Chapter 9 of the Bankruptcy Code: A solution in search of a Problem

By Omer Kimhi

Abstract

As a result of the recent credit crisis, municipal insolvency has become a relevant and important issue. All over America cities are grappling with budgetary problems, and some of them are even considering bankruptcy. The paper analyzes the municipal bankruptcy process, and inquires whether it provides a sensible solution for urban fiscal crises. In order to examine this question, the paper delves into the prevailing rationales of bankruptcy law – the contractual theory and the fresh-start theory. The paper makes the claim that these theories do not adequately explain the municipal bankruptcy process, and that bankruptcy filing can damage the distressed locality as well as its state and other localities within the state. As an alternative to bankruptcy the paper suggests a proactive state oversight model. This model aims to address the economic problems that lie at the heart of the fiscal crisis, and it allows cities to undergo a genuine rehabilitation process.

Table of content

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Introduction:

Due to the recent credit crisis, the problem of municipal insolvency in the U.S. has become one of great relevance and importance. All over America cities are grappling with budget problems, and many of them have huge debts and limited access to the credit markets.[1] The city of Detroit, for example, faces a $300 million deficit, and more than $100 million of liabilities due in 2008 still remained unpaid at the beginning of 2009.[2] The mayor of Los Angeles recently declared that the gravity of Los Angeles' fiscal emergency is enormous, and estimated that unless drastic steps are taken the city will face a $1 billion deficit by 2010-2011.[3] Jefferson County in Alabama is saddled with billions of dollars in debt, and has already defaulted on some of its payments.[4] The Philadelphia Research Initiative recently conducted a study on the finances of thirteen large cities. According to the study, all cities but one face serious budgetary problems, and most of the cities have budget shortfalls of over ten percent of their general fund.[5] The sheer magnitude of local economic distress led Moody's Rating Agency to assign for the first time ever a negative outlook for the

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[1] THE PHILADELPHIA RESEARCH INITIATIVE, TOUGH DECISIONS AND LIMITED OPTIONS, HOW PHILADELPHIA AND OTHER CITIES ARE BALANCING BUDGETS IN A TIME OF RECESSION 1 (2009) [hereinafter TOUGH DECISIONS].

[2] Kenneth Cockrel Jr., City Of Detroit Budget Deficit Reduction Plan; Restoring Detroit's Fiscal Stability; Statement of Detroit Mayor (Jan 30 2009) (transcript available at http://www.detroitmi.gov/Portals/0/docs/mayor/DeficitReductionPlan09/Budget%20Deficit%20Narr%20Jan29%201156%20pm.pdf); also see TOUGH DECISIONS *supra* note 1, at 2.

[3] Phil Willon, *City Could See Layoffs, Furloughs, The Mayor Urges The Council To Declare Fiscal Emergency, Which Would Grant Him Authority To Make Cuts*, LOS ANGELES TIMES, May 13, 2009, at A3.

[4] Shelly Sigo, *JeffCo Has 1st Missed Payment; Defaults on $46M of Accelerated Principal*, THE BOND BUYER, July 9, 2009, at 1.

[5] TOUGH DECISIONS *supra* note 1.

U.S. local government sector as a whole.[6] This negative outlook reflects the significant fiscal challenges faced by the local government sector, mainly as a result of the housing market collapse and the recession.[7] There is no doubt that American cities are in dire straits, and in need of a remedy.

Perhaps the most well known legal remedy for insolvent cities is provided by the Bankruptcy Code.[8] Chapter 9 of the Bankruptcy Code allows insolvent municipalities to file for bankruptcy, and to use the bankruptcy procedure in order to solve their fiscal problems. Bankruptcy provides a financially distressed municipality with protection from its creditors, and enables it to negotiate a plan for readjusting its debts. Through bankruptcy, the locality is able to decrease its debt burden, and to enjoy a fresh start that will hopefully increase its productivity and boost economic development in the city.[9] Presumably, just as commercial corporations (even giant corporations like General Motors or Kmart) benefit from the bankruptcy process, so can municipalities. And indeed, although municipal bankruptcies are extremely rare (a fact that I will try to explain in the paper), in times of local financial distress the idea of bankruptcy filing often arises. Especially today, facing the recession, several local

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[6] MOODY'S U.S. PUBLIC FINANCE, MOODY'S ASSIGNS NEGATIVE OUTLOOK TO U.S. LOCAL GOVERNMENT SECTOR (2009).
[7] *Id*. at 1.
[8] 11 U.S.C. §§ 901-946 (2005).
[9] Michael W. McConnell & Randal C. Picker, *When Cities Go Broke, A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 468-471 (1993); U.S. Courts, *Bankruptcy Basics - Chapter 9 Municipal Bankruptcy – Purpose of Municipal Bankruptcy*, available at http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter9.html#purpose.

governments are contemplating bankruptcy,[10] and it is not unlikely that some of them will eventually file.[11]

But amid the current urban crisis, a fundamental question arises: Does municipal bankruptcy actually represent a sensible policy for dealing with the problems of distressed localities? Can localities benefit from filing in the same way that commercial corporations do? The prevalent answer to this question, at least in the legal literature, seems to be yes. Although literature on the subject of municipal insolvency is scarce, scholars that address this issue tend to focus on municipal bankruptcy as the remedy for local fiscal crises.[12] Some scholars criticize the current Chapter 9 while others take a more favorable approach, but the underlying assumption of the legal scholarship is that municipal insolvency should be dealt with through bankruptcy law.

In the paper I wish to question this underlying assumption. Contrary to existing scholarship, I argue that bankruptcy law, at least in its current form, is not a sensible solution for urban economic crises, and that municipal financial distress should be dealt with in other manners. To base my claim I delve into the basic

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[10] See, *e.g.*, Andrew Ward, *Bankruptcy Rumor Mill, In California, Some Cities Eye the Example of Vallejo*, THE BOND BUYER, May 8, 2009, at 11; Shelly Sigo, *Jefferson County's Other Crisis: S&P Highlights Bankruptcy Fears*, THE BOND BUYER, July 7, 2009, at 7; Corey Williams, *Officials Mull Bankruptcy for Detroit Schools*, THE ASSOCIATED PRESS STATE AND LOCAL WIRE, July 9, 2009, at the State and Regional Section; *Detroit Schools May be Next on the Road to Bankruptcy*, MICHIGAN MESSENGER July 9, 2009; Rebecca Kimitch, *El Monte Considers Bankruptcy,* SAN GABRIEL VALLEY TRIBUNE (CALIFORNIA), June 29, 2009, at News Section.

[11] Brian Burnsed, *Financial Crisis Shock Waves Hit Municipalities*, MSNBC, Sep. 30, 2008, available at http://www.msnbc.msn.com/id/26946065/wid/%2011915773//.

[12] See. *e.g.*, Lawrence P. King, *Municipal Insolvency: The New Chapter IX of The Bankruptcy Act*, 1976 DUKE L.J. 1157 (1976); Barry Winograd, *San Jose Revisited: A Proposal For Negotiated Modification of Public Sector Bargaining Agreements Rejected Under Chapter 9 of The Bankruptcy Code,* 37 HASTINGS L. J. 231 (1985); McConnell & Picker *supra* note 9; Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035 (1997); Steven L. Schwarcz, *Global Decentralization and the Subnational Debt Problem*, 51 DUKE L.J. 1197 (2002); Fred L. Morrison, *American Law in a Time of Global Interdependence: U.S. National Reports to XVITH International Congress of Comparative Law: Section IV The Insolvency of Public Entities in the United States*, 50 AM. J. COMP. L. 567 (2002); Ryan Preston Dahl, *Collective Bargaining Agreements and Chapter 9 Bankruptcy*, 81 AM. BANK. L. J. 295 (2007). For a different opinion emphasizing the importance of other remedies see, Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises* 88 B.U. L. Rev. 633 (2008).

rationales of bankruptcy law, and I show that they are unable to justify a municipal bankruptcy process. Due to the special nature of municipal corporations, the two main bankruptcy theories - the contractual theory (the creditors' bargain) and the fresh start theory – do not properly explain the implementation of the current Chapter 9, and do not clarify why it is beneficial.[13]

The creditors' bargain theory fails to justify municipal bankruptcy, because, unlike Chapter 11, Chapter 9 does not benefit the creditors. In the regular corporate context, bankruptcy is designed to provide a solution to the creditors' common pool problem. By solving the common pool problem, and keeping the debtor's going concern value, bankruptcy law can increase the value the creditors receive from the debtor's estate, and this in turn decreases the price of corporate credit. In the municipal context, on the other hand, a common pool problem does not exist. Bankruptcy is not required in order to keep the locality as a going concern, and, rather than increasing the value the creditors receive from the debtor's estate, Chapter 9 actually decreases it. Municipal bankruptcy, therefore, does not render credit prices cheaper, but on the contrary – it renders them more expensive.

The fresh start theory of bankruptcy also raises difficulties. According to this theory, bankruptcy is designed to decrease the debtor's debt burden (give it a fresh start), thereby promoting economic activity and rehabilitation. In the municipal context, however, although bankruptcy enables the distressed locality to decrease its debts, in most cases this debt decrease will not bring about financial rehabilitation. Bankruptcy provides no answer to the causes of the local crisis, and the problems that brought about the financial deterioration in the first place will continue to haunt the locality even after the filing. Furthermore, bankruptcy with its uncertainties and

[13] See discussion *infra* part III.

stigma may very well aggravate the locality's economic condition. Bankruptcy harms a city's reputation both as a place of residence and as a debtor, and it can increase credit prices not only for the locality that filed, but also for other localities in the state.

As an alternative to bankruptcy, I suggest a proactive state intervention solution.[14] As opposed to bankruptcy, this approach does not take effect only when the municipality is insolvent, but rather the state monitors its localities on an ongoing basis. When the state detects signs of local distress it intervenes in the local affairs, and tries to prevent a crisis from evolving. I show that proactive state intervention gives distressed localities better chances for rehabilitation, because the state is able to address the root causes of the local crisis. I also show that state intervention, when done properly, can be economically beneficial for all public issuers in the state. The state reduces the risk associated with public debt, and, as a corollary, the creditors reduce the interest rates that they charge from the public issuers. Local governments then enjoy both better fiscal health and cheaper credit prices. The advantages of state intervention are demonstrated through the examples of Pittsburgh, Pennsylvania and the state of North Carolina.

The rest of the paper proceeds as follows. Part I generally describes the municipal bankruptcy process, and provides data on municipalities that have used Chapter 9 in the past. Part II explores the legislative history of Chapter 9. This part discusses the purpose of Chapter 9's legislation, and shows that Congress enacted Chapter 9 as corporate bankruptcy *mutatis mutandis*. Part III explains why the implementation of corporate-like bankruptcy procedures on municipalities is wrong. It analyzes the application of the prevailing bankruptcy rationales to municipal bankruptcy, and demonstrates the adverse effects bankruptcy filing might have on

[14] See discussion *infra* part IV.

municipalities. Part IV suggests state intervention as an alternative to bankruptcy, and illustrates the advantages of such an approach.

I. Chapter 9 and Municipal Bankruptcy Filings

Chapter 9 of the Bankruptcy Code provides a bankruptcy procedure to municipalities. Only municipalities may file for Chapter 9, and municipalities may not file for any other chapter in the Bankruptcy Code.[15] Yet, despite the distinct chapter, municipal bankruptcy basically offers corporate like bankruptcy proceedings. Most of the provisions in Chapter 11 are directly incorporated into Chapter 9 (through section 901)[16], and the municipal bankruptcy process is by and large similar to a corporate bankruptcy process.

Like a commercial debtor, a municipality that files for Chapter 9 enjoys an automatic stay.[17] The stay prevents the creditors from bringing any action (or enforcing any judgment) against the locality,[18] and it affords the locality a breathing spell to conduct negotiations with its creditors. Under the auspices of the stay, the locality can begin negotiations on debt readjustment. The locality may try to reach a consensual agreement with its creditors, but it may also attempt to cram down a debt readjustment plan notwithstanding its creditors' objections.[19] If the debt readjustment

[15] 11 U.S.C. § 109 (2005). The term municipality is defined in 11 U.S.C. § 101(40). The term municipality refers to any political subdivision or public agency or instrumentality of a state. The definition is broad, and includes cities, counties, townships, school districts, and public improvement districts. It also includes public bodies that provide public services, which are paid for by the users of the services rather than by the taxpayers (such as bridge, highway or gas authorities); See *In re county of Orange* 183 B.R 594 (Bankr. C.D. Cal. 1995).
[16] 11 U.S.C. § 901 (2005).
[17] *Id.* § 362 is incorporated into Chapter 9 via *Id.* § 901. Also see *id*. § 922.
[18] *Id.* 922(d) limits the applicability of the stay. Pursuant to this section, a chapter 9 filing does not operate to stay the application of pledged special revenues to payment of indebtedness secured by such revenues.
[19] *Id*. §§ 1129(a),1129(b) are partially incorporated into Chapter 9 via *Id.* § 901.

plan meets certain conditions (specified in sections 1129 and 943),[20] the plan gets the approval of the bankruptcy court, and the locality is discharged of all pre-petition debts except for the debts that it assumed under the plan.[21]

Notwithstanding the similarities between Chapter 9 and Chapter 11, there are several major differences between the two chapters. First, as opposed to corporations or individuals, in order to enjoy municipal bankruptcy protection, a municipality must meet certain thresholds. Whereas being a debtor under Chapter 11 (or 7) requires only some sort of connection to the United States,[22] being a debtor under Chapter 9 requires proving five substantive conditions.[23] These conditions include, *inter alia*, that the locality is insolvent, that the locality is expressly and directly authorized to file for bankruptcy by the state, and that the locality tried and failed to negotiate debt readjustment proceedings, or that such negotiations are impracticable. Entering the gates of municipal bankruptcy is, therefore, much harder than entering the gates of other types of bankruptcy, and in many instances a municipal bankruptcy filing is rejected because the municipality is unable to prove the required thresholds.[24]

However, once the bankruptcy filing is approved, the municipality has greater powers than a regular corporate debtor.[25] Due to constitutional reasons, the federal bankruptcy court has limited jurisdiction over a municipal debtor, and, as a result,

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[20] *Id*. §§ 943,1129.
[21] *Id*. § 944.
[22] *Id*. § 109(a).
[23] The requirements are set forth in *Id.* § 109(c): (1) the debtor must be a municipality; (2) the debtor must be specifically authorized by the state; (3) the debtor must be insolvent; (4) the municipality has to show that it desires to effect a plan to adjust its financial obligations; and (5) the locality must show that it tried to negotiate a debt readjustment agreement with its creditors, or that such negotiations are impracticable.
[24] See, *e.g.*, the filing of Bridgeport, Connecticut (In Re City Of Bridgeport, 129 B.R. 332 (Bankr. D. Conn 1991);
[25] McConnell & Picker view the threshold requirements as gatekeepers that reduce the moral hazard associated with the filing. Chapter 9 affords greater powers to municipal debtors, but correspondingly it sets higher thresholds for filing. See McConnell & Picker *supra* note 9 pages 455-457.

localities enjoy greater latitude in the bankruptcy process.[26] Thus, as opposed to Chapter 11, within Chapter 9 the locality has exclusive rights to submit debt readjustment plans for the court's confirmation.[27] Creditors may not submit plans of their own, even if the locality fails to submit any plan for a long period of time. Likewise, a trustee cannot be appointed for the locality.[28] The local leadership continues to run the municipality, even when the locality is mismanaged, and even if the local leadership's behavior harms the creditors' interests. But perhaps most importantly, the bankruptcy court itself is unable to interfere in or jeopardize the locality's political powers in any way. The court may not instruct local officials to take any action (such as a tax increase or an expenditures cut), and so it is incapable of steering the locality towards rehabilitation.[29] The management of the distressed locality is left to local officials' absolute discretion.

Another major difference between corporate and municipal bankruptcies concerns the creditors' protection rules against a cram down. Seemingly these protection rules are directly incorporated into Chapter 9 from Chapter 11, and so Chapter 9 creditors are supposed to have the same level of protection as Chapter 11

[26] U.S CONST. amend. X. According to the amendment, the federal government is forbidden from interfering with the sovereign powers of the states, which include the states' powers over their localities. Congress, therefore, is not allowed to legislate statutes that would limit the states' sovereignty over their local governments, or that would intervene in the political and governmental powers of municipalities.

