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After Orange County: Reforming California Municipal Bankruptcy Law

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Article

After Orange County: Reforming California Municipal Bankruptcy Law

by
FREDERICK TUNG*

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Introduction

Orange County's bankruptcy was an historical event. Municipal bankruptcies are rare, and Orange County's was the largest case ever. At the time of its bankruptcy, the County was the fifth most populous county in the United States, with two and a half million residents. The County's budget exceeded \$3.7 billion, and its employees numbered about 18,000.¹ Even among large municipal bankruptcies, the case was unique. Large cases typically involve declining urban centers, short on tax revenues and long on spending commitments. Orange County, by contrast, was a prosperous suburban county, and its financial demise was triggered by a risky investment strategy gone bad. The County treasurer oversaw a leveraged investment pool that had lost \$1.6 billion by the time of its bankruptcy filing.² In addition, the County's financial distress had direct consequences for many other local government entities. The County invested not only its

1. See MARK BALDASSARE, WHEN GOVERNMENT FAILS: THE ORANGE COUNTY BANKRUPTCY 7 (1998).

2. See *id.* Of the \$20 billion in investments, \$13 billion was made with borrowed money. See *id.* at 90.

own money, but funds of other municipal entities within Orange County³—including cities, school districts, sanitation and water districts, and the County's employee retirement system.⁴ The County's investment woes therefore placed many other municipal entities and their constituencies at risk.

In addition to its financial ripple effects, the Orange County case implicated novel legal issues. One such issue concerns the eligibility of municipal entities to file for bankruptcy, a question that is determined by a mix of federal and state law. In particular, federal law requires specific state authorization in order for a municipality to file. Federal bankruptcy law offers a chapter specifically designed for municipalities in financial distress. However, because of federal Constitutional concerns, a municipal entity may resort to bankruptcy only with the authorization of its state.

This federal requirement of state authorization derives from the Constitutional principle that the federal government may not interfere with states' internal governance. Federal law must respect states' sovereignty over their political subdivisions. So while federal law offers a municipal bankruptcy process, the state authorization requirement leaves to each state the final say over whether and which of its political subdivisions may have access to this process. Together with certain Bankruptcy Code provisions,⁵ each state's authorization statute sets the conditions under which its municipal entities will be eligible for federal bankruptcy. This Article focuses on California's authorization provision.

The states have taken varying approaches in managing their municipalities' access to bankruptcy. Some states provide blanket authorization, in effect pre-approving resort to bankruptcy for their municipal entities without qualifications or conditions.⁶ At least one state flatly prohibits municipal bankruptcy filings.⁷ Some states impose preconditions to filing—for example, prior approval of state officials for the bankruptcy filing or the plan of adjustment, or state

3. See *infra* notes 45-47 and accompanying text.

4. See BALDASSARE, *supra* note 1, at 95.

5. See *infra* Part II[C].

6. See, e.g., ARIZ. REV. STAT. § 35-603 (2001); TEX. LOC. GOV'T CODE § 140.001 (2002). One commentator notes that fourteen states have enacted such blanket authorization statutes. See Daniel J. Freyberg, Note, *Municipal Bankruptcy and Express State Authorization to be a Chapter 9 Debtor: Current State Approaches to Municipal Insolvency—and What Will States Do Now?*, 23 OHIO N.U. L. REV. 1001, 1008 n.66 (1997). A simple count of authorization statutes by itself, however, may oversimplify. See *infra* note 125 and accompanying text.

7. See GA. CODE ANN. § 36-80-5 (2001). Iowa allows a municipal filing only when the municipality has been rendered insolvent as a result of a debt involuntarily incurred. See IOWA CODE §§ 76.16, 76.16A (2002).

appointment of a trustee.⁸ Many states have no statute on municipal bankruptcy at all.⁹

The existing California law provides fairly broad authorization. However, the current statute needs both technical and substantive revision. Enacted in 1949, the statute is obsolete insofar as it references a federal bankruptcy statute that has been superseded. More importantly, as a substantive matter, the broad authorization may be inappropriate. Given the sheer number and various different types of municipal entities that now exist in California—from irrigation districts to investment pools—as well as modern methods of municipal finance, broad and indiscriminate access to municipal bankruptcy is inadvisable. This Article proposes a reform of California's authorizing statute for municipal bankruptcy filings.

Having surveyed other states' approaches,¹⁰ and having reviewed recent municipal financial crises—including that of Orange County—I ultimately recommend a system of discretionary access, in which the governor holds discretionary power to approve, disapprove, or condition a municipality's access to bankruptcy. This Article is organized as follows. Parts I and II provide background.¹¹ Part I describes the general issue of state authorization and the interaction of state and federal law that is required to satisfy federal Constitutional concerns. Part II describes municipal bankruptcy, highlighting its salient features. In Part III, I discuss the broad factors that should be considered in designing a system of state authorization, and I attempt to weigh those various factors in formulating a recommendation. In Part IV, I discuss the range of possible approaches, I describe my proposal, and I discuss the politics of legislating such a proposal. Part V addresses specific questions concerning the scope of the definition of "municipality" under the Bankruptcy Code.¹²

I. State Authorization and Federal Constitutional Concerns

The basic purpose for federal municipal bankruptcy law—Chapter 9 of the Bankruptcy Code¹³—is the same as for private corporations reorganizing under Chapter 11: to allow the debtor a breathing spell from creditors' collection efforts and to enable it to

8. See *infra* Part IV.

9. See Freyberg, *supra* note 6, at 1009 and n.70.

10. This Article does not address state constitutional issues.

11. Readers familiar with federal municipal bankruptcy law and the general problem of state authorization may wish to skip directly to Part IV.

12. 11 U.S.C. §§ 101-1330 (1994 & Supp. IV 1998). This statute is hereafter referred to as the "Bankruptcy Code." Unless otherwise specified, all statutory references herein shall be to the current version of the Bankruptcy Code.

13. 11 U.S.C. §§ 901 et seq. (1994 & Supp. IV 1998).

formulate a repayment plan with creditors.¹⁴ However, because municipalities and private corporations are quite different creatures, and because of Constitutional constraints that are implicated with municipal bankruptcy, Chapter 9 operates very differently from Chapter 11. In particular, a municipality may resort to bankruptcy only with the specific authorization of its state, but once in bankruptcy, the municipal debtor is subject to many fewer constraints than its private corporate counterpart, both in terms of operations and in formulating and achieving court approval of a repayment plan.

A. Federal Constitutional Concerns

Federal municipal bankruptcy law must tread a careful line. Federal bankruptcy law provides a municipal debtor with the power to bind a creditor to a plan of adjustment without its consent. While granting this power, bankruptcy law must at the same time respect the states' sovereign powers over their municipal entities. Therefore, bankruptcy law and bankruptcy courts cannot interfere with the governance or management of a municipal debtor. Understanding this balancing act helps to explain the role of state authorization in the federal scheme.

The Constitution empowers Congress "to establish uniform Laws on the subject of Bankruptcies."¹⁵ The imprimatur of federal bankruptcy law is critical to enabling a municipal debtor to bind its creditors to a plan of adjustment because the Constitution specifically reserves to Congress the power to impair contracts, and specifically prohibits to the states.¹⁶ "Only federal law can give the type of relief afforded by chapter 9."¹⁷

14. See *In re Addison Community Hosp. Auth.*, 175 B.R. 646, 649 (Bankr. E.D. Mich. 1994).

15. U.S. CONST., art. I, § 8, cl. 4.

16. U.S. CONST., art. I, § 10. cl. 1. This Constitutional provision has been held not to create an absolute prohibition against state laws modifying contractual obligations in some exigent circumstances. See *Faitoute Iron & Steel Co. v. City of Asbury Park, N.J.*, 316 U.S. 502 (1942); *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1933); *Ropico, Inc. v. City of New York*, 425 F.Supp. 970 (S.D.N.Y. 1976). However, section 903 of the Bankruptcy Code was enacted specifically to preempt state bankruptcy laws. It provides in part: "[A] state law prescribing a method of composition of indebtedness of [its] municipality may not bind any creditor that does not consent to such composition." 11 U.S.C. § 903(1) (1994). The legislative history explains:

State adjustment acts have been held to be valid, but a bankruptcy law under which the bondholders of a municipality are required to surrender or cancel their obligations should be uniform throughout the States, as the bonds of almost every municipality are widely held. Only under a Federal law should a creditor be found to accept such an adjustment without his consent.

H.R. Rep. No. 2246, 79th Cong. 2d. Sess. 4 (1946). The provision was passed in order to overturn the Supreme Court's decision in *Faitoute*, 316 U.S. 502, which upheld a New

Chapter 9 in effect authorizes municipalities in financial distress to employ the federal power to impair contracts for the purpose of effecting municipal debt adjustments. At the same time, however, federal law must respect the sovereign powers guaranteed to the states by the Tenth Amendment. "The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people."¹⁸ Central to states' sovereignty is their power to govern the affairs of their municipalities. Therefore, federal law and federal bankruptcy courts cannot attempt to intervene directly in municipal management or operations, a sphere that falls squarely within the province of the respective states.

B. The Federal Requirement of State Authorization

The current Chapter 9 is the result of a history of Constitutional and Congressional debate over the proper allocation of power with respect to municipal debt adjustment. Section 109(c)(2), requiring specific state authorization for municipal bankruptcy filings, is a product of this debate. It "has roots in the constitutional principle that the federal government may not interfere with the internal governance of a state or its political subdivisions."¹⁹ A municipality may resort to federal bankruptcy law only with proper authorization from the state.

The current version of Section 109(c)(2) was passed as part of the Bankruptcy Reform Act of 1994.²⁰ It requires specific state authorization for a municipality to file for bankruptcy. In order for a municipality to be eligible for Chapter 9, it must be

specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter.²¹

Prior to 1994, only *general* state authorization was required.²² This general authorization provision basically reiterated the analogous provision from the bankruptcy statute that preceded the current Bankruptcy Code. Section 84 of the Bankruptcy Act stated

Jersey statute authorizing state adjustment plans for insolvent municipalities to bind creditors without their consent.

17. *In re City of Bridgeport*, 128 B.R. 688, 694 (Bankr. D. Conn. 1991) (citing *U. S. v. Bekins*, 304 U.S. 27 (1938)).

18. U.S. CONST. amend. X.

19. Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 457 (1993).

20. Pub. L. No. 103-394, 108 Stat. 4106 (1994).

21. 11 U.S.C. § 109(c)(2) (1994).

22. See 11 U.S.C. § 109(c)(2) (1988) (repealed 1994).

that “[a]ny State’s political subdivision . . . which is generally authorized to file a petition under this chapter by the legislature . . . is eligible for relief.”²³

Courts construing this general authorization requirement reached inconsistent results. Some construed it quite liberally, finding that it “should be broadly construed to provide municipalities maximum access to Chapter 9 within the constitutional limitations of the Tenth Amendment.”²⁴ For example, one court held that general authority was inferred from a municipality’s authority to sue and be sued, to incur debts, and to negotiate contracts that create obligations and debts.²⁵ Other courts were more restrained in finding general authority, refusing to infer authority from a general grant of powers. For instance, the authority of a transit district to sue and be sued was deemed by one court to be insufficient to infer authority to file bankruptcy.²⁶

Congress responded to the confusion by amending Section 109(c)(2) to require specific state authorization.

C. California’s Authorization Statute: Government Code Section 53760

Government Code Section 53760 is California’s current general statute authorizing municipal bankruptcy filings. It provides:

23. Act of April 8, 1976, Pub. L. No. 94-260 (codified at 11 U.S.C. §§ 401-418 (Supp. 1976)).

24. *In re Sullivan County Regional Refuse Disposal Dist.*, 165 B.R. 60, 73 (Bankr. D.N.H. 1994).

