Puerto Rico Skids Into Bankruptcy After Years of Economic Distress; Move amounts to the largest-ever U.S. municipal bankruptcy, sets up showdown with Wall Street creditors

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Full text: Puerto Rico was placed under court protection on Wednesday in what amounts to the largest-ever U.S. municipal bankruptcy, a stark illustration of the depth of the economic crisis afflicting a U.S. territory with more than three million inhabitants.

Puerto Rico and its agencies owe $73 billion to creditors, dwarfing the roughly $9 billion in bond debt owed by the city of Detroit when it entered what was previously the largest municipal bankruptcy in 2013.

The move by a federal oversight board installed by Congress is the culmination of years of economic distress and heavy borrowing that more recently has pitted Wall Street creditors, hungry for payments, against the struggling island.

The officials' decision sets up a showdown with Wall Street firms , including mutual-fund giants Franklin Resources Inc. and OppenheimerFunds Inc., hedge funds Aurelius Capital Management LP and Monarch Alternative Capital LP and some bond insurers. The federal action could mean deeper losses on bonds than analysts have anticipated, though some investors purchased bonds at lower prices and Puerto Rico bond prices were largely unchanged on Wednesday.

It also further complicates the island's bid to improve its relationship with Washington lawmakers, which has grown more fraught as Puerto Rico officials sought aid critical to ending a decadelong economic swoon--aid U.S. officials were loath to provide. Analysts said the bankruptcy could provide a forum for the orderly allocation of Puerto Rico's potential resources.

The Puerto Rico Financial Oversight and Management Board , installed last year by Congress, on Wednesday invoked a law that puts the standoff with creditors before a federal judge in San Juan in a restructuring process known as Title III that doesn't involve the U.S. bankruptcy court system.

The maneuver itself is unlikely to immediately change day-to-day life in Puerto Rico--an island already beset by an unemployment rate above 12%--more than twice the national average.

Sprawling bureaucracy and high electricity costs have stunted business investment, while government cutbacks have closed everything from schools to social-service providers. The departure of some citizens has sapped its tax base, further squeezing budgets.

"What I see all around me is uncertainty. People sometimes just leave the key in the house or the car in the airport and just go," said Nancy Madden, founding director of an educational nonprofit in Humacao, Puerto Rico.

The territory has been in recession for most of the past decade. For years, federal tax credits helped cultivate a robust manufacturing sector and steer the island away from agriculture after World War II. But Congress ended those incentives in 2006, and the economy fell into a recession. Puerto Rico has struggled to create jobs ever since.

As the loss of jobs damped the economy, local leaders strained to cut spending and boost tax collections. Instead, they borrowed to make up for recurring revenue shortfalls.

For over a decade, Puerto Rico's government and its municipal corporations borrowed more to buy time to stave off deeper economic overhauls. With government payrolls down over the past decade, pension funds have fewer workers contributing and the plans are now underfunded by an estimated $45 billion.

For years, investors overlooked these fiscal and demographic problems because Puerto Rico's bonds offered high yields and because they believed the island's economy would eventually recover. Puerto Rico can issue debt exempt from federal, state and local taxes, unlike U.S. states, which made these bonds attractive to many mutual-fund investors and more recently, hedge funds.

But Puerto Rico began to lose access to the credit markets three years ago, when its ratings were downgraded. The door closed for good in 2015 when the island's governor declared the debts unpayable.

Unrest has been growing on the island over installation of the oversight board and cutbacks by government. A massive blackout last year left half the island without power at one point. When the Zika virus landed on Puerto Rico last summer, the government had limited funds to fight back. Also last year, the Santa Rosa Hospital in the southern coastal town of Guayama had its power cut off suddenly after failing to pay millions of dollars in utility bills. A court eventually ordered the power to be turned back on.

When the board first convened last year, about 50 demonstrators surrounded the entrance to the Alexander Hamilton U.S. Custom House in downtown Manhattan, where the meeting was held. Several people were later escorted out of the meeting room after shouting "down with colonialism."

Protests continued as recently as Monday, affecting services at Puerto Rico's largest public hospital, paralyzing the bus system and forcing many businesses to close, the Associated Press reported.

Puerto Rico was in marathon closed-door talks this month toward a global deal with various groups of creditors battling for top repayment priority in a restructuring. Hedge-fund creditors holding defaulted general obligation bonds were on the verge of completing an agreement late Tuesday before the oversight board intervened to stop negotiations, a spokesman for those creditors said.

Federal officials last month approved a wide-ranging framework for government spending that would scale back expenditures and allocations to creditors. Wednesday's move represents a step toward implementing the plan.

The plan "imposes pain everywhere," said Ignacio Alvarez, president and chief operating officer of Banco Popular de Puerto Rico in San Juan. "The cuts to the health system are massive. The cuts to the universities are large."

The Trump administration has largely embraced the oversight-board framework established by the Obama administration. Following a meeting with Gov. Ricardo Rosselló in February, Treasury Secretary Steven Mnuchin said Puerto Rico should continue to work with the oversight board, and a Treasury spokeswoman on Wednesday said the department supported the board's decision to invoke its Title III authority.

The decision marks the start to what could be a lengthy legal fight as Wall Street watches closely to see how other indebted municipal governments, including Chicago and Illinois, may fare in confrontations with investors. Any write-downs also would hit bond insurers Assured Guaranty Ltd., MBIA Inc. and Ambac Financial Group, which have guaranteed billions of dollars of Puerto Rico's bonds.

The Title III request, while unprecedented, isn't unexpected. The board signaled in negotiations this month it wouldn't consider paying creditors more than the roughly $800 million in annual sums allocated to debt service, according to people familiar with the matter.

A legal stay protecting Puerto Rico from lawsuits expired Monday night without standstill agreements with creditors in place. Hedge funds holding general obligation and sales-tax bonds filed lawsuits on Tuesday, naming Gov. Rosselló as a defendant.

The slide into bankruptcy marks a new low in Wall Street's relations with Mr. Rosselló, a political newcomer who pledged as a candidate to repay the territory's debts, shrink the government and strengthen ties with the U.S. Creditors clashed with the previous administration of Alejandro Garcia Padilla but considered Gov. Rosselló a likely ally, said Chas Tyson, vice president at investment banking firm Keefe, Bruyette &Woods Inc.

Mr. Rosselló on Wednesday said he requested the bankruptcy move.

"Now it seems like the honeymoon's over," Mr. Tyson said. "It seems that we're back where we used to be."

Kate Davidson contributed to this article.

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