

Inside

Latest Reports:

- *Detroit Bankruptcy Could Break New Ground*
- *Courts Differ on Who Profits from Unfinished Business When Law Partners Change Firms*
- *Distressed Investors Found Not Liable for Portfolio Company's Personnel Decisions*

Research Report:

Who's Who in School Specialty, Inc.

Special Report:

Canadian Bankruptcy Law Firms

Worth Reading:

Paper Prophets – Fraudulent Accounting and Failed Audits

Special Report:

Outstanding Investment Banking Firms – 2013

turnarounds & workouts

News for People Tracking Distressed Businesses

JULY/AUGUST 2013

VOLUME 27, NUMBER 7/8

Troubled Times in Motor City Detroit's Road Out of Bankruptcy Is Likely Long

by Julie Schaeffer

On July 18, in a historic move destined to ignite complex legal battles among parties with much at stake, Detroit became the largest American city to file for bankruptcy.

“Some real benchmark laws could be set here,” said Jim McTevia of McTevia & Associates. “There are many issues that a normal bankruptcy doesn’t cover.”

Specifically, the filing will undoubtedly initiate precedent-setting battles in federal court on a number of matters, including whether public pensions, previously considered sacrosanct under the Michigan constitution, are protected in municipal bankruptcies.

Other benchmark issues, says McTevia, include the treatment of various municipal bonds as to priority, the treatment of collateralized swaps as to secured or unsecured, and the treatment of municipal assets, such as the ownership of works of art located in the Detroit Institute of Arts.

The battle began when Michigan Governor Rick Snyder appointed Kevyn Orr as the city’s emergency manager to figure out what to do about Detroit’s dire fiscal condition. At the time, Detroit owed around \$18 billion to more than 100,000 creditors, including \$3.5 billion in unfunded obligations and \$5.7 billion in unfunded healthcare liabilities. Orr, says Bill Brandt, President and CEO of Development Specialists, Inc., was perceived by some on the other side as not the easiest person to negotiate with. “They felt that the initial offers were on a ‘take-it-or-leave-it’ basis,” Brandt says. “Their belief was that Orr was initially determined to file a Chapter 9, and therefore was just going through the motions of pretending to bargain.”

In response, certain of the pension beneficiaries retained counsel and then took a look at the provisions of the Michigan state constitution that prohibit the alteration or reduction in existing public employee pension benefits. “That provision is in the Michigan constitution and several other states’ constitutions because public employees do not participate in the Social Security system,” says Brandt. “If you take away their pension plans, they have no safety net.”

The creditors filed suit in Ingham County, the county in which the state capital of Lansing is located, seeking to obtain a declaratory judgment against the effort to file a Chapter 9. The creditors argued that the likely singular purpose for filing a Chapter 9 would be to alter or diminish existing city pension plans. “Their argument was that since such alterations are constitutionally prohibited under Michigan law, the state court could intervene to block the filing of a Chapter 9,” notes Brandt.

A sign of just how contentious the matter likely will become came when the pension funds were beaten to the courthouse by minutes. The pension funds reportedly delayed their filing by five minutes at the request of attorneys for Governor Snyder – and during those five minutes, Snyder’s attorneys filed the bankruptcy petition in Detroit, which generally results in a stay in all other pending lawsuits involving the city. Ronald King, a lawyer representing Detroit’s General Retirement System and the Detroit Police and Fire Retirement System, said he believes the city did not act in good faith. Brandt, for his part, says, “The general feeling I got from some is that this state court effort accelerated

continued on page 2

Detroit, *from page 1*

the timetable for the Chapter 9 filing.”

Regardless, Detroit had filed its Chapter 9 by the time Ingham County Judge Rosemarie Aquilina heard the pension beneficiaries’ arguments. She then ordered that the Detroit bankruptcy filing be withdrawn, ruling Snyder and Orr had violated the state constitution.

“If you read the judge’s order, she says the purpose of Detroit’s Chapter 9 is to diminish the pension plans, which is unconstitutional in Michigan, and therefore the Chapter 9 can’t be filed,” says Brandt. “Detroit, in turn, points out that it has not yet diminished the pension plans and no such motion to do so is pending. So the question is, can Judge Aquilina prevent Detroit from filing the Chapter 9?”

