

II. In re Detroit: Consequences of Detroit's Bankruptcy for Pensioners

A. Introduction

On July 18, 2013, Detroit filed for Chapter 9 bankruptcy, becoming the largest municipality to file for bankruptcy in United States history.¹ Chapter 9 of the U.S. Bankruptcy Code governs municipal government bankruptcy filings, but because of the historical rarity of these filings, many uncertainties still lurk in Chapter 9's provisions.² On December 3, 2013, the U.S. Bankruptcy Court for the Eastern District of Michigan resolved one of those uncertainties by holding that Detroit could cut payments to its over 20,000 pensioners pursuant to Chapter 9, despite provisions in the Michigan Constitution that expressly protect public pensions.³ The consequences of this decision, both for Detroit and for municipalities across the country, are still largely unknown.

This article will analyze the holding of *In re Detroit*, and then explore the implications of that decision for Detroit's pensioners and pensioners in other municipalities throughout the United States. Part B provides an overview of Detroit's financial decline and subsequent Chapter 9 bankruptcy filing. Part C examines the holding of *In re Detroit*. Part D discusses where the Detroit bankruptcy process will go after *In re Detroit* and highlights potential avenues of assistance for Detroit's pensioners. Part E considers the impact that *In re Detroit* will have on pensioners in other municipalities.

B. Background: Detroit's Decline and the Chapter 9 Filing

Detroit was once the industrial heart of the American economy.⁴ At its peak in the 1950s, Detroit was home to millions of

¹ Monica Davey & Mary Williams Walsh, *Billions in Debt, Detroit Tumbles Into Insolvency*, N.Y. TIMES, July 19, 2013, at A1.

² See Richard W. Trotter, *Running on Empty: Municipal Insolvency and Rejection of Collective Bargaining Agreements in Chapter 9 Bankruptcy*, 36 S. ILL. U. L.J. 45, 46–47 (2011).

³ See *In re City of Detroit*, Mich., 504 B.R. 97, 154 (Bankr. E.D. Mich. Dec. 5, 2013) (“Because under the Michigan Constitution, pension rights are contractual rights, they are subject to impairment in a federal bankruptcy proceeding.”).

⁴ See *id.* at 112.

proud citizens and responsible for half of the world's automobile production.⁵ Through the second half of the twentieth century, though, Detroit's once booming economy fell victim to deindustrialization and the exportation of the American automobile manufacturing industry.⁶ Detroit's economic collapse is expressed most clearly by looking at a few statistics. From 1950 to 2012, Detroit's population decreased by 63%.⁷ From 1972 to 2007, Detroit's number of manufacturing establishments decreased by 80%.⁸ While population and employment dropped, crime and structural decay increased dramatically, leaving Detroit with a crime rate in 2012 that more than quadrupled the national average.⁹

In December 2011, the Michigan Department of the Treasury ("Treasury") conducted a review of Detroit's finances, and found that the City faced a "mounting debt problem" and "probable financial stress."¹⁰ One year later, the Treasury stopped hedging their language, and submitted a report to Michigan Governor Rick Snyder stating that Detroit faced a "serious financial problem."¹¹ By March 2013, Governor Snyder had declared a "financial emergency" and recommended that Detroit appoint an emergency manager.¹² On March 25, 2013, Kevyn Orr ("Orr") took the reigns as Detroit's emergency financial manager.¹³ As emergency manager, Orr acts "for and in the place and stead of the governing body" of Detroit and

⁵ *Id.*

⁶ This is an oversimplified analysis of Detroit's financial woes, but it suffices for the purposes of this article. For a thorough and thought-provoking analysis of the economic and political factors that precipitated Detroit's bankruptcy, see Nathan Bomey & John Gallagher, *How Detroit Went Broke: The Answers May Surprise You—and Don't Blame Coleman Young*, DETROIT FREE PRESS (Sept. 15, 2013, 1:10 AM), <http://www.freep.com/interactive/article/20130915/NEWS01/130801004/Detroit-Bankruptcy-history-1950-debt-pension-revenue>.

⁷ *In re City of Detroit*, 504 B.R. at 119.

