UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN

In re	)	Chapter 9
CITY OF DETROIT, MICHIGAN,	)	Case No. 13-53846
Debtor.	)	Hon. Steven W. Rhodes

OBJECTION OF CERTAIN COPS HOLDERS TO DEBTOR'S MOTION TO APPROVE SETTLEMENT AND PLAN SUPPORT AGREEMENT WITH SWAP COUNTERPARTIES

The creditors and parties in interest identified in footnote 1[1] ("**Objectors**") submit this objection (the "**Objection**") to the Debtor's Motion for Entry of an Order, Pursuant to Section 105(A) of the Bankruptcy Code and Bankruptcy Rule 9019, Approving a Settlement and Plan Support Agreement and Granting Related Relief [Dkt. No. 2802] (the "**Motion**").[2] The settlement proposed in the Motion will be referred to herein as the "Proposed Settlement."

The Objectors do not question the validity of the swap agreements (collectively, the "**Swap**"), nor do the Objectors question the validity of the Collateral Agreement (the "**Collateral Agreement**") pledging casino revenues ("Casino Revenues") entered into in 2009. Rather, the Objectors are objecting to the Motion solely because neither UBS AG nor Merrill Lynch Capital Services, Inc. (by assignment from SBS Financial Products Company LLC) (together, the "**Swap Counterparties**") has a secured claim against the City of Detroit ("**City**"). To the extent that the Proposed Settlement purports to "settle" a secured claim, there is simply no secured claim to settle. Each of the Swap Counterparties is merely an unsecured creditor of the

[1] The creditors and parties in interest submitting this objection are: Hypothekenbank Frankfurt AG, Hypothekenbank Frankfurt International S.A., and Erste Europäische Pfandbrief- und Kommunalkreditbank Aktiengesellschaft in Luxemburg S.A., FMS Wertmanagement AöR, and Dexia Crédit Local and Dexia Holdings, Inc.
[2] Capitalized terms used in this Objection but not otherwise defined herein shall have the meaning ascribed to such terms in the Motion.

City and each of their unsecured claims should be considered along with any other unsecured claim in any plan of adjustment in this Case.

Consistent with the law applicable to the approval of settlements generally, and with this Court's prior ruling on January 16, 2014 (the "**Prior Ruling**")[3] on 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(a) of the Bankruptcy Code, (ii) Approving Such Agreement Pursuant to Rule 9019, and (iii) Granting Related Relief [Dkt. No. 17] (together with a supplement filed on December 27, 2013 [Dkt. No. 2341], the "**Prior Settlement Motion**"), the current Motion should be denied on three principal grounds:

- The Proposed Settlement is outside the lowest range of reasonableness and is not in the best interest of creditors because, as with the Prior Settlement, the City is certain to succeed in litigation to invalidate the security interest under the Collateral Agreement for the City's obligations relating to the Swap under Sections 552 and 928 of the Bankruptcy Code.

- The Proposed Settlement, which by its terms is integrally related with the confirmation of the City's proposed Plan of Adjustment (the "**Plan**"), should be approved, if at all, only as part of the Plan process as are other settlements already embedded in the pending Plan, such as those with the State of Michigan, the Detroit Institute of Art, and holders of COPs, GRS, and PFRS Claims.

- If the Proposed Settlement were considered as part of the Plan, it would impermissibly violate the unfair discrimination, best interests of creditors and the third-party release on discharge limitations applicable to the confirmation of the Plan.

In support of their objection, Objectors state as follows:

BACKGROUND

Transaction Background

1. The facts here are all too familiar to the Court and are stated again for ease of reference by the City in its Motion in paragraphs 15-35 thereof. In brief terms, in 2005 and 2006,

[3] A copy of the transcript of the Prior Ruling is attached hereto as Exhibit A.

the Service Corporations entered into the Swap with the Swap Counterparties to hedge against fluctuation of interest rates on those certificates of participation ("**COPs**") issued in 2005 and 2006 that bear interest at a variable rate. The City was obligated under its service contracts (the "Service Contracts") with the Service Corporations to fund the payments to the Swap Counterparties (the "**Hedge Payables**"). By early 2009, the Service Corporations were in default under the Swap and entered into negotiations with the Swap Counterparties to avoid a declaration of a default under the Swap.

2. On June 26, 2009, the City, the Service Corporations, and Swap Counterparties entered into a Collateral Agreement, wherein the City pledged certain revenues and other assets, primarily taxes on the gross receipts of certain casinos located in the City (together, the "**Casino Revenues**") as collateral to the Service Corporations for the payment by the City of the Hedge Payables, who in turn assigned such pledge to the Swap Counterparties as collateral for the obligations of the Service Corporations under the Swap.

3. The City Council of the City authorized the City's entry into the Collateral Agreement by passing Ordinance 05-09 on May 26, 2009 (the "**Ordinance**"), adding Article 16 to Chapter 18 of the City Code, "for the purpose of implementing the transactions contemplated by the [T]erm [S]heet [for the Collateral Agreement]." City Code § 18-16-4(n). The Ordinance went on to state that "all obligations of the city under this ordinance and the definitive documents are contractual obligations." *Id*. at § 18-16-12.

4. The Ordinance did not create a new lien upon all transactions involving the casinos or other city revenue sources. Rather, by its terms, it merely authorized the City to enter into the Collateral Agreement and pledge existing revenues to the Service Corporations for further assignment to the Swap Counterparties under the terms of the Collateral Agreement.

Motion Background

5. This Proposed Settlement does not come before the Court without history. The Court's Prior Ruling rejected the City's prior attempt to settle potential litigation with the Swap Counterparties, by having the City exercise an "optional termination right" given to the Swap Counterparties in the Swap by paying the Swap Counterparties $165 million plus so-called breakage costs of $4.2 million. Bench Op., Jan. 16, 2014 Hrg. Tr. 8:5-8. This Court rejected the Prior Settlement by applying the undisputed standards for approving settlements and concluding, among other things, that the City had a "reasonable" likelihood of success in cutting off the lien of the Swap Counterparties on future Casino Revenues under Sections 552(a) and 928 of the Bankruptcy Code, and observing that litigation on this issue could have been resolved by summary judgment at "relatively insignificant cost", with few issues of collectability. *Id*. at 6:5 - 20:8.

6. In light of nearly unanimous creditor opposition, the Court held that the best interest of creditors was against replacing clearly avoidable "old obligations under the swap agreements and the collateral agreement, which the City concedes as to which (sic) it has litigable claims against the enforcement of them, with new obligations that would be fully protected both by security interests and by court approval." *Id*. at 20:12-16.

7. The City is back with a retooled settlement that fails for the same reasons. The Proposed Settlement purports to concede a secured claim to the Swap Counterparties and to pay them $85,000,000 in cash with respect to such claim and, if the City can get exit financing by the effective date of the Plan, in a matter of months. Yet, every other unsecured creditor will receive nominally 20 cents on the dollar under the Plan as proposed (in fact, likely much less in net present value), and solely based upon a 30-year note that pays no interest for five years and whose repayment is totally speculative. Invalidating the secured claim of the Swap Counterparties, on the other hand, would free up Casino Revenues without the payment of this ransom.

8. Moreover, elements of the Proposed Settlement are worse than the Prior Settlement for the City. The Proposed Settlement does not terminate the Swap, but allows the Swap Counterparties to retain their alleged security interest and continue to receive payments of $4.2 million a month in addition to the $8.4 million already paid. It allows the Swap Counterparties to charge what amounts to a penalty rate of interest if the balance of the $85 million settlement payment is not paid on the effective date of the Plan. Instead of recovering money for creditors, the City is buying the votes of the Swap Counterparties by giving them unfairly favorable treatment. Under the Proposed Settlement, the Swap Counterparties stand to receive a major cash payment instead of deeply subordinated notes. The Proposed Settlement also purports to grant the Swap Counterparties releases and third-party releases of claims that they could not receive under a plan.

ARGUMENT

I. THE PROPOSED SETTLEMENT FAILS UNDER THE STANDARDS APPLIED BY THE COURT TO REJECT THE PRIOR SETTLEMENT.

9. This Court's Prior Ruling aptly states the standards for approving or rejecting the Proposed Settlement. Although the City is entitled to use its "business judgment" in reaching a settlement, the Court must consider four additional factors in determining whether to approve the Proposed Settlement:

> First is the likelihood of the success of any potential litigation that might result if the settlement is denied. The second is the complexity, expense, and delay of such litigation. The third is any collection issues that appear, and the fourth involves the interests of the city's creditors and its residents.

