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TO FILE OR NOT TO FILE: THE CAUSES OF MUNICIPAL BANKRUPTCY IN THE UNITED STATES

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ABSTRACT. About 500 municipalities have declared bankruptcy since Congress passed the Municipal Bankruptcy Act in 1937. Based on the experiences of these municipalities and the municipal bankruptcy literature, this paper develops a theory of why municipalities go bankrupt and discusses various ways to prevent other municipalities from going bankrupt. The paper identifies three-dimensional factors that may make municipalities go bankrupt: long-term and short-term, political and economic, and internal and external perspectives. The paper ends with an observation that government failure in the form of municipal bankruptcy can be reduced by strengthening the audit powers of the states and by utilizing more municipal bond and liability insurance policies.

INTRODUCTION

In the 1990s, several large local governments in the United States had declared bankruptcy or had considered declaring bankruptcy. Orange County, California declared bankruptcy in 1994 after losing more than 1.7 billion dollars in its investment pool. Bridgeport, Connecticut filed for Chapter 9 in 1992 after incurring budget deficits for several years. Washington, D.C. has been under the virtual receivership of Congress since 1996 when it was unable to meet its expenditure obligations as a result of a $600 million annual budget deficit. Miami, Florida, has been faced with a similar fate when the state appointed a financial control board to take away its purses in order to put financial matters back on a sound footing. Although only a small percentage of local governments go through the destructive experiences that these governments went

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through and most bankrupt local governments are small entities, it is alarming to see that the nation's largest local governments are not immune from financial disasters.

Despite the increasing frequency of bankruptcy among large local governments in the last decade, local government scholars, particularly those who study local politics and urban finance, have paid only scant attention to the issue of municipal bankruptcy. There have been a few case studies, but not many comprehensive studies of municipal bankruptcy have been published in the United States. Furthermore, most of the existing studies were done by law scholars who are interested in the legal issues of Chapter 9 bankruptcy rather than by political scientists or public administration scholars who are interested in the politics and systematic causes of bankruptcy (For studies by legal scholars, see Hempel, 1973; Spiotto, 1993; McConnell & Picker, 1993; Spitz, 1993; Kupetz, 1995; Picker, 1995. For case studies, see Cohen, 1989; Jorion, 1995; Brown, 1995; Baldassar, 1998). As a result, little is known about the systematic causes of municipal bankruptcy. Perhaps this lack of attention reflects the good economic times of the recent years when most local governments have been financially well off. However, the bright facade that we see may foreshadow the dark danger that may lurk in the background. It is usually better to prevent a financial disaster from occurring when financial resources are plentiful than to try to fix the barn after the animals are already stolen.

In providing a comprehensive explanation of the causes of municipal bankruptcy, this paper briefly examines the history of municipal bankruptcy law, explains the current debt relief clauses in Chapter 9 of the Bankruptcy Law, develops a multi-dimensional causal model of municipal bankruptcy, examines several prominent municipal bankruptcy cases, and closes with a discussion on ways to prevent future bankruptcies. Throughout the paper, and particularly in the causal model section, two themes are emphasized. One theme is that cases of municipal bankruptcy need to be explained from several perspectives including long-term and short-term, political and economic, and internal and external perspectives. Another theme is that municipal bankruptcy should be explained separately from municipal fiscal crisis because not all municipalities that experience fiscal stress go bankrupt.

The key question of the study is "Why do municipalities declare bankruptcy?" More specifically, the purpose of the study is to develop a multi-dimensional theory of the causes of municipal bankruptcy and test

it empirically with a few municipal bankruptcy cases. The underlying theoretical background of the study is the concept of government failure. Externalities or collective action problems often deter markets from responding to the needs of public services and goods (Olson, 1973). When markets fail to provide necessary goods and services, governments often step in to fill the gap (Weimer & Vining, 1998). However, not all governments function efficiently (Eggers & O'Leary, 1995) and consequently some of them may face fiscal disasters. When governments declare bankruptcy, most people focus on the economic aspects of their operations as prime targets of blame, ignoring the fundamental problems of government (See, for example, Cohen, 1989). Governments usually do not operate in a competitive environment and administrators manage other people (citizens)'s money, not their own. Therefore, this study will emphasize that the root causes of government problems including bankruptcies are not always economic, but often administrative or political. In other words, municipal bankruptcies indicate the presence of government failure as well as the presence of red ink.

This study is of considerable importance to the scholars and practitioners alike. Although there are many legal books on municipal bankruptcy and a few case studies on individual incidences of municipal bankruptcy, systematic theoretical and empirical studies on municipal bankruptcies at the nationwide level are rare. Therefore, this study will fill the existing gap in the bankruptcy literature. The results of this study also have significant practical implications. Practitioners will be able to see the patterns of municipal bankruptcies across the region, years, governments, and other features. Practitioners will also be able to see the importance of different factors that may cause municipal bankruptcy and adjust their decision-making behavior accordingly, to avoid pitfalls that may put their government in financial jeopardy.

HISTORICAL DEVELOPMENT OF BANKRUPTCY LAW

Because humans, corporations, and governments are not perfect, they occasionally will not or cannot pay their debts. What to do with non-paying debtors is a perplexing question that was dealt with differently by various societies at different times. The earliest reference to this issue can be found in the Old Testament. The *Book of Deuteronomy* (15:1-2) indicates that Jews canceled the obligations of debtors every seven years without any punishment. In the Roman Empire, people who did not pay

were executed. In Victorian England, debtors who could not pay were imprisoned (Spiotto, 1993, pp. 3-4). In the United States, bankruptcy laws were developed with the purpose of giving debtors a fresh start. When the nation's founders wrote the Constitution in 1787, they gave the power to enact a bankruptcy law to Congress. In 1898, Congress passed the first bankruptcy law to give debt relief to individuals and corporations. However, bankruptcy rules regarding governments did not appear until 1934 when Congress amended the 1898 bankruptcy law.

There are two related reasons why bankruptcy law regarding municipal governments did not develop until 1934: the Constitutional issues of contract impairment and state sovereignty. The Contract Clause of the U.S. Constitution (Article I, Section 10) prohibits the states, but not Congress, from passing any law impairing the obligations of contracts. The Tenth Amendment confers on the states sovereign powers by reserving for them (or the people) the powers not delegated to the United States. As a result, the states could not pass any law providing debt relief to their local governments without the consent of the federal government, whereas Congress could not pass any municipal debt relief law that usurps the powers of the states to regulate their local governments. In fact, the first municipal bankruptcy law passed by Congress in 1934 was struck down in 1936 by the Supreme Court on the grounds that it violated the states' sovereign right to manage the affairs of their local governments.

