Detroit Leaves Legacy of Tarnished Pledge for Muni Bond Buyers.

Detroit's bankruptcy exit plan sets the city on a path to fiscal redemption. For the $3.7 trillion municipal market, its legacy may be the tarnishing of a pledge that bond investors have held sacrosanct for decades.

Money managers overseeing more than $300 billion of munis say that with general-obligation holders recouping 74 cents on the dollar or less, the agreement undermines a bedrock assumption: that even distressed cities will make good on debt backed by their full faith and credit. The shift means greater scrutiny of legal protections, particularly as a locality's finances deteriorate.

A bond deal in June to finance lighting in Detroit and an offering last month backed by taxes in junk-rated Atlantic City, New Jersey, highlight the new demands. Both featured trustees for bondholders that would guard the revenue behind the debt in the case of a Chapter 9 bankruptcy.

"Lower-rated G.O.s are risky without a statutory lien on specific dedicated tax revenue," said John Miller, co-head of fixed income in Chicago at Nuveen Asset Management, which oversees $98 billion in munis. In Detroit, "G.O.s took a haircut, and it was bigger than other parts of their cost structure, so they were effectively subordinated."

Debt Detectives

U.S. Bankruptcy Judge Steven Rhodes on Nov. 7 approved Detroit's proposal to eliminate $7 billion of debt, determining the plan is fair and overruling objections of the remaining holdouts. Investors in the $1.1 trillion market for general obligations have monitored the proceedings since the city's July 18, 2013, court filing for signs of how different classes of bonds would fare in bankruptcy.

Holders of unlimited-tax general obligations will get 74 percent of the $388 million they're owed, while limited-tax debt recovers 34 percent of $164 million. The losses overturn investors' assumption that issuers would raise taxes as high as needed to pay the unlimited general-obligation debt.

The levels may not set a precedent for recovery in future cases because the figures emerged from settlements rather than a judge's ruling, Miller said.

The city's success in getting holders of debt tied to property taxes to agree to take less than they were due still alters the repayment equation for investors in lower-rated general obligations, said Chris Alwine at Vanguard Group Inc.

Recovery Risk

"The recovery values are not as high as they once were," said Alwine, who oversees $140 billion as Vanguard's head of munis in Valley Forge, Pennsylvania. "That should factor into wider trading levels for general-obligation bonds if they're at risk of any type of restructuring."

Issuers tied to struggling cities have lured investors with stronger pledges to keep borrowing costs down.

In June, the Michigan Finance Authority sold bonds for the Public Lighting Authority, which is responsible for illuminating the streets of Detroit. Offering documents showed that revenue backing the bonds is dedicated by state law, can’t be diverted and is directly deposited with a trustee to pay investors. The debt is graded BBB+ by Fitch Ratings, three steps above junk. It priced in line with an index of BBB revenue bonds, Bloomberg data show, defying speculation the Detroit link would cause it to sell at speculative-grade levels.

Boardwalk Borrowing

Last month, New Jersey’s Casino Reinvestment Development Authority, created in 1984 to boost economic development and jobs in Atlantic City, opted for a similar structure as it issued $241 million of debt. The effort distanced the bonds from the resort town of 40,000, which had its rating cut to one level below investment grade by Moody’s Investors Service this year because of its dependence on gaming.

In the casino deal, New Jersey collects the taxes and the money then flows to a fund held by a trustee for bondholders, according to Fitch, which said the money couldn’t be touched by Atlantic City if it entered bankruptcy.

“In a declining community, you have to look at the legal status and legal structure of how your bonds are secured,” Miller said. “If they’re muddied or unsubstantiated, that presents some risk.”

The other threat to bondholders from Detroit’s exit plan, as well as the one approved in Stockton, California, last month, is how investors are treated relative to retirees.

Employees Favored

Judges in both cases found that protections state lawmakers had given to public-worker pensions don’t apply in bankruptcy because federal law trumps state law. Yet local leaders still fought for plans that favored employees over debt investors.

A key settlement will bring in as much as $816 million from charitable foundations and the state to prop up retirement plans, including police and firefighters. The deal preserved all or most of city workers’ pensions.

By contrast, some investors who settled hold about $1 billion in debt issued by the city in 2006 to bolster its retirement system. Those securities will be canceled, and investors and the insurers that guaranteed the borrowing will get $141 million in new notes and land instead.

The pension-debt holders, including hedge fund managers Aurelius Capital Management LP and and BlueMountain Capital Management LLC, had argued that because they’re being paid less than retired city workers, the plan is unfair. As part of the settlements, they’ve withdrawn those objections.

“Bondholders clearly have to take away that in cases such as these, where there’s municipal-bond debt and pension liabilities both at stake, that bondholders in many cases are going to be junior to pensioners,” said Peter Hayes, who oversees $122 billion as head of munis at New York-based BlackRock Inc. “The lesson is that politics trump law.”

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