



State Review Team Finds Financial Emergency in City of Detroit

What is Next for the City of Detroit?

On February 19, 2013, the six-person Review Team appointed by Michigan's Governor to conduct a detailed financial review of the City of Detroit delivered its report to the Governor. The Report concludes that a financial emergency exists in the City.

As a result of the Review Team's conclusion, the Governor is required to take action under Michigan's emergency financial manager law by no later than March 21, 2013.

The following flow chart summarizes the next steps to be taken in the financial review process of the City of Detroit.

Michigan's emergency manager law is intended to allow the state to monitor the financial affairs of Michigan cities and to appoint a manager in situations where a financial emergency exists. Under current law (Public Act 72 of 1990), the state-appointed manager is referred to as an emergency financial manager (EFM). An EFM has authority to manage the financial affairs of a city. Effective March 28, 2013, under a new law (Public Act 436 of 2012), the manager is referred to as an emergency manager (EM). An EM has authority to manage essentially all affairs of the city, including exercising all powers otherwise vested in the mayor and city council. Any EFM appointed by the state before March 28, 2013 will be vested automatically with all the powers of an EM on March 28, 2013.

With prior authorization by the state, an EFM or an EM has the power to file for bankruptcy of the City under Chapter 9 of the U.S. Bankruptcy Code applicable to municipal bankruptcies. We discuss after the flow chart what to watch for if the City moves in the direction of commencing a Chapter 9 case.

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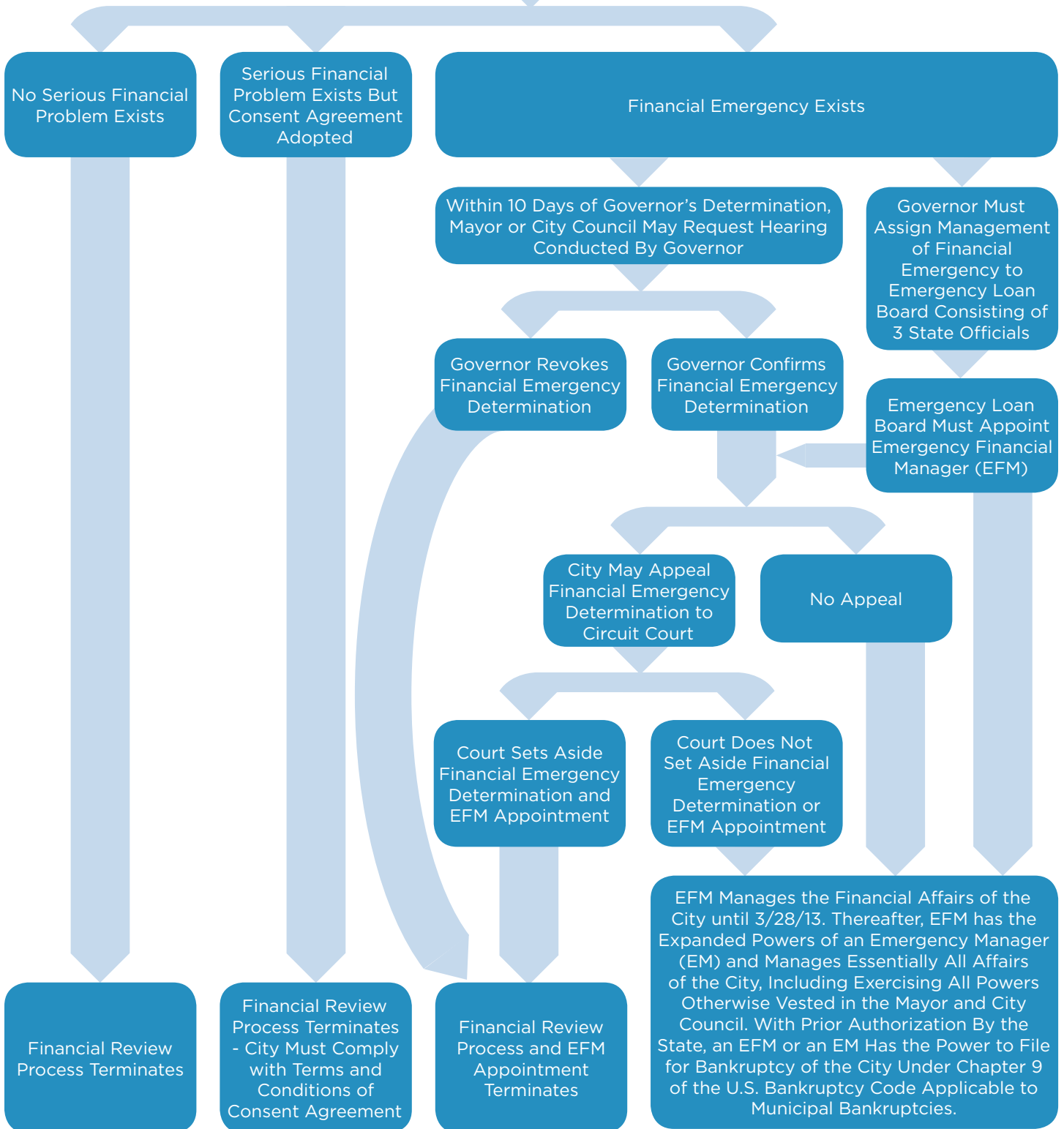
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Review Team Report Delivered 2/19/2013
Concluded Financial Emergency Exists

