And if you lend to those from whom you hope to receive, what credit is that to you?¹

An unsecured municipal security is . . . merely a draft on the good faith of a municipality in exercising its taxing power.²

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¹ Luke 6:34.

² Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 509 (1942) (Frankfurter, J.).
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INTRODUCTION

In late 1994, Orange County, California, shocked the financial community by revealing that it had lost more than one billion dollars from its investment funds. On December 6, the county filed for bankruptcy. Orange County is the largest municipality to have received bankruptcy protection under Chapter 9. More recently, the City of Miami has encountered serious financial difficulties, and its mayor has discussed filing for bankruptcy as an option.

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3 E.g., Leslie Wayne, $1.5 Billion Loss Seen for County, N.Y. Times, Dec. 2, 1994, at D1. Orange County’s losses came about because it took positions with the Orange County Investment Pool that were contingent on declining, or steady, interest rates. See, e.g., Philippe Jorion, Big Bets Gone Bad: Derivatives and Bankruptcy in Orange County 86-87 (1995). When rates rose sharply, the Pool lost some 20% of its value. Id. at 21.

4 Orange County Employees Ass’n v. County of Orange (In re County of Orange), 179 B.R. 177, 179 (Bankr. C.D. Cal. 1995).


While Orange County ultimately submitted a reorganization plan designed to pay off bondholders in full without raising taxes, during the early months of the bankruptcy proceedings public and investor attention focused on the county’s choice between (1) attempting to repudiate its debt and (2) engaging in cost cutting and/or tax increases so that it could pay off its investors in full. To the consternation of some, Orange County and its relatively anti-tax population demonstrated an aversion to increasing taxes. Indeed, Orange County voters rejected a proposed one-half per cent sales tax increase aimed at raising revenues to help meet payments to bondholders.

Had the county sought to impose losses on bondholders, observers realized that no one knew exactly what the county would have needed to do in order to have a bankruptcy reorganization plan approved and thus emerge successfully from the Chapter 9 proceedings.

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8 Leslie Wayne, Orange County Faces Bond Payment Shortfall, N.Y. Times, Feb. 2, 1995, at D1 (“[B]ondholders are becoming worried ... [O]fficials have consistently warned that they will not raise taxes ... [and] have not ruled out a default on the obligations ...”).

9 Id.; Orange Co.: Distress Sale, Time, Mar. 20, 1995, at 21 (“Orange County announced plans to sell off area assets ... tapping every possible revenue source except higher taxes.”); see Robert W. Poole, Jr., Rescuing Orange County (Reason Found. Pol’y Study No. 186, 1995) (arguing that Orange County could solve its financial problems without a tax increase); cf. James Sterngold, Orange County Creditors Said to Accept Plan, N.Y. Times, May 3, 1996, at D1 (discussing large scale budget-cutting undertaken by Orange County).


11 Cf. David L. Dubrow, Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?, 24 Urb. Law. 539, 582 (1992) (“The evaluation of a plan by the court in terms of taxation and budget expenditures is the biggest wild card for all parties in a Chapter 9 case.”). Dubrow continued:

Another major uncertainty is how a court will determine whether a plan relating to a major modern city is “in the best interests of creditors,” “feasible,” and “fair and equitable.” There is no case law applying these broad concepts to a major modern municipality. Consequently, a judge would have great discretion and the outcome would be uncertain.

Id. at 588.

A number of other Chapter 9 issues are also unsettled. One example is whether repos can be liquidated during a Chapter 9 proceeding in spite of the automatic stay. Congress enacted Pub. L. No. 98-353, 98 Stat. 333, 366 (codified as amended at 11 U.S.C. § 559 (1994)), to allow repo liquidation, but did not change 11 U.S.C. § 901(a)
This is puzzling. One would think that the extent to which a bankrupt municipality must harness its taxing power in order to have a reorganization plan approved and receive a discharge from indebtedness would be a central feature of any municipal bankruptcy statute. Instead, as we will see in Part II, Chapter 9 does not directly address the issue, and the legislative history contains only oblique references to it by one of the sponsors of the Bankruptcy Reform Act of 1978.  

Previous commentators on Chapter 9 have attempted to fill in this statutory gap, arguing that municipal debtors should, in many circumstances, be compelled to increase taxes for the benefit of creditors. They have argued that to do otherwise would create perverse incentives by failing to check the moral hazard inherent in municipal borrowing. In other words, in the absence of compulsory tax increases, municipalities could opportunistically obtain discharge in a Chapter 9 proceeding by failing to increase taxes, thus imposing an unbargained-for loss on bondholders. In turn, the prospect of such opportunism would be taken into account by potential lenders, who would choose either not to lend to municipalities at all or to lend but charge exorbitant interest rates.

This Article offers a different interpretation of Chapter 9's failure to compel tax increases. It argues that the failure of the Bankruptcy Code to compel tax increases is, in fact, appropriate. The moral hazard argument for tax increases is misplaced because the legal and economic structure of municipal finance (especially reputational concerns, such as the need for a municipality to remain an attractive place for investment) works to constrain

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12 See infra notes 117-133 and accompanying text.


14 Id. at 466; cf. Dubrow, supra note 11, at 548 (arguing that Chapter 9 must be "accessible" to municipalities yet should "discourage excessive use so as not to encourage fiscal mismanagement"); Jerry W. Markham, Protecting the Institutional Investor—Jungle Predator or Shorn Lamb?, 12 Yale J. on Reg. 345, 360-61 (1995) ("[I]t appears that [Orange] County wants to have its cake and eat it too: [I]t wants the benefits from its good investments, but not the losses from its unlucky ones.").
municipal opportunism. Moreover, the Code's seeming openness to debt discharge without an accompanying tax increase should not be surprising once we analyze a municipality as analogous in important ways to a consumer cooperative and note the limited liability of such entities. Finally, this Article argues that the debtor's ability to place losses on investors is sensible in the municipal bankruptcy context because investors are better risk bearers than are residents. Thus, a bankruptcy judge should be willing to confirm a municipal reorganization plan that does not increase taxes or that increases them somewhat but still imposes some loss on bondholders. 15 A bankruptcy judge, for reasons that will be developed in Part III, should defer to a municipality's reorganization plan within a reasonable range; 16 there should be a presumption of regularity with respect to a municipality's reorganization proposals.

Part I of this Article analyzes the mechanics of a Chapter 9 proceeding. It examines municipalities' ability to use Chapter 9 and the status of investors as claimants in a Chapter 9 proceeding. Finally, it places the municipality, as debtor, and investors, as creditors, in the context of other entities that seek bankruptcy protection, in order to sharpen the issues posed by tax increases and to suggest some new ways of looking at the issue. Part II discusses the issue of tax increases in light of the Bankruptcy Code's statutory language and legislative history. It concludes, in essence, that the resolution of the issue cannot be governed by these sources. Part III of the Article develops the theoretical and historical reasons to believe that mandatory judicial en-
forcement of municipal revenue maximization would be counter-productive.\textsuperscript{17} It considers the municipality's self-interest, the interests of municipal officials, and the likely monitoring strategies of residents and investors. This Part demonstrates that compelled tax increases would inhibit efficient risk sharing between municipalities and their bondholders (and thus hamper the municipal finance market) and that they would not necessarily be successful in raising sufficient revenue to repay bondholders.

A recurring theme in Parts I and III is that the confirmation of plans that fail to increase taxes (or to maximize municipal revenue) will, due to the unique structure of Chapter 9, operate as a default rule. This contrasts with most aspects of bankruptcy law, which operate as mandatory (or "immutable") rules. While this Article argues that a presumption of confirmability should be applied to municipal reorganization plans, municipalities and investors who desire a different result could, as we will see, contract for one.

I. CHAPTER 9 AND THE STATUS OF MUNICIPAL BONDHOLDERS

A. Chapter 9 of the Bankruptcy Code

We begin with an overview of the municipal bankruptcy statute, Chapter 9. Chapter 9 protection is available to insolvent municipalities specifically authorized to file by state law.\textsuperscript{18} Insolvency, for Chapter 9 purposes, is defined as the municipality's being "unable to pay its debts as they become due" or "generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute."\textsuperscript{19} Litigation has ensued over the interpretation of this insolvency requirement. For example, Bridgeport, Connecticut, which made the largest Chapter 9 filing before Orange County's,\textsuperscript{20} was judged not to be insolvent be-

\textsuperscript{17} There appears to be little solid empirical evidence about municipal bankruptcies. For an analysis of the reasons behind the dearth of empirical bankruptcy data, see Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, The Use of Empirical Data in Formulating Bankruptcy Policy, Law & Contemp. Probs., Spring 1987, at 195, 217-20.

\textsuperscript{18} 11 U.S.C. § 109(c) (1994); see infra Section I.B.


cause it was only predicting future insolvency and was not currently insolvent.\footnote{In re City of Bridgeport, 129 B.R. 332, 338 (Bankr. D. Conn. 1991). According to the court's reasoning, a municipality would not have to be literally unable to pay its current bills to qualify as insolvent, but rather the prospective insolvency would have to occur by the conclusion of the next fiscal year. Id.}

A bankruptcy petition may be filed only by the municipality,\footnote{11 U.S.C. § 109(c)(1). The bankruptcy judge “may” dismiss a petition not filed in “good faith.” 11 U.S.C. § 921(c). See infra notes 33-34 and accompanying text. It would be possible (although, as will be argued below, unwise) for a judge to regard a municipality's refusal to raise taxes as indicative of a failure to bargain in “good faith” with creditors pre-petition. See 11 U.S.C. § 109(c)(5)(B); cf. In re Sullivan County Reg'l Refuse Disposal Dist., 165 B.R. 60, 78 (Bankr. D.N.H. 1994) (expressing doubt that special revenue districts that did not “throw [their ability to tap member municipalities’ taxing authority] into the negotiating equations” had negotiated in good faith).} “involuntary” filings, available to creditors of business enterprises, are unavailable.\footnote{11 U.S.C. §§ 901(a), 362(a).} The petition triggers an automatic stay, as in a business bankruptcy,\footnote{11 U.S.C. § 941. In a Chapter 11 case, creditors may file a plan after the 120-day exclusivity period has expired or if a trustee is appointed. 11 U.S.C. § 1121.} plus additional protections (for example, staying actions against municipal officials based upon claims against the municipality).\footnote{E.g., Erik Berglöf, A Control Theory of Venture Capital Finance, 10 J.L. Econ. & Org. 247, 252 n.6 (1994).}

An additional contrast with commercial bankruptcy is that only the municipality may file a plan for debt readjustment.\footnote{That is, the municipality may be able to appropriate the surplus created by plan approval by offering the creditors a payoff only slightly above the “reservation price” at which they would deny confirmation. Id.} Contingent on the attitude of the bankruptcy judge (who could dismiss the case if he or she disapproved of the municipality's conduct), Chapter 9 gives the municipality a great deal of bargaining power—a “first-mover advantage”\footnote{19 U.S.C. § 943.} in which creditors may be faced with the prospect of languishing in bankruptcy or approving the municipality's plan.\footnote{20 U.S.C. § 103(e) (“Except as provided in section 901 of this title, only chapters 1 and 9 of this title apply in a case under such chapter 9.”); 11 U.S.C. § 901(a) (rendering 11 U.S.C. § 301 (“[v]oluntary cases”) applicable in Chapter 9, but not 11 U.S.C. § 303 (“[i]nvoluntary cases”)).}

The bankruptcy judge is charged with assuring that the plan meets the requirements set out in Section 943 in order to con-
firm it. Creditors vote on the municipality's plan, and a judge will consider confirmation if all creditor classes approve the plan or if the "cram down" requirements are met and at least one class of impaired claims votes in favor of the plan. A "cram down" must "not discriminate unfairly" between creditor classes, and must be "fair and equitable." Either way, the bankruptcy judge must ensure that the plan was proposed in "good faith," and is "in the best interests of creditors and is feasible." The possibility of a cram down, coupled with the fact that only the municipal debtor has the power to propose a reorganization plan, gives a municipal debtor considerable leverage in bargaining with creditors as it formulates a reorganization plan.

What, then, of tax increases? A bankruptcy judge could not directly order a municipality under Chapter 9 protection to raise taxes, but he or she could deny confirmation to a municipal reorganization plan that did not raise taxes and then dismiss the case. This scenario would leave the municipality facing its creditors in state court, where the creditors could seek a writ of mandamus ordering a tax increase. A bankruptcy judge's an-

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30 11 U.S.C. §§ 901(a), 1129(a)(8).
32 11 U.S.C. § 1129(b)(1). Given that the requirements noted in the text are met, cram down thus allows the judge to confirm a reorganization plan over the objections of many or most creditors.
35 See infra notes 112-116 and accompanying text.

The creditors could also seek to attach municipal property although they might be prohibited from doing so. E.g., Delta County Levee Improvement Dist. No. 2 v. Leonard, 516 S.W.2d 911, 912 (Tex. 1974) ("Public policy exempts political subdivisions
nounced (or implied) intention not to confirm a plan that did not raise taxes (at least to the point of revenue-maximization) would therefore effectively force a municipality to include such a tax increase in its reorganization plan.\textsuperscript{38}

The bankruptcy judge could justify the confirmation denial by characterizing the plan as not having been proposed in "good faith,"\textsuperscript{39} or as not being in the "best interests of creditors."\textsuperscript{40} The crucial bankruptcy issue, therefore, is whether a judge should approve a municipality's reorganization plan if the municipality does not take steps to maximize its revenues in order to pay off creditors.

\textbf{B. Municipalities' Eligibility to File under Chapter 9}

The favorable bargaining position granted to a municipal debtor might suggest that its ability to enter Chapter 9 would need to be restricted. Section 109(c) of the Bankruptcy Code limits eligibility to file under Chapter 9. To be eligible, an entity must be an insolvent municipality\textsuperscript{41} that wishes to effect a plan to

\begin{itemize}
  \item of the state performing governmental functions from execution or garnishment proceedings.
  \item McConnell and Picker, supra note 13, at 429-50, discuss the various remedies creditors could seek under state law, concluding that "only [mandamus] was usually available in actual practice." Id. at 429.
  \item 11 U.S.C. §§ 901(a), 1129(a)(5).
  \item 11 U.S.C. § 943(b)(7). It should be noted that in the Chapter 9 context, the "best interests of creditors" test does not establish a "floor" for recovery by comparing what creditors would receive under the plan with what they would receive in a liquidation, as would be done under a Chapter 11 reorganization. 11 U.S.C. § 1129(a)(7)(B); see 11 U.S.C. § 901(a) (not applying § 1129(a)(7) to Chapter 9 cases). In applying the best interests of creditors test, courts have instead inquired as to whether the plan "is better than the alternatives." In re Sanitary & Improvement Dist. No. 7, 98 B.R. 970, 974 (Bankr. D. Neb. 1989); 6 Collier on Bankruptcy ¶ 943.03[7][a], at 943-30 to 943-31 (Lawrence P. King ed., 15th ed. rev. 1997); David S. Kupetz, Municipal Debt Adjustment Under the Bankruptcy Code, 27 Urb. Law. 531, 599 (1995).
  \item "Municipality" is defined for bankruptcy purposes as a "political subdivision or public agency or instrumentality of a State." 11 U.S.C. § 101(40) (1994). In the Orange County bankruptcy, the Orange County Investment Pools (OCIP), which had filed concurrently with Orange County for Chapter 9 protection, were dismissed as ineligible for debtor status. In re County of Orange, 183 B.R. 594, 609 (Bankr. C.D. Cal. 1995). The court held that OCIP was not sovereign, and hence not a political subdivision; was not a public agency because it did not operate "a revenue producing enterprise" (such as a hospital—but note that the fund was intended to generate investment income); and was not an instrumentality of the state (although it was an instrumentality of the county). Id. at 602-03.
\end{itemize}
adjust its debts, and must have either unsuccessfully attempted
to negotiate with its creditors, have obtained the agreement of a
majority of its creditors, be unable to negotiate with its credi-
tors, or be seeking to prevent a creditor from obtaining a trans-
fer that would be avoidable as a preference in bankruptcy.42

Until October 1994, a municipality also had to be "generally
authorized" by state law to seek Chapter 9 protection.43 "Gener-
ally authorized" had been interpreted rather broadly to include
cases in which state law was silent on the issue of municipal bank-
ruptcy but gave municipalities the right to sue and be sued, to
incur debt, and to create contracts.44 One state, Georgia, forbids
its municipalities to use Chapter 9,45 and several states require
approval by a state agency before a municipality can file.46 Section
402 of the Bankruptcy Reform Act of 1994 struck "gener-
ally authorized" from 11 U.S.C. § 109(c)(2) and substituted "spec-
ifically authorized, in its capacity as a municipality or by name."47
This provision makes it necessary for a state to authorize ex-
plitly its municipalities to file for Chapter 9 relief. The Bank-
ruptcy Reform Act of 1994 took effect on October 22, 1994,48 and
therefore it applied to the Orange County filing. However, Cali-
ifornia is one of a minority of states that had already specifically
authorized their municipalities to avail themselves of Chapter 9.49

46 E.g., N.J. Stat. Ann. § 52:27-40 (West 1986) (requiring approval of state municipal finance commission); Ohio Rev. Code Ann. § 133.36 (Anderson 1994) (requiring approval of tax commissioner); Miami May File Chapter 9, supra note 6, at A1 ("Florida municipalities can't file for bankruptcy without the Governor's approval").
48 Id. at § 702, 108 Stat. at 4150 ("[T]his Act shall take effect on the date of the enactment of this Act.").
49 Spiotto, supra note 45, at 1194 n.11; Jeffrey Cohen, Declining Health of U.S.
Because states retain the right to choose whether to allow their municipalities to file for protection in a federal bankruptcy court, Chapter 9 is most usefully conceptualized as a default rule. States may condition the ability of a municipality to seek


Bills were introduced in the California State Senate and Assembly in order to update § 53760 to refer to current federal law. S.B. 1274, 1995-96 Reg. Sess. (Cal. 1995), available in LEXIS, States Library, Sttrck File; A.B. 2, 1995-96 2d Extraord. Sess. (Cal. 1995), available in LEXIS, States Library, Sttrck File. A bill was also introduced that would have required California municipalities to obtain permission from the California Legislature before utilizing Chapter 9. A.B. 29, 1995-96 2d Extraord. Sess. (Cal. 1995), available in LEXIS, States Library, Sttrck File. That bill would also have required the municipality to obtain legislative approval before submitting a reorganization plan to the bankruptcy court. Id.