[27] Chapter 11 allows the debtor an exclusivity period of 120 days. After 120 days the court may accept plans also from the creditors or from other interested parties (11 U.S.C § 1121(b)). Chapter 9 does not incorporate section 1121(b), and so the exclusivity period is not limited in time. Also see section 941 (*Id* § 941) stipulating that "the debtor shall file a plan for the adjustment of the debtor's debts", and making no reference to the right of any other person to file debt readjustment plans to court.

[28] Section 1104 (*Id*. § 1104) enables the court, after a notice and a hearing, to order the appointment of a trustee for the debtor. Chapter 9 does not incorporate section 1104, and according to section 926, a trustee can be appointed only for limited purposes (namely avoiding powers) (*Id*. § 926).

[29] The court's powers are expressly restricted in sections 903-904 (*Id*. §§ 903-904). According to section 904, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree interfere with: any of the political or governmental powers of the debtor; any of the property or revenues of the debtor; or the debtor's use or enjoyment of any income-producing property.

creditors.[30] Practically, however, the adoption of the 'corporate' protection rules to municipal bankruptcy does not yield the same results, and creditors of municipalities are much less protected. Perhaps the best example is the application of the absolute priority rule.[31] In the private context, the absolute priority rule provides a potent protection mechanism. If the shareholders (the creditors with the lowest priority) wish to keep their holdings in the company, all other creditors, and particularly the unsecured creditors, must be paid in full.[32] In the municipal context, however, the same rule provides very weak protection. Municipalities have no shareholders, and the unsecured creditors are essentially the lowest priority creditors (the residents, the conceptual equivalents of the shareholders, are not considered as creditors). Consequently, the absolute priority rule is met even when the unsecured creditors are impaired under the plan, and even when the locality gives extra funds to its residents at the expense of its creditors. Providing goods and services to the residents (even unreasonably expensive services) is not considered payment to low priority creditors, and so, as a result, the absolute priority rule is not violated.[33] Chapter 9 then enables municipalities to increase their costs, and to confirm plans that harm their creditors' basic interests.[34]

An additional difference between Chapter 9 and Chapter 11 concerns the debtor's collective bargaining agreements (CBAs). Under Chapter 11, the rejection of

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[30] Section 901 (*Id.* § 901) incorporates most of creditors protection provisions of Chapter 11 (*Id.* § 1129), including the absolute priority protection rule *(Id.* §§ 1129(b)(2)(A) and (B)). Section 943 (*Id.* § 943) sets additional creditors protection rules, specifically for Chapter 9.

[31] *Id.* §§ 1129(b)(2)(A) and (B). Douglas Baird views the absolute priority rule as the most important creditor protection mechanism (DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 66 (4th edition 2006)).

[32] Baird, *supra* note 31 at 69.

[33] COLLIER ON BANKRUPTCY, 943.03[1][f] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2007); McConnell & Picker, *supra* note 9, 464.

[34] *Cf.* William D. Baker, *Chapter 9 Bankruptcy: A Haven for Central Arizona Project Irrigation Districts?*, 27 ARIZ. ST. L.J. 663, 674-675 (1995)

a CBA is governed by section 1113.[35] This section allows the debtor to reject a CBA only after the debtor's negotiations with the authorized representatives of employees (the unions) failed, and only if a court concluded that the modification to the agreement proposed by the debtor was no more than the modifications necessary to permit the debtor's reorganization. Section 1113, however, is not incorporated into Chapter 9. There is no statutory instruction as to the rejection of CBAs in municipal bankruptcy, and courts had to fill this statutory void. Some courts applied the standard of NLRB v. Bildisco & Bildisco[36] (which was the CBA rejection standard prior to the legislation of section 1113).[37] The Bildisco decision offers a relatively lenient standard for the rejection of CBAs, because as opposed to section 1113, under Bildisco the court does not need to inject itself into the negotiations and evaluate the reasonability of the debtor's proposals. The Bildisco standard enables a locality to reject a CBA if the agreement burdens the bankruptcy estate, and if the locality shows that it made reasonable efforts to negotiate a voluntary modification to the agreement without a satisfactory result. It is easier, therefore, to reject CBAs within Chapter 9, and localities can thereby apply greater pressure on their employees to make concessions.[38]

We can see, therefore, that Chapter 9 provides municipalities with relatively easy debt relief. The locality remains politically independent, while confirming a debt readjustment plan from a position of power. Due to these advantages, one could expect that financially distressed localities would use Chapter 9 to deal with a financial crisis. Filing for bankruptcy would enable the locality to get rid of at least part of its debts, and continue to operate with a decreased debt service. However,

[35] 11 U.S.C § 1113
[36] NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984).
[37] In Re City of Vallejo 403 B.R. 72 (51 Bankr. Ct. Dec 2009). But *Cf.* Orange Cty. Employees Ass'n v. County of Orange (In Re County of Orange), 179 B.R. 177 (Bankr. C.D. Cal. 1995).
[38] For an in depth analysis of the treatment of CBAs in Chapter 9, see, Dahl, *supra* note 12.

Chapter 9 statistics show a different story. The chapter is in fact seldom used, and it was almost never used by a large and important city.

According to data about bankruptcy filings,[39] in the thirty three years between 1976 and May 2009 there were about forty bankruptcy filings by general-purpose municipalities, and only about thirty of these filings were approved.[40] On average, a little more than one bankruptcy filing per year,[41] despite the fact that during this thirty three years time frame, local governments underwent several periods of recession (such as in the mid seventies, the beginning of the 1990s, and, of course, the current crisis). In 2008, for example, notwithstanding the recession's major impact on municipalities, only two general-purpose municipalities filed for Chapter 9.[42]

Interestingly, most of the localities that did file for Chapter 9 were extremely small. The median population size of those cities is about 1000 residents, and thirty four out of the forty cities that filed have less than 10,000 residents. Although larger

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[39] The data was gathered until May 2009. Data about Chapter 9 filings of general-purpose municipalities from the late 1990s until May 2009 is available through the federal judiciary's Case Management/ Electronic Case Files (CM/ECF) system of the Federal Bankruptcy Courts (available after registration at http://pacer.psc.uscourts.gov/cmecf/). Additional data was gathered from various media publications (mostly the Bond Buyer periodical) available in Lexis. Data regarding the identity of Chapter 9 debtors during the 1980s was taken from, James E. Spiotto, *Ninth Annual Institute On Municipal Finance Law Selected Municipal Bankruptcy Statistics*, PUBLICATION OF LAW OFFICES OF CHAPMAN AND CUTLER (June 1990) (on file with the author). Data about the 1970s was taken from ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, BANKRUPTCIES, DEFAULTS AND OTHER LOCAL GOVERNMENTS FINANCIAL EMERGENCIES (1985). The data gathered does not include filings of special purpose municipalities.

[40] General-purpose municipalities include cities, counties, towns, and townships. These are municipal corporations that most of us associate with the word municipality, as they provide us with a broad range of public services that we expect from our local government (such as law enforcement, fire protection, education, cultural activities etc.). The number of filings does not include filings done by special purpose municipalities. Special purpose municipalities (also called "special districts") are municipal corporations created to provide a specific kind of governmental service. They usually provide only one type of service (such as water and sewage, infrastructure construction, electricity and so on), and are often funded by special taxes levied specifically to finance this purpose. However, since the paper explores whether Chapter 9 provides a viable solution for the financial distress of general purpose municipalities, the filings done by special districts are irrelevant. These filings indicate the financial failure of a single function or service, rather than a failure of the local government as a whole or a general municipal financial crisis.

[41] Special purpose municipalities tend to use Chapter 9 more. Between 1997 and 2009 there were approximately 180 approved bankruptcies of special purpose municipalities. Statistics about the total number of municipal bankruptcy filings, without differentiating between general and special purpose municipalities are available at http://www.uscourts.gov/bnkrpctystats/bankruptcystats.htm.

[42] Gould, Arkansas (in April 2008) and Vallejo, California (in May 2008).

cities (and even metropolises like New York, Miami, Philadelphia or Washington D.C.) also experienced severe financial stress, with few notable exceptions (such as Orange County) such cities preferred to solve their problems in ways other than bankruptcy. Clearly, municipal bankruptcy filing appeals more to small towns than to the average or large city.[43]

Examining the circumstances that led to the aforementioned bankruptcy filings also reveals interesting results. Although urban crises are usually characterized by slow and gradual economic deterioration,[44] municipal bankruptcy filings were often caused by a one-time sudden exogenous event. This event created a liquidity problem that eventually resulted in bankruptcy. In many cases, the event that led to the filing was simply the loss of a large lawsuit. The locality did not have the resources to pay the awarded damages, and, concerned with the plaintiff's possible actions, filed for bankruptcy protection. This, for example, was the case with the Village of Hillsdale, Missouri (with 1,400 residents, that lost an $88,000 lawsuit to a police officer that slipped on a patch of ice),[45] the city of Reeds Springs, Missouri (with 510 residents, that lost $160,000 in a personal injury lawsuit)[46] or the town of Tyrone, Oklahoma[47] (that lost $150,000 in a lawsuit).[48] Another common reason for bankruptcy filing

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[43] The state of Illinois provides an interesting example. The state has three cities that filed for bankruptcy: The Village of Brooklyn (626 residents), the Village of Washington Park (5451 residents) and the Village of Alorton (2549 residents). Their larger neighbor, East Saint Louis (29,000 residents), also suffered from severe financial difficulties, but avoided bankruptcy with the help of the state. See John Racine, *Illinois Governor's Staff Works on Plan for State Bond Bailout of East St. Louis*, THE BOND BUYER, June 12, 1990, at 1.

[44] See *infra section III(B)(2).*

[45] *St. Louis County Community Files for Bankruptcy*, THE ASSOCIATED PRESS STATE & LOCAL WIRE, December 11, 2001, in the State and Regional Section.

[46] *Personal Injury Judgment Forces Small Town into Bankruptcy*, BCD NEWS AND COMMENT, December 18, 2002.

[47] *Lawsuits Bankrupting Panhandle Town*, THE ASSOCIATED PRESS STATE & LOCAL WIRE, October 5, 2000 in the State and Regional Section.

[48] Also see the bankruptcy filings of Bay Saint Louis, Mississippi in 1977 (that filed due to a $375,000 judgment, see LOCAL GOVERNMENT FINANCIAL EMERGENCIES, *supra* note 39, at 8); North Courtland, Alabama in 1992 (that filed due to a $94,384 judgment, see In Re Fred and Bertha James 184 B.R. 147,148 n.1); Town of Ozan, Arkansas in 1995 (that filed due to a $55,000 judgment, see Larry Copeland, *Ark. Town's Dream of Regained Glory Carried Huge Price*, PHILADELPHIA INQUIRER, July 2

concerns, somewhat surprisingly, the relationship between the municipality and the state or federal government.[49] In these cases the municipality owed a substantial amount of money to the state or to the federal government, and in an act of defiance it filed for bankruptcy protection.[50] Sometimes the municipal administration was also corrupt, and trying, by means of bankruptcy, to prevent state supervision.[51]

This data raises questions concerning the municipal bankruptcy chapter. Why do so few localities attempt to take advantage of Chapter 9? And why, in those cases when Chapter 9 was used, it was by tiny municipalities under peculiar circumstances. This is particularly interesting in light of the severe financial problems municipalities suffer from, and the great privileges Chapter 9 can offer municipal debtors. Chapter 9 was created to help localities that suffer from fiscal crisis, but in practice the chapter

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1995, at A2); South Tucson, Arizona in 1983 (that filed due to a $4.5 Million judgment, see Mathew Kauffman, *Problems that Swamped Other Cities Simpler*, HARTFORD COURANT (CONNECTICUT), July 15 1991, at A6); Mound Bayou, Mississippi in 1987 (that filed due to a $365,000 judgment, see *id*); Merrill, Michigan in 1987 (that filed due to a personal injury judgment in the amount equal to its annual budget, see id.) and more. To a certain extent, the bankruptcy of Orange County (the largest municipal bankruptcy ever filed) can also be associated with this type of reason. Here, no lawsuit was filed, but the municipality suddenly lost a huge amount of money, as a result of the investments of the county's treasurer – Robert Citron.

[49] I note that this reason is surprising, because pursuant to the code, state authorization is one of the requirements for municipal bankruptcy filing. Thus, although a bankruptcy petition filed without the state's approval is bound to be dismissed, municipalities did try to file even when the state expressly opposed the filing.

[50] See. e.g., the bankruptcies of North Bonneville, Washington, in 1991 (due to a debt of 365,000$ to the federal government, see Joe Haberstroh, *Little Town in Feud With Corps that Moved It*, THE SEATTLE TIMES, November 13, 1991, at A1); Lipscomb, Alabama in 1991 (due to a debt to the Farmers Home Administration, see *Alabama Lipscomb*, USA TODAY, April 23, 1991, at 6A); The City of Mack's Creek, Missouri in 1998 (debts to the state and federal governments, see Jon Jeter, *Radar Guns Prove Fatal to Missouri Speed Trap; Town Went Broke After Ticketed Official Fought Back*, THE WASHINGTON POST, November 27,1998, at A10); Bridgeport, Connecticut and Camden, New Jersey filed for Chapter 9 at least in part due to a conflict between the cities and the state government (see, Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANK. DEV. J. 625 (1995); Laura Mansnerus, *All He Wanted Was a Little Respect*, THE NEW YORK TIMES, August 1, 1999, at section 14NJ p. 4).

[51] Take for instance Camden, New Jersey (filed in 1999). New Jersey wanted to erect an oversight board over the City of Camden. Camden's mayor (Milton Milan) was afraid that tighter state control would reveal the corrupted way in which he managed Camden. He thought that bankruptcy filing would convince the state to give the city money without financial oversight (See: Melanie Burney, *N.J. city files for bankruptcy*, CHICAGO SUN-TIMES, July 21, 1999, at 33; Laura Mansnerus, *supra* note 50). The state objected to the bankruptcy filing, and indeed the filing was dismissed only a week after the filing. Also see with regard to Bridgeport, Connecticut, Dorothy A. Brown, *supra* note 50; and with regard to Green County, Alabama, Gita M. Smith, *Green County Ala., Politicians are Under Scrutiny Over Elections Procedures and Handling of Funds*, THE ATLANTA JOURNAL CONSTITUTION, January 19, 1997, at 6B.

does not perform such a function and it can only be described as a dead letter in the Bankruptcy Code. So what went wrong in the legislation?

I begin the exploration of this question with a review of the legislative history of Chapter 9. Examining the legislative history will enable us to better understand why Chapter 9 is constructed as it is, and what were the rationales behind the creation of a municipal bankruptcy process.

II. The Legislative History of Chapter 9

The history of the municipal bankruptcy chapter can be divided into two distinct phases: the first, from the mid 1930s, when, following the Great Depression, Chapter IX was enacted;[52] and the second, from 1976, when, as a response to the New York City financial crisis, the chapter was amended. The 1976 amendments are particularly important, because they changed Chapter IX's basic rationale. Before 1976 the purpose of Chapter IX was solely to overcome the creditors' holdout problem. After 1976, the chapter was supposed to offer municipalities with omnibus bankruptcy proceedings, and it was expected to help localities rehabilitate from their financial troubles.

A. *The 1930s legislation*.

The origins of the municipal bankruptcy chapter lie in the period preceding the Great Depression. In those years the U.S. enjoyed phenomenal economic development, and naturally, the growing national economy also affected local governments. The hectic business activity and the ever-increasing real estate prices facilitated the expansion of local tax bases, and municipalities enjoyed an increase in

[52] Before 1978 the municipal bankruptcy chapter was marked with Roman numerals - Chapter IX. In 1978, with the legislation of the Bankruptcy Code, the roman numerals were replaced by Arab numerals and so the municipal bankruptcy chapter was marked Chapter 9.

revenues and investments.[53] Based on predictions of high levels of income, many municipalities set a high level of expenditure, and entered into long-term loan agreements for utility and infrastructure projects.[54] Unfortunately, these predictions were wrong. In 1929 the U.S. economy entered into the Great Depression, and local governments, being an integral part of the national economy, were severely affected.