Attorney General Bill Schuette has filed an application for Appeals Court consideration of Aquilina’s order, asking that the court put a hold on present and future lower-court proceedings. Brandt thinks he’ll be successful. “Detroit probably has the right legal argument. The city followed the correct procedure in filing the Chapter 9, and there is no current motion pending to abrogate the pension plans, so Detroit has not yet violated any state constitution prohibitions. And, if there is a constitutional argument about whether you can alter the pension plans, it will likely happen in the context of a Chapter 9.”

In appealing Aquilina’s order, says Brandt, the debate will involve the interpretation of the federal supremacy clause of the U.S. constitution and whether provisions in the bankruptcy code can override the dictates of a state’s constitution. “Some will argue that the supremacy clause will allow contract, or pension plan, rejections and override the state constitutional prohibition. There will be a debate on that, but if the supremacy clause can override the state constitution regarding the alteration of

a pension plan, it can also override the state’s efforts to protect Detroit’s public art from a sale process, which the state legislature recently sought to prohibit. In my opinion, you don’t get to pick and choose what portion of your case the supremacy clause applies.”

Next, U.S. District Judge Steven Rhodes will proceed with hearings, during which he will determine if Detroit is eligible to file for Chapter 9. The Bankruptcy Code, for example, specifies the requirements a municipality must meet in order to file for Chapter 9, and they include that the debtor must be insolvent, it must wish to effect a plan to adjust its debts, and it must have previously negotiated with creditors who hold at least a majority of each class of debt that a forthcoming Chapter 9 plan would impair. “That process will likely take a few weeks or more, at a minimum, as I expect that decision to be the result of a trial,” says Brandt.

Meanwhile, Brandt thinks Rhodes will implement some initial aspects of a Chapter 9, such as the automatic stay. Automatic stays would normally, during a Chapter 9, be issued on most lawsuits, including challenges by pension funds and unions. They would also be issued on most of a city’s bills, including unsecured debts, though Detroit would likely continue to pay secured creditors, including water and sewer bondholders, who have the right to seize city assets if Detroit fails to pay.

Looking ahead, if Judge Rhodes allows the city to move forward with a Chapter 9, Orr would propose a plan of reorganization that would likely involve budget cuts, layoffs, and asset sales. If it wins enough support from creditors – including bondholders, unions, and pension boards – the plan will be put to a vote and, with enough support, the city would emerge from bankruptcy. If the plan doesn’t win enough support from creditors, the city would have to continue to negotiate with creditors or pursue a cramdown, which would require winning support of

a minority of creditors and convincing a judge that dissenting creditors are not being reasonable.

The possible length of the case is being widely debated. Some experts believe it could be accomplished as soon as several months, but Brandt doesn’t think that is realistic. “The case began with a great deal of acrimony and is likely only to degenerate into a further level of animus given the cuts being discussed,” he says. “As a result, it’s likely the case will take some time to play out.”

Brandt says it’s important to see Detroit’s filing for what it is. “A lot of people are saying this portends the falling of urban America, but it doesn’t; it’s an isolated incident, in many ways as isolated as Harrisburg or Jefferson County were. It’s one city with a particular set of troubles that have long been festering. You hear a lot about how corruption has caused this, but corruption didn’t drive 1.3 million people out of the city since 1950; the decline of the automotive industry and the commercial reshaping of the Detroit metropolitan area did.”

Brandt adds, “Some in the city say the white power structure of Michigan has long sought to isolate the city’s problems from affecting the rest of the state. You have a city that’s 83 percent black in a state that’s 80 percent white. Some suggest that this racial dynamic is one of the reasons that state politicians have been unwilling to come to the aid of the largely Democratically-controlled city. No one seems to want to talk about this, but the racial politics here are one of the things that makes this filing unique.” □

Reprinted with permission of Beard Group © 2013. *Turnarounds & Workouts* is published monthly by Beard Group, P.O. Box 40915, Washington, D.C. 20016 Telephone: (240) 629-3300.