Introduction

The media attention on several recent municipal bankruptcy filings leads to the question: What role do states play when a municipality faces a fiscal crisis and potential bankruptcy? Examination of some recent cases reveals that states can and do respond in myriad ways to local fiscal problems. How a state reacts may depend on a variety of aspects. Some may be political in nature, such as the nature of relations between the state governor and legislature and the municipality’s top officials. More importantly though, there are legal considerations, including whether state law even permits municipal bankruptcy and whether there are legal provisions for state intervention in local finances and the extent of those problems. Additionally, economic and budgetary concerns can have a significant effect on how a state chooses to respond in a municipal financial crisis, since a state's fiscal condition can be intrinsically tied to the financial health of its localities, particularly its larger ones. Together, these factors help explain the differing ways states react to municipalities in fiscal distress.

This brief provides an overview of municipal bankruptcy and the legal, economic and political role that states play in local fiscal oversight. Drawing on recent case studies, it also identifies four key takeaways, listed below, regarding factors states may want to consider in how they choose to handle fiscally distressed or bankrupt municipalities.

- **State Laws are Shaped by Local Crises**: Because some states may lack clear, comprehensive legal procedures for how to deal with municipal fiscal distress, states sometimes must quickly pass legislation in the midst of a crisis in order to take effective action.
- **Localities Often Resist State Intervention**: State oversight and/or takeover of municipal finances in a time of crisis can sometimes lead to tense relations between the state government and local officials and residents.
- **The Underlying Cause of the Crisis Matters**: States may respond differently to a local crisis depending on its underlying causes, such as how common the issue is among municipalities and whether it was the result of primarily external or internal forces.
- **State Role Can Have Credit Rating Implications**: Recent comments and actions by credit rating agencies indicate that they—and presumably investors—are paying attention to state laws and actions on municipal debt and bankruptcy and how states intervene in fiscally distressed localities.

**Overview of Municipal Bankruptcy**

The U.S. Constitution grants Congress authority over the bankruptcy process, and the U.S. Bankruptcy Code establishes the rules and regulations that determine which entities are eligible to file for bankruptcy and when. While states are considered sovereign entities and therefore not allowed to declare bankruptcy, a municipality is a legal corporation and thus eligible to file for bankruptcy under “Chapter 9” of the Code, provided certain conditions are met. These eligibility conditions are detailed in the text box below.

**Eligibility Criteria for Municipal Bankruptcy**

1. The municipality must have specific authority to file for Chapter 9 bankruptcy under state law.
2. The municipality must be insolvent.
3. The municipality must prove its desire to adopt a plan to adjust its debt.
4. The municipality must satisfy at least one of four specified conditions to demonstrate that it has obtained or tried to obtain an agreement with its creditors, that it is not feasible to negotiate with its creditors holding at least the majority of the claims in each class that the entity intends to impair under its debt adjustment plan, or that it has reason to believe its creditors might attempt to obtain preferential payment or transfer of the entity’s assets.
5. The municipality must be able to show that it filed for bankruptcy in good-faith.

Upon filing for bankruptcy, a municipality could gain court protection from bondholders and vendors, as well as assistance with restructuring its pensions and other post employment obligations. The locality also gains leverage that may prove useful in negotiations with employee unions over labor contracts, pension benefits, and other obligations. However, it is important to note that bankruptcy does not necessarily mean that any or all debts are defaulted upon.

Municipal bankruptcies are actually quite rare. According to the U.S. Census Bureau, there are approximately 89,500 municipal governments in the United States.1 Municipalities are defined to include cities, towns, counties, school and taxing districts, and utilities. Among all U.S. municipalities, there were just 239 bankruptcy filings between 1980 and 2010, as shown in the graph below.2 Most of these cases involved smaller entities such as utilities and special districts. According to more recent data compiled based on federal court records, as of early August 2012, 27 municipalities have filed for Chapter 9 bankruptcy protection since 2010, among which seven were cities or localities.3

While Congress oversees the overarching bankruptcy process, the U.S. Constitution grants each state full autonomy over its local governments. It is for this reason that municipalities must receive legal authority from the state to be eligible to file for bankruptcy under Chapter 9. States may perceive advantages and disadvantages to allowing municipalities to file for bankruptcy. On the one hand, granting municipalities the ability to go bankrupt could hurt localities’ credit ratings. However, removing the municipal bankruptcy option altogether may harm a locality’s leverage if and when it is forced to negotiate with creditors or pension recipients. According to the Congressional Budget Office (2011), at the time of its report, 26 states had laws on the books that authorize municipalities to file for bankruptcy. Among these, 14 states required that the municipality obtain permission from a state authority before filing, while the other 12 imposed no filing restrictions. Meanwhile, 23 states had yet to pass laws on municipal bankruptcies, effectively disallowing municipalities in these states from filing for bankruptcy. Only one state, Georgia, expressly prohibited municipalities from filing.4 States also vary in terms of other laws in place defining how a state may intervene in or oversee a municipality in fiscal distress. Fifteen states have laws on the books “establishing a method of detecting and managing fiscal stress at the local level,” while other states sometimes handle oversight of struggling localities on an “ad hoc basis.”5