⁸ *Id.*

⁹ *Id.* at 120.

¹⁰ *Id.* at 122 (quoting Memorandum from State Treasurer Andy Dillon, Mich., to Governor Rick Snyder, Mich., Preliminary Review of the City of Detroit 3 (Dec. 21, 2011)).

¹¹ *Id.* at 124 (quoting Memorandum from State Treasurer Andy Dillon, Mich., to Governor Rick Snyder, Mich., Preliminary Review of the City of Detroit 1 (Dec. 14, 2012)).

¹² *See id.* at 125 (quoting Letter from Governor Rick Snyder, Mich., to Mayor Dave Bing, Detroit, and Detroit City Council (Mar. 1, 2013)).

¹³ *Id.*

holds “broad powers in receivership to rectify the financial emergency.”¹⁴

Orr began his tenure as emergency manager by meeting with Detroit’s creditors and constructing the “June 14 Creditor Proposal.”¹⁵ The June 14 Creditor Proposal estimated pension liabilities at \$3.5 billion and proposed that Detroit pay off pension liabilities pro rata with Detroit’s other unsecured creditors.¹⁶ For some pensioners, this would translate to roughly “10 cents on the dollar.”¹⁷ Orr hoped that the June 14 Creditor Proposal would prevent Detroit from having to file for bankruptcy and, if accepted by creditors, allow Detroit to pay off its debts without involving the courts.¹⁸ Ultimately, Orr’s efforts proved unsuccessful, and on July 16, 2013, Orr recommended that Detroit file for Chapter 9 bankruptcy.¹⁹

Following Detroit’s Chapter 9 filing, hundreds of individuals and organizations filed objections with the bankruptcy court arguing that Detroit could not cut pension payments under Chapter 9’s provisions.²⁰ The objectors’ main argument was based on article 9, section 24 of the Michigan Constitution, which states that “[t]he accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby.”²¹ The ability of the federal bankruptcy process to impair

¹⁴ *Id.* (quoting MICH. COMP. LAWS § 141.1549(2) (2013)).

¹⁵ *Id.* at 126. Orr’s proposal discussed the “economic headwinds” Detroit faces and included a preliminary plan to restructure the city’s debt. CITY OF DETROIT, PROPOSAL FOR CREDITORS 101 (2013), available at <http://detroitmi.gov/Portals/0/docs/EM/Reports/City%20of%20Detroit%20Proposal%20for%20Creditors1.pdf>.

¹⁶ CITY OF DETROIT, *supra* note 15, at 109.

¹⁷ See Steven Yaccino, *Detroit’s Emergency Manager Rolls Out His Plan for Recovery*, N.Y. TIMES, June 15, 2013, at A11.

¹⁸ *Id.*

¹⁹ See *In re City of Detroit*, 504 B.R. at 128.

²⁰ See Nathan Bomey, *Dozens of Creditors, Others File Objections to Bankruptcy in Federal Court*, DETROIT FREE PRESS (Aug. 19, 2013, 8:47 PM), <http://www.freep.com/article/20130819/NEWS01/308190084/Detroit-bankruptcy-objections-eligibility-Chapter-9>.

²¹ MICH. CONST. art. 9, § 24. Each objection puts forth different arguments and legal justifications for protecting pensions and this article merely discusses the “main thrust” of the objections as a whole. For Judge

constitutionally guaranteed pension benefits was a novel issue for the bankruptcy court to decide.²²

C. The Holding of *In re Detroit*

On December 3, 2013, Judge Rhodes of the U.S. Bankruptcy Court for the Eastern District of Michigan issued a lengthy opinion ruling on a handful of issues concerning Detroit's eligibility for bankruptcy.²³ First, Judge Rhodes concluded that Detroit met all of the statutory requirements of 11 U.S.C. § 109(c) and could enter Chapter 9 bankruptcy.²⁴ Second, and most important for this article, Judge Rhodes held that Detroit could impair pension benefits under Chapter 9 of the bankruptcy code without violating the Michigan Constitution.²⁵