Absent state and federal bankruptcy law, local governments could not declare bankruptcy before 1934. What happened if cities would not pay or, as many did during the Depression, could not pay their debts? Theoretically, creditors could seize (proprietary) assets of the city, seize resident's private property within the city, obtain a lien on future tax revenues, and impose through the court new taxes earmarked for debt service (McConnell & Picker, 1993). Application or enforcement of these remedies, however, was difficult because municipalities were considered to be performing governmental as well as proprietary functions. It was difficult to differentiate proprietary assets from public assets, difficult to impose unlimited liability on individual residents because of the city's mismanagement of funds, and difficult to differentiate the proprietary use portion from the public use portion of future revenues. In practice, imposition of new taxes through the issuance of a writ of mandamus was the most viable remedy (McConnell & Picker, 1993). However, the frequent use of this remedy by creditors

created a series of practical problems. For example, the imposition of new taxes at the time of an economic downturn increased delinquencies, generating an even smaller amount of revenues than before. Also, a mandamus suit by a single creditor was usually followed by many more suits by other creditors who did not want to be the last in line in tapping the city's tax revenues (Spiotto, 1993; McConnell & Picker, 1993). As a result, many debt-stricken cities had to defend themselves in court against tax increases, draining their financial resources even more.

The two conflicting issues of impairing obligations of contract and state sovereignty proved to be less profound than rescuing financially dying local governments during the Great Depression. In the 1930s, thousands of local governments defaulted on their debts as a result of the dramatic reduction in tax revenues. Because of the sagging economy and the flood of mandamus suits against municipal tax revenues, levels of tax delinquency rose to astonishing levels in many cities. In Asheville, North Carolina, tax delinquencies soared from twenty-one percent to fifty-six percent between 1931 and 1934 (ACIR, 1973). In Detroit, Michigan, the tax delinquency rate was thirty-six percent in 1932 and, without debt relief, it was expected to go even higher (McConnell & Picker, 1993). Faced with the ever-increasing amount of debts and dwindling tax revenues, many local governments lobbied Congress to pass debt relief measures. In the process of debating the merits of some sort of debt relief, the Senate Judiciary Committee found that more than 1,000 municipalities were in default in 1934.[1] In response to the growing number of insolvent local governments and an increasing pressure to do something about it, Congress enacted the first municipal bankruptcy law by adding chapter 9 to the 1898 Bankruptcy Act in 1934.

The 1934 Bankruptcy Act permitted municipalities to restructure their debts by negotiating with their creditors, if their state law allowed them to do so. The negotiated settlements could be imposed on minority creditors if they were approved by more than 75 percent of the creditors. As is the case in the current bankruptcy law, the Act did not confer on the court the powers to interfere with the political and administrative powers of the municipality. However, in Ashton v. Cameron County District (1936), the Supreme Court struck down the 1934 Act on the grounds that it may materially restrict the municipality's fiscal affairs. It reasoned that, by allowing the political subdivisions of the state to impair their contractual obligations, Congress was, in essence, intruding upon the sovereignty of the states (Spitz, 1993; Picker, 1995). In response,

Congress passed another amendment in 1937 by slightly modifying the provisions of the 1934 Act. It limited the bankruptcy court's jurisdiction to the determination of whether a resulting reformulated contract was fair (Spitz 1993) and excluded counties from the Act (McConnell & Picker, 1993).[2] Even though the changes were not substantial, the Supreme Court let the new Act stand in *United States v. Berkins* (1938). It reasoned that a federal statute was necessary because the Contracts Clause precluded states from passing laws for the composition of municipal debts (Picker, 1995), essentially reversing its earlier decision in Ashton v. Cameron County District (1936).

After the Berkins decision, Congress amended the bankruptcy law numerous times. For example, it amended the law in 1946 to make sure that municipal bondholders are treated equally in case of debt restructuring. This amendment came after the Supreme Court, in Faitoute Iron and Steel Co. v. Asbury Park (1942) upheld a New Jersey law that permitted municipalities to restructure their debts with the consent of 85 percent of their creditors in amount. The amendment prevented state authorization of compositions that would bind non-consenting creditors (Spitz, 1993). Congress also amended the Act in 1978 to make debt relief more widely available to municipalities by loosening the petition requirements. This amendment came after the 1975 New York City financial crisis. On the brink of the city's default, officials checked out the bankruptcy petition rules and found that 51% of creditors in amount were required to accept a plan before a petition could be filed, along with other onerous conditions. Getting the 51% acceptance was difficult for large cities because they had a large number of creditors and their creditors were mostly bearer bondholders who were difficult to trace (Spitz, 1993).

After the financial problems of Cleveland, Ohio in 1980, Congress again amended the Act, this time to protect creditors who received a pledge of revenue from the bankrupt municipality in 1988. When Cleveland was in financial trouble, it wanted to borrow money from the banks by pledging its specific revenues such as those from the water and power systems for the repayment of its debt. The banks refused to accept the city's pledge because they knew that it becomes void once the city declares bankruptcy. Most recently, in 1994, Congress amended the Act to specify that municipalities have to be specifically authorized by their state to receive debt relief under the Act. This amendment came after Bridgeport filed for bankruptcy protection in 1991. The State of

Connecticut argued that Bridgeport could not file because the state did not grant its municipalities the right to file. However, the bankruptcy court ruled that "the municipality's right to sue and be sued and the right to argue their case in any court" included in the state law was good enough to pass as "generally authorized to file." Therefore, in order to remove further uncertainty about the states' right to either authorize or prohibit their municipalities to file, Congress passed the 1994 amendment.

CURRENT MUNICIPAL BANKRUPTCY LAW

Chapter 9 of the Bankruptcy Code (The 1994 Bankruptcy Amendments; Title 11 U.S.C.)[3] permits a financially distressed municipality to restructure its debt in case of insolvency. When filing a Chapter 9 bankruptcy, the insolvent municipality may continue to provide necessary services to its residents while it reformulates its debts by extending maturities, reducing interest or principal, or refinancing. Three aspects of Chapter 9 bankruptcy are notably different from Chapter 7 (liquidation), 11 (debt reorganization-corporations), and 13 (debt reorganization-individuals) bankruptcies. First, municipalities, like farmers and charitable corporations, are not subject to an involuntary bankruptcy petition because creditors cannot force financially distressed municipalities to file to satisfy their debts. Second, the bankrupt municipality is not required to liquidate its assets to satisfy its creditors. In this respect, municipal bankruptcy is similar to corporate debt reorganization under Chapter 11. Third, the municipality's corporate, governmental, and proprietary powers are not really affected by its filing. A bankruptcy court's role is limited to determining whether a petition is properly filed, a restructuring plan is fair, and the plan is implemented fairly. The court does not interfere with the municipality's powers to control public services, revenues, properties, and other financial matters.

