UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

In re	)	Case No. 13-53846
CITY OF DETROIT, MICHIGAN,	)	In Proceedings Under Chapter 9
Debtor.	)	
	)	Hon. Steven W. Rhodes
AMBAC ASSURANCE CORPORATION,	)	
Plaintiff,	)	
v.	)	Adversary Proceeding No. 13-05310-swr
CITY OF DETROIT, MICHIGAN, KEVYN D. ORR, in his official capacity as 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,	)	Hon. Steven W. Rhodes
Defendants.	)	

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Plaintiff Ambac Assurance Corporation ("Ambac") respectfully submits this memorandum of law in opposition to Defendants' Motion to Dismiss the First Amended Complaint (the "Motion").[1]

I. INTRODUCTION

Ambac's burden with regard to the Motion is minimal. The allegations of the Amended Complaint are factually detailed and legally robust. For purposes of evaluating the City's Motion, they must be taken as true. So long as they state a plausible claim for relief – which they do – the Motion must be denied, and the adversary proceeding must be permitted to proceed.

Seemingly recognizing this, the Defendants attempt to thwart this adversary proceeding by mischaracterizing the Amended Complaint – both the nature of the relief it seeks, and the substance of the underlying claims. The Amended Complaint has six counts, each of which seeks *only declaratory relief*, and each of which is based on *property rights*. Counts I-III seek declarations that state law requires that the Restricted Bond Taxes be segregated and used only for the benefit of the Bondholders, and that the Bondholders, and not the City, have equitable and beneficial ownership of the Restricted Bond Taxes. Counts IV and V seek declarations that the Bondholders have a lien on the Restricted Bond Taxes, and

[1] Capitalized terms used but not otherwise defined have the meanings ascribed to them in Ambac's Amended Complaint for Declaratory Judgment (the "Amended Complaint"or "Am. Compl.")) [ECF 57].

that the Restricted Unlimited Bond Taxes are special revenues. And Count VI seeks a declaration that the City's use of the Restricted Bond Taxes for purposes inconsistent with Ambac's state law property rights constitutes an unconstitutional taking without adequate consideration under the United States Constitution.

Despite the fact that none of these Counts seek anything other than a declaration of law, the Defendants distort the Amended Complaint to portray it as seeking more. So, for example, they profess that Ambac is seeking an order directing the Defendants to take action, *see* Defendants' Memorandum in Support of Motion to Dismiss ("Mem.") at 39, 40, or injunctive relief to enforce the provisions of Act 34, *see* Mem. at 6, 8, 13. This is not true; a plain reading of the Amended Complaint makes clear that Ambac is merely seeking declaratory relief.

The motion takes a similar tack with respect to the substance of Ambac's claims, which are grounded exclusively in state law property rights. In this vein, the Defendants erroneously insist that Ambac seeks full payment on the Bonds it insures, Mem. at 16, 17, to prevent impairment of the Bonds in a plan of adjustment, Mem. at 17-20, and to eclipse the Chapter 9 distribution scheme, Mem. at 20. But the Amended Complaint, again, seeks no such thing.[2] The only issue

[2] Even the lien counts, Counts IV and V, do not seek declarations regarding plan treatment, impairment, or distribution; however, if granted, they would ultimately affect the Bondholders' treatment in a plan, pursuant to the Bankruptcy Code's treatment of secured claims.

before the Court in this adversary proceeding is the nature and extent of the Bondholders' property interest in the Restricted Bond Taxes.

The issues presented by Ambac for declaration are of critical importance, and not just academic. Despite the law's restrictions on the use of the Restricted Bond Taxes, the City is already using these monies for purposes other than the statutorily required payment of debt service on the Bonds, and has made clear that it intends to continue doing so. It defaulted on debt service payments that came due this past October, and has diverted millions of dollars of the Restricted Bond Taxes to pay its lawyers and other restructuring advisors. Additional debt service payments are coming due on April 1, and the City intends to default on these payments as well, and pilfer the Restricted Bond Taxes for other purposes. Declaratory relief is needed now, to inform the Defendants – as well as the Bondholders – of their rights and obligations.

By mischaracterizing both the claims and the relief sought in the Amended Complaint, the Defendants assert arguments for dismissal that are wholly irrelevant. The Defendants' threshold argument – that Ambac cannot state a claim because Act 34 does not provide for a private right of action – fails for this very reason. This argument is a work of fiction – it stems from their distortion of the Complaint and is entirely misplaced under Michigan law. Under Michigan law, a "private right of action" is necessary only to pursue claims for monetary damages.

So long as a statute does not *prohibit* suits by private parties, an action for declaratory relief, like Ambac's, is entirely permissible. The Defendants' invocation of governmental immunity to defeat this adversary proceeding presents a similar fiction. Under Michigan law, governmental immunity bars only claims for money damages; Ambac's claims seek only declaratory relief.

The Defendants' argument that § 904 requires a dismissal is plagued by the same falsehood. While § 904 might affect the Amended Complaint if Ambac sought an order that would "interfere with" the Debtor's use of property, chapter 9 precedent is unequivocal that a *declaratory judgment* may be obtained against a municipal debtor even where it relates to the debtor's use of property. Likewise, the City cannot use § 904 as a shield by arguing that a declaratory judgment directed to municipal officials should for practical purposes be equated to an injunction. Well-settled authority, including from the Supreme Court, holds the exact opposite. Not only is a declaratory judgment directed to governmental defendants permissible, it is appropriate even where injunctive relief to the same effect may be unavailable. *Id.*

The Defendants also move to dismiss the Amended Complaint on the grounds that the state law property rights Ambac seeks to be declared are preempted by the Bankruptcy Code. Here again, the Defendants engage in a fictitious reading of the claims, characterizing them as seeking to use state law to

disturb bankruptcy priorities and prevent impairment in a plan of adjustment. Equally important, the Defendants are demonstrably wrong on the law, as this Court is keenly aware. The Defendants contend that "when a municipality files for chapter 9 protection, state laws . . . no longer govern." Mem. at 17. Yet Defendants acknowledge – as they must – that this Court has already ruled, *in this case*, that state law may "create[] a property interest *that bankruptcy would be required to respect* under *Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914 (1979) (holding that property issues in bankruptcy are determined according to state law)." *See* Mem. at 17, n.8 (citing *In re City of Detroit, Mich.*, No. 13-53846, 2013 WL 6331931, at *44 (Bankr. E.D. Mich. Dec. 5, 2013) (emphasis added)). Even in bankruptcy, property rights continue to be governed by state law and must be respected. Thus, Ambac's claims seeking a declaration of those rights in this case are not only viable but meritorious.

With respect to Ambac's claims for declaratory judgments that the Bondholders, and not the City, have the equitable property interest in the Restricted Bond Taxes, the Defendants have not disputed the restrictions imposed on the City's handling and use of the taxes by Act 34. These restrictions deprive the City of an equitable interest in the funds, and vest it with the Bondholders, as a matter of law. Where, as here, a state statute restricts the use of taxes for the payment of debt service on bonds, the taxing entity holds the taxes in trust for the

bondholders. This doctrine is uncontroverted and finds deep roots in Michigan and other states' municipal law tracing back more than 100 years. In addition, the law is equally well-settled that where one party holds funds designated for the benefit of another, the first party is a mere "conduit" or "delivery vehicle" of the funds, lacking any ownership except, at most, bare legal title. The conclusion that the City has no equitable or beneficial ownership in the Restricted Bond Taxes is not only adequately pled – it is inescapable.

Finally, Counts IV-VI should be sustained for the reasons discussed in the brief filed by National and Assured in their parallel adversary proceeding. Ambac fully adopts and incorporates those arguments by reference, subject to the additional arguments set forth in Sections VIII-XI below.

II. STATEMENT OF FACTS

A. The City's Issuance of the Bonds

The City has issued hundreds of millions of dollars of Unlimited Tax Bonds and Limited Tax Bonds to fund vital capital improvements specifically identified by the Mayor and the City Council. Am. Compl. ¶ 1. Unique among the City's financial obligations, the Unlimited Tax Bonds and Limited Tax Bonds benefit from strict statutory controls over, and pledges of, certain tax revenues dedicated by law for their payment. *Id.* ¶ 2.

The Unlimited Tax Bonds were issued only after the enactment of authorizing resolutions by the City Council, and the approval of a majority of the voters in city-wide elections, establishing a pledge of *ad valorem* taxes as security for the payment of debt service on these obligations. *Id.* ¶ 3; *see* Am. Compl. Exhibit A. At the time the Unlimited Tax Bonds were issued, the City was already levying taxes at the maximum rate permitted by law, and as a consequence, the City Council had to seek voter approval before issuing the Unlimited Tax Bonds, in order to levy and collect *ad valorem* taxes in excess of the limit with which to pay debt service on the Unlimited Tax Bonds. *Id.* ¶¶ 4, 34. For each issuance of Unlimited Tax Bonds, the City's residents voted on bond referenda describing the specific capital project to be financed with the proceeds of the Unlimited Tax Bonds. *Id.* ¶ 3; *see, e.g.*, Am. Compl. Ex. A. The summer *ad* valorem tax bill sent to taxpayers by the City reflects the millage for the Restricted Unlimited Tax Bonds as a separate line item described as "Debt Service." *See* 2012 *Ad Valorem* Tax Bill attached hereto as Ex. A; Am. Compl. ¶ 48. By issuing the Unlimited Tax Bonds, the City became *obligated by law* to assess an amount of *ad valorem* taxes (above such limitations) sufficient to pay debt service on the Unlimited Tax Bonds, and to apply the assessed taxes for this purpose. *Id.* ¶ 4.

Similarly, the City issued the Limited Tax Bonds only after the City Council passed resolutions enumerating the specific capital and financial projects to be

financed with the proceeds of the Limited Tax Bonds. *Id.* ¶¶ 5, 35. The City pledged as security for the payment of debt service on the Limited Tax Bonds *ad valorem* taxes collected within the constitutional, statutory, and charter tax rate limits as a "first budget obligation." *Id.* By issuing the Limited Tax Bonds, the City became *obligated by law* to assess an amount of *ad valorem taxes* (within the maximum rates prescribed by law) sufficient to pay debt service on the Limited Tax Bonds, and to apply the assessed taxes for this purpose. *Id.*

B. The Bonds Insured by Ambac

Ambac insures a portion of the City's Unlimited Tax Bonds and Limited Tax Bonds. *Id.* ¶¶ 2, 24-29. As a monoline bond insurer, Ambac is obligated to pay the owners of Ambac-insured Bonds the full principal of and interest on the Ambac-insured Bonds when due if the City does not make the payments under the insured Bonds. *Id.* ¶ 25. To the extent Ambac makes those payments, it receives an assignment of rights from each registered owner of the Bonds and becomes subrogated to the rights of the Bondholders. *Id.* Ambac insures $77,635,000 of the City's Unlimited Tax Bonds, and $92,705,000 of the City's Limited Tax Bonds. *Id.* ¶ 24-29. The proceeds of the Bonds insured by Ambac financed certain City projects focused on improving public safety, police and fire stations, recreation facilities, museums, zoos, public lighting facilities, and other cultural and economic projects. *Id.* ¶ 33.

C. The Statutory Restrictions

Michigan law strictly regulates the City's levy, treatment, and use of *ad valorem* taxes collected to pay debt service on the Unlimited Tax Bonds and Limited Tax Bonds (the "Restricted Bond Taxes"). *Id.* ¶¶ 6, 32-45.