One of the most important causes of crises in the local governments was the fall in real estate prices.[55] During the Great Depression the total assessed property value in the country declined by $32 billion (an eighteen percent decline from the peak value), and as a result property tax revenues plummeted.[56] Collection rates decreased as well. Residents did not have the money to pay the required taxes, and municipalities were not able to sell the real estate property that they had foreclosed. Naturally, this drove an alarming number of municipalities into a financial crisis. The localities simply could not pay back the debts they took on in the times of economic prosperity, and in January 1934 as many as 2,019 local governments were in default (with a total sum of about $18 billion in outstanding municipal debt).[57]

Due to the gravity of the situation, debt readjustment negotiations between municipalities and their creditors were prevalent. On the one hand, localities could not

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[53] ALBERT M. HILLHOUSE, MUNICIPAL BONDS A CENTURY OF EXPERIENCE, 245 (1936).

[54] State and Local debt grew from $2 billion at the turn of the 20th century to $12.8 billion by 1928, see Natalie R. Cohen, *Municipal Default Patterns: An Historical Study*, 9 PUB. BUDGETING & FIN. 55, 56 (1989).

[55] The assessed valuations of real-estate property for property tax purposes are based on the market value of the property. Therefore, an increase or a decline in market values causes increases or declines in the municipal property tax base.

[56] The total assessed real-estate property value in the country at its peak was $176 billion. The total assessment for 1933-34 was 144 billion, a decline of 32 billion, or 18 percent. However, this decrease was not uniform. Among some states (those with the greatest number of municipal defaults) the decrease in assessment from the peak levels has been in much higher percentages: Arkansas 28.2; Florida 18.9; North Carolina 33.8; Texas 26.1. See: Hillhouse, *supra* note 53, at 240 (citing from the BOND BUYER (Oct. 19, 1935)).

[57] Ashton v. Cameron County Water Improvement District No. 1, 298 U.S. 513, 533-534 (1936); Also see, *Amendment of Bankruptcy Laws – Bankruptcy Of Municipalities: Hearing on S. 1868 and H.R. 5950 Before the Subcomm. of the Senate Comm. on Judiciary*, 73rd CONGRESS 1ST SESS., at 11-12 (1934) (Statement of Hon. J. Mark Wilcox, a representative in Congress from the State of Florida). [Hereinafter: "*Amendment of Bankruptcy Laws – Bankruptcy Of Municipalities*"].

pay their financial obligations when due, so they preferred to reach debt readjustment agreements that enabled them to postpone the payments and avoid possible legal actions by the creditors. On the other hand, the creditors acknowledged that the municipalities did not have the resources to pay them back in full, and they believed that debt readjustment could maximize their debt collections.[58] Due to the common interests of both municipalities and creditors, a significant number of debt readjustment agreements were reached to the benefit of all parties involved.[59]

The problem was that many of the negotiated agreements, even if they received the support of the majority of the creditors, were impossible to consummate because of the strategic resistance of a small minority. Minority creditors held out their consent, as they preferred that the municipality and the majority of the creditors would execute the agreement without them having to waive any of their own claims. The minority hoped that the execution of a debt readjustment agreement would facilitate a local financial recovery, and this recovery would enable them (not bound by the debt readjustment agreement) to recover their claims from the locality in full.[60] Naturally, however, municipalities and majority creditors refused to accept the minorities' opportunistic behavior. They did not want to execute a debt readjustment plan, only to see the benefits of such an agreement usurped by the minority.[61] Thus, executions of local debt reorganization agreements did not take place, even when

[58] Ashton v. Cameron County Water Improvement District No. 1, 298 U.S. 513, 534 (1936)
[59] George H. Dession, *Municipal Debt Adjustment And The Supreme Court*, 46 YALE L. J. 199, 200 (1936).
[60] *Amendment of Bankruptcy Laws – Bankruptcy Of Municipalities, supra* note 57, at 14.
[61] *Id.* at 46 (Statement of David M. Wood) (Mr. Wood explained "We are never able to consummate it [a debt readjustment agreement], because of the few creditors who hold out and demand 100 cents on the dollar, and, if we were to accept new obligations on the refunded basis and extend our maturity for a long period, it would simply enable them to come and get a writ of mandamus to require a tax levy to settle in full for their bonds and make a further tax levy impossible to collect and endanger the refunding bonds and perhaps precipitate a default immediately on the new bonds. Consequently the majority of creditors do not dare to consummate the contract which was agreed upon; neither does the municipality feel that they can consummate it until those creditors have been brought in line".)

these agreements were beneficial to the entire group of creditors.[62] This holdout problem was so severe that no municipality (or any other governmental unit) with considerable widespread indebtedness was able to execute a debt readjustment agreement with its creditors.[63]

Theoretically, the solution to the hold out problem was simple. A majority voting rule had to be implemented, so that if the majority of the creditors consented to a debt readjustment plan, they would be able to force the plan on the dissenting opportunistic minority.[64] States, however, were unable to enact such a law, as they are constitutionally prohibited from impairing the minorities' debt contracts.[65] The solution, therefore, had to come from Congress, and Chapter IX of the Bankruptcy Act was enacted in May 1934 exactly for this purpose.[66] The chapter enabled

[62] In game theory this type of situation is usually depicted as a "chicken game". A "chicken game" is a game of "who breaks down first?", and it is usually described as follows: Two people drive at each other on a narrow road. The first to swerve loses face among his peers (and suffers a damage of -1). If neither swerves, however, they collide (and suffer damages of -3). The consequences of the players' actions can be described by a two by two matrix.

		Minority creditor/driver 1	
		Consent/swerve	Holdout/straight
Other creditors/driver 2	Consent/swerve	(0,0)	(-1,+1)
	Holdout/straight	(1,-1)	(-3,-3)

In our situation a creditor's holdout is equal to the driver's continuing to drive straight ahead, and a creditor's consent is equal to a driver's swerve. A debt-readjustment agreement is beneficial to all parties involved (just like swerving), but it is better for minority creditors to try to holdout and get even better conditions for themselves. In this kind of a game there are two pure strategy equilibria (either holdout/consent or consent/holdout). However, both players try to expose the other guy as a 'chicken', and maximize their own payoffs. See: ANDREW M. COLMAN, GAME THEORY AND ITS APPLICATIONS IN SOCIAL AND BIOLOGICAL SCIENCES, 111-112 (1995).

[63] *Amendment of Bankruptcy Laws – Bankruptcy Of Municipalities, supra* note 57, at 14.

[64] If a majority, rather than a unanimity, voting rule is implemented, then the minority is not pivotal to the agreement's approval. The minority does not have the power to strategically obstruct the approval of a beneficial agreement, and an efficient decision-making process can be achieved. see: Zohar Goshen, *Controlling Strategic Voting: Property Rule or Liability Rule?*, 70 S. CAL L. REV 741, 793 (1996).

[65] U.S. Const. Art. I, § 10

[66] Municipal Bankruptcy Act of 1934, PUB. L. NO. 251, 48 STAT. 798 (1934) (hereinafter 1934 Act"); Sanders Shanks Jr., *The Municipal Bankruptcy Act (Summers Wilcox Bill)*, 28 AM. POL. SCI. REV. 1072 (1934); Dession, *supra* note 59.

municipalities to file for bankruptcy, and under certain conditions to force through beneficial debt readjustment agreements on minority creditors.[67]

It is important to note, though, that Chapter IX was designed solely to overcome the holdout problem. It did not aim to offer a recovery process for distressed localities, and it did not provide a comprehensive corporate-like bankruptcy proceeding.[68] In contrast to corporate bankruptcy, under the 1934 Chapter IX, a municipality could file for bankruptcy only after reaching a debt readjustment agreement, and only after the agreement received the approval of an absolute majority of its creditors.[69] There was no automatic stay, no cram down, and generally, the chapter offered insolvent localities no assistance unless a holdout occurred.[70] The purpose and scope of the legislation were limited, and due to its limited nature, the chapter gained wide support from both debtors and creditors.[71]

Two years after the legislation, the Supreme Court decided Chapter IX was unconstitutional.[72] It was determined that the chapter invaded state sovereignty, and it was declared void. However, the Supreme Court's decision did not discourage the proponents of Chapter IX, and in 1937 Congress enacted a revised chapter.[73] The revised act amended certain provisions of the 1934 legislation, but the concept

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[67]The chapter prescribed the following conditions: First, as a prerequisite to the bankruptcy filing, the municipality had to prepare a debt readjustment agreement with its creditors, and an absolute majority of the creditors had to approve the agreement. (Section 80(a) of the 1934 Act); Second, after the filing a second vote took place, and this time a majority of seventy five percent of the creditors were required (Section 80(d) of the 1934 Act); Finally, the agreement also had to be confirmed by the court, in order to make sure that it did not harm the interests of the minority creditors (Section 80(e)). When an agreement met all the required approvals, it was considered binding upon all the creditors, even on those who had not accepted it.

[68] Shanks, *supra* note 66, at 1072.

[69] Section 80(a) of the 1934 Act

[70] Dession, *supra* note 59, at 215.

[71] Among the supporters of the act were: Municipal officials, investment bankers, bondholders protective committees, scholars and more. (see *id*, at 214). After its legislation the chapter was considered a success by bond attorneys and others involved in the municipal debt readjustment work (Shanks, *supra* note 66, at 1073).

[72] *Ashton v. Cameron County District*, 298 U.S. 513 (1936). The court determined that Chapter IX invaded state sovereignty in violation of the 10th amendment to the constitution.

[73] The Supreme Court upheld the revised act in *United States v. Bekins* 304 U.S. 27 (1938).

remained the same: Chapter IX facilitated the execution of debt readjustment agreements that municipalities and the majority of their creditors have reached prior to the bankruptcy filing.[74] This concept of municipal bankruptcy remained unchanged until the 1970s.

B. *The 1970s amendments*:

The 1970s were years of economic difficulty. Business investments languished, unemployment rates rose to uncomfortable levels, and the country suffered from a recession accompanied by high inflation rates (a condition usually referred to as stagflation).[75] The national economic situation adversely affected local governments' financial condition. On one hand, because of inflation, municipal expenditures, and especially labor expenses, increased. On the other hand, the slow business activity and unemployment caused municipal tax bases to shrink.[76] This double negative effect drove many municipalities into severe financial difficulties.[77]

The most important and serious crisis took place in New York.[78] The national economic situation combined with various other factors severely affected New York's economy, and at the beginning of the 1970s the city's financial condition severely deteriorated. At the height of the New York crisis (April 1975) the financial markets refused to extend the city any more credit, and New York City did not have the funds

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[74] One important change was in the number of consents needed for confirmation of a plan (reduced from 75% to 66.67%).

[75] Christopher Conte, Albert R. Karr, *An outline of U.S. Economy, Chapter 3, The U.S. Economy – A Brief History – stagflation in the 1970*s, available at: http://economics.about.com/od/useconomichistory/a/stagflation.htm.

[76] In many cases public labor agreements included automatic cost-of-living adjustment provisions, and so employment costs, which usually make up a substantial portion of the local budget, grew together with inflation. For the influences of the macro-economic trends on cities, see PEARL M. KAMER, CRISIS IN URBAN PUBLIC FINANCE: A CASE STUDY OF THIRTY EIGHT CITIES 40-43 (1983).

[77] Among the municipalities that experienced financial difficulties were: New York, Cleveland, Washington, Philadelphia, and Baltimore.

[78] Donna E. Shalala & Carol Bellamy, *A State Saves a City: The New York Case*, 1976 DUKE L. J. 1119.

to pay for its debt service or basic operating expenses.[79] With no available cash, New York's officials turned to the federal government for financial assistance, but President Ford denied the city's requests for financial aid (or, as the Daily News famous headline phrased it – "Ford to City: Drop Dead").[80] Instead of federal assistance, President Ford recommended that New York use municipal bankruptcy proceedings to solve its financial problems. The idea was that just as corporations use bankruptcy law to deal with their financial troubles, so could the city of New York.[81]

However, for the same reasons explained earlier, Chapter IX, essentially unchanged from the form it took in the 1930s, was unable to help the City of New York. The chapter could facilitate the approval of an already existing debt readjustment agreement, but New York did not have such an agreement, nor did it negotiate one. New York needed to rehabilitate from its financial troubles, but municipal bankruptcy was meant to solve only a holdout problem - a problem that neither New York nor other municipalities at that time suffered from. Chapter IX, therefore, was of no use to New York, and it generally seemed too old and archaic for cities to use.[82]

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[79] Id. at 1119; Edward M. Gramlich, *The New York City Crisis: What Happened and What is to Be Done*, 66 AM. ECON. REV. 415, 415 (1976); For a detailed account of the development of the New York crisis, see STAFF OF THE SEC. & EXCH. COMM'N, REPORT ON TRANSACTIONS OF THE CITY OF NEW YORK (Comm. Print 1977).

[80] William J. Brink, *Ford to City: Drop Dead, Vows He'll Veto Any Bail-Out*, DAILY NEWS, Oct. 30, 1975, at 1.

[81] COLLIER ON BANKRUPTCY ¶ 900.LH [4] (Alan N. Resnick & Henry J. Sommer editors in chief, 15th edition revised 2006).

[82] H.R. REP. NO. 94-686, 94TH CONG., 1ST SESS. at 4 (1975) (The House Report explains the need to amend the municipal bankruptcy procedure as follows - "The procedure is hopelessly archaic and unworkable for all but the smallest entities"). Also see, *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32, Before the Sub comm. on Civil and Constitutional Rights of the House Judiciary Committee*, 94TH CONG., 1ST SESS., at 634 (1975) (House Rep. Badillo explains "The reason that it is urgent to make amendment is that the existing bankruptcy law would put the city [New York] which is faced with default completely at the mercy of its creditors. The city would not be able to go to court unless it could first get the consent of fifty one percent of the creditors…") [Hereinafter: "*Hearings on H.R. 31 and H.R. 32*"].

Thus, with the purpose of trying to help New York City, Congress amended Chapter IX of the Bankruptcy Act.[83] The amendments were fundamental. The new chapter was no longer confined to setting a majority voting rule for the approval of debt readjustment plans, but rather it adopted a comprehensive bankruptcy procedure designed to help distressed localities (such as New York) survive and deal with financial crises.[84] First, in an attempt to make municipal bankruptcy more accessible, the new chapter eliminated the requirement of presenting a debt readjustment agreement approved by an absolute majority of the creditors prior to the filing. According to the amended chapter, all municipalities could file,[85] even if they did not prepare a debt readjustment agreement, and even if the majority of the creditors opposed the filing.[86] Note that the pre-filing approval requirement makes perfect sense if the bankruptcy is designed solely to solve a holdout problem. Since a holdout problem exists only when an agreement is accepted by a majority of creditors, the requirement serves as an indicator that a bankruptcy process is indeed necessary. However, if, like in the case of corporations, the aim of the bankruptcy process is to provide more comprehensive proceedings, then a pre-filing approval requirement is simply an unwarranted obstacle. Since in 1976 Congress viewed municipal bankruptcy as omnibus corporate like proceedings, then the pre-filing approval requirement had to be eliminated.[87]

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[83] Bankruptcy Reform Act, Pub L. No 94-260, 90 Stat. 315 § 85(e) (April 8 1976).

[84] S. REP NO 94-458, 94TH CONG., 1ST SESS., at 13 (1975) (The Senate's report explained the purpose of the amendments as follows: "It is during the first steps of reorganization that delay could cause the most permanent harm. Provisions must be made to insure that the city has the use of existing deposits and can raise money to meet the ongoing expense for essential city services pending acceptance and functioning of the plan. Uniformity of performance under the plan must be assured although city administration may change. None of the above capabilities are contained in the present act.")

[85] Assuming the threseholds mentioned *supra* note 23 are met.

[86] H.R. REP. NO. 94-686, 94TH CONG., 1ST SESS. at 6 (1975). .

