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Puerto Rico Raises Stakes in Legal Standoff With Budget Proposal.

Even as Congress moves to rescue Puerto Rico, Governor Alejandro Garcia Padilla's budget plan may open the door to its first legal showdown with investors for skipping bond payments.

The $9.1 billion spending plan unveiled Monday allocates $209 million for interest payments on commonwealth debt. That's just 15 percent of the $1.39 billion of principal and interest that Puerto Rico owes from its general fund in the fiscal year starting July 1, including $1 billion for general obligations, according to Luis Cruz, the island's budget director.

While creditors have decided so far against suing over earlier defaults on bonds with weaker repayment pledges, they may not be so patient when it comes to the debt backed by Puerto Rico's constitutional pledge, which states the securities are repaid before other expenditures. It may boil down to whether Congressional leaders are able to come to an agreement and pass legislation allowing a debt restructuring before a $805 million general obligation payment comes due on July 1.

"You can't allow obligations to be broken and not do something about it," said Daniel Solender, who oversees $19 billion as head of municipals at Lord Abbett & Co. in Jersey City, New Jersey, including commonwealth debt. "Otherwise, you're not meeting your fiduciary responsibility. There are priorities he's not following and it's going to get some reaction from bondholders."

Either way, Puerto Rico bond prices already reflect less then full repayment. General obligations with an 8 percent coupon and maturing 2035 traded Wednesday at an average price of 66 cents on the dollar, to yield 13 percent, according to data compiled by Bloomberg.

If Puerto Rico defaults on its general obligations, bondholders may still have to wait to seek remedies through the courts. The commonwealth's debt-moratorium law passed last month includes a pledge to prevent creditors from suing Puerto Rico through January 2017 on a missed payment. The Congressional bill that was approved by a House committee Wednesday contains a provision that safeguards the island against such suits through February 2017.

Two Puerto Rico agencies, the Public Finance Corp. and the Puerto Rico Infrastructure Financing Authority, known as Prifa, have defaulted this fiscal year on about $150 million. They have some of the weakest repayment pledges among commonwealth debt. The legislature declined to allocate debt-service payments to the PFC. Gracia Padilla has redirected rum-tax revenue that usually repays Prifa bonds to cover general obligations, a risk investors were warned of when the debt was first sold.

The release of the budget plan just one day before the House committee began working on the bill and choosing to not include a full payment for general obligations may have been the latest attempt by the governor to force Congress to move forward, Solender said. Garcia Padilla has warned since June that the commonwealth could no longer afford its $70 billion debt burden.

"A lot of the attempts continually seem to be focused on trying to get Congress to take action," Solender said. “This could be part of that process too.”

Investors and bond-insurance companies have filed suits against Puerto Rico for redirecting revenue away from some bonds to repay general obligations instead and to prohibit the government from taking money out of its Government Development Bank and safeguard the bank’s assets.

The budget proposal is a signal that instead of earlier attempts to find cash to meet general obligation deadlines, the administration is now focused on paying public workers and programs before bondholders, said Daniel Hanson, an analyst at Height Securities, a Washington-based broker dealer.

Debt Service

“This is a pretty strong statement that they’re not going to even try to pay anymore,” Hanson said. “In some ways he’s threatening bondholders and saying ‘come and sue us.”’

Garcia Padilla’s $9.1 billion plan is $700 million less than the current year’s revised budget. The difference comes from not paying debt service, Hanson said. The budget for the fiscal year ending June 30 included $1.2 billion to repay debt, $966.5 million more than Garcia Padilla’s fiscal 2017 plan, according to documents from the Department of Management and Budget.

Rather than reacting to the budget proposal, investors are waiting to see what happens on July 1, said Lyle Fitterer, head of tax-exempt debt in Menomonee Falls, Wisconsin, at Wells Fargo Capital, which oversees $39 billion of munis. Well Fargo Capital holds some insured Puerto Rico debt.

“The market is pricing in the fact that they are going to make their interest payment on July 1,” Fitterer said. “If they don’t, I would think that the market would sell off some on that news.”

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