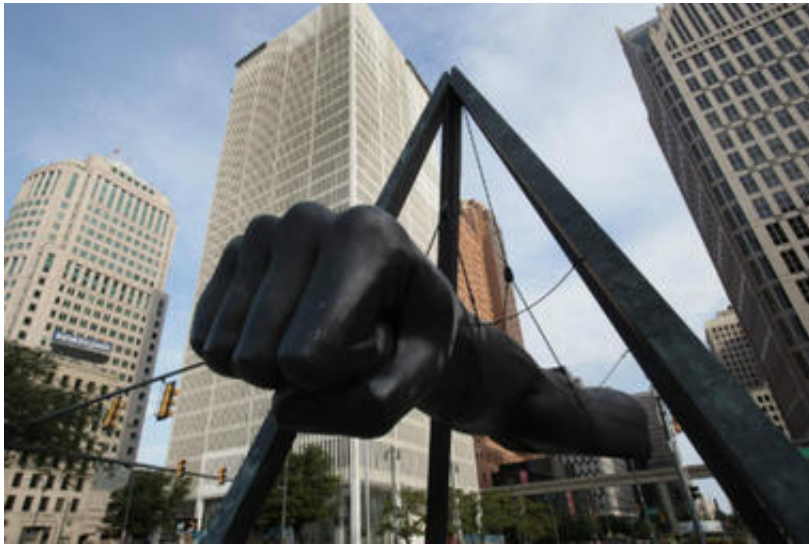


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Detroit bankruptcy: The war shifts to the courts

State officials say they hope that Detroit will emerge from bankruptcy by September 2014, but labor unions and bondholders are gearing up for what is more likely to be a prolonged legal battle.



A sculptor of a giant fist in honor of American boxer and heavy weight champion Joe Louis sits at the intersection of Woodward and Jefferson Avenue in downtown Detroit.

(Rebecca Cook/Reuters/File)

By Mark Guarino, Staff writer / July 22, 2013 at 7:18 pm EDT

Detroit's filing of a petition for Chapter 9 bankruptcy on Thursday marks just a skirmish in what is expected to be a prolonged legal battle between labor unions, bondholders, and state officials over the future of a city that once symbolized the nation's industrial might.

At issue is the fate of \$5.7 billion in unfunded retiree health insurance and \$3.5 billion in unfunded pension payouts for some 30,000 retirees and current city workers. Under federal bankruptcy law, contracts regarding the city's obligations to these pensions can be severed. But labor unions, arguing that Michigan's Constitution prohibits the diminishing of accrued public pension obligations, vow to keep up the fight in court.

Last week, George Orzech, chairman of the Police and Fire Retirement System,

summed up his side's stance toward the evolving legal conflict: "Welcome to war."

The moment Detroit filed for Chapter 9 bankruptcy, a county judge filed an injunction to throw it out of court.

State officials say pension and retiree health benefits will be paid at least through the end of the year, adding that they hope Detroit will emerge from bankruptcy by September 2014. The state and labor unions are disputing exactly how much the different pension funds are underfunded, but emergency manager Kevyn Orr told Fox News Sunday that bankruptcy is the "only way" to get Detroit's liability costs under control so the city is not ultimately swallowed deeper into a financial hole.

"All we're talking about in this restructuring is the unfunded component of those pension funds," Mr. Orr said. "There are going to have to be concessions. Concessions may be different for each fund. And they're going to be focused on the unfunded component."

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With Detroit facing an immediate \$18 billion shortfall, state officials are eager to get out of court as quickly as possible. The Chapter 9 process gives Orr a conceivable fast track, legal experts say, because it does not require allowing outside parties to offer counterproposals on how best to restructure. By contrast, in a Chapter 11 bankruptcy, if Detroit did not get its plan approved by a certain deadline, its creditors would have the right to step in and propose an alternate plan, which might include selling off assets.

"In a Chapter 11 bankruptcy, you have certain requirements that could allow [petitioners] to try and modify retiree benefits. But that's not the case in Chapter 9. Collective bargaining contracts can be rejected without any protection whatsoever," says Randye Soref, a bankruptcy attorney in Los Angeles with Polsinelli, a firm that handled several municipal bankruptcies in California.

Moreover, outside Chapter 9, Detroit would be vulnerable to not having its plan confirmed and having another party in control of its restructuring. Under Chapter 7, the city would be vulnerable to liquidation.

"But neither of those things can happen in a Chapter 9, which means the city holds more cards than they do in a private sector filing," says Michael Sweet, a bankruptcy attorney with Fox Rothschild in San Francisco who helped a number of local governments in California avoid bankruptcy. "The judge can't impose a plan on the city and no one else decides what they can do."

While negotiating with creditors is still allowed during bankruptcy proceedings, Orr's proposal calls for the city's general obligation bondholders to be treated as unsecured creditors, which allows them to receive pennies on the dollar. For their

part, bondholders say Detroit is obligated to pay the full bond amount, which suggests they, too, will seek to slow down the proceedings in court.

Ingham County Circuit Judge Rosemarie Aquilina's injunction against Detroit's bankruptcy is "unprecedented," because it came after the city filed its petition. The ensuing legal battles will likely be treated as a "side circus" to the federal bankruptcy judge who ultimately is assigned the case, says Mr. Sweet.

"I don't see a federal judge ordering [Detroit] out of bankruptcy because of something a state judge said," he adds.

Still, what the court fights will likely do is prolong Detroit's bankruptcy proceedings well past the September 2014 deadline target. Sweet says that, in California, municipalities seeking to file Chapter 9 waited as long as a year or more to even get an eligibility hearing. "And those cities are puny compared to what you have in Detroit," he says.

"Having distractions at a time when people would want to be focused on how to get through it quickly is not constructive," he adds. "That's not to say they can't be moving forward in bankruptcy while addressing these other issues in state court. But you're fighting a war on two fronts. It could make it take longer."

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