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Bondholders and Financially Stressed Municipalities

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BONDHOLDERS AND FINANCIALLY STRESSED MUNICIPALITIES

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I. COMPETING CLAIMS OF BONDHOLDERS AND RESIDENTS

In 1873, the city of Duluth issued bonds to improve its harbor and to create other municipal improvements.[1] The bonds were payable between twenty and thirty years from their date of issue and bore an interest rate of seven percent.[2] Shortly after their issuance, Duluth fell on difficult times. The company of the financier Jay Cooke failed, and with it Cooke's plans to transform Duluth into the eastern terminus and port facility for the Northern Pacific Railroad.[3] The population of the city decreased from 5,000 to 1,500 and those who remained were reluctant to dedicate the few tax dollars left to payment of debt service for bondholders.[4] The state legislature came to the residents' rescue. It carved from the boundaries of Duluth an area comprising "all the business part of the city and business houses, the harbor, railroad depots and tracks, nearly all the dwelling-houses, all the population except about [one hundred] inhabitants, and nineteen-twentieths of all the taxable property," and designated that area as the new vil-

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1. Brewis v. City of Duluth, 9 F. 747, 748 (D. Minn. 1881).
2. *Id.*
3. ERIC H. MONKKONEN, THE LOCAL STATE: PUBLIC MONEY AND AMERICAN CITIES 82–83 (1995).
4. *Id.* at 83.

lage of Duluth.[5] The legislature also directed that service of process in any lawsuit against Duluth be made on the mayor, but then effectively terminated the incumbent mayor without making any provision for a replacement.[6] Finally, the legislature apportioned responsibility for the outstanding bonds between the city and the new village.[7]

Bondholders objected, especially when the city failed to make payments on its outstanding obligations.[8] The bondholders thought they had found their own savior in the federal district court.[9] While that court agreed that the state legislature was free to rearrange municipal boundaries, it initially held that allowing rearrangements without providing for payment of creditors of the predecessor municipality "would be a mockery of justice" and overruled a demurrer interposed by the village with respect to overdue payments on city bonds.[10] After a full trial, however, the court concluded that the evidence revealed that the city, even as redrawn by the legislature, ultimately had "ample means . . . to meet the plaintiff's demand," a result that the court speculated was "largely due . . . to the successful operation" performed by the legislature.[11] As a result, there was no reason to interfere with the apportionment of city debt that the legislature had mandated.[12]

The efforts of the Minnesota Legislature were not ignored by other states that similarly sought to assist distressed municipalities against the demands of bondholders. The Alabama Legislature restructured the city of Mobile into a new entity designated as the Port of Mobile in an effort to frustrate bondholders of the former by denying them access to taxes raised by the latter.[13] The Supreme Court invalidated that effort in an opinion that appeared to be based on the federal Constitution's Contracts Clause,[14] although that clause was not invoked by name.[15] The Court's intervention was also required to nullify Illinois legislation that withdrew from municipalities taxing power

5. *Brewis*, 9 F. at 748.
6. *Id.*
7. *Id.*
8. *Id.*
9. *See id.* at 749–50.
10. *Id.*
11. Brewis v. City of Duluth, 13 F. 334, 335 (D. Minn. 1882).
12. *Id.* at 337.
13. Port of Mobile v. Watson, 116 U.S. 289, 290 (1886).
14. U.S. CONST. art. I, § 1, cl. 1.1.
15. *Watson,* 116 U.S. at 305.

necessary to pay outstanding bonds[16] and to limit the ability of the legislature to divert from bondholders taxes collected by a municipality prior to legislative repeal of its charter.[17]

These cases entail very different legal doctrines that, narrowly construed, address very different situations. Nevertheless, they, along with doctrines that I discuss below and that affect the validity of municipal obligations, share a common theme that warrants their collective consideration. They all illustrate a contest that threatens to become all too familiar as the current fiscal crisis continues to engulf municipal budgets: the effort to resolve competing claims by bondholders and residents to a limited municipal treasury. One might believe that the outcome of these contests had been resolved contractually when the debts that generate them were initially incurred. Implicit allocations of risk may arise from a variety of background legal rules that relate to municipal indebtedness. Issuers of general obligation bonds, those payable from municipal revenues generally, rather than from a specified source, pledge their "full faith and credit" to repayment,[18] and the content of that pledge may be thought to imply an obligation to pay bondholders prior to competing claimants. A preference for bondholder claims over those of residents may also be inferred from the provision of the Bankruptcy Code that permits distressed municipalities to exit bankruptcy only when a proposed plan serves the "best interests of creditors."[19] The content of that test is less definite in the municipal context than in the private sector, since the former does not entail an option of liquidation,[20] which could be used to determine whether a proposed plan makes creditors better off than an alternative resolution. As a result, bankruptcy courts must balance the propriety of imposing tax increases or service reductions on residents[21] against the propriety of compromising obligations to

16. Von Hoffman v. City of Quincy, 71 U.S. 535 (1866).

17. *Id.*; *see also* Meriwether v. Garrett, 102 U.S. 472 (1880).

18. *See* ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE 27 (1996)

19. 11 U.S.C. § 943(b)(7).

20. Michael M. McConnell & Randall C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 465 (1993).

21. As a technical matter, bankruptcy courts cannot "impose" tax increases or service reductions on municipalities. *See* 11 U.S.C. § 903. But they may do indirectly what they cannot do directly by withholding confirmation of a plan offered by a municipality that does not include tax increases or service reductions. *See* Clayton P. Gillette, *Fiscal Federalism, Political Will, and the Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 283 (2012) [hereinafter Gillette, *Fiscal Federalism*]; McConnell & Picker, *supra* note 20, at 474.

bondholders. The mandate of the "best interests of creditors" test arguably strikes that balance in favor of the latter.

One could imagine that a consistent conception of the priorities between bondholders and residents would inform all of these doctrines. Although individual circumstances or the details of specific contractual arrangements might be cause for some deviation from the norm, a default rule favoring either creditors or residents would inform all parties involved in the extension of credit to a municipality of the risk allocation faced in the event that the debtor municipality incurs fiscal distress. That default rule, if based on some overall objective for the allocation of the risk of fiscal distress, could alleviate the vagaries inherent in the various legal principles that are invoked when municipalities seek relief from obligations that have become burdensome. The desirability of such a background default is apparent from the debates that characterize the Duluth litigation with which I began. One might believe that the strong version of the Contracts Clause jurisprudence that is frequently invoked when municipalities seek relief from contractual obligations reveals an unwavering policy of conferring on bondholders priority over residents.[22] But even in the nineteenth century, application of the various legal doctrines that affected the relative rights of bondholders and residents complicated any effort to discern a general priority principle. State courts, as well as legislatures, often exhibited little sympathy for bondholders when municipal projects went financially awry. State courts articulated a "public purpose" doctrine that placed restrictions on the use that localities could make of borrowed funds. Although the doctrine initially received a broad definition, so that assistance to privately held enterprises, such as railroads, could fall within its scope,[23] subsequent courts employed the doctrine to invalidate outstanding bonds as having been issued for projects outside governmental competence once it became clear that the costs of those projects would exceed any related increase in municipal revenues. The Iowa Supreme Court reversed[24] its earlier approval[25] of railroad aid bonds, after the demise of railroads whose commercial success was expected to render payment of the bonds painless. Other state courts similarly construed municipal authority narrowly in order to invalidate bonds issued for purposes

22. *See, e.g.*, Sharpless v. Mayor of Philadelphia, 21 Pa. 147 (1853).

23. *Id.*

24. Stokes v. County of Scott, 10 Iowa 166 (1859); *see also* Iowa *ex rel.* Burlington & Mo. River R.R. v. County of Wapello, 13 Iowa 388 (1862).

25. Dubuque Co. v. Dubuque & Pacific R.R. Co., 4 Greene 1 (Iowa 1853).

that the courts had previously blessed.[26] In what is perhaps the best history of the railroad bond era, A. M. Hillhouse, somewhat derisively laid these reversals at the feet of an elected state judiciary whose terms in office depended on solicitude for an electorate unwilling or unable to satisfy obligations incurred in its name: "Decisions in favor of the bondholders by the state could not long stand in the face of hostile public opinion. . . . If the courts were not in agreement with public opinion, was this not plain evidence that they had been 'bought up' by the railroads? So reasoned the rural mind."[27] Ultimately, animosity towards bond issues spilled over from judicial willingness to invalidate outstanding indebtedness and into an unwillingness to permit municipalities to incur obligations in the first instance, even if nullification required some judicial creativity. The Wisconsin Supreme Court, for example, enjoined one issue of bonds that was to be used to aid a railroad on the grounds that residents had signed the authorizing petition on a Sunday.[28]

Hillhouse and Charles Fairman have recounted the struggle between state and federal courts in which (in pre-*Erie* days) the latter intervened to prevent invalidation of bonds held by non-residents whose efforts at obtaining payment were disappointed by the homeward trend of the former.[29] Even the Supreme Court got into the act. While the Contracts Clause literally applies only to a state's ability to "pass any law" that impairs the obligation of contract, in *Gelpcke v. Dubuque,* the Supreme Court appeared to apply that same understanding to state judicial decisions that had the effect of invalidating bonds issued under a previous interpretation of state law.[30] Residents of Dubuque had voted to allow the city to subscribe to the bonds of two railroads.[31] Under state supreme court precedent in effect at the time of issuance, state law authorized such investments.[32] Subsequent to issuance of the city's bonds, the state supreme court overruled its prior decisions and held that municipal investments in railroad aid were constitutionally prohibited.[33] The Court determined that the reversals by the state supreme court stood out "in unenviable solitude

26. *See, e.g.*, Perrin v. City of New London, 30 N.W. 623 (Wis. 1886).

27. A. M. HILLHOUSE, MUNICIPAL BONDS 161 (1936).

28. De Forth v. Wis. & Minn. R. Co., 9 N.W. 17, 19 (Wis. 1881).

29. *See* CHARLES FAIRMAN, 6 HISTORY OF THE SUPREME COURT OF THE UNITED STATES: RECONSTRUCTION AND REUNION 1864–88 Part One 935–1116 (1971).

30. 68 U.S. 175 (1863).

31. *Id.* at 202–03.

32. *See id.* at 203–04.