[87] *Hearings on H.R. 31 and H.R. 32, supra* note 82 at 641 (Statement of Prof. Lawrence King)) (Prof. Lawrence King explained to Congress: "The rules that were drafted under Chapter IX, and the provisions in H.R. 31 and H.R. 32 would eliminate that restriction [the pre-filing majority approval restriction] and would in effect put a municipality in the same position as a business; if we can use the

Secondly, the bankruptcy procedures themselves changed: the amended Chapter IX created an automatic stay to prevent creditors from seizing municipal property;[88] it included a cram down provision that enabled municipalities to force through a debt readjustment agreement despite the objection of the majority of the creditors;[89] it contained provisions that allowed municipalities to receive new financing at the expense of their old creditors;[90] it allowed municipalities to reject and assume executory contracts;[91] and more.[92] In short, from a limited chapter designed solely to provide a solution to the holdout problem, Chapter IX was amended to provide a corporate-like bankruptcy procedure. If corporate bankruptcy can help rehabilitate private corporations, it was thought, the same procedure should also help distressed municipalities. Prof. Lawrence King, for example, then one of the leading bankruptcy experts in the U.S., expressed this view when he explained to Congress the need for a cram down provision in municipal bankruptcy:[93]

> **"I think if that is relevant to a railroad reorganization, it is even more relevant for a municipality**. There are certainly many statements that have floated around since the Penn Central went into reorganization proceedings that the country needs its railroads. It seems to me it's more important for the country to have its cities. **So, I think if it's good for one, it certainly is good for the other**." (Emphasis added).

Two years later the chapter was again amended, but the 1978 revision was essentially technical. Since the entire Bankruptcy Act was revised that year (creating the Bankruptcy Code), there was a need to amend Chapter IX to reflect the changes

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most recent example, the W.T. Grant Co., which filed yesterday morning under Chapter IX, did not have to file or negotiate a plan to obtain acceptances; it was hard enough and long enough just to prepare the papers for the petition itself, let alone trying to negotiate a plan. This would have been absolutely impossible, and that company would have been adjudicated bankrupt before it could ever do that in advance. The same is true with a city; it should be able to file a petition, and then, within the proceeding itself, work the affected creditors in negotiating a plan."

[88] Bankruptcy Reform Act, Pub L. No 94-260, 90 Stat. 315 § 85(e) (April 8 1976).

[89] *Id.* § 94.

[90] *Id.* § 82(b)(2).

[91] *Id.* § 82(b)(1).

[92] See King, *supra* note 12.

[93] *Hearings on H.R. 31 and H.R. 32, supra* note 82, at 642 (Statement of Prof. Lawrence King).

made in the corporate bankruptcy chapter.[94] The 1978 amendments stressed even further the link between municipal and corporate bankruptcies. This link manifested itself in a direct incorporation of the provisions in Chapter 11 into Chapter 9 (via section 901).[95] As a result of this direct incorporation, any amendment made to the provisions of Chapter 11 adopted by Chapter 9 applies directly to municipalities, without the need for additional legislation and without any consideration of whether the change is applicable to municipalities or not. Indeed, Congress's underlying assumption was that the two chapters are more or less the same. The House Report regarding the legislation reads as follows:[96]

> **The general policy underlying the municipal debt adjustments chapter is the same as that underlying the [business] reorganization chapter**…There are two major differences from general reorganization law: first, the law must be sensitive to the issue of the sovereignty of the States; Second, a municipality is generally not a business enterprise operating for profit, and there are no stockholders…" (Emphasis added).

And as we have seen, this is exactly the way Chapter 9 is constructed - a corporate bankruptcy procedure mutatis mutandis, with differences that generally give municipal debtors even more powers than the powers of a regular corporate debtor.

III. Bankruptcy for Municipalities?

But was Congress correct? Can bankruptcy help municipalities in the same way that it helps commercial corporations? In this part I make the claim that the answer is in the negative. I argue that due to the special nature of municipal

[94] H.R. REP. NO. 95-595; 95TH CONG., 1ST SESS. at 262 (1977) (The report reads: "…The need for substantive revision this year is not great, and H.R. 8200 carries over substantially intact many of the reforms adopted last year. The changes that have been made fall into two categories. First, the municipal debt adjustments chapter, Chapter 9 of proposed title 11, is conformed generally with the revisions in reorganization law contained in the bill. Current Chapter IX is based largely on current Chapter X of the Bankruptcy Act. The new Chapter 9 is brought into conformity with proposed Chapter 11, governing reorganizations generally".

[95] 11 U.S.C § 901 (2005).

[96] H.R. REP. No. 595; 95th CONG., 1ST SESS. at Page 263.

corporations, the application of bankruptcy law to municipalities is problematic and does not yield very good results. To base this claim I return to the rationales of the bankruptcy procedure, and then consider whether the same rationales can be applied to municipalities. I begin with the contractual theory of corporate bankruptcy.

A. *The contractual theory of corporate bankruptcy*:

The most common rationale given to corporate bankruptcy law is the contractual theory of bankruptcy (the creditors' bargain theory).[97] According to this theory bankruptcy is designed to improve the debt collection system when the debtor is insolvent, and thereby to facilitate a cheaper extension of credit.[98]

At the heart of the creditors' bargain theory lies the common pool problem created by the nature of state debt collection remedies. When the debtor is close to insolvency, state law remedies incentivize the creditors to execute on the debtor's assets as quickly as they can. State law prioritizes the creditors' rights to the debtor's assets on a "first come first serve basis", and so under state law each creditor has an interest to be the first to grab assets (otherwise he runs the risk of being last in line to the debtor's assets and getting nothing). The problem with this system is that it creates a detrimental race to the debtor's assets. It causes the debtor to be liquidated piecemeal, even when it is more valuable to the creditors (as a group) to keep the

[97] Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlement, and the Creditors' Bargain*, 91 YALE L. J. 857 (1982); Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173 (1987); Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 442 (1992)("This model [the creditors bargain] is the standard justification for bankruptcy's general supplantation of private contact rights…"); John D. Ayer, *The role of Finance Theory in Shaping Bankruptcy Policy*, 3 AM. BANKR. L. REV. 53, 66 (1995) ("Jackson's article has established it-self as a kind of a founding narrative of bankruptcy thought").

[98] Modern approaches to bankruptcy law reject the creditors bargain theory, and offer more market based approaches (see Barry E. Adler, *A World Without debt*, 72 WASH. U.L.Q 811 (1994); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1050 (1992)). These bankruptcy models rely on market rather than court based valuations of the debtor, and facilitate the elimination (or at least the reduction) of a lengthy bankruptcy process. These modern approaches, however, are irrelevant to municipalities, because municipalities do not have equity, and are not traded in the public markets.

debtor as a going concern.[99] Corporate bankruptcy law aims to solve this problem. Once a bankruptcy petition is filed, the automatic stay precludes the commencement or continuation of any individual legal action against the debtor. No single creditor can grab the debtor's assets, and the assets can be put to whatever use that maximizes their value for the creditors' group as a whole.[100] Viewed this way, corporate bankruptcy mimics a hypothetical contract the creditors would form (if given the chance to negotiate in an ex-ante position). It enables the creditors (as a group) to maximize the value they receive from insolvent debtors, and, as a result, to decrease the price they demand for the extension of credit.[101]

Municipal bankruptcy, however, can not be rationalized in the same manner. As opposed to corporate bankruptcy, the municipal bankruptcy process does not benefit the creditors, but on the contrary – it makes them worse off. Creditors get less value in bankruptcy than they would otherwise get under the state remedies, and from their perspective it is preferable that bankruptcy would not be filed.

The reason for this difference is the special nature of the state remedies given to creditors of municipalities. As opposed to creditors of commercial corporations, in most states, creditors of municipalities are prohibited from executing municipal property.[102] Execution (if allowed at all) is limited to assets that are unnecessary to the

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[99] Jackson, *supra* note 97 at 860-861.

[100] Either piecemeal liquidation or keeping the entire business as a going concern. See id. at 861-868. Also see THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 1-19 (1986).

[101] Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L. J. 1807, 1812-1815 (1998).

[102] Estate of DeBow v. City of E. St. Louis 592 N.E.2D 1137 1140-1142 (Ill. App. Ct. 5th Dist. 1992) ("The rationale […] which supports the prohibition of execution upon municipal property is that a municipal corporation, unlike private corporations, is both a public and political body, clothed with exclusive civil authority and political power and possessing the responsibility to provide security for the lives and property of a great number of persons. To carry out these responsibilities, a municipal corporation must possess physical assets such as buildings, waterworks, fire engines, police cars, etc. Such property is held for public, and only public, purposes, and to allow such assets to be executed upon would impair the municipality's ability to carry out its duties"). Note that the prohibition includes not only tangible assets, such as cars, streets or buildings, but also municipal financial assets. See, Capps v. Citizens Nat'l Bank, 134 S.W. 808 (Tex. Civ. App. 1911); Lee v. City of Fairfield 145 So. 669

municipality's public functions, and public assets (i.e. assets used or held by the city for public purposes) are out of the creditors reach.[103] Even if the locality is in default, the creditors are unable to take municipal property as payment for their loans, and the locality retains complete control of all its public assets.[104] Thus, since piecemeal liquidation is impossible, in the municipal context the state remedies system does not create a common pool problem. The state remedies do not reduce the municipality's "value" to the creditors, and bankruptcy does not increase it.[105]

Moreover, not only does municipal bankruptcy law fail to increase the value distributed to the creditors (when compared to state law), it actually decreases it. Outside bankruptcy, the creditors may be unable to execute local public assets, but they can rely on the local tax revenues for the repayment of their loans. In the event that the locality does not pay its debts in full, the state remedies allow the creditors to ask the court to compel the municipal authorities to levy additional taxes, and the tax revenue surplus is used to pay the creditors (a remedy called mandamus to raise taxes).[106] Inside bankruptcy, however, the court cannot force bankrupt municipalities to raise their tax rates. As explained, the bankruptcy court's powers are limited to the confirmation or rejection of a debt readjustment plan that the municipality itself

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(Ala. 1933); ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE § 5.4.4 at 252 (1992).

[103] AMDURSKY & GILLETTE, *supra* note 102 § 5.4.3 at 248-49. 17 EUGINE MCQUILLIN, THE LAW OF MUNICIPAL CORPORATIONS § 49:44 (3d ed. Rev. 2004).

[104] Bd. of Councilmen v. White, 6 S.W.2d 699, 701 (Ky. 1928); American-La France & Foamite Indus., Inc. v. Town of Winnfield, 168 So. 293, 295 (La. 1936); Lyon v. City of Elizabeth, 43 N.J.L. 158, 161-64 (1881); Jeff B. Fordham, *Methods of Enforcing Satisfaction of Obligation of Public Corporations*, 33 COLUM. L. REV. 28 (1933); Note, *Creditors' Remedies in Municipal Default*, 1976 DUKE L. J. 1363.

[105] Compare, JACKSON, *supra* note 100 at 209-210 ("The problems of business failure themselves are not bankruptcy problems. The resolution of them should not be thought of as bankruptcy-specific. Bankruptcy law does have a role when there are numerous creditors and a common pool problem".)

[106] A mandamus to raise taxes is a court order issued at the request of a creditor that instructs the relevant municipal officials to levy and collect taxes in an amount sufficient to pay a judgment rendered against a locality. Pursuant to the mandamus the municipality must levy a special tax or increase the rates of existing taxes, while it transfers the revenue surplus to the creditors as payment for their claims. The mandamus thus forces the locality to exhaust its tax raising capacity in order to repay its debts. For a more detailed description of this remedy see, MCQUILLIN *supra* note 103 § 49:50; AMDURSKY & GILLETTE, *supra* note 102 § 5.4.1; HILLHOUSE *supra* note 53 at 279-280.

constructed, and the court cannot instruct the locality to levy more from the residents.[107] As a result, the locality has absolute discretion to set its own tax rates, and the creditors are bound by the rates fixed by the locality.

We can therefore see that Chapter 9 puts the creditors in a worse position when compared to the state remedies. Municipal bankruptcy restricts the creditors' returns, because, as opposed to the state court, the bankruptcy court cannot compel the locality to exhaust its tax raising capacity. Consequently, municipal bankruptcy does not facilitate a decrease in credit prices, but rather the other way around. The cost of credit for municipalities may even increase, because the creditors price the adverse effects that the bankruptcy process may bring.

B. *A fresh start theory*

Since the creditors' bargain theory, the founding narrative of corporate bankruptcy thought,[108] fails to explain Chapter 9, perhaps we should change direction. Perhaps municipal bankruptcy is not designed to improve the creditors' collection remedies, but rather to help the municipality itself to rehabilitate. Through bankruptcy, the municipality is able to decrease its debt burden, and the reduced debt burden helps it to recover and to resume financial stability.[109]

According to this theory, Chapter 9 offers a distressed locality the opportunity to negotiate a debt readjustment agreement from a position of power. As explained earlier, bankruptcy vests in the locality certain rights and privileges, and these rights

[107] 11 U.S.C. § 904 (2005).
[108] Ayer, *supra* note 97, at 66.
[109] McConnell & Picker, *supra* note 9 at 469-470. It is true that the creditors are harmed as a result of the debt decrease, and may thus demand a higher price for credit, but the increase in the credit price can be viewed as a kind of an insurance policy payment. Each locality pays a slightly higher price for credit, but in return it is entitled to a fresh start in case it falls into hard times (*Cf.* BAIRD, *supra* note 31, at 34-35).

enable it to pressure its creditors into concessions.[110] The locality's leverage over the creditors derives from several sources. First, due to the automatic stay, so as long as the bankruptcy process continues, the locality is not required to make any payments on account of its pre-petition debt. The lack of payments renders the creditors anxious to end the bankruptcy process as soon as possible, and this obviously plays in favor of the locality.[111] Second, within bankruptcy the locality can assume and reject executory contracts. This authority enables the city to continue enjoying the benefits of profitable contracts, while terminating agreements that the city finds detrimental. This is especially important with regard to collective bargaining agreements. Obligations imposed through collective bargaining, and in particular, labor agreements, constitute a large portion of the city's costs. Bankruptcy then allows the city to unilaterally terminate these agreements, thereby reducing the spending on employment.[112] Third, bankruptcy enables the locality to cram down debt readjustment agreements over the creditors' objection. As mentioned earlier, the locality's ability to cram down an agreement is even stronger than that of a corporate debtor, because the protection of the absolute priority rule is weakened in municipal bankruptcy.[113]

These "bankruptcy privileges" enable localities to pressure (or even to force) its creditors to waive part of their debts or at least to extend the debts' maturity date. The locality is thus able to decrease its debt burden, and as a corollary it is also able to reduce its tax rates and improve the services it provides to its residents. The decreased

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[110] See discussion *supra* part II.
[111] For the effects of the automatic stay in corporate bankruptcy, see Lucian A. Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 J. FIN. 445, 445 (2002). The pressures in municipal bankruptcy are even worsen due to the locality's absolute exclusivity in submitting plans of reorganization. The creditors cannot offer plans of their own, and neither the creditors nor the court can instruct the local leadership as to the management of the locality during the time of bankruptcy.
[112] In Re City of Vallejo 403 B.R. 72 (51 Bankr. Ct. Dec 2009); Dahl, *supra* note 12.
[113] See *supra* notes 31-34, and accompanying text.

tax rates increase the city's productivity. Residents do not have to donate such a significant portion of their income to the city, and as a result they have a greater incentive to generate economic activity. The city's tax base expands, there is greater development, and the local economy is more vibrant. In a sense, therefore, municipal bankruptcy affords the local debtor a kind of fresh start. Coming out of bankruptcy the city has fewer debts, and it is able to leave its financial problems behind it and continue on route to financial recovery.[114]

Notwithstanding this argument, I make the claim that the fresh start theory of Chapter 9 paints too rosy a picture of the municipal bankruptcy process. It is indeed true that Chapter 9 can decrease the city's debt levels, but it is not entirely clear that such decrease will cure the city's economic difficulties. Bankruptcy no doubt helps the city with its short term liquidity problems, but does it present a viable solution for dealing with fiscal problems of municipalities? To answer this question we need to return to the distinction between economic and financial distress, usually made in the context of corporate bankruptcy. This distinction will enable us to examine the strengths and weaknesses of the municipal bankruptcy chapter, and to evaluate whether the chapter can indeed help localities to rehabilitate.

1. Economic and Financial Distress:

Generally speaking corporations become insolvent due to either economic or financial distress.[115] Economic distress occurs when the corporation's revenues are

[114] McConnell & Picker, *supra* note 9, at 469-470; Dahl, *supra* note 12, at 322-323; King *supra* note 12, at 1175 (King writes: "…the present statute and rules conform more closely to other rehabilitation chapters…It is certainly contemplated that such conformity will make its use more practical and will assist in the rehabilitation process when a petition is filed by an eligible entity").

