

# Detroit, Stockton and US Municipal Bankruptcies

## Review by Johan Jol<sup>1</sup>

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Chair: Robert S. Hertzberg, Pepper Hamilton LLP  
Bruce Bennett, Jones Day  
James Doak, Miller Buckfire

The official program listed as panelists for this session: Robert S. Hertzberg of Pepper Hamilton LLP, and Kevyn Orr, formerly the Emergency Manager of the City of Detroit. As often happens in the heated restructuring arena, Kevyn Orr got stuck at the last moment due to some other emergency, but Robert S. Hertzberg, special litigation counsel for the City of Detroit, managed to assemble another interesting panel swiftly. Panelist were Bruce Bennett of Jones Day, co-lead counsel to Detroit and James Doak of Miller Buckfire, investment banker and financial consultant of City of Detroit. While these particular gentlemen were of course telling the story only from the Detroit side, their story was in my view a

fascinating one and the storytellers gave an interesting and lively presentation.

Some of the facts as disclosed by the panel: Detroit was once the fourth-most-populous city of America and the cradle of the America's automobile industry. It was precisely this dependency that got Detroit in trouble when the automotive industry went into a downward spiral<sup>2</sup>. The City of Detroit was hit hard: 80,000 buildings (houses, factories, hotels, stores, etc.) were empty and 50 % of the citizens of Detroit were not paying their taxes (the cash flow generator for any city). Detroit had a broken IT system and roughly US 17 billion of debt on its books, all of which caused significant budget deficits. On the bright side: Detroit still had a world class art collection.

Detroit filed for Chapter 9 proceedings on July 18, 2013. The current version of Chapter 9 came into existence in 1976 as a reaction to the near bankruptcy of New York City in 1975<sup>3</sup>. The purpose of Chapter 9 is not to liquidate but to restructure (the debts of) certain public debtors. In order to be eligible to file, Detroit needed to be a

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<sup>2</sup> By 1950, the population peaked at almost 1.85 million. The Big Three auto companies: Ford, General Motors and Chrysler were the main employers. Both General Motors and Chrysler has their share of a bankruptcy proceeding, Ford was able to avoid that.

<sup>3</sup> See video of Financial Times re almost failure of New York City: <http://video.ft.com/v/1071245984001/New-York-s-brush-with-bankruptcy>



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municipality, specifically empowered by State law to file<sup>4</sup>, it had to be insolvent and have the desire to effect a plan of reorganization. When Detroit filed, its eligibility was disputed but Bankruptcy Judge Rhodes confirmed, in his opinion of December 5, 2013 that City of Detroit may be a debtor under Chapter 9 and reconfirmed the issue in his oral opinion on the record at the confirmation hearing of the Plan on November 7, 2014<sup>5</sup>.

On the legal side, the pivotal issue was whether the City of Detroit could impair its obligations to retired Detroit employees. These employees took the view that their pension obligations were protected by the Michigan Constitution. The bankruptcy judge took a different view. The Plan was - before being put in front of the judge - heavily negotiated and was in essence a successful combination of various settlements. A full description of the Plan was not given by the panel and goes in any event go beyond the scope of this report. It suffices to say that the earlier mentioned art collection, as well as other City assets, were monetized by the City of Detroit.<sup>6</sup> In the Plan, the City of Detroit, together with the

State and the contributing foundations used a so called "Grand Bargain" to shelter the art collection from the claims of the City's creditors - by transferring the art collection permanently to a public trust against a certain payment<sup>7</sup>. Judge Rhodes confirmed the Plan and gave Detroit back to its people<sup>8</sup>. Whether this is the end of the financial distress story of Detroit remains to be seen. Even after the various legal fights which are still going on, among other things appeals against the confirmation of the Plan<sup>9</sup> are settled, the road to success for Detroit will be a difficult one. My take away of this session was: yes, Chapter 9 proceedings, or other debt restructuring possibilities for governmental organizations, do make sense. I am anxious to see how quickly the international insolvency community will be able to pick up on the restructuring of debt of governmental organizations<sup>10</sup> and if those now familiar with the American tools will be willing and able to convince the rest of the world that sovereign debt restructuring mechanisms such as Chapter 9 can be greatly helpful<sup>11</sup>. We may need them soon. This is our wake up call<sup>12</sup>! 🚨

<sup>4</sup> Michigan's Emergency Financial Manager Act permits Michigan's governor to authorize a Chapter 9 filing by a municipality, such as Detroit which happened in the Detroit's case in July 2013.

