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NYT: Detroit Turns Bankruptcy into Challenge of Banks.

Detroit's bankruptcy is rapidly shaping up as a battle of Wall Street vs. Main Street, at least as far as the city's creditors are concerned.

Amy Laskey, a managing director at Fitch Ratings, said in a recent report that she sensed an "us versus them" orientation toward debt repayment. And in the view of bondholders, bond insurers and other financial institutions, it only grew worse last week after the city circulated its plan to emerge from bankruptcy and filed a lawsuit on Friday.

The suit, brought by the city's emergency manager, Kevyn D. Orr, seeks to invalidate complex transactions that helped finance Detroit's pension system in 2005. In a not-so-veiled criticism, the city said the deal was done "at the prompting of investment banks that would profit handsomely from the transaction."

The banks that led the deal were Bank of America and UBS. They helped Detroit borrow $1.4 billion for its shaky pension system and also signed long-term financial contracts with the city, known as interest-rate swaps, to hedge the debt. Detroit has already stopped paying back the $1.4 billion, but for the first six months of its bankruptcy it kept honoring the swaps contracts and at one point offered to pay the two banks hundreds of millions of dollars—money it would have had to borrow—to end them. But the lawsuit now seeks to cancel the swaps, arguing they were illegal from the outset along with the related debt transactions.

Perhaps of even greater concern to creditors is the city's 99-page "plan of adjustment," the all-important document that details how Detroit proposes to resolve its bankruptcy and finance its operations in the future. Banks, bond insurers and other corporate creditors think they are being asked to share a disproportionate amount of pain under the plan, still in draft form and not yet filed with the bankruptcy court.

"The essential issue is the near-total wipeout of the bondholders," said Matt Fabian, a managing director of Municipal Market Advisors. He said Detroit's case appeared to be heading toward a "cramdown," or court-ordered infliction of losses on unwilling creditors.

Municipal bonds have been renegotiated and restructured in the past, both in and out of bankruptcy, with a reduction in interest rates and extension of payments. But bankruptcy specialists say that, until now, municipal bondholders have not had losses of principal forced on them by a court. Participants in the municipal bond markets say the dreaded cramdown may be looming in Detroit, where they are finding themselves increasingly portrayed as greedy, and where plans are taking shape to elevate pensions above municipal bonds, though both are unsecured in bankruptcy.

Bankruptcy law is based on the idea that losses can be kept to a minimum if all parties work together to share the pain instead of cutting preferential deals for themselves at the expense of other creditors. From the beginning of Detroit's bankruptcy last summer, Gov. Rick Snyder of Michigan has said the intent was to "determine the best path forward that respects, and is fair to, pensioners and all parties."

But now Detroit's capital-markets creditors—its bondholders, bond insurers and other financial institutions—say the plan of adjustment is unfair. It calls for the city to give pensioners up to 50 cents on the dollar for their claims, while other unsecured creditors, like those that bought Detroit's general-obligation bonds, would end up with about 20 cents on the dollar. The pensioners' claims would be paid with cash, while general-obligation bondholders would receive notes that Detroit proposes to issue.

"The capital-markets guys can still sue against this as unfair, and they will," Mr. Fabian said.

The debt that raised $1.4 billion for the city pension system in 2005 would suffer bigger losses still. The plan of adjustment does not accept the entire $1.4 billion as a valid claim, only about half of it. So the investors who bought that debt, called "certificates of participation," often called COPs, would end up with about 10 cents on the dollar. It would come in the form of a different series of notes, which has lags built into the payment schedules.

"We understand discriminatory treatment of the COP deal might be politically popular, but we believe it to be flawed both legally and as a matter of public policy," said Derek Donnelly, a managing director for the Financial Guaranty Insurance Company, a bond insurer that promised to backstop the certificates in 2005. The insurance made it easier for Detroit's underwriters, Bank of America and UBS, to market the certificates. And Detroit paid a lower rate of interest on the debt until it defaulted last summer just before the bankruptcy.

The financial institutions that helped raise money for Detroit's pension system are dismayed now to see themselves portrayed as shady characters in the new lawsuit, according to people briefed on the matter. The suit contends their transaction "has put very fatal strains upon the city's finances," but as they see it, the city already had a crushing debt to its own workers, much of which was hidden, before they arrived on the scene. Some of them are now talking privately about lawsuits that would unwind the 2005 borrowing and force Detroit's pension funds to return the money.

Spokesmen for Bank of America and UBS declined to comment on the lawsuit.

Ms. Lasky and Mr. Donnelly both expressed concern that by giving the pensions priority over capital-markets debts, Detroit's lawyers could be making it harder for other Michigan cities, counties and school districts to raise money in the future. Ms. Lasky said that because municipal bankruptcies are so rare, and Detroit's debts so big, the city stood to set an outsized precedent that might even affect cities outside of Michigan.

"Actions and rhetoric that suggest bondholder rights are not an important consideration will continue to damage market perception of the state and its local governments," Ms. Lasky said.

Bankruptcy experts who are not involved in Detroit's case said it would, in fact, be possible for the city's pensioners to come out at the top of the pecking order, even though they were on par with the general-obligation bondholders when the bankruptcy began.

"You can treat general creditors differently, as long as you have a good reason to treat them differently," said David A. Skeel, a law professor at the University of Pennsylvania who specializes in bankruptcy issues. "You don't have to give them exactly the same percentage, but you can't treat them wildly disproportionately."

He said it was not at all rare for a bankruptcy judge to approve a higher rate of recovery for a creditor with some essential business relationship with the bankrupt party. While it would be hard to say that Detroit's retirees fill a conventional business purpose, the city could still make valid arguments that its finances would be hurt if it cut the retirees' benefits too drastically because it would then have to find money to support them in other ways.

"There's also a humanitarian interest in not wanting to cut the pensions severely as well," Mr. Skeel said.

—By Mary Williams Walsh of The New York Times

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