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## A New Fulcrum Point for City Survival

Samir D. Parikh

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## A NEW FULCRUM POINT FOR CITY SURVIVAL

SAMIR D. PARIKH\*

### ABSTRACT

*Municipalities have historically enjoyed immense stability. This era of tranquility is over, and fiscal deterioration is accelerating. Policymakers and scholars have struggled to formulate debt restructuring options; almost all have embraced federal bankruptcy law. But this resource-draining process is not the fulcrum point for any meaningful solution to municipal demise. Indeed, for the vast majority of distressed municipalities, the lever of municipal recovery will not turn on the solutions that have been offered to date. This Article radically shifts the municipal recovery debate by arguing that state law is the centralized point at which officials can exert the necessary amount of pressure to gain concessions from key creditor constituencies. To that end, I propose a comprehensive fiscal monitoring system that identifies and then directs distressed municipalities into a dynamic negotiation model designed to restructure inveterate debt obligations. Animating this proposal is a more nuanced understanding of the Contracts Clause that allows a municipality to explore unilateral contract modification in an effort to facilitate consensual agreements with creditor constituencies.*

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\* Associate Professor of Law, Lewis & Clark Law School. I thank Douglas Baird, Nathan Christensen, Ozan Varol, Brian Blum, Jay Westbrook, Rafael Pardo, Oren Haker, Michelle Wilde Anderson, Paul Diller, Colin Marks, Nancy Rapoport, and Rishi Batra for their input and guidance. I thank Michael Langanger, Andrew Freeman, and Gillian Schroff for their research assistance. Finally, I would like to acknowledge my family for their unwavering support.

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## INTRODUCTION

On October 16, 1975, Hugh Carey, then governor of New York, was attending an event at the Waldorf Astoria when one of his aides approached and informed him that he was needed at his midtown office.<sup>1</sup> No further explanation was necessary. Carey promptly left the event as if he had been summoned to a loved one's deathbed.<sup>2</sup> And, in some ways, he had. New York City was facing its financial death.

When Carey entered his office, he discovered that the city did not have sufficient funds to meet its payroll and other obligations that would come due the next day.<sup>3</sup> City and state officials were working frantically to secure additional funds.<sup>4</sup> Abraham Beame, then mayor of New York City, had called the White House and asked to plead his case to President Gerald Ford.<sup>5</sup> Beame was told that Ford was sleeping, but, rest assured, his staff was monitoring New York City's situation.<sup>6</sup>

The White House was well aware of New York City's impending demise. City leaders planted the seeds of the city's death spiral in the 1960s when they removed barriers to the growth of its payrolls and social programs and financed the city's largesse with excessive borrowing.<sup>7</sup> From 1961 to 1975, municipal employees unionized and labor costs increased 313%.<sup>8</sup> During the same period, spending on social welfare programs increased over 828%.<sup>9</sup> City residents enjoyed free tuition at the City University of New York and subsidized fares on the mass-transit system.<sup>10</sup> City officials lacked the fortitude and political capital to curtail spending; bloated social programs had

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1. See SEYMOUR P. LACHMAN & ROBERT POLNER, *THE MAN WHO SAVED NEW YORK: HUGH CAREY AND THE GREAT FISCAL CRISIS OF 1975*, at 140 (2011).

2. *See id.*

3. *See id.*

4. *See id.* at 142. State budget officials had suggested that the city issue IOUs. *Id.*

5. *See id.* at 140.

6. *See id.*

7. See MARTIN SHEFTER, *POLITICAL CRISIS/FISCAL CRISIS: THE COLLAPSE AND REVIVAL OF NEW YORK CITY* 106 (1985).

8. *Id.* at 116.

9. *Id.*

10. *See id.* at 140.

been overfed for years and could not be weaned.<sup>11</sup> For the decade prior to the city's financial crisis, local officials had allowed expenses to increase by an average of 12% every year while tax revenues increased only 4-5%.<sup>12</sup> Consequently, New York City had to borrow billions of dollars through the municipal credit markets to cover this budgetary shortfall.<sup>13</sup> By 1975, the city had an operating deficit of more than \$3 billion,<sup>14</sup> but made no attempt to curtail spending. Instead, city officials obfuscated the impending crisis with an array of accounting gimmicks that covertly saddled the city with debt that it had little chance to service.<sup>15</sup>

Fearing the worst, Mayor Beame had his staff draft a press release that read, "I have been advised by the comptroller that the City of New York has insufficient cash on hand to meet debt obligations due today. This constitutes the default that we have struggled to avoid."<sup>16</sup> However, the press release was never distributed.<sup>17</sup> In the face of this unprecedented cataclysm, state officials were able to obtain funds from an unlikely source. Albert Shanker, the president of the New York City teachers' union, reluctantly agreed to transfer \$453 million from the Teachers' Retirement System into the city's coffers in exchange for city bonds.<sup>18</sup> This act delayed the city's default, but it did not save the patient. The prospect of the city failing was still very real.

In the months that followed, officials implemented a plan that ultimately allowed the city to avoid a federal bankruptcy filing and heal its financial wounds. The state created the Municipal Assistance Corporation of the City of New York (MAC) to issue new municipal debt.<sup>19</sup> State legislators agreed to provide a 28% increase

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11. *Id.* at 116.

12. *Id.*

13. *Id.*

14. *Id.* at 106. The shortfall would be approximately \$13 billion in today's dollars.

15. These gimmicks included "revenue accruals, capitalization of expenses, raiding reserves, appropriation of illusory fund balances, suspension of payments, carry-forward of deficits, and questionable receivables." PAUL M. HEALY, HARVARD BUS. SCH. CASE STUDY, THE CITY OF NEW YORK 4 (2000); *see SHEFTER, supra* note 7, at 106.

16. LACHMAN & POLNER, *supra* note 1, at 143.

17. *See id.*

18. *Id.* at 144.

19. *See* ROGER DUNSTAN, CAL. RESEARCH BUREAU, NO. CRB-V3-N01, OVERVIEW OF NEW YORK CITY'S FISCAL CRISIS 4 (1995), <http://www.library.ca.gov/crb/95/notes/v3n1.pdf> [<http://perma.cc/2TTQ-9NKA>]. In return, the city was required to implement a variety of austerity

in intergovernmental aid.<sup>20</sup> Bondholders deferred debt and interest payments on bonds, and various banks provided additional financing.<sup>21</sup> Congress passed the New York City Loan Guarantee Act of 1978 that offered \$2.3 billion of short-term loans to New York City.<sup>22</sup> Perhaps most importantly, municipal employees accepted short-term pay cuts and layoffs and allowed pension funds to be invested in new MAC debt.<sup>23</sup>

In the years since New York City's brush with financial collapse, American municipalities<sup>24</sup> have enjoyed relative stability. Since 1954, only sixty-three municipalities with taxing authority sought protection under Chapter 9.<sup>25</sup> But this era of tranquility has ended. Municipalities have begun to experience the same financial inferno that started to consume our national economy in 2008. Tax revenue is declining.<sup>26</sup> Healthcare costs are escalating and eclipsing revenue growth.<sup>27</sup> Unfunded liabilities for state and municipal retirees' healthcare benefits amount to more than \$1 trillion.<sup>28</sup> Pension systems are underfunded by as much as \$4.4 trillion.<sup>29</sup> These burdens

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measures. The city was obligated to raise fees for city services, including the cost of public transit, impose tuition at city universities, cut a variety of city services, decrease the city's work force by 25,000 employees, reverse wage increases, raise taxes, fully fund pension plans, and balance its budget by 1978. *See SHEFTER, supra* note 7, at 134-35.

20. *See SHEFTER, supra* note 7, at 137.

21. DUNSTAN, *supra* note 19, at 5-6.

22. *Id.* at 5.

23. *See HEALY, supra* note 15, at 4.

24. For purposes of this paper, the terms "municipality" and "municipalities" describe counties, cities, and other local governments that enjoy taxing authority.

25. *See* James Spiotto, *Chapter 9 and Alternatives—Part One: Lessons Learned: An Update on the Municipal Bankruptcy Experience*, MUNINET GUIDE (Apr. 23, 2015), <http://www.muninetguide.com/articles/chapter-9-and-alternatives---part-one-lessons-learned-an-upd-733> [<http://perma.cc/TJH4-EJQJ>]. In fact, since 1954, only 318 entities have sought protection under Chapter 9. *Id.* The vast majority of these filings were by utility, water, and other special districts that generally manage one discrete social service and have no taxing authority. *See id.*

26. *See* RICHARD RAVITCH & PAULA VOLCKER, STATE BUDGET CRISIS TASK FORCE, REPORT OF THE STATE BUDGET CRISIS TASK FORCE: SUMMARY REPORT 2 (2012), <http://www.statebudgetcrisis.org/wp-content/images/Report-of-the-State-Budget-Crisis-Task-Force-Summary.pdf> [<http://perma.cc/G5ZP-4C2M>].

27. *See id.* at 1-2.

28. *See id.* at 2.

29. *See* Stuart Buck, *The Legal Ramifications of Public Pension Reform*, 17 TEX. REV. L. & POL. 25, 27 (2012); *see also* Robert Novy-Marx & Joshua Rauh, *The Crisis in Local Government Pensions in the United States*, in GROWING OLD: PAYING FOR RETIREMENT AND INSTITUTIONAL MONEY MANAGEMENT AFTER THE FINANCIAL CRISIS 47, 48 (Yasuyuki Fuchita

fall on the state as well as all municipalities located within its borders. Not surprisingly, twenty-eight municipalities have declared bankruptcy or become subject to a receivership since late 2008, and five of the six largest municipal bankruptcies in American history are in this group.<sup>30</sup> Amidst this bloodshed, experts have predicted an even larger tidal wave of financial distress for municipalities in the upcoming years.<sup>31</sup> The scope of this problem is far broader than many would suspect. Systemic municipal failure is a multi-tiered problem with ripple effects, because fiscally crippled municipalities impose significant economic costs on state and national economies.<sup>32</sup>

Academics and policymakers have struggled to propose viable solutions to the staggering financial problems facing municipalities. Up to this point, the literature has focused on federal bankruptcy law and the options available under Chapter 9.<sup>33</sup> In particular, scholars have argued that Chapter 9 bankruptcy judges need more power and municipal debtors need more weapons in their arsenal to address crippling union obligations and bond debt.<sup>34</sup> Politicians and scholars have made a variety of suggestions, and some have gone so far as to suggest amending the Constitution to allow states to seek federal bankruptcy protection.<sup>35</sup>

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et al. eds., 2011) (assessing the unfunded liability for government pension plans at \$3 trillion).

30. See Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1120 (2014).

31. See Maria Chutchian, *Out-of-Court Municipal Restructuring Will Rise, Experts Say*, LAW360 (Feb. 7, 2014, 5:04 PM), <http://www.law360.com/articles/508223/out-of-court-municipal-restructuring-will-rise-experts-say> [<http://perma.cc/Z86F-G4DZ>].

32. See RAVITCH & VOLCKER, *supra* note 26, at 17-18.

33. See, e.g., Jeffrey B. Ellman & Daniel J. Merrett, *Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?*, 27 EMORY BANKR. DEV. J. 365, 372 (2011); Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281 (2012); Thomas Moers Mayer, *State Sovereignty, State Bankruptcy, and a Reconsideration of Chapter 9*, 85 AM. BANKR. L.J. 363, 365-66 (2011); Juliet M. Moringiello, *Specific Authorization to File Under Chapter 9: Lessons from Harrisburg*, 32 CAL. BANKR. J. 237 (2012); Richard W. Trotter, *Running on Empty: Municipal Insolvency and Rejection of Collective Bargaining Agreements in Chapter 9 Bankruptcy*, 36 S. ILL. U. L.J. 45, 47 (2011).

34. See Gillette, *supra* note 33, at 315-28; Trotter, *supra* note 33, at 47.

35. See Mayer, *supra* note 33, at 369, 385; Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy"*, 59 UCLA L. REV. 322 (2011); David A. Skeel Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677 (2012); Jeb Bush & Newt Gingrich, *Better Off Bankrupt: States Need a New Way to Deal with Budget Crises*, L.A. TIMES, Jan. 27, 2011, at A19; Mary Williams Walsh, *A Path Is Sought for States to Escape Their Debt Burdens*, N.Y. TIMES, Jan. 21, 2011, at A1; see also David A. Skeel, Jr., *Is Bankruptcy the Answer for Troubled Cities and States?*,



Federal bankruptcy law, however, is not the fulcrum point for any meaningful solution to municipal financial distress. The lever of municipal recovery will not turn by implementing the solutions already proposed. Indeed, the literature fails to appreciate that Chapter 9 is a resource-draining process that perpetuates cost shifting, fails to produce needed structural changes, yields poorly formed results, and raises borrowing costs that further burden future generations. This Article radically shifts the municipal recovery debate by eschewing federal bankruptcy law and proposing that state law can be the centralized point at which officials exert the necessary amount of pressure to gain concessions from unions and bondholders. I seek to reframe our solution inquiry through the prism of a state debt adjustment mechanism. My proposal is premised on a comprehensive fiscal monitoring system coupled with a clear debt negotiation structure for distressed municipalities. Animating my proposal is a more nuanced understanding of the Contracts Clause that allows a municipality to explore unilateral contract modification of key obligations in an effort to facilitate consensual agreements with creditor constituencies.

Ultimately, my proposal seeks to (1) identify pressured municipalities at a time when measured adjustments can be sufficient to create sustainable viability, and (2) shepherd distressed municipalities through a dynamic negotiation structure in an effort to capture Chapter 9's primary benefits without the accompanying costs, inefficiencies, and constitutional quandaries.

Part I addresses the challenges subnational governments face. I detail how perverse incentives, cost shifting, and borrower opportunism have created oversized long-term costs that cannot be addressed by traditional debt alleviation methods. In Part II, I provide a brief overview of some of the more aggressive debt restructuring methods that exist at the state and federal level and analyze the deficiencies of the available options. In Part III, I plot the path forward and define the contours of my uniform state debt adjustment system. I explore the goals and benefits of my system and argue that the most effective debt adjustment mechanism is one that facilitates negotiation and incentivizes parties to make meaningful

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50 Hous. L. Rev. 1063, 1064-66 (2013); David E. Solan, *State Bankruptcy: Surviving a Tenth Amendment Challenge*, 42 Golden Gate U. L. Rev. 217, 217-21 (2012).

concessions. Current restructuring options rely exclusively on court adjudication, which drains resources and offers nominal benefits. In this Part, I also reanalyze the Contracts Clause and similar provisions that appear in state constitutions. This analysis explores the forgotten exceptions to the Contracts Clause that serve as a basis for allowing distressed municipalities to impose unilateral contractual modification on creditors. The threat of such alterations will encourage creditors to make meaningful concessions and facilitate consensual agreements.

Finally, Part IV presents my normative approach in full. I propose a uniform state debt adjustment mechanism in which distressed municipalities pass through up to five stages to achieve sustainable viability. The system provides a panoply of benefits. Primarily, I propose early intervention by state officials; this intercession improves the odds of a successful result by addressing local officials' temptation to repeatedly defer meaningful rehabilitative steps. Further, my system gradually escalates state involvement, which respects the municipality's democratic integrity but recognizes that reversing devolution is appropriate during fiscal emergencies. A control board is ultimately vested with key decision-making power, but only after local officials are given sufficient time to avert a crisis. The board will lead negotiations with unions and bondholders, acting aggressively if a true emergency exists, and relying on my novel perspective on the Contracts Clause in order to encourage constituents to negotiate consensual modifications to municipal obligations. The final stage in the system demands that the distressed municipality either achieve a meaningful restructuring for sustainability or seek federal bankruptcy court protection. My system precludes state and federal bailouts, thereby minimizing moral hazard risk on the part of municipalities and lenders.

A second wave of financial turmoil is approaching our nation's subnational governments.<sup>36</sup> Many of these governments cannot withstand this pernicious assault. States have long ignored this problem, and all but a few offer no meaningful restructuring options.<sup>37</sup> Scholars and policymakers have impulsively embraced

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36. See Chutchian, *supra* note 31.

37. See James E. Spiotto, *The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress*, 34 MUN. FIN. J. 1, 11-12 (2013), <http://www.>

Chapter 9.<sup>38</sup> I acknowledge that federal bankruptcy law is a necessary consideration for municipalities facing failure, but it is a tertiary solution. Unlike any article to date, this Article proposes a detailed state debt adjustment system premised on a comprehensive negotiation structure that seeks consensual contractual modification, not resource-draining litigation.

## I. CHALLENGES FACING MUNICIPALITIES

### A. Overview<sup>39</sup>

The Great Recession of 2008 did not cause the systemic problems undermining the nation's municipal landscape; it merely exposed them.<sup>40</sup> The true extent of municipal destabilization was not clear until recently. Indeed, at the turn of this decade, municipalities<sup>41</sup> were able to rely on intergovernmental aid to bolster their balance sheets.<sup>42</sup> Intergovernmental aid includes grants, transfers, and other funds a municipality receives from federal, state, county, or other local governments through ongoing revenue-sharing agreements and one-time infusions.<sup>43</sup> The American Recovery and Reinvestment Act (ARRA)<sup>44</sup> was signed in 2009 as a short-term stimulus bill

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chapmanstrategicadvisors.com/media/publication/1\_Role\_of\_State\_Supervising\_Assisting\_Municipalities\_in\_Distress\_%202011\_MFJ\_csa.pdf [http://perma.cc/838U-Q4D9].

38. See Anderson, *supra* note 30, at 1131. But see Spiotto, *supra* note 37, at 5.

39. Municipal deterioration has been thoroughly chronicled, and a variety of scholars are ably handling the articulation of this phenomenon. See, e.g., Anderson, *supra* note 30; Christine Sgarlata Chung, *Zombieland / The Detroit Bankruptcy: Why Debts Associated with Pensions, Benefits, and Municipal Securities Never Die ... And How They Are Killing Cities Like Detroit*, 41 FORDHAM URB. L.J. 771, 816 (2014). A full exploration of this issue is beyond this Article's scope, but a general overview is instructive.

40. See Anderson, *supra* note 30, at 1130 n.22.

41. As noted above, for purposes of this Article, the terms "municipality" and "municipalities" describe counties, cities, and other local governments that enjoy taxing authority. See *supra* note 24.

42. See THE PEW CHARITABLE TRS., AMERICA'S BIG CITIES IN VOLATILE TIMES: MEETING FISCAL CHALLENGES AND PREPARING FOR THE FUTURE 4 (2013), <http://www.pewtrusts.org/~media/Assets/2013/11/11/AmericasBigCitiesinVolatileTimes.pdf> [http://perma.cc/452D-JHCV] [hereinafter AMERICA'S BIG CITIES].

43. See *id.* at 10.

44. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (codified in scattered sections of 6, 19, 26, 42, and 47 U.S.C.).

seeking to infuse \$787 billion into the economy.<sup>45</sup> A significant portion of these funds represented direct aid to states, funds that often times went to municipalities.<sup>46</sup> Funding through the ARRA helped stabilize localities for a brief period of time, but the ARRA and other measures have merely served to delay the day of reckoning. By 2010, state aid to municipalities decreased by \$12.6 billion from the previous year and decreased again in 2011, 2012, and 2013.<sup>47</sup>

Declining intergovernmental aid has been compounded by declining property tax collections.<sup>48</sup> Property tax revenue had been a stalwart for municipalities during previous economic downturns.<sup>49</sup> But the imploding housing market precipitated the Great Recession, and an unprecedented fall in home prices decimated county coffers.<sup>50</sup> Between 2007 and 2011, home prices fell almost 20% nationally, hitting states like Arizona and Nevada harder.<sup>51</sup>

Today, unfortunately, revenues are declining while costs are rising. City and municipal budgets face rising labor costs in the form of salaries and wages,<sup>52</sup> as well as pensions and daunting employee-related costs for long-term health care for retired employees.<sup>53</sup> In

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45. See *The Recovery Act*, RECOVERY.GOV, [http://www.recovery.gov/arra/About/Pages/The\\_Act.aspx#act](http://www.recovery.gov/arra/About/Pages/The_Act.aspx#act) [<http://perma.cc/DTN9-SFTE>] (last visited Sept. 27, 2015).

46. See ANNUAL REPORT TO THE PRESIDENT ON PROGRESS IMPLEMENTING THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009, CHAPTER 1: THE YEAR IN REVIEW (2010), <http://www.whitehouse.gov/sites/default/files/20100216-annual-report-progress-recovery-act.pdf> [<http://perma.cc/BKX9-UAC2>]. In fact, states have historically funded on average close to one-third of local budgets. See THE PEW CHARITABLE TRS., THE LOCAL SQUEEZE: FALLING REVENUES AND GROWING DEMAND FOR SERVICES CHALLENGE CITIES, COUNTIES, AND SCHOOL DISTRICTS 5-6 (2012), [http://www.pewtrusts.org/~media/Assets/2012/06/Pew\\_Cities\\_Local-Squeeze\\_report.pdf](http://www.pewtrusts.org/~media/Assets/2012/06/Pew_Cities_Local-Squeeze_report.pdf) [<http://perma.cc/8WJN-49EY>] [hereinafter THE LOCAL SQUEEZE] (“Many states provide grants [to localities] for general operations; in other cases, money is set aside for certain uses, such as road repair. States also sometimes share a portion of tax revenues with cities, counties, and school districts based on factors like population, need, and the community’s existing tax burden.”).

47. See THE LOCAL SQUEEZE, *supra* note 46, at 4. In 2011, Nebraska cancelled all funding to cities and counties, and in Maryland, state aid to counties and municipalities dropped 60% from 2007 to 2012. See *id.* at 7.

48. See *id.* at 8-9.

49. See *id.*

50. See *id.* at 9.

51. See *id.* at 9-10.

52. Municipalities spend more than 35% of their budget expenditures on salaries and wages. See *id.* at 13; see also RAVITCH & VOLCKER, *supra* note 26, at 10, 12.

53. See MICHAEL A. PAGANO & CHRISTINA MCFARLAND, NAT’L LEAGUE OF CITIES,

fact, health benefit costs and pension costs have steadily increased for the vast majority of municipalities<sup>54</sup> and will continue to rise for the foreseeable future.<sup>55</sup> Unfunded liabilities for state and municipal retirees' healthcare benefits amount to more than \$1 trillion.<sup>56</sup> Pension systems are underfunded by as much as \$4.4 trillion.<sup>57</sup>

Further, as the Great Recession unfolded, demand spiked for the free services that municipalities provide, particularly health and human services and public safety.<sup>58</sup> Municipalities fund public welfare programs that provide "cash or food assistance, healthcare, low-income housing, and workforce development."<sup>59</sup> From 2007 to 2010, the number of Americans in poverty increased 14%, increasing the demands for services provided by municipalities.<sup>60</sup>

### *B. Perverse Incentives and Cost Shifting*

Many distressed municipalities are suffering from self-inflicted wounds.<sup>61</sup> The systemic problems noted above are invariably the product of perverse incentives that have produced cost shifting over the course of decades.