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3 This figure includes filings by: Central Falls, Rhode Island; Jefferson County, Alabama; Stockton, California; Mammoth Lakes, California; and San Bernardino, California. It also includes two filings (Harrisburg, Pennsylvania and Boise County, Idaho) that were ultimately rejected. See “Bankrupt Cities and Municipalities Map,” Governing, August 2, 2012.
4 Congressional Budget Office, Economic and Budget Issue Brief: Fiscal Stress Faced by Local Governments, December 2010
5 Ibid., p. 8.
In addition to this variation in state laws on municipal bankruptcy and fiscal distress, the causes behind local fiscal crises can vary significantly. Some are caused by forces that may be viewed as more external, such as cyclical economic shocks, investment losses or long-term economic decline. Others may be linked to causes perceived as more within the locality's control, such as structural budget deficits, poor fiscal management and corruption. Many times, some combination of internal and external forces leads a locality down a path toward insolvency.

**States Take Different Approaches to Municipalities in Crisis**

Given the variation among state laws and the various causes of local fiscal crises, it should not be surprising that states respond differently in cases of municipal financial strife, and also that the same state may not respond uniformly to all cases. Recent events demonstrate this variation and also highlight four points, described below, that states may want to consider in addressing municipal fiscal crises – or in planning for possible crises in the future.

**State Laws are Shaped by Local Crises**

As discussed earlier in this brief, the 50 states vary with regard to the legality of municipal bankruptcy. While some states have additional laws and procedures in place for detecting local fiscal problems and dealing with a locality in a fiscal emergency, many do not. Since so many states lack concrete laws or systematic processes surrounding state oversight of local finances and municipal bankruptcy, some wind up writing legislation in this arena in the midst of a crisis. This may not necessarily always be problematic, but state leaders may want to consider whether legislation on this issue should be considered.

For example, when Central Falls, Rhode Island filed a petition in 2010 for the appointment of a judicial receiver to help the city on the brink of fiscal collapse, the legislature promptly passed a new law, the “Act Relating to Cities and Towns – Providing Financial Stability” (R.I. Gen. Laws § 45-9-1 et seq.). The Act put in place a predictable process by which the state would support a city or town that experiences financial distress and was designed to provide stability to Rhode Island municipal credit markets. Despite the state’s intervention and appointment by the Department of Revenue of a receiver, the state receiver – the only one with the authority to file for municipal bankruptcy under the new state law – had the City of Central Falls seek bankruptcy protection in August 2011 to give it more leverage to restructure its obligations. However, just one year after filing for bankruptcy, Central Falls has its fiscal house in order and has entered the next phase in its recovery that will be focused on economic development and financial management, according to Rhode Island’s governor.

The financial crisis in Harrisburg, the small capital city of Pennsylvania, offers another story of how state laws are created or modified to deal with specific municipal crises. For the past 25 years – beginning in the 1980s with the decline of the steel industry – Pennsylvania has had in place a program authorized by the Financially Distressed Municipalities Act of 1987 (P.L. 246, No. 47), commonly referred to as “Act 47.” Under the program, the state can detect early on when a municipality is in distress and provide assistance to the entity to restructure its debt and make other changes to relieve fiscal stress. In December 2010, the state declared Harrisburg financially distressed under Act 47 after it had accumulated more than $300 million in guaranteed debt over time to finance revenue shortfalls and costly upgrades for a trash incinerator. Several months later, according to the long-established law, the state offered a plan to put the city on a solvent fiscal path. However, state lawmakers then promptly amended the law to enable the state to take over the city’s finances if it failed to adopt the state-approved plan to bring the municipality out of insolvency. The city did end up rejecting the state’s rescue plan, prompting the state to step in under the newly modified law. Shortly afterwards, in anticipation of Harrisburg’s decision to file for Chapter 9 bankruptcy, the governor signed another bill in July 2011 forbidding all “third class cities” from filing for bankruptcy for one year (until July 2012). In Pennsylvania, nearly all cities, including Harrisburg, fall into the third class category. As a result, Harrisburg's bankruptcy filing was denied. One year later, the state legislature decided to further postpone the city's opportunity to file, passing a 2012-2013 state budget with a measure attached that bans Harrisburg from claiming bankruptcy for several more months.
California provides yet another example of a state passing new legislation in direct response to a municipal fiscal crisis. As several of the state’s localities faced serious fiscal stress in 2011, the legislature approved a new bill (AB 506) that prohibits a city from filing for bankruptcy until it has completed a mediation process with its creditors. The first application of the law in Stockton, California was unsuccessful in preventing bankruptcy, as the mediation period failed to produce an agreement between the city and its creditors, leading Stockton to become the largest American city in history to file for bankruptcy. However, the negotiations that occurred during mediation between the city and its creditors may at least help expedite Stockton’s bankruptcy proceedings. That being said, the mediation process may also be viewed by some as a “pathway to bankruptcy,” since it helps localities meet the federal requirements to demonstrate insolvency by showing that they have made an effort to find a resolution with creditors outside of bankruptcy.

