"This deal should have the swap counterparties paying the city"

Further evidence shows illegality of Detroit interest rate swaps

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14 January 2014

The US Bankruptcy Court in Detroit heard closing arguments Monday regarding the “swaps deal,” a complex financial arrangement entered into by the city with Bank of America and Swiss bank UBS in 2005. The swaps deal has had disastrous effects on Detroit's finances, draining hundreds of millions of dollars from the city budget.

The deal amounted to a very large bet by the city of Detroit that interest rates would continue to rise. Similar deals were made with cities across the US, which were told by the banks that the interest rate swaps would help them offset costs from rising interest rates.

After the financial crash of 2008, the Federal Reserve initiated policies that drove interest rates to near zero in an effort to protect the balance sheets of the major banks. The sudden fall in interest rates caused Detroit and many other cities to lose the swaps “bet” catastrophically. In 2009, when the city was unable to continue payments averaging more than $4 million per month to the banks, UBS and Bank of America extorted the city with the threat of a $400 million termination fee and gained control over revenues from Detroit's casinos.

Despite Emergency Manager Kevyn Orr's acknowledgment during testimony on January 3 that the deals were likely illegal, his former law partners at Jones Day—which represents the city in the bankruptcy court—have done everything possible to protect the banks, which are now seeking a $165 million “termination fee” to end the deal. Orr was originally going to hand over $230 million to the banks.

During closing arguments, Caroline English, an attorney for Ambac Assurance, said the swaps deal was “void ab initio” (illegal from the very beginning). Rather than the city owing the banks $165 million, the banks should be paying hundreds of millions to the city in reparations, English argued.

“This deal should have the swap counter-parties paying the city, not the city paying the swap counter parties,” English said at the conclusion of her statements. “The swap payments were about 50 million a year…The swap counter-parties owe the city hundreds of millions of dollars.”

English demanded that Bankruptcy Judge Steven Rhodes reject the $165 million deal, arguing the court “can't just rubber stamp what Orr or the city wants to do.”

Ambac Assurance is a municipal bond insurer whose interests conflict with those of Bank of America and UBS, because it will have to cover the losses of the bondholders if the large payment to Bank of America and UBS is approved. In opposing the swaps deal, it is seeking to protect its own interests, not to defend the workers of Detroit. In the process, however, it has presented evidence that further establishes the illegal character of bankruptcy process as a whole.

English said the swaps deal violated Michigan's Revised Municipal Finance Act (2001), also known as Act 34, which was passed, she said, precisely to defend municipalities against predatory financial deals. English argued that the “swap counter-parties have no legal position to be protected by the safe harbors.”

Perverse “safe harbor” provisions have been inserted into the federal bankruptcy code since the late 1970s to protect derivative-dealing banks from losing money as a result of municipal bankruptcies. English said these safe harbor laws should not apply because the deal was never legal in the first place.

The Ambac attorney pointed out that just months ago, Bank of America and UBS were gunning for a termination free of $277.7 million, yet they were convinced to accept the reduced sum of $165 million during negotiations with the city.

The Ambac lawyer said that the banks have been negotiated down because interest rates are now rising. English added that if interest rates continue to rise at the current pace through the end of January, a $165 million payment would actually represent 78 cents on the dollar of what the banks would have demanded if Detroit were not already in Chapter 9 status. In other words, if the swaps deal goes through, the banks will be paid fully four-fifths of their exorbitant "termination fee," while Orr is proposing that pension funds receive a paltry 10 to 15 cents on the dollar for the unfunded pension obligations owed to 23,500 retirees.

English further said that the swaps deal violated the state gaming law, which specifies a number of socially useful purposes for which the gaming money is legally authorized to be used.

During her presentation, English displayed a slide which read, "The Gaming Act Does Not Permit Casino Revenue to Be Used to Pay Swap Obligations," and one reading, "The Liens on Casino Revenue are Void."

Section 12(3) of the Gaming Act confines use of casino revenue to a short list of specific purposes such as funding for public safety and the fire department, English argued. By using the revenues to pay off the banks, she said Orr is reducing the Gaming Act to a dead letter.

In a laughable moment, Marc Ellenberg, the lawyer for Bank of America-Merrill Lynch, argued that the termination payment is "well within the best interests of the city" and that the deal is a "win-win transaction." Ellenberg did not explain how the tens of thousands of Detroit families who lost their homes as a result of sub-prime mortgages devised by the same banks, nor city workers set to lose most of their already meager pensions, could consider the deal a "win."

Judge Rhodes, who ruled that Detroit was eligible for bankruptcy on December 3, has sought to appear as a neutral arbiter. Nevertheless, he upheld the refusal of Orr and the Jones Day attorneys to make public their assessment of the legality of the swaps, despite the decisive importance of this information to the case. Everything he has done so far indicates that the federal judge—who has overseen previous cases robbing auto parts workers and others of their pensions—wants the bankruptcy process to go forward smoothly, as long as it can be given a veneer of legality and "equal sacrifice."

Rhodes is set to make a ruling in the case on Thursday.