[Bond Case Briefs]

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[NYT: In Embattled Detroit, No Talk of Sharing Pain; A bankruptcy in Detroit would have no precedent, despite an unusual flurry of municipal bankruptcies after the financial crisis.]

When New York City threatened to declare bankruptcy in 1975, the idea so terrified everyone that it forced the city, its workers and its recalcitrant bankers to sit down and find ways to share the pain.

Now another large city, Detroit, appears to be on the brink of filing for bankruptcy, but there is little talk of sharing the pain. Instead, the fiscal crisis in Michigan is setting up as a gigantic clash between bondholders and city retiree.

The city's proposals, which could give some bondholders as little as 10 cents on the dollar, are making some creditors think they would be better off in bankruptcy. They see the specter of a federal judge imposing involuntary losses as less ominous than it was for New York.

"The haircut is so severe," said Matt Fabian, a managing director of Municipal Market Advisors, "I think it's scaring them into bankruptcy, rather than away from bankruptcy."

But city retirees, facing the prospect of sharply reduced benefits whether in bankruptcy or under Detroit's restructuring proposal, think they stand squarely on the moral high ground because despite the poverty of many current and retired members, they have already offered big concessions.

"It's not the employees that are costing the city money," said Edward L. McNeil, an official with the American Federation of State, County and Municipal Employees who is leading a coalition of 33 unions that will be affected by any restructuring of Detroit's debts, which total roughly $17 billion. Just last year, he said, those unions offered concessions that could have saved the city hundreds of millions of dollars a year. But Detroit "botched the implementation," he said.

And Michael VanOverbeke, interim general counsel for the general workers' retirement plan, said bondholders were investors hoping for returns, who should expect "a certain amount of risk."

"Planning for retirement and working for employers was not an investment into the market," he added. "These are people who are on a fixed income at this point in their life. They can't go back to work and start all over again." He said it was unthinkable to cut retirees' pensions outside of bankruptcy.

A bankruptcy in Detroit would have no precedent, despite an unusual flurry of municipal bankruptcies after the financial crisis. Rhode Island hurriedly passed a law giving municipal bondhholders priority over other creditors, including retirees, just before the small city of Central Falls filed for bankruptcy. That helped Central Falls resolve its bankruptcy quickly, but no one thinks Michigan could pass such a law. In Jefferson County, Ala., a large majority of the financial trouble grew out of debt issued to rebuild a sewer system, not pensions or other employee benefits. The rights of public workers and bondholders are in conflict in the bankruptcy of Stockton, Calif., but that case is not yet far enough along to be of any guidance to Detroit.

With talks on labor issues scheduled for Thursday, municipal bond market participants say one of their main concerns is that the city's proposal would flatten the traditional hierarchy of creditors, putting say, a retired librarian on par with an investor holding a general obligation bond. That does not square with the laws and conventions of the municipal bond market, where for decades small investors have been told that such bonds are among the safest investments and that for "general obligation" bonds cities could even be compelled to raise taxes, if that's what it took to make good. The "full faith and credit" pledge was supposed to make such bonds stronger than the other main type of muni — revenue bonds, which promised to pay investors out of project revenue.

Public finance experts have warned that broad societal problems could follow a loss of faith in municipalities' commitments to honor their pledges. In a major report on the state of the muni market last year, the Securities and Exchange Commission warned that communities would find it increasingly costly to raise money, throwing into question the time-honored practices of building and financing public works at the local level.

Detroit's proposal shows how much things have changed since the days when the municipal bond market consisted of two types of debt and little else. The emergency manager, Kevyn D. Orr, issued a complicated list of debts with a wide range of gradations, with general obligation bonds now inferior to revenue bonds.

Mr. Orr classified Detroit's general obligation bonds into two groups — secured and unsecured — with the secured ones backed by outside sources of money, like state aid or federal block grants. The unsecured bonds are those that rely only on Detroit's "full faith and credit" pledge. As a practical matter, much of Detroit's bond debt is insured, so bondholders will feel no immediate pain as the city moves forward with its planned defaults. But the bond insurers have the right to do battle in the bondholders' place, and other market interests are likely to join them.

Mr. Fabian said bondholders knew perfectly well that Detroit was broke and could not raise taxes and fees enough to cover all its bonds, but were still shocked by the proposed treatment.

"It's not that people just want to get more money out of Detroit," he said. "It's the violence that's being done to the city's capital structure. It creates a new paradigm for investing in Michigan bonds."

In the past, he said, the ratings agencies included the various debt structures in their evaluations of municipal bonds. An "unlimited-tax general obligation bond," for instance, might be rated one or two notches higher than a "limited tax" version of the same bond. Investors would look at the rating, know what they were getting and pay more for the safer debt.

"Michigan is saying all that will go out the window," Mr. Fabian said. "In effect, they're saying that structure only matters when you don't need it" — when everything is normal and the debt is being repaid.

"And when you need to rely on those legal differences, then they don't matter," he added. "It's distressing."

Municipal market participants are also rattled by a big, sudden increase in Mr. Orr's measurement of Detroit's pension shortfall, which he is also classifying as unsecured, leaving workers and bondholders to compete for whatever pool of money is left over. As of June 30, 2011, the city's most recent actuarial snapshot showed that its two big pension funds were in pretty good shape — short by just $644 million, because the city had issued securities called “certificates of participation” in 2005 and 2006, and put the proceeds into the pension funds.

But Mr. Orr’s report said that estimated shortfall had been “substantially understated” through aggressive assumptions and other distortions. After correcting those, the two funds’ shortfall was closer to $3.5 billion.

And as for those certificates of participation, issued to produce money for pensions, they turn out to be among Detroit’s shakiest debts. The city already skipped a payment due last Friday, and Mr. Orr said the city had found “certain issues related to the validity and/or enforceability” of the debt. His report did not specify what the issues were, but said further investigation might be warranted.

The report said that to some extent, the trustees who sit on Detroit’s pension boards had worsened the pension trouble by promising workers “ad hoc sweeteners” and diverting investment income to other uses. As state-appointed emergency manager, Mr. Orr has authority to remove pension trustees.

But Mr. VanOverbeke said the trustees were not going anywhere. In fact, they have already set aside $5 million for a legal challenge in case Mr. Orr puts them “in a position that they would not have the resources necessary” to protect the pensioners, Mr. VanOverbeke said.

“It wasn’t put aside to do battle,” he said. “They were set aside so that as fiduciaries they can make the appropriate decisions and take the necessary actions as it is deemed appropriate.”