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SIX BILLION REASONS TO GO AFTER BANKS

The case for legal action against the big banks that created and profited from Puerto Rico's debt crisis

Six Billion Reasons to Go After the Banks

For years, watchdogs have argued that significant portions of Puerto Rico's debt were issued illegally. In a surprising twist, the federally-appointed board overseeing the island's debt restructuring now seems to agree, at least in part.

In January, the Financial Oversight and Management Board and the Unsecured Creditors Committee (UCC) argued in federal court that $6 billion of Puerto Rico's general obligation debt was issued illegally, in violation of Puerto Rico's constitutional debt limit.[1] Three offerings are being challenged: a $415 million issuance in March 2012, a $2.3 billion issuance in April 2012, and a $3.5 billion issuance in March 2014.

But while this is a substantial departure from business as usual for the Wall Street-aligned oversight board, it needs to do more to pursue legal accountability for and claims against the banks and other entities that oversaw the issuances and profited from them.

The oversight board, so far, has not named names or pursued legal claims, but it has a special responsibility to do so and time is of the essence: the deadline for filing avoidance actions is May 9, 2019. The oversight board has special powers to bring such claims against parties, such as banks, that were the beneficiaries of fraudulent transfers prior to the bankruptcy filing.[2]

1 https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=OTAyMTY2&id2=0

2 For background on avoidance actions in the case of Puerto Rico's debt restructuring: https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=OTAwMDM4&id2=0 and https://caribbeanbusiness.com/unsecured-puerto-rico-creditors-seek-discovery-on-avoidance-actions/

Players Including:

In addition to offering context on the various debt issuances in question, this report names the names of those involved in creating and profiting from the allegedly illegal debt, including underwriters, revolving door bankers, and law firms. Key findings include:

- **The underwriters on the deals included a who's who of big banks, including Barclays, Popular, UBS, Santander, and Morgan Stanley. Fees paid out of the offerings totaled $294 million.** As underwriters, the banks helped create and market the bonds and advised the government on their issuance, earning hefty fees in the process. In other words, some of the wealthiest corporations in the world profited heavily on the issuance of Puerto Rico's allegedly illegal debt.
- **The proceeds of several of the bond issuances were used to pay termination fees on toxic swaps – to some of the very same banks that were underwriting the bonds.** Morgan Stanley, UBS, and Bank of America all managed to double-dip on these deals, winning underwriting fees and swap termination fees as a result of these questionable arrangements. Barclays was also a double beneficiary, acting as underwriter on a deal that was used to repay $342 million in short-term notes where Barclays had been the sole original purchaser.
- **Popular actually advised the GDB not to go through with the 2014 bond deal – and then acted as an underwriter, anyway, pocketing the fees.** On the other hand Citi, which joined in Popular in advising the GDB not to go through with the deal, did not act as an underwriter.
- **Revolving door relationships at the banks raise questions of self-dealing and conflicts of interest.** This report does not undertake a full mapping of these relationships, though it does point to a pattern of revolving door relationships at Santander, which was an underwriter on all three bond deals (two former Santander executives sit on the oversight board).[3] There were also revolving door relationships coinciding with these specific bond deals that deserve investigation and consideration. For instance, Néstor De Jesús was a municipal banking executive at Barclays when the bank was involved in the 2014 issuance, and joined the board of the Government Development Bank shortly thereafter.
- **The same law firm, Greenberg Traurig, was bond counsel for all three bond issuances in question.** Bond counsels are contracted by the issuer to sign off on the validity of the debt.

3 *For more on this, see: http://hedgeclippers.org/pirates-of-the-caribbean-how-santanders-revolving-door-with-puerto-ricos-development-bank-exacerbated-a-fiscal-catastrophe-for-the-puerto-rican-people/*

The firm continues to do significant debt-related business in Puerto Rico – it recently renewed a contract with PREPA, the public power authority, to continue providing legal advice and assistance concerning the authority's debt restructuring. O'Neill & Borges, a law firm based in Puerto Rico, acted as counsel to the underwriters in all three offerings.

