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Puerto Rico, Treasury in Talks to Restructure Island's Debt.

Puerto Rico and U.S. officials are discussing the issuance of a "superbond" possibly administered by the U.S. Treasury Department that would help restructure the commonwealth's $72 billion of debt, people familiar with the plan said.

Under the plan, the Treasury or a designated third party would administer an account holding at least some of the island's tax collections. Funds in the account would be used to pay holders of the superbond, which would be issued to existing Puerto Rico bondholders in exchange for outstanding debt at a negotiated ratio.

Investors would receive less debt, likely taking an effective "haircut" on the value of their holdings, but would have higher expectations for getting repaid.

The proposal would mark an important change in Puerto Rico's relationship with the U.S. government, which has resisted wading into the island's debt morass. A superbond would need to clear high political hurdles in Washington and Puerto Rico to become a reality. Discussions with bondholders over the size of any haircut could present further challenges to reaching a deal.

Talks between Puerto Rico's representatives and Treasury officials are preliminary, and any plan wouldn't include financial aid or a U.S. guarantee of Puerto Rico debt, the people said. They said the proposed bond would be just one piece of a restructuring puzzle that the island's government is trying to assemble, after admitting this year that it cannot pay its debt in full.

The plan has no immediate precedent but echoes in some respects the Brady bonds used in Latin American debt restructurings of the 1980s. One major difference: Those bonds, named for former Treasury Secretary Nicholas Brady, were backed by Treasury-issued zero-coupon bonds, which guaranteed repayment of the principal and part of the interest of the Latin debt.

The Obama administration "has said repeatedly that it has no plans to provide a bailout to Puerto Rico," and the Treasury Department isn't engaged in talks to "undertake any of Puerto Rico's financial obligations," a Treasury spokesman said Wednesday.

The Treasury and the commonwealth are debating how much of Puerto Rico's taxes would be funneled to the account and who would collect the taxes, the people said. Puerto Rico's leaders may not be willing to surrender control of tax revenue as required by the deal, the people said. Depending on how it is structured, it could also require congressional approval.

Puerto Rico hasn't been able to sell bonds after years of issuing new debt to fund budget deficits. The commonwealth and its advisers have been working for months to develop a package of fiscal and financial overhauls.

A superbond could be appealing to creditors. Hedge funds that own billions of dollars of Puerto Rico debt have been pushing the idea of a superbond for months, hoping it would prevent a default and boost the value of their investments. Bondholders have been unwilling to swap the debt they hold for new bonds backed only by tax revenues under Puerto Rico's supervision because they fear the money could be diverted.

Puerto Rico is working with law firm Cleary Gottlieb Steen & Hamilton LLP, a specialist in government defaults, and Millstein & Co., a financial-advisory firm founded by the Treasury's former chief restructuring officer, Jim Millstein, who ran the successful turnaround of American International Group Inc.
Puerto Rico cannot restructure its bonds in bankruptcy court because it is a commonwealth, not a state. Democratic lawmakers have proposed bills making the island's municipal entities eligible for bankruptcy protection. Republicans in Congress have floated the idea of a federal control board and have said they want Puerto Rico to produce a more detailed plan to balance its budget before they support the legislation.

Concerns about a potential default intensified over the summer as it became clear Puerto Rico was using tax revenue earmarked for debt payments to plug budget gaps. The commonwealth disclosed in September that it expects a $205 million shortfall this year when large bond payments are due.

Government Development Bank of Puerto Rico bonds that mature in 2016 traded at 49 cents on the dollar this month compared with 77 cents on the dollar in June, according to data from Electronic Municipal Market Access.

Fears of a default are intensifying divisions between different types of bondholders who are splitting into various factions, each of which claims priority in the event of a restructuring.

"Our view has always been that there's a high probability of disorderly litigation here, and we see this looming now as imminent," said Ted Hampton, an analyst at Moody's Investors Service.

In September, a bondholder group represented by GLC Advisors & Co. with more than $5 billion in bonds of different stripes split into separate groups. Mutual funds managed by OppenheimerFunds Inc. and Franklin Advisers Inc. also own billions of dollars of Puerto Rico debt, while bond insurers Assured Guaranty Ltd., MBIA Inc. and Ambac Financial Group Inc. have guaranteed billions of dollars of bonds.

Puerto Rico is attempting to capitalize on the divisions by agreeing to negotiate only with bondholders who agree not to discuss terms with investors holding different types of bonds, a person involved in the talks said.

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