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ARTFULLY RESOLVING DETROIT'S BANKRUPTCY

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INTRODUCTION

For the first three decades of the 20th Century, Detroit was the second fastest-growing city in the United States, behind only Los Angeles. It was a center of the high-tech industry of the day – automobile manufacturing – as the city saw the creation of what was, in many ways, a predecessor to today's Silicon Valley. But as spectacular as its rise through the middle of the 20th Century was, its decline and ultimate bankruptcy has been just as precipitous.

As co-author Andrew Moylan wrote in a recent *Reason.com* piece on Detroit:

> More than one million people have headed for the Motor City's exits since its size peaked in 1950. Even when compared to other Rust Belt cities that have experienced significant population loss, Detroit stands out. The only city that has dropped farther from its mid-20th Century peak is St. Louis, but its population has never been even half as large as Detroit's. In fact, of the eight U.S. cities that have lost more than 50 percent of their population in recent decades, Detroit is far and away the largest. Even in its shrunken state today of just over 713,000 residents, it is larger than Pittsburgh's all-time peak of 677,000.[1]

Today, those 713,000 residents receive atrocious public services and labor under extremely high tax burdens, with income taxes levied at the maximum level allowed by state law and property taxes that are higher than every other major American city. The legacy cost of services provided decades ago, as well as the city's current expenses, continue to rise even while the population has dwindled dramatically. The result is a broken city with sky-high crime rates, rampant unemployment and a very uncertain future now that it has officially filed for Chapter 9 bankruptcy.

With the bankruptcy process underway, state-appointed emergency manager Kevyn Orr and the city's 170,000 creditors have begun working to resolve many competing claims in order to restructure the city's operations, retire debt and create a vibrant and sustainable operation for the future. Orr has dubbed this the "Olympics of restructuring," but even that analogy doesn't quite capture the high stakes involved in a municipal bankruptcy that's roughly five times larger than the previous holder of the dubious distinction of the largest in history.

This saga offers a peek at the adversarial relationship that underpins any bankruptcy proceeding. In this case, Orr and other city officials have a strong incentive to undervalue existing assets and pay off as little of the accumulated debt as possible. On the other hand, creditors have an equally strong incentive to push the city to sell off anything that isn't bolted down, regardless of potential negative impacts on the city's ability to create a viable entity moving forward.

For no other asset is this fight more clear than the city's incredible collection of artifacts housed in the Detroit Insti-

1. Andrew Moylan, "Driving a Motor City Revival," *Reason.com*, Dec. 12, 2013. http://reason.com/archives/2013/12/12/driving-a-motor-city-revival

tute of Arts. In total, the DIA has in its possession some 66,000 art treasures collected over nearly 130 years, including works by Van Gogh, Rembrandt, Matisse and the amazing "Detroit Industry" murals painted in 1932 by Diego Rivera. Monetizing the art, even on a small scale, could prove enormously helpful in minimizing harm done to the interests of employees and creditors.

It is far from clear what the resolution will be, but it will undoubtedly establish precedent for future municipal bankruptcies of significant size. The domino effect on other struggling municipalities in Michigan, like Pontiac or Ecorse, and cities like Chicago with even bigger liabilities, will be a matter of intense interest, as they attempt to fix their finances to avoid Detroit's fate.

MOUNTING OBLIGATIONS

Perhaps the most politically explosive creditors are the individuals that comprise the city's pension obligations. Detroit's severe population loss and horrible mismanagement each contributed to the growth of enormous unfunded obligations. In 1960, each pensioner was supported by roughly 2.5 employees. That ratio had dropped to 1:1 toward the end of long-time Mayor Coleman Young's administration, who served from 1974 to 1994.[2] By 2012, it had flipped almost completely, such that there were twice as many retirees as employees to support them.

