

Clients & Friends Memo

Court Rules that Detroit is Eligible for Chapter 9 and that Pensions May be Impaired in Chapter 9

December 6, 2013

On December 5, 2013, the U.S. Bankruptcy Court for the Eastern District of Michigan released its 143 page decision upholding the City of Detroit's eligibility to be a debtor under chapter 9 of the United States Bankruptcy Code. [In re City of Detroit, Michigan, Case No. 13-53846 \(Bankr. E.D. Mich. Dec. 5, 2013\)](#).¹ The Court's decision is the first ever to address the treatment of municipal pensions in bankruptcy, concluding that pension obligations may be adjusted in a chapter 9 case, notwithstanding protective provisions in the state constitution. A similar issue is pending, but not yet decided, in the Stockton and San Bernardino chapter 9 cases in California.

I. Constitutionality of Chapter 9 and the Ability to Impair Pensions

The Court rejected the objectors'² arguments that chapter 9 violates the Tenth Amendment of the U.S. Constitution. The objectors argued that chapter 9 usurps state sovereignty by invalidating state law protections that are afforded to pensioners. The Court concluded that the issue of chapter 9's constitutionality was already decided in *United States v. Bekins*, 304 U.S. 27 (1938), where the U.S. Supreme Court upheld the constitutionality of the Municipal Bankruptcy Act of 1937. Further, the Court found that chapter 9 does not violate the Tenth Amendment because it specifically protects a state's right to consent. Here, eligibility for chapter 9 is expressly predicated on a state "specifically authorizing" a municipality to file for chapter 9 and thus chapter 9 is limited to voluntary proceedings.

The Court also rejected certain objections that chapter 9 is unconstitutional "as applied" in this case. The objectors argued that under the Pensions Clause of the Michigan Constitution,³ the pensioners have an absolute right to be protected from any impairment of their vested pension

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

² The objectors include Michigan Council 25 of the AFL-CIO ("AFSCME"), the Retired Detroit Police & Firefighters Association, the Detroit Retired City Employees Association, the UAW, the Detroit Retirement Systems, and the Retired Detroit Police Members Association.

³ See Article IX, Section 24 of the Michigan Constitution (providing that accrued pension benefits of a state or municipal retirement system "shall not be diminished or impaired" by the state and its political subdivisions).

benefits, including in a chapter 9 case. The Court disagreed and found that the Pensions Clause does not afford an absolute prohibition against impairment of vested pension benefits. In analyzing applicable Michigan law, the Court found that the purpose of the Pensions Clause was not to create an absolute protection for pensioners. Rather, the Court found that the state legislature enacted the Pensions Clause to treat pensions as contractual obligations, as opposed to gifts.

Furthermore, the Court found that even though Michigan had a bankruptcy authorizing statute when the state legislature enacted the Pensions Clause in 1963, the state legislature did not take any measures to protect pensions from impairment in bankruptcy. According to the Court, the state legislature could “have given pensions protection from impairment in bankruptcy in several ways,” including prohibiting municipalities from filing for bankruptcy, creating a property interest, creating a secured interest in the municipality’s property, or explicitly requiring that the State guaranty pension benefits. The Court stated that the state legislature could have provided pensioners with more protections in a municipal bankruptcy, but it declined to do so. Therefore, the Court held that pensions are merely contractual obligations under Michigan law and they are subject to impairment in a federal bankruptcy proceeding.

Furthermore, the Court held that the Bankruptcy Code preempts the Pensions Clause. The Court noted that “if the Tenth Amendment prohibits cuts of pension benefits in this case, then it would also prohibit the adjustment” of any other debt in this case. That result, according to the Court, would be untenable because “it has long been understood that bankruptcy law entails the impairment of contracts.” The Court cautioned, however, its ruling should not be interpreted to mean that the Court would necessarily confirm any plan of adjustment that impairs pensions.