[115] Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 580-581 (1998); Robert K. Rasmussen and David A. Skeel Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 87-88 (1995).

consistently lower than its operating costs. Perhaps the firm produces bad products, perhaps some other firm makes the same products cheaper – in any event the reason for the firm's insolvency is a fundamental malfunction in the firm's business, so that it cannot independently function in the marketplace.[116] A firm suffers from financial distress, on the other hand, when it is able to make operating profits, but at a given moment it does not have sufficient funds to pay back its debts. The problems of a financially distressed firm are not rooted in the firm's business, but rather in the firm's capital structure. The firm has too much debt, and it does not have sufficient income to pay it back when due. If the debt miraculously disappeared, however, then the firm would be able to continue to function and generate profits.[117]

This distinction is important, because the corporate bankruptcy process (on which municipal bankruptcy is based) is designed solely to address the problems of financially (as opposed to economically) distressed firms. In a typical Chapter 11 case, the creditors give up part of their debts, and in return they receive equity interests in the distressed corporation. This capital reorganization decreases the firm's debt burden, and helps it to overcome its liquidity issues. Chapter 11, however, does little in the way of helping economically distressed corporations. Except decreasing the debt burden, the chapter offers no real rehabilitation process, and a losing business will usually not turn profitable after the bankruptcy filing.[118]

In a commercial corporation's context this makes perfect sense. The law should help firms when they can independently survive in the market. These firms can generate profits for their owners, creditors and employees, and they do not need external funding for their operations. However, when a firm is unable to make operating profits, the law should not insist on its existence. It is better to liquidate the

[116] Baird, *supra* note 115, at 580; Rasmussen & Skeel, supra note 115, at 87.
[117] Baird, *supra* note 115, at 580-581; Rasmussen & Skeel, supra note 115, at 88.
[118] Rasmussen & Skeel, *supra* note 115, at 87-88; JACKSON, *supra* note 100, at 2.

economically distressed firm, so that other businesses (that offer better products and services) would be able to use its resources (human and capital) in a more efficient manner. In a way, corporate bankruptcy can be viewed as an evolutionary selection mechanism. Firms that are economically viable undergo a debt restructuring process. Firms that are economically distressed undergo liquidation, and give way to more innovative and successful firms. This is the way the market progresses.[119]

The same, however, is not true with regard to municipal corporations. As opposed to commercial corporations, municipal corporations are designed to supply public goods. They provide essential services to their residents (services such as police and fire protection, education, water and sewage etc.), and the provision of these services must continue even when a locality is facing grave financial difficulties. It is the residents' right to receive adequate services from the government, and this right persists notwithstanding a local fiscal crisis.[120] Thus, since the allocation of essential public services must be maintained, a rehabilitation process should take place even if the locality is "economically distressed". No matter if the locality suffers from grave and fundamental economic difficulties, a cure must be found to overcome the local problems.[121]

But can Chapter 9 provide such a cure for the problems of distressed localities? In order to evaluate this question we need to understand why cities go broke. A better understanding of the roots of the urban crisis will enable us to consider whether a debt readjustment process (and a decrease in the locality's debt burden) is usually enough to help a locality recover, or whether a more in-depth and comprehensive rehabilitation process is required. A detailed discussion of the reasons

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[119] Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173, 183 (1987); Rasmussen & Skeel, *supra* note 115, at 87-88.
[120] *Cf.* Estate of DeBow v. City of E. St. Louis 592 N.E.2D 1137 1140-1142 (Ill. App. Ct. 5th Dist. 1992)
[121] Schwarcz, *supra* note 12, at 1197-1198.

that lead to local fiscal crises is not within the scope of this paper, but even a general description of the economic literature on the subject shows that bankruptcy filing provides no answer to the problems of a distressed city – quite the contrary.

2. Why cities go broke?

The analysis of the reasons for cities' financial deterioration starts with the notion, which is perhaps counter-intuitive, that cities often reach a financial crisis due to reasons that are beyond their local officials' realm of control. Research shows that usually a local crisis is not caused by profligate spending or by the mismanagement of a certain mayor (or another public official), but rather due to deeper more structural reasons.[122] These reasons can be divided into two main categories: socio-economic reasons, and local political reasons.[123]

The socio-economic approach focuses on social and economic changes that decrease the city's revenues or increase its costs. These changes are exogenous to the city, and their solution often lies within the state or federal governments.[124] One such cause is the national economic situation, and in particular a national recession. A recession, as we can see today, causes the city's tax base to dramatically shrink. The falling real estate values reduce the local property tax income, and the declining business activity reduces sales and income tax revenues. Often, however, there is no corresponding decrease in local expenditures. Employment costs usually do not decrease in times of recession (they will even increase if inflation strikes), and welfare

[122] F. LADD & JOHN YINGER, AMERICA'S AILING CITIES: FISCAL HEALTH AND THE DESIGN OF URBAN POLICY 291 (1989) ("As we measure it, a city's fiscal health, standardized or actual, depends on economic, social, and institutional factors that are largely outside the city's control.")

[123] David R. Morgan & Robert E. England, *Explaining Fiscal Stress Among Large U.S. Cities: Toward an Integrative Model*, 3 POL'Y STUD. REV. 73, 73-74 (1983).

[124] Larry C. Ledebur, *City Fiscal Distress: Structural, Demographic and Institutional Causes*, *in Problems of Urban America: Hearing Before the H. Comm. On Gov't Reform*, 102d Cong. 230, 232 (1991) (report of the National League of Cities); LADD & YINGER *supra* note 122, at 3-6.

costs, largely due to growing unemployment, are on the rise. These processes create deficits that can escalate to a local fiscal crisis.[125]

An additional socio-economic cause is suburbanization. Suburbanization is the mass movement of households and firms out of the city and into the suburbs. Usually it is the strong businesses and the upper middle class residents that move, and their out-migration creates harmful effects on the city's economy. First, the local tax base shrinks. The city can no longer enjoy the wealth of tax paying residents that moved, and it suffers a significant decrease in revenues as a result. Second, the vacuum created by those who left often leads to greater unemployment and to the in-migration of poorer populations. Consequently, city welfare and police costs grow, notwithstanding the city's dwindling income.[126] Such developments inevitably lead to economic deterioration, and indeed many local crises that took place in the last fifty years are associated with a suburbanization process.[127]

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[125] TERRY N. CLARK & LORNA C. FERGUSON, CITY MONEY: POLITICAL PROCESSES, FISCAL STRAIN, AND RETRENCHMENT 85-91 (1983); PEARL M. KAMER, CRISIS IN URBAN PUBLIC FINANCE: A CASE STUDY OF THIRTY EIGHT CITIES 40-43 (1983). Research shows that events of municipal defaults are closely related to the country's business cycles. Not surprisingly, the greatest amount of defaults occur during periods of recession. See, Natalie R. Cohen, *Municipal Default Patterns: An Historical Study*, 9 PUB BUDGETING & FIN. 55, 55 (1989).

[126] KAMER, *supra* note 125, at 25-30; WILLIAM J. PAMMER, JR., MANAGING FISCAL STRAIN IN MAJOR AMERICAN CITIES: UNDERSTANDING RETRENCHMENT IN THE PUBLIC SECTOR 5 (1990); JAMES M. HOWELL & CHARLES F. STAMM, URBAN FISCAL STRESS: A COMPARATIVE ANALYSIS OF 66 U.S. CITIES 4-6 (1979); IRENE S. RUBIN, RUNNING IN THE RED: THE POLITICAL DYNAMICS OF URBAN FISCAL STRESS 5-7 (1982); Katherine L. Bradbury , Anthony Downs & Kenneth A. Small, *Some Dynamics of Central City-Suburban Interactions*, 70 AM. ECON. REV. 410, 411 (1984); Peter Drier, Symposium: *The Urban Crisis: The Kerner Commission Report Revisited: America's Urban Crisis: Symptoms, Causes, Solutions*, 71 N.C.L. REV. 1351, 1372-1382 (1993).

[127] A major process of suburbanization took place in the United States during the 1960s and 1970s. In those years, manufacturers, trade, and service industries moved to the suburbs, and affluent tax paying residents followed. The negative consequences of this process were felt mostly in the snow belt cities. Unlike cities in the South and in the West, the northern cities had difficulties in annexing their surrounding territories, and they were unable to recapture the lost population and economic activity. Thus, cities like New York, Baltimore, Philadelphia, Camden and Bridgeport lost a significant number of jobs and tax paying residents, and they experienced severe financial difficulties as a result. See generally, KAMER, *supra* note 125, at 25-35; Franklin J. James, *Economic Distress in Central Cities,* 26-27 (1981) *in* CITIES UNDER STRESS 19-51 (Robert W. Burchell and David Listokin ed. (1981). Also see, Shalala & Bellamy, *supra* note 78, at 1119-1120 (discussing suburbanization in New York City); Kurt Schlichting, *Decentralization and the Decline of the Central City, A Case Study of Demographic and Economic Change in Bridgeport Conn.*, 40 AM. J. OF ECON. & SOC. 353 (1981) (discussing the case of Bridgeport, Connecticut). The suburbanization trend continued also during the 1990s, and on to the 21st century. See John D. Kasarda, Stephen J. Appold, Stuart H. Sweeney and Elaine Sieff, *Central*

Another important socio-economic factor is the states' intergovernmental policies. States play an important role in local finances, and they significantly influence both the revenues and expenditures of cities. With regard to the revenue side, states determine the types and rates of taxes that localities levy, and they also dispense intergovernmental transfers (grants, shared taxes, loans etc.) that constitute a considerable portion of the local income (usually about a third).[128] Changes in state policies, and in particular in the amount of intergovernmental transfers, inevitably affect the local budget, and may cause a local crisis.[129] With regard to the expenditure side, states often impose state mandates on their localities. These mandates compel localities to provide certain services to their residents – services that the localities, if left to their own devices, would not necessarily provide, or would provide at a lower cost.[130] The mandates reduce the localities' flexibility in managing their budget, and localities are forced to follow them even at times of financial difficulties. States that impose too many mandates, and don't give their localities the ability (or the funds) to finance them, contribute to local economic deterioration.[131]

City and Suburban Migration Patterns: Is a Turnaround on the Horizon? 8 HOUSING POL'Y DEBATE 307, 343 (1997); Robert P. Strauss, *The Income of Central City and Suburban Migrants: A Case Study of the Washington D.C. Metropolitan Area*, 51 NAT'L TAX J. 493, 512 (1998); Jack Ochs, *The Roots of Pittsburgh's financial crisis*, PITTSBURGH ECON. Q., December 2005, at 1 (available at http://www.ucsur.pitt.edu/publications.php).

[128] RONALD C. FISHER, STATE AND LOCAL PUBLIC FINANCE 273-274 (1996); 4 ANTIEAU ON LOCAL GOVERNMENT LAW §§ 64.01, 64.03 (Sandra M. Stevensen ed. 2nd ed. 2007); ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, LOCAL GOVERNMENT AUTONOMY: NEEDS FOR STATE CONSTITUTIONAL, STATUTORY, AND JUDICIAL CLARIFICATION 14 (1993).

[129] Ledebur, *supra* note , at 242; Robert P. Inman, *How to Have a Fiscal Crisis: Lessons From Philadelphia*, 85 AM. ECON. REV. 378, 380-383 (1995) (Inman shows that, like other cities, Philadelphia lost a significant amount of federal aid during the 1980s. However whereas state aid to other cities rose to offset the decline, Philadelphia did not enjoy the same increase).

[130] ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, MANDATES: CASES IN STATE LOCAL RELATIONS 1-8 (1990); For an in-depth analysis of the political sources of unfunded mandates, see Edward A. Zelinsky, *Unfunded Mandates, Hidden Taxation, and the Tenth Amendment: On Public Choice, Public Interest, and Public Services*, 46 VAND. L. REV. 1355 (1993).

[131] LADD & YINGER, *supra* note 122, at 8-9. Bridgeport's bankruptcy filing, for example, is associated with the abundance of unfunded mandates that Connecticut imposed on the city during the 1980s. See In re City of Bridgeport, 128 B.R. 688, 692 (Bankr. D. Conn. 1991); Zelinsky, *supra* note 130 at 1360-1361.

However, in addition to these external socio-economic processes, internal political circumstances also play a dominant role. Some scholars attribute these political factors to the political officials themselves. These scholars argue that reckless (and often corrupt) politicians implement unwise financial and accounting practices, and that these practices eventually result in financial calamity.[132] Most scholars, however, look not at the individual politician, but rather at the political system. They argue that certain attributes of the political system push politicians toward overspending without paying sufficient attention to the locality's resources.

Perhaps the most important political attribute in this context is the level of political fragmentation.[133] Political fragmentation measures the degree to which the cost of a dollar of aggregate expenditure is internalized by the individual decision maker in the government. The greater the political fragmentation in a locality, the more likely a financial crisis is to occur.[134]

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[132] JOAN K. MARTIN, URBAN FINANCIAL STRESS: WHY CITIES GO BROKE 129 (1982) (stressing the importance of local managers' accounting manipulations of local fiscal health). Camden, New Jersey provides a good example. Three out of the five mayors whose terms preceded Camden's bankruptcy faced legal problems while in office (or soon thereafter). Camden's mayor from 1973-1981, Angelo J. Errichetti, was convicted in 1981 of federal corruption charges, and left office to enter prison. Camden's mayor from 1994-1997, Arnold W. Webster, was voted out of office after state audit revealed fiscal irregularities, and he later pleaded guilty to fraud. Camden's mayor from 1997-2000, Milton Milan, was convicted on fourteen counts of corruption charges, see: Anne Marie Vassallo, *Solving Camden's Crisis: Makeover or Takeover?*, 33 RUTGERS L. J. 185, 190 n. 31 (2001).

[133] Reza Baqir, *Districting and Government Overspending*, 110 J. POL. ECON. 1318, 1347 (2002); Guntram B. Wolff, *Fiscal Crisis in U.S. Cities: Structural and Non-Structural Causes*, 6 THE ICFAI J. PUB. FIN. 7 (2008) (available at http://www.zei.de/download/zei_wp/B04-28.pdf); Terje P. Hagen & Signy Irene Vabo, *Political Characteristics, Institutional Procedures and Fiscal Performance: Panel Data Analysis of Norwegian Local Governments 1991-1998*, 44 EUR. J. POL. RES. 43, 43-44 (2005); John Ashworth, Benny Geys & Bruno Heyndels, *Government Weakness and Local Public Debt Development in Flemish Municipalities*, 12 INT'L TAX & PUB. FIN 395, 395-396 (2005). Also see with regard to sovereigns: Roberto Perotti & Yianos Kontopoulos, *Fragmented Fiscal Policy*, 86 J. PUB. ECON. 191, 194 (2002); Roberto Ricciuti, *Political Fragmentation and Fiscal Outcomes*, 118 PUB. CHOICE 365, 369 (2004); Nouriel Roubini & Jeffrey D. Sachs, *Political and Economic Determinants of Budget Deficits in the Industrial Democracies*, 33 EUR. ECON. REV. 903, 922 (1989); Jurgen Von Hagen & Ian J. Harden, *Budget Processes and commitment to fiscal discipline*, 39 EUR. ECON. REV. 771 (1995); Mark Hallerberg & Jürgen von Hagen, *Electoral Institutions, Cabinet Negotiations, and Budget Deficits in the European Union* 9 (Nat'l Bureau of Econ. Research, Working Paper No. 6341, 1997), *available at* http://www.nber.org/papers/w6341*;* Andres Valesco, *Debt and Deficits with Fragmented Fiscal Policymaking,* 76 J. OF PUB. ECON. 105 (2000);

[134] Perotti & Kontopoulos, *supra* note 133, at 192.

