The City of Detroit Bankruptcy: How it happened; its future; and why it is important to Michigan

Tonight, I want to take on the daunting task to discuss the City of Detroit bankruptcy; why it happened; how it was resolved; and why it is of such importance to Michigan. As a City Attorney for 38 years, growing up in Chicago when Chicago and Detroit were pretty much regarded as equals, I was fascinated with what happened to Detroit. The only reason I thought Chicago was better than Detroit was that it had two baseball teams which never played as well as the Tigers except in 1959.

Here was a city which, on its face, had so much going for it. In 1950, Detroit reached its population peak with 1,800,000 people as the fourth largest city in the U.S. The Detroit metropolitan area had over 1.85 million people. The City of Detroit, in 2010, had 40% less than that number at just over 700,000 residents. The City of Detroit has a substantial land mass, which we will discuss later in the paper, consisting of approximately 138 square miles. This 138 square mile area can accommodate the city limits of Boston, San Francisco, and Manhattan within its borders. This is truly a physically large city.

Consider the prior grandeur of Detroit: the home of the automobile, once the nation's richest big city; the home of Motown and rhythm and blues; the arsenal of democracy in the 1940s where war machines were made to stop the march of facism; and an incubator of executive management style where its automotive executives went to Washington to infuse their management style and structure. Remember the statement during the Eisenhower years when Charlie Wilson of General Motors stated "What was good for our country was good for General Motors, and vice versa." Detroit and America were jointed at the hip.

Today, Detroit is now America's poorest city. It is the country's illiteracy and dropout capitol, where children must leave their books at school and bring toilet paper from home. It is the unemployment capital, where half of the adult population does not work at a consistent job. There are firemen with no boots; cops with no cars; teachers with no pencils; and city council members with phones tapped by the FBI. So tonight we are going to examine what happened to Detroit; what lead to its bankruptcy; whether the "Grand Bargain" will work; and why it is important to everyone who lives in Michigan.

In 2013 when Detroit filed bankruptcy, it had debts exceeding eighteen billion dollars. There are four major causes of the Detroit bankruptcy. The first was white flight. After the race riots of the 1960s, coupled with former Mayor Coleman Young public statements that white residents and white businesses in Detroit would not be protected, there was dramatic white flight during the 1960s and early 1970s. Communities like Royal Oak, Ferndale, and Auburn Hills expanded dramatically, and by 2010, whites made up 10.6% of Detroit's population.

Second, there were decades of corrupt politicians in Detroit which culminated with the indictment of Mayor Kwame Kilpatrick. Kilpatrick's subsequent criminal trial indicated his on-going affair with his Chief of Staff; bribes and pay-offs were made to family members who were appointed to key positions by Kilpatrick; and the death of a woman who was described as a "stripper" performing at the Mayor's mansion was the culmination of public disgust with leadership and government in Detroit. But this ethical decay was something that had become a way of life in Detroit City government.

Third was the decline and relocation of the auto industry. The auto makers moved most (if not all) of their operations out of Detroit and into the suburbs where neighborhoods were safer and taxes were lower, resulting in huge tax base loss. The 2013 bankruptcy of the City of Detroit was concurrent with the decline of the auto industry, which resulted in the bankruptcy of General Motors and Chrysler.

The fourth reason, which has often been neglected regarding the Detroit bankruptcy, is what the State of Michigan did to cities to balance its budget in the years leading up to the Bankruptcy. It would be fair to say that the State of Michigan, to balance its financial problems, balanced its budget on the backs of cities in Michigan by cutting what is called "revenue sharing". Sixty-Seven Million Dollars ($67,000,000) in state revenue sharing was cut by the State to Detroit. These cuts accounted for nearly one-third of the city's revenue losses between fiscal year 2011 and 2013.