The issues raised by this report are particularly important to consider in the context of the upcoming **May 9th deadline** for avoidance actions and ongoing negotiations around the restructuring of Commonwealth debt. These negotiations will determine the extent to which money from Puerto Rico's general fund is dedicated to paying off Wall Street vultures, rather than funding education, healthcare, and other services for the Puerto Rican people.

THE CONTEXT:

The Commonwealth Debt Adjustment Plan and the May Deadline for Claims Against Banks

In challenging the validity of $6 billion in general obligation (GO) debt, the oversight board and UCC fired an opening shot in negotiations with vulture funds and other creditors around the restructuring of the Commonwealth's general obligation debt. This includes $13 billion in bonds, more or less 17% of the total debt. This restructuring follows the restructuring of COFINA debt, which was approved in federal court in early February.

What will be fought over and determined in the courts is how much money will be left in the coming years for Puerto Rico versus how much is going to Wall Street. The more money that is used to pay the debt, the less there will be for essential services for the population. In this case, however, the connection between the restructuring and the budget for social services will be closer than the recent COFINA deal, since the Commonwealth's General Fund – out of which funding allocations for education, health, and housing are made – is on the negotiating table.

The oversight board's move to challenge the $6 billion in GO debt is a sign that it could take a more adversarial approach to bondholders than it did during negotiations around COFINA debt. The heart of their legal argument is that the constitutional debt limit was passed as a result of the issuances, starting with the March 2012 issuance, and so it should be declared null and void. Key to this argument is that the debt of the Public Buildings Authority (PBA) – backed by building rents that are guaranteed – is effectively backed by the full faith and credit of the Commonwealth and should have been counted towards the limit.

The vulture funds that own the debt are sure to argue aggressively against such a declaration in their drive to extract profit from Puerto Rico.

There are two separate groups of vulture funds that will play a major role in legal negotiations: the General Obligation Group, or GO Group, and the Constitutional Group. According to court filings, three members of these groups, Autonomy Capital, Mason Capital, and Aurelius Capital, currently hold the debt that the oversight board is seeking to declare null and void. Two other key players in the current negotiations, Brigade Capital and Oppenheimer, also hold these bonds.

The following table sets forth their overall holdings (the amounts of challenged debt they hold have not been disclosed):[4, 5, 6]

Owners of Challenged GO Debt

FUNDS[5]	INVESTMENTS AS OF:	AMOUNT OF COMMONWEALTH DEBT*	GROUP
Autonomy Capital	October 19, 2018	$1,028,703,000	GO Group
Aurelius Capital	October 19, 2018	$417,107,028	GO Group
Brigade Capital	May 25, 2018	$112,930,000	N/A
Mason Capital	January 29, 2019	$468,056,000	Constitutional Group
Oppenheimer Funds	November 29, 2018	$910,948,072 ($75 million in challenged GO bonds)[6]	Mutual and PREPA Groups

** This shows the total amount of debt they hold – except for Oppenheimer, specific figures for the challenged debt that they hold are not available, other than the fact that they hold it.*

Importantly, the deadline to file claims against the private institutions that engaged in financial malpractice, fraud or negligence related to the debt is May 9, 2019. As trustee, the oversight board has a special responsibility to do so, and has so far dragged its feet.

Previously the oversight board hired a disputes and investigations firm, Kobre & Kim, to undertake an investigation of the debt, which concluded with a final report issued in August 2018. The report included a whole chapter about possible legal claims, and the oversight board subsequently formed a Special Claims Committee to follow up on these possible claims, and that committee hired a law firm to pursue these possible claims.[7]

As the May 9th deadline approaches, public pressure must be built on the oversight board to push for more claims against banks that could be held liable and forced to pay back Puerto Rico, thus freeing needed financial resources for essential services.