Localities Often Resist State Intervention

When a state opts to take control of a city’s finances in the midst of a crisis, such action is often met with at least some form of resistance at the local level, whether it is from the mayor, city council and other public officials, or residents. While a host of factors can contribute to the health of relations between the state and a municipality in crisis, the size of the municipality and political dynamics likely play a role.

Such resistance can take on different forms. For example, Nassau County, New York recently tried to circumvent its state-controlled oversight board (established more than one year ago in response to the county’s sizeable budget gap) to issue bonds. Another case can be observed in Harrisburg. There, the city’s controller and several council members filed a lawsuit in June 2012 challenging the Pennsylvania’s takeover of city finances in federal court; the suit remains outstanding. Shortly thereafter, Harrisburg’s state receiver sought a court order to force local officials to raise taxes – state law allows the governor to appoint the receiver, but does not authorize that receiver to impose taxes. As of now, the receiver’s request is still pending the court’s consideration, and a hearing is scheduled for August 23, 2012. In the meantime, Harrisburg officials continue to voice their opposition to the state’s ban preventing the city from filing for bankruptcy.

Detroit, Michigan provides yet another example of somewhat strained state-local relations during a municipal fiscal crisis. While the mayor and governor worked out an arrangement, referred to as a “consent agreement,” to avoid state takeover under Michigan’s Emergency Manager Law (Public Act 4), the agreement was only narrowly approved by the city council. Following that, in June 2012, Detroit’s corporation counsel tried to sue Michigan, claiming that the consent agreement was invalid on the basis that the state owed money to the city. In response to this action, the state threatened to withhold revenue sharing payments if the lawsuit was not dropped. Though the County Circuit Court Judge quickly ruled to dismiss the case, another lawsuit soon followed – this time filed by three Detroit residents and union leaders – but this case too was dismissed by the court. Meanwhile, a separate coalition in Michigan has successfully put repeal of the state’s Emergency Manager Law on the ballot this November. Together, these episodes in Michigan certainly underscore the tension that can sometimes dominate relations between local authorities and residents and state government officials in a fiscal crisis.

In Central Falls, Rhode Island, the state also met resistance from local officials. Four of the five members of the city council and mayor challenged the constitutionality of the Fiscal Stability Act, and the state prevailed in Superior Court and again in Supreme Court when the earlier decision was appealed. Resolution of the legal authority was critical for the state in order to have the clear authority to develop a plan of debt adjustment that would gain support from the creditors and be acceptable to the Court. This plan would show a structurally balanced budget over a six year period, and was accomplished through agreements with retirees and active employees. It should be noted that during the receivership, the mayor and council were reduced to advisory status. The receiver plans to transition the elected officials back to power after confirmation of the plan by the court. The receiver is expected to remain in place until January 2013, and then the state continues in an oversight capacity for five years after the receivership ends.

At a recent NASBO meeting, Rhode Island’s Director of Revenue provided a verbal account of her experience overseeing the Central Falls state receivership. She conveyed that while it was challenging without the support of the local officials, transparency of financial projections data was key to minimizing the distrust that existed with retirees, employees and other stakeholders. However, she did also point out that the city’s small size (just over 18,000 residents) helped to facilitate this type of approach.