Eligibility for Debt Relief

Access to debt relief under Chapter 9 is somewhat limited. Section 109(C) requires that the debtor be a municipality, specifically authorized to be a debtor under Chapter 9 by state law, be insolvent, and work out a debt restructuring plan. The following are the exact requirements provided in that section:

(C) An entity may be a debtor under Chapter 9 of this title if and only if such entity-

(1) is a municipality;

(2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by state law, or by a governmental officer or organization empowered by state law to authorize such entity to be a debtor under such chapter;

(3) is insolvent;

(4) desires to effect a plan to adjust such debts; and

(5) (A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(B) has negotiated in good faith with creditors and failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(C) is unable to negotiate with creditors because such negotiation is impracticable; or

(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under Section 547 of this title.

As noted above, the first requirement of municipal filings is that the debtor be a municipality. The Bankruptcy Code defines "municipality" as a "political subdivision, public agency, and instrumentality of a State (11 U.S.C. Section 101 (40)." Although the Code does not define "political subdivision, public agency, and instrumentality," courts have held that a public agency or authority is a municipality for purposes of Section 109C if it 'is subject to control by public authority, state, or municipal' (Kupetz, 1995). Therefore, "municipality" may refer to a city, county, town, village, township, special district, or school district, encompassing all types of local governments. This broad interpretation of the term "municipality" is different from its normal usage by the Census Bureau. As noted in the previous chapter, the Census Bureau's definition of "municipality" includes cities, towns, and villages, but not other local governments such as counties and special districts (U.S. Bureau of Census, 1997). On the other hand, Bankruptcy Courts do not

extend the meaning of "municipality" to all government-related entities. In 1995, for example, the court dismissed a Chapter 9 filing by the Orange County Investment Pools (OCIP), ruling that the OCIP was not a municipality because it was neither a political subdivision, nor an instrumentality of the State of California (Baldassar, 1998).

The second requirement is that the municipality be specifically authorized to be a debtor under state law. This requirement preserves the power of the states to control the financial affairs of their political subdivisions by allowing the states to decide the extent to which their local governments have access to Chapter 9 protection. The phrase, "specifically authorized" replaced the previous language, "generally authorized" in the 1994 Bankruptcy Amendments. Previously, it was sufficient for a municipality to be "generally authorized" to be a Chapter 9 debtor. On top of that, in the past many courts broadly construed the term "generally authorized." In City of Bridgeport (1991), the court ruled that the city had state authorization to file for protection even though the state itself strenuously argued otherwise. The court based its decision on the city's corporate powers to sue and be sued and to institute or defend any action in all courts.[4] Because of this lenient tendency of the courts toward Chapter 9 eligibility, many municipalities were able to file for protection even though their state did not explicitly authorize them to do so. However, this trend is likely to change in the future with the new stricter eligibility requirement of the 1994 Amendments because only 17 states have specifically authorized their municipalities to file for Chapter 9 bankruptcy. Although only Georgia explicitly prohibits its political subdivisions from filing, most states had been ambiguous about their municipalities' Chapter 9 eligibility.[5]

The third requirement is that the municipality be "insolvent" to be eligible for relief under Chapter 9. The Code defines "insolvent" as "generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute," or "unable to pay its debts as they become due" [Section 101 (32C)]. The first part implies that the bills are arriving and they cannot be paid and the second part implies that the bills will arrive in the next few months and cannot be paid then. This definition for insolvency is based on the cash flow of the municipality, deviating from the balance sheet test that compares assets and liabilities. This insolvency test was used when the court accepted a bankruptcy petition from Orange County in 1994. The court found the county insolvent even though it had extensive assets such as airports and office

buildings that greatly exceeded the amount of its debts that were not being paid at the time of filing. The same insolvency test was applied when the court dismissed a petition from the city of Bridgeport in 1991 on the grounds that the city did not exhaust its borrowing power and would not run out of cash in its next fiscal year.[6]

The fourth requirement is that the municipality desire to effect a plan to adjust its debts. This requirement is related to the "good faith" requirement of Section 921(C), which states that "the court may dismiss the petition if the debtor did not file the petition in good faith or if the petition does not meet the requirements of this title." Also, this provision implies that the municipality is expected to behave responsibly throughout the bankruptcy process by eventually producing a reasonable plan to satisfy creditors' claims.

The last requirement consists of four alternative options, of which the insolvent municipality is required to fulfill only one. The first option is to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that it intends to impair under its plan. In most cases, it is impractical to reach a voluntary agreement with creditors who do not want to lose a portion of their investment. The second option is to show that it has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class. Petitions may not meet this "good faith" standard if the debtor does not really intend to reorganize the debt but hinder creditors' efforts to collect their debt (Picker, 1995). The third option is to show that the municipality is unable to negotiate with creditors because such negotiation is impracticable. Although the Code does not define the term "impracticable," the sheer number of creditors and severe time constraints may make negotiations impracticable (Kupetz, 1995). For example, the court stated that it was impracticable for the debtor to have included several hundred bondholders in discussions in the case of Villages at Castle Rock Metro District (145 B.R. 82; Bankr. B.D. Colo., 1990). The fourth option is to show that a creditor may attempt to obtain a transfer that is avoidable under section 547. Title 11 of the U.S. Code, Section 547, allows for the avoidance of preferential transfers to or for the benefit of a creditor. Presumably, this is to prevent creditors from transferring or liquidating the assets of the insolvent municipality.

Petition Review, Dismissal, and Confirmation of the Plan

After a petition is filed with the bankruptcy district court,[7] a bankruptcy judge is designated by the chief judge of the court of appeals for the circuit embracing the district in which the case is commenced. The designated judge reviews the petition and makes all the relevant decisions including dismissal of the petition and confirmation of the plan. The petitioning municipality is required to provide a list of the names, addresses and claims of creditors that hold the twenty largest unsecured claims, and with the petition or by a date fixed by the court, a list containing the name and address of each creditor. It is also required to provide notice of the commencement of a Chapter 9 case at least once a week for three successive weeks in at least one general circulation newspaper published within the district and one other newspaper having a general circulation among bond dealers and bondholders as the court designates (Section 923). The same notice rule applies to the dismissal of a Chapter 9 case.