25. *See In re Villages at Castle Rock Metro. Dist. No. 4*, 145 B.R. 76, 82 (Bankr. D. Colo. 1990). One court found that general authority was “sufficiently implied through a grant of responsibility over fiscal matters combined with a grant of general discretionary powers to implement the powers enumerated.” *Id.* (citing *In re Villages at Castle Rock Metro. Dist. No. 4*, 145 B.R. 76, 82 (Bankr. D. Colo. 1990)). General authority was inferred from a municipality’s authority over its own finances. *See In re City of Bridgeport*, 128 B.R. 688, 693-97 (Bankr. D. Conn. 1991); *In re City of Wellston*, 43 B.R. 348 (Bankr. E.D. Mo. 1984). It was inferred from broad general powers of a municipality to be a party to suits, to borrow money, to issue bonds, to refund any bond indebtedness, to manage, control and supervise all of the business of district, and to exercise all rights and powers necessary or incidental to or implied from such powers. *See In re Villages at Castle Rock Metro. Dist. No. 4*, 145 B.R. 76, 82 (Bankr. D. Colo. 1990). General authority was inferred from a statute vesting municipal districts with “all the powers necessary and requisite of the accomplishment for the purpose for which such district is created, capable of being delegated by the legislature The district is empowered to do all acts necessary, proper or convenient in the exercise of the powers granted herein.” *In re Pleasant View Utility Dist.*, 24 B.R. 632 (Bankr. M.D. Tenn. 1982) (quoting TENN. CODE ANN. § 7-82-306 (1980)), *leave to appeal denied*, 27 B.R. 552 (M.D. Tenn. 1982).

26. *See In re Westport Transit District*, 165 B.R. 93, 98 (Bankr. D. Conn. 1994). *See also In re Carroll Township Authority*, 119 B.R. 61 (Bankr. W.D. Pa. 1990), in which the court relied on Congressional legislative history to conclude that some affirmative action by the state was required in order to demonstrate its authorization. *See id.* at 63.

Any taxing agency or instrumentality of this State, as defined in Section 81 of the act of Congress entitled 'An act to establish a uniform system of bankruptcy throughout the United States,' approved July 1, 1898, as amended, may file the petition mentioned in Section 83 of the Act and prosecute to completion all proceedings permitted by Sections 81, 82, 83 and 84 of the Act.²⁷

Another provision of the Government Code, Section 43739, speaks specifically to bankruptcy filings by certain cities. It states:

Any city authorized to refund its indebtedness pursuant to this article may file a petition under any bankruptcy law of the United States. If the refunding of the city indebtedness is authorized in the bankruptcy proceeding, the city may refund its indebtedness pursuant to this article.²⁸

Both provisions were enacted in 1949, when only general state authorization was required. They both seem to provide fairly broad authorization for California municipal entities to file for bankruptcy.

As I discuss below, Section 53760 should be substantively revised to limit access based on the governor's discretion. As for Section 43739, it should probably be eliminated, so that only one general authorizing statute exists for all municipal entities. To the extent that particular types of entities may require special considerations in connection with bankruptcy authorization or filings, those specifics should also be contained in one general authorizing statute, and not scattered throughout the various substantive sections of the California code.²⁹

Section 53760 also refers to a federal bankruptcy statute that is no longer in effect. It refers to provisions of former Chapter IX of the Bankruptcy Act that were enacted in 1937 and superseded in 1976. Because of potential ambiguities that may arise from the obsolete statutory references,³⁰ all statutory references should reflect current law.

27. CAL. GOVT. CODE § 53760 (1999). In addition, Government Code Section 53761 provides that "[t]he State consents to the adoption of Sections 81, 82, 83 and 84 by Congress and consents to their application to the taxing agencies and instrumentalities of this State." *Id.* § 53761. This provision is probably unnecessary and adds nothing to the authorization contained in Section 53760.

28. *Id.* § 43739.

29. Under current law, for example, the superintendent of schools must authorize the bankruptcy petition for an insolvent school district. *See infra* note 150.

30. While the language appears to offer broad and explicit authority for local agencies to file bankruptcy, the court in *Orange County* specifically rejected such an argument. Instead, the court decided that OCIP was neither a municipality under federal law, nor specifically authorized under state law, because it did not fall within the laundry list of agencies and instrumentalities enumerated in Section 81 of the 1937 Act. *See In re County of Orange*, 183 B.R. 594, 602 (Bankr. C.D. Cal. 1995).

The next Part provides an overview of Chapter 9, its operation and its limitations. The question of structuring a specific state authorization regime is taken up in the following Parts.

II. Bankruptcy System Fundamentals

In this Part, I describe Chapter 9. I first provide an overview of Chapter 9 and its benefits for the municipal debtor. I then discuss Section 109(c) of the Code, which serves a gate keeping function with respect to Chapter 9 and from which the state authorization requirement derives.

A. Benefits of Chapter 9

For a municipality in financial distress, Chapter 9 provides immediate relief from creditor collection efforts and offers a framework within which to negotiate a restructuring of the municipality's debt obligations. The immediate relief from creditors comes in the form of a stay against creditor collection efforts, which is triggered automatically upon the filing of a Chapter 9 petition.³¹ This relief enables the municipality to avoid financial and operational collapse, enabling it instead to continue to provide public services to its residents and others while negotiating a plan of debt adjustment with its creditors. While I briefly describe other salient features of Chapter 9 as well—the ability to deal with unfavorable contracts and the negotiation of the plan of adjustment—I focus particular attention on the automatic stay and invocation of bankruptcy relief, which may have particular relevance for the structuring of the mechanics of state authorization.

(1) The Automatic Stay and Invocation of Bankruptcy Relief

As the Orange County bankruptcy illustrated, timely invocation of the automatic stay and other bankruptcy relief may be critical to the municipal debtor's ability to stabilize its financial position. In that case, three disputes arose implicating the debtor's ability to rely on the invocation of bankruptcy to protect assets from creditors. While the debtor was ultimately unsuccessful in two of these disputes, the novelty of the legal issues raised suggests that the final word has yet to be written on these questions. I make no attempt to resolve these novel bankruptcy questions, a project that is beyond the scope of this Article. Instead, I recount these disputes simply to illustrate the potential significance of timely invocation of municipal bankruptcy.

Early in the case, the County hoped to rely on the automatic stay to block certain of its secured creditors from liquidating their

31. See 11 U.S.C. § 922 (1994).

collateral.³² These secured creditors were investment banks with which the County had entered into sophisticated financial contracts called reverse repurchase agreements.³³ As collateral for the County's obligations under these reverse repurchase agreements, the investment bank creditors held County-owned securities. Shortly after the bankruptcy filing, these creditors liquidated their collateral, despite the fact that such a move might have been a violation of the automatic stay. While certain Bankruptcy Code provisions permit such creditor action,³⁴ it is unclear whether these provisions apply in municipal bankruptcy.³⁵ The issue was ultimately mooted by the County's decision to liquidate its investment pool securities portfolio shortly after the bankruptcy filing.³⁶

A second dispute over the debtor's assets involved the rights of holders of the County's tax revenue anticipation notes (TRANS) with respect to certain pledged tax revenues. In its resolution approving the County's \$200,000,000 borrowing via issuance of the TRANS, the County Board of Supervisors also pledged certain future tax and other unrestricted revenues as security for the TRANS.³⁷ The resolution specified a schedule of anticipated revenues that were to be set aside as they were received, in order to provide the promised collateral.³⁸ However, the County declared bankruptcy after only the

32. See *County of Orange v. Nomura Securities Int'l, Inc.*, Adv. No. 94-02480 (Bankr. S.D. Cal.) (complaint dismissed).

33. A reverse repurchase agreement is essentially a secured loan. The County borrowed money to invest in securities, using securities it already owned as collateral for these loans. The County was obligated to "repurchase" the collateral at a fixed date and price, in effect retiring the loans. The interest rate is simply built into the repurchase price. Failure to repurchase is similar to a loan default, and entitles the other party—the "lender"—to foreclose on the collateral. See generally PHILIPPE JORION, *BIG BETS GONE BAD: DERIVATIVES AND BANKRUPTCY IN ORANGE COUNTY* 30-32 (1995).

34. See 11 U.S.C. §§ 555, 556, 559, 560 (permitting liquidation of securities agreements by nondebtor party, notwithstanding certain provisions of Code, including automatic stay provision).

35. While § 901(a) contains a laundry list of Bankruptcy Code provisions that explicitly apply in Chapter 9, see 11 U.S.C. § 901(a), the provisions relating to liquidation of securities agreements and similar financial contracts, see *supra* note 34, are not included in the list. The National Bankruptcy Review Commission (the "NBRC") has recommended that these provisions be specifically made applicable to Chapter 9 through their inclusion in Section 901(a). See REPORT OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION 991 (1997) [hereinafter NBRC REPORT]. In addition, a provision so amending Section 901(a) is included in the Bankruptcy Reform Act of 2001, which as of this writing is pending in Congress. See Bankruptcy Reform Act of 2001, § 502, S. 420, H.R. 333, 107th Cong. § 502 (2001).

36. See JORION, *supra* note 33, at 104.

37. See *Alliance Capital Mgmt. L.P. v. County of Orange (In re County of Orange)*, 179 B.R. 185, 188 (Bankr. C.D. Cal. 1995), *rev'd on other grounds and remanded by* 189 B.R. 499 (C.D. Cal. 1995).

38. See *id.*

first three set-asides had been made, and it took the plausible position that the invocation of bankruptcy cut off the TRANS holders' rights to any post-bankruptcy revenues or set-asides.³⁹

Ordinarily, a secured creditor's prepetition consensual lien does not extend to property acquired by the debtor after the filing of the bankruptcy petition.⁴⁰ Therefore, the prompt invocation of bankruptcy may enable the debtor to terminate secured creditors' rights relating, for example, to a stream of income or other assets, thereby preserving unencumbered assets for the estate, improving the debtors' prospects for rehabilitation, and enhancing recoveries for general unsecured creditors.

However, while the prepetition secured creditor is generally not entitled to postpetition collateral, it is unclear how this rule applies to a municipality's pledge of future tax revenues to secure its TRANS obligations.⁴¹ The bankruptcy court agreed with the County that its pledge was a "security interest," and therefore that the rights of the TRANS holders were cut off at the time of the bankruptcy filing.⁴² However, the district court reversed on appeal, finding that the pledge constituted a statutory lien that survived the bankruptcy filing.⁴³ Therefore, the lien rights of TRANS holders continued in the County's future revenues as originally scheduled, and were not cut off by the bankruptcy.

A third dispute involved the Orange County Investment Pool (OCIP)⁴⁴ and the claims of its participants, who wished to withdraw their funds as the County and OCIP slid into financial distress. OCIP was an investment pool started by the then-treasurer of Orange County, Robert L. Citron. Under California law, certain government entities could choose to deposit their excess funds into the county treasury for investment by the county treasurer. Other government entities were required to handle their excess funds this way.⁴⁵ From these funds received by the County treasury, Citron created OCIP by

39. *See id.* at 188-89.

40. *See* 11 U.S.C. § 552(a).

41. This issue does not arise with respect to revenue bonds, as to which the lien on special revenues survives the bankruptcy filing. *See id.* § 928(a). The TRANS, however, were general obligation bonds. *See Alliance Capital Mgmt.*, 179 B.R. at 191 n.17.

42. *See Alliance Capital Mgmt.*, 179 B.R. at 194.

43. *See Alliance Capital Mgmt.*, 189 B.R. at 501. The NBRC recommends an amendment to the Code to allow similar treatment for TRANS as the Code currently provides for revenue bonds. The pledge of tax revenues would survive in bankruptcy, but—unlike revenue bonds—would be subject to the municipal debtor's use for "necessary municipal services." *See NBRC REPORT, supra* note 35, at 999.

44. The financial chaos associated with OCIP is by now well known. For a description of the background and state law authorization for OCIP, *see In re County of Orange*, 183 B.R. 594, 596 (Bankr. C.D. Cal. 1995).

45. *See id.*

combining the funds into several pools for investment purposes.⁴⁶ By 1994, OCIP held \$7.6 billion in investments for 190 municipal entities.⁴⁷

Because it was initially unclear whether OCIP could be a Chapter 9 debtor⁴⁸ and who owned the OCIP funds in bankruptcy, it was also unclear whether pool participants had immediate rights to the funds or whether the automatic stay precluded their withdrawals. If the County held only as trustee for the various pool participants, then those trust funds belonged to the beneficiaries, not the County. Under this characterization, such funds would not have been subject to the claims of county creditors, and the beneficiary-participants would not have been subject to the automatic stay with respect to these funds. The bankruptcy court ultimately found that, despite state law creating a trust relation between the County and the pool investors, the funds belonged to the County as a result of the commingling of the assets in the pool.⁴⁹ While this decision did not arise in the automatic stay context, one of the consequences of this ruling is that the automatic stay would have prevented pool participants from withdrawing their funds without county approval.

While the Orange County case highlights the potential need for timely invocation of municipal bankruptcy and the automatic stay, it should be noted that Orange County's case was unusual insofar as it involved an investment pool. The first and third issues described above arose only because of OCIP operations. While similar investment pool-related municipal bankruptcies are not out of the question,⁵⁰ the run-of-the-mill municipal entity does not operate a hedge fund on the side, so the creditor collection issues will be more straightforward. For these municipal entities, immediate invocation of bankruptcy may not be as critical as for private businesses or counties running investment pools.

