

# Issue Paper

PAPERS EXAMINING CRITICAL ISSUES  
FACING THE MICHIGAN LEGISLATURE



**Senate Fiscal Agency**

## LOCAL GOVERNMENT FINANCIAL EMERGENCIES AND MUNICIPAL BANKRUPTCY

by

**Eric Scorsone  
Senior Economist**

**May 2010**



Gary S. Olson, Director – Lansing, Michigan – (517) 373-2768 – TDD (517) 373-0543  
[www.senate.michigan.gov/sfa](http://www.senate.michigan.gov/sfa)

# THE SENATE FISCAL AGENCY

The Senate Fiscal Agency is governed by a board of five members, including the majority and minority leaders of the Senate, the Chairperson of the Appropriations Committee of the Senate, and two other members of the Appropriations Committee of the Senate appointed by the Chairperson of the Appropriations Committee with the concurrence of the Majority Leader of the Senate, one from the minority party.

The purpose of the Agency, as defined by statute, is to be of service to the Senate Appropriations Committee and other members of the Senate. In accordance with this charge the Agency strives to achieve the following objectives:

1. To provide technical, analytical, and preparatory support for all appropriations bills.
2. To provide written analyses of all Senate bills, House bills and Administrative Rules considered by the Senate.
3. To review and evaluate proposed and existing State programs and services.
4. To provide economic and revenue analysis and forecasting.
5. To review and evaluate the impact of Federal budget decisions on the State.
6. To review and evaluate State issuance of long-term and short-term debt.
7. To review and evaluate the State's compliance with constitutional and statutory fiscal requirements.
8. To prepare special reports on fiscal issues as they arise and at the request of members of the Senate.

The Agency is located on the 8th floor of the Victor Office Center. The Agency is an equal opportunity employer.



Gary S. Olson, Director  
Senate Fiscal Agency  
P.O. Box 30036  
Lansing, Michigan 48909-7536  
Telephone (517) 373-2768  
TDD (517) 373-0543

Internet Home Page <http://www.senate.michigan.gov/sfa>

## **ACKNOWLEDGMENTS**

I would like to acknowledge the assistance of Jon Savage from Lewis and Mundy, P.C., Lorraine McGowen from Orrick, Herrington and Sutcliffe, LLP, Michael Alandt from the Municipal Advisory Council of Michigan, and Fredrick Headen from the Michigan Department of Treasury. I would also like to acknowledge the invaluable assistance of Karen Hendrick, Executive Secretary, from the Senate Fiscal Agency.

## TABLE OF CONTENTS

	Page
INTRODUCTION .....	1
PA 2 of 1968: Uniform Budgeting and Accounting Act.....	1
PA 34 of 2001: Revised Municipal Finance Act .....	2
PA 140 of 1971: Glenn Steil State Revenue Sharing Act .....	2
PA 243 of 1980: Emergency Municipal Loan Act .....	2
PA 72 of 1990: Local Government Fiscal Responsibility Act .....	3
MUNICIPAL BANKRUPTCY.....	5
New York City 1975 Fiscal Crisis.....	5
Philadelphia, PA 1991 Fiscal Crisis and Act 11 .....	6
Pennsylvania and Act 47 .....	6
Assessing Different Financial Emergency Approaches .....	7
Basics of Municipal Bankruptcy .....	8
Bankruptcy Conditions .....	8
Bankruptcy Actions .....	9
CONCLUSION .....	11
SOURCES .....	12

## INTRODUCTION

The current economic conditions that have significantly impaired Michigan's economy have led to serious fiscal problems for local government. These problems first began to affect local government through State revenue sharing reductions beginning in 2001. Fiscal stress was greatly exacerbated when revenue sharing cuts were combined with losses in property tax revenue as the national financial crisis began to unfold in 2007 and 2008. This stress has manifested itself in the form of service reductions, employee layoffs, the extensive draw down of fund balance and rainy day reserve funds, and, in some cases, the use of deficit-elimination bonds.

Over the past few years, due to financial emergencies, the State has been forced to take over several municipalities, including the Detroit Public Schools, City of Pontiac, City of Ecorse, Village of Three Oaks, City of Hamtramck, City of Highland Park, and City of Flint. On top of these current problems, unfunded health care and pension liabilities and property tax-secured municipal bonds loom as potential major sources of fiscal stress in the near future. It is certainly possible that other financial emergencies may exist in the future. None of these financial emergencies has led to a municipal bankruptcy as of early 2010.

