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Financial Industry Alert

BANKRUPTCY ALERT

Detroit Confirms Chapter 9 Plan of Adjustment

Approximately 16 months after filing the largest municipal bankruptcy case in history, Detroit received approval November 7 of its chapter 9 plan of adjustment. Judge Stephen Rhodes of the United States Bankruptcy Court for the Eastern District of Michigan confirmed the plan following a several-hour hearing in which he read into the record an "oral opinion." Judge Rhodes held that the plan "meets the legal requirements for confirmation" and lauded the plan, describing it as an "extraordinary accomplishment in bankruptcy and an ideal model for future municipal restructurings." *In re City of Detroit*, Case No. 13-53846 (Bankr. E.D. Mich. Nov. 7, 2014).

Judge Rhodes stated that he would supplement his oral opinion, which he subsequently published on the docket, with a thorough written opinion. On November 12, he announced that he would not publish the opinion until after the plan has gone effective.

Until publication of the written opinion, the oral opinion serves as an abbreviated roadmap to Judge Rhodes' thoughts. Below is a brief summary of the oral opinion. The opinion provides mostly general statements of law, with minimal supporting case law or other support. However, it addresses critical chapter 9 plan confirmation issues. We note that the final published opinion could vary greatly from the oral opinion, and we expect that it will include significantly more detail.

SUMMARY OF ORAL OPINION.

The Court addressed a number of confirmation issues. Below is a bullet point summary of the Judge's most significant conclusions.

Settlements. The Court noted that every significant party had settled with the City and then considered the reasonableness of these settlements.

- Pension Settlement. The Court stated that it "is incumbent upon the Court to estimate the parties' likelihood of success on appeal." The Court estimated that the pension creditors had an approximately 25 percent chance of appellate success. Judge Rhodes provided no color around this calculation. The Court next considered the parties' best case scenario. For the City, it would "plainly be to prevail on appeal and continue in the chapter 9." For the pension claimants "the best-case scenario is much less clear" because the "City would

CONTACTS

Douglas S. Mintz
Of Counsel
(202) 339-8518
dmintz@orrick.com

Peter J. Amend
Managing Associate
(212) 506-3608
pamend@orrick.com

still have no ability to pay the claim even if the claimants prevailed." Thus, the Court held "it is a vast understatement to say that the pension settlement is reasonable. It borders on the miraculous."

- DIA Settlement. The Court found the evidence supports assertions that the DIA faced significant restrictions to its ability to sell its art. However creditors submitted "substantial evidence" supporting the contrary view that the City can sell or monetize the DIA art. Ultimately, the Court concluded that "on balance . . . in any potential litigation concerning the City's rights to sell the DIA art, or concerning the Creditor's right to access the art to satisfy its claims, the position of the Attorney General and the DIA almost certainly would prevail." However such litigation would likely be costly and time consuming. Thus the Court concluded that the settlement was reasonable and favorable.
- UTGO Settlement. The Court held that the City's chance of prevailing in litigation with the Unlimited Tax GO Bondholders was "a coin toss" and the consequence of losing the litigation "could have been dire." The Court concluded that the settlement was "within the range of possible reasonable settlements, although perhaps at the upper end of that range." The Court provided no detailed analysis.
- LTGO, COPs, Syncora and FGIC Settlements. The Court approved each settlement with little analysis of the reasonableness thereof.

Good Faith. The Court observed that section 1129(a)(3) of the Bankruptcy Code requires that the City proposed the plan in good faith. The Court provided no legal standard for good faith, but noted that the plan satisfied the good faith requirements because:

- The City proposed and negotiated the plan for the purpose of enabling the City to provide adequate municipal services;
- The City filed its plan with honesty, good intent and the expectation that the plan was feasible; and
- The process the City undertook to seek confirmation was fair to creditors.

The Court relied on testimony from the Emergency Manager Kevyn Orr, the Mayor, the City Council President, CFO and others, and pointed to the settlements with Syncora, FGIC and the COPs holders as evidence that the City sought to "create new ventures and relationships" to "enable all of the stakeholders in the case to achieve their long-term missions and goals."

Best Interests. The Court identified that the best interest test in chapter 9 (section 943(b)(7) of the Bankruptcy Code) requires creditors to receive "all that they can reasonably expect under the circumstances."