As a practical matter, creditors of traditional municipal debtors—school districts, hospital districts, and the like—have relatively few collection devices at their disposal compared to

46. *See id.* at 596-97.

47. *See id.*

48. The bankruptcy court ultimately decided that OCIP did not qualify as a municipality under federal bankruptcy law, and was therefore ineligible for Chapter 9. *See id.* at 594. *See also infra* note 78 and accompanying text.

49. *See County of Orange v. Merrill Lynch & Co., Inc.*, 191 B.R. 1005, 1013 (Bankr. C.D. Cal. 1996).

50. Despite the spectacular misfortunes of OCIP, investment pools are now a fairly common phenomenon in California municipal finance, as cities and counties search for new revenue sources in times of relative scarcity. Investment pools are quite different from other more traditional municipal entities. Their operations and obligations are different, and therefore financial distress related to an investment pool raises issues quite different from the issues arising out of the bankruptcy of more traditional entities.

creditors of private entities. Aside from the securities-related issues raised in *Orange County*, municipal property is generally not subject to creditor seizure to satisfy municipal debt. One could easily imagine the social and political chaos that would ensue upon the dismemberment of a municipal entity as creditors raced to seize the municipality's assets.⁵¹ The primary creditor remedy available upon the municipal borrower's default is a state court action for mandamus, by which a court orders the municipal debtor to exercise its taxing power to raise the revenue necessary to pay the defaulted debt.⁵² The automatic stay precludes further pursuit of this remedy as well.

(2) *Dealing with Unfavorable Contracts*

For some municipalities, financial distress may require adjustment of the municipality's ongoing contractual obligations, as well as its debt obligations. Chapter 9 provides a tool for accomplishing this, allowing a municipality to reject or renegotiate executory contracts.⁵³ Obligations to employees under collective bargaining agreements, for example, may require modification, as the Orange County case⁵⁴ and the bankruptcy of the San Jose Unified School District in 1983 illustrate.⁵⁵

(3) *Negotiating the Plan of Adjustment*

The ultimate goal for the municipal debtor in Chapter 9 is to reach agreement with creditors over the adjustment of municipal debts. Typical debt adjustments include extending the maturity of particular debt obligations or reducing the interest rate or principal balance. Comprehensive adjustment is accomplished through a plan of adjustment confirmed by the bankruptcy court.⁵⁶ Confirmation

51. See McConnell & Picker, *supra* note 19, at 429.

52. See *id.*

53. See 11 U.S.C. § 365 (1994), which is made applicable to Chapter 9 by 11 U.S.C. § 901(a).

54. See *Orange County Employees Ass'n v. County of Orange*, 179 B.R. 177, 184-85 (Bankr. C.D. Cal. 1995).

55. See Barry Winograd, *San Jose Revisited: A Proposal for Negotiated Modification of Public Sector Bargaining Agreements Rejected Under Chapter 9 of the Bankruptcy Code*, 37 HASTINGS L.J. 231 (1985). One primary purpose for the ultimately unsuccessful bankruptcy filing of the city of Bridgeport, Connecticut, was the modification of its labor contracts. See Thomas Scheffey, *Bridgeport Bankruptcy No 'Slam Dunk Case': Specialists Say Whether City Had Authority to File up in the Air in Historically Unprecedented Scenario*, THE RECORDER, June 20, 1991, at 3. See generally W. Richard Fossey & John M. Sedor, *In re Copper River School District: Collective Bargaining and Chapter 9 Municipal Bankruptcy*, 6 ALASKA L. REV. 133 (1989).

56. See 11 U.S.C. § 943.

enables the debtor, with the requisite creditor majorities,⁵⁷ to bind dissenting minority creditors to the terms of the plan of adjustment. While the requirements for confirmation are numerous, the most significant general requirements are that the plan must be proposed in good faith,⁵⁸ that all creditor classes impaired under the plan must accept the plan,⁵⁹ and that the plan is in the best interests of creditors.⁶⁰

B. Debtor Control in Chapter 9

By enabling a municipal debtor to impair contracts, Chapter 9 affords the debtor significant leverage over its creditors in negotiating debt adjustments. Because of considerations of state sovereignty, however, Chapter 9 imposes almost no countervailing restrictions or limitations on municipal operations or asset disposition. The municipal governance structure remains in place, free to operate without court or creditor interference. In effect, Chapter 9 provides the municipal debtor with a hefty club to wield over creditors, without giving creditors much in the way of protective mechanisms that are available in corporate and individual bankruptcy. On the other hand, municipalities' access to Chapter 9 is much more restricted compared to other types of debtors filing under other chapters of the Bankruptcy Code. Section 109(c) of the Bankruptcy Code serves this gate keeping function for municipal bankruptcy. This section briefly illustrates debtor control in Chapter 9 by contrasting the municipal debtor's position with the more familiar position of the corporate debtor under Chapter 11. The next section then discusses gate keeping under Section 109(c).

Unlike Chapter 11, the scope of federal court authority over a municipal debtor is quite limited. Sections 903 and 904 of the Bankruptcy Code capture the limited approach of Chapter 9. Section 903 provides: "This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise."⁶¹ Section 904 clarifies:

57. *See id.* §§ 901(a), 1126(c).

58. *See id.* §§ 901(a), 1129(a)(3).

59. *See id.* §§ 901(a), 1129(a)(8). A plan may also be crammed down over the objection of an impaired class. *See id.* § 1129(b). However, cram down in Chapter 9 works a little differently from Chapter 11. *See* 6 COLLIER ON BANKRUPTCY ¶ 943.03[1][f] (15th ed. rev'd 1999).

60. *See* 11 U.S.C. § 943(b)(7).

61. *Id.* § 903.

Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with

- (1) any of the political or governmental powers of the debtor;
- (2) any of the property or revenues of the debtor; or
- (3) the debtor's use or enjoyment of any income-producing property.⁶²

While particular provisions of the Bankruptcy Code constrain the Chapter 11 debtor's operations and negotiating leverage with creditors, municipal debtors suffer no analogous constraints. Unlike the Chapter 11 debtor, the Chapter 9 debtor is free to use its assets without interference by the bankruptcy court.⁶³ It need not fear that a bankruptcy trustee will be appointed to take control of operations.⁶⁴ Its ability to borrow money postbankruptcy remains unconstrained.⁶⁵ The debtor may employ and compensate professionals without prior court approval.⁶⁶ Creditors may not place a municipality into involuntary bankruptcy.⁶⁷ They cannot force the municipal debtor's liquidation.⁶⁸ Nor are they guarantied a minimum "liquidation value" payout under the municipal debtor's reorganization plan.⁶⁹ Creditors have no right to file their own plans; only the debtor may file a plan.⁷⁰ The municipal debtor is probably also not subject to the limitations

62. *Id.* § 904.

63. *See id.* Compare *id.* § 363.

64. *Compare id.* § 1104. A trustee can be appointed only for the limited purpose of pursuing avoidance actions on behalf of the estate if the debtor refuses to do so. *See id.* § 926(a).

65. *Compare id.* § 364. "Only when the municipality needs special authority, such as subordination of existing liens, or special priority for the borrowed funds, will the court become involved in the authorization." H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 394 (1977).

66. *Compare id.* §§ 327-331. One confirmation requirement, however, is that "all amounts to be paid by the debtor or by any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable." *Id.* § 943(b)(3).

67. *Compare id.* § 303.

68. *Compare id.* § 1112.

69. There is a requirement that any plan be in the "best interests" of creditors, *see id.* § 943(b)(7), which in the context of corporate bankruptcy was historically interpreted to require that creditors receive as much under the plan as they would have in liquidation. That requirement for corporate bankruptcy is now reflected in Section 1129(a)(7). With a municipality, on the other hand, liquidation is not an option, so the best interest requirement in the Chapter 9 context cannot refer to liquidation values. Instead, the legislative history of Chapter 9 suggests that the test requires that creditors receive in bankruptcy at least what they would have received by virtue of a mandamus proceeding under state law to compel an increased tax levy by the municipality in order to pay off the debt. *See McConnell & Picker, supra* note 19, at 465-66 & n.178.

70. *Compare* 11 U.S.C. § 941 *with id.* § 1121.

imposed on corporate debtors with respect to rejecting collective bargaining agreements or modifying retiree benefits.⁷¹

In all these areas, municipal debtors enjoy more freedom from court oversight and more leverage over their creditors than do private business debtors in Chapter 11.

C. Gate Keeping under Section 109(c)

While municipal debtors enjoy far more leverage over creditors in bankruptcy than their private counterparts, access to municipal bankruptcy is also more restricted. The specific state authorization requirement under Section 109(c)(2) operates as a gate keeping device restricting access to municipal bankruptcy, one that is completely within the control of the various states. Section 109(c) enumerates other eligibility requirements for Chapter 9 as well:

An entity may be a debtor under chapter 9 of this title if and only if such entity—

- (1) is a municipality;
- (2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter;
- (3) is insolvent;
- (4) desires to effect a plan to adjust such debts; and
- (5) (A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
(B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
(C) is unable to negotiate with creditors because such negotiation is impracticable; or
(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.

Besides these requirements, the petition must have been filed in good faith.⁷² In order to provide context for the subsequent discussion concerning state authorization, I briefly describe some of these other hurdles to invoking municipal bankruptcy protection.

71. Compare *id.* §§ 1113, 1114 respectively. See also *Orange County Employees Ass'n v. County of Orange*, 179 B.R. 177 (Bankr. C.D. Cal. 1995).

72. See *id.* § 921(c).

(1) *Municipality*

Only municipalities are eligible for Chapter 9. A municipality is defined as a "political subdivision or public agency or instrumentality of a State."⁷³ "Political subdivision" includes counties, cities, towns, and the like,⁷⁴ that exercise various sovereign powers such as the taxing power, the power of eminent domain, or the police power.⁷⁵ "Public agency or instrumentality" includes incorporated authorities, commissions, and similar public agencies organized for the purpose of constructing, maintaining, and operating revenue-producing enterprises. The term also includes local improvement districts, school districts, and the like, organized or created for the purpose of constructing, improving, maintaining, and operating improvements, schools, ports, etc.⁷⁶

When a bankruptcy petition was filed on behalf of OCIP, the court dismissed the petition, finding that OCIP was neither a political subdivision nor a public agency. As to whether it was an instrumentality of the state, the court found that OCIP's characteristics and objectives did not comport with those of entities historically identified as instrumentalities.⁷⁷ Moreover, that OCIP was an instrumentality of the County did not make it an instrumentality of the state for purposes of Chapter 9.⁷⁸ This analysis has been criticized.⁷⁹

(2) *Insolvency*

A municipality must be insolvent to be eligible for Chapter 9. Insolvency in the municipal context is a bit different from insolvency in the context of private entities. A traditional comparison of assets and liabilities is not useful, given difficulties of valuing municipal assets and the inability of creditors to force the liquidation of a

73. *Id.* § 101(40).

74. *See In re County of Orange*, 183 B.R. 594, 601 n.16 (Bankr. C.D. Cal. 1995).

75. *See id.* at 602.

76. *See id.* at 602-03.

77. *See id.*

78. *See id.* The court found that OCIP was unlike any of the several types of instrumentalities enumerated in the 1937 Bankruptcy Act that was a predecessor to the current statute. The court further held that OCIP was not specifically authorized under California law to file for bankruptcy, since California's authorization provision refers specifically to this same laundry list of instrumentalities from the superseded statute. *See id.*

79. *See* 6 COLLIER, *supra* note 59, at ¶ 900.02[2][a][iii]. Creditors also argued that OCIP was not an entity, and was therefore not eligible under Section 109(c). Creditors claimed that OCIP was merely a legal fiction created on the eve of bankruptcy for the purpose of filing a bankruptcy petition. *See County of Orange*, 183 B.R. at 599. The court found, however, that OCIP had a separate existence long before its bankruptcy, and that it was a governmental unit, which by definition qualifies as an "entity." *See id.*

municipality to satisfy their debts. For municipalities, insolvency is defined in Section 101(32)(C) to mean a "financial condition such that the municipality is (i) not generally paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due."⁸⁰

The bankruptcy filing for the city of Bridgeport, Connecticut, was dismissed because the court found that the debtor was not insolvent.⁸¹ The court clarified that the financial inability must be "imminent and certain, not merely a possibility or speculation."⁸² This requirement operates as something of a screening device to assure that federal bankruptcy powers are not prematurely invoked to intrude on a municipality's negotiation with its creditors and employees over finances.⁸³

(3) *Good Faith*

In addition to the eligibility requirements spelled out in Section 109(c), the Code provides for the dismissal of any Chapter 9 petition not filed in good faith.⁸⁴ For lack of any precedent construing this provision in Chapter 9, the *Orange County* court adopted the Ninth Circuit's good faith test for Chapter 11 filings: "whether the debtor is attempting to unreasonably deter and harass its creditors or attempting to effect a speedy, efficient reorganization on a feasible basis."⁸⁵ In addition, "the purpose of the filing must be to achieve objectives within the legitimate scope of the bankruptcy laws."⁸⁶

* * *

Having sketched the contours of Chapter 9 and the gate keeping function of Section 109(c), we turn to the question of designing an appropriate state authorization mechanism.

