UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF PUERTO RICO

In re: THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, as representative of THE EMPLOYEES RETIREMENT SYSTEM OF THE GOVERNMENT OF THE COMMONWEALTH OF PUERTO RICO, Debtor.[1]	PROMESA Title III Case No. 17-cv-01685 (LTS) Case No. 17-bk-03566 (LTS)
THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, as representative of THE EMPLOYEES RETIREMENT SYSTEM OF THE GOVERNMENT OF THE COMMONWEALTH OF PUERTO RICO, Plaintiff, -against- ALTAIR GLOBAL CREDIT OPPORTUNITIES FUND (A), LLC, ET AL., Defendants-Counterclaimants.	Adv. Proc. No. 17-00213 (LTS)

REPLY OF EMPLOYEES RETIREMENT SYSTEM OF THE GOVERNMENT OF COMMONWEALTH OF PUERTO RICO IN SUPPORT OF ITS MOTION FOR SUMMARY JUDGMENT

[1] The Debtors in these cases and the last four (4) digits of each Debtor's federal tax identification number, as applicable, are (i) Commonwealth of Puerto Rico (Bankruptcy Case No. 17 BK 3283-LTS) (Last Four Digits of Federal Tax ID: 3481), and (ii) Employment Retirement System for the Commonwealth of Puerto Rico (Bankruptcy Case No. 17 BK 3566-LTS) (Last Four Digits of Federal Tax ID: 9686).

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To the Honorable United States District Judge Laura Taylor Swain:

Plaintiff Employees Retirement System of the Government of the Commonwealth of Puerto Rico ("ERS," the "System," or the "Debtor"), by and through the Financial Oversight and Management Board (the "Oversight Board"), as the Debtor's representative pursuant to Section 315(b) of the *Puerto Rico Oversight, Management, and Economic Stability Act* ("PROMESA"),[2] respectfully submits this reply in support of its motion for summary judgment and the memorandum of law in support thereof (the "ERS Memo") [D.I. 91].

PRELIMINARY STATEMENT

In this reply, ERS does not repeat all the arguments it made in its opening brief and in response to the Bondholders'[3] cross-motion, which demonstrate both that the Bondholders' asserted security interest was never perfected and, even if it had been, it would be cut off by section 552 of the Bankruptcy Code as of the ERS title III petition date. Rather, ERS focuses on several specific points raised by the Bondholders.

First, having effectively conceded a lack of compliance with the UCC's filing requirements, the Bondholders are forced to argue the Court should take a "pragmatic approach" to perfection and create exceptions to the UCC's filing requirements. But neither the UCC nor applicable case law permit the Court to do so. The UCC does not have an "incorporation by reference" exception for collateral descriptions in financing statements, and does not permit an exception to (i) Revised Article 9's five-year lapse period for deficient filings like the 2008 Financing Statements, or (ii) the requirement that a financing statement exactly state the debtor's correct name and in the correct field, neither of which were done here. The fact is the

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[2] PROMESA is codified at 48 U.S.C. §§ 2101-2241.

[3] The Defendants in this action are referred to, collectively, as the "Bondholders." Unless otherwise noted, capitalized terms shall have the meaning set forth in the ERS Memo filed on November 3, 2017.

deficiencies in the UCC filings that exist here could have been easily addressed at each step along away – but they were not. The Bondholders ask this Court to excuse that lack of diligence by making exceptions. But doing so would not only run contrary to the UCC and applicable case law, it would also upset the well-established statutory commercial rules that underpin the financial system by providing certainty to lenders extending secured credit.

Second, even putting aside the perfection deficiencies that make up the bulk of the parties' arguments, the Bondholders offer no good reason – either under the Resolution itself or under the UCC – why their alleged security interest could conceivably extend to the Employee Loans or Employee Loan Payments.

Third, the exceptions to section 552(a) urged upon the Court do not apply because the postpetition employer contributions are not proceeds of any prepetition collateral, and Employers' Contributions are not special revenues under any plausible reading or construction.

Fourth, and finally, the Bondholders' new argument (not raised in either party's Complaint or summary judgment motion) that ERS agreed but failed to transfer Employers' Contributions from the Commonwealth central government pursuant to the January Stipulation lacks merit because (i) it is beyond the scope of the Joint Stipulation, and (ii) it is inconsistent with the plain language of the January Stipulation and the Bondholders' cited evidence.

ARGUMENT

I. THE BONDHOLDERS' ASSERTED SECURITY INTEREST WAS NEVER PERFECTED

In their opposition to summary judgment (the "Bondholders Opposition" or "B'hldrs Opp.") [D.I. 120], the Bondholders concede a lack of compliance with the UCC's filing requirements. Nonetheless, they argue the Court should take a "pragmatic approach" to perfection by creating exceptions to the UCC's stringent filing requirements. However, as

explained below, the exceptions urged upon the Court by the Bondholders do not exist in the UCC and are not permitted by case law.

