



An Answer to the Question:

What is Feasibility in Chapter 9?



The following has been said about feasibility:

“What is merely unclear in chapter 11 is an impenetrable fog in chapter 9.”¹

Feasibility is a confirmation requirement for both chapter 11 and chapter 9 of the US Bankruptcy Code, but nowhere in the Code is the term defined. Until Judge Rhodes provided an oral summary of his opinion in the City of Detroit Bankruptcy,² there had been little in the way of authoritative writing on the matter and chapter 9 cases where feasibility played a central role were few. When Judge Rhodes issued his Supplemental Opinion regarding Plan Confirmation, Approving Settlements and Approving Exit Financing on December 31, 2014,³ he expanded his oral findings and provided some insight into his reasoning. Prior to Detroit’s confirmation, most chapter 9 cases involved special purpose municipal districts, very small cities or narrow issues, and often lacked the general public interest that Detroit did and does. The most referenced case law concerning chapter 9 feasibility was contained in the Mount Carbon decision which ruled the Plan of Adjustment (POA) was not feasible, on its face, because it was not based on a reasonable set of projections.⁴ Arguably, not particularly helpful in establishing what constitutes feasibility in the affirmative.

Feasibility Concepts for Detroit and Beyond

One of the myriad of novel issues addressed during the Detroit Bankruptcy is how the feasibility test would be applied absent any authoritative case law. While most restructuring professionals have wrestled with the concept of feasibility in chapter 11, few have dealt with the issue in chapter 9. Much like Justice Potter Stewart’s approach to pornography, “I know it when I see it...,” most experienced restructuring professionals have at least an intuitive sense of how to interpret feasibility in a commercial setting, but have given scant thought to how to apply the feasibility requirement to a city attempting to emerge from bankruptcy.

The fundamental purpose of a municipality was among the first issues to consider. Municipalities are mission based enterprises; they do not exist to generate a profit but rather to fulfill a mission. In the case of a city in chapter 9, its purpose is to provide public services to its citizens and visitors. In Judge Rhodes’ ruling regarding Detroit’s eligibility for chapter 9, he found that the City was “service delivery insolvent;”⁵ that is, Detroit was unable to provide a basic level of municipal services to its citizens. Essentially, this ruling found that not only was the City unable to pay its bills, i.e. fiscally insolvent, it was also broken to its very core, rendering it unable to fulfill its mission.

¹ *Who Bears the Cost? The Necessity of Taxpayer Participation in Chapter 9* by C. Scott Pryor.

² www.mieb.uscourts.gov/news/oral-opinion-record-re-city-detroit-bankruptcy-judge-steven-rhodes-november-7-2014

³ www.kccllc.net/detroit Docket #8993

⁴ *In re Mount Carbon*, 242 B.R. at 36

⁵ www.kccllc.net/Detroit Docket #1945

Additionally, the timeline of existence and potential alternatives to reorganization are also very different in chapter 9. Cities are designed to exist in perpetuity. Restructuring professionals tend to view companies this way as well, but ultimately we know that there are alternatives, including liquidation or selling the company. Because a city really has few options but to survive, it must be put on a path to sustainability.

Given that a municipality must exist in perpetuity, a chapter 9 feasibility assessment is complicated by the question of what is an appropriate time frame. Again, history provides little guidance: forever is too long but how long is reasonable? The time frame for a feasibility assessment is complicated by the fundamental issue that municipalities are creatures of the democratic system. As such, they are greatly impacted by election cycles. While it may be evident who will lead a city's restructuring in the near term, this timeframe is likely limited to the next election, typically less than 4 years. Given these issues, the accuracy of forecasts that extend 10, 20 or 30 years into the future, and the length of time over which POA commitments may be made, determining the measurement period for feasibility is challenging.

These and many other issues impacted how we and others would evaluate the feasibility of Detroit's POA. Ultimately Judge Rhodes, in the Detroit case, determined that he would appoint an expert to evaluate and provide guidance on the issue of feasibility. This is where our extensive thought on the question of chapter 9 feasibility began.

The Standard

Within the first week of our engagement, we began to challenge our team on the definition of feasibility. Our initial team meeting highlighted that we were all of the Justice Stewart mindset in that "we would know (feasibility) when we saw it". It was also clear that in order to fulfill the independent aspect of the assignment, the standard would need to be developed in the abstract before we understood what the fact gathering and analysis would indicate. After an intensive period of conversation, thought and research, we developed the following Standard:

*Is it likely that the City of Detroit, after the confirmation of the Plan of Adjustment, will be able to sustainably provide basic municipal services to the citizens of Detroit and to meet the obligations contemplated in the Plan without the significant probability of a default?*⁶

⁶ M. Kopacz Expert Report of July 18, 2014 at www.detroitmi.gov./emergencymanager/bankruptcychapter9

