UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

In re	Chapter 9
CITY OF DETROIT, MICHIGAN,	Case No. 13-53846
Debtor.	Hon. Steven W. Rhodes
AMBAC ASSURANCE CORPORATION,	
Plaintiff,	Adv. Pro. No. 13-05310
v.	
THE CITY OF DETROIT, MICHIGAN, KEVYN D. ORR, in his official capacity as the EMERGENCY MANAGER, JOHN NAGLICK, in his official capacity as FINANCE DIRECTOR, MICHAEL JAMISON in his official capacity as DEPUTY FINANCE DIRECTOR, and CHERYL JOHNSON, in her official capacity as TREASURER,	
Defendants.	

REPLY TO AMBAC CORPORATION'S
OPPOSITION TO DEFENDANTS' MOTION TO DISMISS

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Page(s)

CASES

STATUTES

Despite providing nearly 60 pages of text in its Opposition,[1] Plaintiff Ambac Assurance Corporation ("Plaintiff" or "Ambac") provides no valid basis to avoid dismissal of its Amended Complaint. Indeed, as explained below, Ambac's Opposition only highlights that it seeks in this proceeding to evade fundamental principles of bankruptcy law. Plaintiff's Amended Complaint should be dismissed with prejudice.

ARGUMENT

I. THERE IS NO PRIVATE RIGHT OF ACTION UNDER THE REVISED MUNICIPAL FINANCE ACT

At the outset, Plaintiff lacks standing to maintain a private action against the City under the Revised Municipal Finance Act. Ambac argues that "[i]t is well settled that a plaintiff may seek declaratory relief regarding violation of a Michigan statute unless the statute expressly deprives such plaintiff of standing to seek relief." Opp. at 12 (citing *Miller v. Allstate Ins. Co.*, 751 N.W.2d 463, 468 (Mich. 2008)). But this is misleading. The *Miller* court did not announce a general rule that "allows a party to 'seek enforcement of the statute through a claim for . . . declaratory judgment.'" *Id*. Rather, the court was citing to its prior decision in *Lash v. City of Traverse City*, 735 N.W.2d 628 (Mich. 2007), in which it held that,

[1]At a hearing on February 10, 2014, counsel for the City erroneously stated that the City's reply brief is limited to 5 pages. Pursuant to this Court's Order Establishing Motion Procedure [Docket No. 283], "[n]otwithstanding LBR 9014-1(e), a reply brief filed by the City shall not exceed 30 pages."

with respect to the statute at issue in that case, the plaintiff could pursue a claim for a declaratory judgment. *Miller*, 751 N.W.2d at 468. Notably, the statute in question in *Lash*—the Residence of Public Employees Act—contains no enforcement mechanism whatsoever. Since the statute is silent as to enforcement, there was no bar to the court's finding of statutory standing to pursue a private claim for declaratory judgment. Here, by contrast, the RMFA establishes a comprehensive enforcement regime, and charges only one entity—the Department of Treasury—with responsibility for administering that regime.

Plaintiff's reliance on *Lansing Sch. Educ. Ass'n v. Lansing Bd. of Educ.*, 792 N.W.2d 686 (Mich. 2010), is likewise misplaced. The statute at issue required school boards to expel any student who physically assaulted a teacher or other school employee. MCL § 380.1311a. The statute did not specify who was responsible for compelling the school board to comply with this statutory obligation, nor did it prescribe any particular manner in which the statute's requirements were to be enforced. *Id*.[2] That the court found that plaintiffs had statutory standing to sue for a declaratory judgment under a statute that is silent as to its enforcement tells us nothing about whether a plaintiff has statutory standing

[2]Part 32 sets forth detailed penalties and enforcement mechanisms applicable to certain sections of the Revised School Code. *See* MCL §§ 380.1801-1816. None applies specifically to § 1311a of the Revised School Code.

to sue under a statute, such as the RMFA, whose enforcement is expressly and solely entrusted to a public agency.

It is for this reason that *Lansing* and *Lash* cannot be read to overrule longstanding Michigan jurisprudence holding that "where a statute creates a new right or imposes a new duty unknown to the common law and provides a comprehensive administrative or other enforcement mechanism or otherwise entrusts the responsibility for upholding the law to a public officer, a private right of action will not be inferred." *Northern Warehousing Inc. v. State*, 2006 Mich. App. LEXIS 2595, at *4-6 (Mich. Ct. App. Aug. 22, 2006) (quoting *Claire-Ann Co. v. Christenson & Christenson, Inc.*, 566 N.W.2d 4 (Mich. Ct. App. 1997). Moreover, such preclusion of a private right of action does not, as Plaintiff argues, merely bar claims for money damages. In *Northern Warehousing*, for example, the court found that where the statute created no private right of action, plaintiffs were not entitled to an injunction enforcing the statute. *Id.* at *15.

Claire-Ann and *Northern Warehousing*, which are both good law in Michigan, demonstrate that—contrary to Plaintiff's assertion—the District Court correctly decided *Garden City Educ. Ass'n v. Sch. Dist. of City of Garden City*, 2013 U.S. Dist. LEXIS 140353 (E.D. Mich. Sept. 30, 2013). That case involved an effort by teachers to enforce § 1249 of the Revised School Code, which addresses teacher evaluations. Unlike the section of the Revised School Code at issue in

Lansing, § 1249 is subject to a "comprehensive . . . enforcement mechanism," including "withholding of state funding" and oversight by the "governor's council on educator effectiveness." *Id*. Accordingly, the teachers could not obtain an injunction to enforce the statute.