III. Managing Access to Chapter 9: First Principles

In this Part, I discuss basic considerations that should inform the design of a state law gate keeping device for municipal bankruptcy.

80. 11 U.S.C. § 101(32)(C) (1994).

81. *See In re City of Bridgeport*, 129 B.R. 332, 339 (Bankr. D. Conn. 1991).

82. *Id.* at 337.

83. Moreover, this and the prerequisite that the debtor have made at least some effort to negotiate with creditors to obtain their consent to a plan, *see supra* Part II[C], give some comfort to the municipal bond market that bankruptcy protection will not be too readily accessible. *See* 6 COLLIER, *supra* note 59, at ¶ 900.02[2][e].

84. *See* 11 U.S.C. § 921(c).

85. *In re County of Orange*, 183 B.R. 594, 608 (Bankr. C.D. Cal. 1995) (citing *In re Marsch*, 36 F.3d 825, 828 (9th Cir. 1994), *In re Arnold*, 806 F.2d 937, 939 (9th Cir. 1986)).

86. *County of Orange*, 183 B.R. at 608.

In determining the proper role for the state in managing access to Chapter 9, I consider, among other things, competing interests in local autonomy versus statewide fiscal management, and the politics of municipal financial distress. In addressing the difficult trade-offs that must be made, it may be useful to distinguish large, multipurpose municipal entities—cities and counties—from smaller or more specialized entities—school or hospital or irrigation districts and the like. The former are generally the more complex, both politically and economically. For the bulk of the following discussion, cities and counties are our primary concern. Smaller and more specialized entities are separately considered at the end of this Part.

In the next Part, I detail my recommendation.

A. The Fundamental Tension: Statewide Impact of Bankruptcy versus Local Autonomy

Resort to bankruptcy may have consequences not only for the filing entity; it may also affect borrowing costs for governmental borrowers statewide.⁸⁷ It may have other negative effects as well. On the other hand, state involvement in municipal financial affairs may infringe on local autonomy and may hamper local efforts to address a fiscal crisis that requires timely and finely tuned action.

In general, preservation of local autonomy is important. SB 349, which was passed in the 1995 legislative session but vetoed by then-governor Wilson, would have created a Local Area Bankruptcy Committee (“LABC”), composed of the state controller, treasurer, and director of finance, that would decide on municipal bankruptcy authorization.⁸⁸ Governor Wilson’s veto message concerning SB 349 expressed the sentiment that the bill “would inappropriately vest responsibility for local fiscal affairs at the state level, creating an instrument of state government to usurp the authority of local officials to decide the wisdom of a bankruptcy filing.”⁸⁹ Moreover, official opponents of SB 349 included the California Municipal Treasurers Association and the Association of California Water Agencies.⁹⁰

State intervention in local affairs should occur only in exceptional circumstances, and not without some specific purpose. In my view, however, municipal financial distress is an exceptional

87. Moreover, the structuring of a system of state authorization may by itself affect borrowing costs in subtle ways, independent of any particular municipality’s financial distress. For example, too liberal access to Chapter 9 may raise overall borrowing costs by forcing the financial markets to account for the general future possibility of municipal repudiation of debts.

88. See S.B. 349, 1995-96 Sess. (Cal. 1995).

89. S.B. 349 Veto (Sept. 30, 1996).

90. See S.B. 349, Senate Floor Analyses (Aug. 29, 1996).

occasion that begs for state involvement and may justify active intervention. Municipal financial distress generally implicates more than merely the local interests of the distressed entity. Bankruptcy may provide a municipality quick relief from certain of its debt obligations, but the municipality—and other state and local borrowers—will end up paying in the financial markets. Regardless of what route is chosen, the costs of default do not disappear. The municipal debt markets will respond to default by raising interest rates, not only for the defaulting debtor in its attempts at future borrowing,⁹¹ but for other municipalities in the state, and to some extent for municipal borrowers in general.⁹²

In the aftermath of the Orange County bankruptcy, for instance, many California issuers of public debt were forced to resort to letters of credit in order to enhance the quality of their issues.⁹³ “We all paid a penalty for Orange County. Orange County rocked and rolled the market. Some governments and markets with good reserves still paid a penalty in the marketplace.”⁹⁴ According to one estimate, California local government entities issuing short-term notes during the summer following Orange County’s bankruptcy filing were required to offer higher yields of fifteen to twenty-five basis points. Together with an additional twenty basis points for bond insurance, some of these California government issuers paid almost an additional half percentage point for their borrowings. For an

91. In June 1996, Orange County issued \$880 million in recovery bonds to pay its prebankruptcy creditors and exit from bankruptcy. The bonds were priced to yield ten to twenty-five basis points more than similarly rated bonds, which translates into an extra \$43.8 million in interest costs. Overall, the county paid about \$60 million extra to borrow, including higher underwriting fees, higher returns to investors, and the costs of bond insurance. See Debora Vrana, *O.C. Bankruptcy All but Over*, L. A. TIMES, June 6, 1996, at A1 (quoting Zane Mann, publisher of California Municipal Bond Advisor).

92. Default on municipal bond indebtedness may have serious ramifications for the entire U.S. municipal bond market. General obligation bonds, for example, are simply unsecured debt obligations backed by the issuer’s “full faith and credit,” a commitment that the municipality will resort to its taxing powers if necessary to satisfy the debt. Bankruptcy signals the issuer’s dishonor of its full faith and credit commitment, which shakes the market’s confidence, not just with respect to the defaulting municipality but with respect to municipal issuers generally.

93. See Arlene Jacobious, *Thanks to Improving Fiscal Picture, L.A. County to Sell Unenhanced TRANS*, THE BOND BUYER, July 17, 1997, at 1 (quoting Maureen Sicotte, director of finance and investments for Los Angeles County).

94. *Id.* Some market participants expected the State of California to step in to assure Orange County’s timely debt repayment, and Orange County’s failure to reaffirm its obligations unequivocally may have eroded the trust between municipal issuers and investors. See *The Effect of the Orange County Crisis on Investors and Issuers*, Commission Report on Government, 27 Bankr. Ct. Dec. (LRP), News and Comment, No. 13 at A8 (Aug. 15, 1995) (quoting Congressional testimony of Daniel Heimowitz, Director of Public Finance Department of Moody’s Investors Services).

expected \$7 billion in aggregate seasonal note borrowings, the extra interest cost would run about \$15 million annually.⁹⁵

The California legislature recognized the statewide implications of municipal default in enacting financial control provisions for Orange County in SB 1276:

It is in the interest of the state and all public debt issuers within the state to enable the County of Orange to finance an acceptable plan of adjustment in order to improve the credit standing of California public debt issuers and to preserve and protect the health, safety, and welfare of the residents of the county and the state. To that end, successfully resolving the county bankruptcy and restoring the financial position of county government is a matter of statewide interest and concern.⁹⁶

Moreover, the effects of a significant municipal default may be felt nationwide. The Orange County bankruptcy filing caused a run on the Texas Investment Pool.⁹⁷ It apparently also raised municipal borrowing costs in Maine, according to the state treasurer.⁹⁸

Financial markets harbor some implicit expectation that the state will stand behind a defaulting municipality's bond obligations. This is understandable, given that state governments have always come to the aid of their distressed municipalities.

While a local government may fall from fiscal grace, the perceived wisdom is that the state will step in to clean up the mess. In almost all cases involving general units of government and tax-supported debt, that has been the case. New York City, Cleveland, Philadelphia, Bridgeport, even little Chelsea in Massachusetts, were thrown a lifeline by the state. Their respective states swam through the often shark-infested waters of politics to effect a rescue. Not since the default of Detroit in the 1930s had a state failed to intervene to head off a default or bankruptcy by a major local government.⁹⁹

In California especially, expectations of state intervention seem reasonable, as the state budget and the budgets of its counties are all interrelated. Beginning with Proposition 13 in 1978, when taxing and spending restrictions were placed on state and local governments,

95. See John E. Petersen, *A Guide to the Municipal Bond Market: The Post-Orange County Era*, GOVERNING (Nov. 1995).

96. CAL. GOV'T CODE § 30400 (1999).

97. See JORION, *supra* note 33, at 74.

98. See *Municipal Markets Lobby for Change; The Trouble with Chapter 9*, 28 Bankr. Ct. Dec. (LRP), News and Comment, No. 22, at A1 (May 5, 1996).

99. Petersen, *supra* note 95. See also BALDASSARE, *supra* note 1, at 86 (1998). "In every other major credit crisis in government in the last 25 years, states have taken a lead role. . . . There is an implied moral obligation of states to help their municipalities." *Id.*, quoting Sally Hofmeister, *Bankruptcy Peculiar to California*, N.Y. TIMES, Jan. 6, 1995, at D1.

counties have become highly dependent on the state to provide the necessary funding for local services.¹⁰⁰

Because municipal bankruptcy is not "free," resort to Chapter 9 should not be done casually. Moreover, because of the possible statewide spillover effects, local autonomy concerns must give way to statewide fiscal concerns, and objections to state involvement in the decision whether to resort to Chapter 9 should be discounted. Bankruptcy of a major municipality will almost certainly raise borrowing costs for other California municipalities and the state, and the bankruptcy process itself is expensive. These potential spillover effects suggest that *the decision to declare bankruptcy should not be left to the sole discretion of any municipality*. In the context of considering reforms to federal bankruptcy law, a working group report of the National Bankruptcy Review Commission asserted:

It is simply "wrong" to allow a financially troubled municipality, whose problems reach and affect not only its own citizens and constituencies but affect others throughout the state, to unilaterally seek relief under the bankruptcy laws without prior authorization from the state within which it operates.¹⁰¹

Given that the costs of default will be borne by the state as a whole, and given the connection between state allocations and local budgets, the state government should have the opportunity to consider whether bankruptcy is the best approach to the problem. While bankruptcy *might* be the best of a number of unattractive alternatives, and perhaps the costs of municipal default *should* be spread throughout the state under some circumstances, that decision is essentially a political one that implicates the entire state. A distressed municipality should not be authorized to decide the question unilaterally. For similar reasons, conditions imposed on a filing municipality should not be inhibited by home rule concerns when a fiscal crisis will have statewide impact. Trusteeship provisions were ultimately enacted in connection with the Orange County bankruptcy, and my proposal incorporates the possibility of similar mechanisms.¹⁰²

B. The Politics and Economics of State Involvement

Resolution of a serious crisis will often require some kind of eventual state involvement. As an historical matter, state governments have always come to the aid of large cities in distress.¹⁰³

100. See BALDASSARE, *supra* note 1, at 86.

101. See *Commission Report on Government*, 29 Bankr. Ct. Dec. (LRP), News and Comment, No. 8 (Aug. 13, 1996) (quoting National Bankruptcy Review Commission report of Working Group on Government as Creditor or Debtor).

102. See *infra* Part IV[B][4].

103. See *supra* note 99 and accompanying text.

Especially in California, where municipalities are restricted in their ability to raise taxes even in the face of financial crisis, the state may be the only possible source of the necessary financing.¹⁰⁴

However, in California, given the absence of a comprehensive framework for state involvement, political and economic dynamics may impede timely joint action by state and local officials. Local officials may prefer not to involve state officials unless and until it is absolutely unavoidable, and state officials may be reluctant to get involved as well. These predilections are understandable. Local officials might fear that state involvement would hamper local action and cause negative publicity. And negative publicity might hurt the municipal entity's restructuring efforts, as well as create political embarrassment to the local officials. For their part, state officials may likewise be reluctant to get involved. Not only will they not have the intimate familiarity with local issues and local history that municipal officials have, but state officials may also fear getting tarred with the political fallout from the crisis if they intervene too early or too aggressively.

