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Zombieland/The Detroit Bankruptcy: Why Debts Associated with Pensions, Benefits, and Municipal Securities Never Die... And How They are Killing Cities Like Detroit

Christine Sgarlata Chung

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**ZOMBIELAND / THE DETROIT
BANKRUPTCY:
WHY DEBTS ASSOCIATED WITH PENSIONS,
BENEFITS, AND MUNICIPAL SECURITIES
NEVER DIE . . . AND HOW THEY ARE
KILLING CITIES LIKE DETROIT**

*Christine Sgarlata Chung**



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INTRODUCTION

Despite pockets of urban renewal and the determined efforts of its loyal citizens, the city of Detroit is a “shadow of the thriving metropolis that it once was,” beset by “decades of fiscal mismanagement, plummeting population, employment and revenues, decaying City infrastructure, deteriorating City services and excessive borrowing that provided short term band-aids at the cost of deepening insolvency.”¹ Detroit has more than 140,000 blighted properties, and approximately 78,000 “abandoned and blighted” structures, some 38,000 of which are considered dangerous.² In 2012, the City’s violent crime rate was five times the national average, and higher than any U.S. city with a population greater than 200,000.³

1. *See, e.g.*, Declaration of Kevyn D. Orr in Support of the City of Detroit, Michigan’s Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code at 4–5, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. July 18, 2013) [hereinafter Orr Declaration]; *see also* Opinion Regarding Eligibility at 20–22, *In re City of Detroit*, Michigan, No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Dec. 5, 2013).

2. *See* Memorandum in Support of Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code at 25, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. July 18, 2013) [hereinafter Memorandum in Support of Statement of Qualifications]; Nick Carey, *Detroit Blight Battle to Take Down Abandoned Buildings Could Be Key to Bankrupt City’s Survival*, HUFFINGTON POST (Apr. 25, 2013, 7:00 AM), http://www.huffingtonpost.com/2013/07/25/detroit-blight-abandoned-buildings-bankrupt-_n_3651224.html. The number of abandoned and blighted structures represents approximately one-fifth of the City’s housing stock. *See id.*

3. *See e.g.*, Opinion Regarding Eligibility, *supra* note 1, at 12; *see also* CITY OF DETROIT OFFICE OF THE EMERGENCY MANAGER, CITY OF DETROIT: PROPOSAL FOR CREDITORS 9 (2013) [hereinafter PROPOSAL FOR CREDITORS], *available at*

The homicide rate alone is at the highest level in nearly forty years.⁴ Citizens wait almost one hour for police to respond to calls, when the national average is only eleven minutes,⁵ and the City's case clearance rate for violent crimes is "substantially below" that of comparable municipalities.⁶

Once a thriving industrial center, Detroit's economy is in shambles. The number of jobs in Detroit has declined precipitously over the years,⁷ and the City's unemployment rate stood at 18.3% as of June 2012, having nearly tripled since 2000.⁸ Those Detroiters fortunate enough to be employed are likely to earn far less than other residents of Michigan, and the percentage of Detroiters living below the poverty line is far greater than in Michigan as whole.⁹ As economic conditions have declined, the City's population has plummeted, falling sixty-three percent since the City's post-War peak and twenty-six percent since just 2000.¹⁰ Economic decline and population loss have eroded the City's tax base, causing tax revenues to plummet¹¹ even as residents' per capita tax burden has ballooned.¹² The City is so cash-strapped that public services for residents and business are

<http://www.detroitmi.gov/Portals/0/docs/EM/Reports/City%20of%20Detroit%20Proposal%20for%20Creditors1.pdf>.

4. See, e.g., Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code, at 12, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. July 18, 2013) [hereinafter Statement of Qualifications].

5. *Id.* at 12; Orr Declaration, *supra* note 1, at 22; Opinion Regarding Eligibility, *supra* note 1, at 12.

6. Orr Declaration, *supra* note 1, at 23.

7. See Orr Declaration, *supra* note 1, at 20 ("The number of jobs in Detroit (for residents and non-residents) declined from 735,104 in 1970, to 562,120 in 1980, to 412,490 in 1990, to 346,545 in 2012.") (citations omitted).

8. PROPOSAL FOR CREDITORS, *supra* note 3, at 1; Orr Declaration, *supra* note 1, at 20 (citing SOUTHEAST MICH. CONFERENCE OF GOV'TS, POPULATION AND HOUSEHOLD ESTIMATES FOR SOUTHEAST MICHIGAN (2012), available at http://www.semcog.org/uploadedFiles/Population_and_Household_Estimates_for_December_2012.pdf).

9. See, e.g., Orr Declaration, *supra* note 1, at 17 ("Detroiters' average *per capita* annual income from 2007 to 2011 was \$15,261; the median household income for that same period was \$27,862.43. During that period, an estimated 36% of Detroiters were living below the poverty line. Only 54% of Detroiters owned a home, the median value of which was \$71,100. To put these numbers in perspective, the average *per capita* annual income in Michigan from 2007 to 2011 was \$25,482.46 the median household income was \$48,669.47 and only 16% of Michigan citizens lived below the poverty line. The state-wide homeownership rate was 74%, and the median home value was \$137,300.49.") (citations omitted).

10. See, e.g., PROPOSAL FOR CREDITORS, *supra* note 3, at 1; Orr Declaration, *supra* note 1, at 13-14.

11. See, e.g., Orr Declaration, *supra* note 1, at 16, 18.

12. See, e.g., *id.* at 16, 20.

now severely inadequate.¹³ Forty percent of the city's street lights do not work.¹⁴ There are reports of abandoned dogs roaming some of the City's streets.¹⁵ Photographs of parts of Detroit remind one of New Orleans, post-Katrina—except that in Detroit, the waters of decay and decline have been seeping into the city for the past fifty years.

On July 18, 2013, in the face of these challenges, Detroit's Emergency Manager Kevyn Orr filed a petition on behalf of the City seeking bankruptcy protection under Chapter 9 of the United States Bankruptcy Code.¹⁶ (As required by Michigan law, Orr filed the petition on Detroit's behalf after having sought and received authorization from Michigan Governor Richard Snyder.¹⁷) The City's filings paint a grim picture of Detroit's fiscal condition. Detroit has more than 100,000 creditors and it owes those creditors more than \$18

13. *See, e.g., id.* at 21–22. On March 15, 2013, attorney Kevyn D. Orr was appointed emergency manager of Detroit by the Local Emergency Financial Assistance Loan Board (LEFALB) created under Sections 141.931–141.942 of the Emergency Municipal Loan Act, pursuant to Public Act 72 of 1990 of the State of Michigan, also known as Sections 141.1201–141.1291 of the Local Government Fiscal Responsibility Act. *Id.*

14. *See, e.g., id.* at 24.

15. *See* Mark Binelli, *City of Strays: Detroit's Epidemic of 50,000 Abandoned Dogs*, ROLLING STONE (Mar. 20, 2012), <http://www.rollingstone.com/culture/news/city-of-strays-detroits-epidemic-of-50-000-wild-dogs-20120320>; Corey Williams, *Detroit Stray Dogs Counted in First Survey of City's Abandoned Pet Population*, HUFFINGTON POST (Sept. 21, 2013, 1:58 PM), http://www.huffingtonpost.com/2013/09/22/detroit-stray-dogs-survey-count_n_3972292.html#slide=more318123.

16. *See* Bankruptcy Petition, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. July 18, 2013). Orr was appointed Emergency Manager in March 2013 after Michigan's Governor found that a financial emergency existed in the City. *See* Opinion Regarding Eligibility, *supra* note 1, at 24–31 (for a discussion of the events leading the appointment of Orr as Emergency Manager); *see also* Orr Declaration, *supra* note 1, at 1–3. As Emergency Manager, Orr acts in the place and stead of the City's elected mayor. *Id.*

17. Statement of Qualifications, *supra* note 4, at 7–9, 11–14; *see also* Letter from Kevin D. Orr, Emergency Manager, City of Detroit, Mich., to Richard Snyder, Governor, State of Mich. & Andrew Dillon, Treasurer, State of Mich. 11 (July 16, 2013), *in* Orr Declaration, *supra* note 1 (attached as Exhibit J) (“The City must be specifically authorized, in its capacity as a municipality or by name, to be a debtor under chapter 9 by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under chapter 9. PA 436 authorizes the commencement of a chapter 9 case by the Emergency Manager upon the Governor's authorization.”).

billion.¹⁸ The City's debts, which are comprised of \$11.9 billion in unsecured debt and \$6.4 billion in secured debt,¹⁹ include:

approximately (a) \$5.85 billion in special revenue obligations; (b) \$6.4 billion in other post-employment benefits, or "OPEB" liabilities; (c) \$3.5 billion in underfunded pension liabilities based on current actuarial estimates; (d) \$1.13 billion in secured and unsecured general obligation ("GO") liabilities; (e) \$1.43 billion in liabilities under pension-related certificates of participation ("COPs"); (f) \$295.5 million in swap liabilities related to the COPs and (g) \$300 million in other liabilities.²⁰

The City's filings state that "debt service on obligations other than those secured by special revenues consumed a staggering 42.5% of the City's revenues in the 2013 fiscal year," a percentage the city estimates will increase to 65% of revenues by 2017.²¹

Detroit's bankruptcy petition—which the City's public workers bitterly oppose²²—raises two issues of first impression with implications for bankruptcy law, state and federal Constitutional law and municipal securities regulation: First, can Detroit use Chapter 9 to reduce or restructure accrued pension rights of retired city workers when the Michigan Constitution contains (i) a clause stating 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" (the Pension Clause),²³ and (ii) a clause stating that "[n]o . . . law impairing the obligation of contract shall be enacted" (the Contracts

18. Memorandum in Support of Statement of Qualifications, *supra* note 2, at 44; *see also* Opinion Regarding Eligibility, *supra* note 1, at 5.

19. Opinion Regarding Eligibility, *supra* note 1, at 5. Detroit is the largest municipal bankruptcy case filed in U.S. history. *See, e.g.*, Michael Fletcher, *Detroit Goes Bankrupt, Largest Municipal Filing in U.S. History*, WASH. POST, July 18, 2013, http://www.washingtonpost.com/business/economy/detroit-files-largest-municipal-bankruptcy-in-us-history/2013/07/18/a8db3f0e-efe6-11e2-bed3-b9b6fe264871_story.html

20. Memorandum in Support of Statement of Qualifications, *supra* note 2, at 2-3; *see also* Opinion Regarding Eligibility, *supra* note 1, at 7.

21. Memorandum in Support of Statement of Qualifications, *supra* note 2, at 3.

22. *See, e.g.*, Objection of the Detroit Retirement Systems to the Motion of Debtor for Entry of an Order (I) Authorizing the Assumption of that Certain Forbearance and Optional Termination Agreement Pursuant to section 365(c) of the Bankruptcy Code, (II) Approving such Agreement Pursuant to Rule 9019 and (III) Granting Related Relief, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Aug. 18, 2013); Consolidated Objection of the Retiree Association Parties to Eligibility, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Aug. 18, 2013).

23. MICH. CONST. art. IX, § 24.

Clause)?²⁴ Second, will debts associated with unlimited tax general obligation bonds (UTGO)—or, bonds backed by the full faith and credit or taxing power of the issuer—be subject to adjustment in bankruptcy, when (i) Detroit already is levying taxes at or near statutory maximums; (ii) citizens cannot, as a practical matter, absorb tax increases due to poverty, economic decline and population loss; and (iii) Detroit does not have (and will not have, without restructuring) sufficient funds to pay in full both accrued pension benefits and general obligation bond debt?

On December 5, 2013, after extensive briefing and lengthy hearings, the United States Bankruptcy Court for the Eastern District of Michigan (Judge Steven Rhodes) issued a landmark 143-page opinion regarding Detroit's eligibility (Opinion Regarding Eligibility).²⁵ Citing the Pension Clause, public workers had argued that Detroit is not eligible to be a Chapter 9 debtor because the City failed to carve out accrued pension benefits and protect them from adjustment.²⁶ After cataloging Detroit's dire financial circumstances and the grim realities of life in Detroit, Judge Rhodes held that Detroit is eligible to be a debtor despite the failure explicitly to protect accrued pension benefits.²⁷ Judge Rhodes further held that accrued pension benefits can be adjusted in Chapter 9 proceedings, notwithstanding the Pension Clause. Judge Rhodes reasoned that accrued pension benefits are contract rights under Michigan law,²⁸ and that they can be impaired in bankruptcy along with other contracts, without running afoul of United States or Michigan Constitutions.²⁹ While Judge Rhodes was careful to emphasize that the court "will not lightly or casually exercise the power under federal bankruptcy law to impair pensions,"³⁰ the opinion (if it stands)³¹

24. *Id.* art. I, § 10.

25. *See* Opinion Regarding Eligibility, *supra* note 1.

26. *Id.* at 29. These objections, and others, are discussed below.

27. *Id.* at 5–6, 38–142.

28. *Id.* at 41–44.

29. *Id.* Judge Rhodes held that "[t]he [Michigan] state constitutional provisions prohibiting the impairment of contracts and pensions impose no constraint on the bankruptcy process." *Id.* at 40.

30. *Id.* at 44.

31. Following Judge Rhodes' ruling respecting eligibility, a number of Objectors filed timely appeals, and later moved to certify Judge Rhodes's opinion regarding the City's eligibility for direct appeal to the Sixth Circuit on an expedited basis. *See, e.g.,* Detroit Fire Fighters Ass'n, Detroit Police Officers Ass'n, and Detroit Police Command Officers Ass'n, Amended Motion to Certify the Court's Eligibility Ruling for Direct Appeal to the Sixth Circuit Court of Appeals, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E. D. Mich. Dec. 19, 2013); Request of

means that that the accrued pension benefits of Detroit's public workers may be subject to impairment in the City's bankruptcy case.³²

Detroit's debt crisis and Judge Rhodes' ruling bring conflicts between municipal stakeholders into sharp relief. First, there are Detroit's residents. Although they are responsible for paying the City's debts through taxes and fees, they (i) face an enormous tax burden, already levied at or near statutory maximums, (ii) have limited resources to meet this burden due to population loss, economic decline and unemployment, and (iii) face escalating expenses, crumbling infrastructure and grossly inadequate services, despite their tax burden. Next, there are public workers, especially retired workers with accrued pensions and other post-employment benefits. These workers are not wealthy (pensioners reportedly receive an average of \$18,000 per year),³³ and they were promised benefits—promises supported by the Pension Clause—but the City's overwhelming debt load makes it difficult to see how these and other obligations can be met. Finally, there are the city's creditors/lenders, including general obligation bondholders, some of whom were promised that the city's taxing power and/or dedicated revenue streams would be available for repayment, but who now are being told that they should expect substantial losses. Put simply, Detroit is faced with a toxic stew of competing rights and obligations, and it cannot simply tax, cut or borrow its way out of economic distress.

The following Article, examines legal questions presented by Detroit's bankruptcy against the backdrop of this toxic stew. Part I examines the municipality as debtor, and discusses how and why municipalities incur debts, and why struggling municipalities like Detroit find it difficult to make ends meet. Part II examines the legal questions referenced above and discusses Judge Rhodes' opinion. Part III examines potential reforms, and argues that state and local governments ought to develop and implement robust systems to (i)

International Union, UAW and *Flowers* Plaintiffs for Certification Permitting Immediate & Direct Appeal to the Sixth Circuit from the Court's Eligibility Determinations, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Dec. 17, 2013). On December 20, 2013, Judge Rhodes issued a memorandum in which he certified that the Objectors' appeals involve a "matter of public importance" under subsection (i) of § 158(d)(2)(A)(i), but recommended that authorization for immediate, direct appeal to the Sixth Circuit be denied. Memorandum Regarding: I. Certification Under 28 U.S.C. § 158(d)(2)(A)(i) II. Recommendation on Whether Direct Appeals Should Be Authorized & III. Parties' Request to Recommend Expedited Consideration of Appeals at 9, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E. D. Mich. Dec. 20, 2013).

32. Opinion Regarding Eligibility, *supra* note 1, at 80.

33. *Id.* at 6.

identify struggling municipalities earlier, (ii) intervene earlier with oversight controls, technical assistance (including assistance with governance, financial decision-making and internal controls) and potentially financial assistance; and (iii) develop robust work-out mechanisms before a crisis erupts. In making these proposals, this Article acknowledges that these reforms require political will, which inevitably is in short supply. Consequently, I argue that requiring fidelity to the public good—via a fiduciary standard for public officials and other stakeholders (including the financial institutions that serve as underwriters and derivatives counterparties in municipal securities offerings and related transactions)—could help to ensure that those in a position to obligate the municipality make decisions that are in the municipality’s best interest, over the long term.

I. THE MUNICIPALITY AS DEBTOR: WHY DO CITIES INCUR DEBT, AND WHY DO THEY STRUGGLE TO MAKE ENDS MEET?

To put Detroit’s fiscal crisis in context, it helps to understand why cities incur debt, and why legal, economic and political forces can make it difficult for distressed cities to make ends meet. The next section addresses this foundational question, focusing on municipalities’ obligation to provide infrastructure and services to residents despite legal, economic and political constraints on both revenue and debt relief.

A. Funding Imperative: Public Purpose

State and local governments face a fundamental fiscal challenge: they must spend on infrastructure and public services, but there are constraints on revenues available for this work, and few opportunities for expense reduction or debt relief.³⁴ Unlike businesses, which may scale back operations or reduce head-count when times are tough, municipalities cannot close up shop. Instead, they must provide at least basic infrastructure (e.g., roads, bridges, water and sewer plants), education (e.g., schools, teachers), and health and safety services (e.g.,

34. See, e.g., Shaheen Borna & Krishna G. Mantripragada, *Morality of Public Deficits: A Historical Perspective*, PUB. BUDGETING & FIN., Spring 1989, at 33, 35 (“The goal of public finance . . . is, ideally, to bring about maximum social welfare . . .”). As I have argued elsewhere, this funding imperative means that municipalities may have less flexibility than their corporate counterparts respecting the timing and amount of borrowing and expenditures, and less flexibility to reduce expenses through deferral, head-count reduction or the sale or leveraging of assets. See Christine Sgarlata Chung, *Municipal Securities: The Crisis of State and Local Government Indebtedness, Systemic Costs of Low Default Rates, and Opportunities for Reform*, 34 CARDOZO L. REV. 1455, 1481–84 (2013).

fire, police, EMS) for residents at all times. For example, compare Detroit's non-waivable obligation to provide basic infrastructure and services (including fire, police, EMS and a public education for its children) with smartphone maker Blackberry, Ltd.'s freedom to lay off 4500 workers and scale back operations in response to deteriorating sales and revenue numbers.³⁵ Similarly, compare Detroit's obligation to "stay in business" despite its insolvency with auto manufacturers' ability to shutter plants, lay off workers and declare bankruptcy in response to fiscal stress.³⁶

In fact, government's obligation to remain open for business drives spending. According to the United States Census Bureau's 2011 summary of state and local government spending, for example, education and utility expenditures "topped their [local government] spending at \$599.3 billion and \$183.7 billion, respectively."³⁷ Public safety spending (police and fire in particular) also weighed heavily on local governments, according to the Census Bureau,³⁸ as did spending on water and gas supply.³⁹ This obligation to spend, even in the face of economic stress, can lead to tensions between stakeholders with competing claims on limited government resources.

35. See, e.g., Hugo Miller, *Blackberry to Fire 4,500, Write Down Up to \$960 Million*, BLOOMBERG (Sept. 20, 2013), <http://www.bloomberg.com/news/2013-09-20/blackberry-to-fire-4-500-write-down-up-to-960-million.html>.

36. See, e.g., MARIAN KRZYWSKI & LAWRENCE A. MOLNAR, *Univ. of Mich. Office of the Vice President for Research, Institute for Research on Labor, Employment and the Economy, Impacts of the Automotive Industry's Restructuring*, FED. RESERVE BANK CHI., http://www.chicagofed.org/digital_assets/others/events/2009/automotive_communities/presentation_impact_of_restructuring.pdf (last visited Mar. 15, 2014) (referencing a case study by the University of Michigan's Institute for Labor, Employment and the Economy which found that the closure of a single plant (the General Motors' Moraine Assembly Plant in Montgomery County, Ohio) led to the loss of thousands of jobs, and had a total economic impact to the regional economy in excess of \$700,000); Bill Vlasic & Nick Bunkley, *Obama Is Upbeat for GM's Future*, N.Y. TIMES, Jan. 1, 2009, http://www.nytimes.com/2009/06/02/business/02auto.html?_r=0 (discussing General Motors' 2009 bankruptcy filing).

37. JEFFREY L. BARNETT & PHILLIP M. VIDAL, U.S. CENSUS BUREAU, STATE AND LOCAL GOVERNMENT FINANCES SUMMARY: 2011 4 (2013), available at http://www2.census.gov/govs/local/summary_report.pdf.

38. Cf. *id.* ("Public safety spending (comprised of police, fire, and corrections) was dominated by local governments, with the exception of spending on corrections. Local governments comprised 86.7 percent of the state and local government total spending on police protection. Spending on fire protection was an entirely local government function. State government spending comprised 63.9 percent of state and local government spending on correction.").

39. *Id.* ("Utility spending was also dominated by local governments, with spending on water supply and gas supply almost entirely conducted by local governments, at 99.4 percent and 99.8 percent, respectively.").

1. *The Challenge of Meeting Basic Infrastructure and Public Service Needs in the Face of Fiscal Constraints.*

Detroit's obligation—and current inability—to meet public safety needs “bring[s] the depth of [the City's] service delivery insolvency into stark relief,”⁴⁰ and demonstrates how a city's obligation to spend, even in the face of fiscal hardship, can accelerate financial collapse and pit stakeholders against one another. As noted in the Introduction, Detroit's public safety needs are enormous and unmet, and the City's large geographic footprint, depopulation and expanding blight continue to worsen the situation.⁴¹ Today, the City's over-burdened police and fire resources are disproportionately diverted to distressed areas in far-flung regions of the of the City which are “littered with abandoned, forfeited or foreclosed land and structures,” and which have become a “breeding ground” for crime.⁴² Of the 11,000 to 12,000 fires that the City experienced each year for the past ten years, approximately sixty percent have occurred in blighted and unoccupied buildings, forcing police and fire departments to expend precious resources fighting blazes in vacant, dangerous structures.⁴³ Even getting to these locations is difficult: the City's infrastructure for police, fire and EMS is so “aged, inadequately maintained and lack[ing in] modern technology” that it has “been reduced to accepting charitable donations to inspect its ground and truck ladders and to upgrade its fleet (donations which do not begin to resolve the issues plaguing the City's vehicle fleet).”⁴⁴ The cost of making a material dent in urban blight, and thus (hopefully) reducing the burden on fire and public safety services, could “easily exceed half a billion dollars” according to the City⁴⁵—resources the City clearly does not have.⁴⁶ Moreover, even if the City

40. See Memorandum in Support of Statement of Qualifications, *supra* note 2, at 23.

41. For a series of maps which reflect the City's population decline, and the challenge of address public health and safety given Detroit's geographically large footprint, see Robert Linn, *The High Cost of Free Walking*, MAPPING STRAIT (Dec. 8, 2011, 3:19 AM), <http://mapdetroit.blogspot.com/2011/high-cost-of-free-walking.html>; *The Shrinking of Detroit*, MAP SCROLL (June 13, 2009, 5:29 PM), <http://mapscroll.blogspot.com/2009/06/shrinking-of-detroit.html>.

42. See Memorandum In Support of Statement of Qualifications, *supra* note 2, 24–25 (citing Orr Declaration, *supra* note 1, at 5).

43. *Id.* at 25.

44. *Id.* at 26.

45. *Id.* at 25.

46. See, e.g., Orr Declaration, *supra* note 1, at 37–41.

could reduce blight, it still would not be able to make the kind of public safety investments needed to put the City back on track.

B. Legacy Liabilities: A Driver of Indebtedness

1. Pensions and OPEB: A Gordian Knot for Municipal Officials

If the City's public safety needs are obvious, however, finding the resources to address these needs has become a Gordian knot. In part, this difficulty is because paying for public safety involves costs associated with current work force (fire, police, EMS) as well as legacy expenses associated with retired workers who worked (and were promised benefits) during earlier, less cash-strapped times.⁴⁷ As noted above, Detroit's legacy pension and OPEB obligations are enormous, representing more than half of the City's outstanding debt, and the City's poverty and economic decline make it difficult to see how it can ever satisfy its legacy expense-related debts.⁴⁸

To understand why legacy obligations are so large and challenging for Detroit, it helps to remember that Detroit's pension plans have design challenges and funding obligations not shared by most private employers.⁴⁹ For example, public pension plans must address the lack of social security participation and coverage for certain workers, and in some cases, earlier mandatory retirement ages.⁵⁰ Detroit's Police and Fire Retirement System (PFRS) administers the pension plan for the City's uniformed personnel,⁵¹ and these retirees generally are not eligible for Social Security retirement benefits or disability benefits.⁵² The legal and accounting regimes applicable to public and private

47. See, e.g., *id.*

48. See Opinion Regarding Eligibility, *supra* note 1, at 3–8 (citing City's report of \$5.7 billion in OPEB liabilities as of June 2011 (the most recent actuarial data available), \$3.5 billion in underfunded pension liabilities based on current actuarial estimates), \$1.43 billion in liabilities under pension-related certificates of obligation (COP); and \$346.6 million in swap liabilities related to the COPs and noting burden these amounts impose on City's finances).