Under the reasoning of *Claire-Ann*, *Northern Warehousing* and *Garden City*, there is no private right of action for any claim – including claims for declaratory judgment – under the sections of the RMFA that Plaintiff seeks to enforce. Even if it were only claims for injunctive relief that fell within the scope of those cases, Plaintiff's claims would nonetheless be barred here because—regardless of how artfully Plaintiff has pled those claims—it is clear that what it seeks is functionally an injunction. Plaintiff tries to skirt the obstacles it faces under Michigan law by claiming that it is merely requesting declaratory relief. If this were true, Plaintiff would be seeking essentially an advisory opinion, one that "confirm[s] [Defendants'] duties under state law," Am. Compl. ¶ 56, but does not have any value in compelling action based on those duties. Such an order would, of course, be of no use to Plaintiff. Thus, although Plaintiff disingenuously says that it does not seek payment "at this time," Am. Compl. at 47, n.4, it is undeniable that this is precisely why it brought this lawsuit. Ambac is seeking to compel action by the City. Plaintiff cannot change the essential nature of its claims by dressing them up as "merely" claims for declaratory judgment.

II. WHETHER PLAINTIFF IS SEEKING PURELY DECLARATORY RELIEF Or SOMETHING MORE, § 904 BARS ITS CLAIMS

A. Section 904 Bars Ambac's Claims For Declaratory Relief

Even if Ambac really were seeking nothing but declaratory relief, Section 904 bars this Court from exercising jurisdiction over its claims. The text of § 904 is broad and unequivocal: It applies "[n]otwithstanding any power of the court," and bars the Court from entering "any stay, order, or decree" that would interfere with the City's political or governmental powers or with its property or revenues. 11 U.S.C. § 904. This prohibition "is so comprehensive that it can only mean that a federal court can use no tool in its toolkit—no inherent authority power, no implied equitable power, no Bankruptcy Code § 105 power, no writ, no stay, no order—to interfere with a municipality regarding political or governmental powers, [or with its] property or revenues." *In re City of Stockton, Cal.*, 478 B.R. 8, 20 (Bankr. E.D. Cal. 2012).[3] As this Court has stated before, § 904 ensures that courts have "only enough jurisdiction to provide meaningful assistance to municipalities that require it, not to address the policy matters that such municipalities control." *In re Addison Cmty. Hosp. Auth.*, 175 B.R. 646, 649 (Bankr. E.D. Mich. 1994). To the extent that Plaintiff's claims are unsecured, the

[3]Plaintiff attempts to dismiss *Stockton* on the grounds that that decision involved only a request for injunctive relief. Opp. at 27. But Plaintiff notably makes no attempt at responding to *Stockton*'s in-depth consideration of § 904, in which the court traced the statute's historical development and reached the conclusion that "the § 904 limitation on the court's authority is absolute." 478 B.R. at 20.

declaratory judgment that Plaintiff seeks would require the Court to go much further than § 904 allows.

Plaintiff purports to have identified "unequivocal" precedent establishing that § 904 does not preclude declaratory relief. Opp. at 4. For this, Ambac offers but one decision, and the case does not say a single word about whether declaratory relief is somehow beyond the reach of § 904. *See* Opp. at 26 (discussing *In re Jefferson Cnty., Ala*., 482 B.R. 404 (Bankr. N.D. Ala. 2012)). Nor could the *Jefferson County* court have reached that issue, since the municipal debtor there had chosen to consent and admit to the court's jurisdiction over the action and had answered the plaintiffs' requests for declaratory relief on the merits, rather than raising section 904 as a bar to the court's authority to award such relief. *See* Jefferson County's Amended Answer, No. 12-00016 (Bankr. N.D. Ala. April 9, 2012), ECF No. 83. Given § 904's express exception for situations in which "the debtor consents" to the court's authority, the court in *Jefferson County* never had to decide whether the statute barred the plaintiffs' claims.

B. Section 904 Would Also Bar Any Order Compelling The City Either To Make Payments To Plaintiff Or To Cease Paying Other Expenses With Ad Valorem Tax Revenues

Even if § 904 did not preclude Plaintiff's request for declaratory relief, the parties agree that, at the very least, it bars the Court from entering an order compelling the City to make payments to UTGO or LTGO bondholders. Plaintiff

correctly acknowledges that section 904 would "present[] [an] obstacle" to such an order (Opp. at 26): "Coercively preserving a status quo that entails payment of money from the City treasury interferes with the City's choice to suspend such payments." *In re City of Stockton, Cal.*, 478 B.R. 8, 21 (Bankr. E.D. Cal. 2012); *see also, e.g., In re Cnty. of Orange*, 179 B.R. 195, 200 (Bankr. C.D. Cal. 1995) (order requiring County to pay professionals on an interim basis "would constitute interference with 'the property or revenues of the debtor.'"). This is true regardless of Plaintiff's flawed argument that the pertinent tax proceeds are property of the bondholders and not of the City, for those proceeds are certainly the City's "revenues" under § 904's protection of "any of the property or revenues of the debtor." *See, e.g., Stockton*, 478 B.R. at 21 ("The contents of the City treasury are 'property or revenues' within the meaning of § 904(2).").