State revenue sharing cutbacks have created economic chaos in cities of Detroit, Flint, Pontiac, and most of the downriver communities around Detroit. With these multi-layered causes for the bankruptcy of Detroit, let's spend a little time discussing what happened. On July 18, 2013, Detroit filed for Chapter 9 Bankruptcy. Its filing was the largest municipal bankruptcy filing in U.S. history by debt, estimated at Eighteen to Twenty Billion Dollars ($18-$20,000,000,000). The bankruptcy filing was a culmination of negotiations between the State of Michigan and the City of Detroit, which broke down.

In April, 2012, then Mayor Dave Bing and the nine (9) member City Council entered into an agreement with the State of Michigan that allowed for greater financial oversight by the State in exchange for the State providing help with Detroit's finances. A financial review team was appointed in December, 2012, to conduct a 60 day review. In February, 2013, Governor Snyder announced that Michigan State Government was taking control of the City of Detroit, since the State found that Detroit had failed to meet deadlines set by State government. Kevin Orr was appointed as the Emergency Financial Manager of Detroit, which, under State law, permitted him to re-write Detroit's contracts and liquidate City assets.

So who was Kevin Orr? Kevin Orr has a bachelor's and juris doctorate degree from the University of Michigan. Following his graduation from the University of Michigan in 1983, he specialized in bankruptcy where he worked for the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, and was ultimately hired by the law firm of Jones Day, where he worked on the Chrysler Bankruptcy in 2009. Kevin Orr also is an Afro-American, which certainly was a consideration for his appointment as Emergency Manager.

In May, 2013, Orr released his financial report, which indicated that Detroit had an extreme cash flow crises and that the City would finish its current fiscal year with a One-Hundred Sixty-Two Million Dollar ($162,000,000) cash flow shortfall. In June, 2013, Detroit stopped making payments on some of its unsecured debts, including pension obligations;

sought Detroit creditors to accept 10% of what they owed; and attempted to negotiate with unions and pension boards which were ultimately unsuccessful. Therefore, Chapter 9 Bankruptcy was filed. The Bankruptcy Petition stated that the reasons for the filing were declining population, retiree health care and pension costs; borrowing to cover budget deficits since 2008; poor record keeping and an antiquated computer system; the fact that 47% of property owners had not paid their 2011 property taxes; and governmental corruption. Prior to filing, City worker pension plans had been supported for nearly 25 years with paying out 13 month checks, rather 12.

In the interest of time and the complexity of the issues involving the Detroit bankruptcy, I want to focus on three (3) major areas of the bankruptcy: (1) the outcome, or what has been called the Grand Bargain; (2) what the bankruptcy cost in legal and consulting fees; and (3) what are the issues going forward in the future for Detroit.

First, the outcome, and how it got there: the Detroit Bankruptcy case was assigned to Bankruptcy Judge Steven Rhodes. Judge Rhodes was also a graduate of the University of Michigan Law School and was regarded with high respect in Detroit as a bankruptcy judge. One of the early steps by Rhodes, in view of the complexity of the financial problems, was his appointment of a mediator to work with the various parties in the bankruptcy. Rhodes appointed Chief Judge Gerald Rosen of the U.S. District Court for the Eastern District of Michigan. Rosen, realizing the magnitude and monumental task before him, appointed associate mediators to deal with the multitude of issues and claims which included U.S. District Judge Victoria Roberts, a Detroit native who was an adjunct professor at the University of Michigan Law School; U.S. Bankruptcy Judge Elizabeth Perris of the District Court in Oregon who had served almost 30 years as Judge and had been a judicial mediator in Chapter 9 Bankruptcies in Stockton, California and Mammoth Lakes, California; Senior U.S. District Judge Wiley Daniel of the District of Colorado; Judge David Coar, who had been a private mediator in large bankruptcy cases; and Detroit lawyer, Eugene Driker, who was considered a leading mediator in Michigan. This mediation team dealt with a multitude of issues. One of the first was trying to determine which assets would be available for creditor distribution. One of the most contested assets were those of the Detroit Institute of Art, which held approximately 66,000 valuable pieces of which only 5% of this collection were bought with City money but the building and collection was owned by the City of Detoit. A major issue was whether this collection could also be monetized in order to satisfy the claims of the Bankruptcy creditors. The second issue was the One Billion Dollar ($1,000,000,000) claim of Financial Guaranty Insurance Company which had the bond debt on the Joe Louis Arena. In October, 2014, a settlement was reached whereby the City and State would pay for the demolition of the Joe Louis Arena once the Redwings moved into a new arena and after the demolition FGIC would receive the arena site and adjacent parking lot, giving the company nearly nine (9) acres for re-development.

