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What Municipal Bond Investors Should Know About the Detroit Municipal Bankruptcy

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During the Great Recession, 60 Minutes aired an interview with banking analyst Meredith Whitney whose dire prediction of an impending municipal bond imbroglio of ''hundreds of billions'' of municipal defaults ignited a firestorm of controversy. While Whitney's forecast never quite materialized, the recent filings of high-profile municipal bankruptcies such as Detroit, Michigan and Stockton, California, is a cautionary tale for bondholders' investment in the $3.7 trillion U.S. municipal market. Conservative, well-respected international publications, such as the *Economist*, have recently warned that the poor state of the United States' public municipal finances threaten the safety of municipal bond investments. While municipal bankruptcies are rare, a discussion of the Detroit bankruptcy case, in particular, offers an instructive lesson about financial instruments widely considered to be the safest fixed income investments in the United States.

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Reasons for the Detroit Bankruptcy

On July 16, 2013, the tepid economic recovery forced Detroit officials to seek bankruptcy protection as dwindling tax revenues and the inability to obtain additional financing made obligations to bondholders, retirees, and employees unaffordable. Detroit's commencement of bankruptcy proceedings wrested the ignominious distinction as the largest U.S. city ever to file for bankruptcy from Stockton, California. Detroit's default on certificates of participation marked some of the last milestones on a road to bankruptcy that had included the imprisonment of Detroit's former mayor for official corruption and the decline of the City's population from a peak of nearly 2 million in 1950 to approximately 685,000 in 2014.[1]

Decades of financial mismanagement and imprudence culminated in the City's accumulation of $17,914 billion in debt. Prior to the bankruptcy filing, the City's financial projection was bleak. For example, more than $0.38 of every tax dollar the City collected was dedicated to the service of legacy debts, with the amount expected to increase to $0.65 in five years.[2] Kevyn Orr, the City's emergency financial manager, characterized the City's decline as a ''death spiral''.[3]

In a jarring example of Detroit's decline, in 2011, approximately 136,000 crimes were reported in the City; 15,245 of these were violent crimes such as homicide and robbery.[4] Detroit ranks as the leader in virtually every category of undesirability for major cities, including

[1] Disclosure Statement with Respect to Plan for the Adjustment of Debtors of the City of Detroit at 19, In re City of Detroit, Michigan, No. 13-53846 (Bankr. E.D. Mich.).

[2] Declaration of Kevyn D. Orr In Support of City of Detroit, Michigan's Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code at 6, No. 13-53846 (Bankr. E.D. Mich).

[3] Declaration of Kevyn D. Orr In Support of City of Detroit, Michigan's Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code at 2, No. 13-53846 (Bankr. E.D. Mich).

[4] Declaration of Kevyn D. Orr In Support of City of Detroit, Michigan's Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code at 22, No. 13-53846 (Bankr. E.D. Mich).

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unemployment, crime rates, abandoned buildings, and reductions in emergency services and personnel. In yet another example of Detroit's destitution, approximately 40% of the City's street lights are not working due to disrepair, vandalism, component theft and neglect.[5] The City's extensive urban blight includes 78,000 abandoned and blighted residential structures with an estimated cost of $8,500.00 per structure for demolition.[6]

Prior to the City's bankruptcy, the City's credit ratings had plummeted to historic lows and were below investment grade. No major U.S. city had a lower credit rating than Detroit. In the wake of the City's post-petition default on certain general bond obligations, Fitch Ratings, Inc. and Standard and Poor's Financial Services LLC downgraded the City's general obligation debt to ''D''. The City is broke, financially and otherwise.

Detroit's problems are not isolated to issues affecting its residents. The City's bankruptcy spills over to investors in municipal debt, bond insurers that insured portions of the municipal debt, and possibly the state and federal government which may need to intervene to provide welfare benefits to public sector employees faced with reduced pensions.

Credit rating agencies and bond insurers have publicly cautioned that the Detroit bankruptcy has the potential to set unfavorable legal precedents for bondholders and insurers. A bond insurer with a stake in the City's restructuring issued a public statement declaring that the City's proposal for restructuring its bond debt was ''harmful to Detroit and the interests of the taxpayers in Michigan'' and ''necessarily imperiled'' the City's access to cost-effective financing.

