

Clients & Friends Alert

Insurers Seek Enforcement of State Law Protections for City of Detroit GO Bonds

November 12, 2013

On November 8, 2013, three monoline insurers of the City's general obligation bonds commenced adversary proceedings in the City of Detroit bankruptcy case.¹ Through these actions, the monoline insurers seek to compel enforcement of the status quo for the general obligation bonds by requiring the City to continue to segregate ad valorem taxes in accordance with Michigan law. As these actions progress, they may clarify whether state law protections for general obligation bonds apply in chapter 9 and test the jurisdictional limitations imposed on a bankruptcy court by section 904(2) of the Bankruptcy Code.

Background

National Public Finance Guarantee Corporation, Ambac Assurance Corporation, and Assured Guaranty Municipal Corporation (the "**Plaintiffs**") filed adversary complaints in the Bankruptcy Court for the Eastern District of Michigan against the City of Detroit, the City's Emergency Manager, and other City officials. The complaints were filed in response to the City's payment default on certain series of unlimited tax general obligation bonds and limited tax general obligation bonds (collectively, "**GO Bonds**") and in response to the City's recently filed motion seeking approval of post-petition financing. The Plaintiffs seek declaratory relief that, among other things, would limit the City's use of ad valorem taxes and require the City to continue segregating certain ad valorem taxes to satisfy its obligations under the GO Bonds.

On October 1, 2013, the City failed to make a \$9.37 million payment on the GO Bonds. The Plaintiffs, as insurers of the GO Bonds, paid under their policies and became subrogated to the rights of the GO Bondholders. According to the Plaintiffs, Michigan law imposes strict limitations on the City's ability to use ad valorem taxes for any purpose other than the repayment of general obligation bonds. The Plaintiffs also contend that Michigan law requires that the ad valorem taxes be deposited into segregated debt retirement accounts as they are collected.

¹ Cadwalader represents Merrill Lynch Capital Services in the City's chapter 9 case.

According to the Plaintiffs, the City allegedly stated publicly that it intends to continue to use the ad valorem taxes to fund the City's general operations. The Plaintiffs also allege that the City stated that it will not segregate the ad valorem taxes. Further, the Plaintiffs maintain that the City is prohibited from granting a super-priority lien on the ad valorem taxes in favor of a potential post-petition lender to the City.

According to the Plaintiffs, "nothing in chapter 9 or federal bankruptcy law allows the City to disregard state law restrictions imposed on the [ad valorem taxes] and use such funds for a non-authorized purpose." The Plaintiffs also maintain that the jurisdictional limitations imposed by section 904 of the Bankruptcy Code do not apply to their adversary proceedings because the City "lacks any equitable or beneficial interest in" the ad valorem taxes.

Analysis

Section 904(2) of the Bankruptcy Code is a keystone in the interplay between federal bankruptcy powers and municipal sovereignty. It prohibits a bankruptcy court from interfering with a municipal debtor's use of its "property or revenues," unless the municipal debtor consents to the bankruptcy court's jurisdiction. See *Association of Retired Employees of the City of Stockton v. City of Stockton (In re City of Stockton)*, 478 B.R. 8 (Bankr. E.D. Cal. 2012) (holding that section 904 prohibits a bankruptcy court from "[c]oercively preserving a status quo that entails payment of money from the City treasury" because it would interfere "with the City's choice to suspend such payments."). Here, the Michigan Bankruptcy Court will have to determine whether it has the power to grant relief that compels the status quo under Michigan law (*i.e.*, restrictions on the use of the ad valorem taxes), since that would dictate how the City chooses to use or not use its property.

Even if the Plaintiffs succeed in causing the ad valorem taxes to be segregated and restricted to paying the GO Bonds, they are not seeking a determination at this time as to the ultimate disposition of the funds. In fact, they acknowledge that the Bankruptcy Court will need to determine at a later date whether the ad valorem taxes are "impressed with a statutory lien" and constitute special revenues under section 902 of the Bankruptcy Code. Chapter 9 applies special protections to special revenue bonds and bonds secured by a statutory lien. 11 U.S.C. §§ 101(53); 928(a). However, bankruptcy courts have previously held that general obligation bonds are merely unsecured claims under the Bankruptcy Code. See, *e.g.*, *Matter of Sanitary & Improvement Dist. No. 7*, 98 B.R. 970, 973-74 (Bankr. D. Neb. 1989) (noting that GO bondholders are unsecured under the Bankruptcy Code, notwithstanding state law protections); *In re Jefferson County*, 465 B.R. 243, 283 (N.D. Ala. 2012) (noting that Congress only chose to protect revenue bonds, and that general obligation bonds are subject to section 552(a) of the Bankruptcy Code).

Conclusion

Clearly, the Plaintiffs' adversary complaint represents an attempt to jockey for favorable treatment under the City's plan of adjustment. The arguments raised by the Plaintiffs will test the limits of the Bankruptcy Court's jurisdiction and the priority of GO bonds under Michigan law in a chapter 9 case.

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