



3-1-2017

The Consequences from Issuing Invalid Municipal Debt: Examining the Voidable Debt Issues in the Detroit Bankruptcy and Puerto Rican Debt Crisis

Joshua C. Showalter

Follow this and additional works at: <http://scholarship.law.unc.edu/ncbi>



Part of the [Banking and Finance Law Commons](#)

Recommended Citation

Joshua C. Showalter, *The Consequences from Issuing Invalid Municipal Debt: Examining the Voidable Debt Issues in the Detroit Bankruptcy and Puerto Rican Debt Crisis*, 21 N.C. BANKING INST. 195 (2017).

Available at: <http://scholarship.law.unc.edu/ncbi/vol21/iss1/12>

The Consequences from Issuing Invalid Municipal Debt: Examining the Voidable Debt Issues in the Detroit Bankruptcy and Puerto Rican Debt Crisis

I. INTRODUCTION

Puerto Rico is in serious trouble.¹ The island commonwealth of 3.5 million people has accumulated a deficit of over \$70 billion (“Puerto Rican Debt Crisis”).² Economists are split on whether this crisis will have any major impact on the United States economy, but so far its effects have been mostly limited to the bond market.³ Regardless of what happens in The Puerto Rican Debt Crisis, how the voidable debt obligation issue is resolved will almost certainly have a substantial impact on the United States economy. In all likelihood, Puerto Rico illegally issued municipal bonds in 2014 and 2015, and now seeks to declare \$4.1 billion of its debts void.⁴ By doing this, Puerto Rico is following the example set by Detroit when, in 2013, the city attempted to void part of its debts by claiming it was illegally issued.⁵ Though such an outcome seems unlikely at first, the little applicable precedent that exists indicates that Puerto Rico will indeed be successful in declaring these bond obligations invalid and ultimately void.⁶

Because bonds are typically viewed as a relatively safe investment opportunity, they have long served as a vital source of

1. Nick Timiraos, *Puerto Rico’s Drastic Population Loss Deepens Its Economic Crisis*, WALL ST. J. (June 29, 2016 7:35 PM), www.wsj.com/articles/puerto-ricos-drastic-population-http://www.wsjloss-deepens-its-economic-crisis-1467219467.

2. *Id.*

3. Mary Williams Walsh and Liz Moyer, *How Puerto Rico Debt is Grappling With a Debt Crisis*, N.Y. TIMES (July 1, 2016), <http://www.nytimes.com/interactive/2016/business/dealbook/puerto-rico-debt-crisis-explained.html>.

4. Voidable debt refers to the fact that the debt obligations were unauthorized and invalid, and thus voidable. This should not be confused with voidable transfers. Francine McKenna, *Puerto Rico Could Seek to Invalidate Over 4 billion in Debt*, MARKETWATCH, (June 2, 2016, 11:37 AM), <http://www.marketwatch.com/story/puerto-rico-could-look-to-invalidate-over-4-billion-of-debt-2016-06-02>.

5. *See infra* Part III.

6. *See infra* Part IV.

support for both states and municipalities.⁷ Although some degree of risk is inherent in any investment, the complete voidance of a typically safe investment of this magnitude is outside of the average investor's—and likely his broker's—risk-benefit analysis.⁸ If Puerto Rico is allowed to declare its obligations void, not only will it cost bondholders billions of dollars, it could also establish a dangerous precedent that could impact how future insolvent municipalities resolve their debt obligations.⁹ Although the issues in these transactions are wide-ranging, there are two particular lessons that can be drawn from the Detroit and Puerto Rico cases: (1) current laws and regulations fail to protect investors from illegally issued bonds in municipal debt securities, and (2) the role of counsel in ensuring the validity of such investments is currently insufficient.

This Note analyzes the consequences of issuing invalid debt by examining the voidable debt situations in both the Detroit bankruptcy and The Puerto Rican Debt Crisis. Further, it highlights important lessons that can be drawn from these cases and advocates for certain changes that could help prevent similar incidents of this type in the future. This Note proceeds in five parts. Part II provides a brief background on municipal bond investing and the laws and regulations that govern such investments.¹⁰ Part III discusses the voidable debt issue that arose in the Detroit bankruptcy.¹¹ Part IV examines the current voidable debt situation in Puerto Rico.¹² Part V discusses the two primary lessons that can be drawn from these two cases.¹³ Part VI concludes by offering policy recommendations as to how best to

7. Dan Weil, *Municipal Bonds: Investing Pros and Cons*, BANKRATE, <http://www.bankrate.com/finance/investing/municipal-bonds-investing-1.aspx> (last updated Oct. 16, 2014) (“S&P Municipal Bond Index had a default rate of just 0.11% in 2013.”).

8. U.S. SEC. & EXCH. COMM’N, REPORT ON THE MUNICIPAL SECURITIES MARKET 35 (2012) [hereinafter REPORT ON THE MUNICIPAL SECURITIES MARKET], <https://www.sec.gov/news/studies/2012/munireport073112.pdf>.

9. Since there currently exists no precedent for how illegal municipal debt of this magnitude should be resolved, any precedent set in this area would be highly persuasive, and would provide future insolvent municipalities a route to void any of their obligations that they find to be unenforceable.

10. See *infra* Part II.

11. See *infra* Part III.

12. See *infra* Part IV.

13. See *infra* Part V.

prevent such situations in the future.¹⁴

II. MUNICIPAL BOND INVESTING AT A GLANCE

A. *The Basics of Municipal Securities*

The municipal securities market is “critical” to the health of our nation’s economy.¹⁵ States, municipalities, U.S. territories, and other local government entities issue municipal securities to finance public projects and meet government cash flow needs,¹⁶ raising billions of dollars every year.¹⁷ Municipal securities come in a variety of forms, with different maturities, interest rates, and sources of payment.¹⁸ They are typically issued through an underwriting process,¹⁹ in which an underwriter, such as a bank, purchases the securities directly from the issuer, and then brings these securities to the market by selling to investors.²⁰ When a municipality or corporation issues a bond, it creates a group of creditors—the holders of these bonds—to whom it becomes indebted.²¹ This exchange creates a contractual loan relationship²² whereby the municipality borrows the money, or principal, from the creditors, and in exchange, the municipality makes interest payments²³ until the bond matures, at which point the municipality pays the

14. See *infra* Part VI.

15. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at i.

16. *Id.*

17. Municipal securities can be issued directly by state or local governments, or through related authorities or agencies. 15 U.S.C. §78c(a)(29) (2015). Municipal securities also include debt issued by Puerto Rico, or any other possession of the United States.” 15 U.S.C. § 78c(a)(16) (defining the term “State”).

18. Philip Grommet, *A Call For Action: An Analysis of the Impending Regulatory Crisis in the Municipal Securities Market*, 38 J. LEGIS. 237, 243 (2012); REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at i (explaining that municipal bonds are issued with different maturity dates, fixed or variable interest rates, and with different payment sources in either revenue bond, which are generated from a certain project, and general obligation bonds which come from tax revenues).

19. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at 15.

20. *Id.* at v. (“Individuals, or ‘retail’ investors, directly or indirectly hold more than 75% of the outstanding principal amount of municipal securities.”).

21. Tamar Frankel, *Municipalities In Distress: A Preventative View*, 33 REV. BANKING & FIN. L. 779, 796 (2014).

22. Grommet, *supra* note 18, at 241.

23. Frankel, *supra* note 21, at 796.

principal back.²⁴

B. Municipal Securities Laws and Regulations

Regulators in the municipal securities market include the Securities and Exchange Commission (“SEC”), the Municipal Securities Rulemaking Board²⁵ (“MSRB”), the Financial Industry Regulatory Authority (“FINRA”), and various other bank-regulatory agencies.²⁶ The SEC has long been involved in the issuance of municipal debt²⁷ with the objective of protecting municipal investors and facilitating capital formation.²⁸ The MSRB was created by the 1975 securities law amendments.²⁹ It is tasked with promoting rules governing the sale of municipal securities in order to prevent, among other things, fraudulent and manipulative acts and practices.³⁰ The municipal securities market, though large in size, has not been subject to the same level of regulation as other investment markets.³¹ This is because municipal securities, with the exception of the antifraud provisions,³² were largely exempted from both the Securities Act of

24. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at iii; Charlotte W. Rhodes, *Living in a Material World: Defining “Materiality” in the Municipal Bond Market and Rule 15c2-12*, 72 WASH. & L. REV. 1989, 1994 (2015).

25. *Overview of Municipal Disclosure*, SEC. INDUS. AND FIN. MARKETS ASS’N, <http://www.sifma.org/issues/capital-markets/municipal-securities/muni-disclosure/overview/> (“The Securities Act Amendments of 1975 created the Municipal Securities Rulemaking Board (MSRB), a self-regulatory organization (SRO) that writes rules governing broker dealers engaged in municipal securities transactions . . . to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, and processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest.”).

26. Grommet, *supra* note 18, at 246.

27. Darien Shanske, *The Feds Are Already Here: The Federal Role In Municipal Debt Finance*, 33 REV. BANKING & FIN. L. 798, 800 (2014) (explaining the role of the SEC? in dealing with municipalities in distress).

28. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at 15.

29. 15 U.S.C. § 78o-4b (2015); REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at 15.

30. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at 15.

31. *Id.*

32. *Id.* The antifraud provisions of the federal securities laws prohibit any person, including municipal issuers and dealers, from making any untrue statement of material fact, or omitting any material facts necessary to make statements made, in the light of the circumstances under which they were made, not misleading, in connection with the offer,

1933³³ and the Securities Exchange Act of 1934.³⁴ Later amendments created some heightened requirements for entities in the municipal securities business,³⁵ but they still expressly limited the SEC's authority over the municipal issuers themselves.³⁶ One notable exception is Rule 15c2-12,³⁷ which, albeit in a "circuitous" manner,³⁸ strengthened the requirements on securities dealers with respect to the disclosures they must obtain from the municipal issuer.³⁹ In the resulting regulatory regime, municipal issuers are overseen indirectly through the entities that deal in municipal securities.⁴⁰

Finally, state and local laws also govern the contracts that create these bond obligations.⁴¹ While federal law focuses on the procedures of issuing these bonds and their tax status, state laws place restrictions on the amount of such bonds and the usage of their proceeds.⁴² Consequently, when bonds are issued in violation of requirements or limitations set by these laws, they generally are void.⁴³

purchase, or sale of any security.

