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Subnational Insolvencies and Chapter 9 of the United States Bankruptcy Code: History of Chapter 9 and Its Operation in the City of Detroit’s Debt Adjustment Case—Part II

Patrick E. Mears*

In this second part of a two-part article, the author focuses on the City of Detroit’s Chapter 9 case. The first part of the article, which appeared in the April/May 2015 issue of Pratt’s Journal of Bankruptcy Law, discusses the constitutional framework underpinning Chapter 9 of the Bankruptcy Code, insolvent municipalities and their stakeholders prior to the advent of Chapter 9, the Great Depression and the enactment of Chapter 9, and the structure of Chapter 9 and its operation.

EVENTS PRECEDING COMMENCEMENT OF THE CITY OF DETROIT’S CHAPTER 9 CASE

The City’s Dire Condition in 2013

The economic problems of the City existed for many years prior to the filing of its Chapter 9 petition with the United States Bankruptcy Court for the Eastern District of Michigan on July 18, 2013, and paralleled the decline of the United States automotive industry that is centered in Detroit. In 1950, at the height of the automotive boom in the United States, Detroit boasted a population of 1.85 million, then the fifth largest city in the United States. By 2012, the city’s population had shrunk to 700,000, making Detroit the eighteenth-largest city in America. The unemployment rate in Detroit in 2013 was 18.6 percent and 36.2 percent of the population lived below the poverty level. Many once-thriving sections of the city are now underpopulated or depopulated, leaving behind abandoned commercial structures and homes that are slowly disintegrating due to exposure to the elements or are the targets of vandalism and arson. In 2013, the city’s murder rate was the second highest in the nation, with 386 homicides or 54.6 murders for every 100,000 citizens. As of April, 2013, approximately 60 percent of the 88,000 street lights operated and maintained by the city’s Public Lighting Department were operating. By

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the time of its Chapter 9 filing, Detroit was a destitute, decaying and dangerous place to live and work.

**Detroit’s Condition of Severe Financial Stress: 2011–2012**

Although Detroit’s population, financial condition and tax base had been shrinking since the 1970s, its problems were brought front and center by a newly elected Governor of the State of Michigan, Rick Snyder, and Michigan’s state legislature, both of which were Republican hands. Utilizing a new Emergency Financial Manager law enacted in 2011, the Michigan Department of the Treasury commenced a review of the city’s financial condition on December 6th. This process ultimately led to a report by the Governor’s Financial Review Team, which was required by state law to report its findings concerning Detroit’s financial condition. On March 25, 2012, this team concluded that the city was in a condition of “severe financial stress,” based upon the following findings:

- Detroit’s cumulative general fund deficit had increased from $91 million to $148 million between 2010 and 2011. The last year that the city experienced a positive year-end fund balance was 2004.
- The city had admittedly and knowingly overestimated revenues and underestimated interest expenses during the prior nine fiscal years, thereby resulting in significant variances between budgeted and actual revenues and expenses during that period.
- Detroit’s cash position was significantly depleting over time.
- The city’s bonded indebtedness ratings had suffered significant downgrades by the rating agencies due to Detroit’s weakened financial position.

**The Consent Agreement and Its Breach by the City: 2012**

On April 5, 2012, the city and the State of Michigan executed a “Financial Stability Agreement,” which is commonly referred to as the “Consent Agreement.” This agreement was negotiated in the context of the then-existing Emergency Financial Manager Act in order to avoid the appointment of an emergency financial manager and to stabilize Detroit’s financial condition. The Consent Agreement created a Financial Advisory Board of 9 members selected by state and city officials, which board exercised an oversight role and possessed limited powers over the city’s budget.

On December 11, 2012, the Michigan Department of Treasury began another review of Detroit’s financial condition because of a recent change in the state’s Emergency Financial Manager law. The State Treasurer reported to the Governor that, as a result of this review, a “serious financial problem” existed in
Detroit, and emphasized the following developments: (i) city officials had violated state law by applying city funds for purposes inconsistent with the city’s appropriation; (ii) the city had projected that it would likely deplete its cash prior to June 30, 2013; (iii) the city had incurred overall deficits in a number of its funds including the General Fund. Another Financial Review Team was then appointed by the Governor, which reported on February 19, 2013, that “a local government financial emergency exists . . . because no satisfactory plan exists to solve a severe financial problem.”

The City’s Financial Emergency and Appointment of an Emergency Manager: 2013

As a result of this report, Governor Snyder declared on March 1, 2013, under state law that a “financial emergency” existed in the City of Detroit and confirmed that conclusion two weeks later. On March 15, 2013, a state board, the Local Emergency Financial Assistance Loan Board, appointed Kevyn Orr, a bankruptcy attorney and member of the multinational Jones Day law firm, as emergency financial manager for the City of Detroit. In this position and pursuant to state law, Orr displaced as the City’s decision-makers the elected mayor and Common Council of the City of Detroit and was granted broad powers to “rectify the financial emergency and to assure the fiscal accountability of the local government and the local government’s capacity to provide . . . necessary governmental services essential to the public health, safety, and welfare.”\(^1\) On March 25, 2013, Orr assumed the office of emergency manager of the City of Detroit.

On June 14, 2013, Orr organized a meeting with approximately 150 representatives of creditors of the city, including persons representing (a) the holders of the city bonds and their insurers; (b) the city’s unions; (c) the city’s retiree associations; and (d) the city’s pension systems. At this meeting, Orr presented the attendees with a proposal to restructure the city’s debt and to invest approximately $1.25 billion over 10 years to improve basic and essential city services. Thereafter, Orr held additional meetings with creditors and their representatives to discuss this proposal. These meetings ceased when Orr, with specific authorization from Governor Snyder, commenced the city’s Chapter 9 case just a few minutes before the beginning of a hearing on a motion in a state court civil action to enjoin Orr from filing a Chapter 9 petition for the City of Detroit.\(^2\)

\(^1\) MCL § 141.1549(2).