The Underlying Cause of the Crisis Matters

A state’s response to a municipality in crisis is likely influenced by the circumstances that led to the crisis in the first place. In cases where a city’s financial collapse is triggered by structural problems related to core governmental activities somewhat common in other jurisdictions, a state may be more inclined to step in to try to prevent negative repercussions for other localities and the state as a whole in terms of access to credit and borrowing costs. This may explain why Rhode Island quickly intervened in Central Falls, a city plagued with huge budget deficits largely resulting from unsustainable pension and other post employment benefit costs along with long-term economic decline. On the other hand, in circumstances when a municipality’s fiscal crisis is traced to one unique, isolated event, such as a particular public works project, the state may feel less of an incentive to intervene. When Jefferson County, Alabama filed for bankruptcy in November 2011, without much prior state intervention, a spokesperson for the governor’s office described the county’s bankruptcy as “unique in its underlying causes” and therefore not reflective of other municipalities in the state and the state as a whole.12 Jefferson County’s bankruptcy resulted mainly from a sewer system improvement project financed through risky bond deals and rife with corruption – 21 individuals were convicted or pleaded guilty of bribery associated with the sewer project.13 Thus, state officials may have been less concerned about the municipal bond market reacting to Jefferson County’s bankruptcy than were their counterparts in Rhode Island during the Central Falls crisis. Further discussion of how a state can influence the credit market’s reacts to municipal fiscal stress can be found below.

State responses to municipal crises may also be guided by wariness about creating a moral hazard. By stepping in to bail out a locality in financial trouble, the state may fear that setting such a precedent will lower the incentive for other localities to manage their finances wisely and cautiously. For this reason, a state may be more likely to help a municipality in a crisis caused largely by external forces (such as economic decline or natural disaster) than one resulting from mostly internal causes (such as poor fiscal management or corruption).

State Role Can Have Credit Rating Implications

Certainly, state and local credit ratings are driven by a complex array of factors – and the role that states play in overseeing municipality finances may be just one of them. An expert from the public finance credit rating industry commented to NASBO members recently on the importance of state laws governing municipalities undergoing fiscal stress – especially due to declining property tax revenues. The expert noted that investors are paying attention to whether or not states have an established tradition of intervening in local financial crises and are seeking to determine whether a state’s credit rating should formally account for this.

In individual cases, state responses to municipal fiscal stress can indeed affect credit ratings. As mentioned above, Rhode Island enacted legislation in the midst of the Central Falls crisis to define the state’s role in the event of a local financial crisis in order to reassure investors. The state also went a step further, shortly before the city filed for bankruptcy, by amending state law (R.I. Gen. Laws § 45-12-1 and 45-12-22.4) to grant general obligation bonds legal priority over a municipality’s other obligations, including retirement benefits. How did rating agencies respond? In June 2012, Central Falls’ general obligation rating was placed on review for upgrade. The “active state oversight of the city’s bankruptcy proceedings, financial operations and cash flow with state legal default protection” was cited as one of the strengths contributing to the upgrade in the rating action announcement.14 Moreover, the announcement indicated that “successful legal challenges to state legislation providing priority lien for bondholders” could make the rating go down.15 Both of these statements indicate the extent to which Rhode Island’s hands-on approach in dealing with Central Falls and establishing bondholder priority can have a positive impact on the city’s credit rating.

A different situation can be found in Stockton and San Bernardino – two cities in California that have also filed for bankruptcy. Unlike Rhode Island, California refrained from much intervention in both localities, except for its action in passing a law requiring a mediation period before filing for bankruptcy, as discussed earlier in this brief. A report recently published by

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15Ibid.
Moody’s, a credit rating agency, for its subscribers examines how the “looming defaults” in these cities might signal a shift towards less willingness to pay debt obligations on the part of distressed municipalities, according to the report release announcement. If true, this could lead other states to follow Rhode Island’s lead and pass a law demanding that cities prioritize bondholder payments. The author of the report also clarified the likelihood of such instances, stating, “Our expectation is that unwillingness-driven defaults will rise but remain rare.”

Conclusion

State responses to local fiscal crises vary state-by-state and case-by-case. This variation can be attributed to a multitude of legal, political and economic factors. As highlighted above, not only do existing state laws affect how a state reacts to municipal fiscal distress, but also state laws are themselves often created or changed in the midst of a local crisis, signaling the lack of concrete, broadly applicable laws on the books in many states related to municipal bankruptcy. Also, the reality that state oversight and/or takeover of municipal finances is often met with strong local opposition may discourage states from intervening, but states like Rhode Island have shown that successful intervention is also possible with the right approach and in the right circumstances. A state’s decision on whether and how to intervene may in addition depend on what caused the crisis in the first place, such as whether it was mostly due to internal or external forces or whether it is likely to be repeated in other municipalities. Finally, credit rating agencies have indicated through recent reports and actions that they are watching how states handle municipalities in fiscal distress and the level of protection granted by states to municipal bondholders. State governments may want to keep each of these points in mind going forward in choosing how they monitor their municipalities and react in times of fiscal crisis. While municipal bankruptcy is rare, it’s still something that garners a lot of publicity and can possibly impact the debt issuance and credit ratings of other localities in the state and elsewhere.

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