OPINION

RICARDO ARDUENGO — AP

A bill reflecting a deal between the Obama administration and Speaker Paul Ryan would restructure Puerto Rico's $70 billion in debt.

An opportunity for Puerto Rico

Bill offers orderly way to restructure debts

BY MARK A. CYMROT AND SIMON JOHNSON

After failing to make a scheduled bond payment on May 2, Puerto Rico is rapidly heading toward a broader default. On July 1, a $2 billion bond payment comes due, and the island will not be able to pay.

Last Wednesday, congressional leaders unveiled a new bill, crafted with help from the Obama administration, that would create an orderly process for restructuring the territory's debts and measures to ensure financial discipline going forward — including the creation of a control board to oversee its public finances.

As the crisis has deepened, a group of Puerto Rico's creditors, made up mainly of hedge fund managers who bought Puerto Rico's debt at deep discounts, has been spending millions of dollars to thwart this initiative, including running TV ads that falsely claim this approach is a "bailout."

This plays into the way the Puerto Rican debt crisis has been framed all along: as a battle between creditors and the government, with the creditors calling for "fairness" and making sure the island meets as much of its bond obligations as possible.

But if you're really worried about creditors, there's a good reason to pass the bill currently before Congress. If opponents succeed in killing the bill — or even just delaying it for a couple of months — it's not only the 3.5 million U.S. citizens living in Puerto Rico who will be hurt. The ensuing void and uncertainty would also mean that most of Puerto Rico's creditors will suffer as well.

If the status quo prevails — meaning no new legislation passes and the territory defaults on all existing bonded debt — it will set off a race for the courthouse among creditors. "If we don't get a bill passed, then lawsuits are going to be coming fast and furiously," Rep. Rob Bishop (R-Utah), co-sponsor of the new bill, recently said.

The creditors fighting a legislative solution have deep pockets and a particular legal strategy. Many of them bought troubled debt with exactly this endgame in mind. They are following a model that had success against Argentina, which in 2001 defaulted on about $70 billion in government debts. Many creditors subsequently accepted government offers to buy back the debt for less than face value. But a number of hedge funds refused to take any offer and held out for much more — while using the U.S. courts to block Argentina's ability to access international capital markets. An agreement was finally reached only earlier this year — 15 years later — allowing the holdouts to earn billions on their investments.

Applying the same strategy to Puerto Rico would impose a high cost on the population and hurt most bondholders. And holdouts will also face serious obstacles in U.S. courts. No one may benefit from the stalemate.

As it's structured now, the relevant bond clauses provide for lawsuits to be filed in Puerto Rican courts, with the sole exception of Puerto Rico's 2014 issue of general obligation bonds that provides for New York jurisdiction. However, when multiple lawsuits are filed on the same general subject, the federal courts can consolidate the cases before one judge — presumably, but not necessarily, in Puerto Rico. The sole judge becomes the czar over Puerto Rico's finances.

Most of Puerto Rico's bonds are tied to specific income streams. The bonds do not give creditors authority to seize La Fortaleza (the governor's office) or other government property. The judge will decide what parts of those income streams are available to creditors. Public health and safety, along with the delivery of essential municipal services, will likely take first priority. And, in a deep recession, the judge may choose not to insist upon increased taxes or other fees (electrical, water, etc.) to pay the creditors.

Internecine war between classes of bondholders is also inevitable. The bonds contain different and conflicting remedies that will spark numerous, time-consuming and expensive legal proceedings. While these lawsuits meander through the courts, Puerto Rico will remain mired in a deep recession, many of its best and brightest will continue to leave for mainland employment, and the judicial logjam will make it hard to address any of the island's fundamental economic problems.

Holdout creditors are relying on provisions in the Puerto Rican constitution that provide public debt "shall first be paid" and authorizing courts "to apply the available revenues" to pay that debt. Those provisions are decidedly ambiguous, and history is not on the side of the holdouts.

If opponents succeed in killing the bill — or even just delaying it for a couple of months — it's not only the 3.5 million U.S. citizens living in Puerto Rico who will be hurt. The ensuing void and uncertainty would also mean that most of Puerto Rico's creditors will suffer as well.

In the case of New York's financial crisis in the 1970s, the state's highest court found unconstitutional a law that delayed bondholder payments but also postponed any remedy until the legislature had time to act. In the more recent case of Detroit's bankruptcy, the judge altered the priority of payments so as to impose lower losses on pensioners than on bondholders.

Looking at the experience of Peru (from 1980-90) or Argentina (from 2001-16), U.S. judges stayed lawsuits that would have interfered with the country's economic recovery, and also denied creditors' requests for pre-judgment or post-judgment attachment of assets that would have hindered negotiations with the vast majority of creditors.

The newly proposed legislation would establish a more orderly process. Public finance in Puerto Rico would remain in the hands of elected officials but now subject to strict scrutiny by an independent oversight board — with its members appointed by the president of the United States, acting on suggestions from the House and Senate leadership. The debt restructuring process will also be overseen by this board, in the important sense of making sure that payments are now put on a sustainable basis. Any debt renegotiation should be voluntary, but a judge can supervise the details of the process subject to sensible constraints — in this sense at least roughly in line with procedures used in municipal bankruptcy. Similar oversight boards proved effective in the financial recovery — and return to growth — of both the District of Columbia and New York City.

Puerto Rico's residents and most bondholders really need the same simple thing: economic growth. That will come quickest if a version of the proposed bill becomes law. But if a small group of creditors succeeds in blocking its passage, the negative consequences for Puerto Rico — and most bondholders — will be felt for years to come.

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