Bond Case Briefs

Municipal Finance Law Since 1971

Detroit Bankruptcy Bond Fight a Watershed for Municipal Market.

(Reuters) – The city of Detroit's effort to declare some of its general obligation bonds as unsecured debt will be challenged in bankruptcy court Wednesday in what could be a precedent-setting turn in the largest-ever municipal bankruptcy in U.S. history.

The issue in front of federal bankruptcy Judge Steven Rhodes is whether a pledge of Detroit tax revenue to pay off the voter-approved bond issues is a binding obligation under Michigan law, as argued by bond insurers in two lawsuits, or merely a promise.

The outcome of the dispute could have a far-reaching impact on the $3.7 trillion municipal market, where general obligation bonds made up some 60 percent of the issues sold in the last decade.

That could reduce investor interest in not only any future Detroit borrowings but in debt from other Michigan municipalities, forcing them to pay higher interest rates. And it could trigger similar concerns for municipal borrowers in other states.

Investors always have considered the full faith and credit pledge by cities, school districts and other issuers to pay off those bonds "sacrosanct," according to Natalie Cohen, the head of muni research at Wells Fargo Securities.

But Detroit's effort to declare some of its GO bonds to be unsecured debt could change that assumption.

"This is a significant issue for the bond community, not just in Detroit but in all cases, because the implication is that if the court finds these aren't secured, this will go far beyond Detroit," said Michael Sweet, a bankruptcy attorney with Fox Rothschild in San Francisco.

The outcome could revolve around the meaning of the word "pledge" under Michigan law.

In the proceeding on Wednesday, Rhodes will hear Detroit's argument that the city's pledge to repay some $410 million of general obligation bonds outstanding as of the end of the city's fiscal 2012 is far less than binding.

In their lawsuits, bond insurers on the hook for making up missed payments on the bonds have asked Rhodes to rule without hearing any testimony, in what is known as a summary judgment.

Rhodes could rule for either side, or he could send the matter to a trial and allow both sides to begin taking depositions and finding expert witnesses to support their arguments. In a December hearing, Rhodes said he might want testimony about how the dispute impacts other creditors.

PROMISE VS OBLIGATION

Detroit must treat the bonds as secured only if a legal lien exists, and under Michigan law, there is no lien, Detroit argues. When Detroit issued the bonds, its pledge to repay the borrowed funds, was, under state law, only a synonym for "'promise,' as in 'I pledge allegiance to the flag,'" the city argued in a court filing.

The three bond insurance firms do not see it that way. National Public Finance Guarantee Corp, the public finance subsidiary of MBIA Inc, and Assured Guaranty Municipal Corp jointly filed one lawsuit, and Ambac Assurance Corp filed another, soon after Detroit defaulted on a $9.4 million interest payment last October 1. That was its first GO bond default under Kevyn Orr, the city's state-appointed emergency manager.

They claim bondholders and the insurers have a statutory lien on property-tax revenue specifically earmarked for the bonds. Instead of repaying the bonds, the city is using that tax money for general purposes and has no right to do so, the insurers argue.

"Nothing in Chapter 9 or elsewhere in bankruptcy law allows the city to disregard the state law restrictions imposed on the restricted bond taxes and use the funds for unauthorized purposes," said a court filing by National Public Finance and Assured.

But the city in its motion to dismiss the lawsuits counters that Chapter 9 of the U.S. Bankruptcy Code trumps state law while Detroit is in bankruptcy. The insurers are seeking protections granted under Chapter 9 only to creditors with a lien. Detroit further argues that the insurers lack standing to enforce state law provisions governing the bonds.

THE PRICE OF VICTORY

A lot is at stake for the insurers.

"Secured in this bankruptcy and not secured can mean the difference between getting paid in full and half your money," said John Pottow, a professor at the University of Michigan Law School.

If Judge Rhodes rules in Detroit's favor, the city could find itself paying unofficial penalties next time it seeks to borrow money, warned James Spiotto, managing director of Chapman Strategic Advisors.

Should Rhodes declare the GO bonds to be unsecured, Detroit could find itself paying an extra 200 basis points or more on future borrowings, he said. "Either your (market) access or costs or both will be impaired, and you'll be paying more," Spiotto said.

Michigan governments likely could see costs rise, too. And muni investors would be forced to sort through which states have laws and history that support the treatment of GO bonds as secured debt, Spiotto added.

If the bond insurers lose, the chief effect will be that liens and other protections will be better documented for future deals, said Sweet, the Fox, Rothschild bankruptcy lawyer.

"It doesn't mean there won't be deals," he said. "They will just be more careful."

(Reporting By Karen Pierog and Tom Hals; Editing by David Greising, Martin Howell and Jan Paschal)