4 https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=OTAyMTY2&id2=0

5 Aurelius and Autonomy: https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=ODk3NzA0&id2=0 ; Brigade: https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=NzQ0MzY5&id2=MTI2NjQwMg== ; Mason: https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=OTAyODM3&id2=0 ; Oppenheimer: https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=OTAwMTIz&id2=0

6 See page 3, footnote 2: https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=OTAyNjM2&id2=0

7 https://drive.google.com/file/d/19-lauVo3w9MPS03xYVe0SWhQin-Q6FEf/view

Three Bond Issuances Under Attack

The oversight board and UCC are challenging three separate debt issuances, arguing that they exceeded the constitutional debt limit and should be declared null and void:

- A $415 million GO issuance in March 2012
- A $2.3 billion GO issuance in April 2012
- A $3.5 billion GO issuance in March 2014

The two 2012 GO bond issuances were some of the last ones authorized by the administration of Luis Fortuño, notable because Fortuño presided over a $16.5 billion debt increase, the biggest of any governor (his administration issued almost $35 billion in bonds).[8]

The 2014 issuance was especially controversial at the time, in part because major credit rating agencies had downgraded the Commonwealth's debt to junk status.[9] Even so, the government went forward with what would be the largest sale of junk-rated bonds in the history of the US municipal debt market.[10]

The 2014 bonds were intensely questioned in the first pre-audit report by the Commission for the Comprehensive Audit of Puerto Rico's Public Credit, which was created by an act of the legislature in 2015 and disbanded by Governor Rosselló's administration in 2017.[11] The report raised concerns about possible violations to Puerto Rico's constitution, as well as dubious accounting and disclosure practices by the underwriters.

Details of each issuance, including the banks and law firms that benefited from the transactions, are shown below:

March 2012 $415 million GO issuance

- **Principal amount issued:** $415,270,000[12]
- **Underwriting fees:** $3,526,954
- **Lead underwriter:** UBS
- **Other underwriters:** Bank of America Merrill Lynch, Popular, Santander, Barclays, BBVAPR MSD, Citigroup, Firstbank PR Securities, Oriental Financial Services, Ramirez & Co, Inc, Raymond James, Scotia MSD
- **Bond counsel:** Greenberg Traurig
- **Underwriters' counsel and special Puerto Rico tax counsel:** O'Neill & Borges
- **Use of proceeds:** The proceeds of the bonds were mainly used to repay a GDB line of credit and to refund outstanding general obligation bonds.

8 *http://especiales.elnuevodia.com/datos/deuda-puerto-rico/ ; the sum of all debt issuances between 2009 and 2012 is over $35 billion.*

9 *https://www.moodys.com/research/Moodys-downgrades-Puerto-Rico-GO-and-related-bonds-to-Ba2--PR_292399*

10 *https://www.ft.com/content/123f38b4-a86b-11e3-8ce1-00144feab7de*

11 *http://big.assets.huffingtonpost.com/Puerto_Rico_Commission_Interim_Report.pdf*

12 *Details of the issuance as shown here are found in the offering statement, on the cover and in sections on underwriting fees and sources and uses of funds: http://www.gdb.pr.gov/investors_resources/documents/PRCommonwealth02a-FIN.pdf*

April 2012 $2.3 billion GO issuance

- **Principal amount issued:** $2,318,190,000[13]
- **Underwriting and swap termination fees:** $163,097,466
- **Lead underwriters:** Barclays and JPMorgan Chase
- **Other underwriters:** Goldman Sachs, Jefferies, BMO Capital Markets, Bank of America Merrill Lynch, Citigroup, Morgan Stanley, Ramirez & Co, Raymond James, RBC Capital Markets, UBS, Wells Fargo, BBVAPR MSD, FirstBank PR Securities, Oriental Financial Services, Santander, Popular, Scotia MSD, VAB Financial
- **Bond counsel:** Greenberg Traurig
- **Underwriters' counsel:** O'Neill & Borges
- **Use of proceeds:** Proceeds from the bonds were used to repay GDB lines of credit, refund outstanding general obligation bonds, pay interest on the bonds in advance through 2015, and pay exit penalties on interest rate swap agreements.