To understand the practice of cost shifting, it is important to consider resource allocation. Municipalities engage in efficient resource allocation when public officials fully internalize all benefits and costs of public action.<sup>62</sup> Undervaluing benefits—or overvaluing costs—will cause public officials to provide too little of the public services in demand. Overvaluing benefits—or undervaluing

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RESEARCH BRIEF ON AMERICA'S CITIES: CITY FISCAL CONDITIONS IN 2013, at 5 (2013), [http://www.nlc.org/Documents/Find%20City%20Solutions/Research%20Innovation/Finance/Final\\_CFC2013.pdf](http://www.nlc.org/Documents/Find%20City%20Solutions/Research%20Innovation/Finance/Final_CFC2013.pdf) [<http://perma.cc/S9U4-S4QX>].

54. *See id.* at 5-6.

55. *See* RAVITCH & VOLCKER, *supra* note 26, at 43-44.

56. *See id.* at 43.

57. *See* Buck, *supra* note 29, at 27; *see also* Novy-Marx & Rauh, *supra* note 29, at 48. For example, Illinois's pension fund is underfunded by an estimated \$187 billion, which is 318% of the state's total revenues. *See* Novy-Marx & Rauh, *supra* note 29, at 48.

58. *See* THE LOCAL SQUEEZE, *supra* note 46, at 14.

59. *See id.*

60. *Id.*

61. I acknowledge that there are municipalities that are suffering due to macro shifts in the national and subnational economies.

62. *See* Clayton P. Gillette, *Fiscal Federalism and the Use of Municipal Bond Proceeds*, 58 N.Y.U. L. REV. 1030, 1072-74 (1983).

costs—will lead to indulgence. But overarching this entire premise are the fundamental perverse incentives that plague political actors in a public choice paradigm. More specifically, many local officials are incentivized to overvalue benefits and undervalue costs; to essentially “overgraze” at the debt commons.<sup>63</sup> For example, states attempt to limit their municipalities’ debt load, but municipalities have historically been able to avoid key aspects of these limitations.<sup>64</sup> Indeed, large municipalities have adopted a model dependent on access to the credit markets.<sup>65</sup> Approximately 44,000 subnational governments issue debt.<sup>66</sup> The municipal bond market approaches \$4 trillion in principal, and there are “over one million different municipal bonds outstanding compared to fewer than 50,000 different corporate bonds.”<sup>67</sup>

Municipal debt is used primarily to fund capital improvement projects,<sup>68</sup> which include all construction, renovation, improvement, fabrication, and customization projects within a municipality’s borders.<sup>69</sup> Infrastructure projects such as roads, railways, and dams represent capital improvement projects. These improvements provide myriad short-term benefits in the form of new jobs and appreciable resource allocation, generally enhancing civic pride.<sup>70</sup> But they can also create long-term fixed obligations, and debt service generally escalates over time. The burden of servicing the debt associated with these projects rarely falls on the officials that initially authorized the expenditure and attendant borrowing.<sup>71</sup> Managing the costs instead falls to future local officials and residents. And, in some cases, the burden extends to state officials and nonresidents. This practice is cost shifting.<sup>72</sup>

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63. See Gillette, *supra* note 33, at 287-88.

64. See, e.g., Spiotto, *supra* note 37, at 8.

65. See *id.* at 3.

66. See Amicus Curiae Brief by the Securities Industry and Financial Markets Ass’n at 6, *In re City of Detroit*, No. 13-53846 (Bankr. E.D. Mich. May 12, 2014).

67. See *id.* at 7.

68. See NEIL O’HARA, *THE FUNDAMENTALS OF MUNICIPAL BONDS* 5 (6th ed. 2012).

69. See *id.*

70. See *id.*

71. See Gillette, *supra* note 33, at 291-92.

72. See Robert P. Inman, *Transfers and Bailouts: Enforcing Local Fiscal Discipline with Lessons from U.S. Federalism*, in *FISCAL DECENTRALIZATION AND THE CHALLENGE OF HARD BUDGET CONSTRAINTS* 35, 38-39 (Jonathan Rodden et al. eds., 2003).

Cost shifting is easily identifiable in the context of borrowing, but it also characterizes labor negotiations. Local officials frequently avoid strikes and other work stoppages by offering unions benefits that accrue at some point in the distant future. This is another facet of cost shifting's pervasive effect. For example, in 1996 the City of San Diego was facing a budget gap.<sup>73</sup> City officials sought to address this shortfall by diverting funds earmarked for employee retirement accounts.<sup>74</sup> In order to gain the necessary consent from employee unions, city officials agreed to increase benefits to current and retired employees.<sup>75</sup> Employees benefitted because they received increased benefits,<sup>76</sup> and the city was still responsible for fully funding retirement benefits. City officials benefitted because they were allowed to underfund the employee retirement system, gaining immediate cash savings and avoiding difficult spending cuts.<sup>77</sup> Also, the increased benefits awarded to city employees accrued over time and did not create an immediate burden on the city's budget. The city officials that arranged this deal captured the short-term benefits.<sup>78</sup> Unfortunately, the consequences of these actions are being felt by the city today. Current city officials are being forced to make unpopular spending cuts to address underfunded retirement accounts.<sup>79</sup> Current residents are facing diminished services and additional taxes due to resources being diverted to rectify the underfunding.<sup>80</sup> These parties are bearing the cost of past indiscretions.<sup>81</sup>

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73. See Vladimir Kogan, *Pension Crisis: Poor Investment Decisions Are to Blame*, SAN DIEGO UNION-TRIB. (Apr. 24, 2011), <http://www.signonsandiego.com/news/2011/apr/24/poor-investment-decisions-are-to-blame/> [http://perma.cc/R7TZ-JPA5].

74. See *id.*

75. See Jennifer Vigil, *'96 Memo Details Pension Strategy*, SAN DIEGO UNION-TRIB. (June 9, 2005), [http://www.signonsandiego.com/uniontrib/20050609/news\\_7m9memo.html](http://www.signonsandiego.com/uniontrib/20050609/news_7m9memo.html) [http://perma.cc/Y394-VEGJ].

76. See *id.*

77. See *id.*

78. See *id.*

79. See Dan Fitzpatrick, *San Diego Pension Dials up the Risk to Combat a Shortfall*, WALL ST. J. (Aug. 13, 2014), <http://online.wsj.com/articles/san-diego-pension-dials-up-the-risk-to-combat-a-shortfall-1407974779> [http://perma.cc/R88G-9GKE].

80. See Steven Greenhut, *Pension Effort Faces More than Unions*, SAN DIEGO UNION-TRIB. (Mar. 18, 2015), <http://www.utsandiego.com/news/2015/mar/18/pension-sacramento-reform-initiative-union-wrath/> [http://perma.cc/3WDB-DRM5].

81. See Fitzpatrick, *supra* note 79.



Cost shifting has proliferated across the country, contributing to the severe financial distress that exists at the subnational government level.

*C. The Elusive Nature of Resource Adjustment*

Distressed municipalities have attempted to effectuate resource adjustment in order to address budgetary shortfalls, but the results have been disheartening. Municipalities are ill-equipped to create new revenue streams to combat financial distress.<sup>82</sup> Forty-six states severely limit a municipality's ability to increase taxes.<sup>83</sup> There are also political obstacles. Elected officials are prone to eschew tax increases in favor of less controversial revenue-generating measures, such as raising fees that are applied to city services.<sup>84</sup> But these fee increases often fail to generate significant funds. Even in states that give municipalities the option of increasing taxes, the imposition of higher taxes may only serve to reduce the tax base. Indeed, macro migration trends demonstrate that the U.S. population is becoming more diffused.<sup>85</sup> This trend shrinks tax bases in affected areas. And tax increases arguably accelerate this trend and eviscerate the benefit of a tax increase.

Attempts to reduce employee-related expenses have also been ineffective. Collective bargaining agreements severely limit adjustments to employee headcount and benefits. Municipalities invariably wind up making minor reductions in headcount that produce minimal cost savings.<sup>86</sup> Hiring freezes are more frequently invoked but similarly futile.<sup>87</sup> Collective bargaining agreements also restrict attempts to reduce healthcare and pension benefits.<sup>88</sup> Further, state

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82. See THE LOCAL SQUEEZE, *supra* note 46, at 21.

83. See *id.* at 11.

84. See PAGANO & MCFARLAND, *supra* note 53, at 6.

85. See Karen Weise, *Austin Is the New Brooklyn*, BLOOMBERG BUS. (Apr. 10, 2014), <http://www.bloomberg.com/bw/articles/2014-04-10/austin-tex-dot-gains-from-urban-flight-to-second-tier-metro-areas> [<http://perma.cc/J5Y9-WXVV>].

86. RAVITCH & VOLCKER, *supra* note 26, at 31.

87. See PAGANO & MCFARLAND, *supra* note 53, at 6. Through a combination of layoffs, attribution, hiring freezes, and furloughs, municipalities are able to reduce their workforce. But these cuts offer marginal relief, accounting for only a 3.4% reduction in workforce between September 2008 and December 2011. See THE LOCAL SQUEEZE, *supra* note 46, at 13.

88. See RAVITCH & VOLCKER, *supra* note 26, at 45.



law compels almost all municipalities to make pension contributions to general funds regardless of constrained budgets. Modifying employment terms for new hires is politically palatable, but “such modifications produce the smallest immediate savings.”<sup>89</sup>

Distressed municipalities that had cash reserves in 2007 invariably accessed these funds as the Great Recession unfolded and now face depleted buffers.<sup>90</sup> For example, Sacramento tapped cash reserves beginning in 2007.<sup>91</sup> At that time, the reserve balance was 31% of general revenue. By 2011, the reserve was down to just 6% of general revenue.<sup>92</sup> Sacramento, as well as the vast majority of other distressed municipalities, cannot rely on its cash reserve to address future fiscal challenges.

Confronted with this brave new world, distressed municipalities have taken desperate measures. Some municipalities have decided to sell government assets and privatize government functions, including parking enforcement, park maintenance, graffiti removal, collection of delinquent taxes, and operation of public venues, such as zoos.<sup>93</sup> In March 2010, New Jersey appointed a Privatization Task Force that sought to evaluate the viability of privatization.<sup>94</sup> Unfortunately, the vast majority of privatization transactions are characterized by short-term cash infusions that produce either excessive future expenses or a disproportionate loss of future revenue. For example, in late 2010, Newark opted to sell and then lease back sixteen of the city’s buildings, including its police and fire headquarters as well as symphony hall.<sup>95</sup> The sale yielded \$74 million for the city, but leasing the buildings back will cost the city \$125 million during the lease term.<sup>96</sup> Similarly, the City of Chicago leased its parking meter system to a consortium led by Morgan Stanley in order to balance its budget.<sup>97</sup> Chicago will ultimately receive \$11.6

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89. *Id.* at 31.

90. *See id.* at 9.

91. *See* AMERICA’S BIG CITIES, *supra* note 42, at 16.

92. *Id.*

93. *See* Ianthe Jeanne Dugan, *Facing Budget Gaps, Cities Sell Parking, Airports, Zoo*, WALL ST. J. (Aug. 23, 2010), <http://online.wsj.com/news/articles/SB20001424052748703960004575427150960867176> [<http://perma.cc/UJ9J-CV34>].

94. 42 N.J. Reg. 690(a) (Apr. 5, 2010).

95. Anderson, *supra* note 30, at 1167-68.

96. *Id.*

97. *See* Darrell Preston, *Morgan Stanley Group’s \$11 Billion Makes Chicago Taxpayers*

billion from its parking meter lease, but the consortium is now expected to make more than ten times that amount over the course of the deal.<sup>98</sup> Further, these one-time sales temporarily fill budgetary gaps but fail to produce any structural reform that improves the municipality's viability.<sup>99</sup>

Against this backdrop, distressed municipalities are forced to seek some mechanism that will allow for systemic debt restructuring. But current options under state and federal law are woefully deficient.

## II. MORE AGGRESSIVE FORMS OF REHABILITATION: STATE AND FEDERAL ATTEMPTS TO ADDRESS MUNICIPAL INSOLVENCY

Traditional restructuring processes tend to provide minimal relief to municipalities with significantly compromised financial structures. As a municipality drifts from distress to crisis, local officials must pivot to more aggressive forms of rehabilitation. Unfortunately, state and federal law offer a mix of poor options.

### A. Current State Law Restructuring Approaches

Historically, state law has failed to offer municipalities meaningful debt adjustment options. This phenomenon may appear to be an intentional decision because municipal defaults are rare,<sup>100</sup> and the issue is difficult to address *ex ante*. However, defaults are rare because "state intervention ... has often prevented defaults from occurring."<sup>101</sup> States have acted as implicit guarantors of municipal debt,

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Cry, BLOOMBERG (Aug. 9, 2010), <http://www.bloomberg.com/news/2010-08-09/morgan-stanley-group-s-11-billion-from-chicago-meters-makes-taxpayers-cry> [<http://perma.cc/P6ZZ-FWH2>].

98. *See id.*

99. *See id.*

100. *See* THE PEW CHARITABLE TRS., THE STATE ROLE IN LOCAL GOVERNMENT FINANCIAL DISTRESS 13 (2013), <http://www.pewtrusts.org/en/research-and-analysis/reports/2013/07/23/the-state-role-in-local-government-financial-distress> [<http://perma.cc/HY9Z-H8MS>] [hereinafter STATE ROLE IN LOCAL GOVERNMENT].

101. David Litvack & Frank Rizzo, *Municipal Default Risk*, 21 MUN. FIN. J. 25, 32 (2000); *see also* Colleen Woodell et al., *U.S. Municipal Rating Transitions and Defaults, 1986-2003*, 24 MUN. FIN. J. 49, 55 (2004) ("Distressed municipalities will typically receive some type of additional state aid, oversight, or other outside intervention that prevents the dramatic credit deterioration that ... [municipalities] may suffer.").

artificially suppressing defaults. But the fact that states occupy this unenviable position has not spurred a groundswell for statutory debt resolution mechanisms. States have remained surprisingly disengaged from the municipal restructuring process.

Approximately thirty-one states have no formal municipal debt restructuring mechanism at all.<sup>102</sup> During fiscal emergencies, appointment of a receiver is the primary option for municipalities in these states. When a receiver is appointed, the receiver and his or her team essentially displace key local officials and are tasked with effecting rapid improvement. This edict forces the receiver to make a series of reactive and aggressive changes that are “only possible because the receiver [does] not have to run for re-election and face the wrath of an organized, focused opposition.”<sup>103</sup> Receivers often employ measures that were previously rejected by local officials as being harmful to the local community and its residents.<sup>104</sup> Local officials understandably seek to avoid this form of debt relief.<sup>105</sup> And because the vast majority of states fail to monitor local government finances, local officials are incentivized to manage or obfuscate fiscal red flags in order to defer such appointments.<sup>106</sup> Receiverships are sought infrequently and at a time when considerable harm has already been realized. By this point, the state is forced to provide a sizeable financial bailout or loan to allow the receiver to stabilize

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102. See JAMES E. SPIOTTO ET AL., MUNICIPALITIES IN DISTRESS?: HOW STATES AND INVESTORS DEAL WITH LOCAL GOVERNMENT FINANCIAL EMERGENCIES, at B-1 to B-2 (2012); see also STATE ROLE IN LOCAL GOVERNMENT, *supra* note 100, at 9-10.

103. Ed Cyr, *Thoughts on the Chelsea Receivership*, 9 GOV'T FIN. REV. 23, 23 (1993).

104. See Lyle Kossis, Note, *Examining the Conflict Between Municipal Receivership and Local Autonomy*, 98 VA. L. REV. 1109, 1135 (2012).

105. See STATE ROLE IN LOCAL GOVERNMENT, *supra* note 100, at 25 (describing the hostility local officials feel towards unelected receivers usurping local democracy); see also Kossis, *supra* note 104, at 1134-35. Texas provides a good case study. The state offers no debt adjustment mechanism. Instead, the state allows municipalities to either seek a receiver or file a Chapter 9 petition. Texas municipalities have consistently opted for the Chapter 9 filing. As of 2012, Texas was the state with the third highest number of municipalities that had filed under Chapter 9. See Steven Church, *Nebraska, not California, Is King of Municipal Collapse*, BLOOMBERG (July 16, 2012), <http://www.bloomberg.com/news/articles/2012-07-16/nebraska-not-california-is-king-of-municipal-collapse> [<http://perma.cc/BMR2-MMUN>].

106. See Beth Walter Honadle, *The States' Role in U.S. Local Government Fiscal Crises: A Theoretical Model and Results of a National Survey*, 26 INT'L J. PUB. ADMIN. 1431, 1434-35 (2003); Philip Kloha et al., *Someone to Watch Over Me: State Monitoring of Local Fiscal Conditions*, 35 AM. REV. PUB. ADMIN. 236, 252 (2005).

the municipality.<sup>107</sup> Consequently, in these states, local officials have few options and cost shifting is the unintended consequence of the state's disengagement. Indeed, without a meaningful restructuring mechanism, local officials face a Hobson's choice: seek a receiver and issue themselves a pink slip, or resort to cost shifting to secure short-term revenue.<sup>108</sup>

The remaining nineteen states offer restructuring mechanisms that are either ad hoc or delineated.<sup>109</sup> These mechanisms can be further classified as being reactive or proactive. For example, Massachusetts offers an example of an ad hoc, reactive system. Under Massachusetts state law, legislation is passed to address municipal distress on a case-by-case basis.<sup>110</sup> The ad hoc statute is purely reactionary and is effective in maintaining local autonomy. Indeed, under this approach, state officials intervene at the request of local officials, rather than in response to a monitoring system that tracks

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107. Litvack & Rizzo, *supra* note 101, at 32; *see also* Woodell et al., *supra* note 101, at 55. Chapter 9 federal bankruptcy is the other option. But only nine of the thirty-one states referenced above unconditionally allow a municipality to file a Chapter 9 petition. *See* SPIOTTO ET AL., *supra* note 102.

108. For example, California does not offer its municipalities a debt restructuring mechanism. Instead, the state has enacted a law that attempts to encourage negotiation by restricting a distressed municipality's access to Chapter 9. *See* CAL. GOV'T CODE § 53760 (West 2014). Under California state law, a bankruptcy filing is conditioned on the municipality satisfying one of two prerequisites: (1) participating in a non-binding negotiation for up to ninety days with interested parties holding claims of at least \$5,000,000; or (2) passing a resolution declaring a fiscal emergency. *Id.* Architects of the legislation acknowledge that the new process does not offer California municipalities any debt restructuring options or support, nor will it reduce the number of Chapter 9 filings. *See* Karol K. Denniston, *Neutral Evaluation in Chapter 9 Bankruptcies: Mitigating Municipal Distress*, 32 CAL. BANKR. J. 261, 286-87 (2012); *see also* STATE ROLE IN LOCAL GOVERNMENT, *supra* note 100, at 4. Indeed, three California municipalities have collapsed into Chapter 9 since the legislation took effect. In February of 2012, the City of Stockton filed a Chapter 9 petition, followed by Mammoth Lakes in July, and San Bernardino in August. *See* Jim Christie, *Stockton, California Files for Bankruptcy*, REUTERS (June 28, 2012, 11:49 PM), <http://www.reuters.com/article/2012/06/29/us-stockton-bankruptcy-idUSBRE85S05120120629> [<http://perma.cc/X98V-9KLU>]; Steven Church & James Nash, *Mammoth Lakes, California, Seeks Bankruptcy Protection*, BLOOMBERG (July 4, 2012), <http://www.bloomberg.com/news/articles/2012-07-03/mammoth-lakes-california-files-for-bankruptcy> [<http://perma.cc/C9DB-4BLE>]; *San Bernardino Files for Bankruptcy*, CNN (Aug. 2, 2012, 3:08 AM), <http://www.cnn.com/2012/08/02/us/california-city-bankruptcy/> [<http://perma.cc/637D-L7EH>].

109. *See* David R. Berman, *Takeovers of Local Governments: An Overview and Evaluation of State Policies*, 25 PUBLIUS J. FEDERALISM 55, 57-58 (1995).

110. *See* SPIOTTO ET AL., *supra* note 102, at 41-43.

financial triggers.<sup>111</sup> This dynamic avoids divisive arguments regarding the fidelity of the local democracy.<sup>112</sup>

But this approach is plagued by a number of faults. Primarily, as with all ad hoc systems, intervention is at the whim of the state legislature. Procedures are not codified, which leads to crippling uncertainty and disparate treatment among municipalities.<sup>113</sup> This approach also undermines bargaining. Counter-parties, including bondholders and unions, believe that the state will come to the rescue, which emboldens holdouts. Local officials believe that the state will come to the rescue, which creates moral hazard.<sup>114</sup> Access to credit and borrowing costs are also distorted. Reactive approaches are similarly deficient because they greatly increase the odds that the municipality will have experienced irreparable deterioration by the time the state intervenes. As discussed above, local officials are loath to relinquish control. By the time state officials assume the reins, drastic measures tend to be the only ones available. Even if the state is able to balance the municipality's budget, it often fails to address the systemic deficiencies that led to the municipality's financial distress. The approach invariably addresses the symptoms, not the disease.<sup>115</sup>

Unfortunately, states with delineated debt restructuring mechanisms have also failed to enact comprehensive approaches that offer municipalities the means to efficiently and affordably address

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111. See Berman, *supra* note 109, at 62 (discussing Bridgeport, Connecticut's request for state intervention regarding its financial crisis in the early 1990s).

112. See *id.*

113. For example, the New York state legislature was generally more permissive when Yonkers and Newburgh experienced financial distress, allowing the cities greater autonomy and freedom to access the debt markets. But the state was less pliant when Buffalo, Troy, Erie County, and Nassau County experienced distress. For those municipalities, the state displaced local officials and appointed an oversight board. The boards for each municipality had differing powers and responsibilities. See STATE ROLE IN LOCAL GOVERNMENT, *supra* note 100, at 22.

114. For example, in 2004, Massachusetts was forced to extend the City of Springfield a \$52 million state loan in order to allow the city to maintain essential services and avoid payment defaults. The State was then forced to extend the repayment deadline in 2009. See Dan Ring, *Massachusetts Senate Passes Relief Bill for Springfield*, REPUBLICAN NEWSROOM (Jan. 6, 2009, 9:34 PM) [http://www.masslive.com/news/index.ssf/2009/01/springfield\\_bailout.html](http://www.masslive.com/news/index.ssf/2009/01/springfield_bailout.html) [<http://perma.cc/6B68-FJCC>].