Because even Plaintiff recognizes that an order *compelling* payments is out of the question, its hope seems to be that an order in its favor would effectively *prohibit* the City from using the proceeds of the extra millage with respect to the UTGO bonds (and apparently also the portion of the general levy otherwise allocable for the LTGO bonds) to pay any other expenses—hence Plaintiff's professed "hope[] that the City would not deliberately" disregard an order declaring its obligations with respect to these revenue amounts. Opp. at 28. But an order interfering with the City's operations by putting its revenues in limbo

would violate section 904 just as much as an order requiring the City to spend those revenues (whether to pay these bondholders or otherwise). In either case, the Court would be telling the City how to manage its finances. This would contravene section 904's unequivocal rule that "a debtor in chapter 9 retains title to, possession of, and complete control over its property and its operations, and is not restricted in its ability to sell, use, or lease its property." *In re Valley Health Sys.*, 429 B.R. 692, 714 (Bankr. C.D. Cal. 2010); *see also* 11 U.S.C. § 901 (excluding § 363 from incorporation into Chapter 9). Plaintiff's complaint is thus no mere request for clarification of rights, but an impermissible attempt to sidestep § 904.

Plaintiff's inability to direct the City in its use of its property or revenue does not mean that that use could not have any collateral consequences. Most obviously, and as the Court has discussed, it is possible that, if the City chooses not to pay the tax revenues at issue to Plaintiff—that is, if the City continues to treat Plaintiff's unsecured claims like those of every other unsecured creditor, consistent with the Bankruptcy Code—some may argue that it should, under Michigan law, lose the authority to collect the extra millage that its residents authorized under RMFA § 701 and the Unlimited Tax Election Act with respect to the UTGO bonds. But that issue is not Plaintiff's to dictate. Rather, the policy of Chapter 9 is to ensure that "state officials remain fully politically accountable to the citizens of the

state and municipality." *In re City of Detroit, Mich*., No. 13-br-53846, 2013 WL 6834647, -- B.R. -- (Bankr. E.D. Mich. Dec. 20, 2013); *see generally* 11 U.S.C. § 903(confirming that nothing in Chapter 9 "limit[s] or impair[s] the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality"). It is certainly not an issue presented to the Court by Plaintiff's complaint and appropriate for decision in this adversary proceeding.

III. PLAINTIFF DOES NOT HAVE A LIEN ON THE CITY'S *AD VALOREM* TAX REVENUE

A. Neither The Revised Municipal Finance Act Nor The Bond Resolutions Created A Lien

Relying mostly on its own allegations, Ambac argues that its claims are secured by a lien on tax revenue. Its main argument is the assertion that the Bonds are "double-barreled," which purportedly makes them "secured" under the Resolutions and Michigan law. *See* NPFG Opp. at 34 *et seq*.[4] But this is unfounded. Whether supported by the City's full faith and credit, an undertaking to pay the Bonds from *ad valorem* taxes, or both, the result is the same — the pledge set out in the Resolutions amounts only to an unsecured promise to pay the Bonds, either from general revenue or *ad valorem* taxes.

[4]Ambac has incorporated by reference the sections of the brief filed by plaintiffs National Public Finance Guarantee Corporation and Assured Guaranty Municipal Corp. in the accompanying Adv. Proc. 13-5309. *See* Opp. at 65.

Plaintiff does not seriously dispute that nothing in any Michigan statute or the Resolutions grants it an express lien in the tax revenues. Plaintiff argues instead that the *ad valorem* tax revenues are levied solely for the benefit of the Bondholders, and therefore, express language in the Resolutions granting a lien, or establishing priority, is not needed. *See* NPFG Opp. at 36-37. This argument cannot be correct. *All* of the bonds the City has issued are supported by the City's taxing authority, but this does not confer upon all bondholders a lien in the taxes the City ultimately levied. Indeed, the Resolutions do not specifically identify any particular tax revenues as collateral to support the Bonds, other than to set forth an unlimited tax promise. The Resolutions include no cash trap mechanism, for example, and the Bondholders are given no recourse against any of the *ad valorem* tax revenue. This is in contrast to the City's secured financings with respect to water and sewer bonds and bonds backed by distributable state aid, where bondholders have express liens in, and clear control over, certain designated revenues.

Plaintiff attempts to distinguish the example of the $8,700,000 General Obligation Bonds dated as of October 1, 2007 issued by the City of Central Falls, Rhode Island (the "Central Falls Bonds"), which Defendants' cited in their main brief. Plaintiff sees a distinction between the Central Falls Bonds and the Bonds here because Central Falls was "merely required to 'appropriate' sufficient funds

from its general tax levy to pay the [Central Falls Bonds]." *See* NPFG Opp. at 37. In fact, the Official Statement for the Central Falls Bonds provides that, to the extent that the general tax levy is insufficient to pay the city's bond obligations, the amount "shall nevertheless be added to the annual tax levy," and that "all taxable property in the City is subject to ad valorem taxation without limitation as to rate or amount" as needed to provide the needed funds. *See* Opp., Exh. 2. Thus, the Central Falls Bonds were no different from Plaintiff's "double barrel" Bonds, which the Rhode Island legislature determined were unsecured, making necessary passage of legislation granting bondholders an express lien.

Plaintiff repeats its references to the words "security" and "pledge" in the Resolutions, which it argues create, by collective implication, a lien against the *ad valorem* taxes. *See* NPFG Opp. at 41. This, of course, is a point the City dealt with in its opening brief. Although we pointed out there that Section 801 of the Resolutions does indeed provide for the discharge of the "lien of this Resolution for the benefit of" the Bonds upon the defeasance of the Bonds, Section 801 is the only provision of either the Resolutions or any relevant Michigan statute that uses the word "lien" at all. *See* MTD at 32. As we also stated before, Section 801 is in no way a granting clause and has no operative effect for purposes of granting the Bondholders a security interest.