The court, led by the judge, may dismiss the petition if the debtor did not file the petition in good faith or if the petition does not meet filing or eligibility requirements (Section 921c). Although the Code does not define the term "good faith," courts have found that where the debtor is using Chapter 9 for legitimate reasons and not merely attempting to delay creditors, good faith is not lacking (Kupetz, 1995).[8] The court dismisses cases if the filing municipalities do not meet eligibility requirements such as specific authorization and insolvency standards. In addition, the court may dismiss the petition for "cause." Some examples of "cause" are unreasonable delay by the debtor, failure by the debtor to propose a plan prior to any deadline that might be set by the court, denial of the confirmation of a plan, denial of additional time for filing another plan, denial of a modification of the plan, or a material default by the debtor under a plan (Section 930; see Kupetz, 1995).

According to Chapter 11, a non-recourse secured claim is treated the same as if it were a recourse claim against the debtor (Section 1111(b)). If this rule is applied to a Chapter 9 case, revenue bonds, which are guaranteed by the revenues that are generated by a specific municipal project (i.e., transportation and utility), may become general obligation bonds, which are guaranteed by the general municipal tax revenues. Therefore, the Code provides that the holder of a claim payable solely from special revenues of the debtor should not be treated as having recourse against the debtor (Section 927). This clause essentially

prevents revenue bond holders from getting paid from the general funds of the municipality. At the same time, the Code states that special revenues acquired by the debtor after the commencement of the case shall remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case (Section 928). This clause prevents special revenues from being diverted for the municipality's general expenses or obligations.

The municipal debtor is required to file a plan for adjustment of debts either with the petition or at a later date. In most cases, the municipal debtor has a very flexible filing schedule because only the debtor can file an adjustment plan in a Chapter 9 case. Once filed, the court must confirm the adjustment plan if it meets seven general requirements. The general requirements stated in Section 943(b) include: the plan complies with the provisions of the confirmation sections (103(e) and 901) and Chapter 9, all amounts to be paid by the debtor and others are fully disclosed and reasonable, the debtor is not prohibited by law from taking necessary action to carry out the plan, and the plan is in the best interests of creditors and is feasible.[9]

The specific confirmation section of Chaptor 9 (Section 901) includes classification of claims, contents of the plan, regulatory approval, minimum acceptance of the plan, cramdown, and other clauses. Many of these clauses are adopted, without modification, from the requirements for confirmation of a plan of reorganization under Chapter 11. The classification clause requires the debtor to place similar claims in a similar class (secured and unsecured classes). The contents clause requires the debtor to designate classes of claims (impaired and unimpaired claims), to provide the same treatment for each claim of a particular class, and to provide adequate means for the plan's implementation. The regulatory approval clause requires the municipal debtor get approval for any rate (e.g., tax and utility rates) change proposal in its debt adjustment plan from the governmental regulatory entity with jurisdiction over the matter. The minimum acceptance clause requires that, if a class of impaired claims is impaired, at least one class of impaired claims must accept the plan. The cramdown clause allows the debtor to obtain confirmation of the plan even if not all the classes accept it. If the plan satisfies the minimum acceptance requirement and if it does not discriminate unfairly with respect to each class of impaired claims that has not accepted the plan, it can still be confirmed.

Once the plan is confirmed, the debtor is discharged from all debts. The provisions of the confirmed plan bind the debtor and creditors, regardless of whether the creditors accepted the plan. The only exception is that the debts owed to an entity that did not have notice or actual knowledge of the case before confirmation still remain the debtor's obligation.[10] Therefore, the municipal debtor can start fresh in its financial dealings as soon as its plan is confirmed. At the same time, its Chapter 9 experience may damage its reputation, lower its bond ratings, and shatter its residents' and outsiders' confidence in its governing structure. Many bankrupt local governments pay higher interest rates for decades and many bondholders of a bankrupt local government may lose a significant amount of money.

CAUSES OF MUNICIPAL BANKRUPTCY

Many municipalities, counties, and special districts declare bankruptcy when they cannot effectively deal with a fiscal problem that they face. Although all local governments are supposed to manage their finances prudently to safeguard the public's money, not all of them actually do. Once faced with a severe fiscal problem, a local government may ride out the storm, default on a portion of its debts, or declare bankruptcy. Therefore, some sort of financial crisis is a precondition for bankruptcy. As a result, the question of what causes them to falter financially becomes an important issue in the process of understanding the causes of municipal bankruptcy. Plus, understanding the causes of financial crisis can lead to appropriate remedies for the financial problems of local governments. However, as will be explained later, a local government's fiscal stress may not directly lead it to bankruptcy. Therefore, the causes of municipal financial crisis are not the same as the causes of municipal bankruptcy.

What brings fiscal crises to local governments? Many scholars have identified various fiscal stress-generating factors. They may include short-sightedness of politicians, greed of bankers and unions, inefficiency of the bureaucracy, demographic changes, economic situations, and others. As a result, when local governments go broke, there is plenty of blame to go around. The chief elected officer, members of the legislative body, bankers, unions, service recipients like welfare mothers, bureaucrats, budget forecasters, and even stingy taxpayers can all be targets of finger pointing in one situation or another.

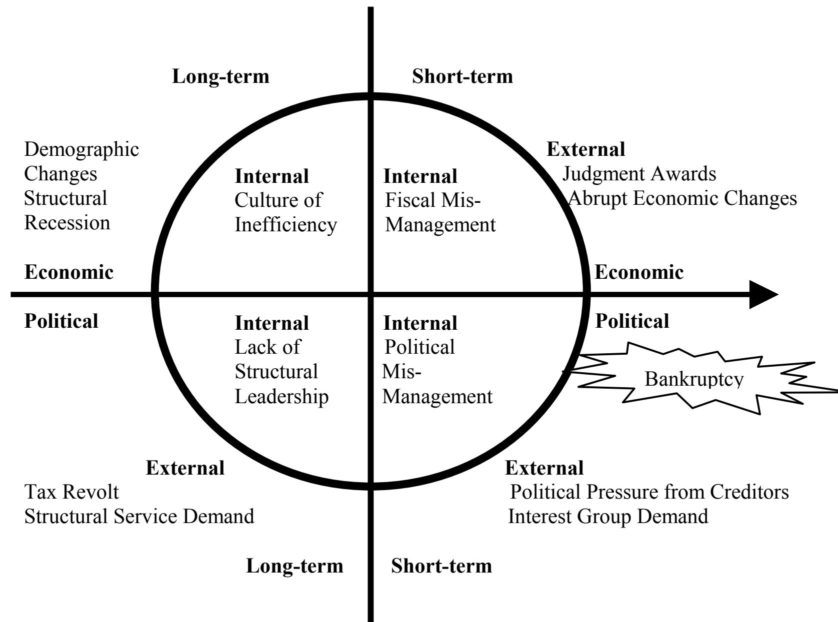
Three Perspectives on the Cause of Municipal Bankruptcy

