Detroit Ruled Eligible For Bankruptcy

December 2013

The City of Detroit filed for Chapter 9 bankruptcy protection on July 18, 2013. On December 3rd, the court ruled that Detroit was indeed eligible to remain under Chapter 9 bankruptcy protection, having sufficiently met insolvency tests. The city now takes on the task of negotiating with creditors while drawing up its plan of adjustment. Below are a few important points:

- Judge Rhodes ruled that Detroit is eligible to remain in bankruptcy due to financial insolvency and "service insolvency". The eligibility ruling was largely anticipated.

- The Judge also ruled that Detroit's problems were so significant and the number of creditors so broad that negotiating in good faith with creditors before filing Chapter 9 was "impossible". This was the major point the unions were making in an attempt to have the bankruptcy filing ruled invalid by the court.

- The Judge further ruled that pensions <u>may</u> be reduced because they are "contractual in nature" and not explicitly protected under federal bankruptcy law, despite protections in Michigan's state constitution. The fact that the Judge addressed the possibility of pension cuts was significant as it was not expected to be raised until later in the proceedings.

- No bondholders or bond insurers opposed Detroit's bankruptcy eligibility as they believe they can get a better deal in bankruptcy rather than settling out of court, primarily because the court can force pension reductions.

- Unions are expected to appeal the judge's decision.

- ***What this means going forward: The city can move forward with negotiating with creditors and eventually putting forth its debt adjustment plan. At this point it seems likely that both bondholders and pensioners will experience "haircuts." However, when we say "bondholders" we are not necessarily including all bondholders. It remains to be seen if unlimited tax general obligation bonds will be reduced.***

Its still too early to speculate on the ultimate outcome and impacts of these proceedings, but yesterday's ruling made it clear that pensions could be cut under federal bankruptcy, which could set precedent in future negotiations between municipalities and pensioners. If pension benefits are allowed to be reduced, this may actually **decrease** future bankruptcy filings and increase the frequency of pension reforms. Pensioners may realize that they are better off negotiating changes to benefits outside of court, increasing their cooperation in pre-bankruptcy negotiations.

We will continue to monitor these proceedings as they develop.

Appleton Partners does not approve Detroit debt for purchase in client accounts.

For more information on Detroit's financial standing, please reference our prior pieces from this summer where we outline the city's recent default (Detroit Debt Default) and discuss the market implications of the city's bankruptcy (Detroit's Bankruptcy Filing). We will be happy to provide additional copies upon request.

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