

# Clients & Friends Alert

## City of Detroit Files Chapter 9 Bankruptcy Petition – Challenges Ahead

July 19, 2013

On the afternoon of July 18, 2013, the City of Detroit filed its highly anticipated petition for relief under Chapter 9 of the Bankruptcy Code in the Bankruptcy Court for the Eastern District of Michigan. This marks the largest municipal bankruptcy filing in United States history.<sup>1</sup> As a result of the Chapter 9 filing, all actions by creditors to collect prepetition claims against the City are enjoined through the imposition of an automatic stay, except for the application of special revenues pledged to indebtedness.

The initial pleadings filed by the City focus on its eligibility for relief under Chapter 9 of the Bankruptcy Code. In its initial pleadings, including a declaration by Detroit Emergency Manager Kevyn Orr, the City has alleged that it is insolvent, unable to meet its obligations and anticipates it will be in that position for years to come. The City further contends that it is not required to exhaust all available means for revenue generation before it can be insolvent and eligible for Chapter 9 relief. Detroit also asserts it is eligible for relief because while it believes negotiations with all of the City's creditors are impracticable, the City has made good faith efforts to engage creditors where possible. The City's pleadings argue that negotiations are impracticable for a number of reasons including the vast number of creditors, and the fact that many of those creditors have indicated they do not want to negotiate based on their pre-petition litigations. Further, the City asserts that it did negotiate in good faith with numerous creditors, and Mr. Orr's declaration details a series of meetings with representatives of various creditor constituencies to substantiate that claim. The City has requested that the Bankruptcy Court set an objection deadline of August 19, 2013 with respect to the eligibility issue.

In addition to pleadings on eligibility, as part of the first-day filings, the City filed a motion, pursuant to section 365(c) of the Bankruptcy Code and Rule 9019 of the Bankruptcy Rules, seeking an order authorizing the assumption of, and approving, a forbearance and optional termination agreement by and among the City of Detroit, the Emergency Manager of the City, the Detroit General Retirement System Service Corporation, and the Detroit Police and Fire Retirement System Service Corporation, on the one hand, and UBS AG and Merrill Lynch Capital Services, Inc. on the other. The forbearance agreement relates to the settlement of swap claims that both UBS

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<sup>1</sup> At this time, a Bankruptcy Judge has not yet been assigned to the case, although one is expected to be assigned shortly.

and Merrill Lynch hold against the Service Corporations. Pursuant to the original terms of those swaps executed in 2006, the swap providers were unsecured and payable on parity with holders of certificates of participation issued by the Service Corporations. As a result of financial circumstances relating to the City in 2009, the swap providers had the right to terminate their swaps against the Service Corporations. However, in exchange for forbearing from exercising their termination rights in 2009, the swap providers received a security interest in certain City revenues relating to three casinos located within the City. As a result of financial circumstances relating to the City in 2012, including the appointment of an emergency financial manager, the swap providers again had the right to terminate their swaps. However, pursuant to the forbearance agreement, the swap providers agreed to settle their now *secured* swap claims of approximately \$340 million for at least 75% of their value. In its motion to assume the forbearance agreement, the City requests that the Court approve the agreement on the basis that it will allow the City to access much needed cash flows, provides for a workable unwind of its swap obligations at a discounted price, and avoids potentially protracted litigation involving the swap transactions.

Cadwalader represented Merrill Lynch in structuring, negotiating and documenting the original 2006 transaction, the 2009 restructuring and collateral arrangement, and the current forbearance agreement.

Notwithstanding the proposed settlement with the swap counterparties, it is anticipated that the City's eligibility for relief under Chapter 9 will be heavily contested, and the City's Chapter 9 case will present a potential conflict between market expectations for certain municipal bonds and fundamental principles underpinning the Bankruptcy Code. Mr. Orr's prepetition restructuring plan proposed to provide the same treatment (and significant impairment) to all unsecured creditors, including general obligation bonds. Further, just prior to the filing of the City's Chapter 9 petition, two Detroit pension funds commenced litigation in Michigan state court challenging the authority of Michigan Governor Rick Snyder to authorize the City's filing.<sup>2</sup> While creditors continue to exercise available leverage and jockey for position with respect to a potential plan of adjustment, any contest about Detroit's eligibility for Chapter 9 relief must be resolved before a plan can be confirmed by the Bankruptcy Court. Such an eligibility contest may take a substantial period of time to resolve.

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<sup>2</sup> As of this memo, an Ingham County, Michigan judge had issued a declaratory judgment order ruling that Detroit's Chapter 9 filing violated the Michigan Constitution and state law, and therefore must be withdrawn. However, in response, Michigan Attorney General Bill Schuette stated he will appeal the ruling and seek emergency consideration by the Michigan Court of Appeals.

Please contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

Lary Stromfeld	+1 212 504 6291	<a href="mailto:lary.stromfeld@cwt.com">lary.stromfeld@cwt.com</a>
Mark Ellenberg	+1 202 862 2238	<a href="mailto:mark.ellenberg@cwt.com">mark.ellenberg@cwt.com</a>
Howard Hawkins	+1 212 504 6422	<a href="mailto:howard.hawkins@cwt.com">howard.hawkins@cwt.com</a>
Ivan Loncar	+1 212 504 6339	<a href="mailto:ivan.loncar@cwt.com">ivan.loncar@cwt.com</a>
Ingrid Bagby	+1 212 504 6894	<a href="mailto:ingrid.bagby@cwt.com">ingrid.bagby@cwt.com</a>
Robert Scherer	+1 212 504 6621	<a href="mailto:robert.scherer@cwt.com">robert.scherer@cwt.com</a>