WOLF POPPER
ESTABLISHED IN 1945

845 Third Avenue, New York, NY 10022
212-451-4600 • wolfpopper.com

Extreme Measures: How Puerto Rico's Bankruptcy Caused a Radical Change to Its Public Pension Retirement Systems

By Chet B. Waldman

Puerto Rico's Financial Crisis

Over the last several decades, a multitude of factors contributed to the steep economic downturn of the Commonwealth of Puerto Rico (the "Commonwealth" or "Puerto Rico"), including a contracting economy, population decline, and changes in tax status and available credits under the U.S. tax code. From the early 2000s through 2016, Puerto Rico's public debt rose rapidly, in part, from borrowing to cover deficits including to pay debt service, and the outlook for Puerto Rico's economy continued declining.[1]

By 2016, Puerto Rico was "in the midst of a fiscal crisis."[2] The Commonwealth was "being crushed under the weight of a public debt that [was] larger" than its gross national product, "it ha[d] started to default on its debt obligations," and it had lost access to external financing.[3] The Commonwealth had over $120 billion in combined debt and unfunded pension liabilities. Specifically, as of August 31, 2016, the Commonwealth had approximately $74 billion of funded debt, estimated pension liabilities of approximately $55.6 billion[4], and insufficient resources to meet those obligations.[5]

----

1 See Disclosure Statement for the Seventh Amended Title III Joint Plan of Adjustment of the Commonwealth of Puerto Rico, et. al. (the "Disclosure Statement") filed on July 30, 2021, at p.1. https://perma.cc/GP8Y-J32Y
2 Puerto Rico v. Franklin Cal. Tax-Free Tr., 136 S. Ct. 1938, 1942 (2016).
3 Walmart Puerto Rico, Inc. v. Zaragoza-Gómez, 174 F.Supp.3d 585, 602 (D.P.R. 2016); H.R. Rep. No. 114-602, at 40 (2016).
4 GASB 67 Net Pension Liability for Puerto Rico's public pension systems as of June 30, 2016 as reported in the June 30, 2016 Actuarial Valuation Reports by the systems' actuary. Excludes medical insurance plan contributions measured under GASB 45.
5 See Disclosure Statement at 1, 3.

Consequently, on June 30, 2016, the President of the United States. signed into law legislation passed by Congress, the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"), 48 U.S.C. § 2101 et seq., to work toward a remedy for the ongoing fiscal and humanitarian crises in Puerto Rico. "The goal of PROMESA is to meet Puerto Rico's immediate need to provide its citizens effective services, to formulate a debt restructuring, and to implement fiscal reform leading to a sustainable economy, fiscal responsibility, and market access."[6]

PROMESA establishes two primary mechanisms for restoring fiscal responsibility. First, Titles I, II, IV and V of PROMESA create the Financial Oversight and Management Board for Puerto Rico (the "Oversight Board") and provide it powers and duties governing the review and certification of multi-year fiscal plans, annual budgets, and infrastructure revitalization, and fast-tracking key infrastructure projects. Second, Titles III and VI of PROMESA provide for debt restructurings, similar to bankruptcy cases and out-of-court restructurings, respectively, for Puerto Rico and its instrumentalities.[7] By incorporating many provisions of Title 11 of the United States Code (the "Bankruptcy Code") into Title III of PROMESA, which provides for restructurings similar to restructurings under chapters 9 and 11 of the Bankruptcy Code, the statute also protects the debtors (i.e., the Commonwealth and certain government affiliated agencies including the Employees Retirement System of the Government of the Commonwealth of Puerto Rico ("ERS")). The Oversight Board is the sole representative of any debtor entity in a Title III case, with the exclusive authority to propose a plan of adjustment.

Historic Problems Leading to Oversight Board

To overcome decades of severe economic decline, operating deficits, lack of financial transparency, management inefficiencies, and excessive borrowing,[8] PROMESA established an independent entity within Puerto Rico's government – the Oversight Board.[9] The Oversight Board is "an entity within the territorial government," rather than a "department, agency, establishment, or instrumentality of the Federal Government."[10] The Oversight Board is statutorily charged with restoring to the Commonwealth fiscal responsibility and market access.[11] To achieve success in carrying out its statutory mission, the Oversight Board is granted authority to oversee the restructuring of the Commonwealth's and its instrumentalities' debt and to require fiscal reforms.