DETROIT IS DECLARED ELIGIBLE TO COMMENCE AND PROSECUTE ITS CHAPTER 9 CASE

Shortly after the filing of Detroit's voluntary Chapter 9 petition, the Sixth Circuit Court of Appeals, which supervises the federal district courts located in the four states of Michigan, Ohio, Kentucky and Tennessee, appointed United States Bankruptcy Judge Steven W. Rhodes to oversee this bankruptcy case. Judge Rhodes was appointed as a bankruptcy judge in Detroit in 1985, reappointed in 1999 and served continuously in that position until his recent retirement.

One of Judge Rhodes' first tasks in Detroit's case was to rule on the 109 filed objections challenging the city's eligibility to commence a Chapter 9 case under Section 109(c) of the Bankruptcy Code. In early Fall of 2013, Judge Rhodes began the hearing on eligibility and on December 5, 2013, issued an 150-page opinion ruling that the City was eligible to commence a Chapter 9 case (the "Eligibility Opinion"). The basic issues considered and addressed by the court in this contested matter and the Eligibility Opinion were the following:

- Did the city improperly file its petition without a contingency that the City would not attempt to alter in the Chapter 9 case the rights of former city employees to their pensions, which rights are arguably constitutionally protected by Michigan’s state constitution?
- Did the city attempt to negotiate with its creditors for a restructuring of municipal debt outside of bankruptcy or were such negotiations “impracticable”?
- Did the city file its Chapter 9 petition in “good faith”?

The City’s Pension Obligations to Retired City Employees

In the City's Chapter 9 Schedules, the City estimated its total debt $18 billion—$11.9 billion in unsecured debt and $6.4 billion in secured debt—all of which was held by more than 100,000 creditors. The estimate of unsecured debt included $3.5 billion of unfunded pension obligations and $5.7 billion in “other post-employment benefits” owing to present City employees and retirees. How this debt could be treated, if at all, in a Chapter 9 plan rapidly became the most litigated and contentious issue in this case.

Michigan’s current state constitution, which came into force in 1963, contains special protections for the pension rights of public employees. Article IX, Section 24, of the constitution reads as follows:

The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual
obligation thereof which shall not be diminished or impaired thereby. Similar protections were not previously included in earlier Michigan constitutions and prior case law had not elevated pension commitments by the state and its municipalities to the status of contracts. Rather, before 1963, Michigan public pensions were treated as “gratuitous allowances that could be revoked at will because a retiree lacked any vested right in their continuation.”

After analyzing the public debates of the Michigan Constitutional Convention conducted in 1961–1962 and subsequent case law on the status of public employee pensions in Michigan, Judge Rhodes concluded that the current state constitution elevated the status of these pension rights to contractual obligations and nothing more. Upon the failure of the State or municipality to pay an employee his pension amounts due under a retirement plan, that employee has the right to commence an action in court to recover his unpaid benefits then due.

Some of the parties objecting to the City’s eligibility for Chapter 9 relief argued that this state constitutional provision granted “absolute protection” to the right to receive public pension benefits and that, because the Chapter 9 petition filed by the City did not carve out these benefits as being sacrosanct in the Chapter 9 case, the filing of the petition was not authorized by state law as required by Section 109(c)(2) of the Bankruptcy Code. Judge Rhodes rejected this argument, noting that state law only elevated public pension obligations to the status of contractual obligations and retirees’ rights to receive these contractual payments may be adjusted in a confirmed Chapter 9 plan. As Judge Rhodes phrased it, “state law cannot reorder the distributional priorities of the bankruptcy code. If the state consents to a municipal bankruptcy, it consents to the application of chapter 9 of the bankruptcy code.”

Nevertheless, Judge Rhodes injected a word of caution concerning any attempt by the City to impair the public pension rights of retirees in a Chapter 9 plan:

No one should interpret this holding that pension rights are subject to impairment in this bankruptcy case to mean that the Court will necessarily confirm any plan of adjustment that impairs pensions. The Court emphasizes that it will not lightly or casually exercise the powers under federal bankruptcy law to impair pensions. Before the Court confirms any plan that the City submits, the Court must find that the plan fully meets the requirements of 11 U.S.C. § 943(b) and the other

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3 Id. at 151.
4 Id. at 161.
applicable provisions of the bankruptcy code. Together, these provisions of law demand this Court’s judicious, legal and equitable consideration of the interests of the City and all of its creditors, as well as the laws of the State of Michigan.\(^5\)

**Good Faith Negotiations with Creditors and Their Impracticability**

As mentioned above, Section 109(c)(5) of the Bankruptcy Code requires a Chapter 9 petitioner to satisfy at least one of four requirements stated therein before a finding of eligibility for Chapter 9 relief may be made by a bankruptcy court. Two of those requirements—(i) that creditors holding a majority in amount of claims in each class to be impaired under a Chapter 9 plan have agreed to such a filing and (ii) the petitioner reasonably believes that a voidable preferential transfer will be obtained by a creditor—have no application in the City’s Chapter 9 case. Thus, the City was required to prove that either (i) the City negotiated with creditors in “good faith” but failed to obtain the agreement of impaired classes of claims to an out-of-court restructuring; or (ii) the City was unable to so negotiate because such negotiation was “impracticable.” Judge Rhodes devoted a substantial portion of the Eligibility Opinion to these two factors—good faith negotiations and their impracticability—and concluded that, even though the City failed to negotiate with its creditors in good faith, those negotiations were nonetheless impracticable under the circumstances.

Judge Rhodes’ factual findings described in detail the various meetings held by Orr with groups of creditors during June 2013. On June 14, Orr met with approximately 150 creditor representatives including those of the City’s debt holders, insurers of that debt, unions, retiree associations and pension systems, at which time Orr presented them with an out-of-court restructuring proposal. Elements of this proposal were (i) an anticipated investment of $1.25 billion over 10 years to improve basic and essential City services; (ii) an expansion of the City’s income and property tax bases; and (iii) the “realization of value” from the Detroit Water and Sewerage Department via the creation of a new authority. Orr also proposed “treatment of secured debt commensurate with the value of the collateral securing such debt” along with the “pro-rata distribution of $2 billion in principal amount of interest-only limited recourse participation notes to holders of unsecured claims.”\(^6\) In addition to this meeting, Orr and his staff held other meetings with creditors regarding this proposal, including a meeting with union representatives and retiree associations in Detroit on June 20, 2013 and a meeting in New York City with representatives of “all six of the

\(^5\) Id. at 154.

