Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem

Omer Kimhi†

As a result of the recent credit crisis, municipal insolvency has become a relevant and important issue. All over America cities are grappling with budget problems, and some of them are even considering bankruptcy. This Article analyzes the municipal bankruptcy process, and inquires whether it provides a sensible solution for urban fiscal crises. In order to examine this question, the Article delves into the prevailing rationales of bankruptcy law—the contractual theory and the fresh start theory. The Article makes the claim that these theories do not adequately explain the municipal bankruptcy process, and that filing for bankruptcy can damage the distressed locality as well as its state and other localities within the state. As an alternative to bankruptcy the Article 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.

---

† Assistant Professor, Haifa University School of Law. This Article is based on three years of research I did on the subject of municipal insolvency at New York University School of Law. I wish to thank Clayton Gillette, Geoffrey Miller, Dick Netzer, Barry Adler, Shmuel Leshem, Oshrat Sity, John Marks, and the members of the New York University JSD Forum for their helpful comments on earlier drafts.
Introduction

Due to the recent credit crisis, the problem of municipal insolvency in the United States 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. 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. The mayor of Los Angeles recently declared that the gravity of Los Angeles’s fiscal emergency is enormous, and estimated that unless drastic steps are taken the city will face a $1 billion deficit by 2010-2011. Jefferson County in Alabama is saddled with billions of dollars in debt and has already defaulted on some of its payments. The Pew Charitable Trusts’ Philadelphia Research Initiative recently conducted a study on the finances of thirteen large cities. According to the study, all of these cities but one face serious budgetary problems, and most of the cities have budget shortfalls of over ten percent of their general funds. The sheer magnitude of local economic distress led the Moody’s rating agency to assign for the first time ever a negative outlook for the U.S. local government sector as a whole. 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. 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. Chapter 9 of the Bankruptcy Code allows insolvent municipalities to file for bankruptcy, and to use the bankruptcy procedure to solve their fiscal problems. Bankruptcy provides a financially distressed municipality with protection from its creditors, and
Chapter 9 of the Bankruptcy Code

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. Presumably, just as commercial corporations, even giant corporations like GM or Kmart, benefit from the bankruptcy process, so too can municipalities. Indeed, although municipal bankruptcies are extremely rare (a fact this Article will try to explain), in times of local financial distress the idea of bankruptcy filing often arises. Especially in the current economic climate, several local governments facing the recession are contemplating bankruptcy, and it is not unlikely that some of them will eventually file.

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? In other words, can localities benefit from filing in the same way that commercial corporations do? The prevailing 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. 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 this Article 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 substantiate my claim I delve into the basic 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 and the fresh start theory—do not properly explain the implementation of the current Chapter 9, and do not clarify why it is beneficial.\footnote{See discussion infra Part III.}

The contractual theory fails to justify municipal bankruptcy because, unlike Chapter 11, Chapter 9 does not benefit the creditors. In the regular corporate context, by solving the creditors’ common pool problem, bankruptcy law increases the value the creditors receive from the debtor’s estate, and decreases the price of credit in the market. In the municipal context, on the other hand, a common pool problem does not exist, and Chapter 9 decreases the value the creditors receive from the debtor’s estate rather than increasing it.

The fresh start theory of bankruptcy also raises difficulties. According to this theory, bankruptcy is designed to decrease the debtor’s debt burden, thereby promoting economic activity and rehabilitation. In the municipal context, 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.

As an alternative to bankruptcy, I suggest a proactive state intervention solution.\footnote{See discussion infra Part IV.} As opposed to bankruptcy, this approach does not take effect only when the municipality is insolvent; 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 a distressed locality a better chance 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 the public issuers. Local governments then enjoy both better fiscal health and cheaper credit prices. The advantages of state intervention are demonstrated by the examples of the city of Pittsburgh and the state of North Carolina.
The rest of the Article proceeds as follows. Part I generally describes the municipal bankruptcy process, and provides data on municipalities that have used Chapter 9 in the past. I show that Chapter 9 filings are extremely rare, and that in those cases where Chapter 9 was used, it was done by tiny municipalities under peculiar circumstances. Part II explores the legislative history of Chapter 9, and in particular two important phases of the legislation: the Chapter's creation in the mid-1930s, and its amendment in the mid-1970s. I argue that although the Chapter was originally created to overcome the creditors holdout problem, in the 1970s its purpose was transformed, and it became 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 municipalities. Part IV suggests state intervention as an alternative to bankruptcy, and illustrates the advantages of such an approach. I show that a proactive state supervision system can help rehabilitate distressed localities, and that in addition it may also create substantial interest savings for all public issuers in the state.

I. Chapter 9 and Municipal Bankruptcy Filings

Chapter 9 of the Bankruptcy Code provides a bankruptcy procedure for municipalities. Only municipalities may file for Chapter 9, and municipalities may not file under any other chapter in the Bankruptcy Code. Yet, despite the distinct chapter, municipal bankruptcy offers bankruptcy proceedings that resemble those available to commercial corporations.

Like a commercial debtor, a municipality that files for Chapter 9 enjoys an automatic stay. The stay prevents creditors from bringing any action, or enforcing any judgment, against the locality, 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

---

15 11 U.S.C. § 109 (2006). 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, 600-03 (Bankr. C.D. Cal. 1995).


17 Id. Section 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.
plan notwithstanding its creditors' objections. If the debt readjustment plan meets certain conditions specified in sections 1129 and 943, the plan receives 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.

However, notwithstanding the similarities between Chapter 9 and Chapter 11, there are several major differences between the two chapters. First, in order to enjoy bankruptcy protection, a municipality must meet thresholds that are different from what corporations or individuals must meet. Whereas being a debtor under Chapter 11 or Chapter 7 requires only some sort of connection to the United States, being a debtor under Chapter 9 requires proving five substantive conditions. These conditions include, among other things, 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 that it meets the threshold requirements.

However, once the bankruptcy filing is approved, the municipality has greater powers than a regular corporate debtor does. For constitutional reasons, the federal bankruptcy court has limited jurisdiction over a municipal debtor, and, as a result, localities enjoy greater latitude in the bankruptcy process. Thus, as opposed to Chapter 11, within Chapter 9

---

18 11 U.S.C. § 1129(a) and (b) are partially incorporated into Chapter 9 via 11 U.S.C. § 901.
19 Id. §§ 943, 1129.
20 Id. § 944.
21 Chapter 11 is the corporate reorganization chapter. Chapter 7 is the liquidation chapter for both individuals and corporations. 11 U.S.C. § 109(a) applies to both chapters, and determines that only a person that resides, or has a domicile, a place of business, or a property in the United States may be a debtor under Title 11. Id. § 109(a).
22 The requirements are set forth in 11 U.S.C. § 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 debtor has to show that it desires to effect a plan to adjust its financial obligations; and (5) the debtor must show that it tried to negotiate a debt readjustment agreement with its creditors, or that such negotiations are impracticable.
24 McConnell and 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, at 455-57.
25 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 pass statutes that would limit the states' sovereignty over their local governments, or that would intervene in the political and governmental powers of municipalities.
the locality has exclusive rights to submit debt readjustment plans for the court's confirmation. 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. 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 with 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. 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 creditors do. 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. 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. In the municipal context, however, the same rule provides very weak

---

26 Chapter 11 allows the debtor an exclusivity period of 120 days. After 120 days the court may also accept plans from the creditors or from other interested parties. 11 U.S.C § 1121(b) (2006). Chapter 9 does not incorporate section 1121(b), and so the exclusivity period is not limited in time. See also 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 in court).