A New Landscape – Hurricanes Irma and Maria

In September 2017, the difficulty of improving Puerto Rico's financial status worsened as Puerto Rico was devastated by Hurricanes Irma and Maria. The hurricanes destroyed much of Puerto Rico's infrastructure and upended the daily lives of all Puerto Ricans and the work of the Oversight Board.[12]

----

6 See Disclosure Statement at 1.
7 48. U.S.C. § 2161.
8 PROMESA § 405(m)(1).
9 48 U.S.C. § 2121(a)(1).
10 Id. § 2121(c)(2); see also 48 U.S.C. § 2194(i)(2) (defining the term "Government of Puerto Rico" to include the Oversight Board for purposes of that section); 48 U.S.C. § 2127(b) (providing that the Oversight Board is funded exclusively by the territorial government of Puerto Rico).
11 PROMESA § 101(a).
12 Disclosure Statement at 4.

Recent Earthquakes and Aftershocks

On December 28, 2019, the first of many significant earthquakes and aftershocks struck Puerto Rico, registering at a magnitude of 4.7 of the Richter scale. On January 6, 2020, Puerto Rico experienced a 5.8 magnitude earthquake and the next day experienced a 6.4 magnitude earthquake, the Caribbean's strongest and most destructive earthquake in a century. Then, on May 2, 2020, another 5.4 magnitude earthquake struck Puerto Rico's southwestern coast. The seismic event, which briefly knocked out power to some areas, hit near the city of Ponce where hundreds of structures, including homes and houses of worship, remain damaged or destroyed.[13]

These earthquakes represent only four of more than 1,000 overall earthquakes of magnitude 3 or greater in Puerto Rico during 2020, with six being over a 5.5 magnitude. According to a January 29, 2020 report published by the United States Geological Survey, there is a high likelihood of continued, material aftershocks over the course of the next several years.[14] These earthquakes have caused significant damage to homes and buildings on Puerto Rico's southern coast, as well as significant damage to the Costa Sur power plant owned and operated by the Puerto Rico Electric Power Authority ("PREPA"), which would typically provide approximately 21% of Puerto Rico's power.

COVID-19 Impact and Response

On March 11, 2020, the World Health Organization declared the Coronavirus Disease 2019 ("COVID-19") a global pandemic. As a result of the health threat and to contain the virus spread across Puerto Rico, then-Governor Vázquez-Garced issued an executive order on March, 12, 2020, declaring a state of emergency in Puerto Rico to concentrate all efforts and implement necessary measures to safeguard the health, well-being, and public safety of the citizens of Puerto Rico.[15]

Ultimately, the Oversight Board collaborated with the Government to develop new fiscal plans with the overarching goal of fulfilling PROMESA's mandates. To do so, the fiscal plans would require a series of ambitious structural reforms and fiscal measures to restore growth and opportunity to the people and businesses of Puerto Rico.[16]

The Massive Changes to Puerto Rico's Public Pension Systems

Puerto Rico's three pension systems (ERS – Employee Retirement System -, TRS – Teachers' Retirement System -, and JRS – Judicial Employees Retirement System) (the "Systems") were dramatically changed following the enactment of Puerto Rico's Act 106 in August 2017 during the time of the Commonwealth's bankruptcy. Effective July 1, 2017, all employer contributions were eliminated pursuant to Act No. 106-2017 and the Commonwealth of Puerto Rico (the "Commonwealth" or the "Government") implemented a "pay-as-you-go" ("PayGo") system for the payment of pensions. Also, pursuant to Act No. 106-2017, the Systems were required to liquidate their assets and transfer the net proceeds to the Department of Treasury of the Commonwealth to pay future pension benefits.

----

13 Disclosure Statement at 4-5.
14 U.S. Geological Survey, 2020 Southwest Puerto Rico Earthquake Sequence (January 29, 2020).
15 Disclosure Statement at 5.
16 Disclosure Statement at 6.

More specifically, on August 23, 2017, the Government of Puerto Rico enacted the Law to Guarantee the Payment of Our Pensioners and Establish a New Plan of Defined Contributions for Public Servants (Act 106), which transformed the Systems into the single PayGo Plan. Act 106 included a declaration that the Systems were in a state of "financial emergency" and cited sections of the Constitution of Puerto Rico vesting the Legislature with authority to pass laws "for the protection of the life, health and wellbeing of the People...when the health, public safety or essential government services are clearly in jeopardy."

