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Subnational Government Bankruptcy, Default, and Fiscal Crisis in the United States

John L. Mikesell[*]

Introduction

Like individuals and businesses, subnational governments sometimes face financial difficulties. Subnational government can get into financial problems in various ways, sometimes through economic or social misfortune; sometimes through incompetence or malevolence; sometimes through a stubborn unwillingness to make tough budgetary choices; and often through a combination of these causes. For creditors and citizens of those governments, the cause is less significant than the result -- unnecessarily high taxes or woefully inadequate government services or both.

The standards for establishing bankruptcy of an economic entity (whether an individual, corporation, or another unit, such as a local government) differ from country to country. However, the concept generally means that the entity is unable to pay its debts as they come due or to pay its debts in full.[1] Bankruptcy or insolvency law in many countries provides for the development of a plan that allows the debtor to resolve these debts through division of assets among the creditors in a way that treats the interests of the creditors with some measure of fairness. The intention is to protect the entity from its creditors so that the assets may be distributed equitably among the creditors and the debtor can be discharged from further liability. The idea is to provide "breathing room" so that the debtor has some opportunity to make things right and may continue to exist if at all possible. The protection is usually through a specialized court or administrative body. The fresh start that bankruptcy affords is presumed beneficial to both the debtor and the creditors. Of course, some entities are beyond hope and the process leads toward complete financial liquidation rather than rehabilitation.

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[1] Bankruptcy on a balance sheet basis exists when the liabilities of the debtor exceed its assets. However, this basis is usually not of great consequence for financial problems of governments. Furthermore, determining what the current market value of assets owned by a government -- many of them specialized for a particular governmental purpose -- is an almost hopeless task.

In the United States, insolvent local governments are dealt with through two mechanisms: municipal bankruptcy under Chapter 9 of the federal bankruptcy code, and financial emergency procedures set forth at the state level.

Municipal Bankruptcy in the United States

The United States bankruptcy law provides the dominant international model for reorganization of the bankrupt entity, as opposed to liquidation. [2] Therefore, it may be particularly relevant for dealing with the financial problems of subnational governments -- it is usually out of the question that the government be eliminated because of the important services it provides the citizenry. Governmental rehabilitation, not liquidation, is the important concern. Also, subnational governments in the United States conduct their finances without supervision or control of the central government. The unwary, unwise, or unlucky government may develop financial problems, including insolvency, and have no central government support to pull it from the situation. For these reasons, the United States law merits particular attention.

Municipal bankruptcy relief in the United States is more recent than bankruptcy programs for businesses and individuals (the first Federal bankruptcy law was adopted in 1800). The delay was constitutional in cause. State governments could not provide debt restructuring because the Contracts Clause of the U. S. Constitution (Article I, Section 10) prohibits states from passing "any bill of attainder, ex post facto law, or law impairing the obligation of contracts…" and Article I, Section 8 grants Congress the power to "establish …uniform laws on the subject of bankruptcies throughout the United States." However, the Tenth Amendment to the Constitution grants state sovereignty over the governance of subnational units of government. State relief programs would violate the contract and bankruptcy clauses of the Constitution; Federal relief programs would violate state sovereignty.

Dramatic decreases in tax revenues during the Great Depression of the 1930s sent 2,019 municipalities, counties, and other subnational units into default on their obligations. Under existing law, the only option available to creditors of those governments was to sue to require higher taxes -- which were unlikely to be collectable in the economic environment of the time -- or for creditors to arrange comprehensive voluntary agreements. The agreements had to encompass the debtor and all creditors and were often halted by a few creditors holding out for full payment of money owed them. Bankruptcy legislation could provide relief from an avalanche of litigation, could get some obligations paid, and could provide subnational governments a new start for their financial operations.

The first municipal bankruptcy legislation, enacted in 1934, was held to be an unconstitutional interference with the Tenth Amendment sovereignty of the states. A revised Municipal Bankruptcy Act in 1937 corrected the problem. The law, after

[2] The German insolvency act, for instance, has emphasized liquidation rather than reorganization. Only from 1999 will the law provide for a full-fledged reorganization proceeding.

periodic revisions, is now generally referred to as Chapter 9 because of its location in the federal bankruptcy code. Other specific chapters of that Code apply to corporations, individuals, farmers, etc.

