



HOULIHAN LOKEY

# City of Detroit Analyzing the Outcome

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MERGERS & ACQUISITIONS  
CAPITAL MARKETS  
FINANCIAL RESTRUCTURING  
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# Detroit “Restructuring” – Presentation Topics

- What Happened
- How it Happened
- Why it Matters

## Houlihan Lokey Advisory Engagement

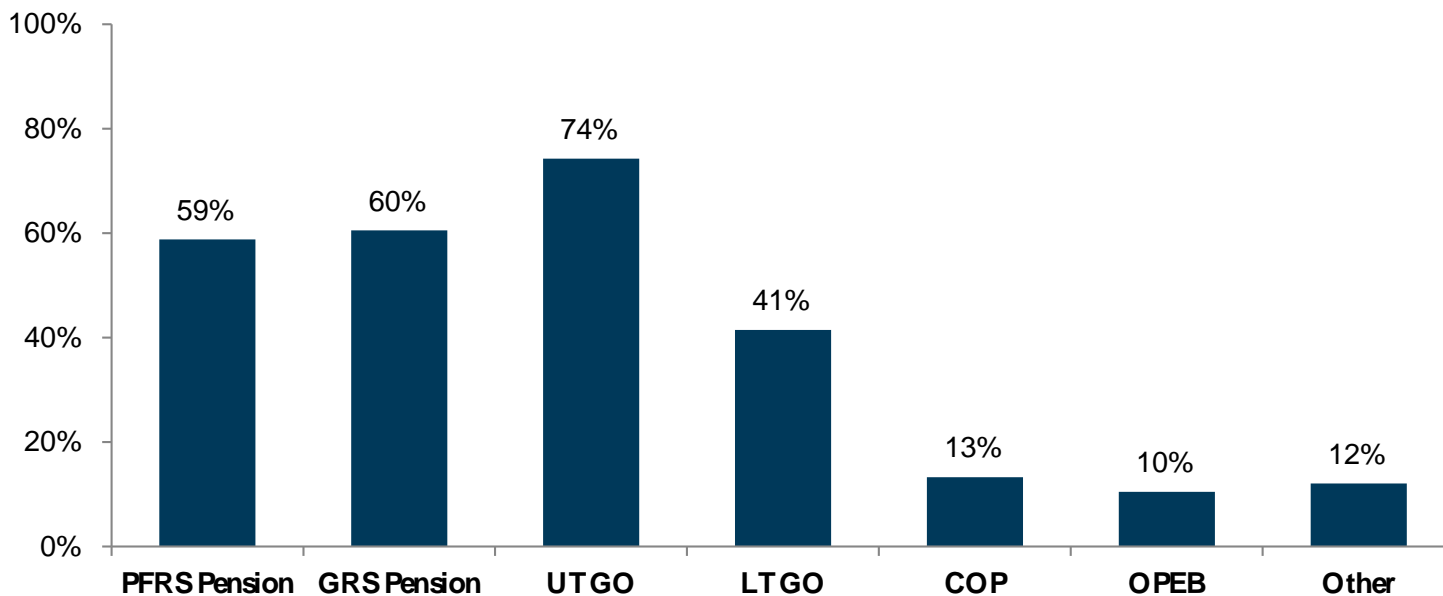
### ■ Financial Advisor to FGIC

### ■ \$1.6 billion total FGIC exposure

- Single largest financial creditor to the City
- \$1.1 billion of Certificate of Participation “COP” debt exposure
- \$0.5 billion of Detroit Water and Sewerage Department (“DWSD”) debt exposure