Exacerbating the gap, the city's pension board gave out nearly $1 billion in so-called "13th check" bonuses – a system for distributing excess earnings – to both city workers and retirees from 1985 to 2008. If that money instead had been invested, there would be an extra $1.9 billion in the city treasury now, an amount equivalent to more than half the current shortfall. Andrew Biggs, former principal deputy commissioner of the Social Security Administration and current American Enterprise Institute scholar, estimated Detroit's benefits were generous enough that a 35-year employee of the city could expect, for life, combined pension and Social Security payments equal to fully 95 percent of their final salary, well above the 70 to 80 percent level that investment advisors suggest for comfortable retirement.[3]

The city, along with the unions that represent current and retired public employees, initially operated under the assumption that the pensions were protected by a 1963 state constitutional provision that declared they "shall not be diminished or impaired."[4] However, a federal judge has ruled that the pensions can be adjusted, because the bankruptcy is being processed under federal law, not state law. As to how much they can be adjusted, law professor David Skeel of the University of Pennsylvania believes provisions of the Michigan Constitution giving contractual status to public pensions will allow adjustment on at least the unfunded piece of the pensions.[5]

The precise extent to which the two major employee pensions are underfunded is in dispute. Orr says the shortfall amounts to $3.5 billion, roughly 19 percent of his estimate of Detroit's total debt. Whatever the true size of the shortfall, it is clear that reduced benefits will be a necessary component of any restructuring plan.

There is well-founded concern that this portion of Detroit's debt might receive preferential treatment over secured creditors, who should theoretically be paid off before any others, when a resolution to the city's $18.5 billion debt is ultimately crafted. When the car company Chrysler entered its federally managed bankruptcy in 2009, secured creditors saw their claims subordinated to unsecured United Auto Worker interests, in what is now widely considered a politically informed choice by Obama administration officials.[6]

In fact, Indiana Treasurer Richard Mourdock went to court on behalf of his state's pension plan investors, objecting that they were being "jumped in line" in violation of contractual obligations.[7] A judge allowed the deal to stand, on grounds that it was preferable to liquidating the company, which would result in Indiana pensioners getting even less. That decision doesn't establish much legal precedent for Detroit, since municipalities can't be liquidated, but it did set political precedent in encouraging manipulation of obligations in contravention of established bankruptcy law.

Manipulation of this sort is not costless. Orr released an initial draft restructuring plan that essentially inverted the traditional debt hierarchy by treating secured general obligation debt as unsecured and elevating pensions to roughly equal footing. The resulting furor has been expensive for Michigan cities floating general obligation bonds, as they're now paying a 30 to 40 basis point premium, in part due to the shadow cast by Detroit's treatment of such debt.[8]

2. Nathan Bomey and John Gallagher, "How Detroit went broke: The answers may surprise you - and don't blame Coleman Young," *Detroit Free Press,* Sept. 15, 2013. http://www.freep.com/interactive/article/20130915/NEWS01/130801004/Detroit-Bankruptcy-history-1950-debt-pension-revenue

3. Andrew Biggs, "The Looting of Detroit's Pensions," *The American*, Feb. 16, 2014. http://www.american.com/archive/2014/february/the-looting-of-detroits-pensions

4. Michigan Constitution, Article IX, § 24

5. David A. Skeel, Jr. "Can Pensions Be Restructured in Detroit's Municipal Bankruptcy?" *The Federalist Society White Paper Series*, October 2013

6. Todd Zywicki, "The Auto Bailout and the Rule of Law," *National Affairs*, Spring 2011. http://www.nationalaffairs.com/publications/detail/the-auto-bailout-and-the-rule-of-law

7. Kevin Allen, "Bailout lawsuit put Mourdock on political map," *South Bend Tribune*, Sept. 29, 2012. http://articles.southbendtribune.com/2012-09-29/news/34168076_1_chrysler-lawsuit-indiana-pensioners-richard-mourdock

8. John Mousseau and Michael Comes, "Detroit Bites Again," Cumberland Advisors Market Commentary. Feb. 3, 2014. http://www.cumber.com/commentary.aspx?file=020314.asp

DETROIT'S ART COLLECTION

Detroit is unique among major cities in having funded directly huge portions of its signature art museum's existence. The enmeshing of public dollars with the Detroit Institute of Arts is staggering in scope. Its Woodward Avenue building was built in 1927 with taxpayer money and expanded in 1966 and 1971 with taxpayer money. Its failing operations budget was bailed out repeatedly with taxpayer money. Much of the art procured from the 1920s through the 1950s was purchased directly with taxpayer money, and the institute is now owned and operated by the city with taxpayer money.

