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What Should Puerto Rico Offer Its Creditors?

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With this week's certification of the commonwealth's fiscal plan, the oversight board and the new government in San Juan took their first tangible steps toward defining how much aggregate debt service Puerto Rico can afford to pay its creditors over the coming years. Undoubtedly, creditors and other stakeholders will push back on their analysis, and no doubt disputes will arise as to how such surplus should be allocated among the island's various creditor groups. But whatever surplus ultimately emerges as available and no matter how it is allocated, the form and nature of the instruments that will be issued to creditors as part of any restructuring may have more enduring consequences than the ultimate size of the debt haircut agreed to by, or imposed on, creditors, or which creditor groups emerge as the eventual winners or losers in the process. To date, the underlying assumption is that creditors will receive, as part of the restructuring, the instruments they currently own, whether they be general obligation (GO) bonds, special-purpose bonds secured by sales tax revenues, bonds backed by other pledges of revenue streams, or bonds supported solely by appropriations when and if approved by the Puerto Rican Legislature. As creditors (or the courts) get closer to compromising existing claims, we hope and expect those discussions will include a deeper and more thoughtful discussion of the form and nature of the instruments that will be issued. To that end, we offer four recommendations to keep in mind when designing the type of instrument that creditors will receive in a restructuring of Puerto Rico's debt.

Recommendation No. 1: Puerto Rico should offer the bulk of its creditors a single new fixed-pay instrument, issued by a federally validated bonding authority, in exchange for old bonds.

Puerto Rico's debt stock consists of nearly two dozen different bond issuers and over 900 CUSIPs, and over two-thirds of its outstanding bonded debt, or nearly $50 billion, is payable from overlapping sources of revenues that are generated and/or collected by the central government. Replicating this debt structure through one or more debt exchanges perpetuates an unwieldy and opaque capital structure and does a disservice to both Puerto Rico and its creditors.

As the last year and a half has demonstrated, in the fight for a dwindling pool of revenues to pay back debt, bondholders will take to the courts to claim as much of the commonwealth's resources as possible, with each creditor group believing it has priority to its revenue stream and, in some cases, challenging the very validity of other credit instruments. Puerto Rico's court dockets are filled with litigation challenging the allocation of funds among competing needs. In the case of the very public litigation between holders of GO and Puerto Rico Sales Tax Financing Corporation (COFINA) debt, this has devolved into an acrimonious fight over the very legality of the COFINA bond issuances themselves.

The depth and ramifications of this pervasive intercreditor conflict for Puerto Rico and its creditors cannot be understated. Of the over $60 billion of overall bonded debt issued by the commonwealth and its instrumentalities, nearly $50 billion relies, directly or indirectly, on revenues generated and/or collected by the commonwealth's central government, and for over $6 billion of that debt, the underlying revenues are explicitly subject to constitutional clawback in favor of the general obligation debt.[1] Another $17.2 billion issued by COFINA relies on sales and use taxes that GO holders claim should be diverted to pay public debt. And, as between the COFINA senior and subordinated creditors, acceleration, remedies and subordination provisions under the COFINA bonds create dramatically opposite incentives for the two groups. These are but a few of the deep-seated intercreditor conflicts that have already boiled over as the new administration tries to reach agreement with its major creditor classes.[2]

Even if creditors agree on relative haircuts now, creditors will not accept as part of a restructuring the same instruments they currently hold — with the embedded intercreditor conflicts and critical legal issues left unresolved.[3] The GO holders, for example, have already asked for a statutory lien on Puerto Rico's "available revenues," implicitly recognizing the impact of PROMESA on their debt instruments. And as part of the senior COFINA holders' restructuring proposals, the group had included requests for a final judgment upholding the validity of their structure and other assurances regarding language purportedly providing them a statutory lien. It is true that the dispute du jour could be addressed in a Title III proceeding (although with appeals it could take years),[4] but new disputes with different fact patterns could arise in the future. And there are practical disadvantages to giving creditors the same bonds in any debt exchange — for example, constitutional debt limits on the amount and tenor of GO and commonwealth-guaranteed debt may substantially limit the ability of Puerto Rico to issue new public debt as part of or following the restructuring and/or to sculpt a new commonwealth capital structure given its limited debt service capacity.

