Representatives of the institutional creditors holding Puerto Rico general obligation bonds and COFINA revenue bonds have reached a tentative agreement in principle regarding which group has a priority interest in the sales tax revenue generated on the island. After years of contesting their respective rights to the cash generated by a 5.5% sales and use tax, the two creditors appear to have concluded that they are better off agreeing to split the available revenue and avoid the possibility of an adverse court decision favoring one group over the other.

Pursuant to the terms of the agreement, which were made public earlier today, Puerto Rico’s Sales Tax Revenue Corporation (aka COFINA) and the Commonwealth government each would be entitled to a share of the pledged sales tax revenue. COFINA would receive 53.65% of the scheduled revenue, beginning in July 2018, and 100% of the cash now held in trust and awaiting a court order on its disposition. However, COFINA’s share would be limited to USD 783.2 million for fiscal year 2019, called the pledged sales tax base amount (PSTBA). The PSTBA would escalate by 4% each year thereafter, capping out at USD 1.85 billion in fiscal year 2041. The Commonwealth, meanwhile, would receive 46.35% of the annual sales tax revenue but would also receive any residual amount over and above the PSTBA dedicated to COFINA. The Commonwealth would retain its interest in revenue derived by sales and use taxes over and above the 5.5% rate.

Bloomberg reports that US District Court Judge Laura Taylor Swain called news of the inter-creditor agreement "enormously significant." COFINA sales tax revenue bonds have rallied on the news, with the price of senior sales tax revenue bonds due in 2036 rising from 70 cents to roughly 83 cents in the past three trading days. COFINA subordinate bond prices also have improved, with selected maturities rising to roughly 40 cents. Meanwhile, prices on general obligation bonds have not exhibited much change. The market is interpreting the agreement as particularly advantageous to COFINA senior bondholders.

We are obliged to remind investors that the inter-creditor agreement is just one step towards a final resolution. The Commonwealth government, as the debtor, and the PROMESA Oversight Board will each have their own perspective as to whether the terms set forth in the inter-creditor agreement are acceptable. The Article III litigation now underway also includes numerous other creditors, whose claims will need to be considered by Judge Swain. In short, the recent news is a positive development, particularly for holders of senior lien sales tax revenue bonds. But we still have a long way to go to reach a final resolution.