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Saving Cities or Exploiting Creditors?: State Redirection of Municipal Assets

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SAVING CITIES OR EXPLOITING CREDITORS?: STATE REDIRECTION OF MUNICIPAL ASSETS

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INTRODUCTION: STATE REDUCTION OF MUNICIPAL ASSETS

States faced with fiscally distressed municipalities typically must confront creditor demands for payment, the satisfaction of which would threaten the provision of local public services. A state that attempts to strike the delicate balance between assisting its local governments and maintaining relationships with creditors has substantial options. The state can, of course, simply provide funding to municipalities, perhaps conditioned on municipal reforms that address the problem of moral hazard.[1] Alternatively, states may assert

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1. For example, during New York City's fiscal crisis in the 1970s, New York State not only provided funding to the city, but also established an emergency financial control board that imposed a three-year wage freeze on city employees, rejected a

authority over the municipality either in concert with or in substitution of municipal officials[2] and attempt to negotiate solutions with creditors or grant creditors priority in municipal revenues.[3] The state may also authorize and encourage the municipality to adjust its debts, primarily by entering Chapter 9 of the federal Bankruptcy Code. Each of these efforts may bring some relief to municipal budgets. But they have very different effects on creditors, and thus on the potential incentives that future creditors may have to invest in municipalities of the state. Providing direct relief to the distressed municipalities or dictating priorities in revenues may permit payment of creditors in full. States may exercise that option in order to signal future creditors that debts will be paid. The importance of such signals to maintain the creditworthiness of municipalities is embodied in provisions such as the New York State Constitution's requirement that cities pledge their faith and credit to debts and exceed real estate tax limits if necessary to pay those debts.[4] Another example is a provision in the General Laws of Rhode Island that requires cities grant creditors "first liens" on tax revenues and thus requires payment of debts prior to other municipal expenses.[5]

Other jurisdictions have been less solicitous of creditors and have embraced some form of the third alternative. States that permit their municipalities to enter bankruptcy essentially signal the possibility that creditor claims will be adjusted in those proceedings.[6] Current law prohibits states from enacting their own version of unilaterally

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contract that had been negotiated with the transport workers' union, required the imposition of tuition at the previously free City University of New York, and modified the city's financial plan. *See* ROBERT W. BAILEY, THE CRISIS REGIME: THE MAC, THE EFCB, AND THE IMPACT OF THE NEW YORK CITY FINANCIAL CRISIS 64–66, 75–77 (1984); *see also* SEYMOUR P. LACHMAN & ROBERT POLNER, THE MAN WHO SAVED NEW YORK 129–37 (2010).

2. *See* Clayton P. Gillette, *Dictatorships for Democracy: Takeovers of Financially Failed Cities*, 114 COLUM. L. REV. 1373, 1373 (2014).

3. For example, when the City of Central Falls, Rhode Island, faced financial hardship, the state enacted a statute that gave bond creditors priority over other creditors, such as pensioners of the city. *See* 45 R.I. GEN. LAWS ANN. § 45-12-1 (West 2014).

4. *See* N.Y. CONST. art. VIII, § 2; Flushing Nat'l Bank v. Mun. Assistance Corp., 358 N.E.2d 848, 850 (N.Y. 1976).

5. *See, e.g.*, 45 R.I. GEN. LAWS ANN. § 45-12-1(a).

6. The Bankruptcy Code requires that states specifically authorize their municipalities to enter federal debt adjustment proceedings. *See* 11 U.S.C. § 109(c)(2). Only half the states have done so. *See* Kristen M. DeJong & Beth A. Dougherty, *Municipal Bankruptcy: A Primer on Chapter 9*, NUVEEN (Oct. 20, 2020), https://www.nuveen.com/en-us/thinking/municipal-bond-investing/municipal-bankruptcy-a-primer-on-chapter-9 [https://perma.cc/VN56-7FYU].

compromising debts of their municipalities.[7] But states may also attempt to shift the costs of municipal fiscal distress from residents to creditors by altering the nature of the underlying debt obligation rather than directly reducing the amount of indebtedness. That may take the form of shifting assets initially used to support debt to a new set of creditors. Those efforts were prominent in the late nineteenth century, as states altered debtor municipalities' boundaries and taxing authority on which existing creditors had relied. More recently, states have attempted to assist distressed municipalities through more subtle means of shifting assets.[8] Both New York State and Illinois, for example, have diverted to new state entities tax revenues previously available to creditors of distressed cities in an effort to generate capital to which those cities would not otherwise have access, and thus allow the continuation of municipal services that face reduction or elimination.[9] The nineteenth-century versions of asset shifting typically failed on the ramparts of the U.S. Constitution's Contracts Clause or similar creditor protections.[10] One might readily dismiss those nineteenth-century analogues as sufficiently antiquated or born of different circumstances to reject their applicability to the more contemporary state interventions on behalf of distressed municipalities. The effects of the nineteenth-century strategies on creditors, however, bear enough similarity to recent instances of redirecting assets that it is useful to determine the implications of those earlier legal challenges for contemporary forms of municipal finance. In this Article, I address those similarities and explain why, even if the early cases remain persuasive authority for the limits of state intervention, they do not inevitably invalidate the current interventions.

States that attempt to reduce municipal debt burdens by shifting assets are not necessarily acting inappropriately, notwithstanding adverse effects on existing creditors. Bond creditors may be better positioned than residents to monitor municipal fiscal performance.[11] Where that is the case, allocating fiscal risks to those creditors rather than to residents or other creditors might induce bondholders or their

7. *See* 11 U.S.C. § 903(1) ("[A] State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition . . . .").

8. *See infra* Part III.

9. *See infra* Part III.

10. *See infra* Part II.

11. *See* Clayton P. Gillette, *Bondholders and Financially Stressed Municipalities*, 39 FORDHAM URB. L.J. 639, 655 (2012).

representatives to act in a manner consistent with their monitoring advantage. A state that shifts risks to creditors may therefore be allocating that risk efficiently. Alternatively, a state might reasonably conclude that it is more important to maintain municipal services than to ensure full payment to creditors, and thus seek to reallocate risks ex post, regardless of which group was better able to monitor budgets ex ante. The very existence of a municipal bankruptcy regime implies that there are circumstances in which concerns for municipal fiscal health prevail over concerns that obligations to creditors will suffer diminution.

Nevertheless, states that offload risks to creditors may also be acting strategically, favoring the imposition of current costs on creditors and long-term costs on future officials and residents who bear the risk that credit markets will demand higher interest rates from defaulting localities. State officials who consider themselves accountable to current residents may have political incentives to engage in that form of risk-shifting. Those incentives may be enhanced where creditors comprise non-residents or represent distant capital markets.[12] Where states interfere with creditors' payments, either by authorizing municipal bankruptcy or by altering the underlying obligations, evaluation of the propriety and substance of that intervention may depend on whether one believes that the state was motivated by the benign story of efficient allocation of risk and maintenance of municipal services or the malign story of exploiting creditors.

In this Article, I suggest that the underlying purpose for which the state diverts assets from cities should determine the legality of the strategy, notwithstanding the similar effects on creditors that result from using the strategy for different purposes. The legal implications may differ if the state diverts assets primarily to exploit non-resident creditors who have little voice in the decision than if the state adopts the same strategy to ensure continued delivery of a distressed municipality's services. I claim that the nineteenth-century cases reveal a willingness to sacrifice creditor security even where unnecessary to maintain the debtor municipality's fiscal status and that courts intervened to mitigate such strategic behavior when they observed it. More contemporary diversions, however, appear to have been undertaken to ensure that the debtor municipality survives liquidity crises and can provide the services for which the municipality

12. *See* CHARLES FAIRMAN, 6 RECONSTRUCTION AND REUNION 1864–1888, at 958–60 (1971); ERIC H. MONKKONEN, THE LOCAL STATE: PUBLIC MONEY AND AMERICAN CITIES 9 (1995).

was created. In effect, the courts appear to demand that the state balance the need for creditor security against municipal fiscal stability and tend to permit diversions that facilitate municipal access to need capital. But the cases neither speak in those terms nor involve much analysis of how shifting assets will reduce creditor recovery, perhaps because — in the nineteenth-century cases, at least — the reduction of creditor security was near total. Thus, the cases appear to reveal judicial concern for what I refer to as the state's motive, that is, judicial suspicion that the state is acting strategically rather than engaging in the kind of balancing that might justify some increase in creditor risk.

Part I provides a brief discussion of overriding principles that govern the capacity of states to alter the debts of their political subdivisions. Part II then discusses several of the major Supreme Court nineteenth-century decisions that addressed efforts by states to reduce creditor access to pledged assets of defaulting municipalities. Those efforts entailed dramatic changes to municipal legal status and geography, such as shifting municipal boundaries and claiming that reformed municipalities did not incur the obligations of their predecessors. Most importantly, Part II discusses not only what states did on behalf of their distressed localities, but why.

Part III discusses more contemporary versions of asset shifting. It also explores the difficulties inherent in determining the effects that even benign efforts to divert revenues have on current creditors. In particular, Part III discusses the significance of stable market values for existing securities during and after the period when the state has created a diversion strategy. Some courts have relied on market values to conclude that current creditors are unharmed by the diversion of assets from the debtor. This Part, however, contends that consideration of market values at the time of litigation over the propriety of allegedly impairing legislation cannot predict potential adverse effects of the diversion strategy in the distant future.

I. STATE RESPONSES TO MUNICIPAL DEBT BURDEN

In the absence of legal constraints, a state could readily shift the risk of fiscal distress simply by compromising municipal debts, leaving debtors with unencumbered access to assets previously pledged to the payment of debt service. In effect, a state could impose its own municipal bankruptcy regime and adjust its municipalities' obligations accordingly. Doing so, however, initially sounds like an obvious violation of the Contracts Clause of the U.S. Constitution. That provision prohibits states from enacting any "[l]aw impairing the

Obligation of Contracts,"[13] and a law that permits a debtor to pay less than is owed seems like the quintessential example of an offending impairment. Of course, since the Depression-era case of *Home Building & Loan Ass'n v. Blaisdell*,[14] courts and commentators have understood the Contracts Clause as eschewing an absolute prohibition on state intervention in public or private contracts.[15] States may enact impairing legislation necessary "to protect the . . . general welfare of the people," and legislatures have "wide discretion . . . in determining what is and what is not necessary."[16] The Clause imposes fewer constraints on state interference with contractual rights where the alleged impairment addresses a widespread social problem that would permit full payment to creditors only at the cost of "safeguard[ing] the vital interests of its people."[17] Moreover, nominally impairing legislation may create no constitutional difficulty where it is accompanied by compensation or replaces one form of security for the adversely affected one.[18] Even admitted impairments may pass constitutional muster where the offending "[l]egislation adjust[s] the rights and responsibilities of contracting parties . . . upon reasonable conditions and [possesses] a character appropriate to the public purpose justifying its adoption."[19] The state's capacity to alter its contractual obligations is weaker, however, where its commitment does not implicate reserved police powers but is "purely financial."[20]

In theory, states may have even more latitude than the constitutional constraint suggests. Justice Felix Frankfurter's intellectual gymnastics in *Faitoute Iron & Steel Co. v. City of Asbury Park*,[21] a case I revisit later in this Article,[22] considered the practical implications of an alleged impairment and thereby created an opportunity for states to restructure debt where the effect was to increase the expected value of otherwise uncollectable debts.[23] Statutory changes in the Bankruptcy Code effectively overruled that case by prohibiting states, and it turns

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13. U.S. CONST. art. I, § 10, cl. 1.
14. 290 U.S. 398 (1934).
15. *See, e.g.*, JAMES W. ELY, JR., THE CONTRACT CLAUSE: A CONSTITUTIONAL HISTORY 239–40 (2016).
16. City of El Paso v. Simmons, 379 U.S. 497, 508–09 (1965) (quoting E. N.Y. Sav. Bank v. Hahn, 326 U.S. 230, 232–33 (1945)).
17. *Blaisdell*, 290 U.S. at 434.
18. *See* United States Tr. Co. v. New Jersey, 431 U.S. 1, 19 (1977).
19. *Id.* at 22.
20. *See id.* at 25.
21. 316 U.S. 502 (1942).
22. *See infra* notes 155–63 and accompanying text.
23. *See Faitoute*, 316 U.S. 502.

out, Puerto Rico, from imposing a composition of indebtedness.[24] But if the state-imposed solution approved in *Faitoute* increases the value of creditors' holdings, then perhaps the proper argument — suggested initially by Michael McConnell and Randal Picker[25] — is to repeal the statutory proscription.[26] Moreover, there is a significant argument, accepted by federal courts in the Southern District of New York[27] and the District of Puerto Rico,[28] that distinguishes between a permissible extension of the time for payment and a prohibited composition of indebtedness.

