The Collapse of Puerto Rico's Economy and Yale's Secret Bond Sale

Hurricanes Irma and Maria devastated Puerto Rico in the fall of 2017. By the start of 2018, large swaths of the island were still without power, running water or critical medical supplies, leaving 3.7 million American citizens in desperate circumstances.[1] The storms worsened an already severe economic crisis – Puerto Rico's GDP has contracted in nine of the previous ten years, and its poverty rate is triple that of the mainland. Puerto Rico sold billions of dollars of bonds to cover skyrocketing deficits since the recession began, and now faces $74 billion in public-sector debt that threatens to make recovery from the natural disasters impossible. [2]

Individuals and organizations within the Yale community have sent aid to Puerto Rico to help alleviate the suffering. However, Yale has another major and hidden influence on the island's future. Five investment companies who together manage $1.3 billion for Yale – Cyrus Capital, Baupost LLC, Fortress Investment Group, Carmel Asset Management and Corbin Capital Partners – held Puerto Rican debt at the end of 2017. Two of the largest – Cyrus Capital and Baupost LLC – were among a small group of creditors suing Puerto Rico to force the territory to pay them back in full and before all other creditors. Litigation of this nature can drag on for years, delaying the government's ability to restructure its finances and begin rebuilding the economy.

Baupost, LLC manages $740 million of Yale's money, and owns ten funds named "Decagon Holdings" which together are the largest owner of bonds issued by Puerto Rico's sales tax authority, "COFINA". CRS Master Fund, LP a fund managed by Cyrus Capital also owned $93 million worth of COFINA bonds at the beginning of the year. CRS Master Fund, LP, is 88.75% owned by Yale, a fact that makes Yale the first University to be publicly identified as a majority owner of a fund holding Puerto Rican debt. Cyrus was, and Baupost remains, members of a small group of creditors who insist not only that Puerto Rico's $74 billion in public debt be paid in full, but are fighting other so-called "vulture funds" to be paid first.[3] As bond prices declined after the storm, Cyrus sold its COFINA holdings, making between $64.6 and $68.5 million in revenue from the transaction. It is unclear at what price Cyrus purchased the bonds so it is unknown whether they made a profit or mitigated a loss with the sale.

Furthermore, Yale's largest-ever donor, billionaire Charles B. Johnson, is the top shareholder in Franklin Resources, which is the second largest holder of Puerto Rican debt. Johnson gave Yale $250 million to construct new dormitories in 2013. Franklin is offering additional loans to help rebuild Puerto Rico's power grid, but only on the condition that the bonds it holds are paid first.[4]

Yale University faces a choice. Will it use its influence to offer Puerto Rico meaningful financial relief in a time of crisis? Or will it seek to grow its $27 billion endowment by continuing to extract wealth from the devastated island?

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[1] https://www.vox.com/2017/12/23/16795342/puerto-rico-maria-christmas
[2] http://cepr.net/publications/reports/life-after-debt-in-puerto-rico-how-many-more-lost-decades
[3] https://www.bloomberg.com/news/articles/2017-05-23/puerto-rico-bondholders-say-everybody-and-nobody-has-valid-claim. Also: https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=NjE5MTg2&id2=0
[4] https://unitehere.app.box.com/file/233120696015

Puerto Rico's Decade of Economic Crisis

Congress passed a federal tax break in 1976 which allowed American manufacturers to avoid corporate income taxes on profits made in U.S. territories, including Puerto Rico.[5] The island's economy flourished but also became dependent on the investment and expansion of corporations from the mainland, led by the pharmaceutical industry.[6] When the tax break was repealed in 1996, those corporations began to leave. By 2006, when the tax break was fully phased out, most industry had left and the economy began a steep decline.[7] From 2006 to 2016, Puerto Rican Gross Domestic Product contracted by 16.4% -- with only a single year of anemic growth in 2012.[8]

The economic freefall has left Puerto Ricans in crisis. According to the Center for Economic and Policy Research the poverty rate on the island stands at 46%, and 58% for children — about three times the average of the 50 states. Unemployment, meanwhile, stands at 11.8%, more than two and a half times the level on the mainland. Approximately 10% of the population has left the island since 2006, further exacerbating the crisis.[9]

With widespread unemployment, population decline and "brain drain,"[10] Puerto Rican deficits rose precipitously during the 2000s. To cover its deficits, Puerto Rico had little choice but to issue huge amounts of debt. The territory's government has sold a variety of bonds on the open market which make up its public debt. $17.8 billion are general obligation bonds. $17.6 billion are bonds issued by the Puerto Rico Sales Tax Financing Corporation (COFINA). $9 billion are bonds issued by PREPA, Puerto Rico's Electric Power Authority. $52.2 billion are pension-related bonds for current and future retirees. An additional $20.8 billion include debts of the Government Development Bank, the water utility and highway agency, and the University of Puerto Rico.[11]

