BARNES & THORNBURG LLP

ALERTS

Finance, Insolvency & Restructuring Alert - Legal Drama In The Motor City: Detroit Is Eligible To Commence A Chapter 9 Case

December 12, 2013 | Atlanta | Chicago | Columbus | Delaware | Elkhart | Fort Wayne | Grand Rapids | Indianapolis | Los Angeles | Minneapolis | South Bend

"You cannot properly appraise the real seriousness of that situation unless you are right there in the city. Everything that frugal men and women put aside for years to save for old age, to get security for themselves — every¬thing that they put aside to make the lot of their children a better one than their own, is now likely to be swept away. There is only one way that you can lighten the load of the municipality and that is to take its debt service off for the time being. Specifically, so that you will understand it, what is it in the city of Detroit? Our budget [this year is] $72,200,000; our tax delinquency is $28,000,000—36 percent . . .I want to express the opinion to you that in the city of Detroit, next year, there will not be enough income to even pay the fundamental services of government, to keep your schools going, your police and fire departments, your health and welfare depart¬ments, let alone to take care of the debt services of that city."

- Frank Murphy, former mayor of Detroit, testifying before the Judiciary Committee of the United States House of Representatives in 1933, in support of proposed municipal bankruptcy legislation.

I. INTRODUCTION

On July 18, 2013, the City of Detroit (the "City"), acting through its Emergency Manager appointed under Michigan's "Local Government and School District Fiscal Accountability Act" (MCL §§ 141.1501, et seq.), filed a petition under Chapter 9 of the Federal Bankruptcy Code (the "Bankruptcy Code"). The filing of this petition was the culmination of a series of events beginning on Dec. 6, 2011, when the Michigan Department of Treasury began a preliminary review of the City's financial condition pursuant to the provisions of a predecessor Emergency Manager statute.

The history of this process is tortuous and resulted in the State of Michigan appointing an Emergency Manager to take over the reins of city government from the Mayor of Detroit and its Common Council with the goal of restructuring the disastrous and scrambled financial condition of the City. On March 1, 2013, the Governor of the State of Michigan, acting in accordance with the provisions of applicable state law, had announced that a "financial emergency" existed in the City of Detroit. Fifteen days later, the State's Local Emergency Financial Assistance Loan Board appointed Kevyn Orr, then a partner in the international law firm of Jones Day, as the Emergency Manager for Detroit and on March 25, 2013, Orr took office.

During the month of June, 2013, Orr held a series of meetings with

RELATED PEOPLE

Patrick E. Mears
Of Counsel (Retired)

P 616-742-3936
patrick.mears@btlaw.com

David M. Powlen
Of Counsel (Retired)

P 302-300-3435
david.powlen@btlaw.com

RELATED PRACTICE AREAS

Creditors' Rights, Restructuring and Bankruptcy

various creditor groups including representatives of various pension systems, retiree associations, unions, bond insurers, and the like and presented them with a proposal for an out-of-court restructuring of the City's huge and unsustainable debt. During these meetings, Orr outlined to the attendees the depth of the city's financial problems and sketched an outline of a possible financial restructuring of those debts which would involve deep discounts on creditors' claims. In early July, two separate lawsuits were commenced against the Governor and Treasurer of the State of Michigan in Michigan state court requesting (i) a declaratory judgment that Michigan's Emergency Financial Manager law was unconstitutional; and (ii) an injunction prohibiting the defendants from authorizing the filing of a petition under Chapter 9 of the Bankruptcy Code in which vested pension benefits might be impaired. Against the backdrop of this litigation, the Governor authorized the City of Detroit, acting through its Emergency Financial Manager, Kevyn Orr, to file a Chapter 9 petition seeking to adjust the municipality's debts with no limitations on the ability of the City to restructure pension indebtedness. This Chapter 9 petition was filed with the bankruptcy court clerk in Detroit on July 18, 2013, at 4:06 p.m., just minutes before the state court conducted hearings in the two cases seeking to enjoin such a Chapter 9 filing. Notwithstanding this filing, the state court entered an order granting the request for an injunction against the governor and declaring the Emergency Financial Manager Act to be unconstitutional "to the extent that it permits the Governor of Michigan to authorize an emergency manager to proceed under Chapter 9 in any manner which threatens to diminish or impair accrued pension benefits."