Historically, however, states have been more creative in reducing creditors' access to municipal assets than simply extending the maturity of the debt in question. In the nineteenth century, state intervention took blatant forms of dissolving indebted municipalities or merging them into other municipalities that claimed no obligation to pay the merged jurisdiction's creditors.[29] As the next Part recounts, those strategies rarely succeeded, defeated by a series of Supreme Court cases that were instrumental in defining the scope of the Contracts Clause during the pre-*Blaisdell* era. But their antiquity does not entail their irrelevance. In a period in which states have discovered more nuanced mechanisms for stripping a discrete set of revenues previously available to creditors, attention to those earlier cases reveals whether the situations are easily distinguishable or whether the same impulses that motivated the obvious diminution of contractual security infect the more nuanced ones.

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24. *See* 11 U.S.C. § 903. For application of the prohibition, see *Puerto Rico v. Franklin California Tax-Free Trust*, 136 S. Ct. 1938, 1938 (2016).

25. *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 479–80 (1993).

26. Given the presence of Chapter 9, a repeal of the statutory proscription would make sense only if state bankruptcy regimes generated benefits not attainable through the federal bankruptcy process and imposed no offsetting costs. One potential benefit would be that states could address structural and governance defects that contribute to municipal fiscal distress in ways not easily achieved through federal law. *See generally* Clayton P. Gillette & David A. Skeel, Jr., *Governance Reform and the Judicial Role in Municipal Bankruptcy*, 125 YALE L.J. 1150 (2016).

27. *See* Ropico, Inc. v. City of New York, 425 F. Supp. 970, 983 (S.D.N.Y. 1976).

28. *See* Assured Guar. Corp. v. Garcia-Padilla, 214 F. Supp. 3d 117, 126 (D.P.R. 2016).

29. *See infra* Part II.

II. THE NINETEENTH-CENTURY DISSOLUTION CASES

A. Railing Against Debt: State Reactions to Municipal Defaults

The story begins in the mid- to late-nineteenth century when municipalities first engaged in debt financing, largely to support promoters of railroad lines or similar infrastructure.[30] Debts incurred for these purposes took the form of what is referred to today as a general obligation bond, payable from the general taxes of the issuer rather than solely from the revenues generated by the railroads that benefitted from the bond proceeds.[31] Thus, bondholders anticipated payment regardless of the success of the enterprise their bonds financed. Nevertheless, these debts were presumed to be relatively burden-free for residents, as the financed facilities would generate economic development and the corresponding tax revenues necessary to pay bondholders.[32]

Commentators such as John Dillon feared the fiscal mischief that long-term debt would impose on municipalities induced by the promise of painless repayment and a belief that any risk would fall on subsequent generations: "[T]he stimulus which the long credit commonly provided for effectually supplies, to over-indebtedness."[33] Indeed, many localities soon discovered that the presumed economic benefits would not materialize — not every municipality could become a major crossroads in the national market that railroads promised to create.[34] Defaults on debt followed, motivated either by the failure of promoters to construct the promised railroad; the financial failure of a constructed railroad; general fiscal distress of the borrowing locality, exacerbated by the railroad aid debt; or simple reluctance to pay debts

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30. *See* ALBERT MILLER HILLHOUSE, MUNICIPAL BONDS: A CENTURY OF EXPERIENCE 143–99 (1936); ALBERTA M. SBRAGIA, DEBT WISH 58–60 (1996).

31. *See* L. A. Powe, Jr., *Rehearsal for Substantive Due Process: The Municipal Bond Cases*, 53 TEX. L. REV. 738, 739–40 (1975).

32. *See* SBRAGIA, *supra* note 30, at 55–57.

33. JOHN F. DILLON, THE LAW OF MUNICIPAL BONDS 5 (1876). Dillon suggested that municipalities seeking railroads and similar internal improvements systematically incurred unaffordable debt:

> The writer has known new counties in a western state, not containing over 10,000 inhabitants, vote, for a single railway, bonds to the amount of $300,000, drawing ten per cent interest, payable annually, and instances are not infrequent where bonds have been issued greater than the assessed value of all the taxable property at the time, within the municipal or territorial sub-division.

Id.

34. *See* Powe, Jr., *supra* note 31, at 739.

— sometimes justified by accusations of bribery or fraud.[35] Eric Monkkonen concluded that in late nineteenth-century Illinois, taxpayers "tried to avoid paying their debts if they thought they could get away with it,"[36] and that decisions to default were often "political, not fiscal,"[37] though he more generously argued that some defaulting localities were retaliating against railroad firms that failed to live up to their contractual obligations.[38]

Confronted with localities either unwilling or unable to pay their debts, states could either support creditors in their claims against their borrowers or assist the recalcitrant localities. One might have thought that states would take the former route to avoid any contagion that might otherwise flow from the reluctance of capital markets to extend credit to the state or its other political subdivisions. However, states — perhaps motivated by the New York's domination of capital markets[39] — frequently opted to enjoy short-term political benefits and intervened to frustrate creditors' remedies. As Dillon put it, "[o]ccasionally it has been witnessed that the state, in all its departments, has actively sympathized with the repudiating municipality, and the public faith has been redeemed only through the coercion of the Supreme Court of the United States."[40]

But one need not attribute purely strategic motives to states that desired to assist their localities at the expense of distant creditors. Localities had a reasonable expectation that technological advances were a condition of economic development, and that support of those technologies — canals, railroads, communication facilities — would attract commercial entities and generate tax revenues essential to economic success.[41] In the nineteenth century, no less than today, local governments sponsored technological development by facilitating the networks that generate agglomeration benefits.[42] They did so by doing

35. *See id.* at 740; *see also* SBRAGIA, *supra* note 30, at 58–60. For plausibly fraudulent practices by railroad promoters to secure the assent of municipalities to the issuance of bonds, see for example FAIRMAN, *supra* note 12, at 958–60; HILLHOUSE, *supra* note 30, at 152; MONKKONEN, *supra* note 12, at 76.

36. MONKKONEN, *supra* note 12, at 69.

37. *Id.* at 76.

38. *See id.*

39. *See* Allison R. Buccola & Vincent S.J. Buccola, *The Municipal Bond Cases Revisited*, 95 AM. BANKR. L.J. (forthcoming 2021) (manuscript at 11–12).

40. DILLON, *supra* note 33, at 6.

41. *See* SBRAGIA, *supra* note 30, at 44–47.

42. *See generally* OSCAR HANDLIN & MARY FLUG HANDLIN, COMMONWEALTH: A STUDY OF THE ROLE OF GOVERNMENT IN THE AMERICAN ECONOMY: MASSACHUSETTS, 1774–1861 (rev. ed. 1987).

what cities seeking economic growth have historically done: support or create the infrastructure necessary to allow the provision of those benefits, such as transportation terminals, or provide the amenities (police services, roads, sanitation) uniquely specific to urban life.[43] A city that failed to adopt novel technologies that would allow it to connect to other cities within a developing national economy was unlikely to grow or even to survive.[44] Notwithstanding the reservations that Dillon expressed, incurring debt was a rational mechanism to attract economic opportunities, since the necessary technologies were sufficiently capital intensive that government units could more readily provide the necessary infusions than nascent capital markets could.[45] Even in an era characterized by limited municipal authority, states granted their localities explicit permission to aid railroads, and municipalities, induced by over-optimism or perhaps a fear of being left behind in the race for metropolitan growth, unhesitatingly entered the competition.[46]

Once those capital investments were made, however, they created a risk that if the anticipated economic benefits failed to materialize, the outstanding debt would cause the debtor municipality to suffer economic and population shrinkage rather than expansion. Failure of large numbers of railroads was inevitable given the number of fledgling companies that sought to dominate the transportation of goods and people.[47] The intense competition among rivalrous cities to become major hubs of transportation and economic activity, however, also meant that railroad failures would cause municipal failures.[48] Those failures, in turn, required states to confront both political and economic pressures to shift the subsequent losses to creditors who had purchased the railroad aid bonds now in default.[49]

While the political incentives to favor residents over non-resident creditors are readily comprehensible, the economic incentives are more complicated. One might believe that states would resist the political pressure to shift losses to avoid the risk that capital markets would punish a defaulting jurisdiction within the state, and that the default of one municipality would tinge the credit of other jurisdictions

43. *See* PAUL BAIROCH, CITIES AND ECONOMIC DEVELOPMENT 151–52 (1988).

44. *See* SBRAGIA, *supra* note 30, at 44–50.

45. *See id.*

46. *See, e.g.*, DILLON, *supra* note 33, at 16; HILLHOUSE, *supra* note 30, at 153; Powe, Jr., *supra* note 31, at 739.

47. *See* FAIRMAN, *supra* note 12, at 934; HILLHOUSE, *supra* note 30, at 149–53.

48. *See* SBRAGIA, *supra* note 30, 58–60.

49. *See id.*

within the state. That economic reality applied regardless of whether defaulting municipalities claimed inability to pay or reluctance to pay predicated on fraud or failure of consideration. Bond purchasers had extended credit based on the promise to pay, and they expected payment.

But the states' motives to intervene may also have reflected recognition of the relationship between debt relief and municipal success. Municipalities attract tax base and investment by providing services that potential and actual residents value no less than the tax price they must pay to receive them.[50] In short, mobile residents and capital will migrate to municipalities that provide services from which residents and capital receive net benefits. That objective cannot be satisfied when there is significant debt overhang, that is, when substantial revenues of the municipality are dedicated to past services or to debt payments from which current payers receive no benefit.[51] Under those conditions, potential investors in a locality are likely to forgo investment, and mobile capital already situated within the municipality is likely to exit to jurisdictions more capable of providing benefits consistent with residents' financial burdens. The consequence of debt overhang is a downward spiral of the local economy as fewer fiscally capable taxpayers must support a continuing stream of debt payments leading to a cycle of additional disinvestment and exit.[52]

That result was exactly what nineteenth-century municipal debtors experienced — loss of population, political will to pay debts, and capacity to pay even those debts that the population recognized as legitimate.[53] State intervention to reduce debt burden by encouraging default and rescuing those localities that took that route, therefore, was not necessarily a political imperative born of a desire to externalize costs. It was equally an economic decision predicated on a desire to maintain economic growth in an era that preceded a federal bankruptcy regime that could facilitate the same result.

50. *See, e.g.*, Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 658–59 (2008). This result is implicit in the Tiebout hypothesis, which predicts that under a series of strong assumptions, in-migration and out-migration will generate an efficient level of municipal services. *See* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 65 J. POL. ECON. 416 (1956).

51. *See, e.g.*, Vincent Buccola, *The Logic and Limits of Municipal Bankruptcy Law*, 86 U. CHI. L. REV. 817, 845 (2019).

52. *See* Clayton P. Gillette, *How Cities Fail: Service Delivery Insolvency and Municipal Bankruptcy*, MICH. ST. L. REV. 1211, 1213–14 (2019).

53. *See* SBRAGIA, *supra* note 30, at 61.

The form of state intervention varied. There are well-told stories[54] of courts providing relief to indebted municipalities by invalidating bonds allegedly issued without sufficient legal authority or compliance with legal prerequisites,[55] or concluding that railroad aid constituted an impermissible private purpose.[56] My concern, however, involves a strategy other than questioning the validity of the bonds. Given the nature of the obligation that the defaulted bonds represented — general obligation bonds payable from the revenues and property of the debtor municipality — creditors' remedies against defaulting municipalities consisted primarily of efforts to seize municipal taxes or other municipal property. Sympathetic states diluted the value of that remedy by the rather direct device of altering the identity of the indebted municipality. This process consisted of measures such as redrawing the defaulting municipality's boundaries or, in more radical cases, abolishing it altogether, allegedly leaving creditors of the issuer without recourse remedy since the nominal debtor municipality no longer existed. I refer to these strategies collectively as involving "dissolution" of the indebted municipality.

Initially, the strategy of dissolution had some success in providing relief to distressed municipalities. In 1879, the Tennessee legislature repealed the charter of the City of Memphis.[57] The city had been in perilous financial condition, partially a consequence of yellow fever outbreaks, and partially a function of mismanagement and failure to collect 40% of levied taxes, some of which were required to pay bonds to support railroad construction and other infrastructure improvements.[58] When creditors brought actions for writs of mandamus to have outstanding taxes collected and paid to them, the state withdrew the city's taxing authority, assumed control of the city's property,[59] created a taxing district to administer taxes that were

54. *See e.g.*, FAIRMAN, *supra* note 12; HILLHOUSE, *supra* note 30; Powe, Jr., *supra* note 31; David Schleicher, *Hands On! Part I: The Trilemma Facing the Federal Government During State and Local Budget Crises* (Yale L. Sch., Pub. L. & Legal Theory Rsch. Paper Series, 2020), https://ssrn.com/abstract=3649278 [https://perma.cc/5DCC-R6KA].

55. *See* Clarke v. Town of Northampton, 120 F. 661, 662 (2d Cir. 1903); *see also* Winona & St. Peter R.R. v. Plainview, 143 U.S. 371, 393 (1892).

