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The municipal bankruptcy crisis: *Lessons from Detroit*

When Detroit filed Chapter 9 municipal bankruptcy with a debt of $18 to $20 billion, it was the largest municipal bankruptcy in US history, dwarfing its predecessor (an Alabama county with $3 billion of sewer bonds). Detroit presents a study in the lessons of a large municipal bankruptcy. These lessons are timely given continuing concerns with respect to the municipal bond market.[1]

Lesson 1: Insufficient cash flow drives municipalities into Chapter 9 bankruptcy.

Lesson 2: Municipal debt and liabilities have disparate features.

Lesson 3: Municipal liabilities are likely to face varying payouts.

Lesson 4: The “cram down” is the new big stick for municipal right-sizing.

Detroit is a case study of the municipal market and can provide insights when additional municipal shocks occur. Its lessons may prove relevant for current Chapter 9 candidates like Puerto Rico, the City of Chicago, and several municipalities in California. With $70 billion of public sector debt, Puerto Rico seems poised to be the next fiscal shock. The Commonwealth has hired restructuring attorneys though it has reiterated its intention to honor all obligations.[2]

Lessons from Detroit

Detroit’s narrative is well known—it is a case study for urban boom and bust.

At the end of World War II, Detroit had been a major element of President Roosevelt’s “Arsenal of Democracy.” The peacetime manufacture of cars and trucks replaced wartime planes and tanks. Its population approached 2.0 million residents, making Detroit the fifth largest city in the United States.[3]

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1 *See*, Michelle Kaske, “Puerto Rico’s Default Plan May Spread Pain Beyond Utility,” *Bloomberg*, June 30, 2014.

2 If Puerto Rico should seek bankruptcy protection it will face many unique challenges. As a territory it is ineligible for Chapter 9 bankruptcy, and so may take more of a “sovereign” approach similar to what has been seen with Native American casino debts. Puerto Rico also must deal with a broad set of creditors, as its debts are held in more than two thirds of municipal portfolios (owing to the status of the Commonwealth’s debt as exempt from federal, state, and local taxes).

3 “Population of the 100 Largest Urban Places: 1950,” U.S. Bureau of the Census, Table 18, Internet Release date, June 15, 1998, available at **http://www.census.gov/population/www/documentation/twps0027/tab18.txt**

Now, the City's population is about 700,000, making it the 18th largest city in the United States. Half of the City parks are closed and 40% of the streetlights are broken.[4] Critics claim Detroit missed several chances to address its fiscal problems. In 2013, the City of Detroit Emergency Manager, Kevyn Orr, filed Chapter 9 municipal bankruptcy.

Lesson 1: Insufficient cash flow drives municipalities into Chapter 9 bankruptcy

Municipalities are not corporations

Public sector bankruptcies differ from corporate bankruptcies. Municipalities are going concerns that cannot be liquidated.[5] The "worth" of a municipal asset is tied to the value it provides the public, not a mathematical fiscal formula. Therefore, municipal liabilities should not be viewed as an offset to assets, but instead for their cash flow implications. A municipality does not become insolvent when liabilities exceed its worth, but when cash flow becomes insufficient to meet cash demand.

While a headline may declare *"Detroit $18 billion in Debt,"* this skirts the core issue that cash flow, not debt, drives municipal bankruptcies. Kevyn Orr, the City of Detroit's state-appointed Emergency Manager, underscored the importance of cash flow when he included Table 1 in his bankruptcy filing.[6]

A headline referencing a $195 million shortfall may grab less attention than one trumpeting $18 billion of debt; however, insufficient cash flow ultimately drove Detroit's fate.

Table 1: City of Detroit FY2013 cash flow shortfall

Detroit revenue item	Change ($mm) FY 2011 - 2013	Change (%) FY 2011 - 2013
Municipal income tax	$10	4%
State revenue sharing	($56)	(31%)
Wagering tax	($4)	(2%)
Property tax	($48)	(35%)
State and service charges	($35)	(29%)
Utility taxes and fees	($10)	(18%)
Other revenue	($59)	(63%)
General fund reimbursement	($1)	(4%)
Transfers	$8	8%
Total cash shortfall	**($195)**	**(17%)**

Lesson 2: Municipal debt and liabilities have disparate features

Defining public sector debt

The City's $18 billion in liabilities was the source for the sound bite: *"Detroit $18 billion in Debt."* An item-by-item review of Detroit's liability schedule, as shown in Table 2, reveals that "true" public sector debt is difficult to define and subject to varying interpretation, resulting in valuations of the City's legacy liabilities ranging from $6 billion to $18 billion.