27 Section 1104 enables the court, after notice and hearing, to order the appointment of a trustee for the debtor. Id. § 1104. 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.

28 The court's powers are expressly restricted in sections 903 and 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.

29 A cram down is an involuntary imposition of a debt reorganization plan over the objection of some classes of creditors. The cram down is done pursuant to 11 U.S.C § 1129(b).

30 Section 901 incorporates most of the creditors' protection provisions of Chapter 11. Id. § 901. These include the absolute priority protection rule. Id. § 1129(b)(2)(A), (B). Section 943 sets additional creditor protection rules, specifically for Chapter 9. Id. § 943.

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

32 BAIRD, supra note 31, at 69.
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 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. Chapter 9 thus enables municipalities to increase their costs, and to confirm plans that harm their creditors' basic interests.

An additional difference between Chapter 9 and Chapter 11 concerns the debtor’s collective bargaining agreements (CBAs). Under Chapter 11, the rejection of a CBA is governed by section 1113. This section allows the debtor to reject a CBA only after the debtor’s negotiations with the authorized representatives of employees, the unions, fail, and only if a court concludes that the modification to the agreement proposed by the debtor is no more than the modification 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 have had to fill this statutory void. Some courts applied the standard of NLRB v. Bildisco & Bildisco, which was the CBA rejection standard prior to the enactment of section 1113. 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 reasonableness 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.\textsuperscript{41} 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, Chapter 9 statistics show a different story. The chapter is in fact seldom used, and it has almost never been used by a large and important city.

According to data on bankruptcy filings,\textsuperscript{42} in the thirty-three years between 1976 and January 2009, there were about forty bankruptcy filings by general-purpose municipalities, and only about thirty of these filings were approved.\textsuperscript{43} On average, a little more than one bankruptcy is filed per year,\textsuperscript{44} despite the fact that during this thirty-three-year time frame, local governments underwent several periods of recession, such as in the mid-1970s, 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.\textsuperscript{45}

\textsuperscript{41} See generally Dahl, supra note 12 (providing an in-depth analysis of the treatment of CBAs in Chapter 9).
\textsuperscript{42} See generally U.S. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, BANKRUPTCIES, DEFAULTS AND OTHER LOCAL GOVERNMENT FINANCIAL EMERGENCIES (1985) [hereinafter LOCAL GOVERNMENT FINANCIAL EMERGENCIES] (providing data about the 1970s); James E. Spiotto, Ninth Annual Institute on Municipal Finance Law, Selected Municipal Bankruptcy Statistics (June 1990) (unpublished report by the law firm Chapman & Cutler, on file with the Yale Journal on Regulation) (providing data regarding the identity of Chapter 9 debtors during the 1980s); PACER Service Center, Case Management/Electronic Case Files, http://pacer.psc.uscourts.gov/cmecc [hereinafter CM/ECF] (providing data about Chapter 9 filings of general-purpose municipalities from the late 1990s until January 2009). The data gathered does not include filings of special-purpose municipalities.
\textsuperscript{43} General-purpose municipalities include cities, counties, towns, and townships. These are the municipal corporations that are most associated with the word "municipality," as they provide a broad range of public services that are expected from local government, such as law enforcement, fire protection, education, and cultural activities. 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, or electricity, and are often funded by special taxes levied specifically for this purpose. Since this Article explores whether Chapter 9 provides a viable solution for the financial distress of general-purpose municipalities, the filings 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.
\textsuperscript{44} Special-purpose municipalities tend to use Chapter 9 more. Between 1997 and 2009, there were approximately 180 approved bankruptcies of special-purpose municipalities. See CM/ECF, supra note 42 (providing statistics about the total number of municipal bankruptcy filings, without differentiating between general- and special-purpose municipalities).
\textsuperscript{45} These were Gould, Arkansas (in April 2008) and Vallejo, California (in May 2008). See id.
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 cities, including metropolises such as New York, Miami, Philadelphia, and Washington, D.C. also experienced severe financial stress, with a few notable exceptions, such as Orange County, these cities preferred to solve their problems in ways other than bankruptcy. Clearly, municipal bankruptcy appeals more to small towns than to the average or large city.

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, 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 1400 residents, which lost an $88,000 lawsuit to a police officer who slipped on a patch of ice; the city of Reeds Springs, Missouri, with 510 residents, which lost $160,000 in a personal injury lawsuit; and the town of Tyrone, Oklahoma, which lost $150,000 in a lawsuit. Another common reason for bankruptcy involves,...
somewhat surprisingly, the relationship between the municipality and the state or federal government. In these cases, the municipality owed a substantial amount of money to the state or federal government, and, in an act of defiance, filed for bankruptcy protection. Sometimes, the municipal administration was also corrupt and tried to prevent state supervision by means of bankruptcy.

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 where Chapter 9 was used, was it used by tiny municipalities under peculiar circumstances? This is particularly interesting in light of the severe financial problems that municipalities suffer from, and of the great privileges that Chapter 9 can offer municipal debtors. Chapter 9 was created to help localities that suffer from fiscal crises, but in practice, the chapter does not perform such a function, and is hardly used by general-purpose municipalities. 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 the rationales behind the creation of a municipal bankruptcy process were.

judgment in an amount equal to its annual budget). To a certain extent, the bankruptcy of Orange County, the largest municipal bankruptcy ever filed, was a result of the same problems. In that case, though no lawsuit was filed, the municipality had suddenly lost a huge amount of money as a result of the investments of the county treasurer Robert Citron. MARK BALDASSARE, WHEN GOVERNMENT FAILS: THE ORANGE COUNTY BANKRUPTCY 13 (1998).

This reason is surprising because, pursuant to the Bankruptcy 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 do try to file even when the state expressly opposes the filing.

See, e.g., Dorothy A. Brown, Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty, 11 BANKR. DEV. J. 625 (1995) (detailing how Bridgeport, Connecticut filed for bankruptcy at least in part due to a conflict with the state government); Joe Haberstroh, Little Town in Feud with Corps That Moved It, SEATTLE TIMES, Nov. 13, 1991, at A1 (detailing how North Bonneville, Washington filed for bankruptcy in 1991 due to a debt of $365,000 to the federal government); Jon Jeter, Radar Guns Prove Fatal to Missouri Speed Trap; Town Went Broke After Ticketed Official Fought Back, WASH. POST, Nov. 27, 1998, at A10 (detailing how Mack's Creek, Missouri filed bankruptcy in 1998 due to debts owed to the state and federal government); Laura Mansnerus, All He Wanted Was a Little Respect, N.Y. TIMES, Aug. 1, 1999, § 14NJ, at 4 (detailing how Camden, New Jersey filed for bankruptcy at least in part due to a conflict with the state government); Alabama Lipscomb, USA TODAY, Apr. 23, 1991, at 6A (detailing how Lipscomb, Alabama filed bankruptcy in 1991 due to a debt to the Farmers Home Administration).

Take, for instance, Camden, New Jersey, which filed for bankruptcy in 1999. New Jersey wanted to erect an oversight board over Camden but its mayor, Milton Milan, was afraid that tighter state control would reveal the corruption accompanying his management of the city. Milan thought that filing for bankruptcy would convince the state to give the city money without financial oversight. See Melanie Burney, N.J. City Files for Bankruptcy, CHI. SUN-TIMES, July 21, 1999, at 33; Mansnerus, supra note 54 (filing of bankruptcy objected to by the state and dismissed a week later); see also Brown, supra note 54 (detailing the filing in Bridgeport, Connecticut); Gita M. Smith, Commissioners Face Impeachment, ATLANTA J., Jan. 19, 1997, at B6 (detailing the filing in Green County, Alabama).
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 (as it was then called) was enacted;\(^{56}\) and the second, from 1976, when, as a response to the New York City financial crisis, the chapter was amended.\(^{57}\) 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 omnibus bankruptcy proceedings and it was expected to help localities recover 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 United States 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 revenues and investments.\(^{58}\) 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.\(^{59}\) Unfortunately, these predictions were wrong. In 1929 the U.S. economy entered 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.\(^{60}\) 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

---

56 Before 1978, the municipal bankruptcy chapter was marked with Roman numerals: Chapter IX. In 1978, with the enactment of the Bankruptcy Code, the Roman numerals were replaced by Arabic numerals, and the municipal bankruptcy chapter was marked Chapter 9.

