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INSIGHT

Adjustment of Puerto Rico's Public Debts

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On January 18, 2022, a federal judge confirmed a plan of adjustment to restructure debts of the Commonwealth of Puerto Rico—the island's central government—and certain closely linked public authorities, as well as pension plans for teachers, public employees, and judges. That confirmation resolves various legal disputes, albeit subject to appeals. It also reduces fiscal uncertainty that emerged once the depth of Puerto Rico's fiscal challenges became widely known.

In 2015, then-Governor Alejandro García Padilla declared the island's public debts, totaling about $72 billion, "unpayable." Unfunded pension liabilities were estimated at $55 billion. Puerto Rico's bonds had been issued by 18 different issuers, engendering disputes over payment priorities. García Padilla, citing provisions in Puerto Rico's Constitution, "clawed back" revenues from several public corporations to support the central government's general obligation (GO) bonds, which sharpened contention between those GO bondholders and public corporations' bondholders. Moreover, some GO bonds appeared to have overstepped debt limits in Puerto Rico's Constitution.

Congress barred Puerto Rico's access to the Bankruptcy Code in 1984. The U.S. Supreme Court struck down Puerto Rico's attempt to employ a local bankruptcy law in 2016. On June 30, 2016, Congress addressed Puerto Rico's fiscal crisis by enacting PROMESA (P.L. 114-187), which established a Financial Oversight and Management Board and two ways to restructure debt. In particular, Title III of PROMESA drew on Chapter 9 and other parts of the Bankruptcy Code to set up a debt restructuring process in which the Oversight Board would represent Puerto Rico's government. The Chief Justice selected federal district court judge Laura Taylor Swain to preside over the Title III cases.

In May 2017, the Oversight Board filed Title III petitions for Puerto Rico's central government, the tax-backed funding authority (COFINA), and several public corporations with the court. The petitions stayed various creditor lawsuits. The two major hurricanes that hit Puerto Rico in September 2017 delayed the restructuring process, as did earthquakes starting in December 2019 and the March 2020 onset of the COVID-19 pandemic.

Nonetheless, the island government's former fiscal agent, the Government Development Bank, was wound up in November 2018 under PROMESA's Title VI process. A plan to restructure bonds issued by the sales-and-use tax-backed funding authority, known as COFINA, was confirmed in February 2019, resolving the dispute between COFINA and GO bondholders (congressional clients may request a memorandum with more details). In particular, sales tax revenues were to be split, with new COFINA

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bondholders to receive 53.65% and GO creditors the remainder. The plan, according to the Board, reduced COFINA debt by 32%.

As the COFINA agreement neared completion, the Board turned to resolving the Commonwealth debt and revamping public pension plans. The Board also filed hundreds of "avoidance actions" challenging various creditor claims, while the Title III court accepted thousands of other claims against the Commonwealth.

In May 2019, the Board, a coalition of hedge funds (many of which had played key roles in COFINA negotiations), and certain other creditor groups announced a preliminary agreement. The resignation of Puerto Rico's governor in August 2019 slowed progress toward approval of a disclosure statement detailing terms of the agreement. In early 2020, allegations of insider trading surfaced and the COVID-19 pandemic caused further delays. The Oversight Board and the Title III court declined to investigate those allegations, deferring to law enforcement agencies. In June 2020, the Supreme Court rejected a challenge to Oversight Board members' appointments, which also had complicated negotiations.

In February 2020, the Oversight Board announced a revised agreement, which raised recovery rates for some senior claims and reduced rates for some junior claims, followed by a draft disclosure statement. Several revised agreement and plan proposals followed, as the Board reached accords with insurers of highway bonds, the unsecured creditors committee, and insurers of rum-revenue-backed bonds. A revised disclosure statement, discussed in July 2021 hearings, was approved in August 2021, clearing the way for October creditor votes and November 2021 hearings on confirmation of a plan of adjustment.

On January 18, 2022, Judge Swain confirmed the plan, clearing the way for an exchange of new bonds for old. The confirmed plan, if it stands on appeal, would preempt dozens of Puerto Rico laws and Article VI of the Puerto Rico Constitution, dismiss litigation related to clawback claims and pension bonds, and restructure public pension systems. Older public employees were transferred from a defined benefit system to a defined contribution system, while younger workers were slated to join the U.S. Social Security system. Puerto Rico policymakers had opposed reducing pension benefits, while the Oversight Board noted that existing pension funds lacked assets to pay those benefits. The plan preserves pension benefit levels to retirees receiving $1,500 per month or less.

Creditors, the Board claimed, would recover on average 69% of their claims, although for some creditor classes the reductions in bond values were as low as 10%. In February 2022, Governor Pedro Pierluisi Urrutia testified that the plan will reduce the central government's debt from $34 billion to $7.4 billion, a 78% reduction. Many creditor classes received cash payouts, long-term bonds with balloon-payment features (capital appreciation bonds; CABs), consummation cash payments used to help reach various agreements, and contingent valuation instruments (CVIs) tied to the island's economic growth, which raise recovery rates. A third-party estimate put recovery rates at 95% for older GO bonds and at 83% for 2014 GO bonds, which some suggested had overstepped constitutional limits when issued.

PROMESA ties the dissolution of the Oversight Board to Puerto Rico's government regaining access to credit markets at "reasonable rates of interest" and four consecutive years of balanced budgets. The Commonwealth's debt restructuring marks a step toward credit market access, although Title III cases for the Puerto Rico Electric Power Authority and the Highway and Transportation Authority remain open.

Congressional concerns about conflicts of interest in Puerto Rico's debt restructuring led to enactment of the Puerto Rico Recovery Accuracy in Disclosures Act in January 2022. In particular, the Oversight Board's strategic advisor, McKinsey & Co., had invested in Puerto Rican public debt. A Board-sponsored report released in February 2019 concluded that McKinsey had complied with legal and contractual requirements, but that its subsidiaries' investments could create the appearance of a conflict. The next day, McKinsey paid $15 million to settle claims that it failed to disclose conflicts of interest in 14 other federal bankruptcy cases across the country.

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