II. THE CHAPTER 9 CASE GATHERS STEAM

Notwithstanding this order entered by the state court, Detroit's Chapter 9 case proceeded in the United States Bankruptcy Court for the Eastern District of Michigan under the auspices of Bankruptcy Judge Steven W. Rhodes. In voluntary cases under Chapter 9 of the Bankruptcy Code, an "order for relief" under that chapter is not entered immediately upon the filing of the petition as in cases under Chapter 11, which prescribes reorganization procedures for entities other than municipalities. Immediately upon the filing of a voluntary Chapter 9 petition with a bankruptcy court clerk, an automatic stay (i.e., an injunction) against the commencement and prosecution of collection actions and other creditor enforcement actions is imposed by operation of law. 11 U.S.C. §§ 362, 922. The automatic stay provisions of section 922(a)(1), unlike the stay applicable in Chapter 11 cases, applies to protect certain third parties—this subsection prohibits the "commencement or continuation, including the commencement or employment of process, of a judicial, administrative or other action against an officer or inhabitant of the debtor that seeks to enforce a claim against the debtor." (Emphasis supplied.)

Since the date on which Detroit filed its petition, there was (and continues to be) a substantial amount of jockeying in the bankruptcy court and in the press by the City and creditor groups concerning the eligibility of the City to be the subject of a Chapter 9 case. Section 109(c) of the Bankruptcy Code sets forth five separate tests for an entity to be an eligible "debtor" under Chapter 9. First, the entity must be a "municipality," which term is defined in section 101(40) of the Bankruptcy Code as a "political subdivision or public agency or instrumentality of a State." 11 U.S.C. § 109(c)(1). This requirement is easily satisfied by the City which, under

applicable state law, is recognized as an instrumentality of the State of Michigan. Second, the entity must be "specifically authorized, in its capacity as a municipality or by name, to be a debtor" under Chapter 9 or "by a governmental officer or organization empowered by State law to authorize such entity to be a debtor" under Chapter 9. 11 U.S.C. § 109(c)(2). Michigan's Emergency Financial Manager Act permits Michigan's governor to authorize a Chapter 9 filing by a municipality, which happened here in July, 2013, and this authorization may contain contingencies. Third, the entity must be "insolvent," which the Bankruptcy Code defines, with respect to a municipality, as a financial condition where the municipality is "generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute" or where the municipality is "unable to pay its debts as they become due." 11 U.S.C. §§ 109(c)(3), 101(32)(C). Fourth, the entity filing the petition must desire "to effect a plan to adjust such debts." 11 U.S.C. § 109(c)(4).

The final requirement for eligibility under Chapter 9 is somewhat complex, requiring the municipality to satisfy at least one of the following four standards specified in section 109(c)(5) of the Bankruptcy Code:

- The municipality must have "obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case" under Chapter 9.
- The municipality must have "negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class" that the municipality intends to impair in a Chapter 9 debt adjustment plan.
- The municipality was "unable to negotiate with creditors because such negotiation [was] impracticable."
- The municipality "reasonably believes that a creditor may attempt to obtain a transfer that is avoidable" as a preference under section 547 of the Bankruptcy Code.

The hearings on the issue of whether the City of Detroit satisfied this test of eligibility for relief under Chapter 9 began in September and concluded in early December 2013. At these hearings, the City was required to establish, by a preponderance of the evidence, that it satisfied each of the five elements of eligibility. One hundred and nine parties filed objections to the City's claimed eligibility under Chapter 9. Judge Rhodes heard testimony from Orr, Michigan's governor, city inhabitants and creditor groups and reviewed hundreds of exhibits. On December 3, Judge Rhodes announced his decision in open court that the City had met is evidentiary burden of proving that it is entitled to relief under Chapter 9 and, a few days later, issued his 143-page opinion in this contested matter (the "Eligibility Opinion").

