

**Detroit's Grand Bargain:  
Bankruptcy, Settlement, and the Road to Revitalization**

**A Concise Synopsis**

By John F. Sase, Ph.D.

*"In our nation, we join together in the promise and in the ideal of a much grander bargain. It is the bargain by which we interact with each other and with our government, all for the common good. That grander bargain, enshrined in our Constitution, is democracy. It is time to restore democracy to the people of the City of Detroit. I urge you to participate in it. And I hope that you will soon realize its full potential."*

--Steven Rhodes, U.S. Bankruptcy Judge, *Oral Opinion on the Record, In re City of Detroit*, 7 November 2014

Federal Judge Steven Rhodes delivered his ruling in the bankruptcy case for the City of Detroit on 7 November 2014. Due to the size and complexity of this Chapter 9 municipal bankruptcy, the case and its ruling well may stand as a landmark example in the fields of Law and Economics. In this column, we review the oral opinion presented by Judge Rhodes. After taking an overall walk-through of his published document, we discuss the structure, conduct, and performance of the many litigants from both sides as well as the aspects that led to the ruling and to a plan that the Court considers to be "reasonable, fair, and equitable," as Rhodes describes it. Next, we take a deeper look at the Grand Bargain that is the fulcrum in this case and that gives the City of Detroit the ability to move ahead.

**An Open Discussion**

The following review of the Court ruling grew from a discussion in a seminar that was held at Wayne State University on 10 November 2014. This seminar took place in my (Dr. Sase's) course on Urban Economics. The dialogue was among graduate students, undergraduate seniors, and myself. These students (A. Bilotta, S. Berkirane, T. Eland, S. Guillot, J. Hamade, J. Hinton, R. Justewicz, L. Moore, J. Palazzolo, J. Roy, B. Singh, and K. Syed) and I hope that this short synopsis will clarify matters as well as provide economic insight to the case and its resolution.

In our discussion, we relied upon *Oral Opinion on the Record, In re City of Detroit*, a document issued by Judge Steven Rhodes on 7 November 2014 in respect to Case 13-53846 filed on 18 July 2013 in United States Bankruptcy Court, Eastern District of Michigan ([http://www.nextchapterdetroit.com/110714-detroit-bankruptcy-order/?hq\\_e=el&hq\\_m=2982586&hq\\_l=2&hq\\_v=6d244e1c90](http://www.nextchapterdetroit.com/110714-detroit-bankruptcy-order/?hq_e=el&hq_m=2982586&hq_l=2&hq_v=6d244e1c90)).

Within this forty-eight page document, the first twenty and the last five pages encapsulate the issues, the arguments on both sides, the settlements upon which both sides agreed, and the ruling of the Court. The remaining pages contain a discussion of deeper legal issues that have arisen, including challenges to the Constitution of the State of Michigan. Since the discussion by my students and I was held in an Economics seminar, our current article focuses on issues that are addressed from an economic standpoint.

The core element of the bankruptcy resolution and the subsequent plan for the revitalization of Detroit has come to be known as the Grand Bargain. This ruling also includes a number of peripheral though important elements that comprise the total \$18 million settlement. Throughout his discussion, Rhodes supports the opinion of the Court by citing the numerous factions that have come together in this Grand Bargain. Through compromise solution, the class representatives have negotiated settlement agreements. In turn, each committee has taken its agreement to a constituency that approved it by majority vote.

In his detailed narrative, Judge Rhodes discusses the claims, the settlements reached, and the alternatives if these settlements do not hold. These elements of the case coalesce in the Grand Bargain and in the plan for revitalization. In respect to the issues involved in each separate class, Rhodes repeatedly comments that taking any decision by the District Court to appeal would entail a process that would take many years to complete, that would be expensive to litigate, and that would have a medium-to-low probability of winning on appeal. (For more on the process of conditional probability used in this third point, see our article “The Economics of Law: The Expected Value of a Case,” [saseconomics.com/readingroom/economicsoflaw.html](http://saseconomics.com/readingroom/economicsoflaw.html)). While addressing each individual class-settlement, Judge Rhodes underscores the fact that the majority in each class voted to approve their respective settlements.

