

Guide to Chapter 9 of the bankruptcy code

What you need to know

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Editor's note: *This guide was written by Miller and Hage for The Jaffe Update, a publication produced in July 2013 before the bankruptcy was filed by Kevyn Orr.*

If Kevyn Orr, the Emergency Manager for the City of Detroit, is unable to effectuate a consensual restructuring of the City of Detroit's ("City") finances, he may be forced to file a petition under Chapter 9 of the Bankruptcy Code on behalf of the City. Likewise, a number of other municipalities in Michigan, and elsewhere, are struggling to meet their short and long-term financial obligations such that Chapter 9 is increasingly a subject for discussion. The following is an overview of some of the major aspects of a Chapter 9 bankruptcy.

1. How is a Chapter 9 commenced?

A Chapter 9 is commenced by the filing of a voluntary petition by the municipality. Creditors may not force a municipality into a bankruptcy.

2. What is the scope of the bankruptcy court's power in a Chapter 9 case?

A bankruptcy court's power is greatly limited under Chapter 9 in deference to the Tenth Amendment of the U.S. Constitution and principles of federalism that reserve to the states sovereignty over their own internal affairs. Accordingly, the state maintains its powers to control municipalities (subject to specific Bankruptcy Code provisions). The bankruptcy court cannot interfere with the political or governmental powers, property, revenues or use or enjoyment of income-producing property of the municipality

3. Can a municipality liquidate in Chapter 9?

No, the purpose of a Chapter 9 is to provide a means to restructure and adjust debt through a plan. Liquidation is not an alternative for a municipality in Chapter 9.

4. Can a party in interest seek to convert a Chapter 9 case to a chapter 7 liquidation or seek the appointment of a trustee?

Creditors have limited rights in a Chapter 9 case; neither the creditors, nor the Office of the United States Trustee ("U.S. Trustee"), can file a motion to convert the case or for appointment of a trustee. A bankruptcy court can appoint an examiner or a trustee only for limited purposes relating to the recovery of avoidable transfers.

5. What are the powers and rights of the U.S. Trustee in a Chapter 9 case?

The U.S. Trustee has no general supervisory authority in a Chapter 9 case because it would constitute an improper interference with the political and financial affairs of the municipality. Accordingly, there is no first meeting of creditors and the municipality does not have reporting obligations with the U.S. Trustee. The U.S. Trustee's role is basically limited to appointing a creditors' committee.

6. Who is eligible to file a Chapter 9 petition?

Only municipalities, in other words, a "political subdivision or public agency or instrumentality of a State," are eligible to file a Chapter 9. Municipalities generally include cities, towns, counties and various governmental organizations. Municipalities are eligible to file a Chapter 9 case subject to specific legislative authority existing in the state in which the governmental entity is located. In Michigan, the governor must consent in writing to the filing, among other requirements.

The Bankruptcy Code requires the municipality to specifically show that it is eligible for filing by demonstrating that: (i) it is insolvent; (ii) it desires to effect a plan to adjust and, not simply to delay or evade payment of, its debts; (iii) it (a) has obtained an agreement on a plan from creditors holding at least a majority in amount of claims in each class that the municipality intends to impair under a plan; (b) has negotiated in good faith with creditors but failed to obtain such agreement; (c) is unable to negotiate with creditors because negotiations are impracticable; or (d) reasonably believes that a creditor may try to obtain a preferential payment or transfer of the municipality's assets. Good faith has been found to be lacking when a municipality provides a "take it or leave it" offer and does not negotiate a feasible plan with creditors or waits until just before the filing to meet with creditors. If the municipality is not eligible to file a Chapter 9, the court must dismiss the case.

7. Who has the right to appear and be heard in a Chapter 9 case?

Any party in interest may appear, including all creditors and the Secretary of the Treasury of the United States. Representatives of the state in which the municipality is located may intervene with respect to matters specified by the bankruptcy court.

8. Does the automatic stay apply in a Chapter 9?

Yes, the automatic stay in Chapter 9 cases is broader than under other Bankruptcy Code chapters. It prohibits creditors from taking actions against: (i) the municipality, (ii) its property, and (iii) its officers and inhabitants if the action seeks to enforce a claim against the municipality. However, the automatic stay does not apply to the application of pledged special revenues to payment of indebtedness secured by such revenues. Thus, an indenture trustee or other agent for such bonds may apply pledged funds to payments coming due or distribute the pledged funds to bondholders during the Chapter 9 case without violating the automatic stay or an order of the bankruptcy court.

9. Can a municipality reject executory contracts in a Chapter 9 and what limitations are imposed on such right?

Yes, a municipality, as part of the exercise of its business judgment, may assume or reject executory contracts. In order to assume an executory contract or unexpired lease, the municipality must cure any defaults and provide adequate assurance of future performance. If a contract is rejected, it is treated as a pre-bankruptcy breach of the contract, giving rise to an unsecured claim for damages. The municipality is not required to follow the steps for rejecting collective bargaining agreements set forth in section 1113 of the Bankruptcy Code, (requiring, among other things, collective bargaining with the union) which is not applicable in Chapter 9. Rather, the municipality only needs to show that: (i) the collective bargaining agreement burdens the estate, (ii) after careful scrutiny the equities balance in favor of contract rejection, and (iii) reasonable efforts to negotiate a voluntary modification have been made and are not likely to produce a prompt and satisfactory solution.