In the more than 60 years that municipal bankruptcy has been available, there have been fewer than 500 municipal bankruptcy petitions filed in total, with 141 filings from 1980 to 1997. That compares with more than 1.4 million individual filings for bankruptcy in 1997 alone. Most municipal filings involve smaller special districts, not general-purpose governments. However, some municipal filings can be large -- the 1994 filing by Orange County, California (the largest in American municipal bankruptcy history) involved a loss of $1.7 billion through gross financial mismanagement.[3]

Purpose of Municipal Bankruptcy. The law provides court protection for a distressed municipality, allowing it to adjust its debts while continuing to provide essential public services. The municipality receives (1) a breathing spell through an automatic stay against the action of creditors and (2) the power to adjust its debts through the bankruptcy plan negotiated with creditors.

Chapter 9 differs from bankruptcy for businesses and individuals in that the law does not provide for liquidation of the assets of the municipality for distribution to satisfy the claims of creditors. Such a liquidation or dissolution would undoubtedly violate the reservation to the states of sovereignty over their internal affairs provided in the Tenth Amendment to the Constitution. Furthermore, to leave the citizenry with no government charged with the provision of vital services would not be acceptable. Chapter 9 bankruptcy aims at provisions that will lead to the financial re-emergence of the municipality. For municipal bankruptcies, the court protects the government from financial claims while the government develops a plan under which it can pay a large share, but usually not all, of its financial obligations. The bankruptcy aims to insure that the government can continue to provide services to its citizenry and retain its assets.

The functions of the bankruptcy court are generally limited to approval of the petition (if the debtor is eligible), confirmation of a plan of debt adjustment, and ensuring implementation of the plan. The municipality may consent to have court jurisdiction in many of the traditional areas of court oversight in bankruptcy, in order to obtain the protection of court orders. However, the bankruptcy court generally is less active in managing a municipal bankruptcy case than in corporate reorganizations.

The Nature of Municipal Bankruptcy. Important features of the municipal bankruptcy process in the United States include the entities eligible for bankruptcy, initiation of bankruptcy proceedings, the relief that bankruptcy affords, the involvement of creditors in the process, the role played by the debtor, treatment of bondholders, the adjustment plan, standards for obtaining approval of the plan, and the standards for discharge from the plan.

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[3] Orange County is the fifth most populous county in the United States. Its economy is strong -- it includes the internationally-known Disneyland theme park -- and its population is prosperous.

Eligibility and Initiation. Only a "municipality" can file for relief under Chapter 9, defined to mean a "political subdivision or public agency or instrumentality of a State." The definition covers cities, counties, townships, school districts, and public improvement districts, and includes revenue-producing bodies that provide services which are paid for by users rather than by general taxes, such as bridge authorities, highway authorities, and gas authorities. The bankruptcy law covers only municipalities; there is no provision for state government bankruptcy.[4]

Three additional eligibility requirements are:

1. The entity must be specifically authorized by its state to pursue this relief. Eighteen of the fifty states provide specific authorization allowing their municipalities access to federal bankruptcy protection. Two states explicitly forbid their municipalities to enter the system.

2. The municipality must be insolvent -- the municipality is "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." Failure to pay wages and salaries, to make pension payments, to pay contractors, or to meet debt service payments of principal or interest would make the government insolvent. Financial difficulty is not sufficient.[5]

3. The municipality must seek the debt adjustment plan and have made an effort to arrange a voluntary program with its creditors. In contrast to bankruptcies of other types of entities, the creditors cannot force the municipality into bankruptcy.

The municipality lists its creditors with the Bankruptcy Court and the court seeks objections to the filing. Objection usually involves whether negotiations have been conducted in good faith, whether the state has authorized the municipality to file, and whether the petition was filed in good faith. The court may dismiss a petition if the debtor did not file the petition in good faith or that the petition does not meet other requirements.

If the petition is not dismissed upon an objection, the Bankruptcy Code requires the court to order relief.

Court Relief. The Bankruptcy Court stops ("stays") all collection actions against the municipality and its property. It prohibits actions against officers of the municipality and inhabitants of the municipality if the action seeks to enforce a claim against the municipality. Thus, the stay prohibits a creditor from trying to collect from an officer

[4] States are excluded from federal bankruptcy court protections because of the belief that such a provision by the national Congress would violate Constitutional guarantees of sovereignty for state government.

[5] Bridgeport, Connecticut was denied bankruptcy protection in the early 1990s because it was not insolvent and had not exhausted its borrowing power to meet obligations that the city government believed to be burdensome.

of a municipality or from trying to collect from an inhabitant money owed to the municipality (for instance, taxes owed the municipality).

Beyond that, the Court has limited power. The municipal debtor's day-to-day activities are not subject to court approval. The court cannot appoint a trustee to run the municipality, cannot convert the case to a liquidation proceeding, cannot stop the debtor from borrowing, and cannot interfere with the operations of the debtor or with the debtor's use of its property and revenues. The court may not substitute its control over the political or governmental affairs or property of the debtor for that of the state and the elected officials of the municipality.