Bench Op., Jan. 16, 2014 Hrg. Tr. 6:8-13. The Court should apply a similar analysis to this

Proposed Settlement since, in the Court's own words:

> the Sixth Circuit's decision in *In re MQV[P], Inc*., 477 Federal Appendix 310, 313 (6th Cir. 2012), is cited, quoted, "When determining whether to approve a proposed settlement, the bankruptcy court may not rubber stamp the agreement or merely rely on the trustee's word that the settlement is reasonable. *Reynolds v. Commissioner of Internal Revenue*, 861 F.2d 469, 473 (6th Cir. 1988). Rather, the bankruptcy court is charged with an affirmative obligation to apprise itself of the underlying facts and to make an independent judgment as to whether the compromise is fair and equitable," In *In re Rankin*, 438 Federal Appendix 420, 426, (6th Cir. 2011), the Court quoted at some length from the Supreme Court's decision in *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414 (1968). "There can be no informed and independent judgment as to whether a proposed compromise is fair and equitable until the bankruptcy judge has appraised -- apprised himself of all of the facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated. Further, the judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise. Basic to this process in every instance, of course, is the need to compare the terms of the compromise with the likely rewards of litigation.

Id. at 6:19-7:22.

10. Moreover, since the Proposed Settlement affects the rights and claims of third parties, the Court must consider those legal rights and the fairness of the decree to those affected. *See Williams v. Vukovich*, 720 F.2d 909, 921 (6th Cir. 1983)). This is particularly true since the Proposed Settlement is coming on the eve of the Plan confirmation process and patently implicates many of the protections of creditors in the type of cram down confirmation that the Plan-support aspect of the Proposed Settlement aims to facilitate. Since the interest of creditors is paramount, the reasonable views of creditors are also entitled to deference. *In re Fodale*, 2013 WL 663729 at * 6, No. 10-69502 (Bankr. E.D. Mich. Feb. 21, 2013). Since the Court’s Prior Ruling on the last three factors of (i) complexity, expense, and delay of such litigation, (ii) collection issues, and (iii)

the interests of the city's creditors and its residents are clearly identical in application to the present circumstances, Objectors will focus on the first factor of likelihood of success of litigation.

A. The Prepetition Liens of the Swap Counterparties Do Not Extend to the City's Post-Petition Casino Revenues.

11. As previously argued before this Court, the City and the Swap Counterparties have again completely failed to address the fact that the City's post-petition receipts received from Casino Revenues are simply not subject to the liens created by the Collateral Agreement by operation of Section 552 of the Bankruptcy Code. Section 552(a) of the Bankruptcy Code provides in relevant part that "property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." 11 U.S.C. §§ 552(a); 901(a) (making Section 552 applicable to chapter 9 proceedings).

1. The Swap Counterparties' Liens are not Statutory Liens.

12. Section 552(a) applies only to liens arising out of any "security agreements," and not to other liens such as statutory liens. *Alliance Capital Mgmt. L.P. v. County of Orange (In re County of Orange)*, 189 B.R. 499, 502 (C.D. Cal. 1995). The City argues that the Ordinance created a statutory lien that exempts the Collateral Agreement from Section 552 of the Bankruptcy Code. (Motion, ¶¶ 38, 39.) However, such an interpretation of the Collateral Agreement and the Ordinance is contrary to the plain language of the Bankruptcy Code, its legislative history, and case law.

13. The Bankruptcy Code defines statutory liens as "a lien arising solely by force of a statute on specified circumstances or conditions, … but does not include [a] security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute." 11 U.S.C. § 101(53). The

automatic attaching or creation of a lien pursuant to a statute, without more, therefore, is critical to the definition of a statutory lien — a lien "dependent upon an agreement" between parties or consent between two parties is a security interest subject to Section 552, "even though there is a statute which may govern many aspects of the lien." *See County of Orange*, 189 B.R. at 502 (quoting 2 COLLIER ON BANKRUPTCY (16th Ed.), ¶ 101.53, at 101-150.51); ("a statutory lien is only one that arises automatically, and is not based on an agreement to give a lien," citing S. REP. NO. 95-989 (1978).

14. The Collateral Agreement — even though approved by the Ordinance — is nothing more than a consensual, prepetition security agreement between the City (as authorized by the City Council) and the Swap Counterparties (as assignees of the Service Corporations) to grant the Swap Counterparties a lien in certain of its prepetition revenues. The Ordinance can in no way rise to the level of a statutory lien. In fact, the Ordinance states that "all obligations of the city under this ordinance and the definitive documents are contractual obligations." City Code § 18-16-12.

2. The Casino Revenues Are Not Special Revenues Under Section 928.

15. Nor is any lien on the Casino Revenues excepted from the general rule of Section 552(a) as a lien on "special revenues acquired by the debtor after the commencement of the case …." 11 U.S.C. § 928(a). Although a lien attaches to post-petition "special revenues" notwithstanding Section 552(a), the City has acknowledged that the Casino Revenues could qualify as "special revenues," if at all, only under Section 902(2)(B), as "special excise taxes imposed on particular activities or transactions," Bench Op., Jan. 16, 2014 Hrg. Tr. 12:10 – 13:6. This section does not apply to the Casino Revenues, which at most are a general excise tax, which Section 928 does not protect.

16. The phrase "special excise taxes" is not defined in the Bankruptcy Code.[4] The legislative history of the 1988 Amendment to the Bankruptcy Code ("**1988 Amendment**")[5] illustrates the difference between an excise tax and a special excise tax. The limiting word "special" was added before "excise tax" in Section 902(2)(B) to express Congress' intention to apply Section 928(a) only to special revenues that secure payment of special revenue bonds. *See* H.R. REP. NO. 100-1011 at 4 (1988). Congress thus limited the application of Section 928(a) to its intended purpose of protecting project financing that encumbers excise tax revenue derived from the project itself. "According to Congress, the 'intent is to define special revenues to include the revenues derived from a project or from a specific tax levy where such revenues are meant to serve as security to the bondholders.'" *In re Heffernan Mem. Hosp. Dist.*, 202 B.R. 147, 148-49 (Bankr. S.D. Cal. 1996) (citing H.R. REP. NO. 100-1011 at 6-7 (1988)).

17. Section 928 only protects special revenues pledged to pay these special revenue bonds. COLLIER ON BANKRUPTCY, ¶ 902.03[1] (16th ed. 2013). "Special excise taxes" are taxes specifically identified and pledged in the bond financing documents and are not "generally" available to all creditors under state law. Thus, a general state sales tax would not be a special excise tax. COLLIER ON BANKRUPTCY, ¶ 902.03[2] (16th ed. 2013) (quoting S. REP. NO. 100-506 (1988)). The narrowness of the safe harbor derived from the expectations of the bondholders and general creditors of the municipality that when a "municipality approves financing though a revenue bond or program … it has made the assumption that the project or program will generate

[4] "Excise tax" is undefined in the Bankruptcy Code, but it has been defined with respect to section 507(a) as: "an indirect tax, one not directly imposed upon persons or property … and is one that is 'imposed on the performance of an act, the engaging in any occupation, or the enjoyment o[f] a privilege.'" *New Neighborhoods, Inc. v. West Va. Workers' Compensation Fund*, 886 F.2d 714, 719 (4th Cir. 1989) (quoting *In re Tri-Manufacturing & Sales Co.*, 82 B.R. 58, 60 (Bankr. S.D. Ohio 1988)). The Ordinance only stated that it was an excise tax, which, as noted below, is not the same thing as a "special" excise tax.

[5] The 1988 Amendment added Section 928 and the definition of special revenues in Section 902(2) to the Bankruptcy Code.

adequate revenue to repay the bondholders and operate the project or program without any general financial obligation on the part of the municipality." S. REP. NO. 100-506 at 5 (1988). Congress enacted Sections 902 and 928 to prevent a municipality's general unsecured creditors from seeking payment from the revenue pledged to special revenue bondholders. *Id.* The legislative history of the 1988 Amendment illustrates the limited situations in which special excise taxes are considered special revenues.