Some authors like Harrigan (1993) categorize the factors that cause municipal fiscal crisis into two forces--internal and external. Internal forces mainly refer to the political vulnerabilities that are shaped by the internal workings of the local government. The pressures exerted on politicians by bureaucratic leaders and public employees' unions to expand expenditures for their benefits, bloated and inefficient bureaucracies, and mismanaged budgeting and accounting procedures all constitute these internal forces that make local governments go under. External forces refer to demographic and socio-economic factors that are beyond the local governments' control. Factors such as the influx of poor people, flights of jobs and middle-class residents to suburbia, inflation, and unemployment can strain the finances of local governments and push them to the brink of financial collapse.

Of course, there is more than one way to categorize these factors. Long-term factors such as socio-economic changes and bureaucratic culture can be distinguished from short-term factors such as temporary bureaucratic inefficiency and budgeting incompetence that directly trigger municipal bankruptcy. Political factors including service demands from special interest groups can be discerned from economic factors such as falling revenues due to unemployment. Although these categories are not mutually exclusive, they accentuate certain aspects of the causes if presented separately. In addition, they may broaden our perspective on municipal bankruptcy by presenting a new dimension to the bankruptcy explanations. Therefore, this paper will explain municipal bankruptcy cases from three overlapping perspectives--long-term and short-term, political and economic, and internal and external. Figure 1 presents a causal graphic model made of these three dimensional factors.

Although all bankrupt local governments have faced some sort of fiscal crisis, not all local governments experiencing fiscal crisis declare bankruptcy. In fact, many cities such as New York, Philadelphia, Washington, D.C., and Miami were able to ride out their financial storm with the help of their state or the federal government. For example, in response to the 1974 financial crisis of New York City, the state of New York and the federal government provided loan guarantees to the city so that it could borrow necessary money to ride out the crisis. The state also created a financial control board to oversee the city's budget and a

FIGURE 1
A Model of the Causes of Municipal Bankruptcy



state agency called the Municipal Assistance Corporation to convert the city's short-term loans into long-term bonds (Harrigan, 1993). Philadelphia, Washington, D.C., and Miami all received some form of financial assistance from their state government (from the federal government in the case of Washington, D.C.). This raises the question of why some local governments declare bankruptcy, but others do not, when they are faced with fiscal crisis. In general, bankruptcy may be avoided if local governments receive emergency financial aid from the state or federal government, if the investors' confidence is restored usually through dramatic political changes, or government leaders put the financial aspect of the house in order by making drastic changes in how it operates.

Local governments that are not so lucky to be beneficiaries of the state or federal government intervention, rapid political changes, or drastic financial management decisions still have to face the dark hours of bankruptcy decision. We may categorize local governments that

actually declare bankruptcy into three somewhat overlapping groups: those that declare bankruptcy because they do not see any hope of recovery in the near future; those that declare bankruptcy because they want to protect their assets, because they may lose them right away unless something is done immediately; those that use bankruptcy as a financial management strategy, using it as a bargaining chip in financial negotiation processes. The remainder of this paper discusses a few prominent cases of municipal bankruptcy and explains them from the short-term, long-term, political and economic, and internal and external perspectives. A summary of bankruptcy causes is presented in a table at the end of this section.

Cases of Municipal Bankruptcy

Orange County, California

After incurring an estimated paper loss of $1.5 billion in its 20 billion dollar investment portfolio, Orange County declared bankruptcy in December 1994. This event sent shock waves through the municipal bond market and to the rest of the nation. With two and a half million residents, Orange County became the largest local government to declare bankruptcy and, with about $1.5 billion of investment loss, it became the local government that wanted to protect the largest amount of assets from creditors through the bankruptcy process. How could this suburban, rich, and conservative county with Disneyland and countless tracts of million dollar homes go broke?

The immediate triggering factor was of course a loss of investment money in the Orange County Investment Pool. Robert Citron, Treasurer of the County, managed the Pool with excess funds to generate investment income for more than 10 years. With its high rate of return, the Pool attracted investment money from cities, special districts, and school districts within the county, and from elsewhere in California. In 1994 the fund had 7.6 billion dollars of investment money, more than 60% of which came from 194 local governments, mostly in Southern California. Citron leveraged the amount by a ratio of almost 3 to 1, causing the fund size to balloon to more than 20 billion dollars. When the Federal Reserve began to raise interest rates in early 1994, the Pool's interest-sensitive bonds began to lose their value and, by the beginning of December, the value of the Pool had shrunk by about $1.5 billion. Given that the size of the county's budget was less than $1.6 billion in 1994, the county could not absorb the loss and continue its business as usual.

The treasurer used a complex investment strategy to generate high levels of income from the Investment Pool. His investment strategy may be summed up by two investment methods: derivatives and reverse purchase agreements. The term “derivatives” refers to securities that gain or lose value following the direction of interest rates. Usually these securities are tied to some index that fluctuates based on the market interest rate. Citron widely used one specific type of derivative known as inverse floaters, which were structured in such a way that their yield goes up as interest rates remain stable or decline. More than 30% of the holdings of the Orange County Investment Pool were classified as inverse floaters at the beginning of 1995.

A reverse purchase agreement is a type of leverage that allows investors to utilize more capital than they possess. This is made possible by using the “buy, borrow, and buy again” technique. In Citron’s case, he first purchased U.S. Treasury notes or bonds from a securities dealer. Then, he received a loan from the dealer using the purchased notes or bonds as collateral, which was supposed to be kept or sold by the dealer if the loan is not repaid within the loan period, usually 180 days. The interest rate on the loan was usually one to two percentages lower than the interest rate of the notes or bonds that were used as collateral. Third, he used the borrowed money to purchase long-term Treasury notes or bonds that generate higher interests than the loan interest that the Investment Pool was paying to the securities dealer. Fourth, he repeated this process two or more times. As a result of this leveraging practice, the portfolio of the Investment Pool was about three times larger than the amount of money that it amassed as investment money.