In holding that Detroit could cut pension benefits, Judge Rhodes first acknowledged that article 9, section 24 of the Michigan Constitution prevents the State of Michigan from impairing Detroit's pension benefits.²⁶ However, the opinion goes on to hold that a federal bankruptcy court is not subject to those restrictions of the Michigan Constitution.²⁷

Judge Rhodes's holding breaks down to the following syllogism. First, bankruptcy courts are authorized by the Bankruptcy Clause of the U.S. Constitution to impair contracts.²⁸ Rhodes stated that "[i]mpairing contracts is what the bankruptcy process does."²⁹ Second, under the Michigan Constitution, pension benefits are given "the status of contractual obligations" and are not entitled to "greater protection than ordinary contract debt."³⁰ In establishing this

Rhodes's treatment of the other objections, see *In re City of Detroit*, 504 B.R. at 129–90.

²² See Monica Davey, Bill Vlasic & Mary Williams Walsh, *Detroit Ruling Lifts a Shield on Pensions*, N.Y. TIMES, Dec. 4, 2013, at A1.

²³ See generally *In re City of Detroit*, 504 B.R. 97.

²⁴ *Id.* at 110. For the statutory requirements of Chapter 9 of the bankruptcy code, see 11 U.S.C. §109 (2012).

²⁵ *In re City of Detroit*, 504 B.R. at 150 ("The state constitutional provisions prohibiting the impairment of contracts and pensions impose no constraint on the bankruptcy process.").

²⁶ *Id.*

²⁷ *Id.*

²⁸ See *id.*

²⁹ *Id.*

³⁰ *Id.* at 150, 153.

premise, Judge Rhodes relied on the plain meaning of the language of article 9, section 24 of the Michigan Constitution, as well as Michigan Supreme Court precedent interpreting that language.³¹ Therefore, if the bankruptcy process can impair contracts, and pension benefits are contractual obligations, it follows that Detroit can impair its pension benefits through Chapter 9 bankruptcy.³²

D. Implications for Detroit Pensioners

1. The Appeals Process

Detroit unions and interest groups were quick to appeal Rhodes's decision.³³ On December 20, 2013, Judge Rhodes recommended that the Sixth Circuit decline to authorize a direct appeal, which would allow the case to skip past the U.S. District Court for the Eastern District of Michigan.³⁴ Furthermore, Judge Rhodes recommended that, even if the Sixth Circuit were to take the direct appeal, they should refuse to expedite the appeal.³⁵ On February 21, 2014, the Sixth Circuit authorized the direct appeal but refused to hear the appeal on an expedited basis.³⁶ The question on appeal will be whether Judge Rhodes erred by finding that Detroit was eligible to enter Chapter 9 bankruptcy.³⁷

Despite the Sixth Circuit's authorization of a direct appeal, it seems unlikely that they will overturn Judge Rhodes's eligibility

³¹ See *id.* at 152–53.

³² *Id.* at 154. For a thorough analysis of pension impairment in Chapter 9 bankruptcy and the eligibility decision by Judge Rhodes, see Vincent S. J. Buccola, *Who Does Bankruptcy? Mapping Pension Impairment in Chapter 9*, 33 REV. BANKING & FIN. L. (forthcoming 2014).

³³ Dale Kasler, *CalPERS Officials: Detroit Pension Ruling Won't Affect Public Employee Retirements Here*, SACRAMENTO BEE (Dec. 13, 2013, 4:33 PM), http://www.sacbee.com/2013/12/13/5998696/calpers-officials-detroit-pension.html#mi_rss=Business (last modified Dec. 14, 2013, 12:41 PM).

³⁴ *In re City of Detroit*, Mich., 504 B.R. 191, 200 (Bankr. E.D. Mich. Dec. 20, 2013).

³⁵ *Id.*

³⁶ Order Granting Motion for Direct Appeal, *In re City of Detroit*, Mich., No. 13-53846 (6th Cir. Feb. 21, 2014), ECF No. 2839.