In leading up to the conditions of a local government financial emergency, several laws play an important role. These laws include the Uniform Budgeting and Accounting Act (PA 2 of 1968), the Revised Municipal Finance Act (PA 34 of 2001), the Glenn Steil State Revenue Sharing Act (PA 140 of 1971), and the Local Government Fiscal Responsibility Act (PA 72 of 1990). These laws work together to establish the processes and procedures that local governments must follow in maintaining their fiscal affairs and provide a set of conditions under which the State may intervene in a variety of forms to address local financial emergencies.

The Michigan Legislature, through Public Act (PA) 72 of 1990, declared that the fiscal health and solvency of local governments is of State concern. The Act gives two reasons for these concerns. First, it states that the insolvency of a local government could affect the health and welfare of citizens. This could be tied to the loss of certain public services, for example. Second, it states that the insolvency of one local government could impair the creditworthiness of the State and other local governments. For these reasons, the Act specifies a process by which the State will monitor and, if necessary, assume responsibility for the fiscal health of local governments.

This issue paper outlines the PA 72 process as well as several other laws related to financial emergencies, including the Federal municipal bankruptcy process, which is one potential end result. This paper discusses the process for general local governments (counties, cities, villages, and townships) and nonschool special districts, and does not apply to school districts which fall under a different process.

### PA 2 of 1968: Uniform Budgeting and Accounting Act

The first statute to consider is the Uniform Budgeting and Accounting Act, which specifies the rules under which municipal budgeting must occur. It also sets forth a chart of accounts that municipalities must use in reporting their finances. The Act has a series of provisions that each local government unit must report in its financial audit and requires this financial audit to be filed within six months of the close of the fiscal year with the Michigan Department of Treasury. This Act does not specifically address financial emergencies but sets the stage for other municipal finance laws.

### PA 34 of 2001: Revised Municipal Finance Act

The Revised Municipal Finance Act is the State's general law governing the actions and rules for the use of municipal bond financing. In this Act, the Michigan Department of Treasury is explicitly authorized to "protect the credit of this state and its municipalities". There are several key provisions in this law used by the Department to assess fiscal health and address potential financial emergencies related to bond defaults.

This Act includes an important provision that requires municipalities under State law to undertake an annual financial audit, reinforcing the provisions of PA 2 of 1968<sup>a</sup>. This audit is a critical tool used by the Department to ensure that municipalities are following the law and maintaining an appropriate fiscal balance. Equally important, this process includes the use of audit reports among other information to certify a municipality as falling under "qualified" or "unqualified" status. Many conditions are required to be in place to avoid unqualified status. These include the following:

- An emergency financial manager is not in place.
- There are no court orders for tax levies.
- Audit reports are on time.
- The municipality is not in violation of provisions for existing municipal securities issued.
- The municipality is not delinquent in transferring employee taxes or taxes owed to other governments.

Qualified status means that a municipality may issue municipal securities without prior approval of the Department of Treasury. If a municipality does not have qualified status, it must seek approval from the Department before issuing municipal securities. This classification process is part of the overall assessment of municipal fiscal health.

### PA 140 of 1971: Glenn Steil State Revenue Sharing Act

The third statute of importance is PA 140 of 1971, often known as the Glenn Steil State Revenue Sharing Act. This Act is the instrument through which statutory revenue sharing is provided to cities, townships, and villages in the State. The Act also specifies that if a local government submits a required annual audit with a deficit in any fund, it must file a plan with the Department of Treasury to resolve the situation. In this case, a deficit condition is defined as a situation in which, at the end of the fiscal year, total expenditures (including previous deficits) are greater than total revenue including any surplus. Again, this is one of the conditions monitored by the Department of Treasury in assessing the potential existence of a financial emergency. The law also authorizes the Department to withhold statutory revenue sharing if a local government does not file an audit as required.

### PA 243 of 1980: Emergency Municipal Loan Act

Another important statute, the Emergency Municipal Loan Act was enacted in 1980 to provide emergency financial assistance to municipalities that are experiencing acute fiscal stress. The Act creates a Local Emergency Financial Assistance Loan Board. The Act provides municipalities with the ability to borrow certain amounts of funds from the State and enter into loan agreements with the Board in the case of a financial emergency. The same Board plays a role in PA 72 of 1990 and is responsible for appointing and overseeing an emergency financial manager under that law.

---

<sup>a</sup> Municipalities under 4,000 in population may file biennial audits.

## PA 72 of 1990: Local Government Fiscal Responsibility Act

Public Act 72 of 1990 is the most important law regarding the State's role in local financial emergencies. As discussed above, the Legislature in this Act expressly stated its reasons for potential intervention in local government fiscal affairs. The Act establishes a process by which a local government may be declared to be in a financial emergency and the different potential roles the State may play in such a situation through the Local Emergency Financial Assistance Loan Board. The following section details the legal process.