Act 34, which the City refers to as the Revised Municipal Finance Act or RMFA, governs the issuance of the Bonds. *Id.* ¶¶ 32-45. Act 34 provides that municipal securities such as the Unlimited Tax Bonds and Limited Tax Bonds must be "payable from and secured by" one of the following: (i) *ad valorem* real and personal property taxes, (ii) special assessments, (iii) the limited or unlimited full faith and credit pledge of the municipality, or (iv) other sources of revenue described in Act 34 for debt or securities authorized by Act 34. *Id.* ¶ 32 (citing Mich. Comp. Laws §§ 141.2103(*l*); 141.2315(l)(c)(i), (2)).

Where, as here, *ad valorem* real property taxes are used to pay and secure municipal securities, Act 34 limits their use to this purpose. *Id.* ¶ 36. The *ad valorem* real property taxes are earmarked by law and pledged to pay the debt service on the Bonds that financed specific projects and systems. *Id.* (citing Act 34 §§ 701(1)-(3), 705; Resolutions § 301(a)). Thus:

> * Act 34 requires the City to levy an amount sufficient to pay promptly the principal of and interest on all Bonds becoming due that year. *Id.* ¶ 37 (citing Act 34 § 701(1)).
>
> * With respect to Unlimited Tax Bonds, which are funded by a voter-approved stream of *ad valorem* taxes in excess of the applicable

> constitutional, statutory, and charter tax rate limitations for the sole purpose of paying debt service on those Bonds, Act 34 further requires that the City levy the full amount of taxes required to repay those Bonds "without limitation as to rate or amount and in addition to other taxes that the municipality may be authorized to levy." *Id.* ¶¶ 3-4, 6, 34, 37 (quoting Act 34 § 701(3)).
>
> * With respect to the Limited Tax Bonds, Act 34 requires the city to "set aside each year from the levy and collection of *ad valorem* taxes as required by this section as *a first budget obligation* for the payment of the [Limited Tax Bonds]." *Id.* ¶ 6, 37 (citing Act 34 § 701(3) (emphasis added)).

Accordingly, Michigan law requires that these Restricted Bond Taxes be levied and collected for so long as the Bonds are outstanding. *Id.* ¶ 37. Indeed, in the absence of voter approval, the City would lack the authority to levy and collect the Restricted Unlimited Bond Taxes; these voter-approved taxes cannot be used for any purpose other than payment of debt service on the Unlimited Tax Bonds. *Id.* ¶¶ 4, 34.

Act 34 further requires that the Restricted Bond Taxes be deposited in a segregated Debt Retirement Fund as they are collected. *Id.* ¶ 38 (citing Act 34 § 701(6) ("As taxes are collected, there shall be set aside that portion of the collections that is allocable to the payment of the principal and interest on [the Bonds]. The portion [of the taxes] set aside shall be divided pro rata among the various sinking funds and debt retirement funds in accordance with the amount levied for that purpose.")); *see also id.* ¶ 39 (citing § 701(1)(d)(i) (taxes must be "[d]eposit[ed] in the debt retirement fund[s] established for the [Bonds] and used

to pay debt service charges or obligations on [the Bonds]")). Each of the Debt Retirement Funds must be "accounted for separately," "used only to retire the municipal securities" for which they were created, and cannot be used for other purposes until those municipal securities have been retired. *Id.* ¶ 40 (quoting Act 34 § 705).

Section 502 of the Resolutions likewise specifies that the Restricted Bond Taxes shall be "placed in the Debt Retirement Fund[s]." *Id.* ¶ 41 (quoting Resolutions § 502). Further, so long as principal and interest on the Bonds remain unpaid, the amounts in the Debt Retirement Funds must only be used to pay principal and interest on the Bonds, and "no moneys shall be withdrawn from the Debt Retirement Fund[s] *except* to pay such principal and interest." *Id.* (quoting Resolutions § 502 (emphasis added)).

The Resolutions also provide that all taxes levied to pay debt service on the Bonds are pledged as security for the timely payment of principal and interest on the Bonds when due. *Id.* ¶ 44 (quoting Resolutions § 301(a) ("the [unlimited/limited] tax . . . [is] hereby irrevocably pledged for the prompt payment of the principal of and interest on the [Bonds].")).

The limitations set forth under Michigan law and the Resolutions were recognized in a State of Michigan Attorney General Opinion, dated February 19, 1982. *Id.*¶ 42, *see* Am. Compl. Ex. L. That opinion states that taxes levied for the

payment of principal and interest on bonds must "be placed in a segregated account," "may only be used to pay principal and interest on the bonds for which the millage was levied while the bonds are outstanding," and may not be transferred out of the segregated fund while the bonds are outstanding. *Id.* ¶ 42 (quoting 1981-1982 Mich. Op. Att'y Gen. 575 (1982)).

In sum, Michigan law requires the Defendants to: (1) levy and collect the full amount of *ad valorem* taxes required to repay principal and interests on the Bonds when due; (2) deposit the Restricted Bond Taxes into segregated Debt Retirement Funds; and (3) use the Restricted Bond Taxes only to pay debt service on the Bonds. *Id.* ¶¶ 6, 32-45.

In addition, the Resolutions provide that all taxes levied to pay debt service on the Bonds are pledged as security for the timely payment of principal and interest on the Bonds when due. *Id.* at 44 (quoting Resolutions § 301(a)). A Michigan statute – the Unlimited Tax Election Act – independently reinforces the Bondholders' lien on the Restricted Unlimited Bond Taxes. *Id.* ¶ 45 (quoting Unlimited Tax Election Act). The "binding unlimited tax pledges" referenced in the Unlimited Tax Election Act "secure" the payment of debt service on the Unlimited Tax Bonds. *Id.*

D. The City's Misuse of the Restricted Bond Taxes

On October 1, 2013, the City defaulted on its obligation to make interest payments on the Unlimited Tax Bonds in the amount of $9,372, 275, including $1,994, 281 insured by Ambac. *Id.* ¶¶ 8, 30. The City also defaulted on its obligation to make interest payments on the Limited Tax Bonds in the amount of $4,348,211, including $2,266,586 insured by Ambac. *Id.* ¶¶ 8, 30.

The City has stated publicly that it intends to continue to levy and collect Restricted Bond Taxes postpetition, but that it will not segregate them. *Id.* ¶ 9. It has further indicated postpetition that it will not use the Restricted Bond Taxes to pay debt service on the Bonds and has or may instead use them for other purposes. *Id.* ¶¶ 9, 58. In fact, Mr. Orr has expressly directed the City to divert millions of dollars in Restricted Limited Bond Taxes to pay more than a dozen law firms and consultants retained to assist the City with its restructuring. *See* Request for Amendment to the FY 2014 Budget, attached hereto as Ex. B; Am. Compl. ¶ 59.

III. STANDARD OF REVIEW

In deciding the Defendants' motion to dismiss, the Court "must construe the complaint in the light most favorable to plaintiffs," and "accept all well-pled factual allegations as true." *Harkless v. Brunner*, 545 F.3d 445, 449 (6th Cir. 2008)); *see also In re DeLorean Motor Co.*, 991 F.2d 1236, 1240 (6th Cir. 1993) (reversing dismissal by bankruptcy court of adversary complaint). A complaint

need not contain "detailed factual allegations" to survive a motion to dismiss, but rather only sufficient facts that, accepted as true "state a claim to relief that is plausible on its face." *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 555, 570 (2007); *see Sutton v. Metro Gov't of Nashville & Davidson Cnty.*, 700 F.3d 865, 871 (6th Cir. 2012) (quoting *Twombly*); *Paige v. Coyner*, 614 F.3d 273, 277 (6th Cir. 2010) (same). As long as the court can "'draw the reasonable inference that the defendant is liable for the misconduct alleged,' a plaintiff's claims must survive a motion to dismiss." *Fabian v. Fulmer Helmets, Inc.*, 628 F.3d 278, 281 (6th Cir. 2010) (quoting *Ashcroft v. Iqbal*, 556 U.S. 662, 663 (2009)); *see Sutton*, 700 F.3d at 871 (same). Each of Ambac's claims easily satisfies this pleading standard, and thus, the Defendants' attempt to prevent this adversary proceeding from getting off the ground must fail. Ambac's claims for declaratory relief have been more than adequately pled, and should have been answered. The Amended Complaint is not subject to dismissal under Rule 7012 at this early stage.

IV. AMBAC MAY SEEK A DECLARATORY JUDGMENT UNDER ACT 34

The first ground on which the Defendants move for dismissal is that Ambac may not sue to enforce Act 34 – an argument that is generated only by the supposition that the Amended Complaint seeks, in reality, something other than a declaratory judgment. The Defendants assert that there is no private right of action under Act 34 and that the State Department of Treasury is vested with exclusive

enforcement powers. The Defendants argue that this strips Ambac of any ability to sue under the statute. In asserting this argument, the Defendants insist that the claims seek more than mere declaratory relief – to the extent they admit the true nature of the claims, they contend that the request for declaratory judgment is merely a "tactic" employed to "circumvent" the statutory enforcement scheme.

The Defendants are wrong – on both their interpretation of the Amended Complaint and their interpretation of Michigan law. Act 34 does not vest exclusive enforcement authority in the Department of Treasury, nor does it prohibit suits by private parties. Michigan law is, therefore, clear that statutory standing is the sole prerequisite to an action for declaratory judgment and is met here. A private right of action is required only when a plaintiff seeks monetary damages. As Ambac is not seeking damages in this action, the question of whether a private right of action exists is entirely irrelevant. Accordingly, the Defendants' arguments for dismissal are not targeted to what Ambac has actually pled, are wholly without merit, and should be denied.

A. The Defendants Confuse Statutory Standing and a Private Right of Action for Damages

Ambac may seek a declaratory judgment under Act 34. The law is well-settled that *absent an express statutory provision to the contrary*, a party has statutory standing, and therefore may seek equitable remedies under Michigan statutes, including specifically a declaratory judgment. The key prerequisite for

equitable remedies is statutory standing, and not a private right of action for damages. The Defendants, however, have conflated these two concepts and treated them as though they are one and the same.

Michigan law draws a clear distinction between the availability to private parties of monetary damages and equitable remedies. Indeed, a two-step analysis has developed in Michigan by which courts separately analyze statutory standing and a private right of action in reviewing the ability to bring statutory claims. *See Miller v. Allstate Ins. Co.*, 481 Mich. 601 (2008).[3] First, courts determine whether the plaintiff has "statutory standing," *i.e.*, "whether [the Legislature] has accorded *this* injured plaintiff the right to sue the defendant to redress his injury." *Id.* at 608. As detailed below, statutory standing exists unless expressly disclaimed by statute, and is sufficient, without more, to enable claims for declaratory and other equitable relief. Therefore, where no money damages are sought, the analysis ends with step one.

[3] *Miller*'s analysis of *constitutional*, as opposed to *statutory*, standing has been subsequently overruled on grounds not relevant here. *See Lansing Sch. Educ. Ass'n v. Lansing Bd. of Educ.*, 487 Mich. 349, 373 (2010) (readopting long-standing standard and holding that constitutional standing is present where "the litigant has a special injury or right, or substantial interest, that will be detrimentally affected in a manner different from the citizenry at large."). On the issue of statutory standing, *Miller's* two-step test is still good law. *See Zigmond Chiropractic, P.C. v. AAA Michigan*, No. 300643, 2013 WL 3836238, at *2 (Mich. Ct. App. July 25, 2013) (statutory standing was present under the *Miller* analysis in the absence of express language precluding suit by the plaintiff).

Second, and only if money damages are sought, the courts determine whether the statute provides a private cause of action for that "particular type of relief." *Miller*, 481 Mich. at 608. Unlike the standard for equitable relief, money damages are available only where the statute expressly and affirmatively provides a private cause of action or where a private cause of action may be implied. *See, e.g. Pompey v. Gen. Motors Corp.*, 385 Mich. 537, 543 (1971).