# Detroit “Restructuring” – What Happened...Reported

## Distribution of Plan Recoveries (\$ in millions)



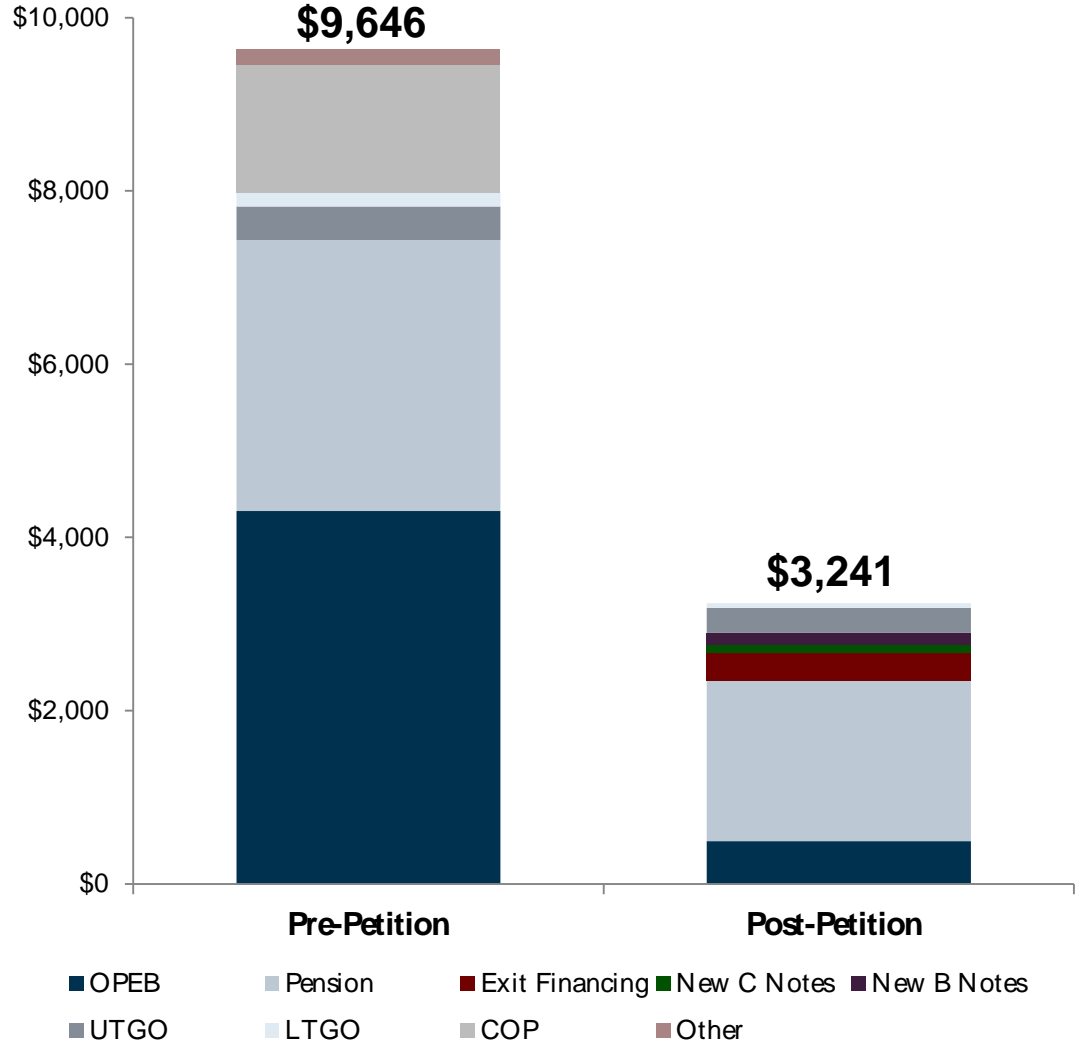
	PFRS Pension	GRS Pension	UTGO	LTGO	COP	OPEB	Other
<b>Claim</b>	\$1,250	\$1,879	\$388	\$164	\$1,473	\$4,303	\$190
<b>Recovery</b>	\$735	\$1,118	\$288	\$68	\$196	\$451	\$23

# Detroit “Restructuring” – What Happened...Reported

## Unsecured Debt - Pre-Petition vs. Post-Petition (\$ in millions)

Pre-Petition	
<b>Retiree Obligation</b>	
OPEB	\$4,303
Pension	\$3,129
<b>Total Retiree Obligation</b>	<b>\$7,432</b>
<b>Debt Obligation</b>	
UTGO	\$388
LTGO	\$164
COP	\$1,473
Other	\$190
<b>Total Debt Obligation</b>	<b>\$2,215</b>
<b>Total Obligation</b>	<b>\$9,646</b>

Post-Petition	
<b>Retiree Obligation</b>	
OPEB	\$493
Pension	\$1,853
<b>Total Retiree Obligation</b>	<b>\$2,346</b>
<b>Debt Obligation</b>	
UTGO	\$288
LTGO	\$55
New B Notes <sup>(1)</sup>	\$139
New C Notes	\$88
Exit Financing	\$325
<b>Total Debt Obligation</b>	<b>\$895</b>
<b>Total Obligation</b>	<b>\$3,241</b>