II. Eligibility for Chapter 9 Protection

Next, the Court turned to the issue of the City’s eligibility to be a chapter 9 debtor. The Court noted that the City bears the burden by establishing by a preponderance of the evidence that the City satisfied each requirement under section 109(c). Section 109(c) of the Bankruptcy Code provides that an entity may only file for chapter 9 if that entity is (i) a municipality, (ii) “specifically authorized” under state law to file for chapter 9, (iii) insolvent, (iv) desires to effect a plan of adjustment, and (v) has engaged in good faith prepetition negotiations with its creditors. 11 U.S.C. § 109(c). With respect to the fifth requirement, a debtor is excused from engaging in such prepetition negotiations where those efforts are “impracticable.” *Id.* § 109(c)(5)(C)

1. State Law Authorization

The Court held that, under Public Act 436 (“PA 436”), the City of Detroit was specifically authorized by Michigan to file for chapter 9. The objections to this requirement focused primarily on the constitutionality of PA 436. The objectors argued that PA 436 is unconstitutional because it

was substantively identical to Public Act 4 (which was repealed in November 2012) and included appropriation provisions for the sole purpose of usurping the public's referendum rights. The Court acknowledged that "there certainly was some credible evidence in support of the assertion" that the state legislature attached appropriations provisions to avoid the referendum requirement. However, the Court concluded that based on Michigan state court decisions, the inclusion of the appropriations provisions in PA 436 was constitutional under Michigan law even if it was done to avoid the referendum requirement.

Next, the Court addressed whether the failure to include contingencies in PA 436 that protect pensions violated the Pensions Clause. The Court held that the failure to protect pension rights did not make PA 436 inconsistent with the Pensions Clause because the Pensions Clause does not provide absolute protections for pensions. Furthermore, the Court held that, based on section 903 of the Bankruptcy Code, once a state consents to a municipal bankruptcy, "no state law can protect contractual pension rights from impairment, just as no law could protect other types of contract rights." State law, according to the Court, "cannot reorder the distributional priorities of the bankruptcy code" and once a state consents to a municipal bankruptcy, the state may not "cherry pick" the application of Bankruptcy Code provisions after the case has been filed. The Court likewise concluded that the failure of the Governor to condition his authorization on the protection of vested benefits did not conflict with the Pensions Clause. The Court noted that any contingency attached to the Governor's authorization "may have rendered the authorization itself invalid."

Finally, the Court addressed whether the Ingham County Circuit Court's decision⁴ regarding the constitutionality of chapter 9 had any preclusive effect on the Bankruptcy Court's ability to decide that the state specifically authorized the City to file for chapter 9. The Court concluded that it did not have any binding effect for two reasons: (i) the state court's declaratory judgment was void because the Bankruptcy Court has exclusive jurisdiction over eligibility issues once the City commences a chapter 9 case, and (ii) the state court violated the automatic stay by granting the declaratory relief after the City filed its chapter 9 petition.

2. *Insolvency*

The Court held that the evidence conclusively established that the City is insolvent as defined in the Bankruptcy Code.⁵ First, the Court concluded that the City was not paying its debts as they came due. In particular, the City deferred payments on obligations that are payable from its general fund

⁴ See Court Approves Extension of the Automatic Stay in Detroit's Chapter 9 Case to State Officials, Clients & Friends Memorandum dated July 26, 2013, available at <http://www.cadwalader.com/resources/clients-friends-memos/court-approves-extension-of-automatic-stay-in-detroits-chapter-9-case>.

⁵ Section 101(32)(C) of the Bankruptcy Code defines "insolvent" as the inability of a municipality to "pay its debts as they become due." 11 U.S.C. § 101(32)(C).

in June 14, 2013, and absent such deferment of payments, the Court noted that the City would have completely run out of cash by the end of that month. The Court rejected the objectors' argument that the City could have avoided insolvency by monetizing its assets. According to the Court, a "one-time infusion of cash" would only delay the inevitable, and would not significantly improve the City's long-term financial problems

Second, the Court held that the City was "service delivery insolvent"—meaning that the City was unable to pay for basic municipal services to maintain the health, safety, and welfare of the citizens of Detroit. According to the Court, the City was unable to maintain its lighting system and its police force's equipment was "in a state of disrepair." As a result of this service delivery insolvency, the Court found that City's crime rate has soared to dangerous levels.

3. Desire to Effect a Plan Adjusting Debts

Similar to other chapter 9 cases, certain objectors argued that the City failed to meet this requirement because it did not file a plan or term sheet with its chapter 9 petition. The objectors also argued that the City did not satisfy this requirement because the City only desired to impair pension benefits and that such impairment would result in a plan that is not confirmable under the Bankruptcy Code. The Court found that whether the City's prepetition restructuring proposal could be confirmed in a chapter 9 case was not relevant to the eligibility proceedings. According to the Court, the City's restructuring proposal "overwhelmingly" supported the conclusion that the City desired to effect a plan adjusting its debts because it classified creditors and proposed adjustments to unsecured debt.

