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Bankruptcy Court Holds that Detroit Is Eligible to File for Chapter 9 Protection

The birthplace of the American auto industry now holds another, less fortunate distinction, that of being the largest municipality to seek and obtain relief under chapter 9 of the Bankruptcy Code. In common with most chapter 9 cases, Detroit's filing has been hotly contested.¹ Last week, the Bankruptcy Court for the Eastern District of Michigan issued a 143-page decision holding, among other things, that Detroit is eligible to be a chapter 9 debtor under section 109(c) of the Bankruptcy Code and that Detroit filed its petition in good faith, thus insulating the petition from dismissal under section 921(c).

Notably, in rejecting pension-related challenges to Detroit's eligibility, the Bankruptcy Court held that "pension rights are . . . subject to impairment in a federal bankruptcy proceeding"—*i.e.*, Detroit's pension debt is not entitled to greater protection than ordinary contract debt notwithstanding Michigan Constitution's pension clause.² While the Bankruptcy Court stressed that its ruling was not a guarantee of confirmation of a plan impairing pensions, the ruling represents a victory for Detroit. The city estimates that unfunded pension and retiree obligations comprise a significant portion of its unsecured debt.

Objectors have already moved to certify the Bankruptcy Court's decision for a direct appeal to the U.S. Court of Appeals for the Sixth Circuit, suggesting that last week's decision may not be the last word in Detroit's chapter 9 eligibility dispute.

Detroit's Eligibility to be a Debtor under Section 109(c)

Let's turn first to Detroit's eligibility for relief under section 109(c).³ While the parties stipulated that Detroit was a municipality, disputes existed with respect to all of the other section 109 elements.

¹ The Bankruptcy Court considered a total of 110 objections to Detroit's eligibility.

² *In re Detroit*, Bankr. No. 13-53846, 2013 WL 6331931, at *44 (Bankr. E.D. Mich. Dec. 5, 2013). The pension clause provides: "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." Mich. Const. art. IX, § 24.

³ Section 109(c) of the Bankruptcy Code provides that an entity may be a chapter 9 debtor only if such entity: (1) is a municipality; (2) is specifically authorized to file a chapter 9 petition by applicable state law (or by a governmental officer or organization empowered by state law to give such authorization); (3) is insolvent; (4) desires to effect a plan to adjust its debts; and (5) has (A) obtained the consent of creditors to a plan required by section 109(c)(5), (B) negotiated in good faith with

Authorization

The Bankruptcy Court held that Detroit's filing was properly authorized under section 109(c)(2) because Detroit complied with P.A. 436—the Michigan statute governing a municipality's authority to file a chapter 9 case. Objectors argued that P.A. 436 was unconstitutional because, among other things, it was enacted after a referendum rejected a similar statute, and the legislature had added appropriation provisions to evade the people's constitutional right to a referendum on the statute.⁴ The Bankruptcy Court disagreed, reasoning that, under Michigan law, the referendum defeat did not prohibit the legislature from enacting P.A. 436, even though it addressed the same subject matter as the earlier statute and contained few changes, adding that courts should not be concerned with a legislature's motives in enacting a law.⁵

The Bankruptcy Court also concluded that the governor's authorization under P.A. 436 was valid under the Michigan Constitution.⁶ While P.A. 436 permitted the governor to place contingencies on Detroit's authorization to proceed under chapter 9, the Bankruptcy Court determined that the governor did not need to include a contingency in his authorization prohibiting Detroit from seeking to impair pension obligations.⁷ Indeed, such a contingency would have been invalid.⁸

Solvency

The Bankruptcy Court found that Detroit was "insolvent" for purposes of section 109(c)(3) because it was

creditors but failed to obtain such consent, or (C) failed to negotiate with creditors because such negotiations are impracticable.
11 U.S.C. § 109(c).

⁴ *In re Detroit*, 2013 WL 6331931, at *45-52. Objectors challenged the constitutionality of chapter 9 and P.A. 436 on numerous grounds and asserted that the Bankruptcy Court lacked the authority to resolve such issues. The Bankruptcy Court, however, rejected these arguments. *Id.* at *22-26.

⁵ *Id.* at *47-49.

⁶ The Bankruptcy Court also rejected the objectors' argument that the emergency manager lacked authority to file the chapter 9 case because he was not an elected official. *Id.* at *52.

⁷ *Id.* at *53.

