THE BOND BUYER

The Daily Newspaper of Public Finance

Thursday July 24, 2014

COMMENTARY

The Municipal Bankruptcy Crisis — Lessons from Detroit

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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.

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 restructuring 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.

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

Public sector bankruptcies differ from corporate bankruptcies. Municipalities are going concerns that cannot be liquidated. 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.

Lesson 2: Municipal debt and liabilities have disparate features.

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 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.

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Lesson 3: Municipal liabilities are likely to face varying 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 Dec. 3, 2013: "Pension benefits are a contractual right and are not entitled to any heightened protection in municipal bankruptcy." 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 says that it "degrades" general obligation bonds.

Sacrosanct assets: Art is typically the first item tagged in

a corporate liquidation. Municipal art in Detroit, worth upwards of $866 million, has yet to be tagged, and 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.

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

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."

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.

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