

Top 4 Conflicts Detroit Will Face In Bankruptcy

By **Maria Chutchian**

Law360, New York (July 19, 2013, 9:24 PM ET) -- As Detroit navigates its way through a bankruptcy of unprecedented proportions, the city is going to find itself facing challenges surrounding angry retirees who want to keep their benefits, bondholders being asked for massive concessions and its own ability to fix its financial infrastructure.

The cash-strapped city's ability to maneuver its way out of Chapter 9 bankruptcy — a process that could take years, experts say — will lie in its responses to the major challenges it is bound to face from creditors, dueling state and federal laws, and its own ability to raise revenue in the long run, experts say.

"How those fights play out will affect what [the] plan is and whether it's implemented," Patton Hahn of Baker Donelson LLP said.

Below are four challenges the city is likely to face in its bankruptcy proceedings.

Reducing Pension Obligations

Michigan's Constitution includes a provision that retirees argue make their accrued pension obligations sacrosanct, which will cause problems for Detroit's leaders, who are relying on reductions in those pensions to help boost its financial situation.

This particular problem arose just one day after the city's emergency manager, Kevyn Orr, filed Detroit's bankruptcy petition with the approval of Gov. Rick Snyder. A state judge deemed the filing unconstitutional because it threatens to diminish retirees' accrued pension benefits, but the governor's office said it will appeal and that it is confident in the constitutionality of its action.

Under Chapter 9, a municipality may lower its pension debt if good faith negotiations fail. Detroit will have to convince a bankruptcy judge that its future economic viability outweighs the hits Orr wants retirees to take.

“It’s an interesting constitutional question as to the degree to which the federal court can override state constitutional protections,” Paul Maco of Bracewell & Giuliani LLP said.

Pension obligations at city and state levels throughout the country are a ticking time bomb, Hahn said. Not only will Orr’s desired pension cuts set the stage for other municipalities considering bankruptcy — to the extent that the state constitutions include similar protections — but they will, on a personal level, have a devastating effect on the retirees themselves.

Despite the legal challenges, some attorneys are confident that the pensions, which hold a large amount of the city’s debt, will be forced to take the painful cuts.

“There is no reason [Orr] shouldn’t be able to drive bond debt and retiree debt and all other unsecured debt way down,” Kenneth E. Noble of Katten Muchin Rosenman LLP said.

Lowering General Obligation Bond Debt

Like pension benefits, general obligation bondholders will likely argue that Michigan’s Constitution protects them against municipalities looking to reduce the debt they owe. Other bankrupt municipalities have managed to reach settlements on their bond debt, like Jefferson County, Ala., which was the largest Chapter 9 bankruptcy until Detroit knocked it off its throne.

Now the city will have to convince a court that bankruptcy law allows its general bond debt to be forgiven.

“There’s going to be an issue of: What does a general obligation mean?” Andrew Gottfried of Morgan Lewis & Bockius LLP said.

Detroit will also have to deal with the effect a successful reduction of its bond debt will have on its position in the bond market, but attorneys differ on what the outcome will be. Credit markets operate on trust, Maco said, and it will be difficult for a municipality to regain that trust if it fails to live up to its promise to pay back its borrowings.

On the other hand, Hahn said, Detroit is more likely to emerge in a more solid financial state and will be more attractive to lenders.

Detroit may need a unique type of borrowing power supported by some type of structure of dedicated revenues or taxes that offer assurances to debt holders for them to reaccess the market, Maco said. That is essentially the model that New York City was provided for about a decade while the city rehabilitated itself in the 1970s, he added.

Orr has said bondholders could receive as little as pennies on the dollar. However, they are insured by monoline companies, which will actually face the most risk if Detroit is unable to pay back its debt, Noble said.

Balancing Tax Revenue and City Expenses

Even if Detroit is able to reduce its monumental debt, it will still have to convince a bankruptcy judge that it will be able to pay for basic municipal services after it exits Chapter 9. That will mean ensuring that it can raise enough revenue to counteract its expenses, which means Detroit residents may have to endure tax hikes, experts say.

“In a sense, Chapter 9 will help their cash flow because they won’t be making any debt payments in the near future,” Hahn said. “But it remains to be seen what happens with tax revenues.”

Creditors will look to force the city to impose the maximum level of tax levies constitutionally allowed, but Detroit’s leaders will fight for lower levels to keep the city economically viable for citizens, according to Noble.

A bankruptcy judge will likely be more susceptible to the city’s argument and find that it does not have the authority to force a city to levy the maximum amount, he added.

Eligibility Under Chapter 9

The first thing Detroit must do before it begins negotiating with creditors is secure a bankruptcy judge’s order approving it for Chapter 9 relief. That will hinge on whether the judge finds that it engaged in enough good faith negotiations with creditors before it filed for bankruptcy, and creditors will almost surely put up a fight.

Creditors could point to Orr’s filing, which he rushed to avoid a state court ruling in separate litigation launched by retirees that would bar him from doing so — a ruling the judge made after he filed anyway. Until very recently, Detroit leaders thought they might not file until well into August or even September, Noble said.

The frantic filing could prompt retirees and bondholders to contend that Detroit leaders didn’t exhaust all options for negotiating a compromise out of court, he said. Still, experts agree that while there will be a fight, there is almost no chance that a bankruptcy judge will find that Detroit does not meet the criteria for a Chapter 9 bankruptcy.

“From all appearances, that is not going to be a difficult one for them to overcome,” Maco said.

--Editing by John Quinn and Melissa Tinklepaugh.

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