

Detroit Settlement Model Looms Over Future Chapter 9s

By **Andrew Scurria**

Law360, New York (November 10, 2014, 7:57 PM ET) -- The end of Detroit's historic and controversial bankruptcy vindicates a mediation process that produced a consensual restructuring plan and created a model for other cities to follow despite criticism that it coerced creditors into forfeiting their legal rights, attorneys say.

With U.S. Bankruptcy Judge Steven Rhodes having confirmed the city's bankruptcy exit plan on Friday, the settlement model Detroit employed to bring to a close its 16-month odyssey through bankruptcy stands as a lasting legacy of the case. Using federal judges and city lawyers as referees, Detroit reached closed-door agreements ensuring that pensioners, bondholders and monoline insurers would all feel some pain on the way to reducing its \$18 billion debt load.

The ultimate success of the mediation came after Wall Street creditors — notably Syncora Holdings Ltd. and its attorneys at Kirkland & Ellis LLP — said they were being strong-armed into accepting steep haircuts and publicly denounced the process.

"This was a big victory for the mediation process, and everybody involved in municipal bankruptcy is going to take notice," said Benjamin Seigel of Buchalter Nemer APC. "If anything encourages people to go to mediation for a plan of negotiation, it certainly has to be this case because without the mediation, it would still be going on."

Detroit was the first city to emerge from Chapter 9 with every constituency taking a hit, according to its attorney, Heather Lennox of Jones Day. The case revolved around the tension between bondholder and pensioner groups, each of which began the case arguing that the city had to repay them in full. Each dollar that went to one group was a dollar less for the other.

Judge Rhodes had backed the city's ability to impair pensions but confirmed a plan that ultimately forced financial creditors to cover most of the cost of restructuring.

The settlements with city stakeholders underscore the political considerations at the heart of Chapter 9, where flexible legal standards and sparse appellate precedent leave creditors at the mercy of the presiding judge, according to Glenn Siegel of Morgan Lewis & Bockius LLP.

"The standard for confirmation in Chapter 9 is not really an objective standard. Essentially, the judge has to decide that the municipality did the best it could under the circumstances," Siegel said. "The ability to get something done in these cases is going to be a very touchy-feely, subjective, political negotiation."

Whether general-obligation bonds and pensions can be impaired in bankruptcy remains an open question since no creditor has ever pressed the issue on appeal. With each side's arguments on shaky ground, the incentives were higher to strike a deal and avoid a potentially ruinous decision.

Like the bankrupt California cities of Stockton and San Bernardino, Detroit chose to prioritize pension claims over Wall Street claims, striking a landmark deal known as the Grand Bargain that used \$816 million raised from donors and the state government to prop up the city's cash-strapped retirement systems.

Mediators tapped to oversee negotiations were the biggest proponents of the controversial deal, along with the Detroit Institute of the Arts, which houses a multibillion-dollar art collection. With the infusion of outside money, the city kept that collection off the auction block.

Other creditors, including Syncora, grumbled that the mediation process was stacked against them and that the head negotiator, U.S. District Judge Gerald Rosen, was pushing a political agenda to placate unhappy city workers.

Then in August, Syncora's attorneys leveled a broadside against Judge Rosen and another mediator, Detroit attorney Eugene Driker, accusing them of letting personal bias into the process. The tactics backfired when the insurer's case against Driker fell apart, and Judge Rhodes threatened sanctions.

The practice of using sitting judges as mediators still concerns many Chapter 9 mavens who worry the process forces politically disfavored creditors to cut bad deals. In mediation, the thinking goes, arbitrary perceptions of fairness win out over each side's legal rights, which can be too costly to figure out in court.

Others say a little coercion might be a good thing in Chapter 9 cases where residents' livelihoods are on the line, and stubborn creditors can hold up vital reinvestments.

"If they didn't come up with a resolution, a lot of people weren't going to get their pensions, and if it went up to the appellate court, it could have been a disaster," Seigel said. "There were too many lives at stake for this to drag on."

Stakeholders in future Chapter 9 cases will take mediation more seriously, he added

Lennox credited the mediation process with persuading Syncora and the other late-stage holdout, Financial Guaranty Insurance Co., to take settlements that offered a mix of cash, debt and property development rights. The land deals, a unique feature of the Detroit case, will tie the insurers' ultimate recoveries closely to the city's economic revival.

"I think the mediators did an excellent job of explaining to all the parties that this is what could happen if you don't cut a deal," Lennox said.

Once the retirees settled, "bondholders had to look at each other and say, 'holy crap,'" she said.

Judge Rosen in particular "got the parties to consider reality," according to Seigel, who represented the local pension system in the bankruptcy of Orange County, California — the largest municipality to go bankrupt before it was topped by Stockton and then Detroit.

The mediation was also influenced by Kevyn Orr, the former Jones Day lawyer who served as Detroit's emergency manager. Orr took flak for negotiating tactics that some saw as heavy-handed, but he succeeded in completing the city's restructuring in 16 months, less than the two-plus years that Stockton and San Bernardino — which have a combined 512,000 residents, nearly 200,000 fewer than Detroit — have spent in bankruptcy.

Distressed municipalities are required to negotiate in good faith with creditors about debt-cutting options outside of Chapter 9 as a prerequisite to seeking bankruptcy protection. In both Detroit and Stockton, creditors have complained that the city didn't try hard enough to negotiate, but both overcame challenges to their Chapter 9 eligibility.

With Detroit's plan now on the books, capital markets creditors have largely accepted that general-obligation bonds take the backseat to pension debts in bankruptcy.

So despite its shortcomings, creditors realize that mediation — and not legal arguments — will drive future Chapter 9 cases, especially after it proved so useful for Detroit, according to Randy Soref of Polsinelli PC.

“While we all comment on things that happen in court, nobody's commenting on how everyone got to the table, and someday, somebody's going to write a book about it,” Soref said. “There really is no protocol other than to say, 'leave people to their own devices, and let them get things done.’”

--Editing by Kat Laskowski and Christine Chun.