49. See Paul M. Secunda, *Constitutional Contracts Clause Challenges in Public Pension Litigation*, 28 HOFSTRA LAB. & EMP. L.J. 263, 263–71 (2011).

50. *Id.*; see also PUB. PLANS PRACTICES TASK FORCE OF THE AM. ACAD. OF ACTUARIES, RISK MANAGEMENT AND PUBLIC PLAN RETIREMENT SYSTEMS 5 (2010), available at http://actuary.org/pdf/pension/PPPTF_Final_Report_c.pdf (“State and local workers were excluded from Social Security, at its inception, and thus, subsequently, many states and local governments endeavored to establish plans.”).

51. Opinion Regarding Eligibility, *supra* note 1, at 6.

52. *Id.* (citing Objection of the Detroit Retirement Systems to the Eligibility of the City of Detroit, Michigan, to be a Debtor Under Chapter 9 of the Bankruptcy Code at 5, *In re City of Detroit*, Michigan, No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Aug. 19, 2013)).

pension plans also are different, and rules for public sector plans vary from state to state.⁵³ In Detroit's case, for example, the Pension

53. See Secunda, *supra* note 49, at 263–71. For example, the Employee Retirement Income Security Act of 1974 (ERISA), does not apply to governmental plans. See Employee Retirement Income Security Act (ERISA) of 1974 § 4(b), 29 U.S.C. § 1003 (2012); ERISA § 3(32). There also are differences in the budgeting process and accounting standards applicable to public pensions which can make it difficult for workers and citizens to understand the nature, scope, and extent of liabilities associated with pension and OPEB obligations. See Secunda, *supra* note 49, at 263–71. The Government Accounting Standards Board (GASB) establishes generally accepted accounting principles that are used by many state and local governments. See *Mission, Vision, and Core Values*, GOVERNMENTAL ACCOUNTING STANDARDS BD., <http://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1175804850352> (last visited Mar. 15, 2012) (stating the mission of MSRB is “[t]o establish and improve standards of state and local governmental accounting and financial reporting that will: [r]esult in useful information for users of financial reports, and [g]uide and educate the public, including issuers, auditors, and users of those financial reports”). Unlike Generally Accepted Accounting Standards for Commission registrants, however, compliance with GASB standards is not mandatory in all jurisdictions. For example, the Texas legislature enacted a law that requires the State, and permits local governments, not to use GASB statement 45, which requires the governmental entities that provide health care, life insurance and other post-employment benefits to retirees to report the estimated accrued cost of the benefits. See TEX. GOV'T CODE ANN. §§ 2266.051, 2266.052, 2266.102 (West 2008); see also *Summary of Statement No. 45: Accounting and Financial Reporting by Employees for Postemployment Benefits Other Than Pensions*, GOVERNMENTAL ACCOUNTING STANDARDS BD. (June 2004), <http://www.gasb.org/st/summary/gstsm45.html>. So, while there are a number of GASB pronouncements concerning pension-related obligations (see list below), individual issuers may or may not comply with them when reporting on financial obligations in this area. See, e.g., STATEMENT NO. 25: FINANCIAL REPORTING OF DEFINED BENEFIT PENSION PLANS AND NOTE DISCLOSURES FOR DEFINED CONTRIBUTION PLANS, GOVERNMENTAL ACCOUNTING STANDARDS BD. (1994), available at http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160029908 (follow “Accept” hyperlink) (establishing financial reporting standards for public defined benefit pension plans) (Note: GASB approved an exposure draft on June 27, 2011 which would amend GASB Statement No. 25); STATEMENT NO. 27, ACCOUNTING FOR PENSIONS BY STATEMENT AND LOCAL GOVERNMENT EMPLOYERS, GOVERNMENTAL ACCOUNTING STANDARDS BD. (1994), available at http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160029312 (follow “Accept” hyperlink) (establishing standards for pension information in the financial reports of state and local government employers) (Note: GASB approved an Exposure Draft on June 27, 2011 which would amend GASB Statement No. 27); STATEMENT NO. 50, PENSION DISCLOSURES, GOVERNMENTAL ACCOUNTING STANDARDS BD. (2007), available at http://www.gasb.org/cs/ContentServer?c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176159988758 (follow the “Accept” hyperlink) (amending GASB Statement Nos. 25 and 27); STATEMENT NO. 67, FINANCIAL REPORTING FOR PENSION PLANS—AN AMENDMENT OF GASB STATEMENT NO. 25, GOVERNMENTAL ACCOUNTING STANDARDS BD. (2012), available at http://www.gasb.org/cs/ContentServer?c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160220594 (follow the “Accept” hyperlink); STATEMENT NO. 68, ACCOUNTING

Benefit Guarantee Corporation does not insure pension benefits under either PFRS or the City's General Retirement System (GRS), which administers the pension plan for the City's non-uniformed personnel.⁵⁴ In addition, as discussed below, the Michigan Pension Clause prevents the City and the State from impairing accrued pension benefits in ways that might be available to private employers under the federal employee benefits regime.⁵⁵

Perhaps most importantly, Detroit's defined benefit pension plans have funding and benefit obligations not shared by most private sector employers.⁵⁶ In contrast to the private sector, where defined contribution plans are the norm, public sector employers like Detroit are much more likely to offer defined benefit plans.⁵⁷ With defined contribution plans, workers contribute to their own retirement through retirement savings accounts (e.g., a 401k).⁵⁸ Workers bear the risk of underfunding with defined contribution plans, because if a worker fails to contribute, contributes an insufficient amount, or if investment choices do not perform as well as the worker had hoped, the worker's retirement account value may suffer,⁵⁹ but the employer

AND FINANCIAL REPORTING FOR PENSIONS—AN AMENDMENT OF GASB STATEMENT NO. 27, GOVERNMENTAL ACCOUNTING STANDARDS BD. (2012), *available at* http://www.gasb.org/cs/ContentServer?c=Document_C&pagename=GASB/Document_C/GASBDocumentPage&cid=1176160220621 (follow “Accept” hyperlink);

54. *See* Opinion Regarding Eligibility, *supra* note 1, at 6.

55. *See id.* at 42 (citing MICH. CONST. art. 9, § 24; *Kosa v. Treasurer of State of Mich.*, 292 N.W.2d 452, 455 (Mich. 1980) (finding that State and City cannot unilaterally impair pensions under Michigan Pension Clause, and noting that clause resulted from an effort by teachers to “lobb[y] for a constitutional amendment granting contractual status to retirement benefits.”)); *see also In re Constitutionality of 2011 PA 38*, 806 N.W.2d 683, 693 (Mich. 2011) (“The obvious intent of § 24, however, was to ensure that public pensions be treated as contractual obligations that, once earned, could not be diminished.”); *see generally* Secunda, *supra* note 49.

56. *See* Secunda, *supra* note 49, at 267–74.

57. *See* BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, NATIONAL COMPENSATION SURVEY: EMPLOYEE BENEFITS IN THE UNITED STATES MARCH 2013, at 177, 366 (2013), *available at* <http://www.bls.gov/ncs/ebs/benefits/2013/ebb10052.pdf>. According to the Bureau of Labor Statistics March 2013 National Compensation Survey, eighty-nine percent of state and local government workers have access to retirement plans. *Id.* at 366 tbl. 2. Eighty-three percent of those with access have access to a defined benefit plan, while only thirty two percent have access to a defined contribution plan. *Id.* By comparison, the survey revealed that only sixty-four percent of private sector workers have access to a retirement plan, and of those with access, only nineteen percent have access to a defined benefit plan compared to fifty-nine percent with access to a defined contribution plan. *Id.* at 177.

58. *See* Secunda, *supra* note 49, at 269–72.

59. *See id.*

has no direct obligation to help or otherwise “make up” for losses.⁶⁰ With defined benefit plans, however, employees are promised a specific monthly benefit based upon a formula.⁶¹ To fund promised benefits, employers and employees make contributions into an investment pool.⁶² The employer makes investment decisions on behalf of the pool, assumes market risk, and must make up the difference if pool is insufficient to pay promised benefits.⁶³

The public employer’s obligation to “make up the difference” if plan assets fall short gives rise to the risk and problem of underfunding. Underfunding occurs when a defined benefit plan sponsor fails to make contributions (or sufficient contributions) to fund accrued actuarial liabilities. In Detroit’s case, the pension systems for public workers have a substantial underfunding problem.⁶⁴ At the end of the City’s 2012 fiscal year, Detroit’s two retirement systems (the GRS and PFRS) together had over 20,000 employees receiving benefits, an additional 2400 former employees who were entitled to but who were not yet receiving benefits, and more than 9,700 active employees who had an expectation of receiving benefits

60. *See id.* at 269–272 (“Of course . . . a larger percentage of these private-sector pension plans are now defined contribution plans, meaning that employers are generally not responsible for having sufficient funds on hand when employees retire. These employers simply make a one-time contribution (or none at all if the employer is dealing with a Section 401(k) deferral plan without a matching contribution) and there are no subsequent pension funding responsibilities. Simply put, employees in the defined benefit context are left with the responsibility of planning so that they have enough in their pension fund account when they retire.”) (internal citations omitted).

61. *See id.* at 268–69.

62. *See id.* at 268–69; *2011 Annual Survey of Public Pensions: State and Local Data*, U.S. CENSUS BUREAU, www.census.gov/govs/retire (last visited Feb. 11, 2014) (spreadsheet entitled “Revenues By State and Local Government”). According to the United States Census Bureau’s 2011 Annual Survey of Public Pensions, in 2011, employees contributed \$40,298,909 to defined benefit plans whereas employers (state and local) contributed a total of \$96,184,812. *See id.* (spreadsheet entitled “Revenues By State and Local Government”). For best practices respecting funding defined benefit plans, see *Best Practice: Guidelines for Funding Defined Benefit Pensions (2013) (CORBA)*, GOV’T FIN. OFFICERS ASS’N, http://www.gfoa.org/index.php?option=com_content&task=view&id=2598 (last visited Feb. 11, 2014) and *Best Practice: Reviewing, Understanding and Using the Actuarial Valuation Report and Its Role in Plan Funding (CORBA) (2013)*, GOV’T FIN. OFFICERS ASS’N, http://www.gfoa.org/index.php?option=com_content&task=view&id=2756 (last visited Feb. 11, 2014).

63. *See* *Secunda*, *supra* note 49, at 268–69.

64. *See* *Opinion Regarding Eligibility*, *supra* note 1, at 6. There has been considerable debate in the bankruptcy court respecting the degree of underfunding. *See e.g., id.*

when they retire, according to the City's bankruptcy filings.⁶⁵ Using current valuation assumptions and methods, as of June 30, 2011, the GRS and PFRS had unfunded actuarial accrued liabilities of approximately \$639.9 million, according to the City's calculations.⁶⁶ According to the City's bankruptcy papers, the actual amount of these liabilities is likely far higher, as current assumptions and valuation methodologies "serve to substantially understate the Systems' unfunded liabilities."⁶⁷ These legacy liabilities are a substantial drain on Detroit's resources: Judge Rhodes found that 38.6% of the City's revenue was consumed by servicing legacy liabilities in 2012,⁶⁸ and that "forecasts for subsequent years, assuming no restructuring, are 42.5% for 2013, 54.3% for 2014, 59.5% for 2015, 63% for 2016, and 64.5% for 2017."⁶⁹

Detroit's situation is not unique. According to the Pew Center on the States, as early as 2008, there was a \$1 trillion gap between the \$2.35 trillion that states and participating localities had set aside to pay pensions,⁷⁰ health care, and OPEB⁷¹ promised to public sector employees, and the \$3.35 trillion in estimated actual cost.⁷² More recently, the Pew Center found that "thirty cities at the center of the nation's most populous metropolitan areas faced more than \$192 billion in unpaid commitments for pensions and other retiree benefits, primarily health care, as of fiscal 2009," including "a long-term

65. See Declaration of Charles M. Moore In Support of the City of Detroit, Michigan's Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code, at 4-5, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. July 18, 2013).

66. *Id.* at 5.

67. *Id.*

68. See Opinion Regarding Eligibility, *supra* note 1, at 7.

69. See *id.* at 7; see also Memorandum in Support of Statement of Qualifications, *supra* note 2, at 3.

70. According to the Government Accountability Office (GAO), "[n]early 20 million employees and over 7 million retirees and survivors are covered by state and local government pension plans." U.S. GOV'T ACCOUNTABILITY OFFICE, GOVERNANCE PRACTICES AND LONG-TERM INVESTMENT STRATEGIES HAVE EVOLVED GRADUALLY AS PLANS TAKE ON INCREASED RISK 1 (2010), available at <http://www.gao.gov/assets/310/308867.pdf>.

71. Pension and OPEB liabilities have been the subject of significant debate and analysis in recent years. See, D. Roderick Kiewiet, *The Day After Tomorrow: The Politics of Public Employee Retirement Benefits*, 2 CAL. J. POL. & POL'Y, Sept. 2010.

72. PEW CTR. ON THE STATES, THE TRILLION DOLLAR GAP: UNFUNDED STATE RETIREMENT SYSTEMS AND THE ROADS TO REFORM 1 (2010), available at http://www.pewstates.org/uploadedFiles/PCS_Assets/2010/Trillion_Dollar_Gap_Underefunded_State_Retirement_Systems_and_the_Roads_to_Reform.pdf.

shortfall of \$88 billion for pensions and \$104 billion for retiree health care and other non-pension benefits.”⁷³

Anecdotally, in addition to Detroit, other municipalities across the United States have identified public workers’ salary, pension benefits and OPEB as contributing to fiscal distress. For example, San Bernadino, California sought Chapter 9 bankruptcy protection in 2012 after declining home prices, falling tax revenues and increasing expenses rendered the city insolvent.⁷⁴ In finding the city to be an eligible debtor, the bankruptcy court commented that that “[c]ity employee salaries and benefits, as in most municipalities, make up 75% of the City’s budget and, as the need for services grew in the [pre-recession] boom, so did the number of City employees and consequent expenses.”⁷⁵ “Adding to these costs” according to the judge “were the particularly lucrative retirement benefits which the Common Council had negotiated in the collective bargaining agreements with the City’s seven unions.”⁷⁶ Public employee contracts, pension and/or OPEB also have been identified as drivers of distress in Central Falls, Rhode Island (filed for bankruptcy in 2011),⁷⁷ and Stockton, California (filed for bankruptcy in 2012).⁷⁸

As the Pew Center has observed, and as the situation in Detroit reflects, unfunded pension and retiree health care plans pose significant challenges for city budgets, citizens and public workers.⁷⁹ For public workers and retirees, underfunding (and the potential for associated loss or diminution of benefits, or impaired stability of the plan) can have a devastating impact on personal financial condition because, in the absence of social security, there is no safety net. For cities, underfunding “limit[s] policymakers’ ability to invest in other priorities because “[e]very dollar that goes to plug a hole in the city’s

73. PEW CHARITABLE TRUSTS, CITIES SQUEEZED BY PENSION AND RETIREE HEALTH CARE SHORTFALL 1 (2013), *available at* http://www.pewstates.org/uploadedFiles/PCS_Assets/2013/Pew_city_pensions_brief.pdf.

74. Voluntary Petition, City of San Bernadino, Cal., No. RS 6:12-bk-28006 MJ (Bankr. C.D. Cal. Aug. 1, 2012); City of San Bernardino Eligibility Opinion at 778–80, *In re* City of San Bernadino, Cal., 499 B.R. 776 (Bankr. C.D. Cal. 2013) (No. RS 6:12-bk-28006 MJ).

75. City of San Bernadino Eligibility Opinion, *supra* note 74, at 779.

76. *Id.*

77. Scott Malone, *Rhode Island’s Central Falls Files for Bankruptcy*, REUTERS, Aug. 1, 2011, *available at* <http://www.reuters.com/article/2011/08/01/us-rhodeisland-centralfalls-idUSTRE7703ID20110801>.

78. *See, e.g.*, Jim Christie, *Stockton Bankruptcy The Result of 15-year Spending Binge*, REUTERS, July 4, 2013, *available at* http://www.huffingtonpost.com/2012/07/04/stockton-bankruptcy_n_1648634.html.

79. *See* PEW CHARITABLE TRUSTS, *supra* note 73, at 1–2.

retirement funds is a dollar that cannot be spent” on infrastructure and services.⁸⁰ In practical terms, this means that fewer dollars are available for public safety, education and infrastructure, as municipalities are forced to allocate resources to pension and OPEB-related obligations. And for taxpayers, the longer unfunded pension and OPEB liabilities go unaddressed, “the larger the bill facing future city budgets and taxpayers,” such that municipalities may be forced to “cut services, reduce the workforce, or raise taxes” to shore up underfunded or unfunded retirement or OPEB-associated funds.⁸¹ Cities and their taxpayers also pay a price for underfunded or unfunded pension and OPEB liabilities in the form of higher borrowing costs (assuming the city’s finances are strong enough to access the municipal securities market on reasonable terms), because “credit rating agencies incorporate unfunded retirement costs into their analyses.”⁸² All of these negative consequences are manifest in Detroit.⁸³

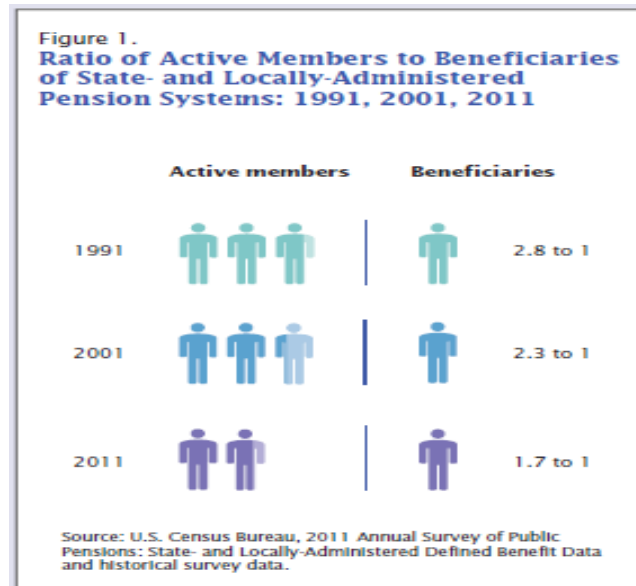
It is important to note that demographic trends like those present in Detroit may exacerbate the problem of underfunding, or (at a minimum) lead to increased demand on benefits pools. When a workforce ages, the number of active participants paying into the system may decrease, even as benefit payments to retired workers increase. According to Census Bureau data, the ratio of active members to beneficiaries of state and locally administered pension systems has changed over time, with the result that there are now fewer active members supporting a larger number of beneficiaries:

80. *Id.* at 1–2.

81. *Id.* at 2.

82. *Id.*

83. According to the City’s bankruptcy filings, legacy liabilities (together with Detroit’s debt load) have made it difficult, if not impossible, for Detroit to access debt markets. See Memorandum in Support of Statement of Qualifications, *supra* note 2, at 28; Orr Declaration, *supra* note 1, at 38 (“[T]he City’s ability to access credit markets to satisfy its cash needs is compromised by its plummeting credit ratings. The City’s credit ratings have reached historic lows and currently are below investment grade. No major U.S. city has a lower credit rating than Detroit. As of June 17, 2003, S&P and Moody’s had lowered Detroit’s credit ratings to CC and Caa3, respectively.”) (citations omitted).



These data mean for every beneficiary receiving period payments under a public pension defined benefit plan, there are now fewer than two active members paying into the pension system.⁸⁵ As the number of active workers decreases and the number of retired workers increases (in 2011, the total number of beneficiaries eligible for periodic payments increased 4.4%), the demand for benefits increases.⁸⁶ As a result, even though pension plan revenues were up in 2011, due to the recovery of the stock market from lows experienced during 2008 and 2009, total payments for state and locally-administered increased as well (they were 8.5% higher in 2011 compared to 2010, due primarily to a 7.6% increase in benefits payments.)⁸⁷ This puts pressure on benefits pools. A number of public officials have voiced concerns about the changing ratio of current versus former workers: Syracuse, New York Mayor Stephanie Miner, for example, has commented that her city is “upside down”

84. ERIKA BECKER MEDINA, U.S. CENSUS BUREAU, ANNUAL SURVEY OF PUBLIC PENSIONS: STATE- AND LOCALLY-ADMINISTERED DEFINED BENEFIT DATA SUMMARY REPORT: 2011, at 1 (2013), available at <http://www2.census.gov/govs/retire/2011summaryreport.pdf>.

85. *Id.* at 2.

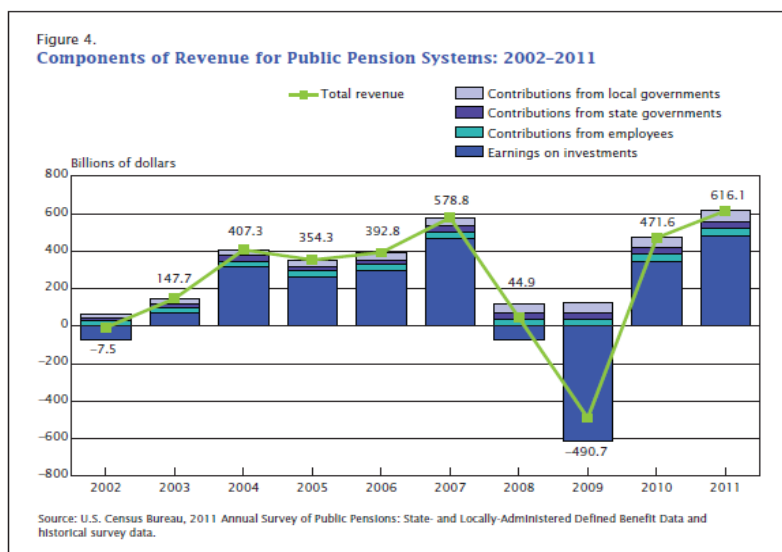
86. *Id.*

87. *Id.*

with respect to health care expenses, in that the city pays more for health care for its retired workers than it does for those still working.⁸⁸

Macroeconomic forces also can intensify fiscal distress associated with pension and OPEB liabilities. According to the United States Census Bureau, declines in the stock market during 2008 and 2009 exacerbated the problem of underfunding in public pension systems:

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Notably, stock market declines put pressure on state and local government budgets at the same time that “the recession . . . cut into state and local tax revenues, limiting the ability of governments to make up these shortfalls.”⁹⁰

C. Municipal Revenue Sources: Inelastic and Constrained by Legal, Economic, and Political Forces

If municipalities already face a difficult funding mandate, legal, economic and political constraints on revenues and debt relief make their burdens that much heavier. When a business needs money for

88. See Jimmy Vielkind, *Is Detroit Bankruptcy Prelude to Upstate Crisis?*, TIMES UNION (July 24, 2013, 6:40 AM), <http://www.timesunion.com/local/article/Is-Detroit-bankruptcy-prelude-to-upstate-crisis-4682870.php>.

89. MEDINA, *supra* note 84, at 2, 5.

90. ALICIA H. MUNNELL ET AL., CNTR. FOR RET. RESEARCH AT BOS. COLL., PENSION OBLIGATION BONDS 1 (2010), *available at* http://crr.bc.edu/wp-content/uploads/2010/01/SLP_9-508.pdf (citing proprietary data).

profit-seeking activities or to satisfy debts, it may tap a variety of sources, including profits from existing operations, returns on investment activity, bank loans, and/or the issuance of equity or debt securities.⁹¹ For-profit enterprises also may free up funds for business activities and debt service by reducing capital expenditures, cutting expenses (e.g., through efficiency gains, headcount reductions), selling assets, restructuring existing obligations, or entering into a corporate combination or other transaction with a fiscally stronger counter-party.⁹²

Municipalities are in an entirely different position. They spend in service of the public good, not for profit, and they cannot issue equity securities to raise capital.⁹³ Municipalities also cannot easily reduce headcount or salary costs,⁹⁴ leverage or sell assets, or combine with

91. For example, AMC Entertainment Holdings, reportedly the second largest movie theater owners in North America announced in September 2013 that it sought to raise \$400 million via an initial public offering of stock and that it planned to use the proceeds of the offering for capital expenditures and to reduce debt. See William Alden, *AMC Aims to Raise \$400 Million in I.P.O.*, N.Y. TIMES, Sept. 13, 2013, http://dealbook.nytimes.com/2013/09/03/amc-aims-to-raise-400-million-in-i-p-o/?_r=0.

92. For example, the mining company Rio Tinto announced last year that it was cutting expenditures and looking into selling business units to reduce its debt burden. See *Rio Targets Debt Reduction in 2014 As Costs Come Down*, REUTERS, Dec. 11, 2013, available at <http://finance.yahoo.com/news/rio-targets-debt-reduction-2014-134409096.html>. Likewise, Air France also announced a restructuring program last year that including that includes layoffs, route restructuring and other measures in a bid to reduce the airline's debt and return to profitability. See Nicola Clark, *Air France Plans to Cut 2,800 More Jobs*, N.Y. TIMES, Sept. 18, 2013, <http://www.nytimes.com/2013/09/19/business/air-france-plans-to-cut-2800-more-jobs.html>.

