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[Detroit Restructuring Plan Includes Bond Default.](#)

CHICAGO – Detroit's announcement Friday that it will default on some of its bonds, including a $39.7 million pension certificate payment due Friday, could have major repercussions for the municipal market, analysts and bond attorneys said.

The moratorium means the city, at least in the early stages of negotiations with its debtors, intends to put some of its so-called unsecured general obligation bonds on par with its lowest-secured debt, a treatment that one market participant called "an amazing step." Unsecured GOs, in the city's view, are those with only a full faith and credit general fund pledge and not a specific lien on a revenue source such as state aid.

News of the pending default triggered a fresh round of downgrades from Standard & Poor's and Fitch Ratings.

Detroit emergency manager Kevyn Orr unveiled a 134-page restructuring proposal Friday as part of a first round of negotiations with creditors that will start Monday and last through July 12. The negotiations follow a warning from Orr that the fiscally distressed city faces a 50-50 chance of pursuing bankruptcy.

The report says the city will stop making payments on what it calls its unsecured debt, which includes $530 million of GOs. That includes default on a $39.7 million June 15 payment to holders of the city's $1.4 billion of pension certificates, widely considered among the city's least-secured obligations.

It's not clear yet whether the city will default on its next GO payment.

"If we are able to restructure and get a deal in place, then we start paying on the new regime," Orr told local reporters after the creditor meeting. "We can't continue paying with the debt service we have going forward."

Orr is proposing issuing $2 billion of notes to pay off holders of $11.4 billion of unsecured debt on a pro-rata basis — a move that would generate less than a dime on the dollar for investors.

Nearly all of Detroit's bonds are insured, so bondholders will likely continue to get paid regardless of the city's defaults. "In the event that debt service payments by the city of Detroit are interrupted, National will ensure that its policyholders receive all of their principal and interest payments on time and in full," said Kevin Brown, spokesman for National Public Finance Guarantee Corp., which wraps nearly $2.5 billion of Detroit bonds.

The city's secured bonds, which total about $7.1 billion, would likely fare better under the plan. Treatment of that debt is "subject to negotiation with holders," the report said. The city is considering floating new bonds to pay off current investors with changed payment terms aimed at generating debt service relief for the city, according to the report.

The report also featured a dramatic increase in the city's estimated unfunded liability in the city's two pension funds, which had been considered one of Detroit's healthiest assets. The new figure puts the unfunded liability at $3.5 billion, up from $600 million. The increased liability could allow Orr to remove current fund trustees.

The city's unsecured bonds total about $2.5 billion, including $1.4 billion of pension certificates, $161 million of limited-tax GOs and $369.1 million of unlimited-tax GOs backed only by a full faith and credit pledge.

Unsecured debt in general totals $11.4 billion. That includes $5.7 billion of other post-employment benefit liabilities, and $3.5 billion of unfunded pension liabilities.

The notion that Detroit may treat holders of some of its GO bonds the same as its OPEB liability could rattle the muni market, some said.

"It's a very different way to think about debt," said Matt Fabian, managing director of Municipal Market Advisors.

"Detroit is attempting to dissolve its capital structure and put its GO bonds on par with its pension certificates and the OPEBs," he said. "It's an amazing step.

"It implies that the state sees no distinction in parity between GOs for any city or their OPEBs or their lowest parity pledge," he said, noting that Orr is a representative of the state. "From this perspective, buying a GO bond from an issuer is similar to having a simple contractual obligation, and losing all sense of incremental security from the GO."

The proposed treatment will only emphasize a growing realization in the muni market that not all GO bonds are created equal. "It seems safe to say that municipal investors will buy bonds with their eyes wide open and know what the security features are," Michael Ross, managing director at Raymond James, said in an email.

Bankruptcy attorney James Spiotto at Chapman and Cutler LLP said it's too early to predict the ultimate treatment of the city's various obligations. A Chapter 9 bankruptcy court could view the obligations the same way Orr has, putting the general fund GOs backed only by Detroit's full faith and credit pledge on par with its OPEBs, Spiotto said.

"There's a possibility of that, and that's the concern you're hearing," Spiotto said. "The market anticipates that your full faith and credit pledge means more.

"The question is how will the market digest that and what will be the adjustment," he said. "Will it be viewed as an aberration, or will the market need more assurances for payments on GOs such that they have additional backup?"

The city's secured bonds include $379 million of GOs, both unlimited and limited-tax, and $878 million of payments due through 2035 on the city's interest-rate swaps hedging the unsecured pension COPs.

Another $5.9 billion of water and sewer revenue bonds are also treated as secured debt. Orr said Friday he would likely lease the departments to a new regional authority that would then sell new bonds to pay off current investors.

Orr also wants to lease the city's the parking system, the popular Belle Isle park, and possibly the Joe Louis Arena. The lighting department was recently transferred to a new bond-issuing authority.

In a statement, Gov. Rick Snyder, who appointed Orr, a former Jones Day bankruptcy attorney, to the post in late March, said there are “no easy answers.”

“The plan Kevyn discussed with creditors today requires shared sacrifice among all involved, but most importantly focuses on a restructuring designed to return Detroit to solid financial footing,” he added.

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