4. Good Faith Negotiations

The Court held that the City did not negotiate in good faith, as required by section 109(c)(5)(B) of the Bankruptcy Code. Among other things, the City argued that it engaged in good faith negotiations because it provided creditors with a restructuring proposal prior to filing for chapter 9 and because the City invited feedback on that proposal. The Court found that the City's efforts did not qualify as "good faith" negotiations. In particular, the Court noted that the City did not provide creditors with sufficient information in its restructuring proposal and also noted that its meetings with creditors were purely informational. According to the Court, "[c]haritably stated, the proposal is very summary in nature." Furthermore, the City explicitly told creditors that its meetings were not negotiations. The Court also concluded that the City did not provide creditors with enough time to evaluate its restructuring proposal. The Court stated that creditors had only 30 days to offer a counterproposal, and that the City's calendar "was very tight and did not request counterproposals." The Court held that 30 days was simply not enough time to engage in meaningful negotiations given the complexity and size of the City's creditor body. Based on these

circumstances, the Court found that the City failed to establish that it engaged in good faith negotiations.

However, the Court held that, based on section 109(c)(5)(C), the negotiation was impracticable and accordingly, the City was excused from the good faith negotiation requirement. The Court found that a debtor can satisfy this requirement if it has a large creditor body. Here, the Court concluded that the City's creditor body was large enough to render prepetition negotiations impracticable because the City has over 100,000 creditors, its creditor list is over 3,500 pages, and many of these creditors were difficult to locate. The Court rejected the objectors' arguments that it was not impracticable for the City to engage in prepetition negotiations over the treatment of pension obligations because the City could have negotiated with the unions. The Court noted that many of those unions did not have the authority to bind any individual retirees. Further, the Court found that it was impracticable for the City "to negotiate with a group that asserts that their position is immutable." According to the Court, the City simply did not have enough time to locate and negotiate with each of its creditors because "time was running out" for the City.

5. Section 921(c)'s Good Faith Requirement

Pursuant to section 921(c), a Court *may* dismiss a chapter 9 case if a municipality did not file its petition in good faith. Here, the Court found that the City filed its petition in good faith. The objectors argued that the City did not file its petition in good faith because the City conspired to file for chapter 9 for a prolonged period of time and did so with the intent to impair pensions. The Court acknowledged that "in some particulars, the record does support the objectors'" narrative. However, the Court found that the objectors' arguments did not establish that the City filed its petition in bad faith.

The Court found that the City filed its petition in good faith because (i) the City's financial problems are exactly the type of problems that chapter 9 seeks to address; (ii) the City's decision to file for chapter 9 after various retiree groups commenced state lawsuits was proper; (iii) the City attempted to improve its financial condition outside of bankruptcy to no avail; and (iv) the citizens of Detroit would be prejudiced if the Court dismissed the City's chapter 9 case. The Court found that if the City's chapter 9 case is dismissed, the City would be forced to return to the path that it was on prior to filing for chapter 9, which would likely require the City to "borrow money, defer capital investments, and shrink its workforce." The Court found that such results would be "dangerous" and "unworkable," and would exacerbate the problems that the City currently faces.

Conclusion

The Court's decision is significant because it is the first to confirm that pensions can be impaired in a chapter 9 case, notwithstanding state constitutional protections. A similar question is presented

in the San Bernardino and Stockton chapter 9 cases. Although CalPERS has suggested that, because it is an arm of the State, the Detroit ruling should not apply to it, the Detroit precedent still casts a long shadow over those cases. Moreover, this ruling may ultimately have implications in other contexts, including whether general obligation bondholders may enforce state law covenants against a municipality during the pendency of a chapter 9 case.

* * * *

Please feel free to contact the following attorneys, if you have any questions about this memorandum.

Lary Stromfeld	+1 212 504 6291	lary.stromfeld@cwt.com
Mark Ellenberg	+1 202 862 2238	mark.ellenberg@cwt.com
Howard Hawkins	+1 212 504 6422	howard.hawkins@cwt.com
Ingrid Bagby	+1 212 504 6894	ingrid.bagby@cwt.com
Ivan Loncar	+1 212 504 6339	ivan.loncar@cwt.com
Thomas Curtin	+1 212 504 6063	thomas.curtin@cwt.com