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Detroit's bankruptcy: The uncharted waters of Chapter 9

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On July 18, 2013, Detroit became the largest municipality to seek protection under Chapter 9 of the U.S. Bankruptcy Code. This article describes several ways in which Detroit's bankruptcy filing has the potential to alter some of the key assumptions of municipal bond (muni) finance, and examines the market reaction to date.

To date, Detroit's bankruptcy filing has had little impact on the cost of municipal financing outside of Michigan, but it has the potential to set a number of precedents with far-reaching consequences.

Chapter 9 provides financially distressed local governments, such as the City of Detroit, protection from creditor claims in the federal bankruptcy courts, subject to a number of state-level restrictions.[1] Michigan is one of 24 states that allow their municipalities to seek Chapter 9 protection. Although the federal requirements for bankruptcy are explicit,[2] the paucity of Chapter 9 filings and the variability in state legal environments effectively make every new case a complex and protracted matter. This holds particularly true for Detroit's filing, which is notable for its sheer size, the multitude of competing claims, and the historical and economic contexts in which the bankruptcy is playing out. Indeed, the intensity of media coverage surrounding Detroit indicates the extent to which the bankruptcy filing of the once-thriving industrial icon has resonated with the American public. In this *Chicago Fed Letter*, we describe how municipal bankruptcy unfolds in Michigan, how Detroit's filing has the potential to change some of the key assumptions of municipal bond finance, and what the market reaction has been thus far.

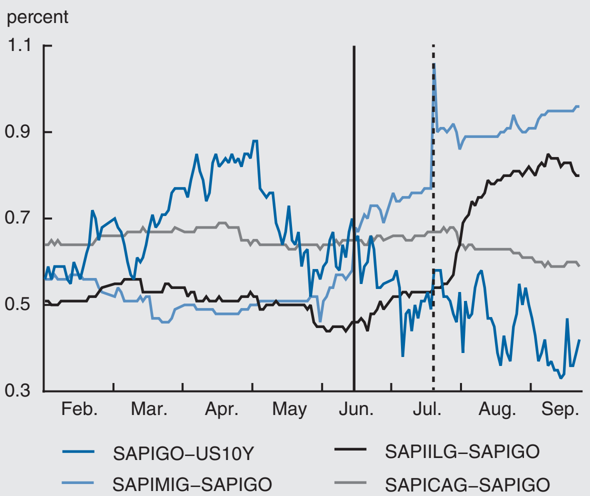
Municipal bankruptcy in Michigan

A unique feature of Michigan law is the ability of the governor to appoint an emergency manager (EM) to take over operations of financially distressed units of local governments, ranging from school districts to entire municipalities. Shortly after the state's February declaration that the City of Detroit was in a financial emergency, Governor Rick Snyder appointed Kevyn Orr as Detroit's EM. Under new legislation that went into effect on March 28, 2013, governor-appointed EMs are allowed to take extraordinary measures, including modifying or terminating collective bargaining agreements and recommending that the municipality enter Chapter 9 bankruptcy.[3] When Chapter 9 protection is sought, the EM has the sole power to propose a restructuring plan to the bankruptcy court.

Obtaining bankruptcy protection is far from straightforward, however. Although Michigan permitted Detroit to seek bankruptcy protection, the bankruptcy judge must determine whether the city is insolvent and can adjust its debts. The judge must also determine whether Detroit, as represented by the EM, had negotiated in good faith with its creditors and had failed to obtain an agreement outside of court. Moreover, the court must rule on a number of legal objections to Detroit's Chapter 9 eligibility—which range from whether Chapter 9 is itself constitutional to whether the state authorization for the city's bankruptcy filing is invalid in light of Michigan's state constitutional protection of pensions.

If the bankruptcy court upholds Detroit's eligibility for Chapter 9 protection, the

1. Yield spreads of S&P municipal bond GO indexes, 2013



NOTES: The plots are the spreads between the yields of Standard & Poor's (S&P) municipal bond general obligation (GO) indexes (or those of an S&P index and ten-year U.S. Treasury bonds). SAPIGO indicates the nationwide S&P Municipal Bond General Obligation Index. US10Y indicates ten-year U.S. Treasury bonds. SAPIMIG indicates the S&P Municipal Bond Michigan General Obligation Index. SAPIILG indicates the S&P Municipal Bond Illinois General Obligation Index. SAPICAG indicates the S&P Municipal Bond California General Obligation Index. The solid vertical line indicates the first trading day (June 17) after the Detroit emergency manager's proposal to creditors. The dashed vertical line indicates the first trading day (July 19) after Detroit's bankruptcy filing.