57 See King, supra note 12.


59 State and local debt grew from $2 billion at the turn of the twentieth century to $12.8 billion by 1928. See Natalie R. Cohen, Municipal Default Patterns: An Historical Study, 9 PUB. BUDGETING & FIN. 55, 56 (1989).

60 The assessed valuations of real estate property for property tax purposes are based on the market value of the property. Therefore, an increase (decline) in market values causes an increase (decline) in the municipal property tax base.
revenues plummeted.\textsuperscript{61} 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.\textsuperscript{62} Naturally, this drove an alarming number of municipalities into 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 2019 local governments were in default with a total sum of about $18 billion in outstanding municipal debt.\textsuperscript{63}

Due to the gravity of the situation, debt readjustment negotiations between municipalities and their creditors were prevalent. On the one hand, localities could not 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.\textsuperscript{64} 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.\textsuperscript{65}

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.\textsuperscript{66} Minority creditors held out their consent, as they preferred that the municipality and the majority of the creditors 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. 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

\textsuperscript{61} The total assessed real estate property value in the country at its peak was $176 billion. The total assessment for 1933-1934 was $144 billion, a decline of $32 billion, or 18%. 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 was in much higher percentages: Arkansas, 28.2%; Florida, 18.9%; North Carolina, 33.8%; and Texas, 26.1%. See \textsc{Hillhouse}, supra note 58, at 240 & n.11 (citing Lent D. Upson, \textit{Local Government Finance in the Depression}, \textsc{Bond Buyer}, Oct. 19, 1935).

\textsuperscript{62} \textsc{Collier on Bankruptcy}, supra note 33, § 900.LH(1).

\textsuperscript{63} \textsc{Ashton v. Cameron Water Improvement Dist. No. 1}, 298 U.S. 513, 533-34 (1935); \textsc{Amendment of Bankruptcy Laws – Bankruptcy of Municipalities: Hearing on S. 1868 and H.R. 5950 Before the S. Subcomm. on the Judiciary, 73d Cong. 11-12 (1934)} [hereinafter \textsc{Amendment of Bankruptcy Laws – Bankruptcy of Municipalities}] [statement of Rep. J. Mark Wilcox].

\textsuperscript{64} See \textsc{Ashton}, 298 U.S. at 534.

\textsuperscript{65} George H. Dession, \textit{Municipal Debt Adjustment and the Supreme Court}, 46 \textsc{Yale L.J.} 199, 200 (1936).

\textsuperscript{66} \textsc{Amendment of Bankruptcy Laws – Bankruptcy of Municipalities, supra} note 63, at 14.
agreement usurped by the minority.\textsuperscript{67} Thus, executions of local debt reorganization agreements did not take place, even when these agreements were beneficial to the entire group of creditors.\textsuperscript{68} 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.\textsuperscript{69}

Theoretically, the solution to the holdout 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.\textsuperscript{70} States, however, were unable to enact such a law, as they are constitutionally prohibited from impairing the minorities' debt contracts.\textsuperscript{71} The solution, therefore, had to come from Congress, and Chapter IX of the Bankruptcy Act was enacted in May 1934 exactly for this purpose.\textsuperscript{72} The chapter enabled

\begin{tabular}{|c|c|c|}
\hline
Minority Creditor/Driver 1 & Consent/Swerve & Holdout/Straight \\
\hline
Other Creditors/Driver 2 & (0,0) & (-1,+1) \\
Holdout/Consent & (1,-1) & (-3,-3) \\
\hline
\end{tabular}

In our situation, a creditor's holdout is equivalent to driving straight and a creditor's consent is equivalent to swerving. A debt readjustment agreement is beneficial to all parties involved (just like swerving), but it is better for minority creditors to try to hold out 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 as a "chicken" in order to maximize his or her own payoff. \textit{See ANDREW M. COLMAN, GAME THEORY AND ITS APPLICATIONS IN SOCIAL AND BIOLOGICAL SCIENCES 111-12 (1995).}

\textsuperscript{67} \textit{Hearings on HR 1670, HR 3083, HR 4311, HR 5009 and HR 5267 Before the House Comm. on the Judiciary, 73d Cong. 45 (1933)} (statement of David M. Wood) ("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.").

\textsuperscript{68} In game theory, this type of situation is usually depicted as a "chicken game," a game of who breaks down first, which can be described as follows. Two people drive towards each other on a narrow road. The first to swerve loses face among his or her peers (and suffers a damage of -1), while the one who does swerve gains (and gains +1). If neither swerves, however, they collide (and each suffers damages of -3). If both swerve, there is no effect. The consequences of the players' actions can be described by a two-by-two matrix.

\textsuperscript{69} \textit{Amendment of Bankruptcy Laws – Bankruptcy of Municipalities, supra note 63, at 14.}

\textsuperscript{70} If a majority, rather than a unanimous, 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 decisionmaking process can be achieved. \textit{See Zohar Goshen, Controlling Strategic Voting: Property Rule or Liability Rule?, 70 S. CAL. L. REV. 741, 792 (1996).}

\textsuperscript{71} \textit{See U.S. CONST. art. I, § 10.}

\textsuperscript{72} Municipal Bankruptcy Act of 1934, Pub. L. No. 251, 48 Stat. 798 (1934) [hereinafter 1934 Municipal Bankruptcy Act]; Dession, \textit{supra note 65; Sanders Shanks Jr., The Municipal Bankruptcy Act (Summers Wilcox Bill), 28 AM. POL. SCI. REV. 1072 (1934).}
Chapter IX, though, 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. 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. There was no automatic stay, no cram down, and generally, the chapter offered insolvent localities no assistance unless a holdout occurred. 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.

Two years after the legislation’s enactment, the Supreme Court decided Chapter IX was unconstitutional. 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. The revised act amended certain provisions of the 1934 legislation, but the concept remained the same: Chapter IX facilitated the execution of debt readjustment agreements that municipalities and the majority of their creditors had reached prior to the bankruptcy filing. This concept of municipal bankruptcy remained unchanged until the 1970s.

---

73 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. 1934 Municipal Bankruptcy Act § 80(a). Second, after the filing, a second vote took place, with approval of seventy-five percent of the creditors required. Id. § 80(d). 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. Id. § 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.

74 Shanks, supra note 72, at 1072.
75 1934 Municipal Bankruptcy Act § 80(a).
76 Dession, supra note 65, at 215.
77 Among the supporters of the act were "municipal officials, investment bankers, bondholders protective committees," and scholars. See id. at 214. After its enactment, the chapter was considered a success by bond attorneys and others involved in municipal debt readjustment work. Shanks, supra note 72, at 1073.
78 Ashton v. Cameron Water Improvement Dist. No. 1, 298 U.S. 513, 532 (1935) (determining that Chapter IX invaded state sovereignty in violation of the Tenth Amendment to the Constitution).
80 One important change was in the number of consents needed for confirmation of a plan, which was reduced from 75% to 66.67%. Compare 1937 Municipal Bankruptcy Act § 83(d), with 1934 Municipal Bankruptcy Act § 80(d).
B. The 1970s Amendment

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). The national economic situation adversely affected local governments’ financial condition. On the one hand, because of inflation, municipal expenditures, and especially labor expenses, increased. On the other hand, the slow business activity and high unemployment caused municipal tax bases to shrink. This double negative effect drove many municipalities into severe financial difficulties.