115. Connecticut and New York are states that also employ an ad hoc, reactive approach to municipalities in distress and have experienced varying degrees of success. See STATE ROLE IN LOCAL GOVERNMENT, *supra* note 100, at 22.

structural deficiencies. Almost all of these mechanisms are reactive. For example, Oregon attempted to fill the legislative void on this issue in 2012. A new law authorizes counties to declare a public safety services emergency.<sup>116</sup> If the governor agrees with the county's assessment, a fiscal assistance board is established to devise a recovery plan.<sup>117</sup> This is a reactive mechanism that is plagued by the same limitations noted above. Further, Oregon has failed to create a structure where a distressed county's creditors are properly motivated to make concessions. Indeed, the fiscal assistance board has absolutely no leverage. The board is not afforded the ability to modify contracts, and Oregon state law does not allow counties or cities to file a Chapter 9 petition.<sup>118</sup> The law attempts to bring parties to the table and negotiate a settlement, but fails to give the fiscal assistance board or the county any leverage to secure consensual agreements. Because Chapter 9 is unavailable, creditors will typically hold out on the premise that the state will intervene if the situation deteriorates. Without any meaningful threat or incentive, the county can only expect meager concessions. Oregon's approach exemplifies the problems that plague the vast majority of delineated state restructuring mechanisms.<sup>119</sup>

Ultimately, distressed municipalities have a dearth of options at the state level. This problem is amplified by the deficiencies at the federal level.

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116. See OR. REV. STAT. ANN. § 203.095 (West 2012).

117. See *id.*; OR. REV. STAT. ANN. § 203.100 (West 2013).

118. Oregon state law allows only irrigation and drainage districts to file for Chapter 9. See OR. REV. STAT. ANN. § 548.705 (West 2015).

119. A few states have adopted proactive, delineated debt restructuring mechanisms, but these mechanisms have their own idiosyncratic deficiencies. For example, Florida has a proactive monitoring system for its municipalities. Municipalities are required to submit to the state a detailed financial report each year. See FLA. STAT. ANN. § 218.30-218.391 (West 2014). The audited report must include the municipality's revenue, expenses, and long-term debt. Reports that indicate significant unresolved financial issues are submitted to a state oversight committee. *Id.* § 218.39. State law also makes municipalities subject to review and oversight by the governor if certain financial-distress indicators are present. *Id.* § 218.503. These procedures theoretically allow state officials to identify distressed municipalities prior to crisis. However, as discussed further below, the restructuring mechanism is limited because it does not contemplate intervention by state officials. Instead, local officials are allowed to attempt to resolve financial crises but are not allowed to file a Chapter 9 petition without obtaining approval from the governor. This system does not create a structure that facilitates negotiation or enhances the prospect of meaningful settlement.

*B. The Misplaced Fulcrum: Why Chapter 9 Is Not the Answer*

In the last forty years, the perception of corporate restructuring under Chapter 11 of the bankruptcy code has evolved dramatically. In the 1960s, distressed companies and the law firms that represented them did not view financial restructuring through federal bankruptcy law as an option.<sup>120</sup> Bankruptcy's stigma was to be avoided at all costs.<sup>121</sup> But over time, the stigma eroded, and bankruptcy reorganization became a viable option to struggling corporations.<sup>122</sup> This metamorphosis came about in part due to the unique powers that Chapter 11 bestows on corporate debtors. Indeed, Chapter 11 is a debt restructuring process that offers myriad forms of relief that are completely unavailable outside of federal bankruptcy court. A powerfully engaged bankruptcy judge guides the Chapter 11 process and can compel negotiations and extract concessions from recalcitrant constituencies. The process moves swiftly due to the limited period during which the debtor has the exclusive right to propose a plan of reorganization. Chapter 11's benefits are unquestioned in the business community, and a bankruptcy filing is no longer viewed as some repugnant last resort.<sup>123</sup> However, Chapter 9 bears little resemblance to Chapter 11.

A Chapter 9 bankruptcy judge plays an extremely different case role than a Chapter 11 bankruptcy judge. Bankruptcy judges are federal actors precluded from directly interfering with a governmental arm of a sovereign state. A federal court's interference with local democracy could undermine structural principles of federalism and separation of powers.<sup>124</sup> This noninterference principle demotes the

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120. See Harvey R. Miller, *Chapter 11 in Transition—From Boom to Bust and Into the Future*, 81 AM. BANKR. L.J. 375, 376 (2007).

121. See *id.*

122. See, e.g., Maria Chutchian, *5 Years Later: What We've Learned Since GM's Bankruptcy*, LAW360 (Apr. 28, 2014, 8:38 PM), <http://www.law360.com/articles/532302/5-years-later-what-we-ve-learned-since-gm-s-bankruptcy> [<http://perma.cc/XGV4-HYQF>] ("Consumer interest in GM and Chrysler has not wavered in the years following their bankruptcies, and that can probably be credited to the decline of the stigma that once accompanied a bankruptcy filing, Chuck Tatelbaum of Tripp Scott said. 'It used to be ... almost like a scarlet letter on you if you were a debtor. Now it's just considered a business matter,' he said.").

123. See *id.*

124. Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 435 (1993).



bankruptcy judge overseeing a Chapter 9 municipal debtor to the role of a detached case manager.<sup>125</sup> The judge lacks the power to guide the case or compel officials to take actions that will address the debtor's systemic deficiencies.<sup>126</sup> Unlike corporate restructurings, Chapter 9 filings are "intensely a negotiation model because the judge's powers are greatly limited."<sup>127</sup> Chapter 9 is a poor tool for resolving a municipality's financial problems because judges lack proper governance controls over municipal debtors and local officials.<sup>128</sup>

The Code does not contemplate a Chapter 9 judge facilitating resource adjustment, and other parties appear unable or unwilling to fill this void. Indeed, a passive jurist creates a problem that goes beyond mere unrealized utility. A passive jurist is attractive to local officials due to political expediency. As noted above, key local officials are invariably displaced in state law reorganizations by a receiver, a state agency, or some sort of control board. Displacement is one of the worst outcomes an elected official can face.<sup>129</sup> "Just as

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125. See Gillette, *supra* note 33, at 291-92.

126. See 11 U.S.C. § 904 (2012) ("Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—(1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property.").

127. STATE ROLE IN LOCAL GOVERNMENT, *supra* note 100, at 12 (quoting Chief Judge Christopher M. Klein of the U.S. Bankruptcy Court for the Eastern District of California).

128. See Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403, 417 (2014); see also McConnell & Picker, *supra* note 124, at 435-36.

129. The bankruptcy case of Harrisburg, Pennsylvania offers insight into this phenomenon. In 1972, the City of Harrisburg opened a for-profit incinerator "to burn trash, produce steam and eventually generate electricity." Stephen C. Fehr, *Pittsburgh and Harrisburg: A Tale of Two Deep-in-Debt Cities*, STATELINE (Oct. 20, 2011), <http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2011/10/20/pittsburgh-and-harrisburg-a-tale-of-two-deepindebt-cities> [<http://perma.cc/US87-CGMV>]. The city issued bonds to finance the project, but the incinerator's costs exceeded revenues. *Id.* In 2003, the federal government shut down the incinerator, demanding that it be retrofitted to comply with the Federal Clean Air Act. See *id.* By that time, the project was \$100 million in debt. *Id.* Undeterred, city officials decided to borrow \$125 million to bring the incinerator into compliance. *Id.* The work was to be performed by Barlow Projects, but the company was unable to finish the project and the City was forced to borrow additional funds to complete the project. See Moringiello, *supra* note 33, at 239. By 2011, the city was unable to make payments on its bond debt, which was four times the city's annual budget. *Id.* at 240. Facing the prospect of a state takeover and appointment of a receiver, city officials authorized and initiated a Chapter 9 bankruptcy filing with the hope of maintaining decision-making authority and exploring other means of obtaining short-term revenue, including a tax increase and asset sale. See *id.* at 240-43. City officials pursued



the management of Chapter 11 debtors are often accused of manipulating the process to save their own jobs, so it is for the ‘management’ of a municipality.”<sup>130</sup> Chapter 9 can become a safe haven for local officials who wish to stay in power and need more time to devise cost-shifting measures.<sup>131</sup> Indeed, officials have generally enjoyed autonomy in Chapter 9 and many have sought measures that provide short-term revenue with oversized long-term costs.<sup>132</sup> This phenomenon explains why so many municipalities encounter significant financial distress shortly after exiting expensive Chapter 9 processes.<sup>133</sup> Ultimately, the risk of additional cost shifting plagues Chapter 9, and the process can be used to merely perpetuate an existing power structure as opposed to supporting structural improvements.

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bankruptcy even though the state had explicitly banned the city from filing a petition. *See id.* at 243.

130. Judith Elkin, *A “Time Out” for Municipalities: The Recent Workings of Chapter 9 of the Bankruptcy Code*, in CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS, COUNSELING MUNICIPALITIES AND ANALYZING RECENT TRENDS AND CASES, ASPATORE, 2011 WL 5053638, at \*6 (2011).

131. For example, Pat Morris was the mayor of San Bernardino, California when the city filed its bankruptcy petition in August 2012. *See* Editorial, *San Bernardino Mayor Pat Morris Never Stopped Looking Forward*, SAN BERNARDINO CTY. SUN (Feb. 28, 2014, 3:38 PM), <http://www.sbsun.com/opinion/20140228/san-bernardino-mayor-pat-morris-never-stopped-looking-forward-editorial> [<http://perma.cc/E8PA-H3TR>]. Morris remained mayor until February 2014. *Id.* Similarly, Matthew Lehman was mayor of Mammoth Lakes, California when the city filed its bankruptcy petition in July 2012. *Lehman Passes Gavel to Wood*, MAMMOTH TIMES (June 20, 2013), <http://www.mammothtimes.com/content/lehman-passes-gavel-wood> [<http://perma.cc/A6KW-ZSP6>]. Lehman remained in power until June 2013. *Id.* Ron Davis was mayor of Prichard, Alabama when the city filed its bankruptcy petition in October 2009. *See* Brendan Kirby, *Troy Ephriam Defeats Incumbent in Prichard Mayoral Race, 2 Councilmen Lose*, AL.COM (Oct. 23, 2012, 8:55 PM), [http://blog.al.com/live/2012/10/troy\\_ephriam\\_defeats\\_incumbent.html](http://blog.al.com/live/2012/10/troy_ephriam_defeats_incumbent.html) [<http://perma.cc/DR5H-XYBA>]. Davis remained in power until January 2013. *Id.*

132. *See supra* notes 130-31 and accompanying text.

133. *See* Denniston, *supra* note 108, at 273 (discussing the bankruptcy case of the city of Vallejo, California and questioning a “process that takes three years to complete and results in confirmation of a plan of adjustment that leaves the city with a \$3.4 million dollar shortfall in its first post-bankruptcy budget”); *see also* Barnett Wright, *One Year Ago Jefferson County Emerged from Bankruptcy. Did Wall Street Fleece the County Commission?*, AL.COM (Dec. 3, 2014), [http://www.al.com/news/birmingham/index.ssf/2014/12/one\\_year\\_later\\_jefferson\\_count.html](http://www.al.com/news/birmingham/index.ssf/2014/12/one_year_later_jefferson_count.html) [<http://perma.cc/5WJF-YUPU>] (describing the difficulties that Jefferson County is experiencing even after undertaking an expensive Chapter 9 bankruptcy process).

The poorly formed results produced by the municipal bankruptcy process come at a staggering financial cost.<sup>134</sup> We can use large-scale corporate bankruptcy cases as a point of reference. There exists extensive literature discussing professionals' fees in Chapter 11 cases.<sup>135</sup> Chapter 11 corporate debtors retain a wide array of professionals to navigate turbulent waters efficiently and successfully. Not surprisingly, the fees generated in these cases can be astronomical.<sup>136</sup> In the Lehman Brothers bankruptcy case, professional fees exceeded \$1 billion.<sup>137</sup> Municipal bankruptcy cases have similar dynamics. "Preparing and litigating a bankruptcy filing for a municipality is no less costly than a major Chapter 11 filing because of the complexity of the issues, and the amount of time and the number of legal, financial and accounting experts needed to reach conclusion."<sup>138</sup> These unavoidable expenses deplete municipal debtors' already diminished financial coffers.<sup>139</sup>

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134. See ROBERT DOTY, BLOOMBERG VISUAL GUIDE TO MUNICIPAL BONDS 23 (2012) (explaining that state officials are "well-aware that [Chapter 9] proceedings are extremely expensive, cumbersome, and time-consuming, with uncertain outcomes"); see also Spiotto, *supra* note 25 ("The Detroit bankruptcy was long and expensive. It is safe to say that the availability of a bankruptcy option has not proven to be a 'quick or easy fix' to municipalities.").

135. See, e.g., Lynn M. LoPucki & Joseph W. Doherty, *Rise of the Financial Advisors: An Empirical Study of the Division of Professional Fees in Large Bankruptcies*, 82 AM. BANKR. L.J. 141 (2008); Stephen J. Lubben, *Corporate Reorganization & Professional Fees*, 82 AM. BANKR. L.J. 77 (2008); Stephen J. Lubben, *The Chapter 11 Attorneys*, 86 AM. BANKR. L.J. 447 (2012); Stephen J. Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*, 74 AM. BANKR. L.J. 509 (2000).

136. See, e.g., Nancy B. Rapoport, *The Case for Value Billing in Chapter 11*, 7 J. BUS. & TECH. L. 117, 119 (2012).

137. See generally Liz Moyer, *Lehman Fees Hit \$1 Billion and Counting*, WALL ST. J., Nov. 23, 2010, at C1 (observing that "[l]ead bankruptcy counsel Weil Gotshal & Manges LLP got paid \$8.8 million in fees and expenses in October, increasing the firm's total to \$245.8 million"); see also Brian Baxter, *Bankruptcy Bonanza: Records Show \$80 Million in Legal Fees for GM*, AM. L. DAILY (June 15, 2009, 11:03 AM), <http://amlawdaily.typepad.com/amlawdaily/2009/06/80-million-in-legal-fees-for-bankrupt-gm.html> [<http://perma.cc/GG6F-EKFL>] (explaining that "GM has paid more than \$80 million in fees to [Weil, Gotshal & Manges, Jenner & Block, and Honigman Miller Schwartz and Cohn] over the past six months," with Weil Gotshal billing around \$54 million, Jenner & Block billing \$11.3 million, and Honigman billing \$15.1 million); Brian Baxter, *Bankruptcy Court Approves \$31 Million More in Chrysler Legal Fees*, AM. L. DAILY (Oct. 27, 2009, 6:40 PM), <http://amlawdaily.typepad.com/amlawdaily/2009/10/chrysler-fees.html> [<http://perma.cc/YWU5-MD9T>].

138. See Elkin, *supra* note 130, at \*6.

139. *Id.*; see also Barnett Wright, *Why Jefferson County Still Pays Millions to Lawyers for a Bankruptcy that Ended in 2013*, AL.COM (Mar. 16, 2015), [http://www.al.com/news/birmingham/index.ssf/2015/03/why\\_jefferson\\_county\\_continues.html](http://www.al.com/news/birmingham/index.ssf/2015/03/why_jefferson_county_continues.html) [<http://perma.cc/GLV9->

Uncertainty amplifies Chapter 9's cost to debtors. The law of municipal restructuring in Chapter 9 is undeveloped because of the relative dearth of filings.<sup>140</sup>

Since 1980, of the 55,000 municipal governments in the United States that sell bonds, only 276 have filed for bankruptcy protection—averaging out to less than ten per year.<sup>141</sup> By comparison, in 2013 alone, 33,212 businesses sought bankruptcy court protection.<sup>142</sup> The relatively meager volume of municipal cases leads to a crippling lack of instructive case law on key issues, most notably the ability of a municipality to reject collective bargaining agreements with employee unions and reduce principal debt obligations owed to bondholders. Succinctly, “[municipal bankruptcy] law is very unclear and uncertain.”<sup>143</sup> Municipalities and the parties affected by their financial distress have little guidance on how courts will rule on key issues.

This lack of precedent undermines settlement. Parties disadvantaged by the bankruptcy process are inclined to litigate even relatively minor disputes.<sup>144</sup> Further, adverse rulings merely set the stage for appeals because the paucity of municipal opinions at the bankruptcy court level is dwarfed by the lack of guidance at the appellate level. This litigation tornado decimates municipal resources.<sup>145</sup>

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140. See RAVITCH & VOLCKER, *supra* note 26, at 55 (explaining how a Chapter 9 filing can be an expensive venture into the unknown).

141. See AMERICA'S BIG CITIES, *supra* note 42, at 7.

142. ADMIN. OFFICE OF THE COURTS, BUSINESS AND NONBUSINESS CASES FILED, BY CHAPTER OF THE BANKRUPTCY CODE, DURING THE 12-MONTH PERIOD ENDING DECEMBER 31, 2013, [http://www.uscourts.gov/uscourts/statistics/bankruptcystatistics/bankruptcyfilings/2013/1213\\_f2.pdf](http://www.uscourts.gov/uscourts/statistics/bankruptcystatistics/bankruptcyfilings/2013/1213_f2.pdf) [<http://perma.cc/DHE4-BSMX>].

143. RAVITCH & VOLCKER, *supra* note 26, at 56.

144. See David L. Tillem, *An Overview of Bankruptcy Litigation*, in BANKRUPTCY LITIGATION AND DISPUTE RESOLUTION: LEADING LAWYERS ON KEY CASE STRATEGIES, RISK ASSESSMENT, AND SETTLEMENT CONSIDERATIONS, ASPATORE, 2008 WL 5939819, at \*6 (2008) (“Bankruptcy litigations, however, can be somewhat more intense if a debtor ... has already abandoned any notion of saving its reputation and is more inclined to try to save its life or its existence. The creditor, on the other hand, may see little advantage in negotiating with the debtor, given that many bankruptcy issues are win or lose.”).

145. For example, disputes over whether the debtor is eligible to file a bankruptcy petition under Section 109 are exhausting. See Michael Newman, Comment, *BAPCPA's New Section 109(H) Credit Counseling Requirement: Is it Having the Effect Congress Intended?*, 2007 UTAH L. REV. 489, 491 (2007) (“Generally speaking, the consequences of a debtor's failure to comply

Chapter 9's harmful effects extend even further. Federal bankruptcy court is an extremely public forum. All filings are public, including sensitive disclosures about a debtor's systemic financial and structural problems.<sup>146</sup> The public nature of these proceedings will invariably lead to a suspension or, at the very least, a reduction in a municipality's credit rating.<sup>147</sup> The municipality will experience higher borrowing costs even after it exits bankruptcy.<sup>148</sup> And, depending on its treatment of bondholders, the additional costs could be significant, undermining the municipality's post-bankruptcy recovery. Adjacent municipalities, and the home state may also face higher borrowing costs if the market fears that the problems affecting the debtor could spread.<sup>149</sup>

Bankruptcy professionals and scholars may dispute the extent of Chapter 9's deficiencies, but in many ways, the effect of these deficiencies has already been corroborated by the municipal debtor market. As noted above, less than 0.1% of all municipal governments issuing debt "have filed for bankruptcy protection since 1980."<sup>150</sup> And only eleven states give their municipalities the discretion to file a Chapter 9 petition.<sup>151</sup> Naturally, the lack of municipal bankruptcy cases since 1980 could be attributed to either a lack

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with the eligibility provisions of section 109 ... are far more severe than the consequences of failure to comply with the 'routine' filing requirements of section 521."). There is no eligibility-inquiry equivalent for corporate debtors. *See* 11 U.S.C. § 109 (2012). But municipal debtors are faced with a gatekeeper issue that is not guided by case law and is characterized by extremely subjective determinations. Eligibility disputes are costly and creditors who have been unwillingly dragged into bankruptcy invariably appeal adverse rulings with the knowledge that a victory ends the entire proceeding. The drain on municipal coffers from this one issue is disproportionately crippling.

146. *See* Elkin, *supra* note 130, at \*7.

147. *See id.* at \*6.

148. *See id.*

149. LACHMAN & POLNER, *supra* note 1, at 167. Although New York City did not file for bankruptcy, its ordeal was extremely public, and it affected the borrowing costs for the state and other cities within New York.

150. *See* AMERICA'S BIG CITIES, *supra* note 42, at 7, 13. The vast majority of Chapter 9 filings are made by utility, water, and other special districts that generally manage one discrete social service and have no taxing authority. *See generally* Spiotto, *supra* note 37.

151. *See* AMERICA'S BIG CITIES, *supra* note 42, at 9-10; GEORGE MASON UNIV. CTR. FOR STATE & LOCAL GOV'T LEADERSHIP, LOCAL GOVERNMENT FISCAL CRISES: THE CRISIS FACING LOCAL GOVERNMENTS AND WHY IT MATTERS 11 (2013), [http://www.s3.amazonaws.com/chssweb/documents/12810/original/GMU\\_Fiscal\\_Lit\\_Review.pdf?1379616883](http://www.s3.amazonaws.com/chssweb/documents/12810/original/GMU_Fiscal_Lit_Review.pdf?1379616883) [<http://perma.cc/M56U-BTCS>].

of free access or a high level of financial stability across the sub-national landscape. But this is not the entire story. The scarcity of cases is the result, at least in part, of the belief key state decision-makers hold that Chapter 9 is a flawed process to be avoided.<sup>152</sup> In some respects, the municipal debtor market has already rejected Chapter 9.

Nevertheless, a wave of insolvency is approaching this market.<sup>153</sup> Chapter 9 is not the fulcrum point for municipal recovery. The solution lies within a state law debt adjustment mechanism.

### III. A NEW FULCRUM POINT<sup>154</sup>

Due to Chapter 9's financial and non-financial costs, inherent inefficiencies, poorly formed results, and potential impotency, municipalities need a meaningful restructuring option at the state level. States should establish a comprehensive restructuring mechanism under state law, and Chapter 9 should be an absolute last resort—a venue to resolve the most vexing municipal problems.

Basic notions of federalism buttress this construct. Although the harm from municipal distress radiates, directly harmed parties are invariably local. In that respect, municipal distress represents a truly regional problem. Aside from a few institutional bondholders, almost all primary stakeholders, including elected officials, overseers, current and former employees, and creditors, are located within the home state.<sup>155</sup> Resolution networks are intrastate, not interstate. Consequently, the role that federal bankruptcy law can play must be minimized. Elected state officials—not an appointed federal jurist—should be tasked with resolving the municipality's financial difficulties.

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152. See *supra* note 134 and accompanying text.

153. See Chutchian, *supra* note 31.

154. My proposal does not attempt to create a parallel bankruptcy system under state law. See, e.g., 11 U.S.C. § 903 (2012) (providing that any “State law prescribing a method of composition of indebtedness [for a municipality] may not bind any creditor that does not consent to such a composition”). My proposal does not attempt to provide any method to specifically adjust a municipality's indebtedness and is unaffected by § 903.

155. See generally Hannah Heck, Comment, *Solving Insolvent Public Pensions: The Limitations of the Current Bankruptcy Option*, 28 EMORY BANKR. DEV. J. 89, 92-97 (2011).

