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Jones Day: Nine Lessons From Detroit's Chapter 9 Case.

On November 7, 2014, Judge Steven Rhodes, the judge presiding over the City of Detroit's bankruptcy case, announced that he would confirm the City's proposed Plan of Adjustment (the "Plan"), including the creditor settlements contained within that Plan. A more detailed written opinion will follow, but the opinion read from the bench on November 7, together with an earlier opinion in this case, are among the most important precedents in U.S. municipal bankruptcy law. Indeed, the City's bankruptcy proceedings more generally—the significant reduction of both bond and pension and retiree health debt, the speed with which the City emerged from bankruptcy, and the largely consensual nature of the Plan—make clear that municipal bankruptcy law can be successfully used to restructure debt and provide a fresh start to cities, counties, towns, school districts, and other general-purpose municipalities.

The Plan that Judge Rhodes confirmed is itself noteworthy. It eliminates more than $7 billion of Detroit's debt and other legacy liabilities and defers repayment of the principal of most of the remaining unsecured debt for at least nine years. Apart from reducing the City's debt load, the plan makes about $1.7 billion available over the next 10 years for restructuring and reinvestment initiatives to address blight, restore the City's infrastructure, and enable the City to improve the services it delivers to residents, especially those promoting public safety. That a Plan of Adjustment with these features was even proposed is a radical departure from what has been the norm in municipal restructurings. Most of the time, municipal restructurings involve modest, if any, adjustments to debt, with austerity measures imposed on the debtor municipality after years of chapter 9 litigation. Here, the City's Plan of Adjustment was proposed, ultimately accepted by almost all classes of creditors, and judicially approved in less than 17 months from the date of the City's chapter 9 filing. That is nothing short of remarkable.

The agreements embodied in the City's Plan of Adjustment, as well as Judge Rhodes's rulings, thus provide several important lessons for investors, municipal and state leaders, and public-sector labor unions.

1. Unsecured creditors have more limited rights against governmental borrowers than against corporate ones. For example, municipal unsecured creditors usually cannot attach, levy against, or otherwise compel the sale of assets of a municipality, whether such assets are characterized as core or not. Frequently, municipal unsecured creditors can collect only out of the municipality's excess cash (unlikely to be available when a municipality is in distress) or the proceeds of increased taxes (if taxes can be increased without further damaging the municipality's ability to retain residents and businesses). Judge Rhodes determined that the commencement of a chapter 9 case does not expand these rights.

2. General obligation ("GO") bonds, usually regarded as the safest type of municipal bonds, are not immune from impairment in a chapter 9 bankruptcy. While GO bonds often are said to be "secured" or backed by a "pledge" of the taxing power of the municipality, these bonds are not necessarily actually secured by collateral. Instead, in municipal finance, these terms may mean only that the issuer has promised to pay the bonds out of a specified revenue stream and that it will raise taxes to do so if necessary. Judge Rhodes noted that the question of whether one type of GO bond represented a secured claim that is enforceable in bankruptcy was a “coin toss.” As to a second type of GO bond, his opinion suggests that there was an approximately 75 percent probability that it would be regarded as unsecured and that the settlement that resulted in a 41 percent distribution to holders of such bonds was at the high end of the range of reasonableness.

3. Where a municipality cannot provide essential services, the municipality’s need to do so may well come before the interests of GO bondholders and other creditors. If there are real constraints on raising taxes—for example, if tax delinquency rates are already high or the municipality will suffer further decline by raising taxes—bankruptcy courts will not require the municipality to increase taxes. In other words, all creditors, including GO bondholders, are exposed to risk if the municipality cannot provide adequate services to its residents and its tax base is stressed.

4. Municipal bonds often do not include certain protections that are becoming standard in corporate debt instruments, subjecting municipal bondholders to avoidable risks. In Detroit, holders and insurers of municipal bonds secured by special revenues were seemingly surprised to learn that bankruptcy courts may well have the power to reset bond interest rates if the rates are above market levels when a plan is considered for confirmation. This has been the law in corporate bankruptcy for at least 35 years, and corporate debt documents have evolved to include “make whole” provisions that, when properly drafted, may substantially protect bond holders from interest rate reductions. Not one of the City’s debt documents included these provisions. Few municipal bonds do.