56. *See, e.g.*, People *ex rel.* Detroit & Howell R.R. Co. v. Twp. Bd. of Salem, 20 Mich. 452, 453 (1870); Stokes v. Cnty. of Scott, 10 Iowa 166, 171 (1859).

57. *See* Meriwether v. Garrett, 102 U.S. 472, 503–04 (1880) (Field, J., concurring).

58. *See id.* at 502–03.

59. The transferred property included "public buildings, squares, promenades, wharves, streets, alleys, parks, fire-engines, hose and carriages, engine-houses, engineer instruments, and all other property, real and personal, previously used for municipal purposes." *Id.* at 504.

imposed directly by the legislature on the geographic area previously defined as the city, and provided a procedure by which the Governor would appoint a receiver for the municipality to collect outstanding taxes and seek to compromise the outstanding debt.[60] The legislation also exempted taxes due or moneys of the county trustee from legal process, prohibited the issuance of any writ of mandamus or other processes from compelling the collection of taxes, and proscribed the use of taxes imposed by the state to pay debts of the dissolved municipalities.[61] In short, the legislature upended the traditional remedies used by municipal creditors to obtain and execute judgments against defaulting debtors. But the legislature also required that pre-dissolution taxes owed to the city be collected by the state-appointed receiver and dedicated to the payment of its debts, a tactic that Justice Stephen J. Field believed to be a demonstration that the legislature was not trying to exempt the city from its "just liabilities."[62]

Not surprisingly, creditors of Memphis initiated an action to collect on their debts and invalidate the state legislation. The federal court in that suit appointed its own receiver to take possession of the city's assets.[63] Thus, there were two competing receivers, one appointed by the Governor and one appointed by the court, each charged with overlapping duties of collecting property and dealing with Memphis creditors. That conflict generated the inevitable dispute that ended with the Supreme Court's complicated and ambiguous decision in *Meriwether v. Garrett*.[64]

The opinion for the Court consisted of a brief statement of the Court's conclusions, but was devoid of any rationale. Those conclusions simply addressed the issue of which assets were available to municipal creditors after the state's intervention; there was no explicit determination concerning the legitimacy of that intervention.[65] The Court defined the assets available to creditors restrictively. Creditors, the Court concluded, did not have access to physical property held in trust for the public or private property of individuals within the city's limits.[66] Nor could creditors reach taxes previously levied but not collected, unless the legislature explicitly so

60. *See id.* at 504–05.
61. *See id.* at 505.
62. *See id.* at 511.
63. *See id.* at 507–08.
64. *See id.* at 508.
65. *See id.* at 501–02 (opinion of the Court).
66. *See id.* at 501.

authorized.[67] The state-appointed receiver could, pursuant to statute, collect taxes that had been levied prior to dissolution, but those funds could only be used for the purposes for which they were raised.[68] The implication was that the legislation had effectively barred Memphis creditors from any recourse against taxes imposed through the state-created taxing district and not explicitly allocated to the payment of Memphis debts. That the taxing district now encompassed the population, geography, and economy of Memphis was legally irrelevant.

In an opinion joined by three other Justices, Justice Field provided his reasoning behind the Court's otherwise unembellished conclusions. Perhaps most importantly, Justice Field concluded that municipal property that had been available to pay debts prior to dissolution would remain available to creditors after dissolution.[69] But taxes previously levied, though uncollected at the time of dissolution, did not qualify as such property. Uncollected taxes imposed for the support of government — "ordinary taxes" — were not property of the municipality that could be seized for debts.[70] "They are only the means provided for obtaining funds to support its government and pay its debts, and disappear as such means with the revocation of the charter, except as the legislature may otherwise provide."[71] Hence, the lower court could not have ordered its receiver to collect them. While mandamus might lie to compel an officer of the municipality to collect outstanding debts, once the office of collection was abolished, "there is nothing upon which the courts can act."[72] Only the legislature could levy taxes and hence prescribe the means by which they are collected.[73] Courts, certainly federal courts, might have been able to compel the collection of currently authorized taxes. But they had no authority to continue taxing powers that had been removed by the legislature or create new taxing authority.[74] Creditors could seize the anomalously designated "private property" of the municipality or proceed by mandamus to require the state-appointed receiver to collect such taxes as the state permitted.[75] Beyond that, unpaid creditors could only

67. *See id.*
68. *See id.* at 501–02.
69. *See id.* at 512 (Field, J., concurring).
70. *See id.* at 514.
71. *Id.*
72. *Id.* at 515.
73. *See id.*
74. *See id.*
75. *See id.* at 514–15.

supplicate to the legislature, [76] which had, of course, already demonstrated a lack of sympathy for their plight.

Although the majority of the Court did not directly address whether dissolution of the debtor municipality without providing for payment of its debts unconstitutionally impaired the obligation of contract, Justice Field's concurrence implied that repeal of a tax "so connected with a contract, as the inducement for its execution" would constitute such a violation.[77] But the debts at issue in *Meriwether* did not involve any specific taxes designated for payment to bondholders. They were secured solely by "ordinary taxes authorized for the support of government" that constituted "only the means provided for obtaining funds to support its government and pay its debts."[78] The power to collect those taxes and use the proceeds to pay debts dissolved when the municipality did, unless the legislature provided otherwise.[79] The negative implication of that statement was that the dissolution of Memphis did not impair an obligation of contract because no commitment of particular taxes had formed part of the contract with bondholders. Certainly, in Justice Field's view, federal courts had limited capacity to interfere with state procedures that restrained the collection of debts or to designate as property of the municipality those assets that the legislature had excluded.

Justice Field further concluded that those who enter into contracts with municipalities do so with full knowledge that the legislature can alter them or their powers.[80] That remark, standing as a statement of the relationship between states and their political subdivisions, seems uncontroversial. But if Justice Field meant that knowledge of state authority over its political subdivisions deprived creditors of all remedies if the state withdrew municipal assets subsequent to the time credit was extended, his conclusion would deprive the Contracts Clause of all meaning. A valid law in effect at the time that bonds are issued certainly becomes incorporated into the bond contract. Thus, if state law validly permitted subsequent modifications of the contract, state imposition of such a modification would not create an impairment.[81] The state's ability subsequently to modify the contract was part of the original bargain. But to transform that proposition into one that embodies a general legislative power unilaterally to impose

76. *See id.* at 515.
77. *Id.* at 514.
78. *Id.*
79. *See id.* at 514–15.
80. *See id.* at 511.
81. *See e.g.*, Ogden v. Saunders, 25 U.S. (12 Wheat.) 213 (1827).

any post-issuance modification of municipal revenue raising authority would eliminate any vestige of the capacity of one legislature to bind another. Perhaps that explains Justice William Strong's dissenting remark that "[i]f ever legislation impaired the obligation of contracts, this did."[82]

The Court's failure to address the issue of impairment directly caused at least some to conclude that dissolution combined with deprivation of all taxing power to pay outstanding debts was constitutionally permissible. Indeed, John Dillon, probably the major authority on municipal finance at the time, interpreted *Meriwether* that way and concluded that if the state dissolved a debtor municipality and failed either to provide for the payment of its debts or to create a successor with taxing authority payable for debt service, then the courts are "practically powerless" to provide creditors with a remedy.[83]

Other states avoided the receivership route but attempted to deprive creditors of municipal assets by merging the indebted locality into other entities that claimed no responsibility for the debts of the pre-merger municipalities. That strategy proved less successful in the federal courts. For example, the town of Racine, Wisconsin, fell victim to the railroad bond craze and subscribed for $50,000 worth of railroad stock in 1853.[84] The city paid for the stock with the proceeds of bonds issued with a 20-year term.[85] With what can only be described as perfect foresight or perfect irony, the state legislature in 1860 renamed Racine as Orwell.[86] The legislature subsequently dissolved the town and annexed its property in parts to other existing towns.[87] Those towns maintained that, since Orwell had disappeared, they had no authority to impose taxes necessary to pay its debts.[88]

One might have thought that disestablishment of a town was the ultimate means of denying creditors access to its taxing authority or property, so that reallocation of Orwell's assets to other towns fell within the doctrines established by *Meriwether*. But the Supreme Court had a different response than it did in the Memphis case. In *Town of Mt. Pleasant v. Beckwith*, the Court concluded that,

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82. *Meriwether*, 102 U.S. at 532 (Strong, J., dissenting).

83. *See* Richard W. Flournoy, Jr., *The Rights of Creditors of a Municipal Corporation When the State Has Passed a Law to Abolish or Alter It*, 12 VA. L. REG. 175, 181–82 (1906).

84. *See* Town of Mt. Pleasant v. Beckwith, 100 U.S. 514, 520 (1879).

85. *See id.* at 514–15.

86. *See id.* at 515.

87. *See id.*

88. *See id.* at 523–24.

> if the extinguished municipality owes outstanding debts, it will be presumed in every such case that the legislature intended that the liabilities as well as the rights of property of the corporation which thereby ceases to exist shall accompany the territory and property into the jurisdiction to which the territory is annexed.[89]

The legislature's failure to make a provision for the payment of debts of the extinguished municipality necessarily impaired the obligation of contract.[90] That proposition, however, would seem, as a logical matter, to apply as readily to the Tennessee law that transformed Memphis into a taxing district as it did to the carving up of Orwell.

Some states simply extinguished municipalities and replaced them with new municipalities. The poster child for this strategy was the Alabama legislature.[91] In 1859, the legislature authorized the City of Mobile to issue bonds to finance the Mobile & Great Northern Railroad Company.[92] The city defaulted on the bonds in 1878, and bondholders sought a writ of mandamus for collection of taxes sufficient to pay the debt.[93] The Alabama legislature cagily responded with a law that abolished the City of Mobile and ordered its property to be sold to pay the debts of the dissolved city.[94] That response was not, however, necessarily an effort to ensure the availability of sufficient assets to satisfy bondholders in full, or even to pay its "just liabilities" to the extent possible. Instead, as in the case of the Tennessee legislation contested in *Meriwether* and as was common in other efforts to resolve default litigation,[95] the ostensible intent of the Alabama legislature was to force creditors to compromise the municipality's debts. The law that required the sale of city property provided for the appointment of commissioners to sell the municipal property and "to treat with the holders of the funded debt of the city of Mobile with a view to its adjustment and settlement."[96] But the law also prohibited the commissioners from imposing new taxes to pay the delinquency that would inevitably arise, given the limited assets available for sale and the priority that other debts had over the railroad bonds.[97] The legislature then incorporated a new municipality,

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89. *Id.* at 529.
90. *See id.* at 530.
91. *See* Port of Mobile v. Watson, 116 U.S. 289 (1886).
92. *See id.* at 290.
93. *See id.* at 292–93.
94. *See id.* at 290–91.
95. *See* HILLHOUSE, *supra* note 30, at 182–87.
96. *Port of Mobile*, 116 U.S. at 293.
97. *See id.* at 293, 299.

designated as Port of Mobile, that comprised about 94% of the taxable property and about 93% of the residents of the former City of Mobile.[98] The omitted property consisted "largely of fields, swamps and land covered with water."[99] But the incorporating legislation essentially prohibited those who governed the Port from levying any taxes to pay the former city's debts.

The Supreme Court saw right through the ruse. The Court concluded that, as in the case of merged municipalities, the Port of Mobile was the legal successor to the City of Mobile and hence liable for its debts:

> Where the resource for the payment of the bonds of a municipal corporation is the power of taxation existing when the bonds were issued, any law which withdraws or limits the taxing power and leaves no adequate means for the payment of the bonds is forbidden by the Constitution of the United States, and is null and void.[100]

While the Court did not invoke the Contracts Clause by name, and some have therefore concluded that the Court never explained the legal basis for its decision,[101] it seems clear that Court had the Contracts Clause in its sights. The rationale it provided for the decision is textbook Contracts Clause jurisprudence: "[T]he remedies for the enforcement of such obligations assumed by a municipal corporation, which existed when the contract was made, must be left unimpaired by the legislature, or, if they are changed, a substantial equivalent must be provided."[102] What may have been implicit, though unspoken, in the Court's decision was a rejection of the drastic nature of the state's action. There was little doubt that the city suffered distress sufficient to warrant "adjustment and settlement" of Mobile's debt.[103] But perhaps the Court was suspicious that the best way to force an equitable compromise was to disestablish the city and purport to revive it without any consideration to creditors' claims for repayment.

Other courts were similarly less attentive to the niceties of existing Contracts Clause doctrine to constrain states that had transparently

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98. *See id.* at 291. The Alabama legislature appears to have had a penchant for dissolving a city and then reincorporating it under a similar name. *See e.g.*, Amy & Co. v. Selma, 77 Ala. 103 (1884).

99. *Port of Mobile*, 116 U.S. at 304.

100. *Id.* at 305.

