STATEMENT OF

PROFESSOR STEPHEN J. LUBBEN

BEFORE

THE COMMITTEE ON ENERGY AND NATURAL RESOURCES

UNITED STATES SENATE

WASHINGTON, D.C.

July 29, 2021

Comments on S. 375: Puerto Rico Recovery Accuracy in Disclosures Act of 2021

Biography:

Stephen J. Lubben holds the Harvey Washington Wiley Chair in Corporate Governance & Business Ethics at Seton Hall Law School in Newark, New Jersey. He has been a member of the Seton Hall faculty since 2002, where he teaches classes in Bankruptcy, Corporate Finance, Financial Institutions, Business Associations, and (very rarely) Constitutional Law.

From 2010 to 2017 he was the "In Debt" columnist for the *New York Times*'s DealBook page. He has been widely quoted by courts and the media on chapter 11 cases, and has been retained as an expert in insolvency and corporate law cases around the world. He previously practiced law with the New York and Los Angeles offices of Skadden, Arps, Slate, Meagher & Flom LLP, as a member of the corporate restructuring department, and was a law clerk for the Honorable John T. Broderick, Jr. of the New Hampshire Supreme Court in Concord from 1996 to 1997.

Introduction

PROMESA[1] was enacted under Congress' territories powers in the aftermath of the Supreme Court's decision that the Commonwealth had no power to enact a restructuring law for its own municipal entities.[2] Title III of PROMESA represents a mix of two existing types of bankruptcy: chapter 11 (corporate reorganization) and chapter 9 (municipal reorganization), along with certain unique, Puerto Rico-specific elements – like the central role of the Oversight Board in the reorganization and the appointment of a district court judge in place of a bankruptcy court judge to hear cases.

Bankruptcy, especially when it takes the form of restructuring, invokes the power of the federal government to alter people's existing legal rights. As a result, people who are impacted by a bankruptcy process have a right to understand in whose interest the process is being conducted. Because S. 375 (or "PRRADA") furthers these important transparency interests in connection with PROMESA, I am pleased to speak today in support of the bill.

Professionals in Bankruptcy Cases (Some Relevant Background)

Before there were reorganizations of local governments, there were reorganizations of corporations.[3] Until the 1930s, corporate reorganizations were conducted in "equity receiverships." As one former bankruptcy professor, now a siting bankruptcy judge, summarizes:

> The insular nature of equity receiverships... lent the process to abuse and generated substantial criticism. The most notable critic was William O. Douglas... He asserted that management and those creditors aligned with management controlled most aspects of the equity receivership process, providing no representation for, and frequently small returns to, other creditors. In fact, creditors not participating in the reorganization committee's plan could be cashed out for a fraction of their debt holdings.
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> Justice Douglas also lamented the role of protective committees in the process. He complained that the committees often were self-selected and influenced, if not controlled, by management and the corporation's investment bankers.[4]

During the New Deal, Congress addressed these problems through codification of corporate bankruptcy. Specific conflicts of interest were proscribed, and professionals became subject to court oversight and extensive disclosure requirements.

But when municipal bankruptcy developed at roughly the same time, this aspect of corporate bankruptcy was not translated into this new context.

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[1] The Puerto Rico Oversight, Management, and Economic Stability Act, 48 U.S.C. §§ 2101-2241.

[2] Puerto Rico had previously been excluded from chapter 9 of the Bankruptcy Code.

[3] *See generally* Stephen J. Lubben, *Fairness and Flexibility: Understanding Corporate Bankruptcy's Arc*, 23 U. Pa. J. Bus. L. 132 (2020).

[4] Michelle M. Harner, *The Search for an Unbiased Fiduciary in Corporate Reorganizations*, 86 Notre Dame L. Rev. 469, 480–81 (2011).

Why? In short, in the 1930s Congress was uncertain "how far" the Supreme Court would permit municipal bankruptcy legislation to go.[5]

Even today, chapter 9's only express regulation of professionals in municipal bankruptcy cases is in the context of plan confirmation, when the court determines the reasonableness of the fees.[6] Chapter 9 provides no guidance on what constitutes reasonable compensation.

Professionals in PROMESA

PROMESA, and particularly title III thereof, is clearly heavily influenced by chapter 9. But title III departs from chapter 9 in several notable respects, including with regard to professional compensation. Indeed, PROMESA adopts an approach closer to that of chapter 11 in this regard.

Under title III, section 316,[7] and section 317,[8] the court is given control over the award of compensation to all professionals throughout the case.[9] Moreover, the court is instructed to evaluate compensation applications under a standard that closely tracks that used in chapter 11 cases.[10] Caselaw developed in the chapter 11 context will presumably inform the court's analysis under sections 316 and 317.[11]

While the PROMESA court is instructed to evaluate professional compensation under a chapter 11 style framework, PROMESA does not expressly incorporate the disclosure requirements in today's chapter 11,[12] which have their roots in the New Deal reforms I noted at the outset. Perhaps because PROMESA follows the chapter 9 model with regard to retention of professionals,[13] while following chapter 11 with regard to compensation, these disclosure obligations were neglected.

