

# **Bond Case Briefs**

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## **Puerto Rico 'Alternative' Investors to Square Off Against Retail Investors.**

The upcoming Puerto Rico bond offering will be sold to hedge funds.

Current Puerto Rico bonds are held by retail investors.

These two groups are likely to clash.

Puerto Rico is heading toward a \$3.5 billion bond offering this month which would be used to help stabilize the island's finances and pay interest on its \$70 billion in current debt. A major question arises as to whether investors in this new debt will be given priority over existing investors who are largely Mom and Pop investors.

Not everyone in Puerto Rico is a fan of the new bond offering.

According to an Associated Press report, senators who voted against the \$3.5 billion offering said it would "force Puerto Rico deeper into debt and warned that the government would not likely be able to pay the money back."

Regardless, some "alternative" investors like hedge funds are licking their chops over the offering, for both the juicy 10% yields on the Puerto Rico junk bonds as well as the favorable terms they can extract from the island commonwealth because of its desperation. One thing is certain, hedge funds buying Puerto Rico's debt will attempt to gain every possible advantage in the transaction.

This is how hedge funds operate. They are putting their money up at a critical time in Puerto Rico's history. The island commonwealth's bond rating this year has been downgraded to "junk" status and they desperately need a cash infusion to service its enormous debt load. Puerto Rico's solvency is shaky at best, thus, hedge fund investors will want to be compensated for this increased risk.

Indeed, these "alternative" investors, or hedge funds that welcome risk and its potentially greater returns, may square off against retail Mom and Pop investors who are holding a large chunk of the existing \$70 billion in Puerto Rico Bonds and municipal bond funds, according to a Reuters report by Brian Chappatta.

"After the island's credit rating was cut to junk last month, it will probably tailor the deal to non-traditional muni buyers such as hedge funds," Chappatta reported, citing three municipal bond sources.

This is an important shift in the market for such municipal bonds, and Mom and Pop investors could be hurt by this change if hedge funds demand to have their interests placed in front of owners of the older Puerto Rico bonds.

"In contrast to the hedge fund investors, the muni-bond investors have traditionally been viewed as 'risk averse' who are looking for extremely safe investments," according to another Reuters

reporter, Dunstan Prial. “This is the difficult environment in which Puerto Rico now plans to raise \$3 billion as sort of a bridge loan to help it pay its debts and cover its expenses until a handful of recently approved financial reforms start to have a meaningful impact on the commonwealth’s budget.”

“And that’s why the proposed bond sale is expected to attract investors such as hedge funds that actively seek risk as a means to larger returns,” Prial reported. “They are a very different breed than those seeking the safety of an Oppenheimer-managed bond fund.”

One bankruptcy attorney told Reuters’ Prial that “these ‘alternative’ investors might even seek to leverage Puerto Rico’s desperation to negotiate terms favorable to them, terms that might include a provision that guaranteed them first-lien status with regard to Puerto Rican revenues earmarked to pay down debt, which would mean they would get paid first in the event the island began defaulting on its debts.”

Meanwhile, all of this has undoubtedly raised concerns among current bondholders that the commonwealth’s ongoing fiscal troubles combined with \$3.5 billion in additional debt obligations could crowd out revenue to pay existing investors.

The clash for repayment priority of hedge fund investors over retail investors is likely to come to a head in the near future. Given that the hedge funds are the latest investors and their money is desperately needed, it looks like they would use their leverage to come out on top.

Look for the hedge funds to demand assurances, possibly even a change to Puerto Rico’s constitution. In some cases, the constitution guarantees that bond investor payments take priority over general obligations of Puerto Rico. That could be scrapped or changed.

Stay tuned. The fight between these two sets of investors is just beginning.

Zamansky LLC are securities and investment fraud attorneys representing investors in federal and state litigation against financial institutions. For more information about Zamansky LLC, please visit <http://www.ubspuertoricofunds.com/>.