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BDA Bankruptcy Paper: Detroit May Be "Game Changer."

Detroit's filing under Chapter 9 of the federal bankruptcy code may be "a game changer" that resolves controversial issues that have not been dealt with in prior cases, according to a nine-page paper on muni defaults and bankruptcy released on Thursday by Bond Dealers of America.

The Detroit proceeding may answer the question of whether a municipality can use Chapter 9 to cut accrued pension rights that are protected by a state constitution, said the paper, which was prepared for BDA by Nixon Peabody, LLP. Michigan's Constitution states such rights "shall not be diminished or impaired."

The case also is expected to address how the bankruptcy laws treat a general obligation bond in contrast to other debts, whether secured or unsecured, and what a pledge of full faith and credit actually means when the issuer goes bankrupt. Detroit's emergency manager Kevyn Orr has recommended the city's GOs be treated as unsecured debt.

Jefferson County, Ala.'s Chapter 9 case helped clarify the rights of holders of special revenue debt, but there is no significant body of case law on GO bonds backed by the full faith and credit of a municipality, according to the paper.

These issues are at the heart of Detroit's bankruptcy filing because the city does not appear to have enough revenues to fully pay its accrued pension and GO bond debts.

The BDA paper provides a primer on Chapter 9, how it differs from Chapter 11 for business bankruptcy cases, and what issues recent Chapter 9 cases have shed light on, with the goal of "provid[ing] context for the upcoming battle" in Detroit between its unions, retirees, GO bondholders and the ongoing needs of taxpayers for essential services.

In a trial on whether Detroit is eligible to Chapter 9 bankruptcy protection, that is scheduled to begin on Oct. 23, the city will have to address two concerns. First it will have to meet a good faith standard and prove that it negotiated in good faith with its creditors prior to its petition, or explain why it was impracticable to do so. Second it will have to beat back challenges to its attempt to adjust pension and other retiree benefits since the state constitution prohibits the diminishment or impairment of these benefits.

The paper recommends that investors, before buying a municipal security, examine the bond documents, state law, and bankruptcy law to determine what will happen to its investment if the issuer does not pay its obligations when they become due.

It even suggests issuers and other transaction participants consider disclosing to bondholders some the risks associated with Chapter 9 filings such as: whether the issuer authorized by its state to file under Chapter 9; whether the bonds will be treated as secured or unsecured if a bankruptcy case is filed; what the collateral is for bonds considered to be secured; and whether bonds are special revenue bonds as defined by Chapter 9.

However, the paper also warns that Chapter 9, “suffers from limited judicial guidance resulting from a paucity of …. cases, thereby making hazardous any predictions as to how a bankruptcy court will rule on an issue arising in a Chapter 9 case.” It also notes that state laws change over time.

A municipality can only file for bankruptcy under Chapter 9 if its state authorizes it to do so, according to the paper. Several Chapter 9 cases have been dismissed for lack of specific state authorization including those filed by Harrisburg, Pa. and Suffolk Regional Off-Track Betting Corp.

States have taken four different approaches to the authorization requirement, the paper said.

Georgia law prohibits its municipalities from filing a Chapter 9 petition. At least 21 states, such as Wisconsin, Tennessee and Virginia, as well as the District of Columbia, have no laws specifically authorizing Chapter 9 filings. Many states, such as Colorado and Kentucky, have laws authorizing Chapter 9 petitions, but may restrict which municipal entities can file them. Other states impose conditions on municipalities that want to file a Chapter 9 petition.

Michigan falls into this latter category, imposing a rigorous process of increasing state supervision of the city with the ultimate step of a state receiver filing a petition on its own initiative or with the approval of a specified state executive. California, which also falls into this category, requires a municipality to either engage in a 60-day mediation process or certify that an emergency exists that does not allow time for mediation, before a filing can be authorized.

Chapter 9 provides municipalities with restructuring tools that are not available to them under state law, the paper said. It provides an automatic stay on all litigation against the city. Pending lawsuits are frozen in place and cannot proceed without permission from the bankruptcy court. Efforts to obtain property from the city also are stayed. This gives the city time to gather its resources and devise a plan to address its debts.

A Chapter 9 filing requires creditors or those in possession of city property turn it back to the city. It also permits a city to bypass state law and reject onerous contracts or leases. The city, for example, may avoid moving into a new building it cannot afford it or may get out of employment contracts considered too rich to continue.

Chapter 9 also allows a city to propose a plan of adjustment that includes a restructuring of debt and force all bondholders to adhere to that plan, once it has consent from only a majority of them, even though bond documents may require the consent of all bondholders for a restructuring of the debt.

Because state law requirements must be met before a city files a Chapter 9 petition, the eligibility process may involve months of arguments and hearings, the paper said.

In addition, in virtually every Chapter 9 filing thus far, “issues are presented to bankruptcy courts on which there is limited or no precedent to look for guidance,” the BDA paper said.

Detroit’s Chapter 9 petition will likely plow new ground for both municipalities and bondholders, it said.

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