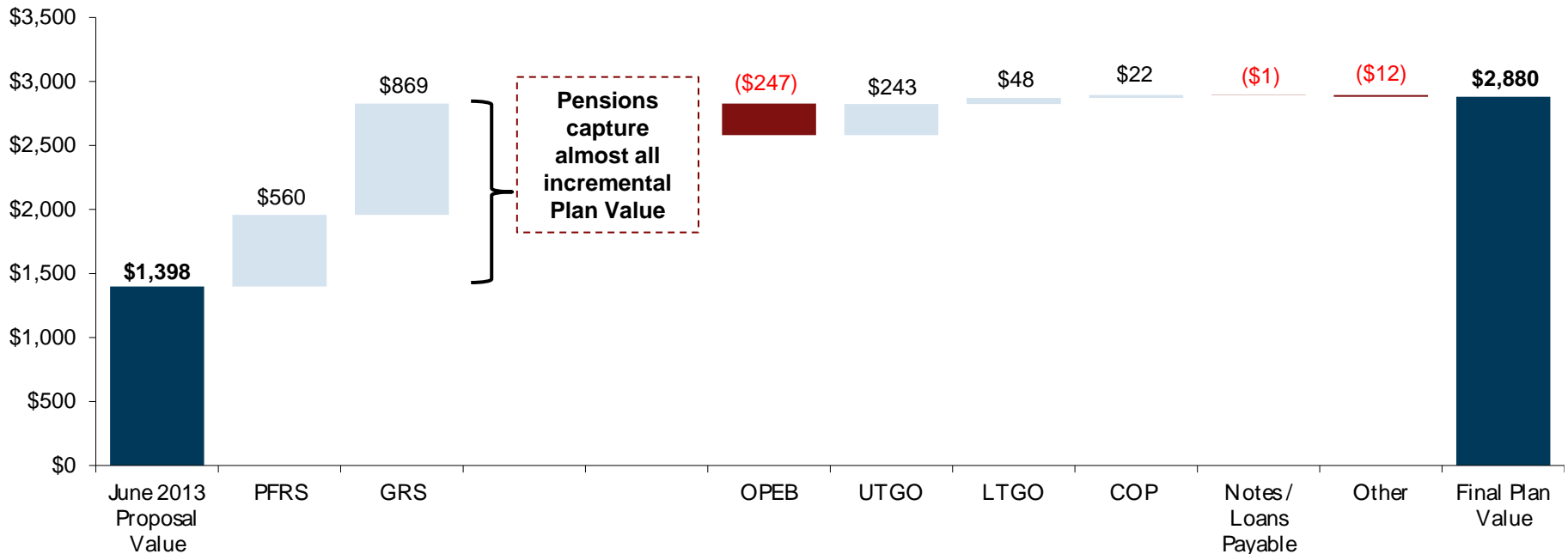


Note: Pre-petition pension obligation reflects UAAL; post-petition pension obligation reflects plan recovery. All other obligation reflect nominal balances  
(1) Reflects New B Notes remaining after \$493 million distribution to OPEB class

# Detroit “Restructuring” – How it Happened

## ■ An illustration / quantification of pension political clout...

### Distribution of Increase in Estimated Plan Recoveries (\$ in millions)



Note: \$1.4 billion creditor recoveries under June 2013 Proposal assumes a 5% discount rate and full repayment of the \$2.0 billion principal amount. Note that per the terms of the Limited Recourse Participation Notes as described in the June 2013 Proposal, the City is not obligated to repay the principal amount. Plan recoveries for recipients of the New B Notes reflect (i) a 5% discount rate consistent with the rate used by the City to calculate New B Notes recoveries in its Plan and (ii) COP - FGIC claims asserted at 100% of principal value

# Detroit “Restructuring” – How it Happened (cont.)

## Key Legal Issues

### ■ Equal legal standing of Pension and Financial creditors

### ■ Unfair Discrimination

- Application of “Markell” and “Aztec” tests

### ■ Best Interests of Creditors

- Examination of In re Pierce Cnty. Hous. Auth., Lorber v. Vista Irr. Dist., and In re Sanitary & Improvement Dist., No. 7