101. *See* Aurelia Chaudhury, Adam J. Levitin & David Schleicher, *Junk Cities: Resolving Insolvency Crises in Overlapping Municipalities*, 107 CALIF. L. REV. 459, 525 n.271 (2019).

102. *Port of Mobile*, 116 U.S. at 305.

103. *See id.* at 293.

denied creditors access to property that initially served as security for their debts. After the failure of Jay Cooke & Company, the largest employer in the City of Duluth, the city's population declined from 5,000 to 1,500 within a year, and tax delinquencies increased significantly.[104] With the city deeply in debt and little means of satisfying bondholders, the legislature adopted the strategy from the Alabama playbook. The Minnesota legislature carved the Village of Duluth out of the City of Duluth, included within the village virtually all of the population and taxable property of the city, denied the city's ability either to have access to taxes raised by the village or to create a means of allowing bondholders suits against the city, but permitted city bondholders to exchange their bonds for village bonds in an amount of one-fourth of the surrendered city bonds.[105] In an opinion that overruled the city and village's demurrer to the complaint, the court concluded that the facts admitted by the defendants permitted creditors to follow the assets of the city into the village.[106] The legislature was entitled to create the village out of the territory of the city and to apportion the existing indebtedness between them; it was not entitled to extract population and taxable property in a manner that denied existing creditors of any reasonable capacity to obtain payment of the debt.[107]

> The obligations of a municipal corporation are not affected, although the name may be changed and the territory increased or diminished, if the new organization embraces substantially the same territory and the same inhabitants. It may be true that generally creditors, to obtain relief, must look exclusively to the corporation creating the debt; but when a state of facts exists as disclosed here, and the old corporation is diminished in population, wealth, and territory to the extent admitted, it would be a mockery of justice to withhold the relief asked.[108]

Not only did the court fail to invoke the language of the Contracts Clause, but also it explicitly deferred the issue of whether the statute impaired the obligation of contracts. Instead, it relied on equitable principles to require the defendants at least to answer the plaintiff's claim for recovery on his bonds.[109]

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104. *See* MONKKONEN, *supra* note 12, at 24.
105. *See* Brewis v. City of Duluth, 9 F. 747, 748–49 (D. Minn. 1881).
106. *See id.*
107. *See id.*
108. *Id.* at 749.
109. *See id.*

Other dissolution strategies to limit creditor recoveries left existing boundaries intact but reduced municipal revenue-raising capacity below what prior bondholders would have anticipated at the time they extended credit. These cases provide precursors to contemporary cases of asset shifting. Where municipal revenues are insufficient to pay both creditors and providers of current services, municipal residents presumably would prefer to have their tax payments dedicated to the latter since the benefits to be realized from the former have already been received. If payments for current services have priority, municipal residents might wish to restrict municipalities' capacity to generate revenues sufficient to pay debts. States facilitated such strategies by withdrawing taxing power from indebted localities, perhaps leaving enough resources to fund essential services while denying payments to creditors. The City of Quincy, Illinois, for example, received legislative approval to purchase railroad stock, pay for the purchase through bond issuance, and impose a special tax sufficient to pay interest on the bonds.[110] Quincy failed to impose the special tax or to pay debt service.[111] But in refusing to pay bondholders, the city also relied on a tax limitation that the legislature enacted subsequent to issuance of the bonds.[112] The city contended that tax revenues within that limit would be insufficient to pay both the expenses of the city and a judgment on the defaulted bonds.[113] Here, too, the Supreme Court intervened to protect creditors by invalidating post-issuance state reductions of local assets — here, taxing capacity — to pay debts. In *Von Hoffman v. City of Quincy*, the Court concluded that the original statute that authorized issuance of the bonds and provided payment through the special tax constituted a contract with bondholders.[114] Subsequent repeal of that taxing authority sufficiently impaired the obligation of that contract as to be "a nullity."[115]

One might have thought that the existence of the special tax in *Von Hoffman* would serve as a sufficient basis for distinguishing the case from *Meriwether* in evaluating state reductions of municipal assets. After all, Justice Field had drawn a distinction between special taxes and ordinary taxes when he found that creditors had no right to the latter in the Memphis case.[116] But that was not the route the Court

110. *See* Von Hoffman v. City of Quincy, 71 U.S. 535, 535–36 (1866).
111. *See id.* at 536.
112. *See id.* at 536–37.
113. *See id.* at 536.
114. *See id.* at 538.
115. *See id.* at 555.
116. *See supra* notes 69–80 and accompanying text.

adopted in *Von Hoffman* or thereafter. *Wolff v. City of New Orleans*[117] also involved the effects of a post-issuance tax limitation. New Orleans had issued railroad aid bonds but imposed no special tax to pay them.[118] After default, the city contended that it held no unappropriated funds that could be used for the bonds and that a statute limiting the amount of taxes that could be imposed prohibited taxation sufficient to pay the outstanding debt.[119] As in *Von Hoffman*, the assumption in *Wolff* appears to have been that funds appropriated to provide essential municipal services took priority over bondholder claims.[120] A strict reading of *Meriwether* might suggest that the court could impose no remedy because the legislature had defined the scope of taxation, and federal courts could not exceed it. A strict reading of *Von Hoffman* might suggest that post-issuance, state-imposed constraints on taxation were not valid against bondholders who anticipated use of the taxing power to pay debt service. But Justice Field chose not to choose among precedents. Instead, he distinguished the cases. For him, the decision in *Meriwether* was justified by the absence of any municipal incorporation that could impose the taxes necessary to pay bondholders:

> The city with all her officers having thus gone out of existence, there was no organization left — no machinery — upon which the courts could act by *mandamus* for the enforcement of her obligations to creditors. The question considered, therefore, was whether the taxes levied before the repeal of the charter, but not paid, were assets which the court could collect through a receiver and apply upon judgments against the city.[121]

The Louisiana legislature, however, had left the New Orleans government intact. Hence, the Court could require the assessment and collection of taxes by the very officers who had created the obligations on which the bondholders had received a judgment.[122] In an expansive reading of *Von Hoffman* that made the existence of a special tax irrelevant, Justice Field interpreted that case as broadly invalidating limits on the taxing power that the city had possessed when the contested bonds were issued.[123]

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117. 103 U.S. 358, 360 (1880).
118. *See id.*
119. *See id.* at 361.
120. *See id.* at 359.
121. *Id.* at 368.
122. *See id.* at 368–69.
123. *See id.* at 369.

That seems like a little too much hair splitting. Certainly, from the creditors' perspective, whether the debtor municipality was merged into another municipality as in *Town of Mt. Pleasant* or the municipality retained its identity but had limited taxing authority as in *Wolff*, or municipal functions were placed under the jurisdiction of a different entity such as the state receiver in *Meriwether*, seems irrelevant to the availability of pledged taxes.[124] Justice John Marshall Harlan perhaps agreed. His concurrence with the majority opinion in *Wolff* made clear his dissatisfaction with Justice Field's discussion of *Meriwether*: "Nor do I wish to be understood as assenting to the correctness of the statement in the opinion as to what was involved and decided in *Meriwether v. Garrett*."[125]

The Court's broad reading of *Von Hoffman* in *Wolff* also appears problematic. Read as a prohibition of post-issuance tax reductions without regard to the consequences for debt satisfaction, the holding in *Wolff* would bar virtually any municipal or state restructuring of city taxing arrangments in place at the time bonds were issued — reformation of property taxes to equalize spending among school districts, granting property tax relief to lower-income property owners, tax abatements to attract residents and tax base, etc. — because all such efforts arguably "render[] less efficacious" the means of enforcing bonds by reducing assets available to creditors.[126] Such an absolutist view of the Contracts Clause may not survive post-*Blaisdell* jurisprudence. But that does not mean that pre-*Blaisdell* cases are irrelevant. Instead it requires a more careful distillation of what motivated the strong holdings in those cases to see whether similar circumstances characterize the more contemporary efforts to divert municipal assets. Unless those circumstances are distinguishable, the similar effects of current municipal asset diversion may generate similar legal results, even if the test for state intervention has become less absolute. I next turn to those issues.

B. Holdouts or Holdups? Motive and Dissolution

The doctrinal distinctions and inconsistencies in these cases suggest that something more complicated than variations on state strategies for withdrawing municipal assets from creditors' reach was at stake. Perhaps the Court was attempting to work out an appropriate balance between creditor rights and the need to grant states some latitude in

124. *See* Flournoy, Jr., *supra* note 83, at 189.
125. *Wolff*, 103 U.S. at 369 (Harlan, J., concurring).
126. *See id.* at 367 (majority opinion).

allowing their localities to escape fiscal distress. That balance could change over time or from case to case, depending, perhaps, on what the courts viewed as the underlying motivation for the legislative diversion of municipal assets. Perhaps the Court was attempting to distinguish between cases in which solvent municipalities were exhibiting a reluctance to pay and cases in which payment was either impossible[127] or, given the fraudulent underpinnings of the contested debt, inequitable.[128] Perhaps the Court, after demonstrating initial compassion for municipalities that received nothing in return for incurring crushing obligations, ultimately decided that permitting states too much latitude to alter creditors' bargains would restrict credit markets at a time when infrastructure finance depended on municipal access to capital. Even in *Meriwether*, Justice Field decried repudiation of debts. In suggesting that creditors could find a sympathetic voice in state legislatures that might yet authorize tax collections that federal judges could not, Justice Field reminded all listeners:

> It is certainly of the highest importance to the people of every State that it should make provision, not merely for the payment of its own indebtedness, but for the payment of the indebtedness of its different municipalities. Hesitation to do this is weakness; refusal to do it is dishonor. Infidelity to engagements causes loss of character to the individual; it entails reproach upon the State.[129]

Others have similarly suggested that in the several hundred decisions concerning municipal bonds in the late nineteenth century, federal courts generally, and the Supreme Court in particular, were motivated largely by a desire to serve the interests of capital.[130] That instrumental thesis may be less compelling than it appears from consideration of the consequences of the decisions, which certainly would have buoyed capital markets. Allison Buccola and Vincent Buccola have recently demonstrated that the Supreme Court decisions were more law-bound than the pro-capital thesis can bear, and that courts frequently decided at least those cases involving the validity of the bonds in a manner that reflected optimal risk allocation rather than

127. *See, e.g.*, HILLHOUSE, *supra* note 30, at 155, 175 (describing the relationship between antipathy towards payments and inability to pay).

128. For accounts of bonds, the proceeds of which were not properly spent, see *id.* at 152, 184. *See also* MONKKONEN, *supra* note 12.

129. Meriwether v. Garrett, 102 U.S. 472, 520 (1880) (Field, J., concurring).

130. *See* FAIRMAN, *supra* note 12; HILLHOUSE, *supra* note 30; Buccola & Buccola, *supra* note 39 (manuscript at 5–6).

blind subservience to the interests of capital.[131] The validity cases, however, were not the only ones that involved the allocation of risk. The dissolution cases similarly addressed allocation of the risk that the project to be funded with bond proceeds — typically railroads — would prove as commercially rewarding as anticipated.[132] Where that did not happen, either because the railroad did not get constructed at all or because it ultimately failed, debtor municipalities that sought to escape payments essentially argued that bondholders, not they, bore the risk of project failure. Municipalities did not necessarily claim that they had no assets to pay bondholders; rather, as cases like *Von Hoffman* and *Wolff* indicate, it was common for municipalities to claim that municipal assets must first be used to maintain municipal services and that bondholders had to bear the risk of project failure if insufficient funds remained to pay debts.[133] State intervention that reduced municipal assets and thus contributed to the shortfall was simply consistent with the understood risk allocation. For creditors, of course, that same intervention was simply strategic offloading of a risk that bondholders had paid to impose on the municipality.

But a close reading of the dissolution cases reveals an alternative or different motivation that complicates the issue of whether states were benignly attempting to rescue distressed localities or malignly attempting to exploit investors. The dissolving state legislation at stake in some of the cases recited that funds could be used to compromise debts and sometimes even to set the reservation price in any negotiation. Recall, for example, the legislative requirement in the City of Mobile dissolution that required the city "to treat with the holders of the funded debt of the city of Mobile with a view to its adjustment and settlement."[134] Similarly, the Tennessee legislation challenged in *Meriwether* created a commission "to settle and compromise the indebtedness of said municipal corporation, by funding the same, at a rate not exceeding fifty-five cents in the dollar on judgments, and not exceeding fifty cents in the dollar for bonds or coupons past due."[135]

In effect, in an era without a federal municipal bankruptcy law, legislative proposals of a "final offer" may have been the functional equivalent of the current requirement that a municipality negotiate in

131. *See* Buccola & Buccola, *supra* note 39.

132. *See supra* Section II.A.

133. *See e.g.*, Wolff v. City of New Orleans, 103 U.S. 358 (1880); Von Hoffman v. City of Quincy, 71 U.S. 535 (1866).

