially its existing form." *Id.*

company terminated its pension plan or closed its offices in Minnesota, it would be subject to a "pension funding charge."[145] Allied Structural Steel Company, shortly thereafter, terminated an office it had in Minnesota, resulting in Allied Structural Steel Company paying a $185,000 pension funding charge pursuant to the retroactive law at issue.[146] But the Court found that Minnesota's law unconstitutionally impaired the obligation of the contract.[147]

With no presumption favoring the legislature's judgment,[148] the Court highlighted four factors in coming to its holding. One, the law did not address a broad or general economic or social problem.[149] Two, prior to the law at issue, the area that Minnesota's law addressed had never been subject to state regulation.[150] Three, similar to the reasoning in *Blaisdell*, the law, rather than being temporary, imposed a "severe, permanent, and immediate change . . . ."[151] Lastly, the aim of Minnesota's law was narrow as it only concerned employers who had voluntarily agreed to create pension plans for their employees.[152] Due to these factors, the Court held that Minnesota's law violated the Contract Clause.[153]

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[145] *Id.*

[146] *See Id.* at 239-40 ("During the summer of 1974 the company began closing its Minnesota office. On July 31, it discharged 11 of its 30 Minnesota employees, and the following month it notified the Minnesota Commissioner of Labor and Industry, as required by the Act, that it was terminating an office in the State.").

[147] *See Id.* at 250-51.

[148] Because *Spannaus* concerned a private contract, the Court would have analyzed this case with "the presumption favoring 'the legislative judgment as to the necessity and reasonable of a particular measure.'" *Id.* at 247 (quoting U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 23 (1977)). Yet the Court in *Spannaus* introduced a sliding scale to aid in its analysis: as the impairment of the obligation becomes more severe, the Court's level of scrutiny in regard to the nature and purpose of the law will increase. *See Spannaus*, 438 U.S. at 245. The Court found that the impairment of the obligation was severe because it retroactively impaired an obligation that Allied Structural Steel Company heavily and reasonably relied on, and its reliance was vital to funding the pension plan. *See Id.* at 245-46. Specifically, the retroactive law impaired the obligation because it nullified express terms of the pension contract as the law required Allied Structural Steel Company to modify the compensation that it agreed to pay its employees under the pension contract. *See Id.* 238-39, 246. Moreover, Allied Structural Steel Company's reliance on the impaired contractual obligation was vital to funding the pension plan because the unexpected $185,000 pension funding charge jeopardized the solvency of the pension plan. *Id.* at 244-46. Due to the severe impairment, the Court carefully examined the nature and purpose of Minnesota's law. *See Id.* Because the Court found that Minnesota's law required careful examination, it did not analyze the constitutionality of the law with a presumption favoring the legislative judgment. *See Id.* at 247.

[149] *See U.S. Trust Co. of N.Y.*, 431 U.S. at 22.

[150] *See Id.*

[151] *Spannaus*, 438 U.S. at 250.

[152] *See Id.*

[153] *See Id.* at 251.

The Court, in *Energy Reserves Group, Inc. v. Kansas Power and Light Co.* (1983), analyzed in depth whether an industry is heavily regulated or not.[154] Specifically, the Court used the fact of whether the parties' contracts at issue concerned a heavily regulated industry as a factor in its threshold inquiry. This inquiry concerned whether the law at issue substantially impaired the obligation of the contract.[155]

The Court determined that the contracts at issue, which concerned natural gas prices, fell within a heavily regulated industry.[156] This is because, although "Kansas did not regulate natural gas prices specifically" at the time the contracts were made, its supervision of the industry was extensive and intrusive.[157] Because the contracts concerned a heavily regulated industry, it was foreseeable that the state may alter the contract.[158] Thus, the parties could not have reasonably relied on the contract being protected from future changes in state law; and therefore, the Kansas law did not substantially impair Kansas Power and Light Company's contract rights.[159]

After the Court concluded that there was not a substantial impairment, it found that the Kansas law addressed a legitimate public purpose and was reasonable and necessary.[160] In finding that the Kansas law was reasonable and necessary, the Court found three factors significant.[161] First, Kansas tailored the law to address the issue at hand, price hikes in natural gas.[162] Second, the Kansas law was temporary in operation as the law "expire[d] when federal price regulation of certain categories of gas terminates."[163] Third, the Kansas law, unlike the

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[154] *See* Energy Reserves Grp., Inc. v. Kan. Power & Light Co., 459 U.S. 400, 413–16 (1983). *See also* Graham, *supra* note 112, at 415-16 (explaining that *Energy Reserves Group* added to the heavily regulated industry doctrine initially enunciated in *Veix v. Sixth Ward Building & Loan Association*, 310 U.S. 32 (1940)).

[155] *See Energy Reserves Grp., Inc.*, 459 U.S. at 413-16.

[156] *See Id.* at 415.

[157] *Id.* at 413-14.

[158] *See Id.* at 416.

[159] *See Id.*

[160] *See Id.* at 416–19.

[161] *See Id.* at 418-19.

