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NYT: 'Safe Harbor' in Bankruptcy Is Upended in Detroit Case.

As Detroit struggles to come up with money to improve services for its residents, two large banks are poised to receive hundreds of millions of dollars to cancel a deal that helped push the city into bankruptcy in the first place.

The two banks, UBS and Bank of America, were the only creditors that managed to reach a settlement with Detroit before the city declared bankruptcy last July. They agreed to let Detroit out of financial contracts called interest-rate swaps for 75 percent of what the city owed, or about \$230 million. They also agreed to give up some casino tax proceeds that Detroit had pledged to them as collateral for the swaps.

The 75 cents on the dollar is a far better deal than the city's other creditors will probably get. And because of an unusual provision in the federal bankruptcy code, these two banks actually have a legal right to 100 cents on the dollar. The provision gives traders in swaps, options and other derivatives a so-called safe harbor, exempting them from the usual stay that blocks creditors' efforts to collect debts.

The provision has turned on its head the meaning of safe harbor in bankruptcy. Bankruptcy proceedings are supposed to give debtors like Detroit a safe place to negotiate a way out their problems under the protective eye of a federal judge.

Bankruptcy law rests on the bedrock principle that the best outcome can be achieved if everybody shares equitably in the pain and losses. But in the brave new world of municipal bankruptcy, the law gives derivatives traders an even safer harbor than Detroit's.

"These safe harbors make no logical sense in this context," said Steven L. Schwarcz, a professor at Duke University School of Law who has written on the special treatment of derivatives in corporate bankruptcies. Detroit was in bankruptcy court last week seeking approval for its deal with Bank of America and UBS.

But on Friday, the bankruptcy judge, Steven W. Rhodes, sent the city and the banks back to confidential mediation to improve the terms for the city. The mediation was expected to continue through Christmas Eve.

But in the tangle that is Detroit's finances, the swaps deal is only one part of the equation. The city is seeking to borrow \$350 million from another bank, Barclays Capital, to finance its operations in bankruptcy, and it needs to resolve the swaps deal before it can get the loan. Without the loan, lawyers for the city say, it soon might not be able to meet its payroll.

But any time a debtor tries to borrow in bankruptcy, it stirs opposition, since the new loan will worsen the insolvency. The Barclays deal also gives it priority over all the existing creditors. And the bulk of the \$350 million loan will go to pay UBS and Bank of America to terminate the swap contracts. Since those two banks would no longer need Detroit's casino revenue as a backstop, the

city could then use that money as collateral for the new Barclays loan.

The rest of the proceeds from the loan, \$120 million, would go to the streetlights, the police, the razing of dilapidated properties and other city services that the residents of Detroit sorely need.

Last week's hearing over these arrangements broke down when Judge Rhodes asked the city's emergency manager, Kevyn Orr, to explain why 75 cents on the dollar was a good deal. Mr. Orr declined to answer the question and asked instead for the hearing to be suspended.

If the current mediation talks fail, the two banks would once again have the safe harbor advantage under law, leaving Detroit to fight back in court by arguing that the swaps were flawed in some way and unenforceable. James E. Spiotto, a bankruptcy lawyer with the law firm Chapman and Cutler in Chicago, who is not involved in Detroit's case, said that prospect might explain why Mr. Orr was unwilling to sing the praises of Detroit's swap settlement in court. If he had, it would be hard for Detroit to come back with a lawsuit contending the swaps were no good.

Bank of America and UBS declined to comment.

Congress created the safe harbor for derivatives because they could pose systemic risk — if one bankrupt institution failed to make payment, it could swiftly bankrupt its trading partners, and they, in turn, might bankrupt their other trading partners, setting off a toxic cascade.

But some bankruptcy experts question the fairness or even the effectiveness of this exception.

Professor Schwarcz said it was not clear that the safe harbors were serving their intended purpose even in cases where the debtors are companies — let alone in a municipal bankruptcy like Detroit's, where thousands of residents are being dragged along on the miserable journey.

"When you're in a municipal bankruptcy, where the debtor is a municipality, there are very strong public-interest considerations that ought to be balanced," Mr. Schwarcz said. He and other specialists said there had not been any such discussion in Detroit's case. Nor, they said, has anyone in Congress asked whether this part of the bankruptcy code was working properly.

"There is very, very strong interest-group support for keeping the safe harbors, but there's not a well-developed interest group that understands the need to change them," said David A. Skeel Jr., a corporate law professor at the University of Pennsylvania. "In my view, there ought to be strong pressure to change the safe harbors."

Congress began exempting derivatives from the automatic stays on collecting debts in bankruptcy in 1978. The initial exemptions — options and futures, among them — were narrow, Mr. Schwarcz wrote in a legislative history of the safe harbor. But every few years after that, Congress broadened them and added new types of derivatives, including swaps in 1990.

Mr. Schwarcz found in his research that the expansion of the safe harbor helped the derivatives industry to grow. The growth then led to bigger risks of a meltdown, prompting calls from the derivatives industry for Congress to expand the safe harbor even further.

In all that growth and expansion, he said in an interview, no one stopped to make sure the safe harbor was truly reducing systemic risk or covering the right types of institutions. The surfacing of safe harbor in a bankruptcy like Detroit's seemed especially jarring.

Detroit entered into the swap contracts back in 2005, when it tapped the municipal bond market for \$1.4 billion to put into its workers' pension funds. Much of the deal was structured with variable-

rate debt, and the swaps were intended to work as a hedge, to protect Detroit if interest rates rose. But as things turned out, rates went down, and under those circumstances, the terms of the swaps called for Detroit to make regular payments to UBS and Merrill Lynch Capital Services, now part of Bank of America. Detroit has been doing so, even in bankruptcy. The swaps now cost it about \$36 million a year.

In retrospect, it seems clear that Detroit was already struggling in 2005 and a poor candidate to borrow the \$1.4 billion. The borrowing required an unusual structure to avoid violating the city's legal debt limit. In 2009, the debt was downgraded to junk, putting the city out of compliance with the terms of the swaps. So Detroit restructured the swap obligations, offering the two banks the tax revenue that it received from local casinos as a backstop.

The city's finances went from bad to worse after that. Now that Detroit is bankrupt, it needs those casino revenue, and some of its biggest battles are being fought over how it dealt with that swap restructuring back in 2009.

"You look at this transaction, and you say it smells," said Mr. Skeel, who is currently a visiting professor at New York University's law school. "It looks exactly like the sort of thing that you would want a bankruptcy judge to be in a position to sort out, and reverse if that is necessary. That's something that the safe harbors make a lot harder."

BY MARY WILLIAMS WALSH