93. See, e.g., ROBERT S. AMDURSKY ET AL., MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE §§ 1.1.1–1.1.2, at 3–9 (2013) (discussing municipalities' focus on public good); ERIC FRIEDLAND, FITCH RATINGS, SPECIAL REPORT: TOP TEN DIFFERENCES BETWEEN MUNICIPAL BONDS AND CORPORATE BONDS 2 (2010), available at http://www.naic.org/documents/committees_e_rating_agency_101118_hearing_fitch_doc3.pdf (noting corporations can raise equity, but municipalities cannot).

94. In addition to the need for personnel to administer public infrastructure and services, municipalities cannot easily reduce headcount because they are much more likely than their private sector counterparts to operate in a union environment. According to the data from the Department of Labor, Bureau of Labor Statistics, in 2012, public-sector workers had a union membership rate (35.9%) more than five times higher than that of private-sector workers (6.6%), with local government workers having the highest union membership rate at 41.7%. See *Union Membership News Release: Union Members—2012*, BUREAU LAB. STAT. (Jan. 23, 2012), http://www.bls.gov/news.release/archives/union2_01232013.htm (“In 2012, 7.3 million employees in the public sector belonged to a union, compared with 7.0 million union workers in the private sector. The union membership rate for public-sector workers (35.9 percent) was substantially higher than the rate for private-sector workers (6.6 percent).”). Union rates are highest at the local government level because local

other governmental units to reduce expenses and/or raise funds.⁹⁵ Instead, municipalities depend upon three principle sources of revenue—(i) fiscal assistance from higher levels of government, (ii) taxes, assessments and use fees; and (iii) borrowing. Each of these sources is vulnerable, volatile, constrained and potentially risky for municipalities and taxpayers, especially during times of financial distress.

1. *Raising Revenues Through Grants and Tax Increases Is Legally, Politically and Practically Difficult*

Relying upon assistance from higher levels of government is risky because the federal and state governments simply do not have the resources, the legal authority or the political will to fund every infrastructure project or public service need that a municipality might have, nor can higher levels of government bail out every city, town, village, school district, fire district, water and sewer district, etc. that might be struggling.⁹⁶ In fact, the lack of grant money for

government payrolls include workers in heavily unionized occupations, such as teachers, police officers, and firefighters. *Id.* In 2012, among full-time wage and salary workers, union members (making no distinction between public and private sector) earned more on average than their non-union counterparts: whereas union members had median usual weekly earnings of \$943 according to Bureau of Labor Statistics (BLS) data, those who were not union members had median weekly earnings of \$742. *Id.* Focusing on local government workers, BLS data reflect that in 2012, median weekly earnings of full-time wage and salary workers who were members of unions (\$989) or represented by a union (\$975) exceeded that of non-union local government workers (\$756). *Id.* The BLS attributes this disparity to a variety of factors including but not limited to collective bargaining. *See id.* In addition to a wage disparity in favor of unionized public workers, data also suggest that state and local government employees are less likely to be laid off compared to their private sector counterparts. ALICIA MUNNELL & REBECCA CANNON FRAENKEL, CNTR FOR RET. RESEARCH AT BOS. COLL., PUBLIC SECTOR WORKERS AND JOB SECURITY (2013), available at <http://crr.bc.edu/wp-content/uploads/2013/05/SLP31.pdf>. Taken together, this data suggests that public employers' labor costs may be higher and less elastic than those of non-union private sector employers.

95. Mergers and/or consolidation of municipalities have long been controversial. *See, e.g.*, Ted Roelofs, *Should Two Towns Become One? Merger Question Moves to Saugatuck-Douglas*, BRIDGE MAG. (Oct. 6, 2013), <http://bridgemi.com/2013/10/should-two-towns-become-one-merger-question-moves-to-saugatuck-douglas>.

96. *See, e.g.*, MOODY'S INVESTORS SERVS., U.S. PUB. FIN., SPECIAL COMMENT, POTENTIAL RISKS OF VARIABLE RATE DEBT AND INTEREST RATE SWAPS FOR U.S. STATE AND LOCAL GOVERNMENTS ARE HEIGHTENED BY ECONOMIC AND FINANCIAL CRISIS 6 (2009) (on file with author) ("The ability to quickly adjust revenues and expenditures is a valuable mitigant to the potential cash flow and liquidity impact of variable rate debt and swaps. To measure an issuer's ability to generate additional revenues, we consider the nature of the revenue streams that are pledged or are available to support the issuer's variable rate debt and swaps, as well as any legal or procedural restrictions that would prevent the issuer from receiving sufficient

infrastructure and services, coupled with the cost of these items, explains why state and local governments turned to—and now depend upon—the municipal securities market to meet funding needs.⁹⁷ In Detroit’s case, declines in state revenue sharing funds have put pressure on the City’s finances: according to bankruptcy filings, “[s]tate revenue sharing [from Michigan to the City] has decreased by \$161,000,000 since 2002 (48%) and by \$76,000,000 (30.6%) since 2008, due to the City’s declining population and significant reductions in statutory revenue sharing by the State.”⁹⁸ Since revenue sharing is tied to population, the City anticipates that “[r]evenue sharing amounts will decrease further if the City’s population continues to decline.”⁹⁹ While the federal and/or state governments might still help Detroit, the sheer size of Detroit’s debt makes it difficult to believe that Detroit’s problems can be solved by grant money alone.

As for tax increases, they are difficult in the best of times. For residents of financially strapped cities like Detroit, which face a structural, long-term erosion of population and tax bases, they may be impossible for all intents and purposes.¹⁰⁰ Detroit’s residents already

revenues within the necessary time frame. For example, Moody’s considers whether levy limits or political reluctance may prevent an issuer from increasing property taxes or utility fees as needed. If the issuer is able and willing to raise revenues, we consider the timeframe in which the increased collections will be received, as delayed receipts may not help the issuer with immediate cost pressures.”).

97. Hildreth and Zorn argue that the growth in the size and complexity of the municipal securities market was “born[] out of necessity” beginning in the late 1970s and early 1980s, as state and local governments were facing “mounting capital need and fewer degrees of freedom to deal with these needs because of high interest rates, inflation and a slowing economy, reduction in federal aid as a result of concern over mounting budget deficits, and tax and expenditure limitations on state and local governments.” W. Bartley Hildreth & C. Kurt Zorn, *The Evolution of the State and Local Government Municipal Debt Market Over the Past Quarter Century*, 25 PUB. BUDGETING & FIN 127, 132–33 (2005).

98. Opinion Regarding Eligibility, *supra* note 1, at 10.

99. PROPOSAL FOR CREDITORS, *supra* note 3, at 4.

100. See Robert Tannenwald, *Are State and Local Revenue Systems Becoming Obsolete*, NEW ENG. ECON. REV., no. 4, 2001, at 28–30. As Robert Tannenwald points out, the long-term erosion of the tax base in cities like Detroit represents a structural problem, especially when municipal budgets shrink while public needs increase:

An analysis of the mix of the nation’s subnational revenues reveals two reasons why both state and local governments are so concerned about the long-run erosion of their tax capacity. First, both depend heavily on uncertain flows of fiscal assistance from a higher level of government. Second, many state and local governments lack a diverse mix of “own-source revenues”—taxes and user charges that they collection on their own authority.

face an overwhelming tax burden: the City's filings note that "[t]he *per capita* tax burden on Detroit residents is the highest in Michigan."¹⁰¹ This burden "is made heavier still by the residents' relative inability to pay," due to the low level of per capita income in Detroit and an unemployment rate which is more than double the national average.¹⁰² And, even if Detroit's citizens had the means to absorb tax increases, tax cap legislation makes the legal authority for any such increase legally suspect. Michigan Public Act 394 of 2012 fixed Detroit's maximum income tax rates at their current levels,¹⁰³ and state law limits on property tax rates and certain utility users' taxes are fixed and at statutory maximums.¹⁰⁴ The City has taken the position in bankruptcy that "even if it were advisable" to increase taxes (which, according to the city "it almost certainly is not") the City is legally incapable of raising revenue through additional taxation."¹⁰⁵ Finally, while the City has increased corporate tax rates and enhanced its collection activities, such measures will not be enough to bridge the City's funding gap.¹⁰⁶

Id. at 28.

101. *See* Orr Declaration, *supra* note 1, at 20.

102. *Id.*

103. MICH. COMP. LAWS § 141.503(2) (2006); *see also* Orr Declaration, *supra* note 1, at 20–21; Memorandum in Support of Statement of Qualifications, *supra* note 2, at 29–30.

104. Michigan law limits municipalities' property tax rates to twenty mills. MICH. COMP. LAWS § 117.3 ("Each city charter shall provide for all of the following: . . . (g) the annual laying and collection taxes in a sum, except as otherwise provided by law, not to exceed 2% of the taxable value of the real and personal property in the city."); *id.* § 117.5 ("(1) A city does not have power to do any of the following: (a) To increase the rate of taxation now fixed by law, unless the authority to do so is given by a majority of the electors of the city voting at the election at which the proposition is submitted, but the increase in any case shall not be in an amount as to cause the rate to exceed 2%, except as provided by law, of the assessed value of the real and personal property in the city."). A constitutionally-required rollback limits property tax rates to 19.952 mills (which is the rate that Detroit now charges). CITIZENS RESEARCH COUNCIL OF MICH., DETROIT CITY GOVERNMENT REVENUES REPORT 382, at 15 (2013), *available at* <http://www.crcmich.org/PUBLICAT/2010s/2013/rpt382.pdf>. Utility users' tax and casino wagering tax are likewise fixed at current 5% and 10.9%, respectively, under state law. *See* MICH. COMP. LAWS §§ 141.1152(1), 432.212(4), (6), (7) (2006).

105. Memorandum in Support of Statement of Qualifications, *supra* note 2, at 29–30.

106. *See* Opinion of Eligibility, *supra* note 1, at 80.

2. *Municipal Securities and Wall Street: A Critical, but Potentially Risky, Source of Funding*

Borrowing to pay for infrastructure, public services or to meet day-to-day funding needs also creates risks and burdens for cities and their taxpayers.¹⁰⁷ While the municipal securities market is a critical source of funding for government activities, it carries risks for municipalities and their taxpayers due to the nature of the security for municipal bonds, risks associated with complex securities, limits on citizens' ability to monitor and police borrowing, and the difficulties that municipalities and taxpayers face in getting relief from associated debts.

a. *Municipal Securities*

Municipal bonds are debt securities issued by states and their political subdivisions and instrumentalities¹⁰⁸ to pay for public projects like the construction of water, sewer and power plants, highways, bridges, hospitals and schools, and to meet day-to-day funding needs.¹⁰⁹ The municipal securities market is sometimes referred to as the tax-exempt market because interest paid on eligible municipal bonds may be exempt from federal income tax, state, and/or local taxes, depending on the characteristics of the instrument and the residence of the bondholder.¹¹⁰

107. See, e.g., AMDURSKY ET AL., *supra* note 93, §§ 1.1.3–1.4, at 9–48 (discussing municipalities' use of debt to fund improvements, history of state and local government indebtedness and characteristics of municipal bonds).

108. See, e.g., *id.* §§ 1.3–1.4, at 29–48. Instrumentalities include entities like school districts, special districts, and public authorities. While a detailed examination of public authorities is outside the scope of this Article, a bit of history is useful. State and local governments began to create public authorities and special districts in the early 1900s to build housing, coordinate economic development incentives, provide low-cost loans, treat wastewater, operate electric utilities, and construct hospitals, among other rationales. See William J. Quirk & Leon E. Wein, *A Short Constitutional History of Entities Commonly Known as Authorities*, 56 CORNELL L. REV. 521 (1971); Lynn Wilson & Clayton Eichelberger, *New York State Public Authority Reform: Where We Have Come From and Where We Need to Go*, N.Y. STATE BAR ASS'N GOV'T, L. & POL'Y J., Fall 2009, at 15–16. Over the past fifty years, the number of authorities and special districts has grown significantly. See U.S. CENSUS BUREAU, GOVERNMENT ORGANIZATIONS: 2002 CENSUS OF GOVERNMENTS, at vii–viii, 6 (2002), available at <https://www.census.gov/prod/2003pubs/gc021x1.pdf>.

109. SEC, REPORT ON THE MUNICIPAL SECURITIES MARKET 5 (2012), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf>.

110. See 26 U.S.C. § 103 (2012). The tax exemption has been the source of some controversy over the years. See, e.g., *South Carolina v. Baker*, 485 U.S. 505 (1988); Rosalyn Y. Carter & W. Bartley Hildreth, *The Evolving Regulatory Environment of State and Local Tax-Exempt Securities*, 4 PUB. BUDGETING & FIN. MGMT. 491, 493–97 (1992); Joan Pryde, *The Ongoing Battle: Almost 70 Years of Assaults on the Tax-*

Traditionally, municipal securities issuers used two types of bonds—general obligation bonds and revenue bonds.¹¹¹ General obligation bonds are secured by the taxing power or “faith and credit” of the issuer,¹¹² and generally are subject to laws which restrain state and local governments from incurring debt¹¹³ without voter approval or from exceeding debt limits.¹¹⁴ Issuers use long-term general

Exempt Municipals, BOND BUYER, Sept. 1991, at 84. There are also taxable municipal bonds (including fully taxable municipal bonds and municipal bonds subject to the Alternative Minimum Tax under the IRC). I do not address this segment of the market in this Article, nor do I examine the Build America Bond program as authorized by the American Recovery and Reinvestment Act of 2009, 123 Stat. 115.

111. *See, e.g.*, AMDURSKY ET AL., *supra* note 93, §§ 1.3.3–1.3.4, at 37–45. In addition to the types of securities listed above, municipal securities issuers have used a variety of other instruments over the years. *See, e.g.*, JOE MYSAK, ENCYCLOPEDIA OF MUNICIPAL BONDS: A REFERENCE GUIDE TO MARKET EVENTS, STRUCTURES, DYNAMICS, AND INVESTMENT KNOWLEDGE (2012). Moral obligation bonds are one such example. According to the Municipal Securities Rulemaking Board (MSRB), a self-regulatory organization charged with establishing fair practices and conduct rules for firms and individuals involved in the underwriting, trading and selling of municipal securities:

The term ‘moral obligation bond’ refers to a bond, usually issued by a state or agency, that is secured by a non-binding covenant that any amount necessary to make up any deficiency in pledged revenues available for debt service will be included in the budget recommendation made to the state legislature or other legislative body, which may appropriate moneys to make up the shortfall. The legislature or other legislative body, however, is not legally obligated to make such an appropriation. Unlike a general obligation pledge, the moral obligation bond does not require voter approval and does not have the state’s official pledge of its full faith and credit.

See Certain Types of Municipal Securities, MUNICIPAL SECURITIES RULEMAKING BD., <http://www.msrb.org/Municipal-Bond-Market/About-Municipal-Securities/Types-of-Municipal-Securities.aspx> (last visited Mar. 15, 2014). There are also so-called “double-barreled” bonds, which are “secured by a defined revenue source as well as the faith and credit of an issuer with taxing power.” *See id.*

112. *See, e.g.*, *State Government Finances—Definitions*, U.S. CENSUS BUREAU, <http://www.census.gov/govs/state/definitions.html> (last visited Mar. 15, 2014) (noting full-faith and credit debt refers to “[l]ong-term debt for which the credit of the government concerned, implying the power of taxation, is unconditionally pledged. Includes debt payable initially from specific taxes on nontax sources, but representing a liability payable from any other available resources if the pledged sources are insufficient”). Whereas general obligation bonds issued by local governments typically are secured by ad valorem property taxes, state government bonds tend to be secured by sales and income taxes. *See Certain Types of Municipal Securities*, *supra* note 111.

113. Debt limits imposed by state and local law are a form of risk management. *See* AMDURSKY ET AL., *supra* note 93, § 4.1.1, at 207–15.

114. Historically, debt limits were enacted after the failure of projects that were financed with bonds secured by the issuer’s faith and credit. *See id.* at 210. As Amurdsky and Gillette point out, “The demise of these enterprises led to increased

obligation bonds to finance public facilities that do not produce revenues, or when it is thought to be inappropriate to levy fees for use as a matter of public policy.¹¹⁵ If an issuer defaults on a general obligation bond, bondholders typically have the right to compel a tax levy or a legislative appropriation.¹¹⁶

Revenue bonds are bonds secured by revenues or receipts from the funded project or other special funds, and are not backed by the taxing power or taxable property of the borrower.¹¹⁷ The idea behind revenue bonds is that issuers will use funds raised through bond offerings to construct facilities that, “theoretically, through the imposition of fees or charges, will generate sufficient revenues to

property taxes to pay bonds, or to default and subsequent loss of access to credit markets, while constituents of the issuer received nothing of commensurate value in return.” *Id.* In addition to straightforward limits, municipal entities may be subject to state statutes designed to spread the costs of public projects over time. For example, New York law prohibits municipalities, school districts or public corporations from incurring indebtedness for a period longer than the useful life of the project as set forth in the statute. *See* N.Y. LOCAL FIN. LAW § 11 (McKinney 2013); *see also* CAL. CONST. art. XVI, § 18(a) (“No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters . . .”). Note, however, that the courts have recognized qualifications to requirements like those set forth in section 18. *See, e.g.,* L.A. Cnty. Trans. Comm’n v. Richmond, 643 P.2d 941 (Cal. 1982) (holding that the transit commission is not a “special district” so a two-thirds vote is not required). Note also that debt limits may not apply to certain court-ordered expenditures. *See, e.g.,* Missouri v. Jenkins, 495 U.S. 33, 57 (1990) (“It is therefore clear that a local government with taxing authority may be ordered to levy taxes in excess of the limit set by state statute where there is reason based in the Constitution for not observing the statutory limitation.”).

115. *See* Ann Judith Gellis, *Mandatory Disclosure for Municipal Securities: A Reevaluation*, 36 BUFF. L. REV. 15, 23 (1987) (“Long-term general obligation bond financing, once the mainstay of municipal financing, is used for funding those public facilities that either do not produce revenues (for example, town halls, police stations etc.), or for which it is considered, as a matter of public policy, inappropriate to levy fees for public use (for example, public schools or parks).”).

116. *See, e.g.,* 15 EUGENE MCQUILLIN, THE LAW OF MUNICIPAL CORPORATIONS (3d ed. 1995).

117. *See, e.g.,* AMDURSKY ET AL., *supra* note 93, § 1.3.4, at 41–45. Revenues pledged for repayment may be derived from “operation of the financed project, grants or excise or other specified non-ad-valorem taxes.” *Certain Types of Municipal Securities*, *supra* note 111. “Some revenue bonds are issued by governmental agencies to fund facilities for essential public services,” like water and sewer systems. *Id.* With these types of revenue bonds, the issuer typically pledges revenues obtained through assessments towards repayment. *Id.* Such pledges typically identify the specific assessments that the issuer can use to pay interest and repay principal, the issuer’s authority and ability to increase assessments to satisfy payment and repayment obligations, and any other, superior claims on the assessment. *Id.*

amortize the debt over the useful life of the facility.”¹¹⁸ As a result, “revenue bond financing has traditionally been associated with the construction of toll roads, bridges, and community water, sewer, and power systems.”¹¹⁹ Issuers may not be required to obtain voter approval before issuing revenue bonds.¹²⁰

More recently, issuers seeking to access lower interest rates available at the short end of the yield curve have used complex instruments such as variable rate demand obligations (VRDO),¹²¹

118. See Gellis, *supra* note 115, at 22; see also ROBERT L. BLAND, A BUDGETING GUIDE FOR LOCAL GOVERNMENT 171 (2d ed. 2007) (“[A] revenue bond represents a limited pledge of revenue sources to the repayment of qualifying bonds. Usually, revenue bonds are used to finance a revenue producing project such as a public housing complex, public hospital, toll road, water or wastewater facilities and lines, or a parking garage. Only revenues earned from the project can be used to repay the bonds used to build the facility. The government does not pledge its full faith and credit to the repayment of these bonds, although it may subsidize the project with general tax revenues, especially during the development phase. Because of the more limited pledge, voter approval is usually not required, and the bonds incur slightly higher interest rates because of the higher risk of default. However, investors can see a clear link between the use of the debt and the repayment of the bonds, which normally increases their confidence that the government will repay the debt.”).

119. See Gellis, *supra* note 115, at 22.

120. BLAND, *supra* note 118, at 171. Conduit or industrial development bonds also have been used for many years. See Kenneth W. Bond, *Conduit Financing: A Primer and Look Around the Corner*, N.Y. STATE BAR ASS’N GOV’T L. & POL’Y J., Fall 2009, at 69. Conduit bonds are debt instruments that governmental units issue for the benefit of conduit borrowers (typically private not-for-profit entities) in furtherance of a public purpose, such as the construction of a not-for-profit hospital, affordable housing projects, student loan programs, and economic development and redevelopment projects. *Id.* at 69–70. Not surprisingly, the concept of “public purpose” has been the subject of considerable discussion in the case law. See, e.g., *Poe v. Hillsborough Cnty.*, 695 So. 2d. 672 (Fla. 1997) (involving issuance of bonds payable from sales and tourist tax proceeds to finance construction and development of a stadium and practice field for lease to a sports franchise was valid because primary public purpose was served by the development of recreation facilities and tourist attractions and private benefit or gain enjoyed by franchise owner was incidental). For a discussion of the rationale and origins of the “so-called public purpose doctrine,” see AMDURSKY ET AL., *supra* note 93, § 3.1, at 113–26; see also 26 U.S.C. § 141 (2012) (covering private activity and qualified bonds).

121. For a brief, “plain English” description of VRDOs, see *Understanding Variable Rate Demand Obligations*, ELECTRONIC MUN. MARKET ACCESS, <http://emma.msrb.org/educationcenter/UnderstandingVRDOs.aspx> (last visited Mar. 2, 2014). Generally speaking, VRDOs are municipal securities for which the interest rate resets on a periodic basis, and which permit investors to liquidate their holdings at par through a “put” or “tender” feature. *Id.* A dealer or remarketing agent is responsible for reselling tendered VRDOs to new investors, and, to ensure that investors are able to use the “put” or “tender” feature in the event a remarketing agent is unable to locate a new purchaser. VRDOs typically operate with a liquidity facility (typically a letter of credit or Standby Bond Purchase Agreement). *Id.*; see also MOODY’S INVESTORS SERVS., *supra* note 96, at 3 (“The majority of Moody’s rated municipal issuers of variable rate demand obligations use dedicated bank

auction rate securities and interest rate swaps in their funding plans.¹²² While markets for these types of instruments contracted during the recent economic crisis, complex non-traditional securities (including derivatives) remain very much a part of the current landscape, and even smaller issuers now regularly use these more complicated and potentially volatile products to meet funding needs.¹²³ As noted above, in Detroit's case, the City appears to have used a range of instruments to meet funding needs, including general obligation bonds, revenue bonds, and more exotic instruments such as the Certificates of Participation (COPs) and interest rate swaps discussed below.¹²⁴ Debt service and related obligations on these instruments all have contributed to the City's financial distress.

b. Risks Associated with Pledging Taxing Power, Revenue Streams

Although stalwarts of municipal finance, even "plain vanilla" general obligation bonds and revenue bonds carry risks for issuers and taxpayers because of the nature of the security pledged. When issuers sell general obligation and revenue bonds to investors, they

liquidity facilities (either standby bond purchase agreements or letters of credit) to support potential tenders by investors.").

122. See Registration of Municipal Advisors, 76 Fed. Reg. 824 (proposed Dec. 20, 2010) (codified at 17 C.F.R. pts. 240, 249) ("[T]he municipal securities market has experienced a proliferation of complex derivative products beginning generally with interest rate swap transactions in the mid 1980's."); see also Erik Sirri, *Testimony Concerning Credit Default Swaps*, U.S. SEC. & EXCH. COMM'N (Nov. 20, 2008), <http://www.sec.gov/news/testimony/2008/ts112008ers.htm>. According to the then-SEC chair in a speech from 2010, seventy percent of issuers of VRDOs have entered into floating-to-fixed swap agreements. See Andrew J. Donohue, Dir., Div. of Inv. Mgmt., SEC, Remarks at Investment Company Institute 2010 General Membership Meeting (May 7, 2010), available at <http://www.sec.gov/news/speech/2010/spch050710mls.htm>.

123. See, e.g., SEC. INDUS. & FIN. MKTS. ASS'N, MUNICIPAL BOND CREDIT REPORT FOR FOURTH QUARTER 2011, at 3 (2011) ("Issuance of variable-rate demand obligations (VRDOs), long-term municipal bonds with a floating interest rate that resets periodically and a put feature, rose in the fourth quarter. According to Thomson Reuters, \$11.4 billion were issued in 4Q'11, more than double the amount from 3Q'11 (\$3.5 billion), but a 6.5 percent decline year-over-year (\$11.4 billion)."); see also Elisse B. Walter, Comm'r, SEC, Regulation of the Municipal Securities Market: Investors Are Not Second Class Citizens (Oct. 28, 2009), available at <https://www.sec.gov/news/speech/2009/spch102809ebw.htm> (providing Commissioner Elisse Walter's commentary on use of complex financing tools).

