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Breaking Barriers – Municipal Bankruptcy
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I. INTRODUCTION

Cities do not often spring to mind as the debtors bankruptcy legislation aims to assist. In Canada, municipal laws and a determination to keep municipal corporations out of the *Bankruptcy and Insolvency Act (BIA)* mean the possibility of a municipal default is remote.\(^2\) However, Detroit’s recent bankruptcy filing, the largest in the United States’ (US) history, shows that municipal debtors and public corporations demand consideration from Canadian firms with pension, bond or insurance interests in the US.

Detroit’s case marks a new approach to municipal bankruptcies. Detroit is setting strong precedents on the treatment of unsecured creditors including bondholders and pensioners. The potentially negative impact of these moves on Detroit’s credit rating may be offset by the City’s emphasis on mediation. Previously municipal bankruptcies have involved lengthy litigation, but Detroit is using court-appointed mediators to help eliminate costly proceedings and spare cities and creditors prolonged pain. Concern amongst legal experts and analysts is that Detroit’s reinvention of municipal bankruptcy may re-cast the little known provisions of the US *Bankruptcy Code* as a more appealing, and thus more commonly utilized tool for government debtors.\(^3\)

Detroit’s bankruptcy case offers three salient lessons for Canadian investors, insurers, pension providers and insolvency practitioners. Specifically:

1. **The government bodies that qualify as municipal entities or ‘insolvent’ are changing** - Bankruptcy courts are accepting new meanings for the term ‘municipality’ and new forms of municipal insolvency - broadening the number of entities that qualify for relief. At the same time, some states are addressing creditor concerns by tightening access to the provisions.

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[View from Canada]].

\(^2\) *Bankruptcy and Insolvency Act*, RSC 1985, c B-3. Courts have held the *BIA* does not apply to Canadian municipal corporations. See: *Québec (Commission Municipale) v Aylmer (Ville)*, 71 Que SC 117, [1933] 2 DLR 638 at 642 [*Québec*]. In 1995 the Insolvency Institute of Canada’s Working Group reviewed the possibility of bringing municipal corporations under the *BIA* and recommended “municipal corporations should not be brought under the BIA’s entities eligible to go bankrupt.” George F Redling, “Summary of Recommendations made by the Bankruptcy and Insolvency Advisory Committee: December 28, 1994” (Paper delivered at the Insolvency Institute of Canada’s Sixth Annual General Meeting and Conference, White Point, Nova Scotia, 21-23 October 1995), Toronto: Insolvency Institute of Canada, 1995, at 10-12.

2. **Priority and payment for pensioners and bondholders has changed** – Detroit’s unprecedented treatment of both bondholders and pensioners is raising eyebrows amongst finance, insurance and legal professionals.

3. **Bankruptcy proceedings require creditors’ commitment to mediation** – Up until Detroit’s case municipal bankruptcies moved slowly, often taking over a year to establish a city’s eligibility for relief and several more years to hammer out bankruptcy plans. Detroit’s case has set a new pace, emphasizing mediation and negotiations, and an apparent willingness to use the creditor cram-down provision in municipal legislation.

This paper reviews Detroit’s current situation, the relevant framework of the US *Bankruptcy Code* and three notable lessons Detroit’s bankruptcy offers insolvency experts.

**Detroit**

Detroit’s decline, and $18 billion in debt, takes in the fallout from the global financial recession and the shrinking tax base and ailing auto industry that came with it. Detroit’s population is 700,000, down from the 1950s high of 1.8 million. The thin population is spread over an area the equivalent of San Francisco, Boston and Manhattan. Budget shortfalls mean Detroit is struggling to service such a large city. Detroit has $11 billion in unsecured debt. It is estimated $9 billion of this is in unfunded retirement benefits; pension shortfalls account for $3.5 billion. Roughly $538 million of bond debt is listed as unsecured city debt.