134. Port of Mobile v. Watson, 116 U.S. 289, 293 (1886).

135. Meriwether v. Garrett, 102 U.S. 472, 475 (1880).

good faith with creditors as a prerequisite to entering Chapter 9.[136] What is less clear is whether these efforts at settlement were, in fact, motivated by good faith and by actual constraints on the debtor's ability to pay, or whether they reflected a strategic desire to drive creditors to the bargaining table and to impose a settlement that required a lesser contribution from the debtor than might be required by a "good faith" standard. As Albert Miller Hillhouse recounted, "[m]uch of the resistance and defensive litigation on the part of the debtor localities was designed solely to wear out the creditors and drive them eventually, in desperation, to a compromise favorable to the repudiators."[137] Notwithstanding expressions of sympathy for residents faced with devastating financial burdens incurred for projects that never reached their potential, Monkkonen concluded, "taxpayers in the late nineteenth century tried to avoid paying their debts if they thought they could get away with it."[138]

These sentiments suggest a degree of creditor powerlessness that seems inconsistent with the traditional understanding of municipal creditors. In the absence of federal bankruptcy proceedings to overcome the Contracts Clause's constraints, the general problem for compromising municipal debts had historically been the presence of holdout creditors.[139] Constitutional restrictions on the state's ability to impair contracts meant that only consensual compositions of municipal indebtedness were permissible — a problem that Congress much later identified as the basis for ultimately enacting a federal municipal bankruptcy law.[140] Until that time, the unanimity requirement for creditor consent to debt adjustment permitted a small number of holdouts to condemn any plan to rescue municipalities from debt overhang by reducing the amount of indebtedness. The states' withdrawal of previously available assets from creditors' reach can be seen as a relatively benign response to the holdout threat. But once armed with that capacity, states could use the withdrawal threat strategically, even against creditors who were not engaged in holdout tactics. Since dissolution threatened to leave creditors with no recovery at all, their next best alternative was to accept any positive recovery promised by the state, even if the locality could have afforded

136. *See* 11 U.S.C. § 109(c)(5)(B).

137. HILLHOUSE, *supra* note 30, at 172.

138. MONKKONEN, *supra* note 12, at 69.

139. *See* Gillette & Skeel, Jr., *supra* note 26, at 1167–68; *see also* Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 353–55 (2010).

140. *See* Gillette & Skeel, Jr., *supra* note 26, at 1167–68.

a greater payout than the state was offering.[141] In effect, the state's option to withdraw assets from the municipality's sources for debt payments allowed it to transform the holdout game controlled by creditors to one of holdup controlled by the state.[142] Under current bankruptcy law, such failure to make a substantial contribution to debt adjustment would likely preclude a municipality from satisfying the requirement of confirmation a proposed plan be "in the best interests of creditors."[143] For example, in *Fano v. Newport Heights Irrigation District*, the court rejected a plan of adjustment that did not impose tax-rate increases on district residents, given the absence of a showing that the district had inadequate taxing power.[144] The court concluded that the failure to impose such increases illicitly placed the entire burden of adjustment on bondholders.[145] The similar lengths to which the state was willing to play its advantage is evident in the Louisiana legislation that led to the decision in *Wolff.*[146] The Louisiana legislature did not simply impose a tax limitation that made payment of the bonds implausible, given the assumed priority of using taxes to pay the "necessary expenses of the city."[147] It also provided an alternative for bondholders that the city contended created a sufficient substitute to avoid any claim of impairment. Creditors could exchange their bonds for "premium bonds."[148] Notwithstanding the euphemism, the premium bonds bore no maturity date.[149] Instead, those bonds were divided into 10,000 series of 100 bonds each, and the time of payment of each bond within a series was determined by an annual lottery drawing of the relevant series, followed by a drawing of bonds within that series to be paid in that year.[150] As summarized by the Court in *Wolff*,

> under this arrangement, whether a creditor will be paid in one or in fifty years, will depend upon the turn of a wheel and the drawing of a lucky number. Of course this plan disregards all the terms upon which the outstanding bonds of the city — and, among others, those held by

141. *See* HILLHOUSE, *supra* note 30, at 172.
142. *See* SBRAGIA, *supra* note 30, at 60.
143. *See* 11 U.S.C. § 943(b)(7).
144. *See* Fano v. Newport Heights Irrigation Dist., 114 F.2d 563, 565–66 (9th Cir. 1940).
145. *See id.*
146. *See* Wolff v. City of New Orleans, 103 U.S. 358, 358 (1880).
147. *See id.* at 363.
148. *See id.*
149. *See id.*
150. *See id.*

> the relator — were issued, and postpones indefinitely the payment of both their principal and interest.[151]

It was against this background that the Court concluded that, although the state legislature retained the discretion "at any time [to] restrict or revoke at its pleasure any of the powers of a municipal corporation, including, among others, that of taxation,"[152] that power "must be exercised in subordination to the principle which secures the inviolability of contracts."[153] But, again, it is plausible that abstract notions of inviolability were less important to the decision than was judicial suspicion of state overreaching. The Court did not engage in any rigorous analysis of what would have constituted a balanced allocation of losses between residents and creditors. Nor did it believe it had to. The Court's ridicule of the state's proposed procedure implied that — as in cases where cities had been dissolved — the state had instituted a mechanism that so drastically disfavored creditors relative to residents as to render its impropriety obvious. A more balanced distribution of losses might have generated a different result.

Whether the state was acting malignly or benignly in the dissolution cases was further complicated by the fact that not all residents within an indebted municipality had the same motives. Hillhouse and Monkkonen suggested that small property owners and rural residents were prone to favor default, while those who had tied their fortunes to city growth wanted to preserve municipal credit and "favored debt payment when feasible and renegotiation when not."[154] But the difficulty in discerning whether it was the state or the creditors who were acting strategically did not necessarily mean that the inquiry was irrelevant. Benign, and thereby permissible, interventions may have been the appropriate conclusion where the court believed the state was attempting to maintain municipal functions and pay its "just liabilities" to the extent possible; a malign intervention constituting an invalid impairment may have been the appropriate conclusion where the court believed the state was attempting to hold up creditors in favor of a recalcitrant but not necessarily impoverished municipality.

More explicit recognition that state intervention placing a disproportionate cost of adjustment on creditors would affect its legality would have to wait until the next period of municipal fiscal distress. The turning point in the analysis occurred in the post-

151. *Id.* at 364.
152. *Id.* at 365.
153. *Id.* at 366.
154. MONKKONEN, *supra* note 12, at 89.

Depression case of *Faitoute Iron & Steel Co. v. City of Asbury Park*[155] referenced at the beginning of this Article. *Faitoute* was not a dissolution case nor one in which the state withdrew assets from the indebted municipality. Instead, it involved a plan for the adjustment or composition of creditors' claims under what was essentially a state bankruptcy act.[156] But Justice Frankfurter's opinion set forth some principles by which the propriety and validity of states stripping assets from municipalities can be evaluated. The New Jersey act allowed a state commission, with the approval of the state supreme court, to adjust the debts of a distressed municipality with the approval of creditors representing 85% of the contested indebtedness if approval of the plan was preceded by findings, among other things, that the municipality could not afford both to pay the debt and to perform its public functions.[157] The proposed plan extended the time for payment of outstanding bonds and reduced the interest rate in the interim but did not compromise the principal amount. Justice Frankfurter seized on the independent nature of the inquiry into affordability and the absence of an alternative that would allow creditors a greater recovery to conclude that the state act did not operate as an impairment.[158] Indeed, he appeared to read a "changed circumstances" exception into the Contracts Clause, under which the intervention of extreme circumstances entitled the state to take action that would preserve municipal functions and taxation but also ensure ultimate payment of creditors.[159] Perhaps most importantly, Justice Frankfurter concluded that the New Jersey scheme reached a balance that was not exploitative of creditors because the compromise passed a market test of impairment; bonds that were selling at 0.69 on the dollar at the time when the legislation was passed were trading at 0.90 on the dollar at the time of the Court's decision.[160]

Justice Frankfurter's criteria for permitting state intervention has conflicting consequences for the dissolution cases. Certainly, he was attentive to the holdout problem that, unaddressed, would leave distressed municipalities at the mercy of creditors, and that arguably

155. 316 U.S. 502 (1942).

156. *See Faitoute*, 316 U.S. at 504.

157. *See* 1933 N.J. Laws 867; *see also* 1931 N.J. Laws 835 (detailing the purpose of statute as dealing with "public emergency").

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

159. *See id.* at 511 ("The necessity compelled by unexpected financial conditions to modify an original arrangement for discharging a city's debt is implied in every such obligation for the very reason that thereby the obligation is discharged, not impaired.").

160. *See id.* at 513.

required some credible threat that failure to compromise would disadvantage creditors.[161] But Justice Frankfurter's analysis suggested that states would not be given free rein to hold up creditors. Instead, some balance between state and creditor interests was the predicate for approving state intervention. His emphasis on the independent evaluation of municipal capacity to pay, on the maintenance of the initial principal amount (notwithstanding the extension of time for payment), on the practicality of an alternative remedy, and on the need to consider the best interests of creditors seems directed at the holdup problem with which states confronted creditors in the nineteenth century.[162] All those factors suggest that the dissolution cases that invalidated the withdrawal of municipal assets were a reaction to a perceived desire by the state and municipality to repudiate debts rather than to balance municipal fiscal need against creditor expectations. In those cases, little in the allegedly impairing legislation provided assurances that debtor municipalities would pay what they could afford while simultaneously performing essential municipal functions.

At the same time, Justice Frankfurter's suggestion that market valuations at the time of litigation could determine the propriety of state intervention raises greater difficulty for the dissolution cases and for evaluating state withdrawal of assets generally. The difficulty arises from the temporal gap between when the allegedly impairing legislation is litigated and when its effects are realized. Bonds, of course, are issued for significant periods of time. In *Faitoute*, the maturity of bonds that fell into default in payment of interest in 1935 was extended to 1966.[163] The original maturity date of the defaulted bonds is not clear from the report of the case, but, given the bonds were issued in 1929 and 1930,[164] it is reasonable to assume that the original maturity dates were significantly earlier than the extended period. As a result, bondholders who were initially willing to take the risk of municipal solvency for a limited period of time were required to take that risk for a longer period, and the fact that the plan of adjustment reduced the nominal interest rate on the new bonds indicates that creditors were not paid to take that longer-term risk. A conclusion that the New Jersey legislation did not cause an impairment under those circumstances because market values of the outstanding bonds had not

161. *See id.* at 510 ("A policy of every man for himself is destructive of the potential resources upon which rests the taxing power which in actual fact constitutes the security for unsecured obligations outstanding against a city.").

162. *See id.* at 504.

163. *See id.* at 507.

164. *See id.*

declined makes assumptions about the relevant credit markets that are not easily sustained. Even if the issuer's financial condition in the period shortly after state intervention improved sufficiently to generate an increase in the bonds' value at that time, there would be no reason to conclude that those favorable financial conditions would continue throughout the extended period during which the bonds would be outstanding. Stripping municipal revenues once available to creditors may be superfluous at the time the withdrawal occurs because sufficient revenues from alternative sources remain available to pay all debt service. But it is plausible that subsequent decline in the debtor's financial position would mean that those same stripped assets become necessary to pay debt service prior to or at maturity. Unless one believes that current market prices of municipal securities perfectly capitalize the risk of all future events, then neither changes nor stability in market prices will correctly gauge the effects of a current alteration of municipal revenue-raising capacity on a future ability to pay. The likelihood of full capitalization in municipal bond markets seems remote, and even lower than in other securities markets, due to relatively thin trading in municipal bonds and relatively low-price transparency.[165]

The concern that financial conditions could worsen subsequent to the withdrawal of assets may be less relevant to the dissolution cases, and perhaps even to *Faitoute*. In those cases, default had already occurred, so it is difficult to imagine that the issuers' financial conditions could worsen post-withdrawal. In addition, in the dissolution cases, the withdrawn assets previously available to creditors were so substantial a part of what had previously been pledged to support the debt that there was little chance that remaining assets could satisfy creditors' claims in full or were proportionate to the sacrifices being made by residents.[166] In short, those were not cases in which there was simply a hypothetical differential between the sufficiency of the original assets and the post-intervention assets to satisfy bondholders or that residents had contributed in good faith to settlement. Thus, the true test of whether a current withdrawal of assets might be improper because of effects in the distant future would

165. *See, e.g.*, Lawrence E. Harris & Michael S. Piwowar, *Secondary Trading Costs in the Municipal Bond Market*, 61 J. FINANCE 1361, 1364 (2006).

166. *See, e.g.*, Port of Mobile v. Watson, 116 U.S. 289 (1886); Meriwether v. Garrett, 102 U.S. 472 (1880); Wolff v. City of New Orleans, 103 U.S. 358 (1880); Town of Mt. Pleasant v. Beckwith, 100 U.S. 514 (1879); Von Hoffman v. City of Quincy, 71 U.S. 535 (1866); Brewis v. City of Duluth, 9 F. 747 (D. Minn. 1881).

have to await situations in which current withdrawal of assets posed more conjectural adverse future effects.