Plaintiff cites *Kinder Morgan Mich., L.L.C. v. City of Jackson*, 744 N.W.2d 184, 191 (Mich. Ct. App. 2007), for the proposition that the phrase "pledge" means "the act of providing 'security for the repayment of debt.'" *See* NPFG Opp. at 43. But the cited passage from the case is dicta, and the *Kinder Morgan* court was not interpreting the statutes or Resolutions at issue here.

Plaintiff focuses as well upon the use of the words "pledge" and "security" in the Resolutions. However, those terms have multiple meanings, and in the absence of a legal granting clause, the use of these words alone does not rise to the level of granting a security interest. In fact, if the word "pledge" did automatically mean "security interest" or "lien," without the need for the technically and legally required granting clause, then every bond issued by the City would be secured in one revenue source or another, including the City's other general obligation bonds, which are backed by a "pledge" in the City's full faith and credit. This cannot be the correct result, nor would such an outcome be consistent with Plaintiff's "double barrel" argument, whereby it seeks to differentiate the Bonds from the City's other bonds. *See* NPFG Opp. at 40.

Plaintiff further asserts that the "statutes pursuant to which the Resolutions were issued make clear that the word 'pledge' was intended to … provide security for payment of the [Bonds] through a pledge of the special *ad valorem* taxes" and that Act 189, in particular, "unequivocally and unambiguously" makes this clear.

See NPFG Opp. at 42. No such clarity exists under the law. Act 189, as cited by Plaintiff, provides that an "Unlimited Tax Pledge" means "*an undertaking*" to "secure and pay a tax obligation from *ad valorem* taxes ...." The Unlimited Tax Pledge, therefore, is not the grant of a lien.

Plaintiff has no "charge against" any property of the City to secure payment of the Bonds. It has no possession of, or control over, the *ad valorem* taxes and has no recourse in respect thereof. Plaintiff has nothing more than a promise of the City to pay, which, like other pre-bankruptcy promises, become general unsecured claims in the chapter 9 case.

For all of these reasons, Plaintiff's attempts to create a definitional statutory lien cannot be credited. The relationship between the parties is contractual, and thus cannot give rise to a statutory lien pursuant to § 101(53) of the Bankruptcy Code. For the reasons already stated, the Resolutions do not constitute a "security agreement" under § 101(50). Thus, the Bondholders do not have a "security interest" in the ad valorem taxes pursuant to § 101(51).

B. The *Ad Valorem* Taxes Are Not Restricted Funds

Ambac wrongly asserts that the City has said that state law restrictions no longer apply after the filing of a bankruptcy case. *See* Opp., p. 32. This is untrue. Instead, the City maintains that state laws that conflict with the Bankruptcy Code's

distribution scheme are preempted when, as here, they purport to require preferential payment of a prepetition debt. *See* MTD at pp. 17-20.

The crux of Ambac's argument is a distinction it would draw between its claimed property interest in the *ad valorem* tax revenues and any impairment of the bonds it holds. Opp. at 33 ("The issue raised by the Amended Complaint is Bondholders' property interest, not impairment.") But this is hair-splitting at its worst, since the very property interest Plaintiff claims to have is the entitlement to be paid in full from the *ad valorem* tax revenues. Unless it had a lien on those revenues, Ambac has no right to payment from these taxes, and seeking a declaratory judgment that the City cannot use the *ad valorem* tax revenues for any purpose except to pay Plaintiff is simply an artful means to avoid impairment.

Ambac cites various cases for the proposition that state law "transfer restrictions" are enforceable in a bankruptcy case. But none of Plaintiff's cases upholds a state law restriction that requires the use of funds for the purpose of paying a different recovery on a particular unsecured debt than that which would result from the application of bankruptcy law. *See Integrated Solutions, Inc. v. Serv. Support Specialties, Inc.*, 124 F.3d 487 (3d. Cir. 1997) (extent of debtor's transferable interest in pre-judgment tort claims); *In re Parkview Hosp.*, 211 B.R. 619 (Bankr. N.D. Ohio 1997) (extent of debtor's interest in funds held in a

charitable trust); *In re Schauer*, 62 B.R. 526 (Bankr. D. Minn. 1986) (Chapter 7 debtor's interest in a farming co-op in which they participated).

Ambac advances two cases from the Ninth Circuit to support its argument that Act 34 creates an enforceable transfer restriction. *See In re Farmers Mkts., Inc.*, 792 F.2d 1400, 1403 (9th Cir 1986); *Artus v. Alaska Dep't of Labor, Emp't Sec. Div. (In re Anchorage Int'l Inn, Inc.)*, 718 F.2d 1446 (9th Cir. 1983). But there is a split between the circuits on this point, and both cases are contrary to Sixth Circuit law. *Compare In re Terwilliger's Catering Plus, Inc*., 911 F.2d 1168, 1173 (6th Cir. 1990) ("In a sense, all debt collection methods that purport to attach to a particular interest in property serve to limit a debtor's interest in the property. Nevertheless, many such interests are not effective to secure a debt in bankruptcy...."); *In re Pompeo*, 195 B.R. 43, 50-51 (Bankr. W.D. Pa. 1996) (applying *Terwilliger* to conclude that "merely labeling as a 'reserved property interest' what is, in effect as well as intent, an attempt by defendants to create a lien, will not avoid a conflict with the federal bankruptcy law").[5]

[5]Plaintiff also cites a series of inapposite cases addressing use restrictions for "special funds." *See* Opp. at 35 (citing *Matter of Sanitary Imp. Dist. No. 7 of Lancaster Cnty., Neb*., 96 B.R. 967, 972 (Bankr. D. Neb. 1989) (opinion expressly made no finding as to "restricted" status of fund at issue); *In re City of Vallejo, Cal.*, No. 08-26813-A-9, 2008 WL 4180008 (Bankr. E.D. Cal. Sept. 5, 2008) (examining only whether debtor was insolvent and thus eligible for Chapter 9); *In re City of Bernardino*, 499 B.R. 776 (Bankr. C.D. Cal. 2013) (same).

