

Puerto Rico Fiscal Reform: The End Of The Beginning

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The financial ills of the commonwealth of Puerto Rico are well-known and documented. During the past decade, Puerto Rico's gross national product (GNP) declined by 14 percent, with a 10 percent decline in the island's population. In 2015, 46 percent of the population lived below the federal poverty line, compared to the U.S. national average of 15 percent. Today, more commonwealth citizens reside on the U.S. mainland than on the island.[1]

Over the last 18 months, the U.S. Congress acknowledged that Puerto Rico was at a fiscal breaking point, unable to provide essential services to their citizens. The unrelenting out-migration of residents and businesses, coupled with burgeoning health care costs, were central to the Obama administration's declaration that Puerto Rico faced a potential "humanitarian crisis." [2]

In this article, we provide context around Puerto Rico petitioning for court protection, and thereby creating the largest municipal bankruptcy in U.S. history.[3] We review the legislative process leading to the filing for court protection, including a discussion of parties supporting and opposing the filing. The review concludes with an analysis of the dominant debt restructuring issues being considered by the court and stakeholders.

Road Map to Fiscal Crisis

The commonwealth's legislative history provides context for Puerto Rico's fiscal crisis. In 1917, the U.S. Congress authorized the commonwealth to issue municipal bonds tax-free from all U.S. federal, state and local governments. The triple tax-exempt status made the bonds highly attractive to U.S. investors and very low cost for the commonwealth.

States in the U.S. are all required to annually produce a balanced budget. Similar requirements existed in Puerto Rico until 1952, when the new constitution relaxed balance budget requirements. A subsequent constitutional amendment in 1961 loosened the reins on debt capacity, encouraging Puerto Rico to fund fiscal shortfalls through the issuance of triple-exempt municipal bonds. As of March 2017, the commonwealth has \$74 billion of debt and liability. Puerto Rico's pension liability is \$49 billion and is 98.5 percent underfunded.



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PROMESA

Unlike mainland municipalities, the commonwealth does not have the power to petition for protection and reorganize municipal debt under Chapter 9 of the U.S. Bankruptcy Code.[4] In 2016, the U.S. Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act into law. Title III of PROMESA provides U.S. territories and commonwealths broad in-court restructuring methods modeled on Chapter 9 of the U.S. Bankruptcy Code.[5]

Oversight Board

A seven-member board is recommended by Congress and appointed by the president to oversee and approve the PROMESA restructuring plan. The appointed board is required to have expertise in finance, municipal bonds, law or government operations.[6] The board has the power to approve:

- Fiscal plans;
- Budgets;
- Voluntary agreements with bondholders;
- Debt restructuring plans; and
- Critical projects eligible for expedited permitting processes.[7]

The oversight board for the commonwealth of Puerto Rico was named by the White House in August 2016 and empowered with ultimate discretion and final authority over the commonwealth's fiscal plan and budget.[8]

Commonwealth Fiscal Plans

As a precursor to a filing for an adjustment of the commonwealth's debt, PROMESA requires that the oversight board positively review and approve a fiscal plan with the following extensive legislative requirements:

- Ensure the funding of essential public services;
- Provide adequate funding for public pension systems;[9]
- Provide for the elimination of structural deficits; and
- Include a debt sustainability analysis.[10]

Table 1. Issuers included in Commonwealth's Certified Plan

| Commonwealth Certified Plan | Bonds and Loans |
|---|-----------------|
| Issuers included in Certified Plan: | (\$ millions) |
| Commonwealth General Obligation | \$13,267 |
| PR Sale Tax Financing Authority | 17,880 |
| PR Highways and Transportation Authority | 4,247 |
| PR Public Building Authority | 4,129 |
| Government Development Bank | 4,126 |
| PR Employee Retirement System | 3,156 |
| PR Infrastructure Finance Authority | 2,207 |
| PR Public Finance Corporation | 1,197 |
| University of Puerto Rico | 496 |
| PR Convention Center District Authority | 386 |
| PR Industrial Development Co. | 156 |
| Other Central Government Entities | 667 |
| Total Commonwealth Certified Plan | \$51,196 |
| Issuers outside of plan: | |
| PR Electric Power Authority | \$8,956 |
| PR Aqueduct and Sewer Authority | 4,568 |
| Children's Trust (Tobacco Settlement) | 1,460 |
| Municipal Related and Other Debts | 1,794 |
| Governmental Loans and Offsets | 5,029 |
| Total Outside of Certified Plan | \$23,069 |
| Total Puerto Rico Public Sector Debt | \$74,265 |

Certified Fiscal Plan

The oversight board chair stated the commonwealth’s certified fiscal plan charted a path for Puerto Rico to: (1) achieve fiscal equilibrium in three years, (2) provide adequate funding for essential services, (3) maintain the solvency of the government pension plans, and (4) restructure the government’s long-term debt.