One of the key issues in the Detroit Bankruptcy was its pension liability and the method of valuing this liability. When Kevin Orr was hired as emergency manager, the prior reports from the City of Detroit indicated that its pension fund was in pretty good shape. After Kevin Orr was appointed, he commissioned a new valuation company to prepare a new calculation of Detroit's pension liability. The new calculation indicated that Detroit had a $3.5 billion dollar hole in its pension system. Pension liability is based upon actuarial computations which are extremely complicated and make assumptions regarding the number of employees who will pay into a plan; the return on investment in the plan; and how many employees will retire at certain ages in the plan for payment.

In the case of the Detroit bankruptcy, this pension liability was extremely important, since Kevin Orr was able to use it to set the stage for negotiation with employees for pension reduction; limiting costs of living increases, and extending pension benefits.

Michigan has a State constitutional provision similar to New York, Illinois, Alaska, Arizona, and Hawaii which protects state pensions once an employee begins his or her employment, thus locking in both accrued and unaccrued benefits. Other states, such as Connecticut, Wisconsin, Wyoming, Maine, New Mexico, and Ohio have all ruled that public pension plans create protectable property interests. Article 24 of the Michigan Constitution states that accrued financial benefits of the State and its political subdivisions shall be a contractual obligation thereof, and shall not be diminished or impaired. This section further states that financial benefits shall be funded during each year and such funding shall not be used for financing unfunded accrued liabilities. So the initial question when Detroit filed for its bankruptcy was whether it was permitted to make any modification or adjustment to its pension obligations to its employees because of State Constitutional protections. In December, 2013, Judge Rhodes determined that pensions are in the nature of contract rights, and that under the supremacy clause in the Federal Constitution, pension benefits could be reduced and altered through the federal bankruptcy process. With this ruling by Judge Rhodes, the negotiations began regarding the reduction in Detroit's pension benefits.

The key to the outcome of the Detroit bankruptcy was legislation which was passed by the State of Michigan, which has come to be known as the "Grand Bargain". The so-called "Grand Bargain" was to address two (2) major issues in the Detroit bankruptcy case: "art" and "pensions". In May, 2014, the Michigan House of Representatives introduced legislation which would give Detroit's retirement system a $194,800,000 lump sum and would create an oversight commission relating to Detroit's recovery post-bankruptcy. In order to make this legislation pass, Michigan House of Representatives Speaker Jase Bolger indicated that this legislation would not pass without unions contributing to help in the Detroit settlement. Called the Grand Bargain, the Michigan Building and Construction Trades Council, along with some additional other unions, agreed to make material contributions toward health care costs which lead to the bankruptcy settlement. After the unions agreed to contribute money towards the settlement, the Michigan House passed the legislation with major bipartisan support. On September 10, Detroit reached a deal with three (3) Michigan counties over regional water and sewer services whereby Oakland, Wayne, and Macomb Counties created a regional water and sewer authority for the Detroit water and sewer utilities.

The Grand Bargain also involved private foundations which committed to fund $366,000,000 over a period of 20 years. With the $195,000,000 funding from the State, these two funds helped to shore up Detroit pension funds and provided a spin-off of the Detroit Institute of Art to an independent non-profit corporation.

The outcome of the bankruptcy was the following:

1. Detroit was able to slash more than $7 Billion Dollars in unsecured liabilities under the

Bankruptcy Plan;

2. It was authorized to reinvest $1.4 Billion Dollars over 10 years in public services and blight

removal ($440 Million in blight removal, $274 Million in police, a $156 Million investment in the City's fire department, and $483 Million in anticipated new revenues).