When Irma and Maria devastated the island, Puerto Rico's public-sector debt had surpassed $74 billion. Additionally, the government owed $40 billion in outstanding pension obligations to state workers.[12]

Wall Street and COFINA Creditors in Court

[5] https://taxfoundation.org/tax-policy-helped-create-puerto-rico-s-fiscal-crisis/
[6] http://cepr.net/publications/reports/life-after-debt-in-puerto-rico-how-many-more-lost-decades
[7] https://www.nytimes.com/2017/08/17/opinion/puerto-rico-economy-austerity.html?mtrref=www.google.com&_r=1
[8] https://tradingeconomics.com/puerto-rico/gdp-growth-annual
[9] http://cepr.net/publications/reports/life-after-debt-in-puerto-rico-how-many-more-lost-decades
[10] https://www.cnbc.com/2017/09/26/heres-how-an-obscure-tax-change-sank-puerto-ricos-economy.html

[11] : https://www.bloomberg.com/graphics/2017-puerto-rico-debt-crisis/
[12] http://www.businessinsider.com/puerto-rico-debt-2017-10

One reason Puerto Rico's debt is so intractable is that Congress stripped the island of its right to declare bankruptcy in 1984.[13] By the spring of 2016, it was clear that Puerto Rico would not be able to continue making regular payments. Without a lawful mechanism to restructure its debt, Puerto Rico was on the verge of defaulting. On June 30, 2016, President Obama signed a law known as PROMESA designed to "encourage Puerto Rico and its federal financial oversight board to negotiate debt-cutting agreements with creditors."[14] PROMESA essentially created a special bankruptcy law for Puerto Rico. Puerto Rico failed to make $2 billion in scheduled payments on its general obligation bonds the next day.

PROMESA created a Financial Management and Oversight Board with the power to control the island's budget and deal with its creditors, and imposed a temporary moratorium on litigation by creditors. The stay expired May 1, 2017. The Financial Management and Oversight Board immediately announced its intention to file for bankruptcy protection for Puerto Rico, and creditors began suing to stop the process.[15]

One of the most aggressive lawsuits has been filed by "senior" creditors holding COFINA bonds. COFINA issues government bonds and receives half of the state government portion of Puerto Rico's sales tax to finance the debt. Holders of "senior" bonds issued by an entity generally have rights to be paid before "junior" bondholders. However, the creditors in the COFINA lawsuit insist that because they hold senior COFINA bonds, not only must they be paid before holders of junior COFINA bonds as would normally be the case, but that all sales taxes raised by the agency must be used to pay them, not holders of the territory's general obligation bonds or other forms of Puerto Rican government debt.[16]

Meanwhile, firms holding general obligation bonds want COFINA's future sales tax revenues to be spread equally among all creditors.[17] Puerto Rico's constitution says that general obligation bonds must be paid before other expenses, and thus the claims of the COFINA senior bondholders violate the constitution.[18]

This litigation could potentially delay the process of economic recovery for the people of Puerto Rico for at least two reasons. First, litigation delays the restructuring or settlement of debt that is necessary for recovery. Second, the outcome of litigation can yield punitive policies. Hedge funds have pressed legal claims on public-sector debt before, most notably in Argentina. There a small group of hedge funds, including Yale's investment manager Bracebridge Capital, rejected debt restructuring and pursued their claims in federal court for fifteen years, slowing the process of recovery and hindering the Argentine

[13] https://www.nytimes.com/2015/12/17/business/dealbook/governor-of-puerto-rico-warns-of-looming-default-without-bankruptcy-plan.html

[14] https://www.reuters.com/article/us-puertorico-debt/puerto-rico-authorizes-debt-payment-suspension-obama-signs-rescue-bill-idUSKCN0ZG09Y; also: https://www.reuters.com/article/puertorico-debt-lawsuit/sales-tax-creditors-kick-off-likely-wave-of-lawsuits-against-puerto-rico-idUSL1N1I400J

[15] https://www.reuters.com/article/us-puertorico-debt-bankruptcy/puerto-rico-files-for-biggest-ever-u-s-local-government-bankruptcy-iHodUSKBN17Z1UC

[16] https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=NjI3NzEx&id2=0

[17] https://www.reuters.com/article/us-puertorico-debt-cofina/puerto-rico-cofina-bondholders-ask-u-s-judge-to-rule-in-debt-fight-idUSKBN16Q0V4