³⁷ Nathan Bomey, *U.S. 6th Circuit Court to Consider Detroit Bankruptcy Eligibility Appeal*, DETROIT FREE PRESS (Feb. 21, 2014, 5:47 PM), <http://freep.com/article/2014221/NEWS01/302210073/Detroit-bankruptcy-Sixth-Circuit-appeal>.

holding.³⁸ In bankruptcy proceedings, “higher courts are typically loathe to overturn complex bankruptcy rulings that involve a nuanced examination of facts.”³⁹ If more complex bankruptcy holdings are less likely to be overturned, this would suggest that Detroit’s bankruptcy, the largest municipal bankruptcy in U.S. history, is unlikely to be reversed on appeal.⁴⁰ Nonetheless, some observers have speculated that Detroit’s bankruptcy case may reach the Supreme Court.⁴¹

2. The Debt Adjustment Plan

Judge Rhodes’s holding did nothing to affirmatively cut pension benefits but merely held that Detroit could cut pension benefits pursuant to Chapter 9 and the Michigan Constitution.⁴² After a debtor enters Chapter 9 bankruptcy, the debtor then formulates a “debt adjustment plan” (“Plan”) laying out its proposed payments to creditors.⁴³

The ultimate goal of Chapter 9 is the creation and enforcement of a Plan to restructure the debtor’s finances and set the debtor on the road toward a financially sound future.⁴⁴ The municipal debtor is required by sections 109(c)(4)-(5) of the Bankruptcy Code to produce an acceptable Plan by negotiating with creditors.⁴⁵ Once a plan is created, it is eligible for confirmation by a court only “if all

³⁸ See Free Press Staff, *Where Does Detroit’s Bankruptcy Go from Here? Here’s a Road Map to How it May Play Out*, DETROIT FREE PRESS (Jan. 1, 2014), <http://freep.com/article/20140101/NEWS01/301010014/Detroit-bankruptcy-end-of-year>.

³⁹ *Id.*

⁴⁰ *See id.*

⁴¹ *See Bomey, supra* note 37.

⁴² *See Kasler, supra* note 33.

⁴³ Francisco Vazquez, *Examining Chapter 9 Municipal Bankruptcy Cases*, in CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS, COUNSELING MUNICIPALITIES, AND ANALYZING RECENT TRENDS AND CASES 174 (Jo Alice Darden ed., 2011) (citing *In re Magma Irrigation & Drainage Dist.*, 193 B.R. 528, 535 (Bankr. D. Ariz. 1994)).

⁴⁴ *See* Francisco Vazquez & Eric Daucher, *Restructuring a Municipality Under Chapter 9*, 29 AM. BANKR. INST. J. 50, 51 (2010).

⁴⁵ 11 U.S.C. §§ 109(c)(4)–(5) (2012).

classes of creditors vote in favor of the plan.”⁴⁶ Alternatively, if not all classes of creditors approve the Plan, a court may nonetheless enforce the Plan’s provisions “if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired” and voted against the Plan.⁴⁷ Once a court confirms the Plan, it is binding on all classes of creditors, and the debtor is forgiven all debts other than those specifically enumerated in the Plan.⁴⁸

Detroit released a preliminary Plan on February 21, 2014⁴⁹ and is currently seeking creditor approval for that Plan.⁵⁰ The Plan proposes cutting general retirees’ pension payments by up to 34% and cutting police and fire retirees’ pension payments by around 10%.⁵¹ The details of the Plan will likely change as Orr continues to negotiate with creditors.⁵² The city’s 170,000 creditors will have until June 9, 2014 to submit their votes on whether to accept the Plan,⁵³ after which Judge Rhodes will have to confirm the Plan before it is implemented.⁵⁴

3. Potential Avenues of Help for Pensioners

All hope is not lost for Detroit’s pensioners yet. The pensioners’ plight engendered a media firestorm, which gave birth to

⁴⁶ Vazquez & Daucher, *supra* note 44. A Plan is “approved” by a class of creditors if it receives an affirmative vote from “two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors.” 11 U.S.C. § 1126(c).

⁴⁷ 11 U.S.C. § 1129(b)(1). The process of a court enforcing a Plan against non-approving creditors is known as “cramming down” a Plan. *See* Vazquez & Daucher, *supra* note 44.