States serve as gatekeepers to the municipal bankruptcy provisions. Michigan appointed an emergency manager, Kevyn Orr, in 2013 to address Detroit’s financial distress. Orr sought bankruptcy protection for Detroit in July 2013. The court granted the city

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4 Corey Williams & Ed White, “Detroit Files for Bankruptcy”, *MacLean’s* (19 July 2013), online: *MacLean’s* <http://www2.macleans.ca/2013/07/19/detroit-files-for-bankruptcy/>.

5 Ibid.


Municipal bankruptcy – Canada vs. the US

Little-known Chapter 9 of the US \textit{Bankruptcy Code} sets out the provisions for municipal bankruptcy, which remained relatively unused up until the last decade.\footnote{11 USC § 101, et seq (2012).} A recent spate of bankruptcies in California, Jefferson County and Detroit changed that and put municipal bankruptcies in the headlines. Detroit’s default caught Canada’s attention due to the City’s size and proximity. Some remembered Detroit had defaulted before, in 1930, taking Windsor with it.\footnote{Marc Joffe found that five Canadian cities with more than 25,000 residents defaulted. Marc Joffe, \textit{Provincial Solvency and Federal Obligations}, (Ottawa: Macdonald-Laurier Institute, October 2012), online: Macdonald-Laurier Institute <\url{http://www.macdonaldlaurier.ca/files/pdf/Provincial-Solvency-October-2012.pdf} >. See also: View from Canada, \textit{supra} note 1.}

In Canada, municipal legislation has been tightened since Windsor, North Vancouver, North York and other cities defaulted in the 1930s.\footnote{Ibid.} Municipal defaults are still technically possible, however municipal Acts provide for provincial control in the event a city reaches an extreme state of financial distress. Experts say a municipal default is unlikely in Canada as the country’s legislative schemes and the cities’ conservative approach to borrowing combine to create a more stable municipal financial climate.\footnote{View from Canada, \textit{supra} note 1.}

Chapter 9

Chapter 9 has no equivalent in Canadian legislation. The Chapter is a powerful tool for struggling municipal debtors. To preserve state sovereignty, large parts of the US \textit{Bankruptcy Code} are not incorporated in Chapter 9, which leaves debtors with far more freedom than in Chapter 11.\footnote{US Const art 1, § 8, cl 4. See also: US Const amend X, US Const art 1, § 10, cl 1, and US Const art VI, cl 2. See also: View from Canada, \textit{supra} note 1.} For example, no estate is created and a trustee is not appointed.

Under Chapter 9 a city is granted three major powers:

1. The city retains control over its political and financial affairs throughout bankruptcy. Unlike Chapter 11 debtors, which are prevented from conducting
business outside of day-to-day operations, cities can borrow money and sell assets with little involvement from the bankruptcy court.16

2. The city is the only entity that can put forth a plan of debt adjustment (unlike in Chapter 11 where creditors have this power). These plans can significantly restructure the city’s debt and impair debt obligations by introducing non-market interest rates, extending repayment terms and decreasing the principle or interest owing. Chapter 9 provides for the court to ‘cram-down’ a plan of adjustment on non-consenting creditor classes, as long as one impaired class of creditors votes to confirm the plan.17

3. Under Chapter 9 a city can accept, reject or modify executory contracts, including collective bargaining agreements.18

To seek access to Chapter 9 a city must first file a petition for relief in bankruptcy court, which brings an automatic stay to halt all collection actions. The city’s eligibility trial follows. If a city achieves eligibility, the city goes on to file a plan of adjustment, which creditors vote on. The cram-down provision may then be exercised. If a city fails to prove eligibility, the case will be dismissed.19

The prevalence of American municipal bankruptcies has remained steady at 10 -13 per year over the past five years; however, the scale of the entities filing for bankruptcy has increased.20 Jefferson County filed for bankruptcy in 2011, holding the title of largest municipal bankruptcy prior to Detroit. Three Californian cities - Stockton, San Bernardino and Mammoth Lakes - filed for bankruptcy within two weeks of each other in 2012. With budget shortfalls, recession crunches and underfunded pensions plaguing cities across the US there is a concern that more municipal bankruptcies may follow.21

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18 11 USC § 365. See also NLRB v Bildisco & Bildisco 465 US 513 [Bildisco].