⁸ *Id.* The Bankruptcy Court also held that a judgment in a state court declaratory judgment action did not prevent Detroit from arguing that the governor properly authorized its chapter 9 filing. *Id.* at *53-59. The Bankruptcy Court reasoned that the judgment was void because it was entered after Detroit had filed its chapter 9 petition and, moreover, it violated the automatic stay. *Id.* at *56-58.

generally not paying its debt as they became due and was in a state of “service delivery insolvency.”⁹ As to the former, throughout 2013, Detroit had deferred payment on millions of dollars in pension contributions and would have run out of cash but for these deferments and “expensive and even catastrophic borrowings.”¹⁰ As to the latter, the Bankruptcy Court noted the deplorable conditions in the city’s police precincts, ballooning crime rates, and overall blight as evidence of “service delivery insolvency”—the inability to pay for services at the level and quality to ensure the health, safety, and welfare of the community.¹¹

Desire to Submit a Plan to Adjust Debts

The Bankruptcy Court concluded that Detroit had established its desire to submit a plan to adjust its debts as required by section 109(c)(4) notwithstanding its intent to impair pension rights. The Bankruptcy Court noted that “a chapter 9 plan may impair pension rights” and, as a result, “[t]he emergency manager’s stated intent to propose a plan that impairs pensions is . . . not inconsistent with a desire to effect a plan.”¹²

Negotiations with Creditors

In the absence of creditor consent to a filing, a municipality can satisfy section 109(c)(5) of the Bankruptcy Code if it negotiates with creditors in good faith or is unable to negotiate because such negotiation is impracticable.¹³

The Bankruptcy Court construed section 109(c)(5)(B) to require municipalities “not just to negotiate generally in good faith with their creditors, but also to negotiate in good faith with creditors over a proposed plan”¹⁴ Detroit presented its creditors with a proposed plan just one month before it filed

⁹ As to a municipality, the Bankruptcy Code defines “insolvent” as “financial condition such that the municipality is—(i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due.” 11 U.S.C. § 101(32)(C).

¹⁰ *In re Detroit*, 2013 WL 6331931, at *60.

¹¹ *Id.* at *60-61 (quoting *In re Stockton*, 493 B.R. 772, 789 (Bankr. E.D. Cal. 2013)). The Bankruptcy Court also held that Detroit’s failure to monetize certain assets (notably, its prized artwork collection) was inconsequential because any such asset sales would not have addressed the “operational, structural financial imbalance facing [Detroit].” *Id.* at *62.

¹² *Id.*

¹³ 11 U.S.C. § 109(c)(5)(B)-(C).

¹⁴ *In re Detroit*, 2013 WL 6331931, at *65 (quoting *In re Mendocino Coast Recreation & Park Dist.*, No. 12-cv-02591-JST, 2013 WL 5423788, at *5 (N.D. Cal. Sept. 27, 2013)).

for chapter 9 protection. The Bankruptcy Court described Detroit’s proposal as summary in nature and found it left creditors with inadequate time and information to make meaningful counterproposals.¹⁵ Accordingly, Detroit failed to satisfy section 109(c)(5)(B).

Nevertheless, the Bankruptcy Court held that Detroit satisfied section 109(c)(5)(C) given the number of creditors (over 100,000) and the size of Detroit’s debt (approximately \$18 billion).¹⁶ The Bankruptcy Court noted that the situation facing Detroit was precisely what Congress foresaw when it enacted the impracticability exception in section 109(c)(5)(C).¹⁷ It buttressed the impracticability finding by pointing to the retiree associations’ refusal to negotiate reduced pension benefits and to Detroit’s ongoing fiscal crisis.¹⁸

“Good Faith” Finding

Section 921(c) adds a possible wrinkle to a chapter 9 eligibility analysis, as it permits a court to dismiss a municipality’s chapter 9 petition “if the debtor did not file the petition in good faith”¹⁹ After conducting a thorough review of the record, the Bankruptcy Court recited several facts supporting the contention that Detroit’s filing was made in bad faith. However, the Bankruptcy Court found that other considerations weighed in favor of a good faith finding, including Detroit’s “profound” insolvency and inability to engage in real negotiations with creditors (the very circumstances for which chapter 9 was designed), its remedial reasons for filing,²⁰ its pre-petition efforts to improve its finances, and the prejudice that would result if the chapter 9 case was dismissed.²¹ It concluded that the totality of the circumstances coupled with the presumption in favor of granting chapter 9 relief for municipalities that satisfy section 109(c)—as Detroit had done in this case—established that Detroit filed its petition in good faith.

¹⁵ *Id.* at *66-68.

¹⁶ *Id.* at *69.

¹⁷ *Id.*

¹⁸ *Id.* at *70-71.

¹⁹ 11 U.S.C. § 921(c).

²⁰ Though objectors argued that Detroit filed its petition to impair its pension obligations, the Bankruptcy Court noted that “discharging debt is the primary motive behind the filing of most bankruptcy petitions” and does not suggest bad faith. *In re Detroit*, 2013 WL 6331931, at *80.

²¹ *Id.* at *79-81.

Conclusion

This decision suggests that large municipalities may, under some circumstances, forgo pre-petition negotiations with creditors and still remain eligible for chapter 9 relief. In the wake of *Detroit*, troubled municipalities may seek to use chapter 9 or the threat of chapter 9 to reduce unwieldy pension obligations.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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