

## ALERTS

# Finance, Insolvency & Restructuring Alert - A Preliminary Road Map To The Chapter 9 Bankruptcy Of The City Of Detroit

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## A. Background to Chapter 9 Filing

Drowning in debt in excess of \$18 billion, the city of Detroit yesterday reached for the lifeline of relief provided by Chapter 9 of the Federal Bankruptcy Code. Detroit filed its Chapter 9 petition with the United States Bankruptcy Court for the Eastern District of Michigan in downtown Detroit on July 18, 2013, at 4:06 p.m. (ET) in order to stave off a last-minute attempt by municipal retirement plans to obtain an injunction from a Michigan state court which, if granted, could have prohibited the bankruptcy filing. In terms of the overall amount of debt affected, this is the largest Chapter 9 bankruptcy in American history. The name and number of this case pending in the United States Bankruptcy Court for the Eastern District of Michigan is *In re City of Detroit*, Case No. 13-53846.

Lawyers for the city of Detroit commenced this case by filing a voluntary Chapter 9 petition which immediately imposed an automatic stay prohibiting collection and foreclosure actions by creditors. The Chief Judge of the Sixth Circuit Court of Appeals who sits in Cincinnati, Ohio and that oversees the operation of bankruptcy courts in the states of Michigan, Ohio, Kentucky and Tennessee, will appoint a bankruptcy judge from the Circuit to handle this Chapter 9 case. This judge could hail from any of the four states in the Circuit and could elect to conduct hearings in this case in his or her home district.

The Chapter 9 petition was signed by Kevyn Orr, the emergency manager of Detroit appointed earlier this year under a revamped state law designed to alleviate the financial problems of Michigan municipalities and school districts. With Michigan's written permission, Orr elected to pursue his restructuring efforts in bankruptcy court when these pre-bankruptcy attempts for a consensual debt restructuring plan with creditors failed to bear fruit.

## B. What Does the Chapter 9 Filing Mean for the City and its Creditors?

### 1. *Automatic Stay Against Most Collection and Foreclosure Actions*

As noted above, most creditors of the city are now automatically stayed from commencing or continuing collection and foreclosure actions against the city and its property. Continuing these actions without first obtaining an order from the bankruptcy court could result in the imposition of financial and other penalties against the transgressing creditor. This stay however, does not prohibit the payment of special revenue pledged to holders of special revenue bonds issued by the city.

### 2. *"Business as Usual" for the City*

## RELATED PEOPLE



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## RELATED PRACTICE AREAS

Creditors' Rights, Restructuring and Bankruptcy

The city will continue to operate its business post-bankruptcy. Section 904 of the Bankruptcy Code applicable in Chapter 9 cases prohibits the bankruptcy court from interfering with (i) the debtor's "political or governmental powers," (ii) the debtor's "property or revenues," or (iii) the debtor's "use or enjoyment of any income-producing property," unless the debtor consents or a Chapter 9 plan so provides.

### *3. Potential Dispute Over the City's Eligibility for Chapter 9 Relief*

Section 109(c) of the Bankruptcy Code imposes eligibility requirements on entities filing for Chapter 9 relief. The first significant contested matters in these cases concern the applicability of these requirements to the municipality filing a Chapter 9 petition. In the recent Chapter 9 case commenced by San Bernardino, Calif., the bankruptcy court's hearings on the city's eligibility for relief extended for approximately one year. In Detroit's case, it is likely that creditors hostile to the Chapter 9 filing will soon file a motion to dismiss this Chapter 9 case on the following grounds:

- a. the city is not "insolvent." 11 U.S.C. § 109(c)(3)
- b. the city, through its emergency manager, failed to negotiate restructuring of the city's debt with creditors in "good faith." 11 U.S.C. § 109(c)(5)(B).
- c. the city is "unable to negotiate with creditors because such negotiation is impracticable." 11 U.S.C. § 109(c)(5)(D).

Anticipating these objections, the city filed late yesterday in its Chapter 9 case a 106-page Memorandum in Support of Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code. (Dkt. No. 14.) The issue of whether the city qualifies for Chapter 9 relief, as a practical matter, must be resolved before the city may propose a plan for the adjustment of its debts. This process could be lengthy.

### *4. Filing Proofs of Claim*

Section 924 of the Bankruptcy Code requires the city to file with the bankruptcy court a "list of creditors." With respect to claims identified in this list, holders need not file proofs of claim in the Chapter 9 case unless their claims are listed as "disputed, contingent, or unliquidated." Bankruptcy Rule 3003, applicable to all Chapter 9 cases filed in the United States, provides that any creditor or indenture trustee may file a proof of claim within the time period prescribed in Bankruptcy Rule 3003(c)(3). This time period will be fixed by the bankruptcy court during the Chapter 9 case and may later be extended by the court "for cause shown." Any proof of claim properly and timely filed will supersede any scheduling of claims by the debtor in the Chapter 9 case. Bankruptcy Rule 3003(c)(4).

In this Chapter 9 case, the city filed yesterday a list of creditors holding the 20 largest unsecured claims against the city. This list specified the estimated amounts of each claim and, with respect to certain claims, listed them as "contingent," "unliquidated" and/or "disputed." The city also filed yesterday other lists of creditors and claims, i.e., holders of long-term debt, SWAP creditors, employee benefit claims, trade creditors and pension funds, but no claim amounts were included. It is anticipated that the city will file more complete schedules of claims later in the case with claim amounts and with indications that certain claims are deemed by the city to be contingent, unliquidated or disputed.