Notably, the swap termination fees funded by the bonds were paid to three of the banks underwriting the offering – **Morgan Stanley**, **UBS**, and **RBC Capital Markets**. In other words, the banks were paid to underwrite bonds that were partially used to pay off those banks for swap agreements.

Banks sold the swaps to Puerto Rico as a form of protection from interest rate fluctuations, but they turned toxic and expensive due to low interest rates in the wake of the 2008 financial crash. Puerto Rico paid these significant termination fees in order to exit the agreements.[14]

March 2014 $3.5 billion GO issuance

- **Principal amount issued:** $3,500,000,000[15]
- **Underwriting fees:** $36,821,531
- **Swap termination fees:** $90,417,100
- **Repayment of COFINA BANs:** $342,365,760
- **Lead underwriters:** Barclays, Morgan Stanley, RBC Capital Markets
- **Other underwriters:** Bank of America Merrill Lynch, Goldman Sachs, JPMorgan Chase, Ramirez & Co, Firstbank PR Securities, Jefferies, Mesirow Financial, Oriental Financial Services, Popular, Santander, UBS
- **Bond counsel:** Greenberg Traurig
- **Disclosure counsel:** Pietrantoni Méndez & Alvarez LLC
- **Underwriters' counsel:** O'Neill & Borges and Sidley Austin
- **Use of proceeds:** To repay GDB lines of credit, refinance refunded bonds, refund COFINA Bond Anticipation Notes (BANs), pay exit penalties on swap agreements, and pay interest on the bonds in advance ($422 million of the proceeds were used for this purpose).

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13 Details of the issuance as shown here are found in the offering statement, on the cover and in sections on underwriting fees and sources and uses of funds: http://www.gdb.pr.gov/investors_resources/documents/PRCommonwealth01a-FIN.pdf

14 For more on Puerto Rico and toxic swaps, see Refund America Project's report on "Puerto Rico's Payday Loans": https://www.scribd.com/doc/317074793/Puerto-Rico-s-Payday-Loans

15 Details of the issuance as shown here are found in the offering statement, on the cover and in sections on underwriting fees and sources and uses of funds: http://www.gdb.pr.gov/investors_resources/documents/CommonwealthPRGO2014SeriesA-FinalOS.PDF

The bonds that were refinanced previously had significantly lower interest rates.[16] Due in part to the extremely high interest rates on the bonds, 275 investment firms jumped in to buy the junk bonds, including many hedge funds, as reported by the Center for Investigative Journalism (CPI, by its Spanish acronym).[17] Notably, the practice of refinancing debt with higher interest bonds was allowed by Fortuño's notorious Public Law 7, which was passed in 2009 and included a number of austerity and anti-labor measures that have carried significant consequences for Puerto Rico.[18]

As with the April 2012 offering, some of the underwriting banks double-dipped on the proceeds of the issuance. Almost $90 million of the proceeds of the 2014 bonds was used to pay swap termination fees. Two of the banks underwriting the offering were also paid these fees: **Morgan Stanley**, which had also been paid termination fees as part of the 2012 issuance, was paid $24 million, and **Bank of America Merrill Lynch** was paid $13.1 million.[19]

Barclays, one of the underwriters of the bonds, had also been the original purchaser of $333 million in COFINA bond anticipation notes (BANs) that were repaid from the proceeds of the offering, and had continued exposure to the BANs as of the offering (including interest, $342 million was repaid).[20] BANs are short-term bonds which are issued in advance of a much larger bond issuance (in this case, the BANs were secured by the proceeds of an upcoming COFINA issuance,[21] but instead they were paid off with this offering).

