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Puerto Rico Set for Tougher Debt Struggle After Court Ruling.

NEW YORK — Hopes of an orderly resolution to Puerto Rico's debt crisis suffered a heavy blow after a court voided the island's restructuring law, raising fears it may be heading for a longer, messier debt overhaul.

Late on Friday a U.S. federal judge ruled that the U.S. commonwealth's so-called Recovery Act, which made some of Puerto Rico's agencies eligible for court-supervised debt restructuring, violated the U.S. constitution by allowing a state government to modify municipal debt.

"This decision will ultimately result in a resolution being dragged out over a longer period of time, having the administrative costs incurred eat into the ultimate recovery for the bondholders," said Tom Metzold, a senior portfolio advisor at Eaton Vance, which holds various insured Puerto Rico bonds.

Puerto Rico is expected to appeal the ruling, kicking off lengthy litigation with a hard to predict outcome and possibly delaying for months the matter's final resolution.

Bondholders are, however, likely to interpret Friday's ruling as a sign that the Puerto Rico authorities are on shaky legal ground. That could lift bonds of public corporations such as the Puerto Rico Electric Power Authority (PREPA) covered by the voided law, by strengthening bondholders' negotiating position, investors said.

In contrast, holders of General Obligation (GO) bonds issued by the island could take a hit. The Recovery Act meant to isolate the government from potential liabilities incurred by agencies such as PREPA and that protection may now be in doubt.

"If you are a holder of a power bond, you could say: 'I have a better negotiating position'," said John Miller, co-head of fixed income for Nuveen Asset Management, which holds various insured Puerto Rico bonds. "But at the GO level and politically, it's negative."

Puerto Rico, struggling with debts of more than $70 billion, passed the law in June, to give public corporations a framework to restructure debt and ring-fence the government from a potential bankruptcy.

U.S. law forbids Puerto Rico's government and its entities from restructuring debt under Chapter 9 of the U.S. bankruptcy code, which was used for Detroit last year, so the Puerto Rico government passed its own restructuring law in June based loosely on U.S. bankruptcy rules.

U.S. mutual funds OppenheimerFunds, a unit of insurer MassMutual Financial Group, and Franklin Templeton, which owned $1.7 billion of PREPA bonds, quickly sued Puerto Rico, saying the commonwealth had no right to pass its own law that ran counter to federal bankruptcy law.

Puerto Rico's representative in Congress, Pedro Pierluisi, introduced a bill to include Puerto Rico in

Chapter 9 of the U.S. Bankruptcy Code.

Metzold said that the picture could change if Congress passes this bill, avoiding a situation where bondholders with competing interests fight it out in a free-for-all battle with no framework to negotiate.

NEGOTIATING POWER

Friday’s ruling has implications for around $20 billion of debt potentially affected under the act, including $9 billion of debt outstanding at the power utility, which is in restructuring talks with bondholders.

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The move gives more negotiating power to holders of PREPA bonds and less power to the utility, as the Recovery Act had essentially allowed Puerto Rico to dictate terms, investors said. It could also have implications for Puerto Rico’s other highly indebted utilities: Aqueduct and Sewer Authority and Highways and Transportation Authority.

“This is a positive development for bondholders and insurers of the so-called public corporations,” said Miller.

How bondholders use their leverage remains to be seen. Without the specter of a bankruptcy process, creditors could cause restructuring talks to drag on.

On the other hand, some creditors may feel empowered to take initiative. PREPA’s problems must be resolved one way or the other, and one person close to Puerto Rico’s creditor community said the onus is now on them to propose a restructuring framework.

Law firm Kramer Levin, representing OppenheimerFunds and Franklin Templeton, said in a statement that the decision was “a major victory for municipal bondholders.”

A potential setback for holders of Puerto Rico’s general debt, Friday’s ruling could also make it tougher for upcoming new debt issues, some investors said.

“I think bringing new issues to enhance liquidity looks very difficult right now,” Miller said, adding that it would be hard to price a large new deal while effectively in a legal limbo.

By REUTERS

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(Additional reporting by Tom Hals and Ed Krudy; Editing by Tomasz Janowski)