Prior to Act 106, the Systems each maintained both defined benefit plans (for which benefit payments were primarily funded by the Commonwealth and other agencies and municipalities that employed municipal workers) and hybrid plans (funded primarily by employer contributions). However, the Commonwealth's primary liability to the Systems prior to Act 106, was for its required annual contributions as an employer.

Through Act 106 the Puerto Rican government transformed the Systems into a single "pay-as-you-go" system (the "Plan") whereby future benefit payments were guaranteed by Puerto Rico's general fund. Act 106 was enacted to address the immediate insolvency of the Systems and avoid extreme hardship and social disorder. The Government's exercise of its police powers in passing Act 106 represented a post-petition guaranty of retiree statutory obligations. Vested pension benefits are property rights under Puerto Rico law.

Under Section 2.4 of Act 106, the Government guaranteed payment of "Accumulated Pension" benefits under all of the then-existing three Systems. Section 3 of Act 106 further contemplates that the guaranteed payments will be made out of (i) a newly created "Accumulated Pensions Payment Account" funded by the liquidation of ERS/JRS/TRS assets; (ii) a pay-go charge to be imposed on Commonwealth agencies, public corporations, municipal governments, and the judicial branch; (iii) budget assignments and special assignments to finance pension payment deficits; (iv) donations; and (v) other funds identified by Puerto Rico's Legislative Assembly.

Section 3.1 of Act 106 also created a new "Defined Contribution Plan" (i.e., the "Plan"), under which all participants in the Systems will make monthly contributions that will be placed in individual Defined Contribution Accounts for each active Plan participant, contributions to these accounts will supplement the "Accumulated Pension" benefits that existed prior to enactment of Act 106. The employee contributions to the Defined Contribution Plan are deposited in a trust account held by the Trust Division of Banco Popular de Puerto Rico and separate from other funds of the Commonwealth (the "Pension Reserve Trust").

Certain plan provisions are different for the three groups of members who entered the Plan prior to July 1, 2013 as described below:

- Members of Act. No 447 are generally those members hired before April 1, 1990 (contributory, defined, benefit program).
- Members of Act No. 1 of February 16, 1990 (Act No. 1) are generally those members hired on or after April 1, 1990 and on or before December 31, 1999 (contributory, defined benefit program).
- Members of Act No. 305 of September 24, 1999 (Act No. 305 or "System 2000") are generally those members hired on or after January 1, 2000 and on or before June 30, 2013 (defined contribution program).

All regular employees hired for the first time on or after July 1, 2013, and former employees who participated in the defined benefit program and the System 2000 program, and were rehired on or after July 1, 2013, become members of the "Contributory Hybrid Program" as a condition to their employment. In addition, employees who at June 30, 2013, were participants of previous programs became part of the Contributory Hybrid Program on July 1, 2013. Also, Act No. 3 of April 4, 2013 (Act. No. 3 of 2013) froze all retirement benefits accrued through June 30, 2013 under the defined benefit program and, thereafter, all future benefits accrued under the defined contribution formula used for the System 2000 program participants.[17]

Puerto Rico Department of the Treasury Announces 2023 Limits on Qualified Retirement Plans

The Puerto Rico Department of the Treasury recently issued Internal Revenue Circular Letter No. 23-01 (CL-IR 23-01) announcing the applicable 2023 limits for Puerto Rico qualified retirement plans. The following are the applicable 2023 limits:

- **Annual Benefit Limit** applicable to defined benefit plans - $265,000 (increased from $245,000 for 2022).
- **Annual Contribution Limit** applicable to participant accounts in defined contribution plans - $66,000 (increased from $61,000 for 2022).
- **Annual Compensation Limit** - $330,000 (increased from $305,000 for 2022).
- **Compensation Limit** for highly compensated employees (HCE) - $150,000 (increased from $135,000 for 2022). This is the limit for the base year (2023) for 2024 testing in the case of calendar year plans.
- **Catch-Up Contributions Limit** applicable only to federal government employees ages 50 or over - $7,500 (increased from $6,500 from 2022).
- **Elective Cash or Deferral Contributions Limit** applicable to participants in a plan sponsored by the federal government or a plan qualified under both Section 1081.01(a) of the PR Code and Section 401(k) of the US code - $20,000 (unchanged from 2022).
- **Elective Cash or Deferral Contributions Limit** applicable to participants in a plan qualified only under Section 1081.01(a) of the PR Code - $15,000 (unchanged from prior years).
- **Catch-up Contributions Limit** applicable to participants in a plan not sponsored by the federal government who at the end of the plan year are at least 50 years of age - $1,500 (unchanged from prior years).
- **After-Tax Voluntary Contributions** by employees participating in a plan qualified only under Section 1081.01(a) of the PR Code – 10% of the aggregate compensation of the employees for all years in which they are participants in a retirement plan (unchanged from prior years).

