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Unsecured Creditors Should Have Had Lower Expectations, wrote Judge Rhodes

WHAT MAY BE THE FUTURE OF BONDHOLDER RECOVERIES?

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Summary

The ultimate recoveries in the Stockton, CA and Detroit, MI bankruptcies gave general government investors unease about how they might be treated in future restructurings. What should also be a future concern is the Detroit bankruptcy judge wrote that other unsecured creditors should have expected to receive less than pensioners.

What Informs Investors About How They Could Make Out in a Restructuring?

There is no roadmap for the recovery levels state and local government bondholders are likely to receive in restructurings. Prior to the Great Recession, recovery experience was generally pretty high—close to 100 percent in most cases. Much of what bondholders can expect to receive after future general government restructurings or defaults remains open to speculation.

Recent experience is especially important for those with faith in an issuer's ability and willingness to pay their liabilities. In Puerto Rico's related restructurings, questions loom regarding how bondholders are to be treated. In Stockton, California, and Detroit, Michigan, bondholder recovery evidence was much lower than previous situations and not as high as generally expected. In Stockton, bondholders recovered about 50 percent while pensioners received 100 percent. In Detroit, bondholders recovered about 25 percent (COPs received 12 percent, GOLT 42 percent and GOULT 73 percent), while pensioners received 82 percent as the two pension plans were cut by a total $1.5 billion.

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It was a telling moment when Judge Steven W. Rhodes, who presided over the Detroit bankruptcy, seemingly following his conscience and not necessarily the law, and indicated to observers that it is not going to be pensioners who will be on the hook in a reorganization. At the conclusion of the Detroit bankruptcy, Judge Rhodes addressed whether or not unsecured creditor recoveries were fair. In his oral opinion, he wrote:

> The Court concludes that fairness and unfairness are matters of conscience and that determining fairness is a matter of relying upon the judgment of conscience.[1]

Judge Rhodes' interpretation has since become known as the "Rhodes Test," wherein "conscience dictates fairness."[2] Judge Rhodes, who oversaw the largest Chapter 9 municipal reorganization to date, further detailed why the court believed pensioners deserved a higher level of recovery while also highlighting that other unsecured creditors should have expected a lower recovery than pensioners. Judge Rhodes wrote:

> Another consideration that appeals to the Court's conscience is the reasonable expectation of the parties. Generally, unsecured creditors reasonably expect similar treatment in bankruptcy. The difference here, however, is that the

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> Michigan constitution gives notice to all of the unsecured creditors of a municipality that the rights of pension creditors are distinct, even if their pension claims are unsecured. That constitutional notice reasonably justifies the enhanced expectations of the pension creditors in this case. At the same time, that notice should also lower the reasonable expectations of the other unsecured creditors in the case.[3]

These are important takeaways from the largest Chapter 9 municipal bankruptcy in U.S. history, especially the last statement, which warns other unsecured creditors that they should have expected pensioners to receive a higher recovery. The results in Stockton and Detroit clearly show that pensioners were favored over bondholders, and the above statement more clearly illustrates Judge Rhodes' thought process. This reading does not necessarily mean this will always be the result, but bondholders need to be prepared that pensioners could continue to make out better in future general government liability restructurings.

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1. See Oral Opinion on the Record, Bankruptcy Judge Steven Rhodes, Nov. 7, 2014, p. 29.
2. Bomey, Nathan; Detroit Resurrected – To Bankruptcy and Back; Norton 2016, p. 238 in paperback.
3. See Oral Opinion on the Record, Bankruptcy Judge Steven Rhodes, Nov. 7, 2014, p.31.

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