124. See, e.g., Memorandum in Support of Qualifications, *supra* note 2, at 2-3; Orr Declaration, *supra* note 1, at 33-36; PROPOSAL FOR CREDITORS, *supra* note 3, at 23-34; OFFICE OF CITY MANAGER, CITY OF DETROIT: PROPOSAL FOR CREDITORS EXECUTIVE SUMMARY 18-29 (June 14, 2013), available at <http://www.detroitmi.gov/Portals/0/docs/EM/Reports/City%20of%20Detroit%20Executive%20Summary%2061413.pdf>.

pledge their taxing power and dedicated revenue streams, respectively, as security for repayment. If taxes or revenue streams run short, the issuer may have to increase taxes and/or cut spending to meet repayment obligations. Since taxpayers must pay government levies, and depend upon public infrastructure and services, tax increases, spending cuts and insolvency can have a devastating impact on private and public life.

For example, Harrisburg, Pennsylvania was forced into receivership after it experienced difficulty repaying general obligation bonds associated with a trash incineration project.¹²⁵ In announcing the city's intention to miss payments due on general obligation bonds, Harrisburg's receiver explained that his "first priority as receiver is to ensure that vital and necessary services such as police and fire are maintained" within Harrisburg during the state of fiscal emergency.¹²⁶ The receiver explained that Harrisburg would not make a payment due on the bonds "to ensure sufficient cash flow so the citizens of Harrisburg continue to receive essential services,"¹²⁷ reflecting the competition for municipal resources that can arise when a municipality experiences financial distress. Similarly, Jefferson County, Alabama reported punishing cuts to public services following its default on bonds issued to pay for water and sewer services and subsequent bankruptcy.¹²⁸ Service cuts can be particularly painful and politically difficult in distressed cities like Detroit that are already

125. See, e.g., *GOB-Smacked: Harrisburg to Default on General Obligation Bonds*, INVESTMENT NEWS (Mar. 9, 2012), <http://www.investmentnews.com/article/20120309/FREE/120309870>.

126. *Id.*; see also Romy Varghese, *Harrisburg Pennsylvania Plans Default on Bond Payments*, BUSINESSWEEK (Mar. 9, 2012), <http://www.businessweek.com/news/2012-03-09/harrisburg-pennsylvania-set-to-default-on-5-dot-27-million-go-bond-payments> (explaining that Harrisburg, Pennsylvania was placed into receivership at the end of 2011, with the receiver announcing that the city would have to skip \$5.27 million in payments due on general obligation bonds to meet basic public service needs).

127. *GOB-Smacked: Harrisburg to Default on General Obligation Bonds*, *supra* note 125; see also Varghese, *supra* note 126 (explaining that Harrisburg, Pennsylvania was placed into receivership at the end of 2011, with the receiver announcing that the city would have to skip \$5.27 million in payments due on general obligation bonds to meet basic public service needs).

128. See, e.g., Mary Williams Walsh, *In Alabama, a County That Fell Off the Financial Cliff*, N.Y. TIMES, Feb. 19, 2012, http://www.nytimes.com/2012/02/19/business/jefferson-county-ala-falls-off-the-bankruptcy-cliff.html?pagewanted=all&_r=1& (discussing public services in Jefferson County, Alabama gutted after the county declared bankruptcy in 2011 in the wake of a corruption scandal tied to more than \$1 billion in municipal bond debt and related interest rate swaps).

struggling to meet basic public infrastructure and health and safety needs.¹²⁹

c. Complex Securities Intended to Manage Pension and OPEB Introduce Risk, May Deepen Insolvency

Using complex securities to manage debts and funding needs may exacerbate risk for state and local governments, especially when products carry interest rate risk, the possibility of early-termination fees, and other variables.¹³⁰ In Detroit's case, in 2005 and 2006, the City entered into a series of funding transactions to address accrued liabilities associated with the city's various pension systems "through arranging for the issuance of certificates of participation [COPs] supported by services contracts between the City and each of the General Retirement System Service Corporation and the Police and Fire Retirement System Service Corporation" via specially created vehicles."¹³¹ The City's goal was to "raise \$1.4 billion for its underfunded pension funds, the GRS and the PFRS."¹³² After creating a non-profit servicing corporation for each of the two pension funds to act as intermediary, the City entered into service contracts with each of the corporations,¹³³ pursuant to which the City

129. See Orr Declaration, *supra* note 1, at 21–33; see also Roger Lowenstein, *Broke Town, U.S.A.*, N.Y. TIMES, Mar. 3, 2011, <http://www.nytimes.com/2011/03/06/magazine/06Muni-t.html?pagewanted=all>; Bobby White, *Scars of Bankruptcy Linger in Vallejo*, WALL ST. J., Jan. 19, 2012, <http://online.wsj.com/news/articles/SB10001424052970204555904577167013455352608> (discussing tax increases and reductions in public services in Vallejo, California after the city declared bankruptcy in 2008 in the face of declining revenues, soaring costs and municipal bond-related obligations).

130. As the Government Finance Officers Association has commented,

Derivative products can be important interest rate management tools that, when used properly, can increase a governmental entity's financial flexibility, provide opportunities for interest rate savings, alter the pattern of debt service payments, create variable rate exposure, change variable rate payments to fixed rate and otherwise limit or hedge variable rate payments. Recent market experience has also shown, however, that derivatives, when used to hedge a particular bond issue, can limit an issuer's flexibility with respect to such bond issue.

Government Finance Officers Association Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy (2003, 2005 and 2010), GOV'T FIN. OFFICERS ASS'N, http://www.gfoa.org/index.php?option=com_content&task=view&id=1590 (last visited Feb. 6, 2014).

131. See Orr Declaration, *supra* note 1, at 33; see also Opinion Regarding Eligibility, *supra* note 1, at 7–8.

132. See Opinion Regarding Eligibility, *supra* note 1, at 7.

133. *Id.*

pledged to make payments to the service corporations.¹³⁴ Each COP represented “an undivided proportionate interest” in the payments that the City had pledged to make to the service corporations under the service contracts.¹³⁵ (The service corporations had created funding trusts, which issued debt obligations to investors (namely, the COPs).¹³⁶) To make the COP offerings more attractive to investors, the City purchased insurance from two bond insurers—XL Capital Assurance, Inc., now known as Syncora, and Financial Guarantee Insurance Company.¹³⁷ At the end of fiscal year 2012, the aggregate outstanding amount of these certificates was approximately \$1.45 billion.¹³⁸

Concurrently with the issuance of certain of these certificates, certain of these special entities also entered into various pay-fixed, receive variable interest rate swap transactions in an aggregate notional amount of \$800,000,000¹³⁹ to hedge cash flows related to interest on its COP debt obligations.”¹⁴⁰ An interest rate swap is a contract between two parties to exchange a series of fixed rate and floating rate interest payments over a defined period of time, without exchanging the underlying principal amount, which is referred to as a “notional” principal amount.¹⁴¹ Municipal securities issuers use interest rate swaps to convert interest rate basis (e.g., from floating to

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.*

138. Orr Declaration, *supra* note 1, at 33 – 34.

139. Opinion Regarding Eligibility, *supra* note 1, at 7; *see also* Orr Declaration, *supra* note 1, at 34.

140. *See* Opinion Regarding Eligibility, *supra* note 1, at 7; *see also* CITY OF DETROIT FINANCE DEP’T, COMPREHENSIVE ANNUAL FINANCIAL REPORT (CAFR) FOR THE FISCAL YEAR ENDED JUNE 20, 2012, at 33 (2012), *available at* <http://emma.msrb.org/EP731053-EP567459-EP968879.pdf>.

141. The MSRB describes interest rate swaps (and their characteristics and uses) as follows:

A specific derivative contract entered into by an issuer or obligor with a swap provider to exchange periodic interest payments. Typically, one party agrees to make payments to the other based upon a fixed rate of interest in exchange for payments based upon a variable rate. The swap contract may provide that the issuer will pay to the swap counter-party a fixed rate of interest in exchange for the counter-party making variable payments equal to the amount payable on the variable rate debt.

Glossary of Municipal Securities Terms: Interest Rate Swap Contract or Agreement, MUN. SEC. RULEMAKING BOARD, <http://www.msrb.org/Glossary/Definition/INTEREST-RATE-SWAP-CONTRACT-OR-AGREEMENT.aspx> (last visited Feb. 6, 2014).

fixed or fixed to floating) to manage liabilities, and (ideally) to enable issuers to lower their costs of borrowing.¹⁴²

While swaps offer the potential for up-front cost savings, they involve risks not present in other financing alternatives.¹⁴³ For example, changes in reference interest rates have caused losses in swap positions taken by hundreds of municipalities, according to the consulting firm National Economic Research Associates (NERA).¹⁴⁴ NERA's research suggests that, in some cases, as interest rates have fallen during the crisis, municipalities have lost money on floating-to-fixed swap agreements that they first entered into to protect against rising interest rates. In other cases, even though interest rates have fallen, municipalities have found that floating payments have increased due to other market developments.¹⁴⁵

In Detroit's case, the service corporations agreed to convert the floating rate of interest on certain of the COPs into a fixed payment.¹⁴⁶ This was, according to Judge Rhodes, a wager by the City, because "if the floating interest rates exceeded a certain rate, the Swap Counterparties would make payments to the Service Corporations. But if the floating interest rates sank below a certain rate, the Service Corporations would make payments to the Swap Counterparties."¹⁴⁷ In addition to the risk that interest rate would move in a direction disadvantageous to the City, the City also was at risk if there was an "event of default" or "termination event,"

142. See Donohue, *supra* note 122.

143. See MASSIMILIANO DE SANTIS, NAT'L ECON. RESEARCH ASSOCS., DEMYSTIFYING FINANCIAL DERIVATIVES: INTEREST RATE SWAPS AND MUNICIPAL DERIVATIVES 2 (2011), available at http://works.bepress.com/cgi/viewcontent.cgi?article=1006&context=massi_de_santis.

144. *Id.* at 7. Among other risks, swaps carry counterparty credit risk, interest rate risk, and basis risk. NEIL O'HARA, THE FUNDAMENTALS OF MUNICIPAL BONDS 249 (6th ed. 2012); U.S. GOV'T ACCOUNTABILITY OFFICE, MUNICIPAL SECURITIES: OVERVIEW OF MARKET STRUCTURE, PRICING AND REGULATION 51-52 (2012) ("Termination risk is the risk that the swap may terminate or be terminated before its expiration. Swap agreements allow for termination of the swap by either party in the case of certain events, such as payment defaults on the swap or credit rating downgrades. For example, if the issuer triggers early termination, it could owe a termination payment reflecting the value of the swap under the market conditions at that time. If market rates have changed to the issuer's disadvantage (e.g., the issuer is a fixed-rate payer and interest rates have declined), the issuer will be 'out of the money' on the swap, that is, the fixed rate that the issuer is paying to the counterparty is higher than the current market rate A termination of a swap can result in a substantial unexpected payment obligation.").

145. DE SANTIS, *supra* note 143.

146. See Opinion Regarding Eligibility, *supra* note 1, at 7.

147. *Id.*

according to Judge Rhodes.¹⁴⁸ Judge Rhodes found that if either event occurred, “the Swap Counterparties could terminate the swaps and demand a potentially enormous termination payment.”¹⁴⁹

In his Opinion Regarding Eligibility, Judge Rhodes found that due to a dramatic decline in interest rates in 2008, the City “lost catastrophically on the swaps bet.”¹⁵⁰ With respect to the POC-related swaps, the City stated in its Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 2012 that “[a] total of \$439.3 million of the negative fair value of derivatives are interest rate swaps associated with the City’s POCs.”¹⁵¹ The CAFR also detailed consequences (termination fees, rating downgrades, etc.) that the City then was facing as a result of its difficulties meeting obligations associated with the POCs and swaps.¹⁵² As reported by Judge

148. *Id.* at 8.

149. *Id.*

150. *See id.*

151. *See* CITY OF DETROIT FINANCE DEP’T, *supra* note 140, at 14.

152. *Id.* at 14, 33. According to the CAFR,

On January 8, 2009, due to POC debt rating and Swap Insurer’s rating declines, the City received formal notice from the Swap Counterparty to four of the eight Swap agreements stating that an event had occurred, which if not cured by the City, would constitute an Additional Termination Event. On January 14, 2009, the City also received formal notice from the Swap Counterparty to the four remaining Swap Agreements. In June 2009, the City and the Counterparties agreed to an amendment to the Swap Agreements, thereby eliminating the Additional Termination Event and the potential for an immediate demand for payment to the Swap Counterparties. As part of the amended Swap Agreements, the Counterparties waived their right to termination payments. Additionally, the City was required to direct its Wagering Tax Revenues to a Trust as collateral for the quarterly payment to the Counterparties and agreed to other new termination events. The termination events under the amended Swap Agreement include a provision for the Counterparties to terminate the amended Swap Agreement and demand a termination payment if POCs ratings are downgraded below “Ba3” or equivalent.

In March 2012, the risk of the amended Swap Agreement termination arose with the credit rating downgrade below “Ba3”. The amount of swap termination payments would be based upon a variety of factors such as the various Swap Counterparties’ financial pricing models, underlying variable debt, index or reference rates, and the point of pricing. Any termination payments would be allocated based on the notional allocation percentage of the affected POCs, between the governmental and business-type activities as of the point of liability accrual. If the termination events are not cured, there presently exists significant risk in connection with the City’s ability to meet the cash demands under the terms of the amended Swap Agreements. As of this report date, the City is negotiating with the counterparties to come up with an acceptable course of action due to the credit rating downgrade. At June 30, 2012, the negative fair value of the POC swap

Rhodes, “[t]he City estimates that the damage will be approximately \$45,000,000 per year for the next ten years.”¹⁵³

Detroit is not the only municipality to struggle with interest rate swaps. In 1994, the relatively wealthy community of Orange County, California declared bankruptcy after a disastrous foray into the derivatives market.¹⁵⁴ Fifteen years later, in 2009, Jefferson County, Alabama declared bankruptcy after federal authorities brought charges against the former mayor of Birmingham, Alabama, J.P. Morgan Securities, Inc. and two J.P. Morgan’s former managing directors in connection with an alleged illegal payment scheme whereby the managing directors funneled money to close friends of county commissioners to win bond offering business for J.P. Morgan Securities and to induce county officials to select J.P. Morgan’s affiliated bank as swaps provider.¹⁵⁵ Due to the way Jefferson

liabilities was \$354.7 million for the governmental activities and totaled \$439.3 million for the primary government.

Id. at 33.

153. Opinion Regarding Eligibility, *supra* note 1, at 8.

154. For discussion of Orange County’s bankruptcy and threatened default, see generally *Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors, Exchange Act Release No. 36761*, U.S. SEC. & EXCH. COMM’N (Jan. 24, 1996), <http://www.sec.gov/info/municipal/mbonds/publicof.htm#PO1>; see also Ann Judith Gellis, *Municipal Securities Market: Same Problems—No Solutions*, 21 DEL. J. CORP. L. 427, 454 (1996) (describing Orange County crisis and losses); Merton H. Miller & David J. Ross, *The Orange County Bankruptcy and Its Aftermath: Some New Evidence*, J. DERIVATIVES, Summer 1997, at 51–60. For a brief discussion of market risk control failure and the Orange County situation, see Kimberly Krawiec, *More than Just “New Financial Bingo”: A Risk-Based Approach to Understanding Derivatives*, 23 J. CORP. L. 1, 27–28 (1997) (citing *Municipal Finance Issues: Hearings Concerning the Municipal Securities Market Before the House Comm. on Commerce*, 105th Cong. 1995 (testimony of Arthur Levitt, Chairman, SEC)).

155. See Press Release, SEC, J.P. Morgan Settles SEC Charges in Jefferson County, Ala. Illegal Payments Scheme, SEC Separately Charges Two Former Managing Directors at Firm (Nov. 4, 2009), *available at* <http://www.sec.gov/news/press/2009/2009-232.htm>; see also Mary Williams Walsh, *Alabama Governor Fails to Prevent County’s Record \$4 Billion Bankruptcy Filing*, N.Y. TIMES, Nov. 9, 2011, http://www.nytimes.com/2011/11/10/us/alabama-governor-fails-to-prevent-jefferson-countys-record-4-billion-bankruptcy-filing.html?_r=0 (reporting that at \$4 billion, Jefferson County’s bankruptcy was then the largest in history, overtaking previous record (a \$1.7 billion bankruptcy filing by Orange County, Calif. in December 1994)). On April 30, 2008, the Commission charged Larry Langford (the then-mayor of Birmingham, Alabama and former president of the Jefferson County Commission) and certain industry professionals with securities fraud in connection with an alleged kick-back scheme involving the county’s efforts to finance improvements to its water and sewer systems, as required by environmental laws. Complaint at 8–33, SEC v. Langford, No. CV-08-B-0761-S (N.D. Ala. Apr. 30, 2008). Langford also was charged in a parallel criminal case for allegedly sending more than \$7 million in county bond business to an investment

County's offerings and swaps transactions were structured, the annual payment on Jefferson County's debt jumped from \$53 million to \$636 million between 2008 and 2009.¹⁵⁶ As debt obligations grew, and the county's finances worsened,¹⁵⁷ sewer taxes skyrocketed and public services were stripped to the bone.¹⁵⁸ More recently, Oakland, California¹⁵⁹ and the State of New Jersey¹⁶⁰ (among others)¹⁶¹ reportedly have wrestled with swap-related obligations.¹⁶²

banker in return for bribes worth \$241,843. Indictment, *United States v. Langford*, 647 F.3d 1309 (11th Cir. 2011). On October 28, 2009, Langford was found guilty in a parallel criminal case on sixty counts of bribery, mail fraud, wire fraud, and tax evasion. *See Langford*, 647 F.3d at 1309, *cert. denied*, 132 S. Ct. 1121 (2012); *see also* Press Release, U.S. Dep't of Justice, Appeals Court Upholds Former Birmingham Mayor and Jefferson County Commission President's Conviction, (Aug. 5, 2011), *available at* <http://www.justice.gov/usao/aln/News/August%202011/August%205%202011%20County%20Commision.htm>. The Commission also brought related cases against J.P. Morgan Securities Inc. and two of its former managing directors in connection with the alleged scheme. *See* Complaint, *SEC v. Charles LeCroy & Douglas McFaddin*, No. CV-09-U-2238-S (N.D. Ala. Nov. 3, 2009), *available at* <http://www.sec.gov/litigation/complaints/2009/comp21280.pdf>; JP Morgan Securities Inc., Securities Act Release No. 9078, Exchange Act Release No. 60928, 2009 WL 3652405 (Nov. 4, 2009).

156. *See* Matt Taibbi, *Looting Main Street*, ROLLING STONE (Mar. 31, 2010), <http://www.rollingstone.com/politics/news/looting-main-street-20100331>. On March 3, 2009, certain of the county's interest rate swap agreements were terminated. *JP Morgan*, 2009 WL 3652405, at *8. "On March 6, 2009, J.P. Morgan Securities' affiliated commercial bank notified the County that it owed \$647,804,118.00 as the result of the termination of the Swap Agreements." *Id.* According to Jefferson County's official budget for 2008–2009, budget revenues were \$289 million. *See* JEFFERSON CNTY. BUDGET MANAGEMENT OFFICE, OFFICIAL OPERATING BUDGET JEFFERSON COUNTY, ALABAMA FISCAL YEAR OCTOBER 1, 2008–SEPTEMBER 30, 2009, at 55 (2008), *available at* http://jeffconline.jccal.org/Sites/Jefferson_County/Documents/Budget%20Management%20Office/2009-Budget-BMO.pdf.

157. Early in 2008, ratings agencies downgraded the County's sewer bond insurers, and shortly thereafter, also downgraded the County's approximately \$3.2 billion of sewer bonds. In February 2008, the auction market for the County's auction-rate sewer bonds failed. *See* JEFFERSON CNTY, ALA., SEWER REVENUE WARRANTS: MATERIAL EVENT NOTICE 1–7 (2008), *available at* <http://blog.al.com/bn/2008/02/Material%20Event%20Notice-%20Sewer%20Bond%202-28-08.pdf>; Shelly Sigo, *Jefferson County Ala., Takes Sewer Rating Hit*, BOND BUYER (Feb. 26, 2008), http://www.bondbuyer.com/issues/117_36/-284135-1.html.

158. *See* Taibbi, *supra* note 156.

159. In 1998, Oakland reportedly issued variable rate bonds in order to help the city finance its pension obligations. *See Oaklanders Demand End to Swap Ripoff*, SEIU LOCAL 1021 (June 12, 2012), <http://www.seiu1021.org/?s=Oakland%E2%80%99s+Goldman+Sachs+Rate+Swap&submit-btn=>. To protect against interest rate spikes, the city entered into an agreement with Goldman Sachs to swap its variable rate for a fixed rate obligation. *Id.* Instead of spiking, however, "interest rates dropped to about half what the city was paying to Goldman Sachs." *Id.* Although the bonds were refunded for additional debt in 2005, the swap agreement was structured to continue until 2021, and requires the city to pay \$5 million per year until that time. *Id.* Terminating the swap reportedly would cost Oakland \$19 million.

d. *Taxpayers Responsible in Ways that Shareholders Are Not*

In addition to the spending mandate and constrained sources of revenue, municipalities and their citizens also have fewer, less effective and more expensive monitoring and policing tools to manage borrowing and spending risk.¹⁶³ In the private sector,

See id.; Aaron Lucchetti, *Interest Rate Deals Sting Cities, States*, WALL ST. J., Mar. 22, 2010, <http://online.wsj.com/article/SB10001424052748703775504575135930211329798.html>.

160. *See* Jarrett Renshaw, *N.J. Spends \$122M to Partially Terminate Interest Rate Swap Deals in Past Month*, NJ.COM (Feb. 9, 2011), http://www.nj.com/news/index.ssf/2011/02/nj_spends_122m_to_partially_te.html (“New Jersey spent more than \$122 million last month to partially terminate eight interest-rate swap deals . . . [T]he [New Jersey Economic Development] [A]uthority issued \$1.1 billion in new bonds to cover the partial termination cost of eight swaps, as well as to refinance roughly \$992 million worth of . . . bonds. About \$122 million of that borrowed money went to fees paid to Goldman Sachs, UBS and Deutsche Bank to terminate the swaps.”); Letter from Robert Lamb, President, Lamont Inv. Advisers Corp., to James Petrino, N.J. Office of Pub. Fin. (Feb. 1, 2011), *available at* http://media.nj.com/ledgerupdates_impact/other/nj-swap-portfolio.pdf (attaching valuation report for details regarding the value of the outstanding swaps).

161. *See, e.g.*, Gretchen Morgenson, *Exotic Deals Put Denver Schools Deeper in Debt*, N.Y. TIMES, Aug. 6, 2010, <http://www.nytimes.com/2010/08/06/business/06denver.html?pagewanted=all> (detailing how and why the Denver School District entered into interest rate swap agreements and the eventual financial impact on the district); Press Release, Dep’t of the Auditor Gen., Philadelphia Derivatives Show Danger of Failure to Rein in Wall Street Penn. (Apr. 27, 2010), *available at* <http://www.auditorgen.state.pa.us/departments/press/phillyderivativesshowdangerfailereinwallstreet.html> (detailing net negative values for interest rate swaps for the City of Philadelphia, the School District of Philadelphia, the Philadelphia Authority for Industrial Development, and the Philadelphia Intergovernmental Cooperation Authority). Note that the constitutionality of school financing systems, while beyond the scope of this Article, has been litigated heavily over the years. *See, e.g.*, Serrano v. Priest, 487 P.2d 1241 (Cal. 1971). In some cases, municipalities that have suffered losses due to swap agreements have sued their swap providers, often resulting in settlements or the restructuring of swap agreements. In 2009, for example, the Alabama Public School and College Authority (APSCA) sued to void a swaption that it had sold to J.P. Morgan and refused to make payments on the swaption until a decision was rendered. *See* Shelly Sigo, *Judge OKs Deal in Alabama, J.P. Morgan Swaption Suit*, BOND BUYER (Dec. 27, 2010), http://www.bondbuyer.com/issues/119_496/judge-okays-deal-in-alabama-1021520-1.html. According to press reports, the APSCA agreed to pay a \$19 million in settlement to J.P. Morgan to resolve the dispute. *Id.*

162. *See* Chung, *supra* note 34, at 1474–77; *see also* discussion in note 156 of the Jefferson County case.

163. *See, e.g.*, DEAN MICHAEL MEAD, GOV’T ACCOUNTING STANDARDS BUREAU, WHAT YOU SHOULD KNOW ABOUT YOUR LOCAL GOVERNMENT’S FINANCES: A GUIDE TO FINANCIAL STATEMENTS 2 (2d ed. 2011); Jerold L. Zimmerman, *The Municipal Accounting Maze: An Analysis of Political Incentives*, 15 J. ACCOUNTING RESEARCH 107 (1977). For a discussion of limits of private ordering as a risk management tool in other contexts, see Mark J. Roe, *The Derivatives Market’s*

investors can decide if and when to invest in a particular corporation's securities. If an equity investor becomes unhappy, she may be able to express her displeasure in a variety of ways, including: (i) voting against incumbent board members during annual director elections, and proposing replacement slates of directors; (ii) making proposals during meetings and/or through the proxy system; and (iii) voting against major transactions proposed by incumbent boards and management.¹⁶⁴ Corporate security holders also may use exit discipline—i.e., selling securities—to express disapproval. Certainly, there are variations in voting rights across security-types and across corporations. Moreover, not every corporate security (debt or equity) is liquid or freely transferrable. The power of the shareholder vote, and shareholders' access to the proxy, also are limited in important respects.¹⁶⁵ That said, because shareholder losses are generally limited to the amount of the shareholder's investment, shareholder losses are capped even if the shareholder is unsuccessful in convincing the company to change course, and even if there are transaction costs associated with exit.