10. May a municipality borrow funds postpetition?

A municipality may borrow money and incur debt with priority over any or all administrative expenses or secured by a lien on the municipality's property; however, some state laws restrict the ability of a municipality to borrow money to fund operating expenses. A municipality is not required to seek permission from the court to use cash collateral or obtain financing.

11. Is there a creditors' committee in a Chapter 9 case?

Yes, the U.S. Trustee is charged with appointing a creditors' committee, but no committee can be appointed until after the determination that the municipality is eligible to be a Chapter 9 debtor.

12. Does a municipality file schedules and a statement of financial affairs?

No, municipalities are not required to file schedules or a statement of financial affairs. The municipality, however, is required to file a list of creditors, which functions like schedules in a chapter 11 case. Any claim on the municipality's list of creditors is deemed allowed, unless the municipality lists the claim as contingent, disputed or unliquidated, in which case, a proof of claim must be filed.

13. What impact does Chapter 9 have on a municipality's ability to pay pre-petition debts?

Chapter 9 does not prevent a municipality from paying its pre-petition debts. Due to constitutional issues, the bankruptcy court lacks authority over the property of the municipality and, thus, the municipality can spend money without court approval.

14. How are pension and bond obligations treated in Chapter 9?

Although there are compelling arguments to the contrary, the prevailing view seems to be that pension

and general obligation bonds are treated as general unsecured claims in a Chapter 9 bankruptcy case. With respect to the City of Detroit, it is expected that creditors will raise various arguments under state and federal law to dispute this treatment if the City moves forward with its plan to offer only pennies on the dollar to the holders of such claims. Conversely, special revenue bonds that are secured by special taxes or revenues, such as water and sewer bonds, are treated as secured claims in bankruptcy and likely cannot be impaired by the municipality in its Chapter 9 case.

15. Is there a process for a municipality to pay post-petition debts?

A municipality is free to use its cash to pay creditors post-petition, both in and outside of the ordinary course of its business, and the bankruptcy court is not permitted to interfere with such payments.

16. Can creditors obtain administrative expenses in Chapter 9?

Yes ... sort of. The municipality is free to pay such creditors but creditors are not given an administrative expense by statute to help ensure payment. Making matters worse, it is not clear whether such claims, if not paid during the case, will be deemed discharged as part of confirmation of a plan. Accordingly, creditors face increased risks doing business with a municipality in bankruptcy vis-à-vis a chapter 11 debtor and, thus, they should consider whether they can get additional protections to ensure payment (i.e. pre-payment, cash on delivery). Creditors should also cease providing services post-petition if their receivable starts to grow to an unusual level.

17. Can a municipality bring preference, fraudulent transfer and other avoidance actions?

Yes, a municipality has the power to pursue avoidance actions, including fraudulent and preferential transfer actions, except with respect to a payment to a bond or note holder. If the municipality refuses to pursue an avoidance action, on request of a creditor, the court may appoint a trustee solely to pursue such cause of action.

18. Does the court need to approve settlements?

No, only if the municipality wants a court order approving the proposed compromise.

19. Does a municipality file a plan and disclosure statement?

Yes. The municipality retains the exclusive right to file a plan of adjustment throughout the case and creditors may not file a competing plan. The court is authorized to fix a deadline for filing a plan.

20. What are the requirements to confirm a plan?

Generally speaking, confirmation of a plan of adjustment resembles confirmation of a plan of reorganization under chapter 11 of the Bankruptcy Code with respect to contents of a plan, impairment, disclosure and solicitation, acceptance, confirmation, feasibility, compliance with the Bankruptcy Code

and cram down (i.e., the plan is "fair and equitable" and does not "discriminate unfairly"). Chapter 9 also imposes additional requirements, including: (i) the plan must comply with the provisions of Chapter 9, (ii) any amounts to be paid by the municipality or any third party under the plan for services or expenses in the case must be reasonable, and (iii) any regulatory or electoral approval necessary in order to carry out the plan has been obtained.

21. What is the effect of confirmation of a plan?

Confirmation of a Chapter 9 plan binds the municipality and all of its creditors, so long as they received notice of the bankruptcy case.

22. Can a Chapter 9 case be dismissed?

Yes, a Chapter 9 case can be dismissed at any time, for cause, including: (i) want of prosecution, (ii) unreasonable delay by the municipality that is prejudicial to creditors, (iii) failure to propose or confirm a plan within the time fixed by the court, (iv) material default by the municipality under a confirmed plan, or (v) termination of a confirmed plan by reason of the occurrence of a condition specified therein.

Because there is no concept of liquidation in a Chapter 9 case, arguably the best remedy for a creditor who believes it is being treated unfairly is to move for a dismissal of the case. The facts and circumstances of each and every party and case are unique. The insolvency and reorganization attorneys at **Jaffe Raitt Heuer & Weiss, P.C.** would be happy to discuss your specific Chapter 9 questions with you. Please do not hesitate to give us a call at (248) 351-3000, or send us an email at jmiller@jaffelaw.com or phage@jaffelaw.com.

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Editor's note: Jaffe Raitt Heuer & Weiss PC represents some of the city of Detroit's creditors.