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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Detroit Will Shape Muni Debt Market For Years To Come

Law360, New York (January 07, 2014, 9:48 AM ET) -- On Dec. 5, 2013, Judge Steven Rhodes of the U.S. Bankruptcy Court for the Eastern District of Michigan held that the city of Detroit had satisfied the five expressly delineated eligibility requirements for filing under Chapter 9 of the U.S. Bankruptcy Code[1] and so could proceed with its bankruptcy case. The court also found that the city had filed its bankruptcy petition in good faith, going so far as to hold that the city should not have been required to engage in prepetition negotiations with creditors when any such negotiations were doomed to fail from the start.

Several creditors and other parties in interest, including representatives of several of Detroit's pension funds, appealed Judge Rhodes' decision shortly after its entry and also sought authorization to have that appeal heard directly by the Sixth Circuit Court of Appeals. Following a hearing on the direct appeal request, on Dec. 20, 2013, Judge Rhodes issued a memorandum opinion certifying that the issues presented by his opinion qualified as matters of "public importance" under 28 U.S.C. § 158(d)(2)(A)(i), thus permitting a direct appeal if allowed by the Sixth Circuit, but nonetheless recommending that the Sixth Circuit either deny the request or, to the extent it grants the request, consult with the court-appointed mediator to determine whether the appeal should be heard on an expedited basis.

With respect to the former recommendation, Judge Rhodes noted that his eligibility opinion was merely an interlocutory order, and that the primary question — i.e., whether the city could "adjust its debts in a way that is consistent with all applicable legal requirements, whether under the bankruptcy code or elsewhere" — had not yet been addressed, let alone decided. With respect to the latter recommendation, Judge Rhodes noted that the mediator was in the best position to determine whether expediting the appeal would best facilitate the mediation and thus be in the best interest of the city, its residents and its creditors. On Jan. 3, 2014, a petition for permission to appeal was filed with the Sixth Circuit.

In making his ruling, among other issues of import, Judge Rhodes held that (i) the city could alter its pension benefits in bankruptcy, notwithstanding certain otherwise protective Michigan state constitutional provisions (the court had earlier indicated that it would put off a decision on this issue until a plan altering pensions was actually proposed), and (ii) the city was authorized to file bankruptcy under Michigan state law despite both U.S. and state constitutional challenges, and despite a Michigan state court ruling to the contrary. Additionally, in dicta Judge Rhodes suggested that Detroit may have been better off filing for bankruptcy years ago.

Pension Obligations

A key issue in Detroit's bankruptcy filing has been the ability of the city to alter its pension obligations under Chapter 9, obligations that are protected by the Michigan state

constitution.[2] Prior to issuing his eligibility opinion, Judge Rhodes had indicated some unwillingness to rule on this particular issue prior to the city's proposal of an actual plan. This would have left the city, and other parties in interest, in the unenviable position of spending thousands, if not millions, of dollars on plan negotiations, only to see those negotiations go for naught to the extent the court were to later rule that the plan's proposed alteration of pension obligation was impermissible.

Additionally, without a clear ruling, pension fund representatives were likely to remain entrenched in their views that pension obligations were unalterable in bankruptcy, thus causing them to refuse to negotiate with the city.

Recognizing these exigencies and the need for a ruling on the pension issue sooner rather than later, Judge Rhodes reconsidered his initial view and issued a ruling holding that Detroit was permitted to alter its pension obligations in bankruptcy. In particular, Judge Rhodes held that, while the Michigan state constitution stated that such rights could not be "diminished or impaired," in a U.S. bankruptcy case, it could not afford them any more extraordinary protection than a typical contractual right which also may not be "impaired." In fact, Judge Rhodes pointed out, the reason that pension rights were enshrined in the Michigan state constitution was to recognize them as contractual rights, since, prior to an amendment to the Michigan state constitution, whether pension obligations even qualified as contractual rights was very much in doubt.

Judge Rhodes held that, while neither the state of Michigan nor the city of Detroit could unilaterally alter Detroit's pension obligations outside of bankruptcy, the federal government, in the form of U.S. Bankruptcy Court, could. As Judge Rhodes noted, "impairing contracts is what the bankruptcy process does." To the extent the state guaranteed Detroit's pension obligations or provided security for them, Judge Rhodes' opinion implied that his analysis may have been different. Michigan law, however, was clear that pension obligations were ordinary contractual obligations and were thus subject to impairment in a properly authorized Chapter 9 proceeding.

