

## 7 Lessons From The Detroit Bankruptcy

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The confirmation last Friday of the city of Detroit’s Chapter 9 plan of adjustment is by far the most significant event in the world of municipal bankruptcy since Congress first enacted Chapter 9’s predecessor statute nearly 80 years ago.[1] Although any detailed analysis of the bankruptcy court’s legal reasoning is premature until Judge Steven Rhodes issues his formal confirmation order and opinion, the outcome of the case offers a number of broad brush lessons for municipalities in distress, and their key constituents and advisers, across the country.

### Chapter 9 Works

This is certainly the biggest message. One of the nation’s largest cities successfully negotiated bankruptcy not only by overcoming various legal hurdles that were seen as potentially insurmountable, but also by navigating the sometimes consensual, sometimes contentious Chapter 9 process to corral widespread support from the city’s key constituencies.



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Here, the major parties involved were nowhere close to any kind of global resolution until confronted with a formal bankruptcy proceeding and, for potential objectors, with the ultimate threat of a bankruptcy court confirming a plan of adjustment over their dissent. And despite many saying that once a big city got into bankruptcy, it would be bogged down forever, the Detroit bankruptcy case was swift by any reasonable measure — the city took less than 16 months to garner the eventual (if, in some cases, reluctant) support of a majority of pensioners, bondholders, bond insurers and other stakeholders for a plan that trims approximately \$7 billion from Detroit’s petition date \$18 billion balance sheet.

### Judge Rhodes’ Ruling on Pensions Remains a Powerful Precedent for Future Municipal Debtors

In December 2013, Judge Rhodes decided what many commentators regarded as the hardest legal issue in Detroit’s case: whether a federal bankruptcy court had authority to approve a plan of adjustment with terms that run contrary to explicit state constitutional guarantees of public employee pension rights. Rhodes answered that question with an unequivocal yes, ruling that “state constitutional provisions prohibiting the impairment of contracts and pensions impose no constraint on the bankruptcy process.”[2]

That decision remains one of a growing trend of decisions (including one from Judge Christopher Klein in the Stockton, California, bankruptcy in late September<sup>[3]</sup>) that suggest that municipalities can use bankruptcy proceedings to restructure and eliminate pension obligations, even if, as in Michigan and California, citizens' pension rights are protected by state constitutional provisions.

And by managing to get general public employee support for its proposed plan, and then by resolving essentially all other significant claims of plan opponents, Detroit may have successfully managed to avoid any federal appellate court test of Judge Rhodes' decision. Assuming that decision is not challenged and remains undisturbed on appeal, it undoubtedly will be an important precedent for other municipalities that resort to Chapter 9 to attempt to restructure pension obligations.

### **State Authorization — and Political Support — Remains a Necessity for a Successful Municipal Bankruptcy**

Under Chapter 9, a municipality's authorization to file bankruptcy under applicable state law remains an unwaivable, threshold statutory (and constitutional) requirement. Here, with Gov. Rick Snyder's support, the Michigan Legislature authorized the city of Detroit to file for bankruptcy. But it is also important to note that the state of Michigan did not give cities authority to make such filings until the Detroit crisis arose, and even today, many states either do not expressly authorize or in fact affirmatively prohibit municipalities from filing for Chapter 9. (As one example, the state of Pennsylvania affirmatively eliminated authority for municipal filings when Harrisburg threatened to file for bankruptcy in 2012, resulting in a subsequent dismissal of Harrisburg's Chapter 9 case.)

And even those states that do permit Chapter 9 filings often have statutes that require the governor, or some legislative or administrative body composed of elected officials, to authorize a filing explicitly. Thus, while, as noted above, Judge Rhodes' ruling sets a significant precedent that federal bankruptcy courts can override state constitutional protections for pensions, it will be interesting to see how the notoriety of that decision affects legislators' willingness to authorize Chapter 9 bankruptcy filings; in many states, one might expect that the very same political forces that have led to high levels of public pension obligations also may inhibit state officials from giving municipalities the powerful tool of Chapter 9 to trim such obligations.

### **Strong Stewardship from Kevyn Orr, the City's Emergency Manager, was Critical**

Kevyn Orr, who was appointed emergency manager of the city of Detroit on March 14, 2013, was a credible and decisive leader throughout the process. After his appointment pursuant to a state statute, Orr initially worked with the city's legal and financial advisers to review Detroit's financial obligations and operational issues and to develop a realistic assessment of potential restructuring alternatives.

Upon concluding that no other "reasonable alternative to rectifying [Detroit]'s financial emergency exists,"<sup>[4]</sup> Orr recommended to Snyder and the Michigan state treasurer that Detroit be authorized to file for Chapter 9. Orr's decisiveness, and his subsequent skillful handling of the bankruptcy case, is a strong endorsement for emergency manager statutes — in the end, the city benefited from an objective, independent subject matter expert who, insulated from ballot box risk, was willing to take politically unpopular but necessary measures.