[162] *See Id.* at 418. "Only natural gas subject to indefinite price escalator clauses poses the danger of rapidly increasing prices in Kansas. Gas under contracts with fixed escalator clauses and interstate gas purchased by the utilities subject to § 109 would not escalate as would intrastate gas subject to indefinite price escalator clauses." *Id.* And "[t]he Kansas Act also rationally exempts the types of new gas the production of which Congress sought to encourage through the higher § 102 prices." *Id.*

[163] *Id.*

law at issue in *Spannaus*, imposed the legislative change gradually, rather than immediately.[164]

Yet these findings are notably different than *US Trust* and *Spannaus* because the Court deferred to the legislative judgment as Kansas was not a party to the contract and the Kansas law did not substantially impair the obligation of the contract.[165] Thus, the holding in *Energy Reserves Group, Incorporated* might have been different had the Court used the same standard of review employed in *US Trust* and *Spannaus*.[166]

D. The First Circuit Applying the Supreme Court's Contract Clause Jurisprudence

The First Circuit is the circuit in which the fate of the Puerto Rican bondholders may be decided.[167] In *United Automobile, Aerospace, Agriculture Implement Workers of America International Union v. Fortuño*, the First Circuit presided over a Contract Clause case arising out of a Puerto Rican collective bargaining agreement.[168] This case highlights the tests and factors that it deems important.[169] The test it adopts from the Supreme Court is two pronged: (1) whether the contract was substantially impaired and (2) whether the impairment was necessary and reasonable to realize an important public purpose.[170] In addition, the First Circuit recognized that a court will consider the five factors in *Blaisdell* when analyzing whether the impairment is necessary and reasonable.[171]

Utilizing this framework to guide its inquiry, the First Circuit held that the plaintiffs failed to plead sufficient facts to show that Puerto Rico violated the

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[164] *See Id.* at 418-19.

[165] *See Id.* at 412-13.

[166] *See* U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 25 (1977) ("[D]eference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake."). *See also Spannaus*, 292 U.S. at 244–47 (explaining that the customary deference to a state legislature is not used when the state is a party to the contract, and because the impairment of the obligation in *Spannaus* is severe, the court will carefully scrutinize the law's nature and purpose).

[167] *See* Kaske & Church, *supra* note 24.

[168] *See, generally,* 633 F.3d 37, 37-49 (1st Cir. 2011).

[169] *See Id.* at 42-46.

[170] *See Id.* at 42-43.

[171] *Id.* at 46 (re-stating the five factors in *Blaisdell*: whether the law (1) addressed an emergency, (2) guards a broad societal interest, (3) "was tailored to its purpose; (4) imposed reasonable conditions, and (5) was limited to the duration of the emergency"). Notably, the five factors in *Blaisdell* are not necessary, but merely factors to guide the court's inquiry as to whether the law is necessary and reasonable. *Id.*

Contract Clause.[172] Specifically, plaintiff failed to plead sufficient facts that the law at issue was unreasonable in light of the circumstances[173] or drastically impaired the contract when a less drastic alternative was available.[174]

Importantly, the First Circuit, in *Fortuño*, considers Puerto Rico a state for Contract Clause purposes.[175] This is notable because the Contract Clause is only triggered when a state passes a law that violates the Contract Clause.[176]

IV. Applying the Contract Clause Jurisprudence to Act 91

This analysis will explore whether Puerto Rico unconstitutionally impaired the obligation of the contract, between Puerto Rico and the General Obligation bondholders, when it issued constitutionally backed bonds to General Obligation bondholders and then, subsequently, diverted taxing revenues to COFINA as a security for COFINA bondholders to aid Puerto Rico's debt crisis.

A. There is an Obligation Between Puerto Rico and the General Obligation Bondholders

The Supreme Court has consistently held that an obligation exists between a state and the bondholders that the state issued bonds to.[177] Moreover, the relationship between Puerto Rico and the General Obligation bondholders is analogous to *U.S. Trust*. The Court, in *U.S. Trust*, found that an obligation existed because New York and New Jersey received financing, and in exchange, the bondholders received a constitutional guarantee under the Contract Clause that those states would not repeal the covenant.[178] Similarly, the General Obligation bondholders helped finance

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[172] *See Id.* at 49.

[173] *Id.* at 46-47 ("[T]he plaintiffs failed to sufficiently describe the contractual provisions allegedly impaired by Act No. 7, and they therefore failed to demonstrate the extent of those impairments. . . . The plaintiffs also failed to plead any factual content to undermine the credibility of Act No. 7's statement that it was enacted to remedy a $3.2 billion deficit. The complaint alleges nothing, other than the conclusory statement that 'the averred purpose is neither significant nor legitimate,' to question the existence of the deficit or the 'basic societal interest' in eliminating it.").

[174] *Id.* at 47, 49 ("Nor does the complaint aver facts demonstrating that Act No. 7 was an excessively drastic means of tackling the deficit. In fact, almost everything in the complaint challenging Act No. 7's reasonableness and necessity is a conclusory statement. For instance, the complaint averred that 'there were other available alternatives with lesser impact to the paramount constitutional rights affected,' but failed to specify any such alternatives or plead any factual content suggesting such alternatives might exist.").

[175] *See, generally, Id.* at 40-49.

[176] U.S. CONST. art. 1, § 10, cl. 1.

[177] *See, e.g.*, U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 17 (1977).

[178] *See Id.* at 18.