> "Hotel-motel taxes, meal taxes, and license fees are included in special excise taxes. They are often imposed for particular purposes. For example, a hotel-motel excise or a meal tax might be imposed in a particular area of a municipality or throughout a city to finance the construction and operation of a convention center. Bonds secured by the special excise tax are issued to finance the construction …. However, where the revenue may be used for other purposes, it should not constitute 'special revenues.'"

Richard B. Levin and Lawrence P. King, "Report of the National Bankruptcy Conference on Proposed Municipal Bankruptcy Amendments," included in the Hearings before the Subcommittee on Courts and Administrative Practice of the Committee on the Judiciary, 100th Cong., 2d Sess. at 553 (S. Hrg. 100-1067, June 10, 1988). Where general revenues are used to finance a variety of municipal activities and are not, for instance, created specifically for any particular purpose or project, they are just that, *general*. *Id*.

18. The Casino Revenues cannot meet the restrictive definition of "special excise tax" or the narrow purpose for which the 1988 Amendment was enacted. See COLLIER ON BANKRUPTCY, ¶ 902.03[1] (16th ed. 2013), *County of Orange*, at 192 (stating that Section 928 was narrowly crafted to apply only to special revenue bonds). The definition must be viewed as it relates to the actual purpose behind the 1988 Amendment and Section 928 of the Bankruptcy Code. *Id*. The Casino Revenues are, instead, a prime example of general revenue raised from a general excise tax. The Casino Revenues are generated from the enactment of Michigan's Gaming

Revenue Act MCL § 432.212 (the "**Gaming Act**") and a wagering tax imposed by the City in 1999, seven years prior to the execution of the Swap and ten years prior to the execution of the Collateral Agreement. Section 12(3)(a) of the Gaming Act identifies eight general categories of purposes for which a wagering tax may be used by a city. The Gaming Act does not identify a specific purpose or project for which the proceeds of a wagering tax must be used. Similarly, Section 18-14-3 of the City Code creates the wagering tax levy as "an excise tax upon the adjusted gross receipts of a casino licensee" from which the Casino Revenues are generated. City Code § 18-14-3 (emphasis added). Section 18-14-10, entitled "Use of Proceeds," does not limit the use of the proceeds from this levy on gaming revenue to any specific project, nor to the satisfaction of the City's obligations under the Swap or Collateral Agreement. Instead, it states: "Proceeds from the levy of the wagering tax that is imposed pursuant to section 18-14-3 of this Code shall be used by the city for the purposes authorized by the [Act]." City Code § 18-14-10.

19. Moreover, neither the Swap nor the Collateral Agreement were executed in connection with the development and construction of the casinos used to generate the Casino Revenues, further distancing the security interest at issue from the intended policy goal of Section 928(a) to encourage bond-financing investment in municipal programs. See 6-928 COLLIER ON BANKRUPTCY, ¶ 928.01 (16th Ed. 2013) (the "effect [of Section 928] is to prevent special revenues that secure an issue of revenue bonds from being diverted to be available from the municipality's general expenses or obligations"); *County of Orange*, 179 B.R. at 191-192 (defining goal of Section 928(a) to remove risk that revenue bondholders would be stripped of their liens on postpetition revenue); *In re Las Vegas Monorail Co.*, 429 B.R. 770, 782 (Bankr. D. Nev. 2010) (acknowledging that Section 928(a) recognizes the difference between industrial or revenue bonds, on the one hand, and general municipal bond financing, on the other hand).

20. For these reasons, Casino Revenues constitute general excise taxes — as the City Code itself defines them — and general revenues. They are not "special excise taxes" and, accordingly, not "special revenues" as defined in Section 902(2) of the Bankruptcy Code and are therefore not subject to exception from the operation of Section 552 by Section 928(a) of the Bankruptcy Code. There can simply be no question about this and thus, there is no possibility that the Swap Counterparties have any secured claim. The City is, in fact, awarding a secured claim to the Swap Counterparties and unabashedly doing so only to place the Swap Counterparties' claims in a separate, "secured" class, to impair the claim, and to afford itself an accepting impaired class for purposes of an eventual cram down of its Plan.

B. Inapplicability of Section 560 of the Bankruptcy Code.

1. Section 560 Does Not Guaranty Full Payment of the Swap Counterparties' Claims, Just the Right To Terminate and Net Promptly After a Bankruptcy Filing.

21. Section 560 of the Bankruptcy Code does not protect the Swap Counterparties in this case.[6] The plain meaning of Section 560 shows that it only applies to termination rights:

> **§ 560 Contractual right to liquidate, terminate, or accelerate a swap agreement**
>
> The *exercise of any contractual right of any swap participant … to cause the liquidation, termination, or acceleration* of one or more swap agreements because of a condition of a kind specified in section 365 (e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by

[6] Objectors do not concede that the assignment of the City's pledge of Casino Revenues and third-party beneficiary rights of the Swap Counterparties under the Service Contracts and pledge of the "City Pledge" and "City Hedge Payables Related Obligations" under the Collateral Agreement bring them within the protection of Section 560, because the Service Contracts and Collateral Agreement are not "swap agreements" and the City is not a "swap counterparty" within the meaning of that section. The interposition of the Service Companies is another reason why Section 560 does not apply to preserve any lien of the Swap Counterparties in the Casino Revenues from the application of Section 552.

> any provision of this title or by order of court or administrative agency in any proceeding under this title ….

11 U.S.C. § 560 (emphasis added). By its terms, Section 560 does not protect security interests securing any termination payment from the provisions of Section 552(a). Section 560 is merely a safe harbor that protects the counterparty's right to terminate the swap, notwithstanding Section 365(e)(1)(B), based on an *ipso facto* clause and, thereafter, to net and close out all positions with the debtor notwithstanding Section 362(a). See 11 U.S.C. § 362(b)(17); *In re Lehman Brothers Holdings, Inc., et al*., 2009 WL 6057286 (No. 08–13555 (JMP), Bankr. S.D.N.Y. Sept. 17, 2009) and Transcript of Proceedings dated September 15, 2009 at 106:24-107:8 (filed as Dkt. No. 5261 in *Lehman* and attached hereto as Exhibit B).

22. Section 560 also does not require that the termination amount[7] be paid in full. It, at best, permits all amounts mutually owing between the counterparty and the debtor to be netted without regard to the automatic stay. The Court suggested in its Prior Ruling the possibility that Section 560 of the Bankruptcy Code would require the termination claim of the Swap Counterparties to be paid in full even if it were unsecured. Bench Op., Jan. 16, 2014 Hrg. Tr. 18:1-3. With respect to the Court, this issue was not briefed. Indeed, the City notes in the Motion that it disagrees with the Court’s suggestion. Motion, p.31, ¶55.The Objectors agree with the City on this point.

23. As noted above, Section 560 deals with termination rights, not the claims that may result from termination or rejection or their characterization for Bankruptcy Code purposes. Nothing in the legislative history indicates that, beyond the ability to terminate and close out

[7] The City claims in the Motion that the termination amount would have been approximately $288 million on the petition date (Motion, p. 14, ¶32). The City admits that, under the Swap, it is the City that must, via Hedge Payables under the Service Contracts, make monthly net payments to the Swap Counterparties of approximately $4.2 million per month. (Motion, p.27, ¶49)

positions notwithstanding the automatic stay, Congress granted any special priority to, or protection of a swap counterparty's claim. *See* S. REP. NO. 101-285 (1990). Congress wanted to preserve termination rights, not claims in bankruptcy,

> in order to preserve the functioning of the market and to eliminate any concern that Code provisions could be read to preclude the exercise of contractual rights of prebankruptcy netting or setoff. This is particularly important to swap participants since netting is the normal, intended course of dealing in swap transactions unlike ordinary commercial transactions where setoff is an extraordinary remedy.

S. REP. NO. 101-285, at 3.[8] The claims of the Swap Participants are not guaranteed to be paid in full by Section 560, but are subject to compromise, if and when they are matured and liquidated unsecured claims.

2. The Automatic Stay Applies to the Swap Counterparties' Exercise of Termination and Netting Against the Collateral.

24. Because the Swap Counterparties failed to timely terminate the Swap and net against the collateral upon the filing of the City's bankruptcy case, their claims are not liquidated or matured at present. Before termination, the Swap "is just another ordinary executory contract."