The extent of political fragmentation is largely determined by the size of the local coalition, and by the number of social groups (constituencies) this coalition represents. The larger and the more fractured the coalition is, the more likely a deficit is to develop.[135] The intuition behind this observation derives from the well known common pool problem.[136] The city's budget can be viewed as a common resource controlled by the different groups that comprise of the city's coalition. Due to the shared control of this common resource (the budget), each group within the coalition has an interest to increase its budgetary demands, because the group fully enjoys the utility of the demands it imposes, but the costs of those demands (and in particular the costs of a possible budgetary deficit) are shared with all other groups in the city. Since the various groups do not fully internalize the costs of their financial claims, as the number of groups increase so do the budgetary pressures.[137]

In addition, due to the fragility of the coalition, in a fragmented political environment interest groups play a dominant role. Interest group support is essential for both forming and sustaining the local coalition, and so politicians are more susceptible to the groups' financial demands.[138] By definition, however, interest groups represent only certain and narrow sector of the local population. They advance their own interests, and pay little attention to the costs their demands impose on the population as whole. Thus, when interest groups have a hold on the local financial

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[135] Perotti & Kontopoulos, *supra* note 133, at 195; Von Hagen & Harden, *supra* note 133, at 772-777; Ricciuti, *supra* note 133, at 369-371.

[136] Mark Hallerberg & Jürgen von Hagen, *supra* note 133, at 6; Wolff, *supra* note 133, at 5.

[137] Take, for example, the building of a public swimming pool. Usually the pool's construction costs are taken from the public budget, whereas the pool is enjoyed only by a small segment of the locality, i.e. those who like swimming and live relatively close to the pool. Nearby swimmers, therefore, have an incentive to pressure politicians to build a large and expensive pool. They will enjoy the pool's benefits, while the costs will be shared by the entire community (see, Wolff, *supra* note 133, at 5). The same rationale of course applies not only to users of public facilities, but to many other local groups who enjoy a restricted benefit financed by the local public budget (such as districts, religious groups, racial groups etc.).

[138] Wolff, *supra* note 133, at 9-17; Ricciuti, *supra* note 133, at 370. For a more general account of interest group influence in politics, see DENNIS C. MUELLER, PUBLIC CHOICE III 475-497 (2002).

decision making, the locality will have difficulties to implement retrenchment measures.[139]

Usually a local fiscal crisis is the result of a combination of both socio-economic processes and political circumstances. The socio-economic processes narrow the city's tax base, and decrease its revenues. In order to maintain economic stability the city then has to adapt its level of expenditures to its new (and reduced) level of income. If the locality's political environment enables it to make the necessary cuts, the city will be able to avert a crisis and remain in relative financial health; but if the local political system does not facilitate such fiscal restraint, then the expenditures burden will be too heavy, and a crisis will evolve. The locality's political system, and especially its level of fragmentation, determines its ability to cope with the changing external circumstances and to avoid economic deterioration.[140]

3. Chapter 9 as a rehabilitation tool

After examining the reasons that cause cities to go broke, it becomes clearer why bankruptcy does not offer localities a genuine chance for rehabilitation.

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[139] Wolff, *supra* note 133, at 9-17; Valesco, *supra* note 133, at 122. Also see Pietro S. Nivola, *Apocalypse Now? Whither the Urban Fiscal Crisis*, 14 POLITY 371, 384 (showing that the level of unionization among city employees is significantly correlated with local fiscal strain). Also see, ESTER R. FUCHS, MAYORS AND MONEY: FISCAL POLICY IN NEW YORK AND CHICAGO 230-272 (1992). (Fuchs provides a detailed and in-depth account of interest group's influence on New York City during the 1960s and 1970s (prior to the city's crisis). She shows that due to the city's fragmented political environment interest group power was enormous. The interest groups had multiple points of access to the political structure, and many times they became a part of the city's formal budgetary decision-making. Since the support of numerous groups was essential in order to pass the budget, their demands were met even at the expense of increasing the total expenditure over and above it financial means. The power of interest groups, therefore, was one of the main causes for the city's crisis).

[140] *Cf.* FUCHS, *supra* note 139, at 5-7 (Fuchs demonstrates the political environment's contribution to the development of a local fiscal crisis through pointing out the differences between Chicago and New York in the 1970s. She shows that although the two cities experienced similar socio-economic processes, New York underwent a severe fiscal crisis, whereas Chicago stayed in relative financial health. The reason for the difference, according to Fuchs, lies in the cities' different political environments. Whereas New York was dominated by multiple interest groups with no one central authority that controlled the budget, Chicago had a strong party machine that was able to resist budgetary pressures).

Bankruptcy may help the city to reduce the level of its debts, but it does little to address the root causes of the economic deterioration.

Take, for example, the socio-economic reasons that lead to a local crisis. These reasons are usually external to the municipality, and involve state or even nation-wide processes. Chapter 9 will not help the city cope with these processes, as they require more in depth and overarching solutions. Chapter 9 cannot broaden a local tax base that shrunk due to a national recession; it has little bearing on the suburbanization trends in the country (whether people and businesses prefer to locate in cities or suburbs); and it has no effect on the intergovernmental funds that the city receives or on the extent of unfunded mandates the state imposes. All these issues should be addressed at state or federal levels, and a simple decrease in the local debt levels provides no remedy for them.

Bankruptcy also does not attend to the city's political problems. The same officials that controlled the locality prior to the filing continue to run it, and the bankruptcy court has no authority to intervene or to derogate from their authority. Note that since the bankruptcy process changes nothing in the locality's political structure, even if the local officials are replaced (through elections), the same expenditure patterns will probably emerge. The city's political fragmentation and the power of interest groups do not diminish as a result of the filing, and the decision-making process in the locality does not change. Therefore, the incentives that promoted local spending (and caused the bankruptcy to begin with) remain in force, and a new leadership, just like the old one, will be unable (or unwilling) to cut the city's costs.

This explains why municipalities that file for Chapter 9 tend to return to insolvency after only a few years. The city of Mack's Creek, for example, filed for

bankruptcy in 1998, then for a second time in 2000,[141] and then it contemplated a third bankruptcy in 2004.[142] The city of Westminster, Texas filed on 2000, and only 4 years later (in 2004) it filed again.[143] The city of Prichard, Alabama filed for bankruptcy at the end of 1999, came out of the bankruptcy only in 2007, and now, talks of a new bankruptcy filing has resumed.[144] Without addressing the cities' core problems, the bankruptcy filing offered no help, and the cities' situation quickly deteriorated again.

The weakness of the municipal bankruptcy process was the reason for Connecticut's objection to Bridgeport's bankruptcy filing in the 1990s. Back then Bridgeport suffered from a severe economic crisis. The city projected a $16M budget deficit for the years 1991-1992, and its residents were burdened with the highest effective tax rate in the state. Bridgeport was unable to finance an adequate level of public services, and even basic services, such as police protection and street cleaning, were not properly provided.[145] Hoping to escape financial disaster, in 1991 the city filed for bankruptcy. Bankruptcy, the city officials thought, would relieve the city's debt burden, and facilitate recovery. The state of Connecticut, however, objected. The state officials did not believe a bankruptcy court to be the proper venue to solve Bridgeport's problems, and they understood bankruptcy could do more harm than

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[141] Data from the federal judiciary's Case Management/ Electronic Case Files (CM/ECF) system, *supra* note 39, Western District of Missouri. Also see John Rogers, *Income Law Puts Speed Trap Town on Fast Track to Bankruptcy*, ST. LOUIS DISPATCH, July 19, 1998, at C1.

[142] Wes Johnson, *Should Mack's Creek Exist? Voters to Decide*, SPRINGFIELD NEWS LEADER, October 16, 2004, at 1A.

[143] Data from the federal judiciary's Case Management/ Electronic Case Files (CM/ECF) system, *supra* note 39, Eastern District of Texas. Also see, *Texas Town takes a tumble*, BCD NEWS & COMMENT, July 21, 2004.

[144] Douglas J. Watson, Donna Milam Handley and Wendy L. Hassett, *Financial Distress and Municipal Bankruptcy: The case of Prichard Alabama*, 17 J. OF PUB. BUDGETING, ACCT. & FIN. MGMT. 129, 147-148 (2005); David Ferrara and Mathew Richardson, *Plan to Dissolve City Faces Obstacles*, MOBILE REGISTER (ALABAMA), July 8, 2009, at B1.

[145] In re City Of Bridgeport, 129 B.R. 332, 335 (Bankr. D. Conn, 1991).

good. Richard Blumenthal, then Connecticut's attorney general, explained to Congress the reasons for the state's objection:[146]

> "The solutions offered by Chapter 9 — a restructuring of debt obligation — may help smaller cities or towns that face short term, totally unanticipated financial calamities, such as natural disaster or an unexpected exorbitant judgment from a lawsuit. However, the bankruptcy process provides no solution to a major city facing long term, endemic problems involving erosion of its tax base, loss of manufacturing jobs, and a decaying infrastructure, all which require, in addition to substantial cash, significant structural changes and long term programs that are well beyond the scope of Chapter 9"

Not only is Chapter 9 an unsuitable mechanism for helping distressed localities, but it may very well aggravate their situation. First, bankruptcy filing harms the city's reputation as a place for residence. A bankrupt locality is associated with poverty and misery, and this image deters businesses and individuals from locating in the city. Bankruptcy, with its uncertainties and stigma, decreases real estate prices and stifles economic activity and investments in the city. Instead of creating growth, bankruptcy may shrink the local tax base and hold the city's development back even further.[147] Second, bankruptcy damages the city's reputation as a debtor. The creditors, harmed by the city's debt repudiation, are reluctant to extend the city any more credit, and the city's credit rating may suffer for years. Bankruptcy, therefore, vastly escalates the city's costs of borrowing, and it can block the city's access to the credit markets altogether.[148] Indeed, bankruptcy filing jeopardizes the very resources

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[146] *Economic Distress in Our Cities: Bridgeport Connecticut, Field Hearing Before the Committee on Banking, Finance and Urban Affairs of the House of Representatives*, 102 Congress, 2nd Sess. 161-2 (1992). (Statement of Richard Blumenthal) (henceforth: "*Economic Distress in Our Cities*").

[147] *Cf.* H.R. REP. NO. 94-686, 94TH CONG., 1ST SESS. 56 (1975) (Separate views of Hon. Elizabeth Holtzman on H.R. 10624) (In her separate view Hon Elizabeth Holtzman expressed doubts about the wisdom of the 1976 amendments: "Bankruptcy provides no answer to the root causes of municipal fiscal troubles or the problems of mismanagement. In fact, bankruptcy, with its uncertainties and stigma, may well aggravate these problems. If municipal services continue to deteriorate and taxes continue to rise, the departure of business and the middle class will undoubtedly accelerate. Thus, the affected city will become even less capable than before of meeting the needs of its citizens.")

[148] See, *Economic Distress in our cities*, *supra* note 146, at 162 (Connecticut attorney general, Richard Blumenthal, explains: "The mere filing of a petition in bankruptcy vastly escalates a city's cost of borrowing — and may indeed, as in Bridgeport's case, completely block a city's access to the bond

the city needs in order to recover – additional taxes (generated by economic development) and credit. The city may come out of the filing with less debt, but also with fewer prospects for the future.

Moreover, a municipal bankruptcy filing can produce negative implications for the state. As explained earlier, states have a tremendous impact on the financial condition of their localities, and they largely influence both the local revenues and expenditures.[149] Due to this strong link between the state and the local economies, a default or bankruptcy filing of one municipality raises concerns about other localities in the same state. A local crisis may be the result of general state policies toward local governments, and it shows that the state does not take the necessary measures to maintain the fiscal health of its localities. The crisis, therefore, although seemingly an isolated local event, may be a sign for more local crises in the future, and may cause the creditors to re-evaluate the risk associated with public debt in the state. These concerns increase the price of credit for all public issuers in the state, even for those issuers that have no direct connection with the city's default. This claim received empirical support in various studies on the effects of the Orange County bankruptcy. Studies show that the county's bankruptcy had significant contagion effects on the entire municipal bond market, and especially on public issuers within California.[150] Following the bankruptcy, there was a considerable decrease in the value of many

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market. Ironically, the very ability to borrow — crippled or killed by the filing, may be a key element in rescuing a city in crisis.")

[149] States determine localities' taxing powers, spending authorities, and debt limitations. They enforce financial regulations (such as balanced budget requirements or financial disclosure rules), as well as various other obligations (mandates), in particular with regard to the services that localities provide. See: *supra* notes 125-128 and accompanying text. Also see, Jeffrey M. Stonecash, *The Politics of State-Local Fiscal Relations*, in GOVERNING PARTNERS STATE-LOCAL RELATIONS IN THE UNITED STATES (Russell L. Hanson ed., 1998); JOHN E. PETERSEN, C. WAYNE STALLINGS & CATHERINE LAVIGNE SPAIN, STATE ROLES IN LOCAL GOVERNMENT FINANCIAL MANAGEMENT: A COMPARATIVE ANALYSIS 1-4 (1979).

[150] John Halstead, Shantaram Hegde & Linda Schmid Klein, *Orange County Bankruptcy: Financial Contagion in Municipal Bond and Bank Equity Markets*, 39 FIN. REV. 293 (2004); Dwight Denison, *Did the Bond Fund Investors Anticipate the Financial Crisis of Orange County?*, 21 MUN. FIN. J. 24 (2000).

municipal bonds, even in bonds that were issued by local governments and other public bodies that had no direct exposure to the county's crisis.[151] The claim also echoes the positions of states with regard to municipal bankruptcy filings. Many states object to Chapter 9 filings,[152] and one of the main reasons state officials give to this objection is the effect bankruptcy might have on other public issuers in the state. Municipal bankruptcy filings, states fear, will have adverse effects on the credit markets all over the state, and they do not want to incur these costs.[153]

This analysis on the effects of municipal bankruptcy sheds light on the data on municipal bankruptcy filing that was described earlier in the paper. First, it explains why there are so few bankruptcy filings to begin with. If Chapter 9 offers little in the way of rehabilitation, but it aggravates the city's economic situation, then it is not surprising that many distressed cities prefer not to file. Second, the analysis explains why most states object to municipal bankruptcies even when a distressed city is

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[151] Halstead et al., *supra* note 150, at 313; Denison, *supra* note 150, at 36. The Orange County example is particularly interesting because at first glance the county's financial troubles seem unrelated to the financial situation of other local governments in the state. The bankruptcy occurred due to bad investments made by the County's treasurer Robert Citron - investments made without the state's approval and without proper financial disclosure. However, a closer look at the circumstances surrounding the crisis does reveal a connection between the crisis and the state's general local policies. The genesis of the Orange County Bankruptcy can be traced back to the approval of California's proposition 13. Proposition 13 imposed limits on property tax increases, and had a devastating effect on the local governments' tax base. Localities lost a significant portion of their revenues, and as a result they were in a frantic search for new non-tax revenues. This caused Robert Citron, as well as other local government officials, to invest in risky investments, so as to make up for the lost revenues. (see, MARK BALDSSARE, WHEN GOVERNMENTS FAIL, THE ORANGE COUNTY BANKRUPTCY 13 (1997)).

[152] Colleen Woodell, William Montrone & Brooks Brady, *U.S. Municipal Rating Transitions and Defaults 1986 – 2003*, 21 MUN FIN. J. 49, 55 (2004); Daniel J. Freyberg, *Comment: Municipal Bankruptcy and Express State Authorization to be a Chapter 9 Debtor: Current State Approaches to Municipal Insolvency – and What Will States do Now?* 23 OHIO N.U.L. REV. 1001, 1008-1017 (1997)

[153] See, *e.g.*, LEDA HARTMAN AND DANIEL ZWERDLING, TRANSCRIPT FROM THE RADIO SHOW: WEEKEND ALL THINGS CONSIDERED, (NPR February 9, 1997) (Hartman and Zwerdling interviewed Ralph Campbell, then North Carolina's State Auditor, about the effects of Princeville's fiscal crisis. Campbell explained: "We are concerned about Princeville. Because what happens in Princeville actually sends a ripple effect across the entire state of North Carolina. It could have an effect on the bond rating of not only the state of North Carolina, but all of our other towns"); Mike Williams, *Around the South: Bankruptcy Not an Option in Solving Miami's Fiscal Crisis*, THE ATLANTA JOURNAL AND CONSTITUTION, December 17, 1996, at 18D (Williams interviewed Lt. Gov. Buddy MacKay, then the head of Miami's state oversight board, about the Miami fiscal crisis. Macky said: "Bankruptcy is not an option. That could have repercussions in the financial markets for the state and its other local governments as well"). Also see New York State Financial Emergency Act, 1975 N.Y. LAWS chap. 868 § 1 (1975).

inclined to file (like in the cases of Camden, New Jersey or Bridgeport, Connecticut). As opposed to a city, a state internalizes all costs and benefits associated with the filing. It takes into account not only the bankruptcy's effects on the city, but also the bankruptcy's effects on the municipal bond market in the state as a whole. Since, as we have seen, the benefits of the bankruptcy (especially long term) are small, whereas the costs to public issuers can be substantial, states often object to municipal bankruptcies. Third, the analysis clarifies why cities that do undergo bankruptcy have the special characteristics discussed earlier (namely, they are extremely small, and entered the crisis due to a one-time unexpected financial calamity). Under these extraordinary circumstances, Chapter 9 can help the city recover, because the locality essentially suffers from liquidity problems. The bankruptcy relieves the city's debt burden created by the single exogenous event, and since the city does not suffer from structural systemic problems, it can thereafter continue to function properly. In addition, in such cases, because of the city's small size, and the extraordinary circumstances of the filing, the effects of the bankruptcy on the bond market are relatively smaller.