All three bills expired without being passed. Cal. Const. art. IV, § 10 ("Any bill introduced during the first year of the biennium of the legislative session that has not been passed by the house of origin by January 31 of the second calendar year of the biennium may no longer be acted on by the house.").

This idea is related to the argument, increasingly made by analysts of corporate bankruptcy, that businesses should be able to contract out of their statutory bankruptcy rights in order to borrow on more advantageous terms or under more advantageous bankruptcy procedures. E.g., Robert K. Rasmussen, Debtor's Choice: A Menu Approach to Corporate Bankruptcy, 71 Tex. L. Rev. 51, 100-02 (1992); Robert K. Rasmussen & David A. Skeel, Jr., The Economic Analysis of Corporate Bankruptcy Law, 3 Am. Bankr. Inst. L. Rev. 85, 98-100 (1995); Alan Schwartz, Bankruptcy Workouts and Debt Contracts, 36 J.L. & Econ. 595, 599 (1993); Alan Schwartz, Contracting About Bankruptcy, 13 J.L. Econ. & Org. 127, 129 (1997); Lucian A. Bebchuk, The Effects of Chapter 11 and Debt Renegotiation on Ex Ante Corporate Decisions 23 (Program in Law & Econ., Harvard Law Sch. Discussion Paper No. 104, 1991).

Currently, such an attempt would be held void as against public policy, e.g., United States v. Royal Bus. Funds Corp., 724 F.2d 12, 15 (2d Cir. 1983), although some lower courts have enforced waivers of the automatic stay in single asset real estate cases. E.g., In re Club Tower L.P., 138 B.R. 307, 311-12 (Bankr. N.D. Ga. 1991). But see In re Jenkins Court Assoc., 181 B.R. 33, 37 (Bankr. E.D. Pa. 1995) (rejecting enforcement of waiver as "too closely approximating the more reviled prohibition against filing for bankruptcy protection"). In the single asset context the collective action justification for bankruptcy law is weak. Cf. In re Sky Group Int'l, 108 B.R. 86, 91 (Bankr. W.D. Pa. 1989) (rejecting enforcement of waiver "where it would be in the best interest of only [the bank] and would be detrimental to ... other creditors"). But see In re University Commons, L.P., 204 B.R. 80, 82 (Bankr. M.D. Fla. 1996) ("The fact that the dismissal is not in the best interest of the unsecured creditors is also without significance.") Municipal bankruptcy provides the opportunity to implement the choice to contract around bankruptcy without requiring the congressional action necessary in the corporate arena.
Chapter 9 protection, either statutorily through rules, or by application of a case-by-case standard, as in those states that require the approval of a state agency before their municipalities can seek Chapter 9 protection. States could, for example, withhold their approval if the municipality had pledged in its borrowings not to utilize Chapter 9. This default status serves as a justification for the pro-debtor orientation of Chapter 9, in which municipal debtors are advantaged vis-à-vis their creditors compared to financially distressed business enterprises. Because states retain the power to regulate and curtail municipal ability to utilize Chapter 9, however, states are free to make use of, or to ignore, the Chapter 9 framework as they see fit. As will be discussed in Part III, there are other reasons to believe that the pro-debtor nature of Chapter 9 is justified. For example, municipal bankruptcy provides a way for municipalities to shift risk away from residents to investors, who are typically the better risk bearers. Under state law, such risk shifting is much more constrained and less predictable. To the extent the pro-debtor orientation of Chapter 9 might prove problematic in certain situations, states can regulate its use accordingly.

C. The Status of Municipal Bondholders in Chapter 9

Now that we have examined the basic mechanics of Chapter 9 and of municipalities’ ability to utilize it, we turn to an analysis of municipal borrowing and the role lenders play as creditors in

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51 See supra note 46 and accompanying text.
52 The fact that several states could immediately implement this solution without legislative action being necessary, and that many other states were placed by the 1994 amendments in a situation where their municipalities cannot partake of Chapter 9, supra note 47 and accompanying text, highlights the political feasibility of this option. In addition, it would probably be acceptable for bankruptcy judges (or, even better, the state, which could also condition plan submission on state approval, as was proposed in California, see supra note 49) to refuse to confirm municipal reorganization plans that did not utilize a tax increase in order to pay off specific creditors that had obtained a Chapter 9 waiver from the municipal debtor. In other words, if a municipality waived the use of Chapter 9 in some, but not all, of its borrowings, that municipality should be allowed to utilize Chapter 9, but not to gain benefits from that use vis-à-vis those creditors to which it had promised not to use federal bankruptcy law. (Such creditors might still be inconvenienced, however, during the pendency of a Chapter 9 proceeding.) Thus, the “presumption of regularity” with respect to a municipality’s reorganization plan should also be conceptualized as a default rule.
53 See supra note 37 and accompanying text.
a Chapter 9 proceeding. Municipalities borrow in order to smooth
the cost of providing government services over time. In par-
ticular, they will undertake an investment if they believe that its
benefits (as from constructing utility plants) will exceed the total
borrowing costs. It seems appropriate that the burden of pay-
ing for the services provided by the infrastructure created with
the borrowed money should be spread over the users of that in-
frastucture, and hence over time. Government borrowing can
also have a less appealing side, however, when current consumers
of municipal infrastructure shift the burden of paying for their
borrowing onto future generations of taxpayers. While limita-
tions on the period for which municipalities can incur certain
types of debt can be seen as an attempt to limit this intergen-
erational opportunism, newer forms of municipal borrowing
can subvert or evade these restrictions.

Governments typically finance their borrowing by issuing bonds
and notes. Several types are particularly salient. General obli-
gation ("GO") bonds are marketed as having their principal and
interest payments "secured by the full faith and credit of an is-
suer that has taxing power." This commitment, while enforce-
able under state law, is made against the backdrop of federal
bankruptcy law. The National Association of Bond Lawyers'
Model Opinion for GO bonds is explicit on this point, providing that "[i]t is to be understood that the rights of the holders of the Bonds and the enforceability thereof may be subject to bankruptcy, insolvency, reorganization . . . and other similar laws." 62

An important bankruptcy policy is to respect creditors' pre-existing rights. 63 GO bonds' "full faith and credit" pledge gives bondholders an important right, but the preservation of pre-existing rights is most important vis-à-vis other creditors. 64 GO bondholders will, at a minimum, find their ability to enforce their right to payments halted by the automatic stay entered at the beginning of a Chapter 9 proceeding, 65 and may need to await plan confirmation 66 in order to receive any payments on their bonds. GO bondholders are, for Chapter 9 purposes, unsecured creditors. Section 506 of the Bankruptcy Code 67 limits secured claims to those "secured by a lien on property." 68 For bankruptcy purposes, a "lien" is defined as a "charge against or interest in property." 69 GO bonds are not secured for bankruptcy purposes because they do not have a concrete interest in any of the municipality's property. 70 Thus, the "full faith and credit" guarantee given by a municipality when it issues GO bonds is qualified by federal bankruptcy law. Indeed the very

place of the making of a contract . . . enter into and form a part of it, as if they were expressly referred to or incorporated in its terms." Von Hoffm v. City of Quincy, 71 U.S. (4 Wall.) 535, 550 (1867). See also infra note 322.

62 National Ass'n of Bond Lawyers, Model Bond Opinion Project 6-7 (1987).

63 Cf. Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 210 (1986) (arguing that bankruptcy statutes should be measured against "the standard of whether they facilitate achieving the asset deployment of greatest benefit to the claimants as a group"). Determining just how important the policy of respecting pre-existing rights should be remains a contested issue. See, e.g., Lawrence Ponoroff, Vicarious Thrills: The Case for Application of Agency Rules in Bankruptcy Dischargeability Litigation, 70 Tul. L. Rev. 2515, 2518 & n.8 (1996).

64 With respect to the debtor, bankruptcy is (of course) also about providing a means for discharging pre-bankruptcy obligations. See Jackson, supra note 63, at 253-79.


67 11 U.S.C. § 506. This section is made applicable to Chapter 9 proceedings by 11 U.S.C. § 901(a).


70 In re Sanitary & Improvement Dist. No. 7, 98 B.R. 970, 973-74 (Bankr. D. Neb. 1989); see also Dubrow, supra note 11, at 569 ("General obligation bonds are comparable to unsecured general obligation debt in a corporate context."); id. at 576.
ability of federal statutory law to "impair" state contracts is the motivation behind, and, as will be argued below, justification for, Chapter 9.\footnote{See infra note 323 and accompanying text.}

Revenue bonds are another common form of municipal borrowing. Their payments come from a particular income source, typically the revenue generated by the facility (such as a bridge, hospital, or utility) constructed with the money raised by the sale of the bonds.\footnote{Merrill Lynch, supra note 59, at 11.} Revenue bonds are secured by collateral—namely, the net value of the income stream generated by the facility in question. Section 928 of the Bankruptcy Code specifies that this lien survives bankruptcy.\footnote{11 U.S.C. § 928. The term "special revenues," which is used in § 928, is defined in § 902(2). The lien is subject to operating expenses. 11 U.S.C. § 928(b).} Revenue bondholders thus have a secured claim against the municipality. This claim, however, is only for an amount up to the value of the income stream secured by the bondholders’ lien. To the extent the value of this collateral is less than the amount due on the revenue bonds, the revenue bondholders are deprived of any unsecured bankruptcy claim by Section 927.\footnote{11 U.S.C. § 927. See also 11 U.S.C. §§ 1111(b), 502(b)(1); Dubrow, supra note 11, at 572.}

While revenue bondholders will thus be secured claimants, they do not have a colorable claim to demand tax increases to ensure that they are fully paid off during Chapter 9 plan confirmation. This is because the municipality has pledged only a particular revenue source to the revenue bondholders; the latter “have no legal right to payment from any other assets of the municipality, including moneys from the general treasury. Taxpayers are not committed to raise taxes to repay such bonds.”\footnote{Dubrow, supra note 11, at 569 (emphasis added).} This fact is made clear by Section 927, which limits revenue bondholders’ payments to the special revenues pledged to them.\footnote{11 U.S.C. §§ 927, 1111(b). A fee, or rate, increase, could be part of the municipality's reorganization plan, if it were also approved by “[a]ny governmental regulatory commission with jurisdiction . . . over the rates of the debtor.” 11 U.S.C. §§ 1129(a)(6), 901(a).}

Revenue bondholders continue to receive payments throughout a Chapter 9 proceeding—Section 922(d) exempts special revenue payments from the automatic stay triggered by the bankruptcy
petition. While secured claimants must receive certain payments, revenue bondholders are secured only to the extent that they can in fact be paid, in full, from the future stream of revenue generated by their particular facility.

Because GO bonds often require taxpayer approval before they can be issued, municipalities have devised a number of creative ways to raise funds without voter approval, even for non-revenue-generating facilities. The impetus has been especially strong in California, where the state constitution requires two-thirds approval in order to issue GO bonds. Orange County and its constituent municipalities relied heavily on Certificates of Participation ("COPs"). While the often vague language of these instruments makes analysis of their exact bankruptcy status diffic-

77 11 U.S.C. § 922(d). The issue remains controversial, with some commentators arguing that only special revenues "already in the creditor's possession (such as funds held by an indenture trustee)" are covered by the section. Dubrow, supra note 11, at 573. See id. at 572-73 for a summary of various views. Collier argues that § 922(d) is permissive—i.e., a debtor may, but need not, continue to make payments from incoming special revenues to revenue bondholders during the pendency of Chapter 9 proceedings. 6 Collier on Bankruptcy, supra note 40, ¶ 922.05[2], at 922-8 to 922-9.

78 Note, though, that secured claimants by no means always receive the full present value of their claims. See infra notes 88-89. Secured creditors also do not need to be paid off in full if all creditor classes vote in favor of the municipality's plan, 11 U.S.C. §§ 901(a), 1129(a)(8), or if their class of secured creditors votes in favor of giving up some value to another, lower, class that also voted in favor of the plan. Klee, supra note 31, at 144.

79 See Dubrow, supra note 11, at 570 ("Revenue bondholders take the risk that special revenues pledged to their bonds will not be sufficient to pay debt service on the bonds.").

80 Some jurisdictions require a vote only for borrowings above a certain amount, others not at all. Amdursky & Gillette, supra note 54, § 2.4, at 60.

81 See Cal. Const. art. XVI, § 18 ("No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability . . . exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the qualified electors thereof . . . .")

The purpose of requiring a vote is to protect taxpayers by giving them a direct voice before their municipality incurs long-term debt. City of Palm Springs v. RINGWALD, 342 P.2d 898, 902-03 (Cal. 1959). The limitation does not apply to revenue bonds, whose repayment is limited to special revenues. 45 Cal. Jur. 3d Municipalities § 357 (1978).

cult, some common trends do exist. A COP is essentially an interest in a lease, and it has some similarities to a mortgage. The holder of the instrument (an investor, filling the position otherwise held by a GO bondholder) provides money to the user of the facility (the municipality), in return for a specified stream of future payments. The COP holder has a security interest in the facility. Payments by the municipality are subject to approval by the municipal government, a source of concern for investors if the facility is less than essential. COP holders could, outside

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83 See Ellen Benoit, Of COPs and Bonds, Fin. World, Apr. 25, 1995, at 69. One bankruptcy judge admitted that he did “not totally comprehend” what the term “certificate of participation” meant. Judge v. Burnhope (In re Leedy Mortgage Co.), 76 B.R. 440, 454 n.7 (Bankr. E.D. Pa. 1987). It is important to remember that any bankruptcy (or other) court determination as to the status of a COP will take into account its specific contractual language, a point too easily forgotten in complex areas of law. Cf. Hamlin Inc. v. Hartford Accident & Indem. Co., 86 F.3d 93, 94 (7th Cir. 1996) (“Most liability insurance policies provide [for a duty to defend].”)(emphasis added).

84 More technically, COPs are instruments issued to investors in tax-exempt lease obligations. The investors have title to the property being leased to the municipality that issues the COPs, although the municipality may all but own the facility (e.g., by holding an option to purchase at a nominal price). The latter situation is more precisely known as a capital lease. See Robert W. Doty, Guidelines for Leases and Certificates of Participation-California Debt Advisory Commission, in Thirteenth Annual Institute on Municipal Finance, at 749, 765-67 (PLI Real Estate Law & Practice Course Handbook Series No. N4-4588, 1995).

For some COPs, based on “nonappropriation leases,” it is the very contingency of the payments that avoids classification as debt, for purposes of state debt limitations. See State ex rel. Kane v. Goldschmidt, 783 P.2d 988, 996 & n.12 (Or. 1989) (en banc) (holding purchase contracts with nonappropriation clause not “debt” for purpose of constitutional debt limitation, and citing numerous decisions from other states in accord). But see Brown v. City of Stuttgart, 847 S.W.2d 710, 712-14 (Ark. 1993) (holding nonappropriation clause did not prevent lease with option to purchase from being debt, because if the funds were not appropriated, the city forfeited accumulated equity). Federal law provides that nonappropriation leases will be treated as obligations of the municipality, rather than as an executory contract that can be rejected in bankruptcy. 11 U.S.C. § 929 (1994).

More commonly, municipalities utilize “abatement” leases, where “the lease obligation is contingent upon the right to beneficial use . . . of the leased property. In other words, the lease obligation ceases if the leased property somehow is destroyed.” Doty, supra note 84, at 765. In such COPs the municipality covenants to make the required lease payments so long as the facility is usable. Id.