Before any sort of municipal bankruptcy filing, a Michigan local government must go through a process specified by PA 72 of 1990. This law sets forth the conditions and process for a financial emergency pertaining to local governments. The first part of the PA 72 process involves an investigation of a possible financial emergency. The process may be started when any of the following file a written request with the State Treasurer:

- Local government governing body.
- Local government chief administrative officer.
- Creditor (owed \$10,000 or more than 1% of general fund revenue).
- Citizen petition (signed by 10% or more of registered electors based on the last gubernatorial election).
- Trustee or actuary of local pension system.

The investigation of a possible financial emergency also may be initiated when any of the following occur:

- Default in bond payment or violation of covenant condition.
- Resolution from the House of Representatives or Senate.
- Violation of conditions of the Revenue Bond Act or Municipal Finance Act.
- Violation of conditions related to the Municipal Emergency Loan Act.
- Failure to comply with a deficit elimination plan.
- Failure to provide an annual audit.
- Delinquency in distribution of property tax revenue to other governments.
- Court-ordered tax levy without governing body approval.

After performing a preliminary financial review triggered by any of these conditions, the State Treasurer must report the situation to the Governor within 30 days.

Based on that initial report by the State Treasurer, the second part of the process begins. The Governor is required, if a serious financial problem is reported by the State Treasurer or if the Governor receives a resolution passed by a local legislative body, to assign a financial review team to the municipality. The team is sent into the local government to determine whether a serious financial problem exists and report to the Governor. This review team will include the State Treasurer (or designee), Auditor General (or designee), nominees from the Speaker of the House and the Senate Majority Leader, and any other officials appointed by the Governor. They must report one of the following:

- A serious financial problem does not exist.
- A serious financial problem exists, but can be dealt with through a consent agreement.
- A local government financial emergency exists because no satisfactory plan exists to address a serious financial problem.

The Governor, following the financial review team's analysis, makes an official determination based on the review team's recommendations. The Governor may declare one of the following:

- A serious financial problem does not exist.
- A serious financial problem exists but a consent agreement is in place.
- A financial emergency exists because no satisfactory plan exists to address the serious financial problem.

In the case of a consent agreement, the local government must approve via resolution such an agreement. The consent agreement is tracked by the financial review team and the Department of Treasury to assure compliance.

If the Governor determines that a financial emergency exists and there is no satisfactory plan, a second set of actions occurs. A local government may appeal the official determination of the Governor. Once the Governor's final decision is made and any appeals worked through, the process is turned over to the Local Emergency Financial Assistance Loan Board. This Board then is responsible for appointing and overseeing the emergency financial manager. The emergency financial manager acts on behalf of the Board to address the problems that exist in the municipality.

The emergency financial manager (EFM) is in charge of making all spending and budgetary decisions for the municipality in conjunction with the Board and cannot be overridden by the local elected officials. The EFM can take any of the following actions and others:

- Amend, revise, and take control of the local budgeting process.
- Require, amend, revise, and approve plans for paying outstanding obligations.
- Require and prescribe special reports to be made by the municipal finance officer.
- Examine all books and records.
- Make, approve, or disapprove any appropriation, contract, expenditure, creation of a position, or filling of any vacancy.
- Review payroll or any claim made against the local government.
- Enter into agreements with other local units of government or private companies.
- Consolidate departments within limitations or provisions of a municipal charter or State law.
- Sell assets except as restricted by local charter.

One important limitation on the EFM is that he or she may enter into negotiations with unions to address employee conditions but does not have the power to automatically override union contracts.

The emergency financial manager stays in place until the Governor makes an official determination, based on a recommendation by the Local Emergency Financial Assistance Loan Board, that a financial emergency no longer exists and control is returned to the local governing body.

Section 22 of PA 72 of 1990 allows an emergency financial manager to authorize the local government to seek Federal bankruptcy protection. This action may be nullified by a vote of the Local Emergency Financial Assistance Loan Board within 60 days of such a filing.

Under Michigan law, there is no explicit authority given to the legislative bodies or chief administrative officers of municipalities to file for bankruptcy. The next section of this paper delves into the issues facing the State and local governments of Michigan when considering the municipal bankruptcy issue.

## MUNICIPAL BANKRUPTCY

An important policy question is the interest and role of the State in municipal bankruptcy actions. The basic framework for municipal bankruptcy stems from a 1937 law passed by Congress (Chapter 9 of the Bankruptcy Act) and has been modified several times since that period<sup>1</sup>. Initially in 1934, the United States Supreme Court ruled municipal bankruptcy as unconstitutional, but a 1937 version of the law withstood court review. At that time, during the height of the Great Depression, over 2,000 local units of government were defaulting or in danger of defaulting on municipal bonds<sup>2</sup>.