\(^6\) Id. at 126.
insurers of the City’s funded bond debt, the pension systems, and U.S. Bank, the trustee or paying agent on all of the City’s bond issuances.”  Additional meetings were held in late June and early July.

At the various hearings on eligibility, the City argued that its out-of-court restructuring proposal presented to creditors on June 14, 2013, and the follow up meetings with creditor groups constituted a “good faith effort to begin negotiations” but the creditors “refused to respond.”  The objectors argued that this proposal lacked sufficient detail to permit them to make any counterproposals and, therefore, good faith negotiations were never even attempted. After an extensive review of the evidence, Judge Rhodes concluded that “the June 14 Proposal to Creditors and the follow up meetings were not sufficient to satisfy the requirements of 11 U.S.C. § 109(c)(5)(B) . . . . The Proposal to Creditors did not provide creditors with sufficient information to make meaningful counter-proposals, especially in the very short time that the City allowed for the discussion period.”

Notwithstanding the lack of good faith negotiations by the City with creditors concerning a possible out-of-court restructuring, Judge Rhodes concluded that any such negotiations would have been “impracticable” and, therefore, the requirements of 11 U.S.C. § 109(c)(5)(B) were satisfied by the City. Judge Rhodes reviewed the relevant case law on the issue of impracticability, noting that this test involves a “fact-sensitive inquiry” that “depends upon the circumstances of the case.” This test was adopted by Congress “to cover situations in which a very large body of creditors would render prefiling negotiations impracticable.”

The Eligibility Opinion then points out that there were over 100,000 creditors listed in the City’s bankruptcy schedules. With respect to retirees, Judge Rhodes observed that the unions disclaimed authority to negotiate on behalf of the large number of retirees and that several retiree associations asserted that “they would never negotiate a reduction in accrued pension benefits.” In conclusion, Judge Rhodes wrote that

[...]

7 Id. at 127.
8 Id. at 174.
9 Id. at 175.
10 Id. at 176–77.
11 Id. at 177.
12 Id.
consent or bankruptcy. Negotiations with retirees and bondholders were impracticable due to the sheer number of creditors, and because many of the retirees and bondholders have no formal representatives who could bind them, or even truly negotiate on their behalf. Additionally, the Court finds that the City’s fiscal crisis was not self-imposed and also made negotiations impracticable.\textsuperscript{13}

\textbf{The Good Faith Requirement for Filing a Chapter 9 Petition}

Section 921(c) of the Bankruptcy Code permits a bankruptcy court, after an objection is filed to a Chapter 9 petition, to dismiss that petition after notice and a hearing “if the debtor did not file the petition in good faith or if the petition does not meet the requirements of [the Bankruptcy Code].” At the outset of this section of the Eligibility Opinion, Judge Rhodes observed:

The City’s alleged bad faith in filing its Chapter 9 petition was a central issue in the eligibility trial. Indeed, in one form or another, all of the objecting parties have taken the position that the City did not file its petition in good faith and that this Court should exercise its discretion under 11 U.S.C. § 921(c) to dismiss the case.\textsuperscript{14}

Judge Rhodes then proceeded to quote a recent decision of the bankruptcy judge handling the pending Chapter 9 case of Stockton, California, Judge Christopher M. Klein, concerning the proper legal standard to determine whether a Chapter 9 petition was filed in “good faith”:

Relevant considerations in the comprehensive analysis for § 921 good faith include whether the City’s financial problems are of a nature contemplated by chapter 9, whether the reasons for filing are consistent with chapter 9, the extent of the City’s prepetition efforts to address the issues, the extent that alternatives to chapter 9 were considered, and whether the City’s residents would be prejudiced by denying chapter 9 relief.\textsuperscript{15}

As an overriding principle, the essence of the good faith requirement in Section 921 is “to prevent abuse of the bankruptcy process.”\textsuperscript{16}

In his review of the record of the eligibility hearing, Judge Rhodes concluded that “in some particulars, the record does support the objectors’ view of the reality that led to this bankruptcy filing.” The evidence in support of the

\textsuperscript{13} \textit{Id.} at 179.
\textsuperscript{14} \textit{Id.} at 180.
\textsuperscript{15} \textit{Id.}
\textsuperscript{16} \textit{Id.}
objectors’ theory included testimony and documentation pointing toward collusion between Orr and the State of Michigan concerning planning for the Chapter 9 filing and providing political cover for state officials after the filing, in addition to certain statements made by Orr to creditor representatives during the June negotiations concerning the “sacrosanct” nature of the City’s pension obligations.\(^\text{17}\)

Nonetheless, Judge Rhodes concluded that the City’s petition was filed in good faith and that the record did not support the objectors’ position “in enough particulars for the Court to find that the filing was in bad faith.”\(^\text{18}\) The Court made it clear in the Eligibility Opinion that its “paramount” concern was for the interest of the City’s inhabitants and that they would be “severely prejudiced” if the Chapter 9 case would be dismissed.\(^\text{19}\)

Pending Appeal from Eligibility Decision

After the entry of Judge Rhodes’ order declaring the City eligible to commence and maintain a Chapter 9 case, the Michigan Council 25 of the American Federation of State, County and Municipal Employees and the city’s pension funds filed motions for permission to appeal this order directly to the Sixth Circuit Court of Appeals, thereby bypassing the intermediate step of appealing to the federal district court or the Bankruptcy Appellate Panel of the Sixth Circuit. On December 16, 2013, Judge Rhodes entered an order granting these requests for a direct appeal to the Sixth Circuit. Because of the legal effect of the Plan’s confirmation, these appeals are now moot and are subject to dismissal.\(^\text{20}\)

SCHEDULING OF THE PLAN CONFIRMATION PROCESS AND DESCRIPTION OF TREATMENT AFFORDED CRITICAL CREDITOR CLASSES IN THE FOURTH AMENDED PLAN

The Scheduling Order Governing the Plan Confirmation Process

As noted in above, the bankruptcy court is directed by statute to schedule a hearing to consider confirmation of a proposed Chapter 9 plan and parties in interest may object to plan confirmation. Because of the massive number of creditors involved in the City’s Chapter 9 case, the significant size of the City’s

\(^{17}\) Id. at 181–83.

