Municipal Brief

Puerto Rico Credit and Market Update
19 July 2019

Chief Investment Office GWM
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- The Financial Oversight Management Board ("FOMB" or the "Oversight Board") disclosed details of the Puerto Rico Electric Power Authority (PREPA) Restructuring Support Agreement (RSA). In exchange for existing debt, participating bondholders are expected to receive 67.5% of par in Tranche A bonds and 10% of par in Tranche B bonds. The terms of the RSA are subject to further judicial review and approval.
- A proposed restructuring for general obligation and Public Building Authority (PBA) debt was announced. Thus far, only a small fraction of bondholders have signed on to the plan. Although the terms of the Restructuring Support Agreement remain relatively fluid, recovery rates are expected to vary based upon the original sale date.
- The US District Court ruled that Employee Retirement System (ERS) revenues were not "special revenues" as defined in the US Bankruptcy Code. While bondholders may have a perfected security interest, Judge Swain ruled that the Section 552 of the Bankruptcy Code prevents any security interest resulting from liens granted to creditors prior to the commencement of bankruptcy from attaching to revenues received by the ERS after the bankruptcy petition was filed.
- The Financial Oversight Management Board ("FOMB" or the "Oversight Board") remains embroiled in numerous lawsuits. The US Court of Appeals for the First Circuit ruled that members of the Oversight Board were appointed in a manner that contravened the provisions of the US constitution but allowed past actions of the Board to stand. The US Supreme Court has agreed to decide whether the Oversight Board’s prior decisions and actions were valid.
- We are obliged to remind readers that the litigation now underway in federal courtrooms remains fluid. Some plaintiffs are challenging the constitutionality of actions already taken by the Oversight Board. Others are contesting the terms of proposed restructuring support agreements. Creditors have coalesced into warring factions that seek a relative advantage in court. As we have said on more than one occasion, traditional financial analysis has diminished in importance. Bondholder recoveries will depend upon the strength of arguments made in federal court – some of them quite novel - and are subject to judicial discretion.

Two members of Governor Ricardo Rosselló’s cabinet were dismissed in the wake of the release of incendiary and derogatory text messages. The governor has rejected calls for his own resignation. Meanwhile, the Federal Bureau of Investigation arrested two former public officials on charges of corruption.

As we go to press, call for Governor Rosselló’s resignation have become more widespread.
A potential restructuring emerges for the GO and PBA obligations

In prior Credit and Market Updates, we have described efforts by the Oversight Board to invalidate certain series of general obligation (GO) and PBA bonds. [1] Those efforts, now underway in federal court, are being undertaken at the same time as the FOMB is promulgating a proposal to reach a negotiated settlement with GO and PBA creditors.

On 16 June 2019, the Financial Oversight Management Board announced they had reached a Plan Support Agreement (PSA) with 10% of the GO and PBA bondholders. Under the terms of the Plan Support Agreement, these creditors will be bifurcated into different creditor “classes” with each proposed class receiving different levels of recovery. The classes are determined by the “vintage” of a particular bond, the pledged security for each bond, and whether a creditor chooses to accept the terms of the proposed agreement by a particular date.

There are eight different proposed recovery points. Vintage bonds are defined as those securities that were sold before 2012. We are not aware of prior instances in the municipal market where parity obligations are accorded such disparate treatment. The FOMB appears to be using the uncertainty created by the litigation as leverage with the intent of obtaining greater concessions from non-vintage bondholders.

The proposed recoveries range from a base case high of 72.6% for some PBA bonds to a low of 23.4% for holders of Series 2012 PBA bonds that choose to continue to litigate. Under the base case, vintage GO bondholders would recover 64.3% of par. The holders of Series 2012 and 2014 bonds would receive 45% and 35%, respectively, provided they agree to join the PSA and cease further litigation. If they choose to continue to litigate and triumph, they would be expected to receive 68.2% of par, according to the PSA. Under the terms of the PSA, bondholders run the risk of forfeiting any recovery if they choose to continue to litigate and lose.