In City of Los Angeles v. Offner, 122 P.2d 14 (Cal. 1942), the court stated that if lease payments were “not in payment of the consideration furnished that year,” they constituted debt requiring a popular vote, but that if lease payments were merely for the year’s use then the lease agreement did not constitute debt. Id. at 16 (quoting Garrett v. Swanton, 13 P.2d 725, 728 (Cal. 1932)). In Dean v. Kuchel, 218 P.2d 521
of bankruptcy, sue the municipality for nonpayment, or even presumably foreclose on the facility. But foreclosure is unlikely to be particularly attractive, since the facility itself, which likely does not generate any revenue (else revenue bonds would probably have been used to finance it), would probably be worth substantially less than the stream of payments the investors would otherwise receive.\textsuperscript{86} In a Chapter 9 proceeding, suit or foreclosure would be halted by the automatic stay. COP holders would have a secured claim to the extent of the value of their collateral, and an unsecured claim for any excess.\textsuperscript{87} Alternatively, COP holders could elect to be fully secured to the amount of their claim.\textsuperscript{88} This would not, however, require that they actually be paid off in full.\textsuperscript{89}

\textsuperscript{86} For example, imagine a default after only a few years of payments, nearly all of which had been interest and little principal, on a facility that had either depreciated substantially in value or had a non-governmental use value substantially less than its cost (as might be the case with a jail or "911" center).

The fact that a facility funded by COPs is likely to be valuable to the municipality but not to a foreclosing creditor actually may make it an ideal security interest, as the well-known illustration of the "puny prince" or the "ugly princess" as an attractive hostage makes clear. E.g., Douglas G. Baird, Security Interests Reconsidered, 80 Va. L. Rev. 2249, 2263-64 (1994); Robert E. Scott, A Relational Theory of Secured Financing, 86 Colum. L. Rev. 901, 930 & n.98 (1986).

In California, the state requires that school districts include terms preventing eviction in the case of nonpayment. Doty, supra note 84, at 818.

\textsuperscript{87} 11 U.S.C. §§ 506(a), 901(a). Section 927's elimination of an unsecured claim would only be applicable if the municipality had limited the payment source of the COPs to "special revenues" of the municipality. See 11 U.S.C. §§ 902(2), 927, 1111(b).

\textsuperscript{88} 11 U.S.C. §§ 901(a), 1111(b). In the event of a cram down, the holders would need to be paid off according to 11 U.S.C. §§ 901(a), 1129(b)(2)(A).

\textsuperscript{89} Assume, for example, that the property securing the COP were worth only $10 million, but that COP holders had been promised future payments worth (in present value terms) $20 million. Pursuant to 11 U.S.C. § 1129(b)(2)(A)(i), the municipality could keep the property (with the COP holders retaining their lien) and replace its $20 million dollar payment obligation with payments worth $10 million but having a face value of $20 million. See 7 Collier on Bankruptcy, supra note 40, ¶ 1111.03[4], at 1111-30 to 1111-33; Charles D. Booth, The Cramdown on Secured Creditors: An Impetus Toward Settlement, 60 Am. Bankr. L.J. 69, 87 (1986). Bargaining between the municipality and the COP holders (and voting on earlier plans proposed by the
COP holders, much like GO bondholders, would be expected to argue in a Chapter 9 proceeding for a tax increase so that they would be paid off in full. The strength of this argument, as compared to that of GO bondholders, is weakened by the fact that COPs typically carry a higher interest rate than GO bonds issued on similar ventures, largely because the COPs lack a "full faith and credit" pledge. 

The final common form of municipal borrowing, notes, are usually issued for short-term borrowing of a year or less. These typically are used to give the municipality funds in advance of its receiving tax money (tax anticipation notes ("TANs")), some other revenue (revenue anticipation notes ("RANs")), or the proceeds of a longer-term bond issue (bond anticipation notes ("BANs")).
Notes are secured or unsecured based upon whether they have a lien on a specific revenue stream. Thus, BANs would probably be secured by the proceeds of the long-term bond sales and TANs by the taxes against whose revenue they were issued. Notes can also include a “full faith and credit” pledge.

Under bankruptcy law, claims that are unenforceable under state law are disallowed. Depending, therefore, on the status of the underlying state law, a bankrupt municipality might be able to argue that notes issued in excess of what actually materi-

9 A California statute, for example, provides for a lien against taxes “levied for the fiscal year” in order to repay the TAN holders. Cal. Gov’t Code § 53829 (West 1997); accord id. § 53856.

In an opinion arising out of the Orange County bankruptcy, the district court overruled the bankruptcy court and held that the statutory lien against tax revenues provided to TAN holders survived the Chapter 9 petition. Alliance Capital Management v. County of Orange (In re County of Orange), 189 B.R. 499, 505 (C.D. Cal. 1995). The county had pledged to set aside incoming tax revenues in a separate fund on a monthly basis (and, in the event of a shortfall, to “make up the difference from any generally available funds”). Id. at 501. The disclosure statement provided to investors did warn that the Bankruptcy Code could interfere with the “enforceability” of the notes. Id. at 501 n.1. The district court concluded that the noteholders had a statutory lien. Id. at 503. Therefore, the county had to continue to set aside incoming tax revenues for the TAN holders. A security interest would not have reached funds collected by the debtor after the petition was filed, due to 11 U.S.C. § 552(a).

It should be kept in mind, in interpreting Alliance Capital, as with any district or bankruptcy court opinion, that while it is “evidence of the state of the law,” it has “no weight as precedent[, no authority.” Anderson v. Romero, 72 F.3d 518,525 (7th Cir. 1995). Thus, the issue is, in reality, far from settled.


In California, notes issued pursuant to Article 7, the traditional temporary borrowing statute enacted in 1949, did not become general obligations, but a new law passed in 1992 gave the issuer the option to elect to make a “payment guarantee” such that any shortfall arising from funds that did not materialize would be made up by the state, which would then withhold a like amount from its future appropriations to the issuer. Cal. Gov’t Code § 53830.5 (West 1997). Notes issued pursuant to Article 7.6, an alternate temporary borrowing statute enacted in 1963, become general obligations of the issuing municipality “to the extent not paid from the taxes [or] revenue . . . pledged.” Cal. Gov’t Code § 53857 (West 1997).

Some states have enacted statutes that make all unfunded tax anticipation notes general obligations of the issuing municipality. E.g., 53 Pa. Stat. Ann. tit. 53, § 12720.405 (West Supp. 1997) (“[T]he amount of any tax anticipation notes issued in compliance with this chapter shall be general obligations of the city and, if the same shall not be paid within the fiscal year in which such notes were issued . . . shall be included in the budget of the city for the ensuing fiscal year and shall be payable from the taxes and revenues of such ensuing year.”).
alizes as yearly revenue are (at least partially) void, and that their holders do not have "claims" for bankruptcy purposes for the full amount of the notes. As was stated in Arthur v. City of Petaluma, "[L]ack of available money of the revenue of the fiscal year against which the claim constitutes a charge . . . is a complete answer to any attempt to enforce payment . . . [out of] ‘the ordinary revenues’ of the city for succeeding years."

While the issue is unsettled and a likely subject of litigation, it appears that in some situations and in some states noteholders would not have a right to demand tax increases from a bankrupt municipality. Because the notes would be partially secured (and this secured amount would be paid off ahead of GO bonds) and partially void (to the extent anticipated revenues did not materialize), there might be no justification to raise taxes on their behalf. This situation arises because under a traditional "best interests of the creditors" test, holders of such notes would not receive any payments on the void amount. Noteholders whose notes became general obligations of the municipality (to the extent that anticipated revenues did not materialize) would have an argument for a tax increase similar to that of GO bond and COP holders.

D. Bondholder v. Resident: A Conceptual Approach

The previous Part demonstrated that in many municipal bankruptcies, a conflict could be expected between the municipality's residents and its bondholders over the issue of a tax increase. In this Part, I further analyze the relationship between municipal residents and municipal bondholders. In order to understand their relative positions, we should begin by recalling that a municipality is, in important ways, similar to a corpora-

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97 See 11 U.S.C. § 101(5)(A) (1994) (defining claim as a "right to payment"). The validity of such notes in California would also likely depend on whether the debt was incurred before (in which case the debt is valid) or after (in which the debt is invalid) that year's revenue had been exhausted. 45 Cal. Jur. 3d Municipalities § 352 (1978). Valid or invalid, however, the fact remains that such noteholders might lack an effective state law remedy, for if the notes do not become general obligations, then noteholders do not have a claim against revenue collected during subsequent years, unless there has been a two-thirds vote in favor of doing so by the electorate. Id.

98 165 P. 698 (Cal. 1917).

tion. Or, more precisely, a corporation and a municipality represent different ways of achieving a similar task: creating and delivering goods and services more efficiently through the creation of an enterprise. Thus, it is unsurprising that municipal and corporate law are related strands that emerged from a common law governing “all chartered entities.”

A corporation is controlled by its shareholders. These shareholders invest money in the corporation and, in turn, receive control over the firm in the form of the power to vote for directors who have the right to make discretionary decisions. The shareholders also receive the corporation’s residual earnings. The other “stakeholders” in a corporation have contractual relationships with the firm. Thus, other investors (e.g., banks and bondholders) lend money in return for a contractual obligation of repayment on certain terms; employees enter into a contractual relationship with the firm governing the terms of their employment; and customers and suppliers enter into contracts for the purchase and sale of goods.

A municipality, in similar fashion, is also at the center of a web of contractual relationships and one “control” relationship. Municipal residents have the functional relationship, vis-à-vis the municipality, of both the shareholders and the customers of a corporation. Or, more precisely, the municipal “firm” contracts for its inputs of capital, labor, and other goods but is controlled by its customers—the residents.

When a corporation enters bankruptcy, losses are distributed systematically. The absolute priority rule places the loss initially onto shareholders, but only to the extent that they have already committed funds to the corporation. The remaining

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103 Cf. id. at 20 (discussing cooperatives).


105 This might be one possible argument against allowing the municipality to slash taxes, see supra note 16. In other words, it could be argued that investors know municipalities’ historical tax rates (or range of rates) and that these rates are similar
losses are apportioned among those having contractual relationships with the firm. These contracts can be violated in bankruptcy, and the contracts "re-written" in favor of the corporation. That is, a corporation can "reject" executory contracts with its employees or suppliers, and pay off its bondholders in cents on the dollar.

It is, admittedly, difficult to apply the absolute priority rule to a bankrupt municipality. But it is important to note that a mandatory tax increase, imposed on a municipality in bankruptcy, resembles a combination price increase on customers and capital call on shareholders. Neither remedy is utilized, for well-known reasons, in a corporate bankruptcy. Sharpening the analogy, a municipality's closest private law counterpart is the consumer cooperative. Imposing a mandatory tax increase on a bankrupt municipality is analogous to imposing a capital call on the members of a consumer cooperative. Yet, such cooperatives typically offer limited liability to their members. This limited liability places some of the losses incurred by a bankrupt cooperative onto contractual parties, such as employees and lenders. A municipality can certainly impose losses on employees or to a corporation's equity "buffer" protecting bondholders.


107 A price increase would be self-defeating, inasmuch as it would drive consumers to competitors. While a similar argument applies to municipal residents, it is true that many residents cannot leave their municipality as easily as most consumers can switch suppliers; we take this point up in Section III.E., infra.


suppliers with whom it has a contractual relationship;\textsuperscript{109} this Article suggests it also may place losses on those who have lent money to the municipality on contractual terms.

Thus private law parallels, in which limited liability shifts losses in bankruptcy from control parties onto parties with contractual relationships with the bankrupt entity, suggest that a mandatory tax increase imposed on municipal residents in favor of bondholders and other investors is neither an inevitable nor obviously correct default rule.\textsuperscript{110} We should not be surprised if in a Chapter 9 bankruptcy proceeding, losses are placed on those parties, including bondholders, who have a contractual relationship with the municipality.

II. TAX INCREASES: THE CODE AND ITS LEGISLATIVE HISTORY

Section I.C. concluded that GO bondholders, COP holders, and, depending on the status of state law, noteholders, would have a colorable argument that the municipality should raise taxes in order to pay them off fully.\textsuperscript{111} In order to evaluate this argument, we need to examine more carefully the language and structure of Chapter 9. This Part explores whether Chapter 9 compels or anticipates such tax increases. Concerning the tax increase issue, Section 904 of the Bankruptcy Code provides that:

\begin{quote}
the court may not, by any stay, order, or decree, in the case or
\end{quote}

\textsuperscript{109} 11 U.S.C. §§ 365, 901(a) (1994); see Clary, supra note 6 (discussing Miami mayor's contemplation of utilizing Chapter 9 "to nullify union contracts [and] renegotiate city leases").

\textsuperscript{110} In the 19th century, there was a division between the New England states and the rest of the nation as to whether municipal creditors could seize the private property of municipal residents to satisfy municipal debts. Most states disallowed these remedies, but New England states, which rejected the corporate analogy and its implication of limited liability for municipal liability, allowed such seizures. McConnell & Picker, supra note 13, at 437-38.

\textsuperscript{111} Other unsecured claimants (e.g., tort creditors, municipal employees owed back pay, or holders of judgments against the municipality under 42 U.S.C. § 1983 (1994)) might also have such an argument, to the extent that a plan would otherwise not be in the "best interests of creditors" under 11 U.S.C. § 943(b)(7) (1994). This Article does not consider the arguments for and against tax increases on behalf of such "non-investor" bankruptcy claimants and will instead confine its treatment of tax increases to bondholders and other investors. However, it would appear somewhat incongruous to grant such creditors an unrestrained right to tax increases to satisfy their claims against municipalities when they might well be only partially compensated were their claims against a bankrupt private corporation or individual.
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.\(^\text{112}\)

A fair reading of this language suggests caution in imputing power to the bankruptcy judge to deny plan confirmation under the Section 943(b)(7) “best interests of creditors” test\(^\text{113}\) because the judge believes that not enough revenues are being raised through the municipality’s power to tax. While the issue is controversial, federal courts do have the authority to order municipal officials to raise taxes in certain circumstances.\(^\text{114}\) However, taxation is certainly a fundamental governmental power,\(^\text{115}\) and it involves the revenues of the municipal debtor as well. A judicially-compelled tax increase would thus appear to run afoul of Section 904, as might the frustration of a municipality’s ability to use Chapter 9 if it did not comply with the judge’s desire for a tax increase.\(^\text{116}\)


\(^{113}\) 11 U.S.C. § 943(b)(7).


\(^{115}\) See Missouri v. Jenkins, 515 U.S. 70, 133 (1995) (Thomas, J., concurring) (describing taxation power as inherently "legislative or executive," not "judicial"); Jenkins, 495 U.S. at 51 ("In assuming for itself the fundamental and delicate power of taxation the District Court not only intruded on local authority but circumvented it altogether."); id. at 67 (Kennedy, J., concurring) ("A judicial taxation order is but an attempt to exercise a power that always has been thought legislative in nature."); see also Pittman v. Chicago Bd. of Educ., 64 F.3d 1098, 1102-03 (7th Cir. 1995) (relying on power of taxation as distinguishing feature as to whether "one person, one vote" need apply in municipal elections), cert. denied, 116 S. Ct. 2497 (1996).

\(^{116}\) Of course, it could be argued that denial of confirmation and subsequent dismissal of the Chapter 9 case did not directly interfere with the debtor's governmental powers, since a tax increase was not ordered by the bankruptcy judge. See supra notes 35-40 and accompanying text. But see Meat Cutters Union Local 81 v. NLRB, 458 F.2d 794, 798 (D.C. Cir. 1972) ("[T]hrough the enactment of Section 8(b)(1)(B) [Congress] endeavored to prescribe a remedy in order to prevent such interferences. While this provision obviously proscribed direct restraint or coercion against an employer itself, it is clear that Congress also intended to prohibit indirect interference . . . .") (citation and internal quotation marks omitted); Kathleen M. Sullivan, Unconstitutional Conditions, 102 Harv. L. Rev. 1413, 1415 (1989) ("The doctrine of unconstitutional conditions holds that government . . . may not do indirectly what it may not do directly. . . . ").
Previous commentators who have argued in favor of the bankruptcy judge in a Chapter 9 proceeding requiring a tax increase in order to compensate GO bondholders fully have looked for support to the legislative history of the Bankruptcy Reform Act of 1978. In particular, they have pointed to the remarks of Representative Don Edwards, the Chairman of the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, as supporting court-imposed tax increases on a bankrupt municipality. However, if Section 904 in fact removes the authority of federal judges to compel tax increases in the municipal bankruptcy context, then under strong and recent precedent, such as United States v. Ron Pair Enterprises, a court should not consider the Bankruptcy Code's legislative history, given that the statutory language is determinative of the issue in question.

If Section 904 is seen as ambiguous, however, then what should be made of the legislative history? Rep. Edwards, in a statement made on September 28, 1978, regarding a House amendment he had introduced, said that it was "expected" that in applying the "best interests of creditors" test of Section 943(b)(7), courts would "be guided by standards set forth in Kelley v. Everglades..."

117 McConnell & Picker, supra note 13, at 465 & n.178 (quoting remarks of Rep. Edwards); see also Dubrow, supra note 11, at 581 (discussing the two cases referred to by Rep. Edwards).


119 Id. at 245 (holding that if statutory language is clear and its "natural interpretation ... does not conflict with any significant state or federal interest, nor with any other aspect of the Code," a court need look no further than the plain meaning of the text); see also Connecticut Nat'l Bank v. Germain, 503 U.S. 249, 254 (1992) ("Germain says that legislative history points to a different result. But we think that judicial inquiry into the applicability of § 1292 begins and ends with what § 1292 does say and with what § 158(d) does not.").