In terms of a state authorization regime, the current system of blanket authorization to file bankruptcy may be a politically attractive arrangement. Local officials do not have to give up any control to state officers. Local officials will be certain that a bankruptcy "out" is available if necessary. State officials enjoy insulation from any negative fallout from the local crisis, and no immediate state budgetary issues are implicated. No special appropriation need be made to resolve the crisis. State officials can simply wait and see. Moreover, the short-term financial costs imposed as a result of the municipal filing are largely invisible from a budgetary standpoint. Those costs come in the form of higher borrowing costs for other municipal issuers, a consequence for which no state official need be blamed.

The political dynamics suggest that, absent some specific incentive to do otherwise, state and local officials may join forces too late, rather than too early. But in general, it may be preferable to err on the side of early state involvement. State participation assures that statewide interests are considered in the formulation and execution of a strategy for addressing the crisis, and early involvement may serve to avoid some of the costs of distress.

Moreover, bankruptcy need not necessarily precede a comprehensive plan of debt restructuring.¹⁰⁵ It may be that state

104. See BALDASSARE, *supra* note 1, at 26. Orange County voters overwhelmingly rejected a proposed half-cent sales tax increase to fund the County's bankruptcy recovery. See *id.* at 160.

involvement could help avoid the need for a bankruptcy filing, thereby minimizing the fallout from a default. State involvement could pave the way for whatever state approvals—executive or legislative—may be required to implement a restructuring outside of bankruptcy. An emergency appropriation or state credit could help to contain a crisis, while setting certain terms and conditions for restructuring. For example, when New York City encountered fiscal problems in 1975, the state intervened. It created agencies to guaranty the city's loans, while imposing fiscal controls on city government.¹⁰⁶ New York and other states, anticipating municipal financial distress, have enacted comprehensive mechanisms for state intervention. These mechanisms generally incorporate the possibility of a bankruptcy filing, but do not depend on it.¹⁰⁷

Any plan for resolution of fiscal crisis will have to address the concerns of creditors, residents, and possibly employees. Whatever arrangement is reached among the municipality and these various constituencies will require state involvement. But no deal will be cut without some mechanism to hold everyone's feet to the fire. Bankruptcy could be that mechanism—as it was in Orange County—but it might not have to be. Prebankruptcy state intervention should at least be considered. Bankruptcy may be politically palatable in the short run, but it is an expensive mechanism in terms of both direct and indirect costs, and these costs are distributed haphazardly through the workings of the bond markets.¹⁰⁸ Moreover, a bankruptcy filing may be interpreted as the municipality's repudiation of its full faith and credit commitment to its bondholders—its commitment to resort to its taxing powers if necessary to satisfy its debt.¹⁰⁹

A discretionary bankruptcy authorization mechanism requiring approval of state officials would encourage early interaction. Local officials, anticipating the possibility of financial distress, would wish to explore the bankruptcy option. But to do that, they would have to consult with the state officials responsible for authorizing the bankruptcy filing. That is, they would have to involve state officials in their bankruptcy planning. State officials, knowing they might have

105. Indeed, Section 109(c) contemplates that a municipality may already have negotiated a plan satisfactory to the majority of its creditors by the time it files for bankruptcy. See 11 U.S.C. § 109(c)(5)(A) (1994). Chapter 9 would then simply be used to impose the plan over the objection of any minority dissenting creditors.

106. See BALDASSARE, *supra* note 1, at 11. This is not to suggest that the nature of New York City's fiscal problems were similar to Orange County's. However, in these cases and others, state involvement is almost always required.

107. See *infra* Part IV.

108. After municipal bankruptcy and default, the next municipality interested in floating a bond issue will suffer higher interest rates in the market, or will simply do without the financing.

109. See BALDASSARE, *supra* note 1, at 119.

to decide whether to authorize a bankruptcy filing, would hopefully take an active role in addressing the problem up front. Placing this responsibility on state officials encourages and requires them to focus on the crisis early and to consider its statewide implications. Such implications may be significant—as in Orange County—or insignificant. A hands-off approach at the state level may or may not be appropriate in given cases. But simple inertia should not be the reason for a lack of proactive state involvement.

Throughout the Orange County crisis, the governor and other state officials had apparently been kept well informed by county officials. However, the state took no action—formal or informal—until after bankruptcy was filed in December 1994, even though signs of financial demise were readily apparent months before the filing. The Orange County treasurer's race in the spring of 1994 called attention to the high risk of the OCIP portfolio. John Moorlach, challenger to the incumbent Treasurer Robert Citron, warned in May 1994 that OCIP had already lost \$1.2 billion because of interest rate hikes by the Federal Reserve that had begun in February. His dire predictions were discounted to some extent as mere political attack on the incumbent. However, by mid-November, outside auditors retained by the County confirmed a \$1.5 billion loss. When the County could not convince its investment bankers not to foreclose on their collateral for the County's reverse repurchase agreements, the County filed for bankruptcy on December 6, 1994.¹¹⁰

Even after the filing, the state made no official move to intervene. Instead, there was mutual finger pointing between state and county officials as to who should bear blame for their failure to work together to avoid the bankruptcy.¹¹¹ Unofficially, Governor Wilson convinced a former member of his administration, Tom Hayes, to step in to manage OCIP shortly after the bankruptcy filing.¹¹² The governor's ties to Orange County presumably helped to pave the way for Hayes' appointment by the county Board of Supervisors. "The governor had accomplished a new kind of 'state intervention.' The county government had retained the former state treasurer as the overseer of the failed investment fund."¹¹³

It was only after the County had declared bankruptcy and defaulted on bond obligations, county taxpayers rejected a proposed half-cent sales tax increase, and the County worked out settlement terms with investment pool participants, that the legislature acted in

110. *See id.* at 175.

111. *See id.* at 121.

112. Hayes had been state treasurer and state auditor-general under Wilson. *See JORION, supra* note 33, at 78.

113. BALDASSARE, *supra* note 1, at 122.

furtherance of a comprehensive resolution of the crisis.¹¹⁴ While it is unclear, given the politics of the situation and the complexity of the legal issues involved, whether a comprehensive settlement could have been accomplished *without* resort to bankruptcy,¹¹⁵ in other cases, bankruptcy and default may be avoidable—or their impact lessened—if the financial expertise and resources of the state are made available early on.

C. Miscellaneous Issues

(1) *Moral Hazard*

In designing a framework to manage access to municipal bankruptcy, we should consider not only the question of how best to handle an imminent financial crisis. We should also consider how best to avoid crises and to address their impact at the earliest possible point. Some crises are, of course, unavoidable. However, to the extent that bankruptcy is or is perceived to be a “safety valve” for municipal entities, the safety valve should not be made too easily available.

Requiring approval of state officials means that municipal access to bankruptcy protection is never certain. Moreover, the prospect of state involvement may mean a curtailing of local autonomy, with possible political costs to local officials. Therefore, at the margin, municipal officials have some incentive to steer a more conservative fiscal course than they might if bankruptcy were always a ready alternative.¹¹⁶ Assuming that local officials do not relish involvement of state officials in local affairs, a state approval requirement and the prospect of further state involvement provide additional incentive to avoid financial distress.

(2) *Confidentiality*

Confidentiality may also matter in the early stages of a financial crisis. A municipality will wish to avoid panicking residents and employees, and one whose bonds are publicly traded will wish to avoid roiling the markets. Introducing state officials into the mix may create some confidentiality risks. Any bankruptcy authorization mechanism should be structured to avoid or at least minimize this risk.

114. See *infra* note 159 and accompanying text.

115. Experts and observers disagree as to whether a bankruptcy filing was necessary. See 28 Bankr. Ct. Dec. (LRP), News and Comment, No. 9, at A1 (February 6, 1996).

116. This is not to say that municipal officials do not already have significant political and other constraints that demand their fiscal vigilance. However, uncertainty as to bankruptcy access may also influence local fiscal decisions.

(3) *Smaller or Specialized Entities*

Problems of statewide financial impact will be greatest, of course, with the large municipalities—large cities and counties. Financial distress for smaller municipal entities may not raise these same concerns. However, for these smaller entities, resort to Chapter 9 may be ill advised for other reasons. Certain types of municipal entities may not be ideal candidates for bankruptcy, not because of any widespread impact of their financial demise or any effect on financial markets. Instead, for some municipalities, the complexity and expense of municipal bankruptcy may make it a poor device for handling financial crisis. In the Orange County case, for example, fees for the County's bankruptcy attorneys and other professionals totaled about \$50 million by the end of the case. This figure does not include the costs of the County's postbankruptcy lawsuits or professional fees for OCIP participants.¹¹⁷ For a small pest control district or sewage district, resort to bankruptcy may generate more costs than it saves. For smaller entities, the bankruptcy process may not be cost-justified.

Distinguishing among the multifarious municipal entities that exist in California in terms of their suitability for Chapter 9 is another reason for limiting access at state officials' discretion.

Crafting a workable system of state involvement is hardly a simple affair. Political deadlock might possibly thwart a timely response to fiscal crisis. However, if managed properly, as described below, state involvement need not hinder or delay financial restructuring, and may in fact facilitate it. Operational issues like timeliness, predictability, flexibility, and interests in minimizing threshold litigation are discussed below in the context of my basic framework for discretionary access.

IV. Structuring the Appropriate System

In this Part, I describe my proposal, which places with the governor the discretion to authorize municipal bankruptcy filings. As prologue, I survey the range of plausible approaches to structuring a state authorization mechanism, discussing the general advantages and drawbacks to each basic approach. I then outline my proposal and explain how it attempts to resolve the various tensions.

A. Municipal Bankruptcy Authorization: The Range of Approaches

In this section, I consider plausible approaches to structuring a state authorization mechanism for municipal bankruptcy. Other states' approaches, as well as the bills introduced in the California

117. See BALDASSARE, *supra* note 1, at 180.

legislature in the aftermath of the Orange County bankruptcy, give some flavor of the range of available alternatives. Approaches range from blanket, unqualified authorization for all of a state's municipal entities to express prohibition across the board. In the middle are proposals requiring straightforward prior approval or some exercise of discretion by state officials. Some states have also devised elaborate nonbankruptcy approaches to municipal financial distress, sometimes including bankruptcy as an option.¹¹⁸ These approaches may lead to outright takeover of a distressed municipal entity by a state government.

(1) *Blanket Authorization*

A dozen or so states authorize unfettered access to municipal bankruptcy for some or all of their municipal entities.¹¹⁹ Blanket authorization for all municipal entities otherwise eligible under federal law has the virtues of simplicity and definiteness. This approach provides the municipality with maximum flexibility in dealing with its financial distress and negotiating with creditors. It reduces the likelihood of bankruptcy court litigation over the scope of state law authorization.¹²⁰ It would appear to enable a timely filing, once the municipality has decided to enter bankruptcy.

However, these apparent advantages and their apparent popularity with some states should not be overstated. Even assuming clear state authorization, litigation may arise with respect to the other federal gate keeping requirements of Section 109(c)—for example, whether the entity qualifies as a municipality or whether it is insolvent.¹²¹ Therefore, some amount of uncertainty will always exist as to a municipality's ready access to Chapter 9.

Even assuming that a blanket authorization provision could provide definiteness and flexibility to a municipality in distress, it has

118. See DEP'T OF PUB. ADMIN., COPING WITH FISCAL DISTRESS IN PENNSYLVANIA'S LOCAL GOVERNMENTS: A PROGRAM EVALUATION OF ACT 47 app. 4 (PA State Univ. Graduate Sch. of Pub. Pol'y & Admin. 1991) [hereinafter COPING WITH FISCAL DISTRESS] (summarizing municipal distress statutes of Florida, Illinois, Maine, Michigan, Nevada, New Jersey, New York, North Carolina, and Ohio).

119. See *supra* note 6 and accompanying text. California's existing authorization statute, Section 53760 of the Government Code, would appear to offer broad authorization as well. Though outdated with respect to its references to federal bankruptcy law, the statute essentially authorizes to any California "taxing agency or instrumentality" to file bankruptcy. See *supra* note 27 and accompanying text. However, the Orange County court found that the statute was not broad enough to cover OCIP. See *supra* note 30 and accompanying text.

120. Recall the litigation that occurred under the predecessor provision to current Section 109(c)(2), which required only *general* state authorization for a municipality to file bankruptcy. See *supra* note 23 and accompanying text.

