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In Puerto Rico Bankruptcy, Mutual Funds Compete with Themselves.

(Reuters) – U.S. mutual funds that held onto Puerto Rican debt as its economy crept toward collapse could get drawn into battles that pit their own investors against each other, as the island navigates the biggest government bankruptcy in U.S. history.

The reason for the quandary lies in the territory's Byzantine capital structure, where 18 public agencies owe a combined $120 billion in bond and pension debt.

Bonds held by the companies' many funds are spread across myriad credits, some in direct competition for recoveries, meaning wins for some investors trigger losses for others.

For OppenheimerFunds and Franklin Advisers, whose combined $10.3 billion in Puerto Rican debt makes them among the island's biggest creditors, negotiating that minefield is particularly important. (For a related graphic, click tmsnrt.rs/2eRyYw3)

The funds say their cross-holdings reflect a long-term commitment to Puerto Rico, and give them more of a stake than other creditors in righting the island's ship. Bankruptcy and municipal bond experts say, however, the competing claims raise questions about whether they can represent investors' best interests.

It adds a wrinkle to already complex restructuring talks, muddying the path to recovery for investors who tied up their savings in Puerto Rico.

Struggling with a 45 percent poverty rate and near-insolvent public healthcare, the island in May filed a form of bankruptcy under the federal 2016 rescue law known as PROMESA, confronting creditors with unique challenges.

"This is not something I've seen in the bankruptcy world," said restructuring expert Drew Dawson.

While it is not rare for a creditor to hold multiple tranches of debt, it is less common when the creditor runs many funds with competing investments, said Dawson, a professor at the University of Miami School of Law.

"You run all these funds – which do you side with?" he said. "If I were an investor, I'd be concerned."

As of April 30, Oppenheimer had about $7.3 billion of total exposure, while Franklin, after offloading some of its Puerto Rico holdings in recent years, had around $3 billion.

Those holdings, based on face value, may not represent exposure for debt bought at a discount, and some of the debt may be insured, shielding the funds from losses.

Playing Two Sides

The island's $17 billion of so-called COFINA debt, secured by sales tax, is the main battleground.

COFINA creditors are locked in litigation with holders of Puerto Rico's general obligation (GO) bonds, with both sides claiming a right to sales tax revenue.

Overall, Franklin and Oppenheimer held $3.2 billion of COFINA as of April 30, more than twice their combined GO holdings. Yet at Franklin, six funds held exclusively GO debt, claims worth a combined $276 million.

Similar clashes exist between senior COFINA holders, who have first claim on the tax revenue, and junior creditors.

Overall, the companies held nearly four times as much junior as senior COFINA debt. Yet Oppenheimer's Rochester Fund Municipals, for example, had $384 million of senior debt and just $83 million of the junior tranche.

Smaller players face similar challenges. The Santander First Puerto Rico Family of Funds ran eight funds each with at least $28 million of COFINA debt. Three of those had at least two-thirds invested in the junior tranche; five had 70 percent or more in the senior class.

Oppenheimer, Franklin and Santander have formed an ad hoc bankruptcy negotiating group, whose strategy so far has been to maximize total returns across portfolios, rather than advocate for funds whose debt may be more senior, according to a Reuters analysis of court filings and public statements by the funds and their advisers.

"Our advocacy is not centered around particular classes of bonds, but around seeking the best overall return for our shareholders," said Kimberly Weinrick, a spokeswoman for Oppenheimer.

A spokeswoman for Franklin declined to comment for this article, while Ann Davis, a Santander spokeswoman, declined to comment on the cross-holdings.One key exception to the alliance: the Franklin funds that hold exclusively general obligation debt have joined a separate negotiating group comprised only of holders of such debt, according to a July 13 court filing.

The GO and mutual fund groups have taken opposing sides in a handful of court battles, which could prompt questions from a judge or other creditors as to which side Franklin is more closely aligned with, Dawson said.

Cross-holdings are not prohibited in bankruptcy, though judges have the authority to decide whether a party is too conflicted to vote on a restructuring plan, he added.

Rival creditors, too, could try to exploit apparent conflicts to limit the mutual funds' bargaining clout. In June, hedge fund owners of senior COFINA bonds asked a bankruptcy judge to bar the mutual funds from a role in nominating a COFINA fiduciary in settlement talks, citing their "undeniable conflict."

The judge told the sides to try to resolve the issue internally, and talks continue.

Sensible but Risky

For years, mutual funds piled into Puerto Rico's debt because it was exempt from local, state and federal taxes and because until PROMESA's passage in June 2016, the island was barred from declaring bankruptcy.

Court documents and public statements from the mutual fund negotiating group suggest it tends to side with classes of debt where its funds have the most exposure.

For example, the funds have primarily advocated for the COFINA junior tranche, where they have the greatest exposure, at the expense of senior COFINA and GO creditors.

They have also fought hard for a restructuring deal at Puerto Rico's power utility PREPA, which owes Oppenheimer and Franklin a combined $1.6 billion, even as Puerto Rico's federally-appointed oversight board warned that a generous deal could hurt Puerto Rico's broader economy.

The strategy is sound, but risky, said Tom Metzold, who spent nearly three decades as a municipal bond portfolio manager at Eaton Vance. By fighting for junior bondholders, the funds raise the odds of a settlement in which everyone gets a fair deal, given that senior creditors are already well represented, Metzold said.

Yet it also opens the funds to criticism that they did not fight hard enough for their senior-most holdings, he said.

"A number of people will be performing autopsies" on whatever decisions the funds make, Metzold said.

"I'm glad I'm not in their shoes."

Reporting by Nick Brown; Editing by Tomasz Janowski

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