For an early statement of the plain meaning rule (albeit outside of bankruptcy), see Aldridge v. Williams, 44 U.S. (3 How.) 9 (Jan. Term 1845).

[T]he judgment of the court cannot, in any degree, be influenced by the construction placed upon [the legislation] by individual members of Congress ... The law as it passed is the will of the majority of both houses, and the only mode in which that will is spoken is in the act itself; and we must gather their intention from the language there used ...

Id. at 24.
Drainage District, 319 U.S. 415 (1943), and Fano v. Newport Heights Irrigation Dist., 114 F.2d 563 (9th Cir. 1940), as under present law, the bankruptcy court should make findings as detailed as possible to support a conclusion that this test has been met."

Fano concerned the bankruptcy of the Newport Heights Irrigation District (in Orange County), which had issued bonds in 1918 and constructed an irrigation system for agricultural use. It experienced financial difficulties during the Great Depression, and in 1934 bondholders accepted a halving of their interest payments. The irrigation system was in need of repair, but the district spent an "extravagant" amount on improvements before filing for bankruptcy in 1937.

The district court confirmed the irrigation district's plan under Chapter IX of the Bankruptcy Act of 1898. The plan had received the support of bondholders holding 89.89% of the outstanding principal of the irrigation district's bonds and would have paid bondholders 62½ cents on the dollar. However, one bondholder (Fano) objected and appealed the plan confirmation.

Finding that the current financial problems of the district had been brought on "by the reconstruction of the system and the

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Edwards, on behalf of the Judiciary Committee, made an even stronger statement about Fano in a House Report submitted in 1975 about proposed bankruptcy reform, citing that case for the proposition that a bankrupt municipality "must exercise its taxing power to the fullest extent possible for the benefit of its creditors." H.R. Rep. No. 94-686, at 33 (1975). However, this report concerned many earlier, different proposals than those later enacted in 1978, see Kenneth N. Klee, Legislative History of the New Bankruptcy Law, 28 DePaul L. Rev. 941, 944 (1979), so to the extent this 1975 statement would be considered at all, Edwards' later statement might well suggest a moderation of the earlier position. Neither McConnell & Picker nor Dubrow refer to this report as support for their pro-tax increase position. See McConnell & Picker, supra note 13; Dubrow, supra note 11.

121 Fano, 114 F.2d at 563-64.
122 Id. at 564.
123 Id. at 564-65.
124 Id. at 563.
125 Id. at 564.
126 Id. at 563.
diversion of tax moneys to the payment therefor,"\textsuperscript{127} the United States Court of Appeals overturned the plan confirmation. It stated that the irrigation district held assets worth "many times the indebtedness" and was not insolvent.\textsuperscript{128} Given these facts, and the low rate (below 5\%) of tax delinquencies in the district, the court noted that it had not found "any reason why the tax rate should not have been increased sufficiently to meet the District's obligations or why it can be said that the plan is 'equitable' and 'fair' and for the 'best interest of the creditors.'"\textsuperscript{129}

In \emph{Kelley}, the other case cited by Rep. Edwards, the United States Supreme Court overturned the lower courts' confirmation of a Chapter IX plan for a Florida drainage district.\textsuperscript{130} While one class of petitioners contended that the plan was not fair, the dispute was not about compelling a tax increase, but rather about the division of payments between two classes of creditors.\textsuperscript{131} The Court, in remanding the case, held "that the record lacks the findings of fact which the statute and the General Orders in Bankruptcy require."\textsuperscript{132} \emph{Kelley} thus appears to stand only for Rep. Edwards' proposition that courts need to make specific factual findings that the "best interests of creditors" and the "fair and equitable" tests have been met.\textsuperscript{133}

The legislative history in favor of compulsory tax increases thus consists of Rep. Edwards' reference to a single Ninth Circuit case involving an irrigation district. That this would serve as compelling authority, in the face of the many factors counseling against such tax increases,\textsuperscript{134} is unlikely.\textsuperscript{135} Indeed, as the

\textsuperscript{127} Id. at 565.
\textsuperscript{128} Id.
\textsuperscript{129} Id. at 565-66.
\textsuperscript{130} \emph{Kelley}, 319 U.S. at 417, 422.
\textsuperscript{131} Id. at 417. The drainage district had apparently made some changes to its taxing system "so as to make all possible taxing resources available for payment of the new bonds." Id. at 421 n.1.
\textsuperscript{132} Id. at 418.
\textsuperscript{133} See supra text accompanying note 120. Indeed, in response to \emph{Kelley}, Congress amended the Bankruptcy Act to detail the findings that needed to be made in order to confirm a plan. Pub. L. No. 79-481, 60 Stat. 409 (codified as amended at 11 U.S.C. § 403(e) (1970)) (repealed 1976); 5 Collier on Bankruptcy ¶ 81.01[1.6], at 1552-53, (James Wm. Moore ed., 14th ed. 1978).
\textsuperscript{134} See infra Part III.
\textsuperscript{135} See, e.g., William N. Eskridge, Jr., & Philip P. Frickey, Cases and Materials on
Supreme Court said in *Weinberger v. Rossi*, "The contemporaneous remarks of a sponsor of legislation are certainly not controlling in analyzing legislative history."

It is, of course, true that some "[l]eading scholars apparently believe that sponsors' statements are entitled to authoritative weight." Such statements have been relied upon by courts in numerous cases. Nonetheless, the authoritativeness of statements by the sponsors of legislation is quite controversial, even among those otherwise enthusiastic about the use of legislative history. Well before the Bankruptcy Code was promulgated, Rep. William Moorhead warned that sponsors could, by employing "friendly colloquy[,] . . . legislate more effectively than all of Congress" once they knew their statements would be re-

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Legislation: Statutes and the Creation of Public Policy 751 (2d ed. 1995) ("[I]t seems clear that the Court is less likely to rely heavily upon legislative history today than it was a decade ago."); id. at 751 n.4; see Wisconsin Pub. Intervenor v. Mortier, 501 U.S. 597, 617 (1991) (Scalia, J., concurring) (asserting Wisconsin Supreme Court Justices' "mistake was failing to recognize how unreliable Committee Reports are—not only as a genuine indicator of congressional intent but as a safe predictor of judicial construction. We use them when it is convenient, and ignore them when it is not."); Richard A. Posner, The Problems of Jurisprudence 291 (1990) ("The interpretation of statutes is highly sensitive to theories of the legislative process, and these are controversial political theories and hence do not provide sure footing for judicial decisions.") (citation omitted).

*456 U.S. 25 (1982).*

136 Id. at 35 n.15. The Court cited its proclamation of the same sentiment, in only slightly different words, in Consumer Prod. Safety Comm'n v. GTE Sylvania, 447 U.S. 102, 118 (1980), and Chrysler Corp. v. Brown, 441 U.S. 281, 311 (1979). In its earliest consideration of the issue, the Court said, "These statements of the author of the act in advocating its adoption cannot, of course, control its construction, where there is doubt as to its meaning; but they . . . serve to indicate the probable intention of Congress in the passage of the act." *Jennison v. Kirk*, 98 U.S. 453, 459-60 (1879).

137 William N. Eskridge, Jr., & Philip P. Frickey, Cases and Materials on Legislation: Statutes and the Creation of Public Policy 735 (1988); see Klee, supra note 120, at 957, 960 (ranking Rep. Edwards' Statement of Sept. 28, 1978, as the third piece of legislative history to be examined during legislative history research of Bankruptcy Code and predicting that consulting such legislative history "will become as routine as 'shepardizing' cases").

138 See, e.g., Federal Energy Admin. v. Algonquin SNG, Inc., 426 U.S. 548, 564 (1976) ("[A] statement of one of the legislation's sponsors . . . deserves to be accorded substantial weight in interpreting the statute."); Schwegmann Bros. v. Calvert Distillers Corp., 341 U.S. 384, 394-95 (1951) ("It is the sponsors that we look to when the meaning of the statutory words is in doubt.").

lied upon by the courts.\textsuperscript{141} This situation exists because while a statute must garner the support of a majority of both houses of Congress, a single sponsor can insert into the \textit{Congressional Record} a statement on what the statute "means."\textsuperscript{142}

Moorhead's line of reasoning led the Seventh Circuit to decline to follow a sponsor's statements, even though they were "the only mention in the legislative history of the specific issue" before the court.\textsuperscript{143} The court noted that the sponsor's statement might represent any number of different things, including disagreement on the issue that kept any discussion of it out of the conference report.\textsuperscript{144} The court therefore concluded that "[t]o give decisive weight to [the sponsor's] remarks—in the absence of textual support or additional indications in the legislative history—would be to run too great a risk of permitting one member to override the intent of Congress as expressed in the language of the statute."\textsuperscript{145} Similar sentiments should guide any future analysis of Rep. Edwards' remarks.

\textsuperscript{141} William S. Moorhead, A Congressman Looks at the Planned Colloquy and Its Effect in the Interpretation of Statutes, 45 A.B.A. J. 1314, 1314 (1959), \textit{quoted in} Eskridge & Frickey, supra note 135, at 791; see W. David Slawson, Legislative History and the Need to Bring Statutory Interpretation Under the Rule of Law, 44 Stan. L. Rev. 383, 383-84 (1992) ("Members of Congress can make law by 'manufacturing' legislative history, thereby evading the Constitutional requirements for legislating that assure that laws receive the appropriate representative consent."); id. at 397 ("Normally, [in manufacturing legislative history] two members, one of whom is a sponsor of the bill, cooperate. The second member asks the sponsor what the bill is intended to mean, and the sponsor answers.").

\textsuperscript{142} Judge Easterbrook has argued that less emphasis should be placed on the views of the sponsors of legislation, and that the views of "the median legislator, the one whose vote could change the outcome" should be ascertained. Frank H. Easterbrook, The Role of Original Intent in Statutory Construction, 11 Harv. J.L. & Pub. Pol'y 59, 63 (1988). See also \textit{In re Sinclair}, 870 F.2d 1340, 1343-44 (7th Cir. 1989) (Easterbrook, J.) (arguing that congressional opinion poll would carry more weight than a committee report drafted by staff and not subject to floor vote).

Cf. Posner, supra note 135, at 292 ("Those who regard the impediments to the legislative process as salutary checks on the excesses of democracy are likely to be distrustful of any expressions of legislative preference that have not run the gauntlet.").

\textsuperscript{143} Monterey Coal Co. v. Federal Mine Safety & Health Review Comm'n, 743 F.2d 589, 596, 598 (7th Cir. 1984).

\textsuperscript{144} Id. at 597. Of course, if legislators were sufficiently attentive, one could argue that if the sponsor adopted such a tactic, an opposing legislator would make a statement repudiating the sponsor's statement.

\textsuperscript{145} Id. at 598.
The Supreme Court, to be sure, has not been entirely consistent in applying a plain language approach in bankruptcy cases. For example, in the recent case of *Dewsnup v. Timm* it failed to apply a plain meaning methodology. If we were to abandon the plain language approach and (also following *Dewsnup*) invoke pre-Code practice, then one could argue that *Fano*, even apart from the sponsor’s statement, supports the proposition that compulsory tax increases were part of the background against which Congress created Chapter 9.

This argument founders, however, on the fact that it is by no means clear that the language and structure of Chapter IX, nor the case law that developed under it, contemplated mandatory tax increases. Chapter IX seems to have been fundamentally concerned with binding dissenting minority creditors to a reorganization plan. The municipality was required to secure the approval of its proposed reorganization plan from creditors with at least fifty-one percent of affected securities in order to enter Chapter IX, and the plan ultimately had to be approved by creditors holding two-thirds of the affected claims (of each class). Courts, in interpreting Chapter IX, did not all adopt a *Fano*-like position. For example, in *Getz v. Edinburgh Consolidated Independent School District*, the Fifth Circuit affirmed the confirmation of a plan over the objection of dissenting creditors. The approval came in spite of the fact that under the plan bondholders received new bonds with lower interest rates while the school district promised only to levy a tax one half as high as the allowable maximum, with half of the tax going to bondhold-

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147 Id. at 433-35 (1992) (Scalia, J., dissenting).
148 Id. at 418-19.
149 Nor, indeed, aspects of its own legislative history. See, e.g., Hearings Before Special Subcomm. on Bankruptcy and Reorganization of the Comm. on the Judiciary, House of Representatives, on H.R. 4307, 79th Cong., 2d Sess. 17 (1946) (statement of J. Bowers Campbell, Municipal Section of the American Bar Association (ABA)) (Chapter IX proceedings “are instituted for the benefit of the landowners. They are the only parties who are taxed. . . .”).
152 101 F.2d 734 (5th Cir. 1939).
ers and half to school maintenance. In so doing, the court stated that the "purpose" of municipal bankruptcy was "to permit the scaling down of municipal securities, on the theory that half a loaf is better than no bread. Some of the bondholders may be dissatisfied... [but] they are bound by the action of the majority." Against this background, the inclusion of a cram down possibility in Chapter 9 can be seen as a further pro-debtor liberalization.

III. THE INCENTIVES FACED BY MUNICIPAL BORROWERS

A. Moral Hazard in Borrowing

Part II showed that Chapter 9 does not provide a firm statutory basis for compulsory tax increases. Indeed, perhaps a better reading of the Chapter is that such increases would interfere with the governmental power of municipalities in a manner forbidden by Section 904. If tax increases are necessary, however, and if not imposing them would be detrimental to municipalities and their investors, a court certainly could construe the statute and legislative history to reach a tax increase result. We turn,

153 Id. at 735, 736.
154 Id. at 736; see West Coast Life Ins. Co. v. Merced Irrigation Dist., 114 F.2d 654, 670 (9th Cir. 1940) (decided after Fano) (affirming plan confirmation and rejecting, inter alia, dissenting creditors' objection to municipality's failure to levy additional taxes), cert. denied, 311 U.S. 718 (1941); Vallette v. City of Vero Beach, 104 F.2d 59, 61, 63 (5th Cir.) (describing dissenting creditors' pre-bankruptcy "judgments on their securities and mandamus absolute for the levy of taxes to pay them" as "fix[ing] no vested right in any existing thing which the bankruptcy power could not touch," and upholding confirmation of plan that apparently placed some losses on bondholders), cert. denied, 308 U.S. 586 (1939).

In some cases the courts affirming plan confirmation pointed to the futility of increasing taxes, from the perspective of creditors overall. E.g., Taylor v. Provident Irrigation Dist., 123 F.2d 965, 967 (9th Cir. 1941) ("[T]he record is persuasive that the debt load... contemplated by the approved plan is all that the lands can reasonably bear."); cert. denied, 315 U.S. 821 (1942); Thomas v. El Dorado Irrigation Dist., 126 F.2d 922, 923-24 (9th Cir.), cert. denied, 317 U.S. 660 (1942). But if creditor satisfaction were the ultimate goal, subject only to not driving tax rates beyond the point where revenue would be maximized, it is not clear why the plan should not have promised bondholders a longer-term contingent interest in tax revenues, so that if agricultural prices (and hence the maximum tax rate) rose, bondholders would benefit as well. In other words, to the extent an equity-like interest is left in the hands of the landowners, the absolute priority rule would seem to be violated—suggesting creditor-satisfaction is not the highest goal if the plan is approved by the requisite number of creditors.
therefore, to the issue of whether tax increases are necessary to the entire system of municipal finance.

The strongest argument for requiring a municipality to raise taxes in order to pay off general obligation bonds in full is that, otherwise, too many municipalities will seek Chapter 9 protection, exploiting bondholders by paying them off in cents on the dollar under the terms of their reorganization plans. Potential purchasers of municipal bonds, in turn, will know that municipalities can act opportunistically in this manner, and they will take this into account in purchasing municipal bonds by demanding high interest rates. The ability of municipalities to exploit Chapter 9 will thus become a cost to the municipality in borrowing money; indeed, it will be a self-fulfilling prophecy because municipalities will need to act exploitatively in order to make borrowing at such high rates worthwhile. Ultimately, the municipal bond market would collapse, with no borrowing or lending taking place.

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155 Note that, as a theoretical matter, it is not clear that pro-debtor bankruptcy rules will lead to a higher rate of bankruptcy. In a pro-creditor system, a creditor's expected recovery in the event of default is greater, which will encourage riskier loans and thus may result in a higher number of bankruptcies. Cf. Jagdeep S. Bhandari & Lawrence A. Weiss, The Increasing Bankruptcy Filing Rate: An Historical Analysis, 67 Am. Bankr. L.J. 1, 8 (1993) ("It was the increase in the debt to income ratio, and not the change in the bankruptcy law, which was principally responsible for the increased bankruptcy filing rate.").

The current rate of municipal bankruptcies is extremely low. E.g., Anna Kuzmik Walker, Harnessing the Free Market: Reinsurance Models for FDIC Deposit Insurance Pricing, 18 Harv. J.L. & Pub. Pol'y 735, 772 (1995); see infra note 297 and accompanying text. Therefore we will assume for the purposes of this Article that a more pro-debtor Chapter 9 would result in a similar or greater number of municipal bankruptcies.


157 See George G. Triantis, Secured Debt Under Conditions of Imperfect Information, 21 J. Legal Stud. 225, 237 (1992) ("The shareholders are forced to switch to the expected riskier investment strategy in order to recapture the value lost through the devaluation of the firm's debt.").