Nevertheless, Chapter 9's minimized role should not be construed as superfluous. Chapter 9 is not an ideal forum for municipal debt restructuring, but the provision serves an important purpose. In addition to providing a venue for nearly terminal municipalities, Chapter 9 incentivizes parties to negotiate when a proper out-of-court negotiation structure is available.<sup>156</sup> Key constituencies fear Chapter 9. Employee unions fear Chapter 9 primarily because judicial trends indicate a growing acceptance of collective bargaining agreement modification.<sup>157</sup> Bondholders fear Chapter 9 because of an evolving view that bondholder obligations are not sacrosanct and principal payment obligations can be slashed.<sup>158</sup> At the same time, state officials also fear Chapter 9 because the costs of the process—including increased borrowing costs for the state as well as municipalities adjacent to the debtor—and the likelihood of compromised results mean that a true recovery may be elusive.<sup>159</sup> Hence, by negotiating in Chapter 9's long shadow, key parties' incentives to compromise are heightened. This shared-preference dynamic enhances the prospects that a properly designed out-of-court negotiation structure will prove successful.

#### A. Overarching Goals

This Article proposes a clear negotiation structure for municipal debt adjustment—a concept that is entirely lacking at the state level

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156. See Moringiello, *supra* note 128, at 439 (“If the state wants to participate in the Chapter 9 case, it can do so by conditioning its Chapter 9 authorization on the debtor's participation in a state oversight program. If the state does not want to do so, the court can ensure that only worthy municipalities—those that are insolvent and that have negotiated in good faith with their creditors—can file.”).

157. See *Cent. Va. Cmty. Coll. v. Katz*, 546 U.S. 356, 362 (2006); *In re City of Stockton*, 478 B.R. 8, 15-16 (Bankr. E.D. Cal. 2012); *In re City of Vallejo*, 432 B.R. 262, 270-71 (Bankr. E.D. Cal. 2010); see also Matt Chiappardi, *Detroit's Ch. 9 Plan Draws Fierce, Immediate Criticism*, LAW360 (Feb. 21, 2014, 5:31 PM), <http://www.law360.com/articles/512047/detroit-s-ch-9-plan-draws-fierce-immediate-criticism> [<http://perma.cc/9P7J-NWYD>]; Maria Chutchian, *Proposed Cuts Will Heat up Detroit's Battle with Retirees*, LAW360 (Apr. 2, 2014, 9:23 PM), <http://www.law360.com/articles/524194/proposed-cuts-will-heat-up-detroit-s-battle-with-retirees> [<http://perma.cc/6NYD-XPEV>].

158. See Chiappardi, *supra* note 157; Maria Chutchian, *Detroit Plan Threatens Muni Bond Market, SIFMA Says*, LAW360 (May 12, 2014, 2:36 PM), <http://www.law360.com/articles/536928/detroit-plan-threatens-muni-bond-market-sifma-says> [<http://perma.cc/RE7Z-PN4E>].

159. See *supra* notes 146-49 and accompanying text.

and one that municipal insolvency literature has failed to explore. In many respects, this Article is working on a clean slate.<sup>160</sup> As a result, the first directive is to delineate clearly my proposal's goals and benefits. After presenting my debt adjustment mechanism's overarching objectives, Part IV will explore system details.

### *1. Sustainable Viability*

Throughout this Article, I have tried to highlight key differences between municipal and corporate debtors. These differences inform the most significant goal of any comprehensive state debt adjustment mechanism. Corporate debtors generally enter restructuring with a host of positive alternative endings. A corporate debtor may wish to travel through the Chapter 11 process and emerge as a reorganized company, as American Airlines recently did.<sup>161</sup> Another option is to sell a few key assets in order to improve cash flow or even sell essentially all assets, as Chrysler did in 2009.<sup>162</sup> A corporate debtor can also file for bankruptcy and pursue litigation claims based exclusively on federal bankruptcy law.<sup>163</sup> Finally, a corporate debtor can liquidate, allowing creditors to stake a claim to whatever funds are realized after an orderly sale, as Circuit City did in 2009.<sup>164</sup> These options afford management leverage in negotiating with creditors.

Further, creditors and employees are not captives of this process. Creditors can choose to exit the process. In large cases, creditor

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160. Scholars have indicated that some form of state debt adjustment mechanism may be worthwhile, but they fail to explore the issue in a substantive manner or explain how municipalities can prevail against a Contracts Clause challenge to any unilateral contract modification proposed by the state. See, e.g., Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 354 (2010).

161. Paul Stinson, *American Airlines Reorganization Plan Takes Flight; Vows 'Full Recovery by Creditors'*, BLOOMBERG BNA (May 8, 2013), <http://www.bna.com/american-airlines-reorganization-plan-takes-flight-vows-full-recovery-by-creditors/> [<http://perma.cc/UCW7-2CXV>].

162. Tomoe Murakami Tse, *Chrysler Gets Judge's Approval for Asset Sale*, WASH. POST (June 1, 2009, 10:44 AM), <http://www.washingtonpost.com/wp-dyn/content/article/2009/06/01/AR2009060100804.html> [<http://perma.cc/2W3T-8PPY>].

163. See *supra* Part II.B (discussing the frequency and advantages of corporations pursuing solutions under federal bankruptcy law).

164. Parija B. Kavilanz, *Circuit City to Shut Down*, CNN MONEY (Jan. 16, 2009, 5:50 PM), [http://money.cnn.com/2009/01/16/news/companies/circuit\\_city/](http://money.cnn.com/2009/01/16/news/companies/circuit_city/) [<http://perma.cc/9KGE-VGJZ>].



claims and corporate debt can be sold easily. Employees can quit, taking their portable 401k plans with them. In many respects, creditor recovery is not necessarily contingent on the debtor's survival. Creditors may recover more if the debtor is liquidated, sold to another party, or if key assets are sold.<sup>165</sup> Relationships between the corporate debtor and its creditors are temporal.

Municipal debtors do not have these diverse restructuring options. Large municipalities cannot liquidate,<sup>166</sup> effectively sell off significant assets,<sup>167</sup> or be acquired by another subnational government. This fact narrows a distressed municipality's options considerably. Municipalities enter restructuring with the sole objective of emerging after achieving some form of debt relief. Creditors are usually bound to municipalities through this process. Current employees have the option of simply quitting their jobs, but, as a whole, municipal employees have developed a skill set not easily transferrable to the private sector. More importantly, the municipality owes employees pension and healthcare benefits. An employee cannot sell this obligation.

Bondholders are in a slightly better position because there is a market for municipal debt. By the time a municipality is seriously exploring restructuring options, however, the debt may be selling at a discount that would make a sale foolish.<sup>168</sup> Bondholders frequently hold an illiquid instrument that will not mature for many years.<sup>169</sup> The conclusion is that key municipal creditors and the municipality experience a level of interdependence that is entirely unique compared to the private sector. These creditors need the municipality to become healthy and viable. A full recovery on creditor claims is possible only by rejuvenating the municipality. Many creditors fail to

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165. See *supra* Part II.B.

166. This option does, however, theoretically exist for small municipalities. See Michelle Wilde Anderson, *Democratic Dissolution: Radical Experimentation in State Takeovers of Local Governments*, 39 *FORDHAM URB. L.J.* 577, 600-01 (2012).

167. See *supra* notes 93-99 and accompanying text.

168. This discount is largely due to severity of the financial crisis municipalities find themselves in before they file for bankruptcy. The worse the financial situation, the less the debt is valued on the market. See *supra* note 106 and accompanying text.

169. See Allan Roth, *Muni Bonds Costs—The Whole Truth*, CBS MONEYWATCH (Aug. 30, 2010, 11:19 AM), <http://www.cbsnews.com/news/muni-bonds-costs-the-whole-truth/> [<http://perma.cc/6DP4-SBLU>] (warning investors that municipal bonds are among the most illiquid assets available to investors).



appreciate this fact. Consequently, my proposal's primary objective is to afford a municipality the means to make necessary structural changes that will ensure sustainable viability. Indeed, sustainable viability represents the only means by which key stakeholders can be made whole and residents can continue to receive essential services in an optimal manner.

## *2. Proactive, Delineated Debt Adjustment Mechanism*

Effective debt restructuring mechanisms are proactive. As noted above, reactive systems have excessive deficiencies, not least of which is that the municipality is nearly terminal by the time restructuring officials intervene.<sup>170</sup> Changes made in 1978 to Chapter 11 of the Bankruptcy Code best exemplify the true value of a proactive approach.

The Bankruptcy Act was the precursor to the current Bankruptcy Code.<sup>171</sup> Chapter X of the Bankruptcy Act applied to corporate reorganizations and required, in almost all corporate bankruptcies, the appointment of a trustee upon approval of the bankruptcy petition.<sup>172</sup> The filing of a bankruptcy petition was, therefore, a precursor to key executives being removed from their positions with the company.<sup>173</sup> The rationale for this approach was the mistaken belief that new management would increase the odds of a successful reorganization.<sup>174</sup> In 1973, the Commission on the Bankruptcy Laws of the United States (Commission)<sup>175</sup> discovered that this provision

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170. *See supra* Part II.A.

171. Samir D. Parikh, *The Improper Application of the Clear and Convincing Standard of Proof: Are Bankruptcy Courts Distorting Accepted Risk Allocation Schemes?*, 78 U. CIN. L. REV. 271, 300 (2009).

172. *Id.*

173. *See id.* (indicating bankruptcy court appointed a disinterested trustee *after* the bankruptcy petition had been approved).

174. This understanding of a trustee's effect on bankruptcy proceedings has changed over time. A presumption against appointing a trustee exists today because it is understood that current management's familiarity with a business allows them to most efficiently orchestrate the corporation's rehabilitation. *Id.* at 302.

175. In 1968, a sub-committee of the Senate Judiciary Committee decided that a special commission was necessary in order to recommend changes to the Bankruptcy Act. *See* Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 173 (2004). In 1970, the National Bankruptcy Review Commission was formed. *Id.* In 1973, the Commission

had an unintended consequence: managers delayed filings while exploring aggressive rehabilitation techniques.<sup>176</sup> These tactics were rarely fruitful. Distressed companies frequently found their way into bankruptcy in a condition where resources had been depleted and liquidation was the only option.<sup>177</sup> The Commission found that Chapter X's approach actually decreased the likelihood of a successful reorganization.<sup>178</sup> In 1978, Congress amended the Bankruptcy Code to allow a corporate debtor's management to continue managing the debtor post-petition, except in cases of pre-petition fraud, dishonesty, incompetence, gross mismanagement, or similar criminal conduct.<sup>179</sup> This change was an attempt to make the bankruptcy process a proactive rehabilitation measure as opposed to the exclusive forum for the postmortem.<sup>180</sup>

The same perverse incentives that the Commission addressed in the 1970s plague municipal insolvency today.<sup>181</sup> To address this dynamic, a successful debt restructuring mechanism must contemplate aggressive, proactive involvement by individuals able to identify and address systemic problems, as well as make necessary structural changes at a time when these changes are meaningful. Multi-faceted monitoring is necessary to empower a proactive approach. Further, the restructuring process must have a sense of urgency. Parties should negotiate exhaustively, but within specific periods of time. Excessive rounds of negotiation increase costs and suppress meaningful agreement. By limiting the period for negotiation, restructuring officials must be empowered to take aggressive action upon expiration of the negotiation period. This dynamism will hopefully minimize process costs while encouraging bargaining.

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issued a report that proposed various changes and explained the policy arguments behind many of these changes. *Id.* at 174-75. This report served as the basis for many of the changes embodied in the 1978 Bankruptcy Code. *See id.* at 173-75.

176. *Id.*

177. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, PART I, H.R. Doc. No. 93-137, at 14 (1973).

178. *Id.* at 36-37.

179. *See* Parikh, *supra* note 171, at 299-300; *see also* 11 U.S.C. § 1104(a)(1) (2010). Trustees may also be appointed if the appointment is in the best interests of creditors, equity security holders, and other interests of the estate. § 1104(a)(2).

180. *See* Parikh, *supra* note 171, at 302.

181. *See supra* Part I.B.

Relatedly, an effective debt adjustment mechanism must be delineated to provide certainty. A process where parameters and procedures are defined *ex ante* incentivizes municipality and creditor constituencies to engage fully. Clarity engenders certainty. Under this premise, all key constituencies have a meaningful understanding of available options. This dynamic minimizes posturing and irrational threats. Without this certainty, the prospect of a state or federal bailout emboldens holdouts. This destructive behavior is typically associated with creditors, but it also affects municipal officials. A debt adjustment mechanism that precludes bailouts addresses the holdout phenomenon. Taking bailouts off the table also minimizes the risk of reckless pre-crisis behavior by local officials that often precipitates financial distress.

Most importantly, I propose eliminating the prospect of bailouts in order to right-size borrowing costs for municipalities. Fiscal federalism theorists have persuasively argued that local officials are incentivized to overgraze at the debt market commons on the premise that their obligations are backstopped by their home state.<sup>182</sup> This implicit guarantee artificially suppresses borrowing costs.<sup>183</sup> General state limits on borrowing and balanced budget requirements are easily circumvented.<sup>184</sup> Consequently, these provisions often fail to address perverse incentives and harm externalization.<sup>185</sup> Less obvious is the premise that an unfounded expectation of a state bailout creates moral hazard risk on the part of lenders.<sup>186</sup> Clandestine guarantors distort the lending market. Instead of lending prudently, lenders are incentivized to overlend, with the knowledge that any default will be covered by the state.<sup>187</sup> If lenders believe that the true risk of default approaches zero, the only material issue

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182. See, e.g., Gillette, *supra* note 33, at 287; see also Woodell et al., *supra* note 101, at 55 (“Distressed municipalities in most states do not have a bankruptcy option; it is frequently restricted by law .... Distressed municipalities will typically receive some additional state aid, oversight, or other outside intervention that prevents the dramatic credit deterioration that [municipalities] may suffer.”).

183. Gillette, *supra* note 33, at 286 (stating that implicit state guarantee reduces the municipalities’ borrowing interest rates).

184. See Spiotto, *supra* note 37, at 8.

185. See *id.* at 8-9.

186. See Richard C. Schragger, *Citizens Versus Bondholders*, 39 FORDHAM URB. L.J. 787, 800-01 (2012). I use the term “lenders” here to include bondholders.

187. *Id.* at 801.

that must be priced is interest rate fluctuations.<sup>188</sup> A delineated reorganization process that eschews bailouts will encourage lenders to adjust the cost of borrowing for municipalities. Ultimately, this change will deter local officials from overgrazing at the debt commons and force lenders to assess municipal borrower default risk accurately, which will ideally minimize lender moral hazard.<sup>189</sup>

### 3. *Meaningful Unilateral Contract Modification Options*

An effective restructuring mechanism does not need to create unilateral contract modification options for municipal or state officials. The system does, however, need to acknowledge that such options may exist under applicable state and federal law, and should empower restructuring officials to use these options if necessary.<sup>190</sup>

Municipal debt restructuring is a process plagued by an extraordinary level of inertia. An array of carrots and sticks are necessary to motivate creditors to come to the bargaining table and consider meaningful concessions. The threat of unilateral contract modification is a necessary—though not sufficient—criterion for successful negotiation. Without this threat, contract counter-parties are content to hold out for a state bailout.<sup>191</sup> Many scholars, academics, and policymakers have taken the position that the Constitution's Contracts Clause and sister provisions found in state constitutions represent an absolute bar on contract modification.<sup>192</sup> This belief

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188. *See id.* at 799-801 (arguing that municipalities holding bonds are not punished for default because states act as guarantors on their municipalities' bonds, which leads to overlending).

189. *See* Gillette, *supra* note 33, at 311-12 (noting that the prospect of a bailout exacerbates the overgrazing problem because the default risk is subsidized by the state).

190. For a full discussion, see *infra* Part III.C.

191. Debtors hold out for the same reason lenders overlend and municipalities overgraze: the belief that the state will not allow a municipality to fail. *See supra* notes 182-89 and accompanying text.

192. *See, e.g.,* David Crump, *The Economic Purpose of the Contract Clause*, 66 SMU L. REV. 687, 689-92 (2013) (arguing that the Clause was adopted for economic reasons, namely to decrease the risk associated with investment); Richard A. Epstein, *Toward a Revitalization of the Contract Clause*, 51 U. CHI. L. REV. 703, 705 (1984) (arguing that the Clause acts as a substantial protection to economic liberties against state interference); Douglas W. Kmiec & John O. McGinnis, *The Contract Clause: A Return to the Original Understanding*, 14 HASTINGS CONST. L.Q. 525, 526 (1987) (arguing that, properly understood, the Clause prohibits all state retrospective interference with contracts); Thomas W. Merrill, *Public Contracts*,

affects collective bargaining agreements and municipal bonds. As explored below, however, this prohibition is wildly overstated and, quite frankly, misunderstood.<sup>193</sup> My restructuring mechanism acknowledges that unilateral contract modification may be permissible for a municipality in financial crisis. Restructuring officials are empowered to use all available powers to gain concessions and attempt to achieve sustainable viability for the municipality. The battle defining the lawful scope of these powers may be waged in state or federal court, but my system does not preclude nor attempt to discourage this fight.

Ideally, as discussed below, a truly distressed municipality would be able to plausibly threaten unilateral modification of its contracts in order to spur necessary concessions from key constituencies.<sup>194</sup> Consensual—not unilateral—modifications are my restructuring mechanism's overriding objective.<sup>195</sup> But consensual modifications cannot be realized without proper incentives.

#### 4. *Maintain Access to Credit Markets*

My restructuring mechanism removes the state as an implicit guarantor of a municipality's debt. This alteration could theoretically raise borrowing costs. In some cases, this change, coupled with a financial crisis, could prevent a municipality from accessing credit markets. Consequently, keeping financing avenues open is one of the primary tasks for restructuring officials under my system. My

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*Private Contracts, and the Transformation of the Constitutional Order*, 37 CASE W. RES. L. REV. 597, 598-99 (1987) (noting that state impairment of public contracts is subject to a more rigorous review than state impairments to private contracts); Robert C. Palmer, *Obligations of Contracts: Intent and Distortion*, 37 CASE W. RES. L. REV. 631, 635-46 (1987) (analyzing the legislative history and text of the Clause and concluding it was meant to impose an absolute prohibition on state interference with contracts); see also Michael Cataldo, Note, *Revival or Revolution: U.S. Trust's Role in the Contracts Clause Circuit Split*, 87 ST. JOHN'S L. REV. 1145, 1147-48 (2013) (establishing the strength of protection the Contracts Clause initially gave contracts); Michael B. Rappaport, Note, *A Procedural Approach to the Contract Clause*, 93 YALE L.J. 918, 918, 923-24 (1984) (proposing a Contracts Clause approach that prohibits a state from altering a contract ex post without just compensation as consistent with the Founders' purpose).

193. See *infra* Part III.C.

194. See *infra* Part III.C.

195. See *infra* Part IV.D. (noting the goal and structure of the proposal is based on consensual contract modification).

system supports restructuring officials in this pursuit by signaling strength to the market. As noted above, my system is delineated and provides a clear restructuring path. Restructuring officials receive the means to effect necessary structural changes. In crisis situations, local officials are often associated with the problems plaguing the municipality.<sup>196</sup> My system minimizes their role. Certainty, coupled with the potential for sustainable viability, will ideally calm creditors and the credit markets.

#### *5. Safeguard the Chapter 9 Option if Negotiations Fail*

True deadlines with undesirable results open doors to negotiation. As noted above, a Chapter 9 filing represents an undesirable result to many municipal constituencies.<sup>197</sup> Twenty-six states forbid cities and counties from filing.<sup>198</sup> Fourteen states attach conditions on a filing or make the filing subject to specific approval by the governor or other state official or agency.<sup>199</sup> These states undermine debt modification by empowering holdouts and relegating themselves to the role of implicit guarantor of municipal debts and services.<sup>200</sup> Under my proposal, restructuring officials have autonomy to authorize a Chapter 9 filing if the negotiations required under the system's parameters prove fruitless. This option is subject to satisfying a variety of negotiation prerequisites, but, once authorized, cannot be altered by state officials or legislatures. This aspect, coupled with the elimination of bailouts, brings holdouts to the negotiating table.

With these five principles in mind—(1) achieving sustainable viability, (2) establishing a proactive delineated system, (3) preserving unilateral contract modification, (4) maintaining access to credit markets, and (5) safeguarding the Chapter 9 option—the next

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196. See *supra* note 63 and accompanying text (explaining how local officials are incentivized to overgraze at the debt commons, which leads to bankruptcy issues).

197. See *supra* Part II.B (discussing the cost, uncertainty, and history of public officials using Chapter 9 to avoid consequences).

198. STATE ROLE IN LOCAL GOVERNMENT, *supra* note 100, at 9-10.

199. *Id.* Only ten states give municipalities discretion to file a Chapter 9 petition. See *id.*

200. *Id.* at 14-17 (explaining that such states intervene out of fear of stigma, contagion, a state-wide credit downgrade, declines in public health and safety, and economic instability).

Section discusses which party should be tasked with managing the restructuring mechanism.

*B. Managing the Restructuring Mechanism: State Primacy and Reversing Devolution During Financial Distress*

The term “devolution” describes a state’s delegation of power and management of local affairs to municipalities and their residents. This practice is the foundation of the “home rule” movement, which seeks to “ensure[] that governmental power is exercised closest to the people.”<sup>201</sup> Devolution must be reversed during municipal financial distress.

As noted above, municipalities are plagued by cost shifting, and policymakers are consumed with discovering ways to minimize this practice.<sup>202</sup> When a municipality is financially distressed, however, cost shifting’s harm has already been realized, and the inquiry must shift to determine which parties are in the best position to bear legacy costs and prevent a financial crisis. Among all key constituencies, states and state officials are best positioned and properly incentivized to address municipal distress in an efficient, meaningful, and sustainable manner.

States are primarily concerned with municipal distress due to contagion risk.<sup>203</sup> Not unlike individuals, states are “enormously concerned with their credit rating.”<sup>204</sup> A state’s credit rating affects borrowing costs and access to credit. The rating holds enormous implications for many key operational issues. Unfortunately, unlike individuals, a subnational government’s debts and financial health are extremely difficult to assess.<sup>205</sup> As noted above, cost-shifting practices abound, and the effects of these practices are not entirely clear to lenders and bondholders. Consequently, perception plays a

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201. David J. Barron, *Reclaiming Home Rule*, 116 HARV. L. REV. 2255, 2259 (2003).

202. See, e.g., Gillette, *supra* note 33, at 330 (summarizing his argument as an attempt to get municipal residents and local officials to internalize the cost of their activities).

203. See STATE ROLE IN LOCAL GOVERNMENT, *supra* note 100, at 16.

204. Schwarcz, *supra* note 35, at 333; see also STATE ROLE IN LOCAL GOVERNMENT, *supra* note 100, at 15-16; Gillette, *supra* note 33, at 304 (“[C]entralized governments that intervene in the face of municipal fiscal distress are motivated largely by a perception of contagion risk.”).