Bankruptcy Issues for Municipal Bond Investors in the Detroit Bankruptcy

The main concerns for general obligation bondholders in municipal bankruptcies is the potential misclassification of general obligation debt as unsecured and the potential prioritization and preferential treatment of unsecured retiree and pension obligations. For bondholders and pensioners, the Detroit bankruptcy case includes two legal issues that should be of interest to bondholders and pensioners:

1) The Bankruptcy Court's ruling that the federal Bankruptcy Code authorizes the City to impair its pension obligations.

2) The dispute between the City and certain insurers of general obligation bonds over the City's unsecured classification of a pledge of City tax revenue to pay off voter-approved bond issuances.

The first issue of concern for municipal bond investors is the prospect that retirees and other public sector employees may receive favorable treatment. In the restructuring of General Motors and Chrysler, for example, bondholders and other unsecured creditors generally considered that the employees and pensioners received favorable treatment. Holders of Detroit's unsecured general obligations bonds are concerned that the City's bankruptcy exit plan disproportionately reduces the recoveries of general obligations bonds in comparison to retiree and pension holders.

The second issue of concern for municipal bond investors in the Detroit bankruptcy proceeding centers on the dispute over the classification of certain general obligation bonds as unsecured.

Prior to its bankruptcy, the City sought voter-approval for the issuance of bonds backed by a pledge of tax revenue. The insurers of those bonds are challenging the City's unsecured classification in that the City's pledge constitutes a lien under Michigan law that confers secured status under federal bankruptcy law.

A lot is at stake for pensioners and bondholders in the Detroit bankruptcy as well as for investors and pensioners without direct exposure to the City's bankruptcy because the case's legal issues may have precedential effect. The majority of the City's indebtedness is comprised of pension obligations and indebtedness under various financial instruments such as bonds, installment notes and loans, certificates of participation, and swap liabilities. According to the Disclosure Statement, the unfunded liabilities of the pension obligations aggregate to $3.474 billion.[7] The City's indebtedness under financial instruments comprises the majority of the City's debt. Clearly then, the City's bankruptcy plan reverberates from Main Street to Wall Street.

The Treatment of Pensioners and Bondholders Under the City's Restructuring Plan

Concomitant with the emergency manager's objective of exiting bankruptcy no later than September 2014, the City recently submitted its restructuring plan. Not surprisingly, stakeholders with contemplated reduced recoveries under the plan have protested the plan. The City's pensioners have publicly demonstrated outside the bankruptcy courthouse against the plan's contemplated reductions, and insurers of bondholders have pressed lawsuits within the bankruptcy proceedings.

The reductions in the City's pension benefits have garnered nationwide attention. The City allocated the approximately 33,000 individuals that participate in the City's retirement systems into two categories in the Plan, the General Retirement Systems (the ''*GRS*'') and the Police and Fire Retirement System (''*PFRS*'') (to-

[5] Declaration of Kevyn D. Orr In Support of City of Detroit, Michigan's Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code at 24, No. 13-53846 (Bankr. E.D. Mich).

[6] Disclosure Statement with Respect to Plan for the Adjustment of Debtors of the City of Detroit at 48, In re City of Detroit, Michigan, No. 13-53846 (Bankr. E.D. Mich.).

[7] Disclosure Statement with Respect to Plan for the Adjustment of Debtors of the City of Detroit at 5, In re City of Detroit, Michigan, No. 13-53846 (Bankr. E.D. Mich.).

gether, the "GRS and the "PFRS" are known as the "*Retirement Systems*").[8] The reasons for the underfunding of the Retirement System, include: imprudent financial planning, allegations that former officials of the Retirement Systems were corrupt, and poor investments in speculative alternative investments. In an astonishing example of fiscal imprudence, participants in the GRS had the option of an investment that earned interest based on a rate of return established at the discretion of the board of trustees for the GRS, which essentially functioned as a guaranteed investment contract with a guaranteed floor investment return of 7.9% even though the funds' actual returns in some years were well below the guaranteed amount. The City's plan does not contemplate the satisfaction of pension obligation in full.[9]

The Plan contemplates that following reductions for the GRS participants that agree to enter into a settlement with the City:

- *PFRS Retired Beneficiaries & PFRS Active Beneficiaries*. The plan contemplates a 4% reduction and the disallowance of the value of any future costs of living allowances, known as "COLA" payments.
- *GRS Retired Beneficiaries & GRS Active Beneficiaries*. The plan contemplates a 26% reduction and the disallowance of any COLA payments.