158 See Clifford W. Smith, Jr. & Jerold B. Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 J. Fin. Econ. 117, 119 n.5 (1979) (discussing the fact that there is not necessarily "a positive price at which... bonds can be sold"); Triantis, supra note 157, at 238 & n.27 ("If wealth-redistributing actions were unconstrained, agency costs would be prohibitive."); infra notes 202-203 and accompanying text (discussing credit-rationing).
Municipal opportunism could take one of several forms. The municipality might utilize borrowed funds to take on risky projects (perhaps building new schools or freeways, hoping a better-skilled workforce or better infrastructure would attract businesses). Without the compulsion of a tax increase to ensure bondholders are paid in full even if the project fails, such a risky project would be attractive to the municipal borrower. If the project succeeded, the municipality would reap the benefits, needing to make only the previously contracted-for payments to lenders. If the project were to fail, however, and drive the municipality into bankruptcy, the losses could be shared with, indeed foisted upon, bondholders.  

Even more brazenly, the municipality might simply spend the borrowed funds to improve its infrastructure, but then refuse to pay off the bonds and instead declare bankruptcy. This would be similar to a corporation’s selling its assets and repurchasing its shares of stock (or issuing a dividend) with the proceeds, then declaring bankruptcy, causing a loss to bondholders.  

A focus on the “moral hazard” problem inherent in municipal borrowing has emerged as the conventional view in analyses of Chapter 9. Concern over the “moral hazard of easy debt relief,” when coupled with the time-honored and still widely-held belief that “[n]o limit should be placed on the power of the municipal debtor to pay its debt” because “[i]t is immoral not to pay debts,”  

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159 Jensen & Meckling, supra note 156, at 335-37; Smith & Warner, supra note 158, at 118-19; Triantis, supra note 157, at 237-38.

160 Smith & Warner, supra note 158, at 117-18; Triantis, supra note 157, at 235.

161 “Moral hazard” refers to situations in which economic actors, because they “do not bear the full consequences” of their actions, maximize their utility at the expense of others. Y. Kotowitz, Moral Hazard, in 3 The New Palgrave: A Dictionary of Economics 549, 549 (John Eatwell, Murray Milgate & Peter Newman eds., 1987). A common example is an individual with theft insurance not protecting an easily-replaceable item.

162 See Dubrow, supra note 11, at 548 (Chapter 9 “should discourage excessive use so as not to encourage fiscal mismanagement.”); McConnell & Picker, supra note 13, at 426 (discussing “tendency of [municipal] debtors to prefer to devote their resources to their own interests instead of repaying their debts”); id. at 475-76 (“[T]he power to order the levying and collection of taxes . . . should be vested in the bankruptcy court . . . . Allowing a city to keep all of its assets while being discharged of its debts is the principal source of the moral hazard problem in municipal bankruptcy.”).

163 McConnell & Picker, supra note 13, at 456.

164 Fraser Brown, Municipal Bonds 41 (1922). Brown’s statement reflects how little
leads naturally to the conclusion that a bankrupt municipality should raise taxes in order to repay bondholders in full.¹⁶₅

¹⁶⁵ See McConnell & Picker, supra note 13, at 475-76 ("[T]he power to order the levying and collection of taxes ... should be vested in the bankruptcy court .... This would merely make explicit ... that the bankruptcy court can exercise the authority over state and local taxes ... "); id. at 466. McConnell and Picker ultimately conclude that the exercise of municipal taxation powers by a federal bankruptcy court may violate the Constitution, and that Chapter 9 is "fundamentally misconceived." Id. at 479. They suggest that municipal bankruptcy should be left to the states. Id. Of course, their concerns with "moral hazard," id. at 426, would require that state courts force tax increases on bankrupt municipalities.
B. Constraints on Moral Hazard: Municipal Finance Law

The moral hazard analysis, with its focus on borrower opportunism, suggests the need for compulsory tax increases in order to benefit both municipalities and lenders. That analysis, however, ignores several crucial elements. First, it ignores the backdrop of state municipal finance law against which municipal borrowing occurs. This regulatory scheme could operate to impose real costs on defaulting municipalities. For example, in California, cities are forbidden to issue bonds with an interest rate in excess of 8%.166 Municipalities generally are forbidden to issue bonds with an interest rate of more than 12%.167 Another statute specifies that municipal bonds can be sold at a discount, but the yield is not to exceed 12%.168 Thus, the real limitation on cities would also appear to be 12%, as bonds with a coupon rate of 8% could be sold at a discount resulting in a 12% yield.

If a default caused a municipality's risk-adjusted cost of capital to exceed 12%, the city would be unable to issue bonds for long-term borrowing—a result analogous169 to a perfectly coordinated cut-off of funds (as a "punishment") by lenders. Of course, the statute could be amended to allow for a higher interest rate in such a situation; and, in fact, the statute setting the maximum city rate was amended in 1969, and again in 1975, in order to increase the maximum rate.170 The general municipal statute also was amended to raise its rate in 1974, 1980, and 1981.171 Indeed, another statute, which sets out the intent of the general maximum rate statute, states that that statute will be "amended from time to time."172 Raising the statutory rate would

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166 Cal. Gov't Code § 43610(d) (West 1983).
168 Id. § 53532 (West 1997); see also Golden Gate Bridge & Highway Dist. v. Filmer, 21 P.2d 112, 113-14 (Cal. 1933) (holding maximum interest rate statutes refer to coupon, not yield, thus allowing sales at discount unless specifically stated otherwise); 52 Cal. Jur. 3d Public Securities and Obligations § 62 (1979 & Supp. 1995).
169 With the caveat discussed below regarding COPs. See infra text after note 172.
170 Cal. Gov't Code § 43610 (West 1983) (Historical Note). These increases were probably due to inflation's causing nominal interest rates to rise, although the rates were not reduced when inflation fell.
presumably be more popular in the state legislature than a state-funded bailout. The latter would impose costs directly on all state taxpayers while the former would directly affect only the bankrupt municipality's taxpayers, who would shoulder the cost of the higher rates. Given the dearth of large municipal bankruptcies, it is of course difficult to predict the actual outcome.

These statutes do not, however, appear to apply to COPs, so a municipality would apparently be able to borrow all it wanted at high interest rates if it eschewed using bonds. Nonetheless, states could certainly modify their statutes to apply to more modern borrowing techniques, and in this way municipal finance law could serve as a way to curtail borrowing by municipalities that had proven to be unduly risky.

C. Constraints on Moral Hazard: Modeling Sovereign Borrowing as a Dynamic Game

Even putting aside the possible constraints of municipal finance law, the moral hazard-driven analysis is flawed as an accurate theoretical model of municipal borrowing. McConnell and Picker criticize Chapter 9's treatment of municipalities as individuals to be given a "fresh start" rather than as business entities that can be reorganized or even liquidated. Yet the ability to repudiate debt and obtain a fresh start, an ability that gives rise to moral hazard in the borrower-lender relationship, is even more characteristic of a sovereign borrower. An individual, after all, must make at least some assets available to creditors. Therefore, in order better to understand this risk of repudiation—the moral hazard that tempts a municipality—we turn to an examination of sovereign borrowing. The analogy between nations and municipalities is strengthened when we realize that many American municipalities would be interspersed in, rather than merely trailing, an ordering of nations by the size of their economies. Orange County, for example, has an economy larger than that of Singapore or Israel.

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175 Jorion, supra note 3, at 2-3.
When nations borrow money, thus incurring "sovereign debt," there is no formal mechanism to ensure that they do not exploit lenders in the way suggested by moral hazard analysis. Indeed, that analysis would predict that national governments would be unable to borrow. Yet, of course, private individuals and enterprises do lend to national governments. And a striking feature of such sovereign debt is that not only do most governments repay their loans, but even those borrowers that experience economic downturns usually undertake measures that cause them considerable pain in order to avoid complete repudiation.7 If opportunism were motivating default, we would expect to see total repudiation.

In fact, the number of nations that have repudiated outright their foreign debt, a step the moral hazard analysis would suggest to be optimal, is very small.17 Furthermore, the nations that have done so since the First World War—North Korea,178 the U.S.S.R. (repudiating debt from the czarist and Kerensky regimes), and Mexico (a partial repudiation in 1914)179—would seem to have been motivated as much by an ideological desire to thumb their noses at bourgeois creditors as by calculated economic opportunism.180 Indeed, it is particularly striking that defaults to American creditors were not more common in an earlier era. Before passage of the Foreign Sovereign Immunities Act in 1976,181 American creditors were unable to use U.S. courts to attach the assets of defaulting sovereigns.182

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178 Sachs, supra note 55, at 231 ("North Korea provides the only case [of outright debt repudiation] involving private credit in the post [World War II] period.").
179 Eichengreen & Portes, supra note 177, at 613 n.22 ("The two notable instances of repudiation in [the interwar] period are" Mexico and the U.S.S.R.).
180 In fact, after the breakup of the U.S.S.R., Russia not only assumed Soviet debts, but agreed to repay hundreds of millions of dollars (although by no means 100 cents on the dollar) to holders of bonds that the Bolsheviks had repudiated in 1918. Uli Schmetzer, Russia to Pay Off Old Bonds; After 78 Years, the Czar's Markers Are Worthless No More, Chi. Trib., Nov. 28, 1996, at 1.
182 See Eichengreen & Portes, supra note 177, at 618 & n.30. The Foreign Sovereign
Thus, a real world situation that the moral hazard-driven analysis would predict to be characterized by an unwillingness to lend, and by debtor exploitation of creditors if money were lent, instead features willing lending and a seeming absence of significant problems of exploitation.

This apparent taming of the moral hazard in sovereign borrowing has been explained in a number of ways that yield productive applications to municipal borrowing. Jeffrey Sachs, for example, has suggested that debtors and creditors face a prisoner's dilemma in sovereign debt situations. In other words, the debtor might be better off defaulting regardless of the creditor's actions, and similarly the creditor may be better off reducing lending regardless of whether the debtor sacrifices to pay back its loans or defaults. While noncooperative behavior would thus lead to a breakdown in lending, Sachs suggests that creditors and debtors have learned to cooperate (the debtor avoids default by imposing a domestic austerity program and the creditor makes additional loans) because that is the optimal outcome.

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McConnell and Picker ignore this point. McConnell & Picker, supra note 13, at 447 ("[I]t would have been difficult for a city to find takers for a bond issue if there were no judicially-enforceable obligation under either state law or contract to levy taxes for payment of principal and interest."); id. at 450 ("[A] city that restricted [the mandamus remedy to compel a tax levy] prospectively would probably find itself barred from the credit markets.").

"For problem debtors real debt-service payments to private creditors from 1983-89 were sufficiently large so that the entire real interest expense was paid ...." Michael P. Dooley & Lars E.O. Svensson, Policy Inconsistency and External Debt Service, 13 J. Int'l Money & Fin. 364, 364 (1994) (citation omitted).

Sachs, supra note 55, at 200-01, 217.

Id. at 200.
When parties face the prospect of interacting repeatedly, transforming a prisoner's dilemma into an iterated prisoner's dilemma, cooperation to reach a mutually beneficial outcome may emerge. While this analysis is promising, a richer insight into the constraints on the moral hazard problem in municipal bankruptcy is gained by analyzing models of government borrowing as a "dynamic game." In a dynamic game, moral hazard can be constrained (the question of whether it is constrained—an empirical question—will be discussed below). A dynamic game includes debt and economic output as endogenous, or "state," variables determined within the model. Thus a government's potential need to borrow money in the future and concern with its economic output affect and are constrained by the government's behavior in all time periods. The borrower's past behavior affects not only lenders' future strategy, but also the very possibilities (e.g., level of output) that will be available to the borrower in future periods for all strategies the borrower might take.

A dynamic game analysis of sovereign borrowing suggests that the often small penalties assessed against sovereign borrowers who default are not indicative of a situation rife with unconstrained moral hazard. Rather, the fact that most debtors struggle to repay, and do repay much of their debt even in times of economic turmoil, indicates the existence of strong incentives

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188 The iterated prisoner's dilemma model suffers from the simplification of modeling creditors' behavior as unitary and coordinated. In addition, repeated interaction in such a game can generate a number of plausible outcomes. See Douglas G. Baird, Robert H. Gertner & Randal C. Picker, Game Theory and the Law 172-73 (1994); Scott, supra note 187, at 2027. That is, cooperation is not guaranteed. On the danger of "being drawn too quickly to a well-known paradigm," see Baird, Gertner & Picker, supra, at 45.
190 For example, a government might seek to borrow funds rather than to impose (distortionary) changes in taxation if it needed to maintain a steady revenue stream in the face of an economic downturn.
191 Chari & Kehoe, JET, supra note 189, at 233; Chari & Kehoe, RES, supra note 189, at 176. On the distinction between repeated and dynamic games, see Drew Fudenberg & Jean Tirole, Game Theory 188-89 (1991).
192 See infra notes 204-205 and accompanying text.
against exploiting borrowers. The fact that actual penalties are often slight reflects lenders' ability to distinguish between opportunistic defaults and those arising from legitimate risks understood to have been shifted from borrowers to lenders.

V.V. Chari and Patrick J. Kehoe have developed a sophisticated model in which a government will choose not to default on debt even though it has the ability to do so (i.e., even though there is no power to force it to raise taxes in order to pay off the debt it has issued). In their model, citizens consume both private and government goods. The government funds its production with a combination of taxes and debt, and the government can default on as much or as little of the debt as it wishes. Citations lend money to the government. Treating this situation as an optimal control problem, Chari and Kehoe demonstrate that it is theoretically possible for not defaulting to be an optimal government strategy, even in the absence of any coordinated creditor response. Default will trigger a move from a low interest rate equilibrium to a high interest rate equilibrium, and the municipality will be unable to regain the more advantageous equilibrium, thus forcing it to pay higher rates on its borrowing forever. Thus, for some levels of debt, a sovereign borrower in such a situation would not exercise its prerogative to default, since the long-term costs of doing so would outweigh the short-term benefits that would be reaped.

Another, somewhat related, explanation for the relative lack of sovereign government defaults has been offered by Herschel I. Grossman and John B. Van Huyck and also by Andrew Atkeson. Their models are based on the sovereign nation's need to maintain a reputation as being trustworthy. Reputation-based explanations of why sovereign nations do not default date back at least to Adam Smith's observation that government debt did not

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193 Chari & Kehoe, JET, supra note 189, at 234-35.
194 An optimal control problem involves the allocation of scarce resources over an interval of time. See, e.g., Michael D. Intriligator, Mathematical Optimization and Economic Theory 292-305 (1971).
195 Chari & Kehoe, JET, supra note 189, at 257.
196 Id.
require particularly high interest rates because it was supported by "the universal confidence in the justice of the state."\footnote{2 Adam Smith, The Wealth of Nations 445 (Edwin Cannan ed., 1976) (1776).}

In Atkeson's model, lenders are unable to monitor whether borrowed funds are invested productively or merely consumed.\footnote{Atkeson, supra note 197, at 1070, 1071. Atkeson, like Chari and Kehoe's, models borrowing as a dynamic rather than a repeated game. Output and repayments in one period affect the attainable output and borrowing outcomes in subsequent periods. Id. at 1071.} While Atkeson goes on to show the existence of lending in spite of borrowers' ability to repudiate, his model differs from Chari and Kehoe's because it assumes that lenders will jointly punish repudiating nations by not lending to them at all in the future.\footnote{Id. at 1076.} While creditor coordination to punish an opportunistic borrower may be an unrealistic assumption (at least in pre-International Monetary Fund ("IMF")/World Bank days),\footnote{Even during that era, however, international lending functioned well. See infra note 251 and accompanying text.} it is possible that an opportunistic borrower could find itself cut off from funds. Adverse selection might work to cause lenders to stop making loans to certain groups of risky potential borrowers.\footnote{Joseph E. Stiglitz & Andrew Weiss, Credit Rationing in Markets With Imperfect Information, 71 Am. Econ. Rev. 393, 393, 406-07 (1981) (Risky "[g]roups ... which are excluded from the credit market may be termed 'red-lined' since there is no interest rate at which they would get loans ....")}. Intuitively, one could imagine that if a lender decided that previously-opportunistic nations would need to be charged an additional $x\%$ to make loans worthwhile, some nations would be priced out of borrowing by this interest rate increase. A nation that planned on future opportunism, however, would not share this fate: The real cost of the additional $x\%$ interest would be low if the borrower were expecting another default. Given that the mix of borrowers would overrepresent likely recidivists, $x\%$ might not be a sufficient increase, a fact that would necessitate another increase, further boosting the proportion of recidivists in the pool of borrowers willing to accept the increase.\footnote{See generally George A. Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q.J. Econ. 488 (1970) (illustrating adverse selection's unraveling of market).}
Historical experience demonstrates, however, that lenders that default but only partially repudiate their debt seldom find themselves unable to borrow further; indeed, it is often striking just how easy it is for a defaulting nation to continue to borrow on international capital markets. The fact that these historical penalties tend to be small suggests that defaults were not opportunistic, but, rather, that the loans involved risk-sharing between borrowers and lenders. Larger penalties are reserved for opportunistic defaults, with their occurrence constrained by the threat of such penalties. The fact that a nation had defaulted non-opportunistically would not necessarily suggest that it would be a larger future risk than another nation that faced a similar ex ante risk of exogenous economic shocks.