III. THE COURT'S ELIGIBILITY OPINION

The Court's opinion, while addressing essentially all of the substantive objections filed by creditors to Detroit's request for a determination of eligibility, focused in large part on three primary issues. First, did the City improperly file its Chapter 9 petition without the contingency that the City would not attempt to alter in the Chapter 9 case the constitutionally

protected rights of former City employees to their pensions? Second, did the City attempt to negotiate with its creditors for a restructuring of the City's debt outside of bankruptcy or, in the alternative, were such negotiations "impracticable" under the circumstances. Finally, did the City file its Chapter 9 petition in "good faith" as required by section 921(c) of the Bankruptcy Code?

A. The City's Pension Obligations to Retired City Employees

At the beginning of Judge Rhodes' opinion, he catalogued and analyzed the City's indebtedness, the massive deterioration in City services that has occurred over a period of years and the drastic reduction in the City's population since 1950. The City estimated its total debt in its Chapter 9 Schedules at $18 billion - - $11.9 billion in unsecured debt and $6.4 billion in secured debt - - all of which is held by more than 100,000 creditors. The estimate of unsecured debt includes $3.5 billion of unfunded pension obligations and $5.7 billion in "other post-employment benefits" owing to present city employees and retirees.

Michigan's current state constitution which came into force in 1963 contains special protections for the pension rights of public employees. Article IX, Section 24, of the constitution reads as follows:

> "The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby."

Similar protections were not previously included in earlier Michigan constitutions and prior case law had not elevated pension commitments by the state and municipalities to the status of contracts. Rather, before 1963, Michigan public pensions were treated as "gratuitous allowances that could be revoked at will because a retiree lacked any vested right in their continuation."

After analyzing the public debates of the Michigan Constitutional Convention conducted in 1961-1962 and subsequent case law on the status of public employee pensions in Michigan, Judge Rhodes concluded that the current state constitution elevated the status of these pension rights to contractual obligations and nothing more. Upon the failure of the State or municipality to pay an employee his pension amounts due under a retirement plan, that employee will have the right to commence an action in court to recover his unpaid benefits then due.

Some of the parties objecting to the City's eligibility for Chapter 9 relief argued that this state constitutional provision granted "absolute protection" to the right to receive public pension benefits and that, because the Chapter 9 petition filed by the City did not carve out these benefits as being sacrosanct in the Chapter 9 case, the filing of the petition was not authorized by state law as required by section 109(c)(2) of the Bankruptcy Code. Judge Rhodes rejected this argument, noting that state law only elevated public pension obligations to the status of contractual obligations and retirees' rights to receive these contractual payments may be adjusted in a confirmed Chapter 9 plan. As Judge Rhodes phrased it, "state law cannot reorder the distributional priorities of the bankruptcy code. If the state consents to a municipal bankruptcy, it consents to the application of chapter 9 of the bankruptcy code."

Interestingly, however, Judge Rhodes injected a word of caution concerning any attempt by the City to impair the public pension rights of retirees in a Chapter 9 plan:

> "No one should interpret this holding that pension rights are subject to impairment in this bankruptcy case to mean that the Court will necessarily confirm any plan of adjustment that impairs pensions. The Court emphasizes that it will not lightly or casually exercise the powers under federal bankruptcy law to impair pensions. Before the Court confirms any plan that the City submits, the Court must find that the plan fully meets the requirements of 11 U.S.C. § 943(b) and the other applicable provisions of the bankruptcy code. Together, these provisions of law demand this Court's judicious, legal and equitable consideration of the interests of the City and all of its creditors, as well as the laws of the State of Michigan."