33. Securities Exchange Act of 1934, 15 U.S.C. §§ 77a-78aa (2015).

34. 15 U.S.C. §§ 78a-78pp (2015); Shanske, *supra* note 27, at 800.

35. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at i. ("The 1975 Amendments required firms transacting business in municipal securities to register with the Commission as broker-dealers, required banks dealing in municipal securities to register as municipal securities dealers, and gave the Commission broad rulemaking and enforcement authority over such broker-dealers and municipal securities dealers.")

36. Securities Exchange Act of 1934, 94 P.L. 29, 89 Stat. 97 Sect. 15B(d)(1) ("Neither the Commission nor the Board is authorized under this title, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.")

37. 17 C.F.R. §240.15c2-12(c) (2016).

38. Grommet, *supra* note 18, at 250.

39. See Exchange Act Release No. 34961, "Municipal Securities Disclosure" (Nov 10, 1994), 59 FR 59590 (Nov. 17, 1994), available at <http://www.sec.gov/rules/final/adpt6.txt> ("1994 Amendment Release") (explaining that 15c2-12 imposes requirements on municipal bond dealers and underwriters (in most offerings) offerings to obtain, review, and distribute to investors copies of the issuer's disclosure documents, and prohibits underwriters from "purchasing or selling municipal securities in connection with a primary offering unless the issuer had committed to providing continuing disclosure regarding the security and issuer, including its financial condition and operating data").

40. See Grommet, *supra* note 18, at 250 (explaining how the current SEC regulations combine to create a "backdoor" regulatory scheme).

41. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at 35.

42. Brian Reilly, *Let's Talk: Avoiding Trouble with Municipal Bonds*, LEAGUE OF MINNESOTA CITIES, (July-Aug 2015), <http://www.lmc.org/page/1/LetsTalkJulyAug2015.jsp>.

43. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at 38.

C. *Municipal Securities Risk and Avoidance*

Municipal bonds are not only a vital source of capital for government entities, they are also a comparably safe⁴⁴ and tax friendly investment.⁴⁵ While safety is a hallmark of municipal bonds, they are not completely without risk.⁴⁶ As fixed-rate instruments, they are subject to interest rate risks that could result in the bond decreasing in value.⁴⁷ An additional, though less common risk, is default risk, where the issuer may be unable to make scheduled interest payments or repay the principal after the bond has reached maturity.⁴⁸

While these risks are inherent in municipal bond investing, interest rate risk can be somewhat anticipated and default risk can generally be safeguarded against by properly analyzing the issuer's creditworthiness.⁴⁹ A risk that most bondholders would not consider, however, is that their investments could be declared completely void, with no interest payments or return of their principal.⁵⁰ While this possibility is not likely contemplated by municipal securities investors, recent events demonstrate that it should be.⁵¹ Investors faced the loss of \$1.44 billion of municipal bond investments in Detroit's bankruptcy,⁵² and now have \$4.1 billion in bonds at risk in Puerto Rico.⁵³

44. *Id.* at ii.

45. Grommet, *supra* note 18, at 250.

46. *See infra* notes 47–48.

47. Investopedia Staff, *The Basics of Municipal Bonds*, INVESTOPEDIA, <http://www.investopedia.com/articles/bonds/05/022805.asp> (last updated Jan. 12, 2017).

48. *Id.*; Dan Weil, *Municipal Bonds: Investing Pros and Cons*, BANKRATE (October 16, 2014), <http://www.bankrate.com/finance/investing/municipal-bonds-investing-1.aspx> (“S&P Municipal Bond Index had a default rate of just 0.11% in 2013.”); Tara Siegal Bernard, *Municipal Bonds Still Considered Safe, Despite Some Ailing Governments*, N.Y. TIMES (July 24, 2016), http://www.nytimes.com/2015/07/25/your-money/municipal-bonds-still-considered-safe-despite-some-ailing-governments.html?_r=0 (stating that the S&P Municipal Bond Index default rate rose to 0.17% in 2014).

49. Tara Siegal Bernard, *Municipal Bonds Still Considered Safe, Despite Some Ailing Governments*, N.Y. TIMES (July 24, 2016), http://www.nytimes.com/2015/07/25/your-money/municipal-bonds-still-considered-safe-despite-some-ailing-governments.html?_r=0 (stating that the S&P Municipal Bond Index default rate rose to 0.17% in 2014).

50. Investopedia Staff, *The Basics of Municipal Bonds*, INVESTOPEDIA, <http://www.investopedia.com/articles/bonds/05/022805.asp> (last updated Jan. 12, 2017).

51. *See infra* Part IV.

52. Moneylife Digital Team, *When Detroit, the World's Traditional Auto Capital, Files for Bankruptcy*, MONEYLIFE (July 19, 2013, 4:10 PM), <http://www.moneylife.in/article/when-detroit-the-worlds-traditional-auto-capital-files-for-bankruptcy/33708.html>.

53. *See infra* Part IV.

III. DETROIT BANKRUPTCY

A. *Detroit's Voidable Debt Issue*

If the voidable debt issue in Puerto Rico was a singular occurrence, it could be written off as an honest mistake made by an ailing commonwealth. However, this exact issue occurred previously in Detroit. On July 13, 2013, the city of Detroit, finding itself at least \$18 billion in debt, filed for Chapter 9 bankruptcy.⁵⁴ The debt came in many forms, such as swaps payments owed to banks, pension liabilities, and post-employment benefits for Detroit's retired workers.⁵⁵ The debt obligation that became the most controversial was its \$1.44 billion in pension-related Certificates of Participation ("COP").⁵⁶ These COPs were bonds issued to subsidize pension funds that Detroit did not have the money to pay.⁵⁷ In order to facilitate the transaction, Detroit, at its debt limit, structured the deal in an "iffy"⁵⁸ way to avoid calling it a debt.⁵⁹ It did this by creating future service contracts ("Service Contracts") via a newly created Service Corporation.⁶⁰ The Service Corporation then sold COPs and used the proceeds to satisfy pension fund obligations.⁶¹ Later, Detroit argued that these contracts were actually debt obligations in violation of Michigan law, and, consequently, unenforceable and void.⁶² The creditors objected and litigation ensued.⁶³

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. Karen Pierog, *Participants In Detroit Pension Borrowing Knew Debt Sale Was 'iffy': City Lawyer*, BUSINESS INSIDER, (Oct. 1, 2014 2:36PM), <http://www.businessinsider.com/r-participants-in-detroit-pension-borrowing-knew-debt-sale-was-iffy-city-lawyer-2014-10> (The COP transaction was described by Detroit's attorney as "iffy" and by FGIC's attorney as "fraudulent.").

59. City of Detroit's Memorandum in Support of its Motion to Dismiss in part FGIC's Counterclaims at 10, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

60. *Id.*

61. *Id.*

62. *Id.* at 15.

63. Karen Pierog, *Detroit Files Lawsuit Seeking to Void Pension Debt*, REUTERS, (Jan. 31, 2014 9:47PM) <http://www.reuters.com/article/us-usa-detroit-bankruptcy-pensions-idUSBREA0U11B20140201>.

Detroit argued that the \$1.44 billion in bonds⁶⁴ were not issued in compliance with Michigan's Home Rule City Act.⁶⁵ Additionally, Detroit argued that it could only incur debt if it was specifically authorized by the state,⁶⁶ and that it failed to meet the conditions of the Michigan Revised Municipal Finance Act⁶⁷—the granting statute.⁶⁸ The argument then turned to whether or not recovery should be granted to the bondholders under these illegal contracts. Detroit first pointed to a Michigan Supreme Court case *American Trust Co. v. Michigan Trust Co.*⁶⁹ and other Michigan cases to show that Michigan courts had long refused to enforce or grant relief under illegal contracts.⁷⁰ It then pointed to another Michigan Supreme Court case, *McCurdy v. Shiawasee County*.⁷¹ This case specifically dealt with illegally issued municipal debt and held that the county was not liable for the money it had received under the illegal contract.⁷² Finally, Detroit cited to the U.S. Supreme Court case *City of Litchfield v. Ballou*,⁷³ which held that borrowing above a state debt ceiling allowed the issuer of such debt to

64. *Id.*

65. Under the Michigan Home Rule City Act ("HRCA"), MCLA § 117.4a, the maximum indebtedness a city could incur was the greater of (1) 10% of the assessed value of all real and personal property in the city; or (2) 15% of the assessed value of all the real and personal property in the city if that portion of the total amount of indebtedness incurred which exceeded 10% was or had been used solely for the construction or renovation of hospital facilities.

66. City of Detroit's Memorandum in Support of its Motion to Dismiss in part FGIC's Counterclaims at 9, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014) (pointing to Mich. Const., art. VII, § 21 that says that the legislature shall provide by general laws for the incorporation of cities, and that such laws shall restrict the powers of cities to borrow money and contract debts).

67. Michigan Revised Municipal Finance Act, MCL § 141.2101.

68. City of Detroit's Memorandum in Support of its Motion to Dismiss in part FGIC's Counterclaims at 9, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014) ("It is also undisputed that the COPs were not issued in accordance with the requirements of [The Michigan Revised Municipal Finance Act], including, among other things, the requirement that the State Treasury Department qualify or approve any municipal borrowing.").

69. *American Trust Co. v. Michigan Trust Co.*, 248 N.W. 829, 830 (Mich. 1933) ("The general rule of law is, that a contract made in violation of a statute is void; and that when a plaintiff cannot establish his cause of action without relying upon an illegal contract, he cannot recover.") (quoting *Miller v. Ammon*, 145 U.S. 421, 426 (U.S. 1892)).