### **The Grand Bargain**

The settlements represented in the Grand Bargain include 1) The Pension Settlement, 2) The Annuity Savings Fund Settlement, 3) The State Contribution

Agreement, and 4) The Detroit Institute of Arts (DIA) Settlement. In summary, the major components of the Grand Bargain--the cornerstone of the revitalization plan—are as follows:

- 1) The Court allows the Unfunded Accrued Actuarial Liability (UAAL) of \$3.1 billion to be divided between the Police and Fire Retirement System (PFRS) and the General Retirement System (GRS). Through mid-2023, the Federal Court interest rate of 6.75% will be used as both the Assumed Investment Return Rate for determining the Future Value of assets and as the discount rate for determining the Present Value of liabilities within the pension plans. As of 1 July 2014, active employees will receive benefits under new hybrid pension plans. Receiving an Adjusted Pension Amount, FBRs retirees will experience no reduction in their accrued pensions, though their future cost-of-living adjustment (COLA) will be reduced by 45%. GRS retirees will experience a 4.5% reduction in accrued benefits and will get no COLA. The planned funding-target for each system reaches 100% within forty years. The Court estimates a 25% probability of success for pension creditors taking their claim to appeal. However, the PFRS has accepted the plan through a majority vote of 82%. The GRS did likewise with a vote of 73%.
- 2) The Annuity Savings Fund Settlement connects to the pension settlement. The City has claimed that the GRS increased its unfunded liability by over-crediting the interest earned for each participant in the voluntary Annuity Savings Fund. For many years, the GRS credited the fund at an assumed rate of return, even when the actual rate was the lesser of the two. The City and the GRS have reached a mid-point net settlement in the amount of \$190 million. The Court estimates a 60% to 70% probability of success on appeal, though the length, complexity, expense of litigation, and issues of collectability could be substantial. However, the GRS claimants have accepted the settlement by a vote of 73%.
- 3) The State Contribution Agreement settles the matter of potential liability on the part of the State of Michigan for the underfunding of both the PFRS and the GRS under the Pension Non-Impairment Provision in the State Constitution (Article IX, Section 24). Per the Agreement, the State must contribute \$194.8 million, immediately. The pension claimants will cease litigation and will release the State and its related entities from liability. The Court states that the novelty and lack of precedence of this case make the determination of the probability for success on appeal challenging. Also, the Court hammers the point that any such litigation would be long,

complex, and expensive. Nevertheless, the parties have settled, with the representatives of the pension claimants concluding that the contribution by the State is fair. These pension claimants have returned a vote that strongly supports the contribution agreement and the release of potential claims.

- 4) Within this Grand Bargain, a number of large financial components have been brought to task by a major core of groups and individuals. These include the Attorney General of the State of Michigan, the Detroit Institute of Arts, the Police and Fire Retirement System, and the General Retirement System, as well as nine private foundations and a number of creditors from the private sector. Throughout this case, the strongest light has been focused on the assets of the Detroit Institute of Arts (DIA) and the restrictions involved with transferring any part of the collection. Within this action, appraised values have risen higher than \$8 billion. How these assets are being handled is creating a precedent in Federal Case Law. One major creditor, the bond-insurer Financial Guaranty Insurance Company (FGIC), called for the DIA to sell its artwork. At the very least, the FGIC wanted the City to monetize the artwork in the form of loan collateral in order to borrow funds to pay off the FGIC. To support its claim, the insurer retained Victor Weiner Associates of New York, which came in with a high-end valuation of \$8.5 billion for the full collection of 60,377 pieces. However, Artvest Partners, LLC has determined a maximum value of \$4.6 billion while noting that, in a liquidation auction, the net proceeds would come in at \$1.1 billion. In response, Emergency Manager Kevyn Orr has stated that this would not constitute a viable path. Furthermore, millage taxes currently help to support the DIA by providing \$23 million per year to the DIA Total Operating Budget of \$28.4 million. If the artwork were to be sold, the DIA could expect to lose 81% of its annual revenue. In response to the crisis that has brewed around these art assets, a number of parties have come together to create the Grand Bargain. As the critical financial issue revolves around pensions and related benefits, the DIA has pledged \$100 million to the pension funds. The State of Michigan has pledged \$350 million to these funds, while nine foundations have pledged \$330 million. The Detroit Institute of Arts Settlement has evolved through a consortium of the State of Michigan and nine charitable foundations, including the Ford, the Kresge, and the John S. and James L. Knight. As a result, the DIA

