
Municipal Bond Offering Disclosures after a Chapter 9 Filing - A Few Reflections on Orange County and the City of Detroit.

Although not intended to be classics of literature, we have found tales of two municipalities and their Chapter 9 bankruptcies. One was warm and prosperous and on the West Coast, whose housewives we have followed in the age of reality TV. The other was from a grittier place in the midwest with industrial gothic scenes and rappers who have captured its spirit. Please join us as we discuss the post Chapter 9 filing bond disclosures of Orange County, CA and the City of Detroit.

Please click here for video.

The purpose of this podcast is to briefly compare and contrast a couple of examples of primary market disclosure for securities offerings made subsequent to the respective Chapter 9 bankruptcy filings by two of the largest municipal issuers- Orange County, California and the City of Detroit.

The two bankruptcies are similar insofar as they both involved large general purpose governments and were high-profile.

The two bankruptcies and the related securities offerings which we will discuss were notably different in terms of timing (separated by about twenty years) and in the nature and timing of the causes that led to the bankruptcies.

Moreover, they are also notably different in that the Orange County example occurred before the County emerged from bankruptcy whereas Detroit had completed its bankruptcy case prior to the reoffering memorandum examined.

Part of the purpose of our podcast is to examine the impact on disclosures made to the markets when these issuers tried accessing the public markets after Chapter 9 filings.

A review of these issuers' disclosures may also be helpful context given a trend by many issuers in the municipal securities market toward greater disclosure about municipal bankruptcy notwithstanding that a Chapter 9 filing may be remote for the vast majority of such issuers.

We will turn some attention initially to a discussion of some points about Chapter 9.

Chapter 9 refers to the provisions of the Federal Bankruptcy Code which address the process where municipalities (which includes cities, counties and other entities) can seek protection under the bankruptcy laws through a voluntary filing.

Chapter 9 is relatively rare and although it draws upon other provisions of the federal bankruptcy code, such as Chapter 11 relating to reorganization, it has certain unique features.

For purposes of our discussion, it is helpful to keep two unique factors in mind. First, there is no involuntary filing under Chapter 9 initiated by creditors. Second, Chapter 9 does not have a liquidation concept. Chapter 9 presumes that a municipal entity will need to continue to operate and provide public services.

Chapter 9, even apart from Detroit, has taken on increased attention in recent years, particularly since the financial crisis from 2008.

The Orange County, California bankruptcy from the mid-1990s is remarkable in a number of aspects. First, it involved a large issuer in a very prosperous area. The bankruptcy was a surprising event not foreseeable based on a normal examination of the County's demographics, economy and tax base. The bankruptcy was also notable given its suddenness. Also, noteworthy is the relatively short time period before Orange County was able to return to the capital markets. In fact, as we will discuss further, Orange County was able to undertake a public bond offering while many uncertainties still existed during its bankruptcy case.

At a very high level, the Orange County bankruptcy can be summarized as stemming from an adverse turn in the County's investment pool which led to staggering losses. The County, through its popularly-elected Treasurer, had made ultra vires investments in derivatives and effectively had wagered on short-term interest rates remaining low. An increase in rates by the Federal Reserve Bank in late 1994 precipitated losses. The County's investment pool, after unwinding a number of positions to manage the risk of further losses incurred a total loss of approximately $1.7 billion, $600 million of which was for the County itself (with the remainder related to other County entities, such as local governments and school districts).

The City of Detroit's bankruptcy, filed in the summer of 2013, although involving a large general purpose governmental issuer was quite distinct from Orange County. The circumstances which gave rise to the bankruptcy were developing over a much longer period of time, arguably several decades, and could not be easily attributable to a single series of events or policy decisions.

It is also arguably the case, that even if the City, with the benefit of hindsight, had made the best policy decisions over the years, the City, if not facing Chapter 9, would have been under severe fiscal stress due to economic and demographic changes (e.g., loss of population).

Also in contrast to Orange County, California, and given what we've said already, the filing of the bankruptcy itself was not surprising as evidenced by considerable debate and involvement by the State of Michigan prior to the filing.

For purposes of our discussion we looked at one offering document each for Orange County and the City of Detroit.

In the case of Orange County, it was the official statement for $278,790,000 Refunding Recovery Bonds, 1995 Series A, dated June 13, 1995 which were publicly offered.

In terms of timing, Orange County had filed for Chapter 9 on December 6, 1994 and had not emerged from bankruptcy as of the time of the official statement. Consequently, this was a public offering document produced in the midst of a Chapter 9 proceeding.

In the case of Detroit, it was a reoffering memorandum, dated August 19, 2015, for $245,000,000 Michigan Finance Authority Local Government Loan Program Revenue Bonds, Series 2014F (City of Detroit Financial Recovery Income Tax Revenue and Refunding Local Project Bonds).

In terms of timing, Detroit emerged from Chapter 9 bankruptcy on December 10, 2014. Consequently, this was a public offering document produced subsequent to the bankruptcy proceeding.

A small amount of background on the related bonds is helpful for context.

The Orange County bonds were not ad valorem bonds but rather were payable from all lawfully available funds of the County and additionally secured by a pledge of certain motor vehicle license fees collected by the State of California. The bonds were insured and the County elected to participate in an intercept program related to the motor license fees. Moreover, debt service payments on the bonds, so long as the County remained in bankruptcy, were given an "administrative expense" priority treatment over unsecured claims against the County by order of the bankruptcy court.

The Michigan Finance Authority's bonds issued on behalf of the City of Detroit are secured by, among other things, certain Municipal Obligations issued by the City payable from certain income tax revenues (which are subject to a statutory lien) from a levy of an excise tax on income and a pledge of the City's limited tax full faith and credit.