## **Once a City is in Bankruptcy, the Process Can Lead to a Multifaceted "Reorganization" with Novel Solutions**

It is well recognized under Chapter 9 that a bankruptcy court has limited power to interfere with a municipality's broad fiscal powers, including its right to use its property, make expenditures and raise taxes as it deems necessary.[5] And many municipalities may often have a lesser ability to make divestitures, obtain additional financing or take other "reorganization" steps that are often critical to a successful Chapter 11 plan for a corporate debtor. But at the end of the Detroit proceeding, in order to get final approval from recalcitrant creditors, the city came up with a variety of creative fiscal solutions meant to benefit various subsets of its creditors, and (at least for now) it appears to have obtained the bankruptcy court's blessing for arguably disparate treatment of various creditor constituencies.

Among other things, Detroit agreed to spin off its water and sewer authority into a new regional system; it gave creditors development rights on desirable city properties; it agreed to extend an arrangement for private management of tunnels; and it refinanced approximately \$1.5 billion in revenue bonds. Although federal law makes clear that the bankruptcy court could not have unilaterally required such actions if Detroit had been unwilling to take them, once the bankruptcy process was invoked, a variety of possibilities opened up at the negotiating table.

### **Bankruptcy Can Be an Occasion for Civic Engagement**

Of all the Detroit developments, perhaps none was more surprising than the fact that the bankruptcy process became an opportunity for active civic engagement, with major participants in the life of the city — foundations and other nonprofit organizations — stepping forward to offer major financial contributions. In particular, the so-called "Grand Bargain" could never have occurred without hundreds of millions of dollars in private pledges, conditioned on acceptance of the plan by public employees and retirees, to stave off a sale of the art collection of the Detroit Institute of Arts. No rational city is going to file for bankruptcy in order to induce such philanthropic engagement, but when any filing is made in the future, that element of the Detroit precedent will be a challenge to similar foundations and donors elsewhere — and a lesson in how unpredictable that outcome may turn out to be.

### **Detroit's Quick Voyage Through Bankruptcy Benefited From a Strong Judicial Presence**

In hindsight, Detroit's Chapter 9 case benefited immensely from the roles of not one, but two, judges. While Judge Rhodes will get most of the publicity for having overseen the potentially volatile case, his early decision to mandate mediation of disputes before Judge Gerald E. Rosen, the chief judge of the United States District Court for the Eastern District of Michigan, was a prescient one.

Rosen is widely credited as the architect of the so-called "Grand Bargain" and was able, over a period of many months, to wring substantial concessions from a varied and disparate group of Detroit creditors. Rhodes, in turn, was willing to make a variety of hard (and sometimes politically unpopular) decisions throughout the case, recognizing, in the end, that while the plan was not popular with all, "[t]here really is no choice here."

Ultimately, the test of whether Detroit's bankruptcy "worked" is not confirmation of the plan, but Detroit's ability to make good on its promises and projections; Judge Rhodes himself recognized as such in his pointed questioning of the city's feasibility expert Martha Kopacz during the confirmation hearing. But few would have predicted when Detroit filed for bankruptcy 16 months ago that general optimism about that future would be as strong as it is today.

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[1] Congress first passed municipal debt adjustment provisions in the 1934 Bankruptcy Act, which added a new Chapter IX to the Bankruptcy Act. After the U.S. Supreme Court found the 1934 Act unconstitutional in *Ashton v. Cameron County Water Improvement District, No. 1*, 298 U.S. 513 (1936), as an improper infringement on the sovereign powers of the states, Congress enacted new municipal bankruptcy provisions in 1937, as Chapter X of the Bankruptcy Act.

[2] *In re City of Detroit, Mich.*, 504 B.R. 97, 150 (Bankr. E.D. Mich. 2013)

[3] See “Stockton Ch. 9 Judge Rules Cities Can Cut Pensions,” Andrew Scurria, *Law360*, Oct. 1, 2014.

[4] See Orr Letter dated July 16, 2013 at [http://michigan.gov/documents/snyder/Detroit\\_EM\\_Kevyn\\_Orr\\_Chapter\\_9\\_Recommendation\\_427831\\_7.pdf](http://michigan.gov/documents/snyder/Detroit_EM_Kevyn_Orr_Chapter_9_Recommendation_427831_7.pdf)

[5] Indeed, the Supreme Court upheld the constitutionality of the municipal provisions of the 1937 Act precisely because it severely restricted a bankruptcy court’s oversight of a municipality’s political or governmental affairs or exercise of its fiscal powers, thereby avoiding impinging on the sovereignty of the states. See 11 U.S.C. § 904.