[18] https://www.bloomberg.com/news/articles/2017-05-23/puerto-rico-bondholders-say-everybody-and-nobody-has-valid-claim

government's access to capital for several years. In the end, Judge Thomas Griesa ruled that the holdout creditors – just 6 percent of the nation's creditors – must be paid in full, plus interest and tens of millions of dollars in legal fees, and that the majority of creditors who had accepted restructuring could not be paid before the holdouts were. [19] Since the ruling the Argentine government has instituted spending cuts that have arrested the nation's recovery.[20]

The Yale Endowment, COFINA and Puerto Rican Debt

Many news reports have focused on the hedge funds and mutual funds invested in Puerto Rico's debt. Hedge funds own nearly 1/3 of the Commonwealth's non-pension-related $74 billion debt.[21] News reports and court documents indicate that at least five of those firms also manage significant portions of the Yale endowment -- Cyrus Capital, Baupost LLC, Fortress Investment Group, Carmel Asset Management,[22] and Corbin Capital Partners.[23]

Baupost manages $740 of the Yale endowment and is Yale's 5th largest investment manager. In October 2017, "The Intercept" revealed that Baupost is the owner of ten funds named "Decagon Holdings," 1-10, which together are the largest owners of bonds issued by COFINA, Puerto Rico's sales taxing authority, at $911 million.[24] Baupost also manages money for Harvard University, and in January 2018 students at Harvard and Yale protested the fund's Puerto Rican debt holdings.[25]

Cyrus Capital manages $547 million of the University's endowment and is Yale's 7th largest manager.[26] Cyrus manages four funds that until January, 2018 held $93 million in bonds issued by COFINA, including CRS Master Fund, LP.[27] Amidst declining bond prices, Cyrus sold its COFINA bonds in January. Cyrus received between $64.6 and $68.5 million from the transaction.[28] It is not known how much Cyrus spent on purchasing these bonds, but while most bondholding funds are pools of capital with a broad investor base, *Yale owns 88.75% of Cyrus's CRS Master Fund, L.P*. [29] This appears to be the first direct evidence of a university owning Puerto Rican debt.

Cyrus has longstanding ties to Yale. The fund is managed by Stephen Cyrus Freidheim (Yale College '86), who worked with Yale CIO David Swensen to establish the Tobin Scholars award program and who initiated the idea of the Swensen Fellows program for Yale.[30]

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[19] https://www.bloomberg.com/news/articles/2016-03-01/singer-makes-369-of-principal-on-argentine-bonds-in-debt-offer
[20] https://www.theguardian.com/world/2017/apr/06/argentina-strike-labor-unions-austerity-wages-inflation
[21] https://www.bloomberg.com/graphics/2017-puerto-rico-debt-crisis/
[22] See: SEC 2003 Form D for CP Investments Fund; 2005 Form D for CP investment Fud II, LP; also Yale University Retirement Plan for Staff Employees, USDOL Form 5500, Schedule C, 2015.
[23] The private capital tracking service Preqin lists Yale University Endowment as a "known investor in Corbin Capital Partners": https://unitehere.app.box.com/file/232451316012;
[24] https://theintercept.com/2017/10/03/we-can-finally-identify-one-of-the-largest-holders-of-puerto-rican-debt/
[25] http://www.thecrimson.com/article/2018/1/25/protest-puerto-rico-debt/; https://yaledailynews.com/blog/2018/01/26/students-call-for-yale-to-divest-from-fund/
[26] Schedule R Yale 990, FYE 06/30/2016
[27] https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=NjI3NzEx&id2=0
[28] https://cases.primeclerk.com/puertorico/Home-DownloadPDF?id1=NzE0NjMz&id2=0
[29] Schedule R Yale 990, FYE 06/30/2016, https://unitehere.app.box.com/file/213942969563
[30] http://economics.yale.edu/news/alumni-behind-tobin-scholars-award#sthash.QN0ysOTB.dpbs

Yale's CRS Master Fund and Baupost's Decagon funds participated in the lawsuit brought by the senior COFINA creditors insisting that sales taxes raised by the agency must be used to pay them first. CRS Master Fund withdrew when Cyrus sold its bonds, but the Decagon funds are still active participants.

Three additional Yale managers have been identified as holders of Puerto Rican debt. Corbin, LLC. has been a Yale investment manager since 2009 and manages $23.4 million for the endowment. Two Corbin funds are identified in court documents as holders of $14.25 million of Puerto Rican General Obligation bonds.[31] Fortress Investment Group has been a Yale investment manager since at least 2004 and manages $22.4 million for the endowment.[32] *El Centro de Periodismo Investigativo* first identified Fortress as a holder of Puerto Rican debt in 2015, though it is unclear precisely which bonds they hold.[33] Carmel Asset Management has been a Yale investment manager since at least 2009 and manages $5.3 million for the university.[34] Jonathan Carmel, portfolio manager for Carmel Asset Management, identified his firm as a holder of Public Buildings Authority bonds in an interview.[35]

Charles B. Johnson: Yale's Biggest Donor

The role of Yale leaders in Puerto Rico's economic distress is not limited to the endowment. The most generous benefactor in the University's history is also the largest shareholder and Chairman emeritus of the company holding the second largest amount of Puerto Rico's debt.

