

## 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.

**Author****James Mann, Head, U.S. Fixed Income Strategies Group**

james.mann@rbc.com; RBC Capital Markets, LLC

**Disclaimer**

The information contained in this report has been compiled by RBC Wealth Management from sources believed to be reliable, but no representation or warranty, express or implied, is made by Royal Bank of Canada, RBC Wealth Management, its affiliates or any other person as to its accuracy, completeness or correctness. The material contained herein is not a product of any research department of RBC Capital Markets, LLC or any of its affiliates. Nothing herein constitutes a recommendation of any security or regarding any issuer; nor is it intended to provide information sufficient to make an investment decision. All opinions and estimates contained in this report constitute RBC Wealth Management's judgment as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. This report is not an offer to sell or a solicitation of an offer to buy any securities. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Every province in Canada, state in the U.S., and most countries throughout the world have their own laws regulating the types of securities and other investment products which may be offered to their residents, as well as the process for doing so. As a result, the securities discussed in this report may not be eligible for sale in some jurisdictions. This report is not, and under no circumstances should be construed as, a solicitation to act as securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. Nothing in this report constitutes legal, accounting or tax advice or individually tailored investment advice. This material is prepared for general circulation to clients and has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The investments or services contained in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about the suitability of such investments or services. To the full extent permitted by law neither RBC Wealth Management nor any of its affiliates, nor any other person, accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. No matter contained in this document may be reproduced or copied by any means without the prior consent of RBC Wealth Management. RBC Wealth Management is a division of RBC Capital Markets, LLC, member NYSE/FINRA/SIPC, which is an indirect wholly-owned subsidiary of the Royal Bank of Canada and, as such, is a related issuer of Royal Bank of Canada and part of the RBC Financial Group. Additional information is available upon request.