Creditor and Third Party Involvement. Creditors may not propose a plan of adjustment. If certain requirements are met, the debtor's plan of adjustment is binding on dissenting creditors. A creditors' committee will have certain powers and duties: selecting and authorizing the employment of one or more attorneys, accountants, or other agents to represent the committee, consulting with the debtor concerning administration of the case, investigating the acts, conduct, assets, liabilities, and financial condition of the debtor, participating in the formulation of a plan, and performing such other services as are in the interest of those represented.

When cities or counties file for relief, many other entities may want to be heard in court. The code specifically include representatives of the Secretary of Treasury of the United States, representatives of the state in which the municipality is located, and representatives of the Securities and Exchange Commission. Others may include municipal employees, local residents, non-resident owners of real property, special tax payers, securities firms, and local banks.

Treatment of Bondholders and Other Lenders. Different types of bonds receive different treatment in municipal bankruptcy cases. General obligation bonds are treated as general debt in the Chapter 9 case. The municipality is not required to make payments of either principal or interest on account of such bonds during the case. The obligations created by general obligation bonds are subject to negotiation and possible restructuring under the plan of adjustment. However, special revenue bonds continue to be secured and serviced during the Chapter 9 case through special revenues, if those revenues are available.

Powers of the Debtor. While in bankruptcy, the debtor has broad powers to use its property, to raise taxes, to spend as it sees fit, and, subject to court approval, to adjust burdensome non-debt contractual relationships. Municipalities may also reject collective bargaining agreements and retiree benefit plans. It may also borrow, having the same power to obtain credit as it does outside of bankruptcy. The court does not have supervisory authority over the amount of debt the municipality incurs in its operation.

Plan for Adjustment of Debts. The Bankruptcy Code provides that the debtor shall file a plan, either with the petition or at a later time fixed by the court. There is no provision in Chapter 9 allowing creditors or other parties to file a plan. Neither creditors nor the court may control the affairs of a municipality indirectly through a

debt adjustment plan that would in effect determine the municipality's future tax and spending decisions.

Reorganization of the debts of a municipality is typically accomplished either by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan. Bondholders are superior creditors, so debt service will ordinarily flow on schedule (besides, the government will want continued access to municipal capital markets), but other contractual obligations may not be met. For instance, wages and salaries may be reduced from their previously agreed-to levels. However, one common tool of corporate enterprise reorganizations -- the conversion of debt to equity (or ownership) of the entity -- is not possible for the municipality.

Approval Standards. The court must confirm a plan if the following conditions are met:

- the plan complies with the general provisions of the overall bankruptcy code and of Chapter 9 of the code;

- all amounts to be paid by the debtor have been fully disclosed and are reasonable;

- the debtor is not prohibited by law from taking any action necessary to carry out the plan;

- except to the extent that the holder of a claim has agreed to a different treatment, the plan provides that on the effective date of the plan each holder of a claim will receive cash equal to the allowed amount of such claim;

- any regulatory or electoral approval necessary to carry out the plan has been obtained, or such provision is expressly conditioned on such approval; and

- the plan is in the best interests of creditors and is feasible.

The “best interests of creditors” generally means that the plan must be better than dismissing the case and permitting every creditor to fend for itself. An alternative that would require the municipality to devote all resources available to the repayment of creditors exceeds the standard.

Discharge. A municipal debtor receives a discharge after (1) confirmation of the plan, (2) deposit by the debtor of any consideration to be distributed under the plan with the disbursing agent appointed by the court, and (3) a determination by the court that securities deposited with the disbursing agent will constitute valid legal obligations of the debtor and that any provision made to pay or secure payment of such obligations is valid. Thus, the discharge requires deposit of the consideration to be distributed under the plan.

The court may retain jurisdiction over the case until the plan has been successfully implemented. Claims against the debtor outside the plan are dismissed.

Bankruptcy and Bond Default. Governments default on their debt without bankruptcy and bankruptcy plans may not include bond default. A government defaults when it does not meet a scheduled payment of principal or interest on a debt issue. Widely-publicized defaults in the United States municipal securities market over the past couple of decades include New York City and Cleveland in the 1970s and the Washington Public Power Supply System in the 1980s. In the New York case, the issuer defined the episode to be a technical default because it unilaterally announced a slower than scheduled payment schedule, not a total failure to repay. Most defaults in the United States are of small issues from special purpose districts. Some defaults are permanent, as with that of the Washington Public Power Supply bonds; some defaults are only temporary, as with the New York City and Cleveland issues. Bondholders may be protected from the economic consequences of default by bond insurance purchased by the issuer. The default may occur without any discernable impact, at least in the short-term, for those receiving services from the defaulting government, but the impact will be felt when the government proposes to borrow again.