Despite these early problems, municipal bankruptcy was and is a rarely used tool to address a growing imbalance between municipal revenue and expenditures and growing debt burden. There were 208 state-controlled municipal bankruptcy filings that occurred over the 30-year period starting in 1981<sup>3</sup>. Looking at a longer time frame, from the 1930s to the 1970s, bankruptcy had been employed by a little over 500 governmental entities as opposed to the hundreds of thousands of corporate and personal bankruptcies over the same period<sup>4</sup>. The majority of municipal bankruptcies involve small single-purpose governmental units such as water and sewer districts. A municipal bankruptcy by a general governmental entity such as a county or city is extremely rare. State governments are not allowed under Federal law to enter into the Federal bankruptcy system.

It is instructive to assess the near and actual bankruptcy experiences of some of the municipalities that have been threatened with such a situation. The following section highlights the cases of New York and Pennsylvania.

### New York City 1975 Fiscal Crisis

The most famous local government fiscal crisis remains New York City's in 1975, which led to major changes in the law. In the middle of the 1970s, New York City had borrowed more than \$2.0 billion, much of it short-term debt, and was running a half-billion-dollar deficit<sup>5</sup>. In 1975, financial institutions were unwilling to lend any further funds to the city thus predicating a potential debt default crisis. In a famous statement, President Ford refused initially to provide loans from the Federal government to New York City. At that time, New York City municipal debt was the "toxic asset" of the period. According to reports of the time, 20.0% of the equity of many of Wall Street's biggest banks was held as New York City municipal debt<sup>6</sup>. New York City was arguably too big to go into municipal bankruptcy given the law that existed at the time.

The equivalent of a "cram down" was performed instead of bankruptcy through negotiations<sup>7</sup>. The banks agreed to a moratorium on principal payments on short-term debt (\$2.3 billion). Some 60,000 workers saw layoffs and wages were frozen for three years. Further, city employees had to pay in the equivalent of \$3.0 billion to the pension system. The city also raised city college tuition. The Federal government ultimately agreed to a \$1.5 billion loan guarantee<sup>8</sup>. Municipal workers agreed to lend \$2.5 billion to the city from pension funds. Banks agreed to refinance both short- and long-term debt. The city was forced to raise taxes, resulting in a 25.0% increase in the city income tax<sup>9</sup>. Finally, an emergency control board, somewhat similar to Michigan's current system, was imposed on the city and has been in place ever since. All of these actions were very similar to what might occur in bankruptcy and were ultimately successful as the city's bond rating was very high by the late 1990s and early 2000s.

A major part of the solution to this fiscal crisis was the creation of the Municipal Assistance Corporation (MAC). The MAC was authorized to issue debt on behalf of New York City and backed by the state's credit rating. Along with the MAC, the Financial Control Board was created. This Board was authorized to oversee the city's financial affairs. Even in 2010, the Financial Control

Board remains in place and has been authorized by law through 2033. From 1975 through 1986, the Financial Control Board was able to approve or disapprove city budgets, contracts, and borrowing. This type of oversight calmed municipal credit markets and allowed the city to gain access to credit. After 1986 and the end of the financial emergency, the Financial Control Board has remained in place but has not exercised any authority, just an oversight function.

In 2005, New York City voters approved major changes to the city charter<sup>10</sup>. These changes included institutionalizing many of the changes that were first undertaken through the Financial Control Board. These provisions included a requirement that the city not end the year with an operating deficit, requirements for a four-year financial plan, a required annual audit, and restrictions on issuance of short-term debt. These provisions were all anticipated to prevent anything like the 1975 financial crisis from occurring again.

### Philadelphia, PA 1991 Fiscal Crisis and Act 11

The City of Philadelphia, Pennsylvania, is another high-profile city that faced a severe fiscal crisis at the beginning of the 1990s. As the 1991 recession took hold, Philadelphia faced a cash shortage. As the 1991 fiscal year approached, the city faced a \$206.0 million deficit against a \$2.1 billion general fund<sup>11</sup>. Philadelphia had been issuing short-term tax anticipation notes to finance its deficit. In September 1990, the city came forward to issue \$400.0 million in short-term notes. No investor would bid for the debt and essentially credit access was shut down for the city. This event triggered a three-year fiscal crisis leading to service reductions, layoffs, and higher taxes<sup>12</sup>. The city also borrowed from its pension funds. The Philadelphia pension trustees were able to extract a very high price; the city repaid the pension loans at an annualized interest rate of over 27.0%<sup>13</sup>.

