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Puerto Rico's Bondholders File First Suit Against Uncle Sam.

Hedge funds holding Puerto Rico bonds sued the U.S. government, the first time creditors have tried to put federal taxpayers on the hook for losses suffered in the island's debt crisis.

A bondholder group represented by the Jones Day law firm filed suit in the U.S. Court of Federal Claims, the Washington tribunal that handles claims against the federal government. Creditors have been suing Puerto Rico since early last year over an escalating series of debt defaults, but never before has a group targeted Uncle Sam directly for damages.

Plaintiffs including Glendon Capital Management LP and Oaktree Capital Management LP are facing possible losses on bonds issued in 2008 to prop up Puerto Rico's struggling pension fund. Their lawsuit, filed Wednesday, blames the federal oversight board that was installed by Congress to dig the island economy out from its $73 billion debt load. The seven-member board placed Puerto Rico's largest public retirement fund under bankruptcy protection in May to restructure those $3 billion in pension bonds.

"Because the oversight board is so clearly a part of the federal government, its actions are themselves the actions of the United States," the complaint says.

Preventing a taxpayer bailout for Puerto Rico's financial woes was a priority for House Speaker Paul Ryan (Wis.) and congressional Republicans who designed Puerto Rico's rescue package. That law, known by its acronym Promesa, "isn't a bailout," according to a statement from Mr. Ryan's office last year. "It preserved that critical principle of protecting taxpayers."

A spokesman for the oversight board didn't immediately respond to a request for comment.

Promesa empowered the oversight board to write down Puerto Rico's massive pile of municipal debt consensually through negotiated deals, or through court-supervised proceedings if negotiations failed. After a decadelong recession punctuated by high unemployment and poverty rates, the U.S. territory is desperate to stem the migration of its residents to the U.S. mainland.

Like many municipal governments, Puerto Rico has long struggled to keep its pension systems healthy. Proceeds from the pension bonds were supposed to help the Puerto Rico Government Employees Retirement System continue paying benefits until elderly pensioners died off and younger public employees began retiring with less-generous benefit packages. Instead, the value of the system's investments cratered during the financial crisis, bringing the pension system to the brink of insolvency today.

The bonds are payable from the pension contributions paid by public employers toward their workers' retirements. Bondholders thought they would be paid first, but the oversight board last month adopted legislation to move the contributions outside the pension system and beyond creditors' grasp.

The plaintiffs asked for a court order declaring that maneuver an illegal taking of private property under the U.S. Constitution, as well as "compensation equal to payment of the principal amount of the [Employees Retirement System] bonds."

Creditors were optimistic the oversight board would quickly approve consensual settlements and avoid prolonged bankruptcy proceedings, but now that hope is dwindling. Deals to restructure the island's general obligation bonds and its electric utility debt have met the board's veto, despite prodding from congressional Republicans to honor restructuring deals negotiated with local officials.

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