----
17 For details about each of the service retirement eligibility requirements, compulsory retirement, and specific benefits to plan participants of each of the Systems see Commonwealth of Puerto Rico Defined Benefit Pension Plan for Participants of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico – Schedule of Employer Allocations and Schedule of Total Pension Liability by Employer dated July 1, 2017 at 5-10. https://perma.cc/CHN3-HALY

Has the PayGo System Been Working As Intended?

According to Christian Sobrino, the Governor-appointed Chairman and Executive Director of the Puerto Rico Fiscal Agency and Financial Advisory Authority between July 2017 – July 2019 and a corporate attorney, "the PayGo system has generally been working as intended with few bumps in the road. The one notable issue the PayGo system faced when rolled out had to do with Section 2.4 of Act 106, which requires a pay-go charge to be imposed on Commonwealth agencies, public corporations, municipal governments, and the judicial branch. The problem arose because municipal government and public corporations generally had not included the pay-go charge in their budgets or had not adjusted their revenue measures to raise their pay-go charge. As a result, certain municipalities and public corporations did not pay all of the PayGo charges the law demands causing the trust account to pay deposits (the Pension Reserve Trust) to have less money than it was supposed to have. For example, during the previous administration, the municipality of San Juan accrued a payable of approximately $100 million to the Plan."

One serious concern going forward with respect to the PayGo system relates to the economic performance of Puerto Rico and the performance of its tax base. If its taxpayer and/or tax revenue base shrinks, the Commonwealth's ability to adequately fund the PayGo Plan is threatened. Many economists and others believe Puerto Rico's tax revenue base will be severely challenged in the future. If that occurs, it could result in dire consequences for the Plan.

Indeed, according to the Financial Oversight & Management Board for Puerto Rico's Fiscal Plan for Commonwealth of Puerto Rico certified as of April 3, 2023 (Vol. I - Transformation Plan (the "2023 Fiscal Plan")), while Puerto Rico's economy received a huge post-COVID economic boost from the U.S. government, the Commonwealth faces serious future risks to its economic health and taxpayer base.

As mentioned in the 2023 Fiscal Plan, "a strong post-COVID recovery fueled by federal stimulus funding has generated near-term economic outperformance in Puerto Rico and across U.S. states. However, federal funds have an outsized and temporary impact that may mask underlying structural weaknesses. Across key economic indicators, Puerto Rico has shown strong performance..."[18]

However, as that same 2023 Fiscal Plan noted, "near term, unprecedented inflows of federal funds are waning, and may be masking underlying weakness in the economy. The economy of Puerto Rico is sensitive to changes in the level of federal funding since federal funds have historically comprised approximately a quarter of personal income. In recent years, Puerto Rico has received an unprecedented infusion of federal funds in the form of Disaster Relief Funding and COVID-19 stimulus that has helped the economic recovery. Through successive federal stimulus and recovery packages, Puerto Rico received approximately $120 billion in federal funds, equivalent to over 150% of 2022 GNP."[19] Most of these COVID-related funds, such as enhanced unemployment benefits, Paycheck Protection Program (PPP) loans, and economic impact payments "were one-time infusions that temporarily boosted output. This major influx of one-time federal funds has strengthened the economy during the pandemic, but even at this level of support Puerto Rico GNP has not yet returned to FY 2016 levels."[20]

In addition, labor force participation is up, and unemployment is at historically low levels. However, as Puerto Rico continues to emerge from the COVID-19 pandemic, the unemployment rate continues to decline in a trend started in 2010 reaching a historic low of 5.8% in August 2022. While unemployment is still relatively high compared to the mainland, Puerto Rico has narrowed the gap to just over 2 percentage points. In addition, labor force participation, despite being below other U.S. states, continues to rise.[21]

----

18 2023 Fiscal Plan at 14. https://perma.cc/PPD7-N4T3
19 2023 Fiscal Plan at 14.
20 2023 Fiscal Plan at 14.
21 2023 Fiscal Plan at 15.

