Municipal Market Comments

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Detroit's Bankruptcy and Possible Implications for Munis

Since Detroit filed for Chapter 9 bankruptcy protection on July 18th, a great deal has been written about the death of general obligation bonds and the seismic shift in market risk facing investors in tax-backed municipal debt. If Detroit is able to shed much of its debt liability through Chapter 9, many observers argue that financially strapped municipalities nationwide will rush to follow suit. Detroit's bankruptcy also highlights the tensions between bondholders and pensioners in situations where the borrowing municipality simply lacks the economic wherewithal to meet all of its obligations in full.

Because Chapter 9 has been so seldom used, there are few meaningful precedents for how to deal with large municipalities. In the case of Detroit, virtually every aspect of the filing is groundbreaking. In the absence of clear case law, municipal analysts and market pundits are having a loud, but not necessarily well-reasoned, debate over whether general obligation (G.O.) bonds are secured debt or unsecured debt of a municipality. In this context, we use G.O. to mean the voter approved, full-faith-and-credit, unlimited-tax bonds of an issuer.

Detroit's Emergency Manager (EM) has taken the position that G.O. bonds, absent some specific additional lien of a defined revenue stream, are unsecured obligations with respect to bankruptcy restructuring. The fact that he has taken this position is unsurprising – the EM is a corporate bankruptcy lawyer who is treating municipal bonds as analogous to the tiering of corporate debt:

- Revenue bonds and limited-tax bonds or swap agreements with a prior lien on a specified revenue stream (state aid payments, casino tax revenues, etc.) are being treated as the equivalent of senior secured corporate debt.
- G.O. bonds, pension funding obligations, appropriation-backed pension certificates and other obligations are being considered as akin to senior unsecured corporate obligations.

That the EM has proposed this methodology for categorizing Detroit's liabilities does not make it so. There is no clearly established tiering of obligations under Chapter 9 because there is such a dearth of case law. When Detroit's bankruptcy is finally settled, we believe the results will help inform future Chapter 9 cases, but we do not believe that Detroit will set strong precedents that future courts can use as a template for municipal bankruptcy. The issues are simply too varied from state-to-state and from issuer-to-issuer. We discuss this perspective in more detail on the following pages.

As we have stated in the past, investors can manage the vast majority of credit risk through careful credit selection and monitoring. It is not enough to watch ratings, however, as they are usually trailing indicators of credit decline. Thorough fundamental research can identify deteriorating credit trends before they become ratings downgrades and keep potential problem credits from ever entering a portfolio. By avoiding deteriorating credits, investors can virtually eliminate any prospect of having to worry about how their bonds might be treated in a bankruptcy proceeding.

What are the likely implications for municipal bonds in the aftermath of Detroit's filing? Unfortunately, there are no easy answers to the questions raised by Detroit. It is easy to paint the municipal marketplace with a broad brush, but the fact remains that municipal bonds are highly individualized securities. There are significant economic, financial, legal and security differences within states and between states that can make all the difference in the credit quality of individual bond issues.

There are some general observations that we believe are likely consequences of the Detroit bankruptcy case:

- Detroit G.O. bonds will likely be impaired to some degree. Regardless of the parsing of lines in the budget or items in the EM's report, the city simply does not have the resources to make good on all of its obligations. At best, impairment could mean a haircut on coupon rate and an extension of principal. We expect, though, that there will ultimately be some reduction in principal for Detroit G.O. investors.
- We do not believe that such an impairment will set a general precedent that other distressed municipalities will use to try to cut bond liabilities. Bankruptcy is a long and expensive process – by one estimate, Jefferson County, Alabama has spent $20 million on legal fees alone since its bankruptcy filing in November 2011. For an issuer that needs access to market capital, the stigma attached to such bondholder impairment will be extremely difficult to overcome. The loss of access to the municipal capital markets, and the resulting increase in borrowing costs through private channels, will hamper the finances of Detroit and any similarly situated issuer for years to come.
- We do not expect that investors or issuers will run from the G.O. credit structure. G.O. bonds are still the foundational credit structure in the market, with over 150 years of market acceptance. Because most municipalities in the U.S. still generate the majority of their general governmental revenues through property taxes, property-tax-secured bonds will continue to be the cornerstone of municipal finance.
- Municipal bonds are an extremely important tool for both issuers and investors. Municipalities need access to affordable capital, and the municipal market provides that funding source. Investors are likewise well served, as they get access to a relatively low-risk tax-advantaged investment opportunity.

