
Hedge Fund Sues to Have Puerto Rico's Bankruptcy Case Thrown Out.

A hedge fund sued on Monday to have Puerto Rico's bankruptcy case thrown out, arguing that the federal oversight board guiding the island's financial affairs was unconstitutionally established.

In a lawsuit filed in United States District Court in San Juan, the hedge fund, Aurelius Capital, cited the "appointments clause" of the United States Constitution, which calls for all principal officers of the federal government to be appointed by the president, and then confirmed by the Senate.

That did not happen when the seven members of the Financial Oversight and Management Board for Puerto Rico were selected, Aurelius said in its motion to dismiss the bankruptcy-like proceedings. The board members were instead "handpicked by individual members of Congress," it said, through "an intricate system of Balkanized lists, designed to severely constrain the president's appointment powers."

No Senate confirmation proceedings occurred, although senators of both parties were among the members of Congress who made recommendations last year to President Barack Obama for the board.

Aurelius Capital was among the firms that fought Argentina in court for years over its sovereign debt default, and ultimately succeeded in pressuring the government there to pay.

A spokesman for the oversight board said the members were reviewing the lawsuit and could not comment.

The oversight board was established last year, when Puerto Rico was sinking under $123 billion of public debt and pension obligations that it amassed by years of borrowing to plug deficits. The federal bankruptcy code bans Puerto Rico from declaring bankruptcy, and by 2016, it was defaulting haphazardly on payment after payment, without any way to take shelter from the many resulting creditor lawsuits.

After a number of hearings, and even expedited arguments before the United States Supreme Court, Congress last year enacted a law called Promesa, which gives insolvent territories a way to seek court protection from their creditors. Title III of Promesa, which is similar to Chapter 9 municipal bankruptcy, gives Puerto Rico the power to abrogate contracts unilaterally — but it has no access to Title III without the oversight board's authorization.

The law went into effect last summer, and in the months that followed, the board members were chosen. Work then began on a five-year fiscal reform plan, and Puerto Rico's Title III proceedings began last May. They were expected to be slow and contentious even before Aurelius Capital challenged the oversight board. That is because Puerto Rico's debt is extremely complex, the hierarchy of creditors is unclear, and the situation has no legal precedent to draw on. Large losses for bondholders are expected.

Aurelius sued just days after the governor of Puerto Rico, Ricardo Rosselló, defied the oversight board for his own reasons. He said on Friday that the board's five-year fiscal reform plan was excessively harsh and that he would not shut down much of the government two days every month for the rest of the fiscal year, something the board saw as necessary to save money and streamline operations.

Aurelius Capital sued in its capacity as a holder of Puerto Rico's general obligation bonds. When those bonds were issued, over many years, Puerto Rico's Constitution in effect guaranteed them, saying that if money ever became tight on the island, the bondholders would have first call on the "available resources" of the territory's government.

Some of Puerto Rico's bondholders argue that they bought the bonds on the understanding that their repayments and interest were by law the government's first priority. They were surprised when they found that Puerto Rico's five-year plan called for deep cuts in all bond payments, including payments to the holders of general-obligation bonds. The oversight board wants to use the savings to finance government operations for the five-year recovery period. But creditors say this approach is at odds with the Puerto Rican Constitution.

To make matters worse, Mr. Rosselló said on Friday that he was not willing to honor yet another provision of the fiscal plan: pension cuts averaging 10 percent for certain retired public workers. The five-year plan calls for the cuts to be phased in over the next three years, with the biggest pensions being cut the most.

Puerto Rico's pension funds have almost exhausted their assets, and all retirees are being shifted to a pay-as-you-go system, in which the central government will pay pensions directly from its budget. That means some of its "available resources," will be used for pensions instead of debt service.

On Monday, Aurelius also asked the federal court in San Juan to lift the "stay" of Promesa, which keeps Puerto Rico's creditors from suing the government. Aurelius said it wanted to seek declaratory and injunctive relief to keep the oversight board from operating until it could be reconstituted in compliance with the appointments clause.

"Whether or not one agrees with the policy positions of the board, foundational legal principles require that it be constituted in compliance with the Constitution," Aurelius's lead lawyer, Theodore B. Olson of Gibson, Dunn & Crutcher, said in a statement.

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