A. The UCC does not permit "incorporation by reference" for financing statements.

ERS and the Bondholders agree that the words actually contained in or attached to the 2008 Financing Statements do not satisfy the UCC's collateral description requirement. The only dispute is whether the 2008 Financing Statements may "incorporate by reference" *unfiled* documents to satisfy the collateral description requirement.

Despite briefing this specific issue multiple times (in the Lift Stay Proceeding and this declaratory judgment action), the Bondholders have failed to cite even one case where a court held a *financing statement* may incorporate by reference *unfiled* documents to satisfy the collateral description requirement. Rather, the Bondholders have cited the same set of cases where a *security agreement* was permitted to incorporate unattached documents. B'hldrs Opp. ¶¶ 10-11.

This point is perhaps most acute in the first case the Bondholders cite for their "incorporation by reference" argument – *In re Amex-Protein Development. Corp.*, 504 F.2d 1056 (9th Cir. 1974). *Amex-Protein* did not involve analysis of a financing statement. Nevertheless, the Bondholders use a subtle sleight of hand in their brief when they swap out the decision's specific reference to "security agreement" and replace it with "financing statement":

> To the contrary, as long as ***a financing statement*** "*provides such information as would lead a reasonable inquirer to the identity of the collateral*" – whether by incorporation of outside documents by reference or otherwise – the collateral description is deemed "sufficient."

B'hldrs Opp. ¶ 10, citing *Amex-Protein* (emphasis added). In fact, the complete quoted portion of *Amex-Protein* states:

> The description ***in the security agreement*** is sufficient, however, if it *provides such information as would lead a reasonable inquirer to the identity of the collateral*.

Amex-Protein, 504 F.2d at 1060 (emphasis added). Indeed, in *Amex-Protein*, a security agreement was permitted to incorporate by reference an unattached financing statement, not vice versa. *Id*. at 1062. ERS submits the Bondholders' sleight of hand here is not accidental, undermines the integrity of the judicial process and, by itself, warrants denial of the Bondholders' cross-motion and the granting of ERS's motion for summary judgment.

The distinction between a security agreement and a financing statement is critically important here. A security agreement is a private contract, governed by contract law. There is no prohibition in the UCC against a security agreement (as a contract) incorporating documents by reference because, unlike a UCC-1 financing statement – whose whole purpose is to disclose to the public the existence of a security interest in certain described collateral – there are no public notice considerations for a security agreement which is simply a private contract between a debtor and creditor.

None of the other cases cited by the Bondholders for their "incorporation by reference" argument apply here. *See* ERS's Response to Bondholders' Cross-Motion for Summary Judgment (the "ERS Opposition" or "ERS Opp.") [D.I. 115] at 7 (chart). Those cases involved either (i) a security agreement – *not a financing statement* – that incorporated an unattached document,[4] or (ii) incorporation of a document *actually attached* to a filed financing statement.[5]

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[4] *In re Amex-Protein Dev. Corp.*, 504 F.2d 1056 (9th Cir. 1974), *In re Prod. Design & Fabrication, Inc.*, 182 B.R. 803 (Bankr. N.D. Iowa 1994), *Greenville Riverboat, LLC v. Less, Getz & Lipman, P.L.L.C.*, 131 F. Supp. 2d 842 (S.D. Miss. 2000), *Miami Valley Prod. Credit Ass'n v. Kimley*, 536 N.E. 2d 1182 (Ohio Ct. App. 1987).

[5] *Int'l Home Prods., Inc., v. First Bank of P. R.*, 495 B.R. 152 (D.P.R. 2013) and *Chase Bank of Fla., N.A. v. Muscarella*, 582 So. 2d 1196 (Fla. Dist. Ct. App. 1991).

There simply is no "incorporation by reference" exception to the UCC's collateral description requirement for financing statements. As courts within the First Circuit have made clear, the "description of the types or items of collateral *is to appear on the face of the financing statement* ***rather than through incorporation of a description appearing elsewhere*** . . . ." *In re Quality Seafoods, Inc.*, 104 B.R. 560, 561 (Bankr. D. Mass. 1989) (emphasis added). Nothing in any of the Bondholders' briefs or cited decisions alters that requirement.

B. The exception to Revised Article 9's 5-year lapse period does not apply.

ERS and the Bondholders agree that if the 2008 Financing Statements had been *effective to perfect* the asserted security interest prior to the effective date of Revised Article 9 (January 2013), the 10-year lapse period under Old Article 9 would apply. The parties disagree as to the lapse period that applies to a financing statement that had *not* been effective to perfect prior to Revised Article 9. The Bondholders argue Revised Article 9's 5-year lapse period applies only to financing statements filed after January 2013. ERS has repeatedly explained, and the Bondholders' have not refuted, the 5-year lapse period applies to financing statements filed prior to January 2013 as well, *unless they were already effective to perfect*.

