Bond Case Briefs

Municipal Finance Law Since 1971

Eight Things we Learned From the Detroit Bankruptcy.

Detroit's historic trip through Bankruptcy Court ended in December 2014 with the confirmation of the City's Plan of Adjustment, which trimmed $7 billion in debt from the city's balance sheet and promised improved resident services. At the beginning of the case, no one predicted that the city would emerge from bankruptcy so quickly — only about 18 months — or that the final Plan of Adjustment would enjoy such widespread support among creditors and politicians. What can we learn from the largest municipal bankruptcy ever?

1. Not all municipalities can take advantage of Chapter 9. Detroit's very first battle after it filed for bankruptcy was whether it was even eligible to do so. This dispute underscored a little known fact: Most U.S. municipalities are unable to file for Chapter 9 bankruptcy. A Chapter 9 filing must be "specifically authorized" by the law of the state where the city is located. So, in the case of municipal bankruptcies, the states themselves control access to the bankruptcy courts. About one-half of the states do not say anything at all about Chapter 9, so the municipalities in those states lack the "specific authority" to file bankruptcy. Other states, such as Michigan, have very rigorous prerequisites that must be satisfied before filing. Missouri law specifically permits most municipalities to file Chapter 9. Incidentally, the term "municipality" is much broader than "city." Other political subdivisions, such as water, school or levy districts, are also included within the definition of "municipality." States cannot themselves file bankruptcy, so Illinois will have to find another way to solve its financial problems. Even if a municipality can file bankruptcy, however, there is another very important threshold question.

2. Can public pension obligations be modified in Chapter 9 cases? Private industry long ago mostly moved from defined benefit pension plans to defined contribution plans. But defined benefit plans are still popular for government employees, including many municipal employees. Many states, including Michigan, have special protections for public pensions in their statutes or even their state constitutions. For instance, Michigan's state constitution says: "The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby." Therefore, when Detroit filed its case, there was a legitimate question about whether the public pensions could be modified in the Chapter 9 case.

Michigan's Attorney General argued that Michigan's constitution absolutely prohibited any restructuring of vested pension benefits. Not surprisingly, various retiree groups also opposed the city's efforts to reduce pension benefits. The bankruptcy judge ultimately determined, however, that pension benefits were not entitled to any more protections than any other contractual benefits and permitted Detroit to propose a plan that reduced vested benefits. The judge in the Stockton, California, Chapter 9 case ruled the same way a few months later. Public retirees can no longer assume that their vested benefits are sacrosanct. A definitive trend is developing in the law that a federal bankruptcy court can modify those kinds of benefits, even though state or local law suggests that they cannot be modified.

3. Bondholders and pensioners vs. residents. The Detroit case was mind-numbingly complex; one observer called it the Olympics of Restructuring. But in its simplest terms, the case was all

about balancing the interests of three groups:

- Bondholders who held billions of dollars of debt issued by Detroit or its city agencies and for whom the prospect of a massive municipal default was utterly unthinkable.
- Retirees who had worked for the city for decades at below-market wages but who looked forward to a stable pension in their retirement.
- And the city's residents, who had seen city services deteriorate to a level not often seen in this country; indeed, one Forbes columnist called Detroit "America's first Third World city."

Each of the three groups had strong legal and equitable arguments that they claimed should be favored at the expense of the others. The bondholders argued that the entire municipal finance market was predicated on a municipality's solemn promise to pay the bonds, no matter what, and that the cost of municipal credit would increase all across the country if Detroit were permitted to default. The retirees argued that their pensions were not overly generous (the pensions generally ranged from $1,500 to $3,000 per month) and pointed out that many of the former employees were ineligible for Social Security because they did not have sufficient service time in the private sector. The residents pointed to Detroit's dramatic population decline, from 1.8 million in 1950 to less than 700,000 in 2013, as evidence that its residents were "voting with their feet" by leaving the City whenever they were able.

Of course, there were also many differences within the three major groups. Some of the bonds (but not all) were insured by large insurance companies, but the exposure of the bond insurers was so large that their own existence was threatened if they had to pay out. Some bonds were secured by income streams from specific projects, but others were not. Even the pension obligations were complicated. The police and firefighters had a separate pension plan from the other retirees, and it was in considerably better financial shape than the general plan. Moreover, the former city employees were entitled to other post-employment benefits (called "OPEB" in pension parlance) in the form of health and life insurance benefits that were not pre-funded at all. When everything was totaled up, Detroit had a staggering $18 billion or so in liabilities.