Puerto Rico when they purchased the General Obligation bonds in exchange for protection not only under the Contract Clause, but also under the Puerto Rican Constitution.[179] Specifically, the Puerto Rican Constitution explains that the General Obligation bonds will be secured by "the full faith and credit and taxing power of the Commonwealth . . . ."[180]

B. A Court Would Not Give Deference to Puerto Rico's Legislature

A court will not analyze this case with a presumption favoring Puerto Rican legislature's judgment as to the necessity and reasonableness.[181] The Supreme Court has consistently held that no such presumption will be given if a state is a party to the contract at issue because a state, under such circumstances, is self-interested.[182] Puerto Rico is a party to the contract with the General Obligation bondholders.[183] Thus, a court would give no presumption in favor of Puerto Rico's legislative judgment in passing Act 91.[184]

C. Act 91 Does Not Falls Within the Reserved Powers Doctrine.

The last hurdle to clear before analyzing whether Act 91 unconstitutionally impaired the obligation of the contract is the reserved powers doctrine.[185] The contract between Puerto Rico and the General Obligation bondholders does not fall within the reserved powers doctrine; thus, the contract is not valid *ab initio*.[186] In *U.S. Trust*, the Court found that the bond contract did not fall within the reserved powers doctrine because the contract was a purely financial promise. In like manner, Puerto Rico's contract with the General Obligation bondholders is purely financial because Puerto Rico promised that the General Obligation bondholders would have first priority to all available resources of Puerto Rico as security.[187] Furthermore, the Supreme Court has recognized that a state is generally held to its bond contract.[188]

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[179] *See* P.R. CONST. art. VI, § 2.

[180] *Id.*

[181] *See* Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 247 (1978) (*citing U.S. Trust Co. of N.Y.*, 431 U.S. at 23).

[182] *See U.S. Trust Co. of N.Y.*, at 25-26.

[183] *See* P.R. CONST. art. VI, § 2.

[184] *See U.S. Trust Co. of N.Y.*, 431 U.S. at 25-26.

[185] *See Id.* at 23. The reserved powers doctrine, in sum, states that if a state bargains away its police powers in a contract, such contract falls under the reserved powers doctrine and is invalid from the beginning. *See Id.* at 23-34. *See also* Stone v. Mississippi, 101 U.S. 814, 817 (1880).

[186] *See U.S. Trust Co. of N.Y.*, 431 U.S. at 24 (*citing* Stone, 101 U.S. at 817) (finding that the contract was invalid ab initio because it fell within the reserve powers doctrine).

[187] *See U.S. Trust Co. of N.Y.*, 431 U.S. at 25.

[188] *See Id.*

Accordingly, Puerto Rico's contract with the General Obligation bondholders is valid.

D. Act 91 did not Unconstitutionally Impair the Obligation of the Contract[189]

i. Act 91 Impaired the Obligation of the Contract

Central to determining whether Act 91 impaired the obligation of the contract is the question of whether the revenues diverted to COFINA fall within the following language of the Puerto Rican Constitution: "available resources."[190] This is because the Puerto Rican Constitution states that the "available resources" are to fund General Obligation bonds.[191] As such, if "available resources" are used to fund COFINA Bonds, then it would impair the General Obligation bondholder's contract with Puerto Rico.[192] Yet Act 91, which established COFINA, states that the funds dedicated to COFINA do not fall within that language, but that may not be the accurate.[193]

To support the view that the diverted funds do fall within the "available resources" language, the legislative history is helpful. Puerto Rico, when adopting its own Constitution, considered the difference between revenues and resources.[194] The delegates of the Puerto Rican Constitutional Convention specifically drew a distinction between revenues and resources, finding that the term resources has a broader application than the word revenues.[195]

Due to this broad application, there is reason to support the claim that tax revenues generated by Puerto Rico's sales and use tax fall within the "available resources" language because the first 5.5% of the sales and use tax revenues is diverted to COFINA, rather than the general reserve funds.[196] In other words, with

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[189] There is a difference between a state law that merely impairs the obligation of a contract, and a state law that unconstitutionally impairs the obligation of the contract. *See Id.* at 21. "Although the Contract Clause appears literally to proscribe 'any' impairment, this Court observed in Blaisdell that 'the prohibition is not an absolute one and is not to be read with literal exactness like a mathematical formula.'" *Id.* (*citing* Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 428 (1934)). "Thus, a finding that there has been a technical impairment is merely a preliminary step in resolving the more difficult question whether that impairment is permitted under the Constitution." *U.S. Trust Co. of N.Y.*, 431 U.S. at 21.

[190] *See* Odinet, *supra* note 10, at 1143.

[191] *See* P.R. CONST. art. VI, § 2 ("The Secretary of the Treasury may be required to apply the available revenues including surplus to the payment of interest on the public debt . . . .") (official translation).

[192] *See Id.*

[193] *See Id.*

[194] *See* Joffe & Martinez, *supra* note 27, at 22–25.

[195] *See Id.*

[196] *See* Aldrete-Sanchez, *supra* note 56.

a broad interpretation and application of the word revenues, it is reasonable that Puerto Rico's tax revenue is not separate and apart from Puerto Rico's available resources simply because the money generated is put in a corporation rather than the general reserve fund.[197]

Other commentators, however, have recognized that the revenues diverted to COFINA may be separate due to the legal framework of Act 91.[198] Specifically, Act 91 has a non-impairment provision and puts the diverted funds into a figurative "lock box."[199] Nevertheless, one legal commentator states that despite the legal framework of Act 91, "most trained lawyers would say that the constitutional provision trumps [Act 91's] firewall . . . ."[200] Although there are valid arguments on both sides, it is currently unclear whether the tax revenues diverted to COFINA fall within the "available resources" language.[201] To further the analysis, it will be assumed *arguendo* that it does fall within the constitutional language; as such, Act 91 is not separate.