Placing the rare cases of small localities aside, it is now clear why Chapter 9 cannot provide a solution for local economic crises. As opposed to Chapter 11, Chapter 9 does not benefit the creditors, and, as opposed to common wisdom, it also does not benefit the locality or the state. Indeed, Congress's underlying assumption in the 1976 legislation (i.e. - if bankruptcy is good for commercial corporations it must also be good for our cities) is mistaken. A municipal corporation is different from a commercial corporation, and the corporate bankruptcy's logic collapses when applied to municipalities. A bankruptcy process that focuses on the readjustment of debt may be sufficient to help a financially distressed commercial corporation (that but for

liquidation problems can properly function in the market place), but it is not sufficient to help localities that suffer from systemic problems that are associated with grand socio-economic processes and political structures. These localities are in need of a more pervasive and in-depth recovery process - a process that the Bankruptcy Code, at least in its current form, does not contain.

IV. State Intervention as an Alternative to Bankruptcy

But what is the alternative? Even if we agree that a debt readjustment process, the kind of process offered by Chapter 9, does not provide a sensible solution for local fiscal crises, is there a better solution for the troubles of distressed municipalities? In this section I argue that the answer is in the positive. I argue that a proactive supervision system by the state on local finance can help rehabilitate distressed localities, and, even more important, it can help prevent local fiscal stress from becoming a crisis.[154]

In order to efficiently supervise local finances, the state should evaluate the localities' condition on an on-going basis. To the extent the state concludes that a certain locality has entered into financial distress, it then creates a special state board that monitors the distressed locality more closely. The board, comprised of several state representatives, prepares a rehabilitation plan, that includes both actions on the part of the locality (in particular, cost cutting) and actions on the part of the state (such as tax reforms or state aid). The board then follows the implementation of the plan, and if the process is successful, the city will be able to recover.[155]

In the following parts I examine state supervision and intervention actions as a solution to local fiscal distress. The analysis has two main parts: First, I explain why,

[154] For a more detailed analysis of the advantages of state intervention, see Kimhi, *supra* note 12, at 664-683.
[155] See *id.*

as opposed to the bankruptcy solution, state intervention has the potential to address the causes of the local crisis and to rehabilitate distressed localities. Second, I look into the state's interests in implementing such a solution. I show that a proactive state oversight system is beneficial for the state, because it can create substantial savings in interest rates for all public issuers.

A. The state's advantages in the rehabilitation of distressed localities:

The starting point for the analysis of the state's rehabilitative potential is the state's plenary powers over its local governments. According to local government law, municipalities are "creatures of the state". Unless otherwise stipulated in the state's constitution, the state can take any action with regard to its local governments, whereas the localities have only those powers delegated to them by the state.[156] These state powers, combined with the fact that the state controls a larger geographical area than each of its cities, enable the state to better address the problems faced by cities. The state can take rehabilitation measures that the local officials are not authorized to take, and it can initiate reforms that include not only the distressed municipality itself, but also the distressed locality's suburbs and other local governments in the state. In the following paragraphs I give several examples for measures that states can take. These examples do not purport to be an exhaustive list of measures, nor do I claim that the implementation of these measures will undoubtedly cure a distressed locality. I provide these examples simply to show that the state has the legal powers and the political ability to address the causes of the local financial deterioration.

[156] Hunter v. City of Pittsburgh, 207 U.S. 161, 178-79 (1907); 1 ANTIEAU ON LOCAL GOVERNMENT LAW, *supra* note 8, § 13.01; Richard Briffault, *Our Localism: Part I – The Structure of Local Government Law*, 90 COLUM. L. REV. 1, 6-9 (1990); Gerald E. Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1057, 1062-1067 (1980); Clayton P. Gillette, *In Partial Praise of Dillon's Rule, or, Can Public Choice Theory Justify Local Government Law?*, 67 CHI.-KENT L. REV 959, 963-68 (1991).

Take the socio-economic factors that cause local crises. These factors are external to the locality, and involve state or even nation-wide processes. The local officials may be unable (or unwilling) to cope with these processes alone, but the state, with its plenary powers and resources, can help the city adapt to the socio-economic changes and prevent financial deterioration.[157]

Perhaps the most important cause of local stress, certainly today, is a national recession. Macro-economic trends (like unemployment, inflation, low private income growth and decreased real estate prices) severely effect local governments, and if not properly dealt with the recession can cause severe local stress. The state and federal governments, therefore, should take measures that mitigate the recession's effects on localities, and especially implement counter-cyclical policies that battle the macro-economic swings. One such measure, suggested by Robert Inman, is counter cyclical revenue-sharing aid.[158] This aid protects cities against the excessive effects of a recession, and helps them to create jobs and economic development. In order not to over compensate cities and create moral hazard problems, Inman suggests an objective measure for the required aid. The aid, according to Inman, should be based on the city's growth index, so as to connect between the city's growth loss and the funds offered as relief.[159] Another possible measure – one that does not require substantial state investments - is a mandatory creation of Budget Stabilization Funds (Hereinafter: "BSF", also called rainy day funds).[160] A BSF is a fiscal device designed to store extra revenues during times of prosperity for use in times of economic downturn. Using legislation, the state can compel its local governments to regularly

[157] See the seminal paper by William J. Baumol, *Macroeconomic of unbalanced growth, the anatomy of urban crisis*, 57 AM. ECON. REV. 415, 426 (1967).
[158] Robert P. Inman, *Dissecting the Urban Crisis, Facts and Counterfacts*, 32 NAT'L TAX J. 127 136-137 (2001).
[159] See Id.
[160] Yilin Hou, *Budgeting for Fiscal Stability over the Business Cycle: A Countercyclical Fiscal Policy and the Multiyear Perspective on Budgeting*, 66 PUB. ADMIN. REV. 730, 736-739 (2006).

put part of their revenues aside in a BSF, and the fund will then allow the city to bridge its income gap during a recession.[161] The BSF enabling legislation institutionalizes the counter-cyclical fiscal policy, and forces local officials not to spend all the accumulated surpluses during boom years and to save part of the income for a rainy day (a policy that local officials would not necessarily implement without the state's statutory instructions). Empirical research shows that states that established a BSF (at the state level) before the 1980, 1982 and 1991 recessions fared better than those that did not, and states that established a BSF earlier weathered recessions better than those that adopted the fund late.[162]

The state can also address the suburbanization effects that cause fiscal crises. A solution for the problems of suburbanization cannot come solely from the city. It requires a view that encompasses the city, the suburbs and other local governments within the state, and it commands authorities that local officials simply do not have. The state can tackle this problem through reforming the local tax system, so that suburban residents will share part of the city's expenses.[163] One possible reform is to enable the city to tax suburban residents that work in the city. By doing so, the state enables the city to recapture part of the wealth that moved to the suburbs and relieve some of its financial burden.[164] Another way to force the suburbs to share the city's

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[161] *Id*. at 737.
[162] *Id.*
[163] The authority to reform the local tax system is usually reserved for the state, see ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, LOCAL GOVERNMENT AUTONOMY: NEEDS FOR STATE CONSTITUTIONAL, STATUTORY, AND JUDICIAL CLARIFICATION 14 (1993); *Cf.* sources cited *supra* notes 149 and 156.
[164] Cleveland, for example, entered a severe fiscal crisis in 1979 (at the time seventy five percent of the city's wage and salary income was earned by suburbanites). As a result, following a state statutory waiver of the voter referendum, the city increased wage tax from 1.0 to 1.5% in March 1, 1979, and then from 1.5 to 2% in March 1, 1981 (see *Actions Taken by Five Cities to Restore Their Financial Health: Hearing Before the Subcomm. on the Dist. of Columbia of the H. Comm. on Gov't Reform and Oversight*, 104th Cong. 65 (1995) (report of Nonna A. Noto, Congressional Research Service Analyst) [Hereinafter: "*Actions Taken by five cities*"]). Yonkers also suffered from a financial crisis in the 1980s, and was given new revenue raising authorities by the state. Special legislation authorized Yonkers to impose an income tax surcharge at a rate of up to 19.25 percent (see *Id*. at 81). The same is also true of Pittsburgh that underwent a crisis in 2003. Pennsylvania's law makers approved a major tax reform that

costs is through the creation of special districts. Special districts are municipal corporations that provide a certain service, and have the authority to independently levy taxes. The special district's jurisdiction does not necessarily overlap with the city's boundaries, and it can include both parts of the city and parts of the suburbs.[165] The state then can assign part of the city's responsibilities to special districts, and since the district is financed through taxes levied on its own jurisdiction, the cost of the service can be shared between the city and the suburbs.[166]

In addition, the state can address the crisis' political causes through the creation of a state financial board. The state board is created to oversee the financial affairs of the city during its time of crisis. The board constructs a rehabilitation process for the locality, and makes sure that the city adheres to the plan's instructions. In case the locality does not follow the plan, the board usually has the authority to withhold city funds or to assume control over the city instead of the elected officials.[167]

The creation of the state board changes the locality's political environment. If prior to the state's intervention, the city's decision-making process was fragmented and lacked central control,[168] the establishment of a board reduces the fragmentation by centralizing the decision-making process.[169] The board becomes the supreme

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generated $35-40 million from the city's employees, many of which were non-residents working in the city (see, Adam L. Cataldo, *Pittsburgh Tax Reform Could Raise Extra $35M in 1st Year*, THE BOND BUYER, Nov. 23, 2004, at 6).

[165] MCQUILLIN, *supra* note 103, at § 2.28.

[166] FUCHS, *supra* note 139, at 192-194. Ester Fuchs explains that the creation of special districts helped Chicago avert a financial crisis in the mid 1970s. She shows that in 1975 more than ten local government jurisdictions supported Chicago's taxpayers, and several of them had boundaries that also included the city's suburbs. (*Id.* at 195-207).

[167] *Actions Taken by five cities, supra* note 164, at 46-56.

[168] See discussion *supra* notes 130-136 and accompanying text.

[169] Theoretical and empirical studies (both on national and local governments) show that a strong authority, especially one with veto powers over the budget, can reduce the extent of political fragmentation and reduce deficits. Reza Baqir, for example, explains that a strong executive authority in local governments is able to reduce spending even when fragmentation (due to districting) exists. See Baqir, *supra* note 133, at 1347-1351. Also see with regard to macroeconomic policy, Persson &

financial authority in the city. It sets limits to the city's expenditures, and makes sure that local officials do not over-spend these limits. The board's instructions must be followed, because otherwise the city (and its officials) may face severe sanctions.[170] Since the board is not dependant on popular support, it is able to take unpopular decisions and endure pressures by interest groups. As a result, the board is politically capable of cutting unnecessary public services, negotiating cheaper labor contracts or eliminating city jobs.[171] The board's existence enables the locality to take the necessary actions toward recovery – actions that the locality was politically incapable of taking prior to the board's creation.[172]

Indeed, as opposed to a bankruptcy process, the state intervention addresses the core causes of the city's financial crisis. The state's legal powers and financial

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Tabellini, *supra* note 133, at 71-72; Perotti & Kontopoulos, *supra* note 133, at 196-197; Hallenberg & Von Hagen, *supra* note 133, at 4-5.

[170] *Actions Taken by Five Cities, supra* note 164, at 52-55; Also see *Financial Control Boards, Hearing before the Subcomm. on the Dist. Of Columbia of the House Comm. on Gov't Reform and Oversight, 104th Cong.* 68-69 (March 8, 1995) [Henceforth: "*Financial Control Boards*"])

[171] The power of state boards in this respect is evident from their ability to cut the city's expenditures, and especially labor costs. Labor unions often have a paralyzing grip on the city's officials (see Nivola, *supra* note 139), and the state's intervention is needed in order to conduct tough negotiations. See, e.g., Ed Cyr, *Thoughts on the Chelsea Receivership*, 9 GOV'T FIN. REV. 23 (1993) (describing how Chelsea's city officials surrendered to interest group pressures and drove the city to insolvency. The state then appointed a state receivership for Chelsea, and the receiver was able to break the union's hold on the city's finances. Within a little more than year the state receiver was able to rehabilitate Chelsea, after 20 years of financial hardship); Also see, FRED FERRETI, THE YEAR THE BIG APPLE WENT BUST 413 (1976) (Ferreti describes the effect the creation of New York State's Emergency Financial Control Board (EFCB) had on the negotiations with city unions. Prior to the establishment of the EFCB the unions pressured the city's politicians, and the city's labor expenses went wild. The EFCB was able to change this devastating pattern. Ferreti explains: "For the municipal unions it was a new game as well. No longer did they negotiate with City Hall or with the Board of Education, for the control board had the power to not only unilaterally impose a freeze on wages, costs of living and increments, but to redraw the contracts. It became the city's bargaining agent as well. And whereas City Hall and whoever was mayor — Wagner, Lindsay or Beame — had to carefully consider the union constituencies during contract talks, the business oriented control board had no such problems.". See also, ROBERT W. BAILEY, THE CRISIS REGIME: THE MAC, THE EFCB, AND THE POLITICAL IMPACT OF THE NEW YORK CITY FINANCIAL CRISIS 68-91 (1984) (describing in detail the negotiations between the unions and the EFCB).

[172] *Cf. Financial Control Boards*, *supra* note 170, at 58 (Bernard E. Anderson, the former chairman of PICA, the state board created for Philadelphia in 1991, explained to Congress the reasons for the Board's success: "I would say that part of the reason we were successful is that an oversight board of the type we have gives elected officials the political cover they need to make unpopular choices and to control spending. In other words, the oversight board, in effect, is a heat shield. The mayor [and] members of the city council can make decisions on spending and blame it on the board because they don't have any choice in the matter, and this can be a very useful device for allowing the city to reduce payrolls, to eliminate services, to restructure government, to introduce new management techniques, to renegotiate labor contracts, and do all other things that are necessary.").

resources can help the to city deal with changing socio-economic circumstances, and the state board, if created, can address the city's problematic political environment. Thus, unlike Chapter 9, state intervention offers a genuine rehabilitation process, and not simply a temporary solution to liquidity problems.

The effectiveness of state intervention was recently demonstrated in Pittsburgh, Pennsylvania. In 2003 Pittsburgh was facing a severe financial crisis. It had a huge budget deficit ($35 million), and a large amount of debt ($879 million, or $2,627 per resident).[173] In order to avoid bankruptcy, the state then created a state financial board. The board initiated a recovery plan that forced the city to cut expenditures, especially through tough negotiations with the unions and a significant reduction of employment costs.[174] In addition, in order to address a massive suburbanization process, the board recommended to reform the city's tax system. It allowed the city to impose taxes on non-residents working in the city, and, as a result, increased the city's tax revenues considerably.[175] Within a year the city eliminated its deficit, and was able to return to the credit markets.[176] But no less important than the recovery itself is the fact that the city's rehabilitation is sustainable. Since state intervention addressed the city's core problems, the city genuinely regained fiscal health and has been able to survive the current recession with impressive success. In a recent study on the financial condition of local governments, Pittsburgh, a city

[173] Timothy McNulty, *Audit Says City Is Going Broke; Flaherty Concurs on Crisis Timetable*, PITTSBURGH POST GAZETTE, Sep 11 2003, at A15; Gillian D'ambrosio, *S&P drops Pittsburgh to Junk Status*, THE BOND BUYER, Oct 16, 2003, at 1.

