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

---


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).

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. 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. 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.

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.

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.

---


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

7 City of Detroit, Proposal for Creditors, June 14, 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.\(^10\)

**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.

---

\(^9\) 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.


\(^13\) Christie’s Appraisals Inc., 2013.

---

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

<table>
<thead>
<tr>
<th>Creditor</th>
<th>Payout commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pensions: general retirees</td>
<td>Payout of 73 to 95.5 cents on the dollar; lower if “no” on plan</td>
</tr>
<tr>
<td>Pensions: police and fire</td>
<td>Payout of 100 cents on the dollar with partial COLA reduction</td>
</tr>
<tr>
<td>Pension COPs</td>
<td>Payout of zero cents on the dollar; validity of claim subject to litigation</td>
</tr>
<tr>
<td>General obligation bonds</td>
<td>Payout of 74 cents on the dollar</td>
</tr>
<tr>
<td>Swap termination payment</td>
<td>Payout of 30 cents on the dollar</td>
</tr>
<tr>
<td>Water and sewer bonds</td>
<td>Payout of 100 cents on the dollar</td>
</tr>
<tr>
<td>Detroit Institute of Art</td>
<td>Art deaccession placed on hold</td>
</tr>
</tbody>
</table>
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.”

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.

Contacts
For more information about this CRA Insights, please contact:

Bradley Wendt
Senior Consultant to CRA
+1-212-520-7227
bwendt@crai.com

Alan Friedman
Vice President
+1-212-520-7118
afriedman@crai.com

Aaron Dolgoff
Principal
+1-617-425-3623
adolgoff@crai.com

Samuel Lynch
Principal
+1-617-425-3089
slynch@crai.com

About the Financial Markets Practice
CRA’s Financial Markets Practice provides advanced consulting services to corporate clients and attorneys. We specialize in applying the tools, principles, and findings of finance, economics, and accounting to complex litigation and business problems. Companies, law firms, and government agencies rely on CRA for high-quality research and analysis, expert testimony, and comprehensive support in litigation and regulatory proceedings. Our reputation is built on exceptional client service and our ability to present innovative and pragmatic solutions to complicated challenges. For additional information about how CRA’s financial experts can help you with your litigation and regulatory needs, please visit www.crai.com/financialmarkets.

The publications included herein were identified based upon a search of publicly available material related to intellectual property. Inclusion or exclusion of any publication should not be viewed as an endorsement or rejection of its content, authors, or affiliated institutions. The views expressed herein are the views and opinions of the authors and do not reflect or represent the views of Charles River Associates or any of the organizations with which the authors are affiliated. Any opinion expressed herein shall not amount to any form of guarantee that the authors or Charles River Associates has determined or predicted future events or circumstances, and no such reliance may be inferred or implied. The authors and Charles River Associates accept no duty of care or liability of any kind whatsoever to any party, and no responsibility for damages, if any, suffered by any party as a result of decisions made, or not made, or actions taken, or not taken, based on this paper. If you have questions or require further information regarding this issue of CRA Insights: Financial Markets, please contact the contributor or editor at Charles River Associates. This material may be considered advertising. Detailed information about Charles River Associates, a registered trade name of CRA International, Inc., is available at www.crai.com.

Copyright 2014 Charles River Associates