70. Answer and Affirmative Defenses of Defendant Financial Guaranty Insurance Company at 17, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

71. *McCurdy v. Shiawasee County*, 118 N.W. 625, 629 (1908).

72. *Id.* (holding that the county had no authority to incur the debt, and therefore the notes were void).

73. *City of Litchfield v. Ballou*, 114 U.S. 190, 191–192 (1885).

declare it invalid,⁷⁴ as authority for its position that it had no obligation to continue making payments to the Service Corporations or to the Funding Trusts.⁷⁵

On the other side, the Financial Guaranty Insurance Company (“FGIC”), which Detroit solicited to insure its bonds,⁷⁶ argued that the creditors were entitled to an alternate recovery such as unjust enrichment, based on the contractual defenses of mistake and misrepresentation.⁷⁷ FGIC also argued that Detroit would receive a windfall if it were not required to restore each party to its pre-contract financial position.⁷⁸ To strengthen this argument, FGIC attempted to distinguish the Detroit situation from *Litchfield* by arguing that, unlike in *Litchfield*, Detroit was not completely without authority to take part in a transaction of this type.⁷⁹ Moreover, FGIC argued that the money raised by the COP transactions was “segregated and readily identifiable,” contrary to the funds in *Litchfield*, and that under such circumstances courts are likely to allow some equitable recovery under an invalid contract.⁸⁰ Additionally, FGIC also argued that the *Litchfield* case dealt with the Illinois constitutional prohibition on raising money in any kind and for any purpose, while here there was only a constitutional mandate to address liability and the ability to raise funds.⁸¹ Thus FGIC further argued that the case law relied upon by

74. *Id.*

75. Answer and Affirmative Defenses of Defendant Financial Guaranty Insurance Company at 17, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

76. Financial Guaranty Insurance Company’s Motion To Intervene Pursuant To Rule 7024 Of The Federal Rules Of Bankruptcy Procedure And Section 1109(B) Of The Bankruptcy Code at 36, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

77. Answer and Affirmative Defenses of Defendant Financial Guaranty Insurance Company at 17, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

78. Answer and Affirmative Defenses of Certificate Holders at 23, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

79. Financial Guaranty Insurance Company’s Opposition to City of Detroit’s Motion to Dismiss in Part FGIC’s Counterclaims at 36, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

80. *Id.*; *City of Litchfield v. Ballou*, 114 U.S. 190, 195 (1885) (“If the complainants are after the money they let the city have, they must clearly identify the money or the fund, or other property which represents that money, in such a manner that it can be reclaimed and delivered without taking other property with it, or injuring other persons or interfering with others’ rights.”).

81. Financial Guaranty Insurance Company’s Opposition to City of Detroit’s Motion to Dismiss in Part FGIC’s Counterclaims at 36, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

Detroit did not support a blanket prohibition on equitable remedies, and hence, that *Litchfield* did not preclude recovery.⁸² The FGIC closed by arguing that courts have imposed equitable remedies to avoid unjust outcomes,⁸³ noting that the *McCurdy* court was not presented with the question of whether a municipality would have to return the conferred benefit under a void contract.⁸⁴

The parties settled without a ruling, so no precedent was created on this issue.⁸⁵ However, the presiding judge in the case stated that Detroit's argument had "substantial merit," and that its claim would have had a "reasonable likelihood of success."⁸⁶ The Detroit bankruptcy demonstrates that the issue in Puerto Rico is not an anomaly, and voidable debt issues may continue to arise in future municipal insolvency cases.

B. The Role of Bond Counsel in Detroit's Offering

In the 2005 Detroit COP offering, Detroit hired the local firm Lewis & Munday PC to act as certificate counsel and deliver an opinion regarding the validity of its bond contracts.⁸⁷ On the other side, UBS, who served as the managing underwriter, hired Honigman Miller Schwartz and Cohn LLP as its counsel.⁸⁸ Lewis & Munday issued legal opinions on June 2, 2005, and again June 12, 2006, for the second issuance.⁸⁹ The opinions stated that the Service Contracts were indeed validly authorized and executed, and hence valid and binding agreements between Detroit and the Service Corporation.⁹⁰

82. *Id.*

83. *Id.* at 34.

84. *Id.* at 35.

85. Francine McKenna, *Puerto Rico Could Seek to Invalidate Over 4 billion in Debt*, MARKETWATCH, (June 2, 2016, 11:37 AM), <http://www.marketwatch.com/story/puerto-rico-could-look-to-invalidate-over-4-billion-of-debt-2016-06-02>.

86. *Id.*

87. DETROIT CERTIFICATES OF PARTICIPATION OFFERING 21 (2005), <http://emma.msrb.org/MS45312-MS210431-MS613402.pdf>. The city employed Lewis & Munday as bond counsel, relying on their expertise and history in the state to help create and ensure the legal framework would work. *Id.*

88. *Id.*

89. City of Detroit's Memorandum in Support of its Motion to Dismiss in part FGIC's Counterclaims at 24, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

90. Joint Motion Of Certificate Holders To Intervene at 36, In re City of Detroit, No.

Furthermore, it stated that the obligation of Detroit to pay the Service Corporation's Funding Trust did not constitute "indebtedness" within the meaning of Michigan's Home Rule City Act.⁹¹ Finally, it opined that the COPs were validly issued, Detroit had authority to make the offering,⁹² and that the transaction was valid.⁹³

After counsel validated the bond offering, Detroit and the underwriters had FGIC insure the bonds.⁹⁴ They did this by providing FGIC with opinion letters prepared by their respective counsel, Lewis & Munday for Detroit and Honigman Miller Schwartz & Cohn for UBS, which stated that Detroit's contractual obligations under the proposed contract were valid and "could not constitute indebtedness under Michigan law or be subject to any limitations on Detroit's net indebtedness capacity."⁹⁵ FGIC, relying on these representations, agreed to insure the bonds.⁹⁶ After prolonged negotiations, FGIC and Detroit reached a settlement that gave the FGIC a portion of its claim.⁹⁷ As of early 2017, FGIC has not pursued any legal action against the law firms involved.

13-53846 (Bankr. E.D. Mich. August 28, 2014).

91. *Id.*

92. *Id.* at 59.

93. *Id.* at 41.

94. Financial Guaranty Insurance Company's Motion To Intervene Pursuant To Rule 7024 Of The Federal Rules Of Bankruptcy Procedure And Section 1109(B) Of The Bankruptcy Code at 36, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

95. City of Detroit's Memorandum in Support of its Motion to Dismiss in part FGIC's Counterclaims at 20, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

96. Joint Motion Of Certificate Holders To Intervene at 36, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014) ("In connection with the Pension Funding Transaction, in both 2005 and 2006, the City made numerous warranties, representations, and covenants regarding the lawfulness and enforceability of the Pension Funding Transaction, including that such transaction was a valid exercise of the City's municipal authority, was not subject to any debt limitations, and required no further action by any governmental body, agency or official. Without these and other material warranties, representations, and covenants as inducements, Interveners would not have participated in the transactions.").

97. Caitlin Devitt, *Leaving Bankruptcy, Detroit Takes on \$1.28B of New Debt*, THE BOND BUYER, (Dec. 11 2014), <http://www.bondbuyer.com/news/regionalnews/leaving-bankruptcy-detroit-takes-on-1b-of-new-debt-1068692-1.html>.

IV. PUERTO RICO'S DEBT CRISIS

A. *Puerto Rico's Debt Crisis and Its Voidable Bonds*

Puerto Rico continues to find itself in a dire financial crisis as 2017 begins.⁹⁸ The island has continually borrowed money over the past thirty years by issuing municipal bonds in order to pay off past debts and compensate for its declining government revenue,⁹⁹ ultimately resulting in \$72.2 billion in debt.¹⁰⁰ As it stands, Puerto Rico is unable to make its upcoming debt payments,¹⁰¹ and is unable to file for Chapter 9 bankruptcy to restructure its debts as Detroit did.¹⁰² This is because in 1984, Congress adopted Section 903(1) of the Bankruptcy code, which amended the definition of “State” in a way that restricts Puerto Rico and its instrumentalities from accessing Chapter 9.¹⁰³ Thirty-three years later, in response, President Obama signed the Puerto Rico Oversight, Management, and Economic Stability Act (“PROMESA”), which issued an automatic stay on all pending litigation against Puerto Rico until February of 2017.¹⁰⁴ This was intended to allow Puerto Rico and its bondholders’ time to reach a settlement agreement.¹⁰⁵ If no agreement can be made, PROMESA allows for a judicial reorganization—modeled after Chapter 9 bankruptcy—of Puerto Rico’s debt.¹⁰⁶

In June 2016, an audit report released by the Commission for the Comprehensive Audit of Puerto Rico’s Public Credit complicated any potential settlement agreement by suggesting that Puerto Rico might be able to declare some of its debt void.¹⁰⁷ The report found that

98. David R. Martin, *Back Story on Puerto Rico’s Debt Crisis*, THE HILL (Sept. 9, 2015 1:00PM), <http://thehill.com/blogs/congress-blog/economy-budget/252723-back-story-on-puerto-ricos-debt-crisis>.

99. Mary Williams Walsh and Liz Moyer, *How Puerto Rico Debt is Grappling With a Debt Crisis*, N.Y. TIMES (July 1, 2016), <http://www.nytimes.com/interactive/2016/business/dealbook/puerto-rico-debt-crisis-explained.html>.

100. Martin, *supra* note 98.

101. Milton Vescovacci, *The Demise of Puerto Is In Part Attributed to U.S. Congressional Action*, 28 BANKR. L. REP. (BNA), No. 25 at 825 (June 23, 2016).

102. *Id.*

103. *Id.*

104. Stephen Selbst, *Puerto Rico Financial Oversight Law Enacted*, 28 BANKR. L. REP. (BNA) No. 31 at 1031 (Aug. 10, 2016).