With municipal securities, voter/taxpayers take the place of shareholders, and municipal officers take the place corporate officers and directors. Once a taxpayer "buys in" to the municipal enterprise through the purchase of residential real estate or the use of municipal services, her choices are limited.¹⁶⁶ She must pay government levies whether or not she agrees with a particular expenditure. She may vote against bond offerings—if the offering is subject to a vote—but her point of view may not prevail, and opportunities to challenge issuances through litigation are limited.¹⁶⁷ If she wishes to unseat

Payment Priorities as Financial Crisis Accelerator, 63 STAN. L. REV. 539, 569–572 (2011) (examining limits of private ordering on risk shifting in derivatives markets).

164. See, e.g., DEL. CODE ANN. tit. 8 § 211(b) (2004) ("Unless directors are elected by written consent in lieu of an annual meeting as permitted by this subsection, an annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the by-laws."); *id.* § 212 (referencing rights of "[e]ach stockholder entitled to vote at a meeting of stockholders or to express consent or dissent to a corporate action" to designate a proxy); *id.* § 216 (referencing number of shares required to constitute a quorum for voting purposes); *id.* § 251(c) (referencing shareholder voting rights with respect to merger/ consolidation); see also 17 C.F.R. § 240.14a-8 (2014) (shareholder proposals).

165. See, e.g., 17 C.F.R. § 240.14a-8 (setting forth eligibility and procedural requirements for including a shareholder proposal in a corporation's proxy materials).

166. See, e.g., MEAD, *supra* note 163, at 2; Gellis, *supra* note 115, at 59–61; Zimmerman, *supra* note 163.

167. According to Amurdsky & Gillette, "In recent years, courts and legislatures have restricted the ability of taxpayers to contest the issuance of municipal bonds."

government officials responsible for particular offerings, she may have to wait until the next election (assuming the local officials behind the offering are elected) or pressure government officials to terminate appointed personnel.¹⁶⁸ She also may have to deal with government structures that entrench existing managers and make it difficult for taxpayers to alter the composition of decision-making bodies.¹⁶⁹ If the taxpayer is not happy with this state of affairs, she may be left with having to sell her real estate and move out of town.¹⁷⁰ Moving, however, is likely to involve significant transaction costs, especially when real estate markets are in turmoil.

In Detroit's case, with its diminished and impoverished population and rock-bottom property values, opportunities for policing and exit discipline may be even more limited and expensive than usual. Moreover, corruption—and the inability of the ordinary citizen to rein in public officials' malfeasance—may have exacerbated Detroit's distress. On October 13, 2013, Detroit's former mayor Kwame M. Kilpatrick was sentenced to twenty-eight years in prison after being convicted on dozens of counts racketeering and extortion, making him one of eighteen public officials convicted of corruption during his

AMURDSKY & GILLETTE, *supra* note 93, § 2.7.4, at 100. As Amurdsky and Gillette explain, judicial review may be limited to specific issues, such as “(1) the regularity of the proceedings at which the bonds are issued; (2) the validity of the bonds; and (3) the legality of the purpose for which the bonds are issued.” *Id.* (citing *Ward v. Commonwealth*, 685 A.2d 1061, 1063 (Pa. Commw. Ct. 1996); *see also City of Lubbock v. Isom*, 615 S.W. 2d 171 (Tex. 1981) (holding challengers of city bond issues were barred from suing under Texas statute which provided that judicial decree validating bonds constituted permanent injunction against any action or proceeding contesting validity of bonds if no appeal taken in statutorily proscribed time frame).

168. As Professor Gellis points out, using the New York City bond crisis of the mid-1970s as an example, politicians may be incentivized to focus on the potential for short-term gains rather than the possibility of long-term costs or losses. Gellis, *supra* note 115, at 47–50. This can lead to sub-optimal decision-making on issues relating to municipal finance. *Id.*

169. There is empirical research suggesting that certain governance structures may impact the likelihood and impact of restatements by municipal securities issuers. Professor Baber and his co-authors investigated the role of voter oversight in connection with accounting restatements in the municipal context and found that “restatements are more likely, and the increase in debt financing costs following restatements are more substantial, when municipal managers are entrenched—that is, when statutory provisions restrict the ability of voters to intervene directly in the municipal decision-making process or to quickly alter the composition of the city council.” WILLIAM R. BABER, ET AL., ACCOUNTING RESTATEMENTS, GOVERNANCE AND MUNICIPAL DEBT FINANCING 29–30 (2011), *available at* http://www.centerforpbefr.rutgers.edu/2012PBFEAM/papers/089-Accounting%20Restatements,%20Governance,%20and%20Municipal%20Debt%20Financing_William%20Baber_Aug.%202011.pdf.

170. *See, e.g.*, Gellis, *supra* note 115, at 59–61.

tenure.¹⁷¹ On December 24, 2013, banks involved in deals negotiated during Kilpatrick's tenure reportedly agreed to compromise certain claims relating to interest rate swap transactions following mediation overseen by United States District Court Chief Judge Gerald Rosen and United States Bankruptcy Court Judge Elizabeth Perris.¹⁷² According to the mediators' recommendation, the agreement (if approved) would "allow[] the City to refinance its debt at more favorable terms, saving approximately \$65 million from the original terms of the Forbearance Agreement, approximately \$25 million at the time of the hearing on the assumption of the Agreement, and permitting the City to reduce its interim loan (commonly referred to as the DIP loan) by up to an additional \$65 million."¹⁷³ The mediators also argued that the proposed agreement would "further provide much needed financial flexibility by freeing up casino revenues held in the collateral account providing funds needed to maintain operations and bolster city services," according to the mediators.¹⁷⁴ With respect to the SWAP counterparties, the mediators stated that the proposed agreement would "enable them to avoid the risk of losing all that they invested and further avoid the lawsuit the City threatened to bring which, if successful, could have forced them to disgorge and pay back to the City all of the payments they received under the swaps."¹⁷⁵

The proposed compromise between the City and SWAP counterparties was subject to court approval, and on January 16, 2014 Judge Rhodes rejected it, reportedly stating that the proposed deal was "just too much money" for the City.¹⁷⁶ Just two weeks later, the

171. Steve Yaccino, *Kwame M. Kilpatrick, Former Detroit Mayor, Sentenced to 28 Years in Corruption Case*, N.Y. TIMES, Oct. 13, 2013, http://www.nytimes.com/2013/10/11/us/former-detroit-mayor-kwame-kilpatrick-sentencing.html?_r=0; see also Indictment, United States v. Kilpatrick, No. CR-10-200403-NGE (E.D. Mich.) (Dec. 15, 2010).

172. See Mediators' Recommendation for Approval of Settlement Between the Debtor & SWAP Counter-Parties, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Dec. 30, 2013); see also Brent Snavely & Joe Guillen, *Detroit's Retirement Systems to Challenge Renegotiated Swaps Settlement with Banks*, DETROIT FREE PRESS, Dec. 26, 2013, <http://www.freep.com/article/20131226/NEWS01/312260107/Retirement-systems-bankruptcy-settlement>.

173. Mediators' Recommendation for Approval of Settlement Between the Debtor & SWAP Counter-Parties, *supra* note 172, at 2.

174. *Id.*

175. *Id.*

176. See, e.g., Mary Williams Walsh, *Judge Disallows Plan by Detroit to Pay Off Banks*, N.Y. TIMES, Jan. 16, 2014, <http://dealbook.nytimes.com/2014/01/16/judge->

City filed a declaratory judgment action against service corporations and funding trusts involved in the COPs (as noted above, certain of Detroit's swaps were connected to the COP transactions) seeking the entry of an order stating that all contractual obligations incurred by the City in connection with the COP transactions are "unenforceable and void *ab initio*."¹⁷⁷ In a nutshell, the City's complaint alleges that the service corporations and funding trusts formed in connection with the COP transactions swaps were a sham and an unlawful attempt to evade debt restrictions.¹⁷⁸ This proceeding is pending as of the date of publication.

D. Default and Discharge Options Limited

1. *Bankruptcy Is Complicated, Not a Get Out Of [Debtor] Jail Free Card*

Finally, constraints on default and discharge also make it difficult for cities (and thus their taxpayers) to obtain relief from debts. As is clear from Detroit's example, municipal bankruptcy operates very differently from individual and entity bankruptcy models. While non-state entities¹⁷⁹ like Detroit may be able to seek bankruptcy protection under Chapter 9, there are meaningful eligibility requirements,¹⁸⁰ involuntary bankruptcies are not permitted,¹⁸¹

rejects-detroits-deal-to-exit-swap-
contracts/?_php=true&_type=blogs&_php=true&_type=blogs&_r=1.

177. Complaint of City of Detroit, Michigan for Declaratory Judgment & Injunctive Relief at 19, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931 (Jan. 31, 2014).

178. *Id.* at 18–19.

179. As constitutionally recognized sovereigns, states cannot declare or be forced into bankruptcy. *See* 11 U.S.C. § 109 (2012) (failing to list states among the entities permitted to seek bankruptcy protection); *id.* § 903 (stating Chapter 9 "does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of the municipality, including expenditures for such exercise," with two exceptions—a state law prescribing a method of composition of municipal debt does not bind any non-consenting creditor, nor does any judgment entered under such state law bind a nonconsenting creditor); *id.* § 904 (limiting the power of a bankruptcy court to "interfere with—(1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property" unless the debtor consents or the plan so provides). *But see* *United States v. Bekins*, 304 U.S. 27, 54 (1938) (holding that the federal government may grant bankruptcy relief to a state under Chapter 10 without violating the Constitution).

180. To be eligible for Chapter 9, an entity must meet the five criteria listed in § 109(c). 11 U.S.C. § 109(c). Specifically, the entity must 1) be a municipality, as defined by the Code; 2) be specifically authorized to be a bankruptcy debtor; 3) be

liquidation is not an option, and the issuer's powers to operate (and thus make payments on debt) may not be affected.¹⁸² For example, because § 928 of the bankruptcy code provides that special revenues obtained by a municipal debtor after a bankruptcy filing are subject to liens granted prior to the bankruptcy filing,¹⁸³ eligible "revenue bondholders are entitled to receive revenue pledged to them without any interference and on a timely basis."¹⁸⁴ General obligation bondholders also may continue to receive payment following a Chapter 9 filing if the state statute authorizing the issuance contained a statutory lien.¹⁸⁵ The bankruptcy code also provides that payments

insolvent as defined by § 101(32)(C); 4) genuinely desire to effect a plan to adjust its debts that exist as of the commencement of the case; and 5) satisfy one of the four alternative statutory requirements for negotiating with its creditors before filing its petition. *Id.* The debtor bears the burden of establishing that it meets each of these statutory requirements. *See, e.g., In re Cnty. of Orange*, 183 B.R. 594, 599 (Bankr. C.D. Cal. 1995). With respect to the "specifically authorized" criteria, fewer than half of the states authorize municipal bankruptcy petitions, assuming the filing municipality meets certain conditions. *See, e.g.,* ALA. CODE § 11-81-3 (LexisNexis 2008); ARIZ. REV. STAT. ANN. § 35-603 (2011); ARK. CODE ANN. § 14-74-103 (2010); CAL. GOV'T CODE § 53760 (2012); IDAHO CODE ANN. § 67-3903 (2013); KY. REV. STAT. ANN. § 66.400 (LexisNexis 2004); LA. REV. STAT. ANN. §§ 13:4741, 39:619-620 (2013); MINN. STAT. § 471.831 (2008); MO. ANN. STAT. § 427.100 (West 2010); MONT. CODE ANN. § 7-7-132 (2013); NEB. REV. STAT. § 13-402 (2012); N.Y. LOCAL FIN. LAW § 85.80 (McKinney 2001); OKLA. STAT. ANN. tit. 62, § 283 (West 2010); S.C. CODE ANN. § 6-1-10 (2004); TEX. LOC. GOV'T CODE ANN. § 140.001 (West 2008); WASH. REV. CODE § 39.64.040 (2012). Other states either prohibit municipal bankruptcy petitions or allow them only if the state approves the petition. *See, e.g.,* CONN. GEN. STAT. § 7-566 (2013); FLA. STAT. § 218.01 (2013); LA. REV. STAT. ANN. § 39:619 (2013); MICH. COMP. LAWS § 141.1566 (West 2005); N.J. STAT. ANN. § 52:27-40 (West 2010); N.C. GEN. STAT. § 23-48 (2013); OHIO REV. CODE ANN. § 133.36 (West 2012); 53 PA. CONS. STAT. § 5571 (2014); R.I. GEN. LAWS § 45-9-7 (2009). Three states have enacted statutes providing limited authorization for specific municipal issuers/debtors. *See, e.g.,* COLO. REV. STAT. § 37-32-102 (2013) (taxing, drainage and irrigation districts); 50 ILL. COMP. STAT. 320/9(b)(4) (West 2008) (power); 20 ILL. COMP. STAT. 3855/1-20(b)(15); OR. REV. STAT. § 548.705 (West 2010) (drainage and irrigation districts).

181. *See* 11 U.S.C. §§ 301, 904 (2012).

182. For example, despite the automatic stay provision of the Bankruptcy Code, 11 U.S.C. § 922(d) allows municipalities to continue paying pledged special revenue, or revenue bonds without obtaining the court's permission or notifying other creditors. *See id.* § 922(d). By comparison, corporate reorganizations occur in the content of the potential liquidation of the debtor. *See id.* § 1123(a).

183. *See id.* § 928.

184. *See* JAMES SPIOTTO, ET AL., MUNICIPALITIES IN DISTRESS? HOW STATES AND INVESTORS DEAL WITH LOCAL GOVERNMENT FINANCIAL EMERGENCIES 56 (2012). For a discussion of the legislative history of this provision, see *id.* at 54-56.

185. *Id.* at 58. As Spiotto and his co-authors point out, this approach was used in the Orange County bankruptcy case, where the court held that the lien securing tax and revenue anticipate notes arising under state law was a statutory lien that survived the county's Chapter 9 petition. *Id.* (citing *In re Cnty. of Orange*, 189 B.R. 499 (S.D.

received by holders of municipal bonds or note obligations within ninety days of the commencement of a municipal bankruptcy petition are not preferences subject to claw-back.¹⁸⁶ Due to provisions like these, issuers may remain obligated to repay municipal bond debt despite seeking bankruptcy protection.¹⁸⁷ At a minimum, as in Detroit's case, these issues present knotty legal questions that cost time and money to resolve.

Even when municipal bankruptcy (and debt adjustment) is available, it is not a "cure-all," especially for taxpayers and public workers. Even before debates over eligibility and debt priority erupted in the Detroit bankruptcy, for example, the bankruptcies in Vallejo, California and Jefferson County, Alabama highlighted costs associated with Chapter 9. Vallejo, California filed for Chapter 9 bankruptcy protection in May 2008 in the face of revenue constraints and expanding debt load, over the objections of public workers.¹⁸⁸ Although Vallejo's bankruptcy filing gave the city breathing room to adjust debts owed to various creditor constituencies, respite came at a price.¹⁸⁹ Through the bankruptcy process, the city adjusted

Cal. 1995)). According to Spiotto, "at least thirty-two states recognize some form of a statutory lien in relation to their bond obligations." *Id.*

186. 11 U.S.C. § 926 (2012).

187. Some thirty states have laws in place that give holders of general obligations bonds and certain other securities issued by municipalities rights of first payment from certain revenue streams even during bankruptcy. *See, e.g.,* SPIOTTO ET AL., *supra* note 184, at 54–55. For a general discussion of municipal insolvency, see Alexander M. Laughlin, *Municipal Insolvencies: An Article on the Treatment of Municipalities Under Chapter 9 of the U.S. Bankruptcy Code*, MUN. FIN. J., Summer 2005, at 37–59.

188. *See In re City of Vallejo*, 403 B.R. 72 (Bankr. E.D. Cal. 2009), *aff'd*, 432 B.R. 262 (E.D. Cal. 2010); Carolyn Jones, *Vallejo's Bankruptcy Ends After 3 Tough Years*, S.F. GATE (Nov. 1, 2011), <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2011/11/01/BARI1LPAHN.DTL>. State and local governments have been battered by the subprime mortgage crisis and resulting economic downturn in a variety of ways in addition to those discussed here. For example, the National Commission on the Causes of the Financial and Economic Crisis in the United States found that "losses on SIVs [structured investment vehicles] and other mortgage-tainted investments also battered local government investment pools across the country, some of which held billions of dollars in these securities." FIN. CRISIS INQUIRY COMM'N, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 254 (2011), *available at* <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

189. *See* LEON R. BARSON ET AL., CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS, COUNSELING MUNICIPALITIES, AND ANALYZING RECENT TRENDS AND CASES 9 (2011) (noting Chapter 9 filing gives distressed municipalities time—and "breathing room"—to develop debt adjustment plans). In *In re City of Vallejo*, the municipality sought to reject its collective bargaining agreements with public workers less than one month after filing its petition for relief under Chapter 9 of the Bankruptcy Code. *See* 403

compensation and benefits packages with city workers, with the reported result that, “city staffers now contribute more to their health insurance, new firefighters have lower pension plans and the fire department no longer has minimum staffing requirements.”¹⁹⁰ Although the city has emerged from bankruptcy, sales taxes remain high, public services remain “hollowed-out” and there are neighborhoods with dilapidated homes.¹⁹¹ City workers and taxpayers also have had to deal with approximately \$8 million in legal fees that the city incurred in connection with the bankruptcy.¹⁹² According to press reports, however, Vallejo paid bondholders in full and on time.¹⁹³ Likewise, in the Jefferson County case, county residents suffered lasting harm in the wake of the political corruption scheme, the default on municipal bonds associated with water and sewer improvement projects and, eventually, the County’s \$4 billion bankruptcy filing.¹⁹⁴ According to press reports, the county’s sewers still do not function properly, county services are operating at

B.R. at 72. The court held that the less stringent standards for rejection of union contracts available under 11 U.S.C. § 365 and the *Bildisco* line of cases applied to Vallejo’s petition versus the more exacting standards for rejection of union contracts under 11 U.S.C. § 1113. *See id.* at 78 (applying the *Bildisco* standard for rejection of executor contracts, which permits a debtor to reject a collective bargaining agreement under 11 U.S.C. § 365 if it shows “1) the collective bargaining agreement burdens the estate; 2) after careful scrutiny, the equities balance favors contract rejection; and 3) ‘reasonable efforts to negotiate a voluntary modification have been made, and are not likely to produce a prompt and satisfactory solution.’” (citing *NLRB. v. Bildisco & Bildisco*, 465 U.S. 513, 526 (1984))).

190. *See Jones, supra* note 188. Fire and police unions had opposed Vallejo’s bankruptcy filing on the grounds that the city used bankruptcy strategically as a means of avoiding contractual obligations respecting benefits. *Id.*

191. *See, e.g., White, supra* note 129 (discussing tax increases and reductions in public services in Vallejo, California after the city declared bankruptcy in 2008 in the face of declining revenues, soaring costs and municipal bond-related obligations).

192. *Id.* Among other reasons for the legal fees, the city and certain of its public workers engaged in extensive litigation over whether the bankruptcy filing was necessary, or whether it was means of avoiding collective bargaining obligations. *See Opposition to Debtor’s Application for Order Setting June 9 Deadline for Filing Objections to Petition, In re City of Vallejo*, No. 08-26813 (MSM) (Bankr. E.D. Cal. May 28, 2008).

193. Patrick McGee, *Vallejo Shows the Way*, BOND BUYER (Feb. 28, 2001), http://www.bondbuyer.com/issues/120_40/vallejo_muni_bankruptcy-1023803-1.html. According to Hildreth and Zorn, the San Jose School District in California also paid its debt service on schedule despite seeking bankruptcy protection in 1983 “due, in part, to Proposition 13 tax limits, but, more pointedly, to void a labor arbitration award.” Hildreth & Zorn, *supra* note 97, at 145.

194. As noted, I discuss the Jefferson County case in my previously published work, Chung, *supra* note 34, at 1474–77.

skeleton crew levels, and the debt still exists.¹⁹⁵ As one county resident reportedly said, “Everyone wonders how the county will ever get out of this financial mess.”¹⁹⁶

a. Default, Discharge and Bailouts Are Disfavored for Political Reasons, Too.

Political realities also limit municipalities’ access to debt relief. In some cases, local government issuers may not reach the point of default or bankruptcy because the state steps in and takes control. As Massachusetts Representative Barney Frank explained in 2008 during Congressional hearings on turmoil in the municipal bond market:

No State, no State legislators, no governor, can allow any one of its municipalities to default because then every other municipality would pay through the nose. So that is why this is not just some charity here; this is self-defense.

The particular municipality, you might pity the municipal workers there. Services may get cut back. Maybe the trash won’t get picked up. But we can guarantee you, we have all been there, you can’t do that [default]. Because if any one municipality falters, every municipality in that State would pay, and there isn’t a State governor and legislature in the country who doesn’t understand that, and that’s why the State guarantee is such a good one.¹⁹⁷

Similarly, as the Securities and Exchange Commission observed in one of its reports on the municipal securities market, bankruptcy generally is a last resort for distressed municipalities:

The low number of bankruptcies in the municipal sector can be attributed to several factors, both legal and practical, including: the negative effects of a bankruptcy filing on the credit ratings not only of the municipalities themselves, but also the states in which they are located, which means that bankruptcy is often used only as a last resort; the public nature of bankruptcy; state restrictions against filing under Chapter 9; and the negative effects on access to future

195. Walsh, *supra* note 128 (noting that public services in Jefferson County, Alabama were gutted after the county declared bankruptcy in 2011 in the wake of a corruption scandal tied to more than \$1 billion in municipal bond debt and related interest rate swaps). New Jersey also has faced considerable turmoil in its efforts to deal with the fiscal problems exposed by the case against it. *See, e.g., State Budgets: The Day of Reckoning*, CBS NEWS (Dec. 19, 2010), <http://www.cbsnews.com/news/state-budgets-the-day-of-reckoning/1>.

196. Walsh, *supra* note 128. As noted, Detroit is not alone in this. *See* Lowenstein, *supra* note 129; Varghese, *supra* note 126; White, *supra* note 129.

197. *Municipal Bond Turmoil: Impact on Cities, Towns, and States: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 25 (2008) (statement of Rep. Barney Frank, Chairman, H. Comm. on Fin. Servs.).

capital markets, which motivates financially distressed municipalities to rely on mechanisms other than Chapter 9 (including state refinancing authorities, receiverships, and commissions) to restructure debt.¹⁹⁸

“States that intervene often want to avoid the stigma that would come from their cities filing for bankruptcy protection,”¹⁹⁹ as well as reduce impacts on other municipalities within the state associated with contagion.²⁰⁰ In Vallejo, California, for example, the city reportedly was not able to access public debt markets for three years during its bankruptcy (2008-2011) for money to maintain its streets or replace its aging police cars and fire trucks.²⁰¹ In addition, after the city made extensive cuts to its police and fire fighter forces, crime rates rose, as did response times to fire and medical emergencies.²⁰² Declines in quality of life in the city—which made the national news—caused Vallejo to lose a portion of its population even as cities in the area gained residents.²⁰³ Concerns about contagion also have merit. In the wake of Detroit’s filing, other Michigan municipalities reportedly were forced to delay planned offerings.²⁰⁴

b. Cuts . . . A Drop in the Bucket, Significant Harm to Public Life

Finally, while budget cuts may be an important tool in solving municipal fiscal crisis, Detroit’s example suggests that cities in financial extremis cannot “cut” their way to solvency. According to its bankruptcy filings, Detroit already has sought to reduce expenses through measures such as employee headcount reductions.²⁰⁵ These cuts have “gutted many City departments, resulting in the deferral of many necessary investments and decreasing level of services to Detroiters,” according to Emergency Manager Orr.²⁰⁶ They also have contributed to a negative feedback loop in Detroit whereby taxes on

198. SEC, *supra* note 109, at 24–25 (citations omitted).

199. See PEW CHARITABLE TRUSTS, THE STATE ROLE IN LOCAL GOVERNMENT FINANCIAL DISTRESS 14 (2013), available at http://www.pewstates.org/uploadedFiles/PCS_Assets/2013/Pew_State_Role_in_Local_Government_Financial_Distress.pdf.

200. *Id.* at 16.

201. *Id.* at 14.

202. *Id.*

203. *Id.*

204. See, e.g., Bloomberg News, *Battle Creek Becomes Second Michigan Municipality to Delay Bond Sale*, CRAIN’S DETROIT BUS. (Aug. 6, 2013), <http://www.craindetroit.com/article/20130806/NEWS01/130819889/battle-creek-becomes-second-michigan-municipality-to-delay-bond-sale>.

205. Orr Declaration, *supra* note 1, at 46.

206. *Id.* at 22.

those who must remain are unsustainable, even as the City's inadequate public infrastructure and services and high tax rates threaten to drive people and business away.

II. KEY LEGAL QUESTIONS: PENSIONER RIGHTS, BONDHOLDER RIGHTS, AND TAXPAYER RIGHTS

Against this backdrop of hard choices and competition for meager resources, Detroit's bankruptcy presents two key legal questions: 1) Can Detroit use Chapter 9 bankruptcy proceedings to reduce or restructure accrued pension benefits of retired city workers when the Michigan Constitution 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"²⁰⁷ and also states that "[n]o . . . law impairing the obligations of contract shall be enacted?"²⁰⁸ 2) How will debts associated with Detroit's municipal securities—and particularly its UTGO—be dealt with, when (i) Detroit is already levying taxes at or near statutory maximums; (ii) City residents cannot absorb taxes increases, and (ii) Detroit does not have (and will not have, without restructuring) sufficient funds to pay its debts?

