Detroit and Stockton Plans Confirmed; Lessons Learned

Article By:

John B. Hutton III

Nancy A. Mitchell

Plans of Adjustment were confirmed recently in each of the landmark Detroit, MI and Stockton, CA bankruptcy cases. Although both cases shared many common legal issues, they took different paths to reach confirmation. Detroit, which resolved its cases by entering into settlements with its major constituents, provides a potential roadmap for future cases but only limited judicial guidance. Stockton provides more judicial precedent. For municipalities and their creditors, however, the lessons learned from the two cases will surely influence future Chapter 9 proceedings.

Lesson 1: Settlement May Be the Best Option for Everyone

The blueprint for the Detroit case was built on achieving settlements with all of the major constituents. Detroit initially proposed a plan that would have provided very low recoveries for many constituents. The major constituents were likely motivated to settle in part by a desire to avoid potentially adverse precedent and in part by a desire to obtain an outcome better than that which was proposed in the original plan. For example, the holders of the unlimited tax general obligation (UTGO) bonds achieved a settlement by arguing, among other things, that certain portions of the City's ad valorem millage could lawfully be collected and only used for UTGO bond debt service, that they had a statutory lien upon such millage, and that such millage constituted special revenues under the Bankruptcy Code. By agreeing to a settlement that recognized some value in this argument, the holders were able to improve their recovery from 15 percent to 74 percent and avoid both bad precedent and a potentially worse economic result. Many constituents were similarly motivated to compromise their claims based on an allocation of value that was reasonable, if not optimal, for their class.

Stockton was also able to settle with many of its constituents but did not achieve a settlement with Franklin Funds, which had loaned $35 million to Stockton in the form of lease revenue bonds primarily for fire stations, parks and infrastructure. The inability of Stockton and Franklin Funds to achieve a settlement resulted in a contested confirmation hearing that concluded in June 2014. The Bankruptcy Court subsequently determined that Franklin Funds was a secured creditor but only to extent of the value of its collateral over which there was material dispute. The City claimed the collateral was worthless and Franklin Funds asserted it was worth at least $15 million. The Court valued the collateral at $4 million, resulting in Franklin being treated as an unsecured creditor for the balance of its claims (approximately $32 million). The result is that the Stockton plan provides Franklin Funds a full recovery on its limited secured claim but limits Franklin Funds to a .94 percent recovery on its unsecured claims. In contrast, the plan provides recoveries to settling bondholders of between 51 percent and 106 percent in at least seven discrete classes under the plan and pays pay pensions in full. In fact, Franklin argued, unsuccessfully, that the plan treatment was punitive, because it had been offered a 55 percent distribution in pre-bankruptcy settlement talks. These arguments were not sufficient to sway the Court, and Franklin was left with a .94 percent recovery on its unsecured claim.

Lesson 2: Being Secured (Even Allegedly) May Mean More Value

The treatment of the various classes of claims in Detroit was premised on creditor classes that enjoyed secured status or benefited from legal priorities under state law receiving more favorable treatment than unsecured creditor classes. Indeed, holders of secured special revenue bonds and holders of secured GO bonds (supported by a pledge of state aid) were largely unimpaired, while holders of general unsecured claims will receive between 10-13 percent. Given that this is generally consistent with the payment waterfall under the Bankruptcy Code, such a result is not particularly surprising. As noted above, holders of UTGO bonds received a 74 percent recovery, while holders of Limited Tax General Obligation (LTGO) bonds will receive 34 percent. These disparate recoveries were a direct result of the ability of the UTGO and LTGO bonds to assert a credible argument that they enjoyed secured status and priority treatment under state law which drove a settlement for those at a higher recovery. Indeed, the City argued at confirmation that the discrimination between classes was not unfair, because the settlements reached with the different classes was based in part upon the relative treatment such classes would receive under state law.

Lesson 3: Saying You Are a Pension Claimant Isn't Enough, But Does Carry Political Weight

The most significant precedent arising from the Detroit case involved the pension creditors. Going into the case, the unions and pension creditors argued that (a) pensions could not be impaired at all in bankruptcy, based upon state constitutional protections for pensions and (b) Detroit was therefore not eligible to file Chapter 9 because its goal was allegedly to impair pensions. In December 2013, the Bankruptcy Court issued a 143-page comprehensive opinion on eligibility, which addressed the issues raised by the pension holders and other threshold issues in the case. In addition to addressing a number of eligibility issues and finding that Detroit was eligible for Chapter 9 bankruptcy, the Court also held that pension rights were contract rights that could be impaired in bankruptcy, notwithstanding state constitutional provisions that prohibited impairment. The Court did caution that it would tread carefully in this area and make sure that any effort to impair pensions met Bankruptcy Code requirements. An October 2014 ruling in the Stockton case similarly found that pension contracts can be rejected in bankruptcy, just like any other executory contract, notwithstanding state statutory provisions that purported to make Section 365 of the Bankruptcy Code (providing for the rejection of contracts) inapplicable to pension obligations.