Two Prongs to the Feasibility Standard

To find a plan feasible we determined that both *qualitative* and *quantitative* measurements are required. We found that implicit within this Standard are many questions, including the following:

- *Are the projections contained in the POA mathematically correct and materially reasonable?*
- *Are the assumptions that the City has used to develop its projections individually, and when taken as a group, reasonable?*
- *Is there an adequate contingency included in the projections?*
- *Does the City have the human resources, or can it likely recruit the human resources, required to meet its obligation under the POA?*
- *Does the City have the appropriate systems and procedures to monitor its financial performance and to provide early warning signs of variances in performance that might cause the City to fall short of the projections and be unable to meet its obligations under the POA?*
- *Are there appropriate structures to ensure the City's compliance with the POA and with reasonable government standards of operation?*
- *Will the City be able to reasonably deliver a minimum level of municipal services?*
- *Is the City's trajectory sustainable?*

Feasibility Time Frame

In Detroit, there was pressure to use a finite, and short, time frame for the evaluation of feasibility. After many discussions, we based our Standard on an indeterminate time period. We determined that the question of time frame for feasibility was more closely tied to the risks we identified in the POA and the risks that were germane to the City's operations. We were mindful that potential risks should be viewed both in terms of their total potential impact and the time horizon over which the impact may occur. That is, as the time horizon expands so does the magnitude of the potential risk need to increase in order for a risk to threaten feasibility. For example, a \$25 million risk in year 20 is not equal to a \$25 million risk in year 1, but a \$300 million risk in year 30 might be more significant than a \$30 million risk in year 5.

Risks and Guarantees

How much risk can be accepted and allow a plan to remain feasible? Mount Carbon established that unrealistically favorable assumptions will cause the debtor to fail the feasibility test. On the other hand, we would argue that a plan with low levels of risk is "so feasible" as to most likely fail the best interests test in chapter 9. If a proposed plan of adjustment is essentially guaranteed, unless all creditors are paid in full, creditors will likely claim that more money could have been provided for distribution. That is, a little more risk could be accepted into the plan in exchange for greater recoveries by creditors. Therefore, the Standard for assessing feasibility must balance the commitments in the POA with the inherent risks and cover a spectrum of possibilities.

Practical Considerations

On the qualitative side, we found that the issue of leadership and the electoral process presents challenges to the question of feasibility. We could only evaluate the skill and will of the current elected officials. We could not speculate, for better or worse, about the capabilities of the next group of elected leaders. Of course, the Court or other stakeholders can insist on certain levels of oversight or control that would extend years into the future. Ultimately though, we have to trust the democratic process and the electorate to demonstrate wisdom when selecting leaders who will be committed to keeping the city on a path toward sustained fiscal and service delivery solvency.

Feasibility Assessment Questions

The assessment questions we developed are intended to address both prongs of the Standard. They are general enough to provide a framework for future chapter 9 cases and are intended to insure that feasibility is assessed in a holistic manner. An appropriate balance between the hard numbers and subjective factors is the goal. To that end, following are some thoughts on the questions to ask and answer that underpin the Standard. Note that the questions delve into areas that, in all likelihood, were a source of the failure that caused the insolvency.

Are the projections materially correct and the assumptions used to develop them individually and collectively reasonable?

Restructuring professionals know that there are different ways to model projections and different ways to look at assumptions. However, the modeling technique needs to be credible and replicable. The math needs to be materially accurate and the assumptions need to be reasonable, individually and when taken as a whole. Care needs to be shown if assumptions are at the aggressive end of a reasonable range, that when aggregated, these assumptions do not collectively produce a projection with little room for error. Corroborating data from third parties can be a help in this regard. Benchmarking comparable municipalities, understanding how the future may vary from the historical, and looking for similar metrics in the private sector can be helpful in evaluating and critiquing the projections.

Does the City have the human resources, or can it likely recruit the human resources, required to execute the POA?

Plans may be designed by restructuring professionals but they are executed by leaders and individuals left behind when the professionals depart. In order to be feasible, a POA needs to take into account what resources are available and whether these resources are sufficient to execute the plan. CEO-level and C-suite level talent is the most important for a city exiting chapter 9. We determined that every resource did not need to be in place, but rather, there must be a concrete plan to obtain and pay the necessary human capital to execute the plan. Having strong leaders in the financial functions, public safety and other areas of particular emphasis, may be so critical that without them, feasibility is threatened.

Does the City have the appropriate systems and procedures to monitor its financial performance and to make appropriate adjustments if it falls short of the projections?