Here, the key language is in the statutory preface to the transition rules of Revised Article 9: "Except as otherwise provided in this part, this act applies to a transaction or lien within its scope, ***even if the transaction or lien was entered into or created before this act takes effect***." § 9-702(a) (emphasis added). This means a 5-year lapse period applies to both a financing statement filed after the effective date of Revised Article 9 (*i.e.*, after January 2013), Section 9-335(a), *and* a financing statement filed prior to January 2013 – unless one of the exceptions applies, Section 9-702(a) ("Except as otherwise provided in this part . . . .").

The only exception that conceivably could apply here is Section 9-703(a), which preserves the perfection of a security interest that was *already perfected* when Revised Article 9

took effect. Under that exception, if a financing statement was already effective to perfect prior to Revised Article 9, it continues to benefit from the 10-year lapse period under Old Article 9. If a financing statement was *not* effective to perfect prior to January 2013 (as is the case with the 2008 Financing Statements), it is subject to the 5-year lapse period under Revised Article 9. Accordingly, once the Court disposes of the Bondholders' "incorporation by reference" argument, it should hold the 2008 Financing Statements were not effective to perfect prior to January 2013 and thus the 5-year lapse period applies.

Thus, because the 2008 Financing Statements (i) were deficient when filed and (ii) lapsed five years later in 2013 (two years before the attempted amendments in 2015 and 2016), they have no bearing on the perfection analysis. That is because, as demonstrated in ERS's prior briefing, a lapsed financing statement cannot be amended, ERS Opp. at 9 (citing *In re Quality Seafoods, Inc.*, 104 B.R. at 561), and it is irrelevant whether a financing statement – lapsed or not – continued to be retained in the records of the filing office, ERS Opp. at 13.

As a result, the Bondholders can only point for perfection to the 2015 and 2016 Amendments. For the reasons set forth in the ERS Memo (at 2) and ERS Opposition (at 8-10), the 2015 and 2016 Amendments were attempted amendments, not new UCC-1 financing statements. They also could not be considered new financing statements because they did not satisfy all the strict filing requirements of a UCC-1 financing statement – including the basic requirements to state exactly the correct name of the debtor, list that correct name on the face of the document, and list it in the correct field. *See In re G. G. Moss Co.*, 1981 WL 137971, at *779 (A filing can perfect a security interest only "when considered by itself the filing also meets ***all the technical statutory requirements of a filing statement*** . . . .") (emphasis added) (citations omitted). The result would be the same if those errors were present on a UCC-1 financing

statement – it would be incapable to perfect. There is no reason to change that result when the errors are present on a UCC-3 attempted amendment.

It is clear the 2015 and 2016 Amendments were filed in an attempt to do just that – *amend* the 2008 Financing Statements to correct their deficient collateral descriptions.[6] They were not filed to serve as new financing statements. The Bondholders now ask the Court to find, after the fact, that those attempted amendments can be deemed fully-compliant new financing statements, but it is clear under the UCC that they cannot because they do not satisfy Article 9's requirements.[7]

C. There is no exception to the UCC's requirement to state exactly the debtor's correct name.

The Bondholders similarly ask the Court to make an exception to the UCC's requirement to state *exactly* the debtor's correct name. B'hldrs Opp. ¶¶ 28-35. The fact is that the official translation of ERS's name – which is the applicable name for UCC purposes – changed pursuant to the amendment to the Enabling Act in 2013, and that name was not listed on the attempted amendments in 2015 and 2016. *See* ERS Opp. at 12, n.13. It is irrelevant how ERS holds itself out to the public, or has signed pleadings in this or other cases. Article 9 recognizes that debtors may use trade names, but expressly does not create a trade name exception to the requirement of stating exactly the correct legal name of the debtor. *See* § 9-703(c) ("A financing statement that provides only the debtor's trade name does not sufficiently provide the name of the debtor.").[8]

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[6] *See* ERS Bondholders' Statement of Undisputed Facts [D.I. 95], ¶¶ 46, 48 (the "collateral change" and "restate covered collateral" boxes are checked in each of the attempted amendments).

[7] It is standard practice under Article 9, expressly contemplated and condoned by Article 9 itself, for a secured party in doubt to proceed under alternative paths. *See, e.g.*, § 9-502, Comment 2.d ("If there is any doubt about an individual's name, a secured party may choose to file *one or more financing statements* that provide a number of possible names for the debtor and a searcher may similarly choose to search under *a number of possible names*." (emphasis added). The Bondholders could have filed a UCC-1 at the same time as the UCC-3, but chose not to.

[8] The Bondholders' argument that the name change is irrelevant because "the ERS acquired important parts of the Pledged Property [] long before November 1, 2013" is faulty for the reasons discussed in Section III.A., *infra*.