Contrary to Citron’s expectation that interest rates would continue to decline, the Federal Reserve increased them several times in 1994. As a result, the portfolio of the Investment Pool lost a significant amount of money by November 1994. As soon as the investment bankers found out about that, they began to demand the Investment Pool to put up with more collateral. Because the cash of the Pool was low, Citron was not able to meet that demand. As the investment bankers began to redeem the collateral securities and investing municipal governments began to demand withdrawals, the Supervisors of the County decided to declare bankruptcy to protect the Investment Pool and also the county.

As is the case with many other incidents of bankruptcy, however, more than one factor was involved in causing the county to fall from the grace. Because of the passage of Proposition 13 in 1978, Orange

County, just like all other California local governments, was not able to increase revenues through property tax hikes or impose new taxes without approval of the local electorate. But the service demands from the residents increased in the1980s as more and more immigrants moved in.[11] To make matters worse, the state of California, along with the rest of the nation, began to experience an economic downturn in the early 1990s. As a result, the state government began to reduce its intergovernmental aid to local governments and eventually took away a portion of revenues as well as the power to distribute certain types of revenues (e.g., sales taxes) from local governments to balance its own mounting budget deficit.

Faced with increasing pressure to not raise taxes and at the same time to provide more services in the 1980s, county supervisors began to depend on investment income as another reliable source of revenue. By the early 1990s, interest income became almost as important a source as property taxes for the county's revenues, as 12 percent of the 1.8 billion-dollar budget came from interest income, whereas 13.3 percent came from property taxes in the 1994 fiscal year (State Controller 1994). In order not to lose this new-found golden goose, county supervisors gave Citron wide discretion in his investment types, methods, and procedures. Although treasurer was an elected position, Citron was reporting to the supervisors. However, the supervisors did not know what he was doing with the Investment Pool money, or did not care to know, as long as he was generating enough investment income for them to spend on their constituents.

Bridgeport, Connecticut

In 1991 Bridgeport, Connecticut became the largest city ever to file for bankruptcy protection in the United States. This dramatic decision came about after several years of financial problems that started in the mid-1980s. As was the case with most northeastern cities, Bridgeport experienced a shift in its economy in the early 1980s from an industry-centered one to a service-oriented one in the early 1980s. As a result, it also experienced slow growth in its list of taxable properties and an increase in tax delinquencies. At the same time, the cost of providing municipal services to its 140,000 residents increased as a result of the municipal employees' demand for increased wages and benefits. To make matters worse, the economic conditions of the northeast region began to deteriorate in the early 1990s.

With Bridgeport facing an annual deficit of $35 million in 1988, the state of Connecticut created a financial review board to oversee the finances of the city. In return, the city was given a moderate amount of financial assistance and a guarantee on a portion of the city's debt. However, neither the city's financial condition nor its economic condition improved. By 1991, Bridgeport had the highest tax rate in Connecticut, its per capita income was only about one-third of the state average, and its unemployment rate was well above state and national rates (Brown 1995, 636). The cumulative effects of these negative trends were a $16 million deficit in the $300 million fiscal 1992 budget and a long-term debt of $200 million.

Although the city's poor financial condition was the main reason why its government filed for bankruptcy protection, the political conflict between the financial control board and the mayor also played an important role. The Democratic-controlled financial control board, representing the state's interest, recommended that the city balance its fiscal 1992 budget by either cutting services or by raising property taxes by 18%. The Republican mayor, Mary Moran, who was scheduled to run for reelection in six months, tried instead to negotiate $12 million in wage concessions in municipal union contracts. After the unions refused to accept the $12 million in concessions, the mayor sought permission to borrow $16 million from the city's pension fund. That was denied by the state (Brown, 1995). As a last resort, the mayor filed for bankruptcy protection, claiming that the city was insolvent. The state contested the bankruptcy filing in court, arguing that the city was not specifically authorized to file for bankruptcy. Although the court ruled that the city was eligible to file for protection under the state's home rule, it also ruled that the city was not insolvent, preventing it from absolving its debts (Zeisler, 1995).

Colorado Metropolitan Centre District, Colorado

In the late 1980s and early 1990s, many special districts in Colorado filed for bankruptcy protection under Chapter 9 of the Bankruptcy Code. Their saga reflects a typical case of private use of public power and the ups and downs of the regional real estate market. As its population grew rapidly in the 1980s, the state of Colorado increasingly began to rely on special districts to meet its infrastructure needs. Noting the financial difficulties of cities, counties, and towns in meeting the infrastructure needs of the newly developing local areas, the state allowed its local

governments to require real estate developers to provide public improvements as a condition to development. In response, many developers established special districts as a means of financing the public infrastructure. Instead of spending their own money to build streets, sewers, and utility facilities that are essential for their land development, they simply created a government to do it.

To establish a special district with property taxing powers, all developers had to do was to get approval from the county for a service plan that contains a description of the proposed services and debt financing strategies, and get approval from the district court of the county a petition requesting the organization of a district, signed by 30% or 200 of the tax paying electors. Tax-paying electors were defined as registered voters who (or whose spouse) owned real or personal taxable property within the boundaries of the proposed district, regardless of whether they resided there or not (Sterling, Ankele & Norton, 1991). Because of these lax requirements, many landowners and developers created special districts to increase the value of their land by building streets and sewers with the proceeds of long-term bonds issued with a promise of repayment with the future property tax revenues. While the real estate market boomed, many districts were able to pay the interest on their bonds with property taxes generated from the new houses built and from the existing land whose value had appreciated due to the infrastructure improvements. But when the real estate market later softened, many of these districts went bankrupt. They did not have any other sources of revenue in the face of declining property tax revenues. The bankruptcy of Colorado Metropolitan Centre District illustrates a typical Colorado special district bankruptcy case in which landowners and developers misused public power for private purposes.

In a suburb of Denver, Colorado, a group of landowners formed a special district named the Colorado Centre Metropolitan District in 1985. The landowners' purpose was to increase the value of their land (about 4,000 acres) by constructing the necessary infrastructures at the expense of the district. The district, prodded by the landowners, issued bonds of about $25 million to build the water lines, sewer systems, roads, and parks. The district attracted a group of private developers to build about 500 single-family homes as an initial phase of the development of the 4,000 acres within its jurisdiction. In the mid 1980s, the real estate market in the Denver area was strong and the development project went

well, completing the infrastructure necessary to support a community of 500 homes and finishing many choice home sites.

