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Detroit Swap Settlement Could Be Key to Bankruptcy Case.

U.S. Bankruptcy Judge Steven Rhodes Wednesday heard arguments from a bond insurer trying to halt Detroit's one and only pre-bankruptcy filing settlement, which would terminate a series of interest-rate swaps hedging $800 million of the city's pension certificates.

Detroit says the settlement is key to its fiscal stability as it moves through the historic bankruptcy case because it would give the city access to about $170 million in annual casino revenue, considered one of its most stable revenue streams.

The settlement is also important because Detroit could use the casino revenue as collateral to secure debtor-in-possession financing. DIP financing typically gives the lender a priority lien, and that could affect the liens of all Detroit's creditors.

"It's going to be one of the more important parts of the case," said a source close to the bankruptcy who asked to remain anonymous.

It would be the first time in a Chapter 9 case that a municipality secured debtor-in-possession financing, the source said.

"If you have DIP financing, you will see another set of discussions about whether it's appropriate in Chapter 9 and the timing of the liens with existing creditors. If you give them enough liquidity, then value is preserved, and if that happens in Detroit it will raise some interesting questions."

Rhodes heard arguments during the Wednesday afternoon hearing from the chief challenger to the settlement, Syncora Guarantee Inc., which insures both the swaps and the pension certificates.

Syncora wants Rhodes to allow it to "trap" the casino revenues, which are used as collateral on the swaps, until the judge rules on the settlement. Rhodes is expected to issue a written opinion on the stay within the week, according to local reports. He may rule on the settlement itself on Sept. 9. The judge ordered Thursday that the dispute be sent to mediation.

The settlement, reached days before emergency manager Kevyn Orr filed for Chapter 9, calls for Detroit to pay UBS AG and Merrill Lynch 75 cents on the dollar to terminate the swaps at a penalty currently estimated at just under $300 million. The agreement would give the city access to roughly $11 million a month in casino revenue currently used as collateral on the swaps. The banks would promise not to pursue insurance payments from Syncora.

Before announcing the settlement, the city sued Syncora, which had instructed the swap custodian to hold back all casino revenue in light of the city's June default on a $40 million debt service payment on the certificates.

Detroit won a temporary restraining order against the freezing of the revenue, and Syncora countersued.

Several bond insurers and holders of some of the pension certificates are also opposed to the

settlement. Along with Syncora, Ambac Assurance Corp., Assured Guaranty Municipal Corp., Financial Guaranty Insurance Company, and National Public Finance Guarantee Corp., filed court briefs challenging the agreement last week, arguing in part that the 75% deal overpays one set of creditors at the expense of others.

The city's attorneys told Rhodes Wednesday that access to the casino money is crucial to Detroit's fiscal health as it attempts to restructure.

"This is probably the highest-quality tax stream the city has," attorney Corinne Ball said. "Being able to use the revenue stream is pivotal."

Syncora argued that the swap termination would negatively affect the firm's financial position, that Orr repeatedly misrepresented the nature of the swaps, which have provisions designed to protect the insurer, and that the casino revenues are exempt from the automatic stay.

"The swaps are an important protection against rising interest rates on the COPs obligations that Syncora insurers," the firm said in a court filing ahead of the Wednesday hearing.

"Put simply, Syncora's exposure will grow dramatically if the city and the swap counterparties are allowed to avoid the operation of the collateral agreement and Syncora's consent rights under the swaps – and that exposure will easily outstrip the ostensible 'release' Syncora will obtain if the swaps are allowed to terminate," Syncora said in the court challenge.

Syncora attorney Stephen Hackney of Kirkland & Ellis LLP said the swaps feature a provision that give Syncora the right to refuse a termination in the event of a default on the certificates, and that in the event of a default, the casino revenues are supposed to automatically accumulate in the trustee's account.

Syncora also argued that the city is not in desperate need of the revenue, citing Orr's restructuring plan as evidence. The plan projects a net operating surplus of $227 million for 2014 without the casino revenue, Syncora said. "The city's desire for cash is not a basis to disregard the plain language of the collateral agreement, which was designed to operate automatically."

Ambac, in its Aug. 16 court filing, called the validity of the swaps lien on casino revenue "highly dubious" and said it is in violation of state law, which does not allow casino revenue to be used as collateral on a financial obligation.

Ambac also argued that the casino revenue does not qualify as special revenues that are exempt from the bankruptcy case.

"An objective evaluation of the necessary factors simply cannot support a compromise so heavily weighted in the swap counterparties' favor," Ambac said. The city is "overpaying one set of creditors at the expense of other similarly situated creditors," the insurer argued.

Assured called the proposed settlement "unreasonably favorable to the swap counterparties."

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