5. State-law limits on a municipality’s ability to issue and collateralize debt are important, and the legality of debt instruments designed to circumvent such limits is highly questionable. In Detroit, some lenders had accepted obligations that were structured to avoid the City’s debt limits. Ordinarily, legal opinions protect investors from this kind of risk, but in appropriate cases, the opinions can successfully be challenged. As a result, holders of some obligations face the real possibility that their claims might not be enforceable at all.

6. State constitutional protections for accrued pensions, like protections against the impairment of contracts more generally, give way to federal bankruptcy power. As a result, accrued but unfunded pensions are likely not immune from impairment by a federal bankruptcy judge. In perhaps the most widely reported decision in the City’s case, Judge Rhodes held that the Michigan Constitution’s Pensions Clause, which provides that accrued pension benefits are “contractual obligations” that cannot be “diminished or impaired” by the state or its political subdivisions, stood as no obstacle to the impairment of pension claims in chapter 9. That Clause, Judge Rhodes held, merely conferred contractual status on pension claims, and the bankruptcy court’s power to impair municipal contracts is well-established—indeed, municipal bankruptcy would be worthless without it. In Stockton’s bankruptcy case, Judge Klein recently reached the same conclusion with respect to similar protections under California law.

7. In the face of unsustainable pension obligations, the emotional, hot-button issue of pension cuts can be consensually resolved with shared sacrifice. Struggling municipalities often are confronted with large pension obligations. Faced with shrinking tax bases and increasing life expectancies, not to mention cost-of-living adjustments and other promises that may have been unrealistic evenwhen made, many municipalities face unfunded pension obligations that cannot be satisfied. The decisions by Judge Rhodes make clear that these obligations can be reduced to realistically fundable levels and that these reductions can be achieved through agreement with retiree interest groups. In Detroit, the agreements also established hybrid pension plans to deliver future pensions for active employees. Such arrangements combined elements of defined benefit and defined contribution programs, and they may be a blueprint for pension reform in other distressed municipalities.

8. Customary funding assumptions for public pension plans may well be unrealistic. As the City's pension expert testified, U.S. public pension plans historically have had "a policy that essentially believes that investment gains [are] permanent and losses [are] temporary." Government and labor leaders, and their pension trustee appointees, need to eschew these "bet on the come" assumptions in favor of more conservative funding and investment approaches. Indeed, in his oral opinion, Judge Rhodes expressly embraced the importance of labor leadership bargaining for appropriate funding of pension benefits, and he admonished labor unions, the City of Detroit, and the State to employ more "honest and realistic accounting and actuarial" assumptions for both pension funding and liability disclosure. Negotiating for ever-increasing pension benefits and assuming that they will ultimately be funded may no longer be an appropriate bargaining strategy.

9. Differences in treatment of unsecured creditors does not necessarily lead to a finding of "unfair discrimination." As Judge Rhodes saw it, the recovery for a class of unsecured pension claims was estimated at as much as 60 percent while the recovery for another class of unsecured creditors was estimated at 13 percent. To Judge Rhodes, this was not unfair discrimination for several reasons: the City had a "strong interest in preserving its relationships with its employees and in enhancing their motivation, consistent with its financial resources," the discrimination was related to the City's mission of providing adequate services to residents, and more favorable treatment of pension claims was consistent with the reasonable expectations of creditors given the Pensions Clause in the Michigan Constitution. This determination will be surprising to many municipal bond market observers who have noted that in many prior cases, claims of bondholders have received greater recoveries than the claims of municipal employees.

To be sure, and fortunately, chapter 9 bankruptcy cases and even municipal defaults are likely to remain rare. Indeed, municipal bonds will likely remain relatively safe investments, and many municipalities have strong tax bases, carry reasonable amounts of debt, and can provide services that are sufficient to retain or even attract residents and businesses. Nevertheless, when evaluating debt of issuers with weaker tax bases and higher debt loads, or extraordinary and unsustainable legacy liabilities, the Detroit case provides important lessons for all municipal stakeholders. And for municipalities that are inexorably headed to insolvency, the Detroit chapter 9 case provides a playbook for the swift and successful application of chapter 9.

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