⁴⁸ Vazquez & Daucher, *supra* note 44.

⁴⁹ Susan Tompor & Joe Guillen, *Detroit Pensioners Face up to 34% Cut, Loss of Cost of Living in Orr Proposal*, DETROIT FREE PRESS (Feb. 21, 2014, 11:49 PM), <http://freep.com/article/20140221/NEWS01/302220009/detroit-plan-adjustment-pensions>.

⁵⁰ Alisa Priddle & Brent Snavelly, *Detroit to Mail Ballots to 170,000 Creditors to Vote on Bankruptcy Plan*, DETROIT FREE PRESS (Feb. 28, 2014, 9:05 PM), <http://freep.com/article/20140228/NEWS01/302280138/Detroit-bankruptcy-plan-of-adjustment-creditors-vote-Kevyn-Orr>.

⁵¹ Tompor & Guillen, *supra* note 49.

⁵² *Id.*

⁵³ Priddle & Snavelly, *supra* note 50.

⁵⁴ Tompor & Guillen, *supra* note 49.

a public outcry for justice for the pensioners.⁵⁵ In response, both the Michigan legislature and philanthropic organizations have stepped up with plans to supplement pension payments.⁵⁶ In perhaps the most publicized plan, nine philanthropic organizations have pledged \$330 million towards the pension payments in return for a privatization of the Detroit Institute of Arts museum.⁵⁷ This plan would both aid pensioners in receiving full payment and protect the Detroit Institute of Arts from having to sell Detroit's precious artwork collection to pay off the city's debts.⁵⁸ Governor Rick Snyder has also been prodding the Michigan legislature to appropriate between \$300 and \$400 million to help Detroit's pensioners.⁵⁹ The Governor's proposal has received little support from Republican legislators though, who have "shown little interest during an election year in providing anything that might be perceived as a bailout for Detroit."⁶⁰ Governor Snyder is adamant that the proposal is not a bailout for banks or for Detroit, but simply an effort aimed at "helping reduce and mitigate the impact [of Detroit's bankruptcy] on retirees."⁶¹

E. Implications for Other Municipal Pensioners

Judge Rhodes's decision to subject pension benefits to impairment under Chapter 9 marked the first time a federal bankruptcy court had ever ruled on that issue.⁶² The significance of this holding is magnified by the recent, unprecedented wave of municipal bankruptcies.⁶³ Though it remains unclear exactly how Judge Rhodes's decision will affect other municipalities working

⁵⁵ See Randy Kennedy, Monica Davey & Steven Yaccino, *Foundations Aim to Save Pensions in Detroit Crisis*, N.Y. TIMES, Jan. 14, 2014, at A1.

⁵⁶ Monica Davey, *Lawmakers Weigh Aid for Detroit on Pensions*, N.Y. TIMES, Jan. 17, 2014, at A12.

⁵⁷ Kennedy, Davey & Yaccino, *supra* note 55.

⁵⁸ *Id.*

⁵⁹ Davey, *supra* note 56.

⁶⁰ *Id.*

⁶¹ Chris Isidore & Melanie Hicken, *Michigan Governor Offers \$350 Million for Detroit Pensions*, CNNMONEY (Jan. 22, 2014, 4:50 PM), <http://money.cnn.com/2014/01/22/news/economy/snyder-detroit-state-bailout>.

⁶² Davey, Vlastic & Walsh, *supra* note 22.

⁶³ See Mark S. Kaufman & B. Summer Chandler, *The Looming Chapter 9 Battle Over State Protection of Vested Public Employee Pension Benefits*, 32 AM. BANKR. INST. J. 14, 14 (2013).

their way through Chapter 9 bankruptcy, a number of theories have already been proposed.⁶⁴