Notably, **Popular** advised the Government Development Bank against the bond issuance, but participated in underwriting the bonds anyway, according to a report commissioned by the oversight board and authored by investigations firm Kobre & Kim. Along with Citi, Popular drafted a memorandum for the chair of the board of directors of the GDB, David H. Chafey Jr., himself a former Popular executive, advising against another Commonwealth bond issuance. Unlike Popular, Citi decided not to underwrite the transaction, citing concerns about the Commonwealth's dire financial situation.[22]

Going After the Banks

The official narrative for why Puerto Rico is deep in a debt crisis blames only the bad management and corruption of the local government. But while the two political parties that have shared power for the last six decades are to blame, this narrative obscures some of the key players who have driven and profited from the debt issuances, particularly banks and law firms.

As shown above, underwriting fees and swap termination fees paid out of the three offerings totaled **$293,863,051**.

16 *The refunded bonds are listed in page 24: http://www.gdb.pr.gov/investors_resources/documents/CommonwealthPRGO2014SeriesA-FinalOS.PDF ; for example of refunded bonds with lower interests see page 4 of the pdf: http://www.gdb.pr.gov/investors_resources/documents/2012-06-13-PRCommonwealth1-OS-Series2007A.pdf*

17 *http://periodismoinvestigativo.com/2016/08/275-investment-firms-jumped-on-puerto-ricos-junk-debt/*

18 *See section 47: http://www.oslpr.org/download/en/2009/A-0007-2009.pdf ; for its consequences, see: https://www.primerahora.com/noticias/gobierno-politica/nota/ley7fueadversaparalaeconomia-496760/*

19 *Page 25: http://www.gdb.pr.gov/investors_resources/documents/CommonwealthPRGO2014SeriesA-FinalOS.PDF*

20 *https://www.documentcloud.org/documents/5700540-COFINA-2013-a-Junior-Lien-Note-333300000.html*

21 *https://www.documentcloud.org/documents/5738765-Resolution.html*

22 *Page 542: https://drive.google.com/file/d/19-lauVo3w9MPS03xYVe0SWhQin-Q6FEf/view*

At the very least, their business practices in overseeing and profiting from these offerings was clearly irresponsible. At worst, they could have engaged in fraud, financial malpractice, or negligence that would justify financial claims against them by the people of Puerto Rico.

Many big banks served as underwriters for the offerings, but several stand out due to the manner in which they benefited, their revolving door relationships, as well as their involvement in other issuances that are worthy of investigation.

Barclays served as lead underwriter on the two biggest offerings and an underwriter on the third. As noted above, a significant portion of the 2014 offering was used to pay off COFINA BANs that Barclays had originally purchased.

Barclays' municipal debt business in Puerto Rico was extensive during this period, and involve a previously unreported revolving door relationship. The director of its Puerto Rico municipal bond office, Néstor De Jesús Pou, joined the board of the GDB shortly after the 2014 offering, and after resigning from Barclays.[23] Shortly after he joined, in October 2014, the GDB oversaw the issuance of $900 million in notes guaranteed by the Commonwealth, and Barclays was part of the syndicate.[24] These kinds of revolving door relationships deserve a much more extensive examination, since the Wall Street capture of government institutions in Puerto Rico appears to have played a significant role in the explosion in debt.

Popular served as an underwriter on all three offerings. As detailed above, it advised against the 2014 offering and underwrote it anyway. Its close relationship with the oversight board is well known, given that board's chair, José Carrión III, is cousin of its executive chairman, Richard Carrión. José's father, José Carrión II, was a shareholder and member of the board of directors of Popular.[25]

Santander underwrote all three offerings, and had extensive revolving door relationships with the GDB. Several reports from the group Hedge Clippers elaborate on the "Santander scheme" – the revolving door saga starring current oversight board member Carlos García and the Batlle brothers, which is one of the most troubling examples of Wall Street's capture of government institutions in Puerto Rico.[26] Juan Carlos Batlle served as president of the GDB during the 2012 bond offerings; he had taken over from García, who had moved back into a position with the bank.

Morgan Stanley was paid not only underwriting fees but exit penalties on toxic swaps out of the proceeds of two of the bonds, as detailed above – $24 million in the case of the 2014 bond, and an undisclosed amount in the case of the April 2012 bond.