B. Good Faith Negotiations With Creditors and Their Impracticability

As mentioned above, section 109(c)(5) of the Bankruptcy Code requires a chapter 9 petitioner to satisfy at least one of four requirements stated therein before a finding of eligibility for Chapter 9 relief may be made by a bankruptcy court. Two of those requirements - - that creditors holding a majority in amount of claims in each class to be impaired under a chapter 9 plan and that a voidable preferential transfer was reasonably believed by the petitioner to be obtained by a creditor - - have no application in the City's Chapter 9 case. Thus, the City was required to prove that either (i) the City negotiated with creditors in "good faith" but failed to obtain the agreement of impaired classes of claims to an out-of-court restructuring; or (ii) the City was unable to so negotiate because such negotiation was "impracticable." Judge Rhodes devoted a substantial portion of the Eligibility Opinion to these two factors - - good faith negotiations and their impracticability - - and concluded that, even though the City failed to negotiate with its creditors in good faith, those negotiations were nonetheless impracticable under the circumstances.

Judge Rhodes' factual findings described in detail the various meetings held by Orr with groups of creditors during June, 2013. On June 14, Orr met with approximately 150 creditor representatives including those of the City's debt holders, insurers of that debt, unions, retiree associations and pension systems, at which time Orr presented them with an out-of-court restructuring proposal. Elements of this proposal were (i) an anticipated investment of $1.25 billion over ten years to improve basic and essential City services; (ii) an expansion of the City's income and property tax bases; and (iii) the "realization of value" from the Detroit Water and Sewerage Department via the creation of a new authority. Orr also proposed "treatment of secured debt commensurate with the value of the collateral securing such debt" along with the "pro-rata distribution of $2 billion in principal amount of interest-only limited recourse participation notes to holders of unsecured claims." In addition to this meeting, Orr and his staff held other meetings with creditors regarding this proposal, including a meeting with union representatives and retiree associations in Detroit on June 20, 2013 and a meeting in New York City with representatives of "all six of the insurers of the City's funded bond debt, the pension systems, and U.S. Bank, the trustee or paying agent on all of the City's bond issuances." Additional meetings were held in late June

and early July.

At the various hearings on eligibility, the City argued that its out-of-court restructuring proposal presented to creditors on June 14, 2013, and the follow up meetings with creditor groups constituted a "good faith effort to begin negotiations" but the creditors "refused to respond." The objectors argued that this proposal lacked sufficient detail to permit them to make any counterproposals and, therefore, good faith negotiations were never begun, much less attempted. After an extensive review of the evidence, Judge Rhodes concluded that "the June 14 Proposal to Creditors and the follow up meetings were not sufficient to satisfy the requirements of 11 U.S.C. § 109(c)(5)(B) . . . .The Proposal to Creditors did not provide creditors with sufficient information to make meaningful counter-proposals, especially in the very short time that the City allowed for the discussion period."

Notwithstanding the lack of good faith negotiations by the City with creditors concerning a possible out-of-court restructuring, Judge Rhodes concluded that any such negotiations would have been "impracticable" and, therefore, the requirements of 11 U.S.C. § 109(c)(5)(B) were satisfied by the City. Judge Rhodes reviewed the relevant case law on the issue of impracticability, noting that this test involves a "fact-sensitive inquiry" that "depends upon the circumstances of the case." This test was adopted by Congress "to cover situations in which a very large body of creditors would render prefiling negotiations impracticable."

The Eligibility Opinion then points out that there were over 100,000 creditors listed in the City's bankruptcy schedules. With respect to retirees, Judge Rhodes observed that the unions disclaimed authority to negotiate on behalf of the large number of retirees and that several retiree associations asserted that "they would never negotiate a reduction in accrued pension benefits." In conclusion, Judge Rhodes wrote that

"[t]he majority of the City's debt is bond debt and legacy debt. Neither the pension debt nor the bond debt are adjustable except through consent or bankruptcy. Negotiations with retirees and bondholders were impracticable due to the sheer number of creditors, and because many of the retirees and bondholders have no formal representatives who could bind them, or even truly negotiate on their behalf. Additionally, the Court finds that the City's fiscal crisis was not self-imposed and also made negotiations impracticable."