\(^{18}\) Id. at 183.

\(^{19}\) Id. at 188–89.

liabilities and the complexity of the factual and legal questions involved, Judge Rhodes entered a Scheduling Order on February 24, 2014, which was thereafter amended on a number of times as the dynamics of the Chapter 9 case changed. The Fourth Amended Order entered on April 21, 2014, as partially amended by Judge Rhodes' Emergency Order of May 2, 2014, established July 11, 2014, as the last day for voting on the acceptance or rejection of the City's Plan and July 24, 2014, as the first day of the confirmation hearing. Voting on the proposed Fourth Amended Plan for the Adjustment of Debts of the City of Detroit, filed on May 5, 2014 (the “Fourth Amended Plan”)

As the case progressed and extensive and intense settlement negotiations were conducted by the City and objecting creditor classes, the commencement date of the confirmation hearing was moved from July 24 to September 2, 2014.

**The Primary Creditors in the Chapter 9 Case**

Of the more than 100,000 creditors involved in the City's Chapter 9 case, only a limited number of creditor classes specified in the Plan were critical to its confirmation on November 7, 2014. These classes are as follows:

(a) *Pension Claims of Retired City Employees.* Claims for pension benefits arising under the Police and Fire Retirement System of the City of Detroit (“PFRS”), which covered retired policemen and firefighters, and under the General Retirement System of the City of Detroit (“GRS”), which provided pension benefits to other city employees, were classified in the Plan in Class 10 (“PFRS claims”) and Class 11 (“GRS claims”). The allowed amount of the unfunded pension liabilities in Class 10 was ultimately determined to be $1.25 billion and the allowed amount of the unfunded portion of the PFRS claims was fixed at $1.879 billion. These claims were held by thousands of former workers and, for many of them, represented their primary financial lifelines. These claimants expressed their political muscle throughout the Chapter 9 case, demonstrating against the City's initial debt adjustment proposal to discount these claims by as much as 34 percent. The handling of these creditors and their claims would prove to be the most difficult and sensitive challenge for the City and its Emergency Manager, Kevyn Orr. As will be discussed below, the Plan treatment of these claims dramatically improved through the “Grand Bargain,”

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22 The voting results were evidenced by the written Declaration of Michael J. Paques Regarding the Solicitation and Tabulation of Votes on, and the Results of Voting With Respect to, Fourth Amended Plan for the Adjustment of Debts of the City of Detroit dated July 21, 2014 and filed the same day in *In re City of Detroit, Michigan* at Docket No. 6197.
that made possible increased plan distributions to these claimants. These two classes of claims voted to accept the Fourth Amended Plan after the terms of the Grand Bargain were announced.

(b) Claims for OPEB Benefits. As of the date of the Chapter 9 petition’s filing, the City was obligated to provide post-retirement health, vision, dental, life and death benefits to retired City employees and their surviving beneficiaries under certain plans established pre-bankruptcy. The claims of these creditors were ultimately allowed in the case in the sum of $4.303 billion. This class also voted to accept the Fourth Amended Plan.

(c) Claims of Bond Insurers, Syncora and FGIC. In 2005 and 2006, the City arranged for the issuance of “certificates of participation” (“COPS”) to fund certain accrued actuarial liabilities of the GRS and PFRS. These COPS represented individual, undivided proportional interests permitting the holders to receive payments to be made by the City. Repayment of $400 million of the 2005 COPS issuance was insured by Syncora Guarantee, Inc. and Syncora Capital Assurance Inc. (collectively, “Syncora”). Repayment the remaining $1 billion of the 2005 COPS issue was insured by Financial Guaranty Insurance Company (“FGIC”). On January 31, 2014, the City commenced an adversary proceeding in the Bankruptcy Court alleging that the 2005 COPS transaction was illegal and should be voided because it was designed to improperly circumvent borrowing limits imposed by Michigan law on the City. The Fourth Amended Plan voted on by the creditors originally provided that the recovery for Class 9, the holders of claims evidenced by COPS, would receive a distribution in the range of zero percent to 10 percent. Consequently, the creditors in this class voted to reject this version of the Plan.

(d) Claims of Holders of LGTO Bonds. Upon the commencement of the City’s Chapter 9 case, there was approximately $163.5 million of outstanding limited-tax, general obligation bonds that had been issued prepetition by the City (the “LGTO Bonds”). These claims were collected in Class 7 of the Fourth Amended Plan. Payments on these bonds had been insured by Ambac Assurance Corporation (“Ambac”). In Detroit’s Fourth Amended Plan that was voted on by creditors, Detroit proposed to pay only 10–13 percent of these bonds and, consequently, the bondholders voted to reject this version of the Plan.

(e) Other Creditor Classes Voting Against the Fourth Amended Plan. In addition to Classes 7 and 9, the class of general unsecured claims (Class 14) totaling approximately $100 million and receiving only a 10–13 percent distribution voted to reject the Fourth Amended Plan as did the “convenience class” (Class 15), which contained those unsecured claims in amounts less than or equal to $25,000 and those other unsecured claims greater than $25,000 that elected to
reduce their claims to $25,000 or less. It was unclear from the tally of votes on the plan whether Class 1A under the Plan, the claims of impaired holders of Detroit Water and Sewer bonds, had accepted or rejected the Fourth Amended Plan. This last issue became moot when those bonds were refinanced and this class was deemed unimpaired by the Plan.