In 1991, the State of Pennsylvania instituted the Pennsylvania Intergovernmental Cooperation Authority (PICA) also known as Act 11. This authority consists of five voting members who are appointed by the Governor and legislative leaders. This authority oversees the City of Philadelphia's financial management. It has issued many reports in its existence benchmarking and comparing Philadelphia to other cities in terms of financial efficiency and other types of issues. It actively engages citizens in understanding the city budget. The authority has the power to issue bonds to be repaid by city taxes, to review all city financial issues, and to approve the city's five-year financial plans. The authority does not have the power to raise new taxes. In these financial plans, the city must project revenue and expenditures including capital commitments and debt repayment plans<sup>14</sup>. The mayor's budgets must conform to the five-year plan and the city controller must verify that Generally Accepted Accounting Principles are being applied and followed. If the city fails to adhere to the financial plan, the authority board, by majority vote, can withhold the payment of any state funds to the city.

### Pennsylvania and Act 47

Besides Philadelphia, other municipalities in the State of Pennsylvania have generally fallen under a law known as Act 47. This law guides the process for state receivership of a financially distressed municipality. Since the mid-1980s, when it passed, 25 municipalities have fallen under this system, including Pittsburgh. Eleven of those municipalities remained under Act 47 for over a decade. Pittsburgh, which fell under Act 47 in 2004, remains under state oversight at this time.

Act 47 differs from Act 11 mentioned above. Under Act 47, the state appoints a coordinator to oversee a municipality's financial affairs. This coordinator may be a firm, which is different from the EFM process used in Michigan. The coordinator may present a financial plan to city council, which can approve or disapprove. If disapproved, the council itself may present a plan to the state for

approval. In this sense, the coordinator system in Pennsylvania has less authority than the EFM system in Michigan. Unlike an EFM, the coordinator can include in its plan options such as raising taxes without voter approval. A financial coordinator can declare an end to the emergency but must undertake an "exit study" before final approval from the state.

Westfall Township, Pennsylvania, was the first general purpose municipality in Pennsylvania to enter into both Act 47 and Chapter 9 bankruptcy, which occurred in the spring of 2009<sup>15</sup>. The Westfall filing was due to a court-ordered judgment of \$20.0 million related to the provision of water and sewer to a housing development. The township debt adjustment plan, approved by the court in early 2010, allowed the city to reorganize debt owed to a local real estate developer and lower the total debt load to \$6.0 million and significantly extend the debt repayment over a period of 20 years<sup>16</sup>. Township residents will experience a significant hike in their property taxes to cover the new debt load. This type of debt reduction would not be possible in state court due to the Contract Clause of the U.S. Constitution. The experience of Westfall Township was that Chapter 9 worked well, particularly due to the small number of creditors<sup>17</sup>.

### Assessing Different Financial Emergency Approaches

The strategies employed in Pennsylvania and New York differ from the typical approach of the EFM employed in Michigan. In those cases, state-appointed boards, as opposed to a single individual, oversee the city's financial affairs. These boards are able to use state financial backing, including credit ratings, to gain access to additional sources of funds. Further, these state boards can inhibit the flow of state funds to the city as a penalty for noncompliance with established plans. There are similarities as well, such as the adoption of a financial plan. In some cases, the EFM actually has more power. Unlike the PICA or the Financial Control Board, for example, the EFM may hire and fire personnel.

Each approach or system has advantages and disadvantages. For small cities or counties, an EFM may be most appropriate. For larger entities, an approach used in the other states may need to be examined by Michigan. One possible scenario would be a combination of an EFM-type approach with a Financial Control Board approach for maximum effectiveness. The EFM does not have the capacity to directly employ state-backed resources as a state financial control board would. Also, a board approach takes the pressure of a massive financial adjustment off the shoulders of one person. An obvious disadvantage is the potential conflicts that could arise between board members. Each approach should be considered as the potential for severe municipal fiscal distress continues to grow.

More generally, some basic differences in responding to financial emergencies begin to appear. One basic policy question is the extent to which an oversight board or an appointed individual is given control over a municipality's finances versus allowing the locally elected officials to retain the authority. This tension is resolved in different ways across the states. In some scenarios, oversight authorities have the power to disapprove of local government actions, while in other systems the oversight authority proposes policies that can be rejected by local authorities. In Michigan, the EFM can generally make financial decisions and overrule the local elected officials. Another basic question is the length of time such financial emergency measures should operate. In other words, different solutions may be called for depending on the type of financial emergency. A third question is the makeup of the oversight authority being put in place and whether it is one person or a group of people. All of these basic challenges must be faced when assessing the performance of past, current, and future legislation to address municipal financial emergencies.

