In the bankruptcy court

Detroit emergency manager conceals evidence of possible financial collusion

Thomas Gaist
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Evidence of potential financial criminality emerged this week as US Bankruptcy Judge Steven Rhodes heard arguments about Detroit Emergency Manager Kevyn Orr's plan to borrow $350 million from the London investment bank Barclays. Under the terms of the loan, which must get Rhodes' approval by January 7, two-thirds of the money will go to megabanks Bank of America-Merrill Lynch and UBS AG, as a termination payment to end the possibly illegal "swaps deals" the banks imposed on the city over the last eight years.

Orr has declared that the city's outstanding pension obligations are "unsecured" debts and offered Detroit city retirees as little as 10 cents on every dollar owed to them. Bank of America and UBS, however, have been treated as "secured" debtors and will be paid between 75 and 82 percent to unwind the swap deals.

Judge Rhodes suspended the proceedings Wednesday after Orr and attorneys from his former law firm, Jones Day, refused to provide evidence of the discussions they held in the run-up to the Barclays deal. During his testimony, Orr repeatedly invoked attorney-client privilege when probed about the existence of such documentation and why the city never challenged the legality of the swaps.

Both Bank of America and UBS are listed as clients of Jones Day. Release of such evidence might reveal blatant conflicts of interest, if not outright criminal collusion, between the giant law firm and the banks.

So blatant was the obstruction of justice that Rhodes told the lawyers, "In the past 28 years, in every case I've settled, everyone knew what the claims were, what the defenses were, what the alleged factual bases for the claims and defenses were, and where the strengths and weaknesses were on either side. I don't have that here."

The swaps were initiated in 2005-6 under the administration of former Detroit Mayor Kwame Kilpatrick to cover pension costs. It was modified in 2009 to give the banks "lockbox" control over gaming (casino) revenues as collateral.

Essentially, the city placed a large bet that interest rates would increase. When rates plunged after the 2008 crash, the city found was forced to shell out large monthly payments to the banks.

Guarav Malhotra, a managing director at Ernst & Young, testified Tuesday that the city has already been paying interest on the swaps deal of $4.2 million per month on average, for a total of some $45 million annually. This is equivalent to five percent of Detroit's yearly revenue.

Wallace Turbeville, a former Goldman Sachs executive from the liberal think tank Demos filed an affidavit in the case on behalf of retirees. He wrote that Pension Obligations Certificates and Certificates of Participation (POC and COPs) were foisted on the city, originally in 2005. Then, when Detroit defaulted on the POC debt in 2009, banks forced the city to pay higher rates on the debt and to put up the casino revenues as collateral—or else make an immediate payment of $400 million.

Turbeville said the complex swap deals were arranged to overcome democratic and legal checks against the loan. "It appears that the COPs structure was used to avoid limitations on debt, such as voter approval of the transaction and legal limits on debt, that would have applied had the conventional general obligation bond been used," he writes.

He also noted, "Many tens of billions of dollars of taxable pension fund debt transactions tied with swaps have been entered into by states and municipalities... They [the swap deals] have been severely criticized as vehicles for price gouging by banks that underwrite the bond debt and provide the swaps."

In the report on the Detroit bankruptcy he authored, Turbeville also wrote, “These swap deals were particularly ill-suited for a city like Detroit, which had been hovering on the edge of a credit rating downgrade for years. Because the risk of a credit downgrade below ‘investment grade’ was so great, the likelihood of a termination was imprudently high. The banks and insurance companies were in a far better position to understand the magnitude of these risks and they had at least an ethical duty to forbear from providing the swaps under such precarious circumstances. The law recognizes special duties that sophisticated financial institutions owe to special entities like cities in providing complex financial products. A strong case can be made that the banks that sold these swaps may have breached their ethical, and possibly legal, obligations to the city in executing these deals.”

In her affidavit, former City Council woman Sharon McPhail detailed the deception and corruption associated with the predatory swap deals. "All of the representatives of the banks continually assured Council members that there would be no risk associated with the City adopting these financial instruments,” McPhail said.

She added that former Detroit Chief Financial Officer Sean Werdlow aggressively pushed for the loan, and that “After this process was over, CFO Werdlow was given a lucrative job with one of the financial institutions involved in the Pension Obligation Certificates."

In her opening statement to the court Tuesday, Jones Day lead attorney Corinne Ball claimed the Barclay deal “represents the best feasible financing realistically available to the city in its current condition, when the city is only able to offer limited collateral and insists on remedies that preserve the city’s ability to operate, even in the face of default."

The loan comes with a 3.5 percent interest rate attached, and this may increase by up to 3 percentage points in coming years. Barclays is charging Detroit a $4.4 million processing fee as part of the deal. The deal includes a "market flex provision," which allows Barclays to increase the interest rate by 3 percent under certain conditions, to 6.5 percent. Changes in the London Interbank Offered Rate (LIBOR), which Barclays has previously been caught manipulating, are one such condition of this "market flex provision."

The LIBOR-rigging scandal, which became public last year, saw banks including UBS and Barclays bolster their profits through illegal manipulations of the crucial rate. Despite Barclays record, Orr is prepared to accept a deal from the bank based on "flexible" interest rates. Barclays will have "rights to utilize gaming and income tax revenues" should the city default on its interest payments to the bank.

Speaking last week about his approach to this case, Judge Rhodes dismissed arguments by retirees that by paying the banks up front with funds from the Barclays loan the city was punishing pensioners. “What is not relevant is whether the settlement prejudices creditors or any particular creditor because any settlement that is proposed to the court prejudices one or more or even all creditors.” The judge said he would only rule on whether the deal was “fair and equitable” and “in the best interest of the estate.”

In fact, the essential issue is who is paid first and why. The bankers who descended on the city to reap huge profits from parasitic and questionably legal deals have been given absolute priority over pensioners. While the losses of the financial speculators can be written off, pensioners whose meager benefits are cut will literally face an early death. Whatever his posturing about being “fair and equitable” Judge Rhodes made clear with his December 3 ruling sanctioning the bankruptcy process and the attack on pensions, that he, no less than Orr and Jones Day, is a representative of the financial interests looting the city.