That is, disclosure may have fallen through the cracks when bits of chapter 9 and chapter 11 were melded in PROMESA.

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[5] Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513 (1936) (invalidating the first attempt at municipal bankruptcy). Congress enacted a revised municipal bankruptcy act in 1937, Pub. L. No. 302, 50 Stat. 653, which was upheld by the Supreme Court. United States v. Bekins, 304 U.S. 27, 54 (1938). That law was extensively revised in the mid-1970s and forms the basis for today's chapter 9.
[6] 11 U.S.C. § 943(b).
[7] 48 U.S.C. § 2176.
[8] 48 U.S.C. § 2177.
[9] On the other hand, the retention decisions of both Puerto Rico and the Oversight Board are not subject to court review, much as in chapter 9. That is, these parties have chapter 9 like powers over retention of professionals, while the court has chapter 11 like powers with regard to compensation of those professionals.
[10] *Compare* 48 U.S.C. § 2176 *with* 11 U.S.C. § 330.
[11] To date, there have been no reported compensation opinions in the title III cases.
[12] *E.g.*, 11 U.S.C. § 327; Bankruptcy Rule 2014, and the extensive judicial gloss on both.
[13] *See supra* note 9; *see also* 48 U.S.C. § 2176(a) ("the court may award to a professional person employed by the debtor (*in the debtor's sole discretion*), the Oversight Board (*in the Oversight Board's sole discretion*), a committee under section 1103 of title 11…") (emphasis added).

The Benefits of PRRADA

PRRADA corrects this apparent oversight in PROMESA. When enacted, the professionals retained by all the major parties to the pending title III cases will be required to make the sort of disclosures that these same professionals already make when they appear in chapter 11 cases.

Not only does PRRADA fix this gap in PROMESA, but it provides the court with Congressional guidance on the award of compensation under sections 316 and 317. Moreover, PRRADA reflects Congress' express determination – and this is a legislative policy determination, that is best made by Congress – that transparency should prevail, while conflicts of interest are banished, in the title III proceedings. That is, divided loyalties are forbidden even if, on a purely economic basis, the court might find that the professional's compensation is "reasonable" under existing section 316.

And this is how it should be. Congress has long recognized that when the power of federal law and the federal courts is used to impose sacrifices in bankruptcy, the process must be fully transparent and fair. The professionals shepherding the debtor through its restructuring must work for the party that retained them in the case, and no one else.

In the PROMESA cases, it is the citizens of Puerto Rico, as taxpayers, who will ultimately pay for the professional fees incurred. And at the same time, these citizens are being asked to make considerable sacrifices, in the form of reduced pensions, higher utility rates, and even reduced employment.

Just as in the railroad reorganizations that worried the New Dealers, the people of Puerto Rico have every right to know that the PROMESA process is not being twisted to advance undisclosed interests. As a matter of basic agency law, a professional owes its client a duty of good faith and loyalty. But whether those standards are being met is only knowable upon full disclosure.

At this critical juncture in their history, PRRADA can provide Puerto Ricans with the information they need to understand the motivations of the professionals who are playing key roles in crafting their Commonwealth's future. While the bill would impose some administrative burdens on the professionals, the disclosures are only those that these professionals are already providing in corporate bankruptcy cases, and it seems that the people of Puerto Rico, our fellow Americans, are entitled to at least that much.

Conclusion

Congress can promote faith in the PROMESA process by mandating transparency. I hope it does so by passing S. 375.

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Technical Notes and Comments on the Bill:

- Section 2(b)(2): I believe the cross reference here should be to subsection (a), rather than (e).
- Section d(2): As presently worded, this section is quite broad, and might allow a professional to argue that their fee application may not be delayed, despite the professional's failure to comply with subsection (a). Why should the professional be paid if they have not complied with the "rules"? I would suggest narrowing this provision so that it provides that only the debtor's plan of adjustment, or reorganization generally, is not delayed by disclosure disputes.
- In addition, note that the reference to "paragraph (1)" seems to be in error – I believe the cross reference here should be to subsection (a).
- Section 2(e)(1)(C): The court is authorized to deny compensation when a professional holds an interest adverse to the *estate*. But there is no bankruptcy estate in a title III case (or a chapter 9 case for that matter).[14] I suggest rewriting this section to read "the debtor and its reorganization" in place of "the interest of the estate."
- Section 2(e)(2): Is this paragraph necessary, given that the court presumably already takes into account similar considerations under section 316 of PROMESA? In any event, the section suffers from the same problematic reference to the "estate," noted above. If retained, the paragraph could be rewritten as "in the best interests of creditors, the debtor, and the debtor's reorganization."

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[14] Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 Wash. & Lee L. Rev. 403, 414 (2014).