Moving forward with this assumption, Supreme Court cases support the conclusion that Act 91 impaired the obligation of the contract.[202] The Court, in *U.S. Trust*, found that the law impaired the obligation because it "totally eliminated an important security provision . . . ."[203] In like manner, Act 91 affects an important provision as it diverts funds pledged as security to the General Obligation bondholders.[204] But Act 91 does not totally bar the General Obligation bondholders from seeking any of Puerto Rico's available resources for security.[205] Rather than a total elimination of an important security provision, Act 91 affects the General Obligation bondholders' security only to a degree.[206] Yet, despite this difference, the Supreme Court has found, on more than one occasion, that there can still be an impairment even when an important contractual provision is affected only to a degree.[207] Moreover, the degree at stake is significant.[208] The proposed funds, for

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[197] *See Id.*

[198] *See* Odinet, *supra* note 10, at 1143.

[199] *See Id.*

[200] *Id.*

[201] *See Id.*

[202] *See, e.g.*, U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 20 (1977).

[203] *Id.* at 19.

[204] *See* Odinet, *supra* note 10, at 1142-44.

[205] *See* Aldrete-Sanchez, *supra* note 56 (explaining that only 5.5% of the commonwealth's sales and use tax will go directly to "COFINA until a guaranteed base amount of tax collections is met").

[206] *See Id.*

[207] *See, e.g.*, Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 441 (1934) (finding an impairment when a law affected a mortgagor's right to possession as the court could "extend the period of redemption from foreclosure sales 'for such additional time as the court may deem just and equitable'").

[208] *See* Aldrete-Sanchez, *supra* note 56.

instance, dedicated to COFINA from 2006 to April 2007 would have exceeded $500 million.[209]

ii. Act 91 did not Severely Impair the General Obligation Bondholders' Contract with Puerto Rico

The severity of the impairment inquiry can affect the level of scrutiny a court uses to analyze constitutionality of the law.[210] Specifically, a severe impairment will trigger "a careful examination of the nature and purpose of the state legislation."[211] The Court, in *Spannaus*, found that the law Minnesota passed severely impaired the obligation due to the following factors: (1) the law retroactively impaired the obligation; (2) the plaintiff heavily and reasonably relied on that obligation; and (3) the plaintiff's reliance on the obligation was vital in regards to funding.[212]

Although Act 91, similar to the first factor in *Spannaus*, retroactively impaired Puerto Rico's obligation to the General Obligation bondholders,[213] Act 91 likely did not severely impair the obligation of the contract. This is because the second and third factor, in *Spannaus*, applied to Act 91 indicate that the impairment was not severe.

As to the second factor in *Spannaus*, it is unclear whether the General Obligation bondholders heavily and reasonably relied on Puerto Rico giving priority to the General Obligation bondholders to all "available resources" in perpetuity. Although, before Act 91, Puerto Rico did not specifically pass legislation that altered the General Obligation bondholders priority to "available resources," that is not dispositive.[214] This is because the Court, in *Energy Reserves Group Incorporated*, found that the parties' could not reasonably rely on the law at issue because the "supervision of the industry was extensive and intrusive."[215] Analogously, history demonstrates that the United States Congress and Puerto Rico have for a long time had a heavy hand in passing laws regarding Puerto Rico's ability to issue bonds to raise money.[216]

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[209] *See Id.* ("Fiscal 2006 sales tax collections through April 2007 reached $95.2 million for the dedicated 1% sales tax and $428.3 million for the 4.5% general fund sales tax. Assuming that all these revenues would have been deposited in the FIA account, the base amount for fiscal 2008 ($185 million) would have been fully funded during the first two and a half months of collections.").

[210] *See* Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 245 (1978).

[211] *See Id.*

[212] *See Id.* at 245-56.

[213] *See* Christman, *supra* note 11, at 93. *See also* Braun, *supra* note 50.

[214] *See* Energy Reserves Grp., Inc. v. Kan. Power & Light Co., 459 U.S. 400, 413–14 (1983). Energy Reserves Grp., Inc., 459 U.S. at 413-14.

[215] *Id.*

[216] *See, generally,* Joffe & Martinez, *supra* note 27, at 25-26.

And as to the third factor in *Spannaus*, given Puerto Rico's economic crisis and the fact that COFINA would have diverted over $500 million from 2006 to April 2007 alone,[217] one, at first glance, may conclude that it is reasonable to infer that the General Obligation bondholders' reliance on having priority on all available resources was vital to re-paying the General Obligation bondholders. Yet this is not the case.

One of the primary reasons behind passing Act 91 and issuing COFINA bonds was to re-finance Puerto Rico's debt owed to the General Obligation bondholders.[218] Thus, it is equally inferable, if not more likely, that issuing COFINA bonds was vital to re-paying the General Obligation bondholders. Especially, in light of Puerto Rico's economic reality,[219] and because when Puerto Rico initially issued COFINA bonds, COFINA Bonds had a credit rating 5 levels higher than the General Obligation bonds.[220] Moreover, dissimilar to here where the impairment reasonably increases the chance of re-payment, the impairment in *Spannaus* potentially disabled the possibility of re-payment.[221]

In sum, dissimilar to *Spannaus*, the General Obligation bondholders may not be able to show that they reasonably relied on the laws in place when the bonds were issued, nor that their reliance on the obligation was vital to re-payment. As such, a court may not carefully examine the nature and purpose of Act 91.[222]

iii. Under the Lens of Blaisdell and its Progeny, Act 91 Unconstitutionally Impaired the Obligation of the Contract