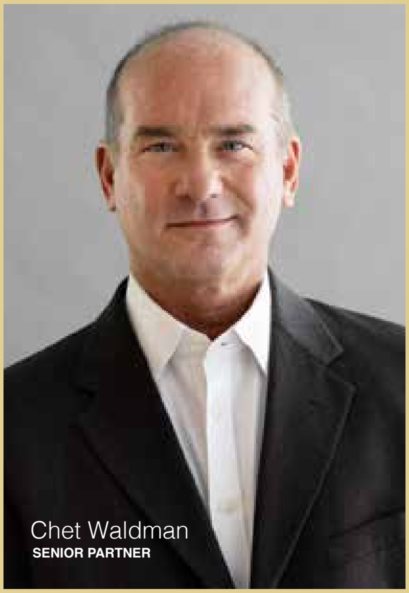
But, the 2023 Fiscal Plan warns that the population is projected to decline due to the demographic composition of Puerto Rico's residents. "In 2016, Puerto Rico began to experience negative natural population change (a higher number of deaths than births). This negative natural change has continued unabated into 2023. Natural population decline is exacerbated by outmigration. While the updated population forecast in the 2023 Fiscal Plan shows higher population projection relative to the 2022 Fiscal Plan due to updates from the 2020 federal census, the declining population trend remains."[22]

Also, as COVID stimulus funds dwindle, the growth outlook for the next several years is "anemic."[23] Households in Puerto Rico and across the U.S. have been buoyed by COVID relief funds. As those funds are drawn down, a drag on the economy may be expected as the pace of consumption and economic activity slows. These economic forecasts are critical to the revenue projections and for informing the budgeting capacity to fund government service delivery."[24] Moreover, future growth is highly dependent on Puerto Rico's ability to deploy federal reconstruction funds. The 2023 Fiscal Plan assumes full deployment of disaster relief funds by 2035. "Less than full deployment is a risk that would substantially lower GNP growth. For example, a scenario with 50% deployment of relief funds would result in a 1.9 percentage point decrease in average GNP growth between FY2023 and FY2027, and a scenario with no further federal reconstruction fund deployments would decrease growth by 3.1 percentage points per year over the same period."[25]

Finally, longer-term, the changes to Federal funding for the Medicaid program create uncertainty. Changes included in the federal 2023 Consolidated Appropriations Act provided a near term boost in funding for the Commonwealth but does not provide additional Medicaid federal funds beyond FFY2027. "The Commonwealth could face a 'Medicaid fiscal cliff,' where it becomes responsible for a significantly increased share of Medicaid expenses."[26]

As noted by the Financial Oversight & Management Board of Puerto Rico in its most recently filed Fiscal Plan, Puerto Rico and the PayGo Systems face substantial challenges in the coming years.

----
22 2023 Fiscal Plan at 17.
23 2023 Fiscal Plan at 17.
24 2023 Fiscal Plan at 17.
25 2023 Fiscal Plan at 18.
26 2023 Fiscal Plan at 19.



About the Author

Chet Waldman is a Senior Partner and member of the Executive Committee at Wolf Popper LLP.

Chet Waldman is a senior partner and member of the executive committee at Wolf Popper LLP. Chet is a graduate of Cornell University and Boston University School of Law. Chet has been at Wolf Popper since 1988 where he has concentrated in federal securities class actions, state and federal merger and acquisition litigations, and derivative litigation. He has been named as a top-rated securities litigation attorney by Super Lawyers (New York-Metro Edition) from 2009-2020. Chet also has extensive experience in litigating health care and consumer fraud cases. He was named as a Top-Rated Super Lawyer (New York-Metro Edition) in 2021-2023 for consumer law.

Chet has been a member of the Securities Litigation Committee and the Mergers & Acquisition Committee of the New York City Bar Association. Chet is currently serving as a member of that Bar Association's Consumer Affairs Committee and continues to participate in meetings and events of the Inter-American Affairs Committee. On June 30, 2017, the individual members of the Inter-American Bar Association ("IABA"), an association made up of more than 30 countries from North America, Central America, South America, England, Spain, and France, elected Chet to represent them as a member of the IABA Council.