The most important and serious crisis took place in New York. 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. In April 1975, at the height of the New York crisis, the financial markets refused to extend the city any more credit, and New York did not have the funds to pay for its debt service or basic operating expenses. 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 headline phrased it, “Ford to City: Drop Dead.” Instead of federal assistance, President Ford recommended that New York use municipal bankruptcy proceedings to solve its financial problems. The idea was that
Chapter 9 of the Bankruptcy Code

just as corporations use bankruptcy law to deal with their financial troubles, so could New York.\textsuperscript{90}

However, for the same reasons explained earlier, Chapter IX, essentially unchanged from the form it took in the 1930s, was unable to help 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.\textsuperscript{91} New York needed to recover from its financial troubles, but municipal bankruptcy was meant to solve only a holdout problem—a problem that neither New York nor other municipalities suffered from at that time. Chapter IX, therefore, was of no use to New York, and it generally seemed too old and "archaic" for cities to use.\textsuperscript{92}

Thus, with the purpose of trying to help New York City, Congress amended Chapter IX of the Bankruptcy Act.\textsuperscript{93} 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 adopted a comprehensive bankruptcy procedure designed to help distressed localities, such as New York, survive and deal with financial crises.\textsuperscript{94} 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,\textsuperscript{95} even if they did not prepare a debt readjustment agreement, and even if the majority of the creditors opposed the filing.\textsuperscript{96} 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.

\textsuperscript{90} See id.
\textsuperscript{91} See id.; see also Local Government Financial Emergencies, supra note 42, at 38.
\textsuperscript{92} H.R. REP. No. 94-686, at 4 (1975) (explaining the need to amend the municipal bankruptcy procedure as follows: "[t]he procedure is hopelessly archaic and unworkable for all but the smallest entities"); see also Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32, Before the Subcomm. on Civil and Constitutional Rights of the H. Comm. on the Judiciary, 94th Cong. 634 (1975) [hereinafter Hearings on H.R. 31 and H.R. 32] (Representative Badillo explained: "The reason that it is urgent to make this 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.").
\textsuperscript{93} Bankruptcy Reform Act, Pub. L. No. 94-260, § 85(e), 90 Stat. 315 (1976) [hereinafter Bankruptcy Reform Act].
\textsuperscript{94} S. REP. No. 94-458, at 13 (1975) ("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.").
\textsuperscript{95} This assumes the thresholds mentioned supra in note 22 are met.
\textsuperscript{96} H.R. REP. NO. 94-686, at 6 (1975).
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 bankruptcies as omnibus corporate-like proceedings, the pre-filing approval requirement had to be eliminated.

Secondly, the bankruptcy procedures themselves changed: the amended Chapter IX created an automatic stay to prevent creditors from seizing municipal property; 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; it contained provisions that allowed municipalities to receive new financing at the expense of their old creditors; it allowed municipalities to reject and assume executory contracts; and more. 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. For example, Lawrence King, then one of the leading bankruptcy experts in the United States, expressed this view when he explained to Congress the need for a cram down provision in municipal bankruptcy:

*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.*

Two years later the chapter was again amended, but the 1978 revision was essentially technical. Since the entire Bankruptcy Act was revised that

---

97 *Hearings on H.R. 31 and H.R. 32, supra note 92, at 641 (statement of Professor Lawrence King)* (“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 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.”).

98 Bankruptcy Reform Act § 85(e).

99 Id. § 94.

100 Id. § 82(b)(2).

101 Id. § 82(b)(1).

102 *See King, supra note 12.*

103 *Hearings on H.R. 31 and H.R. 32, supra note 92, at 642 (statement of Professor Lawrence King)* (emphasis added).
year, creating the Bankruptcy Code, there was a need to amend Chapter IX to reflect the changes made in Chapter 11.\textsuperscript{104} 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.\textsuperscript{105} 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:

\begin{quote}
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.\textsuperscript{106}
\end{quote}

And as we have seen, this is exactly the way Chapter 9 is constructed—a corporate bankruptcy procedure \textit{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 argue that due to the special nature of municipal corporations, the application of bankruptcy law is problematic and does not yield very good results. To substantiate 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.

\textsuperscript{104} H.R. REP. No. 95-595, at 262 (1977), \textit{reprinted in} 1978 U.S.C.C.A.N. 5963, 6220 ("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.").


\textsuperscript{106} H.R. REP. No. 95-595, at 263.
A. The Contractual Theory of Corporate Bankruptcy

The most common rationale given for corporate bankruptcy law is the contractual theory of bankruptcy—the creditors' bargain theory. According to this theory, bankruptcy is designed to improve the debt collection system when the debtor is insolvent, thereby facilitating a cheaper extension of credit.

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. Thus each creditor has an interest in being the first to grab assets—otherwise he runs the risk of being last in line to the debtor's assets and recovering 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 debtor as a going concern. 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 maximizes their value for the creditors' group as a whole. 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' group to maximize the value they receive from insolvent debtors.


108 Modern approaches to bankruptcy law reject the creditors' bargain theory, and offer more market-based approaches. See, e.g., 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.

109 See sources cited supra in note 107.

110 Thomas H. Jackson, Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Non-Bankruptcy Rules, 60 AM. BANKR. L.J. 399, 401-02 (1986).

111 Id.; see also Jackson, supra note 107, at 860-62.

112 The options are either piecemeal liquidation or keeping the entire business as a going concern. See Jackson, supra note 107, at 861-68; see also Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 1-19 (1986).
Chapter 9 of the Bankruptcy Code

and, as a result, to decrease the price they demand for the extension of credit.113

Municipal bankruptcy, however, cannot be rationalized in the same manner. As opposed to corporate bankruptcy, the municipal bankruptcy process does not benefit the creditors; 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.114 Execution, if allowed at all, is limited to assets that are unnecessary to the municipality’s public functions, and public assets (that is, assets used or held by the city for public purposes) are out of the creditors’ reach.115 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.116 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.117

Moreover, municipal bankruptcy law does not just 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


114 Estate of DeBow v. City of E. St. Louis, 592 N.E.2d 1137, 1144 (Ill. App. Ct. 1992) (“The rationale... which support[s] 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.”). Of note, the prohibition includes not only tangible assets, such as cars, streets, and buildings, but also municipal financial assets. See Lee v. City of Fairfield, 145 So. 669 (Ala. 1933); Capps v. Citizens Nat'l Bank, 134 S.W. 808 (Tex. Civ. App. 1911); ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE § 5.4.4, at 252 (1992).


116 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 Obligations of Public Corporations, 33 COLUM. L. REV. 28 (1933); Note, Creditors' Remedies in Municipal Default, 1976 DUKE L.J. 1363.

117 But cf. JACKSON, supra note 112, at 209 (“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.”).
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 law remedy called mandamus to raise taxes allows 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.\textsuperscript{118} 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 constructed, and the court cannot instruct the locality to levy more from the residents.\textsuperscript{119} 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. The cost of credit for municipalities may even increase because the creditors price the adverse effects that the bankruptcy process may bring.