Plaintiffs' assertion that the City has taken inconsistent positions during this case also is mistaken. Opp. at 40-41. The issue arose in connection with the City's creation of a public lighting authority ("PLA"). *See* MCL § 123.1265. Creditors objected because the PLA's operations were funded by the PLA's annual receipt of $12.5 million in utility tax revenue from the City. *See* MCL § 141.1152(5). Among other things, the City argued that there was no impairment of creditors' rights because the statutory structure of the utility tax meant that creditors would have no claim upon the tax revenues in any event. *See* Opp. at 41.

There is no inconsistency. The utility tax in the PLA matter is dedicated to particular governmental functions and is not available for others. This kind of control over the City is permitted by § 903. That that section permits the State to control the exercise of the City's "political or governmental powers, including expenditures for such exercise" does not mean that a State may pass laws that would interfere with the Bankruptcy Code's distribution scheme. *See In re City of Stockton, Cal.*, 478 B.R. 8, 16 (Bankr. E.D. Cal. 2012) ("A state cannot rely on the § 903 reservation of state power to condition or to qualify, *i.e.* to "cherry pick," the application of the Bankruptcy Code provisions that apply in chapter 9 cases after such a case has been filed.... For example, it cannot immunize bond debt held by the state from impairment."); *In re Cnty. of Orange*, 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996) ("Reserving to bankruptcy law the setting of priorities in chapter 9

does not ... conflict with Code § 903 ...."). Section 903 was enacted to assure that the powers afforded to the Bankruptcy Court under Chapter 9 did not interfere with powers of States that were preserved to them under the Tenth Amendment. But nothing contained in the Tenth Amendment allows States to modify "uniform laws on the subject of bankruptcies" enacted by the federal government. U.S. Const, art. I, § 8. The two situations are not in conflict.[6]

IV. PLAINTIFF DOES NOT HAVE A PROPERTY INTEREST IN THE *AD VALOREM* TAX REVENUES, AND ITS "CONDUIT" AND "TRUST" THEORIES Do NOT CREATE ONE

Plaintiff's Amended Complaint raises the new theory that the City is a "mere conduit for the Restricted Bond Taxes," such that it lacks any property interest in the revenues from those taxes. Am. Compl. ¶ 92. Ambac's Opposition significantly expands on this by making the further argument that the City holds the tax revenues in trust for bondholders and, thus, must pay those revenues to the Bondholders, notwithstanding the City's obligations to other creditors. *See, e.g.*, Opp. at 49, 59-60. But both of these state-law-based theories are, at bottom, attempts at rewriting the Bankruptcy Code's priority scheme, and are preempted.

[6]Ambac's argument about the City's use of gaming revenue is equally irrelevant. Opp. at 36. The Michigan Gaming Control and Revenue Act, MCL § 432.201 *et seq.*, limits the budgetary uses to which certain wagering taxes may applied, but does nothing to conflict with the Bankruptcy Code's priorities for the payment of claims.

A. To The Extent That Plaintiff Seeks Special Priority For Its Unsecured Claims, The Bankruptcy Code Preempts State Law

Initially, the Bankruptcy Code preempts any state-law-based priorities that Plaintiff—as an unsecured creditor—could invoke. "[W]hile the nature and extent of the debtor's interest are determined by state law[,] 'once that determination is made, federal bankruptcy law dictates to what extent that interest is property of the estate.'" *In re Omegas Group*, 16 F.3d 1443, 1450 (6th Cir. 1994) (citation omitted).[7]

A decision from Orange County's bankruptcy is on point. *In re County of Orange*, 191 B.R. 1005, 1017 (Bankr. C.D. Cal. 1996). There, plaintiffs invoked a California statute to argue that, where trust funds have been commingled with non-trust funds, the result is not that the debtor controls all the funds, but rather that it controls none of them. *Id*. at 1016. The court rejected the argument. It ruled that if state law sought to impress a trust on all assets of the debtor to the extent of the amount owed to the beneficiary, that state law would conflict with federal bankruptcy law and thus was preempted. Ultimately, "[s]tate trust law must be applied in a manner consistent with federal bankruptcy policy." *Id*. at 1017.

[7]For this same reason, Ambac cannot argue that there is a constructive trust of any sort. The Sixth Circuit clearly stated in *Omegas* that "a creditor's claim of entitlement to a constructive trust is not an 'equitable interest' in the debtor's estate existing prepetition." *Omegas*, 16 F.3d at 1450. Although O*megas* was a chapter 11 case, the analysis is no different in chapter 9.

Plaintiff's trust and conduit theories contravene this bedrock principle. At bottom, Ambac seeks a declaration that the City must pay the additional millage to the Bondholders rather than using those revenues for other expenses. But as Defendants have explained, if the City were compelled to levy and collect taxes solely for the benefit of UTGO or LTGO bondholders, it could not use this revenue for other purposes, and the values available to the City or other creditors would be diminished. MTD at 6. To the extent Ambac seeks special privileges even if its claims are unsecured, it seeks to use state law to manipulate and supersede the federal bankruptcy scheme. If plaintiff truly is arguing that the Michigan statutory scheme requires that it be entitled to a recovery unavailable to other unsecured creditors, then that scheme is preempted.