As a result, the status of the DIA's art has been a flash point in the political battle over the bankruptcy. After all, any objective analysis would put monetizing the art at the top of both the city's and creditors' list of options. One need not diminish the cultural enrichment and aesthetic value of the collection to nonetheless determine that a city that quite literally cannot keep the lights on or maintain a responsive police and fire force must consider every available option to blunt the financial impact on investors and pensioners. The art is a unique asset because, while important to Detroit's cultural heritage, an unaltered DIA is likely not a necessary element to rebuilding the city the way, for example, much of its physical infrastructure is.

The precise value of the collection isn't known, but an evaluation of just 38 of the DIA's most famous pieces done last June at the behest of the *Detroit Free Press* yielded an estimate of $2.5 billion.[9] In December, the famous auction house Christie's released an appraisal of nearly 2,800 works (just 5 percent of the institute's total holdings) purchased directly by the city, saying they were worth as much as $867 million,[10] a figure disputed by many experts as artificially low.

If the value-at-sale of the city's collection is not clear, given that only a tiny fraction has been appraised, it's even less of a foregone conclusion whether any significant portion will actually be sold. Michigan Attorney General Bill Schuette has issued an opinion stating that the art is held in trust and cannot be sold. But in various legal pleadings, creditors have pointed out that Michigan's charitable trust law was only enacted in 1909, nearly a quarter-century after establishment of what was then called the Detroit Museum of Arts.

Complicating matters further, some have argued that many of the pieces not purchased directly with taxpayer dollars can't be sold, owing to gift agreements that prohibit their sale or removal. Katie Reis – a former employee of Washington's Corcoran Gallery, currently with the Wexner Center for the Arts at the Ohio State University – confirmed to co-author Alan Smith that it is common practice for museums acquiring donations to execute gift agreements specifying certain conditions for transfer and display of works. These restrictive agreements govern some of the DIA's works, particularly those received in major bequests from such figures as Robert Hudson Tannahill, an heir to Detroit's Hudson's department store fortune.[11]

There are several ways to take advantage of artwork not covered by such covenants through which Detroit's many stakeholders could derive value. Works could be sold but kept on permanent loan to the DIA. The art could be leased to other exhibitions around the country – a relatively unusual arrangement for museums, who typically loan works for free in reciprocal lending arrangements, but one worth exploring with certain for-profit venues. They could be placed in a trust in which shares could be sold. Given the political firestorm associated with the potential removal of the DIA's works, these alternative structures might provide a middle ground to monetize substantial portions of the art for the benefit of pensioners and other creditors.

POLITICAL PERIL

Rather than sell the art, officials from the city, state, DIA and private foundations have offered a plan that would instead spin off the institute into an independent non-profit trust, in exchange for some $815 million in funding earmarked only for the General Retirement System and Police and Fire Retirement System pension plans. Private foundations would provide $365 million, state taxpayers $350 million and the DIA would raise the remaining $100 million.

The clear intention of the plan is to shield both politically powerful pensioners and the politically sensitive art from contributing significantly to resolving Detroit's debt crisis. The problem is that the plan must first clear political hurdles and then survive potential litigation.

On the political question, the $350 million pledged by Gov. Rick Snyder must first pass the state Legislature as an appropriation, and that could prove a tall order. Republicans control both chambers and have expressed concern that Detroit already gets twice as much per capita in revenue sharing as any other city in Michigan.[12] To some, the prospect of sending more dollars to struggling Detroit is not appealing, particularly in service of a politically motivated back room deal.

9. Mark Stryker and John Gallagher, "DIA's art collection could face sell-off to satisfy Detroit's creditors," *Detroit Free Press*, May 24, 2013. http://www.freep.com/article/20130523/NEWS01/305230154/DIA-Kevyn-Orr-Detroit-bankruptcy-art

10. Mark Stryker, "What's DIA's artwork worth? New Christie's report has the numbers," *Detroit Free Press*, Dec. 19, 2013. http://www.freep.com/article/20131219/ENT05/312190142/detroit-dia-christies-report

11. Associated Press, "Art Treasure Left to Detroit Museum," *New York Times,* Oct. 1, 1969. http://select.nytimes.com/gst/abstract.html?res=F30916FD3454127B93C0A9178BD95F4D8685F9&scp=2&sq=hudson+tannahill&st=p

12. Citizens Research Council of Michigan, "Detroit City Government Revenues," Accessed March 17, 2014. http://www.crcmich.org/PUBLICAT/2010s/2013/rpt382.pdf

Furthermore, it is unclear whether it is legal to negotiate a settlement that treats one class of creditors differently than the rest, channeling all funds raised to unsecured creditors while freezing out secured bondholders. This would contravene typical bankruptcy operations, where assets are sold and funds distributed based on a process involving all creditors, starting with the most senior secured debt.