\textbf{B. A Fresh Start Theory}

Since the creditors’ bargain theory, the founding narrative of corporate bankruptcy thought,\textsuperscript{120} 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, which helps it to recover and resume financial stability.\textsuperscript{121}

According to this theory, Chapter 9 offers a distressed locality the opportunity to negotiate a debt readjustment agreement from a position of

\textsuperscript{118} 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 AMDURSKY & GILLETTE, \textit{supra} note 114, § 5.4.1; HILLHOUSE, \textit{supra} note 58, at 279-80; and McQUILLIN, \textit{supra} note 115, § 49:50.
\textsuperscript{120} Ayer, \textit{supra} note 107, at 66.
\textsuperscript{121} McConnell & Picker, \textit{supra} note 9, at 469-70. 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 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 on hard times. \textit{Cf.} BAIRD, \textit{supra} note 31, at 34-35.
power. As explained earlier, bankruptcy vests in the locality certain rights and privileges, which enable it to pressure its creditors into concessions.\textsuperscript{122} The locality's leverage over the creditors derives from several sources. First, due to the automatic stay, 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 city.\textsuperscript{123} Second, within bankruptcy the city 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.\textsuperscript{124} Bankruptcy then allows the city to unilaterally terminate these agreements, thereby reducing the spending on employment.\textsuperscript{125} Third, bankruptcy enables the city 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.\textsuperscript{126}

These "bankruptcy privileges" enable a locality to pressure, or even to force, its creditors to waive part of its debts or at least to extend the debt's 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 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 and continue on a route to financial recovery.\textsuperscript{127}

\textsuperscript{122} See discussion supra Section II.A.
\textsuperscript{123} For more on the effects of the automatic stay in corporate bankruptcy, see Lucian A. Bebchuk, \textit{Ex Ante Costs of Violating Absolute Priority in Bankruptcy}, 57 J. Fin. 445, 445 (2002). The pressures in municipal bankruptcy are even worse 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.
\textsuperscript{125} \textit{In re} City of Vallejo, 403 B.R. 72 (Bankr. E.D. Cal. 2009); Dahl, supra note 12.
\textsuperscript{126} See supra notes 31-34 and accompanying text.
\textsuperscript{127} Dahl, supra note 12, at 322-23; King, supra note 12, at 1175 ("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."); McConnell & Picker, supra note 9, at 469-70.
Notwithstanding this argument, 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 a 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. Economic distress occurs when the corporation's revenues are 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. 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.

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.

129 Baird, supra note 128, at 580; Rasmussen & Skeel, supra note 128, at 87.
130 Baird, supra note 128, at 580-81; Rasmussen & Skeel, supra note 128, at 88.
131 Rasmussen & Skeel, supra note 128, at 87-88; see JACKSON, supra note 112, at 2.
In the context of a commercial corporation, 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 economically distressed firm, so that other businesses that offer better products and services can 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.\textsuperscript{132}

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, and water and sewage), 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.\textsuperscript{133} 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.\textsuperscript{134}

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 municipal financial crisis will enable us to consider whether a debt readjustment process 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 that lead to local fiscal crises is not within the scope of this Article, 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.

\textsuperscript{132} Baird, \textit{supra} note 107, at 183; Rasmussen & Skeel, \textit{supra} note 128, at 87-88.

\textsuperscript{133} \textit{Cf.} Estate of DeBow v. City of E. St. Louis, 592 N.E.2d 1137, 1140-42 (Ill. App. Ct. 1992) (explaining the prohibition of execution upon municipal property and stressing the municipality's responsibility to provide public services to its residents). For more on this, see sources cited \textit{supra} note 114.

\textsuperscript{134} Schwarcz, \textit{supra} note 12, at 1197-98.
2. Why Do Cities Go Broke?

The analysis of the reasons for cities' financial deterioration starts with the notion, which is perhaps counterintuitive, 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 any other public official, but rather by deeper, more structural reasons. These reasons can be divided into two main categories: socioeconomic reasons and local political reasons.

The socioeconomic 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. 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 may even increase if inflation strikes—and welfare costs, largely due to growing unemployment, are on the rise. These processes create deficits that can escalate to a local fiscal crisis.

An additional socioeconomic 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 taxpaying residents who have moved, and it suffers a significant decrease in revenues as a result. Second, the vacuum created by those who have left often leads to greater

---

135 HELEN F. LADD & JOHN YINGER, AMERICA'SAILING 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.").


138 KAMER, supra note 82, at 40-43.

139 Id.

140 Research shows that events of municipal defaults are closely related to the country's business cycles. Not surprisingly, the greatest amount of defaults occurs during periods of recession. See Cohen, supra note 59, at 55.

141 James, supra note 84, at 26.

142 KAMER, supra note 82, at 26.
unemployment and to the in-migration of poorer populations.\textsuperscript{143} Consequently, city welfare and police costs grow, notwithstanding the city's dwindling income.\textsuperscript{144} 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.\textsuperscript{145}

Another important socioeconomic 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 (for example grants, shared taxes, and loans) that constitute a considerable portion of the local income.\textsuperscript{146} Changes in state policies, and in particular in the amount of intergovernmental transfers, inevitably affect the local budget, and may cause a local crisis.\textsuperscript{147} With regard to the expenditure side, states often impose state mandates on their localities. These mandates compel localities to provide certain services to their

\textsuperscript{143} Id.


\textsuperscript{145} A major process of suburbanization took place in the United States during the 1960s and 1970s. In those years, manufacturing, 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 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 Kamer, supra note 82, at 25-35; James, supra note 84, at 26-27; see also Kurt Schlichting, Decentralization and the Decline of the Central City: A Case Study of Demographic and Economic Change in Bridgeport, Conn., 40 Am. J. Econ. & Soc. 353 (1981) (discussing the case of Bridgeport, Connecticut); Shalala & Bellamy, supra note 85, at 1119-20 [discussing suburbanization in the New York City area]. The suburbanization trend continued also during the 1990s, and into the twenty-first century. See John D. Kasarda et al. Central-City and Suburban Migration Patterns: Is a Turnaround on the Horizon?, 8 Housing Pol'y Debate 307, 343 (1997); Jack Ochs, The Roots of Pittsburgh's Financial Crisis, Pittsburgh Econ. Q., Dec. 2005, at 1, available at http://www.ucsur.pitt.edu/files/peq/peq_2005-12.pdf; 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).


\textsuperscript{147} Robert P. Inman, How To Have a Fiscal Crisis: Lessons from Philadelphia, 85 Am. Econ. Rev. 378, 380-83 (1995) (showing 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); see also Problems of Urban America, supra note 137, at 242.
residents—services that the localities, if left to their own devices, would not necessarily provide, or would provide at a lower cost. The mandates reduce the localities’ flexibility in managing their budgets, and localities are forced to follow them even in times of financial difficulties. States that impose too many mandates, and do not give their localities the ability or the funds to finance them, contribute to local economic deterioration.

