

Bond Case Briefs

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Puerto Rico Commission Says Bonds May Violate Constitution.

Puerto Rico may have sold bonds that violated the commonwealth's constitution, according to preliminary findings from an island commission charged with auditing its \$70 billion of municipal debt.

The report analyzes the commonwealth's last general-obligation bond sale, a \$3.5 billion offering in March 2014, purchased mostly by hedge funds, and a 2015 short-term note issue. The island's constitution restricts annual debt-service on direct obligations and bond maturities, limitations that the 2014 bond sale may have broken, according to the report.

"There is strong factual basis for the commission to continue research into whether the commonwealth complied with the constitution in issuing its debt, and whether the underwriters complied with applicable U.S. Securities and Exchange Commission norms," according to the report.

Puerto Rico and its agencies face a \$2 billion payment to investors on July 1, including \$805 million for general obligations. Governor Alejandro Garcia Padilla has said the island cannot make that payment and cover essential services for 3.5 million residents. Puerto Rico officials have been negotiating with creditors to reduce its debt by asking bondholders to accept less than full payment on their securities.

Control Board

The U.S. House plans to vote next week on a bill that would create a federal control board to oversee Puerto Rico's budgets and manage any debt restructurings. That panel may choose to analyze whether the general obligations are valid, said Matt Fabian, partner at Concord, Massachusetts-based Municipal Market Analytics.

"This is just one report that potentially gives ammunition to the administration or to the fiscal control board, if they want to pursue it," Fabian said Thursday.

Puerto Rico's constitution stipulates that annual principal and interest on its general obligations and commonwealth-guaranteed debt cannot exceed 15 percent of the island's average annual revenues in the last two years. The commonwealth may have sold debt that fails to fall within that restriction, according to the report. The debt-service margin currently stands at 13.6 percent, leaving some room for additional borrowing, Melba Acosta, president of the Government Development Bank, said Monday during a legislative budget hearing.

"While the administration encourages an open and transparent process to review the commonwealth's aggregate debt load, it has no reason to believe that any of the commonwealth's debt was incurred in violation of the Puerto Rico constitution," Victor Suarez, the island's fiscal agent in charge of overseeing its finances, said in a statement Friday.

Disclosure Requirements

An SEC rule requires underwriters and other outside professionals working on municipal-debt sales to determine that a borrower will provide yearly financial statements and audits on time. On April 30, 2014, six weeks after the 2014 bonds were sold, Puerto Rico released a notice saying it would miss a deadline to file its fiscal 2013 audited financials, according to the report. The commonwealth has yet to release its fiscal 2014 audit.

The legislature created the 17-member commission last year to audit Puerto Rico's debt. The panel is comprised of legislative leaders, representatives from financial institutions, members of organized labor and academics. The report recommends that the committee hire staff and get funds to complete a full audit.

"This is how municipal governments have historically looked to repudiate their bonds, by invalidating all or a portion of the debt either through some limit or some kind of problem with its issuance," Fabian said.

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