

Bond Case Briefs

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Puerto Rico's Bankruptcy Is Ending. What Comes Next?

The biggest bankruptcy ever in the municipal debt market is on a path to resolution, now that a U.S. judge has approved a restructuring plan for Puerto Rico. Still, there are plenty more challenges ahead for investors, the island's still-bankrupt electric utility and its beleaguered residents. Even with a sharp reduction in debt payments, the key issue for Puerto Rico is whether it can turn around an economy that's been shrinking for years amid a steady loss of population.

1. How big was Puerto Rico's bankruptcy?

The debt restructuring — an agreement between Puerto Rico's government, bondholders, insurance companies, vendors and labor groups — will erase \$33 billion of debt and other obligations, including the cutting of \$22 billion of bonds to \$7.4 billion. It surpasses Detroit's \$18 billion bankruptcy in 2014, previously the largest. When Puerto Rico's governor announced in 2015 that the commonwealth, a Caribbean island that is a U.S. territory, could not repay what it owed, the debt of the government and the agencies and authorities it controlled totaled \$74 billion.

2. What did the judge decide?

U.S. District Court Judge Laura Taylor Swain agreed to the restructuring plan, including the issuance of new bonds that will reduce Puerto Rico's outstanding debt. She also rejected assertions by some creditors that a federal law, called Promesa, that was passed to allow Puerto Rico to restructure its obligations through U.S. court oversight violates the Constitution. The agreement she approved also avoids cuts to pension benefits for islanders and establishes a new pension reserve trust; Puerto Rico's depleted retirement fund owes an estimated \$55 billion to current and future retirees.

3. How will the debt restructuring work?

Puerto Rico's government and the financial oversight board created by Promesa to manage its bankruptcy process plan to execute a debt exchange on or before March 15. At that time anyone holding a Puerto Rico general obligation bond or commonwealth-guaranteed debt will swap their securities for new restructured general obligations. This will facilitate the reduction in principal to lower Puerto Rico's debt load.

4. What are bondholders getting?

The new bonds will give investors as little as 67.7 cents on the dollar to as much as 80.3 cents on their current holdings, depending on the type of bond they bought and when it was sold. They will also receive a \$7 billion cash payment and a so-called contingent value instrument that pays out if Puerto Rico's sales-tax collections exceed projections.

5. How does the restructuring help Puerto Rico?

Once the bonds are exchanged, Puerto Rico will pay no more than \$1.15 billion in principal and interest annually on its general obligation bonds and sales-tax debt, down from as much as \$3.9 billion. That means for every dollar of taxes and fees that the government collects, just 7.2 cents will go to creditors, leaving the remaining revenue to serve the 3.3 million people of Puerto Rico.

6. Are there any obstacles to the debt restructuring?

The steps necessary for the bond exchange are mostly administrative. The oversight board and the government need to certify an updated multi-year fiscal plan and amend the island's current budget to incorporate the new payments to bondholders.

7. What else needs to be done?

Puerto Rico has authorities and agencies that are also in bankruptcy or working through debt restructurings outside of court. Its government-owned Electric Power Authority, which provides most of the electricity on the island, is still in bankruptcy and is seeking to cut its \$9 billion in debt by about a third. The island's Highways and Transportation Authority is also working to reach a resolution on the \$6 billion it owes in bankruptcy.

8. How did this all happen?

Puerto Rico and its authorities and government agencies racked up the \$74 billion of debt through years of borrowing to cover operating expenses as its economy shrunk and its population fell by 12% between 2010 and 2020. Its debt was widely held: mutual funds throughout the U.S. bought it for its tax-exempt benefits. Once the commonwealth could no longer borrow through the capital markets at affordable rates, it defaulted on its general obligation bonds in 2016 and the oversight board sought bankruptcy in May 2017.

9. What's the plan for recovery?

Puerto Rico officials anticipate investment on the island will grow once the end of bankruptcy removes longstanding uncertainty over the island's finances and the government regains the ability to increase spending on health and education. Federal funds are also expected to boost the island's economy: Puerto Rico is set to receive more than \$40 billion of federal recovery funds in the coming years, including \$1.9 billion included in the Infrastructure Investment and Jobs Act passed in 2021.

10. What's been the reaction among residents?

The federally-appointed oversight board has been very unpopular among residents, who have viewed it as taking away the island's autonomy and ability to govern itself. Many Puerto Ricans also question the settlement, asking why they should repay hedge funds, distressed-debt buyers and other investors when the island has suffered from devastating hurricanes, earthquakes and chronic power outages. Nearly 44% of its residents live in poverty. Another source of discontent is the more than \$1 billion in bankruptcy fees the island owes or has paid to lawyers, financial consultants and outside experts.

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