Could a Detroit-style bankruptcy happen here?

As appeared in the Sept. 6 edition of the St. Louis Business Journal

By David Warfield

Detroit's bankruptcy case is shaping up to be one of the most significant business and public policy stories of the decade. Could a Detroit-style bankruptcy happen here? Probably not in the immediate future, but every informed citizen — particularly those working in the finance or government sectors — should know some critical details about municipal bankruptcies. In fact, anyone who buys, sells, or brokers municipal bonds, or who is involved in the public pension industry, should be keenly interested in the Detroit case.

Can municipalities really file for bankruptcy?

When Detroit filed its case in July, many people were surprised to learn that a municipality can even file for bankruptcy. In fact, the Bankruptcy laws have long included special provisions for municipal bankruptcies (Chapter 9). The term "municipality" includes not only cities and towns, but also counties and special governmental units, like airport authorities and school districts. Since a municipality cannot be liquidated, Chapter 9 focuses on the reorganization of the municipality, similar in some respects to Chapter 11. The municipality in Chapter 9 proposes a Plan of Adjustment that restructures its debts, then seeks approval for the Plan from the Bankruptcy Court.

Can Missouri and Illinois municipalities file for bankruptcy?

Individuals and corporations can file for bankruptcy by simply signing a few papers and paying the filing fee. They do not even have to be insolvent. Contrast this with 16^{th} century northern Italy, where the unfortunate debtor had to walk naked in a public piazza, strike his backside three times against something called "The Rock of Shame," while crying out, "I declare bankruptcy!"

Municipalities don't have to endure such a public spectacle. But they do need to be "specifically authorized" by their state's law in order to file for Chapter 9. Missouri is one of only 12 states that specifically authorize its municipalities to file Chapter 9 without any further conditions. Illinois specifically authorizes municipalities with less than 25,000 residents to file Chapter 9, but only if they first comply with a lengthy and quite cumbersome pre-filing process. Therefore, under current law, Chicago could not file Chapter 9 to deal with its multi-billion-dollar pension shortfall because Illinois does not "specifically authorize" municipalities with more than 25,000 residents to file Chapter 9.

Can public pensions be modified in Chapter 9?

This may be the most important legal issue in the entire case. Detroit's emergency manager has said that one of the primary objectives of Detroit's case will be to restructure the massively underfunded public pension plans for its police, firefighters and other public employees.

Bankruptcy courts routinely deal with underfunded pension plans in the private sector, but the Michigan State Constitution prohibits the accrued financial benefits of public pension plans from ever being "diminished or impaired." This sets up a Constitutional showdown over the respective powers of the state and federal governments. Detroit's bankruptcy judge recently announced that he will defer the resolution of this dispute until the City files its Plan of Adjustment, but do not be surprised if the loser appeals the decision all the way to the U.S. Supreme Court.

While Missouri does not have a specific Constitutional provision like Michigan's, some Missouri courts have prohibited municipalities from reducing vested public pension benefits because of Missouri's general prohibition against impairing contracts. Illinois has a provision in its Constitution that is very similar to Michigan's.

Can municipalities really avoid paying general obligation bonds?

While the municipal bond market is complex and very large, municipal bonds can be divided broadly into two main types. "Revenue Bonds" are secured by a lien on revenue generated from the project for which the bond proceeds are used, such as a sewer plant or public utility. "General Obligation" bonds are backed by the full faith and credit of the issuer, but not by any specific collateral.

Most bankruptcy experts believe that Detroit's general obligation bonds will be deemed "general unsecured claims" in the bankruptcy case, meaning they will likely receive a very small distribution.

Holders of revenue bonds will probably fare better because they will be deemed secured creditors to the extent of the revenues generated by the projects. This will be a particularly interesting result because the municipal bond market has historically believed general obligation bonds are less risky than revenue bonds. Further complicating matters, some bondholders have insurance for their holdings while others do not.

How long does Chapter 9 take?

Orange County, Calif., took about a year and a half to emerge from its Chapter 9 bankruptcy, and Vallejo, Calif., was in Chapter 9 for almost three years. The record, however, is Asbury Park, New Jersey, (of Bruce Springsteen fame), which was in bankruptcy for almost 35 years. While Asbury Park's record seems safe, you should expect Detroit to be in bankruptcy for at least two years.

Does Chapter 9 really work?

Chapter 9's historical track record is not particularly good. One Chapter 9 expert has said that almost half of all Chapter 9 cases are dismissed without approval of a Plan of Adjustment. Some recent Chapter 9 cases have worked fairly well. Chapter 9 works best when it's used to deal with financial problems caused by a single discrete event, such as the disastrous derivative investments made by Orange County or the catastrophic (and corrupt) sewer bond issue in

Jefferson County, Ala. There is really no precedent for a municipality as large, troubled and complex as Detroit.

Could it happen here?

There is no reason to believe that St. Louis or any other major municipality in our region will file Chapter 9 any time in the foreseeable future. If circumstances change, however, Chapter 9 is available for Missouri municipalities but not to Illinois municipalities of more than 25,000 residents. Even if Chapter 9 never comes to a municipality near you, however, the Detroit case will influence the municipal bond markets and public pension industry for years to come.

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