33. *Id.* at 205.

and notoriety."[34] Even if the state court's decision had been rational, the Supreme Court concluded that it could not affect the validity of outstanding bonds issued under the prior interpretation of state authority.[35] The principle (if not the explicit Constitutional clause) that precludes impairment of a contract by subsequent legislative acts similarly "applies where there is a change of judicial decision as to the constitutional power of the legislature to enact the law."[36] Even if the principle did not rest on federal constitutional grounds, it did "rest[] upon the plainest principles of justice."[37]

In light of decisions like *Gelpcke*, it is plausible that one could interpret judicial interventions in favor of bondholders as extending beyond the narrow Contracts Clause issue. Instead, the cases might adumbrate a general principle that gives holders of validly issued bonds priority over countervailing claims on municipal revenues. Resolution of competing claims to a limited municipal treasury during the Depression, however, suggested some retreat from that absolutist position.[38] Claims that debts had been invalidly incurred had declined, perhaps due to the emergence of bond counsel, who provided prospective bondholders with assurances that the bonds satisfied legal prerequisites to issuance. Thus, state courts were more constrained in their ability to nullify outstanding bonds. Nevertheless, fiscally distressed localities did not necessarily want to provide full payment to creditors in an environment in which municipal services were underfunded or where tax increases might induce either exit or nonpayment by residents.[39] Any sense that bondholders were entitled to priority over competing claims dissipated for two reasons. First, given the general principle that tangible municipal assets are not available to satisfy judgment creditors, the entitlement would have to be enforced by legal actions to collect taxes, and courts exercised their discretion over writs of mandamus, or other equitable remedies, to sub-

34. *Id.* at 206.

35. *Id.*

36. *Id.*

37. *Id.*

38. *See* Defoe v. Town of Rutherfordton, 122 F.2d 342, 342–44 (4th Cir. 1941) (granting writ to bondholder because the town was merely "less able to meet its obligations"); Simonton v. City of Pontiac, 255 N.W. 608, 613 (Mich. 1934) (upholding city's debt obligations despite city's impoverished condition); Little River Bank & Trust Co. v. Johnson, 141 So. 141, 143 (Fla. 1932) (concluding that "upon the exhaustion of . . . tax levy, the general revenues of the municipality can be drawn upon to meet these [bond] obligations.").

39. *See e.g.*, *Simonton*, 255 N.W. at 611–12; Florida *ex rel.* Dos Amigos, Inc. v. Lehman, 131 So. 533, 536 (Fla. 1930).

ordinate bondholders to the interests of impoverished municipalities.[40] Writs of mandamus ran against individual officers of the municipalities, who made a practice of avoiding them by resigning office.[41] Courts also refused to grant the writs to impose taxes in excess of a state constitutional debt limitation,[42] or to allow seizure of municipal property.[43]

Second, legislatures intervened once more, but this time to adjust, not repudiate, debts. Legislatures were likely emboldened by Supreme Court approval of state emergency authority that made creditor rights under the Contracts Clause less ironclad than previous opinions had suggested.[44] In perhaps the most notable example, the New Jersey legislature enacted a law that permitted an insolvent municipality and its creditors to adjust claims against insolvent municipalities within the state.[45] The legislation did not permit any reduction of principal, but did include a cramdown provision with respect to dissenters if eighty-five percent in amount of the creditors approved a plan, which could include an extension of the maturity date.[46] The city of Asbury Park defaulted on its obligations after what the Supreme Court described as "a familiar picture of optimistic and extravagant municipal expansion caught in the destructive grip of general economic depression."[47] The city and the requisite percentage of creditors agreed to exchange their bonds for new obligations that would mature at a later date and bear a lower interest rate.[48] But the dissenting bondholders maintained that the cramdown provision bound them to a restructuring that violated the Contracts Clause.[49]

This time, the Supreme Court provided less of a refuge for the aggrieved bondholders. The Court concluded that imposing such a burden on dissenting bondholders did not unconstitutionally impair the

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40. *See, e.g.*, *Rutherfordton*, 122 F.2d at 345.

41. *See* Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 511 (1942).

42. *Cf.* Little River Bank & Trust Co. v. Johnson, 141 So. 141, 143 (Fla. 1932).

43. *See, e.g.*, Gwen T. Coffin, *Enforcement of Judgments Against Municipal Corporations*, 17 CHI.-KENT L. REV. 226, 233 (1939).

44. *See* Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 442–44 (1934).

45. The current version of the statutory scheme can be found at N.J. STAT. ANN. § 52:27 (2011). As discussed below, it is doubtful that the state provision concerning composition of indebtedness survives the current Bankruptcy Code.

46. *Id.* § 52:27-36; *see also id.* §§ 52:27-34–39.

47. Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 503 (1942).

48. *See id.* at 507.

49. *Id.*

obligation of contract.[50] Instead, the Court concluded that the carefully crafted[51] congressional enactment of a federal municipal bankruptcy law should not be interpreted to preclude a state from devising its own plan for resolving the fiscal distress of its political subdivisions.[52] Congress ultimately disagreed with Justice Frankfurter's interpretation that it had intended to preserve for the states a residual debt restructuring power over their own municipalities. Section 903(1) of the Bankruptcy Code embodies precisely the result that Justice Frankfurter deemed unfathomable, as it prohibits a state from prescribing a method of composition of indebtedness that binds nonconsenting creditors.[53]

The Depression experience with municipal distress, therefore, eliminated any thought that different legal doctrines affecting the priority of bondholders and residents could be reduced to a simple allocation of entitlements that would bring certainty to the area. The Court's Contracts Clause cases transformed the clear rule of prior cases into a vague standard that relies on the background circumstances of the legislative intervention, the alternative recourse available to bondholders, and the willingness of the court to exercise discretion over the use of municipal resources. At the same time, judicial refusal to treat bond obligations as embodying a guarantee to pay debts meant that state legal doctrines could not be relied on to provide a clear priority between municipal residents and creditors where municipal resources were too constrained to satisfy both. That ambiguity prevailed even where municipalities provided bondholders with a pledge of its municipality's "faith and credit." That pledge has been variously interpreted as something close to a "good faith" effort to use municipal resources to pay debt service[54]—an effort that munici-

50. *See id.* at 509–14.

51. The bankruptcy law had been drafted to avoid interference with state control over its municipalities by requiring state permission for a municipality to file a petition for debt adjustment.

52. *See Faitoute*, 316 U.S. at 515–16.

53. 11 U.S.C. § 903 provides:

> [T]his chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but—
>
> (1) a State law prescribing method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition . . . .

54. *See* Sacramento Mun. Util. Dist. v. Spink, 303 P.2d 46 (Cal. Dist. Ct. App. 1956); State v. City of Lakeland, 16 So. 2d 924, 925 (Fla. 1944).

palities may have to abandon should municipal services be seriously threatened—and as something closer to an absolute obligation that requires the locality even to exceed tax limitations to ensure that bondholders receive their promised payments.[55]

The New York Court of Appeals came close to clarifying priorities between the claims of bondholders and residents, at least in that state, during the 1970s fiscal crisis in New York City.[56] Ultimately, however, that court simply reinforced the ambiguities in the general jurisprudence concerning the contest.[57] When the city was on the verge of

55. *See* Flushing Nat'l Bank v. Mun. Assistance Corp., 358 N.E.2d 848, 851 (N.Y. 1976).

Indeed, uncertainty about priorities exists even in bankruptcy proceedings involving insolvent municipalities. The absolute priority rule, which applies in Chapter 9 as a formal matter, 11 U.S.C. §§ 901, 1129(b)(2)(A), (B), does not give creditors any particular solace. In corporate bankruptcy, the absolute priority rule—which requires that senior creditors receive full payment before other creditors or claimants receive any payment—induces shareholders to satisfy creditors in full in order to enjoy any residual value of the firm. Municipal residents, however, qualify neither as shareholders nor as creditors. Thus, they are not subject to the absolute priority claims of bondholders and, as a political matter, residents can demand that municipal funds be dedicated to the provision of public goods and services before being allocated to the payment of debt service. Nor is it necessarily advantageous to subordinate residents' claims to those of bondholders. Dedicating tax revenues to creditors rather than to municipal activities will dilute residents' incentives to engage in municipally productive behavior and will likely induce residents to withhold tax payments from which they anticipate receiving little benefit. *See* Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 653 (2008); McConnell & Picker, *supra* note 20, at 470. Further, there are no legal principles requiring that bondholders subordinate their interests to residents, and potential creditors retain a credible threat to withhold badly needed capital from local governments insufficient solicitous of bondholder demands. One might think that the prohibition on court intervention in the political or financial affairs of the bankrupt municipality would provide the latter with substantial leverage in dealing with bondholders, notwithstanding the absence of an absolute priority rule. But, as many have pointed out, the formal prohibition is far weaker in practice, since courts retain substantial discretion to influence the political and financial decisions of the bankrupt municipality by virtue of their judicial capacity to serve as gatekeeper over such issues as qualification for bankruptcy and confirmation of the plan that the municipality must propose to exit bankruptcy. *See* David L. Dubrow, *Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?*, 24 URB. LAW 539 (1992); McConnell & Picker, *supra* note 20, at 466. The former allows courts to determine that a municipality is not "insolvent" because it retains taxing capacity, while the latter permits the court to conclude that a municipality that fails to exercise additional taxing authority has not proposed a plan that satisfies the "best interests of the creditors" requirement. Each of these provides opportunities to bondholders to exercise leverage over municipalities, and reduces any certainty that might otherwise exist about who wins the contest between bondholders and residents.

56. *Flushing*, 358 N.E.2d 848.

57. *Id.*

default, the state attempted to shift some losses from residents to creditors.[58] In an effort to employ some variation on the Asbury Park experience, the New York legislature enacted a Moratorium Act that altered the terms of New York City notes.[59] The legislature presumably believed that a fiscal emergency of the nature that New York City faced satisfied the conditions that allowed Justice Frankfurter to overcome concerns about federal constraints on the impairment of contracts.[60] But the New York Court of Appeals never got to that point. The court instead inferred from state constitutional provisions, such as admonitions to pay debt service even if tax limitations had to be exceeded, that creditors held an absolute right to payment, presumably without regard for the consequences on the issuing locality.[61] Thus, the bondholders appeared entitled to priority in the event of limited funds to satisfy all claimants.

What the Court of Appeals gave with one hand, however, it withdrew with the other. The court ostensibly did not want to authorize creditors to bankrupt the city in order to obtain payment. Once it articulated a clear entitlement in favor of creditors, the court expressed an unwillingness to enforce it.[62] Instead, the court implicitly authorized creditors to use their entitlement to negotiate an appropriate settlement with the state and city. Perhaps it is the equivalent of what the European Union has been attempting to accomplish by negotiating the appropriate level of losses that holders of Greek bonds should absorb without rendering that country's debt burden nonsustainable.[63] The court concluded that it would "be injudicious at this time to allow the extraordinary remedies in the nature of injunction and peremptory mandamus sought by plaintiff" that one might have thought should flow automatically once the court an-

58. *See id.* at 857.

59. *See id.* at 850–57 (quoting New York City Emergency Moratorium, 1975 N.Y. Laws ch. 874, as amd. by ch. 875). The full Act is available at http://newman.baruch.cuny.edu/digital/2003/amfl/mac/pdf_files/Legislation_State/1975-1.pdf.