Despite the unfavorable determinations with regard to pension plans by the Courts in Detroit and Stockton, Lesson #1 still seems to have been applied. In Detroit, the settlements and compromises in the plan resulted in treatment of unsecured pension creditors that was generally more favorable than the treatment of unsecured bondholder and other unsecured financial creditors. In Detroit, the City projects that Police and Fire Retirement System (PFRS) Pension Claims will recover 59 percent and General Retirement System (GRS) Pension Claims will recover 60 percent, while holders of

Certificate of Participation (COP) claims (issued to fund pension plan shortfalls) will recover only 10 percent. This is consistent with the more favorable treatment afforded pension creditors in Stockton, in which CalPERS was not impaired at all despite the Court having ruled from the bench that Stockton could have impaired CalPERS as the holder of contractual rights, and that any resulting statutory lien for termination liability would be avoidable under Section 545 of the Bankruptcy Code. While this trend is not precedent, it does demonstrate a tendency of the municipalities to exercise their business judgment in a manner favorable to employees and retirees, as well as a tendency of the various financial constituents to ultimately recognize the unique circumstances involved with employees and pensions, and the consequences of rejection, including steep termination obligations, the impact on union contracts and difficult pension transition issues.

Lesson 4: Best Interests May Not Mean Your Best Interests

In a Chapter 11 case, the best interest of creditors test compares the result of a liquidation with the proposed result under the plan in order to assure that the creditors get at least as much as they would in a liquidation. In Chapter 9, the test is less clear because a municipality cannot be liquidated in Chapter 9. So in a Chapter 9 case, the question becomes how far the City has to go to satisfy claims. In Stockton, Franklin argued that the City could reasonably pay the lease revenue bonds a much higher percentage than what was proposed in the plan (and in fact offered over 55 percent in pre-bankruptcy negotiations) from public facility fees (PFFs). Franklin argued that it was not an inability to pay but rather unwillingness to pay that drove the low recoveries. In response, the City argued that Franklin was receiving all that it could reasonably expect under the circumstances, and that it would fare worse outside of bankruptcy, since CalPERS would have a priming lien over Franklin's collateral. Without specifically addressing this issue, the Court in Stockton ultimately confirmed the plan, and overruled the Franklin objection. The best interest test was also an issue in Detroit, until the final settlements were reached with Syncora and FGIC, where such creditors argued that the City's valuable art collection must be sold or used as collateral for a loan, so as to pay creditors more than what is offered under the so-called "Grand Bargain," and that other City-owned land not essential for municipal services should have been sold. Although there is no bright line test, the standard that emerges from these cases is whether the plan provides creditors with all they can reasonably expect under the circumstances, a standard that is more flexible than the best interest test in Chapter 11.

Another issue raised by Franklin in the Stockton case: Does the City have to confront its pension obligations in order to provide a more reasonable recovery to Franklin? The plan does not impair pensions at all, and does not seek any reductions in the amounts due to CalPERS. Franklin argued that the City can and should seek pension reductions, as the annual payments to CalPERS will triple in just a decade, from $14 million in 2011-12, to $42 million in 2020-21, and then climb from there. Even though the plan does not propose any pension reductions, there was considerable testimony and argument about whether it should. Franklin argued that if the City tackled its growing pension problem, it would have more money to fund a recovery for Franklin. The Court's ruling in early October signaled that this was an issue of concern to the Court, although ultimately the Court decided that the retirees compromised enough by foregoing certain other benefits. One of the principles of Chapter 9 is that the Court will not make financial or operational decisions for the municipality, and will not dictate to the municipality how to govern its affairs. Consistent with this principle, it is highly unlikely that a Court in Chapter 9 would require the municipality to impair any particular class, even though the Court in Stockton initially questioned the City's reluctance to impair CalPERS, and ruled that such impairment would have been possible.

Franklin argued that it could sue and get judgments every year for missed bond installment payments, and the City would have to include payment of those amounts in its budgets, and Franklin could obtain a writ of mandate as to the PFFs, and exercise rights as to the lease collateral. Creditors in Detroit also argued (before settlements were made) that they can do better outside of bankruptcy. There was a debate about whether the best interest of creditors test focused on the result for the objecting creditor, or for the body of creditors, generally. This issue was not decided in Detroit as a result of the settlements. Although the Stockton Court did not address this issue specifically, the Franklin objection was overruled. Absent binding authority to the contrary, there is room in future cases for adversely impacted creditors to argue that the treatment afforded to them under a plan is less favorable than the recovery they could obtain outside of bankruptcy, and case law that supports evaluating the results for that particular creditor, rather than the body of creditors as a whole.

Lesson 5: Don’t Assume Fair and Equitable is the Answer

Another material issue in municipal bankruptcies is to what extent can a City treat creditors of equal legal priority differently under a plan? In Stockton, Franklin argued that the plan improperly classified and disparately treated Franklin’s claim by lumping it in with the arguably dissimilar health care claims of retirees (who agreed to accept a low recovery on their health care claims in exchange for payment in full of their unfunded pension benefits) while other general fund bond obligations are each separately classified with better treatment. Likewise, the objecting creditors in Detroit had argued that the plan was not fair and equitable, because the bond insurers were receiving treatment much less favorable, and less certain, than the pension claimants. In response, Detroit argued that there was a reasonable business justification for the disparate treatment. This issue was settled in Detroit (with the Court praising the various settlement results), and decided adverse to Franklin in Stockton. The lesson from these results is that municipalities will be granted a fair amount of latitude to treat creditors of equal priority differently, based upon the unique circumstances of a Chapter 9 case, and the particular circumstances of different creditor constituents.

The results in the Detroit case, built largely through settlements and compromise, and the results in Stockton, which confirmed over strenuous objections, likely send a signal that Chapter 9 is a mechanism that can be successfully used to resolve the many complex dynamics involved with a large distressed municipality, such as Detroit, which likely doesn’t have the ability to resolve such a large plethora of issues with so many varied constituents outside of the bankruptcy context. Considering that so many issues were left undecided as the result of compromises, there remains leverage on both sides to negotiate financial treatment in future cases.

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