Like human resources, a municipality needs to have, or be able to obtain and pay for, the information systems and financial reporting infrastructure to ensure proper compliance with, execution of and early warning signals for financial and operational activities. Although current systems may be deplorable, a plan for new systems, and interim “workaround” processes could provide reasonable assurances that a city can achieve a full recovery. What we do know is that, unequivocally, the actual results in the future will not match the projections. Some results may be better and some may be worse and plans will need to be revised throughout the life of the POA. Having the tools that allow the elected officials and government leaders to understand what is working and not, is the first step in making the adjustments that will make the Plan successful in the long run.

Are there appropriate structures to ensure the City’s compliance with the POA and with reasonable government standards of operation?

To overcome concerns regarding the future democratic process, we determined that appropriate oversight structures would be required. In Detroit’s case, the state of Michigan has established a Financial Review Commission⁷ to ensure that the City maintains its focus on the recovery and does not fall back into poor practices. In general, we believe a strong oversight mechanism with the ability to intervene and protect against a future failure of municipal leadership is the ideal. However, in this case the Financial Review Commission has the ability to provide a sufficient means of transparency and raise early warnings if the City falls off track.

⁷ Under the “Grand Bargain Legislation” that was integral to Detroit’s POA, Michigan enacted PA 181 of 2014 establishing a Financial Review Commission, to oversee the City’s fiscal activities including authority to approve the City’s 4-year financial plans, contracts over \$750,000, collective bargaining agreements and possibly pension funding obligations.

Will the City be able to reasonably deliver a minimum level of municipal services? Is the City's trajectory sustainable?

In chapter 11, a debtor is not able to exit bankruptcy if it is insolvent; this is a matter of settled law. As noted above, in Detroit, the City was service delivery insolvent. We struggled with whether service delivery insolvency had an analogous requirement in chapter 9: was Detroit required to be service delivery solvent in order for the POA to be feasible? We ultimately determined that if there was an achievable plan over a reasonable period of time, that the City would likely be able to deliver at least a minimum level of service. While we would all like to see a city become "good" or "great" operationally as the result of the restructuring, we concluded that adequately delivering on the mission was sufficient. Based on evidence of successful implementation of some operational improvements during our six month visit, we believed the trajectory appeared to be sustainable. The combination of a good plan and measurable success in the short term allowed us to find the plan was feasible.

The Feasibility Continuum

The last feasibility test feature we pondered was: is feasibility a binary test? In the end, we determined that there is no single data point that defines feasibility and that the reasonableness of the quantitative and qualitative components of the Standard can be viewed as a range of values. We fundamentally believe that 'reasonable' can exist along a continuum. Assumptions can be skewed towards conservative or aggressive and still remain along the reasonable continuum.

Our expert report on feasibility in the Detroit bankruptcy found that the POA was feasible. However, it did conclude that while the City's projections were on the 'continuum of reasonableness' little space remained on this continuum. The settlements required to achieve near consensus from the objecting creditors pushed the plan, and the related assumptions, to the far end of this continuum. This is not a criticism of the City of Detroit POA, or of the professionals and City officials who worked tirelessly to develop the plan; rather it is a genuine reflection of the reality of the balance between a feasible plan and one that is in the best interest of creditors. Judge Rhodes covered this concept in his Supplemental Opinion.

While the question “what is feasibility in chapter 9?” will be asked over and over, we are honored and humbled that the Standard we developed in Detroit was accepted by the Court. By changing the name of the entity in question, we believe that the Standard can be applied to a wide range of municipal insolvency and restructuring issues in the future.

“In conclusion, therefore, the Court finds that it is likely that the City of Detroit, after the confirmation of the plan of adjustment, will be able to sustainably provide basic municipal services to the citizens of Detroit and to meet the obligations contemplated in the Plan without the significant probability of a default. Accordingly, the Court finds that the City’s plan of adjustment is feasible.”⁸

Martha E. M. Kopacz

Senior Managing Director

Phoenix Management Services

T: 617.840.9155

E: MKopacz@phoenixmanagement.com

Brian Gleason

Senior Managing Director and Shareholder

Phoenix Management Services

T: 484.841.6807

E: Bgleason@phoenixmanagement.com

Phoenix Management Services

Philadelphia

110 Commons Court
Chadds Ford, PA 19317
T: 610.358.4700

Boston

10 Post Office Square
Suite 605 N
Boston, MA 02109
T: 617.600.3600

Florida

401 East Las Olas Blvd,
Suite 1400
Fort Lauderdale, FL 33301
T: 954.332.2405

Atlanta

3340 Peachtree Road NE
Tower Place, Suite 1800
Atlanta, GA 30326
T: 404.814.5285

Cleveland

The Crittenden Building
1382 West Ninth Street, Suite 310
Cleveland, OH 44113
T: 216.274.0522

New York

535 Fifth Avenue,
Suite 1006
New York, NY 10017
T: 646.490.8800

⁸ www.kccllc.net/Detroit Docket #8206