60. *See supra* notes 47–52 (discussing the Court's holding in *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942)).

61. *Flushing*, 358 N.E.2d at 852.

62. *Id.* at 855 ("[Noteholders of the city are entitled to some judicial relief free of throttling by the moratorium statute, but they are not entitled immediately to extraordinary or any particular judicial measures unnecessarily disruptive of the city's delicate financial and economic balance.").

63. *See, e.g.*, Richard Barley, *Greece's Haircut May Not Go Far Enough*, WALL ST. J. (Oct. 27, 2011), http://online.wsj.com/article/SB10001424052970203554104577001752824131834.html?mod=WSJ_hp_LEFTTopStories.

nounced the assignment of priority to creditors.[64] The court then noted that the legislature would soon be in session and would "be in a position once again to treat with the city's problems and to seek a fiscal solution in the light of the holding in this case."[65] In effect, the court was assigning an entitlement and allowing the parties to bargain around it. By imposing on the city the obligation to pay, rather than allowing the city to shift losses to bondholders, the city was required to purchase from bondholders the entitlement to receive payment. Given endowment effects, the price of that purchase would presumably be greater than if the bondholders had to purchase the right to payment from the city. Nevertheless, the right to payment that the court had endorsed up to the penultimate paragraph of its opinion[66] appeared much less secure in the face of "the city's grave fiscal and economic problems."[67]

Not all courts have demonstrated similar solicitude for bondholders when resolving ambiguities in legal doctrines deployed to address municipal fiscal crisis. The railroad aid era, in which a capital-intensive industry enjoyed substantial municipal assistance before the reality of overinvestment defeated expectations, had a parallel in the late twentieth century rush to construct power plants, largely funded by municipal bonds.[68] The financial arrangements that characterized these obligations perhaps gave some pause to those involved in their issuance, in large part because prospective bondholders who might have been reluctant to accept the limited security of promises to pay from revenues generated by operation of controversial generating plants demanded that their bonds carry some additional guaranty of payment. But guaranties gave rise to fear that post-issuance challenges to the bonds could revive the kinds of claims of invalidity that haunted railroad aid bonds a century prior. As a result, the issuance of bonds for the projects was, in many jurisdictions, preceded by some form of test case to determine the validity of the debts incurred to construct and operate the plants.

64. *Flushing*, 358 N.E.2d at 855.

65. *Id.*

66. *See id.* ("The notes in suit provided that the city pledged its faith and credit to pay the notes and to pay them punctually when due. The clause and the constitutional mandate have no office except when their enforcement is inconvenient. A neutral court worthy of its status cannot do less than hold what is so evident.").

67. *Id.*

68. *See, e.g.*, Johnson v. Piedmont Mun. Power Agency, 287 S.E.2d 476 (S.C. 1982); State *ex rel.* Mitchell v. City of Sikeston, 555 S.W.2d 281 (Mo. 1977) (en banc); Opinion of the Justices, 319 So. 2d 699 (Ala. 1975).

But some issuers, either more courageous or less cautious, entered the bond markets without a test of validity.[69] When those plants proved either unnecessary or substantially more costly than anticipated, courts again were called on to arbitrate the claims of bondholders and ratepayers about how to allocate the risks of fiscal myopia.[70] In 1983, the Washington Public Power Supply System committed the largest default that had occurred in the municipal securities market when it failed to pay debt service on $2.25 billion of bonds issued to finance nuclear power plants in the Pacific Northwest.[71] The bonds were payable from utility payments that were to be made by ratepayers to participant municipalities that had agreed to take energy from the financed plants.[72] The predicted demand for electrical energy that had led to the efforts to construct the plants never materialized, and the ultimate construction and operating costs made the electricity that they would have generated more expensive than alternatives.[73] Ratepayer reactions to dramatic increases in their utility charges induced the participating municipalities to challenge the validity of the contracts under which they had agreed to charge their residents a rate that reflected construction costs, even if plants never generated any electricity.[74] The Supreme Court of Washington concluded that although the municipalities were authorized to purchase electricity, they were not authorized to purchase a chance of obtaining electricity, and thus the contracts were ultra vires and invalid.[75] The Supreme Court of Idaho followed suit.[76] The Oregon Supreme Court appeared to take the high road. It held that the obligations incurred by ratepayers were not the equivalent of taxes and thus bonds issued to fund the plants did not exceed state constitutional debt limitations.[77] The court chastised its Pacific Northwest brethren for failing to enforce contractual obligations under their states' constitutional provisions.[78] But, the court concluded, since other courts had failed to require

69. *See, e.g.*, Asson v. City of Burley, 670 P.2d 839 (Idaho 1983); Chemical Bank v. Washington Pub. Power Supply Sys., 666 P.2d 329 (Wash. 1983).

70. *See e.g.*, *Asson*, 670 P.2d 839; *Chemical Bank*, 666 P.2d 329.

71. *See Chemical Bank*, 666 P.2d 329; DANIEL POPE, NUCLEAR IMPLOSIONS: THE RISE AND FALL OF THE WASHINGTON PUBLIC POWER SUPPLY SYSTEM 6–7 (2008).

72. *See Chemical Bank*, 666 P.2d at 332–33.

73. *See generally id.*

74. *See* POPE, *supra* note 71, at 156.

75. *See Chemical Bank*, 666 P.2d at 342.

76. Asson v. City of Burley, 670 P.2d 839, 850 (Idaho 1983).

77. De Fazio v. Wash. Pub. Power Supply Sys., 679 P.2d 1316, 1344 (Or. 1984) (en banc).

78. *Id.* at 1327–28.

payments to bondholders, Oregonians could not be left with the entire burden.[79] Thus, Oregon localities, regretfully, would not be burdened with their contracts either.

In a similar case of cost overruns, a nuclear power plant in New Hampshire that was to supply energy to municipalities in the northeast became less desirable than initially anticipated.[80] Municipalities in Vermont that had contractually ceded their rate-setting to a co-owner of the plant sought to avoid contracts compelling them to charge residents rates sufficient to pay debt service on outstanding bonds, including bonds issued to finance the unforeseen construction costs.[81] The Vermont Supreme Court invalidated the contracts, deeming the concession of rate-setting authority to a third party an unconstitutional delegation of municipal authority.[82] As in the Washington Public Power Supply System cases, any insufficiencies in revenues that resulted from the inability to collect rate payments would impose on bondholders a risk of nonpayment that they believed had been contractually shifted to resident ratepayers.

A few states, however, have enacted statutory regimes that leave little ambiguity about the priority between bondholders and residents in the event of municipal fiscal distress. These statutes, perhaps surprisingly, assign the entitlement to bondholders. For example, Virginia requires the state to pay the holder of any general obligation bond of a locality that is in default and to withhold all payments of state funds to the locality until the default is cured.[83] Rhode Island has arguably gone further. When the city of Central Falls encountered economic hardship sufficient to warrant appointment of a receiver, and a bankruptcy filing seemed plausible, the legislature enacted a statute that purports to transform the city's tax receipts into a revenue stream on which bondholders have a statutory lien.[84] The effect of the statute is to allow the bondholders to have priority in the city's tax revenue stream during bankruptcy proceedings, and to deny the municipality the capacity to give priority to other claimants on tax funds, such as city employees or pensioners.[85] The statutory alloca-

79. *Id.* at 1344–45.

80. Vt. Dep't of Pub. Serv. v. Mass. Mun. Wholesale Elec. Co., 558 A.2d 215 (Vt. 1988), *cert. denied*, 493 U.S. 872 (1989).

81. *Id.* at 216–17.

82. *Id.* at 220.

83. VA. CODE ANN. § 15.2-2659 (2000).

84. R.I. GEN. LAWS § 45-12-1 (2011).

85. Indeed, states frequently provide bondholders of state and local debt assurances of payment. Georgia's constitution requires the legislature to impose taxes and

tion apparently was influential in persuading retirees in Central Falls to accept a plan that would reduce their pensions, but provide full payment to bondholders.[86]

Other states that do not statutorily require payment to bondholders do authorize state takeovers or receiverships to facilitate ad hoc solutions that can be invoked in a manner that, in the short term, favors creditors over residents.[87] Several states have standing statutes that permit receiverships of distressed municipalities or the appointment of financial control boards. Pennsylvania's Municipalities Financial Recovery Act allows a financially distressed locality that has adopted a financial plan proposed by a state-appointed coordinator to exercise additional taxing authority.[88] Michigan allows appointment of a financial emergency manager who essentially displaces elected officials and can exercise additional taxing or borrowing authority.[89] In each of these cases, the dilution of municipal authority is often combined with state capital infusions or other efforts to ensure creditors of the continuing solvency of the municipality, rather than simply to provide residents with the means of avoiding pre-existing obligations. When states trigger these statutes, they frequently do so not in the name of saving services for residents of the distressed locality, but in the name of securing the position of bondholders who might otherwise be unwilling to extend credit to the city, neighboring localities, or the state itself.[90]

Perhaps the historical variability in the assignment of legal priorities to residents and bondholders is inevitable, particularly given the inherent ambiguity of the legal doctrines that are used to allocate the

to appropriate funds necessary to pay outstanding general obligation bonds, and requires the state fiscal officer to cure any deficiency in the bond's sinking fund by setting aside the first revenues thereafter received in the state's general fund. *See* GA. CONST. art. VII, § 4, para. 3. Maryland requires that any debt be accompanied by a tax sufficient to pay principal and interest and prohibits the repeal of such tax or the diversion of its proceeds to other purposes until the debt has been discharged. MD. CONST. art. III, § 34. Minnesota requires the state auditor to levy an annual tax sufficient to pay principal and interest on faith and credit bonds of the state that come due in the "ensuing year and to and including July 1 of the second ensuing year." MINN. CONST. art. XI, § 7.

86. *See* Michael Corkery, *Pensions Chopped but Investors Paid*, WALL ST. J., Dec. 20, 2011, at C1.

87. Typically, even short term subordination of residents' interests is justified by serving their long term interests in the continued access of their localities to capital markets.

88. 53 PA. STAT. ANN. §§ 11701.123, 11701.141 (West 1987).

89. MICH. COMP. LAWS § 141.1519 (2011).

90. *See supra* note 88.

risk of distress. Once one retreats from the position that the Contracts Clause prohibits any modification of debts, the conditions for impairment become sufficiently flexible to permit states and localities that are so inclined to reduce obligations incurred during fiscally prosperous periods. The same is true of legal doctrines concerning "debt" or "public purpose," which issuers have invoked to avoid obligations initially considered valid. The willingness to deploy these doctrines may depend partially on politics, and partially on the desire of officials to address risks of moral hazard. From an ex post perspective, it can be difficult to reverse engineer the motivations of the relevant officials for deciding whether to repudiate debts in favor of their constituents or to risk greater local fiscal distress by enforcing obligations.