- Investors may begin to demand additional yield premium for G.O. bonds compared to essential purpose revenue bonds or tax-backed bonds secured by strong liens on high quality revenue streams.
- Investors should and will demand a higher risk premium (yield spread) for weaker G.O. and other general governmental obligations.
- The variance in state bankruptcy statutes and Chapter 9 case law could create more distinct yield differentials among G.O. bonds from different states.
- We will continue to see state and local governments work to restructure their long-term pension and health care obligations in order to reduce their retiree liabilities going forward.
- We could see states take legislative action to more clearly delineate the standing of various types of obligations, including G.O. bonds, both within and outside of bankruptcy. We may also see state actions to change authorization for Chapter 9. Whether those actions would be a liberalization of Chapter 9 access or more restrictions on the ability of local governments to use bankruptcy could vary widely depending on political perspective.

Chapter 9 and Municipal Fiscal Distress

Chapter 11 is a relatively clean mechanism which lends itself to standard application across companies. By comparison, Chapter 9 is messy and political. Unlike corporations, for municipalities to have access to Chapter 9, state law must provide authorization for municipalities to file. At present:

- 12 states specifically authorize municipalities to seek Chapter 9;
- 12 states allow a filing upon certain conditions or with specific state authorization (Michigan is one of these);
- Three states provide very limited authorization only to certain specified issuers or types of issuers; and
- 23 states outline no Chapter 9 authorization, specifically prohibit Chapter 9 or the laws are unclear.

While Detroit's actions could theoretically be followed in those states with "open" Chapter 9 statutes, thus creating potentially greater event risk for investors, issuers in states with higher political hurdles or greater legal limitations will be less likely to follow suit. Like everything else in municipal finance, financial distress and potential bankruptcy are likely to be very individualized situations. Even within states, though, each situation differs. Why has Detroit moved so quickly while Hamtramck, MI has also been an economic basket case for many years but remains under state oversight, working to right its ship? Chapter 11 is mostly a financial decision. Chapter 9 filers face political forces both locally and at the state level. For this reason, each individual potential Chapter 9 filing will be driven as much by politics as by finances.

How is Detroit different than other Chapter 9 filings, like Jefferson County, Alabama or Stockton, California?

1. Detroit's situation is extreme in every sense. It involves the largest municipality in the state (and the 18th largest city in the nation), the most financially troubled large city in the nation and is perhaps also the most demographically challenged city in the nation (population trends, tax base fundamentals, employment trends, wealth and income metrics, etc.).
2. Michigan is unique in its use of the Emergency Manager. The EM's powers – essentially executive power over all city operations and government functions that supersedes elected and appointed officials – provide an unparalleled platform for a focused restructuring plan relatively free of local and state political entanglements.
3. Detroit's bankruptcy is being aggressively pushed both by the EM and by the Governor. Governor Rick Perry was required both to appoint the EM for the city and to approve of the city's effort to seek Chapter 9, and it has been the Governor's strong support of the EM's proposed workout plan that has enabled the city to move so rapidly into the bankruptcy process. Such a rapid move would be exceedingly unlikely in any other state.

Before Detroit's situation is ultimately resolved, numerous issues will have to be litigated to solve some very sticky state and federal legal questions. We expect that a number of the assumptions in the EM's proposal will be subject to protracted legal challenge. These include, but are not limited to:

The security position of general obligations under Michigan law and under Federal bankruptcy law. The fact that these bonds are approved by the electorate and have a pledge of unlimited taxing power and all available revenues of the issuer will have to be considered. Another nuance of the G.O. debate is the fact that the Michigan EM law states that a plan structured by an EM "shall provide for . . . The payment in full of the scheduled debt service requirements on all bonds, notes and municipal securities of the local government."

The security position of pension obligations in Michigan. Michigan statute provides that pension benefits cannot legally be reduced. There are significant questions surrounding what legally constitutes a "pension benefit." There are also questions regarding the EM's calculation of Detroit's unfunded pension obligations. Detroit's EM calculates an unfunded pension liability for the city that is five times higher than the amount last reported by the city's actuaries.

Subsequent "State's Rights" issues that may arise from bankruptcy court decisions. To the extent that the court approves a plan that runs counter to state statute regarding treatment of liabilities, we could see legal challenges that could potentially rise as high as the Supreme Court level.

Investor lawsuits or regulatory actions regarding past sales of securities. Investors, bond insurers or securities regulators could claim that Detroit's pension funding problems or financial position were not adequately disclosed or that they were purposefully misled by city officials or other financial professionals.

We believe that investors should continue to buy and hold high quality municipal bonds, including G.O. bonds issued by state and local governments. High quality issuers will continue to make timely payment on their obligations. Any weakening in price levels for G.O. bonds as a whole would, in our mind, present a buying opportunity for investors who do the necessary credit screening.

The municipal market tends to overreact to headlines, especially credit problems for highly visible national issuers. The fact is that investors have been demanding additional credit support from Detroit, whether through dedicated liens on taxes or bond insurance, for many years due to the perceived risk that Detroit simply could not shoulder the burden. The market treats other distressed issuers in a similar manner – they have limited market access and must provide more security than a simple G.O. pledge.

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