D. There are no "pragmatic" exceptions to the UCC's filing requirements.

Recognizing the complete deficiency of their perfection arguments, the Bondholders implore the Court to disregard the UCC's filing requirements and ask the Court to instead adopt a "pragmatic approach" to perfection under *In re Cushman Bakery*, 526 F.2d 23 (1st Cir. 1975). *Cushman*, however, endorses no such thing.

In *Cushman*, all parties conceded that "financing statements that were *facially sufficient under the Uniform Commercial Code* were filed in [the appropriate places], listing [the appropriate parties]." 526 F.2d at 28 (emphasis added). The only issue in *Cushman* was whether "a security interest [] intentionally perfected in a manner that may result in concealing a preference from unsecured creditors [] should be held not to be properly perfected under the Maine recording statutes." *Id.* There, the UCC's filing requirements were strictly complied with (unlike here), but the bankruptcy trustee objected because the financing statements did not disclose additional information (not required to be in a financing statement by the UCC) that would have helped him discover a potentially voidable preference. *Cushman* does not support a "pragmatic approach" to perfection, and does not offer any basis to excuse non-compliance with the UCC. *Cushman* stands only for the proposition that a secured claimant need not disclose more in a UCC filing than the UCC requires.

Likewise, contrary to the Bondholders' claims, adhering to the UCC's strict filing requirements would not "grant ERS a windfall." B'hldrs Opp. ¶ 6. First of all, ERS is a debtor – and gains nothing from the Court simply applying the law. Moreover, it is the Bondholders who would unfairly benefit – and other creditors of ERS who would be unfairly prejudiced – if the Court were to create an exception to the UCC where none is warranted, much less permitted. Indeed, as the First Circuit has held:

> Efforts by courts to fashion equitable solutions to mitigate the hardship on particular creditors of literal application of statutory filing requirements [for a financing statement] would have the deleterious effect of undermining the reliance which can be placed upon them. The harm would be more serious than the occasional harshness resulting from strict enforcement.

Uniroyal v. Universal Tire & Auto Supply Co., 557 F.2d 22, 23 (1st Cir. 1977). If the Court were to fashion an equitable solution here, it would not only undermine the purpose of the UCC's filing requirements, it would do so at the expense of ERS's other creditors and demonstrate the "equitable solution" is unprincipled arbitrariness.

Finally, with regard to the Bondholders' argument regarding section 544 in Section I.G., ERS incorporates by reference its response to that argument from its opposition. ERS Opp. at 14-20. Furthermore, any rights the Bondholders may have as the holder of an unperfected security interest are subordinate to the rights of the Oversight Board, which acts as the equivalent of the bankruptcy trustee for ERS, under UCC § 9-317(a)(2)(A). Under that subsection:

> A security interest … is subordinate to the rights of: … (2) … a person that becomes a lien creditor before the earlier of the time: (A) the security interest … is perfected …

UCC § 9-102(a)(52)(C) defines a "lien creditor" to include "a trustee in bankruptcy from the date of the filing of the petition." As a lien creditor, the rights of the Oversight Board are senior to any rights that the Bondholders have as holders of an unperfected security interest without regard to the applicability of section 544. Thus, the Puerto Rico UCC provides a bankruptcy trustee automatically has the status of a lien creditor and it provides that status trumps an unperfected security interest. The Oversight Board is a bankruptcy trustee for purposes of taking on the status of a judicial lien creditor because PROMESA section 301(c)(7) provides the Oversight Board is the trustee for purposes of every Bankruptcy Code provision incorporated into PROMESA Title III that refers to a trustee, and PROMESA section 301(a) incorporates

Bankruptcy Code section 544(a) which provides the trustee shall have the status of, among other things, a judicial lien creditor.

As discussed above, *see* Section I.A., the purpose of a financing statement is to give the world notice of a security interest in particular collateral. If the Court accepted the Bondholders' position that there is no need to perfect a security interest in the assets of a government debtor, the result would be the approval of hidden liens – the very antithesis of the purpose of the UCC and modern secured lending.

II. THE BONDHOLDERS' ASSERTED SECURITY INTEREST IN EMPLOYEE LOANS IS UNPERFECTED, INVALID, AND UNENFORCEABLE

Even if the Bondholders have a perfected security interest in Pledged Property, any perfected security interest does not cover Employee Loans or Employee Loan Payments. As explained in the ERS Memo (at 20-22), the Resolution does not include any collateral description that would include assets such as Employee Loans. Further, Employee Loans were made using cash proceeds of Employers' Contributions. Accordingly, the continuing perfection rule for proceeds contained in UCC Section 9-315(c) does not apply to Employee Loans or Employee Loan Payments derived from those contributions because, pursuant to UCC Section 9-315(d), any security interest in property acquired from cash proceeds is unperfected on the twenty-first (21) day after such property is acquired unless another perfection method has been used (which is not the case here). UCC § 9-315(d)(1)(C). And even if the Bondholders have a security interest in Employee Loan Payments, the absence of perfection in Employee Loans means any security interest in Employee Loan Payments must be independently perfected through control, which the Bondholders have not and cannot establish. *See* ERS Memo at 23-24.