Trading in the bonds has reacted modestly positive to the announcement (see Fig. 1 and Fig. 2). Bonds are trading up slightly since the PSA was announced. This suggests that the market believes the PSA is an opening salvo and that recovery rates will have to improve in order to garner significant bondholder support. The effective date of the plan is 29 February 2020 but this is also subject to revision. Thus far, none of the bond insurers have signed onto the PSA and Assured Guaranty (AGM) has announced its opposition. The Governor of Puerto Rico also objects to the plan, albeit for different reasons.
PREPA seeks court approval
As we discussed in our last quarterly update, PREPA announced that it had reached an agreement with a majority of bondholders to restructure its outstanding debt. Since then, US Bank (as trustee) announced that 72% of bondholders have joined the PREPA RSA. On 10 May, the government filed a motion seeking court approval of the RSA. The motion is scheduled to be heard by the US District Court on 11 September 2019. The Official Committee of Unsecured Creditors and PREPA’s primary union are expected to object to the motion, and are likely to assert that the RSA treats secured creditors too favorably at the expense of unsecured creditors like themselves.

Under the terms of the RSA, bondholders will receive 67.5% (Tranche A bonds) and 10% (Tranche B bonds). The new securitized bonds will be secured by a capped “Transition Charge” that will be charged to customers on a per kilowatt basis. The charge will flow to the Trustee for deposit into the securitization vehicle. The exchange ratio is based on principal amount outstanding plus accrued and unpaid interest through 1 May 2019.

The Tranche A bonds are expected to be current interest bonds, 5.25% tax-exempt coupon with a 40 year maturity. If revenues are insufficient to pay the Tranche A bonds, the Transition Charge will continue until all Tranche A bonds are paid. The Tranche B bonds are accreting interest bearing bonds, with either a 7.0% tax-exempt coupon or 8.75% coupon if taxable with a 47 year final maturity. The Tranche B bonds will only be paid after all Tranche A bonds are paid in full. The Tranche B bonds final maturity will not be extended in the event there is insufficient remaining revenue to pay all debt service, and the lien will be extinguished on final maturity.

On 1 July, the FOMB commenced an adversary proceeding against the Trustee challenging the lien on the PREPA bonds similar to the motion filed against HTA. The Oversight Board appears to have done so to preserve their right to challenge the creditors’ lien on pledged revenue, but immediately filed a motion to stay the prosecution of the lien challenge. If the RSA fails to be consummated, the FOMB can request a removal of the stay and litigate the validity of the lien.
Another adverse court ruling for ERS bonds

As we discussed in our most recent Credit and Market Update (2 May 2019), the Employee Retirement System (*ERS*) has adopted a combative posture with regard to the payment of debt service on its own bonds. For example, the ERS bondholders argued that they held a valid security interest in employer contributions to the retirement system, and thereby enjoyed a priority lien ahead of pension beneficiaries. The ERS and the Oversight Board disagreed and challenged that assertion in court in July 2017.

In August 2018, the US District Court ruled that the creditors’ claims were unenforceable because they did not possess a perfected security interest in the revenue pledged for repayment of the pension obligation bonds. The bondholders promptly appealed to the US Circuit Court, which overruled the District Court in January 2019. The appellate court vacated the trial court decision and concluded that the ERS creditors did, in fact, satisfy the necessary filing requirements and thereby retained a security interest that could not be avoided under PROMESA. The decision breathed new life into the pension bonds, and the case was remanded to the District Court for further argument.

Following remand, the litigants argued over whether another provision of the US Bankruptcy Code prevented creditors from exercising their otherwise valid security interest following a bankruptcy petition. In other words, while the appellate court concluded that the creditors had filed the necessary paperwork to retain a security interest in pledged revenue, the District Court was now asked to decide whether possession of that security interest was a moot point.

The ERS creditors asserted that they held valid and enforceable first priority liens on pledged revenue, regardless of whether the revenue was collected before or after the commencement of the Title III case. The creditors also asserted that employer contributions to the retirement system were properly classified as ‘special revenues’, again entitling them to receive future employer contributions to the retirement system. The ERS and the Oversight Board disagreed, instead claiming that the US Bankruptcy Code prevents any security from attaching to ERS revenues after a petition has been filed. They also contend that ERS’ function to collect contributions and to disburse benefits is derived from the labor of employees and should not be construed as ‘special revenues’ within the meaning of the Bankruptcy Code.

The US District Court sided with the Oversight Board, concluding that employer contributions acquired after the bankruptcy petition was filed are protected from attachment by creditors. Judge Swain granted summary judgment in favor of ERS. The ERS creditors have already filed a Notice of Appeal and will ask the US Circuit Court of Appeals for the First Circuit to reverse the ruling.