By 3/21/2013, Governor Must Make 1 of 3 Determinations



Here are some things to watch for if Detroit starts to move in the direction of commencing a Chapter 9 case

- ▶ Expect the City to reach out to its major creditor groups. One of the requirements for Detroit to be eligible to commence a Chapter 9 case is that it must make a good-faith effort to negotiate with its major creditor groups or show that it is futile to do so. If there is an objection to the filing based on eligibility, the “order for relief,” which results in the automatic stay preventing creditor actions, will not occur in a Chapter 9 case until the bankruptcy court addresses the objection and determines that Detroit is eligible for Chapter 9.
- ▶ If the City commences a Chapter 9 case, it would ideally want to file a plan and disclosure statement with its petition or shortly thereafter. That may mean that there might be weeks of negotiations with major creditor groups to formulate the basis of a plan before a Chapter 9 case is commenced.
- ▶ Don’t assume that in a Chapter 9 case some pre-petition claims will not be paid in the ordinary course or as part of a settlement. Unlike in a Chapter 11 case, the bankruptcy court often cannot control how the City runs its operations. The bankruptcy court in many cases cannot prevent the City from making payments or settling pre-petition claims.
- ▶ Expect to see swap counterparties use to their advantage the “safe harbors” in the Bankruptcy Code that apply to financial contracts. Those “safe harbors” apply in a Chapter 9 case just like in a Chapter 11 or Chapter 7 case.
- ▶ Don’t assume that creditor treatment in a Detroit Chapter 9 bankruptcy case will be the same as in past or ongoing municipal bankruptcies in California or other states. The Bankruptcy Code requires greater deference to state law in a municipal bankruptcy under Chapter 9, so the particular state laws matter much more significantly than in a corporate bankruptcy under Chapter 11.
- ▶ Some secured creditors with a consensual security interest in post-petition revenues consisting of so-called “special revenues” (as defined in the Bankruptcy Code) may find that their security interest continues in post-petition revenues even though in a Chapter 11 case a security interest in post-petition revenues may be cut off. Also, expect bondholders and other creditors to claim that Michigan law provides them a “statutory lien” (as defined in the Bankruptcy Code) on particular revenues of the City since a “statutory lien” will likewise not be subject to cut-off of the interest in post-petition revenues.
- ▶ Certain contracts, like collective bargaining agreements, are treated in a Chapter 9 case just like ordinary executory contracts. They do not receive in a Chapter 9 case the favored treatment that they receive in a Chapter 11 case.
- ▶ Expect creditors to claim special class treatment or priority status over other creditors in a Chapter 9 bankruptcy case based upon particular state laws and the constitution in Michigan that may impose different requirements and provide different protections for different types of municipal obligations outside of bankruptcy.
- ▶ But don’t assume that there will be any special treatment for any particular class of general unsecured claims. While a bankruptcy court will recognize a state law scheme by which some general unsecured claims are subordinated to others, it may not be clear that Michigan has established such a scheme, notwithstanding constitutional or statutory protections given to some obligations under Michigan law. On the other hand, there is much less guidance in a Chapter 9 case than in a Chapter 11 case as to what constitutes “fair and equitable treatment” of even similarly situated creditors under a plan.
- ▶ Expect the EFM or EM to take charge for the City. Don’t look to the bankruptcy court to use a bunch of tools to control the Chapter 9 case. The bankruptcy court has fewer tools in the tool box than it has in a Chapter 11 case. The bankruptcy court cannot order the appointment of a trustee or the conversion of the case to a liquidation under Chapter 7. The bankruptcy court’s primary tool is the dismissal of the case. But, even then, the case could be refiled.
- ▶ Remember that there is much less case law interpreting Chapter 9 than Chapter 7 or Chapter 11. Novel issues will emerge and will need to be addressed without much historical precedent.