

Client Alert

Current Issues Relevant to Our Clients

February 26, 2014

Detroit Files its Chapter 9 Plan of Adjustment

Without reaching a consensual agreement with its various creditors, on Friday, February 21, 2014, the City of Detroit (the "City") filed its Chapter 9 Plan for the Adjustment of Debts (the "Plan") with the U.S. Bankruptcy Court for the Eastern District of Michigan. Pursuant to the Plan, Detroit has outlined proposed recoveries to its various creditors in an effort to reduce an estimated \$18 billion in debt and liabilities. Certain of the proposed recoveries and issues raised by the Plan are outlined below.

Detroit's Plan, however, is very much a work-in-progress — it appears likely given the scope of ongoing litigation that significant changes may be made before any of the City's impaired creditors vote upon a finalized plan and any plan is submitted for approval to the Bankruptcy Court.

Bondholder Treatment Under the Proposed Plan

1. Water and Sewer Bonds

The Plan proposes to pay holders of the City's water and sewer bonds their principal in full. Although the Plan purports to pay water and sewer bondholders 100 percent of the principal amount due on those bonds, the Plan also includes provisions to issue new notes to holders which may serve to reduce interest rates or change other important provisions. As a result, these holders have been deemed impaired and will be entitled to vote on the Plan. It is important to note that the Plan's treatment of these creditors is preliminary, as it is yet to be determined whether the City will transfer its water and sewer system to a regional authority and enter into a related leasing arrangement with a newly formed authority. The negotiations with respect to such a transfer are ongoing.

2. The Detroit Distributable State Aid Bonds

Holders of distributable state aid general obligation bonds of the City are treated as unimpaired creditors under the Plan, meaning that the City does not propose altering its obligations to these bondholders. Such holders will therefore not be entitled to vote upon the proposed Plan. The distributable state aid general obligation bonds are full faith and credit limited tax general obligations of the City and are secured by a pledge of, and statutory lien on, the City's distributable state aid, which consists of certain sales tax assessed and collected by the State of Michigan.

3. Detroit's General Obligation Bonds

Under the Plan, holders of general obligation bond debt secured solely by the full faith and credit of the City would be deemed impaired, treated as unsecured creditors and receive payments of just a fraction of the outstanding face amount of the debt—about 20 cents on the dollar.

Bond insurers, who would be expected to cover certain losses on any of the City's general obligation bonds that they have insured, have previously argued that such general obligation bonds are secured debt, asserting, among other things, that the bondholders hold a secured interest in certain property taxes and therefore should have a higher repayment priority than those creditors holding general unsecured claims against the City. The Bankruptcy Court is expected to rule in the next several weeks as to whether an adversary proceeding challenging the City's classification of its general obligation bond debt as unsecured debt may proceed.

Pensions & Employee Benefits

The Plan includes the City's pensioners along with its general obligation bondholders as general unsecured creditors. The pension holders have been deemed impaired, and will be allowed to vote on the Plan. The Plan provides that any recoveries to pension holders are dependant on a number of factors. Recoveries will be increased to the extent that the pension holders accept the Plan. Additionally, all recoveries are to be funded from

two sources, a settlement with respect to the City's artwork housed at the Detroit Institute of Arts Museum and the receipt of certain specified funds from the State of Michigan. Neither the Art Museum settlement nor the state aid are fully committed at this point. The Plan provides that no additional amounts would be available from the City's general fund for pension funding until June 30, 2023.

Other Key Issues

- In addition to the above proposed payments to creditors, the Plan also calls for investment of \$1.5 billion in City services over 10 years, including specific amounts for capital improvements, blight removal and equipment and technology upgrades.
- As noted above, the Plan does not include a proposed deal to spin off the Detroit Water and Sewerage Department, which the City has estimated could be worth \$1.9 billion over 40 years to the City. The City is still negotiating a potential water deal.
- The City has also sought to wipe out \$1.4 billion in pension debt issued in 2005 to eliminate the City's unfunded pension liabilities. The City argues that the so-called pension obligation certificates of participation were illegal and do not have to be paid. To the extent that the City is determined to be liable for such amounts, the Plan could face a substantial feasibility challenge.
- As part of its restructuring plan, the City has announced plans to obtain \$300 million in new financing upon emergence.
- While the Bankruptcy Court has previously ruled that the City is eligible for Chapter 9 protections, such decision is currently on appeal. On the same day the Plan was issued, the Sixth Circuit granted a petition for direct appeal with respect to the City's eligibility opinion. To the extent that any appeal is successful, the Plan may be deemed moot.

Conclusion

The City announced that it will continue negotiations with creditors in a bid to reach a consensual restructuring plan, which ultimately must be voted upon by the City's impaired creditors and approved by Bankruptcy Judge Steven Rhodes. It is important to note that pursuant to Chapter 9 of the U.S. Bankruptcy Code, only the City may propose a plan of adjustment and any such plan must comply with state law. Unlike in a Chapter 11 bankruptcy proceeding, creditors are not permitted to file a competing plan.

At this time, it is clear that the proposed Plan is very much a work in progress and is likely to change before it is finalized, given the large number of disputed issues

surrounding the City's finances and the nature of the various on-going litigation.

The information contained in this alert was derived solely from the Disclosure Statement with Respect to Plan for the Adjustment of Debts of the City of Detroit [Docket No. 2709] and the Plan for the Adjustment of Debts of the City of Detroit [Docket No. 2708], both publicly filed by the City in its bankruptcy proceeding, Case Number 13-53846 in the U.S. Bankruptcy Court for the Eastern District of Michigan, on February 21, 2014. This alert has been prepared by Chapman and Cutler LLP attorneys solely for informational purposes and is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such materials to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

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