(f) Settlement with Holders of UGTO Bonds. Upon the commencement of the City’s Chapter 9 case, there was approximately $388 million of outstanding unlimited-tax general obligation bonds that had been issued by the city prepetition (the “UGTO Bonds”). Although the City originally proposed to pay only 15 percent of the total claims represented by the UGTO Bonds, the City and the insurer of these bonds, Ambac, ultimately agreed to a 74 percent distribution to these creditors, as evidenced by restructured bonds to be issued upon confirmation of the Plan. This settlement was thereafter incorporated into the Fourth Amended Plan and was accepted by the class of UGTO Bond holders, Class 8.

MEANS FOR IMPLEMENTATION OF THE PLAN

Section 901 of the Bankruptcy Code incorporates certain other provisions of other Code Chapters into Chapter 9, including Section 1123(a)(5), applicable in Chapter 11 cases. This section requires a Chapter 11 plan (and hence a Chapter 9 plan) to contain “adequate means for the plan’s implementation,” including, but not necessarily limited to, retention by the reorganized debtor of property, disposition of property, and cancellation of any “indenture or similar instrument.” These plan provisions are probative of the plan’s feasibility under Section 943(7) of the Bankruptcy Code. The following describes plan provisions that implement the plan:

The “Grand Bargain”

The “Grand Bargain” was a concept that developed over time in the early stages of the City’s Chapter 9 case, likely originating with United States District Judge Gerald Rosen, the head of the mediation team appointed in the Chapter 9 case to resolve disputes between the City and dissident creditor groups. The basic concept was that, in order to preserve the extremely valuable art collection amassed by the Detroit Institute of Arts (“DIA”) since its inception in the early Twentieth Century, the DIA would need to arrange for the contribution of a substantial cash fund to distribute to the City’s pensioners—those creditors in Classes 10 and 11 in the Plan. The DIA is considered to be one of the few

art museums in the United States that boasts an “encyclopedic” collection, ranging from Mesopotamian and early Egyptian Art to modern art, and has many jewels in its collection, the most prominent being “The Wedding Dance” painted by Pieter Bruegel the Elder in approximately 1566. The alternative, first suggested to the DIA early in the Chapter 9 case by Kevyn Orr as well as the City’s lawyers and investment bankers, would be to arrange for the sale of this art to create a fund of not less than $500 million for payments to creditors.24

As the Chapter 9 case progressed, the DIA art issue was raised by certain creditors objecting to the treatment of their claims in the Fourth Amended Plan and its later versions, most notably Syncora and FGIC, both of which stood to forfeit substantial sums by the plan’s treatment of their unsecured claims in Class 9. These bond insurers argued that their treatment as unsecured creditors was substantially worse that the treatment afforded other classes of unsecured creditors, namely the treatment of pension claims in Classes 10 and 11 and, therefore, the Plan unfairly discriminated against those insurers.

Ultimately, the City, the DIA and the State of Michigan (the “State”) announced the terms of the “Grand Bargain,” which addressed the “art issue” affecting the DIA. The Governor of the State agreed to propose legislation that would initially allocate $195 million in State tax revenue to a fund that would be used to pay pension claims. In addition, philanthropic organizations would pledge to pay $366 million over 20 years for distribution on pension claims and another $100 million would be raised by the DIA from fundraising activities. The total amount to be contributed under the Grand Bargain to the Plan’s funding would ultimately amount to $816 million. The concept behind these contributions would “sweeten the pot” for the holders of pension claims and ultimately to produce a vote by Classes 10 and 11 to accept this better plan treatment of their claims. The terms of the Grand Bargain were incorporated into the Fourth Amended Plan and, as hoped, Classes 10 and 11 voted to accept it.

Creation of the Great Lakes Water Authority

Prior to the commencement of the Chapter 9 case, the counties of Wayne, Oakland and Macomb were negotiating for the creation of a regional water authority to reduce costs of their respective water and sewer systems and to make necessary physical improvements to them. The Detroit Water and Sewerage Department owns 3,000 miles of local pipes and 300 miles of suburban pipes leased to 127 suburban communities in the tri-county area.

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24 Id.
creation of this regional system permits these communities to pay approximately $50 million to the City in lease payments over 40 years. This lease agreement will then permit the City to issue $500 to $800 million in bonds to rebuild the City’s aged water and sewer systems. The settlement also enables the Detroit Water and Sewerage Department to contribute $428.5 million over nine years to cover underfunded amounts in the GRS pension scheme. The agreement to create the regional water system was announced on September 9, 2014, after mediation before Judge Rosen. This arrangement has since been implemented.

**Creation of VEBAs to Provide Health and Related Care to City Pensioners**

The Plan incorporated a settlement with the GRS retirees and retired policemen and firefighters that provided for the establishment of separate Voluntary Benefit Beneficiary Associations (“VEBAs”), which are special purpose vehicles recognized by United States tax law, to provide health and other employee benefits to these retirees once the Plan became effective. Upon the Plan’s effective date, the City would be obligated to transfer $218 million in new B Notes to the GRS VEBA. In addition, $232 million in these same notes to the PFRS VEBA would be issued after confirmation in satisfaction of the OEPB Claims in Class 12.

**Execution of New Collective Bargaining Agreements with City’s Unions**

As part of the City’s negotiations with creditor groups for approval of the Grand Bargain, the City negotiated with its unions over terms of new collective bargaining agreements (“CBAs”) for city employees. Unions receiving new CBAs include the Detroit Police Officers Association, the Detroit Fire Fighters Association, the United Auto Workers and the American Federation of State, City and Municipal Employees.