In the following subpart, I discuss legal questions surrounding pension impairment in Part A, and issues relating to Detroit's UTGO bonds in Part B.

A. Can Detroit Use Chapter 9 Bankruptcy Proceedings to Reduce or Restructure Accrued Pension Rights of Retired City Workers, Given Michigan Constitution Pension Clause?

On December 5, 2013, Judge Steven Rhodes held that Detroit is eligible to be a Chapter 9 debtor despite the fact that neither the City nor the State explicitly carved out accrued pension benefits and protected them from adjustment.²⁰⁹ Judge Rhodes also held that accrued pension benefits are subject to impairment in Chapter 9 proceedings, despite the Pension Clause.²¹⁰ In the following section, I discuss the debate surrounding pension impairment and Judge Rhodes's ruling.

207. MICH. CONST., art IX, § 24.

208. MICH. CONST., art I, § 10.

209. See Opinion Regarding Eligibility, *supra* note 1.

210. *Id.*

1. *The Emergency Manager Puts Pension Impairment on the Table.*

Pension impairment has been a hot button issue in the Detroit bankruptcy ever since June 14, 2013, when the Office of the Emergency Manager published a proposal to the City's creditors which referenced adjusting pension obligations.²¹¹ In his proposal, Orr outlined Detroit's dire financial condition and called for a "thorough overhaul and restructuring" of the City's obligations.²¹² Among other initiatives, the June 14 proposal outlined the City's plans to invest \$1.25 billion over ten years to improve basic and essential City services such as police, fire and EMS.²¹³ The June 14 proposal also outlined the City's intention to expand its income and property tax bases, rationalize and adjust income tax rates, and improve tax and fee collection efforts.²¹⁴

With respect to creditor recoveries, Orr proposed the following: (i) "treatment of secured debt commensurate with the value of the collateral securing such debt, including the repayment or refinancing of the City's revenue bonds, secured unlimited and limited tax general obligation bonds, secured installment notes and liabilities arising in connection with swap obligations;"²¹⁵ (ii) "pro rata distribution of \$2,000,000,000 in principal amount of interest-only limited recourse participation notes to holders of unsecured claims," including holders of unsecured limited and unlimited tax general obligation bonds, the service corporations (based on the COPs), the pension systems (based on pension underfunding), and retirees (based on OPEB);²¹⁶ and (iii) "[a] 'Dutch Auction' process for the City to purchase the notes."²¹⁷ Also at the meeting respecting the June 14 proposal, Orr announced his decision to not make the scheduled \$39,700,000 in payments due on the COPs and swap transactions.²¹⁸

With respect to claims for unfunded pension liabilities, Orr stated that "[b]ecause the amounts realized on the underfunding claims will be substantially less than the underfunding amount, there must be

211. *See id.* at 18; *see also* OFFICE OF CITY MANAGER, *supra* note 124; PROPOSAL FOR CREDITORS, *supra* note 3.

212. Opinion Regarding Eligibility, *supra* note 1, at 18; *see also* OFFICE OF CITY MANAGER, *supra* note 124; PROPOSAL FOR CREDITORS, *supra* note 3.

213. *See* PROPOSAL FOR CREDITORS, *supra* note 3, at 61–78 app. J.

214. *Id.* at 79–82.

215. Opinion Regarding Eligibility, *supra* note 1, at 18 (citing PROPOSAL FOR CREDITORS, *supra* note 3, at 101–09).

216. *Id.* at 19 (citing PROPOSAL FOR CREDITORS, *supra* note 3, at 101–09).

217. *Id.* (citing PROPOSAL FOR CREDITORS, *supra* note 3, at 108).

218. *See id.*

significant cuts in accrued, vested pension amounts *for both active and currently retired* persons.”²¹⁹ In subsequent comments, Orr acknowledged the Pension Clause of the Michigan Constitution, but reportedly suggested that neither it nor the Contracts Clause prevented a bankruptcy court from impairing pensions as part of a plan of adjustment under Chapter 9.²²⁰

2. *Retirees Initially Seek Refuge in State Court*

On July 3, 2013, with the possibility of impairment on the table, petitioners filed two separate lawsuits in state court seeking a declaratory judgment that Public Act 436 (the Act pursuant to which Orr was appointed) violated the Michigan Constitution to the extent that it purported to authorize Chapter 9 proceedings without first carving out (or otherwise ring-fencing) accrued pension benefits to protect them from adjustment.²²¹ The petitioners also sought an injunction preventing defendants from authorizing any Chapter 9 proceeding in which vested pension benefits might be impaired.²²² Shortly thereafter, the Detroit pensions systems filed a similar lawsuit.²²³

On July 18, 2013, the Ingham County Circuit Court found that Chapter 9 for Detroit would impair accrued financial benefits in violation of the Pension Clause.²²⁴ The court entered a preliminary injunction enjoining officials from taking further action on behalf of the City through a Chapter 9 proceeding where pension benefits might be impaired.²²⁵ One day later, the court issued a declaratory judgment order holding that accrued pension benefits could not be impaired under the Michigan Constitution, and also made the

219. OFFICE OF CITY MANAGER, *supra* note 124, at 56; *see also* PROPOSAL FOR CREDITORS, *supra* note 3, at 109.

220. *See, e.g., Q & A with Kevyn Orr: Detroit's Emergency Manager Talks About City's Future*, DETROIT FREE PRESS, June 16, 2013, <http://www.freep.com/article/20130616/OPINION05/306160052/kevyn-orr-detroit-emergency-manager-creditors-fiscal-crisis>; Ed White, *Detroit to Get Crucial Ruling in Bankruptcy Case*, YAHOO! NEWS (Dec. 13, 2013), <http://news.yahoo.com/detroit-crucial-ruling-bankruptcy-case-061034373—finance.html>.

221. *See, e.g.,* Amended Complaint, *Flowers v. Snyder*, No. 13-729-CZ (Mich. Cir. Ct. July 8, 2013); Complaint, *Webster v. Michigan*, No. 13-734-CZ (Mich. Cir. Ct. July 3, 2013).

222. *See, e.g.,* sources cited *supra* note 221.

223. Complaint, *Gen. Retirement Syst. of the City of Detroit v. Orr*, No. 13-768-CZ (Mich. Cir. Ct. July 17, 2013).

224. Preliminary Injunction, *Webster v. State*, No. 13-734-CZ (Mich. Cir. Ct. July 18, 2013).

225. *Id.*

following rulings: (i) “PA 436 is unconstitutional and in violation of . . . [the Pension Clause,] to the extent it permits the Governor to authorize an emergency manager to proceed under Chapter 9 in any manner which threatens to impair or diminish accrued pension benefits;” (ii) “[t]he Governor is prohibited by . . . [the Pension Clause] from authorizing an emergency manager under PA 436 to proceed under Chapter 9 in a manner which threatens to diminish or impair accrued pension benefits;” and (iii) “[b]y authorizing [] Emergency Manager [Orr] to proceed under Chapter 9 to diminish or impair accrued pension benefits, [the Governor] acted without authority under Michigan law and in violation of . . . [the Pension Clause].”²²⁶

3. *The Debate Moves to Bankruptcy Court*

This City’s bankruptcy filing moved the debate to bankruptcy court. On July 16, 2013, Emergency Manager Orr recommended to Michigan governor Richard Snyder and to the state’s treasurer that the City file for Chapter 9 relief.²²⁷ On July 18, the same day the state court issued its judgment, Governor Snyder authorized the City to file a Chapter 9 petition.²²⁸ Although section 141.15661(1) of the Michigan Compiled Laws purports to permit the governor to “place contingencies on a local government in order to proceed under chapter 9,”²²⁹ Governor Snyder did not do so. Instead, Governor Snyder explained that he was “choosing not to impose any such contingencies today. Federal law already contains the most important contingency—a requirement that the plan be legally executable.”²³⁰

226. See Order of Declaratory Judgment, *Webster v. State*, No. 13-734-CZ (Mich. Cir. Ct. July 19, 2013).

227. See Letter from Kevin D. Orr, Emergency Manager, City of Detroit, Mich., to Richard Snyder, Governor, State of Mich. & Andrew Dillon, Treasurer, State of Mich. (July 16, 2013), *in* Orr Declaration, *supra* note 1 (attached as Exhibit J).

228. Letter from Richard D. Snyder, Governor, State of Mich. to Kevyn Orr, City Manager, City of Detroit, Mich. & Andrew Dillon, State Treasurer, State of Mich. (July 18, 2013), *in* Orr Declaration, *supra* note 1 (attached as Exhibit K) (citation omitted).

229. MICH. COMP. LAW § 141.1558(1) (2013); see Letter from Richard D. Snyder, Governor, State of Mich. to Kevyn Orr, City Manager, City of Detroit, Mich. & Andrew Dillon, State Treasurer, State of Mich. 4 (July 18, 2013), *in* Orr Declaration, *supra* note 1 (attached as Exhibit K).

230. Letter from Richard D. Snyder, Governor, State of Mich. to Kevyn Orr, City Manager, City of Detroit, Mich. & Andrew Dillon, State Treasurer, State of Mich. 4 (July 18, 2013), *in* Orr Declaration, *supra* note 1 (attached as Exhibit K).

Orr filed the City's Chapter 9 petition that same day.²³¹ After the bankruptcy court entered an order staying pre-petition litigation (including the state court actions), more than one hundred parties (including pensioners and other stakeholders) (hereinafter, collectively, the Objectors) filed objections to Detroit's eligibility in the bankruptcy court action.²³²

Citing the Pension Clause, public worker stakeholders argued that Detroit is not eligible to be a Chapter 9 debtor because the State (and the City) failed explicitly to protect accrued pension benefits from impairment.²³³ Among other arguments, these Objectors asserted that (i) Chapter 9 is unconstitutional on its face under the Bankruptcy Clause of Article I, Section 8 of the United States Constitution because it violates the uniformity requirement, and under the Contracts Clause of Article I, Section 10 to the extent it would permit the impairment of contracts to which the state is a party; and (ii) Chapter 9 is unconstitutional as applied under the Tenth Amendment to the United States Constitution to the extent it does not prohibit the bankruptcy court from impairing vested pension benefits owed to Detroit's retired city workers.²³⁴

231. *See* Bankruptcy Petition, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. July 18, 2013).

232. Order Pursuant to Section 105(a) of the Bankruptcy Code Confirming the Protections of Sections 362, 365 and 922 of the Bankruptcy Code, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. July 25, 2013); *see* Opinion Regarding Eligibility, *supra* note 1, at 2 (noting that 109 parties filed timely objections). As to federalism issues associated with the state court rulings, Judge Rhodes held that the Ingham County court's judgment respecting was not binding under principles of res judicata or collateral estoppel, and also is not a persuasive indication of what the Michigan Supreme Court would hold. *See id.* at 55-56.

233. *See, e.g.*, Objection of the Official Committee of Retirees to Eligibility of the City of Detroit, Michigan to Be A Debtor Under Chapter 9 of the Bankruptcy Code, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Aug. 19, 2013).

234. *Id.* As summarized by the bankruptcy court, 110 separate creditors filed objections to Detroit's eligibility on various grounds, raising the following legal questions:

1. Does chapter 9 of the bankruptcy code violate the uniformity requirement of the bankruptcy clause of the United States Constitution?[:]
2. Does chapter 9 violate the contracts clause of the United States Constitution?[:]
3. Does chapter 9 violate the Tenth Amendment of the United States Constitution, as applied in this case?[:]
4. Does the bankruptcy court have the authority to determine the constitutionality of chapter 9 of the bankruptcy code under *Stern v. Marshall*, 131 S. Ct. 2594 (2011)?[:]
5. Did the voters' rejection of Michigan Public Act 4 of 2011 in November 2012 constitutionally prohibit the Michigan Legislature from enacting Michigan Public Act 436 of 2012?[:]
6. Does Public Act 436 violate

4. Judge Rhodes's Opinion Regarding Eligibility

On December 5, 2013, following extensive briefing and hearings, Judge Rhodes issued a 143-page ruling respecting Detroit's eligibility for Chapter 9 relief.²³⁵ After cataloging Detroit's debts and the impact of the City's financial crisis on the City's beleaguered residents, Judge Rhodes observed that a plan of adjustment may be Detroit's only hope for survival:

The City of Detroit was once a hardworking, diverse, vital city, the home of the automobile industry, proud of its nickname—the “Motor City.” It was rightfully known as the birthplace of the American automobile industry. In 1952, at the height of its prosperity and prestige, it had a population of approximately 1,850,000 residents. In 1950, Detroit was building half of the world's cars.

The evidence before the Court establishes that for decades, however, the City of Detroit has experienced dwindling population, employment, and revenues. This has led to decaying infrastructure,

the Michigan Constitution because it included appropriations provisions for the purpose of evading the right of referendum?[] 7. Does Public Act 436 violate the home rule provisions of the Michigan Constitution?[] 8. Does Public Act 436 violate the pension clause of the Michigan Constitution?[] 9. Does the pension clause of the Michigan Constitution establish protections for pension rights that are greater than contract rights?[] 10. Does the bankruptcy court have the authority to determine the constitutionality of Public Act 436 under *Stern v. Marshall*?[] 11. Did Detroit's emergency manager have valid authority to file this bankruptcy case even though he is not an elected official?[] 12. Was the governor's authorization to file this bankruptcy case valid under the Michigan Constitution even though the authorization did not prohibit the City from impairing pension rights?[] 13. Does the judgment in *Webster v. Michigan*, which was entered post-petition, preclude the City from asserting that the governor's authorization to file this bankruptcy case was valid?[] 14. Was the City “insolvent” under 11 U.S.C. § 101(32)(C), as required by 11 U.S.C. § 109(c)(3)?[] 15. Does the City desire to effect a plan to adjust its debts, as required by 11 U.S.C. § 109(c)(4)?[] 16. Did the City negotiate with its creditors in good faith before filing its bankruptcy petition, as required (in the alternative) by 11 U.S.C. § 109(c)(5)(B)?[] 17. Was the City unable to negotiate with creditors because such negotiation was impracticable, as required (in the alternative) by 11 U.S.C. § 109(c)(5)(C)?[] and] 18. Should the case be dismissed under 11 U.S.C. § 921(c) because the City of Detroit did not file its bankruptcy petition in good faith?

Memorandum Regarding: I. Certification Under 28 U.S.C. § 158(d)(2)(A)(i) II. Recommendation on Whether Direct Appeals Should Be Authorized And III. Parties' Request to Recommend Expedited Consideration of Appeals at 6–7, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Dec. 20, 2013).

235. See Opinion Regarding Eligibility, *supra* note 1.

excessive borrowing, mounting crime rates, spreading blight, and a deteriorating quality of life.

The City no longer has the resources to provide its residents with the basic police, fire and emergency medical services that its residents need for their basic health and safety.

Moreover, the City's governmental operations are wasteful and inefficient. Its equipment, especially its streetlights and its technology, and much of its fire and police equipment, is obsolete. To reverse this decline in basic services, to attract new residents and businesses, and to revitalize and reinvigorate itself, the City needs help.²³⁶

Having framed the case in this fashion, Judge Rhodes held that Detroit meets the criteria set forth in 11 U.S.C. § 109(c) and is eligible to be a Chapter 9 debtor.²³⁷ With respect to pension impairment, Judge Rhodes rejected the Objectors' claim that the City was required to carve out pensions as a condition to Chapter 9 eligibility.²³⁸ Among other specific holdings²³⁹ Judge Rhodes

236. *Id.* at 4. Notably, during hearings on the Objections to Eligibility, Judge Rhodes said (with respect to the Pensions Clause),

The question we all are struggling with is what is the meaning—the substantive meaning—of that provision in the context of a political subdivision that doesn't have the money to comply with it? What's the meaning of it? How do we give meaning to non-impairment . . . if the city doesn't have the money to pay?

Hearing on Eligibility Objections at 41:19, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Oct. 15-16, 2013), available at <http://www.mieb.uscourts.gov/apps/detroit/DetroitAudio.cfm>. Judge Rhodes raised this theme repeatedly during arguments, questioning lawyer after lawyer about what the Pension Clause guarantee means if Detroit does not have the money to meet its pension-related obligations in full, or if meeting those obligations in full (were it even possible) would mean the City was unable to make the kind of investments in infrastructure, services and the living conditions generally necessary to put the City on a path towards recovery. *See, e.g., id.* at 2:45:47–2:48:00.

237. *See generally* Opinion Regarding Eligibility, *supra* note 1.

238. *Id.* at 41–44.

239. *Id.* Other holdings not discussed in this Article include the following: (a) the bankruptcy court has the authority to determine the constitutionality of Chapter 9 and Michigan Public Act 436, *see id.* at 22–26; (b) Michigan Public Act 436 does not violate the Michigan Constitution, *see id.* at 45–52; (c) Detroit's Emergency Manager had valid authority to file the bankruptcy case even though he is not an elected official, *see id.* at 52; (d) the Governor's authorization to file the bankruptcy case was valid under the Michigan Constitution even though the authorization did not prohibit the City from impairing pension rights, *see id.* at 52–53; (e) the judgment in the *Webster* state court action does not preclude the City from asserting that the Governor's authorization to file the bankruptcy case was valid, *see id.* at 53–59; (f) Detroit was insolvent, *see id.* at 59–62; (g) the City desires to effect a plan to adjust its debts, *see id.* at 62–64; (g) the City did not negotiate in good faith with creditors, *see id.* at 64–68; (h) the City filed its bankruptcy petition in good faith, *see id.* at 71–81;

concluded that (a) Chapter 9 is not facially unconstitutional under the Bankruptcy Clause of Article I, Section 8 or the Contracts Clause of Article I, Section 10 of the United States Constitution;²⁴⁰ (b) Chapter 9 does not violate the Tenth Amendment to the United States Constitution;²⁴¹ and (c) Chapter 9 is constitutional as applied in this case despite the failure to ring-fence pensions.²⁴² The following section discusses the parties' arguments, and the court's rulings, on the pension impairment issue.

*a. Objectors Have Standing, Dispute Is Ripe For Adjudication*²⁴³

As a preliminary matter, Judge Rhodes rejected claims that the Objectors lacked standing, and that their claims were not yet ripe for adjudication.²⁴⁴ In pre-hearing papers, the United States and the City argued that the Objectors' claims respecting pension impairment ought to be addressed at the plan confirmation state (and only then if the City proposed a plan of adjustment calling for impairment) because only then would the court know if (and how) the City sought to impair accrued pension benefits.²⁴⁵ Citing the Pension Clause, the Emergency Manager's June 14 proposal and statements regarding court's power to impair pension rights, the Governor's authorization, and the City's petition, the Objectors argued that that they had standing, and that their dispute was ripe for adjudication, on the theory that filing a petition without ring-fencing pension was itself an impairment, and an injury in fact.²⁴⁶

and (i) the Supreme Court's decision in *Midlantic National Bank v. New Jersey Department of Environmental Protection* does not apply in this case. 474 U.S. 494 (1986); see *id.* at 82.

240. *Id.* at 28.

241. *Id.* at 28–29, 32–44.

242. *Id.* at 40–44.

243. Although the court addressed standing and ripeness in the context of his Tenth Amendment analysis “because the United States and the City framed this issue in the context of the Tenth Amendment challenge to chapter 9 of the bankruptcy code,” the court observed that “the same considerations would apply and would lead to the same conclusion” to the extent that standing and ripeness arguments were made respecting the other constitutional challenges presented by Objectors' papers. *Id.* at 29 n.19. Consequently, I have addressed standing and ripeness first, and they are typically threshold issues.

244. *Id.*

245. See, e.g., United States of America's Memorandum in Support of Constitutionality of Chapter 9 of Title 11 of the United States Code at 16–18, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Oct. 11, 2013); see also Opinion Regarding Eligibility, *supra* note 1, at 29–32.

246. See, e.g., The Michigan Council 25 of the American Federation of State, County & Municipal Employees, AFL-CIO and Sub-Chapter 98, City of Detroit

In his Opinion Regarding Eligibility, Judge Rhodes found in favor of Objectors as to both standing and ripeness. With respect to standing, Judge Rhodes held that the Objectors “who are creditors with pension claims against the City” are parties in interest, and thus have standing to assert their constitutional arguments as part of the bankruptcy case.²⁴⁷ With respect to ripeness, the court held that the Objectors’ challenge to Detroit’s eligibility is not an “abstract disagreement ungrounded in the here and now.”²⁴⁸ Rather, the dispute “arises in the concrete factual context of the City of Detroit filing this bankruptcy case under chapter 9 of the bankruptcy code and the objecting parties challenging the constitutionality of that very law.”²⁴⁹ In so holding, Judge Rhodes rejected arguments that the Objectors’ injury was not yet “imminent” because the city had not yet filed a plan of adjustment outlining the precise contours of impairment.²⁵⁰

Notably, Judge Rhodes cited “judicial prudence” and a desire to expedite proceedings as additional support for his rulings respecting ripeness and standing.²⁵¹ Judge Rhodes has made it clear throughout these proceedings that he is anxious for the City’s stakeholders to come together, if possible, to chart a course forward for the City: for example, Judge Rhodes has directed parties to mediation, stating “years of litigation, disputing issues in the courts,” would be “horrendous” for the City.²⁵² In the Opinion Regarding Eligibility, Judge Rhodes reasoned that addressing constitutional issues

Retirees’ Objection to the City of Detroit’s Eligibility to Obtain Relief Under Chapter 9 of the Bankruptcy Code at 33–38, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Aug. 19, 2013) [hereinafter AFSCME Objection to Eligibility]; *see also* Opinion Regarding Eligibility, *supra* note 1, at 29–32.

247. Opinion Regarding Eligibility, *supra* note 1, at 30.

248. *See id.* at 31 (citing *Abbott Labs. v. Gardner*, 387 U.S. 136, 148 (1967)).

249. *Id.*

250. *Id.* at 30–32.

251. *Id.* at 31.

252. *See, e.g., Detroit Attempts to Reach Bankruptcy Settlement in Mediation with Creditors*, GUARDIAN (Sep. 17, 2013), <http://www.theguardian.com/world/2013/sep/17/detroit-bankruptcy-settlement-creditors>. Since issuing his opinion regarding eligibility, Judge Rhodes has continued to direct litigants to mediation; *See also* Order to Certain Parties to Appear for Continued Mediation On DWSD Matters, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Dec. 31, 2013); Order to Certain Parties to Appear for Continued Mediation on UTGO Matters, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Dec. 30, 2103); Order to Certain Parties to Appear for Continued Mediation on LTGO Matters, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Dec. 30, 2103).

surrounding the Pension Clause at the eligibility stage (rather than waiting until the City presents a plan for confirmation) would permit the court and the parties to focus on whether the City's ultimate plan meets the confirmation requirements of the bankruptcy code.²⁵³ While the court might have postponed consideration on ripeness grounds in particular, addressing the relationship between Chapter 9 and the Michigan Constitution at the eligibility likely will influence the parties' willingness (and ability) to negotiate respecting an adjustment plan: after all, if the court had held that accrued pension benefits were off the table entirely, public workers would have little incentive to negotiate and/or compromise. The court's early ruling on impairment is thus consistent with Judge Rhodes' efforts to bring the parties to the table to forge a compromise.

B. Chapter 9 Is Not Facially Unconstitutional

1. Chapter 9 Does Not Violate the Uniformity Clause or the Contracts Clause

In pre-hearing papers, certain of the Objectors (principally the union AFSCME) argued that Chapter 9 is unconstitutional on its face because it "ced[es] to each state the ability to define its own qualifications for a municipality to declare bankruptcy" and thus permits the "promulgation of non-uniform bankruptcies."²⁵⁴ The potential for non-uniformity is particularly acute in states like Michigan, according to AFSCME, because Michigan law (i.e., Public Act 436) allows the governor to attach contingencies to authorization for a Chapter 9 petition.²⁵⁵

For its part, the City argued that the uniformity rule prevents Michigan from conditioning Detroit's entry into bankruptcy on a promise to ring-fence pensions. The City argued that Chapter 9's framework was "well established" when Michigan's Pension Clause was ratified in 1963: then, as now, it establishes criteria for eligibility, allows states to decide whether municipalities may seek Chapter 9 relief, and authorizes the bankruptcy court to impair contracts to which a debtor municipality is a party as part of a plan of adjustment.²⁵⁶ The City argued that the Pension Clause, which was enacted after the Chapter 9 regime was in place, is consistent with the

253. See Opinion Regarding Eligibility, *supra* note 1, at 31.

254. See *id.* at 26 (citing AFSCME Objection to Eligibility, *supra* note 246).

255. *Id.* (citing AFSCME Objection to Eligibility, *supra* note 246).