105. *Id.*

106. *Id.*

107. PUERTO RICO COMM’N FOR THE COMPREHENSIVE AUDIT OF THE PUB. CREDIT, PRE-

portions of the debt were issued in violation of the balanced-budget clause in Puerto Rico's Constitution.¹⁰⁸ This clause prohibits borrowing to finance operating deficits, and states that Puerto Rico cannot take out any debt that would make it spend more than 15% of internal revenues on general obligation debt.¹⁰⁹ The audit report confirmed that Puerto Rico was in all likelihood borrowing to finance operating deficits, and suggested that Puerto Rico has been spending anywhere from fourteen to 25% of its internal revenue on general obligation debt.¹¹⁰ Consequently, these contracts were likely illegal, which would make them unenforceable and possibly void.¹¹¹ Specifically, the 2014 \$3.5 billion General Obligation Bond offering and the 2015 \$900 million offering of Tax Refund Anticipation notes were each likely illegally issued.¹¹² If this turns out to be the case, creditors who invested in these bonds stand to lose at least \$4.1 billion.¹¹³

In light of the magnitude of Puerto Rico's financial situation, the possibility of simply voiding part of its debts is an attractive option, and it appears it has the authority to do so.¹¹⁴ However, this seems to be a highly inequitable result. How can Puerto Rico's penalty for illegally borrowing above its means be that it is allowed to declare the debts void and keep the money for itself? Despite the manifest unfairness of such a result, the applicable law indicates that this is likely the proper legal result.¹¹⁵

B. Why Puerto Rico's Bonds are Unenforceable and Voidable, and Possible Recourse

If the bond contracts are deemed illegal, then Puerto Rico will argue that under Puerto Rico's Constitution, the bond contracts are

AUDIT SURVEY REPORT 2 (2016).

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.* at 27. The term void as used here means that any obligation that did exist under this contract no longer exists, and the contract ceases to exist with no further action taken on it, each party remaining in its present state. *Id.*

112. McKenna, *supra* note 85.

113. *See infra* Part IV.

114. McKenna, *supra* note 85.

115. *See infra* Part IV B.

unenforceable by the bondholders, and thus can be declared void.¹¹⁶ Puerto Rico's bondholders on the other hand will likely argue that, although the contracts may be invalid, they are still entitled to receive some quasi-contractual equitable relief, such as restitution.¹¹⁷ However, as evidenced by the city of Detroit's arguments, courts do not generally grant restitution under agreements that are unenforceable on public policy grounds.¹¹⁸ Specifically here, in order to determine if the bondholders can receive some quasi-contractual recovery, the court will apply state law.¹¹⁹ As is standard with bond offerings, both the 2014 General Obligation Bond offering and 2015 Tax Refund Anticipation Notes in Puerto Rico contained a choice of law provision.¹²⁰ These provisions stated that New York law would apply in all instances except with respect to "authorization," where the laws of Puerto Rico would apply.¹²¹ Whether a court will enforce a choice-of-law clause is not always apparent at the outset, and there is room to dispute which law will apply here.¹²² However, regardless of which state's law applies, it is likely that Puerto Rico will be able to declare its obligations void and its creditors will be entitled to nothing. This is because, like Michigan state law, Puerto Rican case law indicates that if Puerto Rico has borrowed contrary to statutory requirements, then it is allowed to declare its debt obligation void.¹²³ The same is true with New York

116. RESTATEMENT (SECOND) OF CONTRACTS § 7 (Am. Law Inst. 1981) ("A voidable contract is one where a party has the power to elect to avoid its legal obligation created by the contract.").

117. See *supra* Part III.

118. E. Allen Farnsworth, *Contracts* § 5.9(2004).

119. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at i.

120. COMMONWEALTH OF PUERTO RICO, GENERAL OBLIGATION BONDS OF 2014 DISCLOSURE STATEMENT 30 (2014), available at http://www.gdbpr.com/investors_resources/documents/CommonwealthPRGO2014SeriesA-FinalOS.PDF ("The Bonds and the Bond Resolution are governed by and are to be construed in accordance with the laws of the State of New York, except with respect to authorization (or in the case of the Bond Resolution, adoption) and execution of the same by the Commonwealth, which shall be governed by the laws of the Commonwealth."). See PUERTO RICO COMM'N FOR THE COMPREHENSIVE AUDIT OF THE PUBLIC CREDIT, *supra* note 107, at 15 (stating that the 2015 agreement required that New York law govern the agreement like the 2014 general obligation bond offering).

121. *Id.* This provision is a bit ambiguous, and there is room for dispute as to which law should apply, as the issue could be characterized as an authorization issue—Puerto Rico claiming it didn't have the authority to make the offering—or as a suit for recovery under the bonds, which would fall under the "in all instances except" provision.

122. For more on choice of law, see John F. Coyle, *The Canons of Construction for Choice-of-Law Clauses*, 92 Wash. L. Rev. (forthcoming 2017).

123. *Las Marias v. Municipio San Juan*, 156 D.P.R. 868, 872 (P.R. 2003), 2003 WL

case law, as New York has yet to allow recovery against a municipality under a contract it has deemed illegal.¹²⁴ The highest courts in Puerto Rico, New York, and Michigan have consistently held that the policy against awarding damages under an illegal contract—maintaining the integrity of the law and preventing future parties from engaging in such deals—outweighs the potential loss to the other parties.¹²⁵

Furthermore, Supreme Court precedent set forth in *City of Litchfield v. Ballou*¹²⁶ points to no recovery against municipalities under illegal contracts.¹²⁷ The *Ballou* Court decided that borrowing above a state debt ceiling allowed the issuer of such debt to declare it invalid.¹²⁸ In *Ballou*, the city of Litchfield, Illinois, defended non-payment of its bonds on the grounds that the bonds were issued in violation of the state constitution and were therefore voidable.¹²⁹ The state constitution contained an article that declared that “no county, city, township, school

21706387; *Hatton v. Municipio de Ponce*, 134 D.P.R. 1001, 1005 (P.R. 1993), 1994 WL 909605; *Morales v. Municipio de Toa Baja*, 119 D.P.R. 682, 689 (P.R. 1941), 1987 WL 448260; *González v. Municipality*, 61 P.R.R. 357 (1943) (refusing to grant recovery in a case of a contract executed without the pertinent appropriation in the municipal budget for covering the corresponding expense).

124. *See, e.g.*, *Granada Buildings, Inc. v. City of Kingston*, 444 N.E.2d 1325, 1326 (N.Y. 1982) (disallowing recovery against a municipality for policy reasons); *S. T. Grand, Inc. v. City of New York*, 38 A.D.2d 467, 474 (N.Y. App. Div. 1st Dep’t 1972) (dismissing contractor’s action for recovery of an unpaid contract balance because the contract was acquired illegally via a kickback, and as such was unenforceable); *Albany Supply & Equip. Co. v. Cohoes*, 25 A.D.2d 700, 701 (N.Y. App. Div. 3d Dep’t 1966) (affirming that since the verbal contracts were made in direct contravention of the applicable law, there was a lack of authority on the part of agents of a municipal corporation to create a liability, no liability for the municipality could result); *Lutzken v. City of Rochester*, 7 A.D.2d 498, 451 (N.Y. App. Div. 4th Dep’t 1959) (concluding that no legal obligation existed to compensate the individual who removed government tree stumps, because the equitable powers of the courts could not be invoked to sanction a disregard of the statutory requirements necessary to contract with a city for services when public money was at issue); *Seif v. Long Beach*, 36 N.E.2d 630, 631 (N.Y. 1941) (finding that because the city charter only allowed the council to appoint officers or employees when acting as a body at a properly held meeting, the attorney’s assignee should not have been permitted to recover under a theory of tacit ratification since his appointment was not legal).

125. *See Hatton*, 134 D.P.R. at 1005, 1994 WL 909605 (“Regardless of the sum involved—or whether it is a routine or exceptional procedure—the use of public funds is undoubtedly invested with great public interest.”).

126. *City of Litchfield v. Ballou*, 114 U.S. 190, 191 (1885).

127. *See id.* at 190–92 (holding that because the bonds violated Ill. Const. art. IX, § 12, which limited the amount of indebtedness that the city was permitted to incur, the bonds were void and unenforceable).

128. *Id.* at 191–92.

129. *Id.*

district, or other municipal corporation, shall be allowed to become indebted in any manner, or for any purpose, to an amount, including existing indebtedness, in the aggregate exceeding five per centum on the value of the taxable property therein.”¹³⁰ The Supreme Court followed its prior holding in *Buchanon v. City of Litchfield*,¹³¹ which ruled that despite the moral considerations and hardship the bondholders would face, the settled principles of law could not “be disregarded in order to remedy the hardships of special cases,” and granted no recovery for Ballou.¹³² The Court justified its decision by explaining that the plaintiff could not circumvent the problem of suing on an illegal contract by bringing a claim in equity.¹³³ While Puerto Rico’s bondholders may try to distinguish between *Litchfield* and the present case as the Detroit creditors did,¹³⁴ Puerto Rico will likely point to this case as settling the issue in its favor.¹³⁵

While it is likely that Puerto Rico’s bondholders will be denied quasi-contractual recovery, there are some caveats to such an outcome.¹³⁶ First, while the precedent from both New York and Puerto Rico indicates that there should be no recovery under an illegal contract with a municipality, New York law is slightly more favorable for bondholders.¹³⁷ Although both Puerto Rico and New York case law indicate that equitable remedies such as unjust enrichment are not

130. *Id.* at 192 (quoting *Buchanon v. City of Litchfield*, 102 U.S. 278, 280 (1880)).

131. *Buchanon v. City of Litchfield*, 102 U.S. 278, 280 (1880).

132. *Ballou*, 114 U.S. at 191–92.

133. *See id.* at 192–93 (holding that because the bonds violated Ill. Const. art. IX, § 12, which limited the amount of indebtedness that the city was permitted to incur, the bonds were void and unenforceable).

134. Fin. Guaranty Ins. Co. Opposition to City of Detroit’s Mot. to Dismiss in Part FGIC’s Counterclaims at 36, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

135. *See supra* Part III.

