Rebuild For The Motor City?

The age of “Detroit, the Auto Capital” is pretty much over, despite the recovery of the Big Three. Most of national interest in the city over the last few years has focused on the Lions and the Tigers, and news of the city’s government was largely about various corruption cases. But last week’s bankruptcy filing looks likely to change all that – we are due to be educated on “Chapter 9”, on constitutional protection of pension benefits, on actuarial assumptions behind the cost of pensions and even on who owns the paintings in the city’s museum.

Beyond those issues, the kickoff question is the authority of the “Emergency Manager” (who took the city to bankruptcy court) to do anything. The current EM law is only the most recent version of Michigan’s legal procedures for taking over distressed municipalities. The prior version, enacted in 2011, was repealed by the voters in November last year. The present law, which contained some changes from the old one, was enacted only a few weeks later. It contains an appropriation (for the EM’s salary), which, under Michigan law, makes it immune from repeal by the voters. The questions that will have to be decided by the courts are whether the legislature can ignore the will of the voters by reenacting the substance of a repealed law and, if not, whether the new law is sufficiently different from the old one to remove it from the cloud of repeal. This issue, by the way, would be a matter of state law, and one state court has already ruled against the EM.

Assuming that the EM can hurdle that fence, he has brought the city of Detroit before the federal U.S. Bankruptcy Court under a proceeding known as Chapter 9. We all have heard of Chapter 7 and Chapter 11, but Chapter 9 is a special set of rules, applicable to cities, towns and other municipalities, that circumscribe the power of the court to carry out actions routinely pursued in private bankruptcy cases. For example, the law does not allow the court to “interfere with” the governmental powers of the debtor, any of its property or revenue or the debtor’s use or enjoyment of any income producing property. Moreover, the court may not appoint a trustee in bankruptcy nor can it order liquidation of the debtor’s property.
These provisions leave the city with a great deal of discretion to develop and ask the court to enforce a place of debt reorganization. And, in the case of Detroit, the EM will be speaking for the city. Given the finances of the city, one would expect all its creditors to be taking haircuts.

However, there are a few wrinkles here. First of all, the city needs continuing inflows of cash to operate. The EM has stated that lenders are willing to step up to provide that cash at today’s commercial rates, since the city does enjoy the positive cash flow necessary to service new debt. Will those new lenders that are also old lenders expect some kind of preferential treatment from the city?

Next, there is the question of pensions. According to the EM, the city has about $18 billion of obligations. Over a quarter of those are to secured creditors, who come first in line. About $9 billion of the remaining $12 to $13 billion is due to retirees, in the form of pensions and health care obligations. Thus, current and former government workers are, it seems, headed to experience a substantial reduction in benefits. (There is a dispute over just how much pension benefits have been underfunded. Using the traditional tools of valuation used by the Society of Actuaries, the pension underfunding would be about $650 million. However, the EM has chosen to use a newer set of assumptions advocated by some actuaries, but not yet adopted by the Society. Those assumptions make the problem appear more dire and could have the result of increasing the haircut pensioners would have to take.)

But before the EM can cut back on pension benefits, he will have to overcome a provision in Michigan’s constitution that states that “accrued financial benefits” of state and local pensions “shall not be diminished or impaired”. While bankruptcy courts are often called upon to disregard state laws when they conflict with federal law, the Michigan constitutional provision would apply to the EM as an actor for the state. Given the special role played by city representatives under Chapter 9, the EM may be precluded from seeking a reduction of the pensions. We shall see.

Besides all the creditors – lenders, suppliers and workers – who will be called upon to bail out the city, there is the possibility that Detroit will seek to raise cash by selling assets. Just about anything – bridges, roads, parks, buildings – could theoretically be put on the block, but most talk has been addressed to Detroit’s art museum. The holdings of the Detroit Institute of Arts have been estimated to be worth $2 billion, a large number, except when compared to the city’s obligations. The Attorney General of Michigan has stated that the holdings of the Institute are held in trust for the public and cannot be sold; however, the EM is the governor’s man and presumably could ignore the Attorney General. Selling the works would probably mean the end of the Institute, but one must ask whether that bad outcome is worse than the losses to so many public servants who depend on their pensions.
One final word: Detroit is not a city that has granted excessive pension benefits. Most recipients have worked for 30 years and receive pensions averaging $18,000. Police and firefighters can retire earlier and get pensions averaging $30,000, but they are not eligible for Social Security.

Whatever happens in Detroit will not only affect that city and its people. Many other cities are under the gun as well. Indeed, in Michigan alone there are eight cities besides Detroit that are subject to EMs.

Here are the cost data for this month:

- **Scrap and Pig Iron**  The prices of #1 dealer bundles and #1 busheling (Chicago) were both up by $30, to $405 and $410 per mt, respectively. The spot price for Brazilian pig iron (cif New Orleans) was down $16 to $406 per mt. These are pretty steady prices compared to what has gone on in the recent past. (In July, 2008 the price of busheling was $890; by November, it was $125 per mt.)

- **Natural Gas**  The Nymex contract price for natural gas declined 20 cents to $3.74 per mmBtu. This is the third month in which the prices have dropped slightly.

- **Ocean Freight**  The Baltic Capesize Index was at 2012, the first time it has topped 2000 since November last year. Despite slight fluctuations, it has remained very steady over the last couple of years.

- **Foreign Exchange**  The euro and the pound were unchanged this month at $1.31 and $1.54, respectively. The Canadian dollar took a big drop of eight cents and is now worth only $0.97.

We are always interested in receiving your thoughts on all these issues, so let us hear from you. We shall post this letter on our website, [www.coreysteel.com](http://www.coreysteel.com) and on the international site, [www.steelonthenet.com](http://www.steelonthenet.com).