Notably, the Defendants never address *Miller* or this two-step analysis. Rather, the analysis employed by the Defendants leaps to the second step, ignoring the foundational test for statutory standing and the fact that Ambac has not presented a claim for monetary damages. Yet, the law is clear: where only declaratory relief is sought, it is available so long as constitutional and statutory standing exist, and the court need not proceed to step two of the *Miller* test to determine if a private cause of action for damages also exists. *See Lash v. City of Traverse City*, 479 Mich. 180, 196 (2007).

In *Lash*, a police officer sued the city that refused to hire him, seeking money damages, alleging that the city imposed a residency requirement in violation of a state statute. The Supreme Court held that money damages were not available because the statute contained no express private cause of action, nor could one be implied. *Id.* at 194. However, the Supreme Court expressly rejected the notion that a private cause of action was necessary to sue for equitable

remedies under the statute:

> [The] claim that a private cause of action for monetary damages is the only mechanism by which the statute can be enforced is incorrect. *Plaintiff could enforce the statute by seeking* injunctive relief pursuant to MCR 3.310, or *declaratory relief* pursuant to MCR 2.605(A)(1).

Id. at 196 (emphasis added) (internal citations omitted); *see also Lansing Sch. Educ. Ass'n*, 487 Mich. at 373 (declining to reach the issue of whether a statute conferred a private cause of action for damages and holding that plaintiff could pursue claims for declaratory judgment and other equitable relief even absent a private cause of action); *Miller*, 481 Mich. at 609 (explaining that injunctive or declaratory relief can be pursued absent a private cause of action, and referring to *Lash* as an example).

Accordingly, the Defendants' attempt to impose the requirement of an affirmative grant of a private right of action on Ambac's request for a declaratory judgment must be rejected.

B. Ambac Has Statutory Standing Under Act 34 and May Therefore Seek a Declaratory Judgment

Statutory standing exists *absent an express* prohibition in the statute. *Miller*, 481 Mich. at 607 ("[A] party that has constitutional standing may be precluded from enforcing a statutory provision, *if the Legislature so provides*.") (emphasis added); *Zigmond Chiropractic*, 2013 WL 3836238, at *3 (plaintiff has statutory standing to obtain a declaration under Michigan statutes absent an express statutory

prohibition on suits by private parties). Indeed, it is a long-standing principle in Michigan that private parties such as bondholders or those standing in their shoes may seek equitable remedies to enforce state statutes that govern the issuance and repayment of municipal bonds. *See Simonton v. City of Pontiac*, 268 Mich. 11 (1934) (allowing bondholders' protective committee to seek mandamus under the predecessor of Act 34).

The fact that the State Department of Treasury has enforcement powers under Act 34 does not change the analysis. Private parties' statutory standing is routinely found to exist even where the statute identifies a governmental entity that may sue, so long as that designation does not expressly prohibit suit by other parties. *See, e.g., Another Step Forward v. State Farm Auto. Ins. Co.*, No. 06cv15250, 2009 WL 879690 (E.D. Mich. Mar. 30, 2009), *aff'd*, 367 F. App'x 648 (6th Cir. 2010). At issue in *Another Step Forward* was whether a private party could challenge, under Michigan statutes, the propriety of the licensure of medical services providers. As the City does here, the service providers claimed that statutory standing was lacking because the relevant statutes vest enforcement powers with "regulatory agencies and the Michigan Attorney General." *Id.* at *8. The court agreed that "the enforcement of licensing requirements for mental health and adult foster care facilities is relegated to regulatory agencies and the Michigan Attorney General." *Id.* at *9. However, the court rejected the challenge to

statutory standing because the statutes did not contain an express prohibition that prevented *other, i.e.*, private, parties from bringing suit under the statutes. *Id.*; *see also Lighthouse Place Dev., LLC v. Moorings Ass'n*, No. 280863, 2009 WL 1139260, at *6 (Mich. Ct. App. Apr. 28, 2009) (non-owner had statutory standing to sue under the Condominium Act that provided that claims "may" be brought by condominium associations because the right to sue vested in the condominium associations was not "exclusive"); *Zigmond Chiropractic*, 2013 WL 3836238, at *2 (private party had statutory standing under the Public Health Code in the absence of an express prohibition in the statute).

The foregoing decisions are indistinguishable and readily establish Ambac's statutory standing here because Act 34 does not contain an express prohibition on suits by private parties. The Defendants do not identify any provision of the statute that vests enforcement powers *exclusively* with the Department of Treasury. *See* Mem. at 8-9. Section 201 merely enumerates the department's "general powers," without so much as a hint of exclusivity. *See* Mich. Comp. Laws § 141.2201(a) - (d). Similarly, § 802(2) is non-exclusive and merely permissive. *See* Mich. Comp. Laws § 141.2802(2) ("The department *may* institute appropriate proceedings in the courts of this state.") (emphasis added). Conspicuously absent from Act 34 is any indication that *only* the Department of Treasury may sue under the statute, or that private parties may *not* sue. Given the lack of an express prohibition against suits

by private parties, Ambac has statutory standing and may, as a matter of right, seek a declaratory judgment under Act 34.

The authority cited by the Defendants is wholly inapposite. *See* Mem. at 9-12. First, none of the cases in Section I.A of the City's brief deal with declaratory judgments; all analyze the availability of a private cause of action for money damages. *See Pompey*, 385 Mich. at 551 (seeking "compensation for damages suffered by reason of discrimination in private employment"); *Lynch v. County of Arenac*, No. 296775, 2011 WL 2694631 (Mich. Ct. App. July 12, 2011) (Forensic Polygraph Examiner's Act does not provide a private cause of action for damages); *Bricker v. Ausable Valley Cmty. Mental Health Servs.*, No. 281736, 2009 WL 211883, at *4 (Mich. Ct. App. Jan. 29, 2009) (citing *Lash*, 479 Mich. at 194) (governmental defendants enjoyed immunity from tort claims for money damages); *Claire-Ann Co. v Christenson & Christenson, Inc.*, 223 Mich. App. 25, 30-31 (1997) (no private cause of action under the Occupational Code for money damages for negligence, breach of fiduciary duty, silent fraud, and misrepresentation); *Garden City Educ. Ass'n v. Sch. Dist. of Cty. of Garden City*, No. 12cv14886, 2013 WL 5450095 (E.D. Mich. Sept. 30, 2013) (dismissing claims for money damages and injunctive relief).[4]

[4] *Garden City* does not deal with declaratory relief and is therefore not controlling here. However, it is the only case cited by the Defendants that applies Michigan

The authority cited by the Defendants that actually addresses declaratory relief, Mem. at 11-12, is also inapposite. All but one of the cases were decided under inapplicable statutory standing principles from the federal domain or from states other than Michigan. But the question of what rights a Michigan statute vests in private plaintiffs is a question of statutory interpretation, *Lash*, 479 Mich. at 186, and must therefore be answered by Michigan law. *See In re Houston*, No. 11cv60934, 2012 WL 4490890, at *2 (E.D. Mich. Sept. 26, 2012) (applying Michigan rules of statutory construction when interpreting a Michigan Statute); *In re Tudor*, 342 B.R. 540, 554 (Bankr. S.D. Ohio 2005) ("Federal courts interpret state laws according to state rules of statutory construction."); *In re Alexander*, 472 B.R. 815, 821 (9th Cir. BAP 2012) ("Because we are interpreting the instant statute as we believe the Nevada Supreme Court would interpret it, we apply Nevada rules for statutory construction."); *In re Hodes*, 308 B.R. 61, 66 (10th Cir. BAP 2004) ("State laws are interpreted according to the state's rules of statutory

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law to dismiss claims for injunctive relief as well as monetary relief. In that respect, the case was incorrectly decided; its reasoning suffers from the same conflation of the two steps of the *Miller* test as the City's argument. The Court mistakenly imported from step two the requirement that a private cause of action be expressly provided into the analysis of statutory standing under step one. *Id.* at *4. It then cited *Claire-Ann*, 223 Mich. App. 25 (1997), and *Gardner v. Wood*, 429 Mich. 290 (1987) – both tort damages cases – in refusing to infer "a private right of action." *Id.* at *5. While this analysis may have been appropriate to support the dismissal of claims for damages, it did not warrant dismissal of the request for injunctive relief under the aforementioned Michigan authority.

construction.").

More fundamentally, all of these decisions analyze statutes that, in stark contrast with Act 34, contain express and complete prohibitions on private actions that may indeed impact statutory standing under Michigan law. For example, in *Huron Valley Schools v. Sec'y of State*, 266 Mich. App. 638 (2005), the statute provided that administrative procedures were the statute's *exclusive* enforcement mechanism. *Id.* at 646 (a "declaratory judgment action cannot be maintained to resolve disputes which are within the *exclusive* jurisdiction of an administrative agency" (citing *St. Paul Fire & Marine Ins. Co. v. Littky*, 60 Mich. App. 375, 378 (1975)). In *Durr v. Strickland*, 602 F.3d 788 (6th Cir. 2010), and in *Jones v. Hobbs*, 745 F. Supp. 2d 892 (E.D. Ark. 2010), the courts analyzed the federal Food, Drug and Cosmetics Act, which expressly requires that all enforcement actions be brought "in the name of the United States." 21 U.S.C. § 337. Similarly, the statute in *Texas Med. Ass'n v. Aetna Life Ins. Co.*, 80 F.3d 153 (5th Cir. 1996), "indicate[s] that the Texas Board of Insurance is the only party responsible for assuring" compliance with the provisions implicated in the lawsuit. *Id.* at 156.

Nothing in Act 34 dictates exclusive enforcement authority in another entity or deprives Ambac of statutory standing. Accordingly, Ambac may seek a declaratory judgment without having to establish a private cause of action for

damages.[5]

C. Governmental Immunity Does Not Bar a Declaratory Judgment

For all of the reasons discussed above, Ambac also has to the right to bring its claims for declaratory judgment against the individual defendants to the same extent those claims exist against the City. The Defendants point to § 701(7) of Act 34, which imposes personal liability for violations of Act 34 on City officials, and argue there is no express private right of action provided for in that provision. But as Ambac has already demonstrated, this argument is unavailing because a private right of action is not a prerequisite to obtain a declaratory judgment, the sole relief sought by Ambac.

The Defendants go on to argue that Mr. Orr, the City's Emergency Manager,

[5] Even if Ambac were required to establish a private right of action for damages (which it is not), one should be implied under the authority cited by the Defendants. A private right of action may be inferred where "the statutory remedy . . . is plainly inadequate." *Pompey*, 385 Mich. at 555. Under the Defendants' erroneous view that the Michigan Department of Treasury is the sole party that can seek *any* remedies under Act 34, an adequate remedy would plainly be lacking. For all intents and purposes, the City is controlled by the State. The Emergency Manager, who directs the City's actions, is appointed by and "serve[s] at the pleasure of the governor" and may be removed, impeached, or replaced by the State. Mich. Comp. Laws § 141.1549(9)(d). The Emergency Manager's compensation is set and paid, and his service contract is approved, by the State. Mich. Comp. Laws § 141.1549(e). The State may provide additional salary for the Emergency Manager from "private funds" received by the State. Mich. Comp. Laws § 141.1549(f). And, the Michigan Attorney General must defend any suit challenging the authority of the Emergency Manager. Mich. Comp. Laws § 141.1560(2)(c). Under these circumstances, enforcement of Act 34 cannot be left exclusively to the State.

is shielded from suit by governmental immunity. This contention fails as a matter of Michigan law. Requests for declaratory judgment are not subject to governmental immunity. *See Hadfield v. Oakland Cnty. Drain Com'r*, 430 Mich. 139, 152 (1988), *overruled* on other grounds *by Pohutski v. City of Allen Park*, 465 Mich. 675 (2002); *Lash*, 479 Mich. 180 (plaintiff could seek declaratory and injunctive relief against a municipality). Furthermore, even if this Court were to accept the City's outlandish contention that this adversary proceeding sounds in tort, *see* Mem. at 15, governmental immunity would still not bar equitable relief. *See Gaskin v. City of Jackson*, No. 303245, 2012 WL 2865781 (Mich. Ct. App. July 12, 2012) (applying immunity under Mich. Comp. Laws § 691.1407 to claims based in tort to deny claims for money damages but sustain requests for equitable relief).