**Fig. 4: ERS price trend, 6.15% due 1 July 2038**

Source: Bloomberg, UBS, as of 16 July 2019
While we await the outcome of that appeal, the District Court’s decision represents a serious setback for Puerto Rico pension bondholders, who were already fighting attempts by the Unsecured Creditors Committee (UCC) to invalidate the securities in their entirety. The UCC, in conjunction with the Commonwealth and the Employee Retirement System (ERS), asserted in March that the ERS pension obligation bonds were issued illegally.

The District Court decision also introduces a degree of uncertainty regarding the relative strength of revenue bond pledges throughout the US municipal bond market. While the District Court took pains to distinguish the ERS bonds from more traditional securities within the utility and transportation sector, the litigation surrounding bondholder positions in Puerto Rico continues to play havoc with heretofore entrenched notions of bondholder security.

Constitutionality of FOMB actions headed to the US Supreme Court

The US Supreme Court has agreed to hear an appeal challenging a decision by the US Court of Appeals for the First Circuit.[2] The First Circuit upheld the FOMB’s prior actions, despite finding that members of the FOMB were appointed absent a valid confirmation, in contravention of the constitutional requirement that principal officers of the US government be subjected to US Senate confirmation. The plaintiffs are seeking dismissal of the Commonwealth Title III cases.

A ruling in the plaintiff’s favor would delay the resolution of the remaining Title III debt. The case is scheduled to be heard by the US Supreme Court on 15 October.[3] The high court is expected to rule on the case before it adjourns in June 2020.

In June President Trump sent the names of the Oversight Board members to the Senate for confirmation. The Senate has yet to take action.

Tensions between Governor Rosselló and the Oversight Board persist

The FOMB filed a complaint for declaratory and injunctive relief, asserting the Governor is not acting in accordance with the Puerto Rico Oversight Management and Economic Stability Act (PROMESA) and has “engaged in concerted and intentional efforts to impair and/or defeat the purposes of PROMESA.”[4]

The Oversight Board, under PROMESA, is responsible for the creation of a comprehensive fiscal plan. The Commonwealth government is obliged to follow that plan. The Oversight Board contends that a recently enacted statute, Law 29, “will alter, and substantially eliminate, the obligation of Puerto Rico’s municipalities to reimburse the Commonwealth government for hundreds of millions of dollars in pension cost for their own retirees, and will transfer those cost permanently to the Commonwealth”[5]. The Oversight Board contends that the statute is inconsistent with the fiscal plan approved by the FOMB and therefore null and void.
Court rules HTA can continue to withhold debt service
On 26 March 2019, the US Court of Appeals for the First Circuit affirmed[6] the US District Court ruling that HTA did not have to continue paying debt service during the pendency of their bankruptcy proceedings. They could elect to voluntarily make such payments but were not compelled to do so. The opinion also confirmed that the lien on revenues will continue to secure the debt post-bankruptcy. The ruling provides HTA with additional leverage while negotiating for debt reductions but does not completely eliminate bondholders’ security interest.

On 20 May 2019, the FOMB filed a complaint that would undermine the bondholders’ limited negotiating leverage. [7] The complaint contends that the HTA bond resolution granted security interest only in revenues that have been both received by HTA and deposited into certain accounts held by the Fiscal Agent. In effect, the FOMB argues that bondholders only have a right to the pledged revenue if cash is deposited into accounts managed by the Fiscal Agent for the benefit of bondholders. To the extent that revenue is diverted for other purposes beforehand, the creditors have no effective lien. If the US District Court rules in favor of the Oversight Board, HTA bondholders will have lost some of the limited negotiating leverage they retained after the Circuit Court ruling in March.

Criminal investigations unveiled
On 24 June then-Treasury Secretary Raul Maldonado gave a radio interview and disclosed that the FBI was conducting investigations into alleged misconduct within his department. In the course of the interview, he made reference to an “institutional mafia.” Governor Rosselló promptly requested his resignation. The Inspector General is reportedly investigating the matter.

On 30 June, the FOMB filed a lawsuit accusing PREPA fuel suppliers of supplying Non-Compliant Fuel Oil but still receiving payment for higher quality Compliant Fuel Oil, causing PREPA to overpay hundreds of millions of dollars. They also accuse the laboratories, used to test the oil, of being complicit in the scheme. According to news reports, executives at PREPA received kickbacks from the oil suppliers.

On 7 July, the FBI announced the arrest of the territory’s former Secretary of Education and its former Head of the Health Insurance Administration. The individuals are accused of money laundering, fraud and related charges. These arrests follow the arrest in May of the director of the Senate Office of Government Affairs and two contractors for fraudulent billing. Representative Raul Grijalva, chairman of the US House Natural Resources Committee, has called for Governor Rosselló’s resignation.