The plan further provides for escalated reductions for GRS and PFRS participants that do not agree to enter into a settlement with the City over the plan's proposed modification of pension obligations. For pension holder participants that reject the City's settlement proposal, the plan contemplates 10% reductions for PFRS Retired and Active Beneficiaries and 34% for GRS Retired and Active Beneficiaries.[10] The reductions for unsecured bondholders are more severe.

The majority of the City's 20 largest unsecured creditors are comprised of general obligation bond debt holders, of which certain insurers of bondholder debt contest the City's designation as unsecured. Under the plan, unsecured bondholders' recoveries are pegged at a 20% recovery.[11] For the insurers contesting the City's unsecured classification, the designation of unsecured ratcheted down the insurers' recovery by 80% as the plan contemplates a 100% recovery for secured bonds.

The City's secured bond indebtedness includes $5.359 billion for revenue bonds.[12] Revenue bonds are secured by a lien on the property and revenues of certain city enterprises that confer secured status in a bankruptcy proceeding. Bond insurers have initiated lawsuits in the Detroit bankruptcy proceeding for a declaration that the City's pledge of tax revenue to pay down voter-approved bond issuances constitutes a lien under Michigan law that confers secured status in the bankruptcy proceeding. The outcome of the lawsuits for retirees and general obligations bondholders could have far-reaching impact on the stakeholders' recoveries.

Upon release of the City's plan, credit rating agencies publicly cautioned that the disparate treatment of bondholders may have the unintended effect of higher borrowing costs for local issuers and higher property taxes in Michigan.

The Status of General Obligations Bonds in Detroit's Bankruptcy

Under the Bankruptcy Code, the classification of secured claims is limited to claims secured by a lien on property. General obligation bonds are a type of bond backed by a city's "taxing power." To determine a bond's classification in a bankruptcy proceeding, the analysis generally starts with an examination of whether the forum state law confers general obligation bonds with an obligation or lien on property, rather than a pledge. The issue of whether the pledge of Detroit tax revenue to pay down voter approved debt issuance constitutes a lien under Michigan law, which would confer secured status in the bankruptcy proceeding, is front and center in the bankruptcy proceeding.

The City classified certain of its voter-approved general obligation bond debt as unsecured on the basis that the pledge of the City's tax power to repay the bond issuances did not qualify as a lien that confers secured status under federal bankruptcy law. Contrary to the City's position, the bond insurers claim that the City backed its bond issuances with a pledge of taxes, as security, to exclusively repay the bonds that qualified as an obligation under Michigan law, which, in turn, should be accorded secured status under the Bankruptcy Code. For the insurers of Detroit's general obligation debt, the dispute over the classification of the general unsecured bonds severely impacts the prospects of full recovery.

Conclusion

Despite the recent filing of several high-profile municipal bankruptcies, municipal bond analysts still consider municipal bonds a safe investment and a nationwide wave of municipal bankruptcy unlikely. Detroit's and Stockton's bankruptcies have not spooked the marketplace for municipal bonds as interest rates on the highest-quality 30-year bonds do not reflect a substantial risk premium. For these reasons, the Detroit and Stockton bankruptcies are best viewed as a cautionary tale rather than a portent of things to come.

While the Bankruptcy Court has not approved the City's restructuring plan and the lawsuits concerning the City's classification of certain general obligations bondholder debt as unsecured have not been decided, the issues in front of the Michigan Bankruptcy Court should serve to heighten the bond community's awareness about which states protect municipal investment with laws that support the treatment of general obligations bonds as secured debt in municipal bankruptcy.

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[8] Disclosure Statement with Respect to Plan for the Adjustment of Debtors of the City of Detroit at 4, In re City of Detroit, Michigan, No. 13-53846 (Bankr. E.D. Mich.).

[9] Disclosure Statement with Respect to Plan for the Adjustment of Debtors of the City of Detroit at 5, In re City of Detroit, Michigan, No. 13-53846 (Bankr. E.D. Mich.).

[10] Disclosure Statement with Respect to Plan for the Adjustment of Debtors of the City of Detroit at 7, In re City of Detroit, Michigan, No. 13-53846 (Bankr. E.D. Mich.).

[11] Disclosure Statement with Respect to Plan for the Adjustment of Debtors of the City of Detroit at 13, In re City of Detroit, Michigan, No. 13-53846 (Bankr. E.D. Mich.).

[12] Disclosure Statement with Respect to Plan for the Adjustment of Debtors of the City of Detroit at 28, In re City of Detroit, Michigan, No. 13-53846 (Bankr. E.D. Mich.).