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[8] Although the Objectors' do not press the argument here, as the Court noted in the Prior Ruling, the City also had a reasonable likelihood of prevailing on its theory that the grant of a security interest in Casino Revenues was void under the Michigan Gaming Act, MCL §432.212. Bench Op., Jan. 16, 2014 Hrg. Tr. 9:6-11:16; 18:22-25. However, to the extent that there is any question about whether Section 560 would otherwise bestow a "full payment" requirement on whatever termination payment would otherwise be due to the Swap Counterparties, the Objectors do not disagree with the Court's analysis under the Gaming Act, which would be fatal to the Proposed Settlement. If the Court declared the Swap Counterparties' security interest to be void *ab initio* under the Gaming Act, Section 560 and other safe harbors of the Bankruptcy Code would clearly be inapplicable. As one court aptly put it respecting Section 546 of the Bankruptcy Code:

> *Where a transaction is rendered void by state law, it is a nullity. Thus, the purpose of subsection 546(g) is not implicated. The transaction is void and there is no recognized financial instrument to protect from the uncertainties regarding [its treatment] under the Bankruptcy Code.* Rather, the treatment of the financial instrument is the result of state law voiding the entire transaction. If it is determined that the transaction violated [state] law, the agreement would be a nullity and have no legal effect. As a consequence, the transfer would not have been made under or in connection with a swap agreement and it would not be protected from avoidance under Section 546(g) of the Bankruptcy Code.

In re Enron Corp., 323 B.R. 857, 876, 878 (Bankr. S.D.N.Y. 2005) (emphasis added).

In re Enron Corp., 01 B 16034 (AJG), 2005 WL 3874285 (Bankr. S.D.N.Y. Oct. 5, 2005). Simply put, the Swap Counterparties have no matured right to payment at the present time – just bilateral performance obligations on executory contracts.

25. The discussion of claims in the Motion is hypothetical unless and until the Swap Counterparties get relief from the stay and terminate the Swap or the City rejects the Swap. The Proposed Settlement does not trigger a matured claim against the City because it does not permit the Swap Counterparties to terminate the Swap or require the rejection thereof by the City. If and when a debtor rejects an executory contract, "[t]he other party then holds a general unsecured claim for rejection damages against the debtor." *In re O.P.M. Leasing Services*, 56 B.R. 678, 682-83 (Bankr. S.D.N.Y. 1986). That claim is calculated by netting the parties' offsetting claims. *In re Enron Corp*., 349 B.R. at 106 (noting that to do otherwise would entitle the non-debtor counterparty to receive more than what it bargained for). See also *Lehman Brothers, supra* and Tr. of Proceedings, <u>Exhibit B</u>, at 111:23 – 112:2. As with any other executory contract, only rejection of a swap agreement is treated as a breach immediately prior to the petition date. *In re Enron Corp*., 349 B.R. 96, 106 (Bankr. S.D.N.Y. 2006). The City has not elected to terminate the Swap. The automatic stay precludes the Swap Counterparties from doing so at this late date.

26. In *Lehman Brothers*, the swap counterparty ceased performing and, after one year following the filing of the bankruptcy, the debtor sued to compel performance and to enforce the automatic stay. The Court ordered the counterparty to perform the swap agreements because nonperformance was "simply unacceptable and contrary to the spirit of these provisions of the Bankruptcy Code." *Lehman Brothers* at 110:23-25.

> Moreover, legislative history evidences Congress's intent to allow for the prompt closing out or liquidation of open accounts upon the commencement of a bankruptcy case. Citation is to the Congressional history of this, H.R. Rep. 97-420 at 1 (1982), as well as its stated rationale that the immediate termination for default and the netting provisions are critical aspects of swap transactions and are necessary for the protection of all parties in light of the potential for rapid changes in the financial markets. Citation to the Senate Report number 101-285 at 1 (1990).
>
> The safe harbor provisions specifically permit termination solely, quote, "because of a condition of the kind specified in Section 365(e)(1) that is the insolvency or financial condition of the debtor and the commencement of a bankruptcy case. See also *In re Enron Corp.*, 2005. WL 3874285, at *4, Judge Gonzalez's case, 2005. Noting that a counterparty's action under the safe harbor provisions must be made fairly contemporaneously with the bankruptcy filing, less the contract be rendered just another ordinary executory contract.
>
> The Court finds that Metavante's window to act promptly under the safe harbor provisions has passed, and while it may not have had the obligation to terminate immediately upon the filing of LBHI or LBSF, its failure to do so, at this juncture, constitutes a waiver of that right at this point.

Lehman Brothers at 111:3- 112:2. Good reasons exist for this judicial requirement that Section 560 only applies to protect termination and netting rights that are exercised promptly after a bankruptcy case is filed. Otherwise, swap counterparties otherwise could game the system by waiting until market movements improved some or all of their positions before pulling the trigger on termination. Once the swap counterparty delays exercising its right to close out its swap, then it knowingly undertakes the risk of the bankruptcy stay. Under those circumstances, the policy of giving the debtor the protection of the stay and the right to assume or reject the executory swap agreement should take precedence.

27. Here, the Swap Counterparties did not terminate the Swap pre-petition or in the nine months since the City filed bankruptcy. Nor are they terminating the Swap under the Proposed Settlement. Just like the swap counterparty in *Lehman Brothers*, they unquestionably

failed to exercise their contractual right to terminate "promptly" after the commencement of this bankruptcy case. As a result, the Swap Counterparties should be deemed to have waived their rights under Section 560 of the Bankruptcy Code. The automatic stay under Section 362 of the Bankruptcy Code now prevents them from terminating the Swap and netting against the Casino Revenues. Under established law, the Swap Counterparties must continue to perform until the City elects to assume or reject those agreements. *NLRB v. Bildisco & Bildisco*, 465 US 513, 531 (1984). As noted above, an unterminated swap agreement "is just another ordinary executory contract." *In re Enron Corp.*, 01 B 16034 (AJG), 2005 WL 3874285 at *4 (Bankr. S.D.N.Y. October 5, 2005); *In re Enron Corp.*, 349 B.R. at 106 (Bankr. S.D.N.Y. 2006).

28. At best, the Swap Counterparties have unmatured and unliquidated unsecured claims against the Service Corporations and the City. As noted above, the postpetition Casino Revenues do not secure the claims. These claims would arise on exercise of the right to terminate the Swap (if termination and netting against the Casino Revenues is no longer stayed)[9] or upon rejection of the Collateral Agreement, the Service Contracts or even the Swap (if permitted under Section 365 of the Bankruptcy Code). These claims should be treated under the Plan in a class with other unsecured claims. Because the Swap Counterparties' claims can never be more than unsecured claims, the City should not be paying the Swap Counterparties any monthly payments and should be refunded the $8.4 million already paid.

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[9] To the extent that the Swap Counterparties contend that the Section 560 applies because the Swap is an obligation of the City, then (i) the automatic stay under Section 362 of the Bankruptcy Code would block such termination and netting against the Casino Revenues because that the Swap Counterparties' waived the application of Section 560 by delaying the exercise of their termination rights for nine months since the commencement of this Chapter 9 case and (ii) the City has the right to assume or reject the Swap. See ¶¶ 25-26 above.

II. THE PROPOSED SETTLEMENT SHOULD NOT BE APPROVED OUTSIDE THE PLAN PROCESS, AND WOULD NOT BE APPROVED AS PART OF THAT PROCESS.

A. The Proposed Settlement with the Swap Counterparties Should Be Embedded in the Plan Along with the Many Other Settlements Contained Therein.

29. The Proposed Settlement is inextricably linked to the Plan process, which is well underway to a prompt resolution. This Court's Second Amended Order Establishing Procedures, Deadlines and Hearing Dates Relating to the Debtor's Plan of Adjustment, dated March 6, 2014 (the "**Scheduling Order**"), has placed the Plan process on an expedited track to confirmation hearings in mid-July.

30. The Proposed Settlement should be incorporated into the Plan, not handled separately on the eve of the Plan. The Proposed Settlement implicates many Plan processes because it involves plan support, depends on "exit" financing at plan confirmation to pay the bulk of the settlement payment due, compromises on the amount of the claim and requires a release of the City's claims at or after the effective date of the Plan and piggy backs on exculpation based on similar protections that may be granted to creditors under the Plan. Motion at pp. 17 - 20.

