
Congress Shouldn't Provide A 'Super Chapter 9' Escape For Puerto Rico.

Puerto Rico's Governor, Alejandro García Padilla, confirmed everyone's worst fears recently when he testified before a Senate committee that "Puerto Rico will have no choice but to default. Nobody wants this, but it is a reality, and the consequences will be grave."

Indeed, with each passing week, it is looking more and more likely that Puerto Rico will run out of funds before year's end, becoming the first major U.S. jurisdiction to default on all its bonded debt. Such a widespread and indiscriminate default could have a damaging effect on the U.S. municipal bond market, given that the island is the third-largest issuer in the country after the states of California and New York. Moreover, such a default will make it extremely hard for Puerto Rico to return to the capital markets after the current financial storm eventually passes.

As someone who was involved in multiple restructurings of government debt in an earlier career on Wall Street, and as a keen academic observer of fiscal crises during the past decade, I fail to understand the governor's preemptive surrender to the forces pushing him downriver into an all-out bankruptcy.

The importance of respecting the seniority structure

In workouts involving corporate or government entities, it is standard procedure to observe the established hierarchy of creditors. Each security issued, whether debt or equity, has a specific seniority or ranking which determines the order of repayment in the event of a reorganization or bankruptcy. Everybody knows that preferred stock is higher-ranking than common stock, and that senior debt must be repaid before subordinated debt.

Even sovereign governments in financial difficulty prioritize their payments, though they do not operate under a formal bankruptcy regime. For example, governments will keep servicing debts to official multilateral agencies such as the International Monetary Fund and the World Bank, widely regarded as senior creditors, even as they stop paying their bondholders or bank creditors. This is what Greece did in 2012, and even what Argentina has done in the past dozen years in which it has been in and out of default to bondholders.

Besides, Puerto Rico's laws and bond indentures spell out exactly what is to be done should revenues ever prove insufficient to cover debt-service payments. At the top of the proverbial totem pole stand the General Obligations (GOs), which are backed by the Commonwealth's full faith and credit. As per Article VI, Section 8 of the island's Constitution, "interest on the public debt and amortization thereof shall first be paid and must be serviced by the government prior to any other government obligation."

About $13 billion of these GOs are outstanding, plus some $5.5 billion in debts guaranteed by the Commonwealth's good faith and credit, and together they account for roughly one-quarter of total obligations. The first of these payments due consists of $355 million which Puerto Rico's Government Development Bank must pay on December 1, a portion of which is guaranteed by the

Commonwealth's good faith and credit.

At the bottom of the totem pole are the debts of the Public Finance Corporation, on which Puerto Rico has already defaulted, which did not constitute an obligation of the Commonwealth or any of its instrumentalities (other than the corporation itself). Low-priority debts have been racked up also by the island's Highways and Transportation Authority, Infrastructure Financing Authority and Municipal Finance Agency, among others. These have the weakest protections and thus lowest likely recovery rates in any scenario in which creditor seniority is respected.

It boggles the mind that Governor García Padilla is willing to rip up the well-worn playbook of debt restructurings and allow all obligations to go unpaid. The selfish reason why corporations and governments observe established payment priorities is because, in an eventual return to the markets, they can start out by issuing the type of obligations which were respected in the worst of moments. But who is ever going to invest in a Puerto Rico GO again—never mind in any lower-ranked obligation—if they are disrespected now? Only some risk-prone speculators, perhaps, but at usurious interest rates and short maturities, at best.

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Governor García Padilla would also be violating the Constitution and laws of Puerto Rico if he were to allow for a generalized default. He could be impeached for doing so, and never make it to the end of his mandate in January 2017—and his government would certainly be inundated with lawsuits seeking to enforce the legal obligations the island previously assumed.

This is why he has proposed to the Obama Administration, and now he has appealed directly to the U.S. Congress, that he be provided with a "get out of jail free" card: He wants Congress to mandate a broad legal framework that goes well beyond the scope of Chapter 9 to allow for a comprehensive restructuring of all of Puerto Rico's outstanding debt in one fell swoop.

Since the laws passed in Washington trump those approved in San Juan, and they can even override the island's constitution, the governor would be able to disregard every now-lawful obligation and get away with it because "the devil (in Washington) told him to do it."

It is unfortunate that even the U.S. Treasury, which should know better, has endorsed a Super-Chapter 9 "solution" to the island's financial woes—a legislative overreach which would set a dreadful precedent for states, municipalities and other territories in trouble.

In essence, the Administration is asking Congress to compound the mistake it made a century ago, when Puerto Rico was allowed to sell its debt throughout all 50 U.S. states on a triple-tax-free basis, by now having Congress authorize Puerto Rico to disavow its obligations to the millions of investors who believed that the constitutional and other legal pledges made by Puerto Rico were inviolable.

The Obama Administration, instead, should be brokering a new compact with Puerto Rico: reasonable cuts in spending that reflect downward demographic and economic trends, combined with pension reforms and a new business model (to include privatizations and concessions) for the island's money-losing public utilities and agencies, in exchange for an increase in budgetary transfers on account of Medicaid, tax credits and other help to treat the island more like a state than a territory.

And this compact should be enforced by the establishment of a federal Financial Control Board, to ensure that whatever funds are provided by Congress, and debt relief is granted by bondholders, go hand-in-hand with greatly improved management of the island's public finances. At present, the

Administration proposes merely “fiscal oversight in a way that respects Puerto Rico’s autonomy”—namely, something completely toothless. The whole idea behind these boards is for them to be empowered to take the tough decisions on management, spending, revenues and assets for which there was no local political support. As I’ve argued before, the control board set up by Congress in the mid-1990s for the District of Columbia, without authority to impair creditors, is the kind that would be most helpful to Puerto Rico right now.

Forbes Opinion

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Nov. 6, 2015