Market observations
The GO series 2009, 2011, and 2012 are all trading up over the last three months with the 2009 and 2011’s appreciating the most. By contrast, the 2014 bonds are trading down by a modest amount (Fig. 1). Like the GO bonds, the PBA bonds have traded up on the disclosure of a PSA (Fig 2).
Over the last quarter PREPA bonds rallied on news that Assured Guaranty had signed onto the RSA (Fig. 3). The bonds were priced as high as USD 82 but traded back down to around USD 73 more recently.

ERS bonds, on the other hand, are trading lower since the District Court handed down its ruling that ERS bonds are not Special Revenue bonds (Fig. 4). HTA debt has traded within a relatively narrow range over the last quarter but is up by almost 60% since the start of the year (Fig. 7). As we have mentioned before outcomes are based on high level negotiations and court rulings not credit analysis and nothing reflects that reality more than the various trading levels of the GO and ERS securities.

Conclusions:

• The GO and PBA Plan Support Agreement is subject to further revision and may be revised in an effort to obtain more support from creditors. Proposed recovery rates are relatively low and the market appears to be discounting the likelihood of success based on recent trading activity. We believe there is a reasonable chance that a final deal will provide for variable recovery rates, depending upon when the original bonds, now in default, were floated. Creditors who bought bonds at deeply distressed levels may be motivated to accept a lower return and reduce their exposure.

• We expect the US District Court to approve the PREPA Restructuring Support Agreement. While many hurdles remain before a debt exchange can be consummated, there appears to be enough support from creditors to overcome the anticipated objections from unionized employees.

• ERS bondholders’ security was dealt a serious blow by the US District Court when it concluded that the Bankruptcy Code prevented any security interest from attaching to future ERS revenues during a post-petition period. The Court also rejected the argument that pension obligation bonds were “special revenue bonds” as defined by the US Bankruptcy Code. ERS bondholders have already filed the requisite legal notice with the District Court evidencing an intent to appeal, suggesting that a final resolution is months away.

• There has been a cloud of uncertainty over the restructuring process from the moment that PROMESA was enacted. The lack of audited financials has been a persistent problem, undermining faith in the ability of the Commonwealth to manage its fiscal affairs prudently. Recent calls for Governor Rosselló’s resignation will only add to the level of investor skepticism and complicate the daunting task of restructuring the Commonwealth’s considerable debt load.

• We are obliged to remind private clients that prices on Puerto Rico bonds are subject to considerable volatility. Values are likely to shift materially over time, and will be disproportionately affected by arguments made by opposing counsel in bankruptcy proceedings. There are few legal precedents upon which a convincing case can be made that a particular defaulted bond is
either undervalued or overvalued. Puerto Rico credits remain highly speculative investments and should be treated as such in investor portfolios.

[1] The FOMB has not challenged the validity of certain 2011 bonds. Under the terms of the PSA the 2011 bonds are treated as vintage bonds. However the Official Committee of Unsecured Creditors has challenged the validity of the 2011 GO bonds (Case No. 17-03283-LTS Do # 7057, filed 21 May 19).

[2] Case Nos. 18-1671, 18-746, 18-1787, filed 15 February 2019
[3] Case No. 18-1334
[5] Case No. 17-03823-LTS, Doc# 7830, filed 3 July 2019
[6] Case Nos. 18-1165, 18-1166, filed 26 March 2019
[7] Case No. 17-03567-LTS, Doc#564, filed 20 May 2019
Fig. 9: EDB EAI Historical graph: Jan 1980 - April 2019

Source: Economic Development Bank of Puerto Rico
Appendix

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<tr>
<td>GO</td>
<td>General Obligation Bond</td>
<td>TEY</td>
<td>Taxable Equivalent Yield (tax free yield divided by 100 minus the marginal tax rate)</td>
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MMD Municipal Market Data

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<th>Rating Agencies</th>
<th>Credit Ratings</th>
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<td>AAA</td>
<td>Aaa AAA Issuers have exceptionally strong credit quality. AAA is the best credit quality.</td>
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<td>Baa1 BBB+ Issuers have adequate credit quality. This is the lowest Investment Grade category.</td>
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<td>Ba1 BB+ Issuers have weak credit quality. This is the highest Speculative Grade category.</td>
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Appendix

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