31. The City's Plan in fact is packed with similar settlements. For example, there is a proposed settlement with the State of Michigan, certain funding foundations and the Detroit Institute of Arts to fund pensions. Proposed Disclosure Statement at pp. 4, 98. The failure to close those settlements is a risk factor disclosed in all capital letters. *Id.*, p. 4. The Plan proposes numerous other settlements with numerous classes of creditors, including proposed settlement terms for claims in classes 5, 9, 10 and 11 thereunder. *Id.* at pp. 14-17 and Plan sections cited. Indeed, there was a placeholder in the Plan and Disclosure Statement for this Proposed Settlement.

32. Other than the payoff required by the Swap Counterparties in order to lock in their "early vote," there is no reason for them to be treated outside of the Plan. As noted above, the

Swap Counterparties are subject to litigation that is likely to eliminate their security and confirm their treatment as general unsecured creditors (to the extent they have any claim at all as result of the rejection of the Swap).

B. The Proposed Settlement Should Be Rejected Because It Would "Unfairly Discriminate" In Favor of the Swap Counterparties and Not Be "Fair and Equitable".

33. The Proposed Settlement obfuscates the greatly enhanced treatment that the Swap Counterparties will receive. It provides the Swap Counterparties with a total of $85 million in cash from payments that are escrowed every month and a lump sum payment. While the City has not disclosed the current termination payment or buyout payment under the Swap, this is between 30% - 36% of the various "termination" or "buyout" numbers mentioned in the Motion. Motion, ¶ 32. Further, the Swap Counterparties are receiving cash – with cash interest if they are not paid out completely within 180 days of the effective date of the Plan. *Id.*, ¶ 40 ("**Liquidity Event**").

34. In contrast, Objectors will receive at best a nominal 20 cents on the dollar, which almost certainly overstates the present value of their actual recovery. The consideration offered to the Objectors and other classes of unsecured creditors is not payable in cash, but in the form of a pro rata share of New B Notes, which are subject to grave execution risk relating to the City's post-confirmation financial performance. The notes do not bear interest at all for the first five years after the effective date of the Plan, receive "payment in kind" interest for the next five years and do not begin amortization or cash interest payments until the 11th through the 30th years after Plan confirmation. Plan, Exhibit I.A.160. This is grossly disparate from the cash payment due to Swap Counterparties under the Proposed Settlement. Most other impaired creditors are likely to have similar complaints about the discrimination that unfairly favors the Swap Counterparties.

35. The Motion admits that the purpose of the Proposed Settlement is to create an impaired accepting class so that the Plan can be crammed down under Section 1129(b) of the

Bankruptcy Code. However, this section requires that the Court conclude that "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. §1129(b). Objectors submit that this differential treatment of the Swap Counterparties would fail this test if it were applied in the plan confirmation context.

36. This Court should not allow the City's subterfuge by approving a settlement that would not be permitted under Section 1129 of the Bankruptcy Code. One Circuit Court has held that the "fair and equitable" standard for approval of a settlement generally prohibits a debtor from violating the absolute priority rule in connection with a pre-plan settlement and that a bankruptcy court abuses its discretion in approving a pre-plan settlement unless the bankruptcy court ensures that the absolute priority rule is not violated. *United States v. AWECO, Inc. (In re AWECO, Inc.)*, 725 F.2d 293, 298 (5th Cir. 1984) (establishing bright-line test). Other courts considering settlements have looked to the requirements of confirmation as a guide. *In re Iridium Operating LLC*, 478 F.3d 452, 463 (2d Cir. 2007) approved a settlement but remanded for a further determination of whether a settlement satisfied the absolute priority rule. The *Iridium* court held that settlements must be "fair and equitable" in a general sense and noted that "whether a settlement's distribution plan complies with the Bankruptcy Code's priority scheme will often be a dispositive factor." *Id*. at 464. *In re Warren*, No. 10-1110, 2011 WL 3299819 at p. 5 (9th Cir. B.A.P. March 15, 2011) also recognized the importance of a settlement being fair and equitable to all creditors because the Bankruptcy Code "provides the textual basis for the fundamental principle that creditors of equal priority should receive pro rata shares of the debtor's property." *See also TSIC, Inc*., 393 B.R. 71 (Bankr. D. Del. 2008) and *In re World Health Alternatives, Inc*., 344 B.R.

291 (Bankr. D. Del. 2006) (approving settlements over objections raising violation of absolute priority rule because assets are coming from outside debtors' estates).

37. The Proposed Settlement does not involve any additional funds coming into the City's estate. It merely gives the Swap Counterparties a distribution which is in cash and is disproportionately large. The settlement payments consume scarce cash that should be available to creditors generally. If the payments were in fact made, the Plan does not provide for a fair distribution to other creditors. Hence, the Proposed Settlement would unfairly discriminate and be unfair and inequitable – – the direct opposite of what is required by Section 1129(b).

C. The Proposed Settlement Should Be Rejected Because It Involves Impermissible Third-Party Releases.

38. Finally, the Proposed Settlement includes broad and largely undefined provisions for the release by "City Releasors" of, and injunction against claims by "all persons" against, the Swap Counterparties and their affiliates. Motion at ¶ 40 ("Releases and Bar Order"). This would appear to impact the rights of nondebtor entities; namely the Service Corporations, the Funding Trust, the COPs holders and insurers.

39. The third-party releases and bar order required by the Proposed Settlement could not be coerced under a Plan. *In re Dow Corning Corporation*, 280 F.3d 648, 658 (6th Cir. 2002) is the controlling authority in the Sixth Circuit regarding non-consensual third-party releases as part of a plan. *Dow Corning* requires the satisfaction of all of the following seven factors: (1) there is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) the non-debtor has contributed substantial assets to the reorganization; (3) the injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free of indirect suits against parties who would have indemnity or contribution claims against the

debtor; (4) the impacted class, or classes, has overwhelmingly voted to accept the plan; (5) the Plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) the Plan provides an opportunity for those claimants who choose not to settle to recover in full; and (7) the bankruptcy court made a record of specific factual findings that support its conclusions. *Dow Corning*, 280 F.3d at 658.

40. It is clear that the proposed settlement could not satisfy factors (1) through (6). "Even if a settlement is fair and equitable to the parties to the settlement, approval is not appropriate if the rights of others who are not parties to the settlement will be unduly prejudiced." *Walsh v. Hefren-Tillotson, Inc. (In re Devon Capital Mgmt., Inc.),* 261 B.R. 619, 623 (Bankr. W.D. Pa. 2001) (approving settlement agreement only after it was modified to avoid prejudice to third parties). Ignoring the effect of a settlement on rights of third parties "contravenes a basic notion of fairness." *AWECO*, 725 F.2d at 298 (holding that bankruptcy court abused discretion in approving settlement without considering fairness of settlement agreement to third parties); *In re Sportstuff, Inc.*, 430 B.R. 170, 177 (8th Cir. BAP 2010) (holding proposed settlement that dispossessed vendors which were not parties to the settlement from bringing bad faith claims against insurers was not fair and equitable because it improperly impaired significant rights of third parties without compensation or consent); *Rafool v. The Goldfarb Corp. (In re Fleming Packaging Corp.)*, No. 04-8166, 2007 WL 4556981 (Bankr. C.D. Ill., Dec. 20, 2007) (rejecting settlement agreement that prejudiced third parties). Once again, this Court should not permit the Debtor to proceed by a separate motion and settlement to avoid the limitations of confirmation of a plan.

CONCLUSION

WHEREFORE, for the reasons set forth above, Objectors respectfully request that the Court deny the Motion and grant such other and further relief as may be just and proper.

Dated: March 17, 2014

Respectfully submitted,

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UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

IN RE: CITY OF DETROIT, MICHIGAN,	.	Docket No. 13-53846
	.	Detroit, Michigan
	.	January 16, 2014
Debtor.	.	2:00 p.m.

. . . .

BENCH OPINION
BEFORE THE HONORABLE STEVEN W. RHODES
UNITED STATES BANKRUPTCY COURT JUDGE

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Proceedings recorded by electronic sound recording, transcript produced by transcription service.

THE CLERK: All rise. Court is in session. Please be seated. Case Number 13-53846, City of Detroit, Michigan.

THE COURT: Counsel, may I ask you to put your appearances on the record at the lectern, please?

MS. BALL: Good afternoon, your Honor. Corinne Ball, Jones Day, for the City of Detroit.

MR. SHUMAKER: Good afternoon, your Honor. Greg Shumaker of Jones Day for the City of Detroit.

MR. HERTZBERG: Robert Hertzberg, Pepper Hamilton, City of Detroit.