The oversight board’s process for dealing with the commonwealth’s fiscal crisis embodies a “once and done” approach. The board feels such an approach most effectively uses PROMESA tools, and offers the commonwealth the rare opportunity to restructure its debt in an orderly fashion, free of distractions from litigation.[11]

Title III Petition

In March 2017, major holders of the commonwealth’s general obligation and sales tax bonds participated in mediation. These bondholders held approximately 55 percent of the debt to be restructured. Despite multiple mediation sessions and private negotiations, no agreements were reached.

Reflecting the impasse in negotiations and the expiration of the May 1 litigation stay, on May 3, 2017, the oversight board filed a Title III petition for the benefit and protection of Puerto Rico. The oversight board committed to continue negotiations for consensual resolutions with the goal of adjudicating some debt classes outside Title III.[12]

John Roberts, chief justice of the U.S. Supreme Court, appointed U.S. District Judge Laura Taylor Swain to oversee the federal district court case arising from the Title III petition.[13]

Adjustment of Debts

Upon filing the Title III petition, the oversight board declared the commonwealth’s liquidity and solvency problems to be “massive” and that stakeholder sacrifices, “while painful in the short term, are necessary for Puerto Rico’s long-term growth.”[14]

Under a Title III debt adjustment proceeding, the oversight board takes the place of the debtor government. PROMESA provides that the oversight board proposes a plan of debt adjustment, which is voted on by the creditors and, in turn, confirmed by the district court.[15] Adjustments to the certified plan must be approved by the oversight board and cannot be unilaterally modified by the district court.

Table 2. Certified Plan debt sustainability analysis

| Commonwealth Certified Plan | 2018 | 2019 | 2020 | 2021 | 2022 | '17 – '26 Average |
|----------------------------------|----------|----------|----------|----------|----------|-------------------|
| Revenues | \$17,511 | \$16,407 | \$16,434 | \$16,494 | \$16,590 | \$17,080 |
| Plus Certified Plan Savings | 1,875 | 3,393 | 3,799 | 4,515 | 4,789 | 3,958 |
| Less Expenses | (18,981) | 19,233 | 19,512 | 19,950 | 20,477 | 20,251 |
| Cash Flow Available for Debt (A) | \$404 | \$567 | \$722 | \$1,059 | \$903 | \$787 |
| Required Debt Service (B) | \$3,283 | \$3,828 | \$3,437 | \$3,347 | \$3,171 | \$3,339 |
| Debt Recovery Value (A / B) | 0.12x | .15x | .21x | .32x | .28x | .24x |

Upon reviewing the certified plan, the investment bank UBS declared the outlook for owners of Puerto Rico bonds as “discouraging.” Additionally, UBS concluded that commonwealth bondholders would incur “significant losses” and “payments abridged for one to 10 years.”[16] Gov. Ricardo “Ricky” Rosello committed that the commonwealth will pay no more than 24 percent of the certified plan’s debt over the next decade.[17]

Litigation

The Title III petition referenced 22 known litigation proceedings as of May 3, 2017. Additional litigation has subsequently been filed.[18] Central legal issues raised by plaintiffs include:

1. Priority of obligations comprising “public debt” relative to expenses of the commonwealth under the Puerto Rico Constitution;
2. Debt priority positions under the Puerto Rico Constitution;
3. Public service characterizations to include: “essential services,” “nonessential services” and “regular expenses” of the government;
4. Contractual rights of bondholders under the Contracts Clause of Article I of the U.S. Constitution;
5. The transfer of public corporation revenues for general use by the commonwealth under the takings clause of the Fifth Amendment to the U.S. Constitution;
6. Existence and size of “reconciliation adjustment” contingency contained in the certified plan;
7. The certified plan’s macroeconomic and expenses assumptions, federal health care funding levels, and tax collection rates; and
8. The certified plan’s application of clawback bond revenues.

The certified plan takes no positions on “asserted constitutional or contractual rights and remedies.”[19]

The Future

Once the district court determines that the commonwealth’s Title III petition satisfies the legislative requirements of PROMESA, the case will proceed to trial.[20] The complexity of the restructuring is underscored by the commonwealth having 18 issuers of debt, many of which have multiple security pledges and lien structures. Stakeholders’ competing claims on finite revenues dedicated for debt payments further complicate a commonwealth restructuring.

