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Detroit Bankruptcy Taught Muni Investors Painful Lessons.

No matter what a federal judge decides today about approving Detroit's \$18 billion bankruptcy plan, the record-setting case has already taught municipal bond investors some painful lessons.

Above all, pensions trump bonds, and when local politicians are forced to choose sides, Wall Street will be left out.

"It's pretty easy to stick it to the bondholders," said Lee Bogdanoff, a bankruptcy attorney who helped the second-largest U.S. municipality to suffer financial implosion, Jefferson County, Alabama, fight off demands by creditors holding billions of dollars in bonds.

U.S. Bankruptcy Judge Steven Rhodes is set to announce this afternoon whether he'll approve Detroit's proposal to eliminate \$7 billion of debt, including some bonds backed by taxes. Rhodes must determine whether the plan is fair and feasible and whether to accept or overrule the objections of a handful of retirees who still oppose it.

During a two-month trial, Rhodes focused many of his questions on whether the plan was workable, repeatedly telling city officials he wouldn't allow them to enter into any more bad debt deals. He showed less concern about whether the plan was fair to bondholders and other financial creditors, like debt insurers.

Investor Education

"Hopefully this will educate not only investors, but also political leaders," said Richard Ciccarone, a municipal debt analyst and president of Merritt Research Services in Chicago. "You can't treat municipal debt as a risk-free investment."

Detroit filed for bankruptcy in July 2013, listing \$18 billion in liabilities. After decades of population decline and the disappearance of manufacturing jobs in the U.S. automotive capital, it could no longer meet financial obligations while providing essential services.

The city plans to spend about \$1.7 billion to rebuild by removing blight and improving everything from police and fire protection to public transportation.

The case broke new ground in several areas, said James Spiotto, a bankruptcy specialist and managing director at Chicago's Chapman Strategic Advisors LLC, which counsels on financial restructuring.

Sewer Sacrifices

Detroit pushed water and sewer bondholders to make sacrifices, even though their debt was guaranteed by the city's utility, which wasn't in bankruptcy and had been paying its debt on time. Eventually, the city refinanced some of those bonds at lower cost and left the rest unchanged.

The city also succeeded in forcing bondholders who held debt tied to property taxes to agree to take

less than they were owed, something that municipal investors had assumed a bankruptcy court wouldn't allow. Since those so-called general obligation bondholders were covered by insurance, any losses were passed on to the insurers, according to Spiotto.

"That was a gift of the bond insurers to the city," he said.

The most important legal precedent to come out of the Detroit bankruptcy involved the protections state lawmakers had given to public-worker pensions. In a ruling that was later echoed in a case of Stockton, California, Rhodes found that when a city files for bankruptcy, those protections don't apply because federal law trumps state law.

No Priority

That ruling should be a win for municipal debt investors because it means that from a legal perspective, retirees shouldn't get priority over unsecured bondholders, said Bogdanoff, co-managing partner at Klee Tuchin Bogdanoff & Stern LLP, who's not currently involved in the Detroit case. The debt should be considered equivalent, so each side would normally have to take about the same cuts.

In Detroit and in Stockton, however, local leaders predictably pushed plans that favored public workers over investors. So while the Detroit case gives investors a legal victory to leverage in future fights, it also teaches that, unlike corporate reorganizations, municipal bankruptcies are a very political animal.

"The more politically powerful group, the more sympathetic groups wound up doing better," Bogdanoff said. "The Wall Street creditors really took it on the chin."

Under the plan proposed by Detroit Emergency Manager Kevyn Orr and his team of legal and financial advisers, agreements were hashed out with the city's large creditors, including retired workers who accepted modest pension cuts; hedge funds that held pension-related debt; and nearby counties that objected to how the bankruptcy would affect the water and sewer services they receive from the city.

Art Protection

The settlements include an \$816 million deal to bolster pensions in return for protecting city-owned art from liquidation; Detroit's agreement to pay \$85 million to end interest-rate swaps valued at \$288 million; and the pension debt settlements.

Before they settled, pension debt creditors, including hedge fund managers Aurelius Capital Management LP and BlueMountain Capital Management LLC, had argued that because they are being paid far less than retired city workers, the plan is unfair. As part of the settlements, those objections have been withdrawn.

"Until we get clarification from federal appellate courts, we have to conclude a municipality's general fund obligations are structurally subordinated to their pension liabilities," said Tom McLoughlin, head of municipal fixed-income at UBS Wealth Management Americas in New York. Under the bankruptcy code, a municipality "has more latitude to treat creditors in a disparate fashion than you'd see in a typical corporate reorganization," he added.

The case is *In re City of Detroit*, 13-bk-53846, U.S. Bankruptcy Court, Eastern District of Michigan (Detroit).

By Steven Church

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To contact the reporter on this story: Steven Church in Detroit federal court at
schurch3@bloomberg.net

To contact the editors responsible for this story: Andrew Dunn at adunn8@bloomberg.net Joe
Schneider

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