III. DIVERSION OF ASSETS TO NEW CREDITORS

A. Asset Stripping Through Bankruptcy Remote Entities

More recent efforts to withdraw assets from an indebted municipality raise the temporal issue more acutely. In this Section, I discuss how states have engaged in asset stripping through a form that does not simply eliminate a source of revenues previously available to creditors as in the dissolution cases. Rather, state intervention has taken the form of diverting assets previously available to satisfy one set of creditors and making those assets available exclusively to a different set of creditors. In at least some of these cases, the objective of the diversion was to obtain a new capital infusion to the municipality. Post-issuance diversion of assets might initially have insignificant adverse effects on the municipality's capacity to pay its debts. But that same action could, during the period when the debt is outstanding, significantly reduce the security available to the first group of creditors.

This contemporary form of asset stripping evolved from New York City's fiscal crisis in the early to mid-1970s. When the city faced fiscal paralysis, it was precluded from borrowing in the capital markets by a combination of balanced budget requirements, lack of access to capital markets, [167] and state constitutional requirements that permitted issuance of general obligation debt only if secured by the city's faith and credit.[168] While the state legislature was sympathetic to the city's distress and recognized that the city's bankruptcy would have ripple effects across the state,[169] the legislature was not of a mind to dissolve the city or shift municipal boundaries in a manner that would dispossess creditors of the right to realize on taxes of the city. But the legislature did the next best thing, perhaps the functional equivalent from the perspective of pre-existing creditors. The state legislature created the Municipal Assistance Corporation for the City of New York (MAC) as an entity of New York State.[170] The state then removed from New York City the right to collect a sales tax and enacted an identical state tax, the proceeds of which were allocated to MAC, and redirected to MAC the proceeds of the previous New York

167. *See* BAILEY, *supra* note 1, at 17–25.
168. *See* N.Y. CONST. art. VIII, § 2.
169. *See* LACHMAN & POLNER, *supra* note 1, at 132–36.
170. N.Y. PUB. AUTH. LAW § 3033 (McKinney 2003).

City tax on stock transfers (shades of the replacement of Memphis taxes with state taxes allocated to the new taxing district?).[171] MAC then used those revenues to secure its own obligations, the proceeds of which were in turn allocated to New York City's efforts to provide services.[172] Importantly to bondholders, MAC was an entity of the state and the direct recipient of sales and stock transfer tax revenues. Those funds never passed through the city, as they had prior to the enacting legislation. MAC, therefore, constituted a bankruptcy-remote entity,[173] the assets of which presumably could not be reached by city creditors if New York City itself petitioned for debt adjustment under federal bankruptcy law.

The diversion of revenues from the city to MAC became a critical mechanism for solving the liquidity crisis that New York City faced when it was unable to access credit markets on its own. Creditors were willing to lend to MAC funds that would ultimately end up in the city coffers because they felt secure that the pledged revenues were sufficient to pay MAC obligations and that creditors of the city would be unable to reach MAC's assets even if the city entered bankruptcy.

But the fact that those same revenue sources had previously been part of the city treasury meant that pre-existing city creditors would not have considered their availability to pay city debts superfluous. At the time they purchased their bonds, those creditors had received a pledge of the city's "faith and credit," a term of ambiguous meaning but one that the New York Court of Appeals defined as "a commitment to pay and a commitment of the city's revenue generating powers to produce the funds to pay."[174] One might have thought, therefore, that purchasers of bonds secured by such a pledge were relying on the capacity of the city to have continued access to the sources of revenue that it possessed at the time of purchase. After all, tax limitation cases like *Von Hoffman* had been predicated on the

171. *See* BAILEY, *supra* note 1, at 27–28.

172. *See id.*

173. A bankruptcy-remote entity is one that is related to another borrower but that is sufficiently independent in form to prevent consolidation of the assets of both parties in a bankruptcy. Typically, a bankruptcy-remote entity will have a single asset generating a stream of income sufficient to pay the debts of that entity. In addition, the bankruptcy-remote entity is typically structured in a manner that makes it difficult for it to enter bankruptcy. The joint effect is that the bankruptcy of the other borrower will likely not affect the financial status of the bankruptcy-remote entity. *See, e.g.*, David Ramos Muñoz, *Bankruptcy Law v Bankruptcy-Remote Structures. Harmony Out of Dissonance?* (Jan. 1, 2014) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2407940 [https://perma.cc/7GNM-UNQB].

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

general principle that taxing authority in place at the time bonds were issued could not be diluted or eliminated while the bonds were outstanding.[175] Bondholders might reasonably have concluded that stripping revenue sources from the city and reassigning them, thus making outstanding bonds less secure than they had previously been, was indistinguishable from, and no more legitimate under the Contracts Clause than, stripping the city's revenue-generating authority by limiting its taxing capacity, or simply dissolving it or merging it into another municipality that claimed no obligation to satisfy the city's bondholders.

The diversion of municipal revenues initially thought available to existing creditors has been deployed elsewhere, either to assist a distressed municipality or simply to raise additional capital. Perhaps most famously or notoriously, Puerto Rico officials created an authority, Corporación del Fondo de Interés Apremiante (COFINA), to receive sales tax revenues, presumably to issue bonds secured by those revenues, and thereby obtain capital at relatively low interest rates.[176] That capital was then to be used to finance a deficit and reduce the Commonwealth's significant debt burden.[177] But the COFINA experience reveals the very risk that funds once relied on by existing creditors, then diverted elsewhere could become appropriate if not necessary to satisfy the former group's claims. Subsequent to the issuance of COFINA bonds, the Commonwealth's deficit grew, not shrank, and general obligation bondholders who suffered default ultimately contended that they had both a claim to sales tax revenues and priority in those revenues over the COFINA bondholders.[178] While that claim was rooted in arguments about the meaning of arcane terms in the Commonwealth Constitution, its underpinnings are again reminiscent of the claims in the nineteenth-century cases — general obligation bondholders have claims to revenue sources subsequently diverted to other purposes.

More recently, Illinois has created bankruptcy-remote structures in an effort to assist the City of Chicago, which faces significant financial

175. *See* Von Hoffman v. City of Quincy, 71 U.S. 535, 554–55 (1866).

176. *See* Nicole Gelinas, *Chicago's Debt Dereliction*, CITY J. (2017), https://www.city-journal.org/html/chicago's-debt-dereliction-15497.html [https://perma.cc/3MFU-BFCV]; *see also About*, COFINA, https://cofina.pr.gov/cofina-pr/about/i6094 [https://perma.cc/Z7UZ-593P] (last visited Mar. 16, 2021).

177. *See* Gelinas, *supra* note 176.

178. *See In re* Fin. Oversight & Mgmt. Bd., 361 F. Supp. 3d 203, 220–21 (D.P.R. 2019).

challenges.[179] Initially, Chicago's school district, which is legally separate from the city itself, was permitted to issue bonds financed through a capital improvement tax, a move that allowed the bonds to be rated well above the junk bond ratings that Chicago city's own bonds attracted.[180] The state legislature subsequently permitted Chicago and other home rule municipalities to create nonprofit corporations and to assign them state-collected sales tax revenues that would otherwise have been dedicated to the city.[181] Those nonprofit corporations may then issue debt, secured by the sales tax revenues.[182] Because the nonprofit corporation is likely to have lower borrowing costs than a distressed city like Chicago, it can use the sales tax revenues to pay debt service and have sufficient funds remaining to distribute back to the city.[183] But the reallocation of sales tax revenues means that general obligation bondholders of Chicago retain access to fewer assets to satisfy their claims after the diversion than they did previously, and the precarious financial situation of the city suggests that that reduction is, again, not superfluous.

If diversion risks the same adverse effects for creditors as dissolution strategies, then one might claim that the former strategy is no more appropriate than the more blatant forms of asset stripping one sees in the latter. That was essentially the claim that a bondholder made in the wake of the reallocation of New York City taxes to MAC. In *Quirk v. Municipal Assistance Corp.*,[184] the New York Court of Appeals upheld the diversion to MAC of the revenues previously available to the city on the grounds that "[i]n no way was the city ever committed to maintain sales tax revenues or stock transfer tax revenues for the benefit of its bondholders."[185] Bondholders were instead protected by the state constitution's faith and credit pledge, payable from local real estate taxes. Bondholders — even those who were the recipients of the

179. *See* Gelinas, *supra* note 176.

180. *See Chicago Schools Sell $1 Bln Bonds with Lower Market Penalty*, REUTERS (Nov. 16, 2017, 7:46 PM), https://www.reuters.com/article/idUSL1N1NM2P5 [https://perma.cc/3GNB-59X8].

181. *See Chicago Refunds an Additional $673 Million with Sales Tax Bonds*, CIVIC FED'N (Dec. 7, 2018), https://www.civicfed.org/civic-federation/blog/chicago-refunds-additional-673-million-sales-tax-bonds [https://perma.cc/C7UE-DYBK].

182. *See* Gelinas, *supra* note 176.

183. *See Chicago Refunds an Additional $673 Million with Sales Tax Bonds*, *supra* note 181; *see also* Gelinas, *supra* note 176; Karen Pierog, *New Chicago Debt Structure Wins Initial Approval*, REUTERS (Oct. 5, 2017, 5:16 PM), https://www.reuters.com/article/us-chicago-bonds/new-chicago-debt-structure-wins-initial-approval-idUSKBN1CA2QC [https://perma.cc/XTL4-FKZG].

184. 363 N.E.2d 549 (N.Y. 1977).

185. *Id.* at 550.

city's pledge of its faith and credit — had no "right to insist that any particular existing taxes be maintained or new ones imposed to produce those revenues" necessary to meet that pledge.[186] Without citing Justice Field's distinction in *Meriwether*, the court implicitly acknowledged his assertion that "ordinary taxes" that had not been explicitly dedicated to debt service on specific bonds were not necessarily available to satisfy a bondholder's claim to municipal revenues.

B. The Temporal Issue — Future Consequences of Current Asset Stripping

Notwithstanding its approval of the diversion strategy, the court's opinion in *Quirk* was notable for two qualifying remarks. First, the court concluded with the admonition that "[a] different case would be presented if, realistically, the city were stripped of all sources of revenue, other than the real estate tax."[187] In short, the court appeared to endorse the same kind of Lockean proviso evident in the nineteenth-century Supreme Court decisions and more explicit in *Faitoute* — legislative manipulation of municipal resources was acceptable, as long as bondholders' opportunity to receive payment was not diluted too much in light of the what was necessary to resolve municipal fiscal distress. Of course, the temporal issue complicates the issue of how great that opportunity is or must be when a current withdrawal of assets could implicate the potential for default in years to come. The court of appeals left that issue unaddressed. Indeed, the court concluded that the outcome of a case in which all non-real estate revenues were diverted "would be, at this time, unpredictable."[188] But more than in *Faitoute*, where bonds were already in default, the need to determine the subsequent impact of a diversion on existing holders of long-term bonds complicates the analysis. Whether or not a particular state intervention impairs an obligation must be decided when the allegedly offending legislation is enacted. It cannot be the case that the diversion of revenues did not constitute an impairment when taxes were allocated to MAC in 1977 but would be unconstitutional if it turned out that the sales tax revenues were necessary to pay city creditors in full when city bonds matured in the distant future. The decision that the legislation did not create an impairment when enacted essentially binds the future.

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186. *Id.*
187. *Id.* at 551.
188. *Id.*

As I noted above, a market test will provide little assistance in determining the future, potentially impairing effects of current legislation.[189] Diversion of sales taxes, for example, might not have adversely affected the value of New York City bonds at a time when the very creation of MAC signaled an unwillingness of the state to allow New York City to fail or for its bonds to go into default. But predicting the effect of the loss of sales taxes during the entire period when previously issued New York City bonds would be outstanding is riddled with uncertainty, and resolving the impairment issue by looking only at immediate market effects at the time of litigation shifts to bondholders the risk that such revenues will be necessary to service the debt in the future.

Second, the court of appeals recognized the similarity of New York's plan to the discredited efforts by states to remove the property and taxes of indebted municipalities from the reach of creditors. The court's citation for its assertion about the consequences of the "different case" in which the city lacked all other revenue sources was none other than the Supreme Court's decision in the *Port of Mobile* case.[190] In each situation, creditors who relied on assets available to the municipality at the time that credit was extended were disappointed to discover that those assets had been assigned to a third party.[191] Thus, even in upholding a diversion strategy, the court was unwilling to distinguish its situation entirely from dissolution cases.