MS. ENGLISH: Good afternoon, your Honor. Caroline Turner English from Arent Fox for Ambac.

MR. ARNAULT: Good afternoon, your Honor. Bill Arnault from Kirkland & Ellis on behalf of Syncora.

MR. MARRIOTT: Good afternoon, your Honor. Vince Marriott, Ballard Spahr, on behalf of EEPK and affiliates.

MR. GORDON: Good afternoon, your Honor. Robert Gordon and Jennifer Green, Clark Hill, on behalf of the Detroit Retirement Systems.

MR. JAMES: Good afternoon, your Honor. Mark James of Williams, Williams, Ratter & Plunkett on behalf of Financial Guaranty Insurance Company.

MR. GOLDBERG: Good afternoon, your Honor. Jerome Goldberg on behalf of interested party, David Sole.

MR. CLARK: Your Honor, Jared Clark, Bingham

McCutchen, UBS AG.

MR. PLECHA: Good afternoon, your Honor. Ryan Plecha from Lippitt O'Keefe on behalf of the retiree association parties.

THE COURT: Anyone here on behalf of Bank of America Merrill Lynch?

MR. WATSON: Good afternoon, your Honor. Scott Watson, Warner, Norcross & Judd, on behalf of UBS and Bank of America Merrill Lynch.

THE COURT: Okay. Thank you, sir. Is there anyone on the phone that would like to place an appearance on the record?

MR. FRIMMER: Your Honor, this is Rick Frimmer from Schiff Hardin on behalf of FMS.

THE COURT: Did we get that? Okay. This matter is before the Court on two motions. The first is the motion to approve the city's assumption of its optional termination agreement -- forbearance agreement and optional termination agreement with the swap counterparties. This was negotiated in large part pre-petition and then amended post-petition. The second matter that's before the Court is a motion to approve the city's request for certain post-petition financing. The Court will address that first motion first.

The motion is a bit of a hybrid motion in that it is a motion to assume an executory contract and also to approve a settlement under Rule 9019. Of course, the motion to approve the assumption is to be adjudged under Section 365 of the Bankruptcy Code. It's unnecessary to linger over the -- whether the standards of Section 365 apply or Rule 9019 applies. The Court concludes it's the same business judgment test regardless. It is appropriate, therefore, to consider the following factors upon which the Court notes the parties appear to agree. The first is the likelihood of the success of any potential litigation that might result if the settlement is denied. The second is the complexity, expense, and delay of such litigation. The third is any collection issues that appear, and the fourth involves the interests of the city's creditors and its residents.

The parties have cited to the Court several cases that describe in more detail the Court's obligation when approval of a settlement is requested. In particular, those authorities cited by Ms. English, Ambac's attorney, appear to concisely state what the Court's burden is, so, for example, the Sixth Circuit's decision in <u>In re. MQV, Inc.</u>, 477 Federal Appendix 310, 313, Sixth Circuit, 2012, is cited, quoted, "When determining whether to approve a proposed settlement, the bankruptcy court may not rubber stamp the agreement or merely rely on the trustee's word that the settlement is reasonable. <u>Reynolds</u> versus <u>Commissioner of Internal Revenue</u>, 861 F.2d 469, 473, Sixth Circuit, 1988. Rather, the bankruptcy court is charged with an affirmative obligation to apprise itself of the underlying facts and to make an independent judgment as to whether the compromise is fair and equitable," close quote.

In In re. Rankin, 438 Federal Appendix 420, 426, Sixth Circuit, 2011, the Court quoted at some length from the Supreme Court's decision in Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 1968. Quote, "There can be no informed and independent judgment as to whether a proposed compromise is fair and equitable until the bankruptcy judge has appraised -- apprised himself of all of the facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated. Further, the judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise. Basic to this process in every instance, of course, is the need to compare the terms of the compromise with the likely rewards of litigation."

In light of these authorities, the Court has undertaken the required inquiry. It has gone to some length to form an intelligent and objective opinion of the probabilities of the ultimate success of any proposed litigation that the city might undertake, and the Court will review that in a moment.

First, to review the proposed settlement in the forbearance and optional termination agreement, this agreement permits the termination of the swap agreements upon payment by the city of $165 million plus so-called breakage costs of $4.2 million. The counterparties agree to forbear from terminating the swaps and from trapping gaming revenues prior to the city's optional termination. The total termination liability on the swaps as of December 31st, 2013, was $247 million. The $165 million settlement amount represents approximately 67 percent of that amount. The termination liability, of course, is dependent upon interest rates, which have changed from time to time during the course of these proceedings and even, of course, since December 31st, 2013. Regardless, under the most recent settlement that the city asked the Court to approve, the settlement amount remains at this $165 million amount or $169.2 million amount. The agreement would allow the city continued access to the casino revenues of approximately $15 per month and permits it to unwind the swap contracts at this discounted price. It also obviously eliminates potential litigation between the city and the swap counterparties, UBS and Bank of America Merrill Lynch.

So the Court will now review the likelihood of success of any of the various claims that the city might make against the swap counterparties and those swap counterparties' various defenses in that litigation all in the event, of course, that this motion is denied.

Initially, the city might well claim that the swap counterparties' lien on the casino revenue pursuant to the 2009 collateral agreement is void under state law because the purpose for which the casino revenue was pledged is not a permissible purpose under MCL Section 432.212, the Michigan Gaming Control and Revenue Act. Under that Act, the permissible uses are, (i) The hiring, training, and deployment of street patrol officers; (ii) Neighborhood and downtown economic development programs designed to create local jobs; (iii) Public safety programs such as emergency medical services, fire department programs, and street lighting; (iv) Anti-gang and youth development programs; (v) Other programs that are designed to contribute to the improvement of the quality of life in the city; (vi) Relief to the taxpayers of the city from one or more taxes or fees imposed by the city; (vii) The costs of capital improvements; and, (viii) Road repairs and improvements.

The city might claim, therefore, that this statute does not permit gaming revenues to be used as security for a loan, especially as security for a loan that does not fit one of these permissible uses under the Gaming Act.

In defense to this claim, the swap counterparties might well argue that the pledge of the casino revenue here in this case was permissible under Subpart (v) of MCL Section 432.212 as a program designed to contribute to the improvement of the quality of life in the city and Subpart (vi) as relief to the taxpayers of the city from one or more taxes or fees imposed by the city. They would argue that this is evidenced by Detroit City Code Sections 18-16-1 through 4. These municipal code sections provide that the pledge was necessary because the city was in default on the swap agreement in January of 2009 and was facing the threat of a large termination payment. Moreover, Section 4(k) specifically provides that, one -- quote, "one, pledging the wagering tax property will improve the quality of life in the city beyond what it would be in the absence of such action; and, two, pledging the wagering tax property will increase" -- sorry -- "will reduce taxes levied or imposed by the city or to be levied or imposed by the city from what they would be in the absence of such action," close quote.

In addition to these City Council findings, the executive director of the Michigan Gaming Control Board stated in a 2009 letter to the city's outside gaming counsel that, "Upon review of this matter, I do not find any compliance issues at this time." Finally, in addition, the swap counterparties would point to an opinion letter from Lewis & Munday, a law firm retained by the city in 2009, stating that the pledge of the casino revenue, quote, "will constitute authorized purposes," close quote, under the Michigan Gaming and Control Act.

Now, to these responses by the swap counterparties, the city might respond that the connection between curing the default under the swap agreement in 2009 and improving the quality of life of the city -- of the citizens of Detroit is a tenuous connection. They would -- or the city would further argue that it is not at all clear that the legislative findings by the Detroit City Council or the opinion letters of the attorneys can validate the collateral agreement if it otherwise represents an impermissible use of the casino revenues under the Michigan Gaming and Control Act. In a second claim that the city might make, the city might argue that the casino revenue lien did not survive the filing of the bankruptcy petition, so under this claim, the city would argue that even if the swap counterparties' lien on the casino revenues is valid under state law, that lien does not survive the bankruptcy filing under Section 552(a) of the Bankruptcy Code because it is not a statutory lien and is not proceeds.

In response, the swap counterparties might argue that the collateral agreement did create a statutory lien in the casino revenue because it was created by the enactment of the City Council of Municipal Code Sections 18-16-1 through 7. In response to that argument by the swap counterparties, the city might respond that the City Council only enacted these sections to effectuate the terms of the collateral agreement to which the parties had already agreed. For example, Section 18-16-12 states, quote, "All obligations of the city under this ordinance and the definitive documents are contractual obligations," close quote.