A. The City Is Not a Mere Conduit

Ambac's conduit theory, too, fails on several levels. Plaintiff does not dispute the point in Defendants' main brief, that a conduit is an intermediary party who receives a transfer of someone else's monies, but does not gain actual dominion or control over the funds. *See* MTD at 21. Here, the City is the only entity empowered to assess and collect the taxes, and no bondholder could possibly itself assess or collect the taxes Plaintiff now claims. The tax revenues, in other words, are not someone else's money; the City could not be cut out of the flow of funds to leave a transaction directly between taxpayers and bondholders. For this

reason alone, the City is not merely a conduit. The City is "endow[ed] [] with public power, and charge[d] [] with [] public dut[ies] and obligation[s]…. [It is] not and cannot be regarded as … [a] mere conduit[] of connections between bondholders and taxpayers. *City & Cnty. of Dallas Levee Imp. Dist. v. Indus. Props. Corp.*, 89 F.2d 731, 733 (5th Cir. 1937).

The decisions Plaintiff cites do not contradict this principle. While Ambac likens the City variously to a distributor,[8] to a carrier that collects and processes payments on behalf of other carriers,[9] and to an internet service provider that has already been paid for its services in full but seeks to gain a double recovery,[10] none of those characterizations is apposite to a municipality endowed with the power to levy and collect taxes. Moreover, many of the decisions that Plaintiff invokes are

---

[8] *See In re Computrex*, 403 F.3d 807 (6th Cir. 2005) (debtor who merely handled administrative job of processing invoices and cutting checks was a conduit); *In re Tap, Inc*., 52 B.R. 271 (Bankr. D. Mass. 1985) (debtor whose sole business it was to handle payroll and data processing was a conduit); *In re Joliet-Will Cnty. Cmty. Action Agency*, 847 F.2d 430 (7th Cir. 1988) (debtor community agency who received grants and other state and federal funds solely to pass directly on to intended need recipients was an agent); *In re West Central Hous. Dev. Org.*, 338 B.R. 482 (Bankr. D. Co. 2005) (debtor subrecipient of federal grants for certain type of loans for individuals lacked equitable interest in loan assets).

[9] *See In re Ann Arbor R.R. Co*., 623 F.2d 480 (6th Cir. 1980) (railroad carrier who collected freight revenues earned by interline railroads collected such amount in trust); *Parker Motor Freight, Inc. v. Fifth Third Bank*, 116 F.3d 1137 (6th Cir. 1997) (finding transportation and freight charges, when collected by one carrier on behalf of another for services performed, holds such amounts in trust).

[10] *See In re CMC Telecom, Inc*., 383 B.R. 52 (Bankr. E.D. Mich. 2008); *In re LAN Tamers, Inc.*, 329 F.3d 204 (1st Cir. 2003).

based on an analysis of property rights under § 541 of the Bankruptcy Code, which does not apply to a Chapter 9 debtor. *See* 11 U.S.C. § 901(a). The City obviously is not a "mere conduit."

B. The *Ad Valorem* Tax Revenues Are Not Held in Trust for the Bondholders

Plaintiff offers an additional theory that the City merely holds the additional millage revenue in trust for the benefit of the Bondholders. Like the conduit theory, Ambac's new argument must be rejected.[11]

No trust owns any of the City's property tax revenues. "Under Michigan law, the creation of a trust depends on intent and the existence of the required elements." *In re E. Paving Co.*, 293 B.R. 704, 708 (Bankr. E.D. Mich. 2003); *see also, e.g., Perry v. Bankston*, 1997 Mich. App. Lexis 1598, at *6 (Mich. Ct. App. 1997) ("Whether or not a trust was created must depend upon the intention of the [settlor] in providing for the disposition of the [property] in the manner which he instructed and whether the necessary requisites to the creation of a trust were observed.") (citation omitted). The required elements of an express trust are "(1) the existence of a clearly defined res; (2) an unambiguous trust relationship; and (3) specific affirmative duties undertaken by the trustee." *In re E. Paving*, 293

[11]In addition to its other flaws, Plaintiff's argument also is inconsistent with its assertion that it has a lien on the tax revenues.

B.R. at 708 (citation omitted). Here, Plaintiff fails at least at the second element, and the authority it cites fails to support its position.

1. There Was No Intent to Create a Trust, Nor Was An Unambiguous Trust Relationship Established

Michigan law is clear: "[a] sufficient declaration of trust is essential to the creation of an express or voluntary trust … It must express the intention to create a trust." *Fun 'N Sun RV v. State (In re Certified Question)*, 527 N.W.2d 468, 479 n.31 (Mich. 1994) (citation omitted).[12] Here, the City never manifested an intention to establish a trust for the benefit of the Bondholders. Although Michigan law regulates in detail how municipalities should handle tax revenues in repaying bonds, Plaintiff can point to no provision of Michigan law that unmistakably indicates an intent to establish a trust in favor of the Bondholders. This silence is particularly telling since other provisions of the RMFA, not at issue here, explicitly *do* indicate the legislature's intention to create trusts if, when, and where it wanted them. Section 518, for instance, addresses the issuance of a municipal security to pay the costs of unfunded accrued health care liability. In

[12]Indeed, the 1982 State of Michigan Attorney General Opinion cited to by Plaintiff's Opposition only bolsters the argument that, while the levy, treatment, and use of *ad valorem* taxes is indeed highly regulated and controlled, it has absolutely nothing to do with a trust. Rather than establishing that taxes are held in a trust fund for the benefit of bondholders, the opinion clarifies that, in large part, the purpose of this regulatory structure is to protect taxpayers. Nowhere does the opinion—or for that matter, the Municipal Finance Act, upon which the opinion is based—suggest that the legislature intended the creation of a trust.