Debt repudiation occurs when the borrower announces that it will make no more principal or interest payments on debt, that it will no longer recognize that debt as a liability. This action is rare; bond markets have long memories and a government which has repudiated debt will have difficulty borrowing again. Some American states repudiated debt issued in the first half of the nineteenth century to finance canals, roads, railroads, and other internal improvements. Some projects were absolutely scandalous and money almost certainly was stolen by both government and private thieves. However, these repudiating governments faced premium interest rates on their borrowing well into the twentieth century because the capital markets remembered the experience. These repudiations occurred before there were bankruptcy laws in the United States, so the repudiating governments, while possibly insolvent, were not officially bankrupt.

Problems with American Municipal Bankruptcy Procedures. Several revisions to the existing bankruptcy procedures have been proposed:

1. Provide more protection to the interests of creditors. The current system provides strong protection for the municipality. The municipality develops the restructuring plan and the treatment of classes of creditors. Creditors are largely observers to the process.

2. Provide creditors access to municipal revenue. As soon as the bankruptcy filing occurs, payments to creditors stop, but payments (taxes) continue to flow to creditors. Creditors cannot get access to the municipality's assets and cannot attach revenue flows to the municipality.

3. Provide supervision of affairs of the municipality. Bankrupt municipalities are not supervised in their operations. Under federal law, bankrupt individuals and businesses are placed under management supervision to help them get their affairs back in order. Bankrupt municipalities often got in financial

difficulty because of incompetence, not bad luck or economic conditions, and their performance will not improve after bankruptcy unless they have help.

4. Constrain government policies. During the bankruptcy, the municipality retains complete control over political and governmental decisions. That includes powers to tax and to establish spending priorities. The same political managers who got the municipality into insolvency continue to make basic policy for the government. They are relieved from requirements to pay creditors, get to establish terms for debt payment, and receive tax payments in the interim.

Financial Emergency Procedures

No substantial city government in the United States has filed for Chapter 9 bankruptcy protection. Most potential candidates in the past twenty-five years have fallen under special management arrangements imposed by a superior government to manage local finances when they are in great jeopardy. The state intervenes with extraordinary controls to constrain the financial and economic damage and to prevent a bankruptcy filing. Around twenty states have laws for provision of state assistance (and control) for municipalities in financial distress.

The system from Florida may be used as an example, although each state has its own features. Florida law establishes the objectives of the program:

1. To preserve and protect the fiscal solvency or local governmental entities.
2. To assist local governmental entities in providing essential services without interruption and in meeting their financial obligations.
3. To assist local governmental entities through the improvement of local financial management procedures. [6]

Failure to pay obligations (wages, retirement benefits, debt service, etc.), to meet actuarial funding standards for retirement systems, or to have insufficient reserves to cover a deficit for two successive years causes determination of a financial emergency under the Florida law and brings the municipality under close state control, including establishment of a board to oversee the operations of the locality, and assistance. The board and the local government develop a plan that must include: "1. Provision for payment in full of all payments due or to come due on debt obligations, pension payments, and all payments and charges imposed or mandated by federal or state law and for all judgements and past due accounts, as priority items of expenditure. 2. Establishment of a basis of priority budgeting or zero-based budgeting, so as to eliminate low-priority items that are not affordable. 3. The prohibition of a level of operations which can be sustained only with nonrecurring revenues."[7] Unless the

[6] Florida Statutes (Supplement 1996), 218.501.
[7] Ibid., 218.503 - h.

state approves, the municipality may not seek relief under the federal bankruptcy system while it is in financial emergency status.

Compared to Chapter 9 bankruptcies, the state emergency boards involve far greater loss of local control and a greater effort to reform and educate local officials. The emergency boards are empowered to change local priorities and to change fiscal decisions coming from the local political processes and may cause greater discomfort for local officials than would a bankruptcy. Examples of emergency boards include the Pennsylvania Intergovernmental Cooperation Authority (Philadelphia, 1991), the New York State Financial Control Board (for New York City, 1975), and the Miami Financial Emergency Oversight Board (1996). Washington, D.C. lost most of its fiscal independence to a Congressionally-appointed board in 1997, for similar reasons.

Summing Up

Most municipal financial problems in the United States are the product of poor management, not economic collapse or bad luck. This makes the appointment of a receiver or trustee, a disinterested third party, to establish sound financial management a reasonable response.