UBS was lead underwriter on the March 2012 issuance and, as noted above, was paid swap termination fees out of the proceeds of the April 2012 issuance.

UBS has a long history in Puerto Rico that is worthy of far more scrutiny and investigation. It was the largest wealth management business on the island at its peak, and continues to be a major bondholder. Last year, a former executive went public with criticism of the bank for its role in fueling Puerto Rico's debt crisis.[27]

23 https://www.bloomberg.com/research/stocks/people/person.asp?personId=324070123&privcapId=294078

24 http://www.gdb.pr.gov/documents/GDBTRANsPressRelease101014.pdf

25 https://www.sec.gov/Archives/edgar/data/763901/000095014407002272/g05906def14a.htm

26 http://hedgeclippers.org/pirates-of-the-caribbean-how-santanders-revolving-door-with-puerto-ricos-development-bank-exacerbated-a-fiscal-catastrophe-for-the-puerto-rican-people

27 https://www.pbs.org/wgbh/frontline/article/former-ubs-insider-says-banks-fueled-economic-crisis-in-puerto-rico/

UBS was adviser, underwriter, and, through its funds, buyer of the controversial three bond issuances made by the Employees Retirement System (ERS) in 2008.[28] The financial strategy advised by UBS backfired, leading to billions in losses. These transactions are cited as the target of potential legal claims in the Kobre & Kim final report.[29]

Banks are not the only entities that benefited from these transactions – law firms also profited in the form of fees:

Greenberg Traurig acted as bond counsel on all three deals. In this role, it signed off on the legal validity of the debt. The large firm did extensive work in Puerto Rico around other debt deals, too, acting as counsel on 12 bond issuances worth $9 billion (including the three noted above).[30] Publicly-available documents do not disclose the firm's fees for these deals.

The firm has also been very active in the recent debt restructuring processes of Puerto Rico's public corporations and the Title III cases. The firm was contracted in June 2017 by the Puerto Rico Aqueduct and Sewer Authority (PRASA) and the Puerto Rico Fiscal Agency and Financial Advisory Authority (AAFAF, by its Spanish acronym) for legal services relating to the corporation's operational and financial restructuring. The PRASA contract was worth up to $3 million for one year of service.[31] The firm has also been working for the Puerto Rico Electric Power Authority (PREPA) since 2017 for the same services. Recently, it renewed its contract until June 2019.[32]

O'Neill & Borges, a law firm based in San Juan, also worked on each deal as counsel to the underwriters. It has been the local legal adviser of the oversight board since 2016.[33] Pedro Pierluisi, previous resident commissioner in Washington and brother-in-law of the board's chair, José Carrión, is a long time member of the firm.

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28 *Offering statements for the three issuances: http://www.gdb.pr.gov/investors_resources/ers.html ; House report on the controversies: 3er Informe Preliminar rendido de Sistemas de Retiro del Servicio Público (CAMARA)*

29 *See part XVI: https://drive.google.com/file/d/19-lauVo3w9MPS03xYVe0SWhQin-Q6FEf/view*

30 *See the Commonwealth bond issuances here: http://www.gdb.pr.gov/investors_resources/commonwealth.html ; for the Puerto Rico Infrastructure Financing Authority, see here: http://www.gdb.pr.gov/investors_resources/documents/2011-12-16-PRInfrastructure01b-FIN_000.pdf*

31 *https://contratos.ocpr.gov.pr/contract/downloaddocument?documentid=960239*

32 *https://aeepr.com/es-pr/QuienesSomos/Contratos%20Generales/2019-P00009%20Greenberg%20Traurig%20LLP.pdf*

33 *https://drive.google.com/file/d/1gX_CkXhtUxoC2vRjhXlloUuiKGEh154B/view*

This report has been created in collaboration with the Costruyamos Otro Acuerdo campaign that seeks to organize Puerto Rican communities around a just recovery for the island through a democratically led debt restructuring process.