The alternative is to propose a single instrument issued by a federally authorized "bonding authority".[5] The bonding authority would be created through an amendment to the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) — a draft of the necessary language was circulated prior to PROMESA's enactment — and would basically provide for a new issuer, issuing one or more classes of bonds, to be issued in varying proportions to exchanging creditors after oversight board approval. Although the debt would not be "backed," or in any way supported or guaranteed, by the federal government, as part of the legislation creating a bonding authority, liens would be federally authorized and automatically perfected. In addition, grounding the authority of the new issuer in PROMESA would not only provide a federal imprimatur to the bonding authority and its resulting debt issuances, but also immunize it from potential legal challenges asserted in the future based on Puerto Rican law. Debt issued under this bonding authority, including by virtue of the granting and lien language contained in the federal statute, would be superior from a legal perspective to any of the debt in the existing debt stock of Puerto Rico (and could include whatever enhancements in terms of statutory liens, New York law or forum, collective action provisions, or other protections as the parties may negotiate), as it would no longer be subject to challenge under Puerto Rican law or its constitution. It would, of course, also have the effect of aligning the interests of all creditors and restraining the impulse of some investors to attack their fellow creditors in the future if and when the commonwealth were to experience financial stress.

This is not a new idea nor an unrealistic ask of Congress. It was included in the federal legislation used to help Washington, D.C., with its fiscal crisis in 1995. During the passage of PROMESA last summer, the commonwealth government and the U.S. Treasury sought to incorporate similar language in drafts of PROMESA. Indeed, at that time, most creditors and their advisers agreed with and recognized the benefits of such a bonding authority. And, as per the Congressional Budget Office, the cost of implementing the bonding authority from a U.S. taxpayer perspective would be minimal.

The benefits of collapsing the commonwealth's debt stock into a single issuer or a reduced number of issuers are substantial. Beyond the additional legal certainty and improved security that a bonding authority and a single instrument could provide, creditors and Puerto Rico will also benefit from simplicity: one set of consolidated cash flows for one instrument instead of fractured streams of tax revenues and payment terms for hundreds of distinct CUSIPs. A simplified capital structure will not only help bring more transparency to the market, benefiting stakeholders, rating agencies and other market participants, but also bring greater liquidity to the bonds, which will no longer be divided among 18 different issuers. This means Puerto Rico can also market itself to a broader range of investors, who to date have stayed away from Puerto Rican bonds as an investment, given the complexity of the capital structure and opaque legal issues surrounding each of the various Puerto Rican debt issuances. This in turn will help existing creditors as an expanded market for Puerto Rican debt will provide even greater liquidity and ultimately higher values for restructured debt — a benefit that was confirmed by various investment banks when this issue was first raised as part of the previous administration's restructuring efforts.

Recommendation No. 2: Puerto Rico should offer a contingent value instrument, or "growth bond," alongside the fixed-pay instrument issued by the bonding authority.

A contingent value instrument is an instrument that gives the holder the right to receive additional debt service payments from the debtor in the event that certain growth-linked triggers (such as increases in gross domestic product or government revenues) are met. This type of instrument would be especially apt in Puerto Rico's situation, where sizable haircuts are inevitable given the limited ability of the commonwealth to pay its contracted debt going forward.

The "growth bond" offers an elegant solution to the looming haircuts that would be a win-win for creditors and Puerto Rico alike. For creditors, it offers an instrument that gives them the opportunity to recoup losses due to a haircut on their original principal and allows them to participate in the upside of economic growth and recovery. For Puerto Rico, it allows the island to make significant debt relief more palatable to creditors and create incentives for creditors to be partners in growing the island's economy.

And this too is not a novel strategy — for one, contingent value instruments have been used in several major sovereign restructurings in the recent past: Argentina in 2005, Greece in 2012 and Ukraine in 2015. They have also appeared in municipal restructurings; the city of Stockton, California, used a variant of CVIs in its agreement with one of its bond insurers as part of its 2015 Chapter 9 bankruptcy. Moreover, the concept was included in prior commonwealth restructuring proposals and, in fact, was also something creditors included in various forms in their counterproposals.

For a growth bond to work for Puerto Rico, it needs to be designed to enhance — not jeopardize — the prospects for future economic growth. Accordingly, we suggest that it be structured with these elements in mind: First, before additional payments kick in under the instrument, the commonwealth will need to have created some breathing room to lay the foundation for enduring economic expansion.