Simply put, because cash proceeds of collateral (*i.e.* Revenues) subject to an effective security interest were used to generate alleged new non-cash proceeds (*i.e.* Employee Loans), the

Employee Loans could only be Bondholder collateral subject to a perfected security interest if the Bondholders had a security interest that covered that type of collateral and had perfected the security interest. Importantly, the Employee Loans are not cash proceeds of Revenues as the Bondholders argue. B'hldrs Opp. ¶ 40. Rather, Employee Loans were generated *from* cash proceeds. Accordingly, any security interest in Employee Loans and Employee Loan Proceeds became unperfected 21 days after being remitted to ERS. UCC § 9-315(d)(1)(C).

Further, as set forth in the ERS Opposition (at 32-33), Employee Loan Payments do not constitute Employers' Contributions because Employee Loan Payments are remitted along *with* Employers' Contributions, *not in lieu* thereof. Moreover, the obligation of employers to remit Employee Loan Payments to ERS was codified in Section 4-106 of the Enabling Act, which is not a section encompassed by the definition of Employers' Contributions in the Resolution.

Finally, the Bondholders' argument that Employee Loans and Employee Loan Payments constitute Pledged Property as cash or non-cash proceeds of Pledged Property misses the mark. The Resolution cannot perfect the Bondholders' security interest. Only complying with the UCC can. As described above, the Bondholders have failed to perfect any security interest in Employee Loans and Employee Loan Proceeds under the UCC.

III. THE BONDHOLDERS' SECURITY INTEREST DOES NOT ATTACH TO THE POSTPETITION EMPLOYERS' CONTRIBUTIONS RECEIVED BY ERS

Even if the Bondholders have a perfected security interest, section 552(a)[9] stops their security interest from attaching to postpetition Employers' Contributions.[10] Section 552(a) provides "[e]xcept as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any

[9] References to "Section xx" in this Section III refer to sections of the Bankruptcy Code.

[10] The only Employers' Contributions at issue are those received by ERS from May 21, 2017 to July 1, 2017, because ERS stopped receiving all contributions after July 1, 2017 due to the implementation of Pay-Go.

security agreement entered into by the debtor before the commencement of the case." 11 U.S.C. § 552(a). Section 552(a) prevents a security interest from attaching to after-acquired property following the petition date. *N.H. Bus. Dev. Corp. v. Cross Baking Co., Inc. (In re Cross Baking Co., Inc.)*, 818 F.2d 1027, 1029 (1st Cir. 1987). Employers' Contributions received by ERS postpetition constitute after-acquired property. Accordingly, section 552(a) prevents the Bondholders' security interest from attaching to Employers' Contributions received postpetition.

A. Postpetition Employers' Contributions are not proceeds of any prepetition collateral and, accordingly, the exception of Section 552(b) does not apply.

There are two possible exceptions to section 552(a), neither of which applies. The exception in section 552(b) providing a security interest will attach to postpetition proceeds of prepetition collateral is not applicable because ERS's postpetition revenues, namely Employers' Contributions, are not proceeds of collateral that existed prepetition. *See* ERS Memo at 25-31. As set forth more fully in the ERS Memo, an employer's contribution amount was a percentage of each employee's contribution amount. *See* 3 L.P.R.A. § 787f. An employer was not obligated to remit contributions to ERS until an employee performs work, thereby triggering the employee's own contribution obligation. If no obligation to remit contributions existed as of the petition date, ERS could not have had a "right" to receive future Employers' Contributions. Accordingly, postpetition Employers' Contributions are not proceeds of ERS's general right to receive Employers' Contributions.

Where a secured creditor has a prepetition security interest in a debtor's right to receive property but the obligation to remit the property did not exist as of the petition date, no prepetition right to receive such postpetition property exists. *See, e.g.*, *In re HRC Joint Venture*, 175 B.R. 948, 952 (Bankr. S.D. Ohio 1994) (holding postpetition remittances from hotel operator to hotel owner-debtor are not proceeds of security interest in remittances because debtor's right

to collect such remittances was dependent on postpetition operations; no right to collect on postpetition operations existed on the petition date); *In re Gross-Feibel Co.*, 21 B.R. 648, 650 (Bankr. S.D. Ohio 1982) (holding refund checks issued to debtor postpetition are not proceeds of security interest in debtor's general intangibles because debtor's right to receive them did not exist as of petition date). In the same manner, because the obligation of an employer to remit contributions to ERS did not arise until an employee performed work and the employer's contribution amount was calculated from employees' contributions, ERS's right to receive contributions during the postpetition period represents a new receivable that did not exist as of the petition date. As such, postpetition Employers' Contributions are not proceeds of an existing prepetition collection right.