4. It really helps to own a $1 billion art collection. Along with its 78,000 abandoned buildings and 70 Superfund sites, Detroit also happened to own a world class art collection that included Van Gogh's "Self-Portrait," Rembrandt's "The Visitation," and Matisse's "The Window." Detroit's involvement in the art world dated back to 1919, when the City bailed out its then-bankrupt local art. In the 1920s, when Detroit was riding particularly high, the museum went on a buying spree and accumulated a collection that was the envy of museums in much larger cities. By 2013 when Detroit filed Chapter 9, the art collection was probably the city's most valuable asset, and the bondholders and retirees, who could agree on almost nothing else, both argued that it would be unfair for Detroit to keep its valuable artwork while asking for creditors to take deep discounts. After months of legal wrangling and public sniping, with estimates of the art collection's value ranging from $350 million to $2 billion, the parties reached the so-called "Grand Bargain."

This agreement, forged in dozens of court-ordered mediation sessions, formed the cornerstone of Detroit's bankruptcy plan. The deal called for the transfer of the art collection to a charitable trust in exchange for $816 million contributed from the State of Michigan, private donors, and several large charitable foundations, including the Ford Foundation, which donated $125 million itself. The retirees had to agree to accept relatively modest reductions in their monthly pensions (less than 5%) but future cost of living adjustments were eliminated. Also, almost all of the other post-employment benefits, such as retiree health care and life insurance, were slashed or eliminated.

5. Retirees fared much better than bondholders. The consensus is that the retirees fared much better than the bondholders in Detroit's case, and that the disparity in treatment was as more

because of political concerns than legal distinctions. For instance, the funders of the Grand Bargain insisted that their contributions go toward shoring up the pension plans — not into the pockets of the bondholders. As the case progressed, the judge, the court-ordered mediators, and the other parties began clearly discounting the bondholders' arguments that the entire U.S. municipal bond market would be harmed if Detroit did not pay back its bond debt in full. The city reached agreements with its other creditor groups before turning its attention to the bondholders (or more precisely, the companies that insured the bonds against a default). Faced with the prospect of being the only remaining major hold-out, the bondholders began a frantic round of last-minute deal making.

For instance, Detroit and Syncora (one of the largest bond insurers) reached a deal that will set the creativity bar very high for future settlements in other cases. Syncora just happened to own the company that operates the Detroit-Windsor tunnel, having acquired that company when it filed bankruptcy several years ago. The lease on the tunnel was set to expire in 2020. As part of its settlement with Syncora, the City of Detroit agreed to extend the tunnel lease through 2040, and to give a Syncora a long term lease on a city-owned parking lot, conditioned on Syncora's commitment to make $13 million in improvements on the garage. The city also gave Syncora credits to purchase additional city-owned property in the future, including the old Joe Louis Arena. Similarly creative arrangements were reached with the other major bond insurer.

6. Not all bonds are alike. The bondholders were treated very differently, depending on the types of bonds they held. Some of the bonds that were well secured by project revenues will actually receive payment in full. Other bonds, which were secured by little or no collateral, will receive as little as 15% of their claims. This result turned the municipal bond market on its head. Historically, the bond market has considered so-called "general obligation" bonds as the safest debt that a municipality can issue because the municipality can always raise taxes to make bond payments. Special revenue bonds, on the other hand, have historically been viewed as more risky because the bond payments could come only from the collateral securing them. In the Detroit case, however, "general obligation" bonds were considered unsecured claims that are typically among the last to receive any payment in a bankruptcy case. To-date, however, the gloom and doom predictions about the future of the municipal bond market have been unfounded.

7. Municipal reorganizations are expensive. The total bill for Detroit's bankruptcy professionals was around $170 million, or about $10 million per month. Jones Day, the city's lead bankruptcy counsel, is set to collect over $51 million in fees, which it claims equates to about $17 million in discounts from its normal billing rates. Dentons, the lead bankruptcy counsel for the official retirees committee, made over $14 million. Dozens of other law firms and consultants also worked on the case. A law firm was even appointed to review and monitor the other professionals' bills, and that firm has been paid over $500,000.

8. City services should improve. Residents and visitors to Detroit have long endured abysmal city services. The average response time for a Detroit police call in 2013 was 58 minutes, compared to 11 minutes nationwide. Forty percent of the city's street lights were burned out in 2013. As part of the bankruptcy restructuring, Detroit plans to spend $1.7 billion over 10 years in so-called reinvestment and restricting initiatives, including $400 million to demolish the 78,000 or so blighted or abandoned buildings, $91 million to replace police vehicles — more than half of which are over 10 years old — and $152 million in IT expenditures — about 80% of the city's computers still run Windows XP.

Thankfully, Detroit is *sui generis*. No one expects a flood of municipal bankruptcies based on the relative success (at least insofar as we can tell at this point) of Detroit's restructuring. Missouri's large cities, however, are not immune from some of the same pressures and problems that

contributed to Detroit’s financial melt-down.

2/11/2015

by David Warfield | Thompson Coburn LLP

(This article originally appeared in Missouri Lawyers Weekly.)

Copyright © 2026 Bond Case Briefs | bondcasebriefs.com