Accordingly, governmental immunity is not implicated by Ambac's request for a declaratory judgment, and the Defendants' motion to dismiss on this ground must be denied.

V. NONE OF THE RELIEF SOUGHT IN THIS ADVERSARY PROCEEDING IS BARRED BY § 904

A. Section 904 Does Not Bar Declaratory Judgment

Defendants' contention that § 904 precludes the declaratory relief sought in this adversary proceeding must be rejected. At the core of Defendants' contention is the fiction it continues to engage in that Ambac has not sought mere declaratory

relief. All six counts of the Amended Complaint seek declarations of the parties' respective property interests, which are not subject to the limitations imposed by § 904. In an apparent recognition that declaratory judgment is permissible under these circumstances, Defendants repeatedly misrepresent the relief sought. *See, e.g.*, Mem. at 39 ("Plaintiff seeks at least in part *an order from this Court directing the City* to divert certain revenues."), 40 (characterizing relief sought as an "order" directed to City officials). A plain reading of the Amended Complaint belies the veracity of the Defendants' position.

Because Ambac seeks only declaratory and not injunctive relief, § 904 presents no obstacle. Declaratory relief may be granted against chapter 9 debtors even where the declaration concerns the disposition and use of municipal property by the municipality. *See In re Jefferson County*, 482 B.R. 404 (Bankr. N.D. Ala. 2012). In that case, a trustee for warrantholders brought an adversary proceeding against the debtor county for declaratory judgment as to whether sewer system costs could be paid by the county ahead of debt service payments to warrantholders. *Id.* Not only did the court consider the merits of the claim, § 904 notwithstanding, but it entered a judgment declaring that the county could not pay certain expenses from the fund and affirmatively detailing what the county must do with the funds:

> At the end of each monthly period, as is determined under the Indenture, *the monies remaining in the Revenue Account* following payment of the Operating Expenses that were (1) incurred in the then current month or any prior month and (2) due and payable in the then current month or a

> prior month *are to be remitted in the priority and manner as set forth in Article XI of the Indenture without withholding of any monies for depreciation, amortization, reserves, or estimated expenditures that are the subject of this litigation*.

Id. at 444 (emphasis added). The availability of declaratory judgment against municipal debtors despite § 904 is not surprising since, as established in Section V. B below, declaratory judgment merely sets forth the parties' respective rights and obligations, and lacks the coercive effect of an injunctive order.

Defendants' reliance on the *Stockton* decisions is misplaced, because none of those decisions addressed the impact of § 904 on declaratory relief. *See In re City of Stockton, Cal*, 478 B.R. 8, 21 (Bankr. E.D. Cal. 2012) (dismissing request for an *injunction* requiring the debtor to make payments on account of retirees' health benefits); *In re City of Stockton, Cal.*, 486 B.R. 194 (Bankr. E.D. Cal. 2013) (municipal debtor need not obtain court approval of compromises or settlements); *In re City of Stockton, Cal.*, 484 B.R. 372 (Bankr. E.D. Cal. 2012) (discussing application of automatic stay to city officials). The sole *relevant* chapter 9 authority supports the availability of declaratory judgment here, and there is no authority whatsoever to support the Defendants' view that § 904 bars declaratory relief. Section 904, therefore, is inapplicable to the relief sought by Ambac.

B. The Declaratory Relief Sought by Ambac Is Not Equivalent to Injunctive Relief

Undeterred, the Defendants attempt next to blur the distinction between declaratory and injunctive relief. They contend that a request for declaratory judgment should be equated to injunctive relief where it is directed to governmental defendants who may be more inclined to abide by a declaration of law than private parties. *See* Mem. at 13 (arguing that Ambac seeks to "compel the City to comply with the provisions of [Act 34] through the mechanism of declaratory judgment action" because governmental officials "are likely to conform their conduct" to a declaratory judgment).

This argument fails as a matter of both fact and law. As to the former, the Amended Complaint seeks mere declarations of property rights and could not therefore be equated to a request for injunctive relief. While Ambac certainly hopes that the City would not deliberately choose to violate the law, the fact that a declaratory judgment is rendered is no more coercive than any law currently existing that restrains the conduct of the City and other law-abiding citizens. It is the law that constrains them, not any declaration sought by Ambac imposing additional conditions or requirements.

More fundamentally, the argument is based on a legally faulty conflation of declaratory and injunctive relief. The law is unequivocal that declaratory relief, even when directed to governments or their officials, is legally distinct from

injunctive relief and lacks the coercive power of an injunction. As the Supreme Court explained:

> [E]ven though a declaratory judgment has 'the force and effect of a final judgment,' 28 U.S.C. § 2201, it is a much milder form of relief than an injunction. Though it may be persuasive, it is not ultimately coercive; noncompliance with it may be inappropriate, but is not contempt.

Steffel v. Thompson, 415 U.S. 452, 471 (1974); *see also Cincinnati Elec. Corp. v. Kleppe*, 509 F.2d 1080, 1089 (6th Cir. 1975) (granting declaratory relief in lieu of injunctive relief because that remedy properly balanced "the public's interest in having a government procurement process which can be administered without disruptive court-ordered restraints" with "the interests of the party seeking the injunction"); *Zwickler v. Koota*, 389 U.S. 241, 254 (1967) ("[A] request for declaratory judgment that a state statute is overbroad must be considered independently of any request for injunctive relief against enforcement of that statute.").

The sole decision the Defendants cite on this issue – *Franklin v. Massachusetts*, 505 U.S. 788 (1992) – drives home the point. *See* Mem. at 13. In that case, the Supreme Court noted that the district court's grant of an injunction against the President was likely improper because courts lack jurisdiction to enjoin the President in performance of his official duties. *Id.* at 802. Nevertheless, the Court found that a declaratory judgment was available to accomplish the same

result: "[f]or the purposes of establishing standing, however, we need not decide whether injunctive relief against the President was appropriate, because we conclude that the injury alleged is likely to be redressed by declaratory relief against the Secretary alone," as "we may assume it is substantially likely that the President and other executive and congressional officials would abide by" this declaratory judgment. *Id.* at 803. Thus, the Supreme Court's holding instructs that it is perfectly appropriate to issue a declaratory judgment, even if an injunction to the same effect may be unavailable. This, of course, is fatal to the Defendants' position.

Having established that it has the right to sue for and obtain a declaratory judgment from this Court, Ambac now turns to the City's substantive arguments in support of its motion to dismiss.

VI. COUNT I STATES A CLAIM BECAUSE STATE LAW RESTRICTIONS ON A MUNICIPALITY'S USE OF FUNDS SURVIVE IN BANKRUPTCY

A. The Restricted Bond Taxes Are Restricted Funds

Count I seeks a declaration that the Restricted Bond Taxes are "restricted funds," which must be segregated and not used for any purpose other than paying the Bonds. Restricted funds are amounts that are constrained by legislation to be used only for the specific purposes provided in the legislation. GASB Statement

54. Here, there is no question that the Restricted Bond Taxes are restricted funds under Michigan law and, not surprisingly, the City virtually admits this.

Act 34 imposes strict controls over, and limitations upon, the use of the Restricted Taxes, *i.e.*, the *ad valorem* taxes levied to secure payment of debt service on both the Unlimited Tax Bonds and the Limited Tax Bonds. *See* Act 34 § 701(1), (3). In the first place, and contrary to Defendants' mischaracterization, *see* Mem. at 3 (referring to "unspecified real estate taxes the City collects"), Act 34 is both precise and specific as to the stream of taxes dedicated for payment of the Bonds. Section 701(1)(a) requires the City to levy *ad valorem* taxes in amounts sufficient to pay the debt service on the Bonds. Mich. Comp. Laws § 141.2701(1)(a). Section 701(3) requires, with regard to the Unlimited Tax Bonds, that the City levy each year the full amount of taxes necessary for payment of the Unlimited Tax Bonds, without limitation as to rate or amount and in addition to other taxes that the City may be authorized to levy. Mich. Comp. Laws § 141.2701(3). Section 701(3) further requires, with regard to the Limited Tax Bonds, that the City set aside each year, from the levy and collection of *ad valorem* taxes required by the Section, "as a first budget obligation," the amount necessary for the payment of debt service on the Limited Tax Bonds. *Id.*

Section 701(6) then provides, with respect to both the Unlimited Tax Bonds and the Limited Tax Bonds, that "[a]s taxes are collected, there *shall* be set aside

that portion of the collections that is allocable to the payment of the principal and interest on the [Bonds]." Mich. Comp. Laws § 141.2701(6) (emphasis added). The portion set aside is to be divided among the applicable debt retirement funds in accordance with the amount levied for each purpose, and if tax collections of more than one issue of Bonds are paid into a debt retirement fund, the taxes are to be allocated on the City's books and records among the various issues in accordance with the amounts levied for each purpose. *Id.*; *see also* § 701(d)(i), Mich. Comp. Laws § 141.2701(1)(d)(i) (requiring that the City establish debt retirement funds, and deposit the proceeds of the tax levies into those funds to be "used to pay debt service charges or obligations" on the Bonds). Thus, the use of the Restricted Bond Taxes is strictly delineated and constrained, and as such, they are classic restricted funds.

The Defendants as much as admit this, as they acknowledge that Act 34 requires that the City segregate the Restricted Bond Taxes and not use them for any purpose other than to pay the Bonds. Mem. at 16. Their sole basis for challenging Count I is the assertion that these state law restrictions cease to apply once a bankruptcy case is commenced, because the Bankruptcy Code preempts them. Therefore, they contend, Ambac has not stated a claim for a declaration that Michigan law imposes these restrictions during the pendency of the bankruptcy case. The defendants are mistaken.

B. The Bankruptcy Code Does Not Preempt a Finding that the Restricted Bond Taxes Are Restricted Funds Under State Law

Like so many of their arguments, the Defendants' preemption argument is premised on a make-believe version of the Amended Complaint. They argue that a determination that the Restricted Bond Taxes constitute "restricted funds" must be preempted because it would conflict with bankruptcy provisions relating to distribution priorities and impairment. But Count I does *not* allege, as Defendants pretend, that the Bonds must be paid in full, or that they cannot be impaired. Nor does Count I seek any sort of bankruptcy priority for the Bonds. Determining whether Bondholders have an equitable or beneficial property interest in the Restricted Bond Taxes is a wholly different issue from determining whether the Bonds can legally be impaired under a plan of adjustment. The issue raised by the Amended Complaint is Bondholders' property interest, not impairment.[6] Count I seeks only a declaration that Act 34 requires segregation of the Restricted Bond Taxes and mandates that the Restricted Bond Taxes not be commingled or used for any purpose other than the payment of debt service on the Bonds. In other words,

[6] As discussed *infra*, Section VII, a case cited by the Defendants – *In re City of Columbia Falls, Mont., Special Imp. Dist. No. 25*, 143 B.R. 750, 759 (Bankr. D. Mont. 1992) – perfectly illustrates this dichotomy. *Columbia Falls* held that the bonds at issue there could be impaired in the plan, while at the same time holding that the bondholders had the sole equitable interest in the taxes levied to secure the bonds, which could, as a consequence, be used *only* for payment of the bondholders.

Count I seeks a declaratory judgment regarding state law restrictions on property rights. As such, it is in no way susceptible to preemption by the Bankruptcy Code.

It is axiomatic that property rights, even in bankruptcy, are determined by state law:

> Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.