Therefore, the instrument should require that no payments should be made until a defined period of time has passed and growth at some minimum agreed level has been achieved. Second, additional payment should be triggered off of an increase in central government cash revenues, as opposed to GDP/gross national product-linked measures (which are difficult to measure for Puerto Rico and are more appropriate in the sovereign context) or other measures that may not correlate with economic growth at all. Third, once additional payments kick in, excess revenues should be shared between payments under the growth bonds and retention by the government so that residents of Puerto Rico can continue to benefit from an improved economy. This could include features such as aggregate caps on amounts paid and trailing calculation periods to even out any irregularities in revenues. And fourth, the instrument should include safety valves to deal with unforeseen events, such as natural disasters or reductions in federal assistance, that would enable Puerto Rico to suspend its obligations under the instrument to mitigate the effects such events have on the economy as a whole.

Recommendation No. 3: Puerto Rico must address the needs of local creditors.

It is estimated that at least $7 billion of Puerto Rico's bonded debt is held on-island. These holders include local mutual funds and financial institutions, individual investors, and investment portfolios for the local credit unions (or cooperativas), in which roughly one-third of Puerto Ricans have deposited their savings. Of these estimated $7 billion, it is further estimated that a sizeable portion of such investments were made in bonds issued by some of the weakest credits on the island, which are expected to suffer the most significant haircuts. The effect of these haircuts on Puerto Rico would be doubly disastrous: hundreds of thousands of Puerto Ricans, including the lower-income and the elderly, could see their retirement funds and savings evaporate, and the local economy would be further crippled, in turn retarding the commonwealth's ability to restore economic growth and repay its creditors.

It is therefore imperative that any restructuring proposal incorporates a restructuring solution that addresses the needs of local holders. Such a solution could take many forms, including: a long-dated instrument that maintains the same par value as the old bonds (but with a lower interest rate and little or no amortizations) for those holders who are focused on capital preservation or estate planning; transferable tax credits for lost principal that offset local taxes owed (calculated to not materially erode in any given year government revenues for such year), which could enable local holders to monetize or offset some of the losses they may experience; options to swap discounted debt for "equity" in new public vehicles set up to hold assets that are expected to be privatized; a government-sponsored support mechanism to protect the viability of local credit unions (cooperativas) and help them offset losses from discounted debt that otherwise might harm some of the most vulnerable residents of Puerto Rico; and/or the establishment in Title III of a convenience class of local individual, retail holders to mitigate their losses up to an agreed maximum amount of discounted debt.

While each of these solutions would need to balance the legitimate concerns that off-island creditors will surely have, the importance of preventing a collapse on the island should be obvious. Indeed, when raised during the previous administration's debt negotiations, off-island creditors seemed understanding of this imperative.

Recommendation No. 4: Puerto Rico, and its creditors, must act fast.

Almost as important as the type of instrument that creditors receive, is the recognition by all parties that they need to move quickly. As we approach the extended PROMESA stay deadline, the economic contraction underway in Puerto Rico worsens with each passing day. And, as one recent analysis points out,[6] unlike a sovereign state that undergoes a similar economic contraction, there is a real risk that the loss of economic power in Puerto Rico over the next several years will be a permanent one, as Puerto Rican residents can easily and cheaply relocate to the United States, where they can find greater employment opportunities and rely on a broader safety net of social- and health-related services and benefits. The accelerating pace of outmigration should concern all creditors, as it translates quite clearly into less revenue for Puerto Rico and less potential surplus available for debt service. The longer the restructuring process takes, the greater the impact this will have and the lower creditor recoveries ultimately will be.

For creditors seeking to litigate their way to better recoveries based on the purported strength of their particular debt instruments, the passage of time will also not prove to be beneficial. The plain truth is that there are no clear winners among the various creditor groups. Every debt instrument has its inherent vulnerabilities, and PROMESA creates new ones — for everyone, from GOs, to credits with dedicated pledged revenue streams, to the weakest appropriations-backed bonds. The incorporation into PROMESA of the Bankruptcy Code's cramdown power, and the power of the oversight board to use a fiscal plan as either a shield or sword to influence creditor behavior and affect judicial outcomes, is significant and affects all credits. As the litigation wears on and the oversight board and the courts tire of the inability to find a consensual solution, these vulnerabilities will become more pronounced and more likely to be exploited.