SOURCE: Authors' calculations based on data from Standard & Poor's.

city will file its restructuring plan (i.e., its "plan for adjustment of debts"), which will outline proposed payments to different types of creditors. Unlike corporate bankruptcy, there is no provision in Chapter 9 allowing creditors to file their own plan. Moreover, the court can force the acceptance of the city plan as long as a majority of *any* class of the impaired creditors accepts the proposal. As a result, creditors have few opportunities to challenge restructuring in Chapter 9.

Much of the market commentary and news coverage to date has centered on the EM restructuring proposal, presented to creditors on June 14, 2013.[4] Although the EM proposal is in no way binding and may end up being quite different from the final plan for adjustment of debts, it provides a basis for the expected treatment of various types of debt. As such, the proposal created considerable controversy, since it ignored several conventional approaches to prioritizing and valuing liabilities of a bankrupt municipality.

Unique aspects of the EM proposal

To understand the unorthodox nature of the EM plan, one needs to decompose Detroit's liabilities into specific categories. Detroit's largest single obligation is the approximately $6 billion in water and sewer bonds that are backed by the specific pledge of revenues from the city's utility system. Detroit also has about $1 billion in outstanding general obligation (GO) debt. GO debt is typically paid out of the overall tax revenues and does not have a dedicated repayment source. However, Detroit's GO debt comes in a number of different flavors. Some GO debt, known as unlimited tax general obligation (UTGO) bonds, was issued with explicit voter approval that commits the city to levy unlimited taxes for repayment. Other GO debt, known as limited tax general obligation (LTGO) bonds, was issued directly by the city and can only be paid from general funds. Moreover, some of the UTGO and LTGO bonds have separate streams of committed revenues coming from the state and are, therefore, referred to as "double-barreled" bonds. These distinctions highlight the fact that various GO bonds can enjoy different forms of legal protection and can count on different sources of revenues for their repayment.

In addition to bonded debt, Detroit's liabilities comprise outstanding pension and other post-employment benefit (OPEB) obligations, mainly for medical insurance coverage, to both current and retired city workers, police, and firefighters. The pension and OPEB obligations have been valued in the EM plan at $3.5 billion and $5.7 billion, respectively. The remaining components of Detroit's liabilities are two sets of financial securities closely related to its pension obligations—pension obligation certificates (POCs) and the associated swap contracts that convert variable-interest payments on POCs into fixed-rate obligations. The POCs and associated swaps have been valued in the EM plan at $1.5 billion and $0.8 billion, respectively.

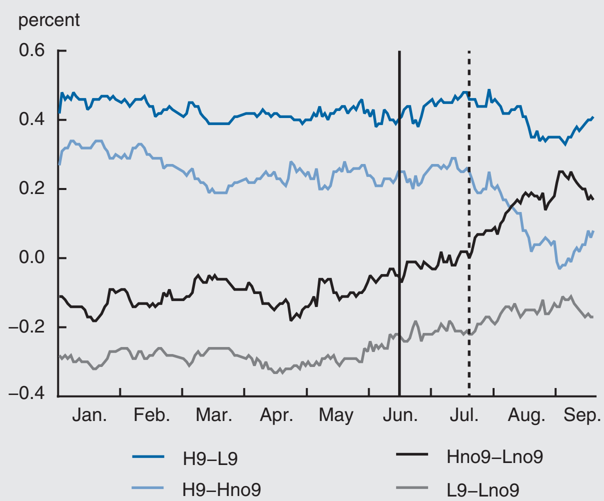
Chapter 9 bankruptcy grants senior status to debts secured by the pledge of specific revenues (e.g., the water and sewer system bonds secured by utility bill payments). All other debts are treated as equally unsecured under the law. As senior debt is repaid first, all other debts can be repaid only from the revenues that are left over. Put differently, every dollar of debt that is regarded as being secured diminishes the pool of money available for repaying unsecured claims. Theoretically, this suggests that all unsecured debt is impaired (i.e., repaid less than fully) in bankruptcy. The exact degree of impairment of each type of unsecured debt is determined during the bankruptcy process.