Butner v. United States, 440 U.S. 48, 55 (1979); *see also, e.g., Nobleman v. Am. Savings Bank*, 508 U.S. 324 (1993) (same); *In re Dow Corning Corp.*, 456 F.3d 668, 684 (6th Cir. 2006) (same). Accordingly, "[w]hether a party has an interest in property and the extent of that interest is determined by applicable nonbankruptcy law." *In re Harchar*, 694 F.3d 639, 647 (6th Cir. 2012); *see also In re Stewart*, 499 B.R. 557, 563 (Bankr. E.D. Mich. 2013) (same).[7]

[7] Subsequent case law makes clear that the reference in *Butner* and its progeny to "some other federal interest" that may "require[] a different result" is to a federal interest that manifests itself in express statutory language or clear legislative intent. For example, in *Travelers Casualty and Surety Co. of America v. Pacific Gas & Electric Co.*, 549 U.S. 443 (2007) the Court overruled the so-called "*Fobian* Rule" – which dictated that attorneys' fees were not recoverable in bankruptcy for litigant issues peculiar to federal bankruptcy law – because nothing in section 502(b) "expressly disallow[s]" those claims. *Id.* at 451-52. "[W]e generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are *expressly disallowed*." *Id.* at 552 (citing 11 U.S.C. § 502(b)) (emphasis added); *see also BFP v. Resolution Trust Corp.*, 511 U.S. 531, 544-45 (1994) ("[t]o displace traditional state regulation . . . the federal statutory purpose must be 'clear

Consistent with this fundamental principle, bankruptcy courts regularly respect and defer to state law restrictions on the use of property. In *Matter of Sanitary Imp. Dist. No. 7 of Lancaster Cnty, Neb.*, 96 B.R. 967, 972 (Bankr. D. Neb. 1989), for example, the court expressly stated that "[t]he Code does not override state law concerning the use debtor may make of its property . . . neither the Code nor the Nebraska statute authorize a Chapter 9 debtor to pay [] expenses out of a restricted fund." Similarly, the court in *In re City of Vallejo, Cal.*, No. 08-26813-A-9, 2008 WL 4180008, at *5 (Bankr. E.D. Cal. Sept. 5, 2008), *aff'd*, 408 B.R. 280 (9th Cir. BAP 2009), held that cash and investments restricted by law or grant to specific uses were not available to cover the operating expenses of the City, and could not, therefore, be considered in determining whether the City was

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and manifest' . . . Otherwise, the Bankruptcy Code will be construed to adopt, rather than to displace, pre-existing state law."); *Barnhill v. Johnson*, 503 U.S. 393, 398 (1992) ("In the absence of any *controlling federal law*, 'property' and 'interests' in property are creatures of state law."); *In re Reinhardt*, 563 F.3d 558, 563 (6th Cir. 2009) (noting that conflict preemption of a state law only occurs where it is impossible to comply with both federal and state law and concluding that no such preemption applied to an Ohio law's rule regarding whether a mobile home constituted real property); *In re Curry*, 347 B.R. 596, 600-01 (6th Cir. 2006) (recognizing that *Butner* will preclude a state property interest only when an "actual conflict exists between state laws and bankruptcy laws enacted by Congress," and finding here that the Ohio law actually conflicted with text of sections 363, 542, and 1303 of the Act); *In re Ajay Sports, Inc.*, 370 B.R. 703, 709 (E.D. Mich. 2007) ("[T]he settled principle [is] that creditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code." (quoting *Travelers*, 549 U.S. at 449)).

insolvent. More recently, the court in *In re City of San Bernardino*, 499 B.R. 776, 789 (Bankr. C.D. Cal. 2013), held that the California Constitution precluded the City from using restricted funds for general fund purposes.

This Court has likewise recognized this well-settled concept in not just one, but *two* recent decisions *in this case*. First, in the Court's decision on the City's eligibility to file for bankruptcy, the Court pointed out that had the 1963 revision to the Michigan Constitution been written differently, it "could have given pensions protection from impairment in bankruptcy." Decision at 79-80 [ECF 1945]. For example, "[i]t could have somehow created a property interest that bankruptcy would be required to respect under *Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914 (1979) (holding that property issues in bankruptcy are determined according to state law)." *Id.* Similarly, in the Court's decision on the City's DIP motion, the Court observed that the City "must comply with state law unless, of course, [the Code] expressly provides otherwise," and then held that the City could permissibly offer gaming tax revenues as security for a loan pursuant to the Gaming Control Act, "but only if the proceeds of the loan that are so secured are used as limited by state law," Hrg. Tr. at 25-26 (Jan. 16, 2014), explicitly recognizing that state law restrictions are respected in bankruptcy.

Numerous decisions under other chapters of the Bankruptcy Code reach the same result. *See, e.g.*, *Integrated Solutions, Inc. v. Service Support Specialties,*

Inc., 124 F.3d 487 (3d Cir. 1997) (state law restrictions on the transferability of property not preempted by Bankruptcy Code); *In re Farmers Markets, Inc.*, 792 F.2d 1400, 1403 (9th Cir. 1986) (Bankruptcy Code does not preempt state law that restricts transfer of liquor license until delinquent taxes paid in full; "estate may take no greater interest than that held by the debtor"); *In re Parkview Hosp.*, 211 B.R. 619 (Bankr. N.D. Ohio 1997) (hospital research fund was restricted to designated use and not available for distribution to creditors); *In re Schauer*, 62 B.R. 526 (Bankr. D. Minn. 1986) (restriction on transfer of revolving fund certificates enforceable in bankruptcy).

The premise for these decisions, as explained by the Court of Appeals for the Third Circuit in *Integrated Solutions*, is that "unless federal bankruptcy law has *specifically* preempted a state law restriction imposed on property of the estate, the trustee's rights in the property are limited to only those rights that the debtor possessed pre-petition." *Integrated Solutions*, 124 F.3d at 492-93 (emphasis added) (citing *Butner*). And Congress clearly knows how to be explicit when it intends to displace state law in the Bankruptcy Code. *See, e.g.*, 11 U.S.C. § 541(c)(1) ("[A]n interest of the debtor in property becomes property of the estate . . . *notwithstanding any provision in . . . nonbankruptcy law* (A) that restricts or conditions transfer of such interest by the debtor . . . " (emphasis added)); *see also Integrated Solutions*, 124 F.3d at 493 (quoting other examples).

Here, as in the numerous decisions cited above, there is nothing in the Bankruptcy Code that specifically preempts the state law restrictions imposed on the Restricted Bond Taxes by Act 34. The Defendants argue otherwise, referring vaguely to the preemption of state law priorities that are inconsistent with the distribution rules contained in the Bankruptcy Code. Mem. at 20. But the issue here is property rights, not priorities or distribution rules. As aptly stated by the Court of Appeals for the Ninth Circuit in *Farmers Markets*, 792 F.2d at 1403:

> Section 24049 [the state law restriction] could arguably be cast as inconsistent with the bankruptcy process because parties claiming under it may fare better in bankruptcy than they would if there were no such statute. Yet this argument confuses the classification of an interest with the displacement of the Code's priority scheme. To classify what might otherwise be a lesser claim as a proprietary interest does not displace the priority provisions. It merely reclassifies an interest within that scheme. In *Artus v. Alaska Department of Labor, Employment Security Division (In re Anchorage International Inn, Inc.)*, 718 F.2d 1446 (9th Cir.1983), we concluded that state law does not conflict with federal bankruptcy law merely because it favors one class of creditors over another. *Id.* at 1451. *See also* J.A. MacLachlan, *Handbook of the Law of Bankruptcy* 145 (1956) ("Priorities are to be distinguished from property rights."). The Code expressly recognizes such preferences in the form of perfected security interests and statutory liens. 11 U.S.C. §§ 506(a), 545 (1982). Although it does preempt state law schemes to circumvent the bankruptcy laws by invalidating liens or priorities triggered by the bankruptcy or insolvency of the debtor, 11 U.S.C. § 545 (1982), § 24049 presents no such problem.

The cases cited by the Defendants in support of a contrary result are readily distinguishable. Several of these cases stand only for the proposition that state law may not shield specific types of claims from impairment in a plan. *See, e.g.*,

Matter of Sanitary & Imp. Dist., No. 7, 98 B.R. 970, 974 (Bankr. D. Neb. 1989) (rejecting argument that state law required the plan of adjustment to require the debtor "to pay prepetition bondholders" in full); *In re City of Columbia Falls, Mont., Special Imp. Dist. No. 25*, 143 B.R. 750, 759 (Bankr. D. Mont. 1992) (same); *In re City of Stockton, Cal.*, 478 B.R. 8, 16 (Bankr. E.D. Cal. 2012) ("It follows, then, that contracts may be impaired in this chapter 9 case without offending the Constitution."). As discussed above, Count I does not seek a declaration that the Bonds may not be impaired; consequently, these decisions are inapposite.

The remaining cases cited by the Defendants apply conflict preemption and hold the state law to be preempted based on an actual and irreconcilable conflict between state and bankruptcy law.[8] Specifically, these decisions generally reject creditors' attempts to obtain priority status – something Ambac is not seeking. *See In re City of Vallejo*, 403 B.R. 72, 77 (Bankr. E.D. Cal. 2009), *aff'd*, 432 B.R. 262 (E.D. Cal. 2010) (state labor law was preempted because it conflicted with § 365); *In re Kitty Hawk, Inc.*, 255 B.R. 428 (Bankr. N.D. Tex. 2000) (rejecting the union's contention that its claims are entitled to administrative priority); *In re Cnty.*

[8] The sole exception is *Matter of Haber Oil Co., Inc.*, 12 F.3d 426, 436 (5th Cir. 1994), a case in which the Court declined, on the facts before it, to find a constructive trust based on fraud. The Court does not address preemption at all, and thus the case is inapposite.

of Orange, 191 B.R. 1005, 1016-1017 (Bankr. C.D. Cal. 1996) (state statute excusing creditors from the requirement of tracing their trust funds conflicted with bankruptcy law); *In re Lull Corp.*, 162 B.R. 234, 239 (Bankr. D. Minn. 1993) (state statute conflicted with the wage priority established by § 507(a)(4)); *In re Nat'l Bickford Foremost, Inc.*, 116 B.R. 351 (Bankr. D.R.I. 1990) (rejecting priority status under § 507(a)(3) and (4) where the claim arose "outside the Code's priority claim period."); *In re Redford Roofing Co., Inc.*, 54 B.R. 254 (Bankr. N.D. Ill. 1985) (prepetition workers' compensation claim was not a claim for wages or an administrative expense, and thus was not entitled to priority).

In short, Count I seeks a declaratory judgment concerning property rights – a declaration that under state law, the Restricted Bond Taxes are restricted funds and may not be used for any purpose other than the purpose for which they are designated by state law. The abundant case law overwhelmingly establishes that state law restrictions like those at issue here are routinely recognized in bankruptcy, and are not preempted.