Once fiscal distress materializes, local officials will want to maintain the political allegiance of their constituents, and thus have incentives to externalize costs to non-resident bondholders. Local officials may be able to convince state officials to provide relief, either by assisting in the repudiation or restructuring of debts or by facilitating capital infusions that allow payment of debts with minimal local distress. State officials, however, are likely to extract concessions that leave residents worse off as the price of assistance. State officials have incentives both to avoid the moral hazard problem related to bailouts and to overcome bondholders' reluctance to make further investments in a state that allowed default. In those situations, state officials may wish to protect state interests against the risk of contagion and, if the distressed municipality is of minor importance to their electoral success, may be able to do so without risking loss of political support from a needed political base. The possibility that states will intercede with receiverships, control boards or other governing entities that are not directly elected by local constituents[91] may increase where the party in power at the state level differs from the party in power at the local level. Much of the debate about state intervention and municipal independence in situations such as Harrisburg and Bridgeport, for instance, was attributable to partisan politics.[92] The

91. Because the receiverships, control boards, or other governing entities are not beholden to the local voters, there is an increased potential to favor bondholders over residents. *See, e.g.*, 53 PA. STAT. ANN. §§ 1170.123, 1170.141 (West 1987).

92. *See, e.g.*, Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEV. J. 625 (1995); Sabrina Tavernise, *Pennsylvania's Capital City Files for Bankruptcy*, HERALD-TRIBUNE (Oct. 12, 2011), http://www.heraldtribune.com/article/20111012/ZNYT02/110123012.

bondholder community[93] is likely to have both the financial wherewithal and the opportunities for repeat play to persuade either local or state officials that their political reputations and the long-term interests of their constituents require allocating the risks of fiscal distress to taxpayers rather than to bondholders who may subsequently refuse to invest in the state, or to do so only at rates that reflect a higher likelihood of subsequent defaults.

Even apolitical officials, however, could favor bondholders over residents if they feared that local defaults would impose additional costs on other localities or to the state itself. The evidence of contagion from local defaults is mixed, but, as I have suggested in recent work, the evidence of fear of contagion is somewhat robust.[94] Whether fear of contagion reflects a rational risk, or is only articulated as a pretext for favoritism of bondholders over residents based on some alternative objective, is a more difficult issue. The presence of more robust capital markets than existed during earlier periods of municipal fiscal distress makes the risk of contagion more realistic, since prospective bondholders have greater choice among investments and can avoid risks related to issuers that are perceived as in danger of default. It is, therefore, difficult to use history to determine whether contagion or the possibility of partisan politics serve as a basis for allocating the risk of fiscal distress between residents and bondholders. A default rule that transcends the various legal doctrines that address municipal fiscal crisis must be derived from some other principle.

II. ASSIGNING ENTITLEMENTS TO SUPERIOR MONITORS

The litany of ways in which states and localities resolve conflicts between residents and bondholders reveals the ambiguities inherent in the relevant legal doctrines. The resulting variety of decisions, however, can interfere with effective resolution of municipal distress, as uncertainty about entitlements is likely to increase both the time and costs of deciding how to allocate scarce resources. Statutory allocations of the risk of fiscal distress may bring more certainty to the process, and may reduce costs. The clear assignment of priorities to bondholders in the Central Falls bankruptcy and pensioners' subsequent acceptance has been viewed as an antidote to the protracted litigation in the Vallejo, California bankruptcy, which is reported as

93. The bondholder community generally consists of financial institutions, investment bankers, and broker-dealers, as well as more far-flung individual investors.

94. *See* Gillette, *Fiscal Federalism*, *supra* note 21.

having consumed $10 million of city funds.[95] But clarity does not necessarily translate into an optimal assignment of the relevant risks. *Flushing National Bank*[96] suggests that once legal entitlements are resolved, bargaining around them can occur, so that an initially suboptimal assignment of entitlement can be corrected. Nevertheless, the initial allocation of an entitlement is likely to affect the ultimate bargain. As the Central Falls situation suggests, assigning the entitlement to bondholders allows them to demand a lower "haircut" before acceding to a plan for restructuring municipal debt, while assigning the entitlement to residents would confer on them equivalent leverage against creditors. Transaction costs may deter bargains that would otherwise adjust entitlements more efficiently, and endowment effects may increase the reservation price demanded by initial holders above what they would be willing to pay to purchase the same entitlement.[97] As a consequence, initial entitlements matter, not only for the distribution of gains between the parties, but also for the willingness of the parties to take measures that would have desirable social effects. If, for instance, the objective of legal intervention in allocating the risk of fiscal distress is not merely to prioritize claims to a limited fund, but also to prevent the materialization of distress in the first instance, then it is worth considering whether the assignment of entitlements in the face of potential default can affect that objective.

In this Part, I suggest that legal rules allocating the risk of municipal fiscal distress be viewed as a means to incentivize groups best positioned to detect or forestall fiscal distress. If residents or bondholders enjoy an advantage in monitoring against fiscal distress, then assigning the entitlement to the other party induces the better positioned party to undertake the monitoring task. If, for instance, bondholders are better positioned to monitor than residents, then assigning priority to bondholders discourages them from taking advantage of that position (because they are more likely to receive payments even without monitoring), requires residents to purchase the entitlement from bondholders (at a cost that includes the endowment effect inefficiently granted to bondholders), or requires residents to monitor at a cost higher than would be incurred by bondholders. To enhance this objective, legal rules should place the risk on the superior moni-

95. Bobby White, *U.S. News: Bankruptcy Exit Approved for City*, WALL ST. J., Aug. 6, 2011, at A2.

96. 358 N.E.2d 848 (N.Y. 1976).

97. The role of transaction costs and endowment effects are well rehearsed in the literature of contracting. *See, e.g.*, Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NW. U. L. REV. 1227, 1269–70 (2003).

tor in order to induce that group to take advantage of its position. Indeed, that same approach should reflect the results that residents and bondholders would reach if they were able to bargain ex ante about the consequences of fiscal distress.[98] Rational creditors in such a bargain will demand interest rates that reflect the risk and costs that they would bear in the event of default. Rational debtors would prefer to bear those risks themselves and pay a lower interest rate if they were able to avoid default or its consequences at an expected cost less than what creditors would charge.

The emphasis on monitoring is also consistent with explanations of how public credit can enhance local democratic institutions. Creditors typically prefer to control expenditures in order to ensure that debtors do not use borrowed funds for ventures other than those anticipated at the time of the loan. The emergence of democratic institutions is often attributed to efforts by executives who wanted to solve this contracting problem by conceding control over expenditure decisions to representative assemblies of creditors.[99] But in more contemporary democracies, representative assemblies are composed of residents whose interests are not necessarily aligned with those of creditors.[100] Where that is the case, delegation by public entities of control rights to private creditors is inconsistent with democratic governance. Creditors might attempt to write a complete contingent contract detailing what debtors could do under any set of circumstances, but such a contract would be extremely costly to draft in light of events difficult to foresee at the time of contracting. But representatives, who are spending public money rather than their own may also favor expenditures for personal objectives rather than those of their constituents. It is plausible that on some expenditure decisions, the interests of creditors and constituents are more closely aligned than those of representatives and constituents. Representatives may discover that maximizing their personal objectives, such as attaining reelection, attaining higher office, or attaining post-public service employment, requires allegiance to expenditures on behalf of discrete

98. Of course, residents and bondholders essentially bargain ex ante when local officials and underwriters negotiate the terms of a bond transaction or when underwriters submit bids in a competitive auction of bonds. Agency costs inherent in representation, however, may cause some deviation between an optimal allocation of risks and the one that the parties would directly negotiate if bargaining were costless.

99. *See, e.g.*, DAVID STASAVAGE, STATES OF CREDIT: SIZE, POWER, AND THE DEVELOPMENT OF EUROPEAN POLITICS 6–14 (2011).

100. Clayton P. Gillette, *Can Public Debt Enhance Democracy?*, 50 WM. & MARY L. REV. 937, 943–44 (2008) [hereinafter Gillette, *Public Debt*].

groups rather than to constituents as a whole, while creditors may discover that their interest in ensuring repayment of debts aligns well with the interest of constituents in the exercise of fiscal responsibility. One might think that residents would be in a good position to monitor against fiscal irresponsibility. After all, it is their funds that representatives are spending. It is, however, plausible that creditors, or some subgroup of them, has both greater incentive and capacity to monitor than do residents. If so, and if the interests of creditors and residents are sufficiently aligned, then inducing the former group to serve as proxies for the latter would reduce overall monitoring costs while generating superior supervision of representatives.

In what follows, therefore, I take an ex ante approach to the issue of whether residents or bondholders should enjoy the entitlement to priority in the event of municipal fiscal distress. I conclude that, while bondholders suffer from significant disincentives and collective action problems that discourage monitoring, some financial intermediaries that act on behalf of bondholders already invest in monitoring local fiscal prudence in a manner that aligns with the interests of residents. Assigning priority to residents in the event of fiscal distress, therefore, would induce bondholders to ensure that those involved in the bond issuance process would exploit their monitoring capacity to avoid bondholder losses or provide ex ante compensation in the form of higher interest rates.

If it seems peculiar to suggest that creditors may be better monitors of municipal officials than the residents who elect those officials, think about the analogous situations in which providers of services (creditors) are deemed to have better information about the use of those services than the users themselves (residents). For instance, the Federal Communications Commission recently proposed that cell phone service providers notify cell phone users when they are about to approach their contractual time limits, although one might believe that the users themselves are well positioned to monitor their own usage.[101] Similarly, Congress has mandated that credit card issuers consider whether prospective card holders will be able to pay their bills,[102] even though one might initially believe that applicants for cards are better monitors of their own financial wherewithal. In both situations, the justification for the anti-intuitive regulation is that pro-

101. *See* Press Release, FCC Proposes Rules to Help Mobile Phone Users Avoid "Bill Shock," (Oct. 14, 2010), *available at* http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-302192A1.pdf.

102. *See* Credit CARD Act of 2009, H.R. 627, 111th Cong. § 150 (2009).

viders have sufficient information about both the individual user and similarly situated users to make low-cost assessments about the user that are more accurate than the user's own speculation. In short, the assignment of priority to residents over creditors may reflect a standard resolution of a problem of asymmetric information in which we induce parties with superior information to disclose or act on that information in order to allocate risks that might otherwise fall on parties less able to avoid or bear them.

A. Residents as Monitors

Any claim that bondholders should serve as monitors of the local treasury initially seems perplexing. Residents, and homeowners in particular, appear to have both the incentive and advantage in monitoring. Homeowners, whose largest asset frequently is immobile property, should want to protect the value of their homes from municipal profligacy and high taxes that diminish resale value.[103] Since even relatively mobile residents cannot exit costlessly,[104] they should be willing to monitor against official misconduct to avoid paying for services that have value below their tax price.