In practice, however, municipalities seeking Chapter 9 protection have previously treated GO debt as senior to other unsecured claims such as pensions in their debt adjustment plans. This meant that GO bondholders were typically repaid in full, even as some pension and OPEB obligations were diminished. In fact, between 1970 and 2011 (when Jefferson County, Alabama, filed for bankruptcy), no GO bond in the Moody's credit rating universe was impaired in a Chapter 9 bankruptcy.

Yet, the EM proposal called for steep cuts in payments to most bondholders, as well as to pensions being received by retirees, pension and OPEB obligations owed to current employees, and POCs held by pension creditors. Only the water and sewer system bonds and double-barreled UTGO and LTGO bonds were regarded as secured and thus subject to repayment in full. On average, the unsecured creditors were offered about ten cents on each dollar in claims they held.

The EM's proposed placement of some GO bonds on the same footing as retirement and employment obligations surprised market participants. It triggered extensive commentary on the need for investors to rethink their assumptions about recovery values of GO debt in bankruptcy. Although Detroit's combination

2. Yield spreads of municipal bond portfolios, 2013



NOTES: The sample of 92 bonds was selected by choosing at most two bonds from each issuer from the set of uninsured fixed-rate general obligation bonds issued by the cities included in Pew Charitable Trusts (2013). When multiple bonds from the same issuer met these criteria, the two with a maturity closest to ten years were selected. H9 is a portfolio of bonds issued by cities with high per capita pension and other post-employment benefit (OPEB) obligations located in Chapter 9 states. L9 is a portfolio of bonds issued by cities with low per capita pension and OPEB obligations located in Chapter 9 states. Hno9 is a portfolio of bonds issued by cities with high per capita pension and OPEB obligations located in non-Chapter 9 states. Lno9 is a portfolio of bonds issued by cities with low per capita pension and OPEB obligations located in non-Chapter 9 states. "High" and "low" obligations are defined as above and below the median, respectively. The plots are the spreads between the weighted average yields of the portfolios. The solid vertical line indicates the first trading day (June 17) after the Detroit emergency manager's proposal to creditors. The dashed vertical line indicates the first trading day (July 19) after Detroit's bankruptcy filing.

SOURCES: Authors' calculations based on data from Bloomberg and Pew Charitable Trusts (2013).

of financial woes and structural economic problems is unique, a substantial number of local governments nationwide face large pension and OPEB obligations. For these governments and their creditors, Detroit's case is a potential bellwether.

Another surprising aspect of the EM proposal was its failure to differentiate between debt backed by the unlimited tax pledge and debt lacking such a pledge. UTGO debt is typically repaid from a special property levy that has no limit and, as such, relies on revenues that are entirely separate from those used to cover general-fund operations.[5] This feature of UTGO debt makes it quite similar to other secured debt, contrary to the EM's statements implying that none of the GO bonds have legal security. This issue will be ultimately settled by the court, and it might have wide-reaching consequences for the pricing of voter-approved GO debt.

Implications for municipal bonds

In the preceding section, we touched on the potential market ramifications of legal rulings with respect to the treatment of pension and OPEB obligations, as well as GO debt backed by unlimited tax pledges. The standing of pension obligations relative to other municipal liabilities is particularly important to bondholders and the broader public given the multitude of well-publicized funding shortfalls in a great number of American cities. For example, data from a recent Pew Charitable Trusts study of large cities indicate that they have funded only 57.5% of the $511.2 billion of retirement benefits promised to their employees.[6]

There is a conflict between state and federal laws as to whether pension obligations can be impaired by a federal bankruptcy court. Michigan's state constitution prohibits reductions of promised pension benefits, but Detroit's EM argues that Michigan law allows for pension cuts in federal bankruptcy court. Pension funds have challenged the EM's interpretation on the grounds that it violates both the Tenth Amendment to the U.S. Constitution and state law. To date there is no jurisprudence addressing the question of whether a municipality can diminish pension obligations protected by a state constitution. If the court agrees with pension creditors that state protections hold supreme, this could change market expectations with respect to the relative standing of municipal debt issued by cities located in states with such protections (e.g., Chicago, Los Angeles, and New York City). Furthermore, any precedent that makes pension obligations senior to municipal bonds on broad Tenth Amendment grounds could have a material effect on the pricing of municipal debt for any city with large underfunded pension obligations.

How have the markets reacted thus far?