256. See *id.*

Chapter 9 regime, in that it “does not include any restrictions on the authorization or filing of municipal bankruptcy,” nor does it prevent the bankruptcy court from adjusting accrued pension-related debt.²⁵⁷ The City also argued that even if the Pension Clause could be interpreted to condition Detroit’s access to Chapter 9 relief on ring-fencing, or to limit Detroit’s ability to use Chapter 9 to adjust debts, any such limits would be prohibited and preempted under federal law.²⁵⁸ The City argued that under the uniformity requirement and the Supremacy Clause,²⁵⁹ Congress’ power to enact a comprehensive federal scheme for bankruptcies “displaces any contrary state-law provisions that purport to alter or impair a debtor’s powers under the Bankruptcy Code.”²⁶⁰ The City argued that while Michigan has the authority to decide whether to permit its municipalities to seek protection under Chapter 9, having chosen to permit Chapter 9 filings, it does not have the authority to “override” the uniform scheme of federal bankruptcy through state laws which would limit or condition the tools of debt adjustment available to municipalities once in bankruptcy.²⁶¹

257. See City of Detroit’s Consolidated Reply to Objections to the Entry of an Order for Relief at 25, *In re City of Detroit*, Mich. No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Sept. 6, 2013). As authority, the City’s pre-hearing papers cite several cases which held that municipalities were eligible to be Chapter 9 debtors, even though pensions were potentially vulnerable to impairment in bankruptcy, as well as an Alabama case where, reportedly, “chapter 9 has not only been authorized but, consistent with constitutional protections for contracts, has also been used to reduce pensions.” *Id.* at 27 (citing *In re City of Stockton*, 493 B.R. 222 (Bankr. E.D. Cal. 2013); *Int’l Ass’n of Firefighters, Local 1186 v. City of Vallejo* (*In re City of Vallejo*), 408 B.R. 280 (B.A.P. 9th Cir. 2009); *In re City of Prichard* at 6–7, No. 99-13465 (Bankr. S.D. Ala. Oct. 6, 2000) (Dkt. No. 123) (order confirming plan of adjustment reducing all existing and future pension benefits payments by 8.5%)).

258. See *id.* at 29–31.

259. See *id.*

260. *Id.* at 30 (citing *In re City of Stockton*, 478 B.R. 8, 16 (Bankr. E.D. Cal. 2012)).

261. *Id.*; see also *In re City of Vallejo*, 403 B.R. 72, 76–77 (Bankr. E.D. Cal. 2009); *aff’d sub nom. Int’l Bhd. of Elec. Workers, Local 2376 v. City of Vallejo* (*In re City of Vallejo*), 432 B.R. 262 (E.D. Cal. 2010) (“Incorporating state substantive law into chapter 9 to amend, modify or negate substantive provisions of chapter 9 would violate Congress’ ability to enact uniform bankruptcy laws.”); *Stockton*, 478 B.R. at 16 (“A state cannot . . . condition or . . . qualify, i.e., to ‘cherry pick,’ the application of the Bankruptcy Code provisions that apply in chapter 9 cases after such a case has been filed.”); *Cnty. Of Orange v. Merrill Lynch & Co.* (*In re Cnty. of Orange*), 191 B.R. 1005, 1020 (Bankr. C.D. Cal. 1996) (holding (1) Chapter 9 sets priorities among creditors such that state statute setting priority could be preempted by federal law; and (2) deviating from federal scheme would “violate the constitutional mandate for uniform bankruptcy laws” by determining creditor priorities based on factors that vary from state to state).

In rejecting the Objectors' uniformity requirement challenge, Judge Rhodes held that Chapter 9 does exactly what the uniformity requirement mandates — namely, it applies uniformly to all Chapter 9 debtors.²⁶² Here, the relevant class of debtors is the universe of municipal entities that meets the eligibility requirements of Section 109(c) of the bankruptcy code.²⁶³ As Judge Rhodes recognized, one such qualification is that the entity is “specifically authorized . . . to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter.”²⁶⁴ Citing *Stellwagen v. Clum*,²⁶⁵ *Hanover Nat'l Bank v. Moyses*,²⁶⁶ and *Schultz v. United States*,²⁶⁷ Judge Rhodes held that as long as the specifically authorized requirement is applied to the class of eligible debtors, “it is of no consequence in the uniformity analysis that this requirement of state authorization to file a chapter 9 case may lead to different results in different states.”²⁶⁸

The Court dealt more harshly with the Objectors' argument that Chapter 9 is unconstitutional under the Contracts Clause, deeming it “frivolous.”²⁶⁹ Noting that Chapter 9 is a federal law, Judge Rhodes held that the Contracts Clause of the U.S. Constitution (which provides, “No *state* shall . . . pass any . . . Law impairing the Obligation of Contracts . . .”) does not prohibit *Congress* from enacting a law impairing the obligation of contracts.²⁷⁰ Quoting *In re City of Stockton*,²⁷¹ Judge Rhodes found that “[t]he Bankruptcy Clause necessarily authorizes Congress to make laws that would impair contracts. It has long been understood that bankruptcy law entails impairment of contracts.”²⁷² Because contract impairment is at the heart of any bankruptcy proceeding, Judge Rhodes rejected the

262. See Opinion Regarding Eligibility, *supra* note 1, at 27.

263. *Id.*

264. *Id.* (citing 11 U.S.C. § 109(c)(2) (2012)).

265. 245 U.S. 605 (1918).

266. 186 U.S. 181 (1902).

267. 529 F.3d 343 (6th Cir. 2008).

268. Opinion Regarding Eligibility, *supra* note 1, at 27.

269. *Id.* at 28. The Contracts Clause, which is Article I, Section 10 of the United States Constitution provides, “No State shall . . . pass any . . . Law Impairing the Obligation of Contracts . . .” U.S. CONST. art. I § 10. The Objectors had argued that Chapter 9 violates the Contracts Clause because it permits the impairment of contracts. See Opinion Regarding Eligibility, *supra* note 1, at 26.

270. *Id.* (emphasis added); see also U.S. CONST. article I, § 10, cl. 1.

271. 478 B.R. 8 (Bankr. E.D. Cal. 2012).

272. Opinion Regarding Eligibility, *supra* note 1, at 40 (citing *In re City of Stockton*, 478 B.R. 8, 15 (Bankr. E.D. Cal. 2012)).

idea that the Contracts Clause makes Chapter 9 unconstitutional on its face.

Although the role of state choice figures more centrally in Judge Rhodes’” as applied” analysis under the Tenth Amendment (discussed below), it is worth noting that other courts have cited the constitutional imperative for uniformity in rejecting the idea that states can pick and choose how Chapter 9 will apply—particularly with regard to priorities. For example, in the Orange County bankruptcy, the court held that California was not at liberty to determine absolutely debtors’ property interests/rights through state law, having consented to the availability of Chapter 9 relief for eligible debtors:

If chapter 9 permitted states to define all properties of the debtor in bankruptcy regardless of the situation and to rewrite bankruptcy priorities, then chapter 9 would become a balkanized landscape of questionable value. Moreover, chapter 9 would violate the constitutional mandate for *uniform* bankruptcy laws.

Reserving to bankruptcy law the setting of priorities in chapter 9 does not unnecessarily impinge on states’ rights or the ability of a municipal debtor to provide important services to the public. Nor does this principle conflict with Code § 903, which reserves to the state the power to control the municipal debtor in the exercise of its political or governmental powers.

Furthermore, pursuant to Code § 109(c)(2), a municipal debtor must be specifically authorized by state law to file a chapter 9 . . . By authorizing the use of chapter 9 by its municipalities, California must accept chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest. The right to discharge is not a benefit without burdens.

As the court in *In re City of Columbia Falls, Montana, Special Improvement Dist., No. 25*, 143 B.R. 750, 759 (Bankr.D.Mont.1992), held in approving a chapter 9 plan of adjustment where the plan did not pay prepetition bondholders the full amount of their claim with interest in contravention of state law, “to create a federal statute based upon a theory that federal intervention was necessary to permit adjustment of a municipality’s debts and then to prohibit the municipality from adjusting such debts is not, in the point of the view of this Court, a logical or necessary result.”²⁷³

273. See *In re County of Orange*, 191 B.R. 1005, 1020–21 (Bankr. C.D. Cal. Jan. 24, 1996) (citations omitted); see also *In re City of Vallejo*, 403 B.R. 72, 76–77 (Bankr. E.D. Cal. 2009), *aff’d sub nom.*, Int’l Bd. of Elec. Workers, Local 2376 v. City of Vallejo (*In re City of Vallejo*), 432 B.R. 262 (E.D. Cal. 2010) (“Incorporating state

This line of cases suggests that having consented to Chapter 9 relief for eligible debtors, Michigan may not limit Detroit's access to Chapter 9, or to the tools of adjustment available in Chapter 9, without running afoul of the uniformity requirement and supremacy rules.

2. Chapter 9 Does Not Violate the Tenth Amendment.

Several of the Objectors also argued that Chapter 9 is facially unconstitutional under the Tenth Amendment because it unduly impinges upon state sovereignty.²⁷⁴ Judge Rhodes rejected this argument as well. Citing the seminal *United States v. Bekins* case, Judge Rhodes held that “[t]he question of whether a federal municipal bankruptcy act can be administered consistent with the principles of federalism reflected in the Tenth Amendment has already been decided” by the Supreme Court in *Bekins*—affirmatively.²⁷⁵ In *Bekins*, “the Supreme Court specifically upheld the constitutionality of the Municipal Corporation Bankruptcy Act, 50 Stat. 653 (1937), over objections that the statute violated the Tenth Amendment.”²⁷⁶ Considering *Bekins* and its progeny, Judge Rhodes held that *Bekins* remains good authority and reasoned that the states’ ability to consent (or not) to the availability of Chapter 9 relief for their municipalities is key to *Bekins* continued force.²⁷⁷ Judge Rhodes observed that, “[i]f the state is acting voluntarily, it is free to engage with the federal government across a broad range of subject areas. The Tenth Amendment is violated only when the state does not consent.”²⁷⁸ So, while the federal government cannot (and does not through Chapter 9) compel states to authorize municipalities to file for Chapter 9 relief, and while municipalities are not free to seek Chapter 9 relief without state authorization (in recognition of state sovereignty), states can decide to engage with the federal government by authorizing municipal bankruptcy for political subdivision under Chapter 9 without running afoul of federalism and state sovereignty principles embodied in the Tenth Amendment.²⁷⁹

substantive law into chapter 9 to amend, modify or negate substantive provisions of chapter 9 would violate Congress’ ability to enact uniform bankruptcy laws.”).

274. See Opinion Regarding Eligibility, *supra* note 1, at 28–29; AFSCME Objection to Eligibility, *supra* note 246, at 15–16.

275. Opinion Regarding Eligibility, *supra* note 1, at 32.

276. *Id.* (citing *United States v. Bekins*, 304 U.S. 27, 53–54 (1938)).

277. *Id.* at 32–38.

278. Opinion Regarding Eligibility, *supra* note 1, at 37.

279. *Id.* at 37–38. In so holding, Judge Rhodes read *Faitoutie Iron & Steel Co. v. City of Asbury Park, New Jersey*, 316 U.S. 502, (1942) as limited to its own facts. *Id.*

C. Chapter 9 Is Constitutional “As Applied”

State choice also played a key role in Judge Rhodes’ analysis of the “as applied” challenge to Chapter 9. Several of the Objectors argued that Chapter 9 is unconstitutional as applied to the extent it would permit Michigan to authorize one of its political subdivisions to file for bankruptcy without explicitly ring-fencing or otherwise explicitly protecting vested pension benefits, given that neither Michigan nor Detroit can impair accrued pension benefits under the Pension Clause.²⁸⁰ In rejecting this challenge, Judge Rhodes found that while Michigan and Detroit cannot adjust Detroit’s accrued pension-related obligations, the bankruptcy court is not so constrained.²⁸¹

Judge Rhodes’ ruling is based on two key holdings. First, as noted previously, Judge Rhodes found that the bankruptcy code permits, and in fact anticipates, that the bankruptcy court will impair contracts as part of any plan of adjustment.²⁸² In fact, debt adjustment is the *raison d’être* of bankruptcy, as the court recognized in the *City of Stockton* bankruptcy case, in a passage Judge Rhodes quotes:

In other words, while a state cannot make a law impairing the obligation of contract, Congress can do so. The goal of the Bankruptcy Code is adjusting the debtor-creditor relationship. Every discharge impairs contracts. While bankruptcy law endeavors to provide a system of orderly, predictable rules or treatment of parties whose contracts are impaired, that does not change the starring role of contract impairment in bankruptcy.

It follows, then, that contracts may be impaired on this chapter 9 case without offending the Constitution. The Bankruptcy Clause gives Congress express power to legislate uniform laws of bankruptcy that result in impairment of contract; and Congress is not subject to the restriction that the Contracts Clause places on states.”²⁸³

at 34–35. In *Asbury Park*, a New Jersey state court “authorized” an adjustment plan, making certain bonds significantly more valuable. 316 U.S. at 507–08, 512–13. Although the Supreme Court sustained this alternation of a municipal bond contract, it was careful to state that its holding did “not go beyond the case before” it. *Id.* at 516. Noting that the “limited application of *Asbury Park* to its own facts has been repeatedly recognized,” Judge Rhodes held that it is now “firmly established that the Contracts Clause of the United States Constitution bars a state from enacting municipal bankruptcy legislation.” Opinion Regarding Eligibility, *supra* note 1, at 35.

280. *Id.* at 40.

281. *See id.* at 40.

282. *Id.*

283. *Id.* at 40–41 (citing *In re City of Stockton, Cal.*, 478 B.R. 8, 16 (Bankr. E.D. Cal. 2012)).

Mindful of the bankruptcy court's power to impair contracts, Judge Rhodes held that "[f]or Tenth Amendment and state sovereignty purposes, nothing distinguishes pension debt in a municipal bankruptcy case from any other debt."²⁸⁴ Under *Bekins*, so long as the state consents to Chapter 9, a bankruptcy court may adjust municipal debts (including pension debts) as part of a larger plan of adjust without infringing on state sovereignty—even if the debt implicates rights or property interests that otherwise protected by the state constitution, and even if the State could not so act.²⁸⁵

Second, Judge Rhodes found, after a lengthy review of precedent and legislative history, that pension rights are a contractual obligation under the Michigan Constitution, and thus subject to adjustment in a Chapter 9 proceeding along with other contract debts.²⁸⁶ Judge Rhodes based this holding on (a) the language of the Michigan Constitution, which states that pension rights are a "contractual obligation," (b) Michigan case law, including *Kosa v. State Treasurer of Michigan*,²⁸⁷ and *In re Request for Advisory Opinion Regarding Constitutionality of 2011 Pa. 38*,²⁸⁸ and (c) the legislative history of the Pension Clause as recounted in *Kosa*.²⁸⁹

With respect to legislative history, Judge Rhodes observed that, at common law, public pensions were treated as "gratuitous allowances that could be revoked at will" prior to actual distribution as a matter of contract law.²⁹⁰ The Pension Clause, which was included in the constitution adopted in Michigan in 1963, speaks to this issue in contract law terms: it 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

284. *See id.* at 41.

285. *Id.* at 40–41.

286. *Id.* at 40–41.

287. 292 N.W.2d 452 (Mich. 1980).

288. 806 N.W.2d 683 (Mich. 2011).

289. Opinion Regarding Eligibility, *supra* note 1, at 42–44.

290. *Id.* at 41 (citing *Brown v. Highland Park*, 30 N.W.2d 798, 800 (Mich. 1948) ("We are convinced that the majority of cases in other jurisdictions establishes the rule that a pension granted by public authorities is not a contractual obligation, that the pensioner has no vested right, and that a pension is terminable at the will of a municipality, at least while acting within reasonable limits. At best plaintiffs in this case have an expectancy based upon continuance of existing charter provisions.")). Judge Rhodes also cited *Kosa*, where the court observed, "Until the adoption of Const. 1963, art. 9, § 24, legislative appropriation for retirement fund reserves was considered to be an *ex gratia* action. Consequently, the most that could be said about pre-con legislative appropriations for retirees was that there was some kind of implied commitment to fund pension reserves." *Kosa*, 292 N.W.2d at 459 (citation omitted).

be diminished or impaired thereby.”²⁹¹ In a passage cited by Judge Rhodes, the Michigan Supreme Court in *Kosa* referenced the following discourse from legislative history respecting the Pensions Clause which suggests that the Pension Clause was intended to give pensioners a contractual right to accrued pension benefits:

MR. VAN DUSEN: Mr. Chairman, if I may elaborate briefly on Mr. Brake’s answer to Mr. Downs’ question, I would like to indicate that the words ‘accrued financial benefits’ were used designedly, so that the contractual right of the employee would be limited to the deferred compensation embodied in any pension plan, and that we hope to avoid thereby a proliferation of litigation by individual participants in retirement systems talking about the general benefits structure, or something other than his specific right to receive benefits. It is not intended that an individual employee should, as a result of this language, be given the right to sue the employing unit to require the actuarial funding of past service benefits, or anything of that nature. What it is designed to do is to say that when his benefits come due, he’s got a contractual right to receive them. And, in answer to your second question, he has the contractual right to sue for them. So that he has no particular interest in the funding of somebody else’s benefits as long as he has the contractual right to sue for his.

“MR. DOWNS: I appreciate Mr. Van Dusen’s comments. Again, I want to see if I understand this. Then he would not have a remedy of legally forcing the legislative body each year to set aside the appropriate amount, but when the money did come due this would be a contractual right for which he could sue a ministerial officer that could be mandamus or enjoined; is that correct?

“MR. VAN DUSEN: That’s my understanding, Mr. Downs.”²⁹²

In another passage quoted by the Judge Rhodes, the *Kosa* court also summarized the Pension Clause using the language of contract:

To sum up, while the Legislature’s constitutional *contractual obligation* is not to impair “accrued financial benefits,” even if that obligation also related to the funding system, there would be no impairment of the *contractual obligation* because the substituted “entry age normal” system supports the benefit structure as strongly as the replaced “attained age” system.²⁹³

Based on case law and the cited legislative history, Judge Rhodes concluded that the Pension Clause treats accrued pension rights as

291. Opinion Regarding Eligibility, *supra* at 42 (citing MICH. CONST. art. IX, § 24).

292. *Id.* at 42 (emphasis added) (quoting *Kosa*, 292 N.W.2d at 459 n.21).

293. *Id.* at 42 (emphasis added) (citing *Kosa*, 292 N.W.2d at 461).

contract rights, and that it does not confer extraordinary protection beyond that available to contracts generally.²⁹⁴ In so holding, Judge Rhodes rejected arguments advanced by the Michigan Attorney General and the Objectors the Michigan Pensions Clause represents an “impermeable imperative” which prohibits the adjustment of accrued pension-related debt under any circumstances (save (presumably) through constitutional reform).²⁹⁵

In addition to Michigan case law and the legislative history, Judge Rhodes also cited the larger context surrounding the Pension Clause as grounds for his ruling. Judge Rhodes noted that the *Bekins* Court had held that municipal bankruptcy was constitutional by the time the Pension Clause was adopted.²⁹⁶ With *Bekins* in place, the Michigan legislature then elected to allow its political subdivisions to file Chapter 9 bankruptcy. Judge Rhodes reasoned that if the Michigan legislature had wanted to give accrued pension benefits special protection against impairment in a Chapter 9 proceeding, it could have “prohibited Michigan municipalities from filing bankruptcy[,] . . . created a property interest that bankruptcy would be required to respect under *Butner v. United States*[,]”²⁹⁷ . . . established some sort of a secured interest in the municipality’s property[,] . . . [or] explicitly required the State to guaranty pension benefits.”²⁹⁸ But, as Judge Rhodes recognized, the Michigan legislature “did none of those.”²⁹⁹ Instead, it used the language of contract, and allowed for the possibility of adjustment though Chapter 9.³⁰⁰ With the Michigan Legislature having failed to confer extraordinary protections on accrued pension benefits when the Pension Clause was enacted, Judge Rhodes was not willing to imply such protections under either Pension Clause or Chapter 9.

Judge Rhodes’ holding is well-grounded in legislative history, precedent and construction. As Judge Rhodes observed, at common law, pensions were viewed as “allowances that could be revoked at will, because a retiree lacked any vested right in their continuation.”³⁰¹

294. *Id.* at 43.

295. See Attorney General Bill Schuette’s Statement Regarding the Michigan Constitution & the Bankruptcy of the City of Detroit at 15, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Aug. 19, 2013).

296. Opinion Regarding Eligibility, *supra* note 1, at 44.

297. 440 U.S. 48 (1979) (holding that property issues in bankruptcy are determined according to state law).

298. Opinion Regarding Eligibility, *supra* note 1, at 44.

299. *Id.*

300. *Id.*

301. *Id.* at 41.

The legislative history, as interpreted by the Michigan Supreme Court in *Kosa*, suggests that accrued pension benefits were accorded the status of contract rights when the Pension Clause was added to the Michigan Constitution in 1963 to prevent state officials from revoking a grant of pension benefits any time prior to distribution.³⁰² In effect, the Pension Clause makes the promise to provide a pension binding as a matter of contract law. By using the language of contract, and its permitting municipalities to file for Chapter 9 protection, the Michigan legislature did not evince an intent to give accrued pension benefits the extraordinary protection sought by the Objectors.

D. Cautionary Language, and a Hobson's Choice for City Managers

It is important to note that Judge Rhodes was in no way cavalier about the impact of his decision respecting accrued pension benefits. To the contrary, he made it clear that he will not confirm a plan of adjustment that puts the burden of Detroit's debts unfairly on the backs of the City's retired public workers:

[T]he Court is compelled to comment. No one should interpret this holding that pension rights are subject to impairment in this bankruptcy case to mean that the Court will necessarily confirm any plan of adjustment that impairs pensions. The Court emphasizes that it will not lightly or casually exercise the power under federal bankruptcy law to impair pensions. Before the Court confirms any plan that the City Submits, the Court must find that the plan fully meets the requirements of 11 U.S.C. § 943(b) and the other applicable provisions of the bankruptcy code. Together, these provisions of law demand this Court's judicious legal and equitable consideration of the interests of the City and all of its creditors, as well as the laws of the State of Michigan.³⁰³

302. *Id.* at 41–43.

303. *Id.* at 44. 11 U.S.C. §§ 943(b)(4) and 1129(a)(s) of the Bankruptcy Code provide that for a plan to be confirmable, it must have been proposed in good faith and “not by any means forbidden by law,” and that the debtor must not be “prohibited by law from taking any action necessary to carry out the plan,” respectively. In *In re Sanitary & Improvement Dist. #7*, the United States Bankruptcy Court for the District of Nebraska refused to confirm a plan containing a bondholder discount prohibited by state law as contrary to the requirements of 11 U.S.C. §§ 943(b)(4) and 1129(a)(s) of the Bankruptcy Code. 98 B.R. 970, 973 (Bankr. D. Neb. 1989). Even if the Pensions Clause does not bar impairment in bankruptcy, the treatment of pension debt in the Michigan Constitution likely will weigh on the City and Judge Rhodes in drafting, and considering for confirmation, any plan of adjustment.

In fact, Judge Rhodes spoke at length about the realities of Detroit's insolvency when explaining his ruling, and he urged stakeholders to address the human costs that insolvency and, potentially, pension adjustment, will have on retirees and citizens alike.³⁰⁴ Judge Rhodes recognized that Detroit's pensioners are among the City's most vulnerable stakeholders, and while he has continued to push for a consensual resolution, he has put all parties on notice that he will scrutinize any plan of adjustment for compliance with the letter and intent of the code.³⁰⁵

But if Judge Rhodes recognized the special vulnerability of the City's pensioners, he also recognized that the City's citizens are vulnerable too, beset by crime, unemployment, poverty, woefully inadequate services, and years of political corruption.³⁰⁶ In effect, Judge Rhodes treats Detroit's residents as another creditor constituency in his Opinion, owed a debt in the form of at least minimally acceptable infrastructure and public services. While the impairment of pension benefits is, obviously, horrible to contemplate, retirees may receive even less in the future if the city is unable to adjust its debts and emerge from bankruptcy with a viable recovery plan in place. Indeed, if Detroit truly is to recover, it needs a plan—one in which people and businesses return to the City and contribute tax revenue to the city's fiscal health, and one in which the City is able to provide at least basic public services.³⁰⁷ The longer this is not possible, the less likely it is that pension-holders will, over the long

304. See, e.g., Hearing on Statement Regarding Eligibility Ruling, *In re City of Detroit*, Michigan, No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Dec. 3, 2013), available at <http://www.mieb.uscourts.gov/apps/detroit/DetroitAudio.cfm>; Opinion Regarding Eligibility, *supra* note 1, at 81; see also Hearing on Eligibility Objections, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Oct. 15–16, 2013), available at <http://www.mieb.uscourts.gov/apps/detroit/DetroitAudio.cfm>.

305. Opinion Regarding Eligibility, *supra* note 1, at 81; see also Editorial, *For Detroit's Retirees, Michigan's Pension Promise Must Be Kept*, DETROIT FREE PRESS, Aug. 1, 2013, <http://www.freep.com/article/20130801/OPINION01/308010019/michigan-constitution-pensions-detroit> (“Among the city's claimants, retirees are the most vulnerable. Their payouts are meager—an average of \$30,000 a year for police and fire, \$19,000 for other city employees—but absolutely crucial to their survival. And even though the pension systems' elected leadership mismanaged funds, made poor investments and overstated the funds' health, to visit the consequences of those missteps on recipients is a Dickensian nightmare.”). Judge Rhodes cited the \$18,000 figure in his opinion regarding eligibility. See Opinion Regarding Eligibility, *supra* note 1, at 6.