## Basics of Municipal Bankruptcy

Municipal bankruptcy law is very different from the traditional corporate and personal bankruptcy laws. The goal of Federal Chapter 9 bankruptcy is to provide debt relief to a state-controlled municipal bond issuer<sup>18</sup>. It implies that a government, with very little debt for example, but facing a significant imbalance between revenue and expenditures, will not likely benefit from a Chapter 9 filing. Many governments have a variety of strategies when facing a fiscal deficit. They may reduce costs by cutting personnel, raising health care premiums, cutting operating expenditures, or engaging in intergovernmental cooperation. On the other side of the balance sheet, local governments may raise taxes or fees or reduce tax breaks. Of course, in some cases, local governments will be forced to take on debt to finance fiscal deficits. Debt problems also can arise via tax increment financing districts, sewer and water projects, and other infrastructure-related investments. In some cases, this debt may create financial stress on other parts of the government.

In crafting Chapter 9, Congress recognized that it faced a difficult tradeoff.<sup>19</sup> Traditionally, bankruptcy was a process that allowed a Federal judge to work with a debtor to restructure its financial situation to address the financial imbalances. This is the power expressly provided to Congress and the Federal courts via the Contract Clause of the U.S. Constitution<sup>20</sup>. However, unlike a private corporation or an individual, Congress and the Federal courts have limited control over local governments. This is because, unlike private corporations and individuals, local governments are "creatures or instrumentalities" of state government and the state has sovereign power over these governments<sup>21</sup>. In practice, this means that the Federal government cannot impinge on the powers or responsibilities of local governments due to the 10<sup>th</sup> amendment of the U.S. Constitution. This also means in practice that it cannot force local governments to raise taxes or cut spending to pay off their debt. Thus, the Chapter 9 bankruptcy process is fairly weak compared with traditional bankruptcy proceedings.

There are three types of approaches to a municipal bankruptcy: prepackaged, prenegotiated, and "free fall"<sup>22</sup>. In a prepackaged deal, the municipality would come to agreement with its creditors before filing with an accepted debt plan of adjustment. A second option, the prenegotiated approach, would be based on a deal with the major municipal creditors. This option facilitates the court cases and may result in lower court and legal fees. The third approach is a free fall bankruptcy in which no negotiations have been agreed to with major creditors before filing. Pursuant to the Federal law, a municipality must have attempted to negotiate in good faith before entering the protection of Chapter 9 but it is not required to have reached an agreement.

Another issue is the relationship between state municipal distress statutes and Federal Chapter 9 bankruptcy law. Specifically, some states have attempted to adjust municipal debt plans regardless of creditor consent to avoid default. State law may not impair contracts or "prescribe a method of composition of indebtedness" without the consent of creditors<sup>23</sup>. There is some case law precedent for state intervention that adjusts municipal debt burdens by "extending" debt repayment without the consent of creditors<sup>24</sup>. This extension cannot result in an impairment of principal. Regardless, the state can play a role in assisting and overseeing a municipality that is fiscally distressed. However, there remains a significant degree of ambiguity as to how far states can go in assisting municipalities and avoiding bankruptcy.

## Bankruptcy Conditions

There are several conditions that a municipality must meet in order to qualify as a debtor and be eligible for Chapter 9<sup>25</sup>. Most importantly, the filing agency must be a political subdivision or instrumentality of the state government. It must be authorized under state law to file for bankruptcy. It must be unable to pay back its debt and be insolvent. This is a significant provision as it does not

imply that a municipality must have reached its debt ceiling or be levying maximum allowable taxes, for example. Finally, a municipality must be actively negotiating in good faith with creditors or have gotten the agreement of a majority of creditors to file for bankruptcy.

The first condition stated above, that the filing entity must be a political subdivision of a state, has several components. In 1994, Congress passed a series of reforms intended to address the question of which municipalities can enter into bankruptcy protection and under what conditions they can do so. This Congressional action followed on the heels of the Bridgeport, Connecticut, bankruptcy filing. In that case, the state tried to block the city from entering into bankruptcy<sup>26</sup>. At that time, Bridgeport was facing over 450 lawsuits from various actions<sup>27</sup>. Further, one of the city's stated purposes was to repudiate union contracts<sup>28</sup>. The state objected that it had not provided authorization for the city to file bankruptcy. The Federal court ultimately ruled that the state had "generally authorized" bankruptcy filings but that the city did not meet insolvency conditions, and it was summarily removed from bankruptcy protection<sup>29</sup>.