Nevertheless, as I have explored in earlier work, resident underinvestment in monitoring is a perfectly rational response, given the public good nature of monitoring and the standard responses of individuals to problems that require collective action.[105] Begin with the assumption that all residents prefer that their local officials exercise fiscal responsibility and define that objective similarly. Even under those conditions, it would not be in the interest of any individual resident to monitor, because each can enjoy identical benefits without incurring the commensurate costs if some other resident monitors. The great paradox of public goods provision is that, while the fact that governments that make decisions for the collective and impose taxes to pay for desired goods are traditionally seen as a solution to free riding that would otherwise occur, monitoring government itself possesses the characteristics of a public good. If I monitor to ensure faithful government, I can neither exclude you from the benefits of

103. *See* WILLIAM FISCHEL, THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND-USE POLICIES 4–5 (2005).

104. Exiting a locale requires moving which entails, at a minimum, time to find a suitable alternative residence, time packing and unpacking, and transportation costs such as a moving company.

105. *See* Gillette, *Public Debt*, *supra* note 100.

my efforts nor force you to bear their costs.[106] I am, therefore, likely to withhold those efforts in the hopes that someone else, on whom I can free ride, fills the gap.

Of course, outside of relatively small, homogeneous localities, all residents will not posit the same objective for their local officials' expenditure decisions. Some will prefer that the local budget be dedicated to schools, some to parks, police, and fire protection. The objectives of residents may also fluctuate with expected periods of resiresidency, as those who anticipate emigrating within relatively short periods of time may prefer current capital expenditures, and hence more debt, for which (assuming imperfect capitalization) future residents will pay. As a result, one resident cannot rely on monitoring by another, because the active resident might be monitoring for some objective that the free riding resident does not share. The variety of objective functions, however, does not mean that we will get an optimal level of monitoring. To the contrary, it may mean that local officials have a greater capacity to deviate from the preferences of median voters. There are numerous explanations for this phenomenon. First, the variety of plausible objectives means that local officials can justify any of a variety of expenditure decisions as a democratic response to the expressed interests of at least some residents who have a view of the appropriate municipal objective function that differs from the interests of dissenting residents. In short, the variety of plausible objectives that local officials can pursue obfuscates what it means for officials to act in a responsible manner. Second, the variety of potentially appropriate local objectives means that when particular residents do monitor, it is not necessarily the case that they are representative of the preferences of the locality as a whole. Instead, they may be monitoring for an idiosyncratic expenditure rather than for fiscal responsibility generally. A relatively small group that has an organizational advantage, perhaps because its members receive substantial and concentrated benefits from the proposed governmental action, may form a more effective lobbying group than the majority of residents who disfavor the action, but for whom the costs of active opposition exceed the costs they will incur if the proposal is adopted.[107]

The problem obviously becomes worse once we relax the assumption of publicly interested actors. Residents (or nonresidents) who

106. *See* CLAYTON P. GILLETTE, LOCAL REDISTRIBUTION AND LOCAL DEMOCRACY: INTEREST GROUPS AND THE COURT 150–54 (2011).

107. *Id.* at 19–21.

seek special benefits that are inconsistent with the public interest typically pursue concentrated benefits through the imposition of diffuse costs in order to reduce the saliency of the costs to potential opponents.. Indeed, highly salient projects that are funded out of the local treasury, such as construction of sports stadiums, tend to create controversy on all sides.[108] And there may be times when even proposals for relatively small expenditures generate debate, perhaps because they would adversely affect one discrete, organized group even as they conferred benefits on another. For instance, proposals to issue industrial development bonds to attract chain stores at subsidized rates are likely to stimulate organized opposition by existing independent merchants with whom the newcomers will compete.[109] But even these pockets of opposition do not necessarily serve the broader interests of the community. Supporters of independent stores may successfully oppose the introduction of national chains on grounds that the latter are antithetical to a unique community identity.[110] Yet such decisions may not reflect calculations of the relative efficiencies of larger stores, efficiencies that are substantial in the aggregate, but perhaps too speculative and small in individual cases to induce their beneficiaries to monitor local officials to ensure that the benefits are realized.[111]

Indeed, the myriad objectives that localities attempt to satisfy simultaneously can transform the budgeting process into a means by which local officials consolidate political coalitions by directing funds to as many constituent groups as possible. In the absence of hard budget constraints, the incentives of local officials to satisfy the demands of potentially influential groups becomes a hallmark of fiscal irresponsibility.[112] Hard budget constraints would facilitate monitoring, in that the zero-sum nature of expenditures would induce each interested group to examine expenditures made to others in order to maximize its own share of the budget. But even balanced budget re-

108. *See, e.g.*, Jennifer Steinhauer, *Another Big Idea Brought Down by Politics*, N.Y. TIMES, June 7, 2005, at A1.

109. *See* WDW Properties v. City of Sumter, 535 S.E.2d 631 (S.C. 2000).

110. *See, e.g.*, Paul Ingram & Hayagreeva Rao, *Store Wars: The Enactment and Repeal of Anti-Chain-Store Legislation in America*, 110 AM. J. SOC. 2, 447 (2004), *available at* http://www.columbia.edu/~pi17/ingram_rao.pdf.

111. *See* Richard Schragger, *The Anti-Chain Store Movement, Localist Ideology, and the Remnants of the Progressive Constitution, 1920–1940*, 90 IOWA L. REV. 1011, 1091–92 (2005).

112. *See, e.g.*, Gregory L. Rosston et al., *The Effect of Private Interests on Regulated Retail and Wholesale Prices*, 51 J.L. & ECON. 479 (2008), *available at* http://www.colorado.edu/Economics/people/JLE_in_press.pdf.

quirements do not necessarily amount to hard budget constraints in an era in which restrictions on debt have been eviscerated and many of the rewards that can be used to consolidate political gains, such as pensions, can be deferred to future budgets.[113] Moreover, the monitoring incentives created by those hard budget constraints that remain still require a more robust interest group competition than exists in most localities. At the extreme, local officials may ignore some potential interest groups or seek affirmatively to drive those constituents from the locality in order to entrench political power among residents who remain.[114] Even short of the extreme, local officials can circumvent monitors by proposing projects on a take-it-or-leave-it basis at a cost that exceeds what the median voter would deem optimal, but by an amount less than what the median voter would bear to abandon the project.[115] Alternatively, it may be in the interest of groups to increase aggregate spending if the marginal effect is to increase their share of the collective pie. The result is a form of logrolling in which representatives trade for highly localized expenditures that benefit the groups most important to their political success, even though the proposed project imposes net costs on the locality as a whole. This appears to be one explanation for Baqir's observation that increasing the size of the local legislative body increases the size of government.[116] Even short of that objective, some potential interests will be too small or diffuse or unable to organize to compete for a share of the budget or, more importantly, to contest inefficient claims on budget.

The costs of monitoring for the median voter might be decreasing as technological advances enhance the fiscal transparency of localities. With increasing frequency, major cities post their budgets on websites.[117] But those budgets can be too opaque to facilitate the

113. *See* Richard Briffault, *The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 923 (2003); Richard Schragger, *Democracy and Debt*, 121 YALE L.J. 860, 869 (2012).

114. *See* Edward L. Glaeser & Andrei Shleifer, *The Curley Effect: The Economics of Shaping the Electorate*, 21 J.L. ECON. & ORG. 1, 3 (2005).

115. *See* Thomas Romer & Howard Rosenthal, *Bureaucrats Versus Voters: On the Political Economy of Resource Allocation by Direct Democracy*, 93 Q. J. ECON. 563, 575–76 (1979). For an application of the Romer-Rosenthal hypothesis to local initiatives, see Clayton P. Gillette, *Direct Democracy and Debt*, 13 J. CONTEMP. LEGAL ISSUES 365, 396–97 (2004).

116. *See, e.g.*, Reza Baqir, *Districting and Government Overspending*, 110 J. POL. ECON. 1318, 1351 (2002).

117. *See, e.g.*, *Office of Budget Management*, CITY OF BOSTON, http://www.cityofboston.gov/budget/ (last visited June 4, 2012); *Office of Management and Budget*,

kind of monitoring that allows examination and evaluation of individual expenditures. First, it can be difficult to decipher the nature of expenditures or appropriations.[118] Second, even if one knows the line item expenditures in the budget, it can be difficult to gauge the propriety of any given expenditure. Unlike firms, in which comparisons in expenditures for various goods and services may be informative, the geographic and financial position of any locality is likely to limit the utility of expenditure comparisons. What one city spends per teacher or per sanitation worker relative to the expenditures of other cities may be probative of fiscal propriety, but it may also reflect labor market conditions in different geographic areas or other features less connected to fiscal propriety. Within public labor markets, comparisons to private sector employees in similar occupations provide a great deal of ammunition for analysis.[119] But even if academic analysts invest in obtaining the relevant data, it is less certain that the electorate has the incentive or capacity to determine whether labor costs are higher than they "should" be or to determine whether fiscal distress is imminent given obligations for personnel wages, health costs, and pensions.

Of course, not all residents will find the costs of monitoring prohibitive. The market for politics will give political opponents an incentive to detect misfeasance of incumbents and to publicize it to residents. Local media also has incentives to discover budgetary scandals. As I write this Article, *The New York Times* reports that the Brooklyn Borough President runs a series of charities that have received substantial contributions from developers, financial institutions, and corporations with interests in local legislation and building projects.[120] But it is less clear that investigations of individual scan-

CITY OF CHICAGO, http://www.cityofchicago.org/city/en/depts/obm.html (last visited June 4, 2012); *Office of Management and Budget*, NYC.GOV, http://www.nyc.gov/html/omb/html/publications/publications.shtml (last visited June 4, 2012).

118. For example, is Boston's 2012 snow removal budget of $17,059,444 inclusive of equipment, sand and salt, and labor costs, or are some of those factors included elsewhere in the budget? *See Public Works & Transportation Budget 2012*, CITY OF BOSTON, http://www.cityofboston.gov/Images_Documents/09%20Public%20Works%20%26%20Transportation%20Cabinet%20A_tcm3-24788.pdf (last visited June 4, 2012).

119. *See, e.g.*, Kenneth J. McDonnell, *Benefit Cost Comparisons Between State and Local Governments and Private-Sector Employers*, 29 EBRI NOTES 2 (2008), *available at* http://www.ebri.org/pdf/EBRI_Notes_06-2008.pdf.