The Bondholders try to side-step *HRC Joint Venture* by characterizing an employer's duty to remit contributions as a fixed obligation independent of the requirement for employees to perform work. B'hldrs Opp. ¶ 50. The Bondholders cite to three provisions of the Enabling Act, 3 L.P.R.A. §§ 787, 787q, and 782, in support. Yet none of the cited provisions support the Bondholders' assertion:

> 3 L.P.R.A § 787: This section merely provides a generic statement regarding the general obligations of employers and does not provide how those obligations are calculated or triggered. *See* 3 L.P.R.A § 787.
>
> 3 L.P.R.A § 787q: This section provides "[i]n order to make up the System's cash flow deficit, every fiscal year, beginning on fiscal year 2013-2014 and ending on fiscal year 2032-2033, the System shall receive a contribution equal to the Additional Uniform Contribution." 3 L.P.R.A. § 787q(a). This Additional Uniform Contribution is not a fixed obligation "independent of the work performed by the current employees" as the Bondholders allege. Opp. ¶ 50. The "Additional Uniform Contribution" owed *is dependent on employees performing services* as the Additional Uniform Contribution is a "percentage of the total employer contributions corresponding to such employer during the current fiscal year." 3 L.P.R.A § 787q(b). Since employer contributions are calculated from employee services, the Additional Uniform Contribution is dependent on employees performing work. Moreover, 3 L.P.R.A § 787q is the codification of Section 5-117 of the Enabling Act and is therefore not included in the definition

of Employers' Contributions. *See* Resolution at VI-33 ("Employers' Contributions shall mean the contributions paid from and after the date hereof that are made by the Employers … pursuant to *Sections 2-116, 3-105 and 4-113* of the [Enabling] Act.") (emphasis added). Thus, any payment obligation under 3 L.P.R.A § 787q does not constitute Employers' Contributions.

3 L.P.R.A. § 782(h): This section sets forth the consequences and obligations of an employer withdrawing from ERS. This section addresses, among other items, the obligation of the employer to remedy any deficiencies for contributions owed but not remitted by the employer and to pay for already vested benefits owed to employees. 3 L.P.R.A. § 782(h). Further, 3 L.P.R.A. § 782(h) is the codification of Section 1-110 of the Enabling Act and is not included in the definition of Employers' Contributions. Accordingly, any payment obligation under 3 L.P.R.A. § 782(h) does not constitute Employers' Contributions.

The rest of the Bondholders' opposition consists of arguments already asserted in prior filings and that ERS has already refuted.

To find the Bondholders have a pre-existing right to future Employers' Contributions is inconsistent with the disclosed risk Employers' Contributions could be reduced or eliminated (and for which the parties accounted for by placing a corresponding covenant in the Resolution to address such risk). *See* Case No. 17-bk-3566 [D.I. 101-5, Exhibit E], at 26; *see also* Resolution § 709.2.

But even if the Bondholders are correct in their interpretation of the Resolution, they fail to explain how such a reading bars application of section 552(a) to postpetition Employers' Contributions. Indeed, all the Bondholders have demonstrated is an expected future interest in after-acquired property. ERS Opp. at 22-23. Accordingly, section 552(a) prevents the Bondholders' security interest from attaching to postpetition Employers' Contributions.

The Bondholders argue ERS's right to receive future contributions exists regardless of whether an employee performs work, and this somehow transforms ERS's postpetition collection rights into a pre-existing receivable. B'hldrs Opp. ¶ 51. This argument fails because without the employees performing work, employers would not be obligated to remit any contributions to

ERS. If employers are not obligated to remit funds, then any collection right is rendered meaningless. *See In re HRC Joint Venture*, 175 B.R. at 952-53.

The Bondholders ask this Court to ignore *HRC Joint Venture* and the other cases cited by ERS because the First Circuit case of *Cadle Co. v. Schlichtmann*, 267 F.3d 14 (1st Cir. 2001) allegedly controls. B'hldrs Opp. ¶ 53. *Cadle*, however, stands for the unremarkable proposition that, where a debtor receives proceeds postpetition from its existing prepetition collateral, those proceeds are exempted from section 552(a) pursuant to section 552(b)(1). In *Cadle*, a law partner confirmed to the partnership's bank lender that his "letter serves as an additional security interest of the bank in all *Groton* fees received by this office." *Id.* at 16 (emphasis added). The letter did not provide the fees payable under the contingency fee agreement subject to the security interest would be reduced for subsequent legal services required to be entitled to the fees. The contingent fee was paid into an escrow account before the law partnership's bankruptcy and the contingent fee was paid to the debtor after the bankruptcy filing. *Id.* at 21. *Cadle* does not aid the Bondholders because "[t]he [contingency] fee … came out of the distribution from the Groton settlement and became payable by reason – and only by reason – of the fee agreement between the (now dissolved) firm and the Groton plaintiffs." *Id*. at 17. It was not the fact the debtor performed postpetition work that generated the fee but rather the existence of the contract which obligated the client to pay its attorney at the conclusion of the litigation, regardless of any events or actions taken postpetition. *Id*. at 16-17. The security interest was in the gross contingent fee.