<sup>5</sup> Oral Opinion on Detroit plan of confirmation of Judge Rhodes, available at: [http://www.mieb.uscourts.gov/sites/default/files/notices/Oral\\_Opinion\\_on\\_Detroit\\_Plan\\_Confirmation\\_Judge\\_Rhodes\\_FINAL\\_for\\_Release.pdf](http://www.mieb.uscourts.gov/sites/default/files/notices/Oral_Opinion_on_Detroit_Plan_Confirmation_Judge_Rhodes_FINAL_for_Release.pdf)

<sup>6</sup> Detroit's other main asset was its water and disposal system, which provides water and sewer disposal for itself and three Michigan counties. The plan also provided for the creation of a new water and sewer authority and restructured over \$6 billion of the debt that was secured by water and sewer revenue.

<sup>7</sup> The price for transferring the collection and buildings permanently to a public trust is as I understand less than the low end of the Christie's valuation of just a part of the art collection. The Bankruptcy Court denied the efforts of the City's bondholders to use the art to secure a loan to the City for over \$1 billion.

<sup>8</sup> Judge Rhodes said: "Before I conclude, I want to address the people of the City of Detroit, whose passion for this City is remarkable in its breadth, in its expression, and in its unwavering endurance, I just said that your leader are about to get the City back. Actually of course, it you who are about to get your City bank. It is your City." See page 56 of the Oral Opinion on Detroit plan of confirmation; for those who want to listen to a part of his Oral Opinion, go to: Bankruptcy Beat, Detroit Judge to Residents: Tour Anger Will Prevent Another Meltdown, available at the website of Wall Street Journal, <http://blogs.wsj.com/bankruptcy/2014/11/10/detroit-judge-to-residents-your-anger-will-prevent-another-meltdown/>

<sup>9</sup> I understand that appeals (or at least one) of the Plan of Confirmation are (is) pending, see for example Detroit Active and Retired Employees Association, see: <http://voiceofdetroit.net/2015/02/03/retirees-carry-on-the-battle-for-detroit-appealing-bankruptcy-to-higher-court/> .

<sup>10</sup> For example, my home country the Netherlands does not have such a mechanism in place.

<sup>11</sup> See on the latest information re sovereign debt level the McKinsey Global Institute report of February 2015, to be found: [http://www.mckinsey.com/insights/economic\\_studies/debt\\_and\\_not\\_much\\_deleveraging](http://www.mckinsey.com/insights/economic_studies/debt_and_not_much_deleveraging) , see on the United Nations Status of Sovereign Debt Restructuring Mechanism, the United Nations General Assembly decision of August 2014, to be found here: [http://www.un.org/ga/search/view\\_doc.asp?symbol=A/68/L.57/Rev.1&Lang=E](http://www.un.org/ga/search/view_doc.asp?symbol=A/68/L.57/Rev.1&Lang=E)

<sup>12</sup> And for the younger ones looking for a niche in the restructuring market: this might just be it.

## Tell me a Secret: Investigations and Information Exchange in Cross-border Insolvencies



### Review by Johnson Kong

BDO  
Hong Kong

Chair: Felicity Toubé QC, South Square  
Cosimo Borrelli, Borrelli Walsh  
Hugh Dickson, Grant Thornton  
Edward Mackereth, Ogier

A capacity crowd attended this very first breakout session held in the Grand Ballroom. This lively session was built on a hypothetical case study under which a Jersey financial regulator has discovered that a Jersey incorporated financial institution, which operates across a number of jurisdictions through different legal entities, has been selling financial products to clients through its "friends" who are all employees working on commission but some of these products sold to clients do not exist. In addition, while some of the clients have received money they are now being approached by "friends" everyday to pay more money in by way of margin. On the other hand when clients seek to retrieve money out of the financial institution, the time taken to release profits is extending well beyond a reasonable period of time.

The regulator has decided to take action and seek advice