The city would further argue here that even if the lien does survive -- or excuse me -- does not survive the filing of the petition under Section 552 -- I'm sorry. I have my party wrong here. The swap counterparties would argue that even if the lien does not survive the filing of the petition under Section 552, the lien would survive the filing of the bankruptcy petition under Section 928 of the Bankruptcy Code. That section provides, quote, "Notwithstanding section 552(a), special revenues acquired by the debtor after the commencement of this case shall remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case"; thus, the swap counterparties would argue that the lien may survive if the casino revenues constitute special revenues.

In response to that, the city would argue that the definition of "special revenues" in Section 902(2)(B) does not apply to casino revenues because casino revenues were not created specifically for the purpose of financing the collateral agreement. Special revenues, the city would note, include special excise taxes under Section 902(b)(2), but the casino revenues constitute general excise taxes.

The city would further argue that the Bankruptcy Code safe harbors for swap agreements in several sections of the Bankruptcy Code, including Section 362(b)(17) and Section 560, do not apply to either the swap agreement or to the 2009 collateral agreement. Thus, the city would argue that the swap counterparties may not trap the casino revenue during the pendency of the bankruptcy case. Section 362(b)(17) provides in pertinent part that the automatic stay does not operate as a stay of the exercise by a swap participant or a financial participant of any contractual right related to any swap agreement. Similarly, Section 560 provides in pertinent part that the exercise of any contractual right of any swap participant to cause the liquidation, termination, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title. The city would claim that these safe harbors do not apply, however, because the safe harbors only protect swap participants, as that term is defined in Section 101(53C), quote, "An entity that, at the time of the filing of the petition, has an outstanding swap agreement with the debtor," close quote. The city would claim that if the swap counterparties had a valid swap agreement with anyone, it was with the service corporations, not the city.

The swap counterparties would respond in defense to this claim that they were actually in an agreement with the city. The city controlled the service corporations, they would maintain, and remains responsible for any of the service corporations' obligations under the swap agreement and the collateral agreement.

The city would also claim that the swap harbors do not apply if the swap agreement and the collateral agreement are void ab initio; that is to say, from the beginning. The idea is here that if the agreements are void from the beginning, ab initio, under state law, they are simply not swap-related -- there are simply no swap-related contractual rights to enforce. Moreover, if the swap counterparties' alleged rights are avoided, it will be by operation of state law, not by any court proceeding under the Bankruptcy Code.

On the other hand, the swap counterparties would argue in defense that this argument by the city ignores the purpose of the safe harbors, which is to protect the nationwide derivatives markets from the bankruptcy of a single party. In response to that, the city would argue that the problem with this defense is a logic problem. They would ask how can the safe harbors protect contractual rights that do not exist under state law? While a distinction must be drawn or may be drawn between void and voidable agreements, the city argues that it has litigable claims that the swap agreement and the collateral agreement are void and have been from the outset.

Of course, the advantageous result to the city and the reason to pursue this claim is that if its claim to invalidate the collateral agreement is sustained, it would free up the gaming revenue for use in providing city services and also perhaps to allow this property -- these revenue -- these gaming revenues to serve as collateral for loans.

In the absence of the settlement, the city might also pursue a potential claim challenging the underlying swap agreements themselves. The city would argue that the swaps themselves are invalid because the city did not comply with the Revised Municipal Finance Act called Act 34, MCL Section 141.2101 and following. Specifically, MCL Section 141.2317, which governs swap transactions entered into by municipalities, requires either (a) that the interest under the agreement constitutes a limited tax full faith and credit pledge from the general funds of the municipality or (b) subject to any existing contracts, the interest under the agreement shall be payable from any available money or revenue sources, including revenues that shall be specified in the agreement, securing the municipal security in connection with which the agreement is entered into. And the city would contend that neither of those conditions for a city to enter into a swap transaction were met here.

In response, the swap counterparties would assert that Act 34 does not apply because the swap agreements were between the swap counterparties and the service corporations, not the city. In response to that, the city might argue that the service corporations are a sham and should be disregarded, and they would also assert that the agreement between the city and the service corp. is itself a swap agreement as that term is broadly defined in the Bankruptcy Code.

In response -- in partial response to at least the argument that service corporations are a sham, the swap counterparties might argue the doctrine of in pari delicto or unclean hands may prevent the city from arguing that the service corporations should be disregarded. As noted, the city might also claim that the agreements between the service corporations and the city were themselves swap agreements covered by Act 34 but that the service contracts are themselves unenforceable because they, too, fail to comply with Act 34. The swap counterparties might argue that the city has powers under the Home Rule Act which could independently authorize the swap agreements, and, of course, the swap counterparties would certainly argue that the same safe harbor provisions of the Bankruptcy Code that the Court discussed earlier in connection with the city's challenge to the collateral agreement apply to protect the swap agreements themselves.

The city's challenge to invalidate the swap agreements has potentially very advantageous consequences for the city. If successful, not only would the city be released from any obligation to the swap counterparties, but the city might also recover the alleged $300 million that it has already paid to the swap counterparties. In response, of course, the swap counterparties might have an in pari delicto defense to that claim.

As we drill down further here, we find a question that the parties did not actually address, and that is what if the collateral agreement is found to be void under the Michigan Gaming Act or that it does not survive the bankruptcy filing under Sections 552 and 928 but that the swap agreement is enforceable? The question may become will the city then be able to treat the termination liability as an unsecured claim and impair it in the plan process, or will the safe harbor provisions require the city to pay the claim in full even though it's unsecured? It appears to the Court that it is more likely that Section 560 of the Bankruptcy Code does require the termination claim to be paid in full even if it is unsecured. This makes much higher, of course, the stakes of the city's claim that the swap agreements are void under Act 34.

There is also, as Mr. Goldberg argued, a potentially broader series of challenges to the swap agreements and the collateral agreement, for that matter, as well, that they were induced by fraud, are subject to equitable subordination, or that they were unconscionable. And, of course, the readily identifiable defense to these by the swap counterparties would be that the city was well-represented in these transactions, that these transactions were negotiated at arm's length, and that there was no fraud or coercion or undue influence or any wrongdoing on their part.

The Court must emphasize, having outlined these various claims and defenses, that it is not for the Court at this time to decide these issues, and that's true even though the depth of the parties' presentations on them were just about as if motions for summary judgment were before the Court. Rather, the Court is simply to evaluate the likelihood of success. The Court has carefully considered that question and has determined that the city is reasonably likely to succeed on its challenges to the collateral agreement under the Gaming Act and the Bankruptcy Code. The

Court further concludes that the city is reasonably likely to succeed on its challenge to the swap agreements under PA 34. As to the city's other potential claims, while they are certainly not frivolous, their likelihood of success is less apparent on the record before the Court at this time.

The Court will now review the other factors to be taken into account in determining whether to approve this settlement. Addressing the delay, complexity, and cost of the litigation, the Court must conclude, of course, that these are substantial considerations here. Certainly the issue of the validity of the trap of the casino revenues can be promptly resolved by this Court through summary judgment. It is less clear, of course, how quickly appeals would be resolved. The same can be said concerning the city's challenge to the swap agreements under Public Act 34. Any other challenges, however, that the city might pursue are very fact-intensive and would require substantial discovery, some perhaps even international in scope, and that litigation might take years if the city decides to pursue that. The expenses, especially the legal expenses, of filing a lawsuit challenging the collateral agreement and the underlying swap agreements, for filing a motion for a preliminary injunction, and for filing a motion for summary judgment on the legal issues involved in challenging these agreements would be undoubtedly substantial but, given the amount of money at stake, relatively insignificant.

Addressing now the issue of collectibility, the Court concludes that nothing in the record suggests that this is any issue here except that, as noted earlier, if the swap counterparties are unsecured and if their claims are not protected by Section 560 of the Bankruptcy Code, their termination fee may be subject to impairment through the plan of adjustment.