In the late 1980s, the real estate market in the Denver area collapsed. As a result, the private developers were able to sell only about 50 houses, even though they finished many more. In the early stage of development, the district kept the amount of annual property taxes low, at about $300 per house, to attract new homebuyers. Later, when the houses were not selling, it imposed an annual property tax of about $10,000 per house to make its bond payment. Because the residents were not able to pay the exorbitant amount of property taxes, the district went bankrupt. At the same time, developers who were not able to sell their speculative houses went bankrupt as did the savings and loans association that had lent money to them. Eventually the federal Resolution Trust Corporation took over the savings and loan association, leaving the U.S. taxpayers to pick up the tab for the cost of the failed development (Stamas, 1992).

San Jose School District, California

In 1983, San Jose School District declared bankruptcy, primarily for the purpose of nullifying employee pay increases agreed upon through a collective bargaining process. Pressured by its teachers' unions, the district agreed, in 1982, to give its employees a total of about $3 million in pay increases in fiscal year 1983 and a total of about $8 million in fiscal year 1984. When the state determined school-aid appropriations for 1983 and 1984, the district's share was not enough to honor its pay increase agreement with the unions. The district was operating under the state requirement that each school district balance its budget to receive the next year's aid. It could not raise property taxes because of the property tax limitations imposed on it by Proposition 13 in 1978. At the same time, the state required it to provide education services to its children. Faced with a mounting budget deficit in the current and future fiscal years, it declared itself insolvent in order to reject the wage increase contract it signed earlier (ACIR, 1985).

One unique aspect of this case is that the debtor did not attempt to impair the rights of its bondholders. As in the case of the city of Medley, Florida (1968), creditors holding the long-term bonds issued by the debtor were not parties to the bankruptcy proceedings because the debtor made it clear that it wanted to adjust only non-bonded obligations. The school district stated that the bonds were secured by a property tax assessed by the county controller's office on property within the district,

and a sufficient amount of revenue was being generated for payment of principal and interest (Spiotto, 1993). The court ruled that the district was insolvent and that wage obligations can be modified to balance its budget and meet the immediate educational needs of the district (ACIR, 1985).

Bay St. Louis, Missouri

In 1977 the city of Bay St. Louis filed for bankruptcy protection under Chapter 9 of the Federal Bankruptcy Code. The reason was its inability to pay a close to $400,000 judgment awarded to a plaintiff who was injured at its pier. The plaintiff, who was from Louisiana, was awarded the judgment by a federal court after breaking his neck at the city's construction site. Given that it had a total budget of only about $700,000, did not have any liability insurance, and was levying its legal limit of property taxes, the city feared that it would cease to function as a municipality if forced to pay the judgment out of its current revenues. The plaintiff tried to garnish the city's bank accounts for payment of the judgment before and after the bankruptcy proceedings, and strenuously contested its bankruptcy filing, alleging that the city filed the bankruptcy petition for the purpose of delay. After the city could not comply with the court order to borrow the payment from a bank, the court dismissed the petition in 1978. The next year, the city borrowed money and increased its sales tax in order to pay the judgment (ACIR, 1985).

Although we tend to think there is one simple reason why a local government may declare bankruptcy, the issue of the cause of bankruptcy is not as simple as it seems. As can be seen from the cases previously discussed, the short-term and long-term, political and economic, and internal and external factors jointly or independently are reasons for a municipality to go bankrupt. Although these three perspectives on the causes of municipal bankruptcy are overlapping and interrelated, each perspective accentuates a unique aspect of municipal bankruptcy and adds a different flavor to the explanation of why a municipality files for bankruptcy protection. Table 1 summarizes the discussions of the above cases based on the three identified perspectives.

CONCLUDING OBSERVATIONS

More than 500 local governments went bankrupt since the first municipal bankruptcy law was passed in 1937. Their reasons for filing

TABLE 1
Three Perspectives on the Causes of Municipal Bankruptcy

Bankrupt Municipality	1. Short-term and long-term factors. 2. Internal and external factors. 3. Political and economic factors.
Orange County, CA (1994)	1. Short-term investment loss due to abrupt changes in interest rates and long-term difficulty in raising revenues due to the tax revolt movement. 2. Internal pressure to generate more interest income and external pressure for more services mostly from new immigrants. 3. Lack of supervision on the investment activities of the Treasurer by County Supervisors and the decision to invest in risky securities and the consequent investment loss.
Bridgeport, CT (1991)	1. Short-term financial mismanagement and long-term decline of the city due to suburbanization. 2. Internal pressure to increase wages by the employees unions and external demand for more services from poor residents. 3. Mayor's ideological predisposition to not raising taxes and mounting debts.
Colorado Metropolitan Centre District, CO (1983)	1. Revenue shortfall due to the downturn in the real estate market and a lack of long-term financial planning. 2. Lack of revenue diversification (exclusive reliance on property taxes) and abrupt recession. 3. Landowners' one-time use of the public power to create a special district and mis-forecast of the revenues.
San Jose School District, CA (1983)	1. Short-term reduction in state aid and long-term reduction in property tax revenues due to the tax revolt movement. 2. Pressure to increase wages from the employees unions and increased student enrollment. 3. Lack of political power to stand up against the unions and financial mismanagement.
Bay St. Louis, MS (1977)	1. Large judgment award, threat to garnish the city's bank accounts, and lack of long-term financial planning including lack of liability insurance. 2. Lack of supervision regarding the city's pier construction site and a non-resident's lawsuit. 3. Politicians' reluctance to raise taxes to pay for the judgment and the city's lack of risk-management policies.

for bankruptcy protection varies because they all faced different financial circumstances. All of the factors that led local governments to bankruptcy can be explained by the short-term and long-term, political and economic, and internal and external dimensions. These overlapping dimensions can enrich our understanding of the causes of municipal bankruptcy and broaden our perspectives.

It is notable that not all local governments experiencing financial stress actually declare bankruptcy, as evidenced by the cases of New York, Philadelphia, Washington, D.C., and Miami. The key to avoiding bankruptcy is to get financial help from a higher level of government and to clean house quickly, usually with a new political leader. It is also notable that not all local governments that declared bankruptcy had experienced the "traditional" financial crisis that arises from the usual mismatch between revenues and expenditures. The cases of Bridgeport, Bay St. Louis, and San Jose School District show that some extra financial motives such as politicians' reluctance to raise taxes, judgment awards, and nullification of collective bargaining agreements can play important roles in local bankruptcy protection decisions. Of course, all of these local governments had financial problems, but those problems could have been addressed by other means, or at least their problems were not caused by the financial problems from their usual operations.

