



Motor City Cruises Into Bankruptcy

Anthony J. Napolitano, Esq. and Benjamin S. Seigel, Esq.

On July 18, 2013, the City of Detroit, Michigan commenced a bankruptcy case under chapter 9 of the Bankruptcy Code as a result of over \$18 billion dollars in accrued obligations and dwindling revenue sources. Since the commencement of a chapter 9 case in Michigan requires the express authorization of the Governor, Detroit's petition attached a very poignant letter from Gov. Richard Snyder acknowledging the financial issues plaguing the City, and authorizing the chapter 9 petition as it posed the only viable solution for resolving the City's financial problems. Some of the key points from Gov. Snyder's letter include the following:

- "The City's population has declined 63% from its peak, including a 28% decline since 2000. That exodus has brought Detroit to the point that it cannot satisfy promises it made in the past."
- "The City's unemployment rate has nearly tripled since 2000 and is more than double the national average."
- "Detroiters already have a higher tax rate than anywhere in Michigan, and even with that revenue the City has not been able to keep up with its basic obligations, both to its citizens and creditors."
- "Its citizens wait an average of 58 minutes for the police to respond to their calls, compared to a national average of 11 minutes. Only 8.7% of cases are solved, compared to a statewide average of 30.5%."

While historic given the size of the City of Detroit, the bankruptcy of a municipality is not unprecedented. Over the past several years we have seen the bankruptcies of the City of Vallejo, the City of Stockton, and the City of San Bernardino in California. And nationwide the City of Harrisburg, Pennsylvania and the County of Jefferson, Alabama have also commenced chapter 9 cases. In fact, since 2008 there have been more than 50 chapter 9 filings nationwide.

Chapter 9 will provide Detroit with tremendous opportunity to restructure its financial affairs. In general, a municipality has far greater flexibility to effectuate the adjustment of its

debts compared to typical business reorganizations under chapter 11. This is primarily due to the tension between state sovereignty and Congress' authorization to provide for uniform bankruptcy laws. For instance, there is no provision in chapter 9 for the liquidation of a municipal debtor's assets and the distribution of the proceeds to creditors. The bankruptcy court is given no supervisory authority with respect to the debtor's ability to incur debts and control costs. In chapter 9, the municipal debtor has complete control over its operations, without interference from the court or creditors.

While creditors typically can play an active role in chapter 11 cases and to a lesser extent chapter 7, 12 and 13 cases, the role of creditors in a chapter 9 case is much more limited. The following is a brief summary on the implications for various stakeholders in a municipal bankruptcy:

Bondholders. Municipalities commonly have "general obligation bonds" or "special revenue bonds," which are treated significantly different in bankruptcy. General obligation bonds are backed by the full faith and credit of the municipality and not a pledged revenue stream, as such they are treated as unsecured debt in a chapter 9 bankruptcy case. Accordingly, the municipal debtor is not required to make any payments of either principal or interest on account of such bonds during the pendency of the chapter 9 case. As unsecured debt, general obligation bonds are subject to negotiation and possible restructuring under the plan of adjustment, which may include the reduction of interest rates, extension of maturity dates, and modification to repayment terms.

Special revenue bonds are commonly issued to finance the construction or expansion of revenue-producing public projects such as public utilities, airports, transportation systems and toll roads. Special revenue bonds are unlike general obligation bonds since the payment stream from the capital project is pledged to the bondholders as security for the payment of the revenue bonds. Unlike general obligation bonds, holders of special revenue bonds are generally entitled to post-petition payments and lien preservation rights.



July 2013

Trade Creditors. While creditors typically can play an active role in chapter 11 cases, the role of creditors in a chapter 9 case is much more limited. In a chapter 9 case, there is no first meeting of creditors to provide the U.S. Trustee and interested creditors with an opportunity to question the municipal debtor about its assets, liabilities and financial affairs. Additionally, creditors may not propose a competing plan of adjustment, and dissenting creditors are ultimately bound by the terms of a confirmed chapter 9 plan, which may include a substantial reduction in debt. Hence, businesses and individuals that do business with a municipal debtor are commonly at the whims of such debtor in a chapter 9 case.

Contractual Parties. A municipal debtor may be a lessor or a lessee with respect to real or personal property, or may be a party to a contract for services. Section 365 of the Bankruptcy Code permits the municipal debtor to assume or reject the “executory contract” or unexpired lease depending on whether the municipality views the executory contract or unexpired lease to be favorable or unfavorable. The municipal debtor’s decision will affect the rights of its counterparty. Municipal finance leases receive commonly special treatment in chapter 9.

Labor Unions. Municipal debtors are typically parties to collective bargaining agreements with their labor unions setting forth basic terms of employment. The Supreme Court held in *N.L.R.B. v. Bildisco & Bildisco*, a chapter 11 case, that a collective bargaining agreement with a labor union is an executory contract that may be rejected in bankruptcy. In response to the *Bildisco* decision, Congress enacted section 1113 of the Bankruptcy Code to provide greater protection to organized labor in chapter 11 bankruptcy cases. While many of the provisions of chapter 11 apply to chapter 9, section 1113 does not. Accordingly, municipal debtors can avail themselves of the less stringent standard under *Bildisco* for the rejection of collective bargaining agreements. The bankruptcy court in *City of Vallejo* recently held that a chapter 9 debtor does not have to meet the more stringent chapter 11 standards in dealing with its labor unions.

Distressed Asset Purchasers. Governor Snyder in his letter noted that “having large swaths of largely abandoned structures—approximately 78,000—creates additional public safety problems and reduces the quality of life in the City.” Undoubtedly, Detroit has an overwhelming amount of

surplus assets that it will need to shed to raise revenue and to eliminate ongoing expenses. This provides a tremendous opportunity to purchasers of distressed assets. In chapter 11 cases asset sales are commonly achieved through section 363 of the Bankruptcy Code, which has some strict requirements to ensure that a sale of assets may be achieved free and clear of the liens and claims of creditors. While section 363 is not applicable in chapter 9 cases, this does not mean that such “free and clear” dispositions are not available; it is more of an acknowledgement of the municipal debtor’s sovereignty in being able to administer to its own assets free from Bankruptcy Court interference.

The key to Detroit’s success in chapter 9 and its ability to confirm a plan of adjustment of its debts will be in its ability to obtain significant cuts and concessions from both its unsecured bondholders, labor unions and on account of its health and pension obligations. It has been reported that prior to commencement of the chapter 9 case, the City had sought to reduce \$11 billion in unsecured debt to \$2 billion, and to reduce its secured debt burden by 25%. Chapter 9 will certainly give the City the necessary leverage to obtain such significant reductions.



Anthony J. Napolitano is a Senior Counsel in Buchalter Nemer’s Insolvency and Financial Solutions Practice Group and has represented creditors and bond trustees in municipal workouts and chapter 9 municipal bankruptcies. Mr. Napolitano also authored a chapter on municipal bankruptcies for Thomson Reuters’ *Business Workouts Manual*. Mr. Napolitano can be reached at (213) 891-5109.



Benjamin S. Seigel is a Shareholder in Buchalter Nemer’s Insolvency and Financial Solutions Practice Group and represented the Orange County Employees Retirement System in the Orange County chapter 9 bankruptcy case. Mr. Seigel can be reached at (213) 891-5006.