II. LESSONS LEARNED FROM DETROIT

1. Which municipalities are eligible for bankruptcy and when?

Given the immense power municipal bankruptcy brings, access to Chapter 9 is more restricted than other sections of the US *Bankruptcy Code*. Cities must make it over several eligibility hurdles to access bankruptcy relief.

Eligibility is one of the most heavily litigated points in municipal bankruptcy. Detroit, and other high profile recent cases offer four important qualifications on which government entities may access Chapter 9. Generally, the changes expand the scope of the Chapter, offering cautions for investors dealing with government entities. However, the changes also enhance the role of the state – giving creditors some assurance access to Chapter 9 will be more closely monitored.

To access Chapter 9, it is set out in the US *Bankruptcy Code* a city must prove it:

1) is a municipality
2) is financially insolvent,
3) has state authorization to pursue Chapter 9,
4) has a desire to restructure its finances,
5) and has passed the “creditor negotiation tests.”

Municipality

Municipal bankruptcies are increasingly testing the definition of ‘municipality’. The US *Bankruptcy Code* defines a municipality as a “political subdivision or public agency or instrumentality of a State.” Political subdivision is generally accepted to take in: counties, townships and towns, while public agencies refer to “state sponsored or controlled bodies that raise revenue through taxes.” Health systems, hospital districts, drainage districts and public benefit corporations are some of the other entities that have joined cities to qualify for Chapter 9 relief.

As public works continue to take on private dimensions, litigation results to determine if these bodies are municipalities. In *Re Las Vegas Monorail Corp*, the Las Vegas Monorail sought to file under Chapter 11. Given the highly restricted access to Chapter 9 in Nevada, creditors sought to block bankruptcy relief and argued the debtor was a municipality ineligible for Chapter 11. The court concluded the monorail was not a municipal debtor and suggested a test for ‘instrumentality’.

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22 11 USC § 109 (c) (2).
23 11 USC § 101 (40).
26 429 BR 770 at 788-89 (Bankr D Nev 2010) [*Las Vegas Monorail Corp*].
The court suggested testing: 1) if an entity has “traditional government qualities” or is engaged in traditional government functions and 2) if so, whether the entity has a public service purpose and there is state control and 3) what the state terms the entity. The court urged a broad reading of the section to respect Congress’s desire not to restrict eligibility. The decision offers important considerations for contractors and financial institutions dealing with quasi-government bodies.

Insolvency

An insolvent municipality is defined in the Bankruptcy Code as “generally not paying its debts as they become due” or “unable to pay debts as they become due.” A city can demonstrate an inability to pay outstanding debts to meet the first arm of the test. A cash flow analysis that shows a municipality will be unable to pay its debts as they come due in the current fiscal year or next year meets the second arm. However, in light of a city’s unique place in providing public services courts have recently added a new layer to the insolvency analysis.

In In Re City of Stockton, the court found three forms of insolvency exist for cities: cash insolvency – “the opposite of paying debts as they become due”, budget insolvency – “longer-term budget imbalances” and service delivery insolvency – “the degree of inability to fund essential government services.” While Stockton had cash on hand, the Bankruptcy Court found the City was at risk of compromising citizens’ health and welfare and faced service delivery insolvency. In Detroit’s case, opponents argued the City was not as insolvent as it claims, however the Bankruptcy Court accepted the ailing City met the definition of insolvent.

Creditor Negotiation

A city must pass one of three creditor negotiation tests to be eligible for bankruptcy. A city can show it has:

1. obtained agreement of the majority of creditors that will be impaired under a plan in Chapter 9; or
2. negotiated in good faith with creditors but failed to obtain the agreement of a majority of creditors; or
3. been unable to negotiate with creditors because negotiation is “impracticable.”

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27 Ibid.
30 In Re City of Stockton, 493 B.R. 772 at 789 (Bankr EdCal 2013).
31 Ibid, at 790.
32 Detroit Ruling, supra note 9.
33 11 USC §109 (c) (5).
Detroit’s case is notable in that while the judge found a lack of good faith negotiations with creditors on the part of the City, he ruled that such negotiations, for a city with 170,000 creditors were impracticable.\footnote{Detroit Ruling, \textit{supra} note 9.} As larger cities are likely to have numerous creditors, the implications for future bankruptcies are clear.