Apart from Michigan municipalities, the market reaction to the Detroit bankruptcy filing has been negligible. In the week following the EM's June 14, 2013, proposal to subordinate GO bonds, the difference (spread) between the yield on the nationwide Standard & Poor's (S&P) Municipal Bond General Obligation Index (SAPIGO) and the yield on ten-year U.S. Treasury bonds declined 8 basis points (figure 1). The SAPIGO–ten-year U.S. Treasury bond yield spread did increase by 9 basis points the day after Detroit's Chapter 9 filing on July 18 but quickly returned to its pre-bankruptcy level. In contrast, the spread between the yield on the S&P Municipal Bond Michigan General Obligation Index (SAPIMIG) and the yield on SAPIGO increased 14 basis points following the EM proposal. The spread further jumped by 29 basis points on the day after Detroit's bankruptcy filing and has remained elevated since, suggesting that the filing has had a material impact on borrowing costs of Michigan municipal issuers.

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Although the market penalized Michigan municipal issuers, there was little immediate price impact in municipalities with large unfunded pension obligations located in other states. Figure 1 graphs the yield spread between S&P municipal bond GO indexes for California (SAPICAG), Illinois (SAPIILG), and Michigan and the nationwide SAPIGO. Illinois debt issuers, in particular, have faced recent credit downgrades because of unfunded pension obligations and legislative stalemate in addressing this issue, so the SAPIILG–SAPIGO yield spread increased noticeably in August.

Did the muni market start demanding a larger risk premium for issuers with large pension and OPEB liabilities in the wake of Detroit's bankruptcy filing? To answer this question, we selected 92 bonds issued by cities in Pew Charitable Trusts (2013) and sorted these bonds into four equal-duration portfolios based on issuers' per capita pension and OPEB obligations and whether the issuer was located in a Chapter 9-eligible state. The yield spreads between these bond portfolios are graphed in figure 2. The baseline series labeled (H9–L9) depicts the difference in yields on bonds issued by cities with high obligations located in Chapter 9 states and bonds issued by cities with low obligations located in Chapter 9 states. The H9–L9 yield spread is remarkably stable around the dates of the EM proposal (June 14) and Detroit's bankruptcy filing (July 18). Market participants appear to require no more compensation to hold bonds issued by cities with obligations that are subject to Chapter 9. In fact, the yield spread between bonds from high-obligation issuers located in Chapter 9 states (H9) and those from similar issuers located in non-Chapter 9 states (Hno9) declined approximately 20 basis points in the month after Detroit's bankruptcy filing. Over the same period, the yield spread between bonds issued by high- and low-obligation cities located in non-Chapter 9 states (Hno9–Lno9) increased. This evidence suggests the absence of any systematic discrimination against issuers located in Chapter 9 states or issuers with high per capita pension and OPEB obligations following Detroit's bankruptcy filing.

Conclusion

As of this point, Detroit's bankruptcy filing has had little impact on the cost of municipal financing outside of Michigan. Nonetheless, Detroit's case has the potential to set a number of precedents with far-reaching consequences, such as the treatment of pension and OPEB obligations vis-à-vis bonded debt, the degree of protection afforded by state constitutions, and the value of the unlimited tax pledges approved by the electorate. The resolution of these issues in court will change the shape of municipal financial markets for years to come.

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[1] For details, see Gene Amromin and Anna Paulson, 2011, "Tempestuous municipal debt markets: Oxymoron or new reality?," *Chicago Fed Letter*, Federal Reserve Bank of Chicago, No. 291, October.

[2] Section 109(c) of the U.S. Bankruptcy Code sets forth the eligibility requirements for Chapter 9.

[3] The new EM law (Public Act 436) was passed after Michigan voters had repealed the previous version of the law (Public Act 4) in a November 2012 referendum. Both of the EM laws are subject to several lawsuits challenging their constitutionality.

[4] The EM plan is available at www.freep.com/assets/freep/pdf/C4206913614.PDF.

[5] The official statement for 2008 UTGO bonds states: "In accordance with State law, the City is obligated to levy and collect taxes without regard to any constitutional, statutory or Charter tax rate limitations for payment of such obligations," quoted on p. 15 of www.scribd.com/doc/159347508/Barclays-Municipal-Research-Detroit-Chapter-9-Begins.

[6] Authors' calculations based on data from Pew Charitable Trusts, 2013, "A widening gap in cities: Shortfalls in funding for pensions and retiree health care," report, Washington, DC, January, exhibit 1, p. 3.