1. The Bad

Many observers have pointed out ways that Judge Rhodes's holding could harm other municipal pensioners in the future.⁶⁵ First, Judge Rhodes's holding may set a precedent for cutting pension payments during times of municipal financial stress, thereby undermining the security of municipal pensions across the country.⁶⁶ Second, Judge Rhodes's holding is especially damning to the security of other municipal pension programs, because the Michigan Constitution established extremely strong pension protections that are not found in other state constitutions.⁶⁷ This argument suggests that "the greater includes the lesser": if Michigan's constitutionally protected pension benefits are subject to impairment, then pension benefits in *every* municipality are subject to impairment if they have similar or weaker statutory and constitutional protection than Michigan pensions.⁶⁸ Finally, Judge Rhodes's holding may give municipalities a disproportionately strong bargaining position over pensioners.⁶⁹ Now that municipalities know that they can simply be forgiven of their pension debts in Chapter 9 bankruptcy, they will have an unfair advantage at the negotiating table and will be disincentivized to engage in out-of-court negotiations with pensioners.⁷⁰

2. The Good

Though Detroit's pensioners will likely face payment cuts, some commentators have focused on potentially beneficial effects of Judge Rhodes's holding for other municipal pensioners.⁷¹ First, Detroit's bankruptcy nightmare may motivate other municipalities to

⁶⁴ See, e.g., Nora Macaluso, *Ruling on Detroit Pensions Seen as Incentive to Other Cities to Fix Funding Issues*, 25 Bankr. L. Rep. (BNA) 1705, 1706 (Dec. 19, 2013); Davey, Vlastic & Walsh, *supra* note 22.

⁶⁵ See, e.g., Davey, Vlastic & Walsh, *supra* note 22.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ See *id.*

⁶⁹ *Id.*

⁷⁰ See *id.*

⁷¹ See, e.g., Macaluso, *supra* note 64.

take a more proactive approach towards monitoring and funding their pension funds, thereby avoiding similar pension cuts in the future.⁷² Illinois has already responded by introducing legislation that would bring their pension funds to “full funding” within the next three decades.⁷³ Second, Judge Rhodes’s holding could spur municipal employees—the people who have the most to lose from underfunded pension programs—to act as a sort of “watchdog” over municipal pension systems and municipal finance in general.⁷⁴ Pensioners may have let Detroit’s pension liabilities expand out of control only because they falsely perceived article 9, section 24 of the Michigan Constitution as absolutely protecting their pension benefits. Following Judge Rhodes’s holding, that illusion has been shattered, and public employees now have a strong incentive to pay closer attention to municipal finance.⁷⁵ Finally, Judge Rhodes was interpreting the Michigan Constitution in *In re Detroit*, not the constitution of any other state.⁷⁶ Thus, bankruptcy courts in different states may reach different conclusions regarding their state’s constitutional pension protections.⁷⁷

F. Conclusion

Judge Rhodes’s holding in *In re Detroit* may raise more questions than it answers. The full implications of *In re Detroit* will be realized only when other municipalities try to impair their pension benefits. The City of San Bernardino, California could be an early indicator of *In re Detroit*’s impact.⁷⁸ San Bernardino filed for Chapter 9 bankruptcy in August 2012 and is approximately \$17 million behind in payments to the state pension program.⁷⁹ A number of other cities, including Los Angeles, Philadelphia, and Oakland,

⁷² *Id.*

⁷³ *Id.*

⁷⁴ Editorial, *A Wake-up Call from Detroit*, L.A. TIMES, Dec. 5, 2013, at A18.

⁷⁵ *Id.*

⁷⁶ Kasler, *supra* note 33.

⁷⁷ *Id.*

⁷⁸ *See id.*

⁷⁹ Tim Reid, *Bankrupt San Bernardino in Showdown with California Pension Fund Over Arrears*, REUTERS (Oct. 29, 2013, 8:40 PM), <http://reuters.com/article/2013/10/30/us-municipality-sanber-idUSBRE99T01020131030>.

have drastically underfunded pension programs.⁸⁰ If nothing else, *In re Detroit* has opened a political dialogue on municipal pension funding and has shone a glaring light on the financial practices of many of the nation's largest cities. Detroit's pensions may be lost, but *In re Detroit* could provide the impetus for other cities to finally take a proactive approach towards pension funding, ensuring that "another Detroit" is avoided.

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⁸⁰ Macaluso, *supra* note 64.

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