

DETROIT'S ELIGIBILITY OPINION ON THE CONSTITUTIONALITY OF MICHIGAN LAW AND LEGAL NATURE OF PENSION DEBT

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Chapter 9 is a weird animal. It provides a legal framework in which state sovereignty and local political power intersect with our federal courts before a non-Article III arbiter. In particular, the Tenth Amendment mutes the power of our bankruptcy judges in chapter 9 cases and provides chapter 9 debtors with discretion not available to debtors under chapter 7, 11 or 13. Nevertheless, there are two points in a chapter 9 case when the bankruptcy court's powers are at their greatest: at the eligibility hearing and at the confirmation hearing. At each of these points a municipality's ability to utilize the benefits and protections of chapter 9 is most in peril. In Detroit's case, because the city has survived the challenges to its eligibility, at least for the time being, it can now move toward filing a plan of adjustment and seeking confirmation of an adjustment plan.

I. The Eligibility Analysis

At its core, an eligibility analysis is fact-sensitive and unique for each municipality that files a chapter 9 petition. That is because the confluence of issues contributing to a municipality's fiscal condition is distinct to that city, county or other locality. Section 109(c) of the Code, which sets forth the eligibility requirements under chapter 9, requires an entity that files for chapter 9 protection (1) to be an insolvent municipality that desires to effect a plan to adjust its debts, and (2) either to have negotiated in good faith with its creditors prior to the filing or not to have been required to negotiate due to the impracticality of carrying on such negotiations. Furthermore, the state in which the municipality is located must specifically authorize the municipality to be a debtor. These are non-negotiable requirements that any potential chapter 9 debtor must prove to the bankruptcy court before an order for relief will be entered.

II. The Eligibility Ruling in Detroit

On December 5, 2013, Judge Rhodes entered a 150-page opinion on the issue of Detroit's eligibility. *In re City of Detroit, Michigan*, ___ BR ___, 2013 WL 6331931 (Bankr ED Mich 2013). The court found that Detroit was eligible for chapter 9 protection because it satisfied the eligibility requirements in §§109(c) and 921(c). (Section 921(c) is implicated in the eligibility analysis only if a creditor objects to the filing for an absence of good faith. It should be noted that findings that a debtor has satisfied the requirements of §109(c) create

a rebuttable presumption of good faith.) In so ruling, the court denied 110 objections and waded through more than 50 briefs filed by objectors. 2013 WL 6331931, at *5.

Notwithstanding the inherent limitations in fact-based findings, the opinion will likely affect the calculus employed by other municipalities in determining the viability of the chapter 9 option – and possibly serve as an impetus for other states considering enacting laws that would enable their local governments to access the debt-deleveraging tools of chapter 9. This is likely because woven into the bankruptcy court's eligibility opinion and its findings of city insolvency and good faith are two legal rulings of great import.

III. The Bankruptcy Court Has Jurisdiction Over Constitutional Questions

The first legal ruling – that the bankruptcy court has the power to determine the constitutionality of chapter 9 and the constitutionality of the Michigan statute authorizing the filing (PA 436) – should resolve the question of whether *Stern v. Marshall*, 131 S Ct 2594 (2011), effectively withdrew these constitutional challenges from the purview of the bankruptcy court. In ruling that *Stern* did not remove these issues from the bankruptcy court's power to enter final judgments, Judge Rhodes made a number of important observations, including that (1) an eligibility determination is within the public rights doctrine, and therefore the bankruptcy court has authority to decide all of the objections in connection with eligibility, and (2) *Stern* did not address concerns of federal versus state, but rather only bankruptcy versus nonbankruptcy. 2013 WL 6331931, at *22-*23.

This ruling also provides some insulation to municipalities seriously considering chapter 9 from getting bounced between state and federal court. Detroit offers a prime example of the confusion and the judicial drama that can result from questions of unclear jurisdiction. In that case, ten minutes after the city filed its chapter 9 petition, a state court judge enjoined the Governor and the Emergency Manager from taking any further actions in the bankruptcy proceeding. A day later the state court entered an order declaring PA 436 unconstitutional. Judge Rhodes' eligibility opinion provides a lucid analysis of why the state court judgment is void, citing 28 USC §1334(a) for the rule that upon the bankruptcy filing, federal law provides the federal court with exclusive jurisdiction to determine issues relating to the city's eligibility. 2013 WL 6331931, at *56-*58.