306. Opinion Regarding Eligibility, *supra* note 1, at 81.

307. See, e.g. *id.* at 18–19.

term, receive anything close to the benefits which they were promised.

Finally, one wonders whether there was an element of pragmatism involved in Judge Rhodes' ruling, along with Constitutional analysis. (Though, in questioning whether practical realities played a role, I do not mean to suggest that Judge Rhodes' ruling is legally suspect. In fact, I think Judge Rhodes' ruling on impairment is correct.) Had Judge Rhodes taken accrued pension benefits off the table entirely at the eligibility stage, the Objectors might have simply walked away from mediation and any attempt at a consensual resolution. By contrast, if impairment is a possibility, the Objectors might have more incentive and leeway to negotiate. The possibility of pension impairment almost might spur a political solution—in the form of state involvement—as well, though that is of course not a certainty (and, perhaps not even a possibility) at this time. Once the City has established a sustainable economic model, pension-holders could be put first in line for additional recoveries if and when the city's fortunes improve. And, both the City and its pensioners may have a strong moral claim on the State to mitigate the real and pain and suffering that both the City and its pensioners are experiencing as a result of the City's financial collapse. But some adjustment (or, at least the possibility of adjustment) may be necessary as a practical matter, if Detroit is to have any chance at getting back on its feet.

III. WILL UNLIMITED TAX GENERAL OBLIGATION BONDHOLDERS TAKE A HAIRCUT?

Although not addressed in the Opinion Regarding Eligibility, a second key issue presented by Detroit's bankruptcy is whether unlimited tax general obligation (UTGO) bondholders can and should be treated as unsecured debt, and thus on par with other unsecured obligations (including pension-related COP liability), in the bankruptcy. In his June 14, 2013 proposal for creditors, Emergency Manager Orr rattled bondholders (and markets) by categorizing these obligations as unsecured, such that all UTGO bonds (other than those additionally secured by a state intercept payment) would be treated on a *pari passu* basis with all general fund obligations, then proposing a plan of reorganization that would have meant a substantial haircut for bondholders.³⁰⁸ Suggestions that the

308. See PROPOSAL FOR CREDITORS, *supra* note 3, at 98 (including in estimate of unsecured claims UTGO bonds not additionally secured by state interceptor payments and unsecured pension and OPEB).

obligation to tax might be limited by tax cap legislation and economic necessity raised questions about what the “full faith and credit” and pledge of taxing power means, especially in the case of a deeply insolvent municipality like Detroit.³⁰⁹

Market reaction to Orr’s characterization was swift, and unsurprisingly, negative. In a letter to Michigan Governor Snyder, the industry trade association SIFMA argued that the pledge of taxing power ought to make UTGO bonds “first budget obligations” backed by an obligation to raise property taxes to levels necessary to repay principal and interest:

Detroit has issued a number of different types of securities with different sources of repayment and security, as described in the offering documents for each transaction. Market expectation is there would be different treatment for holders of different types of securities. It is generally the expectation of market participants that holders of general obligation unlimited tax bonds would be paid principal and interest as it comes due, based on a pledge of the debtor’s “full faith, and credit” to repay the bonds, in addition to the characterization of the bonds as “first budget obligations, including the proceeds of annual ad valorem property taxes, which must, to the extent necessary, be levied on all taxable property.” This pledge is seen by the capital markets to be an obligation to raise property taxes to the level necessary to pay the principal and interest in the bonds as they come due. The Michigan Constitution also provides that repayment of voter approved bonded indebtedness is guaranteed.³¹⁰

The SIFMA letter distinguished the city’s obligations with respect to UTGO bonds from those associated with certificates of participation which, according to SIFMA, are not backed by a full faith and credit pledge.³¹¹ SIFMA argued that treating the UTGO bonds on par with unsecured contractual obligations (such as those at issue in the City’s COPs) would be contrary to offering materials and would hurt Detroit along with other Michigan municipalities:

309. *See id.* at 120 app. E (listing \$410,830,000 in unlimited tax general obligation bonds on schedule of unsecured general obligation liabilities as of June 30, 2012).

310. Letter from Ira Hammerman, Gen. Counsel, Sec. Indus. & Fin. Mkts. Ass’n to Richard Snyder, Gov., State of Mich. (July 18, 2013), *available at* <http://online.wsj.com/public/resources/documents/SifmaDetroit.pdf>.

311. *Id.* Instead, offering documents for the certifications of participation reportedly describe the instruments as unsecured contractual obligations that are “not general obligations of the City, and neither the faith and credit, taxing power nor any specific revenues of the City are pledged” thereto. *Id.*

Any action that would permit general obligation bonds to be treated on a *pari passu* basis with unsecured contractual obligations that are not backed by a full faith and credit pledge ignores the appropriate priority that should be given to these bonds. We believe that any such treatment will have a long lasting negative impact on the ability of Michigan's municipalities to obtain financing on favorable terms . . . [M]arket participants may be reluctant to purchase Michigan general obligation unlimited tax bonds and general obligation limited tax bonds in the future, causing the cost of financing infrastructure projects to rise.³¹²

Finally, SIFMA argued that treating UTGO bonds on par with the City's outstanding COPs could have a destabilizing effect on the municipal market as a whole, with Michigan municipalities particularly at risk.³¹³ Around the same time, Ambac (a bond insurer, which reportedly is the insurer on several of the UTGO issuances at issue) released a press release raising many of the same concerns.³¹⁴

On November 8 and 13, 2013, three monoline insurers of outstanding bonds issued by Detroit filed a complaint for declaratory judgment in the bankruptcy, seeking entry of an order declaring that Detroit must levy, collect, and apply *ad valorem* taxes for the sole purpose of paying the principal and interest on unlimited tax bonds insured by the plaintiffs.³¹⁵ The complaint alleges that the unlimited tax bonds at issue are “[u]nique among the City’s financial obligations,” in that they were issued “only after resolutions by the City Council, the legislative body of the City, and approval by a majority of the voters in a city-wide election establishing a pledge of *ad valorem* taxes, as security, to repay these obligations exclusively.”³¹⁶ The complaint further alleges that “in approving each bond referendum, [Detroit’s] voters authorized the City to exceed otherwise applicable maximum rate for *ad valorem* taxes” set forth in

312. *Id.*

313. *See id.*

314. *See* PROPOSAL FOR CREDITORS, *supra* note 3, at app. E at 120–21 (listing issuances showing Ambac as insurer); *Ambac Comments on Detroit*, AMBAC (July 8, 2013), <http://ir.ambac.com/releasedetail.cfm?ReleaseID=775687>.

315. *See* Complaint of Ambac Assurance Corp. for Declaratory Judgment & Order, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931 (Nov. 8, 2014) [hereinafter *Ambac Complaint*]; Complaint of National Public Finance Guarantee Corp., et. al for Declaratory Judgment & Order, *In re* City of Detroit, Mich., No. 13-53846, 2013 WL 6331931 (Nov. 13, 2013) [hereinafter *National Complaint*]. For details regarding the issuances in dispute, see *National Complaint*, *supra*, at 5–13, 11–32.

316. *Ambac Complaint*, *supra* note 315, at 2; *National Complaint*, *supra* note 315, at 2.

the Michigan Constitution.³¹⁷ The plaintiffs argue that Detroit already had reached the tax rate limitations set forth in the Michigan Constitution at the time of issuance,³¹⁸ and that the voters' approval of the issuances, coupled with resolutions adopted by Detroit's City Council, require Detroit to levy *ad valorem* taxes in amounts sufficient to repay bondholders notwithstanding tax rate limitations, and to collect and apply tax receipts for the sole purpose of meeting debt service obligations.³¹⁹

Precedent respecting whether Detroit can use Chapter 9 and/or tax cap legislation to treat UTGO bonds as unsecured, and on a *pari passu* basis with other unsecured obligations, is thin. There is some authority for the proposition that, under 1988 amendments made to the Bankruptcy Code, voter-authorized general-obligation debt for capital projects backed by a specific tax levy that do not feed the general fund would be considered special-revenue debt, which is secured. In January 2012, for example, the bankruptcy court in the Jefferson County bankruptcy case divested a state court-appointed receiver for the county's sewer system from possession of the sewer system, and granted the bondholders the right to reach net sewer system revenues collected by the county after the filing of the Chapter 9 petition.³²⁰ Citing the 1988 amendments to the bankruptcy code, the court held that, "[t]he structure and intent of what Congress enacted by its 1988 amendments to chapter 9 was to provide a mechanism whereby the pledged special revenues would continue to be paid uninterrupted to those to which/whom payment of the sewer system's indebtedness is secured by a lien on special revenues."³²¹ The result, according to the Alabama court, is that "11 U.S.C. § 922(d) excludes continued payment of these pledged special revenues to the lienholder from being staying under 11 U.S.C. § 362(a) or 11 U.S.C. § 922(a)."³²² As to Detroit issuances with similar language, bondholders may have an argument under the theory adopted by the Alabama bankruptcy court.

To the extent that Detroit pledged its taxing power without regard to any constitutional, statutory or charter tax-rate limitations, issues

317. Ambac Complaint, *supra* note 315, at 3, National Complaint, *supra* note 315, at 3.

318. Ambac Complaint, *supra* note 315, at 3, National Complaint, *supra* note 315, at 3.

319. Ambac Complaint, *supra* note 315, at 13–21; National Complaint, *supra* note 315, at 3–4, 13–19.

320. *See In re Jefferson Cnty., Ala.*, 474 B.R. 228, 273–74 (Bankr. N.D. Ala. 2012).

321. *Id.* at 274.

322. *Id.* at 274 (internal quotation marks omitted).

remain knotty. The impact of tax cap legislation on municipal finances has long been a subject of debate, with some opining that tax caps have contributed to insolvency in places like Orange County and Vallejo.³²³ Moreover, the legal relationship between tax caps and debt limits on one hand, and a pledge of taxing power on the other, remains nuanced. In *Flushing National Bank v. Municipal Assistance Corp.*, for example, the New York Court of Appeals held that a city may not contract indebtedness under the New York State Constitution unless it has, “pledged its faith and credit for the payment of the principal thereof and the interest thereon,” an obligation which the court described as both “a commitment to pay and a commitment of the city’s revenue generating powers to produce the funds to pay.”³²⁴ The *Flushing* Court further held that this regime “express[es] a constitutional imperative: debt obligations must be paid even if tax limits be exceeded.”³²⁵ But *Flushing* is a complicated case, in no small measure because while the Court declared the moratorium statute at issue unconstitutional, it nevertheless sought to facilitate a political/legislative solution.³²⁶ Furthermore, the year after *Flushing* was decided, the Court of Appeals modified its views somewhat in *Quirk v. Municipal Assistance Corp.*, holding that only real property taxes are subject to the prior lien of first revenue.³²⁷ Given political and economic consequences, it is perhaps not surprising other cities facing financial distress (e.g., Vallejo, Central Falls, Rhode Island³²⁸ and Harrisburg) reportedly worked with

323. See James E. Spiotto, *Municipal Finance and Chapter 9 Bankruptcy*, MUN. FIN. J., no. 1, 1996, at 3 (“The investment losses suffered by Orange County are best attributed to the disparate efforts of a revenue-starved municipality that had faced shrinking revenues and expanding costs because of a constitutionally imposed tax cap (Proposition 13). The difficulty with an artificial and unrealistic tax cap and similar constitutional limits on taxation is that there are certain municipal services that are required and expected by the citizens. If revenues available to municipalities are capped in an unrealistic and artificial way, the ability of municipalities to supply those necessary services is significantly curtailed.”). For an early analysis of the impact of Proposition 13, see FED. RESERVE BANK OF S. F. ECON. REV., PROPOSITION 13 AND FINANCIAL MARKETS 5–6 (1979). For additional commentary on impact of tax caps and other similar restraints, see MOODY’S INVESTORS SERVS., *supra* note 96, at 3.

324. 358 N.E.2d 848, 851 (N.Y. 1976) (internal quotation marks omitted) (citing N.Y. CONST. art. VIII, § 2) (holding that faith and credit pledge is a prior lien on revenues of issuer).

325. *Id.* at 852.

326. *Id.* at 855.

327. 363 N.E.2d 549, 551 (N.Y. 1977).

328. See, e.g., Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES, Sept. 6, 2012, <http://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html> (noting that bondholders were paid through tax increases and deep cuts to pensions and other employee benefits). Notably, “[i]n

creditors to ensure that bondholders get paid rather than litigate through to a decision.

In Detroit's case, while Judge Rhodes has not yet considered bondholder claims, these debts would appear to be contractual in nature, and thus potentially subject to adjustment notwithstanding pledges of taxing power. As between bondholders, the precise language requirements of individual issuances may be important. UTGO bondholders who can make arguments under the theory adopted in the Jefferson County case, and/or those holding bonds containing a pledge to raise taxes notwithstanding tax caps, or other similar legislation, may have stronger claims of priority under theories advanced in cases such as *Flushing* and *Quirk*, compared to issuances without such language. Whatever arguments are made, however, the reality is as noted above: Detroit does not have the money, and even if it can (and must) tax, it cannot raise enough money through taxation to make a meaningful dent in the City's first budget obligations due to the City's economic plight. In these circumstances, paying bondholders before pensioners, in the face of the Pensions Clause, seems unlikely. Perhaps for these and related reasons, Judge Rhodes has referred bondholders to mediation, most recently in the days and weeks immediately following his ruling respecting eligibility.³²⁹

IV. WHERE DOES THIS LEAVE US?

So, if the legal landscape is uncertain, and the economic situation dire, where does that leave us? While there certainly are political obstacles to honest conversations about debt adjustment, Detroit's situation ought to spur conversations around reforms to municipal funding models and debt. Following are a list of potential reforms that states and municipalities might consider to avoid some of the problems now plaguing Detroit.

2011, the Rhode Island State General Assembly enacted a law giving bondholders the right to place liens on tax revenue," which has the effect of ensuring that bondholders will receive payment before other creditors following a municipal bankruptcy. *Id.*

329. See Order to Certain Parties to Appear for Continued Mediation on DWSD Matters, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Dec. 30, 2013); Order to Certain Parties to Appear For Continued Mediation on UTGO Matters, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Dec. 30, 2013); Order to Certain Parties to Appear for Continued Mediation on LTGO Matters, *In re City of Detroit*, Mich., No. 13-53846, 2013 WL 6331931 (Bankr. E.D. Mich. Dec. 30, 2013).

First, states and their political subdivisions would do well develop and implement early warning systems containing unambiguous and non-voluntary consequences for municipalities that fall into financial distress. Detroit's problems were known, predictable and visible for many years prior to the bankruptcy filing. While the State did adopt an intervention procedure (including the appointment of an emergency manager),³³⁰ one might argue that this was too little, too late. In the future, states would do well to adopt metrics of fiscal distress that would identify struggling municipalities earlier to provide earlier feedback to state and local officials, citizens and public workers.³³¹

Second, having identified problems earlier, states should develop (or enhance) systems of intervention. According to the Pew Charitable Trust, some nineteen states have intervention programs for distressed municipalities, with regimes using a range of strategies from technical assistance to receivers, emergency managers and control boards.³³² Some regimes allow restructuring of finances, including debt, labor contracts, taxes, fees and creditors³³³ and some provide technical assistance and advice, while others offer loans and grants.³³⁴ (Interestingly, the Pew Charitable Trust found that Northeastern states are the most likely to have intervention laws: the Pew Trust speculated that this may be due to presence of many older cities dealing with the decline of their manufacturing base.³³⁵)

With respect to intervention, I recommend robust systems of intervention (including oversight, technical, and financial assistance), particularly with regard to planned municipal bond offerings and related derivatives transactions. With respect to governance, I have argued in earlier work that public officials and other stakeholders (including underwriters and swaps providers) ought to be subject to fiduciary duties when developing and implementing financing plans involving municipal securities and related derivatives transactions,

330. See Opinion Regarding Eligibility, *supra* note 1, at 13 (discussing legal basis for appointment, and activities of, Detroit's Emergency Manager).

331. In 2012, New York adopted a fiscal stress monitoring system for local governments. See *Local Government and School Accountability: Fiscal Stress Monitoring System*, N.Y. ST. OFFICE ST. COMPTROLLER, <http://osc.state.ny.us/localgov/fiscalmonitoring/index.htm> (last visited Feb. 10, 2014). According the Pew Charitable Trusts, North Carolina has the oldest intervention program in the country. See PEW CHARITABLE TRUSTS, *supra* note 199, at 5.

332. PEW CHARITABLE TRUSTS, *supra* note 199, at 9–10, 20.

333. *Id.* at 7, 18–20.

334. *Id.*

335. *Id.* at 22.

with particular attention to transactions involving complex instruments with interest rate risk and/or the possibility of high termination fees.³³⁶ I refer to and incorporate those arguments by reference here, on the theory that governance reforms are key to righting local governments' financial ships. Municipalities in distress should have alternatives to the kind of improvident, "kick the can" down the road transactions now plaguing Detroit. Underwriters and derivatives providers should deal with distressed municipalities under a fiduciary standard when structuring funding and financing plans to avoid the temptation to sell structures and products that work over the short, but not the long, term.³³⁷ It may well be that existing regimes are "good enough" to deal with the kind of corruption seen in Jefferson County, Alabama and Detroit, as evidenced by the criminal convictions of public officials in those jurisdictions. But, fiscal distress is not always the result of criminally sanctionable fraud. Sometimes, it is the result of negligence—of short-sighted, marginally self-interested decision-making, the effects of which are felt over the long term.³³⁸ A uniform fiduciary standard at the time transactions are structured—particularly one involving all of the financial professionals upon which cities, towns, villages, etc. depend—could enhance governance and improve financial decision-making across the board. Improving governance with respect to municipal securities and related transactions is not a cure-all, but it might help prevent or slow a city's descent into insolvency.

With respect to fiscal intervention, early warning systems could call upon states to intervene with financial assistance (whether in the form of grants, guarantees, etc.) at an earlier stage, with an eye towards preventing complete fiscal collapse. Prior to distress, states might also do well to consider systems by which smaller municipalities can work with and through the state (through state agencies, public benefit corporations, or the like) to access public markets for borrowing. Allowing smaller issuers, or issuers experiencing some distress, to work with and through the states will give these issuers

336. Chung, *supra* note 34, at 1520–37.

337. *Id.* at 1523.

338. See, e.g., PEW CHARITABLE TRUSTS, *supra* note 199, at 35; see also Andrew Kaylotay, *What Makes Muni Swaps So Special? Nothing, Actually*, BOND BUYER (Feb. 4, 2011), http://kalotay.com/sites/default/files/municipal-articles/What%20Makes%20Muni%20Swaps%20So%20Special_Bond%20Buyer.pdf.

access to better technical and financial assistance, and may result in better “deal terms” and thus prevent or mitigate financial distress.³³⁹

Obviously, financial intervention and assistance is the most controversial step in any regime—while states do not want municipalities to fall into receivership or (where available) bankruptcy, they also do not want cities to incur debts on the assumption that the state will provide a bailout. The reality is, however, that local governments are creatures of the state. They have obligations because of state (and federal) legal and regulatory regimes, at least in part, and they depend on state aid in ways large and small. If states do not like bailouts, either because of concerns about moral hazard or based on concerns about the consequences of allowing municipalities to default, then states should get involved earlier to help municipalities to make better decisions—and, as a last resort, to backstop those decisions if a municipalities’ fortunes go awry.

Third, states would do well to consider well-articulated intervention and reorganization/adjustment mechanisms earlier rather than later, so that plans and resources are in place before a crisis erupts. When a municipality falls into financial distress, stakeholders may hold out for payment, on the assumption that they will be first in line for the issuer’s limited assets. In the absence of work-out mechanisms, crises may erupt, linger, and get solved (if at all) in an ad-hoc fashion. A more orderly restructuring of unsustainable debt—through a statutory regime and/or control board-style mechanisms—can reduce loss and enhance a municipality’s ability to return to fiscal stability.³⁴⁰ For states that have not yet implemented intervention or workout mechanisms of this sort, such reforms would make sense.

These proposals are controversial and difficult to implement, as they implicate core questions of governance and representative democracy. And, state intervention in local fiscal crises admittedly

339. *See* Chung, *supra* note 34, at 1478 (discussing financing for water and sewer projects made available through Environmental Facilities Corporation, a New York Public Benefit corporation).

340. *See* Spiotto, *supra* note 323, at 11 (proposing uniform state restructuring legislation, and suggesting that, “[t]he first step in developing uniform state restructuring legislation is to understand the needs of financially distressed municipalities through an analysis of alternatives. Then consideration should be given to the possible responses a state may make to a financially distressed municipality. Finally, a structure for a successful rehabilitation of a municipality may very well involve an oversight or refinance authority, an idea that is a tried and true success story (New York City and Philadelphia).”).

has been controversial (as is the case in Detroit), and has met with a mixed record of success, due to concerns about loss of local control.³⁴¹ For all of these reasons, if distress metrics, interventions and/or work out mechanisms are to make a difference, they must involve all stakeholders in solutions, including taxpayers, public workers, retirees and bondholders. While these stakeholders may be forced to the table through receivership or bankruptcy, these mechanisms involve rough justice. Starting a dialogue earlier, under the auspices of state oversight and in the context of a regime that identifies and seeks to remediate difficulties early on, might enable solutions, or enhance the balancing of interests necessary to address fiscal strain.

Apart from such mechanisms, some state and local governments have reduced benefits for workers who come into the system later. For example, New York State has done this through by placing employees into “tiers” with different levels of benefits, based on date of employment.³⁴² State and local governments also have explored switching from away from defined benefit plans to a defined contribution model, at least for workers entering the system: at least thirteen states have introduced some form of defined contribution plan, according to the Center for Retirement Research at Boston College.³⁴³ In Michigan, for example, the state closed a defined benefit plan sponsored by Michigan State Employee retirement system to new entrants in 1997 and caused employees hired after that date to be enrolled in 401(k) administered by private financial services firm.³⁴⁴ Professor Michael Thom reportedly found that privatization has been a net positive for the state of Michigan during some fiscal periods (i.e., the 2008–2010), from a fiscal perspective.³⁴⁵

341. See, e.g., PEW CHARITABLE TRUSTS, *supra* note 199, at 23–26.

342. See, e.g., *New York State & Local Retirement System: What Tier Are You In?*, N.Y. ST. OFFICE ST. COMPTROLLER, http://www.osc.state.ny.us/retire/members/find_your_tier.php (last visited Feb. 10, 2014); *N.Y. State and Local Employees’ Retirement System: Chapter 9 Your Retirement Benefits*, N.Y. ST. WORK-LIFE SERVS., <http://www.worklife.ny.gov/preretirement/selfhelpguide/ch9.html> (last visited Feb. 10, 2014).

343. See ALICIA MUNNELL ET AL., CNTR FOR RET. RESEARCH AT BOS. COLL., A ROLE FOR DEFINED CONTRIBUTION PLANS IN THE PUBLIC SECTOR 1 (2011), *available at* http://crr.bc.edu/wp-content/uploads/2011/04/slp_16-508.pdf.

344. See *About the State Employees’ Retirement System*, MICH. DEPT. TECH. MGMT. & BUDGET OFFICE RETIREMENT SERVICES, <http://www.michigan.gov/ors/0,1607,7-144-6183-109542--,00.html> (last visited Mar. 15, 2014).

345. See JEFFREY GUILFOYLE, CITIZENS RESEARCH COUNCIL OF MICH., MICHIGAN’S NEW NORMAL: OUR STATE’S ECONOMIC, REVENUE, AND BUDGET SITUATION 45 (2011), *available at* http://www.crcmich.org/PUBLICAT/2010s/2011/NMU_02-17-11.pdf (citing MICHAEL THOM, ASSESSING THE COST OF DEFINED BENEFIT AND DEFINED CONTRIBUTION PLANS TO PUBLIC EMPLOYERS (2010)). See

Finally, state and local governments also might consider implementing ERISA-style flexibility for benefits not yet accrued.

At the end of the day, however, what is most needed to resolve local government fiscal distress is political courage—something that inevitably is in short supply. Public officials must be prepared to have honest conversations about what cities and towns need, and what they can afford. And, they must be willing to advance cost-saving measures, even if particular constituencies might object. Put simply, they ought to serve with candor and integrity, focused always on the best interest of the municipality and its citizen taxpayers, having been entrusted with citizens' public safety and financial health. For this reason, I restate and reaffirm my earlier argument that requiring fidelity to the public good—via a mandatory, non-waivable fiduciary standard for public officials and stakeholders who market and sell financial products to municipalities—would help to ensure that those in a position to bind the municipality make decisions that are in the municipality's best interest, over the long term.³⁴⁶ This will not guarantee success—but it will give municipalities a fighting chance. In these times, for cities like Detroit, perhaps that is all we can hope for.

generally Michael Thom, *From Pension to 401(k): A Case Study of Public Sector Retirement in Michigan*, in PENSIONS: POLICIES, NEW REFORMS AND CURRENT CHALLENGES 227 (Thom Reilly ed., 2014).

346. In a forthcoming work examining the fiduciary standard, Sitkoff explains that a mandatory fiduciary core serves a cautionary and protective function in fiduciary relationships by clarifying rights and obligations, and thus is reconcilable with an economic theory of fiduciary law. See Robert H. Sitkoff, *An Economic Theory of Fiduciary Law*, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW (Andrew Gold & Paul Miller, eds.) (forthcoming 2014).