The original proceeds from both bond offerings were used for refinancing purposes. In the case of Orange County, warrants were refunded. In the case of Detroit, it was to pay off certain classes of claims and to finance certain reinvestment and revitalization projects. In each case, and what is somewhat unique for general purpose governments, certain reserve accounts were also funded.

One interesting factor related to the disclosure and more precisely, the manner of the offerings, was that neither disclosure document indicated that any sort of investor letter would be required or particularly focused on matters of suitability. In each case, the applicable bonds were offered in $5,000 denominations.

This is likely largely due to certain favorable credit features. The Michigan Authority bonds received an investment grade rating. The County's bonds were insured by a then triple A bond insurer.

Both of the offering documents included a risk factors type section and addressed the risk of a potential second bankruptcy. This was not addressed so much in the context of identifying and discussing potential sources of further or recurring financial problems but rather more in the context of potential impact in terms of modifications of rights and the impact on the security of holders.

Due to the particular nature of the bankruptcies, the Orange County disclosure spent considerably more time discussing the factors which contributed to the bankruptcy. This is not surprising given that the Orange County bankruptcy was not anticipated and was due to very specific events which were not necessarily tied to underlying economic circumstances. In contrast, Detroit's fiscal deterioration was something which occurred over a longer period of time and could not be attributed reasonably to isolated events.

Both offering documents devoted substantial attention to recovery plans and governance matters, such as oversight and reorganization, under state law.

Orange County's disclosure addressed a restructuring of the County Administrative Office including the creation in February 1995 of a new Chief Executive Officer position and the establishment of a Treasury Oversight Committee which was comprised of five citizens "to review the Treasurer's investments and ensure adherence to stated policies."

Detroit's disclosure discussed a nine-member Financial Review Commission created in November 2014, about a month prior to the exit from bankruptcy and went into extensive detail about Michigan Act 436, and the role of the Emergency Manager and the City Council in the budget process, the

Michigan Financial Review Commission Act 181 of 2014, and Act 182 which requires the City to adopt a multi-year financial plan subject to Financial Review Commission approval.

A somewhat unique aspect of the Detroit financing is its discussion of statutory liens under the Bankruptcy Code and the explicit discussion that Bond Counsel to the City provided a reasoned opinion that any residual interest in the pledged income tax revenues should be subject to a statutory lien in favor of the holders of the municipal obligations. The disclosure elaborated how bond counsel's opinion was based on certain "reasoned conclusions" such as that "both pre-deposit and post-deposit liens are created by Act 279 and that the pre-deposit lien created by Act 279 arises automatically under such Act upon the occurrence of "specified circumstances or conditions" which is a term of art in the definition of statutory lien under the Bankruptcy Code.

The Detroit offering memorandum also discussed in detail Act 279's provision of a statutorily-created trust for the pledged income tax revenues.

Again, it discussed how bond counsel to the City provided a reasoned opinion that the trust would be enforceable in bankruptcy and should not be reachable by general creditors of the City. Again, the disclosure indicated how the opinion of bond counsel was based on certain reasoned conclusions which were briefly outlined in the disclosure.

In terms of take-aways: disclosure is driven in part by the timing of the bankruptcy proceeding (i.e., where the case stands procedurally at the time of the offering document's disclosure).

For example, in the case of the particular Orange County official statement examined, the posture of various ongoing litigation and settlements were discussed with more prominence than in Detroit where certain settlements (including with bond insurers) were addressed in the City Appendix III.

Disclosure is also impacted by the causes of a bankruptcy which influence the discussion of remedial or preventative steps.

Orange County focused more on telling the front-end story of its bankruptcy than Detroit where the story slowly (and somewhat painfully) unfolded over a long period of time with very extensive attention in the general media.

The Detroit offering document is somewhat unique in public finance in that it has generally been atypical for reasoned opinions (rather than the typical "clean" opinions) to be given in public finance transactions and to be discussed in detail within an official statement or other offering document. The Detroit case is a leading example of increased attention paid to statutory liens (or other provisions that may give bondholders a stronger position vis a vis general unsecured creditors).

Recognizing that there are many other observations that can be added over time, I found it interesting that the risk factor disclosure, did not go into particularly great detail (or analysis) about economic and similar risks facing the City. There was a very high level and general identification of what reasonably seems to be all the key factors set out in a few clear and concise but modest paragraphs captioned "Uncertainty of Future Income Tax Revenue" and "Economic and Other Factors Affecting the Financial Condition of the City"– which took up less than a single page).

The Michigan Finance Authority disclosure, however, did take a forward-looking perspective on disclosure (which is generally not the case in bond issues for local governments that are tax-supported) by including a "Projected Pledged Income Tax Revenue" table that showed the then-existing projections for four fiscal years (through June 30, 2019) which lined up with the four-year scope of the City's financial plan. The City Appendix III showed a breakdown of the projections over major revenue and expense categories throughout the projection period. I did not find in the Orange County disclosure any analogous use of projections.

Moreover, there was not a significant discussion (or identification) in the risk factors disclosure of the risks that may arise in relation to the somewhat amorphous area of competing claims of retirees and workers against other creditors. This may be due to two reasons. First, are the inherent uncertainties in this area. Second, and I think easier for me to appreciate, is the consideration (and I caution that I speculate) that statutorily created priorities for these bondholders may, in the City's view, have obviated a need to try to parse out the uncertain landscape when dealing with unsecured creditors in the context of equities towards a municipality's workers and retirees. The disclosure, however, was very focused on pensions and OPEBs and provided a detailed discussion in the City Appendix III about the nature of the pension and OPEB settlements and how the benefit plans were affected and aligned going forward out of the bankruptcy.

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