

Can Alphabet Soup Fix Puerto Rico's Debt Service Issues?

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Last week, the Working Group for the Fiscal and Economic Recovery of Puerto Rico gave the broadest hint yet of the next tactic in Puerto Rico's ongoing quest to deleverage itself. Although the details have not yet been articulated, Puerto Rico apparently proposes to blend into a single pot several types of distinct taxes currently earmarked to pay or support different types of bonds issued by a number of its legally separate municipal bond issuers, with the hope that the resulting concoction will meet the tastes of a sufficient number of its differing bond creditors to induce them to voluntarily exchange their various types of bonds for a single type of new debt presumably supported by the new blended tax revenue stream.

According to the "Restructuring Process and Principles" slides released by the Working Group on September 24, "the Working Group is working with the Commonwealth's advisors to structure a debt-relief transaction that will permit the Commonwealth's available surplus to be used to make payments on its indebtedness while the initiatives and reforms undertaken as part of the [Fiscal and Economic Growth Plan](#) take hold." Per the release, "[t]he consensual negotiation and ultimate transaction will seek to involve not just creditors of one governmental entity, but instead the creditors of many entities, as part of a single, comprehensive exchange transaction. The goal of this approach is to avoid a piecemeal strategy that may result in uncoordinated and inconsistent agreements with creditors, litigation among creditor groups, and a lower chance of success."

As the saying goes, good luck with that.

The Working Group's trial balloon is short on details as to which existing debt would be involved in the contemplated "single, comprehensive exchange transaction." Given the magnitude of the Working Group's projected funding gap, after other proposed corrective measures are undertaken, of \$14 billion from FY 2016 to FY 2020, and given that direct and guaranteed general obligation bonds and COFINA sales tax bonds constitute approximately \$34 billion out of Puerto Rico's approximately \$71 billion in outstanding public sector bonds, it seems virtually certain that, at a minimum, the contemplated "super-exchange" would involve the g.o. bonds and the COFINA bonds. Other types of bonds supported, directly or on a contingent basis, by Commonwealth tax revenues are of substantially lesser magnitude and, in many instances, also are payable from independent revenue streams. Some or, depending on the Working Group's appetite for complexity, all of those other types of bonds also are likely to be targeted for the to-be-negotiated "super-exchange"; as listed in the Working Group's September 9 report, they include bonds issued by HTA, GDB, PBA, PFC, PRIFA, UPR, PRCCDA, PRIDCO, GSA and ERS.

In evaluating the feasibility of a negotiated exchange that stirs together this alphabet soup of issuers and creditors, we start from the following premises:

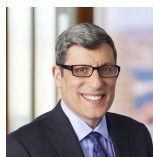
- Debt service on the g.o. debt has top priority, under the Puerto Rico constitution, on the Commonwealth's "available resources." Although enforcement of this legal priority would raise some thorny issues, and although much of the g.o. debt may now be held by holders with a basis well below par, there is no clear incentive for many g.o. bondholders to give up any portion of their legal entitlement to full debt service payment from "available resources" for what the Working Group's slides characterize as reduced payment from the Commonwealth's "available surplus."
- Debt service on COFINA bonds is payable from a statutorily assigned portion of the sales tax or of any substitute tax such as the VAT. The statutorily assigned taxes should be sufficient to pay full debt service on the COFINA bonds for the foreseeable future. Puerto Rico case law as well as a series of Puerto Rico Attorney General opinions support the validity of such an assignment. Much of the outstanding g.o. debt has been issued and/or purchased with full awareness by the g.o. bondholders that the relevant portion of the sales tax has been assigned to COFINA and its bondholders. Similar

assignments of specified tax revenues to independent bond-issuing authorities have been upheld in other jurisdictions. The complaint allegedly ready on someone's shelf seeking an adjudication that the COFINA structure is a legal sham or that the assigned sales tax revenues remain "available resources" for the payment of g.o. debt service may be filed some day, but from our perspective COFINA holders should like their chances in any such litigation. Absent disproportionate fear of an adverse result in any such litigation, there is no clear incentive for many COFINA bondholders to give up any portion of their legal entitlement to full debt service payment from the statutorily assigned and pledged sales tax revenues for reduced payment from any other source.

- What, if anything, could be achieved by Puerto Rico in consensual debt reduction negotiations with holders of other types of debt with more tenuous claims on Commonwealth taxes (due to express clawback provisions, appropriation requirements, lack of a constitutional payment priority or security interest or other factors) is an interesting question, but may be moot in the event of substantial nonparticipation in a "super-exchange" by g.o. and COFINA bondholders, as Puerto Rico cannot achieve the debt service reductions it asserts it needs without substantial buy-in from the g.o. and/or COFINA bondholders.
- Although the "Restructuring Process and Principles" slides state that "[t]he transaction will be structured to take into account the priorities of the debt that creditors hold", it is difficult to derive much meaning from that statement. Any restructuring that reduces debt service payable on the g.o. bonds in order to pay other Commonwealth expenses will disregard the constitutional priority of debt service in application of available resources. Any restructuring that reduces debt service payable on COFINA bonds in order to apply some of the sales tax/VAT pledged as security to COFINA bonds to instead pay Commonwealth expenses will violate the statutory priority of COFINA bond debt service. To the extent that the restructuring would be consensual, it may be tautological that there will be no dishonoring of any constitutional or statutory priority, as the participating bondholders will have agreed to any deviation from such priorities. If one assumes that Puerto Rico intends to seek concessions from the g.o. bondholders and/or COFINA bondholders, the statement that priorities will be "taken into account" in the proposed "super-exchange" can best be read as a statement that other types of tax-supported debt to be included in the proposed "super-exchange" may be offered less favorable exchange ratios than the g.o.'s and/or COFINAs.
- The difficulties and uncertain outcome of consensual debt reduction negotiations involving PREPA, a single credit payable solely from electricity revenues widely deemed insufficient to cover the associated revenue bonds, do not bode well for the outcome of consensual debt reduction negotiations involving homogenization of numerous separate credits, including some with strong legal claims for full payment of their debt.
- Negotiated exchanges involving some degree of municipal debt reduction or bondholder concessions have succeeded in certain other contexts, but few that we are aware of in which the issuer did not have access to a bankruptcy option as an alternative. Successful exchanges involving issuers that did not have access to a bankruptcy process (e.g., certain tribal casino bonds) involved debt that did not benefit from strong legal claims on tax revenues of the type held by Puerto Rico's g.o. and COFINA holders.

Puerto Rico's announced strategy for dealing with its debt has evolved from ring-fencing its tax-supported debt and attempting to address its public corporation debt with a Puerto Rico bankruptcy statute to targeting its tax-supported debt in a consensual negotiation process. The Working Group and its advisors may sincerely believe that a "debt lite" consommé can emerge from such pot-stirring, but may also believe that a failed process will provide additional ammunition for what Puerto Rico really wants to address its unwieldy debt structure: enactment of federal "super Chapter 9" legislation that would give it access to a federal bankruptcy process encompassing its g.o. bonds as well as its public corporation debt.

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