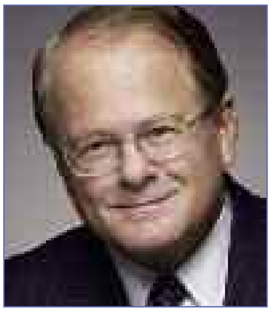
Panic in Detroit: municipal bankruptcy and lessons for city pension schemes



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The financial meltdown of Detroit may result in fallout not only for the city's own retirement schemes, but for public pension funds on both sides of the Atlantic that worry about the increasingly fragile state of municipal finances.

Detroit's financial problems are deeply rooted. The loss of manufacturing jobs, a shift of higher-income taxpayers to the city's exurbs, and mounting obligations to the city's retired workers combined to leave the municipality in dire financial straits.

In March 2013, the Governor of Michigan declared a state of financial emergency in Detroit, resulting in the appointment of private attorney Kevyn D. Orr as Detroit's "Emergency Manager". In July, Orr filed a bankruptcy petition on behalf of Detroit seeking to restructure at least $18 billion in city liabilities, representing the largest municipal bankruptcy in U.S. history.

These events have caused considerable uncertainty for Detroit's two largest unsecured creditors: the city's two pension schemes, which have about $5 billion in assets and represent 9,700 uniformed and non-uniformed city workers, as well as more than 20,000 retirees.

A threshold issue confronting the pensions is Orr's ability to take over the schemes' boards of trustees. The Michigan Emergency Manager Law, which gives Orr his authority, provides that he can either change the makeup of a scheme's board, or be appointed as its sole trustee by the Michigan Treasurer if he can prove

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that the scheme is underfunded by 20% or more. By the schemes' own calculations, neither is underfunded by more than 20%; by Orr's calculations, both are. A third and decisive analysis will likely be conducted by a committee that is currently being assembled by the bankruptcy court to represent retirees in the bankruptcy proceedings.

Another question is whether Detroit is even eligible for bankruptcy protection. More than 100 objections to Detroit's bankruptcy petition have already been filed – including objections by the pension schemes, unions and municipal bond insurers – asserting that, among other things, Orr failed to comply with the bankruptcy laws, did not negotiate in good faith with creditors and has not proved that Detroit is insolvent.

The potential effect of the bankruptcy case on pension rights is also unsettled. Michigan is one of a handful of U.S. states that provide a constitutional protection for accrued pension rights. In contrast, the federal bankruptcy laws do not give any priority to pension rights.

The question of which source of law has supremacy – the Michigan state constitution or the federal bankruptcy laws – is uncharted legal territory. A spokesman for Mr. Orr has stated that the bankruptcy laws trump any state constitutional protection. However, the Michigan Attorney General has taken the position that, as a public officer, Mr. Orr is obliged to follow the state constitution in proposing a plan of reorganisation for Detroit.

Many of these questions may be resolved soon. The bankruptcy court has appointed a mediator to oversee a mediation session between Orr and some of Detroit's creditors, including the pension schemes, on 17 September 2013. The bankruptcy court is scheduled to hold a hearing on Detroit's eligibility for bankruptcy protection on 23 October 2013.

The lessons to be drawn from the Detroit experience are of interest far beyond the American "Rust Belt". U.S. public pensions schemes concede that they are underfunded by more than $1 trillion and, in the U.K., pension schemes for the civil service, NHS, police, teachers and armed forces are all reportedly underfunded as well. As the events in Detroit continue to unfold, their impact may be felt on both sides of the Atlantic.