It should be noted in this regard that many commentators, and the popular press, seem to believe that a municipality that defaulted on its debt would be unable to borrow again. But so long as the default were not opportunistic, such a conclusion would appear to be unwarranted from both a theoretical and a historical perspective. Indeed, new lenders stepped forward during Orange County’s bankruptcy proceedings despite the very real prospect that old lenders would not be paid in full.

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204 Dooley & Svensson, supra note 184, at 365 (“[H]istorical experience and theoretical arguments suggest that penalties imposed on defaulting countries by creditors are likely to be small and temporary.”); Eichengreen & Portes, supra note 177, at 600; Grossman & Van Huyck, supra note 176, at 222 (“Far from a permanent bar to flotation of new debt issues, Guatemalan defaults were regularly renegotiated to permit new borrowing.”).

205 See infra notes 283-307 and accompanying text.

206 E.g., Dubrow, supra note 11, at 547 (“[M]unicipalities with financial difficulties would readily lose access to the credit markets, thereby ensuring their financial collapse.”); Wayne, supra note 8 (“Should Orange County default on its outstanding bonds, it would most likely be unable to ever borrow again in the municipal markets.”).


208 Leslie Wayne, Orange County, Calif., Pays a Price for a Step Toward Recovery, N.Y. Times, June 14, 1995, at D10 (discussing “remarkable fact that Orange County can still borrow money while it is trying to default on its existing debts”).

Along similar lines, while it is often said that New York City's mid-1970's fiscal crisis caused the city to be shut out of the municipal borrowing market, e.g., Donna E. Shalala & Carol Bellamy, A State Saves a City: The New York Case, 1976 Duke L.J. 1119, 1119 (“In the Spring of 1975 the City of New York was unable to market its debt.”); Subcomm. on Econ. Stabilization, House Comm. on Banking, Fin., and
Grossman and Van Huyck present a model in which lenders are able to observe the borrower's output and whether factors outside the borrower's control have been beneficial or detrimental.\(^{209}\) They argue that this assumption is realistic because most of the factors that have, historically, led to default (especially deterioration in a nation's terms of trade\(^{210}\) or war\(^{211}\)) are in fact observable to outsiders.\(^{212}\) Grossman and Van Huyck go on to demonstrate that concern with its reputation may lead a nation to pay back its debts, and therefore induce lenders to advance money to it initially.\(^{213}\) Their model assumes that default causes lenders to cut off funds to the defaulting nation for a (random) period of time.\(^{214}\)

The assumption that lenders are able to monitor both how the debtor spends its borrowed funds and what external economic forces are affecting the debtor also seems plausible for municipalities; this is a reason to prefer the Grossman and Van Huyck

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Urban Affairs, 95th Cong., Securities and Exchange Commission Staff Report on Transactions in Securities of the City of New York, intro. at 1 (Comm. Print 1977) ("[S]ince [March 1975] the public debt market has been closed to the City."), closer analysis reveals this statement to be incomplete. New York City could have raised funds had it been willing to pay a reasonable risk premium (as through selling its debt at a discount, or with a higher interest rate), reflecting its precarious financial condition. See id. ch. 1 at 200 (noting that the city's Investors' Conference Committee recommended "issuing . . . bonds at discount"). And the risk premium might not have been especially great had the city moved quickly to show that it was controlling its spending. See id. at 166 (discussing "concern that the underwriting syndicate would not be able to sell any additional City notes or bonds unless the City could better demonstrate its ability to control its expenses"); id. at 199, 222. Instead of paying this higher price, however, the city preferred to lobby for a federal bailout, see id. at 189-90, 212 (discussing Mayor's "proposal to create a Federal municipal-finance agency that could issue bonds and buy city note issues at low rates of interest"), 227 (noting financier's description of city's strategy as a "game of chicken" [with] . . . the State, the Federal Government, and the banks), pointing to its inability to borrow on its traditional terms. See id. at 187. It appears that the city would have fared far better in investors' eyes had it moved quickly to cut expenses. As it was, the State of New York established a "Municipal Assistance Corporation," which, backed by the State, borrowed billions for the city during mid- and late-1975. Id. at 258.

\(^{209}\) Grossman & Van Huyck, supra note 176, at 1089.

\(^{210}\) Eichengreen & Portes, supra note 177, at 615; Sachs, supra note 55, at 225-26. Deterioration in the terms of trade refers to a situation such as that which occurs when a nation experiences a steep decline in the price of one of its major exports.

\(^{211}\) Eichengreen & Portes, supra note 177, at 624; Sachs, supra note 55, at 222.

\(^{212}\) Grossman & Van Huyck, supra note 176, at 1089 & n.2.

\(^{213}\) Id. at 1095, 1097.

\(^{214}\) Id. at 1093.
model to Atkeson's, which assumed non-monitorability.\(^{215}\) Yet even if an alert investor could ascertain these facts, one might be concerned that any given investor will rationally invest little in monitoring, instead choosing to free ride off the efforts of others, much like corporate shareholders.\(^{216}\) However, municipal bond investing provides a number of focal points that would make some monitoring cost-effective. Much municipal bond investing occurs via mutual funds, and these funds provide a means of overcoming the collective action problem to monitoring.\(^{217}\) Investors are also aided by municipal bond rating agencies, which take account of the uses to be made of the borrowed money in determining their creditworthiness rating.\(^{218}\) Of equal or greater importance is the fact that private bond insurance is available for municipal bonds,\(^{219}\) and even COPs.\(^{220}\) Insurers in

\(^{215}\) See supra text accompanying note 199.

\(^{216}\) E.g., Manuel A. Utset, Disciplining Managers: Shareholder Cooperation in the Shadow of Shareholder Competition, 44 Emory L.J. 71, 73 (1995). See generally Mancur Olson, The Logic of Collective Action (1971) (showing that even rational members of a group generally will not act in concert to advance their common interests). The monitoring engaged in by individual investors might also be suboptimal in that much of it could be duplicative. Saul Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 Yale L.J. 49, 49 & n.2 (1982).


\(^{218}\) Robert Lamb & Stephen P. Rappaport, Municipal Bonds: The Comprehensive Review of Tax-Exempt Securities and Public Finance 59 (1980) (including "uses [and] purposes ... of debt issuance" in list of factors utilized in rating municipal bonds). Of course, that such factors will be taken into account does not ensure that municipalities will always use funds wisely; however, they will have to pay higher interest rates for riskier investments.

Nor are bond-rating agencies perfect, of course. It is arguable that Orange County's bonds were rated too highly. See Jorion, supra note 3, at 107-08. It has been suggested that rating agencies seek to curry favor with issuing municipalities because their fees are paid by issuers. John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va. L. Rev. 717, 745 & n.83 (1984); see also Charles Gasparino, Bond Raters Draw Heat Over Miami, Wall St. J., Dec. 10, 1996, at C1.

\(^{219}\) E.g., L. Paul Hsueh & P.R. Chandy, An Examination of the Yield Spread Between Insured and Uninsured Debt, 12 J. Fin. Res. 235, 235 (1989); John M.
essence take the risk of default off of investors;\footnote{Quigley & Daniel L. Rubinfeld, Private Guarantees for Municipal Bonds: Evidence From the Aftermarket, Nat’l Tax J., Dec. 1991, at 29, 29 (1991).} for an issue of insured bonds, the insurer has the full incentive to monitor that a single investor would have.\footnote{Presumably, bond insurance is available for municipal, but not corporate, bonds because tax considerations often lead investors to limit municipal bond investments to their state of domicile, see infra note 286. A bond insurer can more fully eliminate unsystematic risk by insuring bonds from across the nation, and can thus offer insurance at an attractive price. In addition, while municipalities have a low default rate, see supra note 155, the availability of insurance gives municipal investors the chance to invest at another point along the risk-return trade-off curve, similar to an investor’s choice in taxable bonds between Treasuries (which have an extremely low default risk, see infra note 254 and accompanying text) and corporate bonds.} Bond insurance thus avoids duplicative monitoring by individual investors (an advantage of the bond rating agencies as well).\footnote{Doty, supra note 84, at 790.}

Not only will investors monitor municipalities, but municipalities have an incentive to assist that monitoring by disclosing relevant information to investors.\footnote{Cf. Easterbrook & Fischel, supra note 107, at 52 (“The ability of potential victims to protect themselves against loss through insurance is a strong reason for disregarding distributional concerns in choosing among liability rules.”).} This information would include,

\footnote{Because the risk of loss from default is now on the insurer, the need of investors to “monitor the monitor”—a problem with the use of many third party monitors, such as outside corporate directors, see Levmore, supra note 216, at 61—will be minimal, so long as the insurer is not itself in danger of becoming insolvent.}

\footnote{See, e.g., Richard A. Booth, Limited Liability and the Efficient Allocation of Resources, 89 Nw. U. L. Rev. 140, 147 (1994) (discussing use of “an outside monitor to avoid duplicative costs”).}

\footnote{Those municipalities with an overall “good” mix of information will disclose it so as not to be classified by investors with municipalities that have average or poor information. This, in turn, will cause those with average information to disclose so as not to be lumped with those that have poor information. See Easterbrook & Fischel, supra note 107, at 288-90; Alan Schwartz, A Theory of Loan Priorities, 18 J. Legal Stud. 209, 220-21 (1989). This result is known as “unraveling.” Baird, Gertner & Picker, supra note 188, at 89-90. Among the better evidence that unraveling occurs is the fact that many corporations disclosed considerable financial information in the pre-Securities Exchange Act era. George J. Benston, Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934, 63 Am. Econ. Rev. 132, 133 (1973).}

\footnote{Amdursky and Gillette note that “the need to impose a regulatory structure on municipal securities is less compelling [than for corporate securities].” Amdursky & Gillette, supra note 54, at 317. For example, business firms might fear disclosing information valuable to rivals. Easterbrook & Fischel, supra note 107, at 290-91. This would be less of a concern in the municipal setting. Amdursky and Gillette nonetheless argue that mandatory disclosure might be necessary, as if officials thought they could}
for example, the issuing municipality's financial condition and the use to which funds will be put. This inherent incentive to disclose is reinforced by federal securities law, which mandates\(^\text{225}\) that underwriters obtain relevant information from issuers and provide that information to interested investors on municipal securities offerings of one million dollars or more.\(^\text{226}\)

The disclosure obligation was recently made ongoing, with yearly financial reports, including audited financial statements, now being required.\(^\text{227}\) The combination of ongoing disclosure, a secondary market in municipal bonds (which insures that monitoring investors will not be locked into an ever-more perilous course),\(^\text{228}\) and the ability of investors to pre-condition the use of funds using bond covenants\(^\text{229}\) all suggest that bondholders should be able to monitor conceal bad information in order to issue bonds at a lower interest rate. Amdursky & Gillette, supra note 54, at 317-18. While such a situation would occur only in the absence of unraveling, there is some evidence that municipal officials sometimes act in this way. See, e.g., Dan Cook, Disclosure Becomes a Bond Issue, Miami Daily Bus. Rev., Nov. 5, 1996, at A1, available in LEXIS, News Library, Curnws File ("[The county finance director] told the [Dade County] [C]ommission the mere inclusion of a disclosure statement might run up the cost of floating the bonds."); see also Coffee, supra note 218, at 745-46 (pointing to instances of failure of municipal officials to disclose adequately); Ann Judith Gellis, Mandatory Disclosure for Municipal Securities: A Reevaluation, 36 Buff. L. Rev. 15, 44-65 (1987) (arguing that municipalities are less likely to disclose voluntarily than are corporations).\(^\text{226}\)

Mandatory disclosure raises the danger of creating too much disclosure—i.e., disclosure that is costlier than the benefit it brings. See, e.g., Amdursky & Gillette, supra note 54, at 319; SEC Muni Rule Costly, Ineffective—Lawyer, Reuters Fin. Serv., Oct. 18, 1996, available in LEXIS, News Library, Curnws file (discussing claim that certain Securities & Exchange Commission ("SEC") municipal disclosure rules do not much "improve[] information flow to investors . . . but . . . cost[] . . . millions of dollars"). The optimal amount of both monitoring and disclosure is certainly less than the total possible amount of both activities.

\(^{225}\) 17 C.F.R. § 240.15c2-12(a),(b) (1997).


\(^{228}\) An investor that merely sells its shares will not be (directly) aiding other investors, see Levmore, supra note 216, at 63 & n.65, but other investors may notice that exit and take it as a signal to further investigate the municipality. Cf. Triantis & Daniels, supra note 217, at 1080-81 (discussing signaling effect a creditor's exit has for other creditors).

\(^{229}\) SEC Exchange Act Release No. 33,742, 59 Fed. Reg. 12,759, 12,760 (1994), reprinted in [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,324, at 85,152 (March 9, 1994) ("With the exception of general obligation bonds, most offerings include a trust indenture which sets forth the undertakings between the issuer and the holders of municipal securities . . . . If there is no trust indenture, as in a general obli-
and constrain municipal actions adequately. Indeed, even in the Orange County bankruptcy, which was not presaged by years of municipal decay, it is difficult to make a credible case that bondholders were legitimately taken by surprise.\textsuperscript{230}

Jeremy Bulow and Kenneth Rogoff critique reputation-based models of sovereign borrowing.\textsuperscript{231} They argue that, if direct lender sanctions are not expected, a borrower would find it advantageous to default on and repudiate its debt.\textsuperscript{232} This situation would lead to a transfer of money from lenders to the borrower, but it might result in unattractive future borrowing terms. Yet, they argue, the borrower could still gain the insurance-like benefits of contingent debt\textsuperscript{233} by purchasing cash-in-advance insurance policies, or by investing money (perhaps the money it

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\textsuperscript{230} First, even if Orange County's use of its funds was completely unknown to investors, the latter were on constructive notice that the county was taking substantial risks. That conclusion is the only plausible explanation for the high returns the county had received in previous years. During 1973-1993, its investment pool had made profits of over three-quarters of a billion dollars in excess of what it would have received had it earned the same return as the state's investment pool. Jorion, supra note 3, at 84.

Second, even without the compulsion of 17 C.F.R. \S 240.15c2-12(b)(5) (1996) (which took effect in 1995), supra note 227, considerable information was in fact disclosed by Orange County as to the use of its funds and its investment holdings. This included a monthly report "made available to investors" that detailed the county's investment holdings. Jorion, supra note 3, at 89-93. Moreover, the opponent running against the incumbent treasurer made the risks of Orange County's holdings the centerpiece of his campaign. This campaign attracted coverage in the Wall Street Journal as early as mid-April 1994. Earl C. Gottschalk Jr., Derivatives Roil California Political Race, Wall St. J., Apr. 15, 1994, at C1; see infra note 272.


\textsuperscript{232} Id. at 46.

\textsuperscript{233} See infra notes 293-296 and accompanying text.
\end{flushleft}
had gained through repudiation) abroad in such a way as to hedge its future economic risks or meet its borrowing needs.\textsuperscript{24}

Of course, in practice we do not observe sovereigns purchasing insurance contracts of this sort, nor do they appear to retain borrowed money, default on the loan agreement, and then invest the money abroad. Perhaps this is because a municipality, or indeed any sovereign borrower, needs to be concerned with more than its reputation in the credit markets. Its treatment of lenders will also affect the likelihood that investors will be willing to make capital investments within the sovereign's jurisdiction. This state of affairs highlights an additional aspect of the long-term cost to a borrower of opportunistic defaults. Opportunism results in deterred investment in addition to higher-cost future borrowing.

In a model developed by Michael P. Dooley and Lars E.O. Svensson, outsiders will be loath to make capital investments in a defaulting nation for fear that if they do so, they will be exploited by the government once their investments are in place.\textsuperscript{25} Counterintuitively, they argue that sovereign borrowing is characterized not by the fact that borrowers cannot credibly commit to repay their borrowings, but rather that they cannot credibly commit to default.\textsuperscript{26} In other words, since default will have some costs,\textsuperscript{27} a borrower can be expected to try to foist the costs of that default onto other parties, through such methods as in-

\textsuperscript{24} Bulow & Rogoff, supra note 231, at 45-46; see Bulow & Rogoff, supra note 182, at 158.

\textsuperscript{25} Dooley & Svensson, supra note 184, at 368.

\textsuperscript{26} Id. at 365.

\textsuperscript{27} Dooley and Svensson assume “small but positive costs for default.” Id. at 366. While lender coordination problems are likely to render effective “punishment” of defaulters difficult, it does seem likely that default will have some positive cost. Most obviously, a government that has defaulted might appear riskier than one that has not, and therefore be required to pay a higher interest rate. This will be a cost of default. Additionally, there are some historical examples of lender retaliation against defaulting nations—for example, when Germany stopped paying interest on its Dawes and Young plan bonds in 1933, American creditors ultimately received a less favorable settlement than the nationals of some European nations that threatened retaliation (via trade sanctions) against Germany. Eichengreen & Portes, supra note 177, at 619-20. This example suggests that creditors may sometimes be able to impose costs on a debtor, although typically trade restrictions will be unpopular because they will damage residents of both the creditor and debtor nations. Dooley & Svensson, supra note 184, at 366; see also supra note 182 (discussing the Foreign Sovereign Immunities Act).
creasing taxes on fixed investments made in the borrower’s territory in order to pay back some of the defaulted debt. This expectation would only be strengthened if the borrower had already shown a predilection for opportunism (i.e., its default was not “justified”).