121. See *supra* Part II[C].

one fundamental shortcoming insofar as it ignores the possible statewide financial impact of a municipal filing. By providing blanket access to Chapter 9 without some explicit mechanism for state intervention, the state foregoes its opportunity and responsibility to act to minimize the possible statewide costs of financial distress, which will be borne indirectly by other municipalities and the state as a whole.¹²²

Like California, some states enacted blanket authorization provisions decades ago and never revised them. Washington State, for instance, authorizes "any taxing district" to "file the petition mentioned in section 80 of chapter IX of the federal bankruptcy act."¹²³ This is the same obsolete reference found in California's authorizing provision. The Washington statute was enacted in 1935.¹²⁴ Given that the vast majority of municipal filings have historically involved small special purpose entities—irrigation districts, school districts, and the like—and that the bankruptcy of a city or county is extremely rare, it is not surprising that states enacting authorization provisions fifty or sixty years ago would have failed to consider possible statewide ramifications from bankruptcy filings by cities and counties.¹²⁵

122. *See supra* Part II[A].

123. WASH. REV. CODE § 39.64.040 (1999).

124. *See id.*

125. Moreover, what initially appear to be "blanket" authorization provisions sometimes turn out to be more limited in scope. For example, Florida's authorization statute would appear to provide blanket authorization for all its municipal entities. It states:

For the purpose of rendering effective the privilege and benefits of any amendments to the bankruptcy laws of the United States that may be enacted for the relief of municipalities, taxing districts and political subdivisions, the state represented by its legislative body gives its assent to, and accepts the provisions of any such bankruptcy laws that may be enacted by the Congress of the United States for the benefit and relief of municipalities, taxing districts and political subdivisions and its several municipalities, taxing districts and political subdivisions, at the discretion of the governing authorities thereof, may institute and conduct and carry out, by any appropriate bankruptcy procedure that may be enacted into the laws of the United States for the purpose of conferring upon municipalities, taxing districts and political subdivisions, relief by proceedings in bankruptcy in the federal courts.

FLA. STAT. § 218.01 (1999). However, Florida law also provides for active intervention by the governor in case of financial emergency, which is triggered upon the occurrence of any of several specific financial or other defaults. During the period of financial emergency, the municipal entity may not seek bankruptcy protection without the governor's approval. *See id.* § 218.503(4). The governor also has significant oversight authority over the local entity and may appoint a financial oversight board. *See id.* § 218.503(3). It is unlikely that a municipality would be a candidate for bankruptcy without already having triggered a financial emergency. Therefore, as a practical matter, the blanket authorization provision may never matter.

(2) *Blanket Prohibition*

Like blanket authorization, blanket prohibition of all municipal entities from filing bankruptcy has the advantages of simplicity and definiteness. There will be no litigation over municipal access to Chapter 9. However, this approach obviously makes unavailable what might be a useful tool for financial crisis management. It is quite a blunt approach, effectively predetermining that a Chapter 9 filing will *never* be appropriate for any municipal entity in the state.

At the least, the state would have to provide some other mechanism for addressing municipal financial crisis. But state law approaches may have shortcomings because of federal Constitutional limitations on impairment of contracts.¹²⁶ Blanket prohibition is probably too blunt and is not recommended. Only Georgia expressly prohibits all resort to Chapter 9.¹²⁷

(3) *Limited Nondiscretionary Access*

A middle path between blanket authorization and blanket prohibition would be to create categories of municipal entities that would have varying standards for bankruptcy authorization. Some might be granted unconditional authority to file; others would have conditional authority for bankruptcy; and still others would be prohibited. Given the multifarious types of municipal entities that exist in California, it might be possible to distinguish particular types of entities that should or should not have access to bankruptcy. General purpose political subdivisions—cities and counties—are distinguishable from special purpose entities—irrigation, hospital, and pest control districts. The statewide political and economic ramifications of financial distress would generally be more drastic with the former than the latter. The latter are more likely to be smaller, with smaller budgets and fewer constituents that might be affected by an entity's financial distress.

This "pre-defined access" approach has merit insofar as it offers the prospect of separate, somewhat tailored solutions for different types of municipalities. This might provide some definiteness and predictability for particular municipal entities, financial markets, and creditors, as compared to a wholly discretionary system. By drawing lines ahead of time, this approach might avoid the politicization and confusion that could occur in attempting to exercise discretionary authority in the charged context of a particular crisis.

On the other hand, this approach may suffer the risk of rapid obsolescence. Times change faster than statutes do, as the current

126. See *supra* Part I[A].

127. See *supra* note 7 and accompanying text.

authorization provision illustrates. New types of municipal entities may arise. Witness the Orange County Investment Pool. New types of financing are possible. It may be too much to hope that a statute of this type would maintain its relevance without constant revision, a fairly unattractive prospect.

Moreover, even adopting a line drawing approach, it is not altogether clear where to draw the lines or even what the appropriate line drawing criteria should be. Even distinguishing general purpose entities from special purpose districts as proposed above does not give us clear direction as to which group—if either—should have more ready access to Chapter 9. As discussed earlier, limiting access for cities and counties is justified because of the statewide implications of a filing and the necessary involvement of state officials in structuring a comprehensive fix.¹²⁸ By contrast, limiting access for smaller special purpose entities makes sense because bankruptcy might not be a cost effective way to resolve their fiscal woes. A pest control district, for example, might not possess the financial, legal, or other expertise necessary to use bankruptcy effectively, or even to decide whether bankruptcy would be useful.¹²⁹ In addition, municipalities of the same type may have vastly different fiscal problems. One county, for example, may suffer from a progressively shrinking tax base and a daunting payroll burden, while another risks financial default because of poor investment decisions. In either case, whether and when to allow resort to bankruptcy is difficult to decide in the abstract.

In my research, I did not come across any state with a coherent or comprehensive system for categorizing municipal entities for purposes of bankruptcy access. Some states have particular authorizing statutes for particular types of entities, but these appear to have been enacted on an ad hoc basis for the specific types of municipal entities addressed, and not in any comprehensive way. For example, Colorado has separate authorizing provisions for irrigation and drainage districts¹³⁰ and special districts,¹³¹ but no statute of general application.¹³² As a result, authorization statutes for particular entities may be scattered throughout a state's general laws.

128. See *supra* Part III[A].

129. See *supra* Part III[C].

130. See COLO. REV. STAT. § 37-32-102 (1999).

131. See *id.* § 32-1-1403.

132. The reason for this lack of a general statute in Colorado and other states may be that before 1994 federal bankruptcy law did not require specific state authorization but only general authorization. Many courts were willing to infer general authorization quite readily. See cases cited *supra* notes 24-25. States may therefore have assumed that for general purpose municipalities, explicit statutory authorization was unnecessary, and they

B. A Proposal for Discretionary Access

The basic premise of my proposal is that the governor must authorize any municipal bankruptcy filing. The governor should also have wide latitude to attach conditions to the bankruptcy authorization. In terms of setting conditions, the governor should have a short menu of well-defined options at his disposal, including the possible appointment of a trustee to manage the municipal entity through its financial crisis.

My approach attempts to encourage and facilitate cooperation between the state and the distressed municipality. Rather than empowering the governor to dictate terms to a municipality in trouble, it will encourage early communication between the two and a negotiated resolution of any financial crisis. This section describes the structure and scope of the discretionary system. The next section explains the anticipated negotiation dynamics.

(1) Other State Models

Several states have similar discretionary systems. Connecticut requires the governor's consent.¹³³ In addition, if he consents, the governor must report to the state treasurer and the General Assembly to explain the basis for this decision.¹³⁴ North Carolina requires preapproval by a Local Government Commission,¹³⁵ a nine-member commission that forms a division within the state treasurer's department. The Commission comprises the state treasurer, the state auditor, the secretary of state, the secretary of revenue, and five appointees.¹³⁶

In New Jersey, a Municipal Finance Commission must approve both the filing of the petition¹³⁷ and any plan of adjustment.¹³⁸ These provisions are part of a general state intervention scheme. Once a municipality has been in financial default to bondholders or noteholders for more than sixty days, the Commission may intervene

have not gotten around to amending their statutes following the 1994 bankruptcy amendment requiring specific authorization.

133. See CONN. GEN. STAT. § 7-566 (1999).

134. See *id.* This provision was enacted in the wake of the controversy over the city of Bridgeport's attempt to file bankruptcy over the objection of the state of Connecticut, which claimed that Bridgeport was not authorized to file under state law. See *In re City of Bridgeport*, 128 B.R. 688 (Bankr. W.D. Conn. 1991). That case arose under former Section 109(c) of the Bankruptcy Code, which required only general state authorization to file. See *supra* note 22 and accompanying text.

135. See N.C. GEN. STAT. § 23-48 (1999). This provision, enacted in 1939, is a bit outdated. It refers to creditor approval issues from a 1937 federal bankruptcy statute. See *id.*

136. See *id.* § 159-3.

137. See N.J. STAT. § 52:27-40 (1999).

138. See *id.* § 52:27-42.

to manage the financial affairs of the municipality.¹³⁹ Other states have similar comprehensive schemes for assertion of state control over municipalities in distress. Typically the body designated by the state to oversee or manage the municipality also has power to authorize or even initiate a bankruptcy filing.¹⁴⁰

Pennsylvania has *two* separate systems for cities in distress—one for its largest cities¹⁴¹ and one for smaller cities and towns.¹⁴² The Pennsylvania Intergovernmental Cooperation Authority is a state agency charged with providing technical and financial assistance to large cities in distress.¹⁴³ Among other things, the Authority may issue bonds and extend loans to the “assisted city.” While this system is quite elaborate, several details are worth noting. First, neither the Authority nor the assisted city may file for bankruptcy as long as the Authority has bonds outstanding.¹⁴⁴ Second, the governor must approve any bankruptcy petition and the plan of adjustment, which must be submitted for the governor’s approval along with the petition.¹⁴⁵ For certain other municipal entities, the Department of Internal Affairs must authorize the bankruptcy filing and approve the plan of adjustment.¹⁴⁶

(2) *Why the Governor?*

Given the need for early state involvement in municipal financial distress situations, the governor’s office is probably the best place to begin that cooperative process. The governor is the chief executive of the state, and his office may be best situated to bring expertise and resources to bear on the problem and to initiate any legislative or

139. See *id.* § 52:27-2. The Commission is in the Division of Local Government within the Department of the Treasury. See *id.* § 52:18A-20.

140. See Freyberg, *supra* note 6, at 1011.

141. The Pennsylvania Intergovernmental Cooperative Authority Act (“Act 6”) was passed in 1991. See 53 PA. STAT. §§ 12720.101-709 (1999). It applies only for “cities of the first class,” which are those with populations exceeding one million. See *id.* § 101. At the time of enactment of Act 6, Philadelphia was the only first class city in the state. See Comment, Drew Patrick Gannon, *An Analysis of Pennsylvania’s Legislative Programs for Financially Distressed Municipalities and the Reaction of Municipal Labor Unions*, 98 DICK. L. REV. 281, 292 (1994).

142. The Municipal Financial Recovery Act (“Act 47”) was enacted in 1987. See *id.* §§ 11701.101-501. It was designed specifically to address the fiscal crises of dying steel towns in western Pennsylvania. See Gannon, *supra* note 141.

143. See 53 PA. STAT. § 12720.203 (1999).

144. See *id.* § 12720.211(A).

145. See *id.* § 12720.211(B), (C).

146. See *id.* § 5571. Pennsylvania’s model of state intervention may be particularly instructive insofar as it has actually gotten some use. In 1992, the city of Scranton, the fifth largest in the state, became the *tenth* municipality to seek refuge under Pennsylvania’s Financially Distressed Municipalities Act of 1987. See Michael deCourcy Hinds, *A Campaign to Pull Scranton Back from Disaster*, N. Y. TIMES, July 21, 1992, at A12.

executive action that may be necessary. Placing responsibility for the decision with the governor's office also eliminates any ambiguity concerning who at the state level is "responsible" for authorizing the bankruptcy filing. This has both political and practical administrative benefits.

Having only one state official making the authorization decision assures that that official bears the entire responsibility—that is, receives all the credit or blame—for a good or bad decision or strategy.¹⁴⁷ That political clarity will encourage the full attention of the governor's office to the crisis. Any inclination to head for the sidelines, to try to sidestep the likely political fallout from the crisis, would be untenable. As the sole gatekeeper regarding any possible bankruptcy strategy, the governor and his office would have no choice but to become involved. This clear delineation of authority also assures that if necessary, prompt action is possible. In case exigent circumstances require an immediate decision concerning a bankruptcy filing, the governor can provide the necessary authorization. By contrast, a committee structure or legislative approach might include more procedural baggage, which always creates the possibility of gridlock or other delay.