[4] Monica Davey and Mary Williams Walsh, "Billions in Debt, Detroit Tumbles into Insolvency," *New York Times*, July 18, 2013.

[5] State constitutions determine whether a municipality can file Chapter 9 municipal bankruptcy. As sovereigns, states cannot file Chapter 9. Thirteen states explicitly authorize Chapter 9 municipal bankruptcy filings, while 11 states provide conditional authority (Michigan falls under the latter). *See* James Spiotto, Working Papers, *The Oxford Handbook of State and Local Debt*, 2011.

[6] City of Detroit Bankruptcy Filing, July 8, 2013.

- **General obligation bonds and notes** are bonds secured by the full faith and taxing power of the government. As a voter-approved debt instrument, Detroit's $1.1 billion of general obligation debt is, without question, a general liability.

- **Water and sewer enterprise debt** are bonds secured by revenues and user fees derived from municipal assets. The Detroit water and sewer system serves three million customers in Southeastern Michigan, which includes municipalities other than the City of Detroit. As self-supporting debt, justification exists for scheduling: (i) zero, (ii) all, or (iii) the City's pro-rata portion, equal to $1.3 billion.

- **Pension certificates of participation (COPs)** are instruments secured by a proportionate share of enterprise revenues rather than secured directly by the enterprise revenues. All proceeds from the financing were deposited for the sole benefit of the pension funds; accordingly, the central issue in the valuation of COPs is proper accounting, not classification.

- **Pension swap termination** is the dollar amount paid to or received by the issuer resulting from the unwinding of a hedging transaction. Benefits (including hedging gains and/or losses) from this financing were deposited for the sole benefit of the pension funds; accordingly, the central issue in the valuation of these amounts is proper accounting, not classification.

- **Unfunded pension** is the combined total unfunded liability for two categories of City pensions. The City's FY 2012 financials listed the combined pension liability at $977 million versus the Chapter 9 schedule of $3.5 billion. The discrepancy in these two liability figures is due almost exclusively to the underlying actuarial assumptions.[7]

- **Unfunded health benefits** represent the unfunded future liability for health care benefits for City employees. The robust liability estimate reflects conservative assumptions (resulting in a higher cost) compared to the assumptions used by similarly situated cities to estimate the cost of providing future health care.[8]

Table 2: Range of legacy liabilities for the City of Detroit

Legacy liability	**Low** ($ bn)	**High** ($ bn)
General obligation debt	$1,130	$1,130
Water and sewer debt	0	5,840
Pension COPs	0	1,430
Pension swap termination	0	347
Other	0	300
Pension (contingent)	977	3,500
Health care (contingent)	4,000	5,700
Total legacy liabilities	**$6,107**	**$18,247**

[7] City of Detroit, Proposal for Creditors, June 14, 2013.

[8] Wallace Turbeville, "The Detroit Bankruptcy," Demos, November 20, 2013.

Lesson 3: Municipal liabilities are likely to face varying payouts

Plan of Adjustment

The Detroit bankruptcy filing was preceded by weeks of tense negotiations with Emergency Manager Orr trying to convince bondholders to accept pennies on the dollar, and unions to relinquish hard won pension and other benefits. The actual act of filing for Chapter 9 placed all negotiations on hold. The City prepared the initial Plan of Adjustment, detailing payments to 16 classes of creditors.[9] Detroit's Plan of Adjustment, shown in Table 3, treats some creditors with payouts of 100 cents on the dollar, while others will receive as low as 30 cents on the dollar.[10]

Table 3: City of Detroit Plan of Adjustment payouts as of May 5, 2014

Creditor	Payout commentary
Pensions: general retirees	Payout of 73 to 95.5 cents on the dollar; lower if "no" on plan
Pensions: police and fire	Payout of 100 cents on the dollar with partial COLA reduction
Pension COPs	Payout of zero cents on the dollar; validity of claim subject to litigation
General obligation bonds	Payout of 74 cents on the dollar
Swap termination payment	Payout of 30 cents on the dollar
Water and sewer bonds	Payout of 100 cents on the dollar
Detroit Institute of Art	Art deaccession placed on hold