contrast to the sections governing the Bonds, it explicitly provides that the proceeds of such a security "shall be deposited in *a health care trust fund*, *a trust created by the issuer which has as its beneficiary a health care trust fund*, or, for a county, city, village, or township, *a restricted fund within a trust*." RMFA § 518(6) (emphasis added). That same section goes on to detail the requirements that a trust created under that section must comply with, including reports on its financial condition and tax-exempt status. *Id*. If the Legislature had intended the Debt Retirement Funds to be trusts, it knew how to make this clear. *Cf. White v. Burlington N. & Santa Fe Ry*., 364 F.3d 789 (6th Cir. 2004) ("[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.") (internal citation omitted). The fact that it chose not to do so confirms that there is no trust in the tax revenues at issue here.

Nor do provisions that purport to limit the City's use of funds to a particular purpose give rise to a trust. "The fact that the money deposited in the account was intended to be used for a specific purpose … does not make it a trust fund … ." *Portage Aluminum Co. v. Kentwood Nat'l Bank*, 307 N.W.2d 761, 764 (Mich. Ct. App. 1981); *see also Goodenough v. Union Guardian Trust Co*., 267 N.W. 772,

774 (Mich. 1936) (same). In the absence of an expressed intent to create a trust, no trust exists.

2. The Authority Ambac Relies Upon is Inapposite

Because no trust has been created under Michigan law, the cases cited by Plaintiff are inapplicable. Indeed, virtually all of the cases are distinguishable on the grounds that they concern the treatment of an already-existing corpus in a trust. *See* Opp. at 44-46. Notably, Plaintiff is unable to point to a single controlling opinion from a Michigan court that supports its trust theory. Plaintiff cites only one decision, *Sawicki v. City of Harper Woods*, 118 N.W.2d 293 (Mich. 1962), that even involved tax proceeds used to finance debt service on bonds. But what Plaintiff fails to note is that the language and reasoning it relies on from *Sawicki* comes from Chief Justice Carr's *dissenting* opinion. Justice Souris's opinion for the majority relied on the plain language of the pertinent statute—and not any notion of trusts—in determining that the record was unclear as to whether the plaintiff taxpayers were entitled to a refund of excessive assessments. Moreover, even if the trust theory had carried the day in *Sawicki*, that decision has never been cited in the 50 years since its publication, except for one historical reference in a subsequent proceeding in the same case.

Plaintiff's reliance on *Grand Rapids Public Schools v. City of Grand Rapids*, 146 Mich. App. 652 (1985) is equally misplaced. The court made no finding that a

trust existed. Rather, the case simply stands for the general rule that interest on public funds follows the principal; it involved the allocation of funds between a city and a public school district within the city's jurisdiction. In short, Ambac has done little more than collect a handful of Michigan decisions that contain the word "trust" somewhere near a mention of "public funds." None of these decisions supports Plaintiff's theory that a trust exists here.

V. PLAINTIFF'S CLAIMS WITH RESPECT TO THE LIMITED TAX OBLIGATION BONDS ARE UNTENABLE

Ambac erroneously asserts that "the Limited Tax Bonds share virtually all of the attributes of and protections afforded the Unlimited Tax Bonds." Opp. at 62. Yet Plaintiff's claim that the LTGOs are secured by liens is even less tenable than its claim that the UTGOs are secured. Unlike the UTGOs, the LTGOs are not subject to a promise by the City to raise taxes without limitation as to rate or amount in order to pay them; rather, the LTGOs are – as their name implies – a limited obligation.[13] Outside of bankruptcy, § 701 of the RMFA merely provides that LTGOs are to be paid as a "first budget obligation." MCL § 141.2701.

[13]Curiously, Plaintiff suggests that LTGOs actually have a superior position to the UTGOs. Whereas Plaintiff argues only that UTGOs hold a lien on certain ad valorem taxes approved by voters for the purpose of paying them, Plaintiff claims that LTGOs have a lien on all of the ad valorem taxes collected by the City. Opp. at 63-64. Thus, Plaintiff suggests, it is better to have a claim on limited taxes than on unlimited ones.

This "first budget obligation" does not create a lien or a trust, nor is the City a conduit; the obligation is simply a promise that the City will make sure that it pays the LTGOs. That promise, like other promises to pay, is simply a contractual obligation that has no weight once the City has entered chapter 9. It does not amend, modify or negate the priorities set forth in the Bankruptcy Code. *See* MTD at 18-22.

Nor can Plaintiff's demand for subordination of all other unsecured claims to the LTGOs be justified under § 510 of the Bankruptcy Code. While that section does generally make subordination agreements enforceable in bankruptcy, there is no such agreement here. A subordination agreement is, by definition, an "inter-creditor arrangement[]" that, *as between the parties to the agreement*, "alters the normal priority of the junior creditor's claim so that it becomes eligible to receive a distribution only after the claims of the senior creditor have been satisfied." *HSBC Bank USA v. Branch (In re Bank of New Engl. Corp.)*, 364 F.3d 355, 361 (1st Cir. Mass. 2004). Subordination "leav[es] non-parties unaffected by it." *Caterpillar Fin. Servs. v. Peoples Nat'l Bank, N.A.*, 710 F.3d 691, 693 (7th Cir. Ill. 2013). In other words, subordination is a private agreement between creditors to swap payment rights that should have no impact on either the debtor (from whose perspective the priorities are the same) or other creditors (whose priorities are not altered).