At present, the bankruptcy court has not fixed a date for filing proofs of claim in this case. When that date is fixed, however, creditors will have the option of filing those claims. As a general rule, creditors should file their own claims and not rely on the debtor's description of those claims in their claim schedules. Even if the debtor provides an accurate description of a creditor's claim in its initial schedules, the debtor may later amend them to reduce the amount of a claim or describe it as contingent, unliquidated or disputed. Without filing a proof of claim in these circumstances, the affected creditor may be bound by the debtor's claim description. For example, in these circumstances, a claim listed as "disputed" may receive no distributions under a confirmed Chapter 9 plan in the absence of a timely filed and superseding proof of claim.

#### *5. Appointment of a Creditors Committee*

Chapter 9 of the Bankruptcy Code specifically permits the appointment of a creditors committee in these cases by the wholesale incorporation into Chapter 9 of sections 1102 and 1103 of the Code. Thus, the Office of the United States Trustee will later in this case appoint a "committee of creditors holding unsecured claims," which ordinarily consists of seven members who are willing to serve on the committee. Committee members act as fiduciaries for the holders of unsecured claims and are empowered to retain professionals, e.g., attorneys and accountants, to assist the committee in the performance of their duties and to "participate in the formulation of a plan." Typically, creditors committees are a source of information about the Chapter 9 case for their constituent class. Committees are also empowered to investigate the acts, conduct, assets and liabilities and financial condition of the debtor and other related matters and may support or object to confirmation of a plan.

#### *6. Plan to Adjust Debts of a Municipality*

A Chapter 9 plan will be the keystone of the city of Detroit's debt restructuring attempts. Only a debtor – here, the city – may file a Chapter 9 plan. Because the city did not file a plan yesterday with its petition, the city will be required to file one later within a time period to be fixed by the bankruptcy court. Based upon Kevyn Orr's pronouncements leading up to the city's Chapter 9 filing, one should expect a plan that provides for small distributions to unsecured creditors and for sales of valuable city assets, which could possibly include the art collection of the Detroit Institute of Arts.

The bankruptcy court may confirm a Chapter 9 plan if it satisfies the seven tests set forth in section 943(b) of the Bankruptcy Code, which includes a determination that the plan "is in the best interests of creditors and is feasible." Creditors holding allowed claims against the city will be entitled to vote to accept or reject the Chapter 9 plan proposed by the city. While the precise scope of this seventh standard for plan confirmation has yet to be defined by case law, some courts have held that this test requires a finding by the bankruptcy court that the proposed plan is better than any available alternatives and that the debtor is able to make all plan payments. See, e.g., *In re Sanitary and Improvement District No. 7*, 98 B.R. 970 (Bankr. D. Neb. 1989).

The bankruptcy court will conduct a hearing to consider whether the city's plan satisfies the seven tests mentioned above and to rule on any objections to confirmation of the plan that may be filed by creditors or other interested parties. At this hearing, the judge will hear and consider legal arguments for and against confirmation and may also hear

testimony of witnesses. If the bankruptcy court decides to confirm the plan, the judge will issue a written order of confirmation. Once confirmed, the provisions of the Chapter 9 plan will bind the debtor and all creditors, even those creditors that failed to file a proof of claim and those creditors who voted against the plan. 11 U.S.C. § 944(a). Also upon confirmation, the debtor will be discharged from its debts except for those carved out from discharge in the plan or confirmation order and those debts owed to any creditor that had no notice or knowledge of the case prior to plan confirmation. 11 U.S.C. § 944(c). After confirmation, the bankruptcy court may keep the case open “for such period of time as is necessary for the successful implementation of the plan.” 11 U.S.C. § 945(a). Once administration of the case is finished, the court “shall close the case.” 11 U.S.C. § 945(b).

### **C. Going Forward From Here**

Creditors of the city of Detroit may choose to collect and assemble the written documents evidencing the basis for their claims against the city and the amounts thereof. For example, creditors with long-term supply contracts with the city might locate complete and signed copies of such contracts and any open invoices thereunder. Many creditors are likely to engage counsel promptly, especially those who hold large claims against the city and/or are a party to an executory contract or unexpired lease with the city that is subject to assumption or rejection by the city. At some future date, creditors will need to decide whether or not to file proofs of claim after closely reviewing any communications relating to this Chapter 9 case for the establishment of a date by which all proofs of claim must be filed and where they must be sent. Many affected parties will also be watching the case for notice of appointment of a claims agent. Large debtors like the city often retain claims agents to collect proofs of claim and bankruptcy courts often order that original proofs of claim must be timely filed with these agents.

For additional information, please contact the Barnes & Thornburg attorney with whom you work, or one of the following members of the firm’s Finance, Insolvency & Restructuring group: Patrick E. Mears at 616-742-3936 or [patrick.mears@btlaw.com](mailto:patrick.mears@btlaw.com); or David M. Powlen at 302-300-3435 or [david.powlen@btlaw.com](mailto:david.powlen@btlaw.com).

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