[174] The board forced the city to adjust its level of expenditures to its income, and it enabled city officials to make difficult decisions that prior to the board's existence were politically impossible. Over the last five years, the city has reduced its work force by an estimated twenty five percent, closed fire stations as well as pools and recreation centers, instituted a multi-year wage freeze, restructured health benefits to shift a greater portion of cost onto employees, and eliminated retiree health benefits for future hires. See, TOUGH DECISIONS, *supra* note 1, at 5.

[175] Adam L. Cataldo, *Pittsburgh Tax Reform Could Raise Extra $35M in 1st Year*, THE BOND BUYER, Nov. 23, 2004 at 6.

[176] Robert Whalen, *Steel City's BBB Deal*, THE BOND BUYER, May 8 2006, at 37 (The Bond Buyer reports that: "In its rating report, Fitch attributes the city's improved finances to tax structure changes and assistance from two oversight panels.").

teetering on bankruptcy in 2003-4, was the only city not looking at a deficit for FY2009 or 2010.[177]

This is of course not to say that the state can magically cure distressed localities. The recovery of a distressed locality may be a long process, and naturally the state's powers are limited. However, state intervention seems superior to a bankruptcy solution. It addresses the causes of the financial deterioration, and it does not entail severe reputational costs (as a bankruptcy procedure does).

B. *The gains from state fiscal oversight*:

The problem with state oversight solution may be the incentives of state officials to implement it. Although state intervention can help local governments recover from a financial crisis, it is not entirely clear that politicians would endorse such a solution. State politicians may prefer to deal with local financial crises in other manners (or not to deal with them at all), not because they believe state intervention is a bad solution, but rather because of political interests.

As part of a successful recovery process, the state may be compelled to take expensive rehabilitation measures (such as cutting unfunded mandates, increasing state aid, or guaranteeing additional city credit). The cost of these measures comes out of the state budget, and since state resources are scarce, state politicians may prefer to spend state funds on other purposes – not necessarily on local rehabilitation. The state politicians' reluctance to invest in local oversight is at least partly due to the fact that they do not receive adequate political benefits as a result of state help. The local financial condition is usually perceived as a local matter, and the general public does not readily associate a city's rehabilitation with the state's efforts. Therefore, even if

[177] TOUGH DECISIONS, *supra* note 1, at 5.

the distressed locality recovers from a crisis because of state assistance, often it will be the local officials that will receive the credit, and the contribution by the state will go unrecognized.[178] Moreover, even when state involvement is acknowledged, it is usually understood to serve the narrow benefits of the distressed locality. Other constituencies in the state, it seems, do not profit from state funds "wasted" on a local recovery process, and so politicians representing these constituencies may try to minimize the state's aid.[179] They would prefer that the state's scarce resources will be spent on their own constituency, and may find it hard to explain (to their voters) why they supported dispensing state funds on helping a local government that conducted itself in a fiscally irresponsible manner.[180]

This conception, however, is wrong and harmful. Evidence shows that state oversight, if done properly, benefits not only the locality that receives the state's assistance, but also the state and other localities in the state. This is especially true when the state oversees local governments on an ongoing basis. Ongoing and proactive state oversight helps local governments to better conduct their finances, and prevents local financial distress from becoming a full-blown fiscal crisis. This in turn benefits public issuers in the state as a whole. When creditors know that the state oversees the local economies, they are willing to extend credit to public issuers in the state at a cheaper price. The creditors understand that because of the state oversight

[178] *Cf.* Zelinsky, *supra* note 130 at 1374-75. (Zelinsky explains that the general public do not appreciate the link between their municipal tax bills and their state legislators adoption of unfunded mandates. The same may be true with regard to the opposite state policy. The public may not appreciate the link between the state's assistance and local fiscal stability).

[179] *Cf.* Sheryll D. Cashin, *Localism, Self Interest and the Tyranny of the Favored Quarter: Addressing the Barriers to New Regionalism*, 88 GEO. L. J. 1985, 2022-2027 (2000).

[180] Margaret Weir, *Central Cities Loss of Power in State Politics*, 2 CITYSCAPE: J. POL'Y DEV. 23, 23-28 (1996) (Weir shows that: "Increasingly, state politics are driven by political considerations that have little connection with the problems of local governance. This shift is particularly detrimental to cities as they have become less able to fend for them-selves and more dependant on outside assistance. These changes have made it more difficult to build policy coalitions that address urban problems…").

there is a lower risk of local default, and correspondingly, credit prices for public issuers decrease.[181]

Perhaps the best example of the benefits that the state oversight system can bring can be found in the state of North Carolina. North Carolina has about 650 general-purpose local governments (including cities, towns, and counties). Most of the local governments are rural, and they have a limited tax base and limited revenue sources.[182] In 2007 the median household income in the state was ranked thirty seven in the country,[183] and the per-capita bankruptcy filing rate was the thirteenth highest.[184] But despite these unfavorable financial conditions, North Carolina's local governments are the healthiest in the country. The state has the highest number of top-rated (AAA or equivalent) local governments, and the localities are charged lower interest rates even when compared with equally rated local governments from other states.[185] The reason for local government success in North Carolina, is close state oversight. North Carolina created a special state agency to supervise local government

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[181] *Cf.* Dennis Epple & Chester Spatt, *State Restrictions on Local Debt: Their Role in Preventing Default*, 29 J. PUB. ECON. 199 (1986). (Epple & Spatt argue that a default of one local government may affect the interest rates of other local governments in the state as well. *See id.* at 200-01. As a result, local governments – those that do not wish to default – have an interest in maintaining their state's reputation in the enforcement of local debts. *Id.* at 218. Since a debt limit reduces the number of localities that are prone to default, various local governments in the state benefit from the debt limit and support it. The same logic applies here. Proactive municipal insolvency legislation promotes the state's reputation for the enforcement of local debts. Such legislation thereby reduces the interest rates local governments have to pay, and benefits all local governments).

[182] North Carolina has seven local governments with a population of more than 100,000 residents; Nineteen local governments with populations between 25,000-100,000 residents; forty four local governments with populations between 10,000-25,000, and the rest have less than 10,000 residents. Data is available at http://www.nclm.org/about%20cities%20and%20towns/populationlistalt.htm.

[183] Data from U.S. Census Bureau, 2007 American Community Survey, available at http://factfinder.census.gov/servlet/GRTTable?_bm=y&-_box_head_nbr=R1901&-ds_name=ACS_2007_1YR_G00_&-format=US-30.

[184] Data from the American Bankruptcy Institute, available at http://www.statemaster.com/graph/eco_ban_fil_percap-economy-bankruptcy-filings-per-capita.

[185] Mayraj Fahim, *North Carolina Still Influences U.S. Local Government Finance*, CITY MAYORS, Mar. 31, 2005, http://www.citymayors.com/finance/nc_finance.html; Charles K. Coe, *Preventing Local Government Fiscal Crises: The North Carolina Approach*, 27 PUB. BUDGETING & FIN. 39, 39 (2007).

finances, the Local Government Commission (Hereinafter: "LGC"), and the agency monitors local governments and ensures their financial stability.[186]

The LGC oversight system includes two main divisions: debt management and fiscal management. In terms of debt management North Carolina is the only state legally responsible for the issuance of all local debt. Local governments cannot issue debt without the LGC's approval, and the commission also takes an active role in the actual sale and marketing of the debt securities.[187] In terms of fiscal management, the LGC provides ongoing supervision of the local government's fiscal condition. All local governments in the state are required to submit semi-annual financial statements, and the LGC reviews the reports and regularly assesses the condition of the local economies. To the extent the LGC detects signs of financial distress, it has the authority to intervene in local affairs and assist the locality in order to avoid a potential crisis.[188] Usually the LGC's intervention takes an advisory role, and it works in cooperation with the local officials. However, if local officials do not cooperate, the commission has the authority to assume financial control, and to take over the management of the locality.[189]

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[186] Fahim, *supra* note 185; Coe, *supra* note 185.

[187] Localities that want to issue debt (especially general obligation debt) undergo a lengthy approval process, in which the LGC evaluates the adequacy of the bond amount, the locality's ability to pay back the debt and the bond's effect on the local property tax and other revenue sources. Only if the LGC is convinced that the debt is both necessary and reasonable (in terms of its effects on the local economy and the locality's ability to pay it back) will the LGC approve its issuance. See, Coe, *supra* note 185, at 41; K. Lee Carter, Jr., *State Oversight of Local Government Finance*, *in* STATE AND LOCAL GOVERNMENT IN NORTH CAROLINA: THEIR EVOLUTION AND CURRENT STATUS 71, 76-78 (Charles D. Liner ed. 2d ed. 1995); N.C. DEPT OF STATE TREAS., THE STATE TREASURER'S ANNUAL REPORT FOR FISCAL YEAR 2007-2008, at 58-60 [HEREINAFTER: STATE TREASURER'S ANNUAL REPORT 2008].

[188] Coe, *supra* note 185, at 41-45; Carter *supra* note 187, at 78-80; STATE TREASURER'S ANNUAL REPORT 2008, at 60-61. To improve its evaluation, as early as the 1970s, the commission created a database of local financial information, and the database facilitates time trend analysis and comparison among the different localities. This database affords a warning system that enables the LGC to detect even early signs of local financial distress. See, Richard Larkin & Jeff Schaub, *State of North Carolina Local Government Commission, Credit Enhancement Program Review*, FITCH IBCA TAX SUPPORTED SPECIAL REPORT, Mar 29, 2009, at 4, available at http://www.nira.or.jp/past/newsj/seisakuf/04/siryou/08.pdf. [*Hereinafter*, *Fitch Report*].

[189] One such case was the LGC's takeover of the city of Princeville, see *Fitch Report*, *supra* note 188; Rob Christensen, *A Big Government Idea that Makes Conservatives Proud*, NEWS & OBSERVER (RALEIGH, NC), Jan 12, 1998 at A3.

The fruits of North Carolina's local supervision system are enjoyed by all public issuers in the state. Creditors and credit rating agencies appreciate the LGC's work, because they understand that the agency will not let localities go under and default. This reduces the risk of lending to North Carolina's public issuers, and as a result credit rating agencies give localities in the state high credit ratings.[190] Due to the LGC's supervision, the Fitch rating agency formally enhances the credit rating of all North Carolina's public issuers rated below "AA" by one or two steps,[191] and other credit rating agencies, even if they do not have a formal credit enhancement policy, look favorably on North Carolina's local debt.[192] The improved credit ratings, in turn, translates into huge savings in interest. The cumulative interest savings by North Carolina's local governments reaches millions of dollars every year (sometimes tens of millions),[193] far greater than the costs of the state supervision system.[194] These

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[190] Fahim, *supra* note 185; Coe, *supra* note 185.

[191] *Fitch Report*, *supra* note 188, at 1 (The Fitch Report reads: "The frequency and thoroughness of review by the LGC, coupled with its record of assuming fiscal control before stress leads to crisis, provides additional credit strength to most local issuers. In recognition of this 'credit firewall', Fitch IBCA will grant credit enhancement of one to two notches on debt rating below 'AA' for local government issuers under the supervision of the State of North Carolina LGC").

[192] Tedra Desue, *Moody's: North Carolina Counties Come on Top*, THE BOND BUYER, July 12, 2000, at 4 (The Bond Buyer reports on a moody's credit report on North Carolina's LGC: "A special report released by Moody's Investors Service last week found the credit outlook for North Carolina's counties to be favorable, with its local governments experiencing stronger credit quality than others in the nation as a whole. Sean O'Brien, an assistant vice president at Moody's and author of the report, said the role the state's Local Government Commission plays in county finances contributes considerably to their success. Although the LGC does not financially guarantee local government debt commitments, it does provide active oversight of all issuers in the state. Furthermore, if an issuer defaults, the LGC can take over that government's books, O'Brien explained"). Also see Coe, *supra* note 185, at 40 n. 4 (citing an S&P report, Richard Marino, Colleen Woodell and LaVerne Thomas, *North Carolina Local Government Commission Contributes to Higher Ratings* (New York: Standard & Poor's, 2001)).

[193] Coe calculated the annual interest savings that result from a one notch credit enhancement (that the Fitch credit rating agency declared it gives North Carolina localities due to the LGC's monitoring). Under the assumption of $7.5 billion in outstanding debt (which was North Carolina's local governments' outstanding debt as of June 30, 2005), he reaches the conclusion that local governments save annually $6.75 million dollars in interest payments (see Coe, *supra* note 185, at 46). A different calculation was performed by North Carolina' treasury. In 2003-4 the treasury calculated the interest rates that North Carolina's localities pay for general obligation bonds compared to the national Bond Buyer index. According to the treasury, in fiscal year 2003-4 the localities paid an average of eighty two basis points under the national bond buyer index, resulting in savings of $37 million over the life of the bonds. See, N.C. DEPT OF STATE TREAS., THE STATE TREASURER'S ANNUAL REPORT FOR FISCAL YEAR 2003-4 at 29.

[194] The LGC's fiscal year 2006 budget was $2,619,761, see Coe, *supra* note 185.

savings contribute of course to all local governments in the state, and not just to localities that experience financial difficulties.

North Carolina's example proves that state fiscal oversight not only doesn't waste tax payer's money, but rather it can save it. State oversight improves local fiscal health, affords healthier and better managed municipalities for residents to live in, and, in addition, decreases the price of credit. As opposed to what may be perceived by state politicians, the gains of state oversight can be substantial.

V. **Conclusion**

So if the rehabilitation of distressed municipalities can be better achieved through state intervention actions, and if Chapter 9 filing has adverse effects on both the locality and the state, then perhaps we should re-examine the purpose of municipal bankruptcy. Like in the 1930s legislation, Chapter 9 should be limited to the solution of a holdout problem, and the rehabilitation of distressed localities should be left in the hands of the state. Bankruptcy can facilitate the approval of a beneficial debt readjustment agreement over the objection of an opportunistic minority, but it will do little to help a city overcome economic distress.

This is not merely a theoretical observation. Especially now, during the current crisis, the analysis has important implications on state policies.[195] States should not rely on Chapter 9 to save their cities (like president Ford suggested in

[195] The California legislature, for example, is currently debating its policy on municipal bankruptcy. Under a recently proposed bill California lawmakers suggest to make it more difficult for municipalities to file for bankruptcy (California Assembly Bill No. 155, available at http://www.leginfo.ca.gov/pub/09-10/bill/asm/ab_0151-0200/ab_155_bill_20090701_amended_sen_v96.pdf). The bill requires local governments to ask permission to file for chapter 9 from the California Debt and Investment Commission, and it obligates local governments to demonstrate that they exhausted all other remedies prior to filing. The bill has already passed the State Assembly, and is now pending the approval of the Senate. For different opinions about the bill and the role of the municipal bankruptcy process see, Andrew Ward, *Calif. Bill Would Make Chap. 9 a Tougher Path*, THE BOND BUYER, 21 April, 2009, at 1; Andrew Ward, *Bill to Make Municipal Bankruptcy Harder Passes California Assembly*, THE BOND BUYER, June 8, 2009, at 5.

respect to New York City),[196] but rather, they should proactively monitor the local finances and get involved to the extent necessary.[197] The paper demonstrated the benefits of such state policy, especially when compared to the adverse effects bankruptcy filing might have.

[196] See *supra* notes 80-81, and accompanying text.

[197] In the last few years several states have begun to follow the North Carolina example, and they too try to implement models to increase state monitoring and promote early state intervention. Pennsylvania, for example, created the Early Intervention Program. (see, PENNSYLVANIA GOVERNOR'S CENTER FOR LOCAL GOVERNMENT SERVICES, EARLY INTERVENTION GUIDELINES (Jan. 2009) (available at http://www.newpa.com/find-and-apply-for-funding/funding-and-program-finder/funding-detail/index.aspx?progId=98). Michigan also amended its statute, and allowed for preliminary reviews to be conducted by the state's treasurer, in order to determine the existence of local financial problems. (see, Local Government Fiscal Responsibility Act, Mich. Comp. Laws § 141.1201-1291; Michigan, senate bill 1064, 2002 MI. P.A. 408; The Citizens Research Council of Michigan, *Avoiding Local Government Financial Crisis: The Role Of State Oversight*, (July 2000), available at: http://www.crcmich.org/PUBLICAT/2000s/2000/rpt329.pdf).