136. Such caveats include the relief the presiding court determines is appropriate. While unjust enrichment is the remedy that makes the most sense, there is a long line of cases that have awarded quantum meruit damages as a quasi-contractual remedy against a municipality in New York, though this would be a tough argument to make since this remedy is typically given for work done, not money given over. *See Aniero Concrete Co. v. New York City Constr. Auth.*, 2000 U.S. Dist. LEXIS 8833 at *3 (S.D.N.Y. June 27, 2000) (holding that public policy prevented Aniero from recovering in quasi-contract for work that was not furnished pursuant to a contract complying with the statutory “competitive bidding process”).

137. *See infra* note 138.

prohibited *per se* against a municipality,¹³⁸ it appears that New York has only applied this in a case where a contract was unenforceable by law or local provision.¹³⁹ Thus, if New York law is applied, bondholders may have a better shot at recovery.¹⁴⁰ Second, there is very little precedent in this area, and none dealing with a bond issuance of this magnitude.¹⁴¹ Most cases that deal with unjust enrichment against a municipality deal with issues such as contracts being declared void for failing to meet bidding requirements.¹⁴² However, in most of these cases, courts have decided not to hold a municipality liable on a quasi-contractual theory, as doing so would likely spur lawsuits from disgruntled, or perhaps opportunistic, contractors.¹⁴³ Finally, because there is so little precedent

138 See, e.g., *Aniero Concrete Co.*, 2000 U.S. Dist. LEXIS 8833 (holding that public policy prevented Aniero from recovering in quasi-contract for work that was not furnished pursuant to a contract complying with the statutory “competitive bidding process”); *Parsa v. State of New York*, 474 N.E.2d 235, 238 (N.Y. 1984) (holding that a physician could maintain, but failed to prove, an action in quasi contract against the State to recover money paid by the federal government for services allegedly performed by the physician pursuant to a State contract that was not properly approved, since the claimant was not seeking to enforce an agreement, but rather to recover funds from the State which he alleged belonged to him and which the State was wrongfully withholding from him); *Gerzof v. Sweeny*, 239 N.E.2d 521, 644–45 (N.Y.1968) (finding that although the illegality of the contract here would normally require the vendor to return all monies paid by the village, the vendor would be allowed to retain much of its interest in the generator in light of the magnitude of both the forfeiture and the enrichment afforded the village); *Vrooman v. Village of Middleville*, 91 A.D.2d 833, 834 (N.Y. App. Div. 4th Dep’t 1982) (holding that even though the contract between the village and *Vrooman* was unenforceable, quantum meruit recovery was allowable because the project “had been ordered by the state, the services provided by plaintiff were essential to the project, and the village significantly benefitted from them”). *Plan Bienestar Salud v. Alcalde Cabo Rojo*, 114 D.P.R. 697, 698 (P.R.1983), 1983 WL 204161 at *3 (“In the case of Puerto Rico, the situations examined so far by the Court have not led to the application of the unjust enrichment doctrine.”).

139 *Gerzof v. Sweeny*, 239 N.E.2d 521, 644–45 (N.Y.1968); *Vrooman v. Village of Middleville*, 91 A.D.2d at 834.

140 See *supra* IV.B.

141 Based on Author’s research.

142 See, e.g., *Aniero Concrete Co.*, 2000 U.S. Dist. LEXIS 8833 at *3 (holding that public policy prevented Aniero from recovering in quasi-contract for work that was not furnished pursuant to a contract complying with the statutory “competitive bidding process”).

143 Jerald J. Director, *Liability of Municipality on Quasi Contract for Value of Property or Work Furnished Without Compliance with Bidding Requirements*, AMERICAN LAW REPORTS, 33 A.L.R.3d 1164, 1164 (1970); see, e.g., *Granada Buildings, Inc. v. City of Kingston*, 444 N.E.2d 1324, 1326 (N.Y. 1982) (disallowing recovery against a municipality for policy reasons); *Gerzof*, 239 N.E.2d at 644–45 (finding that although the illegality of the contract here would normally require the vendor to return all monies paid by the village, the vendor would be allowed to retain much of its interest in the generator in light of the magnitude of both the forfeiture and the enrichment afforded the village).

in this area, the presiding judge will have a great deal of discretion, which could easily change the outcome. Still, case law from Puerto Rico and New York indicates that the scales are tipped significantly in Puerto Rico's favor, and even if the presiding judge makes classifications beneficial to the bondholders, the precedent is overwhelmingly in favor of no recovery being granted.¹⁴⁴ Consequently, this issue could hurt the current negotiations between Puerto Rico and its creditors. Puerto Rico, believing the contracts are void, will refuse to pay anything on the bonds, while the bondholders will wait until PROMESA's automatic stay passes and argue they should still be granted some sort of recovery on equitable grounds.

C. The Role of Bond Counsel in the Puerto Rican Offerings

The Puerto Rican bond offering disclosures each contained a disclaimer stating that Puerto Rico's authority to issue the bonds was subject to the aforementioned Constitutional provisions.¹⁴⁵ However, any concern as to the authority of Puerto Rico to make this offering should have been extinguished when bond counsel from each side signed off on the validity of the agreement.¹⁴⁶ In both of Puerto Rico's illegal issuances, major, well-respected law firms served as counsel and delivered the opinion to Puerto Rico that its bond obligations would be valid.¹⁴⁷ The typical opinion states that counsel has examined a certified copy of the transcript of proceedings authorizing the bonds, and that based on this examination, the lawyer is of the opinion that the securities are legal and binding obligations of the issuer.¹⁴⁸ For the 2014 offering, Puerto Rico engaged several law firms to advise on the matter and retained Greenberg Traurig LLP ("Greenberg") to serve as counsel for Puerto Rico.¹⁴⁹ For the 2015 Tax Refund Anticipation

144. See *supra* Part IV.B.

145. See PUERTO RICO COMM'N FOR THE COMPREHENSIVE AUDIT OF THE PUB. CREDIT, *supra* note 107, at 23 (discussing the Puerto Rican Constitution as it relates to municipal bonds for debt financing).

146. See *infra* Part V.B.

147. PUERTO RICO COMM'N FOR THE COMPREHENSIVE AUDIT OF THE PUB. CREDIT, *supra* note 107, at 9.

148. C. Richard Johnson & Robert H. Wheeler, *Securities Law Duties of Bond Counsel*, 1976 DUKE L.J. 1205, 1208 (1975).

Notes, the law firm of Pietrantonio, Mendez, and Alvarez LLC advised Puerto Rico, and Squire, Patton, and Boggs served as bond counsel to a syndicate of banks led by J.P. Morgan.¹⁵⁰ All of the firms declared that the deal was validly entered into¹⁵¹ and each firm received \$235,000 in legal fees.¹⁵²

Greenberg, as bond counsel for Puerto Rico, examined many laws¹⁵³ in order to ascertain whether or not Puerto Rico had the authority to make the offering, and found that “[t]he Bonds [were] issued pursuant to the Acts and the Bond Resolution.”¹⁵⁴ With respect to the underlying facts for the opinion, Greenberg “relied on representations of the Secretary contained in the Bond Resolution” along with other certifications provided to them without verifying the information by way of an independent investigation.¹⁵⁵ It gave the opinion that (1) the acts were valid; (2) the proceedings were validly and legally taken; and (3) these acts, proceedings, and certification showed lawful authority for the issuance and sale of the bonds.¹⁵⁶ It went further to say that “the [b]onds constitute valid and binding general obligations of the Commonwealth for the payment of the principal of and the interest on the [b]onds.”¹⁵⁷ Peculiarly, nowhere in their opinion letter did Greenberg address the Constitutional provision

¹⁴⁹ PUERTO RICO COMM’N FOR THE COMPREHENSIVE AUDIT OF THE PUB. CREDIT, *supra* note 107, at 9.

¹⁵⁰ PUERTO RICO COMM’N FOR THE COMPREHENSIVE AUDIT OF THE PUB. CREDIT, *supra* note 107, at 9.

¹⁵¹ PUERTO RICO COMM’N FOR THE COMPREHENSIVE AUDIT OF THE PUB. CREDIT, *supra* note 107, at 9.

¹⁵² PUERTO RICO COMM’N FOR THE COMPREHENSIVE AUDIT OF THE PUB. CREDIT, *supra* note 107, at 9.

¹⁵³ See COMMONWEALTH OF PUERTO RICO, *supra* note 120, at app. III-1 (describing the specific laws that counsel examined in making their determination, including Act No. 33, Act No. 242-2011, Act No. 45-2013, and Act No. 34-14).

¹⁵⁴ See COMMONWEALTH OF PUERTO RICO, *supra* note 120, at app. III-1 (describing the specific laws that counsel examined in making their determination, including Act No. 33, Act No. 242-2011, Act No. 45-2013, and Act No. 34-14).

¹⁵⁵ See COMMONWEALTH OF PUERTO RICO, *supra* note 120, at app. III-1 (describing the specific laws that counsel examined in making their determination, including Act No. 33, Act No. 242-2011, Act No. 45-2013, and Act No. 34-14).

¹⁵⁶ See COMMONWEALTH OF PUERTO RICO, *supra* note 120, at app. III-1 (describing the specific laws that counsel examined in making their determination, including Act No. 33, Act No. 242-2011, Act No. 45-2013, and Act No. 34-14).

¹⁵⁷ *Id.*

discussed in the bond disclosure statement itself,¹⁵⁸ which has now likely made these obligations illegal and void.¹⁵⁹

D. Possible Recourse for Puerto Rico's Bondholders

Because creditors will in all likelihood be unable to recover against Puerto Rico, they may try to seek alternative recourse against the bond counsel who signed off on the validity of Puerto Rico's bond offering.¹⁶⁰ Though bond opinions are not meant to be a guarantee, counsel can nevertheless be held liable for an erroneous opinion.¹⁶¹ In *In re Flight Transportation Corporation Securities Litigation*,¹⁶² purchasers of securities brought an action alleging negligent misrepresentation against the law firm that represented the underwriter in a public offering of securities.¹⁶³ The purchasers argued that the law firm assisted in the preparation of the disclosure information and failed to exercise its duty of conducting a "due diligence" investigation of the information contained in the disclosure.¹⁶⁴ While the plaintiffs here alleged fraud and foul play by the defense counsel,¹⁶⁵ this case shows that a firm could be held liable for its mistakes, as the negligence action against the underwriter's counsel survived the defendant's motion to

¹⁵⁸ *Id.*

¹⁵⁹ *See supra* Part IV.B.

