Bond Case Briefs

Municipal Finance Law Since 1971

WSJ: Detroit's Bankruptcy Retreat.

Failure to reform pensions defeats the purpose of Chapter 9.

The court “will not participate or perpetuate hasty and imprudent financial decision-making,” federal bankruptcy judge Steven Rhodes said last week in his decision to strike Detroit emergency manager Kevyn Orr’s proposed swaps settlement. The financing deal can be redone, but the judge should also keep his words in mind as the state and private foundations attempt a deus ex machina to save the public pension status quo.

Detroit’s bankruptcy has turned into a brawl, prolonging the pain and impairing Mr. Orr’s plans for a municipal revival. The city’s unsecured creditors, who could receive less than 10 cents on the dollar, and its unions are fighting to maximize their repayment and have demanded a fire-sale of the Detroit Institute of Arts’ collections to raise cash.

Enter chief district Judge Gerald Rosen, whom Judge Rhodes has appointed as a bankruptcy mediator. In November Judge Rosen floated the idea of raising donations from private foundations to preserve the art and using the cash to shore up pensions, which could also come under the scalpel in bankruptcy.

Nine foundations including Kresge, Ford and Knight have pledged $330 million to keep the art out of creditors’ hands, and Republican Governor Rick Snyder is trying to persuade state legislators to match the philanthropy with funds from the 1998 tobacco settlement. Note: The tobacco payout was intended for public health, not pensions.

Meantime, Judge Rosen has impelled Mr. Orr to rescind his order last month freezing pension benefits, suspending retirees’ cost-of-living adjustments and moving workers to 401(k)-style plans. These modest measures would reduce Detroit’s $3.5 billion pension liability and help make them sustainable in the future. Most private businesses long ago shifted employees to 401(k)s, but public unions think of them as entitlements.

That’s especially true in Detroit where one worker supports two retirees. Benefit formulas are also unaffordable. Firefighters retiring at 50 can earn 70% of their highest salary plus a 1.9% annual cost-of-living inflator in perpetuity. The average pension for public-safety workers is $30,000 and for other municipal employees $20,000, but many workers retire in their 30s and 40s and have second careers.

Fraud and abuse are rife. Detroit’s union-controlled pension funds have paid annual bonus checks to retirees and mingled funds with workers’ putative “defined-contribution” accounts. Nearly a quarter of retired public-safety officers receive a disability pension equaling two-thirds their pay. Twenty retirees under the age of 20 have also somehow managed to qualify for pensions averaging $27,000. None of this is surprising given that several trustees and money managers have been indicted in corruption probes.

The big risk is that Judge Rosen’s plan will preclude the necessary pension reforms that Mr. Orr has proposed. Unions have ginned up fear that old and sick retirees will be thrown onto the streets, but cuts would probably be structured to spare older and lower-income pensioners. Those most affected would be current workers who would receive a reduced annuity but a new 401(k).

Michigan lawmakers appear open to assisting the pension bailout, which may be good politics in an election year. But GOP state senate majority leader Randy Richardville had a smart idea when he suggested that unions should have to contribute too. By our estimates public-safety unions collect more than $5 million every year in member dues that could go to the cause.

Judge Rhodes has indicated that he won't approve settlements, even those recommended by the court's mediator, that don't resolve the city's systemic problems. Let's hope he holds that line. The point of bankruptcy is to get legal protection to make the hard decisions that politicians have dodged. Preserving defined-benefit pensions would defeat the purpose of bankruptcy and undercut Detroit's inchoate recovery.

Updated Jan. 23, 2014 11:51 p.m. ET