Chet is a frequent lecturer on securities litigation matters, healthcare litigation, and the fiduciary duties of pension system trustees throughout the U.S., Latin America, and Canada.

About Wolf Popper LLP

Wolf Popper is a leading complex litigation law firm that represents clients in high stakes individual and class action litigations in state and federal courts throughout the United States. The firm specializes in securities fraud, mergers and acquisitions, consumer fraud litigation, healthcare litigation, ERISA, and commercial litigation and arbitration. Wolf Popper was founded in 1945, and is headquartered in New York City. Wolf Popper also has offices in Houston, Texas; Chicago and Springfield, Illinois; Boston, Massachusetts; and San Juan, Puerto Rico.

Wolf Popper's attorneys are experienced litigators, many of whom have prior experience at AmLaw 100 firms or in government agencies. Wolf Popper's reputation and expertise has been repeatedly recognized by courts, which have appointed Wolf Popper and its attorneys as lead counsel in complex litigations throughout the country. Over the past seventy-five years, Wolf Popper has recovered billions of dollars for its clients.

Wolf Popper was one of the first laws firms in the United States to develop a class action securities litigation practice. The practice was founded in 1958, and grew out of the Firm's historical commitment to protecting the rights of individuals. Wolf Popper's long-established role in the securities bar provides its clients with an understanding and insight into federal securities and state fiduciary duty laws that could only be obtained through years of practice in the fields.

Wolf Popper provides a range of services which are designed to aid shareholders seeking to recover damages related to fraud and other corporate misconduct, as well as shareholders who seek to advocate for improved corporate governance.

Wolf Popper routinely represents damaged and defrauded institutional and other large investors in class action and individual securities litigations. Wolf Popper is regularly appointed lead or co-lead counsel in complex securities litigations. Wolf Popper is very selective in the cases it litigates. The Firm's careful factual and legal research and selective prosecution has resulted in a significant percentage of the securities litigations in which the Firm is involved being sustained over, or being settled prior to a decision on, a motion to dismiss. Wolf Popper regularly litigates cases alleging materially false and misleading statements in violation of the federal securities laws, as well situations involving as other corporate misconduct, such as (i) excessive compensation being paid to a company's management; (ii) self-dealing transactions between a company and its management or directors; or (iii) where a majority/controlling shareholder seeks to cash out the public, minority shareholders at a grossly unfair price or in a manner that compromises the process necessary to ensure that the public shareholders are treated fairly.

Wolf Popper's portfolio monitoring service aims to educate the Firm institutional investor clients about securities litigation and corporate misconduct issues that impact their investment portfolios. The Firm provides monthly and case specific reports related to current litigations and disclosures of potential fraud or other corporate misconduct. Wolf Popper also provides clients with monthly reports of recently reached class action settlements to help clients identify settlements in which they might be entitled to participate.

Wolf Popper serves as a trusted advisor to institutional shareholders, and strives to help board members, directors, administrators, and other fiduciaries meet their duties and responsibilities to protect fund assets and mitigate the risks and liabilities. Wolf Popper represents a number of state, county, and municipal pension funds as well as Taft-Hartley plans and other sophisticated institutional investors. Wolf Popper's portfolio monitoring services are provided to institutional investors at absolutely No Out-of-Pocket Cost and Risk Free. Wolf Popper provides litigation services to institutional investors on a contingent fee and non-recourse basis.

Wolf Popper has a long history of representing international clientele. Wolf Popper's office in San Juan, Puerto Rico provides the firm with a gateway to the civil law system in Latin America and Europe; Wolf Popper has working relationships with firms throughout those jurisdictions. Latin American institutional investors worldwide can expect fully bilingual services in portfolio monitoring and securities litigation from diverse and experienced attorneys.

Wolf Popper's founders always recognized the value of a workforce comprised of talent across the demographic spectrum. The Firm has been committed to diversity and inclusion and gender equality since its inception and is proud to continue to embrace that tradition of inclusion to the benefit of the Firm and the clients we serve.

To learn more, please visit us at *www.wolfpopper.com*, or email us at *outreach@wolfpopper.com*.

www.wolfpopper.com Wolf Popper LLP @WolfPopperLLP