Indeed, the City itself acknowledged as much in its Motion for Entry of an Order (I) Authorizing the Debtor to Enter Into and Perform Under Certain Transaction Documents with the Public Lighting Authority and (II) Granting Other Related Relief (ECF # 1341) ("PLA Motion"). In seeking approval of a transaction involving a City pledge of $12.5 million per year of utility tax revenues

to a newly formed public lighting authority, the City (and the State of Michigan) argued that the utility tax revenues were restricted by state law to specific uses and thus not available to other creditors in any event. Hrg. Tr. (Nov. 27, 2013) at 11-12, 47 (City), 14-15 (State). Specifically, § 2(4) of the Utility Users Tax Act provides that utility tax revenues may be used only to retain or hire police officers, unless pledged to pay bonds issued by a public lighting authority. Mich. Comp. Laws § 141.1152(4). Section 2(5) of the Act provides that if a municipality forms a public lighting authority, the municipality "shall" pay $12.5 million a year of the utility tax revenues to that authority. Mich. Comp. Laws § 141.1152(5). The City formed a public lighting authority on February 5, 2013, PLA Tr. at 4, and thus argued that it was required by this state law to pay $12.5 million a year to the authority, notwithstanding its bankruptcy proceeding, *i.e.*, that the tax revenues were restricted to this specific use and were not available for distribution to other creditors. *See* Hrg. Tr. at 47 ("we've already created the PLA, so we're already obligated to fund the $12-1/2 million every year . . . So even if you don't approve this motion, that $12-1/2 million will never be available to pay [creditors] at a plan of adjustment stage."). Clearly, the City recognizes that state law restrictions on the use of property are of full force and effect in bankruptcy.

VII. COUNTS II AND III STATE CLAIMS BECAUSE THE BONDHOLDERS, AND NOT THE CITY, HAVE THE EQUITABLE AND BENEFICIAL PROPERTY INTEREST IN THE RESTRICTED BOND TAXES

In Counts II and III of the Complaint, Ambac seeks a declaratory judgment that the Bondholders, and not the City, have the equitable and beneficial property interests in the Restricted Bond Taxes. Under Michigan law, the Restricted Bond Taxes are dedicated for debt service on the Bonds. Act 34 requires that they be segregated promptly upon receipt into accounts solely for the Bondholders, and provides that the monies can be used only to pay debt service on the Bonds. Thus, neither the City nor its other creditors can benefit from or have legal access to the Restricted Bond Taxes. Indeed, the Restricted Unlimited Bond Taxes can be levied and collected *solely* in connection with the Unlimited Tax Bonds; if the Unlimited Tax Bonds ceased to exist, the City would no longer have the legal authority to levy or collect the Restricted Unlimited Bond Taxes. Consequently, the City has no equitable or beneficial interest in the Restricted Bond Taxes; the equitable and beneficial interest belongs to the Bondholders.

Courts have frequently addressed situations similar to this one, and they have invariably reached the same ultimate conclusion – that the equitable and beneficial ownership in the property at issue belongs to the person for whose benefit it is designated. While the result is uniformly the same, court decisions tend to fall into one of two general groups. Some apply a "trust" theory, holding that the funds at

issue are held in trust for the benefit of the entity for which the funds are legally dedicated. Others apply a "conduit" theory, holding that the entity in the City's position is merely a conduit with, at most, bare legal title. Both approaches lead to the same conclusion here – that the equitable and beneficial ownership in the Restricted Bond Taxes belong to the Bondholders, and not the City.

A. Because the Restricted Bond Taxes May Be Used Only for the Benefit of the Bondholders, They are Held In Trust in which the Bondholders Have the Equitable and Beneficial Interest

It has long been well-settled that where, as here, a state statute restricts the use of tax assessments for the payment of principal and interest on bonds, the taxing entity holds the taxes in trust for the bondholders. The decision in *Columbia Falls*, 143 B.R. 750, is particularly instructive. Pursuant to Montana law, Columbia Falls created special improvement districts (SIDs) to provide enhancements to its subdivisions, and then issued bonds to finance the enhancements. Acting in accordance with state law and city resolutions, the city then levied taxes on lots within the subdivisions. The taxes were pledged to the bondholders, and were required to be deposited into a revolving fund. The revolving fund, in turn, "loaned" the tax proceeds to a district fund to the extent required by the district fund to pay the principal and interest on the bonds. 143 B.R. at 752-54.

The debtor SIDs and the city sought to use money held in the revolving funds to pay delinquent property taxes on properties within the SID district. Rejecting their

request, the court held that "the funds are trust funds under state law." *Id.* at 762. Explaining, the court quoted the Montana Supreme Court:

> A fund that is derived from a special levy or one created for a specific purpose is in the hands of municipal officials in trust. The municipality is merely a custodian, and its duties relative to such funds are purely ministerial. *It may not use or divert them.*

Id. (quoting *State ex rel. Clark v. Bailey*, 99 Mont. 484, 44 P. 2d 740, 746 (1935) (emphasis added by court)). Accordingly, the court concluded that the requested use would involve a "use of trust assets for a purpose other than the payment of principal and interest on the bonds as they become due . . . inconsistent with the role of the municipality as a custodian, with purely ministerial powers." *Id.*[9]

Numerous other decisions reach the same result. *See, e.g.*, *Federal Deposit Ins. Corp. v. Casady*, 106 F.2d 784, 788 (10th Cir. 1939) (under Oklahoma law requiring assessments for local improvements and interest thereon to be paid to town treasurer to be kept in separate special fund, "[t]he relation between the town or city through its officers and the bondholder thus created is that of an express trust created by law in which the city is the trustee and the bondholder the cestui que trustent.");

[9] Significantly, the Defendants cite *Columbia Falls* for a separate holding in the case – that bondholder claims can be impaired in Chapter 9 despite a state law requiring payment in full. Mem. at 19. This holding, as contrasted with the holding discussed above, demonstrates clearly the distinction between the issues raised in the Amended Complaint and the plan-focused issues the Defendants erroneously insist are at issue in this matter. The Amended Complaint addresses *only* the parties' property rights and interests in the Restricted Bond Taxes, and *not* the treatment of the Bonds themselves in the City's plan of adjustment.

Cty. & Cnty. of Dallas Levee Imp. Dist. v. Indus. Props. Corp., 89 F.2d 731 (5th Cir. 1937) (taxes collected for servicing bonds "are simply held in trust for the purposes expressed in the statute, of paying the interest and the principal of the bonded indebtedness."); *Bexar County Hosp. Dist. v. Crosby*, 160 Tex. 116, 122 (1959) (under Texas law, taxes levied specifically to retire certain bonded indebtedness are held by the city and county in trust for the bondholders, and cannot be applied to any purpose except the bond indebtedness); *Bedell v. Lassiter*, 143 Fla. 43, 44 (1940) (under Florida law, taxes levied and collected to secure payment of bonds constitute a trust fund for the benefit of bondholders); *Hays v. Isaacs*, 275 Ky. 26 (1938) (under Kentucky law, sinking fund held by County and holding taxes collected for repayment of bonds "is a trust for the benefit of the holders of the bonds" and cannot be diverted to another purpose); *City of Austin v. Cahill*, 99 Tex. 172, 187-88 (1905) ("It is a very generally recognized rule that, in appropriating or disposing of tax funds, money raised for a specific purpose cannot be used for any other purpose. The reason is quite obvious. Since the fund is raised for the benefit of a particular class, it is in a special sense impressed with a trust for that class, and hence to divert it would necessarily be to misapply it." (internal citations and quotations omitted)).

This is also the law in Michigan, and has been since at least 1888. In *Taggert v. City of Detroit*, 71 Mich. 92 (1888), the Michigan Supreme Court addressed a situation in which a state law required the city to maintain a sinking fund for the

repayment of bonds issued in connection with the construction of a public market. Some of the bonds were purchased by the city itself and held in the sinking fund, and the city sought to treat those bonds as having been paid and to abolish the fund. The court rejected the city's plan, stating that it "would be a fraud on the tax-payers, and a violation of the act of the legislature, to relinquish the fund set apart for that purpose, *which was made a trust fund*." *Id.* at 98-99 (emphasis added). The court further observed that "[t]he fact that the city has not in fact kept the market sinking fund distinct can make no difference. It is bound to keep it untouched, and, if funds have been diverted, the city is bound to restore them where they belong." *Id.* at 99. In fact, the court added, "Until the legislature shall see fit to provide otherwise, there can be no step taken to use the trust property for other purposes, without a direct violation of legal duty, and it cannot be allowed." *Id.*

This trust principle has remained the law in Michigan for more than a century. In *Sawicki v. City of Harper Woods*, 368 Mich. 435 (1962), the Michigan Supreme Court addressed bonds issued and sold to finance street improvements that were backed by special assessments levied to assist in financing the improvements and to repay the bonds. Landowners subject to the assessments sued for a refund, asserting that there was a surplus in the fund in which the assessments were held. The issue before the court was whether the landowners were entitled to a refund currently, or

only after the outstanding bonds were paid in full. *Id.* at 437-38. The court held that the landowners' action was premature, stating:

> [T]he purchasers of the bonds issued had the right to rely on the charter provisions in accordance with which the [bonds were issued]. The special assessments collected from plaintiffs and others under such provisions, and in accordance with the general rule pertaining thereto, *constituted a trust fund*, which fund was designed to furnish security for the payment of the obligations.

Id. at 440 (emphasis added); *see also Bray v. Dept. of State*, 418 Mich. 149, 175 (1983) (on a point unrelated to the holding of the majority, the dissent noted: "It is well established that money collected by virtue of a special assessment constitutes a trust fund and that the governmental body collecting the assessment is the trustee of the fund." (citations omitted)).

In a similar vein, the Michigan Court of Appeals held in *Grand Rapids Public Schools v. The City of Grand Rapids*, 146 Mich. App. 652, 656-57 (1985), that *ad valorem* taxes collected by a city treasurer and designated for the city's school districts are held in a trust fund, such that interest earned on the fund belonged to the beneficiary school districts rather than to the municipal treasurer who acts as trustee or custodian of the fund. Explaining its holding, the court observed that "a city or county treasurer is a *fiduciary* in the management and application of public funds." 146 Mich. App. at 657 (citing *Lewkowicz v. Youngblood*, 86 Mich. App. 663, 667 (1978), *aff'd sub nom. Romulus City*

Treasurer v. Wayne County Drain Comm'r, 413 Mich. 728 (1982) (emphasis added)).

Significantly, all of the courts applying the trust approach reach this result despite the fact that the word "trust" is never used in any of the relevant provisions of state law, city charters, or authorizing resolutions. This is consistent with the principle in the Sixth Circuit that the "failure to expressly designate the relationship as one of trust does not necessarily negate its existence." *In re Arctic Exp. Inc.*, 636 F.3d 781, 792 (6th Cir. 2011) (quoting *In re Penn Cent. Transp. Co.*, 486 F.2d 519, 524 (3d Cir. 1973) (en banc), *cert. denied*, 415 U.S. 990 (1974)). "A property arrangement may constitute a trust . . . even though such terms as 'trust' or 'trustee' are not used." *Id.* (quoting Restatement (Third) of Trusts § 5 cmt. a (2003)); *see also In re Cannon*, 277 F.3d 838, 850 (6th Cir. 2002) (when "a person has or accepts possession of personal property with the express or implied understanding that he is not to hold it as his own absolute property, but is to hold and apply it for certain specific purposes or for the benefit of certain specified persons, a valid and enforceable . . . trust exists.").

This body of case law is directly on point to the circumstances presented here. The City collects the Restricted Bond Taxes that are indisputably earmarked, and not the City's to do with as it pleases. In the case of the Unlimited Bond Taxes, they were levied solely for the purpose of paying the Unlimited Bonds, and

in the case of the Limited Bond Taxes, they are collected as a first budget obligation solely for the purpose of paying the Limited Bonds. Both must be segregated by the City, and neither may be used by the City at its discretion. As payment of the Bonds is the only permissible use of these funds and the Bondholders are the only recipients entitled to the funds, there is simply no other conclusion but that the Restricted Bond Taxes are held in trust for the benefit of the Bondholders.[10] Tellingly, the Defendants do not argue otherwise.