**Establishment of Exit Financing Facility**

The Plan requested approval of a $325 million exit financing facility to be obtained from the sale of taxable bonds by Barclays Plc. The proceeds of this financing would be used to repay the balance due on debtor-in-possession financing established by Barclays’ earlier in the case ($120 million), to pay the balance due the SWAP participants holding Class 5 claims that was the subject of an earlier settlement approved by the Bankruptcy Court, and to repay the remaining sums due LGTO bondholders under the LGTO settlement described above. The balance remaining under the financing after these payments are made would then be available to finance the cost of “Restructuring and Reinvestment Initiatives” contemplated by the Plan and described below.
Commitment to Restructuring and Reinvestment Initiatives

The Plan provides for $1.7 billion of “restructuring and reinvestment initiatives” (“RRI”) to fix the broken infrastructure of City government and services and to clear urban blight. Evidence submitted to the Bankruptcy Court during the Chapter 9 case established that necessary equipment for city services, e.g., ambulances, police cars and fire trucks, are in dire need of repair and replacement. The City’s Chief Information Officer testified during the confirmation hearings that the municipal computer systems were “beyond fundamentally broken”—the antiquated desktop computers often took 10 minutes to start and the basic software was “generations behind.”25 The City’s primary restructuring advisor, Charles Moore of Conway MacKenzie, at the same hearing testified that in one fire station that he visited, an empty soda can was placed in front of the fax machine and, when an incoming fax was received and knocked the can onto the floor, the employees would know to check the machine.26

The City plans to spend $80 million for new information technology by June 30, 2023. Other RRI monies will be expended to demolish more than 80,000 vacant buildings, most of which are located in 132 square miles of blighted City neighborhoods.27 Moore also testified at the confirmation hearing that the RRI are expected to increase city revenue by $483 million and cut operating costs by $358 million by mid-2023.28 The Plan, however, does not describe the future size and shape of the City. The City’s infrastructure was constructed anticipating a population of more than the 688,000 residents of today; the City’s population has shrunk to this figure from a high-tide mark of 1.8 million residents in 1950. Obvious questions not addressed by the Plan include (i) to what use or uses should the large areas of now-empty land be put, and (ii) should the City shrink its boundaries to a more manageable and cost-efficient size. Presumably, these questions were intentionally avoided by the Plan drafters.

and are being left for later consideration by the politicians in charge of City
government post-confirmation.

EVENTS BETWEEN ANNOUNCEMENT OF VOTE TALLY AND
CONFIRMATION OF PLAN

Announcement of Results of Voting on the Fourth Amended Plan

On July 21, 2014, the claims, noticing and balloting agent appointed in the
Chapter 9 case filed its Declaration announcing the results of voting on the
Fourth Amended Plan. As mentioned above, the critical Class 10 and 11
creditors voted to accept the Plan in light of the Grand Bargain and Classes 7
(LGTO bondholders), 9 (COPS), 14 (General Unsecured) and 15
(Convenience) voted to reject the Plan. The agent could not determine, based
on the ballots received, whether Class 1A (holders of certain Detroit Water and
Sewer bonds) had accepted or rejected the Fourth Amended Plan.29

Syncora and FGIC Opposition to Plan Confirmation and Subsequent
Settlements

As previously described, Syncora and FGIC, whose claims totaled approxi-
mately $1.4 billion arising from the challenged COPS transactions, were
confronted with plan treatment that would result in a return estimated to be
only 10–13 percent. Consequently, both bond insurers (especially Syncora, who
quickly earned the media’s moniker of being “Detroit’s No. 1 opponent”)
turned up the heat significantly after the vote was announced. In a pleading
filed by Syncora on August 12, 2014, Syncora made spectacular charges of
“naked favoritism” against the chief mediator, District Judge Gerald Rosen, and
another member of the mediation team, Eugene Driker, a highly respected
Detroit lawyer whose wife had been a long-time trustee of the DIA and was
then serving in an emeritus role. In this pleading, Syncora alleged that Judge
Rosen and Driker had “acted improperly by orchestrating a settlement that
alienates the city’s most valuable assets [i.e., the retention of the DIA’s art
collection via the Grand Bargain] for the sole benefit of one creditor group [the
City’s pensioners].”30 After a hearing on the City’s motion to strike these
allegations from the court record was held on August 25, 2014, Bankruptcy
Judge Rhodes found that Syncora’s allegations of mediator bias were “scandal-
ous and defamatory” and that the “highly personal attack” on Judge Rosen was

29 See supra.
30 “Detroit bankruptcy judge may consider sanctions for Syncora attorneys,” Detroit Free
factually unwarranted, unprofessional and unjust. In addition, Rhodes directed Syncora to show cause why it and its counsel, Kirkland & Ellis, should not be sanctioned over the statements in Syncora’s pleading.31

On August 26, 2014, Judge Rosen ordered Syncora, FGIC and other hold-out creditors into mediation only one week before the start of the hearing on confirmation of the Plan.32 Against the background of the dispute over Syncora’s “scandalous” assertions regarding mediation and the confirmation hearing, the City and Syncora quickly settled their differences. On September 9, 2014, Syncora and the City announced that they had reached an “agreement in principle” to resolve Syncora’s confirmation objections and both parties asked the Bankruptcy Court to suspend the confirmation hearing to permit them to resolve all issues. The settlement agreement ultimately signed by the parties was thereafter incorporated into the Plan for approval by the Bankruptcy Court. In brief, the settlement provided that Syncora would receive (i) $23.5 million in New B Notes issued under the Plan, (ii) $21.3 million in New C Notes, (iii) $6.25 million in Class 9 settlement credits, and (iv) an additional $5 million in cash. The City would assume an existing lease of a portion of the Detroit-Windsor automobile tunnel with a Syncora subsidiary and this lease would be extended for an additional 20 years until 2040. The revenue generated by a parking garage in Grand Circus Park would be transferred to Syncora pursuant to a 30-year concession of that facility. In addition, the City granted a five-year option to a Syncora subsidiary to purchase as many as six downtown lots owned by the City. This settlement agreement was thereupon incorporated into the Plan. The estimated recovery by Syncora under the settlement was estimated by the City at 13 percent of its Class 9 claim.

As anticipated by many observers, FGIC thereafter announced its own settlement with the City. The provisions of this settlement agreement provided that FGIC will receive (i) $74.2 million in New B Notes, (ii) $67.2 in New C Notes, and (iii) $19.75 million in Class 9 settlement credits on account of its Class 9 claim. In addition, the City will enter into a development agreement with FGIC concerning the Joe Louis Arena site for the construction a residential, office and retail project. With respect to the FGIC’s swap claim, it


will be treated as an unsecured claim in Class 14 and will receive from the Detroit Development Authority ("DDA"), a creditor holding a $33 million claim against the City placed in Class 13 of the Plan, the DDA's rights to distributions under the New B Notes to be issued under the Plan. This settlement agreement was also incorporated into the Plan and will provide to FGIC an estimated 13 percent recovery on its claims against the City.