Even if the government tries to reduce the disincentive to investment created by this situation, by, for example, promising not to tax new investments in order to pay off old creditors, “the new investment can create the conditions under which it will be optimal for the government to break that promise.” This is because, given some costs to default, the optimal tax rate will increase along with the level of investment. In order to achieve and sustain a high investment, high growth development path, a sovereign borrower will therefore avoid getting into such a bind in the first place—by paying off its debts as they come due. A similar argument applies to municipalities—individuals and enterprises would be loath to invest in a municipality that has repudiated its debt (especially if it did so opportunistically), because given the costs to default—namely, higher interest rates—the municipality will have the incentive and opportunity to exploit investments once they are in place, either in order to pay off some of the defaulted loans or because it has another opportunity to act exploitatively.

For our purposes, the important lesson of these models is that moral hazard is not a theoretical necessity in situations of government borrowing. Debtor governments may find it in their interest to repay their debt, even if repayment entails consider-

238 Dooley & Svensson, supra note 184, at 372.
239 Id.
241 Nonetheless, the potential for debtor opportunism does result in some agency costs, such as the investor monitoring discussed above. Supra notes 209-223 and accompanying text; see Jensen & Meckling, supra note 156, at 308. Agency costs also include “bonding” costs imposed directly on the borrower, such as the disclosure of financial information. Id. at 323, 325. As discussed above, many of the latter costs are mandatory due to federal securities rules. See supra notes 225-227 and accompanying text. See also Jensen & Meckling, supra note 156, at 309 (stating agency costs exist “in all organizations . . . at every level of management in firms, . . . in cooperatives, in governmental authorities”).
able sacrifice. Ultimately, however, these theoretical findings only go part of the distance towards disposing of the moral hazard-driven analysis. Most models can be shown—by some other, more “sophisticated” model—to lead to the “wrong” results. Subtle changes in assumptions might be made, or increasingly sophisticated theoretical frameworks applied. It may be difficult or impossible to choose between competing models, each of which is—on its own terms—correct. One should perhaps always be at least somewhat skeptical of criticism of a powerfully simple model that relies upon a host of complicating details.242

Nonetheless, we have seen that moral hazard in sovereign borrowing is merely a theoretical possibility, not a necessity as is so often assumed. And as we shall now see, empirical evidence that such moral hazard is constrained, as predicted by the dynamic game models examined above,243 is strong. This should, perhaps, be relatively unsurprising—private individuals and enterprises do lend to governments that have the ability to default, and those governments typically struggle to pay back the debt in spite of the lack of any severe or coordinated debtor punishment in the event of default.

Avraham Ben-Bassat and Daniel Gottlieb present evidence that would seem to support the Dooley and Svensson model, in which default will knock a nation off of a high investment, high growth development path, with consequent reductions in gross national product (“GNP”) growth.244 They found that the magnitude of a nation’s GNP loss after default was significantly, and positively, correlated with the degree of “openness” of the defaulting nation’s economy.245 In other words, the fewer hin-

242 Cf. Richard A. Posner, The Future of Law and Economics: A Comment on Ellickson, 65 Chi.-Kent L. Rev. 57, 60 (1989) (discussing danger of building models so complicated that, while “consistent with all possible observations . . . cannot be confirmed either”); id. at 62 (“[T]oo many bells and whistles will stop the analytic engine in its tracks.”).

243 See supra notes 189-192 and accompanying text.

244 Avraham Ben-Bassat & Daniel Gottlieb, Optimal International Reserves and Sovereign Risk, 33 J. Int’l Econ. 345 (1992). Ben-Bassat and Gottlieb consider any nation that renegotiated its debt to have “defaulted.” Id. at 352. Of course, most “defaults” by this definition are not outright repudiations—creditors typically do not lose all of their investment during a renegotiation. Grossman & Van Huyck, supra note 176, at 1088.

245 Ben-Bassat & Gottlieb, supra note 244, at 348, 353.
drances there are to outside investment and trade, and therefore the more specialized a nation's economy becomes due to a high degree of integration with other nations, the costlier is default. Defaulting nations with open economies experienced substantially substandard economic performance in the years following a default. This situation is consistent with their having defaulted only in the face of severe economic problems—in which case in the years following default they did not necessarily face creditor-imposed penalties, but they did continue to struggle with the very problems that legitimated (i.e., rendered non-opportunistic) their default in the first place.

This finding has important implications for municipal default because municipalities are very open economies. Investment, as well as goods, services, and people, moves without hindrance between different municipalities within the United States—an openness unmatched on the international scene (although perhaps approached by the nations of the European Union). Thus, it would also be consistent with their having defaulted opportunistically, and then having faced detrimental penalties such as reduced investment and higher-cost borrowing.

Presumably, closed economies suffered fewer post-default problems because at least some had defaulted opportunistically, and hence were not suffering the long-term consequences of the (non)event causing the default; nor were they losing many expected investments, since their economies were quite closed to begin with.

Default only upon the realization of poor economic outcomes might still be thought indicative of moral hazard, if the poor economic outcomes were linked to excessive risk-taking by sovereign borrowers. See supra note 159 and accompanying text. However, since investors can monitor (and constrain as through covenants) a borrowers' actions, supra notes 209-229 and accompanying text, such excessive risk-taking should be controllable because lenders can charge for it via higher rates. In other words, lenders will receive enough of a risk-premium in situations where borrowers do not default that they can afford losses in cases where borrowers do default.

See Treaty Establishing the European Community, Feb. 7, 1992, 1992 O.J. (C 224) 1, [1992] 1 C.M.L.R. 573, arts. 9 (banning "customs duties" and "all charges having equivalent effect" between member states), 30 (banning "quantitative restrictions on imports and all measures having equivalent effect"), 34 (banning "quantitative restrictions on exports"), 48 (establishing "freedom of movement for workers"), 63 (delineating planned liberalization of the provision of services), 67 (delineating planned liberalization of the provision of capital), 95 (banning discriminatory taxation).
an automobile manufacturer would be unlikely to choose to construct a new plant in an "opportunistic" municipality, where the firm's property taxes could be raised once the plant was finished. On the international scene, in contrast, a manufacturer might still consider constructing a plant in an opportunistic nation if heavy tariffs on imports made local production the only way to sell in the domestic market.

Significantly, Ben-Bassat and Gottlieb's results do not correspond to the moral hazard analysis. In that model, while GNP might well decline during the year of default (if, for instance, the borrower waited to default until the high-risk investment for which the borrowed money was used failed), we would not expect any GNP-loss carryovers to subsequent years. Indeed, since the benefits of default outweigh the losses in the moral hazard analysis, we would expect defaulting nations to outperform similarly situated nations that did not default.\textsuperscript{250}

Further support for the lack of moral hazard as a serious problem in government lending may be found by examining the history of governmental borrowing in more detail. One indication of the constraints on moral hazard is the fact that lenders to foreign governments have, overall, profited (as one would expect, given the continuation of sovereign lending). For example, in studying foreign borrowing during the 1920s, as exemplified by bonds sold in the United States and United Kingdom (the two largest overseas lenders of the day), Eichengreen and Portes conclude that "[d]espite the preoccupation of many commentators with sovereign default, it appears that investors who lent to national governments ultimately received respectable rates of return."\textsuperscript{251} And this was for bonds issued as the world was heading for the Great Depression and global warfare. As world capital markets have grown more efficient,\textsuperscript{252} the difference in bond interest rates that private investors have demanded of less developed nations, as compared to developed ones, has narrowed considerably, to only slightly more than one half of one percent

\textsuperscript{250} Instead, we find the opposite. Ben-Bassat & Gottlieb, supra note 244, at 352 & n.6.

\textsuperscript{251} Eichengreen & Portes, supra note 177, at 630; see id. at 601, 625-27.

\textsuperscript{252} E.g., Hansmann & Kraakman, supra note 107, at 1926 ("[T]he capital markets ... have matured considerably over the past hundred years."); Financial Border Patrol, Investor's Bus. Daily, Jan. 18, 1995, at A3 (discussing "increased efficiency" of global capital markets).
during the mid to late 1970s.\textsuperscript{253} Consider in this regard that U.S. corporations, even those with significant positive equity, are required to pay higher interest rates when they borrow than do many governments, even though the latter could repudiate their debt (or, alternatively, their debt held by foreigners) without any direct penalty. Indeed, the rate at which the U.S. government borrows is often used as a proxy for the rate of return on "risk free" investments.\textsuperscript{254}

A possible limitation in applying these models of sovereign borrowing to municipalities is that some municipalities might not have much of a "GNP" to be concerned about. That is, they might be bedroom communities filled with residential neighborhoods. Such municipalities could be relatively unconcerned about lowered GNP growth, or being knocked off of a "high development" path, because most of its residents could work in a neighboring municipality and thus be concerned about its GNP growth, not that of the municipality in which they reside.

Two points cut against this analysis, however. The first is that such communities are unlikely to be heavy users, or at any rate to need to be heavy users, of the municipal bond market. If the municipality is already developed to the capacity allowed by its zoning laws, it will not require many additional capital improvements, and thus will not have a great need to issue long term bonds.

Second, to the extent that such "bedroom communities" did prove problematic—because they needed to borrow (perhaps for major repairs to infrastructure) but presented a moral hazard problem because of their lack of significant production—a solution might be for states to reformulate their municipal laws so only counties would seek Chapter 9 protection. This could either be done explicitly,\textsuperscript{255} or de facto by reformulating municipal finance so that only counties, rather than cities or towns, would need to default. A model for the latter strategy might be Califor-

\textsuperscript{253} Sachs, supra note 55, at 204, 208 tbl.7-6.


nia’s “Teeter Plan,” under which a county “provides for all of its political sub-divisions to receive their tax levy in full. The County reserves against any tax revenue shortfall.” The Teeter Plan allows a county to establish a tax losses reserve fund “to cover losses that may occur in the amount of tax liens as a result of special sales of tax-defaulted property.” Thus, following the Teeter Plan model, counties, not their smaller constituent municipalities, might be made responsible for repaying borrowed funds. Moreover, since counties do have their own production, or GNP, their moral hazard would be adequately constrained, as suggested by the discussion above.

D. Disaggregating the Municipal Actor: Public Choice and Agency Cost Perspectives

So far, we have considered the municipal borrower as a unitary entity. In reality, of course, this is a simplification: A municipality’s decisions will be influenced, perhaps disproportionately, by various interest groups amongst its residents, and by the personal agendas of its officials. When viewed from such a public choice and agency cost perspective, should we be less sanguine about our hostility toward compulsory tax increases in municipal bankruptcies? In other words, might compulsory tax increases be

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259 One would, of course, need an extensive analysis of the non-bankruptcy costs and benefits of such a program before implementing it.


261 Cf. 1 Kenneth J. Arrow, A Difficulty in the Concept of Social Welfare, in Collected Papers of Kenneth J. Arrow 1, 3 (1983) (“Game theory was based on utility functions for individuals, but when applied to international relations, the ‘players’ were countries, not individuals. In what sense could collectivities be said to have utility functions?”).
necessary in order to constrain the moral hazard of municipal officials or well-organized interest groups, who would otherwise act opportunistically (borrowing and then defaulting), to the detriment of both investors and most municipal residents?

The answer is no. The mere existence of public choice problems does not support mandatory tax increases. Indeed, once we delve within the municipality, no longer viewing it as a unitary, rational actor, the justification for establishing a Chapter 9 default rule that places the risk of loss on investors is strengthened.

A mandatory tax increase places the cost of opportunistic behavior by an interest group or municipal officials onto municipal residents as a whole; if a municipality is able to have its debt discharged without paying off bondholders in full then the direct financial loss of even opportunistic behavior is placed on bondholders and other municipal investors. In deciding between these outcomes, the relevant question is which group better bears the residual risk that cannot be eliminated, and which can better reduce the magnitude of such abusive practices.\(^{262}\)

It seems doubtful that municipal officials' interests will systematically diverge from those of their constituents in the direction of excessive risk-taking. Indeed, and here the analogy to a public corporation's managers\(^{263}\) is useful, municipal officials might well be expected to be more risk averse than their constituents.\(^{264}\)

If the municipal officials who undertake a risky project are still in office when the project fails, they will be faced with a number of unpalatable outcomes, including fiscal austerity, tax increases, and/or bankruptcy with the likelihood of reduced future growth even if they do not raise taxes. This situation will be unpleasant at a minimum, and will likely result in a loss of their jobs and

\(^{262}\) Cf. Göran Skogh, The Transactions Cost Theory of Insurance: Contracting Impediments and Costs, 56 J. Risk & Ins. 726, 729 (1989) (“[I]n the pool-of-risks theory [of insurance], moral hazard is treated as a complication. In the transaction-cost theory, moral hazard is the raison d'être for insurance.... Risk-sharing [has an]... impact on the controls taken [to reduce risk]....”).


\(^{264}\) Cf. Amdursky & Gillette, supra note 54, at 330 (In a public authority where officials “are appointed rather than elected[,]” the “officials will tend to resolve conflicts between bondholders and constituents in favor of the former.”).
possible legal difficulties.\textsuperscript{265} If, on the other hand, the officials do not contemplate remaining in office for an extended time, they would be unable to benefit if the project succeeded and generated a high payoff. One could envision an argument that municipal officials might be able to reap short-term gain from engaging in high-risk ventures. However, short of outright fraud (discussed below), it is difficult to see what that gain would be.\textsuperscript{266} Even in the short term, officials will be faced with high interest payments if they use funds recklessly, and the higher taxes necessary to fund these higher interest rates will likely be unpopular. In contrast, by choosing a lower-risk project, officials could deliver infrastructure to their constituents at lower cost and with a lesser potential for major problems.

Even though municipal officials are unlikely opportunists, certain municipal interest groups might favor opportunistic conduct toward investors. For example, students and retirees could benefit not only from the tax relief that follows debt repudiation, but even perhaps, perversely, from the decreased economic growth that follows an unjustified default. Since their incomes are not directly tied to the economic fortunes of the municipality, these residents might enjoy a higher standard of living in a relatively depressed area, where their relative incomes would be higher.\textsuperscript{267}

Such a scenario is indeed problematic. But it does not argue for compulsory tax increases in the event of municipal bankruptcy. True, the potential for such tax increases would increase the incentive of other residents to better engage in and monitor the political situation so that the municipal government would be less likely to be hijacked by these special interest groups. But a compulsory tax increase would also shelter municipal investors, at least to the extent that it would likely be successful in


\textsuperscript{266} Such a tactic by municipal officials could only succeed if investors are surprisingly inattentive, a state of affairs that is unlikely. See supra notes 209-229 and accompanying text.

\textsuperscript{267} Although even these residents are likely to rely on municipal services such as transportation and police services.
raising sufficient funds to pay them off in full. We should not thus shelter investors (at least as a default rule) if the threat of opportunistic losses would induce investor monitoring that would be more effective than monitoring by residents.\textsuperscript{268} By monitoring who will be doing what with the borrowed money in a municipality, investors may be able not only to protect themselves by charging for opportunistic conduct ahead of time, but also, at least by charging higher rates, signal the rest of the municipality's residents as to what is occurring. We should be confident that investors can monitor municipal borrowers—recall our discussion of this point above.\textsuperscript{269}

Certainly, even without compulsory tax increases, municipal residents will still have an incentive to monitor against inordinate interest group influence. Residents have an interest in avoiding the reduced economic growth and lessened ability to borrow that follow opportunistic default. This interest does suggest a possible objection: If both investors and residents have an incentive to monitor, both groups could act strategically, shunning monitoring in the hope that they could free ride off the other's effort.\textsuperscript{270} A full analysis suggests that this is unlikely to be a problem.

First, sovereign borrowing at the international level does not seem to lead to "chicken" games between investors and residents in which neither group monitors the use of funds and both therefore are exploited by opportunistic risk-taking. Second, municipal residents are unlikely to act as a unified "player" in a game of chicken (even though investors might). Indeed, it is the very

\textsuperscript{268} Cf. Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 455 (7th Cir.) (Posner, J.) ("From the standpoint of deterrence, the question is whether the type of fraud that engulfed Cenco ... will be deterred more effectively if Cenco can shift the ... cost of the fraud from ... its stockholders ... to the independent auditor who failed to prevent the fraud. We think not." If the loss were shifted off the stockholders, "their incentives to hire honest managers and monitor their behavior will be reduced."))), cert denied, 103 S. Ct. 177 (1982).

\textsuperscript{269} See supra notes 209-229 and accompanying text. Also recall that in the international context, across a wide variety of political systems, lenders earn adequate returns on their loans in spite of the ability of borrowers to default opportunistically. See supra notes 251-254 and accompanying text.