State Authorization

In respect of the constitutional forces shaping bankruptcy law in the US, states must authorize cities to proceed under Chapter 9. Twenty-four states clearly authorize cities to file.\footnote{Only two states, Georgia and Iowa, specifically prohibit municipal bankruptcy. Fruman Jacobson et al, \textit{Resolving Governmental Unit and Municipal Financial Distress} (2011) [unpublished, archived at SNR Denton LLP (Chicago)] at 7.} However, with the increasing number of large municipal bankruptcies, states are beginning to tighten access to Chapter 9. The reforms offer some comfort for creditors as the legislation aims to avoid the final step into bankruptcy and to protect creditors such as bondholders.

California enacted legislation requiring mandatory mediation with all parties affected by a possible bankruptcy.\footnote{US, AB 506, \textit{An act to amend Section 53760 of, and to add Sections 53760.1, 53760.3, 53760.5, and 53760.7 to, the Government Code, relating to local government, 2011-12, Reg Sess, Cal, 2011 (enacted). See Cal Gov't Code §§ 53760.1-53760.7 [Act to amend Section 53760].}} Rhode Island similarly reformed state laws to limit some of its cities’ powers in bankruptcy.\footnote{The State Role in Local Government Financial Distress (Philadelphia, PA: PEW Charitable Trusts, July 2013) at 13, online: \texttt{<http://www.pewstates.org/research/reports/the-state-role-in-local-government-financial-distress-85899492075>} [State Role].} The state created a first of its kind law providing enhanced security for general obligation bondholders through a first priority lien on a city taxes and general fund revenues. Michigan voters felt the state took an overly interventionist approach to municipal finances and defeated municipal bankruptcy laws in 2012.\footnote{Ibid.} The state enacted a new program as a result, but maintained an active role for the state in overseeing municipal bankruptcy despite voter protests.

2. Priority and payment for pensioners and bondholders

Detroit’s bankruptcy is most notable for putting pensioners and bondholders on equal footing – at least legally. As sections of the US \textit{Bankruptcy Code} setting out priority for unsecured claims such as pension liabilities and general obligation bonds are not incorporated in Chapter 9, insolvency experts tend to view both as unsecured claims against a city.\footnote{An unusual note is that the order of priority often expected for special revenue bonds and general obligation bonds is flipped in Chapter 9 proceedings. Special revenue bonds, those backed by specific municipal revenues, take priority. Section 928 of the \textit{Code} offers express protection for these commitments.} However, municipal bondholders had, until Detroit, successfully avoided
facing losses of principal through court-approved bankruptcy plans. Cities treated bondholders favourably as the bodies were wary of compromising bond debt and facing restricted access to capital markets. Pensioners also expected to receive careful handling in municipal bankruptcy as many state Constitutions, including Michigan’s, offer pensions specific protection.

Detroit’s case has shifted the municipal bankruptcy landscape. Orr made it clear that he would treat general obligation bonds and pensioners as unsecured creditors and that he expected both groups to accept steep cuts. Initial plans offered 10 cents on the dollar for bondholders, with similar rates for pensioners. Further, in a landmark decision in December 2013 Bankruptcy Court Judge Steven Rhodes declared that Michigan’s state Constitution does not override federal bankruptcy legislation. Therefore the state pension protections yield to the City’s right to pursue a plan of adjustment, and if necessary compromise pension obligations.

The plans and court decision met with immediate outcry. Bondholders argued they should be paid ahead of other unsecured creditors, as bond debt is backed by the “full faith and credit” of the municipal issuer – or its taxing ability. Bond insurers launched suits challenging the decision to treat general obligation bonds as unsecured. Meanwhile, pension funds appealed the constitutional decision on state protection for pensions.