# Detroit “Restructuring” – How it Happened (cont.)

## Key Legal Issues

### ■ Equal legal standing of Pension and Financial creditors

*“Pension benefits are a contractual obligation of a municipality and not entitled to any heightened protection in bankruptcy.”*

**Judge Steven Rhodes**  
***December 3, 2013***



## Key Legal Issues

### ■ Unfair Discrimination

#### “Aztec” Test

- **Definition:** According to the Debtor, the Aztec standard is a four-factor test that is a “comprehensive framework for evaluating all of the questions that may bear on the question of unfair discrimination”
- **Criteria:** The Aztec test considers:
  1. Whether the discrimination is supported by a reasonable basis;
  2. Whether the debtor can confirm and consummate a plan without the discrimination;
  3. Whether the discrimination is proposed in good faith; and
  4. The treatment of the classes discriminated against

#### “Markell” Rebuttable Presumption Standard

A rebuttable presumption of unfair discrimination arises if three criteria are satisfied

- **Criteria:** A rebuttable presumption that a plan is unfairly discriminatory will arise when there is:
  1. A dissenting class;
  2. Another class of the same priority; and
  3. A difference in the plan’s treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution
- The presumption may only be rebutted by showing (i) outside of bankruptcy, the dissenting class would similarly receive less than the class receiving greater recovery; (ii) the preferred class infused new value into the restructuring, which offset its gain; or (iii) allocation of risk was consistent with the risk assumed by the parties pre-petition

## Key Legal Issues

### ■ Best Interests of Creditors

#### In re Pierce Cnty. Hous. Auth.

- **Definition:** According to the Debtor, the best interests of creditors test has been described as a “floor requiring a reasonable effort at payment of creditors by the municipal debtor”

#### Lorber v. Vista Irr. Dist.

- **Definition:** According to the Debtor, creditors receive “all they can reasonably expect in the circumstances”

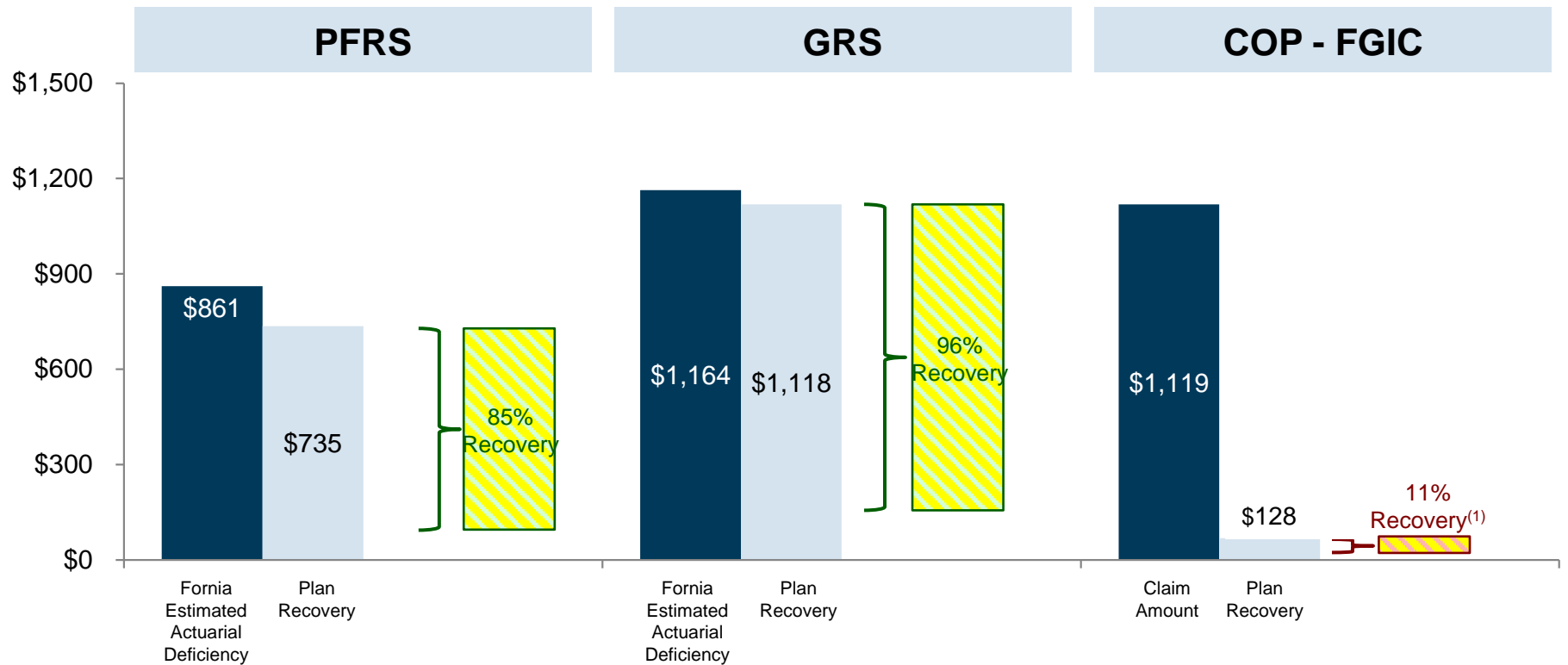
#### In re Sanitary & Improvement Dist., No. 7