C. The Good Faith Requirement for Filing a Chapter 9 Petition

Section 921(c) of the Bankruptcy Code permits a bankruptcy court, after an objection is filed to a Chapter 9 petition, to dismiss that petition after notice and a hearing "if the debtor did not file the petition in good faith or if the petition does not meet the requirements of [the Bankruptcy Code]." At the outset of this section of the Eligibility Opinion, Judge Rhodes observed that:

"[t]he City's alleged bad faith in filing its Chapter 9 petition was a central issue in the eligibility trial. Indeed, in one form or another, all of the objecting parties have taken the position that the City did not file its petition in good faith and that this Court should exercise its discretion under 11 U.S.C. § 921(c) to dismiss the case."

Judge Rhodes then proceeded to quote a recent decision of the bankruptcy judge handling the pending Chapter 9 case of Stockton,

California, Judge Christopher M. Klein, concerning the proper legal standard to determine whether a Chapter 9 petition was filed in “good faith”:

“Relevant considerations in the comprehensive analysis for § 921 good faith include whether the City’s financial problems are of a nature contemplated by chapter 9, whether the reasons for filing are consistent with chapter 9, the extent of the City’s prepetition efforts to address the issues, the extent that alternatives to chapter 9 were considered, and whether the City’s residents would be prejudiced by denying chapter 9 relief.”

As an overriding principle, the essence of the good faith requirement in section 921 is “to prevent abuse of the bankruptcy process.”

In his review of the record of the eligibility hearing, Judge Rhodes concluded that “in some particulars, the record does support the objectors’ view of the reality that led to this bankruptcy filing.” The evidence in support of the objectors’ theory included testimony and documentation pointing toward collusion between Orr and the State of Michigan concerning planning for the Chapter 9 filing and providing political cover for state officials after the filing, in addition to certain statements made by Orr to creditor representatives during the June negotiations concerning the “sacrosanct” nature of the City’s pension obligations.

Nonetheless, Judge Rhodes concluded that the City’s petition was filed in good faith and that the record did not support the objectors’ position “in enough particulars for the Court to find that the filing was in bad faith.” The Court made it clear in the Eligibility Opinion that its “paramount” concern was for the interest of the City’s inhabitants and that they would be “severely prejudiced” if the Chapter 9 case is dismissed:

The Court concludes that this factor is of paramount importance in this case. The City’s debt and cash flow insolvency is causing its nearly 700,000 residents to suffer hardship. As already discussed at length in this opinion, the City is “service delivery insolvent.” See Parts III B 6-11 and XIII B, above. Its services do not function properly due to inadequate funding. The City has an extraordinarily high crime rate; too many street lights do not function; EMS does not timely respond; the City’s parks are neglected and disappearing; and the equipment for police, EMS and fire services are outdated and inadequate.

Over 38% of the City’s revenues were consumed by servicing debt in 2012, and that figure is projected to increase to nearly 65% of the budget by 2017 if the debt is not restructured. Ex. 414 at 39 (Dkt. #11) Without revitalization, revenues will continue to plummet as residents leave Detroit for municipalities with lower tax rates and acceptable services.

Without the protection of chapter 9, the City will be forced to continue on the path that it was on until it filed this case. In order to free up cash for day-to-day operations, the City would continue to borrow money, defer capital investments, and shrink its workforce. This solution has proven unworkable. It is also dangerous for its residents.

If the City were to continue to default on its financial obligations, as it would outside of bankruptcy, creditor lawsuits would further deplete the City’s resources. On the other hand, in seeking chapter 9 relief, the City not only reorganizes its debt and enhances City services, but it also

creates an opportunity for investments in its revitalization efforts for the good of the residents of Detroit. Ex. 43 at 61.

IV. WHERE DO WE GO FROM HERE?

In conclusion, Judge Rhodes recited the City's statements made on the record that the City intends to obtain confirmation of a plan of debt adjustment "with all deliberate speed and to file its plan shortly" and "strongly" encouraged the parties to "negotiate toward a consensual plan." For a description of the Chapter 9 plan process including confirmation of a plan that will bind all creditors and other parties in interest see the prior Client Alert entitled "A Preliminary Road Map to the Chapter 9 Bankruptcy of the City of Detroit" available on the firm's website.

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 or David M. Powlen at 302-300-3435 or david.powlen@btlaw.com.

You can also visit us online at http://www.btlaw.com/financeinsolvencyandrestructuring/.