120. *See* Liz Robbins & Allison Leigh Cowan, *From Brooklyn Office, Mixing Clout and Charity*, N.Y. TIMES (Oct. 24, 2011), http://www.nytimes.com/2011/10/25/nyregion/for-brooklyn-leader-marty-markowitz-mix-of-business-charity-and-power.html?_r=1&hp.

dals or defalcations provide the electorate with a low-cost overview of possible budgetary distress or overextension of borrowing. For example, as bonds issued to assist New York City during its fiscal crisis of the 1970s were maturing a few years ago, the city found itself in another downturn that made payment of the debt difficult.[121] The state and the city approved a complicated but controversial plan to extend the maturity of the debt from 2008 to 2034, effectively imposing on city residents in the latter year the obligation to pay debts incurred in 1978.[122] Although the plan, which funneled funds through multiple state and city agencies and committed the city to the payment of $5.1 billion over thirty years, was challenged as violating state constitutional limitations on debt incurred by the state and the city, *The New York Times* contained but a single article about the issue, and made no mention of the Court of Appeals proceedings that resolved the issue.[123] Perhaps complex financing arrangements, even those that have substantial implications for municipal budgets, do not provide sufficiently sensational reading material outside the arcane bond community.

The general problem of monitoring, then, is that those who find it worthwhile to engage in the enterprise do not necessarily have interests that align with that part of the electorate that fails to monitor. Potential political opponents monitor for salient defalcations that might generate votes; media monitors for salient scandals that might sell newspapers; interest groups monitor to ensure that their favored projects are sufficiently funded. Those groups are unlikely to have interests that align well with monitoring the budget as a whole to determine whether the municipality has become overextended. Indeed, as I indicated above, the variety of interests that seek simultaneous satisfaction is more likely to generate a situation in which political of-

121. Michael Cooper, *Going Against Governor, Mayor Plans to Sell Bonds*, N.Y. TIMES (Aug. 13, 2003), http://www.nytimes.com/2003/08/13/nyregion/going-against-governor-mayor-plans-to-sell-bonds.html.

122. *Id.*

123. Al Baker, *Pataki Blocks Deal Crucial to City Plan to End Fiscal Crisis*, N.Y. TIMES (Aug. 7, 2003), http://www.nytimes.com/2003/08/07/nyregion/pataki-blocks-deal-crucial-to-city-plan-to-end-fiscal-crisis.html?scp=2&sq=lgac&st=cse. The *Times* did write an article about the Appellate Division decision in the case, but not about the subsequent Court of Appeals decision. *See* Michael Cooper & Al Baker, *Court Backs Plan for State to Repay City's Debt*, N.Y. TIMES (Mar. 5, 2004), http://www.nytimes.com/2004/03/05/nyregion/court-backs-plan-for-state-to-repay-city-s-debt.html?scp=1&sq=court%20of%20appeals%20local%20government%20assistance&st=cse. The relevant case is *Local Gov't Assistance Corp. v. Sales Tax Asset Receivable Corp.*, 813 N.E.2d 587 (N.Y. 2004).

ficials who want to be attentive to the myriad demands made by constituents are likely to exploit means of increasing the size of the budget pie rather than to foster competition for a fixed pie. Borrowing, and subsequent overextension of the local treasury, becomes a major mechanism for achieving that function. Ideally, residents would monitor against excessive indebtedness. But the combination of politics and inability to overcome collective action problems means that resident efforts will consistently fall far short of that ideal.

B. Creditors as Substitute Monitors

Are bondholders able to fill the gap in monitoring against fiscal distress? If so, then it might be desirable to induce them to take advantage of that position by imposing losses on them in the event distress forces a choice between satisfying residents and bondholders. This is not to deny that bondholders could alter that position contractually or that bondholders would retain the implicit threat to impose higher interest costs on municipalities if they took a higher risk of nonpayment. But if bondholders are, indeed, better positioned to detect and deter those risks than are residents, then any higher interest payments would reflect the superior allocation of the risk.

It is not clear that bondholders can serve as effective substitutes for non-monitoring residents. Many of the characteristics that discourage resident monitoring apply with equal force to creditors. Although creditors will be smaller in number than residents, they are likely to be sufficiently numerous and diffuse to create collective action problems, since monitoring is no less of a public good with respect to bondholders than it is with respect to residents. Thus, no bondholder who can free ride on the efforts of others has an incentive to monitor personally. Trustees for bondholders, who may solve collective action problems related to matters such as distribution of funds or litigation when defaults materialize, are not typically charged with pre-default monitoring.[124] Nor is there reason to believe that institutions that serve as trustees necessarily have the resources or expertise to assume monitoring obligations.[125]

Bondholders might have greater monitoring capacity if they represented primarily large institutions whose investments warranted the costs of investigation. But the world of bondholding appears not to

124. *See Bond Trustees*, PUBLIC BONDS, http://www.publicbonds.org/major_players/trustees.htm (last visited June 4, 2012).

125. *See id.*

be dominated by those types. The Investment Company Institute reports that individuals hold about thirty-five percent of municipal bonds directly, and another thirty-six percent indirectly through funds.[126] Moreover, as I discuss below, even institutional bondholders that hold large amounts of a particular locality's bonds in their portfolio may eschew monitoring in favor of lower cost strategies for dealing with fiscal risks.

Even if municipal creditors have the capacity to overcome the collective action problem, two questions remain. First, are there other reasons to question whether they will incur the costs of monitoring? Second, if they monitor, will their interests align with those of residents sufficiently to say that they are acting as surrogates for the latter?

Begin with the first question. Creditors cannot be expected to monitor unless the personal benefits they realize from that effort offset their monitoring costs and no lower-cost alternatives exist. Creditors whose holdings may be otherwise sufficiently large to warrant monitoring are also likely to be well-positioned to employ other strategies that reduce their exposure to debtor default.[127] Most obviously, institutional creditors can reduce their risks by diversifying their investments.[128] In addition, and notwithstanding the current distress of monoline insurers in the municipal bond industry,[129] issuers frequently market bonds with insurance, so that bondholders are essentially buying the credit of the insurer, not the issuer, and are correspondingly discouraged from monitoring the issuer.[130] Insurers themselves may be thought to monitor in order to reduce their own risk, but it is equally or more plausible that they will manage risk through diversification. Creditors may prefer these strategies because the historic low incidence of default in the municipal market[131] means that the expected losses that would materialize from failure to monitor are so

126. *See Frequently Asked Questions About Municipal Bonds*, INVESTMENT CO. INSTITUTE, http://www.ici.org/policy/markets/domestic/faqs_muni_bond (last visited June 4, 2012).

127. For fuller discussion of these points, *see supra* note 93 and accompanying text.

128. *Cf.* WILBUR G. LEWELLEN, THE OWNERSHIP INCOME OF MANAGEMENT (1971).

129. For a description of the difficulties suffered by some monoline insurers that invested in derivatives, see, for example, Robert P. Bartlett, III, *Inefficiencies in the Information Thicket: A Case Study of Derivative Disclosures During the Financial Crisis*, 36 J. CORP. L. 1, 25–30 (2010).

130. *See, e.g.*, *AFGI's The Basics*, AFGI, www.afgi.org/who-fact.htm (last visited June 4, 2012).

131. *See, e.g.*, *infra* notes 139–40.

low as to question the cost-effectiveness of monitoring. Seligman reports that the default rate on municipal bonds from 1983 to 1988 was 0.7%, while the default rate for corporate debt was 1.1%.[132] A Report of the House of Representatives Committee on Financial Services, which considered the Municipal Bond Fairness Act of 2008, concluded that default rates for municipal bonds were significantly lower than default rates for corporate bonds of the same rating.[133] The Report found the following comparison of cumulative historic default rates (in percent) for municipal and corporate borrowers.[134]

Rating categories	Moody's		S&P	
	Muni	Corp	Muni	Corp
Aaa/AAA	0.00	0.52	0.00	0.60
Aa/AA	0.06	0.52	0.00	1.50
A/A	0.03	1.29	0.23	2.91
Baa/BBB	0.13	4.64	0.32	10.29
Ba/BB	2.65	19.12	1.74	29.93
B/B	11.86	43.34	8.48	53.72
Caa–C/CCC–C	16.58	69.18	44.81	69.19
Investment Grade	0.07	2.09	0.20	4.14
Non-Invest Grade	4.29	31.37	7.37	42.35
All	0.10	9.70	0.29	12.98

Losses that result in the event of default may also diminish the incentives of at least some municipal creditors to monitor. While creditors of municipalities typically cannot seize tangible assets of the debtor in the event of default, creditors secured by specific revenue

132. Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 699 (1995).

133. H.R. REP. NO. 110-835 (2008), MUNICIPAL BOND FAIRNESS ACT, 5 (2008), *available at* http://www.gpo.gov/fdsys/pkg/CRPT-110hrpt835/pdf/CRPT-110hrpt835.pdf. Default rates vary dramatically among bonds of different quality. One researcher estimated that for municipal bonds issued between 1979 and 1994, investment grade municipal bonds had default rates of 0.31 to 0.3%. Below investment grade bonds had estimated default rates of 3.05 to 4.06%. A 1997 study of a ten-year period for corporate bonds revealed defaults rates ranging from .06% for AAA ratings to 3.27% for BBB ratings. Below that, rates of 18.09% for BB ratings, 34.99% for B ratings and 56.65% for bonds with CCC ratings. *See* David Litvack, *Are Municipal Bonds Rated Too Low?, 18th Annual Institute on Municipal Finance Regulation, Compliance & Enforcement*, 1162 PLI/CORP 479, 498 (2000). Finally, default risk varies with issuers. From 1980 through April 1999, there were no defaults by state governments. *Id.* at 483. Approximately 60% by dollar volume of municipal bond defaults were attributable to local authorities, 20% to state authorities, and 19% to municipalities. *Id.* at 483.

134. H.R. REP. NO. 110-835, *supra* note 133, at 5.

streams may have somewhat greater leverage.[135] Creditors who have received a pledge of certain revenues are entitled to priority with respect to those revenues even in bankruptcy, a preference that reduces the need to monitor against anything other than the demise of the source of those revenues.[136]

The second question suggests that, even if some creditors do monitor, this may not replace resident monitoring because the interests of the groups overlap only imperfectly. Unlike residents who, at least outside of small localities, are likely to have heterogeneous preferences about municipal expenditures, creditors have a common objective—they want to be paid. Monitoring costs for bondholders, therefore, are lower than those for residents in the sense that the former are less concerned with the multiplicity of plausible municipal objectives that can obfuscate the utility of local expenditures and thus raise the costs of monitoring for good government. Bondholders will be less interested in specific expenditures and more concerned with the overall fiscal health of the municipality. In that sense, they plausibly could serve as substitutes for residents with similar interests, although they will be less effective as substitutes for residents' preferences about the particular bundle of goods and services that the municipality offers. For bondholders, fiscal health means little more than the capacity to avoid default on principal and interest payments. A municipality that operates inefficiently or that faces fiscal distress of a sort that does not implicate the security of outstanding bonds (such as loss of a revenue source to which bondholders do not have access) may be of substantial interest to residents, but will not be a focal point of monitoring even by creditors who decide to undertake that effort.

