Bond Case Briefs

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Puerto Rico's Top Creditors Flex Muscles in Bond Fight.

Funds controlled by Franklin Advisers, OppenheimerFunds request to be entered as defendants in suit brought by hedge funds holding defaulted GO bonds

Puerto Rico's largest mutual-fund bondholders have broken their silence in an ongoing $30 billion creditor standoff, underscoring tensions between the commonwealth's traditional municipal investor base and the hedge funds now involved in its financial restructuring.

Funds controlled by fixed-income giants Franklin Advisers and OppenheimerFunds asked a federal judge last week to enter them as defendants in a lawsuit brought by hedge funds holding general obligation, or GO, bonds that have been in default since July.

The lawsuit pits those creditors against investors holding $17 billion in competing bonds known as Cofinas for their Spanish acronym and backed by sales tax revenues. If successful, the lawsuit could compromise the Cofina bondholders' liens and free up a fresh source of repayment for the GO bondholders, which are guaranteed under the Puerto Rican constitution.

The courts, on the other hand, could affirm the commonwealth's longstanding position that the sales-tax revenues are off-limits to the GO bondholders. U.S. District Court Judge Francisco Besosa could also freeze the dispute in the hopes that the warring investor groups will negotiate a settlement, as the Cofina investors have urged.

Congress installed a federal oversight board over the summer to take over Puerto Rico's financial decision-making, but it has yet to announce the hiring of legal and financial advisors with whom creditors will negotiate. The legal status of the Cofina revenues has never been tested in the courts, and resolving it now would take a major question on creditors' rights out of the board's hands. For now, it wants the dispute paused under the automatic stay provisions of the Puerto Rico Oversight, Management and Economic Stability Act, or PROMESA.

Franklin and Oppenheimer, along with Santander Asset Management, are cross-holders with a combined $3.6 billion in Cofina claims and $1.1 billion in GO claims, according to a filing in Puerto Rico federal court.

With $2.8 billion of their exposure in subordinated Cofina debt, the mutual funds said they have the "greatest possible interest" in protecting the sales taxes from being diverted. Junior Cofina bonds would suffer the most if the revenue stream were interrupted, although they have continued to be paid even with the territorial government in default on its constitutional debt.

Hedge funds exclusively holding senior Cofina bonds have already asked to be heard in the lawsuit. Those bondholders, including GoldenTree Asset Management, Merced Capital and Taconic Capital Advisors, hold zero-coupon bonds that don't come due for decades, according to people familiar with the matter. Their group has taken the position that diverting the sales taxes would cause their claims to come due immediately, leapfrogging over those of junior creditors.

As holders of both types of bonds, the mutual funds said they aren't conflicted and have reason to guard the interests of all creditors within the $17 billion Cofina debt stack. Puerto Rican lawmakers first segregated sales-tax revenues from its general fund a decade ago to create an alternate borrowing mechanism.

"The interests of Cofina, its bondholders generally and its current-pay subordinate bonds in particular are served by maintaining the statutory transfer," lawyers for Franklin, Oppenheimer and Santander wrote in court papers. "It is likely that the senior Cofina bondholders want Cofina to default."

A spokesman for the mutual funds declined to comment beyond the filing. Representatives for the GO bondholder group and for Cofina bond trustee Bank of New York Mellon didn't immediately respond to requests for comment.

James Doak of Miller Buckfire & Co., an adviser to the senior Cofina bondholder group, called the mutual funds' appearance "a positive for Puerto Rico, the oversight board and the incoming administration."

"Major, long-standing investors holding both GO and Cofina bonds are stepping forward to defend PROMESA's stay provision and reject more litigious GO bondholders' attempts to seize [sales tax] revenue," he said.

The benchmark 8%-coupon GO bonds due in 2035 traded Friday at 69.5 cents on the dollar, according to FactSet, having cooled off from a post-election rally that pushed prices to 73 cents. Puerto Rico recently elected Dr. Ricardo Rossello, a statehood supporter perceived by investors as friendlier to creditor interests, to replace Gov. Alejandro García Padilla. The new governor takes office in January.

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