

Making Sense of Detroit's Bankruptcy Filing

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Last week Detroit filed the largest municipal bankruptcy in U.S. history. Detroit's decades-long fiscal and economic decline has been well documented, and the filing was not a surprise to market participants. The aspect that may have caught some off guard is how quickly Kevyn Orr, the state-appointed emergency financial manager, decided to file for Chapter 9. It has barely been one month since Mr. Orr kicked off negotiations with Detroit creditors. The accelerated filing was necessitated by an impending lawsuit by the city's pension funds' seeking to preserve benefits for city retirees. We would caution investors that Chapter 9 is a very complicated and protracted legal process, and it is difficult to predict how various creditors will be treated given limited precedent, especially for public entities of this size and with this many creditors — roughly 100,000. We believe Detroit's filing does not represent a material threat to the broader municipal market. The causes of Detroit's bankruptcy are many and have been decades in the making. The city experienced a confluence of economic dislocation, population loss, poor leadership, corruption and fiscal erosion. While the bankruptcy filing has long been considered probable, we were troubled by Michigan's unwillingness to provide any support — either organizational or financial — in an effort to avoid bankruptcy. Historically, many states have provided some level of assistance to their troubled and often iconic cities. Examples include New York City in 1975, Philadelphia in 1992 and Cleveland in 1978. However, perhaps more troubling from a municipal credit

standpoint is the Governor of Michigan's recent endorsement of Mr. Orr's restructuring proposal that included an impairment of the city's Unlimited Tax General Obligation (UTGO) debt — essentially lumping GO debt in with the city's other unsecured creditors. UTGO bonds have long been considered the gold standard in the municipal market. The governor's endorsement of this impairment of Detroit's UTGOs is especially troubling, as it could carry significant implications for other distressed Michigan municipalities. As the bankruptcy process has just begun, it is impossible to predict how the bankruptcy judge will ultimately treat general obligation bondholders and other creditors, most notably the city's pension funds. However, any precedent set from Detroit's Chapter 9 filing will be of limited value beyond Michigan's borders. The strength, or lack thereof, of the security pledge of a municipality is different in each state and must be evaluated case by case. The wide disparity in the strength of municipal security pledges does not lend itself to broad based statements.

Detroit's bankruptcy process is expected to be unpredictable, lengthy, political and contentious. We will follow the proceedings closely, paying particular attention to the treatment of the UTGO bonds by the court. We advise investors to exercise caution against extrapolating any commentary on Detroit to the broader municipal market. Detroit is not the beginning of an impending wave of bankruptcies. We continue to believe that municipal bankruptcies will be rare events.

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