205. Gillette, *supra* note 33, at 303.



large role in evaluating a state's creditworthiness, which explains contagion risk. Professor Gillette notes that "[i]n theory, contagion should not occur because investors [and lenders] will distinguish financially healthy jurisdictions from distressed ones."<sup>206</sup> But the municipal borrower market is an opaque market characterized by limited disclosure that precludes accurate risk assessment.<sup>207</sup> Consequently, default risk is premised on a number of factors outside the state's control. Standard & Poor's, one of the preeminent municipal debt rating agencies, considers local government financial difficulties among its broad set of criteria for establishing a state's credit rating.<sup>208</sup> Distress in one municipality can affect the credit rating for other municipalities within that state and infect the state itself. Various studies have reached inconsistent results, but there is evidence that the contagion from New York City's near default in the 1970s affected borrowing costs for other local municipalities and the state.<sup>209</sup> Though this contagion effect may be temporary, the phenomenon and its potential harm cannot be ignored.<sup>210</sup>

Furthermore, essential services customarily provided by municipalities, including fire, police, health, and safety services, are implicitly guaranteed by the state. Distressed municipalities are often unable to pay for essential services. Service interruptions create a gaping hole into which the state is forced to plunge. As summarized by Pennsylvania Governor Tom Corbett, "municipal governments

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206. *Id.*

207. *Id.*; see also ANDREW ANG & RICHARD C. GREEN, THE HAMILTON PROJECT, LOWERING BORROWING COSTS FOR STATES AND MUNICIPALITIES THROUGH COMMONMUNI 8-9 (2011), [https://www0.gsb.columbia.edu/faculty/aang/papers/THP%20ANG-GREEN%20DiscusPage\\_Feb2011.pdf](https://www0.gsb.columbia.edu/faculty/aang/papers/THP%20ANG-GREEN%20DiscusPage_Feb2011.pdf) [<https://perma.cc/62DA-5DWP>].

208. See STANDARD & POOR'S, TOP 10 MANAGEMENT CHARACTERISTICS OF HIGHLY RATED CREDITS IN U.S. PUBLIC FINANCE 1, 4 (2013), <http://www.ncsl.org/Portals/1/documents/fiscal/Top10Management.pdf> [<http://perma.cc/W5V3-32E7>] ("At the state level, we believe that local government fiscal difficulties can increase and become a funding challenge for the state.").

209. See Edward M. Gramlich, *New York: Ripple or Tidal Wave? The New York City Fiscal Crisis: What Happened and What Is to be Done?*, 66 AM. ECON. REV. 415, 423-26 (1976).

210. See David S. Kidwell & Charles A. Trzcinka, *Municipal Bond Pricing and the New York City Fiscal Crisis*, 37 J. FINANCE 1239, 1246 (1982). Importantly, contagion also exists in another context. Financial struggles and bankruptcy are particularly troubling for sub-national governments. When a prominent city files for bankruptcy or is experiencing financial crisis, these events color the perception of that city, as well as surrounding cities and the state in which that city is located. See STATE ROLE IN LOCAL GOVERNMENT, *supra* note 100, at 15-16. No state official wishes to be associated with this scarlet letter.



[should address] their own problems and com[e] together to develop a fiscal recovery plan when necessary .... But when that fails to happen, the state has to take action to ensure public safety.”<sup>211</sup> For example, in 2011, the City of Camden, New Jersey was forced to cut the city’s police force, which led to an increase in crime in the city.<sup>212</sup> New Jersey Governor Chris Christie had no choice but to redirect state troopers to patrol Camden to address the shortfall.<sup>213</sup>

States have also arguably guaranteed their municipalities’ pension obligations. As of 2008, “there [were] over 2,500 different public employee retirement systems providing benefits to the over 20 million” public sector employees.<sup>214</sup> Approximately “1,659 of [these systems] are municipal, while 218 exist at the state level.”<sup>215</sup> Government plans are not protected by the Employee Retirement Income Security Act (ERISA) or backstopped by the Pension Benefit Guarantee Corporation;<sup>216</sup> thus, this burden could fall on the state. And the burden is staggering. Pension systems are estimated to be underfunded by as much as \$4.4 trillion.<sup>217</sup> Like any guarantor, states are incentivized to ensure that the primary obligor does not default on its obligations.<sup>218</sup>

Finally, the state is uniquely positioned to lead the restructuring effort. State officials can facilitate necessary borrowing from the credit markets and relax state law borrowing restrictions. The state can allow the municipality to raise taxes or engage in revenue-

211. See Tara Leo Auchey, *Governor Corbett Signs Senate Bill 1151*, TODAY’S THE DAY HARRISBURG (Oct. 20, 2011), <http://todaysthehbg.com/governor-corbett-signs-senate-bill-1151/> [<http://perma.cc/WRQ4-MWWX>].

212. See Press Release, State of N.J., Office of the Governor, Governor Chris Christie Deploys State Police Resources to Aid Law Enforcement Efforts in Camden, NJ (Dec. 12, 2011) <http://www.state.nj.us/governor/news/news/552011/approved/20111212c.html> [<http://perma.cc/W5QK-PN85>].

213. See *id.*

214. John Beshears et al., *Behavioral Economics Perspectives on Public Sector Pension Plans* 4 (Nat’l Bureau of Econ. Research, Working Paper No. 16728, 2011) (citing data from the U.S. Census Bureau and the U.S. Bureau of Labor Statistics).

215. Buck, *supra* note 29, at 43-44.

216. See Ellman & Merrett, *supra* note 33, at 368.

217. See Buck, *supra* note 29, at 27; see also Novy-Marx & Rauh, *supra* note 29, at 48.

218. New York City’s financial crisis in the 1970s provides another example. Putting aside all the state had to provide to get the city through the crisis, in the years afterwards, the state had to increase intergovernmental aid to the city, assume the costs of the city’s Medicaid program and court system, and finance City University’s senior colleges. See SHEFTER, *supra* note 7, at 137-38.

generating practices that may otherwise be restricted under state law. And state officials are best situated to understand macro trends within state borders.

One key criticism of reversing devolution is that state officials' intervention compromises the integrity of the local municipal democracy.<sup>219</sup> Unfortunately, this is a necessary evil during financial distress. As we saw with New York City in the 1970s, local officials are sometimes too beholden to local interests to effectuate necessary change.<sup>220</sup> Local officials may be "imperfect agents of their [own] constituents" and are prone to "make decisions that serve personal political objectives."<sup>221</sup> Painful resource adjustment is difficult to achieve without abundant supplies of political will and political capital. Consequently, local officials are often tempted to make adjustments at the periphery, which quickly devolves to cost shifting. Political paralysis is common.<sup>222</sup>

Also, by the time a crisis materializes, local officials may be seen as being so closely aligned with the political forces responsible for the financial distress that current and prospective creditors may balk at any continued involvement. This disapproval frustrates negotiations with current bondholders and employees, and it may restrict access to credit markets.

Fundamentally, destabilizing financial distress is a complex problem demanding expertise that local officials rarely possess.<sup>223</sup> Local officials often have had many years to try to address structural problems. Affording these officials additional time is potentially irrational. Finally, the threat of reversing devolution serves as another means to encourage local officials to internalize the benefits and costs of their actions.<sup>224</sup>

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219. My proposal attempts to limit the effect of this compromise by including various elected officials in the restructuring process. *See infra* Part IV.C.2.

220. *See* LACHMAN & POLNER, *supra* note 1, at 118.

221. *See* Gillette, *supra* note 33, at 286.

222. Political paralysis is common for other reasons as well. Many agencies and officials that contribute to a municipality's financial distress are not subject to control by the municipality. These actors, such as health and human service agencies, impose costs on a municipality's budget, but are subject to state control.

223. I acknowledge that, in many cases, state officials may be no more knowledgeable or effective than local officials, but I assert that they most often represent the greatest likelihood for a successful restructuring.

224. Other constituencies are also ill-suited to monitor or guide a restructuring process.

*C. Addressing the Contracts Clause*

A properly functioning debt adjustment mechanism will primarily reduce a municipality's debt burden by targeting (1) labor costs and benefits and (2) bondholder debt. I focus on these two debt classes because they disproportionately affect a municipality's capital structure.<sup>225</sup> Even minor concessions within these classes can have a significant effect on a municipality's viability.

Not surprisingly, unilateral modification of these obligations is extremely difficult. Historically, distressed subnational governments have attempted to alter or defer payment obligations related to these two debt classes. Parties seeking to block these modifications have relied on state and federal constitutional provisions and have enjoyed protection in the courts.<sup>226</sup> Subnational governments have perhaps overreacted to defeats and unwittingly abandoned these battle lines. By conceding this high ground, however, distressed municipalities lack the leverage necessary to obtain meaningful concessions in restructuring negotiations. This fact, coupled with the disastrous dynamics that already exist in most states, embolden holdouts.

In the following subsection, I argue that the Contracts Clause, as it appears in the Constitution and various state constitutions, has been widely misunderstood. In fact, by utilizing carefully tailored, temporary contractual modifications, distressed municipalities have far more leverage and bargaining power than they likely suspect.

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For instance, residents are transient, and because municipalities are not profit-generating entities, residents—unlike shareholders—have little incentive to monitor them. Free riding is therefore far more common. *See* Schragger, *supra* note 186, at 790-91. Creditors are theoretically in a good position to curtail excessive risk-taking by restricting lending, but their monitoring is incomplete because their only concern is debt repayment. They are also prone to exploiting borrowers and other investors if information asymmetries exist. *See id.* at 790-92.

225. For example, salaries for employees of the City of Detroit constituted 50% of the city's operating expenses. Debt service was 16% of operating expenses. Pension contributions represented 10% of operating expenses. And healthcare benefits for retirees were approximately 18% of operating expenses. CITY OF DETROIT: PROPOSAL FOR CREDITORS 44-50 (2013), <http://www.detroitmi.gov/Portals/0/docs/EM/Reports/City%20of%20Detroit%20Proposal%20for%20Creditors1.pdf> [<http://perma.cc/4GGB-LB4X>].

226. *See* Buck, *supra* note 29, at 28-29.

### 1. *A New Perspective on the Contracts Clause*

The vast majority of states employ a contractual approach in protecting labor benefits and debt obligations owed to bondholders.<sup>227</sup> This means that states view these debts as contractual obligations even where benefits and entitlements are not specifically delineated in a written agreement. Consequently, any attempt by a subnational government<sup>228</sup> to unilaterally modify labor benefits or bondholder debt is subject to the Contracts Clause.

Article 1, Section 10 of the U.S. Constitution provides that “[n]o State shall ... pass any ... Law impairing the Obligation of Contracts.”<sup>229</sup> This seemingly rigid prohibition coupled with a host of

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227. See Eric M. Madiar, *Public Pension Benefits Under Siege: Does State Law Facilitate or Block Recent Efforts to Cut the Pension Benefits of Public Servants?*, 27 A.B.A. J. LAB. & EMP. L. 179, 181 (2012). A few states safeguard employee pension benefits through other approaches:

Connecticut, for example, ascribes to the proprietary approach. Under the proprietary approach, public employees obtain a property interest in statutory retirement benefits once they satisfy eligibility requirements; however, that interest is only protected from arbitrary legislative action by due process .... Minnesota adheres to the promissory estoppel approach .... The estoppel approach seeks to avoid injustice and focuses on the reasonableness of an employee’s reliance on the statutory benefit .... [P]ension benefits in states adopting [these] approach[es] lack meaningful legal protection outside of truly arbitrary action by the legislature.

*Id.* at 183-84. The gratuity approach has been adopted by Arkansas, Indiana, and Texas. *Id.* at 185. Under this approach, certain labor benefits are “mere expectanc[ies], created by the law, and liable to be revoked or destroyed by the same authority.” *Id.* at 184 (quoting *Pennie v. Reis*, 132 U.S. 464, 471 (1889)).

228. The Contracts Clause prohibition would arguably apply to state actors as well, and it would presumably preclude state court judges from impairing state and municipal contracts in instances when judicial action is ostensibly a substitute for legislation. See *N.Y. Times Co. v. Sullivan*, 376 U.S. 254 (1964); *Bridges v. California*, 314 U.S. 252 (1941).

229. U.S. CONST. art. I, § 10, cl. 1. The Contracts Clause’s intent and meaning are unclear. The “social and political context of the clause reveals little about the intentions of the framers.” Epstein, *supra* note 192, at 706. The debates over the clause at the Constitutional Convention were brief and inconclusive. See, e.g., *Allied Structural Steel Co. v. Spannus*, 438 U.S. 234, 257 (1978) (Brennan, J., dissenting); Epstein, *supra* note 192, at 706-08; Merrill, *supra* note 192, at 598-99. Furthermore, “not much more is to be gleaned from the historical accounts of the debates at the drafting and ratifying conventions.” Epstein, *supra* note 192, at 706. However, in those states in which the Clause was debated, it was understood to ensure access to credit for states and their citizens. See *Crump*, *supra* note 192, at 693. During this time, a preeminent problem was “the action of faithless states in trying to solve the problems of postwar depression by allowing paper securities to become worthless and by abrogating private contracts so as to benefit the abrogating states’ citizens at the expense of creditors.”

undefined terms has fed a litany of scholarly debates regarding the Clause's intent, meaning, and scope.<sup>230</sup> The Clause's terse language has also created a widely held misconception that the prohibition is absolute.<sup>231</sup> Fortunately, this scholarly cacophony dissipates within the judiciary. Contracts Clause jurisprudence has evolved slowly, but most courts have coalesced around key tenets. Courts have acknowledged that the Constitution is not a suicide pact,<sup>232</sup> and case law has been surprisingly uniform on the Clause's primary facets and exceptions, offering municipal debtors a surprising degree of bargaining leverage with unions and bondholders.

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*Id.* at 691. Indeed, states had engaged in "an ignoble array of legislative schemes for the defeat of creditors and the invasion of contractual obligations. Legislative interferences had been so numerous ... that the confidence essential to prosperous trade had been undermined and the utter destruction of credit was threatened." *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 427 (1934). These types of opportunistic defaults and rent-seeking activities were perpetrated by a small subset of subnational borrowers. *See, e.g.*, Epstein, *supra* note 192, at 713 n.28. Nevertheless, the effect of these defaults on the market was significant, causing lenders to frequently charge usurious rates of interest or deny states and their residents access to credit. *See Crump, supra* note 192, at 690-91. Many states saw contract enforcement as a means to ensure capital availability. *See id.*

230. *See, e.g.*, Crump, *supra* note 192, at 689-91; Epstein, *supra* note 192, at 706-08; Kmiec & McGinnis, *supra* note 192, at 525-27; Merrill, *supra* note 192, at 598-99; Palmer, *supra* note 192, at 631; *see also* Cataldo, *supra* note 192, at 1145-46; Rappaport, *supra* note 192, at 918-19.

231. Some scholars have argued that the Clause was intended to be an absolute bar on retroactive and prospective state impairment of private and public contracts. *See* Epstein, *supra* note 192, at 706-07; Kmiec & McGinnis, *supra* note 192, at 526; Palmer, *supra* note 192, at 635-36; Rappaport, *supra* note 192, at 923-24. But this position is difficult to reconcile with the historical record. There was a distinct lack of debate regarding the Clause at the Constitutional Convention. *See* Epstein, *supra* note 192, at 706. But if the Clause was to be applied literally, curtailment of state power would be severe. It is reasonable to expect that a sweeping impairment of this kind would have garnered more debate. Further, as noted above, in states that did debate the Clause—including South Carolina, Pennsylvania, North Carolina, and Virginia—the Clause was seen as addressing opportunistic defaults of the kind that had proliferated during that time and affected credit availability. *See* Crump, *supra* note 192, at 693-94. The Clause was not seen as superseding a state's basic police power to regulate private abuses or ensure the viability of the sovereign. *See id.* at 690. An argument can be made that, despite its language, the Clause's scope is circumscribed, as evidenced by the nominal discussion prior to ratification.

232. *See Terminiello v. City of Chicago*, 337 U.S. 1, 37 (1949) (Jackson, J., dissenting).

## 2. *The Federal Judiciary's Approach to the Contracts Clause*

Shortly after ratification of the Constitution, the Supreme Court was tasked with resolving the Contracts Clause's apparent ambiguity. The initial resolution promoted a "muscular restraint on state authority."<sup>233</sup> In a series of cases beginning in 1810, the Court staked out clear parameters by (1) interpreting the term "contract" broadly, (2) applying the Clause to both private contracts between individuals and public contracts between the state and individuals, and (3) adopting a near absolute prohibition on contract impairment by interpreting the term "impair" as equivalent to "alter."<sup>234</sup> The Court, led by Justice Marshall, used a firm hand to develop an unquestioned prohibition.<sup>235</sup> In the process, the Court affirmed the sanctity of contracts and supported the fledgling nation's market economy.<sup>236</sup>

But the Clause's ascension during this time represented the peak of its restraining power. A more stable nation prompted the Court to consider if there were exceptions to the Clause. In 1848, the Court acknowledged that there had to be a subset of state powers that were not subject to the Clause.<sup>237</sup> In *West River Bridge Co. v. Dix*, the Court held that every contract is made in subordination to a state's right of eminent domain.<sup>238</sup> In *Stone v. Mississippi*, the Court created what would become the reserved powers doctrine.<sup>239</sup> In that case, the Mississippi legislature granted a charter to the Mississippi Agricultural and Manufacturing Aid Society (Mississippi Agricultural) that allowed it to conduct a lottery for a period of twenty-five years.<sup>240</sup> However, the state adopted a constitution the

233. James W. Ely, Jr., *Whatever Happened to the Contract Clause?*, 4 CHARLESTON L. REV. 371, 374 (2010).

234. See *Green v. Biddle*, 21 U.S. 1 (1823); *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. 518 (1819); *Sturges v. Crowninshield*, 17 U.S. 122 (1819); *New Jersey v. Wilson*, 11 U.S. 164, 167 (1812); *Fletcher v. Peck*, 10 U.S. 87, 89 (1810); see also Kmiec & McGinnis, *supra* note 192, at 535-37.

235. Kmiec & McGinnis, *supra* note 192, at 535-40.

236. See Ely, *supra* note 233, at 374.

237. See *W. River Bridge Co. v. Dix*, 47 U.S. 507, 532-33 (1848).

238. *Id.*

239. 101 U.S. 814, 818 (1879). The reserved powers doctrine describes the proposition that a state may not enter a contract that "surrenders an essential attribute of its sovereignty." *U.S. Tr. Co. of N.Y. v. New Jersey*, 431 U.S. 1, 23 (1977).

240. *Stone*, 101 U.S. at 814-15.

following year that prohibited state lotteries and the sale of lottery tickets.<sup>241</sup> Mississippi Agricultural brought suit, arguing that its charter represented a contract that was insulated from state alteration by the Contracts Clause.<sup>242</sup>

In rejecting Mississippi Agricultural's argument, the Court carved out another exception to the Contracts Clause. The Court explained that no legislature could "curtail the power of its successors to make such laws as they may deem proper in matters of police."<sup>243</sup> In other words, the states had sovereign powers as to certain matters that could not be released by contract or bound by the Contracts Clause. With this ruling, the Court created a formidable exception. The Court noted that the exception certainly encompassed matters affecting the public health or morals, but also stated that other actions could be affected.<sup>244</sup> Jurists would have to determine on a case-by-case basis if the exception applied.<sup>245</sup>

The Clause's deterioration continued into the twentieth century and culminated with *Home Building & Loan Ass'n v. Blaisdell*.<sup>246</sup> In the midst of the Great Depression, the Minnesota legislature recognized that a severe financial and economic cataclysm was threatening farmers, businesses, and property owners.<sup>247</sup> The legislature declared a state of emergency and passed legislation that ostensibly created a two-year moratorium on the foreclosure of a variety of mortgages.<sup>248</sup> The legislation did not impair the integrity of the mortgage indebtedness, and mortgagees received a nominal rental payment during the moratorium.<sup>249</sup> The legislation was challenged as violating the Contracts Clause.

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241. *Id.* at 815.

242. *Id.* at 816.

243. *Id.* at 818.

244. *Id.*

245. *See id.*

246. *See* 290 U.S. 398 (1934).

247. *Id.* at 421 n.3.

248. *Id.* Naturally, this legislation assisted homeowners, but it also arguably assisted lenders. This ruling avoided the collective action problem that would have invariably arisen. Without the legislation, lenders would have rushed to foreclose on properties—acting in a manner that best suited their individual objectives. But a significant number of lenders would have sought to promptly resell the foreclosed property. These turnaround sales would have accelerated the decline in real property prices and created a glut in the market. The lenders, as a collective body, would have suffered.

249. *Id.* at 425.



In addressing the primary issue on appeal, the Court clarified that the prohibition found in the Contracts Clause was “not an absolute one and [could not] ... be read with [the] literal exactness of a mathematical formula.”<sup>250</sup> In exploring the contours of the Clause, the Court explained that states are empowered to safeguard their residents’ vital interests.<sup>251</sup> “It does not matter that legislation appropriate to that end ‘has the result of modifying or abrogating contracts already in effect.’ ... [T]he reservation of essential attributes of sovereign power is ... read into contracts as a postulate of the legal order.”<sup>252</sup> The Court then cited *Stone* and noted that this reservation of power had been recognized in instances affecting public health and safety.<sup>253</sup> But the power extended further, and the state’s economic interests could justify the exercise of its police power notwithstanding the interference with existing contracts.<sup>254</sup> The Court explained that the constitutional prohibition could not be construed as restricting limited and temporary contractual modifications necessitated by fiscal emergencies.<sup>255</sup>

With this foundation, the Court concluded that the legislation was constitutional because (1) an economic emergency existed in Minnesota, (2) the legislation addressed an emergency related to a basic interest of society and was not for the mere advantage of particular individuals, (3) the moratorium was appropriately tailored to the emergency that it was designed to meet, (4) the imposed conditions were reasonable, and (5) the impairment was temporary.<sup>256</sup> In reaching its conclusion, the Court noted that the Minnesota legislature had determined that there was a true emergency, and the Court would defer to that assessment.<sup>257</sup> The Court did not indicate that this deference would change in any way if the state had been a party to the contracts at issue. This opinion and the Court’s dispositive factors are the foundation for current Contracts Clause jurisprudence.

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250. *Id.* at 428.

251. *Id.* at 434.

252. *Id.* at 434-35 (quoting *Stephenson v. Binford*, 287 U.S. 251, 276 (1932)).

253. *Id.* at 436.

254. *Id.* at 437.

255. *Id.* at 439.

256. *See id.* at 444-47.

257. *Id.* at 444.