Addressing now the interest of the public and creditors, in weighing this factor, the Court considers the fact that the city is requesting the Court's approval to replace its old obligations under the swap agreements and the collateral agreement, which the city concedes as to which it has litigable claims against the enforcement of them, with new obligations that would be fully protected both by security interests and by court approval. The Court stated earlier and states again that it will not participate in or permit the city to perpetuate the very kinds of hasty and imprudent financial decision-making that led to the disastrous swaps and COPs transactions. Those practices have already caused great harm to the city's creditors and to its citizens. In the Court's view, one goal of this Chapter 9 case is to end these practices so that the city can truly recover from its past mistakes and move forward, and the Court intends to conduct itself accordingly. In case parenthetically this dicta needs any further clarification, let me state that the Court intends to carefully scrutinize the feasibility of any plan of adjustment.

At the same time, it is also true that the residents of the city have an interest in city leadership that focuses all of its attention on the city's future and its revitalization. This is, indeed, a very important consideration, as the Court has previously emphasized. And let there be no doubt that litigation can be very distracting, and the Court must also consider that several creditors have objected to this motion, and their views and the depth of their views are very important in the Court's analysis.

On balance, the Court concludes that the motion to assume the forbearance agreement should be denied. The Court rationally balances the city's claims against the swap parties with the swap parties' defenses to those claims, considers the complexity of the litigation and the expense and time of it and the interests of the city's residents and creditors. In so doing, it must conclude that the $169 million settlement to the swap counterparties is just too high a price to pay for the city to put this issue behind it. It is higher than the highest reasonable number. If it were close, the Court would approve it, but by any rational analysis, it's not close. The Court looked for every way it could to approve the settlement. As the city argued, the law prefers settlements. But it could not find a way. It's just too much money, and the Court must insist that any settlement be rational, as the law itself requires. In its eligibility opinion, the Court found that the city had entered into a series of bad deals to solve its financial problems. The law says that when the city filed this bankruptcy, that must stop. It also says that this Court must be the one to stop it, if necessary. It is necessary here. Accordingly, the motion is denied. In these circumstances, it is unnecessary to address the consent rights issue.

Turning now to the motion for post-petition financing, 11 U.S.C., Section 364(c), provides, "If a trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt - (1) with priority over any or all administrative expenses of the kind specified in section 503(b) or section 507(b) of this title; (2) secured by a lien on property of the estate that is not otherwise subject to a lien." The city seeks to borrow $285 million from Barclay and to grant Barclay a lien in casino revenues, income tax revenues, utility tax revenues, and water and sewerage revenue. Of that amount, $165 million was proposed to go to the swap counterparties to settle that claim or those claims, and $120 million would go for quality of life improvements, which may include increase in police staffing, purchase of emergency vehicles, blight removal, and updating the city's technology resources. Because the motion to assume the forbearance agreement and settlement agreement is denied, the request for the loan to fund that settlement must be denied as well. However, the Court finds that the request for approval to borrow $120 million on a secured basis should be granted with conditions. Specifically, the Court finds that the city has established by a preponderance of the evidence that this loan is in the best interest of the city; that it needs the money; that the terms are market terms and the best available to the city; that they were negotiated in good faith; and that they were negotiated at arm's length. Indeed, the Court finds that there was no substantial contradictory evidence on these points.

The objecting parties raise these arguments: one, the city did not attempt to obtain an unsecured loan; two, the city did not provide the City Council with sufficient information to evaluate the loan and did not comply with the legal requirements for disclosure to the City Council; three, the city has not adequately explained the proposed use of the quality of life loan proceeds; and, four, this approval should await the plan confirmation process.

With respect to the first objection, the Court concludes that the city has adequately established that the unsecured credit would not have been available to the city. The objecting parties cite cases holding that the city was required to actually attempt to obtain unsecured credit and that the city did not do that here. The Court finds these cases unpersuasive because they impose a requirement that is simply not in the statutory language of Section 364(c). That section simply requires the Court to find that the debtor has established by a preponderance of the evidence that it is unable to obtain unsecured credit. There are, of course, many ways to prove that fact. Showing that the debtor actually attempted and failed to do that is only one way to prove it. In this case, the Court concludes that there was credible evidence that the city is unable to obtain unsecured credit. That evidence makes sense, in the Court's experience, and it was uncontradicted in the evidence. Accordingly, the Court finds that the city has established by a preponderance of the evidence that it is unable to obtain unsecured credit.

With respect to the second objection, Public Act 436, Sections 19(1) and (2), require the emergency manager to submit his proposed action to the City Council. The City Council then has a period of time to propose comparable or better terms for the action. Plainly, the adequacy of the disclosure to the City Council should be determined based on whether the disclosure by the emergency manager allowed the city to take advantage of its statutory opportunity to propose an alternative. Here the Court concludes that the disclosures that the city made to City Council, especially as they pertained to the proposed interest rates, were sufficient to permit it to evaluate the loan and for the City Council to go out into the marketplace to attempt to obtain an alternative. Accordingly, the Court concludes that there was substantial compliance with PA 436, and this objection is overruled.

It is next asserted that the city has not adequately explained the uses of the loan proceeds. In the Court's view, this objection overlaps with the question of the conditions that the Court has determined must be placed on the loan. The problem arises because the record is contradictory on what the proceeds of this loan would be used for. In recognition of the limitations on the use of gaming revenues under state law, some evidence suggests that the city will use the proceeds for, quote, "quality of life," close quote, purposes. Other evidence, however, suggests that the proceeds will simply be working capital. The city contends that even if gaming revenue is provided as security, the limitations of the Gaming Act do not apply because Section 364 authorizes this Court to approve the loan without regard for any state law limitations. The Court rejects this view of its authority under Section 364 and concludes that any offer of security for a loan under Section 364 must comply with state law unless, of course, Section 364 expressly provides otherwise. As the city points out, the Court can, under Section 364, give a senior or priming lien to existing liens which might be or would be in derogation of state law; however, nothing in Section 364 suggests that a Court can allow a municipality to use its property in violation of state law. The Court does conclude that offering gaming revenue as security for a loan would comply with the Gaming Control Act but only if the proceeds of the loan that are so secured are used as limited by state law. Accordingly, if this loan is secured by gaming revenues, the proceeds must be used for the purposes identified in the Gaming Act. The Court must caution the city here, however. While the Act does permit the use of gaming revenues to improve quality of life in the city, that authorization cannot be applied so broadly that it effectively eliminates the statutorily imposed limitations. Specifically, nothing in the Act authorizes proceeds to be used for working capital. To enforce this state statutory limitation, the Court will condition this approval on a process by which the city gives 14 days' written and filed notice of its intent to use the proceeds during which interested parties can object on the grounds that the proposed use is not consistent with the Gaming Act. The Court would then schedule a prompt hearing and promptly resolve the objection. Consistent with Section 904, however, the Court will not review any aspect of the use of the proceeds other than its compliance with the Gaming Act.

In the alternative, of course, subject to Barclays' approval, the city could use as security other property for this loan such as other revenue streams that carry with them no such restrictions under state law. In that event, the Court -- excuse me. In that event, the process that the Court outlined would not be necessary and would not be imposed.

The Court further cautions the city that if it does decide to pursue only the quality of life loan at this time, it may want to consider whether under state law it is necessary to present the revised loan to the City Council under PA 436 and to the Emergency Loan Board for its approval. This caution, however, is not intended to be a ruling on this issue.

Finally, the Court will overrule the objection that this loan should be approved only in the context of plan confirmation. The city has determined out of necessity to pursue this loan now. Section 364 of the Bankruptcy Code certainly permits the city to do that. Under Section 904 it is not for this Court to review the city's political and governmental decisions, which pursuing this loan plainly is. Accordingly, this objection is overruled.

Finally, the Court must emphasize that the parties should not interpret this Court's denial of this particular settlement to mean that they should not continue to attempt to resolve these issues through negotiations. They absolutely should. The Court agrees that the settlement of the swaps claims is better for everyone than litigation and hopes that everyone still agrees with that. If the city feels the need to pursue immediate litigation, so be it, but even so, litigation and negotiation can and should be pursued at the same time. In any event, the Court strongly encourages the parties to continue to negotiate.

At this time, the Court is going to conduct a closed conference with counsel, and so I'm going to ask everyone in the courtroom who is not an attorney in the case to leave the courtroom. We're also going to shut down the closed circuit feeds and turn off CourtCall.

(Proceedings concluded at 2:49 p.m.)

INDEX

WITNESSES:

None

EXHIBITS:

None

I certify that the foregoing is a correct transcript from the sound recording of the proceedings in the above-entitled matter.

/s/ Lois Garrett   January 18, 2014

Lois Garrett