will secure and guarantee commitments for contributions to the PFRS and the GRS at an average of \$5 million per year over twenty years (\$100 million). Furthermore, the charitable foundations will contribute an average of \$18.3 million per year for the same duration (\$366 million). The City will transfer the art collection of the Institute to The Detroit Institute of Arts Corporation, a not-for-profit that operates the DIA and that will hold the art in a perpetual charitable trust. The Court states that historical-documentary evidence supports two major assertions made by the State and the DIA. The DIA asserts that the donors of many of the artworks imposed specific transfer restrictions upon these works at the time of donation. Furthermore, both the DIA and Bill Schuette, the Attorney General of Michigan, take the position that the art is subject to a trust that prohibits the City from selling it to pay debts. Though creditors submitted substantial evidence and legal grounds to the contrary, the Court concluded that a vigorous contestation by the Attorney General and the DIA almost certainly would prevail in litigation that could take years to achieve and be costly to pursue. Furthermore, the Court cites the existence of credible evidence that any attempt to sell the artwork by the City, which currently is the owner of record, may result in a loss of more than two-thirds of the operating revenue of the DIA. This would be due to the cancellation of millage taxes from Wayne, Oakland, and Macomb Counties.

### **The Other Important Issues**

The preceding four components of the Grand Bargain represent the critical ones for the satisfactory conclusion of this action and for Detroit moving forward toward revitalization. However, the Detroit Bankruptcy Case includes a number of other settlements as well. Before concluding, let us mention a few of these elements: The issue involving other post-employment benefits for retirees, including health care and life insurance (OPEB), has settled at a midpoint compromise of \$4.3 billion. The bond insurers that paid default claims on Unlimited Tax General Obligation bonds (UTGO) claimed a lien on the revenue stream of City property taxes. However, they settled their claim for \$388 million. Syncora Guarantee had several disputes with the City. Their agreement brought \$45 million to Syncora in the form of new debt instruments as well as a five-year property development concession and the joint assumption of the Detroit-Windsor Tunnel lease until 2040.

## **“The Grand Plan”**

In the attainment of the Grand Bargain and the subsequent plan for revitalization, many groups have come together to create a structure that was built upon a series of individual class settlements. The representative committees achieved this through conduct that allowed for settlement agreements to materialize through give-and-take negotiations. The various classes performed well by voting to approve the respective settlements that were brought forth by their representatives. Judge Rhodes delivered a ruling on the ensemble of agreements that were reached. Given that this bargain is a mousse that has not quite set, he transparently warned the key players that any efforts that could jeopardize the Grand Bargain would result in a long and expensive scenario that has a low probability of surviving the appeal process. For this plan to work, then, all of the components must be in harmony. As an economist, I (Dr. Sase) agree that this Grand Bargain crafted by the Court is “reasonable, fair, and equitable.” Though in need of fine-tuning, the resulting plan for revitalization can work economically. The bargains are sound, the dollar amounts are reasonable (given the situation), and the long-run projections are attainable, with a little bit of luck. Let us hope that clear heads will prevail as to not jeopardize our mousse during this period of fragility.

We hope that our synopsis has aided the understanding of this important case and the underscores the precedence that it sets in the fields of Law and Economics. For our readership, we hope that we have offered a concise and clear treatment that will assist everyone in further explaining the outcome and potential future of the City of Detroit to colleagues, clients, and the community at large.

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