- Here, "the only legal alternative to plan confirmation is dismissal . . . . Accordingly, the Court will also consider whether the plan is a better alternative for creditors than dismissal." In particular, the standard requires that the plan be in the best interests of creditors "as a whole, not any particular creditor or class of creditors."
- With respect to arguments that the City could have paid more by raising taxes and monetizing assets such as the DIA art, the Court stated: "[N]o provision of law allows the creditors to access the DIA art to satisfy their claims . . . . The market value of the art, therefore, is irrelevant in this case."
- Under section 904 of the Bankruptcy Code, the City's determination not to sell or monetize the artwork is "off limits to this Court." Moreover, even if the Court had authority to interfere, it would not have. "[To] maintain the art at the DIA is critical to the feasibility of the City's plan of adjustment and to the City's future. . . . The DIA stands at the center of the City as an invaluable beacon of culture, education . . . and economic development. . . . To sell the DIA art would only deepen Detroit's fiscal, economic and social problems. To sell the DIA art would be to forfeit Detroit's future. The City made the right decision."

- Further, the Court held that the plan is better for creditors than dismissal, whereby a "great number of creditors would race for . . . relief and the result would be chaos and an administrative nightmare for all involved."

Unfair Discrimination. With respect to dissenting creditors, the Court stated that it may confirm the plan over dissenting classes "if the plan does not discriminate unfairly and is fair and equitable."

- The Court held that the discrimination among similarly situated creditors with different recoveries was not necessarily unfair. "[F]airness and unfairness are matters of conscience and . . . determining fairness is a matter of relying upon the judgment of conscience. Congress certainly could have established in section 1129(b) a more specific standard to determine unfair discrimination, including any of the more specific standards adopted in the case law. The sole statutory test, however, is whether the discrimination is unfair."
- The Court found that the City "demonstrated a substantial mission-related justification to propose higher recoveries to its pension claimants. . . . Its employees and retirees are and were the backbone of the structures by which the City fulfills its mission. The City therefore has a strong interest in preserving its relationships with its employees and in enhancing their motivation . . . ." The Court stated that the City has no "similar mission-related investment in its relationships with its other unsecured creditors . . . ." The Court also cited the protections provided under the Michigan constitution as support for better treatment of the pension creditors.
- The Court further found that the better treatment of the GO bondholders and other settling unsecured creditors was fair because the settlements were reasonable.

Fair and Equitable. The Court considered the "fair and equitable" standard for confirmation.

- It first held that the Court must investigate whether there is "evidence of any misconduct that would require the Court's remedy as a condition of confirmation or whether the City or any class of creditors has committed any overreaching." The Court found no such evidence here.
- Second, the Court asked whether there are circumstances here suggesting that "it is fair and equitable to impose the plan on the dissenting creditors . . . ."
- The Court noted that the margins by which dissenting classes rejected the plan were slim, and asked "is it fair and equitable to confirm this plan over the dissent of literally a handful of unsecured creditors, most of whom have claims under $25,000 . . . ?" The Court balanced the hardship for those dissenting creditors versus the hardship of the larger creditor body if the plan is not confirmed and found "There is really no choice here. There are no viable alternatives to this plan that will solve the City's problems and at the same time pay more to [the dissenting classes] to get their support."

Constitutional Takings Argument. The Court considered a number of constitutional arguments, most notably that the plan constitutes an improper government taking.

- The Court did not address the legal merits of this argument in its oral opinion. However, the Court intends to do so in its written opinion.
- Instead, the Court held that section 944(c)(1) of the Bankruptcy Code gives a court discretion to exempt debts from discharge in the confirmation order, and thus, the Court stated that the objecting parties' Takings Clause claims are "exempt from discharge which eliminates any constitutional grounds to deny confirmation of the City's plan of adjustment."

Feasibility. The Court relied heavily on the testimony of its expert, Martha Kopacz, to determine feasibility, accepting her testimony and reports in full. Based on this evidence, the Court found that the City created a

"workable" plan that the City Council and Mayor will need to implement. The Court also cited the creation of the Financial Review Commission as supportive of the feasibility of the plan.

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If you would like to receive additional information on any topic discussed in this publication, please contact any of our partners in the Restructuring Group listed below:

Daniela Andreatta
Milan
+39 02 45 41 3861
dandreatta@orrick.com

Dr. Benedikt Burger
Frankfurt
+49 69 7158 8-221
bburger@orrick.com

Raniero D'Aversa
New York
(212) 506-3715
rdaversa@orrick.com

Saam Golshani
Paris
+33 1 5353 7254
sgolshani@orrick.com

Frederick Holden
San Francisco
(415) 773-5985
fholden@orrick.com

Marc Levinson
Sacramento
(916) 329-4910
malevinson@orrick.com

Lorraine McGowen
New York
(212) 506-5114
lmcgowen@orrick.com

Laura Metzger
New York
(212) 506-5149
lmetzger@orrick.com

Thomas Mitchell
San Francisco
(415) 773-5732
tcmitchell@orrick.com

Stephen Phillips
London
+44 20 7862 4704
stephen.phillips@orrick.com

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