

U.S. market brief

Wealth
Management

Puerto Rico enters Title III federal bankruptcy

The U.S. Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) in June 2016 to aid Puerto Rico in restoring fiscal balance. As outlined in the PROMESA legislation, an independent oversight board was appointed to supervise this fiscal transformation. As an initial step, the PROMESA board certified the commonwealth's fiscal recovery plan on March 13, which served as the basis for the commonwealth's proposed recovery values.



The certified fiscal plan did not designate amounts to the different debt obligations but instead only outlined how much money is available to all bondholders each year. The certified plan also funnels all revenues, including pledged COFINA sales taxes and other dedicated revenues, to the commonwealth's General Fund; pays all government services next; and then allots the remaining revenues to bondholders. In effect, the certified plan subordinates all debt obligations to the commonwealth's operations and redirects pledged revenues for the benefit of the commonwealth.

Disregards security provisions

The PROMESA board acknowledged the certified plan does not respect constitutional or contractual rights and remedies, or the dedication of available revenues, which, as a consequence, dooms this initial plan, in our opinion. The PROMESA law that empowers the PROMESA board to certify a fiscal plan has many competing requirements including respecting the lawful priorities and liens of debt obligations, non-transfer of pledged resources, and adequately funding pension obligations and essential public services.

While we concede that Puerto Rico cannot fully honor all the requirements mentioned above given its precarious financial situation, we also believe a valid certified plan cannot arbitrarily disregard fundamental requirements of the PROMESA law. In this case, the certified plan completely dismisses the lawful priorities and liens of the various debt obligations and transfers all pledged resources to the commonwealth without approval.

Title III

The PROMESA board authorized the commonwealth to enter Title III on May 3 after consensual renegotiations with creditors proved unproductive based on the poor recovery prospects outlined in the certified plan. Title III is a federal bankruptcy framework created specifically for U.S. territories that combines elements of Chapter 11 (corporate restructuring bankruptcy) and Chapter 9 (municipal bankruptcy).

Title III mechanics

U.S. Supreme Court Chief Justice John Roberts will select a federal district court judge to hear this case, and there is a continuing stay on litigation.

Both Puerto Rico and creditors may propose debt modifications to the PROMESA board, but only the board can file a Plan of Adjustment (PoA) with the federal courts. Initially we thought the board's independence would be a very

important distinction compared to a traditional municipal bankruptcy; however, we now believe the PROMESA board is biased toward the commonwealth and, therefore, will use the current fiscal plan as the nucleus of the PoA.

The PoA will need to include proposed recovery values for every outstanding debt obligation—something that was absent in the certified fiscal plan.

Thereafter, the presiding federal judge may confirm the PoA if it complies with various requirements, including consistency with the certified fiscal plan, and that it is feasible and in the best interest of creditors. However, it is important to note that no creditor acceptance is required under Title III and will be crammed down on all creditors if the federal judge determines the PoA meets the requirements outlined above.

Continuing consensual renegotiations

Puerto Rico and all creditors may continue consensual renegotiations while in Title III, and we suspect the presiding judge will strongly encourage it. Each creditor group will be placed into separate pools, and each pool may accept a voluntary debt restructuring if at least two-thirds of the owners by principal agree, and the debt modification adheres to the certified fiscal plan. If the restructuring is accepted under those parameters, it is crammed down on all other dissenting creditors within the pool. Similar to other municipal bankruptcies, the judge may insinuate possible adverse outcomes for both parties to elicit compromise.

Concluding thoughts

The Title III designation changes little, in our opinion, and may actually benefit creditors because they may now dispute the certified fiscal plan, which is the basis for the proposed debt recovery values.

If the presiding judge agrees that the certified fiscal plan violates the PROMESA law, the plan would then need to be modified, which could lead to better outcomes for certain creditors. We believe creditor rights and rule of law cannot be completely dismissed, but we acknowledge that operational-necessity argument practically elevates certain essential services above debt obligations.

The certified fiscal plan is fundamentally flawed, in our opinion, because it reprioritizes and subordinates all debt obligations to the commonwealth's operations, redirects pledged revenues, and completely ignores security protections. Furthermore, we believe the plan violates the Contracts and Taking Clauses of the U.S. Constitution.

We think the General Obligation (GO) and GO-guaranteed debt, including that issued by the Public Building Authority, and COFINA sales tax securities have strong security provisions that afford these bondholders better legal protections than is provided in the certified plan. Conversely, we think Puerto Rico debt obligations with weaker security protections will not fare well under any restructuring scenario.

Ultimately, creditors are either going to arrive at acceptable consensual terms or a judge is going to determine the appropriate recoveries based on the weight afforded legal protections versus operational necessity. As such, it is vitally important to understand that nothing is absolute in a distressed situation because there are many unknowns, including legal interpretations of security protections vis-à-vis operational necessity.

If the commonwealth or the creditors do not agree with the judge's ruling, they may appeal the case to a higher court.

Market access

From a broader perspective, the commonwealth must be made to understand that it is grossly miscalculating the likelihood of future market access. It should also know that shared sacrifice can only be spread so far and that exceeding a certain threshold could have perilous consequences in the capital markets. In the end, Puerto Rico needs the capital markets, but the capital markets do not need Puerto Rico. While we concede the municipal market typically has a short memory, in this case, based on the currently proposed recovery values, investors' wounds could be deep and enduring.

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