

# THE LEGAL REPORT

Aaron L. Castle

VanOverbeke, Michaud & Timmony, P.C.

## MUNICIPAL BANKRUPTCY IN MICHIGAN Mapping the Uncharted Waters

How many different words can you think of using the letters in the word “BANKRUPTCY”? In light of the City of Detroit’s recent Chapter 9 bankruptcy filing three words in particular come to mind: (1) BANKs; (2) RUPTured; and (3) CitY. Ok, so I added a few letters here and there, but you get the idea.

Bankruptcy in the United States is authorized under Article 1, Section 8, Clause 4 of the United States Constitution which provides that Congress shall have power to establish “uniform Laws on the subject of Bankruptcies throughout the United States.” Pursuant to this authority, Congress has enacted Title 11 of the United States Code, as amended (the “Bankruptcy Code”).<sup>1</sup>

Chapter 9 of the Bankruptcy Code<sup>2</sup> (“Chapter 9”) governs the filing of a petition for bankruptcy protection on behalf of a municipality. On July 18, 2013, the City of Detroit (the “City”) became the first municipality in the State of Michigan to file for Chapter 9 bankruptcy protection. It also became the largest municipality (in terms of debt) in the history of the United States to seek such protections under Chapter 9.

Chapter 9 is far and away the least invoked Chapter of the Bankruptcy Code. Since January of 2010, this writer is aware of only thirty-six total filings under Chapter 9 of the Bankruptcy Code (compared to 10,597 Chapter 11 filings in the fiscal year 2012 alone).<sup>3</sup> Of the thirty-six Chapter 9 filings since 2010, only eight have been filed by local government municipalities, three of which were preliminarily dismissed by the bankruptcy courts. Accordingly, it goes without saying that the Chapter 9 bankruptcy process is not well-established and understood when compared to other areas of bankruptcy under the law (i.e., Chapter 7, Chapter 11, Chapter 13).

### The Chapter 9 Case

There are a number of prerequisites that must be satisfied before a municipality can obtain Chapter 9 protection.<sup>4</sup> First, the filing of a petition for Chapter 9 bankruptcy must be authorized under state law. In Michigan, Chapter 9 filings are authorized under the Local Financial Stability and Choice Act.<sup>5</sup> Specifically, Section 18 of the local financial stability and choice act<sup>6</sup> authorizes an emergency manager to proceed under Chapter 9 upon approval from the governor.

Second, the municipality must be “insolvent” as defined in the Bankruptcy Code.<sup>7</sup> With respect to a municipality, the term “insolvent” means that the municipality’s financial condition is such that the municipality is unable to pay its undisputed debts as they become due, or will be unable to pay such debts as they become due.<sup>8</sup>

Third, the municipality must provide evidence that its filing was made in good faith by showing that it attempted to avoid the filing or that the filing was unavoidable as follows:

- 1) It has obtained the agreement of a majority (in amount of outstanding debt) of its creditors holding claims that will be impaired under a Chapter 9 plan of adjustment; or
- 2) It has negotiated in good faith with its creditors and has been unable to reach an agreement; or
- 3) Negotiations are impracticable due to the number of claimants; or
- 4) A creditor is attempting to gain a preference over the municipality’s other creditors.<sup>9</sup>

A municipality provides evidence that it has satisfied the aforementioned prerequisites by submitting a number of pleadings and declarations with its Chapter 9 petition. For example, a Chapter 9 petition must also include a general list of its creditors which includes all individuals and entities that may assert a claim against the bankruptcy.<sup>10</sup> Furthermore, the municipality must file a more detailed list of its creditors holding the 20 largest unsecured claims, including the requirement that contact information is provided. In the City of Detroit’s Chapter 9 filing, its two largest unsecured creditors are the General Retirement System of the City of Detroit and the Police and Fire Retirement System of the City of Detroit. The municipality’s creditors may challenge its claims of eligibility by submitting written objections to the bankruptcy court.

Immediately upon the filing of a Chapter 9 petition, active and pending litigation (subject to certain exceptions) against the debtor as well as its officers and employees is automatically stayed from further proceedings until the resolution of the Chapter 9 case. The stay continues in effect throughout the duration of the Chapter 9 case, although a claimant may seek permission from the bankruptcy court to terminate or modify the stay.