However, in addition to these external socioeconomic 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. 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. Political fragmentation measures the


149 LADD & YINGER, supra note 135, 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 148, at 1360-61.

150 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, left office, and served a prison term. Camden’s mayor from 1994-1997, Arnold W. Webster, was voted out of office after a 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, Note, Solving Camden’s Crisis: Makeover or Takeover?, 33 RUTGERS L.J. 185, 190 n.31 (2001).

degree to which the cost of a dollar of aggregate expenditure is internalized by the individual decisionmaker in the government. The greater the political fragmentation in a locality, the more likely a financial crisis is to occur.\footnote{Perotti & Kontopoulos, supra note 151, 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.\footnote{Id. at 195; see also von Hagen & Harden, supra note 151, at 772-77; Ricciuti, supra note 151, at 369-71.} The intuition behind this observation derives from the well-known common pool problem.\footnote{Wolff, supra note 151, at 5; Hallerberg & von Hagen, supra note 151, at 6.} The city budget can be viewed as a common resource controlled by the different groups that comprise the city 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. However, 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.\footnote{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, 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 151, at 5. The same rationale of course applies not only to users of public facilities, but also to many other local groups who enjoy a restricted benefit financed by the local public budget (such as districts, religious groups, and racial groups).}

In addition, due to the fragility of the coalition, interest groups play a dominant role in a fragmented political environment. Interest group support is essential for both forming and sustaining the local coalition, and so politicians are more susceptible to the groups' financial demands.\footnote{Ricciuti, supra note 151, at 370; Wolff, supra note 151, at 9-17. For a more general account of interest group influence in politics, see Dennis C. Mueller, Public Choice III, at 475-97 (2002).} By definition, however, interest groups represent only a certain 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 a whole. Thus, when interest groups have a hold on the local financial decisionmaking, the locality will have difficulties in implementing retrenchment measures.\footnote{Valesco, supra note 151, at 122; Wolff, supra note 151, at 9-17; see also Ester R. Fuchs, Mayors and Money: Fiscal Policy in New York and Chicago 230-72 (1992). Fuchs provides a detailed and in-depth account of interest group 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}
Usually a local fiscal crisis is the result of a combination of both socioeconomic processes and political circumstances. The socioeconomic 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 arise. 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.158

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

Take, for example, the socioeconomic reasons that lead to a local crisis. These reasons are usually external to the municipality and involve state or even nationwide 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, and it has no effect on the intergovernmental funds that the city receives or on the extent of unfunded mandates the state imposes. All of these issues should be addressed at state or federal levels, and a simple decrease in 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 political structure, and many times they became a part of the city's formal budgetary decisionmaking. 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 its financial means. The power of interest groups, therefore, was one of the main causes for the city's crisis. For more, see Nivola, supra note 124, at 384. Nivola shows that the level of unionization among city employees is significantly correlated with local fiscal strain.

158 Cf. Fuchs, supra note 157, at 5-7. Fuchs demonstrates the political environment's contribution to the development of a local fiscal crisis by pointing out the differences between Chicago and New York in the 1970s. Although the two cities experienced similar socioeconomic processes, New York underwent a severe fiscal crisis, whereas Chicago stayed in relative financial health. Fuchs also argues that the reason for the difference 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.
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 decisionmaking 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 Macks Creek, for example, filed for bankruptcy in 1998 and filed a second time in 2000,159 and it contemplated a third bankruptcy in 2004.160 The city of Westminster, Texas filed in 2000, and only four years later it filed again.161 The city of Prichard, Alabama filed for bankruptcy at the end of 1999, came out of the bankruptcy only in 2007, and as of this writing, talks of a new bankruptcy filing have resumed.162 Without addressing the cities' core problems, the bankruptcy filings offered no help, and the cities' situations 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 $16 million budget deficit for the years 1991-1992, and its residents were burdened with the highest effective tax rate in the state.163 Bridgeport was unable to finance adequate levels of public services, and even basic services, such as police protection and street cleaning, were not properly provided.164 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 that bankruptcy could do more harm than good. Richard Blumenthal, then Connecticut's Attorney General, explained to Congress the reasons for the state's objection:

159 CM/ECF, supra note 42 (providing data on the Western District of Missouri); see also John Rogers, Income Law Puts Speed Trap Town on Fast Track to Bankruptcy, ST. LOUIS POST-DISPATCH (Mo.), July 19, 1998, at C1.
161 CM/ECF, supra note 42 (providing data on the Eastern District of Texas); see also Texas Town Takes a Tumble, 43 BCD NEWS & COMMENT 5, July 21, 2004.
164 Id.
The solutions offered by Chapter 9—a restructuring of debt obligations—may help smaller cities or towns that face short term, totally unanticipated financial calamities such as a 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 9.165

Chapter 9 is not only an unsuitable mechanism for helping distressed localities; it may very well aggravate their situations. 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.166 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.167 Indeed, bankruptcy filing jeopardizes the very resource 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 have negative implications for the state. As explained earlier, states have a tremendous impact on the financial condition of their localities, and they significantly

---


166 Cf. H.R. Rep. No. 94-686, at 56 (1975) (separate views of Hon. Elizabeth Holtzman on H.R. 10,624) (expressing doubts about the wisdom of the 1976 amendments). Holtzman said: "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." Id.

167 See Economic Distress in Our Cities, supra note 165, at 162 ("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 market. Ironically, the very ability to borrow—crippled or killed by the filing of a bankruptcy petition—may be a key element in rescuing a city in crisis.")
influence both local revenues and expenditures.168 Due to this strong link between state and 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 that more local crises will occur in the future, and may cause the creditors to reevaluate 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, especially on public issuers within California.169 Following the bankruptcy, there was a considerable decrease in the value of many 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.170 The claim also echoes the positions of states with regard to municipal bankruptcy filings. Many states object to Chapter 9 filings,171 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

---

168 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), particularly with regard to the services that localities provide. See supra note 146 and accompanying text; see also JOHN E. PETERSSEN, C. WAYNE STALLINGS & CATHERINE LAVIGNE SPAIN, STATE ROLES IN LOCAL GOVERNMENT FINANCIAL MANAGEMENT: A COMPARATIVE ANALYSIS 1-4 (1979); Jeffrey M. Stonecash, The Politics of State-Local Fiscal Relations, in GOVERNING PARTNERS: STATE-LOCAL RELATIONS IN THE UNITED STATES 75 (Russell L. Hanson ed., 1998).


170 Denison, supra note 169, at 36; Halstead et al., supra note 169, at 313. The Orange County example is particularly interesting because at first glance the county’s financial troubles seemed unrelated to the financial situation of other local governments in the state. The bankruptcy occurred due to bad investments made by Orange County’s treasurer Robert Citron—investments made without the state’s approval and without proper financial disclosure. BALDASSARE, supra note 52, at 13. 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. See id. 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 id.

adverse effects on the credit markets all over the state, and they do not want to incur these costs.\textsuperscript{172}

This analysis of the effects of municipal bankruptcy sheds light on the municipal bankruptcy filing data that were described earlier in this Article. First, it explains why there are so few bankruptcy filings in the first place. If Chapter 9 offers little in the way of rehabilitation, while aggravating 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 inclined to file, like in the cases of Camden, New Jersey or Bridgeport, Connecticut. Unlike 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—that 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 corporate bankruptcy's logic collapses when applied to municipalities. A bankruptcy process that focuses on the

\textsuperscript{172} See, e.g., Weekend All Things Considered (NPR Radio Broadcast Feb. 9, 1997) (interviewing 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." \textit{Id.}; see also Mike Williams, 'Bankruptcy Not an Option' in Solving Miami's Fiscal Crisis, ATLANTA J.-CONST., Dec. 17, 1996, at 18D. Williams interviewed Lieutenant Governor Buddy MacKay, then the head of Miami's state oversight board, about the Miami fiscal crisis. MacKay said: "Bankruptcy is not an option. That could have repercussions in the financial markets for the state and its other local governments as well." \textit{Id.}; see also New York State Financial Emergency Act for the City of New York, 1975 N.Y. Sess. Laws 868 (McKinney).
readjustment of debt may be sufficient to help a financially distressed commercial corporation that, but for liquidity problems, can properly function in the marketplace. But it is not sufficient to help localities that suffer from systemic problems that are associated with grand socioeconomic 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 Part I argue that the answer is yes. A proactive supervision system of local finance by the state can help rehabilitate distressed localities, and, even more important, it can help prevent local fiscal stress from becoming a crisis.173

In order to efficiently supervise local finances, the state should evaluate the localities’ condition on an ongoing 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.174

In this Part, I examine state supervision and intervention actions as a solution to local fiscal distress. The analysis has two main components. First, I explain why, 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. 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

173 For more analysis of the advantages of state intervention, see Kimhi, supra note 12, at 664-83.
174 See id.
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. 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 of 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.

