Bond Case Briefs

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WSJ: Mow-Down in Motown.

Bond insurers have a good case against Detroit for unfair treatment in bankruptcy.

Federal Judge Steven Rhodes will begin hearings Tuesday to determine whether Detroit's readjustment plan fulfills the legal and fiscal requirements to exit Chapter 9 bankruptcy. The trial may provide investors a lesson, instructive but painful, in how politics can override law in municipal bankruptcies.

Since declaring bankruptcy in July 2013, Detroit has cut deals with nearly all of its major creditors. Workers, retirees and most bondholders this summer voted to accept the plan. Yet Judge Rhodes must still validate that the plan is "fair and equitable" and was proposed in good faith, among other standards of Chapter 9.

The reality is that some creditors are making out far better than others with similar legal standing. The city has offered general-obligation bondholders 34 to 74 cents on the dollar. Voluntary Employee Beneficiary Associations will administer reduced health benefits, and pensions will be modestly trimmed under a deal negotiated by the court's mediator.

The state, the Detroit Institute of Art and some philanthropies have pledged $816 million to shield the city's artwork from monetization. These proceeds will exclusively fund pensions and minimize benefit cuts. Accruals for non-public safety workers will be pared by 4.5% in lieu of the 26% emergency manager Kevyn Orr proposed earlier this year. The city has even agreed to restore cost-of-living adjustments and accruals in nine years if the pension funds are flush.

In other words, the plan patently favors workers and retirees over bond insurers Syncora and Financial Guaranty Insurance Company that have similar legal standing. To their current regret, the two companies insured $1.4 billion in certificates of participation (COPs), a common form of government financing, that the city issued last decade to shore up its pension funds. According to the city's calculations, insurers stand to recover at most 10 cents on the dollar, which is 30 to 50 cents less than the pension funds. Does the city really consider this distribution equitable and fair?

Under Chapter 9, a city isn't required to monetize its assets. However, it can't requisition assets to goose the recovery of a single creditor as Detroit has done with its art. As a counter-example, imagine the political blowback if the city had decided to sell its Belle Island to make bond insurers whole and no one else.

Detroit has tried to browbeat Syncora and Financial Guaranty into settling for the mere 10% by suing to void the COPs. In 2005 Detroit politicians circumvented their state-imposed debt limit by creating "service corporations" and intermediary pension-fund trusts to issue the COPs. They provided third-party legal opinions to investors validating the framework.

But earlier this year the city sued its service corporations to undo the COPs transaction, even as it wants to keep the $1.4 billion it borrowed. If the transaction was invalid, then the city can't retain the proceeds. This would be as if Argentina sued itself in international court for issuing bonds in alleged violation of its sovereign laws and then refused to repay its lenders. The legal terms for this are fraud and theft.

Detroit is supposedly seeking to rehabilitate its political culture, so it’s not a good sign that it’s trying to pull a fast one on creditors. The cynicism is reinforced by the city’s agreement to pay banks 30 cents on the dollar for interest-rate swaps tied to the COPs. If the COPs are invalid, why aren’t the swaps too?

Retirees and unsecured GO-bond holders have also been promised a higher recovery if courts undo the COPs transaction. By dangling this fillip, the city induced the unsecured bondholders to support the plan.

Trouble is, if courts void the COPs, the pension funds may be required to disgorge the $1.4 billion and interest. That could render the pension funds insolvent. Since the COPs litigation could extend past bankruptcy, Detroit might face another fiasco down the road.

Bankruptcy allows municipalities to break contracts and restructure obligations, but in return they are required to treat creditors fairly. Institutions and individuals lend on the presumption that courts will enforce the law. If municipalities can mow over creditors and the rule of law in bankruptcy, they deserve to pay a political-risk premium to borrow, assuming anyone is still foolish enough to lend.

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