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Hedge Funds Face Off Over Puerto Rico as Recovery Effort Begins.

Hedge funds that piled into Puerto Rico bonds are mounting a battle against each other in court, seeking to shelter their investments from the island's escalating series of defaults.

Arms of Aurelius Capital Management, Stone Lion Capital Partners and other owners of general-obligation debt, which is given top priority under the island's constitution, are seeking to block Governor Alejandro Garcia Padilla from steering sales-tax revenue to bondholders with a claim to the funds. On Oct. 24, sales-tax debt holders requested that U.S. District Court Judge Francisco Besosa temporarily halt the litigation, a step he declined to take when asked to do so by Puerto Rico.

"It's natural that investors in these two different types of securities would pursue all legal remedies that are present to improve their returns and to try to lock in the best possible treatment in the restructuring," said Ted Hampton, a Moody's Investors Service analyst in New York.

The litigation marks a push by bondholders to win a leg up as Puerto Rico heads toward a new phase aimed at ending its long-building debt crisis. A U.S. board is just beginning its effort to help oversee an orderly way to cut \$70 billion of debt backed by varying revenues and legal safeguards, a step that eluded Garcia Padilla during months of on-and-off negotiations. If some creditors balk, the board can try to foist losses on them in court, an option the Puerto Rican governor didn't have.

Congress moved to forestall legal wrangling in the meantime by ordering a stay on lawsuits by creditors seeking to force Puerto Rico to honor its debts. The G.O. bondholders claim the administration directed money away from the general fund, which they say violates the federal rescue law, called Promesa, enacted this year. They also say Puerto Rico cannot pay its sales-tax debt while defaulting on general-obligation bonds.

"Puerto Rico's constitution could not be clearer — general-obligation debt has the first claim on Puerto Rico's available resources, including sales taxes," Andrew Rosenberg, a partner at Paul, Weiss, Rifkind, Wharton and Garrison who is advising a group of G.O. bondholders, said in an e-mail.

The clash between the hedge funds centers on the island's two largest classes of debt, a \$30 billion chunk that carries the strongest repayment pledges. Puerto Rico's constitution states that general obligations must be repaid before other expenses, while the sales-tax bonds, known by the Spanish acronym Cofina, have a first claim on that revenue. GoldenTree Asset Management LP, Merced Capital LP and Whitebox Advisors LLC are among senior Cofina bondholders that have sought to head off the G.O. lawsuit.

Cofinas are one of the few Puerto Rico securities not in default, and Garcia Padilla's administration continues to allocate sales-tax revenue every month to its bond trustee. The commonwealth and its agencies have missed about \$1.8 billion of principal and interest since August 2015, including a \$780 million general-obligation payment on July 1. Another \$360 million is owed on the bonds in January.

The Cofina bondholders are asking the court not to redirect the sales-tax revenue to the general fund.

"Diverting Cofina's sales and use tax revenue would constitute a violation of our legal property rights, which are protected under both the Puerto Rico and U.S. constitutions," Greg Marose, spokesman for the senior Cofina investors at Edelman Financial Communications in New York, said in an e-mail.

Garcia Padilla's last restructuring offer gave general-obligation bondholders a recovery of 83.5 cents on the dollar, compared with 80 cents on senior sales-tax bonds, according to the commonwealth's last bondholder offer in June.

That's higher than where the bonds are trading. General obligations maturing 2035 with an 8 percent coupon changed hands Wednesday at an average 68.7 cents, data compiled by Bloomberg show. Senior Cofina debt with a 5.75 percent coupon and maturing 2057 traded Tuesday at 71.8 cents.

While the two classes of debt may ultimately receive similar recoveries through negotiation or in court, the constitutional pledge for the general obligations gives those investors a strong legal argument, said Matt Fabian, a partner at Concord, Massachusetts-based Municipal Market Analytics.

"I have a hard time understanding how the commonwealth can make a promise that's stronger than its own constitution," Fabian said. "That defies my understanding of promises."

Puerto Rico began selling Cofina bonds in 2007 as a way to get around the island's debt limit. The proceeds repaid loans the commonwealth owed to its Government Development Bank and helped to cover budget deficits. A court could ultimately view the sales-tax debt as unconstitutional because it allowed Puerto Rico to avoid its debt ceiling mandate.

"It does appear as though the Cofina bondholders have some issues at risk," said Phil Fischer, head of municipal research at Bank of America Merrill Lynch in New York.

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