Orr remained steadfast with the support of Judge Rhodes. Bond insurers eventually dropped their contention that Orr was treating general obligation bonds improperly and reached a stronger settlement with the City than Orr had originally proposed. Insurers will receive 74 per cent of the debt they are owed. Similarly, some of the City’s pension

41 Michigan Constitution art. IX, §24
43 Detroit Ruling, supra note 9.
fund boards reached a deal in principle with the City in April 2014, agreeing to cuts of 4.5 per cent to their monthly payments.\textsuperscript{47}

It is a rosier picture than the one initially proposed for Detroit’s bondholders, insurers, financiers and pensioners – particularly given the unprecedented, and wide latitude the Bankruptcy Court initially granted the City to restructure its debts. The settlements point to the importance of mediation in Detroit’s case and the third key lesson coming out of its bankruptcy.

3. Pace and efficiency of bankruptcy proceedings

Given the potentially lengthy litigation that Detroit’s precedent-setting treatment of bonds and pensions generated, the speed of the City’s case also breaks new ground in municipal bankruptcy. Orr is aiming to complete Detroit’s bankruptcy by October 2014.

The City’s eligibility trial took six months under Orr’s leadership. The plan of adjustment was unveiled two months later. A busy three months of negotiations means the City will submit this plan to creditors this month (May 2014). Orr may be learning from Central Falls, Rhode Island where a speedy exit from bankruptcy (13 months for the smaller city) saw the City earn a credit rating upgrade.\textsuperscript{48}

Orr’s record to date sets a brisk new pace for municipal bankruptcy cases, one that is only possible with an increased emphasis on mediation. California was one of the first states to use court-appointed mediators extensively and Detroit appears to have learned lessons from its experience. Shortly after Detroit filed for bankruptcy Judge Rhodes appointed US District Judge Gerald Rosen as Chief Mediator. Judge Rosen has worked extensively with Detroit’s creditors including major banks to arrive at settlements. These deals will allow a plan of adjustment to be before creditors with the support of a class of voters; this support is crucial as it triggers the ability for the court to use the cram-down provision.

Since presenting the plan of adjustment in February 2014 Orr has lobbied creditors to pursue agreements in mediation rather than face the cram-down provision.\textsuperscript{49} After


insurers reached a deal in April 2014 and agreed to vote for Orr’s plan, Orr warned unsettled parties: “the train is leaving the station…they need to get on board.”50

Mediation has been paired with an austere approach from the Court. For example, banks that helped arrange financing for Detroit’s pension plans in 2005 faced a suit from Orr seeking to invalidate these complex pension debt interest-rate transactions. However, in mediation the parties were able to reach an agreement. Judge Rhodes rejected their settlements not once, but twice. He agreed to a third settlement that saw the City pay $85 million on the $288 million debt; down from the original proposal for the City to pay $230 million.51

Mediation has led to other unique arrangements such as an ‘art-for pensions’ deal.52 Reports surfaced after the city filed for bankruptcy that Detroit’s art collection could be sold to pay creditors. Judge Rosen helped bring together State and philanthropic groups to fund $820 million to buy the collection. A plan to sell a new non-profit would allow the City to direct billions towards pension obligations.53

The City and the Court’s strong stance on mediation may explain the immense progress Detroit has made with creditors in a relatively short time. Perhaps aiming to avoid potential court-ordered losses, bond insurers have dropped suits against the City, financial institutions have reached settlements and pensioners have agreed to cuts. The expedient trial brings lower legal costs, spares residents prolonged pain and brings predictability for creditors. Detroit’s emphasis on settlements, rather than legal rulings offers a promising template for future government debtors.

III. CONCLUSION

With Detroit’s case breaking barriers in what had previously been accepted as appropriate treatment for pensions and bonds, the far-reaching freedoms of Chapter 9 have grown. Detroit’s case has also provided incentives for state legislative reforms to ensure creditors are protected where possible and set a new pace for bankruptcy proceedings, emphasizing creative mediation. The changes Detroit has introduced to bankruptcy law may make Chapter 9 a more user-friendly, and thus more appealing option for other distressed cities.

53 Ibid.
With four cities in Michigan alone currently under emergency managers, Detroit offers insolvency practitioners lessons worth learning.\textsuperscript{54}