**Changes to City's Governance**

On November 5, 2013, Michael Duggan, the former head of the Detroit Medical Center, was elected Mayor of the City by a 55 percent vote and was sworn in on January 1, 2014. Duggan, however, had little, if any, power in this position until Kevyn Orr's term as Emergency Manager of the City came to an end on September 28, 2014. Three days before, the Detroit City Council approved a resolution to retain Kevyn Orr for the purpose of "successfully achieving confirmation and implementation" of Detroit's Chapter 9 plan. In early October, 2014, Duggan testified during the confirmation hearing that he had successfully "recruited top municipal and corporate executives from New York to Kentucky" to run the City once it emerges from bankruptcy.

**Enactment of State Legislation to Fund the Grand Bargain and Create a Financial Oversight**

On June 20, 2014, Michigan Governor Rick Snyder signed into law a package of State legislation to fund the state's $195 million portion of the Grand Bargain. This legislation included a requirement that a nine-member financial oversight panel will be created to monitor Detroit's financial performance under a confirmed Plan to insure that the City retains a qualified chief financial officer who will submit four-year financial plans (the "Oversight Panel"). The Oversight Panel will remain in place until the City satisfies certain financial thresholds established in the legislation.

**ANNOUNCEMENT OF DECISION CONFIRMING THE PLAN**

On November 7, 2014, after the conclusion of the hearing on confirmation of the City’s Eighth Amended Plan of Debt Adjustment, Bankruptcy Judge Rhodes announced his decision from the bench. After he read his decision into

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the record, the Bankruptcy Court Clerk released the transcript of the opinion confirming the City’s Plan.35

Approval of Settlements and Exit Financing

After reviewing each settlement in detail, Judge Rhodes first approved all of the settlements incorporated into the Plan as “reasonable.” These settlements include (i) the Grand Bargain, which incorporated the “State Contribution Agreement” that transfers $195 million to the City to fund payments to City retirees on their pension claims; (ii) the “DIA Settlement” that encompasses the $366 million contributed by corporate donors and $100 million of other contributions solicited by the DIA; and (iii) the Pension Settlement itself. Other settlements approved by the court were the LGTO Settlement, the Syncora and FGIC Settlements and the OPEB Settlement involving the claims in Class 12 and the creation of the two VEBAs to provide future health care and other retiree benefits to members of this class. In addition, Judge Rhodes approved the City's request to approve $325 million in exit financing available to the City upon the effective date of the Plan. Judge Rhodes found that the terms of the financing were reasonable and that the lender, Barclays, was providing this credit facility in “good faith.”

Determination That the City Proposed the Plan in “Good Faith”

Section 1129(a)(3) of the Bankruptcy Code, which requires a finding that a plan has been proposed in “good faith” as a precondition to its confirmation, is specifically incorporated into Chapter 9 by Section 901 of the Bankruptcy Code. Upon reviewing the evidence introduced at the confirmation hearing, Judge Rhodes held that this confirmation requirement had been satisfied by the City. The Court found that the City had drafted and proposed the Plan for the purpose of adjusting the City’s debt and to provide adequate municipal services to its residents and that the City had filed the Plan “with honesty, good intentions and with the reasonable expectation that the plan is feasible.”

Determination That the Plan Is in the Best Interests of Creditors

Section 943(7) of the Bankruptcy Code requires that, in order for a Chapter 9 plan to be confirmed, it must be “in the best interests of creditors.” Because a municipality’s assets in a Chapter 9 case cannot be liquidated nor can an alternative plan be proposed by a party in interest in the case, the only alternative to confirmation of a plan of debt adjustment in a Chapter 9 case is its dismissal. Because of this reality, the “best interests” test is unlike the test in

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Chapter 11 cases where the plan must provide treatment of all claims in the reorganization plan that is not less than those creditors would receive in a liquidation of the debtor’s assets. The test, as stated by Judge Rhodes, is whether the creditors will receive under the plan “all that they can reasonably expect under the circumstances.” In other words, is the plan a better alternative to dismissal of the Chapter 9 case? Judge Rhodes noted that a number of creditors had argued that they would be better off if the case were dismissed and the City was required to raise taxes and monetize its assets, especially the DIA’s art collection. He rejected that argument on the grounds that the Bankruptcy Court is prohibited by Section 904 of the Bankruptcy Code from directing the sale of the City’s assets and that the only remedy afforded to City creditors under State law is to force the assessment and imposition of higher property taxes on the City’s property to create a fund for repayment of claims. Thus, the value of the City’s art collection, which was a major point of contention, was irrelevant to the case. Even if the value had been relevant and the City could be forced to sell the DIA collection, this would have been an unwise choice by the City. Because this art is a valuable cultural asset that has value above and beyond its monetary value to present and future city and state residents, the City had made the “right decision” in refusing to sell these items. Consequently, Judge Rhodes found that the “best interests of creditors” test for confirmation under Chapter 9 had been satisfied by the City.