Precedent-setting proposed payouts

Detroit's Plan of Adjustment breaks new ground for the payouts proposed for several areas, with the following three of particular note:

- **Pension write-down**: Judge Steven Rhodes wrote on December 3, 2013: "*Pension benefits are a contractual right and are not entitled to any heightened protection in municipal bankruptcy.*"[11] The ruling by Judge Rhodes was surprising to some, as pension benefits are guaranteed in many state constitutions, including Michigan.

- **General obligation debt**: A basic tenet of the municipal market is that general obligation bonds are the safest municipal security. Revenue bonds have historically traded and continue to trade at higher yields relative to general obligation bonds, reflecting the perceived greater risk of revenue bonds. Detroit's Plan of Adjustment inverts this relationship, prescribing revenue bond recovery of 100% and general obligation bond recovery of 74%. Fitch Ratings describes this treatment as "hostile" and that it "degrades" general obligation bonds.[12]

- **Sacrosanct assets**: Art is typically the first item tagged in a corporate liquidation. Municipal art in Detroit, worth upwards of $866 million,[13] has yet to be tagged, may likely be preserved, and used as collateral for a "grand bargain" with the State of Michigan and other benefactors to further preserve pension payouts.

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[9] Plan for the Adjustment of Debts of the City of Detroit, February 21, 2014.

[10] Fourth Amended Plan for the Adjustment of Debts of the City of Detroit, May 5, 2014; Yvette Shields, "Detroit Reaches Settlement on LTGOs," *Bond Buyer*, June 16, 2014. Note that Limited Tax General Obligation bondholders reportedly have reached a settlement on these obligations; currently, there is no information available regarding the settled recovery rate.

[11] Monica Davey, Bill Vlasic, and Mary Williams Walsh, "Detroit Ruling on Bankruptcy Lifts Pension Protections," *New York Times*, December 3, 2013.

[12] "Fitch: Detroit Plan of Adjustment Hostile to Bondholders," Fitch Ratings press release, February 24, 2014, on Fitch Ratings web site, **https://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=821493**

[13] Christie's Appraisals Inc., 2013.

Lesson 4: The "cram down" is the new big stick for municipal right-sizing

Cram down as trump card

A cram down may occur when one impaired creditor class consents to the Plan of Adjustment. The consent from the single impaired creditor class permits the Plan of Adjustment to be "crammed down" (i.e., deemed effective) to all other creditor classes as long as the Plan of Adjustment "does not unfairly discriminate against any one class and is fair and equitable."[14]

In Detroit the swap providers for the pension financing constitute a single, impaired creditor class, and achieved an agreement on a settlement amount of $85 million. On April 11, 2014 the City's swap termination amount was approved, allowing the Plan of Adjustment to be deemed effective for the 15 other creditor classes, with or without their consent.

The importance of the cram down is visible in the context of the proposed payouts for general obligation bonds, and the proposed treatment of union pensions. If either of these creditor classes had blocking rights, approval of the Plan of Adjustment would be highly challenging, if not impossible. The cram down mitigates this challenge.

Lessons learned

The Detroit bankruptcy provides market participants new and unique data points with respect to the potential resolution of municipal insolvency. The experiences observed in the context of the City of Detroit may prove especially timely given the likelihood of additional municipal fiscal shocks in the near future.

About the author

Bradley Wendt has more than 25 years of financial markets experience including fixed income capital markets, credit analyses, electronic trading, regulatory compliance, bond insurance, and securities pricing. His municipal securities expertise includes creating and running Goldman Sachs' Municipal Capital Markets Group and managing Goldman Sachs' $40 billion short-term municipal remarketing desk. Mr. Wendt was the founding member of the broker-dealer committee that created the SIFMA municipal swap index and was honored by *Institutional Investor* with its "Deal of the Year Award" for an innovative municipal securities transaction.

[14] National Federation of Municipal Analysts, "Detroit – Proposed Plan of Adjustment," Conference Call, April 8, 2014.

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