Divergent interests are likely to be even more prominent where the debt is secured by a subset of municipal revenues or by revenues generated by the project financed with bond proceeds rather than, as in the case of a general obligation bond, the general revenues of the municipality. Holders of general obligation bonds are unlikely to consider the propriety of a particular project financed with such bonds, as long as they believe that the municipality will have sufficient resources from which it can draw to pay debt service. Residents, for instance, may prefer not to fund a new public library if they faced significant opportunity costs. Residents, therefore, would presumably

135. *See* David M. Eisenberg, *Creditors' Remedies in Municipal Default*, 1976 DUKE L.J. 1363 (1976).

136. 11 U.S.C. § 928(a).

monitor budgetary constraints, but for the collective action problem. Since the debt incurred for the project is likely secured by the faith and credit of the borrower,[137] creditors are less likely to scrutinize the decision to construct a new library. One might believe that creditors would, at the least, examine the financial feasibility of the library and the contracting process to ensure that statutory bidding procedures were followed, and thus minimize the risk that their loan would subsequently be invalidated, although bond counsel opinions on validity will typically displace the need for inquiry by creditors.[138] To the extent that those procedures serve as proxies for local need for the library, one might infer that creditor scrutiny advanced the interests of residents. But creditors are unlikely to be concerned about the effectiveness or propriety of specific projects that do not threaten the availability of revenues sufficient to pay debt service. Indeed, any concern bondholders might have for fiscal impropriety related to corruption is diluted by the fact that creditors are likely entitled to payment, even if there exists an illegality in the underlying contractual relations between the locality and those involved in the project.[139]

Holders of revenue bonds are even less likely to serve as surrogates for residents. Those bonds are typically funded through collection of user fees and service charges rather than taxes. Bondholders are unlikely to be concerned about the general operation of the municipality, as long as the project in which they have an interest is financially healthy, or at least capable of generating revenues. As I noted above, creditors who receive a pledge of special revenues have even less incentive to monitor the locality generally, because that pledge survives even bankruptcy filings.

The divergence of interests between municipal creditors and residents means that the former are unlikely to police against the types of

137. For examples of projects funded by general obligation bonds, see the City of Albuquerque's website for a summary of their 2011–2020 decade plan sections, available at http://www.cabq.gov/cip/2011-go-bond-program-and-2011-2020-decade-plan/2011-2020-decade-plan-sections.

138. For a discussion of the circumstances under which municipal debt may be invalidated for failure to adhere to statutory or constitutional requirements, see AMDURSKY & GILLETTE, *supra* note 18, at 290–314.

139. Section 8-202(b)(2) of the Uniform Commercial Code provides that a security issued by a governmental subdivision that is issued with a defect going to its validity will be valid in the hands of a good faith purchaser for value if it has been issued for a substantial consideration and for a purpose for which the issuer has power to borrow the security. Even if the underlying violation would otherwise invalidate the bond, itself a questionable proposition, the typical recital by the issuer that there has been compliance with statutory requirements will estop the issuer from using the violation to avoid payment. *See* U.C.C. § 8-202(a).

fiscal imprudence that led to the adoption of state constitutional restrictions on municipal debt. Consider, for instance, the concerns that underlie the public purpose doctrine: if localities are not constrained in the purposes for which they issue debt, they are likely to invest in projects that benefit discrete groups[140] or that skew market forces by involving government in enterprises more appropriately reserved to private firms.[141] But creditors who care only about prospects for repayment may be unconcerned about the propriety of public/private cooperation or the extent to which scarce local resources are misdirected to one project at the expense of alternatives.

Indeed, in some situations, the interests of creditors could be antithetical to those of residents. If this is the case, then—far from augmenting residents' monitoring—monitoring by creditors could actually exacerbate the problem by inducing officials to address creditor concerns that conflict with those of residents. Conflict between the interests of creditors and residents is always plausible. In part, that conflict arises from the incentives of debtors to use borrowed funds for riskier projects than creditors might prefer, because the latter receive no benefit from the increased risk. Creditors would prefer to see their debtors undertake relatively riskless projects that ensure repayment of the debt, even if the expected value of a riskier project exceeds that of the riskless project.[142] In the municipal context, this might mean, for instance, that creditors would prefer that a housing project initially intended to benefit a mix of the poor and the elderly contain a larger percentage of the latter (because the elderly may be seen as more stable and willing to maintain the value of their residence), even though the locality has greater needs to accommodate the interests on the nonelderly poor. This example reflects that resi-

140. State *ex rel.* McLeod v. Riley, 27 S.C. 323, 328 (1981).

141. Vill. of Moyie Springs v. Aurora Mfg. Co., 353 P.2d 767, 775 (Idaho 1960). For this reason, the public purpose doctrine may be applicable to revenue bonds, even though they do not implicate the issuer's fiscal status. Alternatively, the doctrine may apply to revenue bonds because those debts may implicate the issuer's fiscal status even though the issuer is not responsible for payment of debt service. *See* AMDURSKY & GILLETTE, *supra* note 18, at 87–90.

142. Assume, for instance, that a creditor makes a loan of \$100. The firm expects to use the proceeds of the loan to implement Project A or Project B. Project A has a 0.9 probability of returning \$120 and a 0.1 probability of returning \$50. Thus, Project A has an expected value of \$113. Project B has a 0.5 probability of returning \$1000 and a 0.5 probability of returning \$0. Thus, Project B has an expected value of \$500. Hence, risk neutral equity holders would prefer Project B. But the creditor receives no more than \$100 regardless of the firm's success. Thus, it faces an expected recovery of \$95 from Project A (0.9 of \$100 + 0.1 of \$50) and an expected value of \$50 from Project B (0.5 of \$100 + 0.5 of \$0). Hence, the holder will favor Project A.

dents are properly concerned about issues other than (or in addition to) the financial security of their locality, and might be willing to sacrifice that security for other objectives. To the extent that efficient delivery of municipal services could mean denying those services to residents who could not pay their marginal cost, pricing schemes that require subsidies or that encourage overuse might place the municipal treasury at a risk that residents believe is worth taking from a distributional perspective. Creditors, on the other hand, will desire only to maximize the probability of repayment.

C. Surrogates for Bondholders

To this point, I have suggested that bondholders are unlikely to serve as substitute monitors for residents because bondholders have superior low-cost alternatives for protecting their investments, face low probability of losses and thus face relatively high monitoring costs, and have interests that diverge from those of residents. But "bondholder" monitoring does not necessarily entail monitoring by bondholders as a class. Just as creditors might, in theory at least, serve as surrogates for residents, so may a subset of creditors or their representatives (a term that I do not mean to use in a legal sense) serve as surrogates for the larger group. If a subgroup of creditors has sufficient incentives or obligations to monitor against general fiscal distress, then it may confer benefits on the larger group and on other groups (residents) as well. Is there any reason, then, to conclude that a subset of creditors or representatives of creditors are better situated to monitor against fiscal distress than are residents?

If collective action problems impede creditor monitoring, but monitoring is worthwhile to creditors as a group, then one might imagine that intermediaries who are able to monitor on behalf of the group and recoup their investment might evolve to fill the gap. Intermediaries that could, at relatively low cost, make investigations that are not worth making for individual investors, would presumably be able to market information discovered from their inquiries to investors who would be willing to bear a pro rata share of the search costs. Alternatively, intermediaries could market their services to municipalities, which could signal their quality by including the imprimatur of the intermediary. In theory, rating agencies fit this description. Standard & Poor's, for instance, describes an intense investigatory process in which its representatives meet with municipal officials, peruse and analyze financial records of the municipality, submit information to a committee that assigns ratings, review appeals by municipalities, review outstanding ratings at the time of a new issue sale of a previously rated entity, and monitor disclosure events and public filings to determine the existence of financial, legal, and natural events that might affect credit quality.[143] If rating agencies fulfilled these goals, they might serve functions equivalent to those of active monitors. For purposes of developing and publicizing information concerning debtors, the position of rating agencies is analogous to that of unsecured creditors who engage in pre-loan screening of firms. Barry Adler notes that even if unsecured creditors do not monitor loans ex post, they are likely to engage in broad pre-loan screening of firm assets, including those, such as managerial skill, with little encumberable value in order to assess the risk of the loan.[144] Subsequent grant of the loan on terms less favorable than expected may provide current and potential equity holders with a signal of mismanagement, while favorable terms may constitute a signal of quality on which others can rely.[145] Pre-loan screening generates sufficient benefits for unsecured creditors that they are willing to generate information on which others can free ride. Rating agencies do not obtain any personal value from their investigations, as they are not proposing to lend to the entities for which they provide ratings.[146] But they are able to capture the benefit of the information they provide to third parties by charging municipalities for the costs of investigation,[147] and municipalities receive sufficient benefit from obtaining those ratings that they are willing to incur those costs. In this manner, rating agencies can theoretically signal bondholders about any general indicators of fiscal distress.

Individual instances of pre-loan screening by rating agencies do not constitute monitoring because the inquiry takes place only at a single point—prior to the issuance of a series of bonds. But many munici-

143. *See Standard & Poor's Guide to Credit Rating Essentials*, STANDARD & POOR'S, https://www.mycreditprofile.standardandpoors.com/mysp/myspservlet?requestName=DownloadHotTopics&blobIdParam=YYYXYXXYYXY (last visited June 4, 2012).

144. *See* Barry E. Adler, *An Equity-Agency Solution to The Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73, 91–94 (1993).

145. *Id.*

146. *See Standard & Poor's Ratings Definitions*, STANDARD & POOR'S, http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245328288201.

147. *See* Zeke Faux, *Credit Rating Fees Rise Faster Than Inflation as Governments Downgraded*, BLOOMBERG (Nov. 15, 2011), *available at* http://www.bloomberg.com/news/2011-11-15/credit-rating-fees-rise-faster-than-inflation-as-governments-fret-expenses.html.

palities require recurrent access to the credit markets. General purpose municipalities and some authorities (such as housing authorities and industrial development authorities) fund multiple projects on an ongoing basis.[148] As the description of Standard & Poor's[149] suggests, each entry into the credit markets is likely to trigger a new evaluation by rating agencies. If rating requirements are sufficiently frequent, they become the functional equivalent of monitoring while a loan is outstanding. Notwithstanding that we would now have an additional layer of principal-agent slippage (residents relying on creditors who are relying on rating agencies), under certain circumstances,[150] the interests of all interested parties should be sufficiently aligned to provide reliable signals of municipal fiscal quality.

