Warnings sound on restructuring fallout

New York Fed calls for action as analysts see Prepa default getting closer

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Multiple warnings of how turbulent a default could be for Puerto Rico sounded last week, as the Puerto Rico Electric Power Authority (Prepa) barely remained financially afloat and Moody's Investors Service estimated the Puerto Rico government could run out of cash as soon as next March.

With the passage of the Puerto Rico Public Corporation Debt Compliance & Recovery Act in June, and a series of punishing downgrades of commonwealth credit since then, Prepa is just the first of several troubled public corporations expected to attempt to restructure its debt.

The passage of the law has damaged Puerto Rico's credit across the board, as rating agencies say it signals an unwillingness on the part of the Puerto Rico government to comply with its debt burden.

Moreover, most experts say the law by itself will do little to fix Puerto Rico's economic and financial problems.

"While drafted to protect central government liquidity, the public debt-restructuring law will provide little long-term benefit, even if it survives litigation from bondholders, because it doesn't address fundamental financial and economic challenges," Moody's said.

"We believe the benefits to the commonwealth of using the debt-restructuring law will prove somewhat limited, in part because debt defaults under the law will further hamper market access, preventing or limiting transactions to replenish GDB [Government Development Bank] liquidity," Moody's said. "In addition, even if the public corporations are able to shrink debt-service burdens by imposing new terms on creditors, the public corporations may still need more financial assistance to continue operations."

Moody's said that pressure plus a history of recurring revenue shortfalls could see the GDB running out of cash by next spring.

Adding to the uncertainty is that the legality of the law is being challenged in federal court.

Resident Commissioner Pedro Pierluisi also stepped up last week with a proposed amendment that would allow Puerto Rico's public corporations to reorganize under Chapter 9 of the federal bankruptcy code. The measure received positive feedback from both Democrats and Republicans, but there is little chance of it passing anytime soon, according to CARIBBEAN BUSINESS sources.

In a report on Puerto Rico's economy released last week, the New York Federal Reserve Bank of New York urged quick action to fix Puerto Rico's problems, saying a successful reform needs to strengthen public corporation finances and the efficiency of their operations, calling for an overhaul of their governance and corporate structure, and saying "selective privatization" could help shore up government finances and economic performance.

"The island appears to face two alternatives: either manage its own economic adjustment and put the commonwealth on a secure fiscal basis, or wait for outmigration and the discipline of the market to force an even more painful adjustment, particularly for those unable or unwilling to leave the island," the report stated.

"While these adjustments can be difficult, the experience of New York City suggests it is possible to tackle fiscal pressures head on and come out stronger. Puerto Rico clearly has the assets and attributes to do so," the report said.

The biggest warning about the dangers of default, however, came from Argentina, which defaulted last week for the second time in 13 years. In 2011, Argentina defaulted on about $100 billion of debt, offering creditors a deal at about 25% on the dollar. Many refused, including holdouts who successfully sued up to the U.S. Supreme Court to get the full amount owed. That led to the South American country's second default.

James K. Glassman, former U.S. undersecretary of State for Public Diplomacy & Public Affairs and a visiting fellow with the American Enterprise Institute, compared Puerto Rico and Argentina during a congressional hearing last week on "Building Prosperity in Latin America: Investor Confidence in the Rule of Law."

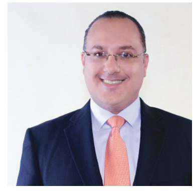
"In many ways, the Puerto Rican situation is developing along Argentine lines, including the high-handed way the government has laid the groundwork for a debt restructuring, the possibility of a long and bloody legal challenge, and the presence of so many U.S. hedge funds in the battle," he said.

These events, along with the decision of Prepa's banks to allow two more weeks of negotiating time, "will only stoke more uncertainty for the island and possibly more selling. All of this plays into the Puerto Rico restructuring team's strategy to beat down bond prices as low as possible so the prices can serve as starting points for restructuring negotiations," said Robert Donahue, managing director at Municipal Market Advisors. "These developments…increase the probability that existing bondholders may be getting a taste of 'criollo' bankruptcy—Puerto Rico-style—sooner rather than later." ■

LEGAL TIDBITS

Mergers & Acquisitions:
A buyer's guide

By Pedro A Barceló Lugo Esq.



There are essentially three kinds of sellers in merger and acquisition (M&A) transactions: (i) the private seller, which usually has a small group of owners (entrepreneurs or family); (ii) the public company seller; and (iii) a big company selling a portion of itself. Regardless of the deal structure i.e., statutory merger, purchase of stock or assets, this classification by target type will have an impact upon a buyer's understanding of the deal process, negotiations, documentation, terms and, ultimately, the outcome of the deal.

Due diligence is perhaps more important and more difficult in the private seller scenario than in other seller types. Given the typical small number of owners and the relationship among them, it is common for private sellers to lack information as well as formalities in their recordkeeping, financials and documentation on key company constituencies. As a result, buyers should be wary as to the reliability of the information provided. Additionally, private sellers' financials are usually not audited, and there are usually numerous related-party transactions. Buyers might also find confusion among shareholders as to what property is considered the company's and what is considered the individual's.

When dealing with private sellers, it is good practice to always inquire about the reason to sell and the timing of the decision. If it was made a while ago, then there may be concerns regarding the reliability of their accounting and financials. These might have been manipulated to make the firm more attractive for purchase. This is why representations and warranties are perhaps some of the most negotiated provisions with private sellers. Their purpose is to formalize the diligence, condition the closing and create a cause of actions, if they survive closing. Indeed, the survival of representations and warranties as a post-closing contractual protection will serve as an "insurance policy" for buyers if confronted with unreliable information.

Moreover, in the private seller scenario, there may be more flexibility to bridge the gap on purchase price issues through negotiations. For instance, as an incentive, buyers could propose an earn-out clause if the company meets or exceeds certain expectations after closing. Alternatively, buyers could also consider seller financing and include offset rights against payment to seller as insurance for potential claims.

Finally, with a private target there is a higher degree of certainty of getting deal approval since the buyer is typically negotiating directly with the owner. On the other hand, dealing with an owner may lead to uncertainty as they are more likely to change their minds as negotiations progress. Consequently, it is in the buyers' best interest to have a formal agreement signed as early as possible.