One restructuring technique likely to be considered by Puerto Rico is permitting only one class of securities to survive (e.g., commonwealth general obligation bonds). This approach has been successfully implemented in sovereign bankruptcies and provides a critical, homogenous currency for debt negotiations.[21] A solitary restructuring security accommodates debt exchanges on a pro-rata and

lien-priority basis. A single security class should also accelerate Puerto Rico's return to the capital markets by concentrating market liquidity and bolstering investor confidence.

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[1] John Dizard, "Puerto Rico Faces Worse Debt Crisis Than Argentina," Financial Times, April 28, 2017, available at <https://www.ft.com/content/6b4b2dd0-2b73-11e7-bc4b-5528796fe35c>

[2] Mary Williams Walsh, Michael Corkery and Julie Hirschfeld Davis, "Obama Administration Draws Up Plan to Help Puerto Rico With Debt," The New York Times, Oct. 21, 2015, available at https://www.nytimes.com/2015/10/22/business/dealbook/obama-administration-draws-up-plan-to-help-puerto-rico-with-debt.html?_r=0.

[3] The debt to be restructured for Puerto Rico is eight times the amount of debt restructured in the prior largest U.S. municipal bankruptcy for the city of Detroit.

[4] United States Courts website, May 18, 2017.

[5] Once a PROMESA Title III petition is filed, the court is empowered to issue a broad confirmation order that definitively discharges, upon confirmation, all obligations and provides a clean slate for the debtor to reenter the market place. The court's tools underlying the universal discharge include: (1) cramdown power for nonconsenting classes of claims allowing a qualified plan of adjustment to be approved by a single impaired class and (2) debtor-in-possession financing, providing lenders a superpriority lien.

[6] The oversight board's powers are somewhat similar to those of the District of Columbia Control Board established by the U.S. Congress in 1995.

[7] Congressional Research Service, The Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA: HR 5278, S. 2328) p. 15.

[8] Steven Mufson, "White House Names Seven to Puerto Rico Oversight Board," The Washington Post, Aug. 31, 2016, available at https://www.washingtonpost.com/business/economy/white-house-names-seven-to-puerto-rico-oversight-board/2016/08/31/9cee9376-6f8b-11e6-9705-23e51a2f424d_story.html?utm_term=.59954ceb9c8a.

[9] The solvency of Puerto Rico pension systems will likely be addressed on a pay-as-you-go basis from general fund revenues. The pension costs for fiscal year 2018 are estimated at \$989 million.

(Source: American Enterprise Institute, May 3, 2017.)

[10] Statement of Oversight Board in Connection with PROMESA Title III Petition, United States District Court for the District of Puerto Rico, May 3, 2017.

[11] American Enterprise Institute, Transcript: Puerto Rico's Ongoing Economic Crisis, May 3, 2017.

[12] Heather Gillers, "Who are Most Exposed to Puerto Rico Bankruptcy? Mutual Funds and Hedge Funds," The Wall Street Journal, May 3, 2017, available at <https://www.wsj.com/articles/who-are-most-exposed-to-puerto-ricos-bankruptcy-mutual-funds-and-hedge-funds-1493840870>.

[13] Judge Swain was appointed a U.S. bankruptcy judge for the Eastern District of New York in 1996. Steven Church, "Puerto Rico Judge Handled Seinfeld Cookbook, Madoff Cases," Bloomberg, May 5, 2017, available at <https://www.bloomberg.com/news/articles/2017-05-05/puerto-rico-debt-judge-handled-seinfeld-cookbook-madoff-cases>.

[14] Ernst & Young was retained to bridge the financial statement gap between 2014 and the present. In the certified plan, the oversight board incorporated the midpoint of EY's estimate for 2017 expenditures. (Source: AEI, May 3, 2017.)

[15] Congressional Research Service, The Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA: HR 5278, S. 2328) p. 15.

[16] UBS Municipal Brief, "Puerto Rico Credit and Market Update," May 8, 2017, p.6; April 18, 2017, p.9.

[17] Fidelity, "Puerto Rico Governor insists judge cannot revise next 10 years of debt payments," May 5, 2017.

[18] Assured Guaranty Corp. et al v. Commonwealth of Puerto Rico et al., U.S. District Court, District of Puerto Rico, May 3, 2017.

[19] Government of Puerto Rico, "Fiscal Plan for Puerto Rico," March 13, 2017, available at <http://www.aafaf.pr.gov/assets/planfiscal13demarzo2017.pdf>.

[20] The total time line of the restructuring is unknown. Detroit and San Bernardino's restructurings required 1.5 and 5 years respectively. The executive director's employment agreement's initial term is four years. (Source: PROMESA website).

[21] Ukraine used a single security (denominated in U.S. dollar and euro) for defaulted debt exchanges in 2000.