¹⁶⁰ Existing case law indicates this may be possible. *See, e.g.*, *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988) (where a group of bondholders sought to hold the underwriter's counsel liable for malpractice); *Bradford Sec. Processing Serv. v. Plaza Bank & Tr.*, 653 P.2d 188 (Okla. 1982) (holding bond counsel liable for giving a negligent opinion about certain elements of the bond issue); *Security Bank & Tr. v. Fabricating, Inc.*, 673 S.W.2d 860 (Tenn. 1983) (holding the municipality's bond counsel liable for its negligence in failing to investigate and discover errors in the issuer's financial statements); *Mehaffy, Rider, Windholz & Wilson v. Cent. Bank Denver*, 892 P.2d 230 (Colo. 1995) (finding that an attorney who issued a legal opinion in connection with a municipal note or bond offering owed a duty to a non-client that would support a claim for negligent misrepresentation when the legal opinion was issued at the request of his client for the purpose of inducing the non-client to purchase municipal bonds issued by the client).

¹⁶¹ NAT'L ASS'N OF BOND LAWYERS, *THE FUNCTION AND PROFESSIONAL RESPONSIBILITY OF BOND COUNSEL* 20 (2011), https://www.nabl.org/portals/0/documents/nabl_function_and_professional_responsibilities_of_bond_counsel.pdf.

¹⁶² *In re Flight Transportation Corporation Securities Litigation*, 593 F. Supp. 612 (D. Minn. 1984).

¹⁶³ *Id.* at 612.

¹⁶⁴ *Id.* at 614.

¹⁶⁵ *Id.* at 615. No fraud or foul play has been alleged against Puerto Rico's counsel at this time.

dismiss.¹⁶⁶ While a bond opinion is not meant to be a guarantee of all of the matters it addresses, an “erroneous” opinion—such as the one given by Puerto Rico’s bond counsel—can nevertheless result in liability for bond counsel under certain state law.¹⁶⁷ Whether or not the creditors would be successful in a suit is uncertain, but such an action could offer an alternative path to recourse down the line.¹⁶⁸

E. Where Puerto Rico Stands

On October 14, 2016, Governor Alejandro Padilla submitted a fiscal plan for Puerto Rico, which is currently in the process of being approved, and will determine the extent of the restructuring Puerto Rico needs to undergo.¹⁶⁹ At the same time, negotiations between Puerto Rico and its creditors have been unsuccessful, as some of Puerto Rico’s creditors are still fighting to have the automatic stay removed rather than negotiate.¹⁷⁰ So far the creditors’ motions have been denied,¹⁷¹ but with the automatic stay set to expire February 15, 2017, “[t]ime is of the essence” for an agreement to be met.¹⁷²

V. LESSONS FROM DETROIT AND PUERTO RICO

The possibility that investors could lose billions in municipal bond investments because of contractual issues necessitates the reevaluation of how these bonds are both issued and regulated. According to Moody’s Investors Service, “Detroit’s attempt to invalidate its \$1.4 billion in pension certificates” was a “radical” move that was unlikely to be mimicked by other issuers even if Detroit had

166. *Id.* at 619.

167. NAT’L ASS’N OF BOND LAWYERS, *supra* note 160, at 20.

168. *See supra* Part IV.D.

169. Press Release, U.S. Dep’t of the Treasury, Remarks by Counselor Antonio Weiss on Puerto Rico Before the National Tax Association (Nov. 11, 2016), <https://www.treasury.gov/press-center/press-releases/Pages/jl0606.aspx>.

170. *It’s Vital to Make Way for Debt Negotiations*, ELNUEVODIA (Nov. 4, 2016, 8:54 AM), <http://www.elnuevo.com/english/english/nota/itsvitaltomakewayfordebt negotiations-2258778>.

171. *Id.*

172. Press Release, U.S. Dep’t of the Treasury, Remarks by Counselor Antonio Weiss on Puerto Rico Before the National Tax Association (Nov. 11, 2016), <https://www.treasury.gov/press-center/press-releases/Pages/jl0606.aspx>.

been successful.¹⁷³ Moody's prediction was clearly wrong.¹⁷⁴ Whether Puerto Rico's potential avoidance of its bond obligations will have any major impact on the municipal bond market remains to be seen, but some economists believe that allowing Puerto Rico to shirk on its promise to repay could have a chilling effect on the U.S. municipal debt market, thereby raising the cost of borrowing for other struggling cities.¹⁷⁵ Even if the issue in Puerto Rico has little direct impact on the U.S. bond market, the precedent set by this case could be very harmful. While courts in Puerto Rico and New York have relied on the policy of protecting taxpayers and maintaining the integrity of the law, allowing insolvent municipalities to declare illegally issued bonds void would establish a practice severely detrimental to investors.¹⁷⁶ If the penalty for borrowing above its means is keeping the borrowed money at the expense of its creditors, a struggling municipality will have little incentive to ensure that its bond offerings are in compliance with the law.¹⁷⁷ While there are certainly lessons to be learned on both sides of the issue, because on one side—Puerto Rico—is likely to benefit from this situation, the focus here will be on the lessons for investors.¹⁷⁸ The two major lessons that can be drawn from Detroit and Puerto Rico are: (1) investors are not currently protected from these voidable bond issues, and (2) counsel's role in these transactions is currently inadequate.

173. Caitlin Devitt, *Moody's Sees Detroit COPS Repudiation as Isolated*, BOND BUYER (Feb. 14, 2014), http://www.bondbuyer.com/issues/123_32/moodys-sees-detroit-cops-repudiation-as-isolated-1059885-1.html.

174. *See supra* Part IV.

175. Mary Williams Walsh & Liz Moyer, *How Puerto Rico Debt is Grappling With a Debt Crisis*, N.Y. TIMES: DEALBOOK (July 1, 2016), <http://www.nytimes.com/interactive/2016/business/dealbook/puerto-rico-debt-crisis-explained.html>.

176. Since there currently exists no precedent for how illegal municipal debt of this magnitude should be resolved, any precedent set in this area would be highly persuasive, and would provide future insolvent municipalities a route to void any of their obligations that they find to be unenforceable.

177. If municipalities only stand to gain from issuing invalid debts, municipalities will lack sufficient motivation to do anything to prevent such transactions.

178. *See infra* Part V.A and B.

A. *Current Municipal Bond Regulations Do Not Prevent Illegal Bond Offerings from Occurring, and Current Laws Do Not Protect Investors When They Do*

Puerto Rico was able to issue \$4.1 billion in likely voidable bonds.¹⁷⁹ The Commonwealth has used municipal securities in violation of their Constitution for decades,¹⁸⁰ and now it is seeking to avoid the entirely foreseeable repercussions. The fact that such a manifestly unjust practice is even possible demonstrates that the current regulation of municipal securities is inadequate.¹⁸¹ This inadequacy is due to “sparse regulatory enforcement,”¹⁸² illustrated by the SEC’s small number of enforcement proceedings and the “disparate treatment” of municipalities compared to corporations regarding regulatory noncompliance.¹⁸³

The majority of issuer regulations deal with disclosure obligations.¹⁸⁴ Disclosure statements contain financial information “critical” for investors to assess the financial condition of a municipal issuer and thus analyze their investment’s safety.¹⁸⁵ Unfortunately for investors, compliance with continuing disclosure requirements has been inconsistent and inadequate, both in timeliness¹⁸⁶ and content.¹⁸⁷ This is because, with the exception of securities fraud, the SEC’s authority over the disclosure practices of municipal issuers is limited under existing laws.¹⁸⁸ For example, Rule 15c2-12, which sets the requirements for

179. *See supra* Part IV.

180. *See* PUERTO RICO COMM’N FOR THE COMPREHENSIVE AUDIT OF THE PUB. CREDIT, *supra* note 120, at 23 (“The Commonwealth cannot issue public debt, as defined by the Constitution, with a maturity of more than 30 years, unless it is for financing the construction of housing.”).

181. *See infra* Part V.A.

182. Grommet, *supra* note 18, at 256.

183. Grommet, *supra* note 18, at 260.

184. Grommet, *supra* note 18, at 260–61.

185. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at 69 (“Additional financial information, such as budgetary information, can be used . . . by citizens and citizens groups to assist them in analyzing whether tax dollars were spent in accordance with budgetary restrictions.”).

186. *Id.* at iv.

187. Grommet, *supra* note 18, at 259 (“First, more than one-third of recent municipal securities issuers failed to comply with the Rule 15c2-12 continuing disclosure requirements.”).

188. *Id.* at 2.

municipal securities disclosures,¹⁸⁹ does not establish the form and content of the financial information required to be disclosed for a primary offering of municipal securities.¹⁹⁰ In addition, currently there are no uniform standards of accounting in the municipal securities market, and the SEC lacks authority to prescribe any.¹⁹¹ Consequently, the SEC has rarely enforced disclosure compliance using Rule 15c2-12,¹⁹² and enforcement actions for violations have mostly been limited to a few antifraud actions.¹⁹³

Recently there has been significant concern that many municipality-issuers are not complying with their continuing disclosure obligations and federal securities law violations involving fraudulent statements are widespread.¹⁹⁴ To combat these disclosure violations, the SEC started the Municipalities Continuing Disclosure Cooperation Initiative, which allows underwriters and issuers to receive more lenient settlement terms from the SEC if they self-report violations, including false claims, of their “self-imposed continuing disclosure agreements.”¹⁹⁵ The initiative has resulted in many self-reported violations,¹⁹⁶ and while it fails to address the contractual issue at the heart of the Puerto Rican and Detroit situations, it does indicate heightened concern over the current municipal bond market regulatory framework.¹⁹⁷

There are many issues with the way municipal bonds are

189. 17 C.F.R. § 240.15c2-12 (2016).

190. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at 70 (“The Commission recognized the need for flexibility in determining the content and scope of disclosed financial information given the diversity among types of issuers, types of issues, and sources of repayment.”).

191. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at 71.

192. As of 2012 no municipal securities regulator has ever enforced these regulations in court; Grommet, *supra* note 18, at 260.

193. *Id.*

194. DIV. OF ENFORCEMENT, U.S. SEC. & EXCH. COMM’N, MUNICIPALITIES CONTINUING DISCLOSURE COOPERATION INITIATIVE (2014), <https://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml>.

195. Jack Casey, *SEC Won’t Be Pinned Down on MCDC Continuing Disclosure Violations*, BOND BUYER (Sept. 11, 2015), <http://www.bondbuyer.com/news/washington-enforcement/sec-wont-be-pinned-down-on-mcdc-continuing-disclosure-violations-1084366-1.html>.

196. *Id.*

197. Press Release, U.S. Dep’t of the Treasury, Remarks by Counselor Antonio Weiss on Puerto Rico Before the National Tax Association (Nov. 11, 2016), <https://www.treasury.gov/press-center/press-releases/Pages/jl0606.aspx>.

currently regulated, but even if these issues were to be remedied, the current regulatory scheme does nothing to directly combat the lack of a municipalities' constitutional authority to issue bonds.¹⁹⁸ Regardless of whether there were violations in the Puerto Rican bond offering, current regulations do not require an initial showing of an issuer's authority to make a bond issuance.¹⁹⁹ Accordingly, current municipal securities regulations do not prevent illegal bond issuances from occurring, and thus do not protect investors from voidable bond agreements.²⁰⁰

Furthermore, when a voidable bond agreement is made, state law offers little to no protection to investors.²⁰¹ Invalid municipal contract case law indicates, that where a municipality acts without authority, its contracts will be unenforceable and its obligations can be declared void.²⁰² While some states like Washington²⁰³ seem to be more open to allowing unjust enrichment claims against municipalities, other states like Ohio seem to have a stronger policy against awarding such damages.²⁰⁴ In states with so-called "curative" legislation provisions, the state can retroactively validate otherwise invalid

198. See *supra* Part II.B.

199. See *supra* Part II.B.

200. See *supra* Part II.B.

201. See *infra* Part V.A.

202. See, e.g., *Granada Buildings, Inc. v. City of Kingston*, 444 N.E.2d 1325, 1326 (N.Y. 1982) (disallowing recovery against a municipality for policy reasons); *S. T. Grand, Inc. v. City of New York*, 38 A.D.2d 467, 474 (N.Y. App. Div. 1st Dep't 1972) (dismissing contractor's action for recovery of an unpaid contract balance because the contract was acquired illegally via a kickback, and as such was unenforceable); *González v. Municipality*, 61 P.R.R. 357 (1943) (refusing to grant recovery in a case of a contract executed without the pertinent appropriation in the municipal budget for covering the corresponding expense); *Concrete Wall Co. v. City of Brook Park*, 1976 WL190697, at *5 (Ohio Ct. App. 8th Dist. Feb. 26, 1976) (holding that the state of Ohio does not award unjust enrichment to enforce covenants given by municipalities since in *City of Lancaster v. Miller* it was decided that "[p]eople who deal with municipal bodies for their own profit should be required at their peril to take notice of limitations upon the powers of those bodies which these statutes impose").

203. See *Edwards v. Renton*, 409 P.2d 153, 155 (Wash. 1965) (holding that although the agreement to do work on city traffic lights was invalid, damages should be awarded to the developers on equitable principles based on the reasonable value of the benefits flowing to the city from the improvement).

204. E.g., *Concrete Wall Co. v. City of Brook Park*, 1976 WL190697, at *5 (Ohio Ct. App. 8th Dist. Feb. 26, 1976) (holding that the state of Ohio does not award unjust enrichment to enforce covenants given by municipalities since in *City of Lancaster v. Miller* it was decided that "[p]eople who deal with municipal bodies for their own profit should be required at their peril to take notice of limitations upon the powers of those bodies which these statutes impose").

government action.²⁰⁵ Curative legislation comes in the form of judicial or legislative validation that can allow a state to meet its contractual obligations when it otherwise lacked authority,²⁰⁶ or can protect bonds from validity challenges.²⁰⁷ Unfortunately, curative legislation cannot be used to validate bonds issued illegally under a state Constitution²⁰⁸ or bonds issued in violation of a constitutional debt limitation.²⁰⁹ While other legal loopholes may exist in a state's law that would allow otherwise illegal bond obligations to be enforceable, or would allow recovery under them, generally the law does not protect investors who invested in an illegal bond issuance by a state or municipality.²¹⁰

B. The Current Role of Municipal Bond Counsel Is Insufficient to Protect Investors

As demonstrated in both Detroit and Puerto Rico, lawyers take on a crucial role in municipal securities offerings.²¹¹ Attorneys assumed the role of bond counsel in municipal bonds starting in the 1870s, when many bonds were improperly authorized and invalid.²¹² These invalid offerings caused confidence in the municipal bond market to plummet.²¹³ In order to restore confidence in these investments,

205. See Laura K. Wendell, *Mistakes Happen: Fixing Them Through Curative Legislation*, 37 STETSON L. REV. 459, 459 (2008) (“[G]overnments have the opportunity under Florida law to fix certain mistakes through legislation enacted after the fact for an express, curative purpose.”); Philip Lee, *Chapter 6: Curing Bond Errors and Saving Taxpayers Money*, 39 MCGEORGE L. REV. 477, 478 (2008) (describing the curative effects that Chapter 6 has on bond issues).

206. Maurice B. Kirk, *Statutory Validation of Public Bonds*, 7 U. CHI. L. REV. 281, 281 (1974).

207. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at 38.

208. See, e.g., *State v. Belleair*, 170 So. 434, 437 (Fla. 1936) (reversing a validation decree on four bond issues since they were issued in violation of Fla. Const. art. 9, § 7).

209. Kirk, *supra* note 206, at 281; Bd. of Educ. of Calloway Cty. v. Talbott, 86 S.W.2d 1059, 1064 (Ky. Ct. App. 1935) (“If [the legislature] is without constitutional power, it cannot by a subsequent act cure the want of power to act in the first instance.”).

210. See *supra* Part V.

211. See REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 8, at 47 (“Lawyers, such as bond counsel, disclosure counsel, issuer’s (or borrower’s) counsel, trustee’s counsel, and counsel to the underwriters, also perform important roles in municipal securities offerings and have certain obligations.”).

212. U.S. SEC. & EXCH. COMM’N, STAFF REPORT ON TRANSACTIONS IN SEC. OF THE CITY OF NEW YORK ch. 6, at 1 (1977) [hereinafter STAFF REPORT ON TRANSACTIONS], <https://www.sec.gov/info/municipal/staffreport0877.pdf>.

213. *Id.*

independent counsel began to sign off on the validity of the proposed municipal offerings.²¹⁴ These opinions “reassured” investors that no legal risks pertaining to validity or enforceability of their investments were present.²¹⁵ Today, counsel’s role concerns (1) the validity and enforceability of the authorization and issuance of municipal securities, and (2) the tax-exempt nature of the security.²¹⁶ To accomplish these tasks, counsel reviews the applicable law to confirm the issuer’s authority to issue the bonds as well as the issuer’s conformity with any other legal requirements pertaining to its bonds’ validity²¹⁷—including a municipality’s maximum bond indebtedness.²¹⁸

Bond counsel are supposed to render an opinion regarding the validity and enforceability of bonds only if they are “firmly convinced” as to their validity.²¹⁹ Objectively, counsel should not have been “firmly convinced,” given the financial issues both in Detroit and Puerto Rico, and particularly with the funding mechanism employed in Detroit.²²⁰ While admittedly there is a degree of hindsight in this critique, Puerto Rico acknowledged in both of its offerings that it might not have the authority to borrow due to constitutional constraints.²²¹ In addition, both the 2014 General Obligation Bond issuance and the 2015 Tax Refund Anticipation Notes issuance contained the applicable constitutional provisions, and discussed them in some detail.²²² Despite this, in both offerings counsel attested that the bonds were valid and enforceable.²²³

214. *Id.*

215. *Id.*

216. *Id.*

217. Colin W. Chiu, LOS ANGELES CITY ATTORNEY’S OFFICE, *Role of the City Attorney in the Issuance of Bonds* 5–8 (Feb. 27, 2003), <http://www.cacities.org/getattachment/5b2bc5f4-b8ad-4bf7-866e-7e729ee4f6e0/LR-Colin-Chiu-Paper-Role-of-the-City-Atty.aspx>.

218. *Id.* at 11.

219. NAT’L ASS’N OF BOND LAWYERS, *supra* note 160, at 11.

220. See Karen Pierog, *Participants in Detroit Pension Borrowing Knew Debt Sale Was ‘Iffy’: City Lawyer*, BUSINESS INSIDER (Oct. 1, 2014 2:36 PM), <http://www.businessinsider.com/r-participants-in-detroit-pension-borrowing-knew-debt-sale-was-iffy-city-lawyer-2014-10> (explaining that everyone knew that the mechanism used for the Detroit bond offering was iffy).