Approval of the diversion strategy in *Quirk* may have been underwritten by the state's interesting, if unique, constitutional requirement that general obligation bonds must be paid, even if limits on real estate taxes must be exceeded.[192] The court of appeals had previously relied on that provision to invalidate the state's attempt to impose a moratorium on New York City's note payments.[193] That mandate could be interpreted as rendering any additional security for bondholders superfluous and thus rendering the diversion of other taxes irrelevant. But that is not what the court said, and the use of diversion by jurisdictions not bound by such security provisions suggests that a general defense of the strategy requires a broader justification.[194]

189. *See supra* notes 159–65 and accompanying text.

190. *See Quirk*, 363 N.E.2d at 551.

191. *See* Port of Mobile v. Watson, 116 U.S. 289 (1886); *Quirk*, 363 N.E.2d at 551.

192. *See Quirk*, 363 N.E.2d at 551.

193. *See* Flushing Nat'l Bank v. Mun. Assistance Corp., 358 N.E.2d 848, 852 (N.Y. 1976).

194. *See id.*

One could find some justification in analogous changes in municipal financial structures that have not generated constitutional difficulties. Indeed, subtle forms of municipal asset stripping that reduced revenues available to pre-existing creditors have been a standard financing procedure for municipalities for decades, as states and municipalities issued revenue bonds in an effort to evade state constitutional debt limits.[195] Those limits typically apply to general obligation bonds, that is, bonds that are secured by the general revenues of the issuer.[196] Debts secured by a "special fund," on the other hand, have traditionally fallen outside the scope of constitutional debt subject to debt limitations.[197] Initially, special funds comprised revenues generated by operation of the project constructed with bond proceeds, such as tolls from a financed toll bridge or parking revenues from a financed parking structure.[198] Excluding funds generated by the financed project from the category of constitutional debt made sense insofar as those revenues would not have existed but for the project financed with debt.[199] They did not place the municipal treasury at risk because bondholders could only look to the revenues generated by operation of the facility financed with bond proceeds for repayment.[200] If the financed project failed, it was the bondholders, not residents of the issuer, that bore the loss since bondholders could not look to non-project revenues to cover any shortfall.[201] Courts that require some "nexus" between the project financed with bond proceeds and the revenue sources dedicated to debt service may be more focused on preventing an expansion of municipal indebtedness in a manner that eviscerates constitutional debt limits, but implicitly the adoption of the narrow special fund theory also ensures that holders of general obligation bonds have access to a broader array of municipal revenues.[202]

Notwithstanding the justifications for excluding special fund or revenue debt from debt limitations, for several decades, multiple

195. *See* ROBERT S. AMDURSKY, CLAYTON P. GILLETTE & G. ALLEN BASS, MUNICIPAL DEBT FINANCE LAW 230–48 (2d ed. 2013); Robert H. Bowmar, *The Anachronism Called Debt Limitation*, 52 IOWA L. REV. 863, 873–84 (1957).

196. *See* AMDURSKY ET AL., *supra* note 195, at 239–40.

197. *See id.* at 230–48; Bowmar, *supra* note 195, at 873–84.

198. *See* AMDURSKY ET AL., *supra* note 195, at 230–48.

199. *See id.* at 230–31.

200. *See id.*

201. *See id.*

202. *See, e.g.*, Convention Ctr. Auth. v. Anzai, 890 P.2d 1197, 1205 (Haw. 1995). *See generally* Eakin v. State *ex rel.* Cap. Improvement Bd. of Managers, 474 N.E.2d 62 (Ind. 1985).

jurisdictions have adopted a broad interpretation of the special fund doctrine that excluded from debt limits any obligations that were supported by a specific revenue stream of the issuer, even though those revenues bore no relationship to the project funded with bond proceeds.[203] Parking meter revenues, for example, might have been available to pay holders of general obligation bonds, but might then be diverted to pay bonds of a convention center authority, even if the parking meters were located at a distance from the convention center. That interpretation prevailed even though the pledged revenues may otherwise have been available to pay pre-existing general obligation bondholders. Courts have justified the expansion of the doctrine on various grounds, but largely on the theory that debt limitations apply to obligations secured by ad valorem property taxes.[204]

Although the broad special fund doctrine has been attacked as a subterfuge on state constitutional debt limits,[205] I am not aware of any successful claim that, by removing a source of revenue that may otherwise have been available to holders of general obligation bonds issued prior to the diversion of revenues to revenue bonds, the doctrine also violates the Contracts Clause. At most, courts have expressed concern that balkanization of different revenue sources would effectively undermine any constraint on municipal borrowing.[206] But that balkanization tends to occur when municipalities that require a means of evading a debt limitation remain in relatively good fiscal health, as evidenced by the fact that they have access to the credit markets. The broad special fund doctrine effectively allows localities to expand their debt-incurring capacity to take advantage of that access or avoid an electoral vote that would be triggered if general obligation bonds, and the accompanying property taxes, were used to finance the same project. The Minnesota Supreme Court upheld an extreme version of the concept when it permitted bonds to finance construction and repair public buildings to be secured by a tax levy on all taxable property in the state in an amount sufficient to pay debt service, but excluded those bonds from the constitutional debt limit on the grounds

203. *See* AMDURSKY ET AL., *supra* note 195, at 244.

204. *See generally* Long v. Napolitano, 53 P.3d 172 (Ariz. 2002).

205. *See* AMDURSKY ET AL., *supra* note 195, at 147; Bowmar, *supra* note 195; C. Robert Morris, Jr., *Evading Debt Limitations with Public Building Authorities: The Costly Subversion of State Constitutions*, 68 YALE L.J. 234 (1958); Nadav Shoked, *Debt Limits' End*, 102 IOWA L. REV. 1239 (2017). Of course, if debt limitations do not realistically permit municipalities to secure necessary capital, then mechanisms for circumventing them may be necessary to ensure appropriate capital funding. *See* Clayton P. Gillette, *Fiscal Home Rule*, 86 DENV. U. L. REV. 1241, 1256–64 (2009).

206. *See, e.g.*, Naftalin v. King, 90 N.W.2d 185, 190 n.6 (Minn. 1958).

that — although the bonds were secured by the type of ad valorem property taxes associated with general obligations that are the hallmark of "constitutional" debt — the legislative carve out essentially created a special fund that was sufficiently analogous to a revenue bond.[207]

Widespread adoption of the special fund doctrine suggests that it would not be vulnerable to invalidation under the Contracts Clause, even if it were reconceptualized as a means of asset stripping rather than a mechanism for circumventing debt limits. The absence of any such challenge to the practice notwithstanding the enlargement of the special fund doctrines suggests that bondholders do not consider themselves protected against such a strategy. Courts that have committed to the doctrine may be motivated by a sense that debt limits themselves are either arbitrary or antiquated.[208] Failure to validate even radical strategies for their circumvention could prevent municipalities from financing essential infrastructure. It is implausible that courts would disrupt municipal credit markets at this stage by finding that debts supported by revenues with an insufficient nexus to the financed project impaired the obligations of general obligation bondholders. But to the extent that acceptance of the broad special fund doctrine is predicated on the necessity for municipalities to access credit markets, it may have similar implications when asset stripping takes other forms or similarly serves municipal necessity, even at the risk of diluting the security of pre-existing creditors.

One might then return to Justice Frankfurter's use of a market test[209] to define the permissible scope of asset stripping. If market prices of existing municipal securities remain stable after the issuer adopts a diversion strategy or issues additional bonds secured by a special fund, one might claim that serves as relatively conclusive evidence that the diversion failed to impair the pre-existing obligation. Nevertheless, courts have not made significant use of the market test. The court in *Quirk*, for example, made no inquiry into the effect of the reallocation of sales tax and stock transfer tax revenues on city bonds.[210] The most significant post-*Faitoute* use of the market test appears in *United States Trust Co. v. New Jersey*[211] and its controversial application there. The Court held that the repeal of a statutory covenant that the Port Authority of New York and New Jersey would not subsidize mass

207. *See generally id.*
208. *See* AMDURSKY ET AL., *supra* note 195, at 309–13.
209. *See* Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942).
210. *See* Quirk v. Mun. Assistance Corp., 363 N.E.2d 549 (N.Y. 1977).
211. 431 U.S. 1, 18–19 (1977).

transit facilities constituted an unconstitutional impairment.[212] As evidence of an impairment, bondholders contended that the post-repeal market for the bonds had become thin, while the issuer maintained that the market had recovered and the bonds retained their "A" rating.[213] The majority concluded that evidence concerning the market effects of the repeal was too ambiguous to assist in the determination of an impairment.[214] Justice Harry Blackmun found additional ambiguity in the possibility that non-repeal factors could have affected market value, while other conditions, notably the very litigation about the repeal's validity, might mean that not all relevant effects had yet been factored into market prices.[215] Justice William J. Brennan's dissent in *United States Trust Co.* observed that the ambiguity over market effects revealed an inability of bondholders to prove an adverse effect of the repeal and reiterated that any market effect had involved only a short-term reduction in value.[216]

Neither side in the *United States Trust Co.* debate, however, addressed the temporal issue that I have suggested is inherent in assessing potential impairments. Justice Blackmun's observation that not all effects may be reflected in market prices at the time of litigation must be correct, but not only for the reasons that he suggested, that is, the litigation's own effect on market value.[217] Rather, the primary problem with using the market test to evaluate a current modification of the issuer's revenue-raising capacity lies in the possibility of an event that dramatically increases default risk but is sufficiently remote at the time of litigation as not to be factored into current market prices. That is not to say that the potential for such a risk means that any modification of revenue raising capacity creates an unconstitutional impairment. That conclusion would return us to the pre-Depression case law that read the Contracts Clause as an absolute and would

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212. *See id.* at 32.

213. *See id.* at 18–19.

214. *See id.* at 19.

215. *See id.*

216. *See id.* at 42–43 (Brennan, J., dissenting). A subsequent case from the State of Washington echoed Justice Blackmun's concern about the endogenous effects of litigation. In *Pierce County v. State*, the Washington Supreme Court invalidated as an unconstitutional impairment of contract an initiative that withdrew an issuer's ability to levy and collect a motor vehicle excise tax, the proceeds of which had been pledged as security for bonds issued to finance a transportation system. *See* Pierce County v. State, 148 P.3d 1002, 1006–07 (Wash. 2002). But when the issuer argued that continued market for the bonds after enactment of the tax repeal revealed the absence of any impairment, the court responded that market price stability may simply have revealed an expectation that the court would invalidate the law. *See id.* at 1013–14.

217. *See United States Trust Co.*, 431 U.S. at 19.

preclude adjustments to outstanding obligations when they are most needed.[218] But it does suggest that the market test is somewhat of a one-way ratchet for purposes of the impairment test. If the state's diversion of municipal revenues does cause an immediate and substantial decline in the affected bonds' market value, an impairment seems obvious. On the other hand, the absence of a market value decline at the time of the state's intervention does not necessarily indicate the absence of an impairment since future events, unanticipated at the time of the litigation or otherwise not fully capitalized into current market prices, may reveal that the reduced security was necessary to make bondholders whole after all.

Perhaps the decision that came closest to wrestling with the temporal issue was the opinion of the California Supreme Court when it evaluated the effects of California's sweeping restrictions on property taxation.[219] The initiative that promulgated those restrictions excluded from the new tax limitation any indebtedness previously approved by the voters.[220] That exclusion appears to have been a bow towards nineteenth-century Supreme Court cases such as *Von Hoffman*. But the exclusion did not apply to bonds that had been issued without the requirement of a bond election, such as redevelopment bonds secured by anticipated property tax increments attributable to redevelopment.[221] The California Supreme Court acknowledged that the new restrictions would reduce those tax increments to the detriment of bondholders.[222] Nevertheless, the court concluded that no impairment of the bondholders was implicated.[223] The court relied on the peculiar reasoning that nothing in the new law "requires local agencies to default either in meeting their preexisting contracts or in liquidating their outstanding bonds," and that no default had yet occurred.[224] Of course, the Contracts Clause prohibition on the "impairment" of the obligation of contract assumes that current alterations of the initial bond contract may have future consequences rather than cause immediate default. Nonpayment of an obligation may constitute a breach of the underlying contract, but it does not constitute an impairment. Rather, an impairment arises when the state

218. *See, e.g.*, Von Hoffman v. City of Quincy, 71 U.S. 535, 553 (1866).
219. *See* Amador Valley Joint Union High Sch. Dist. v. State Bd. of Equalization, 583 P.2d 1281 (Cal. 1978).
220. *See id.* at 1284.
221. *See id.* at 1295–96.
222. *See id.* at 1296.
223. *See id.*
224. *Id.*

takes an action today that reduces the likelihood that the obligor will be able to perform in the future in a manner consistent with the parties' original understanding.[225] Thus, the court's contention, that in the absence of default any claim of a constitutional violation was premature,[226] seems inconsistent with underlying Contracts Clause principles.