3. General Pensioners would get a 4.5% cut in their monthly check and the elimination of the

annual cost of living adjustment increases. Police and fire pensioners got a reduction in their cost of living increases. A major issue for pensioners was the clawback provision which required lump sum payments based upon previous valuations of their vested interest.

4. The DIA, its building and collection was saved from liquidation.

What did it cost? One of the distressing outcomes of the Detroit Bankruptcy was the amount spent on legal fees and other consultants. As of December 31, 2014, the city of Detroit indicated that the city had paid $164.91 Million in fees for the bankruptcy, including $57.9 Million to Jones Day, $17.28 Million to Conway McKenzie for operational restructuring, $20.22 Million to Earnest & Young for financial restructuring, $22.82 million to investment banking firm Miller Buckfire, and $15.41 million to Dentons U.S. LLP, a law firm that acted on behalf of an official committee of City retirees fighting pension cuts.

How do you put the cost of the Detroit bankruptcy in perspective? One commentator has indicated that the $164 Million investment in legal counsel returned $70 in debt reduction for every $1 spent. With these reductions, some commentators have said that this outcome was a bargain.

So what is the stage which has been set for Detroit's re-development? First, the City must begin to restore public services which have collapsed almost entirely in recent years. Second, it must tear down blighted properties, and third, it must attract a new generation of people to invest their lives in Detroit. Let's examine each of these challenges.

Restoring Public Services to Properties

One of the consequences of the Detroit bankruptcy has been the creation of two very different cities. On the one hand, there remains stately neighborhoods like Palmers Woods and Sherwood Forest, which are located close to downtown Detroit. These communities are the venues of beautiful old tudor revival castles and homes which were built by the fabulously wealthy automotive pioneers. These communities are protected by private security firms to provide 24 hour protection. However, the rest of the 139 square mile expanse of the City of Detroit is populated by long-time residents who have fought for decades to survive in an environment that has become increasingly uninhabitable. In the first Detroit, private security is common, and the living is relatively safe. In the second Detroit, running water has been cut off from at least 27,000 households. One Wayne State law professor has described the dilemma of the City of Detroit to provide basic services as: "some police, some fire protection, and a bulldozer department to raise abandoned houses."

One area which has seen significant economic revival is the downtown section of Detroit which is undergoing several construction projects. Dan Gilbert, the billionaire founder of Quicken Loans, one of the largest mortgage companies in the United States, moved his company's headquarters from the suburb of Livonia to downtown Detroit, bringing thousands of his employees to the city center with him. Gilbert has purchased significant downtown property and owns approximately 60 buildings which are all protected by private security firms and hundreds of closed-circuit cameras.

In addition to Detroit being a city of two cities, southeast Michigan is a study of very wealthy white America located outside the City of Detroit. Oakland County is the fourth wealthiest county in the United States of counties with a million or more residents. The greater Detroit area, including its suburbs, ranks among the top financial centers, top four centers of high technology employment, and the second largest source of engineering and architectural talent in America. The median income in Oakland County is over $65,000 last year. The median income in Birmingham, Michigan, just across Detroit's border, earn more than $94,000. In nearby Bloomfield Hills, still within the Detroit metropolitan area, the median income was close to $105,000. As a result, we have a city of two cities, and huge disparate wealth next to Detroit.

In conclusion, we must ask the question of why Detroit is so important to the State of Michigan. Travel out of the State of Michigan, and if a cab driver asks where are you from and you reply the State of Michigan, inevitably the cab driver will say that he/she knows about Detroit. Notice that they never comment about the wealth in Oakland County; the technological incubation of Ann Arbor; or the beauty and development of the west side of the State of Michigan. Michigan, whether it likes it or not, is joined at the hip with the legacy of Detroit. Sitting on the west side of the State of Michigan, we have womb-like comfort that we are doing things right. It is easy to say that it is their problem. Frankly, it is our problem and the reputation of our State.