Subsequent years yielded additional rulings that reaffirmed the exceptions to the Clause.<sup>258</sup> In 1977, the Court revisited the Clause in *U.S. Trust Co. v. New Jersey*.<sup>259</sup> In the early 1960s, the New Jersey Port Authority (NJPA) was experiencing financial distress and had difficulty accessing the credit markets.<sup>260</sup> In an effort to boost investor confidence, the state passed legislation that provided new bondholders a dedicated revenue stream to satisfy bond obligations.<sup>261</sup> This was accomplished in part by precluding the NJPA from diverting revenue from the general fund to a variety of unapproved purposes.<sup>262</sup> The covenant helped the NJPA gain access to the bond markets, but soon proved to be a significant hindrance to various state transportation policy objectives. Consequently, in 1974, the state chose to retroactively repeal the covenant.<sup>263</sup> A trustee for a group of bondholders brought suit, arguing that the state had violated the Contracts Clause.<sup>264</sup> The Court agreed.<sup>265</sup>

The Court struck down the state statute finding that there was no emergency motivating the legislation, but the impairment was significant and represented a total repudiation.<sup>266</sup> Further, a less drastic modification could have been pursued. The Court moved away from the *Blaisdell* Court's high-deference approach to the state legislature's assessment of reasonableness and necessity, and noted that, because the state held a vested interest as a party to the contract, complete deference to the legislature's assessment of reasonableness and necessity would not be appropriate.<sup>267</sup> Ultimately, the Court held that the state could not refuse

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258. See, e.g., *City of El Paso v. Simmons*, 379 U.S. 497 (1965); *Gelfert v. Nat'l City Bank*, 313 U.S. 221, 235 (1941); *Veix v. Sixth Ward Bldg. & Loan Ass'n*, 310 U.S. 32 (1940).

259. See 431 U.S. 1 (1977).

260. See *id.* at 8-9.

261. See *id.* at 9.

262. See *id.* at 9-10.

263. See *id.* at 13-14.

264. *Id.* at 1.

265. *Id.* at 26, 32.

266. *Id.* at 25-29.

267. See *id.* at 25-26. *Blaisdell* prescribed a specific approach in evaluating a request to unilaterally modify a contract exclusively between private parties. *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 407 (1934). *U.S. Trust* involved contracts between private parties and the state, which can be described as "public contracts." See *U.S. Tr.*, 431 U.S. at 17, 45 n.13 (1977). In addressing the unilateral modification of a public contract, courts still follow the approach formulated by the *Blaisdell* court, but afford less deference to the

to meet legitimate financial obligations simply because it would prefer to spend the money to support some public good.<sup>268</sup> However, in reaffirming the—albeit diminished—power of the Contracts Clause, the Court promoted the criteria promulgated by the *Blaisdell* Court as the appropriate methodology for Contracts Clause interpretation.<sup>269</sup>

The following year, the Court heard *Allied Structural Steel Co. v. Spanaus*.<sup>270</sup> In that case, the plaintiff (Allied Structural) was an Illinois corporation with a small office in Minnesota.<sup>271</sup> The company offered employees a pension plan, but the plan did not require the company to make specific contributions and there were no sanctions for a failure to fully fund the plan.<sup>272</sup> The company retained the right to amend the plan and terminate it at any time.<sup>273</sup> In 1974, Minnesota passed legislation that stated that a qualifying private employer that provided pension benefits under a qualifying plan was subject to a pension funding charge if it terminated the plan or closed its Minnesota office.<sup>274</sup> Allied Structural closed its Minnesota office shortly thereafter, and the state assessed a \$185,000 funding charge.<sup>275</sup> The company argued that the legislation violated the Contracts Clause.<sup>276</sup>

In its ruling, the Court reiterated that the Contracts Clause is not absolute and cannot eviscerate a state's police power.<sup>277</sup> The Court endorsed the *Blaisdell* criteria for evaluating state action under the Contracts Clause but added an additional facet. The Court noted that the initial inquiry in such cases:

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state legislature's assessments regarding the need for the modification. However, "less deference does not imply no deference." *Buffalo Teachers Fed'n v. Tobe*, 464 F.3d 362, 370 (2d Cir. 2006). This is the only material difference in addressing private and public contracts.

268. *U.S. Tr.*, 431 U.S. at 29.

269. *See id.* at 15. Scholars have attacked the *U.S. Trust* opinion on a number of bases, including that it fails to respect the Clause's original intent. *See, e.g.*, Cataldo, *supra* note 192, at 1146. These criticisms, however, are generally outside the scope of this Article.

270. 438 U.S. 234 (1978).

271. *Id.* at 236.

272. *Id.* at 237.

273. *Id.*

274. *Id.* at 238.

275. *Id.* at 239.

276. *Id.* at 239-40.

277. *Id.* at 241.

must be whether the state law has, in fact, operated as a substantial impairment of a contractual relationship.... Minimal alteration of contractual obligations may end the inquiry at its first stage. Severe impairment ... will push the inquiry to a careful examination of the nature and purpose of the state legislation.<sup>278</sup>

After determining that the impairment at issue was severe, the Court moved through the *Blaisdell* criteria, finding the legislation deficient from all perspectives.<sup>279</sup> In striking down the legislation, the Court noted that the law was not enacted to deal with a widespread emergency or economic problem.<sup>280</sup> Further, the law caused a severe, retroactive, permanent, and immediate change in contractual relationships.<sup>281</sup> The Court concluded that even a diminished Contracts Clause prohibited the legislation at issue.<sup>282</sup>

This triumvirate shaped Contracts Clause jurisprudence through the twentieth century. Modern Contracts Clause cases, discussed below, have expanded on a variety of fundamental principles in a manner favorable to distressed municipalities.

In *Baltimore Teachers Union v. Mayor of Baltimore*, the Fourth Circuit Court of Appeals ruled that a temporary modification of a union contract was permissible.<sup>283</sup> In that case, Baltimore had unexpectedly lost \$13.3 million in state aid.<sup>284</sup> In response, the city implemented a temporary furlough plan under which essentially all city employees lost the annual equivalent of 2.5 days, or 0.95% of their gross annual salary.<sup>285</sup> The plan saved the city \$2 million.<sup>286</sup> Unions representing city teachers and police officers filed a complaint arguing that the city's action violated the Contracts Clause.<sup>287</sup> The federal district court agreed.<sup>288</sup>

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278. *Id.* at 244-45.

279. *Id.* at 247, 250.

280. *Id.* at 250.

281. *Id.*

282. *Id.* at 250-51.

283. 6 F.3d 1012, 1022 (4th Cir. 1993).

284. *Id.* at 1014.

285. *Id.*

286. *Id.*

287. *Id.*

288. *Id.*

On appeal, the Fourth Circuit applied the three-part test promulgated by the Supreme Court in *Blaisdell*, *U.S. Trust*, and *Allied* (the “*Blaisdell* Three-Part Test”).<sup>289</sup> The circuit court found that the plan represented an actual impairment of a contract and that the impairment was substantial.<sup>290</sup> Therefore, the city’s action was subject to the Contracts Clause.<sup>291</sup> The final step in the test was determining whether the action was a reasonable exercise of the state’s sovereign power.<sup>292</sup> To do this, the court considered the *Blaisdell* criteria.<sup>293</sup> The circuit court found that the criteria insulated the city’s plan from constitutional attack.<sup>294</sup> Most notably, the court explained that it would defer to the state legislature’s assessment of three issues, whether: (1) some legitimate public purpose existed, (2) the action taken was necessary to address this purpose, and (3) the action was reasonable in light of the surrounding circumstances.<sup>295</sup> The court deemed this deference appropriate even when public contracts are involved.<sup>296</sup> The court explained:

The authority of the states to impair contracts, to be sure, must be constrained in some meaningful way. The Contract Clause, however, does not require the courts—even where public contracts have been impaired—to sit as superlegislatures, determining, for example, whether it would have been more appropriate instead for Baltimore to close its schools for a week ... or to reduce funding to the arts .... Not only are we ill-equipped even to consider the evidence that would be relevant to such conflicting policy alternatives; we have no objective standards against which to assess the merit of the multitude of alternatives.<sup>297</sup>

Perhaps even more significant than the court’s deferential analysis was its opinion on unilateral contract modification during times of economic distress. The court stated that “[p]ublic employees—

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289. *Id.* at 1015.

290. *Id.* at 1015-16, 1018.

291. *See id.* at 1018.

292. *See id.*

293. *See id.* at 1019-21.

294. *See id.* at 1021-22.

295. *See id.* at 1015.

296. *Id.* at 1019.

297. *Id.* at 1021-22 (quoting *E. N.Y. Sav. Bank v. Hahn*, 326 U.S. 230, 234 (1945)).

federal or state—by definition serve the public and their expectations are necessarily defined, at least in part, by the public interest. [And it] should not be wholly unexpected ... that these public servants might well be called upon to sacrifice first when the public interest demands sacrifice.”<sup>298</sup>

Both the First and Second Circuit Courts of Appeal have subscribed to this approach. In *Buffalo Teachers Federation v. Tobe*, the Second Circuit addressed a Contracts Clause challenge to a city-imposed wage freeze on ostensibly all city employees.<sup>299</sup> In 2003, the City of Buffalo was experiencing significant financial distress.<sup>300</sup> The New York State Legislature created the Buffalo Fiscal Authority (BFA), a public benefit corporation tasked with stabilizing the city’s finances.<sup>301</sup> The BFA approved a four-year restructuring plan for Buffalo.<sup>302</sup> But within a year, the Authority learned that the city’s financial situation had deteriorated significantly and unexpectedly.<sup>303</sup> In response, the BFA instituted a wage freeze with respect to city employees.<sup>304</sup> The freeze was not permanent but, subject to the BFA’s discretion, would stay in place as long as the city’s significant instability persisted.<sup>305</sup> The city unions argued that the freeze violated the Contracts Clause.<sup>306</sup> Surprisingly, the Second Circuit explained that the state would not be held liable for violating the Contracts Clause unless the *plaintiffs* were able to produce evidence that the state’s self-interest motivated its conduct.<sup>307</sup> On this issue, the plaintiffs bore the burden of proof.<sup>308</sup>

In upholding the BFA’s action, the Second Circuit followed the *Blaisdell* Three-Part Test and the *Baltimore Teachers Union* court’s rationale. The court deferred to the state legislature’s conclusions regarding the city’s fiscal crisis and the necessity and reasonableness of the wage freeze.<sup>309</sup> The court noted that the state legislature

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298. *Id.* at 1021.

299. *See* 464 F.3d 362 (2d Cir. 2006).

300. *Id.* at 365.

301. *Id.* at 365-66.

302. *Id.* at 366.

303. *See id.*

304. *Id.* at 366-67.

305. *Id.* at 371.

306. *Id.* at 367.

307. *Id.* at 365.

308. *Id.* The court did not cite any authority for this approach.

309. *Id.* at 370-71.

would be afforded less deference because a public contract was at issue; however, “less deference [did] not imply no deference.”<sup>310</sup> The court acknowledged that it could not analyze all factors underlying the legislation at issue and make an independent determination that a better statutory solution existed.<sup>311</sup> Ultimately, the court concluded that a review of the *Blaisdell* criteria established that the action was a reasonable exercise of the state’s sovereign power.<sup>312</sup>

In *UAW v. Fortuno*, the First Circuit continued the evolution of Contracts Clause jurisprudence.<sup>313</sup> In 2009, Puerto Rico declared a fiscal state of emergency.<sup>314</sup> As a cost-saving measure, the legislature implemented a multi-phase plan to reduce the government payroll.<sup>315</sup> For a period of two years, the plan froze employee salaries and suspended a number of employee benefits and protections.<sup>316</sup> National and local labor unions brought suit alleging, inter alia, that the plan violated the Contracts Clause.<sup>317</sup> The district court dismissed the Contracts Clause claim, finding that the plaintiffs had failed to sufficiently allege that the plan’s impairment was unreasonable or unnecessary to an important government interest.<sup>318</sup> On appeal, the First Circuit analyzed the burden-of-proof issue raised by the Second Circuit in *Buffalo Teachers Federation*.<sup>319</sup> The court concluded that the plaintiffs had the burden of proof as to the necessity and reasonableness of the state action.<sup>320</sup> The court explained that:

To demand that the state prove reasonableness and necessity would force governments to endure costly discovery each time a plaintiff advance[d] a plausible allegation of a substantial impairment, even where that plaintiff cannot allege a single fact to question the reasonableness or necessity of the impairment. This would not only financially burden states, it would likely

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310. *Id.* at 370.

311. *Id.*

312. *Id.* at 376.

313. 633 F.3d 37 (1st Cir. 2011).

314. *Id.* at 39.

315. *Id.*

316. *Id.* at 39-40.

317. *See id.* at 40.

318. *Id.*

319. *See id.* at 42-44.

320. *Id.* at 42.



discourage legislative action impacting public contracts. Such a result is particularly undesirable in today's fiscal environment, where many states face daunting budget deficits that may necessitate decisive and dramatic action.<sup>321</sup>

The court evaluated the *Blaisdell* criteria and ultimately upheld the dismissal of the plaintiff's Contracts Clause claims.<sup>322</sup>

### *3. Distilling Contracts Clause Jurisprudence to Understand a Distressed Municipality's Bargaining Position*

One of the most startling aspects of modern Contracts Clause jurisprudence is that it demonstrates a shift in the national consciousness

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321. *Id.* at 43.

322. *Id.* at 47. Some state constitutions contain the state's own contracts clause, but these provisions invariably mirror the federal Constitution's Contracts Clause, and the standard of review is identical for both. See 16B AM. JUR. 2D *Constitutional Law* § 753 (2009) ("Generally, the federal and state constitutional guarantees against the impairment of contractual obligations are interpreted essentially identically and given the same effect."); Amy B. Monahan, *Statutes as Contracts? The "California Rule" and its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1040 (2012); see also *Commonwealth Edison Co. v. Ill. Commerce Comm'n*, 924 N.E.2d 1065, 1085 n.1 (Ill. App. Ct. 2009) (observing that there does not appear to be any indication that the federal and state contracts clauses should be analyzed differently); *Blue Cross & Blue Shield v. Milliken*, 367 N.W. 2d 1, 13 (Mich. 1985) (expressly adopting the U.S. Supreme Court standard for analyzing Contracts Clause claims under its own constitution); *Fid. Union Tr. Co. v. N.J. Highway Auth.*, 426 A.2d 488, 500 (N.J. 1981) (recognizing that the state and federal versions of the Contracts Clause provide "parallel guarantees"); *Parsonese v. Midland Nat'l Ins. Co.*, 706 A.2d 814, 818 (Pa. 1998) (adopting *Blaisdell* five-factor test in determining if legislation violated a state contracts clause provision); *Burns v. Pub. Ct. Emps. Ret. Bd.*, 853 A.2d 1146, 1154 n.13 (Pa. Commw. Ct. 2004) ("Generally, our review of a challenge raising the impairment of contracts provision [sic] of the Pennsylvania Constitution depends on the federal standard."); *Liberty Mut. Ins. Co. v. Tex. Dep't of Ins.*, 187 S.W.3d 808, 824 (Tex. App. 2006) (finding that the state's contracts clause mirrors the federal version). Generally speaking, few states have state supreme court precedent or a developed body of lower court case law that provides that its state contracts clause provision is more circumscribed than the federal provision or that the bar is absolute. Florida is the only exception. In that state, lower courts have ruled that the state contracts clause may actually be less accommodating to states than its federal counterpart. See *Coral Lakes Cmty. Ass'n v. Busey Bank, N.A.*, 30 So. 3d 579, 585 (Fla. Dist. Ct. App. 2010); *Lee Cty. v. Brown*, 929 So. 2d 1202, 1209 (Fla. Dist. Ct. App. 2006); *Sarasota Cty. v. Andrews*, 573 So. 2d 113, 115 (Fla. Dist. Ct. App. 1991). However, the state supreme court has not necessarily endorsed this approach. The court last commented on the issue almost thirty-five years ago. See *Pomponio v. Claridge of Pompano Condo.*, 378 So. 2d 774, 780 (Fla. 1979) (stating that when considering whether an impairment is permissible, the degree of contractual impairment must be weighed against the source of the state's power and the evil the impairment seeks to remedy).

on issues of unilateral contract modification. Naturally, overcoming contractual and constitutional restrictions on unilateral contract modification remains extremely difficult. But judicial perspective is evolving as parties begin to acknowledge that current legislatures cannot prevent future legislatures from using their police power to protect residents during fiscal emergencies.<sup>323</sup> Further, holding states and municipalities to debt and pension plan structures “that were conceived many years ago in different financial and labor market conditions” only serves to impede municipalities’ ability to address systemic financial deficiencies effectively to the detriment of all constituencies.<sup>324</sup> This shift in judicial perspective has already occurred in business bankruptcy cases.<sup>325</sup>

Certainly, variances exist in the manner circuit courts of appeal have approached Contracts Clause challenges to state legislation. Scholarly debate on these variances is thought-provoking but ultimately irrelevant. Indeed, the precise application of the *Blaisdell* Three-Part Test has little bearing on the primary thrust of my debt adjustment mechanism. I am unconcerned with a municipality’s likelihood of prevailing at the end of some years-long litigation

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323. See, e.g., *Barshop v. Medina Cty. Underground Water Conservation Dist.*, 925 S.W.2d 618, 635 (Tex. 1996) (“[A]n exercise of the police power necessary to safeguard the public safety and welfare can justify the impairment of contractual rights and obligations.”).

324. Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL’Y 617, 645 (2010). A number of modern cases have struck down state action as violative of the Contracts Clause, but in these cases there was clearly no fiscal emergency or legitimate public interest at stake. See, e.g., *S. Cal. Gas Co. v. City of Santa Ana*, 336 F.3d 885, 897 (9th Cir. 2003); *Toledo Area AFL-CIO Council v. Pizza*, 154 F.3d 307, 312 (6th Cir. 1998); *Nev. Emp. Ass’n, Inc. v. Keating*, 903 F.2d 1223, 1228 (9th Cir. 1990). This deficiency provides the basis for overturning state action. These opinions do not undermine the circuit rulings in *Baltimore Teachers Union*, *Buffalo Teachers Federation*, or *Fortuno* discussed above.

325. See, e.g., *In re Chi. Constr. Specialties, Inc.*, 510 B.R. 205, 224 (Bankr. N.D. Ill. 2014) (allowing a liquidating debtor to reject its collective bargaining agreements); *In re Patriot Coal Corp.*, 493 B.R. 65, 140 (Bankr. E.D. Mo. 2013) (debtors allowed to reject collective bargaining agreement based on union’s refusal of necessary changes); *In re AMR Corp.*, No. 11-15463, 2012 WL 3834798 (Bankr. S.D.N.Y. Sept. 5, 2012) (debtor allowed to reject collective bargaining agreement with its pilots); *In re Delta Air Lines, Inc.*, 359 B.R. 468, 489 (Bankr. S.D.N.Y. 2006) (balance of the equities favored rejection of pilots’ collective bargaining agreement); *Ass’n of Flight Attendants-CWA, AFL-CIO v. Mesaba Aviation, Inc.*, 350 B.R. 435, 465 (D. Minn. 2006) (debtor authorized to reject its collective bargaining agreements); *In re Nw. Airlines Corp.*, 346 B.R. 307, 331 (Bankr. S.D.N.Y. 2006) (allowing debtor to reject flight attendants’ collective bargaining agreement); *In re U.S. Airways*, No. 04-13819, 2004 WL 2578966 (E.D. Va. Oct. 15, 2004) (allowing for rejection of collective bargaining agreement).

process. The fulcrum is not whether the threat of unilateral modification has a likelihood of success. Rather, the fulcrum is whether the threat is plausible. As explored above, the threat *is* plausible for many distressed municipalities depending on the type of state action to be pursued. Indeed, Contracts Clause jurisprudence provides key tenets. The Contracts Clause is not absolute.<sup>326</sup> Minor contractual modifications may not even implicate the Clause.<sup>327</sup> Further, even substantial impairments<sup>328</sup> may not violate the Clause if a true fiscal emergency exists or legitimate public interest is implicated.<sup>329</sup> Modifications that are temporary, appropriately tailored to address the emergency at hand, and reasonable in light of the surrounding circumstances are generally protected from constitutional attack.<sup>330</sup> Perhaps most importantly, courts will defer to state legislatures on these issues. This deference is appropriate even when a public contract is at issue. Finally, due to the nature of these disputes, the burden of proof may be on the party challenging state action.

The distillation of these cases is nothing short of a revelation for subnational officials. Indeed, to the extent a state provides a proper debt adjustment mechanism, municipalities that appreciate the nuances of precedent and shifting opinion within the judiciary have a host of restructuring opportunities. Of course, my system's ultimate goal is to achieve consensual—not unilateral—modifications.<sup>331</sup> But, as noted above, consensual modifications cannot be realized unless the state has sufficient bargaining leverage. This methodology is the means to address the holdout problem without resorting to a federal bankruptcy process that drains resources, creates constitutional quandaries, demoralizes the municipality, and yields poorly formed results.<sup>332</sup>

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326. *Home Bldg. & Loan Ass'n v. Blaisdell*, 209 U.S. 398, 428 (1934).

327. *Id.* at 439.

328. A "substantial impairment" is one in which the legislation at issue "detrimentally affects the financial framework which induced the [lenders] to originally [enter into the transaction], without providing alternative or additional security." *See, e.g., Pierce Cty. v. State*, 148 P.3d 1002, 1011 (Wash. 2006).

329. *Blaisdell*, 209 U.S. at 439.

330. *Id.* at 444.

331. Naturally, consensual modifications are not subject to the Contracts Clause.

332. Some states, most notably New York, have explicit constitutional provisions that "provide that [pension] rights are fixed as of the date the employee enters the retirement system and cannot thereafter be diminished or impaired." Monahan, *supra* note 324, at 622.

#### IV. THE NUANCES OF AN OPTIMAL STATE DEBT ADJUSTMENT MECHANISM

The previous section lays the foundation and outlines the framework for my debt adjustment mechanism. The discussion that follows provides the detailed stages of my normative approach.

##### *A. Stage One: Soft Monitoring's Scarecrow*

Most states are not aware of local government fiscal difficulties until a true crisis has materialized.<sup>333</sup> According to a recent survey of states, only fifteen states monitored local government financial conditions using indicator criteria.<sup>334</sup> Delayed intervention leaves state and local officials with circumscribed restructuring options. My normative approach begins with soft monitoring that seeks to identify municipalities engaging in fiscal pollution. Municipalities will be required to send key financial data and audits to a state agency or state officials throughout the year.<sup>335</sup> The review will identify financial dynamics unique to the municipality and macro trends that could affect the municipality's stability. Financial dynamics include short-term debt, cash flow, year-end fund balance, operating deficits, fixed costs, and whether tax limits are being respected. The review would also consider macro trends, including population loss and migration trends, decline in home prices, loss of intergovernmental aid, residents' age, business movement and factory closures, unemployment, and poverty levels. The ultimate

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Other labor provisions are not similarly protected.