In my view, affirmative authorization should always be required. That is, the authorization statute should not permit or create the potential for authorization by default as a result of the governor's failure to act on an application. Among other things, SB 349 provided that any request for authorization would be considered approved after five days unless the LABC responded otherwise. However, that kind of "pocket approval" is exactly the sort of mechanism that attenuates political accountability and facilitates inaction at the state level. It leaves the municipality to its own devices without any active involvement by state officials.¹⁴⁸

The point of *not* allowing for passive authorization is to improve political accountability by assuring that state officials must do *something*, as opposed to doing nothing, in the face of a municipal crisis. Eliminating the possibility of passive state authorization forces the governor to act, either by explicitly acquiescing to the request for authorization or coming up with an alternative. It also underscores

147. My preference for the governor is not a strong one. I am more concerned that *one* senior state official be responsible for exercising the discretionary power to authorize municipal filings. The state treasurer might be an equally appropriate state officer. For the following discussion, however, I will assume that the governor is the designated officer.

148. In addition, there is always the issue of what should be the appropriate amount of time within which the authorizing body or person must respond before a decision is made by default. Too long a period might hamper timely action by the distressed municipality. Too short a period might force uninformed decisions by state officials vested with the discretionary authority.

the point that a municipal filing is more than simply a local matter, and as such demands the attention and action of the governor and other state officials.

Local officials might balk at the possibility that the governor's inaction might delay a bankruptcy filing indefinitely. However, this theoretical possibility should not create a basis for objection. Given the statewide financial impact of a bankruptcy filing, no municipal entity has any "right" to file based on any notion of home rule or local autonomy. Once a local crisis threatens to impose costs on other entities throughout the state, the crisis is no longer simply a matter of local concern. Moreover, as earlier discussed, ready access to Chapter 9 creates moral hazard problems, and uncertain access may have some disciplining effect on local officials.¹⁴⁹ To the extent that timely action by the governor may matter, it will be up to local officials to coordinate with the governor's office, making sure that the governor is up to speed on the issues, so that he may make timely decisions as necessary. A municipal filing should *always* require some affirmative authorization from the state.

(3) *Guidelines Concerning Discretion*

It may be advisable in the authorizing statute to include guidelines for the governor's exercise of discretion. The authorizing statute might describe factors for the governor to consider or particular agencies to consult, depending on the type of municipal entity. For example, the superintendent of schools would be a useful adviser to the governor concerning the possible bankruptcy filing for a school district. Perhaps the superintendent's concurrence in the governor's grant of bankruptcy authorization should be required as well.¹⁵⁰ This sort of "authority-sharing" arrangement would depend on the particular type of municipality at issue, but in any event should at a minimum require the governor's affirmative authorization.

Pennsylvania's authorizing statute for large cities provides an example. It describes the process by which the governor must exercise discretion with respect to a city contemplating a municipal filing, including particular agencies with which the governor must consult:

- (1) When any such petition shall be submitted to the Governor for approval, accompanied with a proposed plan of readjustment of the debts of a city, the Governor shall make a careful and thorough

149. See *supra* Part III[C][1].

150. Under current law, the state-appointed administrator for a distressed school district must approve the school district's bankruptcy filing. See CAL. EDUC. CODE § 41325 (1999). See also *In re Richmond Unified School Dist.*, 133 B.R. 221 (Bankr. N.D. Cal. 1991) (granting Chapter 9 debtor's motion to dismiss case after state school superintendent appointed administrator to govern school district).

investigation of the financial condition of such city, of its assets and liabilities, of its sinking fund, and whether the affairs thereof are managed in a careful, prudent and economic manner in order to ascertain whether the presentation of such petition is justified, or represents an unjust attempt by such city to evade payment of some of its contractual obligations, and, if the Governor believes that such petition should be approved, whether the plan of readjustment submitted will be helpful to the financial condition of the city and is feasible and, at the same time, fair and equitable to all creditors.

(2) The Governor shall also, prior to giving his approval, ascertain the amount, if any, of the obligations of any such petitioning city which is held by any agency or agencies of the State government as trust funds and shall, before approving any such petition and plan of readjustment, consult with and give every such agency an opportunity to be heard and the privilege to examine the findings of the Governor resulting from the investigation hereinbefore required to be made, and shall likewise hear any other creditor of such city, whether resident in or outside of this Commonwealth, who shall apply therefor.

(3) The Governor, if he approves a petition, shall, before giving his approval, require such modification in the proposed plan for readjusting the debts as to him appear proper.¹⁵¹

Providing guidelines would be politically useful as well, making clear that the governor's discretion is not unfettered. On the other hand, guidelines that are too elaborate might hobble the system, either requiring excessive investigation by the governor before making a decision or creating the possibility of litigation over the governor's compliance with the guidelines. The right balance will be important.

(4) *Conditions to Filing: Financial and Operational Oversight*

As the state officer empowered to authorize a municipal bankruptcy filing, the governor should also be given the power to attach conditions to any authorization.¹⁵² Certain conditions may be appropriate in order to facilitate a prompt resolution of the crisis and to mitigate the statewide impact of a filing. Several states have enacted fairly elaborate nonbankruptcy approaches to municipal distress, with varying degrees of oversight and control over municipal affairs during the pendency of the crisis. For our purposes, similar provisions could be included as "off-the-rack" options for the

151. 53 PA. STAT. § 12720.211(C) (1999).

152. For a thorough discussion of the legal basis for the state's imposition of conditions to authorization, see AMY CHANG, MUNICIPAL BANKRUPTCY: STATE AUTHORIZATION UNDER THE FEDERAL BANKRUPTCY CODE (Pub. Law Research Inst., Univ. of Cal., Hastings College of the Law, Working Paper Series (Fall 1995)), available at www.uchastings.edu/plri/fal95tex/muniban.html.

governor to attach as conditions to an authorization for a bankruptcy filing. Conditions could range from the governor's prebankruptcy approval of a proposed plan of adjustment to the governor's appointment of a trustee to manage the municipality's affairs during the pendency of the bankruptcy case.

In Michigan, if evidence exists of a "serious financial problem" with a local government, the governor may appoint a "review team" to make an assessment.¹⁵³ The review team is empowered not only to investigate the local government entity, but also, if necessary, to negotiate a consent agreement with the local government concerning long-range plans for financial recovery.¹⁵⁴ If a consent agreement is not obtained or the local government subsequently fails to comply, then the governor may declare a financial emergency and basically effect a takeover of the local government by an emergency financial manager.¹⁵⁵ The emergency financial manager has authority to place the local government in bankruptcy if attempts to adopt and implement a feasible financial plan fail.¹⁵⁶

While these nonbankruptcy municipal crisis management structures may be a bit more elaborate than California may need or want, they provide useful models of state management from which to borrow. Resort to these devices could be done contemporaneously with an authorization to file bankruptcy. Without limiting the governor's discretion to tailor conditions to particular circumstances, I propose three basic "off-the-rack" conditions—and one variation—that might be useful.

(a) Option 1

The most aggressive condition that the governor could attach to a bankruptcy authorization would be his appointment of a trustee to manage the municipality's affairs, including plan formulation, for the

153. See MICH. COMP. LAWS § 141.1213 (1999).

154. The agreement may provide for remedial measures considered necessary including a long-range financial recovery plan requiring specific local actions. The agreement may utilize state financial management and technical assistance as necessary in order to alleviate the local financial problem. The agreement may also provide for periodic fiscal status reports to the state treasurer. In order for the consent agreement to go into effect, it shall be approved, by resolution, by the governing body of the local government. *Id.* § 141.1214.

155. The governor shall "assign the responsibility for managing the local government financial emergency to the local emergency financial assistance loan board," which appoints an emergency financial manager. *Id.* § 141.1218(1).

156. This decision to file bankruptcy is subject to veto by the local emergency financial assistance loan board. See *id.* § 141.1222.

duration of the case. This condition should probably be reserved only for serious cases of financial mismanagement.¹⁵⁷

The option to appoint a trustee should also be available to the governor for the duration of any ongoing bankruptcy case, in case the debtor fails to comply with other, earlier conditions to authorization as described below. Because no well-defined mechanism exists to *revoke* a municipal debtor's previously granted state authorization, the state may need to resort to appointment of a trustee in order to enforce its conditions or to dismiss a bankruptcy proceeding that the state deems is no longer advisable.

(b) Option 1A

A less intrusive precondition to bankruptcy authorization would be appointment of a trustee with the sole responsibility of formulating the plan. Municipal operations would continue to be managed by local officials, while the trustee focused on creditor negotiations. Failure of local officials to cooperate with the trustee with respect to plan formulation might result in expanded powers for the trustee.¹⁵⁸

(c) Option 2

This approach is less aggressive than Option 1, but would allow the governor to monitor the case quite closely. It would require that a plan of adjustment be submitted for the governor's approval along with the request for bankruptcy authorization. Authorization could then be conditioned on the filing of the governor-approved plan either contemporaneously with the filing of the bankruptcy petition or before some specified deadline date. The governor could (a) reserve the right to approve any modification to the plan, and (b) set a deadline for plan confirmation as well. A post-filing violation of these conditions could trigger the governor's appointment of a trustee, either to take control of the plan formulation process or to manage the municipal debtor in general.

157. Because of the intrusiveness of this condition, perhaps its use should require the governor to obtain the concurrence of the state treasurer or another state official. However, the benefits of including restraints on the governor's discretion should be carefully weighed against the possible costs of deadlock. Imagine, for example, that the governor refuses to authorize bankruptcy without appointment of a trustee, but the state treasurer refuses to concur in that precondition. The governor, the state treasurer, and municipal officials would then be locked in a sort of triangular negotiation, with possibilities for political opportunism all around.

158. Pennsylvania's approach for general municipal distress takes a similar approach. Upon the filing of a petition, a plan coordinator is appointed to formulate the plan. *See* 53 PA. STAT. § 11701.262(C) (1999). The municipal debtor's failure to cooperate with the coordinator can result in suspension of state funding to the municipality. *See id.* § 11701.264.

(d) Option 3

The least intrusive approach would be for the governor to authorize the filing, and set deadlines for the filing and confirmation of a plan of adjustment. Failure to meet either deadline could result in appointment of a trustee.

There is legislative precedent in California for these approaches, and in particular for reliance on the trustee mechanism. With a series of bills, the legislature approved the diversion of infrastructure funds to the Orange County general fund to enable the county to fund a bankruptcy plan.¹⁵⁹ With SB 1276, the legislature added a “back-up mechanism” to “guarantee that the county will be able to prepare and obtain confirmation of an acceptable plan of adjustment.”¹⁶⁰ This back-up mechanism was the possible appointment of a state trustee at the discretion of the governor if the County had not filed a plan by January 1, 1996.¹⁶¹ Further, if the governor determined that timely confirmation of a plan appeared unlikely by May 1, 1996, then appointment of a trustee was required.¹⁶² The trustee, if appointed, was broadly authorized to act for the County, exercising all powers of the board of supervisors.¹⁶³

C. Negotiated Resolution

The structure described above anticipates that state and local officials will discuss possible conditions to bankruptcy authorization prior to any formal authorization request. For example, the governor might wish to appoint a trustee, but the municipality might oppose. As I envision the structure, the governor could not impose a trustee simply based on a municipality’s application for authorization, but may require it as a condition to filing. The municipality would be free to reject the governor’s bankruptcy authorization and attached conditions by deciding not to file for bankruptcy, and the conditions to authorization would never go into effect.

This approach gives the municipality some measure of local sovereignty and yet encourages it to explore the bankruptcy option with the governor. While this may ultimately result in a standoff between the governor and the municipality, hopefully they would be

159. See BALDASSARE, *supra* note 1, at 167-68 (describing series of bills—AB 1664, SB 863, SB 1276 and SB 727—that effected funding of Orange County plan).