After receipt of the Chapter 9 petition, accompanying pleadings and declarations, and all objections thereto, the bankruptcy court will decide whether the municipality is eligible to proceed as a Chapter 9 debtor. If the court determines that the municipality has met the requirements for Chapter 9 bankruptcy protection, it will issue an Order for Relief under Chapter 9.<sup>11</sup> Following issuance of the Order for Relief, the United States Trustee may appoint a committee or committees to represent the interests of creditors holding similar classes of claims.<sup>12</sup> Committees serve and speak for all similarly situated creditors, and the members of and professionals employed by a committee have a duty to act

in the best interests of the class of creditors they represent.<sup>13</sup> In the City of Detroit Chapter 9 case, the Court has already approved the establishment of a committee to represent the interests of the City's retirees.

The ultimate reason behind a municipality filing for Chapter 9 bankruptcy is to allow the municipality to confirm a plan of adjustment that restructures its debt. Similar to a Chapter 11 plan of reorganization, a Chapter 9 plan of adjustment is essentially an agreement between the municipality and its creditors for the "adjustment" of pre-bankruptcy debts and obligations with new contractual terms and considerations. A Chapter 9 plan of adjustment must be "confirmed" by a municipality's creditors and the bankruptcy court. The following requirements must be satisfied for confirmation of a plan of adjustment under Chapter 9:

- 1) The plan must comply with all applicable provisions of the Bankruptcy Code;
- 2) All amounts to be paid by the debtor for services and expenses in connection with the case (i.e., legal fees) are fully disclosed and are reasonable;
- 3) The municipality is not prohibited by any law from taking any action necessary to carry out the plan;
- 4) The plan must provide for the payment of administrative expenses under section 507(a)(2) of the Bankruptcy Code;
- 5) Any regulatory and/or electoral approval necessary to consummate the plan has been obtained; or such provisions of the plan are conditioned of the requisite approval; and
- 6) The plan is feasible and is in the best interests of the creditors.<sup>14</sup>

Creditors who hold impaired claims under a Chapter 9 plan of adjustment may object to confirmation of the plan. However, a bankruptcy court may confirm a Chapter 9 plan of adjustment over the objection of creditors if at least one impaired class of creditors has accepted the plan and it determines that all other requirements of the Bankruptcy Code have been satisfied.<sup>15</sup> Upon confirmation, a municipality and all of its creditors, including those that voted to reject the plan, are legally bound by the terms of the plan of adjustment.

### **The Role of the Bankruptcy Court**

A common misconception about Chapter 9 bankruptcy is the role of the bankruptcy court over the operations of the municipality. In Chapter 11 bankruptcy cases the bankruptcy judge has significant authority over the debtor's actions throughout the course of the case. However, in Chapter 9 cases, the Tenth Amendment to the United States Constitution prohibits the court from taking over control of the municipality. Rather, the court's role under Chapter 9 is better described as an overseer that must be consulted with regard to the actions of the debtor as they relate to its creditors.

The primary responsibilities of a bankruptcy judge in a Chapter 9 case are as follows:

- 1) To determine the municipality's eligibility to file the Chapter 9 bankruptcy petition;
- 2) To oversee the assumption or rejection of executory contracts and unexpired leases;
- 3) To decide avoidable transfer actions; and
- 4) To confirm or decline to confirm the municipality's plan of adjustment.

Despite this limited role, the judge in a Chapter 9 case can be very helpful in his or her role as a neutral arbiter of difficult disputes and bringing the parties to a point where a plan of adjustment can be approved. Furthermore, the bankruptcy judge in a Chapter 9 case is often asked to rule on the rejection of executory contracts and the impact of state law that is contrary to the provisions of the Bankruptcy Code.

### **The Impact of Chapter 9 on Public Pensions**

The United States Supreme Court has held that collective bargaining agreements ("CBAs") are executory contracts subject to rejection under Section 365 of the Bankruptcy Code.<sup>16</sup> Several challenges to this ruling have been raised in the Chapter 9 context. For example, the City of Vallejo, California sought to reject certain CBAs in conjunction with its Chapter 9 filing.<sup>17</sup> The affected unions objected under a California state law that limited a municipality's ability to avoid its contractual obligations under a CBA, arguing that such laws needed to be applied to the city's efforts in its Chapter 9 case. The *Vallejo* court concluded that pursuant to the Supremacy Clause of the United States Constitution (Art. VI, Clause 2), the Bankruptcy Code preempted California labor laws with respect to rejection of the CBAs in question.<sup>18</sup> The *Vallejo* court stated that "by authorizing the use of Chapter 9 by its municipalities, California must accept Chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest."<sup>19</sup> Relying on the Supreme Court's *Bildisco* opinion, the *Vallejo* court ultimately determined that a municipality may reject an unexpired CBA by meeting the three requirements set out in *Bildisco*: (1) the CBA burdens the municipality's ability to reorganize; (2) after careful scrutiny, the equities balance in favor of contract rejection; and (3) reasonable efforts to negotiate a voluntary modification of the CBA were made, and are not likely to result in a timely and satisfactory resolution.<sup>20</sup> Subsequent Chapter 9 bankruptcy opinions are consistent with the *Vallejo* holding.<sup>21</sup>