Although the economic and social emergency that Puerto Rico faces does not create power, the emergency may furnish the occasion for the exercise of power.[223] Puerto Rico, similar to Minnesota in *Blaisdell*, is experiencing a humanitarian crisis and has therefore, adopted a law that retroactively impaired Puerto Rico's obligation to its General Obligation bondholders.[224] But Puerto Rico's Act 91 does not satisfy all five of the *Blaisdell* factors that subsequent Supreme Court opinions have interpreted as necessary to *Blaisdell*'s holding.[225]

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[217] *See* Aldrete-Sanchez, *supra* note 56.
[218] *Id.*
[219] *See* Bases, *supra* note 8 (stating that Puerto Rico has a 45% poverty rate). *See also* Carr, *supra* note 1 (explaining that Puerto Rico has more than $70 billion in debt, "a failed economy, severe poverty, and [a] massive debt crisis").
[220] *See* Odinet, *supra* note 10, at 1143.
[221] *See* Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 246 (1978) ("[T]he statute in question here nullifies express terms of the company's contractual obligations and imposes a completely unexpected liability in potentially disabling amounts.").
[222] *See Id.* at 245-46.
[223] *See* Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 426 (1934).
[224] S*ee Id.* at 416. *See also* Carr, *supra* note 1.
[225] *See Blaisdell*, 290 U.S. at 444-48. *See also Spannaus*, 438 U.S. at 242.

Act 91, however, satisfies the first four of the *Blaisdell* factors.[226] As to the first and second factor, Puerto Rico passed Act 91 in the midst of an economic emergency to protect society at large. This is because Puerto Rico, experiencing the effects of crippling debt, passed Act 91 to refinance the extra constitutional debt and to borrow at a cheaper rate.[227] Further, Puerto Rico could not receive financing by issuing General Obligation bonds because, in 2007, it had reached its debt ceiling.[228] Additionally, in regards to the third factor, because Puerto Rico could not issue any more General Obligation bonds and the General Obligation bonds were more expensive to issue than the COFINA bonds, Puerto Rico tailored Act 91 to the emergency at hand.[229]

In addition, under the fourth *Blaisdell* factor, the conditions of Act 91 were reasonable.[230] Although Act 91 bars the funds diverted to COFINA from becoming collateral security for the General Obligation bondholders, the Minnesota law in *Blaisdell* barred mortgagees from exercising their possessory rights.[231] Also, as in *Blaisdell*, where the Minnesota law required mortgagor to pay the reasonable rental value of the property during the extended redemption period, Act 91 helped refinance the General Obligation bonds.[232] In short, Act 91's conditions are equitably related to the exigency.[233]

Although Act 91 satisfies the first four *Blaisdell* factors, it does not satisfy the fifth factor as it is not temporary in operation.[234] The temporary in operation factor is key in the underlying analysis in *Blaisdell* and its progeny.[235] Because Act 91 is permanent in application, it likely, under *Blaisdell*, unconstitutionally impairs the obligation of the contract.[236] Some of the more modern Supreme Court Contract

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[226] The following, which serves as a reminder, are the five *Blaisdell* factors: (1) whether there was an economic emergency that "furnished the proper occasion for the exercise of the reserved power of the stat to protect the vital interests of the community"; (2) whether the state enacted the law to protect the society at large or a favored group; (3) whether the law is tailored the challenges of the emergency at hand; (4) whether the conditions of the law are reasonable; and (5) whether the law is temporary in operation and limited to the duration of the declared economic emergency. *See* Blaisdell, 290 U.S. at 444-48.

[227] *See* Aldrete-Sanchez, *supra* note 56.

[228] *See* Christman, *supra* note 11, at 93.

[229] *See Blaisdell*, 290 U.S. at 444-48. *See also* Aldrete-Sanchez, *supra* note 56. *See* Christman, *supra* note 11, at 93.

[230] *See Blaisdell*, 290 U.S. at 444-48.

[231] *See Id.* at 416.

[232] *See Id.* at 416-17; *see also* Christman, *supra* note 11, at 93.

[233] *See* W.B. Worthen Co. v. Kavanaugh, 295 U.S. 56, 63 (1935).

[234] *See Blaisdell*, 290 U.S. at 444-48. *See also* Aldrete-Sanchez, *supra* note 56.

[235] *See Blaisdell*, 290 U.S. at 444-48. *See also* W.B. Worthen Co. v. Thomas, 292 U.S. 426, 434 (1934) (explaining that the law was unconstitutional because it was neither temporary nor conditional); *Kavanaugh*, 295 U.S. at 62-63 (stating that the law was unconstitutional because it was not conditional nor limited to the duration of the emergency).

[236] *See Blaisdell*, U.S. 290 at 444-48.