- **Definition:** According to the Debtor, the best interest of creditors “simply requires the Court to make a determination of whether or not the plan as proposed is better than the [alternative to chapter 9, dismissal of the case]”

# Detroit “Restructuring” – How it Happened (cont.)

■ **Unfair Discrimination** – the Plan is unquestionably discriminatory. The lingering question is whether the discrimination was justified

**Pension Recoveries as % of Fornia Estimated Actuarial Deficiencies (\$ in millions)**



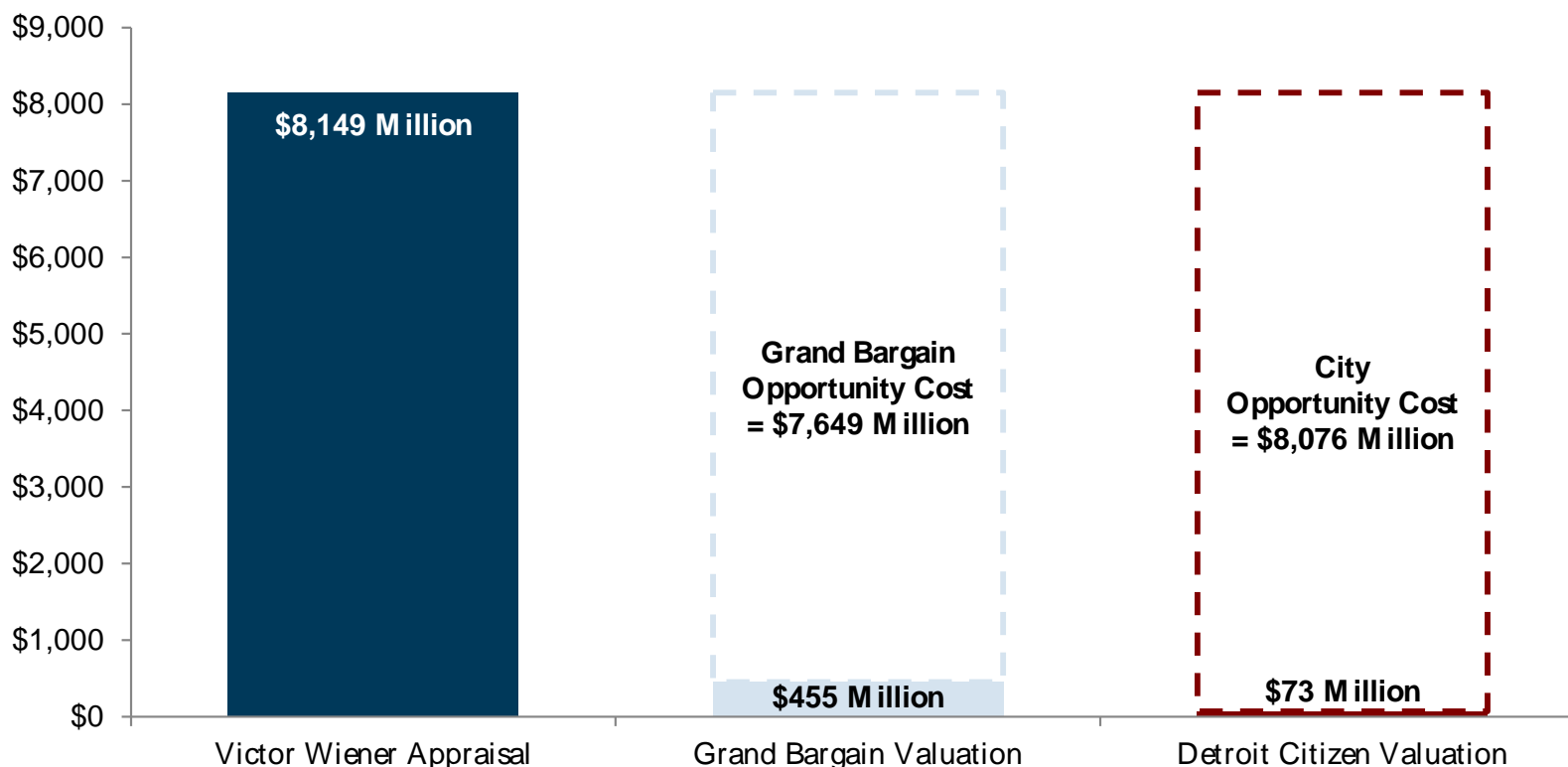
(1) COP recoveries reflect a 9% discount rate to value the New B Notes consideration