IV. Chapter 9 and Michigan Law Are Constitutional

A. *United States v. Bekins* Remains Controlling
Challenges to the constitutionality of chapter 9 in

the Detroit eligibility fight took three forms. The first challenge was that chapter 9 violates the uniformity requirement of Article I, Section 8 of the US Constitution by allowing for non-uniform bankruptcies within states. Judge Rhodes dismissed this objection, concluding that it is not the outcome that determines uniformity but the process, and that chapter 9 applies uniformly to all chapter 9 debtors.

The second challenge was that chapter 9 violates the federal Contracts Clause, Article I, Section 10 of the US Constitution. Judge Rhodes characterized this argument as frivolous because the federal Contracts Clause does not prohibit Congress from impairing contractual obligations; the prohibition only applies to states.

The third challenge to chapter 9 was that it violated the Tenth Amendment of the US Constitution by permitting Michigan to authorize Detroit to file for chapter 9 without the explicit protection of accrued pension rights. Judge Rhodes dismissed this challenge as well, and held that when the state consents to a chapter 9 bankruptcy, the Tenth Amendment does not prohibit the impairment of contract rights that are otherwise protected by the state constitution. Thus, while the state of Michigan cannot adjust pension and other contractual obligations through its own legislative process under its own state constitution, the bankruptcy process is not constrained by the limitations of Michigan law or the Michigan Constitution. According to Judge Rhodes, "*Bekins* makes it clear, however, that with state consent, the adjustment of municipal debts does not impermissibly intrude on state sovereignty." 2013 WL 6331931, at *41. Judge Rhodes also quashed any attempt by interested parties to distinguish pension rights from other contractual rights that can be impaired by federal bankruptcy law.

B. PA 436 Is Constitutional and Valid

The challenge to the constitutionality of PA 436 was essentially an argument that Detroit was not authorized to file this case under the Michigan Constitution, and thus Detroit did not satisfy the eligibility requirement in §109(c)(2) of the Code. In particular, several objectors argued that PA 436 is unconstitutional because it fails to protect pensions from impairment in bankruptcy in violation of the Michigan Constitution.

The court held this argument presumes that pension benefits are entitled to greater protections than other contract claims. Judge Rhodes rejected this argument, concluding that pension benefits are a contractual obligation of the municipality. 2013 WL 6331931, at *41-*44. Thus, the failure of PA 436 to protect pension rights in a municipal bankruptcy did not make that law inconsistent with the pension clause of the Michigan Constitution. Likewise, the Governor's failure to place any contingencies on the city's filing, including protecting pension benefits, did not render

the Governor's authorization invalid.

V. The Edge of the Eligibility Ruling

It is important to emphasize what Judge Rhodes's decision did not address: whether his court is prepared to confirm a nonconsensual plan over the objections of impaired classes of general obligation bond debt or pension claims. Legally speaking, whether a plan of adjustment that forces a dissenting class of retirees to accept pennies on the dollar on their pension claims can satisfy the "fair and equitable" test in §1129(b)(2) remains an open question. There is little legal precedent here, as most chapter 9 plans are consensual. How the bankruptcy court will interpret the "fair and equitable" and "unfair discrimination" tests if the city is unable to propose a consensual plan of adjustment is anybody's guess.

Notwithstanding the appeal of the eligibility opinion to the Sixth Circuit, a number of issues have been disposed of in connection with the court's ruling that Detroit satisfied the Code's eligibility requirements, including the constitutional challenges to chapter 9 and Michigan law. Whether or not the Court of Appeals has a chance to speak on these rulings depends, in part, on the pace of developments on the ground, in particular whether the city can reach a consensual agreement with its creditors. Irrespective of the outcome, Judge Rhodes's opinion on Detroit's eligibility should have a lasting effect on the debate over the constitutionality of chapter 9 and state law authorizing municipalities to file for chapter 9, and may spur other states to consider adopting laws similar to PA 436.

CLAIM-OBJECTION SERVICE IN OREGON AFTER MONK

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In an August 9, 2013, decision, Judge Frank R. Alley held that the common Oregon practice of serving a proof-of-claim objection on the creditor only at the notice address in the creditor's claim does not necessarily comply with several Federal Rules of Bankruptcy Procedure (BRs) that, together, require service in accordance with BR 7004. He also held that the manner in which the claim objection was served deprived the creditor of its constitutional due-process right. *In re Monk*, 2013 WL 4051864 (Bankr D Or 2013). The Oregon bankruptcy court subsequently revised the claim-objection form to increase the chance that use of the form will be consistent with *Monk*. As a result, there are four new steps that a careful Oregon practitioner should take to ensure proper service of a claim objection.

I. The Monk Decision

In *Monk*, the chapter 13 debtors scheduled a claim