333. See Honadle, *supra* note 106, at 1431-61.

334. See Kloha et al., *supra* note 106, at 240, 252.

335. In Florida, local governments are required to hire independent certified public accountants to review municipal finances, but the infidelity of the credit rating agencies in the 2000s demonstrates that auditors can be conflicted in these scenarios. See Deryn Darcy, Note, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2009 COLUM. BUS. L. REV. 605, 642-43 (2009). Consequently, a more reasoned approach is for the state to appoint the auditor. North Carolina requires local governments to submit financial data extracted from state-mandated reports prepared by independent auditors. See STANDARD & POOR'S, NORTH CAROLINA'S LOCAL GOVERNMENTS REMAIN FISCALLY HEALTHY DESPITE THE RECENT RECESSION 1, 3 (2013), <http://www.huntersville.org/Portals/0/Finance/North%20Carolina%20SP%20Report.pdf> [http://perma.cc/E8W6-HHDG].

inquiry is whether the municipality can service its debt while providing key services to residents in an optimal manner.<sup>336</sup>

In most cases, soft monitoring will be sufficient to deter excessive cost shifting. Studies demonstrate that people modify their behavior if they believe they are being monitored, even if the monitor cannot take any action against them.<sup>337</sup> Imagine that an individual is driving a car at a speed that is twenty miles above the posted speed limit. As she turns a corner, she sees a machine on the side of the road that displays her speed below a sign that shows the legal speed limit on the street. The driver is likely to materially adjust her speed even if she does not believe that a police officer is in the area.<sup>338</sup> Similarly, soft monitoring's scarecrow will increase the likelihood that local officials will internalize the costs and benefits of their decisions, even if they do not believe that state overseers are actively reviewing submitted financial data.<sup>339</sup>

Soft monitoring's final product is a general classification of all municipalities within the state. Municipalities with the most troubled fiscal architecture would be designated as "pressured." Pressured municipalities would be notified and graduate to a hard monitoring system with financial triggers.

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336. See OFFICE OF THE N.Y. STATE COMPTROLLER, FISCAL STRESS MONITORING SYSTEM (Apr. 2014), <http://www.osc.state.ny.us/localgov/pubs/fiscalmonitoring/pdf/fiscalstressmonitoring.pdf> [<http://perma.cc/H8B2-DJ2K>].

337. See Melissa Bateson et al., *Cues of Being Watched Enhance Cooperation in a Real-World Setting*, 2 BIOLOGY LETTERS 412, 413 (2006).

338. See *id.*

339. The Dodd-Frank Wall Street Reform and Consumer Protection Act created the Financial Stability Oversight Council (the "Council"). Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 111, 124 Stat. 1376, 1392-94 (2010) (codified at 12 U.S.C. § 5321). The Council includes the chairs of the Federal Reserve Board of Governors, the FDIC, the SEC, and the Comptroller of the Currency. *Id.* Among their many duties, Council members are required to annually certify to Congress that: "[T]he Council, the Government and the private sector are taking all reasonable steps to ensure financial stability and to mitigate systemic risk that would negatively affect the economy." *Id.* § 112(b)(1). If Council members are unable to make this certification, they need to state what additional steps should be taken to ensure financial stability. *Id.* § 112(b)(2). States could require local comptrollers to make a similar statement to accompany year-end audits. For example, a local comptroller could be required to either (1) certify to the state legislature that his or her office is taking all reasonable steps to ensure the municipality's ability to provide essential services to its residents and pay debts as they come due, or (2) explain what additional steps need to be taken in order to ensure service delivery and debt payment.

*B. Stage Two: Financial Triggers*

In stage two, pressured municipalities will be analyzed to determine if they are deteriorating to a fiscally distressed level. As noted above, a successful debt adjustment mechanism must be proactive—identifying distressed municipalities early, and acting aggressively to avoid a crisis and preserve restructuring options. Monitoring coupled with financial triggers is essential to this process. Because we are attempting to identify municipalities at an earlier stage of financial deterioration, relying exclusively on customary red flags—including payment defaults—is ineffective; they represent symptoms of a disease that has already proliferated.

States would need to formulate their own lists of financial triggers, but they should incorporate a collection from the following criteria:

- (1) the municipality's credit rating has been downgraded;
- (2) the municipality executed an intra-fund transfer that suggests a deficit somewhere in the budget;<sup>340</sup>
- (3) the municipality failed to file timely financial reports;
- (4) a major employer located within the municipality has closed an office or significantly downsized its operations;
- (5) the municipality failed to transfer taxes withheld on employee income or employer and employee contributions for a pension, retirement, or benefit plan;
- (6) the municipality's mandated audit report shows funds with deficit fund balances;
- (7) local officials have failed to correct problems—including internal control problems—after being notified by state officials;
- (8) the municipality has insufficient cash to meet required payroll payments in a timely manner;
- (9) the municipality has violated a covenant in its credit agreements;
- (10) the municipality has recognized sizeable losses as a result of unnecessarily aggressive investment practices;
- (11) the municipality has expended restricted funds in violation of applicable terms and provisions;

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340. For example, in fiscal year 2011, Minneapolis moved approximately \$1.8 million from its general contingency fund to the fire and police departments to avoid cutting staff or closing stations. See *THE LOCAL SQUEEZE*, *supra* note 46, at 18.

- (12) the ending balance in the municipality's general fund has declined for two consecutive years;
- (13) the municipality is experiencing significant service delivery interruptions;
- (14) the municipality faces the likelihood of a default on debt payments or an inability to pay vendors, employees, or creditors with uncontested claims; and
- (15) the municipality has experienced high levels of revenue inefficiency.<sup>341</sup>

No combination of triggers equals fiscal distress. State officials must qualitatively analyze triggers that apply to determine if the proper course is additional monitoring or intervention.

### *C. Stage Three: Reversing Devolution During Municipal Distress*

Intervention is necessary where the state determines that a municipality is or will be unable to fulfill its financial obligations while still providing key services to residents in an optimal manner.<sup>342</sup> As discussed above, at this stage, devolution is reversed because the state is best situated to oversee this restructuring process. But this intervention can come in a variety of forms.

#### *1. The Poles in the Local Governance Spectrum*

There exists a spectrum for local governance. As discussed above, at one end is the home rule paradigm where local officials manage and direct governmental functions, theoretically acting as directly accountable agents for municipal residents.<sup>343</sup> The state receiver<sup>344</sup> is at the other end of the spectrum.

A receiver is an individual appointed under state law to assume fundamental decision-making authority from local officials, which

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341. For example, state officials would compare all state municipalities' tax rates with their respective revenue yields. Those with the largest discrepancies could be considered to be operating the least efficiently.

342. For purposes of potential unilateral contract modification, the state legislature should authorize intervention only after declaring that the municipality is experiencing a fiscal emergency.

343. See *supra* note 201 and accompanying text.

344. Sometimes referred to as an "emergency manager."



arguably undermines democratic decision making. The receiver is appointed by an elected official or a group of elected officials.<sup>345</sup> In many cases, the appointment of a receiver will precipitate the removal of key local officials.<sup>346</sup> The receiver and her team bear little responsibility to residents.<sup>347</sup> Indeed, receivers often employ measures that were previously rejected by local officials as being harmful to the local community and its residents.<sup>348</sup> For example, under Michigan state law, the governor is empowered to appoint a receiver—referred to as an “emergency manager”—for financially distressed municipalities.<sup>349</sup> The receiver is instructed to “act for and in the place and stead of the governing body and the chief administrative officer of the local government.”<sup>350</sup> Further, local government officials may not exercise the powers of their office without the receiver’s express written approval.<sup>351</sup> The state statute delineates that some actions are excluded from this restriction, but the state receiver may still place conditions as to those exempted actions.<sup>352</sup> The receiver is empowered to issue orders to elected and appointed local officials.<sup>353</sup> Failure to adhere to the receiver’s orders can be grounds for a local official to be barred from his or her government office, email, and internal information systems.<sup>354</sup>

But the flaws of the receiver model go further.<sup>355</sup> Indeed, creating a dictator-like figure in charge of expenditures, budgets, and priorities within each budget may be misguided. One person can be subject to the same personal political failings as local officials. In fact, receivers present an even heightened risk of capture and self-dealing due to the almost unilateral power they enjoy and the speed with which transactions are executed.<sup>356</sup> For example, receivers often deal with private companies that represent attractive future employers or clients:

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345. See Kossis, *supra* note 104, at 1110.

346. See *id.*

347. See *id.* at 1121-23.

348. See *id.* at 1134-35.

349. MICH. COMP. LAWS § 141.1549(1) (2012).

350. *Id.* § 141.1549(2).

351. *Id.*

352. *Id.*

353. *Id.* § 141.1550(1) (2012).

354. *Id.* § 141.1550(2).

355. See Anderson, *supra* note 166, at 604-10.

356. See *id.* at 609.

[In 2009,] the [receiver] in Pontiac, Michigan sold the disused Pontiac Silverdome (which cost \$55 million to build) for \$580,000 to a Toronto-based company—a “firesale” price reflecting the depths of the recession, but money that the [receiver] said was necessary to relieve the city of maintenance costs. That price was a stunning fall from the \$20 million allegedly offered by a minority-owned, Michigan-based company several years before.... The very same receiver then joined the buyer’s company after leaving the [receiver] post.<sup>357</sup>

## 2. *Restructuring Control Boards and the Center Point*

Alternatively, a restructuring control board is somewhere in the middle of the spectrum and represents the best course. By establishing a board, traditional political forces that have shaped a municipality’s problems will be less influential.<sup>358</sup> The board is to act in the best interests of the municipality and its residents—which include current and future residents—as well as key creditor constituencies. The board should be free to take action that is politically unpopular in order to increase the likelihood that the municipality will enjoy sustainable viability. Theoretically, the board attempts to preserve local democracy by giving residents a voice through elected state and local officials who either directly participate in the board’s decision-making processes or select board members who will be directing board action. A diffused decision-making structure makes the board less susceptible to capture and self-dealing. A state can opt to support local autonomy further by instructing the board to macromanage the municipality. More specifically, the board can be tasked with making key policy decisions regarding the municipality’s borrowing, taxing, and contract modification architecture. The board would establish the overarching construct, and local officials would be allowed to make certain decisions within the board’s parameters.

My state debt adjustment mechanism affords the board a broad grant of power, though the board may choose to take a conservative approach in utilizing its arsenal. Primarily, the board should be

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357. *See id.* (footnotes omitted).

358. *See Cyr, supra* note 103, at 23.

allowed to conduct all aspects of municipal operations through majority vote.<sup>359</sup> These options include effectuating debt service, making necessary contributions to pension funds, managing tax policy,<sup>360</sup> hiring and removing municipal employees, seeking additional financing,<sup>361</sup> exercising the authority of local officials, and restructuring municipal offices, departments, and agencies. The board will have the discretion to formulate an optimal delegation structure. The board would be bound by state law but could request that the state legislature waive certain restrictions if such a waiver process exists under state law. The board's ultimate goal would be to develop a recovery plan and new operating budget that restructures the municipality's expenses and obligations to ensure sustainable viability. As part of this process, the board should manage all creditor negotiations and enjoy subpoena power as well as the power to review municipal records and bookkeeping.<sup>362</sup>

The board should be composed of an odd number of members, somewhere between five and eleven. Ideally, the board would be a collective of (1) local and state officials or individuals appointed by such officials, including city and state comptrollers, (2) a retired

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359. I believe that a simple majority is appropriate to authorize action. A model premised on a super-majority or unanimous vote would almost certainly encounter paralysis.

360. Ten states already give state interveners the ability to increase existing taxes and fees or implement new ones. *See* STATE ROLE IN LOCAL GOVERNMENT, *supra* note 100, at 19.

361. One of the board's primary directives is to maintain access to the credit markets for the municipality. The board must act quickly to ensure that the municipality is not shut out of the credit markets. New York City was shut out in 1975 and only regained partial access to the long-term bond market in 1981. *See* SHEFTER, *supra* note 7, at 141-42. The city did not obtain investment grade ratings for its notes and bonds until 1983. *See id.*

362. The state statute should not provide that the board is given the power to unilaterally modify, reject, or terminate municipal contracts. A statute that contains this type of provision would invariably face a preemptive constitutional challenge. For example, in March 2013, the Michigan state legislature passed the Local Financial Stability and Choice Act (LFSCA), which granted an appointed emergency manager the power to unilaterally modify municipal contracts. The LFSCA was immediately challenged as violating the state and federal Constitutions. *See* Complaint for Declaratory & Injunctive Relief at 4, *Phillips v. Synder*, No. 2:13-cv-11370-GCS-RSW (E.D. Mich. Mar. 27, 2013). By not explicitly conferring this rejection power, the state should be able to insulate the statute from a preemptive attack by unions and creditors. As noted above, an effective restructuring mechanism does not need to create unilateral contract modification options for municipal or state officials. But the system does need to acknowledge that such options may exist under applicable state and federal law and should empower restructuring officials to use these options if necessary. The state statute must allow the board to act on behalf of the municipality and undertake such unilateral actions that are permitted under state and federal law.

jurist or legal academic, and (3) unelected individuals from the private sector selected by the governor.<sup>363</sup> The inclusion of current or retired heads of corporations, and executives at prominent local and state businesses will give the board credibility within the lender and bondholder communities. This composition attempts to support the fidelity of the local democracy while ensuring that perverse political incentives and cost shifting are minimized in developing meaningful restructuring practices.

*D. Stage Four: A Clear Negotiation Structure and Contract Modification*

Distressed municipalities cannot simply rely on budgetary cuts in order to achieve sustainable viability.<sup>364</sup> Significant relief from existing debt obligations is necessary. Consequently, as noted above, a clear negotiation structure is my proposal's primary contribution. Within this structure, the board will be empowered to lead settlement discussions with key creditors, though it may choose to delegate these duties in some cases. As noted above, the ultimate goal of these negotiations is consensual modification of key contracts and

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363. One initial hurdle is securing the participation of successful private sector individuals. But this may not be the insurmountable obstacle many would suspect. In 2008, the Obama administration organized the Automotive Task Force (ATF) to develop a reorganization plan for General Motors and Chrysler. See STEVEN RATTNER, OVERHAUL: AN INSIDER'S ACCOUNT OF THE OBAMA ADMINISTRATION'S EMERGENCY RESCUE OF THE AUTO INDUSTRY 20, 46 (2010). The ATF was composed of a mix of automotive experts, attorneys, and private sector finance and restructuring professionals. Steven Rattner headed the ATF. At the time, Rattner was the managing principal for Quadrangle Group, a private investment firm that had more than \$6 billion of assets under management. Needless to say, Rattner accepted a staggering pay cut in order to head the ATF. Rattner described his decision to accept the low-pay, high-stress position as follows:

Our country was facing the greatest financial and economic crisis since the Great Depression; when would the skills of a finance guy like me possibly be more useful? If I hung back this time, what would I be saving myself for? ... I was on the verge of the experience of a lifetime. I was being given a chance to play a central role in the largest industrial restructuring in history from within the most powerful institution in the world.

*Id.* at 5, 13. States would need to approach private sector professionals from this angle. The service would certainly be grueling, and remuneration would be far less than these professionals customarily receive. However, these individuals would have the opportunity to set policy and effectuate meaningful change during desperate times for a municipality. The experience would be supremely challenging and uniquely rewarding.

364. See Chung, *supra* note 39, at 816.

debt obligations. My debt adjustment mechanism attempts to identify municipalities before crisis and at a time where radical concessions are not necessary. The board will be tasked with proposing modifications and accepting or rejecting settlement offers.<sup>365</sup> Neither the state legislature nor state officials should be allowed to occupy a blocking position or hold veto power. This is another component that reduces creditor holdout risk.

The board and its professionals will begin by quantifying the fixed cost relief necessary to stabilize the municipality. In effectuating debt relief, these officials will seek consensual contractual modifications from key creditor groups. These proposals will be premised on the nuanced understanding of the Contracts Clause detailed earlier in this Article.<sup>366</sup> The bulk of this relief will come from bondholders and employees. My system is premised on a shared burden among all creditor constituencies and seeks to capture distressed municipalities at a time where less sweeping concessions will be sufficient. Bondholders and employee unions both fear that their group will bear a grossly disproportionate financial burden from a restructuring. My mechanism's shared-burden principle reduces the concessions any one group is forced to make, creating a more palatable process.<sup>367</sup>

Naturally, drawing creditors to the negotiating table can be difficult but, as explained above, my debt adjustment mechanism offers enough carrots and sticks to minimize disengagement risk. Negotiations should follow customary out-of-court restructuring discussions that characterize corporate reorganizations. The municipality or the state should cover key creditor constituencies' reasonable professional fees related to the negotiation.

Most importantly, my mechanism provides a limited ninety-day negotiation period with one thirty-day forbearance period that can

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365. Each state would have to determine whether negotiations would be conducted by a neutral mediator, legal counsel for the board, or some other board representative. The customary practice in out-of-court business restructurings is for legal counsel to lead the negotiations.

366. *See supra* Part III.C.

367. I acknowledge that there will be scenarios where bondholders find means to insulate themselves and ostensibly force union employees to bear a disproportionately large burden. In such cases, the municipality may have no choice but to pursue a Chapter 9 filing. As noted throughout this paper, my proposal does not eliminate the Chapter 9 option from the distressed municipal landscape.

be invoked by any contract party. After that, the board must vote to either (1) pursue unilateral contract modification in order to gain concessions essential to sustainable viability or (2) file a Chapter 9 petition on the municipality's behalf. This rigid timeline will spur dynamic negotiations.

### *1. Negotiating with Bondholders*

There exist permutations among types of municipal debt, but bonds can generally be classified as being either "general obligation" or "revenue." General obligation bonds ("GO Bonds") represent unsecured debt that is backed by the full faith and credit of the issuing municipality and payable from the general funds of the issuer.<sup>368</sup> "[T]he precise source and priority of payment ... may vary considerably from issuer to issuer."<sup>369</sup> Almost all municipalities rely on GO Bonds to fund daily operations and capital projects.<sup>370</sup> Local government GO Bonds are payable from the issuer's *ad valorem* taxes.<sup>371</sup> GO Bonds issued by states are serviced by appropriations made by the legislature.<sup>372</sup>

On the other hand, revenue bonds are bonds that are serviced by payments or fees originating from the project the bonds financed. These bonds are generally not backed by the municipality's taxing power, although there are exceptions.<sup>373</sup> Revenue bonds have had a higher default risk than GO Bonds because payments depend almost exclusively on the revenues generated from the project.<sup>374</sup>

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368. See *Sources of Repayment*, MUN. SEC. RULEMAKING BD. (last visited Sept. 27, 2015), <http://www.msrb.org/EducationCenter/Municipal-Market/About/Overview/Sources-of-Repayment.aspx> [<http://perma.cc/A3AG-9CWX>].

369. *Id.*

370. See Brief by the Securities Industry, *supra* note 66, at 1.

371. See *Sources of Repayment*, *supra* note 368.

372. See *id.*

373. Some revenue bonds are "double-barreled" bonds, with revenue shortfalls backed by the issuer's full faith and credit. See *id.*

374. Bondholders have limited enforcement powers under state law when dealing with a defaulting municipal borrower. See SPIOTTO ET AL., *supra* note 102, at 42, 57 (appendix lists each state's protections). And contractual remedies may vary depending on bond provisions. Bondholders' real leverage comes from the prospect that a defaulting municipality will be locked out of the credit markets or face borrowing costs that are so high as to ostensibly constitute a lock out. In light of limited enforcement mechanisms, bondholders frequently obtain payment protection including bond insurance, letters of credit, or a guarantee by another unit of government. In the rare event that a municipality defaults on insured bonds, the insurer

The scope of negotiations with bondholders is usually narrow.<sup>375</sup> Bondholders are entitled to interest and principal payments on the bonds they hold. Historically, distressed municipalities have sought to defer or reduce interest payments while pushing back maturity dates, essentially turning short-term obligations into long-term obligations. Bondholders have ostensibly priced their debt to account for the risk of default and are often represented by agents that understand that debt restructuring is a natural part of lending.<sup>376</sup> In fact, bondholders have acknowledged that, during times of financial distress, their debt is subject to adjustment as to interest rates and the timing of payments.<sup>377</sup> However, the general rule is that bondholders have not priced their debt to account for a reduction in principal because nonconsensual reductions of this nature have not occurred in the municipal debt market.<sup>378</sup>

With this in mind, the board would initiate an out-of-court restructuring with bondholders by stressing some of the key objectives of the applicable state debt adjustment mechanism. The board would stress that the bondholders' recovery is contingent on the municipality enjoying sustained viability, which ensures payment of the principal and interest. This invariably improves the municipality's credit rating, which facilitates reselling the municipality's debt in secondary markets. But under my mechanism, meaningful

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becomes responsible for interest and principal payments. The insurer attempts to recover from the defaulting municipality. Bondholder interests are often times pursued by insurers, not the bondholders. See Matthew Dolan, *A Bond Insurer Takes on Detroit*, WALL ST. J., July 14, 2014, at C6. However, the Great Recession decimated the bond insurance industry. In 2005, 62% of long-term, fixed-rate municipal securities were insured. That figure dropped to 21% by 2008, 9% by 2009, and only 6% by 2010. See DOTY, *supra* note 134, at 105-06.

375. I acknowledge that general obligation bondholders and revenue bondholders may receive slightly different treatment by the board, but this Section's discussion captures the overarching perspective on bondholder negotiations.

376. See Brief by the Securities Industry, *supra* note 66, at 11. Holders of corporate bonds regularly agree to restructure notes in order to stay out of bankruptcy court. See, e.g., Matt Chiappardi, *Caesars Reaches Deal to Refinance \$155M in Debt*, LAW360 (Aug. 12, 2014, 2:17 PM), <http://www.law360.com/articles/566421/caesars-reaches-deal-to-refinance-155m-in-debt> [<http://perma.cc/6YZU-7553>].

377. See Brief by the Securities Industry, *supra* note 66, at 11.

378. See *id.* *Faitoute Iron & Steel Co. v. City of Asbury Park* represents one of the few cases in which a federal or state court allowed a municipality to exchange existing bonds for new ones with lower interest rates and deferred maturity dates without unanimous bondholder consent. See 316 U.S. 502, 512-16 (1942). But some courts have found certain modifications of bonds not to constitute substantial impairment implicating the Contracts Clause. See *S.C. Pub. Serv. Auth. v. Citizens & S. Nat'l Bank of S.C.*, 386 S.E.2d 775, 790 (S.C. 1989).



concessions are necessary from all constituencies because state law would prevent the state from offering any *ex ante* bailout or material emergency funding.<sup>379</sup> The board will potentially negotiate with employee unions simultaneously and could make consensual bondholder modifications contingent on the board receiving similar concessions from all or some key employee unions. Ultimately, the bondholders benefit from these consensual modifications and those made by other creditor constituencies because the municipal borrower is stabilized and thus far less likely to completely default.

The board could offer bondholders a choice between a package involving some assortment of terms that reduce interest rates and extend maturity dates or one that defers interest and principal payments for some period of time to allow the municipality temporary debt relief. Ideally, the municipality would be in the initial stages of distress and relatively incremental concessions will suffice. In such cases, the board may be able to spur concessions by arguing that the terms they seek are minor modifications that do not constitute substantial impairment implicating the Contracts Clause. Indeed, payment deferral is arguably built into interest rates charged on debt.<sup>380</sup> The local government bond market is populated with informed buyers and multiple sellers, and the market should fully price this risk.<sup>381</sup> I believe it would be difficult for a bondholder to argue that these types of modifications could not have been anticipated at the time of contracting. However, even if the Contracts Clause is implicated, the board could argue that an emergency has been declared by the legislature,<sup>382</sup> and that temporary deferral of interest and principal payments is appropriately tailored to address the emergency at hand and reasonable in light of the emergency and concessions sought from other key constituencies. Naturally, the goal of this line of argument is to spur bondholder concessions and reach consensual agreements.