# Detroit “Restructuring” – How it Happened (cont.)

## ■ Best Interests of Creditors – many financial creditors still dispute whether this hurdle was met

- The Grand Bargain is one of several examples

### Measuring Opportunity Cost – Collective (\$ in millions)



# Detroit “Restructuring” – How it Happened (cont.)

- As demonstrated by the cases below in which COLA benefits of state pension plans were reduced or eliminated, pension reform can be implemented outside of a Chapter 9 context
- In the majority of cases, COLA reductions were upheld by the courts, with the primary rationale for allowing the cut being that COLA benefits are not a contractual right and can be modified as necessary
  - For example, in Minnesota, the judge ruled that the COLA was not a protected core benefit and that the COLA modification was necessary to prevent the long-term fiscal deterioration of the pension plan
  - Similarly, in Colorado, the judge found that the plaintiffs could have no reasonable expectation of a specific COLA amount for life given that the General Assembly has changed the COLA formula numerous times over the past 40 years

**Responses to COLA Cuts (2010-2014)**

State	COLA Cut Upheld	Rationale	Court	Year
Colorado	Yes <sup>(1)</sup>	COLA not a contractual right	State District	2011
Florida	Yes	COLA not protected under applicable state law	State Supreme	2013
Maine	Yes	COLA not a contractual right	U.S. District	2013
Minnesota	Yes	COLA not a contractual right	State District	2011
Montana	Yes	Complaint dismissed <sup>(3)</sup>	State District	2013
New Jersey	N/A	Complaint dismissed for lack of jurisdiction	U.S. District	2012
	Yes <sup>(1)</sup>	Complaint dismissed <sup>(4)</sup>	State Superior	2012
New Mexico	Yes	COLA not a contractual right	State Supreme	2013
Rhode Island	Yes <sup>(2)</sup>	N/A	Mediation	2014
South Dakota	Yes	COLA not a contractual right	State Circuit	2012
Washington	No <sup>(1)</sup>	Illegal impairment of contract	State Superior	2011

(1) Case is currently on appeal

(2) Mediation rejected

(3) The court refused to issue a preliminary injunction, finding it was not clear that plaintiffs would be successful in proving that the COLA was protected as a contractual right

(4) No written opinion

## Other Missed Opportunities

- Other asset monetizations
- More significant operational restructurings
- Driving City cash flow recoveries

## Missed Opportunities – Key Explanatory Variables

# Politics

- Impediment to asset monetizations
- Impediment to operational restructuring
- Impediment to equal treatment

# Detroit “Restructuring” – Why It Matters

- **Pricing municipal credit risk**
  
- **Treatment of legacy employee obligations**
  - The layers of moral hazard
  
- **Best interests and the monetization of assets**
  - “Preserve the assets for a better day”?
  
- **At what point is there systemic risk?**
  - Puerto Rico, Chicago, Cleveland, Baltimore, Los Angeles, etc.



# The End of Detroit for FGIC...

## ■ Best friends forever