As part of changes to the municipal bankruptcy law in 1994 and the Bridgeport situation, states now must allow or disallow municipal bankruptcy through a specific authorization in law<sup>30</sup>. There is only one specific path to municipal bankruptcy in Michigan, which is through PA 72 of 1990. In that law, the emergency financial manager has the right to authorize a local government to file for bankruptcy unless disapproved by the Local Emergency Financial Assistance Loan Board within 60 days of filing. Beyond the PA 72 route, there is no other specific legal path in Michigan allowing municipalities to enter into bankruptcy. The Federal courts have ruled that if a general provision regarding protecting the health and welfare of citizens is given to local governments by the state, this may be construed as broad enough to be implicit approval of the right of a local government to enter into municipal bankruptcy<sup>31</sup>. Thus, there remains ambiguity as to whether a municipality in Michigan can file without an emergency financial manager in place. This has not been tested.

### Bankruptcy Actions

There are several advantages to a municipal bankruptcy filing. One of the most important advantages is the automatic stay that prevents creditors from taking action without approval of the bankruptcy court<sup>32</sup>. This protection applies to the elected officials, managers, and employees of the municipality as well as the citizens of the jurisdiction. This process allows the municipality to take its time and work with expert advisers to assess the best course forward. The most significant benefit is the ability of the municipality to restructure, extend, or reduce its debt burden in conjunction with creditors. A municipality may be able to withhold all payments of bond interest and principal during the process. One potential benefit, depending on the outcome of the pending City of Vallejo case (discussed below), would be the nullification and restructuring of union contracts. This is one area in which an EFM does not and cannot have the power to unilaterally nullify contracts.

There are several major disadvantages in a bankruptcy filing.<sup>33</sup> In private sector bankruptcies, part of the goal is the reorganization of the entity to ensure its long-term survival or the liquidation of the entity if it is nonviable. For example, a major part of the General Motors and Chrysler bankruptcies was the reorganization of those companies so they could be profitable in the long term. A Federal bankruptcy court has no authority to undertake a liquidation of a governmental entity. This can be accomplished only through constitutional or statutory means via state government, depending on the governmental entity. Thus, municipal bankruptcy is limited in another fashion as a tool to address long-term municipal structural financial imbalances.

Another downside is the potential impact of a bankruptcy filing on a municipality's credit rating and access to credit markets. There is extensive and growing literature regarding the impact of municipal bankruptcies on municipal bond issuers in the affected state. One of the concerns facing state government and its oversight of local governments is that if one municipal bond issuer defaults, it could have an impact on the availability and cost of credit to other issuers. The academic municipal bond literature supports the notion that, if a bankruptcy filing occurs, there is at least a short- and medium-term impact on credit cost and access for both the individual government and other local governments in the state.

A related issue is whether even the very public discussion of municipal bankruptcy may result in a downgrading of credit rating. A related question is whether this potential downgrading could affect similar municipalities across the state. According to a 2009 report by Standard and Poor's, a discussion of bankruptcy is part of a general strategy of establishing the benefits and consequences of any set of actions<sup>34</sup>. They do not perceive that such discussions will lead to a downgrading of credit. Contrary to Standards and Poor's report, Fitch also has issued a 2010 report with a more negative view. Fitch has stated that public discussion of bankruptcy will potentially trigger a credit review and possible downgrading<sup>35</sup>.

The repudiation and unilateral restructuring of union contracts remains an important issue in municipal bankruptcy filings. In 1978, Congress amended the bankruptcy law in such a way that it allowed municipalities to reject "executory" contracts<sup>36</sup>. Executory contracts are those that remain unfilled, such as a labor contract or an unexpired lease. This provision may be of significance to local governments facing fiscal crisis. In most cases, labor expenses are 60.0% to 70.0% of a municipality's expenses.

In 2008, the City of Vallejo, California, declared bankruptcy. It was only the second California municipality in state history to do so. Many of the problems facing Vallejo can be tied at least partly to the housing bubble and financial crisis. The city has suffered both crime and fiscal problems since the declaration. Police operations were cut from nearly 160 officers to 100 officers with a sharp rise in crime during the same period<sup>37</sup>. In a significant ruling, a Federal judge ruled that the city could break its union contracts. This ruling is now in front of a Federal appellate court. This case goes to the heart of the previous discussion regarding executory contracts.

It is useful to compare the powers of a Michigan emergency financial manager with those of the Federal bankruptcy court. The EFM has the possibility of fundamentally reorganizing local government operations. Past EFMs have sold off assets, led negotiations to restructure contracts, and privatized services. These are all actions that a Federal bankruptcy court cannot take based on judicial precedent from the past 70 years. At least in the short term, these actions have often led to financial improvements. However, there are several important components of the Federal municipal bankruptcy process that cannot be undertaken by an EFM.