221. COMMONWEALTH OF PUERTO RICO, *supra* note 120, at 31–32.

222. COMMONWEALTH OF PUERTO RICO, *supra* note 120, at 31–32.

223. COMMONWEALTH OF PUERTO RICO, *supra* note 120, at app.III; Joint Motion Of Certificate Holders To Intervene at 36, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

Admittedly, bond opinions are by practice, limited,²²⁴ and municipal bond counsel, contrary to corporate bond counsel, do not represent that they have gone beyond a formal review of the documents when they submit the opinion to the client municipality.²²⁵ In fact, as is typical in the practice,²²⁶ counsel in the Puerto Rican offering specifically stated that it was relying on facts from the Puerto Rican Secretary and made no further inquiry into the facts themselves.²²⁷ Thus, it is highly likely that these firms did not have access to all of Puerto Rico's accounting and budgetary information, and even if they did, they still may not have been able to determine whether Puerto Rico was within its 15% limitation in order to determine whether the bonds were in compliance with Puerto Rico's Constitutional debt limit.²²⁸ However, it is quite clear from the bond offering disclosure that at least some of the funds were to be used to finance operational costs and prior deficits.²²⁹ Puerto Rico's Constitution requires that Puerto Rico maintain a balanced budget, which prohibits the government from borrowing to cover budget deficits.²³⁰ As a result, Puerto Rico's actions were clearly inconsistent with the law, and their illegal expenditures were not hidden in the offering.²³¹

The purpose of bond counsel is to ensure that the bonds are valid and that the municipality has the authority to make the offering,²³² but as seen here, counsel's current role is insufficient.²³³ Although investors realize there are inherently some limitations in counsel opinions,²³⁴ these "limitations" typically deal with the marketability of the bonds, or substantial changes that occur only after the opinion is rendered, rather than the validity of the underlying transaction.²³⁵ Both

224. NAT'L ASS'N OF BOND LAWYERS, *supra* note 160, at 12.

225. Johnson & Wheeler, *supra* note 147, at 1209.

226. NAT'L ASS'N OF BOND LAWYERS, *supra* note 160, at 11.

227. COMMONWEALTH OF PUERTO RICO, *supra* note 120, at 31–32.

228. NATIONAL ASSOCIATION OF BOND LAWYERS, *supra* note 153, at 12.

229. COMMONWEALTH OF PUERTO RICO, *supra* note 120, at 24.

230. PUERTO RICO COMM'N FOR THE COMPREHENSIVE AUDIT OF THE PUB. CREDIT, *supra* note 107, at 1.

231. *See supra* Part V.B.

232. STAFF REPORT ON TRANSACTIONS, *supra* note 211, at ch. 6, 1.

233. *See supra* Parts III and IV.

234. NAT'L ASS'N OF BOND LAWYERS, *supra* note 160, at 12.

235. *Id.*

investors and insurers rely on these opinions,²³⁶ and consequently, law firms that serve as bond counsel need to be held to a higher standard.²³⁷ If firms are to sign off on a \$4.1 billion bond offering, there should not be a scintilla of doubt that the bonds are in fact valid.²³⁸ Without knowing whether or not Puerto Rico was within its debt limitation, counsel should not have signed off on the enforceability of these deals.²³⁹ In addition, more attention needs to be paid to the laws governing bond offerings.²⁴⁰ Puerto Rico was not hiding the fact that it was spending its bond proceeds in violation of its Constitution, and either its counsel or the bank's counsel should have spotted this and stopped the offering.²⁴¹

VI. CONCLUSION

Currently, the consequence of issuing invalid municipal debt is that investors lose billions.²⁴² While there are several lessons to be learned from the Detroit and Puerto Rico debacles, the most important lesson is that investors must understand they are not currently protected from their bonds being declared void—notwithstanding a clean opinion by the counsel involved in the bond's issuance.²⁴³ With this increased awareness, investors can start to take measures to increase the safety of their investments. While all investments possess some uncertainty, any additional assurance an investor can acquire that the bonds are legal and enforceable is clearly desirable. After Detroit and Puerto Rico, choice-of-law provisions should garner more attention in these deals.²⁴⁴ These provisions allow parties to contract with greater certainty, as the provisions allow parties to predict their rights and liabilities under the contract.²⁴⁵ While in Puerto Rico the applicable law may not be

236. Joint Motion Of Certificate Holders To Intervene at 36, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014).

237. See *supra* notes 45–46.

238. See *supra* notes 45–46.

239. See *supra* Part V.B.

240. See *supra* Part V.B.

241. See *supra* notes 45–46.

242. See *supra* notes 45–46.

243. See *supra* Parts III.B, IV.C.

244. See *supra* Part IV.A

245. Barbara Wahl, *Rethinking Boilerplate Provisions in Contracts*, ASS'N OF CORP. COUNSEL (Mar. 4, 2015), <http://www.acc.com/legalresources/quickcounsel/rethinking->

outcome determinative, a survey of state law around the country suggests that the presence of small differences in laws could be important for creditors seeking quasi-contractual recovery.²⁴⁶

While investors must take actions to protect themselves, improvements to municipal securities regulation should also be implemented.²⁴⁷ Currently, unless there was some fraudulent activity in connection with a bond offering, an issuer is unlikely to face liability under federal securities laws.²⁴⁸ Although a change to the regulatory scheme to address an issue as rare as voidable municipal bonds is unlikely, further regulation of municipal issuers will nevertheless provide increased protection to investors by ensuring their access to financial information and timely continuing disclosures.²⁴⁹ In order to accomplish this, Congress should give the SEC funding and authority to directly require disclosures from municipal issuers, establish the form and content of these disclosures, and enforce their continuing disclosure obligations and deadlines.²⁵⁰ In addition, Congress should consider authorizing the SEC to require municipal securities issuers to have their financial statements audited, and allow the Internal Revenue Service and SEC to share more information about an issuer's fiscal situation.²⁵¹

boilerplate-provisions-in-contracts.cfm.

246. See, e.g., *Providence v Providence Elec. Light Co.*, 91 S.W. 664, 664 (Ky. App. Ct. 1906) (holding that though the contract was void because it was made in violation of Ky. Const. § 164, because the City received the benefits of the lights furnished by the light company, the City was liable to pay for the reasonable value of the lights that it had received); *Edwards v. Renton*, 409 P.2d 153, 154 (Wash. 1965) (holding that although the agreement to do work on city traffic lights was invalid, damages should be awarded to the developers on equitable principles based on the reasonable value of the benefits flowing to the city from the improvement); *Concrete Wall Co. v. City of Brook Park*, Ohio App. LEXIS 7435 at *5 (1976) (holding that the state of Ohio does not award unjust enrichment to enforce covenants given by municipalities since in *City of Lancaster v. Miller* it was decided that “[p]eople who deal with municipal bodies for their own profit should be required at their peril to take notice of limitations upon the powers of those bodies which these statutes impose”).

247. See *supra* Part V.A.

248. Christine Sgarlata Chung, *Government Budgets as the Hunger Games: The Brutal Competition for State and Local Government Resources Given Municipal Securities Debt, Pension and OBEP Obligations, and Taxpayer Need*, 33 REV. BANKING & FIN. L. 663, 744 (2014).

249. See *supra* Part V.A.

250. See Chung, *supra* note 248, at 744–755 (advocating for possible strategies to protect investors and increase municipal disclosure).

251. See Chung, *supra* note 247, at 744–755 (advocating for possible strategies to protect investors and increase municipal disclosure).

This would not only provide bondholders with more accurate information, it also would allow bond counsel to have better information as to the financial state of the issuer and make a more informed opinion regarding the authority of the issuer in these transactions.²⁵²

Finally, the role of legal counsel in these transactions must be reevaluated and improved.²⁵³ As previously discussed, “curative” legislation is not available to remedy counsel issues.²⁵⁴ The consequences for counsel mistakes are billion dollar losses to investors, for whom there is seemingly little or no recourse.²⁵⁵ When a material fact, if false, has the ability to invalidate the entire transaction and render bond counsel’s opinion incorrect, counsel must conduct further investigation rather than rely solely on certifications presented to them by the issuer.²⁵⁶ Counsel must also ensure that their opinions fully consider the relevant laws and facts that will dictate the offering’s validity, as they could face potential lawsuits from the investors and other institutions who heavily rely on their opinions in evaluating whether to invest in these securities.²⁵⁷

A combination of increased investor awareness, regulatory improvements, and more thorough municipal bond counsel practices will prevent another Detroit or Puerto Rican debt debacle in the future.²⁵⁸ On the other hand, there could be some positives that come from these cases. A lack of equitable remedies to protect investors should result in more prudent and careful investing, and may prompt regulatory changes resulting in better investor protection. At the same

252. *See supra* Part V.A.

253. *See supra* Part V.B.

254. *See supra* Part V.

255. *See supra* Part IV.B.

256. *See supra* Part V.B.

257. Joint Motion Of Certificate Holders To Intervene at 36, In re City of Detroit, No. 13-53846 (Bankr. E.D. Mich. August 28, 2014) (“In connection with the Pension Funding Transaction, in both 2005 and 2006, the City made numerous warranties, representations, and covenants regarding the lawfulness and enforceability of the Pension Funding Transaction, including that such transaction was a valid exercise of the City’s municipal authority, was not subject to any debt limitations, and required no further action by any governmental body, agency or official. Without these and other material warranties, representations, and covenants as inducements, Interveners would not have participated in the transactions.”).

258. *See supra* Part V.B.

time, municipalities attempting to void debts will likely result in mistrust in municipalities and could hurt future municipal efforts in raising funds.²⁵⁹ The greatest potential negative impact is that, if Puerto Rico is able keep the billions it received from its invalid bonds, it could encourage future municipalities in dire financial situations to do the same. Looking toward the looming debt crisis in Chicago and other struggling municipalities, the precedent set from this case could be influential in shaping the municipal securities market going forward.

JOSHUA C. SHOWALTER*

259. See STAFF REPORT ON TRANSACTIONS, *supra* note 212 (pointing to the relationship between municipal bond agreements being deemed invalid, and investor trust in municipal bonds).

* I would like to thank my parents for their unconditional love and support throughout my life and law school career. Without them I would not be where I am today. I am also grateful to my editors Cory McKenna and Kenneth Lee for their thoughtful comments and guidance during the editing process. Finally, I am thankful to Professor Melissa Jacoby for introducing me to this topic and inspiring me to dig deeper into these issues.