Clause cases, however, allow for laws to satisfy the Contract Clause even if the law is not limited to the duration of the emergency.[237]

iv. Act 91, under US Trust and Faitoute Iron & Steel Company, does not Unconstitutionally Impair the Obligation of the Contract

Once it is established that the law in question serves an important public purpose, the inquiry into whether the law is reasonable and necessary begins.[238] Act 91, similar to the law at issue in *U.S. Trust*, retroactively and permanently impaired the obligation of the bond contract.[239] Despite the law at issue, in *U.S. Trust*, not being temporary in nature, the Court did not find that the permanent effect of the law was the reason the law unconstitutionally impaired the obligation of the contract.[240] Rather, the Court found the law unnecessary because it completely repealed the covenant the bondholders relied on for collateral and a less drastic modification or alternative measure could have achieved the same goals.[241] This is not the case with Act 91. First, Act 91 does not completely repeal the General Obligation bondholders' priority to all available resources.[242] In fact, Act 91 merely gave COFINA bondholders first priority on the first 5.5% of the revenues collected from Puerto Rico's sales and use tax.[243]

Second, unlike *U.S. Trust* where the Court found that the law was unnecessary because a less drastic modification could have achieved the same result, Act 91 was the alternative. This is because at the time Puerto Rico passed Act 91 Puerto Rico reached its debt ceiling and appeared to be unable to re-pay its General Obligation bondholders.[244] Moreover, Puerto Rico's ability to generate money through taxing is not a viable alternative because the General Obligation bondholders' priority to all of the available resources, which included tax revenues, was insufficient, and Puerto Rico's tax base has dramatically diminished.[245] In sum, Act 91 was Puerto

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[237] *See, e.g.*, U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 22 n.19 (1977) (stating that the later decision abandoned *Blaisdell*'s absolute requirement that the law be temporary) (*citing* Viex v. Sixth Ward Bldg. & Loan Ass'n, 310 U.S. 32 39-40 (1940); East N.Y. Sav. Bank v. Hahn, 326 U.S. 230 (1940)).

[238] *See Id.* at 25-28.

[239] *See* Aldrete-Sanchez, *supra* note 56. *See also U.S. Trust Co. of N.Y.*, 431 U.S. at 13-14.

[240] *See, generally, U.S. Trust Co. of N.Y.*, 431 U.S. at 30-32.

[241] *See Id.* at 29-30.

[242] *See* Aldrete-Sanchez, *supra* note 56.

[243] *See Id.*

[244] *See Id. See, generally,* Christman, *supra* note 11, at 91-94.

[245] *See* Peter Whoriskey, *Shrinking, Shrinking, Shrinking: Puerto Rico Faces a Demographic Disaster*, WASH. POST, (Oct. 18, 2017), https://www.washingtonpost.com/business/economy/shrinking-shrinking-shrinking-puerto-rico-faces-a-demographic-disaster/2017/10/17/21141334-aac2-11e7-850e-2bdd1236be5d_story.html?utm_term=.46179297ea79. *See also* Aldrete-Sanchez, *supra* note 56.

Rico's alternative and necessary plan to satisfy its debt to the General Obligation bondholders.

And importantly, the Court, in *U.S. Trust*, recognized factors in *Faitoute*, which made the impairments to the bond contract in *Faitoute* necessary, to guide the Court's inquiry as to whether a law is necessary. The *Faitoute* factors recognized by *U.S. Trust* are analogous to the situation in Puerto Rico.[246] Specifically, the essential factor in *Faitoute* is that the bondholders had only theoretical rights.[247] This is because the city could not raise enough through tax revenue to satisfy the debt owed to the bondholders under the old terms; thus, the law at issue helped the municipality pay back the bonds it issued more effectively.[248] Similarly, evidence supports that Puerto Rico could not raise the needed money through taxes to meet its obligation to the General Obligation bondholders,[249] Moreover, Puerto Rico faces a humanitarian crisis that affects more than its economy.[250] Thus, the General Obligation bondholder had merely a theoretical right to payment.

Furthermore, Puerto Rico passed Act 91, in part, to re-finance its extra-constitutional debt, arising from its General Obligation bonds.[251] Due to this, Act 91 helps Puerto Rico, analogous to *Faitoute*, repay the General Obligation bonds more effectively. Therefore, as in *Faitoute*, which is the only case in the 20th century where the Court upheld a law impairing a bond contract, Act 91 is necessary to serve an important public purpose.[252]

Act 91 is reasonable in serving an important public purpose.[253] The dispositive fact, in *U.S. Trust*, was that the changes in the circumstances, which led the states to repeal the covenant, were "of degree and not of kind."[254] In other words, the concerns at the time the states repealed the covenant, which impaired the

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[246] *See U.S. Trust Co. of N.Y.*, 431 U.S. at 27-28 (*citing* Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 511 (1942)).

[247] *See U.S. Trust Co. of N.Y.*, 431 U.S. at 27-28 (*citing Faitoute Iron & Steel Co.*, 316 U.S. at 511).

[248] *See U.S. Trust Co. of N.Y.*, 431 U.S. at 27-28 (*citing Faitoute Iron & Steel Co.*, 316 U.S. at 511).

[249] *See, e.g.*, Odinet, *supra* note 10, at 1115 ("[I]n July 2015, the Commonwealth's governor declared on live television that the island could not pay its $72 billion in debt--there simply was 'no more cash.'").

[250] *See* Aldrete-Sanchez, *supra* note 56. Puerto Rico faces a number of issues including the following: (1) an increasing unemployment rate that triples that of the United States average; (2) a rising crime rate which is triggered by economic unrest and trained professionals leaving Puerto Rico; and (3) a staggering poverty rate that is double "the most impoverished state in the United states." Odinet, *supra* note 10, at 1114-15. *See also* Carr, *supra* note 1 (finding that Puerto Rico is on the brink of a humanitarian crisis due to Puerto Rico's economic difficulties and Hurricane Maria's impact on Puerto Rico).

[251] *See* Aldrete-Sanchez, *supra* note 56.

[252] *See U.S. Trust Co. of N.Y.*, 431 U.S. at 27 (*citing Faitoute Iron & Steel Co.*, 316 U.S. at 502).

