

The Motor City Faces a Rocky Road in Chapter 9 Bankruptcy

By: Jason W. Bank, Chair of Kerr Russell's Bankruptcy and Restructuring Practice

On the day of his appointment as the City of Detroit's emergency financial manager, Kevyn Orr referred to the herculean task of fixing the city's balance sheet as the "Olympics of Restructuring." In order to earn the gold medal, Mr. Orr has filed the largest Chapter 9 municipal bankruptcy in U.S. history. This article discusses some of the key aspects of Chapter 9 and explores the significant differences between Chapter 9 and Chapter 11 business reorganizations.

Many in the business community are all too familiar with Chapter 11 bankruptcy after the economic strife that the region, and particularly, the auto industry, experienced over the past decade. However, business leaders and professionals in the region have had little or no experience with Chapter 9 proceedings. The only Chapter 9 case filed in the U.S. Bankruptcy Court for the Eastern District of Michigan involved a small community hospital authority.

In order to proceed under Chapter 9, the City of Detroit will first be required to demonstrate that it is "eligible" for Chapter 9 by, among other things, proving that it is insolvent and that it negotiated in good faith with creditors in order to reach agreements outside of bankruptcy. This is a key distinction from Chapter 11, where there is no requirement for a business to prove that it is eligible for Chapter 11 relief at the beginning of a case. There will also be legal challenges over whether Governor Rick Snyder properly authorized Orr to file bankruptcy.

Eligibility is a hotly contested issue in Chapter 9 proceedings, and courts have spent months determining the eligibility issue in other Chapter 9 cases recently filed throughout the country. U.S. Bankruptcy Judge Steven W. Rhodes has authorized the parties to conduct two months of discovery on the eligibility issue. Judge Rhodes has scheduled a trial on whether the City is eligible to proceed in Chapter 9 on October 23, 2013.

Attorneys for the pensions and unions argue that the Bankruptcy Court does not have the authority to trump the Michigan Constitution, which does not permit the impairment of pension benefits for public employees. As a result, these parties assert that the Bankruptcy Court should order that the City is not eligible to file for Chapter 9 where the purpose of the filing is to reduce benefits. It is possible that the Bankruptcy Court will rule that the City of Detroit is eligible to file for Chapter 9 without deciding this critical issue.

Unlike Chapter 11, where court approval over how a business spends its money is often required, Chapter 9 specifically prohibits a bankruptcy court from interfering with any of the political or governmental powers of a municipal debtor or the municipal debtor's use or enjoyment of any income-producing property. Judge Rhodes discussed his Court's limited role in Chapter 9 at an August 2, 2013 status conference. The City of Detroit may continue to pay its bills without obtaining approval from the Court.

Chapter 9 does not prohibit the City from paying debts arising prior to the bankruptcy date to creditors or vendors. Due to the bankruptcy filing, however, creditors and vendors are prohibited from seeking to collect their debts from the city that arose prior to the bankruptcy filing date. However, other actions may be taken to protect their interests and rights. Creditors that continue to work on contracts with the City may file motions with the Bankruptcy Court to compel performance under the contract or compel the City to reject the contract.

Chapter 9 permits rejection (i.e., termination) of collective bargaining agreements. In Chapter 11 business reorganizations, a business may only reject or modify a CBA after satisfying exhaustive statutory requirements relating to negotiations with the bargaining unit. There are no similar requirements under Chapter 9 of the Bankruptcy Code.

A municipality emerges from Chapter 9 when it files a plan of adjustment, which permits the municipality to discharge pre-bankruptcy filing debts and obligations and emerge from Chapter 9 with reduced liabilities. This is similar to the plan of reorganization that is filed in Chapter 11 cases.

A significant battle may take place in a Chapter 9 proceeding over whether creditors may insist on the city selling certain assets, including assets of the Detroit Institute of Arts, in order to maximize the return to creditors. Sales of assets have become standard operating procedure in Chapter 11, but it is unlikely that the Bankruptcy Court has the authority to order a sale of assets in Chapter 9. However, creditors may insist on a sale of certain assets in connection with negotiations over the plan of adjustment.

Due to the large number of recent Chapter 11 filings, a "playbook" has been developed for Chapter 11 business proceedings, and there are numerous court decisions upon which businesses and creditors may rely in making decisions on how to proceed with troubled credits. No playbook has been developed in Chapter 9, meaning the City of Detroit and its creditors will be writing new chapters of the book as they travel through the uncharted waters of the largest municipal bankruptcy filing in U.S. history.