As a more plausible response to the claim of impairment, the court observed that the state created a fund to provide loan funds to local agencies at risk of defaulting on bonds, though it remained unclear, even to the court, how such loans would be structured or repaid.[227] If the court was concluding that the substitution of one form of security for another would be sufficient to ward off an impairment, it relied on established principles, but only if the new security was the equivalent of the old.[228] Certainly, the court's ultimate determination that default was not an "*[i]nevitable* consequence" of the tax limitation sets an idiosyncratically high bar for an impairment.[229]

But for purposes of the temporal issue, the California court's more interesting analysis involved its recognition that withdrawal of assets today may have implications for creditors only in the distant future.[230] Those who claimed an impairment alleged that the new tax limits created an immediate "depreciation" of the security relied upon by the obligees.[231] The court did not deny that such an effect had occurred. Rather, it concluded that Contracts Clause jurisprudence permitted post-obligation modification of statutes affecting creditors as long as those changes did not affect an express term of the agreement or have a substantial effect on the repayment of debts.[232] In short, the court maintained, existing case law did not provide "that an unlawful impairment occurs immediately upon imposition of the tax restriction, without regard to its ultimate effect upon the repayment of preexisting debts."[233] But, again, therein lies the difficulty. When dealing with obligations that may be outstanding for several decades after the state intervention, one cannot easily forecast the "ultimate effect" on the

225. *See, e.g.*, Hays v. Port of Seattle, 251 U.S. 233, 237 (1920).
226. *See Amador Valley*, 583 P.2d at 1297.
227. *See id.*
228. *See e.g.*, W.A. Foote Mem'l Hosp., Inc. v. Kelley, 211 N.W.2d 649 (Mich. 1973); *In re* Op. of the Justs., 246 A.2d 90 (Del. 1968); Beaumont v. Faubus, 394 S.W.2d 478 (Ark. 1965); Jacksonville Port Auth. v. State, 161 So. 2d 825 (Fla. 1964).
229. *Amador Valley*, 583 P.2d at 1297 (emphasis added).
230. *See id.*
231. *See id.*
232. *See id.*
233. *Id.*

ability to pay creditors. For example, holders of Puerto Rico's general obligation bonds did not challenge the diversion of sales taxes to secure COFINA bonds when the enabling legislation was enacted in 2006, but those same bondholders strenuously objected when it developed a decade later that the Commonwealth had insufficient funds to pay its full indebtedness.[234] The consequence is that current market values are at best a rough proxy that assume the risk of future events is fully capitalized. Perhaps for that reason, other courts have simply ignored the temporal issue.[235]

That leaves us, however, with the following puzzle: if the diversion strategy has potential consequences for creditors similar to those that generated dissolution, then can the legal implications of the diversion cases be distinguished from those of the dissolution cases? Aurelia Chaudhury, Adam J. Levitin, and David Schleicher suggested that at least some of the nineteenth-century dissolution cases are of limited precedential value, in part because their reasonings are opaque.[236] But the cases may be sufficiently similar in their effects on creditors that it would be undesirable to declare the earlier ones inapplicable, and sufficiently distinguishable that they teach us some useful lessons about municipal finance. They are certainly similar insofar as they reveal the utility of an asset stripping strategy by a state intent on assisting its financially imperiled municipalities from the reach of creditors. Removing the City of Mobile's revenue-raising capacity was no less of an effort to assist its residents than shifting the New York City sales tax from city creditors to MAC creditors.

There is, of course, a difference in the immediacy of the impact on creditors. In the dissolution cases, default had already occurred or was

234. *In re* Fin. Oversight & Mgmt. Bd., 361 F. Supp. 3d 203, 220–21 (D.P.R. 2019).

235. The Massachusetts Supreme Judicial Court rendered an advisory opinion concerning the effect of a similar proposed constitutional tax limitation on outstanding bonds of the Commonwealth. *See In re* Op. of the Justs., 9 N.E.2d 189 (Mass. 1937). That proposal contained no exception for outstanding bonds issued when the Commonwealth presumably possessed unlimited taxing power to pay debt service. *See id.* The court, citing the nineteenth-century dissolution cases, concluded that "any law which withdraws or limits the taxing power, and leaves no adequate means for the payment of the bonds, is forbidden." *Id.* at 191 (quoting Port of Mobile v. Watson, 116 U.S. 289, 305 (1886)). But the court found that the tax limitation did not have the unconstitutional effect for the intriguing reason that creditors of Massachusetts municipalities retained an ancient remedy of levying an execution issued on a judgment in their favor on the real estate of any person within such city or town. *See id.* While proceeding against the property of multiple residents of the indebted municipality might not be "so convenient as collection from a town or city treasurer," the availability of the remedy negated the argument that the tax limitation caused an impairment. *Id.*

236. *See* Chaudhury et al., *supra* note 101, at 525 n.272.

imminent, so there was no doubt that withdrawing assets would interfere with creditors' ability to satisfy judgments obtained against issuers.[237] In the diversion cases, actual losses would only occur in the future and might be purely hypothetical throughout the period when affected bonds remained outstanding.[238] The court in *Quirk* implied that diversion of taxes did not necessarily entail default.[239] It was plausible that alternative revenue sources, especially the constitutionally required tax on real estate, would be sufficient to pay debts.[240] That apparent difference dissipates somewhat when one recognizes the difficulty of forecasting the long-term effects of current changes in bondholder security. Still, there is a matter of degree in the temporal effects of the alleged impairment, and in legal doctrines, matters of degree may matter.[241]

Nevertheless, I am tempted to conclude that the most important distinction between the cases lies in the motive for adopting the dissolution or diversion strategy, largely as revealed by the state's demand that the debtor minimize the loss to creditors. Again, some kind of balancing or, in modern bankruptcy terms, "good faith" negotiation seems necessary before judicial validation of the asset stripping strategy. Recall that one way to explain the dissolution cases is to view them as a reaction to states that had been insufficiently attentive to creditors' interests and overly protective of debtor municipalities.[242] Return, for example, to Monkkonen's claim that the widespread defaults of the nineteenth-century railroad bond era often reflected political resistance to payment of debts rather than fiscal incapacity, or that residents were motivated by a failure to receive the benefits for which they thought they, or their officials, had bargained.[243] The dissolution cases perhaps reveal an unwillingness by courts, at least federal courts, to deny residents an escape route when bonds were validly issued but default was triggered by regret due to the failure of the financed project. Even if these debts were legally valid, that is, they had been issued for a permissible purpose and the issuer had jumped through the necessary prerequisites to issuance, the fact

237. *See supra* Section II.A.

238. *See supra* Section III.A.

239. *See* Quirk v. Mun. Assistance Corp., 363 N.E.2d 549, 646–47 (N.Y. 1977).

240. *See id.* at 647.

241. *See* Jacob & Youngs, Inc. v. Kent, 129 N.E. 889, 891 (N.Y. 1921) ("The same omission may take on one aspect or another according to its setting. . . . The question is one of degree.").

242. See *supra* notes 155–65 and accompanying text.

243. *See* MONKKONEN, *supra* note 12, at 69.

remained that residents felt both overly burdened and duped.[244] Monkkonen suggested that when railroads actually operated, the residents did not default, notwithstanding plausible arguments that the underlying debts had been illegally incurred.[245] The negative implication for Monkkonen is that debt repudiation was politically motivated and was used to shift risks of debts that had been validly, if imprudently, incurred from residents to bondholders. Fairman's rich history of the period suggests a similar battle in which nonpayment was underscored by political resistance even to compromise with bondholders that might have required the debtor to bear some of the risk of project failure.[246]

The motivation behind MAC's creation and diversion of New York City revenues to MAC bonds appeared quite different. The New York legislature, and more recently Illinois, were creating new entities, albeit bankruptcy-remote ones, to obtain additional capital for a municipality otherwise unable to access credit markets.[247] Rather than dissolve the city, the New York legislature was arguably diverting revenue to ensure the city's survival by addressing a liquidity crisis. In the dissolution cases, in short, the primary objective was to reduce creditor security or to hold up creditors in an effort to avoid improvidently incurred obligations.[248] In the contemporary diversion cases, reducing creditor security was a necessary but secondary by-product of an effort to create a new set of creditors willing to invest capital if they could rely on specific security other than the city's general credit.[249] In this sense, the diversion strategy is akin to the special fund cases, in which new capital essential to municipal economic development can only be obtained by circumventing debt limitations. Courts faced with governments in fiscal distress or constraints on growth have similarly winked at constitutional requirements by concluding that the use of intermediaries such as MAC did not undermine obligations for debtors to borrow only on a general obligation basis,[250] or that the inclusion of a clause allowing the legislature to refuse to appropriate funds for debt service removed an obligation from the category of debt.[251]

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244. *See supra* Section II.A.
245. *See* MONKKONEN, *supra* note 12, at 69.
246. *See* FAIRMAN, *supra* note 12, at 974–84.
247. *See* Gelinas, *supra* note 176, at 134.
248. *See supra* Section II.A.
249. *See supra* Section III.A.
250. *See e.g.*, Loc. Gov't Assistance Corp. v. Sales Tax Asset Receivable Corp., 813 N.E.2d 587 (N.Y. 2004); Wein v. City of New York, 331 N.E.2d 514 (N.Y. 1975).
251. *See* Schowalter v. State, 822 N.W.2d 292, 302–03 (Minn. 2012).

Indeed, the stated objective in New York was to stave off default and bankruptcy that, if plausible, would likely have required bondholders to settle for significantly less than the face value of their bonds.[252] As in *Faitoute,* the practical implications of the strategy may be different from the apparent efforts in the dissolution cases to repudiate debts fully or to force a settlement on bondholders who may have believed that they had already paid to offload the risk of project failure that had materialized.

Of course, dissolution strategies similarly improve the municipal balance sheet by offloading debt. There is an economic equivalence between a distressed municipality that is able to save a dollar of debt service by denying creditors access to that dollar and a municipality that is able to attract an additional dollar of revenue by securitizing revenues diverted from what was previously available to creditors. In either case, the distressed municipality has a dollar more than it previously did and has the potential to reduce debt overhang. But if we are concerned with ensuring that distressed localities are able to fund the services for which they were created and attract additional investment — rather than to pay for previously incurred debts, which is likely to deter investment — there may be a distinction between the two strategies.[253] The diversion strategy is adopted for the very specific purpose of receiving capital infusions that can be used to provide services rather than to pay legacy costs and thus allow the municipality to regain its financial footing. Diversion of prior city revenues in cases like MAC thereby addressed a liquidity crisis through a strategy which, if successful, would plausibly increase the probability of recoveries for existing creditors. Nothing in the dissolution cases suggests that local savings from debt reduction would be used to attract new capital, and certainly they reveal no expectation that dissolution would make creditors better off. Indeed, the repudiation of debt suggests both that the municipalities themselves had adopted an anti-debt position[254] and that, even if they had not, repudiation would make future creditors wary of extending credit to them. Repudiation may have been appropriate to avoid an existential threat to the defaulting municipalities. But there was no hint, as there has been in the diversion

252. I say "if plausible" because the version of the Bankruptcy Code that dealt with municipal bankruptcy at the time was largely impractical for large cities, insofar as it required the consent of a higher percentage of creditors than could have been obtained. *See* Gillette & Skeel, Jr., *supra* note 26, at 1176–82.

253. *See* Buccola & Buccola, *supra* note 39 (manuscript at 11–12); McConnell & Picker, *supra* note 25, at 460.

254. *See* FAIRMAN, *supra* note 12, at 947–66.

cases, that state intervention was part of an overall strategy to foster municipal economic growth and thus ensure delivery of the local public goods and services that the municipality was created to provide.

CONCLUSION

States that seek to resolve fiscal distress within their political subdivisions face both political and economic pressures to balance residents' and creditors' interests. History reveals that those pressures may lead the state to engage in strategies that significantly favor one set of interests over the other. Constitutional constraints, and the Contracts Clause in particular, create a bulwark against favoritism that significantly exploits creditors. But the scope of those constraints must be attentive to the reasons why a state has selected one strategy for dealing with municipal fiscal distress over another. Strategies that deprive creditors of access to assets previously thought pledged but that provide distressed cities with needed capital receive more deference than strategies that allow debtors to avoid the consequences of a default that has already occurred. The former suggests a concerted effort to avoid debt overhang and ensure the economic development necessary for a city to finance the services it was created to provide. The latter does not. Strategies that entail significant debtor contributions to relieving fiscal distress receive more deference than strategies that impose a holdup "compromise" on creditors. The former suggests a desire to balance the interests of both residents and creditors. The latter does not. Courts may have difficulty distinguishing among these situations. In particular, they will inevitably have difficulty predicting the long-term consequences of current efforts to divert revenues from the grasp of creditors. At the very least, however, history suggests that judicial reactions to state-approved asset stripping strategies that plausibly have similar effects on creditors depend on the court's conception of what the state was attempting to accomplish more than on a desire to achieve doctrinal consistency.