Specific Authorization to File

In a related ruling, and for reasons similar to those noted above, Judge Rhodes also held that Detroit's bankruptcy filing was "specifically authorized" under state law, as required by Bankruptcy Code section 109(c)(2). In so ruling, Judge Rhodes overruled objections by several parties, as well as a contrary opinion from a Michigan state court, that such authorization was unconstitutional under the U.S. and Michigan state constitutions in that it did not provide for the protection of accrued pension benefits.

While again acknowledging that Michigan and Detroit did not have the right to alter pension rights, or any other contractual rights, under the contracts clause of the United States constitution outside of bankruptcy, and that therefore, the state could not authorize the city to do so, Judge Rhodes noted that such impairment is expressly permitted during, and is in fact one of the primary purposes for, bankruptcy proceedings. The state of Michigan's authorization of Detroit's Chapter 9 filing, through the process established under the state's emergency manager law was therefore proper, even to the extent that it could result in the impairment of the city's pension obligations. As Judge Rhodes noted, the Michigan legislature could have elected to prevent Michigan municipalities from filing under Chapter 9 but did not. Instead, it chose to let them file, knowing full well that in Chapter 9, pension obligations could be altered.

For similar reasons, Judge Rhodes also rejected the argument, put forward both by several objecting parties and a contrary Michigan state court opinion, that the Michigan law permitting the appointment of an emergency manager for the city of Detroit, and the filing of a chapter 9 petition, was unconstitutional under Michigan state law. As an initial matter,

Judge Rhodes held that the state court opinion was void in that it was issued after Detroit's bankruptcy petition had been filed in violation of the automatic stay. Judge Rhodes described the state court judgment as a perfect example of the "chaotic and disorderly race to judgment" that the automatic stay is specifically meant to avoid. Judge Rhodes further noted that he believed the Michigan Supreme Court would agree that Michigan's emergency manager law was constitutional, even if a Chapter 9 filing could lead to alteration of a city's pension obligations.

Good Faith

An additional issue addressed in Judge Rhodes' ruling focused on Detroit's "good faith" leading up to its bankruptcy filing. In particular, two of the five express eligibility factors (i.e., whether the city desired to effect a plan to adjust its debts and whether the city negotiated with its creditors in good faith) depend on the city's good faith intent, as does the more general question of whether the petition itself was filed in good faith.

While finding that Detroit had demonstrated the requisite intent to satisfy all of these requirements, Judge Rhodes did note certain questionable actions by the city. For instance, in describing the city's discussions with creditors in the weeks prior to its filing, the court refused to accept that they were indeed good faith negotiations in which the city truly expected to succeed, pointing for instance to the presentational, rather than conversational, method in which they were presented and the short time frames in which creditors were required to respond. Similarly, the court quoted from a bevy of emails which indicated that Detroit had in fact set itself on a course for a bankruptcy filing years ago, its protestations to the contrary notwithstanding.

According to Judge Rhodes, whether or not the negotiations themselves could be described as having been conducted in good faith, much of this was simply unnecessary. With respect to negotiations with creditors, Detroit may have been better served by accepting (and publicly stating) that negotiations with hundreds of thousands of creditors was impractical; indeed Judge Rhodes noted that he was satisfied that when Congress enacted the impracticability provision, which permits a municipal bankruptcy filing in spite of no good faith negotiations with creditors if such negotiations are impractical, "it foresaw precisely the situation facing the City of Detroit."

More generally, Judge Rhodes noted that, with its worsening financial crises, Detroit "could have, and probably should have, filed for bankruptcy relief long before it did, perhaps even years before" and that putting off that filing in order to engage in what it viewed as the necessary processes likely did more harm than good.

Conclusion

As the largest municipality to file under Chapter 9, decisions rendered in Detroit's bankruptcy case will impact the municipal debt market for years to come. One can already see the long-term potential impact from this recent eligibility opinion both from the big-ticket items, such as the bankruptcy court's ruling on the ability of municipalities to alter long-term pension obligations, and the smaller items, such as if and when a city should consider filing. All in all, Judge Rhodes' first major decision in the case appears to provide a guideline for municipal filings in the future.

—By J. Robert Stoll, Sean T. Scott, John R. Schmidt and Aaron Gavant, Mayer Brown LLP

J. Robert Stoll is a partner in Mayer Brown's Chicago and New York offices. Sean Scott, John R. Schmidt and Aaron Gavant

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[1] Judge Rhodes held that the city was: (i) a "municipality" as defined by the Bankruptcy Code; (ii) specifically authorized to file for bankruptcy protection under state law; (iii) "insolvent" as defined by the Bankruptcy Code; (iv) desired to effect a plan to adjust its debts; and (v) not required to negotiate in good faith with its creditors in advance of its bankruptcy filing since such negotiations were impractical.

[2] See Article IX, Section 24, Michigan Constitution ("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.").

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