Here, in contrast, ERS's entitlement to Employers' Contributions after the petition date was from the inception, and always, dependent for the contributions' existence and amounts, on postpetition services performed by third party employees. As *HRC Joint Venture* makes clear, a

right to receive property that does not yet exist – and may never exist – because it is contingent on future services from other parties does not render the property proceeds of such right to receive when the property comes into existence.[11] *See* ERS Memo at 29-31. Unlike *Cadle*, the postpetition Employers' Contributions here did not exist and were not put into an escrow account prior to commencement of ERS's Title III case.

The Bondholders have no response to *HRC Joint Venture*. Instead, the Bondholders rely yet again on *Johnson v. Cottonport Bank*, 259 B.R. 125 (W.D. La. 2000). But *Cottonport* involved distinct facts rendering it inapposite. In *Cottonport*, the debtor was a member of the Biloxi Tribe in Louisiana. As a tribe member, the debtor received a "per capita distribution" from the tribe – a monthly payment of approximately $1,000 – which "does not vary from month to month" and for which "[n]o services need be performed in order to receive the money." *Id*. at 127. The debtor granted a bank a security interest in "any funds to be received" from the tribe. *Id*. at 129. The *Cottonport* court held postpetition per capita distributions constituted proceeds of the existing collateral subject to the bank's security interest. Unlike here, the bank had a security interest in an existing prepetition right to collect money remitted to the debtor which the tribe was obligated to remit. Although each payment was due in the future, no future services or actions were needed to trigger the debtor's right to such payment.[12]

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[11] The Bondholders' attempt to analogize postpetition Employers' Contributions to proceeds generated from the sale of prepetition inventory likewise fails. *See Unsecured Creditors Comm. v. Marpecon Fin. Corp. (In re Bumper Sales, Inc.)*, 907 F.2d 1430, 1437 (4th Cir. 1990) (where a debtor granted a security interest in prepetition inventory and sold the inventory postpetition, the monies received postpetition constituted proceeds that remained encumbered).

[12] The Bondholders' argument that they have a lien on ERS's right to receive past and future Employers' Contributions boils down to an asserted lien on an income stream of ERS. The "stream" theory of collateral derives from two decisions under the former Bankruptcy Act concluding that rights to payment acquired by the debtor during the preference period were not preferences because the security interest attached to a "stream" of payments that existed before the preference period. However, the legislative history of Bankruptcy Code § 547 shows those cases were legislatively overruled by the Bankruptcy Code: "Paragraph (5) [of Bankruptcy Code § 547(c)] codifies the improvement in position test, and thereby "overrules" cases such as *DuBay v. Williams*, 417 F.2d 1277 (9th Cir. 1969), and *Grain Merchants of Indiana, Inc. v. Union Bank & Savings. Co., Bellevue, Ohio*, 408 F.2d 209 (7th Cir.

This is not the case with ERS. Any obligation to remit Employers' Contributions was dependent on, and did not exist, until employees performed services. When the employees performed services, the employer became obligated to pay contributions in the amount of a percentage of payroll, which became a new receivable. This new receivable therefore *was after-acquired* property that came into existence postpetition and was not subject to attachment pursuant to section 552(a).

B. Section 928 does not apply because Employers' Contributions do not constitute special revenues.

The exception of section 928, providing a security interest will attach to special revenues received postpetition, does not apply because Employers' Contributions are not special revenues.

In their opposition, the Bondholders ask this Court to adopt an expansive reading of the phrase "or other services" as used in the Bankruptcy Code's definition of "special revenues" in section 902(2)(A), to encompass paying retirement benefits to public employees. B'hldrs Opp. ¶ 62. As explained in ERS's opposition, the Bondholders' argument ignores fundamental rules of statutory interpretation and would expand the scope of services subject to section 902(2)(A) in a way that renders meaningless Congress's specification of transportation and utility services in the definition. ERS Opp. at 27-28.

The inclusion of the word "system" in ERS's name does not mean section 902(2)(A) applies. The Bondholders' allegation that "the ERS does not even acknowledge that it is a 'system' despite its name," in furtherance of its argument that ERS is literally a "system" that provides "services" pursuant to section 902(2)(A), illustrates the weakness of the argument, not its strength. B'hldrs Opp. ¶ 63. ERS is a trust that pays retirement benefits. It is not a system

1969)." H.R. Rep. No. 95-595, at 373 (1977); S. Rep. No. 95-989, at 88 (1978). Because no "stream" exists for preference purposes, no "stream" can exist for postpetition lien purposes.

for section 902(2)(A) purposes because ERS does not provide public services utilizing a physical infrastructure, as contemplated by the section's reference to utility and transportation systems and the legislative history. *See* ERS Opp. at 27-28.