[10] The City may argue that the Bondholders are not entitled to claim a beneficial interest in the Restricted Bond Taxes, alleging that the City has commingled the money in violation of the requirements of Act 34, making it untraceable. *See In re County of Orange*, 191 B.R. 1005, 1015 (Bankr. C.D. Cal. 1996) (concluding that a beneficiary of an insolvent trustee debtor must be able to trace its funds in order to claim any property of the debtor). However, the Sixth Circuit has adopted the "lowest intermediate balance test," pursuant to which a bankruptcy court will follow the money into a commingled fund so long as the balance of the commingled funds has at all times equaled or exceeded the amount of the money held in trust, and any reduction in the amount of the commingled funds is assumed to be from withdrawal of non-trust funds. *See First Fed. of Mich. v. Barrow*, 878 F.2d 912, 916 (6th Cir. 1989) (quoting 4 L. King, Collier on Bankruptcy, ¶ 541.13, at 541-79 to 541-80 (15th ed. 1988)); *see also In re Columbia Gas Sys. Inc.*, 977 F.2d 1039, 1063 (3d Cir. 1993) (same). Thus, if the City were to make this argument, it would at most create an issue of fact, requiring denial of its motion to dismiss. And in any event, this argument would have applicability *only* to the extent that the City has, to date, failed to comply with Act 34's requirement that it segregate the Restricted Bond taxes, and not to Restricted Bond Taxes collected in the future.

B. The City is a Mere Conduit of the Restricted Bond Taxes and Therefore Lacks Any Equitable or Beneficial Interest in Them

A second approach courts take to situations where one party holds funds designated for the benefit of another is to characterize the first party as a mere "conduit" or "delivery vehicle" of the funds, lacking any ownership except, at most, bare legal title. This approach, like the trust approach, leads ineluctably to the conclusion that the City has no equitable or beneficial ownership in the Restricted Bond Taxes at issue here.

The leading case from the Sixth Circuit that applies this theory is *In re Computrex, Inc.*, 403 F.3d 807 (6th Cir. 2005). In *Computrex*, the debtor's business was to arrange shipping logistics for manufacturers. Computrex would process bills from the shipping carriers it had arranged and send an invoice to the client covering both the shipping charges and Computrex's fee; the client would then send a check to Computrex, who was then supposed to use those funds to pay the carriers. *Id*. at 809. Pursuant to this arrangement, the carriers of one client, Contech, were paid millions of dollars within the ninety days of the filing of the involuntary petition. Computrex's Chapter 7 trustee sued to have these payments set aside as preferences. The bankruptcy court, the district court, and the Sixth Circuit all held that Computrex "lacked any property interest in Contech's money." *Id.* at 812.

The Sixth Circuit carefully analyzed the contractual relationship between the parties, noting that "[th]e relationship was strictly defined, and [the Debtor]'s brief

possession of Contech's funds was to be similar to that of a transfer station along the road to payment of Contech's carriers." *Id*. at 811. The trustee argued, however, that the parties' contract did not require Computrex to pay the carriers with Contech's own funds – that Computrex was permitted to commingle its clients' funds, and therefore, Computrex exercised sufficient control and dominion over the funds to establish that it had a property interest in the funds making them part of its estate. *Id.* at 812. The court rejected this argument, holding that the fact that the debtor did in fact commingle its clients' funds did not establish that the funds were part of its estate.[11] *Id.* Rather, regardless of the debtor's control over and misuse of the funds, the debtor was plainly supposed to be "merely a disbursing agent." *Id*. at 813. It therefore did not have an equitable property interest in the funds. *Id.*

The First Circuit reached the same conclusion in *In re LAN Tamers, Inc*., 329 F.3d 204 (1st Cir. 2003). *LAN Tamers* involved a federal program designed to encourage public schools to connect to the internet. LAN Tamers was an internet service provider that installed internet connections in school districts; the school districts paid LAN Tamers directly for its services, and were then reimbursed by the

[11] Other bankruptcy court decisions, including from this district, also hold that the tracing requirement is inapplicable to the "conduit" doctrine, and that the parties' respective property rights are unaffected by the debtor's comingling or misuse of the funds in question. *See, e.g., In re CMC Telecom, Inc.*, 383 BR 52, 64 (Bankr. E.D. Mich. 2008); *In re W. Cent. Housing Dev. Org.*, 338 B.R. 482, 490 (Bankr. D.Colo. 2005).

federal program for the cost. However, the federal program made the reimbursements by paying them to LAN Tamers, rather than the school districts, and LAN Tamers was then statutorily required to forward the reimbursements to the school districts. *Id*. at 207. The issue in the First Circuit was whether reimbursement money was property of LAN Tamers' estate, available for distribution to its creditors, or was instead was the property of the school districts – in this case, the city of Springfield, Massachusetts. *Id.* at 208-09.

While the lower courts applied a trust theory to conclude that the reimbursements were not property of the estate, the Court of Appeals reached the same result through the conduit theory:

> The usage [of the trust theory] may prove confusing . . . because these supposed trusts might lack characteristics of trusts recognized for other purposes under state law. We think it better to avoid the language of trusts and rest our holding more simply on the fact that LAN Tamers, as a mere delivery vehicle, lacked an equitable interest in the reimbursements under the federal program.

Id. at 214.

The court thus began its analysis by pointing out that property is excluded from a debtor's estate "where the bankrupt entity is only a delivery vehicle and lacks any equitable interest in the property it delivers." *Id.* at 210.[12] The court then

[12] The Court's statement was a reference to Section 541(d) of the Bankruptcy Code. Section 541 is not incorporated into Chapter 9, because it defines "property of the estate" and there is no separate "estate" created in Chapter 9. Section 541(d)

analyzed the situation with a three-prong inquiry in which it examined: (1) the role the debtor was intended to play with respect to the property; (2) the degree and intensity of regulatory control over the property; and (3) the extent to which recognizing a greater ownership interest on the part of the debtor – and thereby diverting the property in question to the creditors – would thwart the overall purpose of the regulatory scheme. *Id*. at 212. Having done so, the court concluded that the debtor served "only as a delivery vehicle" for reimbursement funds and that it lacked "any equitable interest in the property it delivers." *Id*. at 210. The debtor had "absolutely no freedom to do anything with the reimbursements except forward them" to the school district within ten days because Congress intended the money to pay only for "very specific activities." *Id*. at 212. At most, LAN Tamers would hold "bare legal title to the reimbursements for a short time." *Id*.

The *LAN Tamers* analysis was adopted by this Court in *In re CMC Telecom, Inc*., 383 B.R. 52, 62 (Bankr. E.D. Mich. 2008). In that case, where virtually identical facts were presented, the Court similarly concluded that the school district,

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and the case law thereunder, which address the extent of a debtor's interest in property with respect to which the legal and equitable title is divided, is nonetheless instructive in analyzing property interests in Chapter 9 because even in the absence of an "estate," the Court must determine the extent of the municipality's interest in property.

not the internet provider in possession of the money, had the equitable interest in the property at issue:

> [T]his Court finds that the reimbursement funds paid . . . to Defendant in the present case, like the funds at issue in the *LAN Tamers* case, are not property of the bankruptcy estate, and belong solely to Plaintiffs – the entities the statutory scheme was intended to benefit. Defendant/Debtor's creditors have no right to these funds and these funds cannot be used to fund the Debtor's Plan of Reorganization. Debtor had a mere possessory interest in these funds when Debtor filed for bankruptcy. Debtor did not have equitable title to the funds and they are not property of the estate.

Id. at 62. Moreover, as in *Computrex*, the Court rejected the notion that a different result was required as a result of the debtor's comingling of the money with its other funds. *Id*. at 64 (the "mere possession of the funds and commingling the money in a general operating account" did not make the funds the property of the debtor).

Numerous courts in other jurisdictions have also applied this approach, whereby entities that are mere conduits or delivery vehicles of the funds they possess are found not to have an equitable property interest. *See, e.g., T & B Scottsdale Contractors, Inc. v. United States*, 866 F.2d 1372, 1376 (11th Cir. 1989) (bank account maintained by primary contractor contained funds from subcontractor to pay its materialmen; funds not part of subcontractor's bankruptcy estate because held solely for benefit of materialmen); *In re Joliet-Will Cnty. Cmty. Action Agency*, 847 F.2d 430, 432 (7th Cir. 1988) (debtor operating on federal and state grant money was a "trustee, custodian, or other intermediary" of those funds and had no beneficial title

interest in them); *In re W. Cent. Housing Dev. Org*., 338 B.R. at 490 (debtor held only bare legal title, not a beneficial interest, in funds over which debtor lacked "unfettered discretion," even though the funds were commingled with other monies); *In re Tap, Inc.*, 52 B.R. 271, 276 (Bankr. D. Mass. 1985) (where debtor payroll company was obligated to use the funds received from client solely for the payment of taxes, debtor was a "mere conduit," and a trust relationship existed between the client and the debtor requiring the debtor to return the money to the client).

Indeed, the "mere conduit" doctrine sometimes overlaps with the "trust" approach discussed in the preceding section, as is best demonstrated by the decision of the Third Circuit in *In re Columbia Gas Sys. Inc.*, 997 F.2d 1039 (3d Cir. 1993). In *Columbia Gas*, the Third Circuit examined whether funds earmarked for customer refunds, suppliers' bills, and other surcharges were the debtor's property. As in *LAN Tamers*, the court concluded that where a debtor is a mere conduit for funds to travel from one party to another, it lacks an equitable interest in the monies. *Id.* at 1059. Departing from *LAN Tamers* in its concern about employing trust doctrines, however, the Third Circuit concluded that imposing a constructive trust on the monies held by a debtor but designated for a third party was appropriate. *Id.* at 1056 (citing *In re Penn Central Transp. Co.*, 486 F.2d at 523-27; *see also In re FirstPay, Inc.*, No. 05-1695PM, 2012 WL 3778952 (Bankr. D. Md. Aug. 30, 1012) (relying on *LAN Tamers*, but concluding that Maryland law imposed a resulting trust on funds held by

the debtor that were designated for payment to the IRS). The *Columbia Gas/Penn Central* approach that blends the conduit and trust theories has twice been employed by the Sixth Circuit. *See Parker Motor Freight, Inc. v. Fifth Third Bank*, 116 F.3d 1137, 1140 (6th Cir. 1997) (expressly following *Penn Central* and *Columbia Gas* in holding that transportation and freight charges, when collected by one motor carrier on behalf of another for services the latter has performed, are held in trust for the latter); *In re Ann Arbor Railroad Co.*, 623 F.2d 480 (6th Cir. 1980) (following *Penn Central*).[13]

The lesson from these cases is clear: entities that are duty bound to deliver funds to a specified recipient do not hold equitable title to those funds. Here, as in the foregoing decisions, the Defendants are collecting and holding funds that are designated specifically and solely to be used to pay other parties. The Defendants lack any discretion with respect to the money. Act 34 strictly defines the relationship between the City and the Bondholders, and expressly provides that the Restricted

[13] Significantly, the approach utilized by these cases is not foreclosed by *In re Omegas Grp., Inc.*, 16 F.3d 1443 (6th Cir. 1994). In that decision, the Sixth Court held that a constructive trust is a remedy that cannot be relied on in bankruptcy "[u]nless a court has already impressed a constructive trust upon certain assets *or a legislature has created a specific statutory right to have particular kinds of funds held as if in trust*." (emphasis added). Here, the Michigan legislature plainly created just such a specific statutory right with the provisions and restrictions contained in Act 34.

Bond Taxes are to be set aside in the Debt Retirement Funds and then used for no purpose other than paying debt service on the Bonds.

To be sure, the City is responsible for levying and collecting the taxes, just as the conduit entities in the above cases were responsible for collecting the funds they acquired and possessed. But the City may not then *use* those taxes for its own purposes; rather, it must deliver them to their designated beneficiaries, the Bondholders. The City is merely the vehicle of delivery. And, actual use of the funds by the Defendants contrary to the contractual or statutory limitations does not create any greater property interest. The fact that the Defendants may claim the funds have been commingled or used for other purposes consistent with its "dominion and control" over the funds does not change the conclusion. *See Computrex*, 403 F.3d 3d at 812. The salient fact is that the Defendants were not *permitted* by the statutory scheme to use the funds for any other purpose. Consequently, here, as in the cases discussed above, the Defendants lack any equitable or beneficial interest in the Restricted Bond Taxes.