A WAY FORWARD

Instead of valuing (and potentially undervaluing) small portions of the DIA's works, the emergency manager and other city officials should embark on an honest legal assessment of which works can be sold. They then should perform a full-scale appraisal of the entire collection, in order to have as complete a picture as possible of exactly how much value is stored inside the walls of 5200 Woodward Ave.

The city should then work with community figures and creditors of all types to arrange a deal to monetize as much of the art as is practical. This likely would not involve emptying the building from stem to stern, nor should it. Care should be taken to keep as much of the work in Detroit as is possible. However, every untapped dollar that remains at the DIA represents a dollar that must come out of future pension checks of Detroit employees or a dollar that must be paid on top of ordinary rates in order to convince investors to set aside their fears about loaning money to a struggling city.

Any deal to monetize the art should be conducted at fair-market values, not fire sale prices. There remains an incentive for city officials to understate the value of the DIA's assets in order to understate their ability to pay off debts. But if Detroit is forced to take the heartbreaking step of selling its art, it should get the maximum value, to reduce as much as possible the burdens on pensioners and other creditors. Proceeds from monetizing the art shouldn't be used in a political fashion or just to pay one class of creditor.

It is understandable why the emergency manager might seek to jump pensioners ahead in line. After all, most pension recipients are honest, hard-working individuals who did their level best while union leaders and city officials broke their trust and mismanaged the fund's assets.

However, bankruptcy is an inherently messy process. The sad reality is that putting unsecured pension debt ahead of secured bondholders risks doing more damage to Detroit and other troubled cities by increasing substantially the premium investors will demand to finance the city's recovery. If they fear being subordinated to other creditors – due not to any legal process, but instead to politics – the premiums they will demand for investing will be enormous.

The associated ripple effect will start in Detroit, where already-high borrowing costs would rise even higher, but it likely will not end there. While its overall economic picture is better than Detroit's, Chicago's pension system is actually in much worse shape. The Windy City faces a pension payment of more than $1 billion next year, fully one-third of the city's operating budget. Mayor Rahm Emanuel has warned that property taxes may have to double in order to pay the bill.[13] If Detroit executes a politically motivated plan to bail out pensioners at the expense of other creditors, Chicago and other cities facing large pension shortfalls might experience spikes in borrowing costs.

CONCLUSION

There are no right answers in municipal bankruptcy, and precious few in the City of Detroit as a whole. The city's bankruptcy is instead an exercise in carefully distributing the pain associated with decades of population decline, economic stagnation, poisonous racism, regional isolation, mismanagement in all corners and outright corruption.

If Detroit is insufficiently assertive in monetizing its art assets, it will increase that pain by leaving money on the table that could have helped pay off debt and alleviate legitimate human misery. If it does monetize its art assets, but only in service of paying off unsecured pension debt in contravention of bankruptcy law, it will further increase that pain by raising its borrowing costs and undermining its financial future.

Detroit's motto in Latin is "Speramus meliora; resurget cineribus," which translates to "We hope for better things; it shall rise from the ashes." Instead of seeking the elusive silver bullet solution that will help the city rise from its ashes, Detroit must bite the bankruptcy bullet in order to rebuild itself anew.

13. Editorial, "Public Pension Red Alert," *The Wall Street Journal,* March 7, 2014. http://online.wsj.com/news/articles/SB10001424052702304815004579419371878171830

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During his career in corporate public affairs, Smith managed a public affairs staff at a national trade association of consumer products manufacturers and suppliers, as well as at two insurance companies.

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In Ohio, Smith investigated securities fraud as head of the enforcement section of the Ohio Division of Securities, and for three years, served as chief counsel to the minority in the Ohio House of Representatives. He served as special agent of the Federal Bureau of Investigation from 1969-1974, mostly investigating violations of federal criminal law in New York City and New York state.