160. CAL. GOV’T CODE § 30400(b).

161. See *id.* § 30401(a).

162. See *id.*

163. See *id.* § 30402. Because of the unusual circumstance that many *creditors* were also municipal entities, the trustee was also authorized to act on behalf of these cities, public districts, and other governmental agencies with claims against the county, to the extent necessary to prevent denial of confirmation of a plan of adjustment. See *id.* § 30405.

able to reach a negotiated arrangement.¹⁶⁴ This model of negotiated management of financial crisis follows other states' nonbankruptcy mechanisms for resolution of municipal distress. As previously described, Michigan's "review team" appointed by the governor is empowered to negotiate a consent agreement with a distressed local government concerning a recovery plan.¹⁶⁵ Pennsylvania's Intergovernmental Cooperation Authority is authorized to negotiate "intergovernmental cooperation agreements" with cities in need of assistance, and general assistance may not be provided unless such an agreement is in effect.¹⁶⁶

In contrast to these elaborate nonbankruptcy schemes, my proposal is less formal, less elaborate, and less aggressive than these other state systems. Because it is based on bankruptcy authorization, the system I propose is formally triggered only by a municipal entity's application for bankruptcy authorization and its subsequent bankruptcy filing. By contrast, some states' municipal distress systems include objective triggers of financial distress that enable early unilateral state intervention. I believe a more informal approach is appropriate for California. States that have elaborate state intervention provisions, like Michigan and Pennsylvania, typically anticipated multiple municipal crises as a result of general economic downturns and declining tax bases in their respective regions. Without prompt and active intervention by the state, successive municipal crises could have had severe statewide ramifications.¹⁶⁷ In California, by contrast, municipal financial distress is quite rare, especially for general purpose municipalities.

D. The Politics of Legislating Discretionary Access

This distinction between California's situation and those of states like Michigan and Pennsylvania suggests a final issue worth mentioning: the politics of legislating a discretionary access approach. Consistent with earlier discussion on the politics of state involvement in municipal distress,¹⁶⁸ the crafting of a more active role for the state in the affairs of financially distressed municipalities may face opposition from municipal entities and indifference from state

164. Possible legislative action would always be available to resolve a deadlock, either by authorizing the governor to appoint a trustee regardless of any bankruptcy filing, or by granting special authorization for the municipality to file, or something in between.

165. See *supra* notes 153-154 and accompanying text.

166. See 53 PA. STAT. § 12720.203(D) (1999).

167. See generally *COPING WITH FISCAL DISTRESS*, *supra* note 118 (focusing on six distressed Pennsylvania municipalities—three cities and three boroughs—that became financially distressed in the three years following implementation of the Financially Distressed Municipalities Act (Act 47 of 1987), and commenting on efficacy of that act).

168. See *supra* Part III[B].

officials. Even for a financially healthy municipality, its local officials may find unappealing the possibility of an increased role for the state in the case of its hypothetical financial distress. State officials as well may be unenthusiastic about the prospect of early involvement in managing local distress situations.

However, each municipality, while concerned for its own autonomy, must also consider the consequences of autonomy for other municipalities in the state. Because a healthy municipality may be adversely affected by another municipal entity's financial mismanagement or misfortunes, municipalities might favor legislating some system of active state involvement in municipal distress. Especially in states facing statewide economic crisis, healthy local entities may support state intervention in the affairs of distressed entities. A healthy entity has much to lose in that context without state intervention to stem the crisis. State officials likewise may have no choice in that situation but to assert an active role. Moreover, the specter of once-pending statewide financial crisis may go a long way toward explaining the existence of provisions for aggressive state intervention in other states.

California currently faces no such crisis. Legislating a more active role for the state—even the relatively minor amendment of requiring the governor's authorization for a Chapter 9 filing—may therefore fail to attract instant political support. Ironically, however, the absence of any imminent financial emergency may offer an ideal environment for careful consideration of such legislation. Deliberation removed from the passions of an immediate crisis may produce a better system of state authorization—one that better accounts for statewide interests—than case-specific legislation forged under time pressure in the face of catastrophe.

V. Some Issues Concerning the Scope and Definition of “Municipality”

As earlier discussed, only a municipality—a “political subdivision or public agency or instrumentality of a State”¹⁶⁹—is eligible for Chapter 9. In the course of discussion over California's state authorization scheme, particular questions have been raised concerning the scope and clarity of this federal definition, and whether a state authorization scheme may account for such issues. In this Part, I consider these questions.

169. See 11 U.S.C. § 101(40) (1994).

A. A State Law Definition of "Municipality"

Noting possible ambiguity in the U.S. bankruptcy law definition, some have suggested that a state authorization statute for Chapter 9 should include a state law definition of "municipality" or an enumeration of entities that qualify.¹⁷⁰ This comes in the wake of the controversial bankruptcy court decision in *Orange County* finding that OCIP was not a municipality under the federal statute and therefore not eligible for Chapter 9.¹⁷¹ A state law definition or list of public entities might be useful in indicating to a bankruptcy court what California considers a "public agency or instrumentality" of the state. In particular, a state law provision might at the margin encourage a bankruptcy court to construe Chapter 9 access more liberally than it otherwise would.¹⁷²

This approach has some promise but also some limitations. On the positive side, it makes sense for the state to want to broaden the definition of "municipality" as much as possible, since the state can always limit access through its authorizing power. A state agency should not be denied access to Chapter 9 simply because it has a novel purpose that may not comport with traditional municipal functions.

On the other hand, technically, only the federal definition matters. That definition cannot be expanded by state legislation, any more than any federal statute is subject to modification by a state legislature. No state can *expand* the availability of Chapter 9 by *redefining* the term "municipality." Regardless of any state law definition, it will ultimately always be up to a bankruptcy court to decide whether a particular debtor qualifies under federal law. A state law definition might be informative and persuasive to a bankruptcy court judge, but it cannot rewrite federal law.

A list approach may be more effective. It would not redefine terms contained in the federal statute, but would merely provide a reference for the bankruptcy judge in her attempts to construe the terms "political subdivision" and "public agency or instrumentality" from federal law and decide whether a particular state-created entity qualifies. For example, some manifestation by the state that it considers a county-created investment pool to be a state agency or instrumentality might be persuasive.

170. See Memorandum from Henry C. Kevane, partner, Pachulski Stang Ziehl Young & Jones, to Randall Henry, Office of Senator Quentin L. Kopp at 3 (May 31, 1996) (on file with the California Law Revision Commission).

171. See *supra* note 78 and accompanying text.

172. Presumably, resort to a state law definition would be unnecessary if the point were to narrow access to Chapter 9, since the state can do that anyway through its authorizing power.

This approach has limits, of course. It would be useful only when the entity at issue has some plausible claim to being a public entity. A private firm would not qualify, regardless of any state law spin.

B. Nonprofit Corporations

A question has been raised as to whether a nonprofit corporation that administers government-funded programs may be eligible for Chapter 9.¹⁷³ Given that some or all of the assets of the nonprofit are either restricted grant funds or assets purchased with such funds, the basic concern is that the granting government agency be able to recover the assets, instead of having them used to satisfy the claims of general creditors.¹⁷⁴ The short answer to this inquiry is two-fold. First, nonprofit corporations generally do not qualify as municipalities, even if their sole activity is administering government-funded programs. Therefore, they are ineligible for Chapter 9. Second, concerns of the granting government agencies can adequately be addressed in Chapter 11, for which nonprofit corporations are clearly eligible.

The basic statutory hurdle for such entities with respect to Chapter 9 is that because they are private entities, as opposed to government entities, they will generally fail to qualify as municipalities. What distinguishes a public entity from a private one is that a public entity is subject to the control of some public authority.¹⁷⁵ A nonprofit corporation will generally fail this test. While its grant funds may be subject to government control in the sense that uses of the funds are typically restricted by the terms of the applicable grants, that type of contractual restriction imposed by the government does not change the essentially private character of the corporation. Nonprofit corporations are ordinarily formed and controlled by private parties, not governmental entities. Their managers and directors are private parties. Contracting with a government entity cannot transform the private entity into a public one. The special protections from federal court interference that

173. See Stan Ulrich, *Bankruptcy Code: Chapter 9 Issues*, Staff Memorandum 97-19, California Law Revision Commission, at 7 (March 22, 1997).

174. Telephone Interview with Colin W. Wied, Esq., former commissioner and chairperson, California Law Revision Commission (Mar. 7, 2000).

175. See *In re Westport Transit District*, 165 B.R. 93, 95 (D. Conn. 1994) (ultimately dismissing petition because municipal entity was not authorized to file); *In re Ellicott School Building Authority*, 150 B.R. 261, 264 (Bankr. D. Colo. 1992); *In re Greene County Hospital*, 59 B.R. 388, 389 (S.D. Miss. 1986) (citing *Ex parte York County Natural Gas Authority*, 238 F. Supp. 964, 976 (W.D. S.C. 1965), *modified*, 362 F.2d 78 (4th Cir. 1965), *cert. denied*, 383 U.S. 970 (1966)). In *Greene County Hospital*, the court found that because a hospital was subject to control by a county board of supervisors, it qualified as a public agency. *Greene County Hospital*, 59 B.R. at 390.

Chapter 9 affords to municipal debtors are unnecessary for private corporations, which do not raise Tenth Amendment concerns.¹⁷⁶

Moreover, the use of a nonprofit for quasi-governmental purposes is sometimes driven by a desire to *avoid* certain state law restrictions that might apply to public agencies. The only published decision specifically addressed to this issue is *In re Ellicott School Building Authority*,¹⁷⁷ which involved a nonprofit corporation whose main purpose was to engage in a lease financing arrangement for a school building. The debtor nonprofit corporation was formed to finance, construct, and own a school building that it would lease to Colorado School District 22.

The debtor financed its land acquisition and construction with two bond issues.¹⁷⁸ Use of a nonprofit corporation to issue the bonds was necessary in order to avoid state law requirements concerning voter approval for tax increases. Voters in the school district had earlier defeated a bond proposal that would have authorized a tax increase to finance the new school building.¹⁷⁹ The debtor's articles of incorporation required that the debtor's directors be residents of the school district, but not elected officials or employees of the school district. The apparent purpose of this latter restriction was to assure that the nonprofit would not be considered the alter ego of the school district, and the debt would not be considered municipal debt subject to state law restrictions.¹⁸⁰ Given this structuring and the point of forming the nonprofit in the first place, it would have been ironic if the debtor nonprofit had subsequently been permitted to claim status as a public agency and avail itself of Chapter 9.

While nonprofit corporations will not generally be eligible for Chapter 9, they are eligible for Chapter 11 reorganization—without the need for any state authorization¹⁸¹—and are accorded some advantages over their for-profit counterparts. Creditors cannot involuntarily place a nonprofit corporate debtor into bankruptcy.¹⁸² A nonprofit corporation's Chapter 11 case cannot be converted to a Chapter 7 liquidation without its consent.¹⁸³

176. See *supra* Part I.

177. 150 B.R. 261 (Bankr. D. Colo. 1992).

178. The bonds were secured by a mortgage on the land and improvements and an assignment of the lease between the debtor and the school district. See *id.* at 262.

179. See *id.* at 263.

180. See *id.* at 264.

181. See 11 U.S.C. § 109 (1994).

182. See *id.* § 303(a). The Code does not specifically use the term "nonprofit." Instead, a nonprofit corporation is "a corporation that is not a moneyed, business, or commercial corporation." *Id.*

183. See *id.* § 1112(c).

Perhaps most important for a nonprofit administering government-funded programs, the government funds may not necessarily be subject to creditors' claims. To the extent that the government grants restrict the debtor's uses of grant funds, the debtor may be deemed merely "an agent to carry out specified tasks" for the grantor.¹⁸⁴ The case of *Joliet-Will County*¹⁸⁵ involved grants that imposed "minute controls" on the use of government funds.¹⁸⁶ The recipient had very little discretion:

Each grant contains a budget specifying the items for which costs chargeable to the grant may be incurred and the amount that may be charged for each item. The grantee may not switch unused funds between items, and although he has title to any personal property bought with grant moneys he must reconvey to the government, if the government tells him to, every piece of property costing \$1,000 or more. In these circumstances, the grantee's ownership is nominal, like a trustee's.¹⁸⁷

As such, the debtor is not a borrower from the granting agency but a trustee for the agency's funds. The funds are not the debtor's property and are therefore not subject to creditors' claims. Instead, they are assets of the granting agencies, which can recover them out of bankruptcy.¹⁸⁸

Conclusion

I have proposed a discretionary system of state authorization that balances (a) the state's interest in its financial health and the financial health of its various municipalities with (b) individual municipalities' interests in local autonomy. California's authorization statute should place discretion with the governor to decide whether and under what conditions a municipality may file for bankruptcy. His discretion should not be unlimited, but should be subject to guidelines that may vary depending on the type of municipality involved.

By using bankruptcy authorization as a triggering mechanism for state involvement in local financial distress, I hope to encourage early interaction between local and state officials and ultimately a cooperative approach to resolving local distress.

184. *In re Joliet-Will County Community Action Agency*, 847 F.2d 430, 432 (7th Cir. 1988).

185. *See id.*

186. *Id.*

187. *Id.*

188. *See id.*