Nor do Revenues constitute special revenues under section 902(2)(D). Section 902(2)(D) is a very narrow category of special revenues for "other revenues or receipts *derived from particular functions of the debtor*." 11 U.S.C. § 902(2)(D) (emphasis added). The "particular functions" of ERS previously were to pay pension payments and benefits to certain public retirees. Employers' Contributions were not "derived from" ERS activity. They were derived from the labor of employees and used to fund ERS's payment of pension benefits. Thus, Employers' Contributions are not a result of any services ERS provides.

The Bondholders wrongly argue Employers' Contributions are "derived" from ERS's right to receive Employers' Contributions because Webster's dictionary defines the word "derived" to mean "to take or receive" from a source. B'hldrs Opp. ¶¶ 59-60. This is nonsense. If the Court were to adopt the Bondholders' logic, there could never be revenues received by a municipality that fail to satisfy the definition of special revenues since all receivables would necessarily be derived from a collection function.

The Bondholders' position also is inconsistent with the legislative history of section 902(2)(D) indicating the reference to "particular functions" encompasses minor revenue raising services. The Bondholders are wrong. *See* ERS Memo at 33. The overall structure of section 902(2) demonstrates subsection 902(2)(D) must be narrow, otherwise section 902(2)(A) would be nullified by section 902(2)(D) as every act that generates revenue would satisfy section 902(2)(D). *See* ERS Opp. at 29. Such a result violates basic rules of statutory construction. *See RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 645 (2012) (explaining the

rule that specific provisions control over general provisions "avoids not contradiction but the superfluity of a specific provision that is swallowed by the general one, 'violat[ing] the cardinal rule that, if possible, effect shall be given to every clause and part of a statute.'") (citations omitted). For the foregoing reasons, the Employers' Contributions are not special revenues.

C. The Bondholders' constitutional avoidance argument is without merit.

The Bondholders argue applying section 552(a) to prevent their security interest from attaching to postpetition Employers' Contributions "raises serious constitutional questions" under the Takings Clause that the Court should avoid. B'hldrs Opp. ¶ 67. The Bondholders are wrong. As described more fully in ERS's opposition, no unconstitutional taking exists because section 552(a) merely codified previously established jurisprudence. ERS Opp. at 30-31.

IV. ERS HAS NOT VIOLATED THE BOND RESOLUTION, SECURITY AGREEMENT, OR JANUARY STIPULATION

The Bondholders have also raised a new claim in Section IV that ERS violated the Resolution, Security Agreement, and January Stipulation (from the *Altair* Litigation) by not transferring Employers' Contributions from the Commonwealth central government to the Fiscal Agent. This argument fails for two reasons.

First, this is a new claim, not raised by either party in its respective Complaint or summary judgment motion, which falls outside the scope of this action. The Joint Stipulation – which governs the scope of this action – is limited to the issue of ERS's rights regarding Employers' Contributions "received during the month of May 2017." The parties have been referring to these as the May Contributions. The Bondholders' Section IV, however, concerns alleged "monthly" contributions from the Commonwealth central government *prior to May 2017*. The Bondholders' new claim should be rejected on this basis alone.

Second, the Bondholders' argument is counter to the plain language of the January Stipulation and not supported by the cited evidence. The January Stipulation provides that "***[t]o the extent that ERS receives*** any Commonwealth central government Employers' Contributions, [] such contributions shall be retained in the Segregated Account pending further order of the Court[.]" ERS historically received in its operational bank account Employers' Contributions only from public corporations and municipalities, and that remained so until ERS stopped receiving all Employers' Contributions as of July 1, 2017. In contrast, in 2017, ERS did not receive any Employers' Contributions from the Commonwealth central government. Those contributions are deposited directly into a treasury account maintained and controlled by the Commonwealth. This is consistent with the deposition testimony the Bondholders cite, which confirms that Employers' Contributions from the Commonwealth central government are deposited directly into the treasury account "and they sent us [ERS] a document and those transactions are accounted for and recorded." [D.I. 92-16] at 307:2-20. Accordingly, because ERS did not receive the Commonwealth central government contributions about which the Bondholders now complain, it could not have violated the January Stipulation.[13]

CONCLUSION

For the foregoing reasons, as well as those set forth in the ERS Memo, ERS's motion for summary judgment should be granted.

[13] Similarly, there is no violation of the Resolution or Security Agreement (also outside the scope of this action). As the Bondholders note, the Resolution simply required – much like the January Stipulation – that ERS transfer Employers' Contributions received during a given month "[o]n the last Business Day of the month." Resolution § 504. Accordingly, even though ERS never received any Commonwealth central government contributions in May, even if it had it would have been barred from making any transfer of those monies on May 31 due to the filing of the ERS title III petition on May 21.

Dated: November 22, 2017
New York, NY

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that, on this same date, I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system, which will send notifications of such filing to all CM/ECF participants in this case.

/s/ Luis F. del Valle-Emmanuelli
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