What Ambac is demanding here is not the "subordination" contemplated and authorized by § 510. As an initial matter, an agreement between a debtor and a creditor clearly is not a negotiated *inter-creditor* agreement and cannot be used to leapfrog over the claims of similarly-situated unsecured creditors who never agreed to such subordination. Ambac's attempt to subordinate all other unsecured claims to the LTGO claims through the RMFA's "first budget obligation" language is also improper because it demands prioritization from the debtor's perspective, whereas true subordination should be neutral from the debtor's perspective.

Moreover, § 510(a) does not countenance the use of state law to create whole new priorities for entire classes of claims. *Id.* at 364 (explaining that "section 510(a) does not vest in the states any power to make bankruptcy-specific rules: the statute's clear directive for the use of applicable nonbankruptcy law leaves no room for state legislatures or state courts to create special rules pertaining strictly and solely to bankruptcy matters"); *see also Int'l Shoe Co. v. Pinkus*, 278 U.S. 261, 265 (1929) (clarifying that states are not free to enact laws that interfere with federal bankruptcy law or that provide additional or auxiliary regulation with respect to bankruptcy matters) (cited by court in *HSBC*).

VI. PLAINTIFF IS UNABLE TO STATE A TAKINGS CLAIM.

Finally, Plaintiff's takings claim must be dismissed. Plaintiff's primary contention is that it has a security interest or lien in the *ad valorem* tax revenues,

which is protected by the Takings Clause. Opp. at 61. Defendants have acknowledged that, if Plaintiff had a security interest or lien (which, as explained above and in our opening brief, it does not), it may have a basis for bringing a takings claim. *See* MTD at 37-38.

But Plaintiff in its Opposition seeks more than that, contending that it could have a takings claim, even if its claims in bankruptcy were unsecured, so long as its unsecured interests amount to "property interests." Opp. at 61. Plaintiff is wrong and fundamentally misunderstands bankruptcy to contend that the Takings Clause protects such interests in bankruptcy. By definition, "[i]f the claim is unsecured, it is not 'property' for purposes of the Takings Clause." *In re Treco*, 240 F.3d 148, 161 (2d Cir. 2001).

Unsurprisingly, Plaintiff cites no case recognizing the possibility of a takings claim in bankruptcy involving an unsecured claim. And for good reason: To the extent that a claim is unsecured, it is merely an expectancy in having funds necessary to pay that claim. And in an ongoing bankruptcy proceeding, this expectancy is entirely conditional: The unsecured claim can be compromised, with the correlative effect of compromising the creditor's interest in repayment. There is no "property" interest that can be separated from the amount of the unsecured claim, which remains subject to compromise. And this means that no takings

claim arises when an unsecured creditor's interest is diminished or eliminated as part of the debtor's process of compromising unsecured claims.

Here, Plaintiff has rightly acknowledged this basic concept by conceding that its "property" interest can be impaired. *See* Opp. at 33. This is sufficient to dispose of its takings claim with respect to any such "property."

CONCLUSION

For the foregoing reasons, Defendants submit that the Amended Complaint should be dismissed with prejudice.

[signature page follows]

Dated: February 17, 2014

Respectfully submitted,

Bruce Bennett (CA 105430)
JONES DAY
555 South Flower Street
Fiftieth Floor
Los Angeles, California 90071
Telephone: (213) 243-2382
Facsimile: (213) 243-2539
bbennett@jonesday.com

Brad B. Erens (IL 6206864)
JONES DAY
77 West Wacker
Chicago, Illinois 60601
Telephone: (312) 269-4050
bberens@jonesday.com

Geoffrey S. Stewart (DC 287979)
JONES DAY
51 Louisiana Avenue, N.W.
Washington, D.C.
Telephone: (202) 879-3939
gstewart@jonesday.com

/s/ Deborah Kovsky-Apap
Robert S. Hertzberg (P30261)
Deborah Kovsky-Apap (P68258)
PEPPER HAMILTON LLP
4000 Town Center
Southfield, Michigan 48075
Telephone: (248) 359-7300
Facsimile: (248) 359-7700
hertzbergr@pepperlaw.com
kovskyd@pepperlaw.com

ATTORNEYS FOR THE DEFENDANTS

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

In re	Chapter 9
CITY OF DETROIT, MICHIGAN,	Case No. 13-53846
Debtor.	Hon. Steven W. Rhodes
AMBAC ASSURANCE CORPORATION,	
Plaintiff,	Adv. Pro. No. 13-05310
v.	
THE CITY OF DETROIT, MICHIGAN, KEVYN D. ORR, in his official capacity as the EMERGENCY MANAGER, JOHN NAGLICK, in his official capacity as FINANCE DIRECTOR, MICHAEL JAMISON in his official capacity as DEPUTY FINANCE DIRECTOR, and CHERYL JOHNSON, in her official capacity as TREASURER,	
Defendants.	

CERTIFICATE OF SERVICE

I hereby certify that on February 17, 2014, I caused the foregoing Reply to Plaintiffs' Opposition to Defendants' Motion to Dismiss to be electronically filed with the Clerk of the Court using the ECF system, which will

send notification of such filing to all counsel registered to receive notice in this adversary proceeding.

/s/ Deborah Kovsky-Apap
Robert S. Hertzberg (P30261)
Deborah Kovsky-Apap (P68258)
PEPPER HAMILTON LLP
4000 Town Center
Southfield, Michigan 48075
Telephone: (248) 359-7300
Facsimile: (248) 359-7700
hertzbergr@pepperlaw.com
kovskyd@pepperlaw.com

ATTORNEYS FOR THE DEFENDANTS