Consider the socioeconomic factors that cause local crises. These factors are external to the locality, and involve state or even nationwide processes. The local officials may be unable or unwilling to cope with these processes alone, but the state, with its plenary power and resources, can help the city adapt to the socioeconomic changes and prevent financial deterioration.

Perhaps the most important cause of local stress, certainly today, is a national recession. Macroeconomic trends, like unemployment, inflation, low private-income growth, and decreased real estate prices, severely affect local governments, and, if not properly dealt with, can cause severe local stress. The state and federal governments, therefore, should take measures that mitigate the recession's effects on localities, and should especially implement countercyclical policies that battle the macroeconomic swings. One such measure, suggested by Robert Inman, is countercyclical revenue-sharing aid. This aid protects cities against the excessive effects of a recession and helps them to create jobs and economic development. In order not to overcompensate 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

177 For a seminal paper, see William J. Baumol, Macroeconomics of Unbalanced Growth: The Anatomy of Urban Crisis, 57 AM. ECON. REV. 415, 426 (1967).
179 Id. at 137 & n.23 (citing the President's 1978 National Urban Policy Report that proposed exactly the same policy).
Chapter 9 of the Bankruptcy Code

index, so as to connect the city’s growth loss to the funds offered as relief. Another possible measure—one that does not require substantial state investments—is mandatory creation of a Budget Stabilization Fund (BSF), also called a rainy day fund. 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 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. The BSF enabling legislation institutionalizes the countercyclical 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 instruction. 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 later.

The state also can 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 resources 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. 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. Another way to force the suburbs to share the city’s 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

---

180 See id. at 137.
182 Id. at 737.
183 Id.
184 The authority to reform the local tax system is usually reserved for the state. See NEEDS FOR STATE CLARIFICATION, supra note 146, at 14.
185 Cleveland, for example, entered a severe fiscal crisis in 1979, when 75% 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 the wage tax from 1.0% to 1.5% on March 1, 1979, and then from 1.5% to 2.0% on March 1, 1981. See Actions Taken by Five Cities, supra note 46. 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%. See id. at 81. The same is also true of Pittsburgh, which underwent a crisis in 2003. Pennsylvania’s lawmakers approved a major tax reform that generated $35-40 million from the city’s employees, many of whom were non-residents working in the city. See Adam L. Cataldo, Pittsburgh Tax Reform Could Raise Extra $35M in 1st Year, BOND BUYER, Nov. 23, 2004, at 6.
both parts of the city and parts of the suburbs. 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.

In addition, the state can address the crisis’s 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 from the local elected officials.

The creation of the state board changes the locality’s political environment. If prior to the state’s intervention, the city’s decisionmaking process was fragmented and lacked central control, the establishment of a board reduces the fragmentation by centralizing the decisionmaking process. The board becomes the supreme financial authority in the city. It sets limits to the city’s expenditures, and makes sure that local officials do not overspend. The board’s instructions must be followed, because otherwise the city and its officials may face severe sanctions. Since the board is not dependent on popular support, it is able to make unpopular decisions and endure pressure from interest groups. As a result, the board is politically capable of cutting unnecessary public services, negotiating cheaper labor contracts, or eliminating city jobs. The board’s existence

186 McQuillin, supra note 115, § 2.28.
187 Fuchs, supra note 157, at 192-94. 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.
188 Actions Taken by Five Cities, supra note 46, at 46-56.
189 See supra notes 151-158 and accompanying text.
190 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 151, at 1347-51. Regarding macroeconomic policy, see also Perotti & Kontopoulos, supra note 151, at 196-97; and Hallerberg & von Hagen, supra note 151, at 4-5.
192 The power of state boards in this respect is evident from their ability to cut the city’s expenditures, and especially its labor costs. Labor unions often have a paralyzing grip on the city’s officials. See Nivola, supra note 124. 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). Cyr describes 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 a year the state receiver was able to rehabilitate Chelsea, after twenty years of financial hardship. Id. For more on state interventions into relations between unions and municipalities, see ROBERT W. BAILEY, THE CRISIS REGIME: THE MAC, THE EFCB, AND THE POLITICAL IMPACT OF THE NEW YORK CITY FINANCIAL CRISIS 68-91
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.\textsuperscript{193}

Indeed, as opposed to a bankruptcy process, the state intervention process addresses the core causes of the city’s financial crisis. The state’s legal powers and financial resources can help the city deal with changing socioeconomic 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 $34 million budget deficit, and a large amount of debt—$879 million, or $2627 per resident.\textsuperscript{194} In order to avoid bankruptcy, the state created a 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.\textsuperscript{195} In addition, in order to address a massive suburbanization process, the board recommended a reform of 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.\textsuperscript{196} Within a year the city eliminated its deficit, and was able to return to the credit markets.\textsuperscript{197} 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 teetering on bankruptcy in 2003-2004, was the only city considered in the study not looking at a deficit for fiscal year 2009 or 2010.\textsuperscript{198} This is of course not to say that states can magically cure a distressed locality. The recovery of a distressed locality may be a long process, and naturally the state's powers are also limited. Nevertheless, state intervention seems superior to bankruptcy. It addresses the causes of the financial deterioration, and it does not entail the severe reputational costs that a bankruptcy procedure does.

The local rehabilitation, however, does not come without a price. The coin with which the locality pays for its recovery is a temporary loss of its local autonomy due to the state's intervention in its local affairs. During the time a board is in place, the locality must comply with the board's instructions, and the local officials may be prohibited from taking certain actions.\textsuperscript{199} The infringement on the local autonomy is particularly problematic, since the board members are nominated and not elected by the residents. The board members are not politically accountable to any constituency, and are not required to respect the residents' preferences for public goods and services.

To mitigate these adverse effects, some states enacted special statutes that detail when and how the state can intervene to help a distressed locality.\textsuperscript{200} These statutes specify certain financial conditions that indicate the occurrence of a potential local crisis and justify state action to prevent

\textsuperscript{196} Cataldo, supra note 185, at 6.

\textsuperscript{197} Robert Whalen, \textit{Steel City's BBB Deal}, BOND BUYER, May 8, 2006, at 37 ("In its rating report, Fitch attributes the city's improved finances to tax structure changes and assistance from two oversight panels.").

\textsuperscript{198} TOUGH DECISIONS, supra note 1, at 5. Other cities studied in the report were: Detroit, Columbus (Ohio), Phoenix, Kansas City (Missouri), Chicago, Los Angeles, New York, Philadelphia, Atlanta, Boston, Baltimore, and Seattle. \textit{Id.} at 4.

\textsuperscript{199} Boards usually approve a rehabilitation plan for the distressed locality, and make sure that the locality adheres to the plan's instructions. In addition, boards have the power to limit the city's expenditures, to enable the city to borrow or to prevent it from borrowing, to approve or veto the city's budget, to approve or disapprove new contracts, to order cuts in the city's staff, and more. See Pennsylvania Intergovernmental Cooperation Authority Act for Cities of the First Class, 53 PA. CONS. STAT. ANN. § 12720.101-.709 (West 1991) (specifying authorities of Philadelphia's oversight board); New York State Financial Emergency Act for the City of New York, 1975 N.Y. Sess. Laws 1408-44 (McKinney) (specifying authorities of the New York Emergency Financial Control Board). See generally Actions Taken by Five Cities, supra note 46, at 52-53.

