Bond Case Briefs

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Puerto Rico's Bankruptcy Fight Is About to Plunge Into the Unknown.

- **Bondholders push competing claims but island may void them all**
- **'This is a government restructuring, not a court one'**

Dealing with Puerto Rico's crushing debt has started to resemble a circular firing squad.

Simply put, the bankrupt island can't pay everything it owes, so creditors are taking aim at each other as they squabble over who will get what's left. But the debt's size and the tangled process invented to rescue Puerto Rico mean there's no established rule book to shape what comes next.

Holders of general-obligation debt have declared their right to be paid first, owners of sales-tax bonds are squabbling with one another over who deserves priority, and they're all up against the commonwealth's leaders, who want the cash for essential services. Amid this melee, Puerto Rico's federal overseers will have to choose between paying U.S. hedge funds everything they're owed or keeping schools, water and electricity running.

"There just isn't enough money," said Matt Fabian, a partner with Municipal Market Analytics Inc. in Concord, Massachusetts, who foresees a chaotic brew of lawsuits, federal interventions and politics. "Nobody has any idea what's going to happen."

All told, Puerto Rico has about $74 billion in debt and $49 billion in pension liabilities. Hedge funds holding $1.4 billion of general-obligation bonds, including Aurelius Capital Management and Monarch Alternative Capital, have already sued to get overdue principal and interest. On the other side, owners of $17 billion in sales-tax bonds, including Tilden Park Capital Management and GoldenTree Asset Management, have entered the fray. They'll meet for the first time in court on May 17 in San Juan.

Default Notice

The dispute over the sales-tax bonds, named Cofinas after the agency that issued them, began in earnest May 4. That's when the trustee, Bank of New York Mellon Corp., sent a notice of default to the authority that sold the bonds. The object was to keep the government from diverting the sales-tax revenue to other purposes before it pays what it owes to investors.

The New York-based bank acted after weeks of pressure from senior bond owners who urged the trustee to safeguard their claims. In the process, junior bondholders were irked because the default notice could mean no payments for them until the senior bondholders are paid in full. The notice sets a 30-day deadline for a response from Puerto Rico, which is supposed to pay about $256 million of principal and interest on Aug. 1, according to data compiled by Bloomberg.

Puerto Rico's status as a commonwealth means it's not subject to traditional bankruptcy laws. Instead, the island filed for the next best thing to deflect claims, called Title III. It's an in-court restructuring based on the U.S. bankruptcy code that was created under Puerto Rico's Promesa law last year. But it’s never been used before, which means any cuts imposed by U.S. District Court Judge Laura Taylor Swain will be more likely to face years of appeals than a typical case.

Delayed Filing

Puerto Rico’s initial Title III filing on May 3 didn’t include Cofina. If it had, BNY Mellon may have been prohibited from sending its May 4 default notice. But the oversight and management board didn’t file its separate Title III action for Cofina until May 5, giving the bank a window to declare the default.

The delay means it’s unclear whether the Title III filing voids BNY Mellon’s default notice, as well as a separate default notice sent by Ambac Assurance Corp. on May 1. Regardless, BNY Mellon and senior creditors are prepared contest a court’s decision if it’s not in their favor, according to a person familiar with the matter, who asked not to be identified discussing private information. The government hasn’t said how it will respond.

“As a public policy, legal defense strategies are not discussed until they are presented in judicial forums,” Yennifer Alvarez, a spokeswoman for Governor Ricardo Rossello, wrote in an emailed comment.

The senior bondholder group, which controls about one-third of the senior Cofina bonds, is led by hedge funds Whitebox Advisors, Tilden Park Capital Management, GoldenTree Asset Management and Merced Capital, according to Susheel Kirpalani, a lawyer at Quinn Emanuel Urquhart & Sullivan who represents the group.

Debt Due

For investors, there’s a lot at stake. Cofina holders are owed more than $8 billion in debt service through 2026, with $704 million in payments due in the next fiscal year, which starts in July, according to the commonwealth’s fiscal plan.

The territory owes all bondholders $33.4 billion in debt payments between now and 2026, according to the plan, but it proposes to pay only about $8 billion. The government hasn’t said how bondholders should divide those payments, or which group is first in line.

“This is a government restructuring, not a court one, so the government will be in the driver’s seat,” Fabian said. “Creditors will not be heard to the extent they’re saying, ‘let’s do it a different way.’ Those arguments won’t have any standing in a court.”

Owners of junior Cofinas could be left vulnerable. BNY Mellon holds a trustee reserve fund of sales-tax revenue with about $400 million, more than enough to handle the upcoming August payment, according to people familiar with the matter.

But because of the default notice, junior bondholders are unlikely to be paid, in order to safeguard claims of the senior Cofinas, said the people, who asked not to be identified discussing private transactions. Given the limited funds available for debt repayment, there’s a chance the subordinated holders could get little or no recovery. A representative for BNY Mellon declined to comment.

What’s more, general-obligation bondholders claim that the entire Cofina structure violates the island’s constitution, and all the sales-tax revenue is owed to them. If the general-obligation claims are supported in court, all of the Cofina debt could be ruled invalid and investors could receive nothing at all.

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