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Puerto Rico's Bankruptcy Plan Is Almost Done, and It Could Start a Fight

By Mary Williams Walsh

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After three years of negotiations, Puerto Rico's federal overseers are at last finishing up a plan to complete the restructuring of the island's roughly $124 billion in debt. To resolve the biggest government financial collapse in United States history, they have had to untangle the island's thorny finances, negotiate with creditors and figure out how to do it without endangering the livelihoods of retirees who rely solely on their pensions.

That may have been the easy part.

Some of the island's creditors — including the hedge fund Aurelius Capital Management, which held up Argentina's debt settlement for years for a better deal — will almost certainly challenge the plan on the ground that it violates the territory's 1952 Constitution.

At the center of it all are two intertwined issues. The oversight board wants to cut back the amount paid to some of those who hold the territory's debt while also giving an unexpectedly good deal to more than 300,000 workers and retirees, some of whom do not even have Social Security. The good deal for the pension holders means a worse one for the holders of Puerto Rico's debt.

"You can make social and political decisions," said James E. Spiotto, a longtime municipal bankruptcy lawyer who is not involved in Puerto Rico's legal proceedings. "But it's best to have them wrapped up in a settlement that everybody agrees to."

The plan is expected to be presented to Judge Laura Taylor Swain in Federal District Court in San Juan, P.R., in the next few weeks. But the approach the board has taken could invite titanic legal battles and appeals, Mr. Spiotto said.

"You want resolution, not litigation," he said. "I think there's a significant risk to what's being done."

In many ways, Puerto Rico's collapse has been uncharted legal territory. It took an act of Congress in 2016 to create the bankruptcy-like law, known as Promesa, that is being used to deal with the crisis.

That has turned Puerto Rico into something of a test case. Although cities and municipalities — most notably Detroit in 2013 — have declared bankruptcy, states are not eligible to do so. But a number of them are dealing with serious financial problems because of pension costs.

A combination of inadequate funding over the decades, a wave of retiring baby boomers and the lingering effects of the 2008 financial crisis has forced states to reduce benefits, increase funding or both. But a few states — including Illinois, New Jersey, Kentucky, Connecticut and Colorado — are still far behind, and more drastic measures may be tempting if Puerto Rico can provide a road map to recovery.

"If this works — if Promesa works and the restructuring works — it may make bankruptcy for states seem like something that lawmakers should be considering a little more seriously," said David A. Skeel Jr., a University of Pennsylvania law professor who is on the oversight board and has written on the possibility of states using bankruptcy. "But if it doesn't work, it would have the opposite effect."

Whether Puerto Rico is able to blaze new ground in the world of government debt restructuring will not be decided until after the courts resolve any challenges to the novel steps the oversight board has taken: its treatment of retirees and an attempt to have $9 billion of its debt declared unconstitutional.

Promesa contains a legal requirement that Puerto Rico "provide adequate funding for public pension systems" — carefully chosen language that has given the island legal cover to keep paying retirees their pensions, even as it defaulted on bonds that would normally have been paid first.

The board has essentially switched the usual order of priority used in bankruptcy: It put workers and retirees, with their roughly $55 billion in pension obligations, near the front of the line, and pushed back the general-obligation bondholders whose investments financed the island over the years.

Under the current proposals, 61 percent of the retirees would keep receiving their full pensions, said Natalie Jaresko, the oversight board's executive director. Other pensions would be cut on a sliding scale, but even those owed the most would get 91.5 percent of their payments. Current employees would be shifted into individual retirement accounts.

That’s a better deal than is being offered to the general-obligation bondholders, who would get 64 cents on the dollar, at best. And retirees are being offered a far more generous deal than expected, given that the island’s pension system has been stripped bare.

Normally, the money in a pension fund secures the benefits. If an employer goes bankrupt, the participants are still guaranteed benefits based on what has been set aside: A fully funded pension system will pay full benefits, and a partly funded pension system will pay partial benefits.

But there is no money set aside in Puerto Rico. The participants in such a case would normally be considered unsecured creditors — the kind who typically get a fraction of what they’re owed. One group of unsecured creditors, trade vendors to the Puerto Rican government, is being offered just 9 cents on the dollar, on average.

The federal board in charge of Puerto Rico’s finances was a point of contention among residents, but it is proposing an unexpectedly good deal for retirees.
Carlos Giusti/Associated Press

The retirees’ terms rival those achieved by Detroit’s after their city went bankrupt. (Unlike states, cities are eligible for bankruptcy unless prohibited by state law.) Detroit’s retired police officers and firefighters are still receiving 100 percent of their original pensions, with smaller annual cost-of-living increases, while other retirees are getting 95.5 percent.

But Detroit's pension funds were said to be about two-thirds funded, and a threat to sell off treasures owned by the Detroit Institute of Arts raised hundreds of millions of dollars more from philanthropic and governmental bodies that were horrified at the idea of pieces by van Gogh, Matisse and others going to private collectors.

At least one company that stands to lose money under the proposed Puerto Rico deal says it is preparing a challenge.

Assured Guaranty, a bond insurer with exposure to some of Puerto Rico's debt, said it was ready to go to court because the deal threatened to "significantly erode the municipal bond market's confidence" and make it harder for governments to take on big projects.

The proposed deal, the insurer said, is based on "a number of terms that violate Puerto Rico law, its Constitution and Promesa."

Under the island's Constitution, general-obligation bondholders are said to have "first claim" on "all available resources" of the government to ensure the repayment of their roughly $17 billion of bonds.

But they're being offered less than the pension holders, who are being offered more than 90 percent of what they're owed. Some general-obligation bondholders are being offered 64 cents on the dollar, but others are being offered less as part of a hardball negotiating tactic by the oversight board.

The board said this year that it would challenge the validity of several billion dollars' worth of bonds, including general-obligation bonds that were brought to market in 2012 and 2014. It says that those bonds were issued in violation of Puerto Rico's constitutional debt ceiling, and that the people of Puerto Rico should not have to repay them.

As a result, only the general-obligation bonds issued before 2012 would pay the proposed 64 cents on the dollar. Investors who hold the bonds issued in 2012 are being offered 45 cents, and those holding the 2014 vintage are being offered 35 cents.

Many holders of the older bonds are expected to take their 64 cents and be done with it. But holders of the 2012 and 2014 bonds — including Aurelius — are likely to sue.

Aurelius declined to comment on its plans. But it has already sued Puerto Rico, contending that the island must respect its constitutional pledge of using "all available resources" to ensure repayment. That suit has been stayed while the oversight board works on its plan, but any challenge could use the same argument.

Aurelius could also use the legal argument that got results in the Argentine case: that the restructuring plan illegally discriminates against the holders of similar bonds.

Such lawsuits would be an all-or-nothing gamble. If the bondholders won, they would get the same 64 percent repayment rate as the holders of the older bonds. If the board won, the bonds would be voided and the bondholders would get nothing.

That group of bondholders has some company in opposing the deal. Puerto Rican teachers — who would be moved into individual retirement accounts under the deal — voted against it in an early ballot, even though the American Federation of Teachers had urged a yes vote.

Retired teachers will not cast ballots until after the restructuring plan is introduced in court.

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