Determination That the Plan Did Not Discriminate Unfairly

Section 1129(b) of the Bankruptcy Code, incorporated into Chapter 9 under Section 901 of the Code, permits the Bankruptcy Court to confirm a Chapter 9 plan over the objection of a dissenting class or classes of creditors if the Court finds that the plan does not discriminate unfairly and is fair and equitable with respect to those classes. Judge Rhodes first stated that the Plan does discriminate: unsecured creditors in Class 7 (LGTO Claims), Class 8 (UGTO Claims) and Class 17 (36th District Court Indirect Claims) will receive under the Plan significantly higher percentages than the members of dissenting Classes 14 (General Unsecured Claims) and 15 (Convenience Claims). This is also likely true for the pension claims in Classes 10 and 11, the beneficiaries of the Grand Bargain. Judge Rhodes characterized his task with respect to this confirmation standard as one of the exercise of a judge’s individual conscience. Is the discrimination against Classes 14 and 15 unfair from that perspective? Judge Rhodes concluded that this discrimination is not unfair. First, with respect to the pension classes and the 36th District Court, for which the City acts as its funding agent, the City had “mission-related investments” with respect to them. The same could not be said for the two dissenting classes. In addition, the creditors in the dissenting classes lacked any reasonable expectation of
recovering a higher percentage of their claims, unlike the pension creditors who had the expectation that their pension claims would be completely protected in the Chapter 9 case due to provisions in the Michigan Constitution discussed above. Finally, Judge Rhodes reasoned that, because the settlements that resulted in higher Plan distributions to certain classes of unsecured claims were determined to be reasonable, then those settlements could not be deemed to have resulted in unfair discrimination with respect to the two dissenting classes.

**Determination That the Plan Is Fair and Equitable**

Section 1129(b) of the Bankruptcy Code permits the Bankruptcy Court to confirm a plan that is deemed to be “fair and equitable” with respect to dissenting classes. Here, Judge Rhodes phrased the issue before him as: should the court force the plan on “unwilling creditors,” i.e., those in Classes 14 and 15. In answering this question in the affirmative, Judge Rhodes focused first on the vote tally of those two classes. In Class 14, composed of general unsecured creditors, the Court recited that 93 votes were cast in favor of the plan and 98 were against. Thus, a switch of only three votes in favor of the Plan would have changed the result. With respect to Class 15, the Convenience Class, a switch of 19 votes from “Reject” to “Accept” would have resulted in a “Yes” vote for that class. In considering the closeness of the vote and the fact that most of the claims rejecting the Plan in both classes amounted to less than $25,000, the Court concluded that, on a “balance of hardships” test, the Plan is “fair and equitable” with respect to Classes 14 and 15, especially when considering that all of the other affected unsecured creditor classes, especially Classes 10 and 11, would suffer greater hardships from a denial of confirmation than those suffered by Classes 14 and 15 as a result of Plan confirmation.

**Determination That the Plan Is Feasible**

Section 943(7) of the Bankruptcy Code requires that, in order for a plan of debt adjustment in a Chapter 9 case to be confirmed, that plan must be “feasible.” In his bench opinion, Judge Rhodes first reviewed the testimony of the Court’s expert witness on feasibility, Martha E.M. Kopacz, given at the confirmation hearing and adopted her standard of feasibility of a Chapter 9 plan: “Is it likely that the City of Detroit, after the confirmation of the Plan of Adjustment, will be able to sustainably provide basic municipal services to the citizens of Detroit to meet the obligations in the Plan without the significant probability of a default.” Judge Rhodes then reviewed her testimony in some detail and agreed with her conclusion that the City’s assumptions underlying the Plan’s projections concerning revenues, expenses and plan payments were “reasonable.” Therefore, the judge concluded that the Plan was indeed feasible. Judge Rhodes nevertheless appealed to City officials, asking them to remain vigilant to insure that the Plan commitments to pensioners continue to be
fulfilled throughout the course of the Plan and to the Governor to appoint experienced and wise persons to the 9-member Oversight Commission.

ENTRY OF CONFIRMATION ORDER AND EFFECTIVE DATE OF PLAN

On November 12, 2014, Judge Rhodes entered in the City’s Chapter 9 case his “Order Confirming Eighth Amended Plan for the Adjustment of Debts of the City of Detroit,” a 225-page document incorporating his analysis contained in the Oral Opinion but in a more detailed and thorough manner (the “Confirmation Order”). Of this Order, 128 pages is the text of Judge Rhodes’ findings and holdings; the remainder of the document consists of the text of the Plan, as confirmed (Appendix 1) and the draft Notice of Confirmation to be served on creditors and published in the Wall Street Journal, USA Today, and the Detroit Free Press (Appendix II). The effective date of the Plan occurred on December 10, 2014. On December 31, 2014, Judge Rhodes released a 219-page Supplemental Opinion Regarding Plan Confirmation, Approving Settlements and Approving Exit Financing.

CONCLUSION

Much like the Chapter 11 cases of General Motors Corporation and Chrysler Corporation in 2009, the City’s Chapter 9 case was resolved in record time: a mere 15 months elapsed between the filing of the City’s Chapter 9 petition on July 18, 2013, and the confirmation of the Plan on November 7, 2014. Much difficult restructuring work involving complex financial instruments had to be done in a very small window of time in order to stop the “death spiral” of a large city in order to reverse decades of financial mismanagement and, in some instances, criminal fraud. Some important precedents were established along the way in this Chapter 9 case, among them the following: (i) retiree pension claims may be reduced in a Chapter 9 plan; and (ii) municipal bond claims that are unsecured obligations of the Chapter 9 debtor may also be impaired in a plan. Just eight days prior to Judge Rhodes’ ruling on confirmation of the City’s Plan, Bankruptcy Judge Christopher Klein in the City of Stockton (California) Chapter 9 case confirmed Stockton’s plan of debt adjustment over the objection of a bond creditor that would receive only a .94 percent distribution on its

36 The Confirmation Order was entered on the docket at Docket No. 8272 in the City’s Chapter 9 case.
37 This Supplemental Opinion was entered on the docket at Docket No. 8993 in the City’s Chapter 9 case.
claims. Although Judge Klein had earlier stated that Stockton could properly seek rejection of its pension plan with Calpers, the city elected not to do so and left the pension plan unaffected by the bankruptcy. These two developments will likely open the door for the filing of similar plans seeking reduction of pension claims and unsecured bond claims in Chapter 9 cases. In addition, these precedents may also increase the frequency of consensual workout agreements involving United States municipalities, now that at least two courts have gone on record regarding the vulnerability of pension and bond claims in Chapter 9 cases. Pension and bond claimants may now be reluctant to “roll the dice” in Chapter 9 cases and may elect to reduce their claims in out-of-court negotiations with financially troubled municipalities.