Nevertheless, one must be skeptical of the capacity or willingness of rating agencies to perform this function. Even before the most recent financial crisis, rating agencies were frequently criticized for their failure to add significantly to public information concerning the corporations and municipalities that they reviewed.[151] On this view, rather than discovering and distilling information that permits more informed decisions by investors, rating agencies simply react to inforinformation that is already known to the marketplace. Consider, for instance, John Coffee's critique of the market's ability to rely on ratings to displace disclosure of information directly to investors in municipal securities:

> First, in the New York City fiscal crisis, Moody's did not reduce New York's rating until the crisis was universally acknowledged. Second, because the issuer pays the bond rating agency to be rated, there is a conflict of interest problem. Third, the bond rating agencies are not themselves investigating agencies. Instead, they depend on the data that the issuer gives them. Yet a recent survey by Arthur Young & Co., the auditing firm, suggests that this data's accuracy is in serious

148. *See, e.g.*, *2010 Annual Report*, NEW YORK CITY HOUSING & URBAN DEVELOPMENT CORP., https://www.nychdc.com/content/pdf/AnnualReports/Annual%20Report%202010.pdf (last visited June 4, 2012).

149. *Understanding Standard & Poor's Rating Definitions*, STANDARD & POOR'S, http://www.standardandpoors.com/spf/delivery/assets/files/Understanding_Rating_Definitions.pdf (last visited June 4, 2012).

150. The requisite circumstances will exist if municipalities frequently enter capital markets, make observable covenants, and are funding projects, the failure of which would signify general fiscal distress within the locality.

151. *See, e.g.*, L. MACDONALD WAKEMAN, THE REAL FUNCTION OF BOND RATING AGENCIES, IN THE MODERN THEORY OF CORPORATE FINANCE 391 (Michael C. Jensen & Clifford W. Smith, Jr. eds., 1984); Frank Partnoy, *The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 647–48 (1999).

> doubt. In a 1983 survey of 557 municipalities, it found that fifty-four percent of the municipalities issued financial reports that were so incomplete or flawed that their independent accountants could give only qualified opinions. In part, these problems may stem from the still rudimentary state of the accounting principles applicable to governmental and nonprofit bodies. The bottom line, however, is that if ratings are based on poor data, they will not protect investors who desire to avoid high risk: garbage in, garbage out.[152]

Certainly little has happened since Coffee wrote to improve the perception of rating agency performance, at least in the private sector adversely affected by the recent fiscal crisis.[153] If rating agencies are simply serving as filters for publicly available information, or are simply conduits for governmentally-created information, then their role falls far from the monitoring function that their literature suggests they play.

But independent intermediaries are not the only potential surrogates for bondholder monitoring. Perhaps those more directly involved in bond issuance, primarily underwriters, may serve the interests of the full range of creditors. Underwriters have the incentive of all creditors to monitor because they typically purchase an entire bond issue and frequently retain significant amounts of the issue in their own portfolio. In addition, underwriters can take advantage of legal defenses against liability for nondisclosure if they exercise due diligence with respect to certain representations in offering documents.[154] In effect, the due diligence requirements that the law already imposes on them[155] means that they have already sunk costs into monitoring. Again, these obligations may exist only with respect to pre-loan screening, but for repeat players in the credit markets, continual ex ante screening may be tantamount to ex post monitoring. Those incentives are enhanced by the SEC's adoption of Rule 15c2-

152. John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 745–46 (1984). Coffee's last criticism may be less relevant now than when he stated it. Increasingly, municipal accounting systems have been regularized to permit easier comprehension by professionals and investors. In addition, as I discuss below, federal securities laws now induce localities to make more comprehensive financial disclosure than was previously the case. *See* Securities Exchange Act of 1934, 17 C.F.R. § 240.15c2-12.

153. *See, e.g.*, Lynn Bai, *The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?*, 7 N.Y.U. J.L. & BUS. 47 (2010); Claire A. Hill, *Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities?*, 71 U. PITT. L. REV. 585 (2010).

154. *See* 15 U.S.C. § 77(k)(b)(3).

155. *See* 15 U.S.C. § 77.

12.[156] This rule prohibits brokers, dealers, and municipal securities dealers from purchasing or selling municipal securities unless they reasonably believe that the state or local government issuing the securities has agreed to disclose certain financial information on an ongoing basis.[157] Although the rule is nominally directed at brokers and dealers in municipal debt offerings, it effectively requires underwriters to enter contractual relationships with issuers to provide the required financial information in accessible formats.[158] That information includes general information concerning the issuer, as well as financial information related to specific events that indicate impending fiscal distress, such as payment delinquencies, non-payment defaults, unscheduled draws on debt service reserves or credit enhancements, bond calls, and rating changes.[159]

This is not to suggest that underwriters are at fault when they facilitate the issuance of debt that is risky or with respect to which there has been a default. Instead, if the objective in assigning priorities to limited funds in the event of default takes into account the relative capacity of the relevant actors to monitor against fiscal distress, the fact that underwriters who market bonds have both legal and financial incentives to access the appropriate information indicates that bondholders may be better positioned to identify impending fiscal distress than residents. To the extent that the interests of underwriters monitoring for disclosure aligns with monitoring against financial irresponsibility generally, those involved in the issuance process serve as surrogates for residents at zero marginal cost. As a result, in a hypothetical bargain between bondholders and residents, the latter would pay bondholders to subordinate priority, since bondholders' representatives could assess the default risk at lower cost. Moreover, since evidence of fiscal distress unearthed during the due diligence process is likely to translate into higher interest rates that underwriters either negotiate with issuers or incorporate into their bids for a competitively bid issue, bondholders are compensated to take the default risk and have less basis for complaint about receiving lower priority than residents.

Indeed, to the extent that underwriters' interests are aligned with those of bondholders generally, subordinating bondholders' claims to those of residents could have the additional positive effect of reducing

156. *See* 17 C.F.R. § 240.15c2-12 (2010).
157. *See id.*
158. *See id.*
159. *See id.*

underwriters' incentives to incur debt that could exacerbate fiscal distress.[160] That point was made seventy-five years ago by A. M. Hillhouse, who contended that investment bankers encourage the issuance of bonds, including unnecessary ones, in order to maintain business volumes that may have developed during times of prosperity and to capture clients before competitors have an opportunity to do so.[161] He then turned to the incentives of these investors:

> Trafficking in the "shame of the cities" [the overextension of debt] might also be laid in part at the investor's door. Both the high interest rates on doubtful municipals and the tax-exempt feature appeal to his desire for profit . . . . High rates of interest may seem unconscionable, but where the initiative was taken by the borrowers, the investor cannot be condemned. Rates must vary with the quality of the credit. Unfortunately, however, like all lenders, the investor in municipal bonds may subsequently seek to reap even though he has unwisely or recklessly sown.[162]

The exposure of those involved in the bond issuance process to fiscal information, and thus their capacity to constrain risky issuance, is apparent from accounts of those issues that have proven problematic or that ended up in default. Even prior to the adoption of Rule 15c2-12, underwriters had access to information that presaged fiscal distress. Again, New York City provides an example that may be more salient due to the size and importance of that city in the national economy, but that may also be representative. The SEC Staff Report that investigated issuance of New York City securities certainly castigated city officials for the use of unsound accounting and reporting practices that obscured financial data about the city's revenues, costs,

160. The current bankruptcy of Jefferson County, Alabama is frequently attributed to the issuance of bonds and related swap agreements that left the county with substantially greater than anticipated costs of developing a sewer system. The complicated arrangements were tarnished by allegations of bid rigging and bribery involving an underwriter and two of its managing directors. The SEC entered into a settlement that required the underwriter to pay a penalty of $25 million, make a payment of $50 million to Jefferson County, and forfeit more than $647 million in claimed termination fees. *See* Press Release, S.E.C., J.P. Morgan Settles SEC Charges in Jefferson County, Ala. Illegal Payments Scheme (Nov. 4, 2009), *available at* http://www.sec.gov/news/digest/2009/dig120409.htm; Campbell Robertson & Mary Williams Walsh, *Debt Crisis? Bankruptcy Fears? See Jefferson County, Ala.*, N.Y. TIMES (July 29, 2011), http://www.nytimes.com/2011/07/30/us/30jefferson.html?hp=&pagewanted=all.

161. HILLHOUSE, *supra* note 27. Richard Schragger makes a similar point, which he attributes to Richard Briffault. *See* Schragger, *supra* note 111, at 871 n.40.

162. HILLHOUSE, *supra* note 27, at 254–55.

and financial position.[163] But the Report also alleged that underwriters were aware of the burgeoning city debt, the limited capacity of the city to repay that debt, and their own impending incapacity to sell debt because of the city's fiscal position and the saturation of the market with city securities.[164] Similarly, both academic and official investigations of the issuance process for the nuclear power projects involved in the Washington Public Power Supply System defaults reveal substantial underwriter involvement in generating and publicizing the information that induced municipalities to participate and assessing the financial viability of the projects that ultimately went awry.[165] The SEC Staff Report on the matter concluded that even underwriters in competitive offerings who did not—unlike underwriters in negotiated offerings—participate in the creation of disclosure documents had knowledge of and concerns about problems relating to project costs, power demand that would affect the rates payable by residents, and the market for the bonds.[166]

CONCLUSION

I am not using these instances of misbehavior in the bond issuance process to suggest that there is pervasive wrongdoing in the bond markets. These instances are admittedly pathologies which, for that reason, have generated sufficient comment to reveal the extent to which those involved in bond issuance have access to financial information about the issuer. But the fact that they are pathologies is just the point. In most cases, information to which underwriters have low-cost access and that they are likely to obtain for reasons having nothing to do with the assignment of priorities in the event of default is likely to be used appropriately to assess risks and price them. The consequence is that bondholders receive the benefit of information that both they and residents might otherwise eschew. But if that is the case, then assigning residents—who are less likely to obtain similar information—priority to limited municipal funds would appear to replicate the very bargain that bondholders and residents would reach

163. *See* SUBCOMMITTEE ON ECONOMIC STABILIZATION OF THE COMMISSION ON BANKING, FINANCE AND URBAN AFFAIRS, 95TH CONG., 1ST SESS., STAFF REPORT ON TRANSACTION IN SECURITIES IN THE CITY OF NEW YORK ch. 3 (1977).

164. *Id.* ch. 4.

165. *See* S.E.C., STAFF REPORT ON THE INVESTIGATION IN THE MATTER OF TRANSACTIONS IN WASHINGTON PUBLIC POWER SUPPLY SYSTEM SECURITIES (1988), *available at* http://c0403731.cdn.cloudfiles.rackspacecloud.com/collection/papers/1980/1988_0901_SEC_WPPSS.pdf; POPE, *supra* note 71.

166. *See* S.E.C., *supra* note 165, at 177–90.

if they could negotiate. Bondholders who have been compensated ex ante to take risks have little basis for complaint when those risks materialize. The intervention of the state to elevate bondholders over residents may make political sense, but it misses this important element of allocating the risk of municipal fiscal distress in a manner that reduces the likelihood that it will materialize.