[253] *See U.S. Trust Co. of N.Y.*, 431 U.S. at 25.

[254] *See Id.* at 32.

obligation of the contract, were the same concerns at the time the states created the covenant.[255]

Dissimilarly, after Puerto Rico enacted its constitution, which created the contract between Puerto Rico and its General Obligation bondholders, unexpected changes occurred. Specifically, Puerto Rico, in 1961, increased the amount of General Obligation bond debt that it could issue,[256] allowing Puerto Rico to issue the staggering amount of debt it currently has. Moreover, in 1996, Congress passed a law that eliminated section 936 in chapter 26 of the United States Code, causing Puerto Rico's largest employers and many of its residents to leave the island.[257] This not only negatively affected Puerto Rico's economy, but it greatly diminished its tax base and as a result, materially reduced Puerto Rico's tax revenues. Importantly, Puerto Rico's tax revenue is what funds the repayment of the General Obligation bonds.

Moreover, Act 91, similar to *Faitoute*, reasonably impaired the bond contract because Puerto Rico experienced "unexpected financial conditions."[258] The Great Depression, in *Faitoute*, was the un-expected financial condition.[259] Puerto Rico's economic condition is analogous to the Great Depression in that it has put Puerto Rico on the brink of a humanitarian crisis.[260] Thus, Act 91 does not violate the Contract Clause.

v. Act 91, under Spannaus, Does Violate the Contract Clause

Although Act 91 does not violate the Contract Clause under *U.S. Trust* and *Faitoute*, it does violate the Contract Clause under other modern Supreme Court

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[255] *See Id.* at 31-32 (finding that (1) the need for mass transportation, (2) "the likelihood that publicly owned commuter railroads would produce a substantial deficit," and (3) the public's concern with the environment and energy conservation were known at the time the covenant was created). Not only were the same concerns present at the time the covenant was created, but the covenant was also designed to address such concerns.

[256] *See* Joffe & Martinez, *supra* note 27, at 13.

[257] *See* Chistman, *supra* note 11, at 90-91 ("Section 936 gave manufacturers a federal income tax credit for (1) producing products within Puerto Rico and selling them abroad, and (2) for investing their profits in Puerto Rico. This led Puerto Rico to accumulate large amounts of U.S. investment capital . . . ."). In sum, section 936 caused major manufacturers to move to Puerto Rico, creating a significant economic benefit. Congress, however, enacted Section 936 during the Cold War to enhance the Puerto Rican economy and "establish Puerto Rico as 'a free-market, democratic alternative to Cuba.'" *See Id.* The elimination of Section 936 triggered a recession, which Puerto Rico has yet to recover from. *See* Odinet, *supra* note 10, at 1113-14 ("After the repeal, manufacturers closed up shop almost immediately—nearly sixty-one companies shut down. By November 1996, the manufacturing sector lost a net of 17,720 jobs, bringing the total number of jobs to the lowest in two decades.").

[258] *See U.S. Trust Co. of N.Y.*, 431 U.S. at 28 (*citing Faitoute Iron & Steel Co.*, 316 U.S. at 511).

[259] *Faitoute Iron & Steel Co.*, 316 U.S. at 503, 509-12.

[260] *See* Carr, *supra* note 1.

cases.[261] This is because the Court, in *Spannaus*, reiterates the importance of the temporary in operation factor listed in *Blaisdell*.[262] In addition, the Court highlights that the permanent change was severe and immediate.[263] Although Act 91 did not severely impair the obligation as previously noted, Act 91, similar to the Minnesota law in *Spannaus*, had a permanent effect and was not implemented gradually.[264] Therefore, Puerto Rico's Act 91 violates the Contract Clause under *Spannaus*.[265]

E. A court should use US Trust and Faitoute when determining whether Act 91 violates the Contract Clause

US Trust and *Faitoute* are the appropriate precedent because they concern municipal bond contracts. Moreover, the court, in *US Trust*, indicates that when a court presides over a Contract Clause case regarding a municipal bond contract, a court should use precedent where courts determined whether a law unconstitutionally impaired the obligation of a municipal bond contract.[266] Also, municipal bond Contract Clause cases have unique inquiries. Specifically, in *US Trust* and *Faitoute*, the Court focused on whether the bondholders had theoretical rights to re-payment and whether the law, which impaired the obligation, was aimed at re-financing the debt owed under the municipal bond contract.[267] As such, because the determination as to whether Act 91 violates the contract clause concerns municipal bonds, *US Trust* and *Faitoute* provide the appropriate precedent.

Moreover, the Court's decision in *Spannaus* and *Energy Reserves Group Inc.* are less appropriate for several reasons. First, the laws at issue in *Spannaus* and *Energy Reserves Group Inc.*, notably, did not impair a state's municipal bond contract.[268] Second, the Court's Contract Clause inquiry, in *Energy Reserves Group Inc.*,

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[261] *See, e.g.*, Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 234 (1978).

[262] *See Id.* at 250.

[263] *See Id.*

[264] *See* Aldrete-Sanchez, *supra* note 56 (explaining that Act 91, which Puerto Rico passed in 2006, established COFINA, and "COFINA's sole legal purpose is to issue bonds and use other financing mechanisms to pay or refinance (directly or indirectly) all or part of the extra-constitutional debt of the Commonwealth of Puerto Rico as of June 30, 2006, and the accrued interest thereon, using as a source of repayment the portion of the tax deposited in the Dedicated Sales Tax Fund").