In summary, municipal bankruptcy is not a perfect solution for municipal insolvency. Given the limitations placed on the Federal bankruptcy court in such situations, this strategy may be useful for a municipality with a significant amount of debt. Overall, the Michigan approach to use an EFM and the use of consent agreements may, in fact, be a better solution depending on the nature of the fiscal imbalances and the debt load. Even more importantly, where debt burden is not a major issue, an EFM may be able to make difficult choices in terms of government services, structure, and policy absent the assistance of the Federal court.

## **CONCLUSION**

While there is evidence that emergency financial managers or similar approaches used in New York and Pennsylvania have been able to address short-term financial imbalances, there remains the difficult question of long-term financial sustainability. Given that, for example, the City of Ecorse, Michigan, has had two EFMs in the past 20 years, there is the issue of long-term policies that resolve these financial challenges. In some cases, the possibility of local government consolidation or dissolution may need to be considered. A different set of laws governs the process of consolidation, dissolution, or annexation. There may be a need in the future to consider the implications of the financial emergency laws and their linkage to consolidation or annexation laws.

## SOURCES

1. Spitz, Jonathan. "Federalism, States and the Power to Regulate Municipal Bankruptcies: Who May be Debtor under Section 109(c)". *Bankruptcy Development Journal* 621, 1992.
2. Id. McConnell, Michael W. and Randal C. Picker. "When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy". *University of Chicago Law Review* Vol. 60, No. 2 (Spring, 1993) pg. 425-495.
3. Breckinridge Capital Investors. "Bankruptcy Basic for Municipal Bondholders". Special Report, October 2009.
4. McConnell and Picker.
5. Gramlich, Edward. "The New York City Fiscal Crisis: What Happened and What is to be Done" *American Economic Review*, Vol. 66 No. 2. (1976). New York City Independent Budget Commission. "Dawn of a New Era: New York City Fiscal Policy After the Financial Emergency Act". Background Paper, November 2007.
6. Weisman, Steve R. "Could Detroit Trigger a New Meltdown?". *The Daily Beast*, November 2, 2008.
7. Id.
8. Id.
9. Time, Dec 8th, 1975 "Last Minute Bailout of a City on the Brink".
10. Knox, John and Levinson, Marc. "Municipal Bankruptcy: Avoiding and Using Chapter 9 in Times of Fiscal Stress". Orrick, Herrington & Sutcliffe, LLP. 2009.
11. New York Times. "Its Cash and Tempers Short, Philadelphia Seeks Solvency". September 11, 1990.
12. Inman, Robert, "How to have a Fiscal Crisis: Lessons from Philadelphia". *American Economic Review*, Vol. 85, No. 2 (May, 1995)
13. Fortune Magazine. "The Great Pension Robbery". January 13, 1992.
14. Issues PA. "Pittsburgh's Fiscal Crisis: What's Happening Now". April 2004.
15. The Public Purse Blog. "Chapter Nine Municipal Bankruptcy in Pennsylvania". March 10, 2010.
16. Miller, James, J.D. Personal Interview April 27, 2010.
17. Id.
18. Spitz.

19. Dubrow, David L. "Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis". *The Urban Lawyer*, Vol. 24, No. 3 Summer 1992.
20. McConnell and Picker.
21. *Id.*
22. Knox and Levinson.
23. Spitz.
24. Kordana, Kevin. "Tax Increases in Municipal Bankruptcies". *Virginia Law Review*, Vol. 83, No. 6 September 1997, pg. 1035-1107.
25. Lewis, Carol W. "Municipal Bankruptcy and the States: Authorization to File under Chapter 9". *Urban Affairs Review*, 1994, Vol. 30. pg. 3-24.
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*
31. McConnell and Picker.
32. Knox, John and Marc Levinson. "Municipal Bankruptcy: Avoiding and Using Chapter 9 in Times of Fiscal Stress". <http://www.orrick.com/fileupload/1736.pdf>. 2009.
33. Kordana.
34. Standard and Poor's. "What Credit Concerns Does Talk Of Municipal Bankruptcy Raise?" Standard and Poor's Global Credit Portal, December 15, 2009.
35. Raphael, Richard J., Friedland, Eric, Laskey, Amy R., and Doppelt, Amy S. "The Perils of Considering Municipal Bankruptcy". *Fitch Ratings, Puvlic Finance*, January 27, 2010.
36. Lewis.
37. San Diego News Room, 2010.