In September 2013, Charles B. Johnson donated $250 million to Yale University for the construction of two dormitories, the largest gift in Yale's history.[36] One of the two dorms is named Benjamin Franklin College, which shares a name with Johnson's family business.

Charles B. Johnson is the retired Board Chair and largest shareholder in Franklin Resources. Johnson owns 19.3% of the company.[37] His son Gregory E. Johnson is Chairman and CEO, his daughter Jennifer M. Johnson serves as President and Chief Operating Officer, while his other son Charles E. Johnson, Founder and Managing Member of Tano Capital, is also a director.[38] Charles B. Johnson's brother Rupert is Vice Chairman of the Board and owns 19.2% of the company. [39] Altogether, the Johnson family owns more than 40% of the outstanding shares of Franklin.[40]

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[31] https://unitehere.box.com/s/4gzvxvln5tpro0gn1f5foor63kb85er9
[32] http://www.33wallstreet.org/uploads/2/0/5/2/20520884/nationstar.pdf
[33] http://periodismoinvestigativo.com/2015/07/the-trajectory-of-hedge-funds-found-in-puerto-rico/
[34] https://unitehere.box.com/s/0ugwsoptlo78vnw0pealjtiikwijx1k7
[35] https://unitehere.box.com/s/jmdmdaej0cndbeoo0cgdh4mxvwx164j4
[36] https://news.yale.edu/2013/09/29/historic-250-million-gift-yale-alumnus-largest-ever
[37] https://www.sec.gov/Archives/edgar/data/38777/000120677418000008/franklin3306241-def14a.htm, p. 21.
[38] https://www.sec.gov/Archives/edgar/data/38777/000120677418000008/franklin3306241-def14a.htm, p. 51.
[39] https://www.sec.gov/Archives/edgar/data/38777/000120677418000008/franklin3306241-def14a.htm, p. 21.
[40] https://www.sec.gov/Archives/edgar/data/38777/000120677418000008/franklin3306241-def14a.htm#stock_own, p. 21 (Charles B. Johnson and Rupert Johnson = 19.2% + 19.3% = 38.5%); p. 22, where the total stock holdings of named officers and directors = 122,823,491 shares, or 22.2% of outstanding shares. Charles E. Johnson (6,383,451) + Gregory E. Johnson (5,365,457) + Jennifer M. Johnson (4,548,594) = 16,297,502 shares. 16,297,502/122,823,491 = .1327 x .222 = 2.945% of outstanding shares. 38.5% + 2.945% = 41.44% of outstanding shares.

The Johnson family company holds at least $1.8 billion of Puerto Rican debt through various subsidiaries and has entered litigation as a member of the "Ad Hoc Group of General Obligation Bondholders."[41] Following Hurricane Maria, Franklin was part of a group of investors offering $1 billion in new loans for repairs to Puerto Rico's devastated power grid, but only if the investors making the contribution would be "vaulted to the front of the queue for repayment of their debts."[42]

Yale's Decision

Yale claims that it was "one of the first institutions to address formally the ethical responsibilities of institutional investors."[43] Jonathan Macey, Chair of Yale's Advisory Committee on Investor Responsibility, wrote in response to an inquiry, "our committee is of the view divestment is not warranted when an investor is abiding by applicable bankruptcy procedures."[44] Nevertheless, at least five of Yale's managers are attempting to profit by extracting wealth from Puerto Rico in a time of sustained crisis. Two of Yale's top managers and its top donor have participated in legal claims that threaten to delay Puerto Rico's recovery. A Yale-owned fund sold its bonds amidst falling prices, extracting wealth while leaving Puerto Rico's debt obligations intact. Yale and Swensen are leaders in the investor community, and could have a profound impact on Puerto Rico's prospects for recovery by instructing their managers to withdraw from litigation and cancel their holdings in debt.

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[41] https://www.franklintempleton.com/advisor/products/fund-resources/puerto-rico
[42] https://www.ft.com/content/ad1e28ec-a315-11e7-b797-b61809486fe2
[43] http://investments.yale.edu/social-responsibility
[44] https://unitehere.box.com/s/es9t6gvqx5piijar5p2z1peru2lyahq7