And then there are the risks of uncertainty, and their impact on creditor recoveries, that arise as the process drags on with no end in sight. The dramatic fiscal cliff due to nonrenewal of Affordable Care Act funding, the running down of pension assets to pay benefits, the high percentage of government revenues dependent, directly and indirectly, on U.S. and Puerto Rican tax policies — these are but a few of the many volatile factors at play. And as the commonwealth's finances only get worse, the commonwealth government may be forced to take even more dramatic actions, including liquidating various instrumentalities and/or expropriating pledged revenue streams. No one can be certain of how these factors will unfold or what responses they may engender, but the longer the restructuring process extends, the more likely these types of risks will materialize and potentially dramatically alter and extend the process, to the detriment of all creditors. None of this will serve the people of Puerto Rico nor aid its government in securing further support from Washington, D.C., support that is necessary to put Puerto Rico on firmer ground to eventually repay its restructured debt. And none of this will serve creditors who, after all, will for decades be completely dependent on a functioning island economy in order to recoup their investments. Time, therefore, is not on anyone's side, and all stakeholders would be well-advised to move toward a compromise that aligns interests and preserves what remains of the commonwealth's ability to eventually repay its debts.

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The recommendations included above are by no means exhaustive; there are many other issues that will need to be addressed as part of any global restructuring. And there is no assurance that they can be achieved, as they depend in part on returning to Congress to amend PROMESA to authorize the establishment of a Puerto Rican bonding authority. However, when Congress helped Washington, D.C., overcome its financial difficulties in the 1990s, Congress (and the federal government) acted more than once when it was clear that their initial efforts would be insufficient. In the case of Puerto Rico, it is clear that further congressional and federal assistance will be required, whether to address the looming health care crisis on the island or the loss of Affordable Care Act funding. Further legislative gaps in PROMESA may also arise as the commonwealth and the oversight board move forward with a restructuring plan.[7] In any event, since the establishment of the bonding authority is a positive for both Puerto Rico and its creditors and will not cost U.S taxpayers anything, we would hope that it would not meet much resistance on Capitol Hill.

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DISCLOSURE: Cleary Gottlieb assisted the commonwealth of Puerto Rico and its instrumentalities with their financial challenges prior to the recent change in government.

[1] That is just the debt that is explicitly subject to clawback. GO bondholders are actively seeking to claw back revenues from issuers that did not issue bonds explicitly covered by the clawback mechanism. If successful, billions more (including the $17.2 billion of COFINA bonds) could be embroiled in an intercreditor conflict with the GO holders.

[2] Aside from the GO challenge to COFINA, the validity of several billions of GO and guaranteed bonds is also susceptible to challenge for failure to comply with Puerto Rican law, including constitutional limitations, as discussed in more depth in the second article in this series, "Issues To Expect In A Title III Puerto Rico Restructuring," published in Law360.

[3] For example, the governing bond documents for COFINA specify that the commonwealth government retains the right to “limit or restrict” the character of the pledged sales and use taxes, which could permit a rescission of the tax and leave holders without recourse.

[4] But not in Title VI, as described in the first article in this series, "Why Puerto Rico Will Likely Rely On PROMESA Title III," published in Law360. PROMESA only gives a judge the jurisdiction to resolve ancillary disputes in a Title III proceeding.

[5] Although a single instrument, this could nonetheless have different series to accommodate varying preferences among creditors, such as long-dated par-preservation instruments or capital appreciation-type bonds.

[6] “Getting Puerto Rico’s Fiscal Baseline Right,” by Brad W. Setser, Mar. 10, 2017, http://blogs.cfr.org/setser/2017/03/10/getting-puerto-ricos-fiscal-baseline-right/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+CFR_BradSetserBlog+%28Brad+Setser%3A+Follow+the+Money%29.

[7] One critical issue that is likely to arise is the preservation of tax-exempt status of the old bonds in a restructuring, for which legislative action could provide certainty of such status and avoid the need for several months of costly, painstaking diligence. Similar to the bonding authority, a draft of the necessary amendments was circulated but never included in the final PROMESA legislation. All parties should be advocating for their inclusion in any subsequent amendments to PROMESA.