Application of the three-pronged test developed by *LAN Tamers* confirms this conclusion. Under the first prong of the *LAN Tamers* inquiry, the court considers the role the debtor was intended to play with respect to the funds. In *LAN Tamers* and *CMC Telecom*, the debtors were required by statute to deliver reimbursement payments to school districts. In *West Central Housing*, the debtor was required to

disburse federal grant money to needy citizens. Here, the City's role with respect to the Restricted Bond Taxes is similarly limited – the City may use the Restricted Bond Taxes solely for debt service on the Bonds.

Under the second prong of the *LAN Tamers* test, the court examines the degree and intensity of regulatory control over the property. Like the strict regulatory controls in place in *LAN Tamers* and *CMC Telecom*, strict regulation applies here. Act 34 and the Resolutions control when and how *ad valorem* taxes are to be levied to pay the interest and principal on the Bonds, where those taxes are to be deposited, how they are to be segregated and accounted for "as the taxes are collected," and how they are to be used. The governing regulations give the City absolutely no discretion as to how, when, and why it can collect the Restricted Bond Taxes or how it can use those Taxes. Indeed, the debtor in *West Central Housing* had considerably more discretion over the funds than the City does here because it maintained some decision-making authority over who would receive housing loans. Nonetheless, the court found that the debtor in that case had only a possessory interest in the federal grant money used to make the loans, and that "[s]uch discretion does not equate to a beneficial interest." 338 B.R. at 492.

Under the third prong of the test, the court examines the extent to which recognizing a greater ownership interest on the part of the debtor – and thereby diverting the property in question to the creditors – would thwart the overall purpose

of the regulatory scheme. Here, Act 34 was put in place to address a state-wide concern and "protect the credit of the State and its municipalities." Senate Fiscal Agency Bill Analysis of SB 29/0102 (Substitute S-3) (Apr. 16, 2001) at 1 ("The bill would create [Act 34] to regulate borrowing by municipalities, and their issuance of obligations, and prescribe the powers and duties of the Department of Treasury *to protect the credit of the State and its municipalities*.") (emphasis added) (internal quotations omitted). Diverting these funds from the Bondholders and using them for another purpose would thus be detrimental not only to the Bondholders, but also to the City and the State of Michigan.[14]

In short, regardless of which analytical framework is applied – the trust theory or the conduit theory – only one result emerges. After levying and collecting the taxes, the City is statutorily permitted to do only two things: deposit the Restricted Bond Taxes in segregated debt retirement funds, and use them only to pay debt service on the Bonds. Under these circumstances, it is inescapable that the equitable

[14] Consistent with its legislative history, Act 34 itself provides that the Department of Treasury, which regulates the Act's provisions, "is authorized and *directed to protect the credit of this state and its municipalities*." *Id.* (emphasis added). Mich. Comp. Laws Ann. § 141.2201. Allowing the City to ignore its statutory mandates under Act 34 would negatively affect the creditworthiness of both the City and the State of Michigan, thus increasing their future borrowing costs. The detailed regulatory regime reflected in Act 34 is designed to protect the credit of the State of Michigan as a whole by insuring the solvency of *all* of its individual municipalities. This goal would be undermined if a single municipality was allowed to flout the statutory scheme and disregard its imperatives.

and beneficial ownership interest in the Restricted Bond Taxes belongs to the Bondholders and that Ambac has stated claims in this regard.

C. The Decisions Cited by the City Do Not Support Dismissal

The Defendants largely ignore the Complaint's allegations that the Bondholders have a property interest in the Restricted Bond Taxes – indeed, they cite only three decisions, none from Michigan or the Sixth Circuit, and devote a scant page and a half to the discussion. But nothing offered by the Defendants supports their position that Counts II and III should be dismissed for failure to state a claim that the Bondholders, and not the City, have equitable title to the Restricted Bond Taxes.

The Defendants first cite *Lippi v. City Bank*, 955 F.2d 599 (9th Cir. 1992), for the proposition that a conduit is an intermediary party who gains no actual dominion or control over money transferred to it, and contends that the City *does* control the Restricted Bond Taxes, because the City assesses and collects them. That rejoinder, however, is overly simplistic. The relevant question is whether the City has discretion with respect to the use of the taxes, and it clearly does not. Act 34 explicitly provides that the Restricted Bond Taxes must be segregated, and used solely for the benefit of the Bondholders.

Next, the Defendants cite *Cty. and Cnty. of Dallas Levee Imp. Dist. v. Indus. Props. Corp.*, 89 F.2d 731 (5th Cir. 1937), for the proposition that "a public district

cannot be regarded as a mere conduit between bondholders and taxpayers." But in fact, as noted previously, *Dallas Levee* stated that the taxes collected by the district were held in trust for the purposes expressed in the statute, *i.e.*, the payment of interest and principal on the bonds. The seemingly contrary holding to which the Defendants refer was merely a holding that, for purposes of federal diversity jurisdiction, the district could not be disregarded as a party to the proceedings. That holding, of course, naturally follows the court's trust holding; although the district lacked equitable interest in the funds, as the trustee of the trust, it possessed legal title.

Finally, *Ware v. R.E. Crummer & Co.*, 128 F.2d 114 (5th Cir. 1942), the third decision cited by the Defendants, is wholly inapposite. In *Ware*, the municipal debtor collected funds to establish a sinking fund, which was to be used to pay principal and interest on refunding bonds provided for in the municipality's plan of composition. After the court declined to approve the plan because it was not feasible, it held that, under applicable Florida law, the monies in the sinking fund "were freed" from the plan. *Id*. at 117. It was in *that* context, where the sole purpose for which the funds were collected had failed – that the court held that they were subject to the municipality's control and were property of the municipality.

In sum, the Defendants have raised no meritorious argument in support of their motion to dismiss Counts II and III of the Amended Complaint. Their motion should, therefore, be denied.

VIII. THE UNLIMITED TAX BONDS AND THE LIMITED TAX BONDS ARE SECURED BY LIENS ON THE *AD VALOREM* TAX REVENUES

Ambac fully joins and incorporates by reference the arguments asserted and the exhibits cited by National and Assured in Section III.A-C, E of their Opposition to Defendants' Motion to Dismiss. *See National Public Finance Guarantee Corporation, et al. v. City of Detroit, et al.*, Adv. Pro. No. 13-05309-swr, [ECF No. 62] (the "Insurer Brief") at Section III.A-C, E. Those arguments establish that the Unlimited Tax Bonds represent secured obligations of the City.

The same arguments establish that Limited Tax Bonds are similarly secured. Because neither National nor Assured insures any Limited Tax Bonds issued by the City, the Insurer Brief does not address the pledge securing the Limited Tax Bonds. However, the Limited Tax Bonds share virtually all of the attributes of and protections afforded the Unlimited Tax Bonds, and therefore also share their secured status.

The Limited Tax Bonds are "double barreled" for the reasons stated in the Insurer Brief. Similarly to the Unlimited Tax Bonds, the Limited Tax Bonds are secured both by full faith and credit and a defined, albeit different, stream of

revenue – the first *ad valorem* tax dollars collected by the City. Section 301(a) of the Limited Bond Tax Resolutions creates a comma-delimited list of what is "pledged" for the repayment of the GO bonds, and this security includes both "barrels" of the Limited Tax Bonds: the pledge of full faith and credit and "the limited tax":

> The Bonds shall be general obligations of the City, and *the limited tax, full faith, credit* and resources of the City *are hereby irrevocably pledged* for the prompt payment of the principal of and interest on the Bonds.

Limited Tax Bond Resolutions, § 301(a).[15]

The Resolutions and Act 34 then specifically identify the "limited tax" stream. In the very next sentence, § 301(a) provides that pledged, "as a first budget obligation," are "the proceeds of an annual levy of *ad valorem* taxes on all taxable property in the City, subject to applicable constitutional, statutory, and charter tax rate limitations." *See id*. Act 34 independently confirms it in identifying the pledged stream as the moneys, "set aside each year from the levy

[15] As is the case with the Unlimited Tax Resolutions, other provisions of the Limited Tax Resolutions confirm the creation and existence of a lien. *See, e.g.*, Limited Tax Resolutions, § 801 (providing that upon repayment of the bonds, "the *lien of this Resolution* for the benefit of such Bonds shall be discharged") (emphasis added), § 701 (permitting supplemental resolutions "to confirm or further assure the *security hereof* or to grant or *pledge . . . any additional security*") (emphasis added), § 309 (providing that any new bond issued to replace a mutilated or destroyed bond "shall be *equally secured*" as the "Bonds issued under this Resolution") (emphasis added).

and collection of ad valorem taxes . . . as a first budget obligation." *See* Mich. Comp. Laws § 141.2701(3). The pledged moneys must be set aside as a first budget obligation and deposited in the applicable debt service retirement funds "[a]s taxes are collected." *See* Mich. Comp. Laws § 141.2701(6).

In addition to identifying the revenue stream pledged for the repayment of the Limited Tax Bonds, the structure and provisions of Act 34 serve to confirm their secured status. For example, just like the Unlimited Tax Bonds, the Limited Tax Bonds are "securities" within the meaning of Act 34 and, therefore, are "evidence of debt . . . issued by a municipality, which *pledged* payment of the debt by the municipality *from an identified source of revenue*," Mich. Comp. Laws § 141.2103(r) (emphasis added), and may be "*secured by*," among others, *ad valorem* and personal property taxes. Mich. Comp. Laws § 141.2103(*l*) (emphasis added). The use of the words "pledge" and "secured by" as used in the Resolutions and Act 34 should be interpreted as creating a lien for the reasons stated in the Insurer Motion.

Accordingly, the Limited Tax Bonds are secured both by a general obligation pledge and a lien on the first *ad valorem* tax dollars collected by the City. Both Limited Tax Bonds and Unlimited Tax Bonds are secured.

IX. THE RESOLUTIONS HAVE THE FORCE OF STATUTE AND CREATE STATUTORY LIENS SECURING THE UNLIMITED AND LIMITED TAX BONDS

Ambac fully joins and incorporates by reference the arguments asserted by National and Assured in Section III.D of their Opposition to Defendants' Motion to Dismiss. *See* Insurer Brief at Section III.D. These arguments apply with equal force to both the Limited Tax Bonds and the Unlimited Tax Bonds, such that both are secured by statutory liens.

X. THE *AD VALOREM* TAXES SECURING UNLIMITED TAX BONDS ARE SPECIAL REVENUES

Ambac fully joins and incorporates by reference the arguments asserted by National and Assured in Section IV of their Opposition to Defendants' Motion to Dismiss. *See* Insurer Brief at Section IV. For the reasons stated therein, the stream of *ad valorem* taxes securing the Unlimited Tax Bonds represents special revenues.

XI. AMBAC HAS STATED A VIABLE TAKINGS CLAIM

Ambac fully joins and incorporates by reference the arguments asserted by National and Assured in Section V of their Opposition to Defendants' Motion to Dismiss. *See* Insurer Brief at Section V. These arguments apply with equal force both to the Limited Tax Bonds and the Unlimited Tax Bonds, and Ambac has, therefore, stated a takings claim with respect to both the Limited Tax Bonds and Unlimited Tax Bonds.

XII. CONCLUSION

For all of the foregoing reasons, the Defendants' motion to dismiss should be denied.

Respectfully Submitted,

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EXHIBITS

Exhibit A 2012 *Ad Valorem* Tax Bill

Exhibit B Request for Amendment to the FY 2014 Budget