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379. As explored below, my mechanism does contemplate intergovernmental aid as part of the formal recovery plan.

380. See Inman, *supra* note 72, at 62.

381. See *id.*

382. As noted above, before reversing devolution and considering potential unilateral contract modification, the state legislature should declare that the municipality is experiencing a fiscal emergency.

## 2. *Negotiating with Employee Unions*

Negotiations with employee unions are usually more convoluted than those with bondholders. As detailed above, the Contracts Clause is not an absolute prohibition on unilateral contract modification, but the swath of exempt modifications to employee benefits is narrow.

Discussions with employee unions will follow many of the key tenets discussed as to bondholder negotiations. Most importantly, both current and past employees are bound to the municipality, and a financially viable municipality increases the likelihood that employees will stay employed and/or receive benefits. However, the board must be careful to seek only modifications that the state could arguably impose without union consent. Negotiations of this nature are inherently contentious, and overreaching can poison the well. Navigating these landmines requires a clear delineation of what the board is seeking to modify and those benefits that are sacrosanct.

The board has a number of options when considering a modification of employee benefits. Generally, modifications affecting future employees will engender little controversy. Unfortunately, municipal savings from reducing compensation and benefits afforded to future employees are inadequate to address a municipality's financial distress in any meaningful way.<sup>383</sup> The board usually will be forced to seek concessions from employee unions that will affect both current and retired employees, including possible wage reductions, furloughs, layoffs, cost of living adjustments, contribution increases, pension multiplier reductions, and retirement age increases.

### a. *Compensation and Benefits*

Employees receive compensation for their services in the form of current cash wages, benefits, and deferred compensation. While wages and benefits are received at set intervals shortly after services are rendered, deferred compensation involves payments and benefits that accrue over the term of employment and vest at some later date.<sup>384</sup> Other benefits that accrue over the term of

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383. See RAVITCH & VOLCKER, *supra* note 26, at 14-15.

384. See *id.* at 12-15.

employment exist, including cost of living adjustments and health-care benefits.<sup>385</sup> The aggregate of these expenses represents a municipality's primary fixed costs.<sup>386</sup> Consequently, legislatures seeking to assist distressed municipalities regularly consider ways to reduce or defer these expenses. Scholars have explored the propriety of these measures at a granular level.<sup>387</sup> And a host of courts have offered differing perspectives.<sup>388</sup> But one preeminent principle has emerged from the academic literature and the judiciary that is relevant to this Article: employees have a right to enjoy benefits that have vested and accrued, but states have the power to modify employee benefits and the pension system prospectively.<sup>389</sup> Oddly, state legislatures that have attempted to modify benefits have tried to take away accrued benefits as opposed to focusing on prospective benefits.<sup>390</sup> This is the consequence of waiting until a crisis point before attempting to address financial difficulties. Indeed, deferred action is the precursor to aggressive action for the vast majority of financially pressured municipalities. Not surprisingly, attempts to retroactively modify employee benefits rarely succeed.<sup>391</sup>

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385. *See id.* at 14.

386. *See supra* note 225.

387. *See, e.g.,* Buck, *supra* note 29, at 27; Monahan, *supra* note 322, at 1031-32; Paul Secunda, *Constitutional Contracts Clause Challenges in Public Pension Litigation*, 28 HOFSTRA LAB. & EMPL. L.J. 263, 263-300 (2011).

388. *See, e.g.,* Md. State Teachers Ass'n v. Hughes, 594 F.Supp. 1353, 1363 (D. Md. 1984); Yeazell v. Copins, 402 P.2d 541, 545-46 (Ariz. 1965); Betts v. Bd. of Admins. of the Pub. Emps.' Ret. Sys., 582 P.2d 614, 617 (Cal. 1978); Police Pension and Relief Bd. of City and Cty. of Denver v. McPhail, 338 P.2d 694, 697 (Colo. 1959); Petras v. State Bd. of Pension Trs., 464 A.2d 894, 895-96 (Del. 1983); Smith v. Bd. of Trs. of La. State Emps.' Ret. Sys., 851 So. 2d 1100, 1106 (La. 2003); Sylvestre v. State, 214 N.W.2d 658, 666-67 (Minn. 1978); Nicholas v. State, 992 P.2d 262, 264 (Nev. 2000); Baker v. Okla. Firefighters Pension & Ret. Sys., 718 P.2d 348, 351-52 (Okla. 1986); Hughes v. State, 838 P.2d 1018, 1029 (Or. 1992); Booth v. Sims, 456 S.E.2d 167, 181 (W.Va. 1994); *see also* Robertson v. Kulongoski, 359 F. Supp. 2d 1094, 1104 (D. Or. 2004).

389. *See* Buck, *supra* note 29, at 60-61.

390. *See id.* Mr. Buck has formulated an intriguing proposal regarding equitable proration of benefit reductions. The equitable proration argument that follows is drawn from Mr. Buck's scholarship.

391. *See id.* at 61; Whitney Cloud, Comment, *State Pension Deficits, the Recession, and a Modern View of the Contract Clause*, 120 YALE L.J. 2199, 2202 (2011); *see also* Kaho'ohano-hano v. State, 162 P.3d 696, 736 (Haw. 2007) (holding that a law decreasing the amount the state had to invest for public retirees violated beneficiaries' contractual rights); *Nicholas*, 992 P.2d at 264 (stating that, once vested and thereby contractual, the legislature cannot unilaterally modify contract rights); *McKenna v. State Emps.' Ret. Bd.*, 421 A.2d 1236, 1243 (Pa. Commw. Ct. 1980) (tracing a history of invalidated retroactive pension modifications in

Ultimately, as detailed below, the board should feel comfortable seeking modification of prospective benefits. Assuming the modifications are narrowly tailored, the board would be able to argue that it could unilaterally impose these modifications. The argument should be persuasive and initiate discussion of an alternative consensual modification between the parties. However, the initial challenge is determining whether a modification affects prospective or retroactive benefits. This analysis will unfold on a benefit-by-benefit basis below.

*b. Current Employee Concessions*

Some municipalities experiencing fiscal emergencies have been successful in unilaterally imposing temporary contract modifications on current employees. Once the emergency has dissipated, benefits generally rise and return to normal levels.<sup>392</sup> The primary concessions the board can seek are wage freezes, wage reductions, hiring freezes, health care contribution increases, and furloughs—all on a temporary basis. Courts have authorized these actions, and the board would not be overreaching in seeking these concessions upfront.<sup>393</sup> The modifications would not be permanent, but would stay in place as long as the municipality's emergency situation persisted, as determined by the board or any subsequent monitoring agency. The municipality would most likely have to include a sunset provision that eliminated the modifications by a certain date.

The primary concern with temporary debt-relief measures is that the municipality may be simply deferring its day of reckoning. However, my debt adjustment system is designed to identify municipalities at an early stage of financial deterioration. Consequently, less drastic measures should prove to be effective as long as all key constituencies contribute to the reform efforts.

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holding that an amendment to the statutory method for calculating the benefits of retired judges violated the state's contracts clause).

392. See SHEFTER, *supra* note 7, at 141-42; see also *Balt. Teachers Union v. Mayor of Balt.*, 6 F.3d 1012, 1015 (4th Cir. 1993).

393. See, e.g., *UAW v. Fortuno*, 633 F.3d 37, 46 (1st Cir. 2011); *Buffalo Teachers Fed'n v. Tobe*, 464 F.3d 362, 371-72 (2d Cir. 2006); *Balt. Teachers Union*, 6 F.3d at 1015; *Teamsters Local 97 v. State*, 84 A.3d 989, 1010 (N.J. Super. Ct. App. Div. 2014); *Subway-Surface Supervisors Ass'n v. N.Y.C. Transit Auth.*, 375 N.E.2d 384, 388 (N.Y. 1978).

To the extent the debt relief from the concessions noted above is proportionately insufficient, the board could consider more aggressive proposals. For example, the board may propose a modification of the pension multiplier for pension benefits.<sup>394</sup> Assume that a municipality is part of a state pension system that offers employees a 4% multiplier in determining pension payments upon retirement. Under such a system, an individual employed for twenty years would be entitled to 80% of her final average salary per year for the duration of her retirement. Imagine that a municipality becomes subject to the state debt adjustment mechanism, and the board proposes that the multiplier be reduced to 1%. An employee that has worked for the municipality for ten years and is ten years away from retirement would receive a prorated multiplier.<sup>395</sup> This employee has accrued ten years of service at the 4% multiplier rate. This benefit has vested and generally cannot be modified. However, if this employee chooses to continue as a municipal employee for another ten years until retirement, that service will accrue at a 1% rate. This modification affects a prospective benefit that has not vested. Assuming the employee continues working for another ten years, upon retirement after twenty years of service this employee would have a 2.5% multiplier rate,<sup>396</sup> and she would be entitled to 50% of her final average salary per year for the duration of her retirement.<sup>397</sup> This is an example of separating a prospective modification from a vested right.<sup>398</sup>

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394. See Buck, *supra* note 29, at 61.

395. See *id.*

396. Ten years at a 4% multiplier and another ten years at a 1% multiplier averages out to a 2.5% multiplier. Twenty years multiplied by 2.5% equals 50%. The board could make this proposal more palatable by agreeing to consider an increase to the multiplier after a given number of years.

397. Though this Article focuses on state law retirement benefits, federal Social Security benefits provide an instructive point of reference. As explored by Professor Monahan, Social Security benefits are noncontractual in nature and represent a property interest protected by the Fifth Amendment. "As a result, potential Social Security recipients are entitled to procedural due process and are protected only against arbitrary government action 'utterly lacking in rational justification.' Therefore, even 'earned' Social Security benefits can be reduced or revoked if such changes have a rational basis." Monahan, *supra* note 322, at 1045-46 (quoting *Flemming v. Nestor*, 363 U.S. 603, 611 (1960)).

398. The board could take a more aggressive approach and ask employees to increase contributions to their retirement accounts. In cases where employees do not already contribute, the board could ask that employees begin contributing. This change will provide immediate cash relief for the municipality. The board could also seek to increase the retirement age for

*c. Retiree Concessions*

Retirees present a different problem. These former employees have completed their service and are oftentimes in the process of receiving accrued and fully vested benefits.<sup>399</sup> Unilateral contractual modifications are limited, which restricts consensual modification proposals. But prospective modifications are available.

For example, cost-of-living adjustments (COLAs) represent the primary avenue of debt relief. Many states use a formula to determine COLAs for retirees, but some states do not explicitly delineate how the COLAs for retirees will be determined from year to year. In these cases, COLAs arguably represent a prospective benefit and unilateral modification of this term may be permissible. The board could propose a reduction or elimination of COLAs for retirees during the duration of the municipality's distress period. Coupled with this proposal, the board could also direct officials to more carefully assess final average salary to ensure that employees are not receiving an artificially inflated number that leads to excess benefits throughout retirement.

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current employees. Note that these proposals are extremely aggressive, not necessarily within the exception to the Contracts Clause, and may effectively end negotiations.

399. A few states—including Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, and New York—have state constitutional provisions that provide that vested pension benefits cannot be unilaterally modified or impaired, but the protection offered by such provisions is not as sweeping as many employee unions would hope. *See Monahan, supra* note 322, at 1071-74; *see also* ALASKA CONST. art. XII, § 7; ARIZ. CONST. art. XXIX, § 1 (state case law is not entirely clear on what protections the constitutional provision provides); HAW. CONST. art. XVI, § 2 (interpreted by courts to protect pension benefits that have been earned but not retirement benefits that have yet to be earned through services rendered); ILL. CONST., art. XIII, § 5; LA. CONST. art. X, § 29; MICH. CONST., art. IX, § 24 (interpreted by courts to protect pension benefits that have been earned but not retirement benefits that have yet to be earned through services rendered); N.Y. CONST. art. V, § 7; *Kraus v. Bd. of Trs. of Police Pension Fund of Niles*, 390 N.E. 2d 1281 (Ill. App. Ct. 1979); *Smith v. Bd. of Trs. of La. State Emps.' Ret. Sys.*, 851 So. 2d 1100, 1105-06 (La. 2003) (explaining that state constitution protects accrued benefits of state public pension plan participation but holding that accrued benefits mean “in the sense of due and payable; vested”); *Civil Serv. Emps. Ass'n, Local 1000 v. Regan*, 525 N.E.2d 1 (N.Y. 1988); *Lippman v. Bd. of Educ. of the Sewanhaka Cent. High Sch. Dist.*, 487 N.E.2d 897 (N.Y. 1985) (provision does not protect changes in employment conditions, or changes to statutes or regulations that may incidentally have an adverse effect on benefits payable upon retirement). Further, Professor Monahan has argued that states providing robust contractual protection should revisit legal precedent and safeguard only those benefits an employee has accrued through past service. *See Monahan, supra* note 322, at 1081-82.

Ultimately, my debt adjustment mechanism is premised on early detection, dynamic action, and consensual contract modifications that seek relief from all key constituencies. This construct does not contemplate dramatic reductions in employee benefits or bondholder obligations. In the event that the debt relief concessions outlined above are insufficient, the board may have no alternative but to authorize a Chapter 9 bankruptcy filing. Municipalities requiring sweeping changes must look to the federal bankruptcy process.

*E. Stage Five: Recovery Plan*

As noted above, my mechanism provides a limited ninety-day negotiation period with one additional thirty-day forbearance period that any contract party can invoke. Ideally, at the end of formal negotiations, the board will have obtained the necessary concessions and be in the process of formulating a recovery plan and new operating budget that will afford the municipality sustainable viability. The board should be able to verify that it believes that the municipality will not be subject to another stage three board appointment for the next five years.<sup>400</sup> This verification will minimize recidivism risk.

The recovery plan must contain a plethora of information, including the concessions received from each creditor constituency, the means and timeline for implementation of the concessions, any support the state or other governmental entities offer,<sup>401</sup> municipal assets that were sold or are to be sold, incurrence of new debt, treatment of claims against the municipality, description of any sunset provisions regarding the board's disbandment, and which entity or individuals will monitor the municipality to ensure consummation of the plan. The board will also be tasked with formulating a new operating budget with a five-year horizon based on the recovery plan. A rehabilitated municipality will be subject to an extended period of hard monitoring regardless of its financial position. The

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400. Financial projections beyond five years are far too speculative.

401. Under my system, additional intergovernmental aid is available only pursuant to a formal recovery plan. Further, receipt of intergovernmental aid should be contingent on the municipality properly following the directives found in the plan.



board can be permanently disbanded upon the municipality achieving certain fiscal benchmarks.

However, if the board is unable to gain the necessary concessions for the municipality's sustainable viability, the board must pursue one of two options. First, the board may seek unilateral modification of municipal contracts in order to gain the concessions that proved elusive in stage four creditor negotiations. Alternatively, if the board believes that the temporary relief afforded by unilateral modifications would still be insufficient or is unlikely to be upheld if challenged, the board must vote to file a Chapter 9 petition on behalf of the municipality. As noted above, my mechanism grants the board this power, and neither the state legislature nor the governor can halt it.

A negotiation process that culminates in a Chapter 9 filing could arguably be construed as a failure. In such cases, the state devoted resources to an out-of-court restructuring process that was unable to successfully rehabilitate the municipality. However, I think this assessment would be misguided. A municipality that matriculates through my state debt adjustment mechanism but ultimately files for Chapter 9 does so after an exploration of its key issues and with a thorough understanding of necessary relief. This understanding will promote a faster, less expensive Chapter 9 proceeding that is more likely to yield optimal results.<sup>402</sup> Further, as noted above, my mechanism cannot assist all municipalities in distress. Federal bankruptcy court is still the venue for the most troubled cases. My system seeks to supplant Chapter 9 only as to a distinct—albeit large—subset within the distressed municipality market.

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402. We see this phenomenon in the corporate bankruptcy world. Companies participate in out-of-court restructuring processes that are oftentimes not fruitful. However, these companies are able to enter into federal bankruptcy court on the fast track to recovery. In some cases, these companies have been able to resolve the vast majority of their problems and emerge from bankruptcy within a matter of weeks. Mike Spector, *Quickie Bankruptcy Filings: Companies Zoom In, Zoom Out*, WALL ST. J. (Jan. 5, 2010, 12:01 AM), <http://www.wsj.com/articles/SB10001424052748704789404574636164199387026> [<http://perma.cc/652U-QZCV>]. The same benefits should inure to municipalities that complete extensive out-of-court negotiations. See Henry C. Kevane, *Deploying the "Prepackaged" Plan of Adjustments in Chapter 9*, in CHAPTER 9 BANKRUPTCY STRATEGIES 107, 118, 120, 130 (2011).

V. CONSEQUENCES OF IMPLEMENTATION: RAMIFICATIONS TO  
BORROWING COSTS

My proposed state debt adjustment mechanism is an ambitious solution to an extremely pernicious problem. But there is one significant consequence of implementation that must be addressed.

My mechanism increases the likelihood that municipalities will be able to effectively reorganize their debt structure without resorting to Chapter 9. However, a threat to bondholder interests is inherent in these improved prospects for sustainable viability. My mechanism creates a negotiation structure that affords municipalities leverage they may not have attempted to exert otherwise and, quite frankly, may never have even realized they had. One could argue that municipalities within a state that enacts my debt adjustment mechanism could face significantly higher borrowing costs because their ability to reduce the value of bondholder claims has been bolstered.<sup>403</sup> In other words, with their newfound leverage, municipalities may act competently and aggressively in addressing their fiscal difficulties to the detriment of bondholder constituencies. This newfound power may compel bondholders to demand higher interest rates or additional protections to offset this risk. Despite these valid concerns, I believe the likelihood of a significant increase in borrowing costs is overstated.

Changes in borrowing costs are often captured by changes to a borrower's credit rating.<sup>404</sup> The changes are not necessarily symmetrical, but credit ratings are certainly instructive. This is especially true for institutional borrowers that have their financial architecture inspected by an independent rating agency. Credit rating agencies have uniformly endorsed states with intervention programs and have explained that such programs—even those that have significant practical limitations—improve the likelihood of sustainable viability for municipalities.<sup>405</sup> Bonds issued by states that have

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403. See Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 578, 581-82 (1998).

404. See DOTY, *supra* note 134, at 39-41.

405. See LISA COLE, MOODY'S U.S. PUB. FIN., GENERAL OBLIGATION BONDS ISSUED BY U.S. LOCAL GOVERNMENTS 14 (Oct. 2009), <http://www.mysouthborough.com/wp-content/uploads/2010/04/Moodys-GO-methodology-10-09.pdf> [<http://perma.cc/7MG9-LJBE>].

intervention programs have enjoyed higher credit ratings.<sup>406</sup> Credit rating agencies have also embraced comprehensive state monitoring of municipalities.<sup>407</sup> My debt adjustment mechanism provides for comprehensive monitoring by the state. With the state in the primary monitoring role, many of the information asymmetries that have plagued the municipal borrower market will be eliminated.<sup>408</sup> This monitoring coupled with a comprehensive intervention program will create more stable municipalities. Credit rating agencies have embraced this premise and given states with strong monitoring programs higher bond ratings.<sup>409</sup>

Further, my debt adjustment mechanism is not just proactive, but also delineated. Consequently, the mechanism provides certainty through a clear negotiation structure, timetables, and a circumscribed list of preferred concessions that does not accept opportunistic defaults. Certainty has value. I believe that a state's adoption of my debt adjustment mechanism will have no material effect on borrowing costs because the mechanism's certainty—vis-à-vis the uncertainty under almost all existing state systems—offsets the potential impairment risk.<sup>410</sup>

Finally, as noted above, my system is premised on a shared burden among all creditor constituencies and seeks to capture distressed municipalities at a time when less sweeping concessions will be sufficient. Bondholders and employee unions both fear that their

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406. *See id.*

407. *See id.* at 11.

408. *See DOTY, supra* note 134, at 40-41 (explaining that rating agencies have historically not been able to engage in the extensive independent due diligence expected of underwriters).

409. Moody's has stated that properly functioning state oversight programs ensure that local governments are secure, which bolsters credit ratings for the state and its municipalities. *See COLE, supra* note 405, at 11, 14. More specifically, North Carolina has the most aggressive state monitoring program in the country. *See STANDARD & POOR'S, supra* note 335, at 3. As a result, all three credit rating agencies have given bonds issued by the state and its municipalities the highest bond rating, specifically citing the state's oversight and prudent financial management. *See STATE ROLE IN LOCAL GOVERNMENT, supra* note 100, at 33.

410. *See* Michael Bradley et al., *Reaction to Legal Shocks and Their Antidotes: Lessons from the Sovereign Debt Market*, 39 J. LEGAL STUD. 289, 295-98 (2010) (finding that the addition of collective action clauses—which enable supermajority voting to change payment terms—in sovereign bond indentures did not appear to increase sovereign borrowing costs); *see also* Anne O. Krueger, *Sovereign Debt Restructuring Mechanism—One Year Later* (Dec. 10, 2002), <https://www.imf.org/external/np/speeches/2002/121001.htm> [<http://perma.cc/V94R-3AVK>] (explaining that the creation of a sovereign debt restructuring mechanism could in fact reduce country borrowing costs).

group will bear a grossly disproportionate financial burden from a restructuring. My mechanism's shared-burden principle reduces the concessions any one group is forced to make, creating a more palatable process.

Ultimately, even if borrowing costs do increase, I believe the increase will be relatively nominal. More importantly, I believe that the effect on the municipality from a nominal increase in borrowing costs would actually be positive. As detailed in Part III.A.2, incrementally higher borrowing costs restrict overgrazing at the debt commons, limit cost shifting, and minimize moral hazard.<sup>411</sup> Local officials will be inclined to internalize the costs and benefits of their decisions, creating a more optimal municipal paradigm.

#### CONCLUSION

Municipalities face daunting fiscal challenges that threaten to fundamentally undermine basic service delivery. Though the depths of these problems have only recently been revealed, many municipalities face significant impairment.<sup>412</sup> Academics and policymakers have focused on Chapter 9 and present federal bankruptcy law as the most viable solution. But Chapter 9's flaws are numerous and well-known. This Article envisions an entirely new model: a state-law based adjustment system that seeks to identify pressured municipalities at an early stage of deterioration and then shepherd these municipalities through a dynamic negotiation process with an eye toward avoiding resource-draining litigation. My proposal has no parallel under existing state-law systems and offers systemic rehabilitation at a time when a new approach is desperately needed.

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411. See *supra* notes 182-89 and accompanying text.

412. See Chutchian, *supra* note 31.