In light of the foregoing opinions it is not unreasonable to conclude that municipalities in Chapter 9 bankruptcy have the option to restructure future and existing pension obligations. In fact, the City of Central Falls, Rhode Island recently approved a Chapter 9 plan of adjustment that will ensure that the city will repay its bondholders in full by increasing taxes and reducing pensions and other employee benefits.<sup>22</sup> The Central Falls plan imposes a four percent (4%) property tax increase for the next five years and cuts pensions by up to fifty-five percent

(55%) for workers who retired the youngest.<sup>23</sup> The decision to give the bondholders preference was controversial, especially when compared to other municipalities that have emerged from Chapter 9 bankruptcy without reducing pensions (e.g., Vallejo, California and Jefferson County, Alabama).

In Michigan, public pensions are protected from diminishment or impairment by Article IX, Section 24 of the state constitution. A federal bankruptcy court has yet to address the impact that such a provision may have on a municipality's ability to restructure pensions under Chapter 9. However, existing case law (particularly the *Vallejo* and *Stockton* opinions) suggests that the constitutional protections afforded to public pensions in Michigan (i.e., Article IX, Section 24) may be overruled by the Bankruptcy Code.

All indications from the City of Detroit's Chapter 9 case indicate that pensions are in the crosshairs. As expected, this has certainly proven to be a controversial approach with the City's retirees and beneficiaries. Furthermore, this approach seems to imply that the retirees are the cause of the City's financial condition. In any case, a municipality's debt restructuring and plan of adjustment under Chapter 9 is not required to take into account the underlying causes of the economic distress. Accordingly, pensions are likely to remain a topic of conversation as the City goes through the Chapter 9 process.

At the end of the day, the decision to restructure existing pension obligations under Chapter 9 of the Bankruptcy Code is a choice that must be made by the municipality. In Michigan the legality of such a choice is yet to be determined. However, I personally believe that the potential reduction of pensions under the City's Chapter 9 filing should not be a question of economics or legality, but a question of fairness. Whether fairness will prevail is yet to be seen.

Important Note: This summary is intended to be informational only and this article is intended to provide a general overview of the subject matter covered. This information should not be considered the rendering of legal or other professional services and should not be used as a substitute for consultation with professional advisers.

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<sup>1</sup> 11 U.S.C. § 101 *et seq.*

<sup>2</sup> 11 U.S.C. §§ 901-946.

<sup>3</sup> The Third Branch News, *Bankruptcy Filings Down in Fiscal Year 2012*, (November 7, 2012), <http://news.uscourts.gov/bankruptcy-filings-down-fiscal-year-2012>.

<sup>4</sup> See, 11 U.S.C. § 109(c).

<sup>5</sup> MCL § 141.1541 *et seq.*

<sup>6</sup> MCL § 141.1558.

<sup>7</sup> 11 U.S.C. § 109(c)(3).

<sup>8</sup> 11 U.S.C. § 101(32)(c).

<sup>9</sup> 11 U.S.C. § 109(c)(5).

<sup>10</sup> 11 U.S.C. § 924.

<sup>11</sup> 11 U.S.C. § 921(d).

<sup>12</sup> 11 U.S.C. § 1102.

<sup>13</sup> 11 U.S.C. § 1103.

<sup>14</sup> 11 U.S.C. § 943(b).

<sup>15</sup> 11 U.S.C. §§ 943(b); 1129(b).

<sup>16</sup> *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 526 (1984).

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<sup>17</sup> See, *In re City of Vallejo*, 403 B.R. 72, 75 (Bankr. E.D. Cal. 2009).

<sup>18</sup> *Id.*, at 77.

<sup>19</sup> *Id.*, at 76, citing *In re County of Orange*, 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996).

<sup>20</sup> *Id.*, at 78, quoting *Bildisco*, 465 U.S. at 526.

<sup>21</sup> See, *In re City of Stockton*, 478 B.R. 8 (Bankr. E.D. Cal. 2012) (holding that city's unilateral reduction of retiree health benefits payments was authorized under the Bankruptcy Code which trumps the contracts clause of the California state constitution); *In re City of Central Falls*, 2011 Bankr. LEXIS 5432 (Bankr. R.I., 2011).

<sup>22</sup> Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. Times, Sept. 6, 2012.

<sup>23</sup> *Id.*