\textsuperscript{200} See, e.g., NEV. REV. STAT. § 354.685 (2007); OHIO REV. CODE ANN. § 118.022-.03 (LexisNexis 2007); Municipalities Financial Recovery Act, 53 PA. CONS. STAT. ANN. § 11701.201 (West 1997).
Chapter 9 of the Bankruptcy Code

further deterioration. Pursuant to these statutes, the state can only intervene when the financial conditions are met, and can only take the actions permitted by the statute. This decreases the chances of arbitrary interventions, and enables better judicial review of the state's actions.

B. The Gains from State Fiscal Oversight

An additional concern about the 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 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. 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. They would prefer that the state's scarce resources be spent on their own

---


202 In addition, the financial indicators are able to predict forthcoming crises, enabling the state to take action before the local distress becomes a full blown crisis. See Kloha et al., supra note 201, at 236-37.

203 Cf. Zelinsky, supra note 148, at 1374-75. Zelinsky explains that the general public does not appreciate the link between its municipal tax bills and its 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.

constituencies, 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.\textsuperscript{205}

This conception, however, is wrong and harmful. As will be demonstrated in the following paragraphs, 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 there is a lower risk of local default, and correspondingly, credit prices for public issuers decrease.\textsuperscript{206}

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.\textsuperscript{207} Most of the local governments are rural, and they have a limited tax base and limited revenue sources.\textsuperscript{208} In 2007 the median household income in the state was ranked thirty-eighth in the country,\textsuperscript{209} and the per capita bankruptcy filing rate was the thirteenth

\begin{flushright}
\textsuperscript{205} Margaret Weir, \textit{Central Cities' Loss of Power in State Politics}, 2 \textit{Cityscape: J. Pol'y Dev. & Res.} 23, 23-24 (1996) ("Increasingly, [s]tate 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 themselves and more dependent on outside assistance. These changes have made it more difficult to build policy coalitions that address urban problems....").
\end{flushright}

\begin{flushright}
\textsuperscript{206} Cf. Dennis Epple \& Chester Spatt, \textit{State Restrictions on Local Debt: Their Role in Preventing Default}, 29 \textit{J. Pub. Econ.} 199 (1986). Dennis Epple and Chester Spatt argue that a default of one local government may affect the interest rates of other local governments in the state as well. \textit{Id.} at 219. 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. \textit{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.
\end{flushright}

\begin{flushright}
\end{flushright}

\begin{flushright}
\textsuperscript{208} North Carolina has 7 local governments with a population of more than 100,000 residents; 19 local governments with populations between 25,000 and 99,000 residents; 44 local governments with populations between 10,000 and 24,999 residents, with the rest having less than 10,000 residents. See id.
\end{flushright}

\begin{flushright}
\end{flushright}
highest. But despite these unfavorable financial conditions, North Carolina's local governments are among the healthiest in the country. The state has the highest number of AAA or equivalently rated local governments, and the localities are charged lower interest rates even when compared with equally rated local governments from other states. The reason for local government success in North Carolina is close state oversight. North Carolina created a special state agency to supervise local government finances, the Local Government Commission (LGC), and the agency monitors local governments and ensures their financial stability.

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 debt securities. 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. 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


212 Coe, supra note 211; Fahim, supra note 211.

213 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 211, at 41; see also N.C. DEPT OF STATE TREASURY, THE STATE TREASURER'S ANNUAL REPORT FOR FISCAL YEAR 2007-2008, at 58-60 [hereinafter STATE TREASURER'S ANNUAL REPORT 2008]; 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).

214 See STATE TREASURER'S ANNUAL REPORT 2008, supra note 213, at 60-61; Carter, supra note 213, at 78-80; Coe, supra note 211, at 41-45. To improve its evaluation, as early as the 1970s the Commission had created a database of local financial information, which facilitates time-trend analysis and comparisons 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 P. LARKIN & JEFF SCABA, STATE OF NORTH CAROLINA LOCAL GOVERNMENT COMMISSION: CREDIT ENHANCEMENT PROGRAM REVIEW, FITCH IBCA TAX SUPPORTED SPECIAL REPORT 4 (2009), available at http://www.nira.or.jp/past/news/seisakuf/04/siryou/08.pdf [hereinafter FITCH REPORT].
has the authority to assume financial control, and to take over the management of the locality.\textsuperscript{215}

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.\textsuperscript{216} Due to the LGC's supervision, the Fitch rating agency formally enhances the credit rating of all North Carolina public issuers rated below "AA" by one or two steps,\textsuperscript{217} and other credit rating agencies, even if they do not have a formal credit enhancement policy, look favorably on North Carolina's local debt.\textsuperscript{218} The improved credit rating, in turn, translates into huge savings in interest. The cumulative interest savings by North Carolina's local governments reach millions of dollars every year, sometimes tens of millions—\textsuperscript{219}—a sum of money far greater than the costs of the state supervision system.\textsuperscript{220} These 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 does not waste taxpayers' money, but also can save it. State oversight improves local fiscal health, affords healthier and better managed

\textsuperscript{215} One such case was the LGC's takeover of the city of Princeville. See Fitch Report, supra note 214; Rob Christensen, A Big Government Idea That Makes Conservatives Proud, NEWS \& OBSERVER (Raleigh, N.C.), Jan. 12, 1998, at A3.

\textsuperscript{216} Coe, supra note 211; Fahim, supra note 211.

\textsuperscript{217} See Fitch Report, supra note 214, at 1 ("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.").

\textsuperscript{218} Tedra DeSue, Moody's: North Carolina Counties Come Out on Top, BOND BUYER, July 12, 2000, at 4 ("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."); see also Coe, supra note 211, at 40 n.4.

\textsuperscript{219} 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, Coe reaches the conclusion that local governments save $6.75 million annually in interest payments. See Coe, supra note 211, at 46. A different calculation was performed by North Carolina's Treasury. In 2003-2004 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 2003-2004 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. DEP'T OF STATE TREASURY, THE STATE TREASURER'S ANNUAL REPORT FOR FISCAL YEAR 2003-2004, at 29.

\textsuperscript{220} The LGC's fiscal year 2006 budget was $2,619,761. See Coe, supra note 211, at 45.
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.

Conclusion

If the rehabilitation of distressed municipalities can be better achieved through state intervention actions, and if filing for Chapter 9 has adverse effects on both the locality and the state, then perhaps we should reexamine the purpose of municipal bankruptcy. As 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 for state policies. As President Ford suggested with respect to New York City, states should not rely on Chapter 9 to save their cities, but rather they should proactively monitor the local finances and get involved to the extent necessary. This Article demonstrates the benefits of such state policy, especially when compared to the adverse effects filing for bankruptcy might have.

---

221 The California legislature, for example, is currently debating its policy on municipal bankruptcy. Under a recently proposed bill, California lawmakers suggest making it more difficult for municipalities to file for bankruptcy. See A.B. 155, 2009 Assemb., Reg. Sess. (Cal. 2009), 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 approval of the Senate as of this writing. For opinions about the bill and the role of the municipal bankruptcy process, see Andrew Ward, Bill To Make Municipal Bankruptcy Harder Passes California Assembly, BOND BUYER, June 8, 2009, at 5; and Andrew Ward, Calif: Bill Would Make Chap. 9 a Tougher Path, BOND BUYER, Apr. 21, 2009, at 1.

222 See supra notes 88-90 and accompanying text.