[265] *See Spannaus*, 438 U.S. at 49-51.

[266] *See* U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 28 (1977) ("We therefore conclude that repeal of the 1962 covenant cannot be sustained on the basis of this Court's prior decisions in Faitoute and other municipal bond cases.").

[267] *See, e.g.*, *Id.* at 27-28 ("No one has suggested here that the States acted for the purpose of benefiting the bondholders, and there is no serious contention that the value of the bonds was enhanced by repeal of the 1962 covenant.").

[268] *See, generally, Spannaus*, 438 U.S. at 236-40. *See also Energy Reserves Grp. Inc.*, 459 U.S. at 403-09.

was focused on the Heavily Regulated Industry doctrine. Whereas, the Supreme Court Contract Clause cases analyzing municipal bonds have not even conducted a Heavily Regulated Industry doctrine analysis.[269] Third, in *Spannaus*, the court placed emphasis on the temporary operation of the law that impaired the obligation of the contract, and this emphasis contrasts the inquiry *US Trust* and *Faitoute*. For example, there is no indication that the law at issue in *Faitoute* was temporary in operation—in fact, it is still good law today.[270]

Lastly, *Blaisdell* and its progeny are the least appropriate Supreme Court precedent even though *Kavanaugh* concerns municipal bonds.[271] The modern Contract Clause jurisprudence has notably shifted from the rigid application of the five *Blaisdell* factors to balancing factors to make determinations as to a law's necessity and reasonableness as in *US Trust* and *Spannaus*. Not only is this shift apparent from the cases, but commentators on Contract Clause jurisprudence have stated so as well.[272] Thus, because the underlying framework that guides a court's Contract Clause has changed, *Blaisdell* and its progeny are not appropriate.

V. Conclusion

In conclusion, Act 91 does not unconstitutionally violate the Contract Clause. This conclusion hinges on what precedent a court applies. A court should use *US Trust* and *Faitoute* to guide its inquiry, which supports the constitutionality of Act 91 under the Contract Clause.

The Contract Clause provides a balancing test, allowing struggling states to safeguard the interests of their citizens. This is especially so in the context of an economic emergency. Unfortunately, not only is Puerto Rico suffering from harsh economic realities, but it could face a humanitarian crisis. As such, Puerto Rico has the opportunity to aid its citizens even if it comes at the expense of upholding contractual rights.

But given Puerto Rico's economic reality, the General Obligation bondholders merely had a theoretical right to payment. And because the General Obligation bondholder's contractual right to repayment is a right only in theory, it is ambiguous

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[269] *See, generally, Energy Reserves Grp. Inc.*, 459 U.S. at 403-09. This note does use the Heavily Regulated Industry Doctrine precedent in the analysis as to whether Act 91 severely impaired the obligation of the contract, but it merely uses this doctrine as to whether the General Obligation Bondholder heavily and reasonably relied on the obligation, not whether the municipal bonds fall within this doctrine. *Supra* section IV. D. ii.

[270] *See* N.J.S.A. § 52:27-65; *see also* N.J.S.A. § 52:27-39.

[271] *See, generally,* W.B. Worthen Co. v. Kavanaugh, 295 U.S. 56, 56–63 (1935).

[272] *See, e.g.*, Graham, *supra* note 112, at 409-10 (finding that the framework that guides a court's Contract Clause analysis has changed under the Supreme Court's modern Contract Clause Jurisprudence).

[273] *See* Braun, *supra* note 50.

if upholding the constitutionality of Act 91, under the Contract Clause, comes at the expense of contractual rights. Moreover, Act 91, at the time it was passed, arguably made the General Obligation bondholder's right to repayment more of a realistic reality. This is because Puerto Rico passed Act 91 to re-finance the General Obligation bonds, thereby increasing the likelihood that Puerto Rico would satisfy its outstanding debt to the General Obligation bondholders. Similarly, in *Faitoute*, the state legislature passed a law, which was constitutional under the Contract Clause, to re-finance the state's outstanding debt to its bondholders, who at the time merely had a theoretical right to repayment. Thus, similar to the Supreme Court in *Faitoute* a court should find that Act 91 does not unconstitutionally impair the obligation of the contract.

A court's decision as to the Constitutionality of Act 91 under the Contact Clause will not only significantly impact Puerto Rico, but will also have a meaningful impact on struggling municipalities across the United States. This is because municipalities have passed laws similar to Act 91 to help meet their economic challenges. Notably, these municipalities include some of the United States' biggest cities. For example, Chicago and other municipalities have passed laws to establish corporations similar to COFINA to issue municipal bonds.[273] With major U.S. cities establishing their own Act 91, courts around the country could soon be utilizing the Contract Clause to weigh rights between those that are party to a municipal bond contract and the well-being of the citizens within that state.

As such, it will be important for courts to be familiar not only with the Court's Contract Clause jurisprudence, but also with the different approaches the Court has taken when deciding cases under the Contract Clause. Moreover, courts may have the opportunity to expressly hold what is implicit in the Court's jurisprudence, which is that municipal bond contracts are different than other contracts for purposes of the Contract Clause. Specifically, a state law that impairs the obligation of bond contract does not violate the Contract Clause when the bondholder merely has a theoretical contract right to repayment and the state law's aim is to make said theoretical right into a reality. This is true even when the state law permanently and retroactively impairs the obligation of the contract. As such, Puerto Rico's Act 91 should pass constitutional scrutiny.