As Bailey (1985) and Shefter (1985) noted, a fiscal crisis often comes after a political crisis. Politicians often increase the flow of benefits to specific groups that provide political support to them, going beyond the fiscal means of their government. A fiscal crisis often convinces economic elites to form a political coalition in order to reform or rescue the city government. The coalition leads to a "reform administration" or a "crisis regime." Once in power, reform politicians make terms with various supporters of the pre-crisis regime in the process of meeting the imperatives of vote generation. If this accelerates the pace of municipal spending, coupled with some negative economic and demographic changes, the stage may set for another fiscal crisis.

In other words, municipal bankruptcy is a form of government failure, not just a market failure. Political factors shape, influence, or even determine whether a government will file for bankruptcy protection. In many of the cases discussed, it was clear that political factors were even more important than economic factors, or that political causes were even more fundamental than economic causes. When public powers were used for private purposes, private goods were delivered by public

entities, bureaucracies were not systematically supervised, public entities failed. In situations like these, even good market mechanisms will not be able to save governments from going bankrupt.

Given that municipal bankruptcies are caused by both economic and political factors, it is difficult to prescribe remedies. From the political side, strengthening the audit powers of the state might be in order, to make sure that both political and economic powers are not abused at the local level. As of now, many states do not regularly audit the books of their local governments, although many of them require their local governments to submit financial statements at the end of each fiscal year. Given that more special districts go bankrupt each year than any other types of government, this practice of auditing local finances can be directed to them first.[12] Also, it is highly desirable to make sure that local governments carry some form of liability insurance. Although the litigious nature of the American citizens appears to have tapered off in recent years, local governments without liability insurance can be pushed to the financial brink by a single victim of bodily injury or property damage. It is also desirable to reduce local governments' responsibilities by privatizing functions that really belong to the private sector. Many special districts perform quasi-private functions such as providing gas and developmental improvements services. When their enterprises go sour, the taxpayers often pick up the tab. If local governments do go into the business of offering private goods and services, then they'd better have a long-term financial plan and maintain their private functions separately from their public functions.

From the economic side, encouraging local governments to use more insured bonds may prevent some of them from going bankrupt, particularly if those governments issue large amounts of revenue bonds.[13] Prohibiting local governments from engaging in speculative investments may also help. Raising money for investment purposes from other local governments and issuing long-term bonds for the same purpose should not be part of local governments' functions. Although political and economic remedies for municipal bankruptcy may abound, we are likely to see more bankruptcies in the near future. Just as the pursuit of profits is a fundamental economic activity, losing money for whatever reason, reluctance to pay debts, adventurous investments, and caving in to political pressures are all part of human nature.

NOTES

1. Two years later, in 1936, the Supreme Court found that 2,019 local governments were in default. See *Ashton v. Cameron County Water District,* 298 U.S. 513 (1936).
2. Congress included counties again in the 1946 Amendment.
3. The bankruptcy reform bills that were passed by the Senate and House in early 2001 do not affect the substance of Chapter 9.
4. For other examples of a broad interpretation of general authorization, see Pleasant View Utility District of Cheatham County, 24 B.R. 632 (Bankr. M.D. Tenn., 1982), City of Wellston, 43 B.R. 348 (Bankr. E.D. Mo., 1984), and Green County Hospital, 59 B.R. 390 (Bankr. S.D. Miss. 1986). For an example of a narrow interpretation, see Carroll Township Authority, 119 B.R. 61 (Bankr. W.D. Pa., 1990) and North and South Shenango Joint Municipal Authority, 80 B.R. 57 (Bankr. W.D. Pa., 1982).
5. The following states have specifically authorized their municipalities to file for bankruptcy: Arizona, Arkansas, California, Colorado, Florida, Idaho, Kentucky, Louisiana, Michigan, Montana, New Jersey, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, and Texas. Some states like Florida require their municipalities to receive state approval before they file for bankruptcy.
6. The wording of the relevant statement of the court indicated that insolvency involves proving that the city will be unable to pay its debts as they become due in its current fiscal year or in the next fiscal year (City of Bridgeport, 129 B.R. 332; Bankr. B.D. Conn., 1991).
7. Because a Chapter 9 case begins right after a petition is filed with the bankruptcy court, an automatic stay goes into effect immediately. An automatic stay prohibits and invalidates post-bankruptcy actions taken against the debtor and its property.
8. In Sullivan County Regional Refuse Disposal District, the court declared that filing for bankruptcy without seriously considering its benefits and consequences, but with an intent to use it as a late hour litigation tactic, lacks good faith (165 B.R.73; Bankr. B.D. N.H., 1994).

9. The best interests of creditors test requires the Court to determine whether the plan as proposed is better than the alternatives (*Hollstein v. Sanitary & Improvement District, 7*, 96 B.R. 967; Bankr. B.D. Neb., 1989). The feasibility test requires the debtor to show that it can meet its obligations under the plan and still maintain its operations at a level that is satisfactory to the debtor.

10. In the case of *Nebraska Security Bank v. Sanitary & Improvement District* 7 (119 B.R. 193; Bankr. B.D. Neb., 1990), the Court ruled that ignorance of the claims deadline was not sufficient to allow claims to survive discharge on confirmation of the Chapter 9 plan because the creditor did receive notice of the case and was knowledgeable of the case.

11. For example, the Hispanic population grew by 97 percent, the Asian population by 177 percent, and the black population by 60 percent in the 1980s, even though the non-Hispanic white population grew by only 3 percent in the same time period (Baldassare, 1998).

12. In a broader sense, an overall assessment of the fiscal conditions of local governments rather than simple fiscal auditing can be more effective. For example, the Financial Trends Monitoring System (FTMS) recommended by the Internal City/County Management Association suggests that financial indicators of local governments should include broader factors such as socioeconomic trends and infrastructure investments (Groves and Valente 1994). Local governments usually insure bonds and get a quarter point or less interest reduction. As Mikesell (1999) notes, only about half of all bonds are sold with insurance. Most private bond insurers insure only investment grade bonds. Expanding insurance to lower grade bonds through some form of state-credit guarantee or private bond insurance may be an option for some states.

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