\textsuperscript{270} Levmore, supra note 216, at 54; see William M. Landes & Richard A. Posner, The Economic Structure of Tort Law 199-200 (1987) (discussing scenario in which potential joint tortfeasors might both choose not to take care); Baird, Gertner & Picker, supra note 188, at 44 (discussing game of "chicken").
factionalism of municipal residents that creates the public choice problem in the first place. Thus, given factionalized municipal residents, with some factions relatively passive and others eager to free ride off the monitoring efforts of others, the addition of yet another faction (investors) is unlikely to worsen the situation dramatically. This ties in to the third, and most important, point: Monitoring by residents is likely to be weak in any event, and thus investors’ best strategy would likely be to engage in substantial monitoring rather than to attempt to free ride on residents’ efforts. Certainly, the issue is a complicated one because residents also have certain focal points, such as newspapers or opposition political candidates, with an incentive to monitor the use of funds and to expose interest-group opportunism.

Yet, in practice, residents seem to operate as relatively poor monitors, despite such focal points. In Orange County, for example, voters ignored the warnings brought to them by Robert Citron’s electoral opponent as to the riskiness of Citron’s investment strategy; Citron was reelected on the eve of disaster in June 1994, with sixty-one percent of the vote. Moreover, the fact that municipalities frequently and successfully subvert mechanisms requiring direct popular input into debt levels, such as bypassing the referendum incident to the issuance of GO bonds and raising funds with COPs instead, again suggests that residents are not well-positioned or incentivized to monitor and control interest-group influence on a sustained, on-going basis.

Lax monitoring by municipal residents, as compared to investors, is further evidenced by the “pay to play” corruption that has not infrequently accompanied the issuance of municipal bonds. In “pay to play,” a municipal bond brokerage firm, or its employees, make contributions to the election campaigns of municipal officials. In return, these firms receive preferential treatment

271 Cf. Amdursky & Gillette, supra note 54, at 330-31 (discussing dispersion of the typical public authority’s constituents). Again, in situations where residents might monitor more effectively than investors, the municipality could, if the state government allowed, contract out of Chapter 9. See supra Section I.B.


273 See supra note 85.


275 In 1994, the Municipal Securities Rulemaking Board (MSRB) (established by 15
in getting bond-offering work,\textsuperscript{276} with its attendant fees, from the municipality. This corruption is a clear example of municipal public choice problems. Its importance for our purposes is that this corruption comes at the expense of municipal residents rather than investors.\textsuperscript{277} This suggests that municipal residents are less than ideally positioned to control public choice opportunism.

If a supplier were to bribe municipal officials in order to receive a contract, one would expect a higher price and/or lower quality on the underlying contract (i.e., the supplier recovers the cost of the bribes at the expense of residents). So, too, if a broker gives money to officials so that underwriting business is thrown his or her way, we expect the broker's fees for that underwriting contract to be inflated.\textsuperscript{278} And we would not expect

\textsuperscript{276}See \textit{Blount}, 61 F.3d at 944 ("A bought politician tends to make distorted choices.").

\textsuperscript{277}See id. at 945 ("As to the harm to investors, we tend to share the petitioner's skepticism."); id. at 947 ("It is not at all clear that investors are harmed or even perceive themselves to be harmed when underwriters obtain business through shady practices.").

\textsuperscript{278}Apparently a belief shared by the MSRB, given that Rule G-37 exempts
investors to be damaged by the bribery, since investors need to be courted on a competitive market. Bribe-giver and bribe-taker choose the easier prey, in the process signaling that investors, not residents, are monitoring enough to prevent their easy duping.

Since investors are likely to be the better and cheaper monitors, it makes sense for residents in effect to pay investors (via slightly higher interest rates) to undertake that role in order to reduce the amount of opportunism, to the benefit of investors and (most) residents alike. Yet even investors will engage in only a cost-justified level of monitoring. Undoubtedly, even with this higher level of monitoring, municipal officials and interest groups will still engage in a certain amount of inappropriate activity, such as outright fraud. But investors are the better


In short, officials who take "pay to play" payments are induced to award supra-competitive fees to the "players"; the incidence of these higher fees falls on the municipality, since the terms offered to investors need to compete with the terms offered by municipalities whose officials do not receive bribes. To the extent municipal bond brokerage involves economies of scale, the bribing brokers' need to charge a higher fee would be lessened by their larger market share.

See Gasparino, supra note 217 ("[T]he federal government is investigating whether many Wall Street firms overcharged municipalities for their bond work.").

This point, while apparently recognized by the court in Blount, see supra note 277 (expressing skepticism that "pay to play" harms investors), seemed to confuse the court in SEC v. Washington County Util. Dist., 676 F.2d 218 (6th Cir. 1982). There, the court appropriately noted that

[since kickbacks were paid by [the broker] from the compensation he received from the offering of bonds, his fee was higher than it would have been had he not paid [a municipal official] his share. This excess cost to the district was reflected in [the broker]'s 'spread'—the difference between his purchase price [from the municipality] and his selling price [to investors].

Id. at 225 n.15. Yet, without explanation, the court incorrectly assumed that the larger spread would be reflected in a higher price to investors rather than a lower price for the municipality. Id. at 225 ("[A]n investor... could have reasonably concluded that investment in the [municipality]'s bonds was unwise because the kickbacks increased the costs of the offering.").

The anti-fraud provisions of federal securities law, most notably the SEC's Rule 10b-5, are applicable in the municipal context. Amdursky & Gillette, supra note 54, at 350-52.

Robert Citron, Orange County's treasurer, pled guilty to several counts of "securities fraud and misappropriation," Michael G. Wagner, Trial of Former Citron Assistant Postponed Until March, L.A. Times, Dec. 7, 1996, at B4, and the county's former assistant treasurer was convicted of five felony counts after a jury trial in May. Greg Hernandez, Shelby Grad & Davan Maharaj, Raabe Guilty in Bankruptcy Case, L.A. Times, May 3, 1997, at A1. The SEC has also sued CS First Boston, the investment bank, for fraudulent failure to disclose facts it knew or should have known about Orange
bearers of this residual, uncontrollable risk as well, for reasons that will be analyzed in the next Part.

E. The Efficiency Case Against Compulsory Tax Increases

To conclude that municipal borrowing does not present significant moral hazard is only to suggest that compulsory tax increases in the event of default are not necessary in order to prevent municipalities from exploiting bondholders. It does not demonstrate conclusively that there should not be a compulsory tax increase. There are, however, several important reasons why a municipality should not be forced to raise taxes in the event of default. Again, it is important to emphasize that these arguments are made in the context of developing the better practice for plan confirmation in Chapter 9. States (or municipalities) that felt otherwise could continue to operate under state law. Some municipalities, or at least some municipalities some of the time, might benefit if they precommitted to raise taxes in the event of default.

The most important argument against compulsory tax increases is that they prevent efficient risk-shifting. Bondholders are, on

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1 See supra Section I.B.

2 In other words, even though they could still borrow effectively in a non-compulsory tax increase situation, they might be able to borrow on terms they prefer (i.e., lower rates but less risk shifted to bondholders) if they could pre-commit to increasing taxes as much as possible in the event of default. This might be true if, for example, the constraints on moral hazard analyzed above would not support a municipality's borrowing a particularly large sum. Note in this context, however, that municipal borrowing is already skewed towards over-borrowing by the federal tax exemption on municipal bond interest. E.g., Clayton P. Gillette, Fiscal Federalism and the Use of Municipal Bond Proceeds, 58 N.Y.U. L. Rev. 1030, 1055-56 (1983).
average, better risk-bearers than municipal residents. This is true for two key reasons. First, bondholders can diversify their investments between multiple municipalities. Residents, however, cannot diversify their risk—they will need to pay taxes wherever they choose to live (and this will typically be in only one municipality). Diversification will actually reduce the overall risk created by municipal borrowing, because if an investor holds a well-diversified portfolio of municipal bonds, unsys-

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23 For an indication of the Supreme Court’s wariness of municipalities’ suitability as risk-bearers, see Owen v. City of Independence, 445 U.S. 622, 670 (1980) (5-4 decision) (Powell, J., dissenting) (“Even enthusiastic proponents of municipal liability have conceded that ruinous judgments... could imperil local governments.... For some municipalities, the result could be a severe limitation on their ability to serve the public.”).

24 See Sachs, supra note 55, at 200 (“The default option can be a way for... borrowers to transfer economic risks to their better diversified creditors, and thus may be part of an efficient debt structure.”). And, of course, bondholders can further diversify by investing in other financial instruments, such as equities or corporate bonds.

25 “The basic institution for shifting the risks of business... to the general public is the securities market. Individuals can diversify their portfolio.... This ability of individuals to spread risks thereby permits firms to engage in projects which otherwise would be unacceptable. Consequently, society is better off.” J.J. McCall, Insurance, in 2 The New Palgrave, supra note 161, at 868, 869.

26 A factor that hinders diversification among municipal-bond investors is the denial of a state tax exemption on the interest income of municipal bonds if the investor is not a resident of the issuing state. Thus, there are tax advantages for an Illinois resident to confine his or her municipal bond portfolio to Illinois bonds. Jorion, supra note 3, at 112-13; Sharon R. King, The Climate is Colder for Home-Grown Funds, N.Y. Times, July 28, 1996, § 3, at 3. While many of the benefits of diversification can be captured with a fairly small number of holdings, see, e.g., David W. Leebron, Limited Liability, Tort Victims, and Creditors, 91 Colum. L. Rev. 1565, 1596 n.100 (1991), there would likely be less correlation in returns (and hence more diversification) from municipalities across the nation than in one state. The existence of private bond insurance lessens the influence of this factor, however, since insured bonds allow investors to invest within one state but transfer default risk to the insurer, which will diversify its risk by insuring municipal bond offerings from across the nation. Also, an investor may simply pay some state taxes in order to capture diversification gains if the latter are large enough.

It could be argued that the denial of a state tax exemption for out-of-state bonds reflects a desire to keep bondholding within the state, and that that desire reflects a determination that the benefits of greater diversification are outweighed by the lesser incentive to default of a municipality faced with bondholders who are state (and, perhaps, even municipal) residents. This lesser incentive could come from the retaliation a state legislature might undertake against a municipality that defaulted on its bonds.

This point is weakened, however, by several factors. The first is that reasoning that begins by assuming the rationality of tax statutes is inherently suspect, since these
tenacious risk\textsuperscript{287} will be eliminated. Because municipal defaults will be somewhat correlated (e.g., with bad macroeconomic conditions), all risk cannot be eliminated through diversification—market, or systematic, risk\textsuperscript{288} will remain on the bondholders.\textsuperscript{289}

The second reason bondholders are better risk-bearers than residents is that they are, on average, wealthier than residents.\textsuperscript{290}

\textsuperscript{287} Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 156 & n.14 (5th ed. 1996).
\textsuperscript{288} Id. at 156 & n.15.
\textsuperscript{290} One might think that in an era of widespread pension funds this would no longer be true. However, only about half of full-time private employees are provided with employer pension plans, and only about one quarter of retirees are receiving private pensions. John R. Woods, Pension Vesting and Preretirement Lump Sums Among Full-Time Private Sector Employees, Soc. Security Bull., Fall 1993, at 3, 3 (1993). Even more importantly, tax-exempt pension funds are unlikely to invest in tax-advantaged municipal bonds.

Thus, that investors are wealthier than residents is especially true for investors in municipal bonds, because the tax advantages of municipal bonds are unlikely to appeal to low-income, low-bracket taxpayers. See Michael J. Graetz, Federal Income Taxation 267 (2d ed. 1988). At the same time, the risk of higher taxes does not fall equally on all residents, since wealthier residents are likely to pay more municipal taxes than are poorer residents (as by owning more property). See id. To the extent that municipal
The wealthier someone is, the less risk averse (on the margin) he or she tends to be. And risk is more efficiently borne by those who are less risk averse than by those who are more risk averse.

It is only if municipal debt is, ultimately, excusable in some circumstances that a municipality’s risk in borrowing and investing can be shifted to bondholders, the more efficient risk-bearers. (Lest one be concerned at the possibility of shifting risk to investors in “safe” municipal bonds, we should remember that even without credit risk, municipal bonds pose substantial interest rate risks: If rates rise, the value of investors’ bonds falls.) This point is most clearly elucidated in the conceptual framework adopted by Grossman and Van Huyck, who view governmental borrowing as “implicitly contingent” on economic outcomes. The municipality, and its investment of the borrowed funds, is subject to risk outside of its control (i.e., to exogenous shocks). The debt is “contingent” in the sense that bad outcomes allow a partial repudiation of the debt, depending upon the severity of the shock. Only the worst possible outcome justifies total default. The model thus explains why most defaults result in only partial repudiation and only rarely in a total loss for bondholders.

This does raise the puzzle of why municipal borrowers and lenders do not try to contract more explicitly about allocating the risk of exogenous shocks, more fully specifying the contingent nature of the repayment obligation. An answer may be that given the historically low probability of municipal defaults, the considerable complexity of addressing such issues in

governments engage in redistribution, however, cutbacks in municipal services may disproportionately affect poorer residents.


293 E.g., Jorion, supra note 3, at 59.


295 Id. at 1089, 1097. An example of municipal defaults in the face of such exogenous shocks (here, warfare) is the defaults by many Southern municipalities that followed the withdrawal of occupying Northern troops. See Peter W. Low & John C. Jeffries, Jr., Federal Courts and the Law of Federal-State Relations 878 (3d ed. 1994).


297 E.g., Walker, supra note 155, at 772.
a contract, and the likelihood that interpreting such a contract post-default would lead to complex and expensive litigation, the parties choose instead to rely on both the ability of bankruptcy law to provide a discharge from indebtedness and municipalities' own interest in not acting opportunistically. We noted above the possibility of borrowers' purchasing insurance contracts as an alternative to issuing contingent debt. Drafting, interpreting, and litigating such insurance contracts would, however, pose problems similar to those of incorporating the host of contingencies that can lead to municipal economic downturns into the borrowing contract itself. Issuing contingent debt might thus be an efficient way for the government to insure itself against a poor investment outcome—bond sales allow it to, in effect, purchase insurance at the same time and through the same transactions it carries out to raise funds from a large number of small investors. The costs of collection in the event of a bad outcome would be considerable were insurance policies to be purchased from such a large number of (individual) insurers.

Under such a contingent debt regime, even though there could be more defaults than under a compulsory-tax increase system, this would not be a bad result. In other words, eschewing any compulsion to raise taxes could result in additional defaults—due to more efficient risk-shifting—but such an increase would not be troubling, so long as moral hazard is constrained. Defaults would represent the transfer of the risk of poor investment outcomes to bondholders, the better risk-bearers. Economic risks

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298 Mark P. Gergen, A Defense of Judicial Reconstruction of Contracts, 71 Ind. L.J. 45, 52 n.51 (1995) (noting that parties “may not account for a foreseen risk in contracting if its probability is low and it is difficult to address in the contract”); Restatement (Second) of Contracts § 261 cmt. c (1979) (“Factors such as the practical difficulty of reaching agreement on the myriad of conceivable terms of a complex agreement may excuse a failure to deal with improbable contingencies.”); Clayton P. Gillette, Commercial Rationality and the Duty to Adjust Long-Term Contracts, 69 Minn. L. Rev. 521, 535-37 (1985).

299 See supra text accompanying note 233.

300 Thus saving on the overhead costs involved in purchasing an insurance policy from an insurer.

301 Grossman & Van Huyck, supra note 176, at 1089.

302 Under a system of compulsory tax increases, a municipality might bypass Chapter 9 and just raise taxes when it first began to run into financial difficulties; see also supra note 155 (discussing issue of rate of bankruptcies under alternative regimes).

303 See Sachs, supra note 55, at 200 (“If defaults are prevented[,]... there is a risk
exist even in a compulsory tax increase world. The difference is simply that such risks might not be manifest as defaults if tax increases were compulsory. Instead, they would sometimes appear as tax increases. Thus, one should not be disturbed by the fact that all municipalities would need to pay slightly higher interest rates—this would be worthwhile given the removal from municipal residents of the risk of financial disaster in the event of exogenous economic shocks. A distaste for municipal defaults per se should not lead us to impose a policy that lessens defaults, but is, overall, less efficient because it places the risk of municipal investments on poor risk-bearers.

Admittedly, municipal bonds would not be a perfect vehicle for risk shifting. However, risk from exogenous economic shocks will not be borne at all efficiently if tax increases are compelled in the event of default. There is little reason to expect municipal tax liability to fall on those who, for example, agitated in favor of and voted for a particular program and not on those who opposed it. Similarly, the mobility of taxpayers,
both in and out of a municipality, makes the relation between risk-creation and risk-bearing even more tenuous.\(^{307}\)

Another important reason why compulsory tax increases are inefficient follows from Charles Tiebout's famous insight into municipal finance, the "Tiebout Hypothesis."\(^{308}\) Because consumers (and producers) pay attention to the blend of taxation and public services offered by a community in deciding where to live (or, indeed, in deciding whether to remain where they are currently living),\(^{309}\) a compulsory tax increase will have deleterious effects on a municipality's economic development. Indeed, the fear of the negative consequences of such an increase might well be the main motive behind the municipality's reluctance to raise taxes by its own choice.

Compulsory tax increases, as discussed above, prevent risk-shifting, leaving the risk of poor investment outcomes on a municipality's residents. Once a municipality realizes a bad outcome, it will become unattractive as a place to reside compared with successful municipalities if it must bear the cost of that outcome.\(^{310}\) For a given level of taxation, residents of the "loser" municipality will receive less police protection, schooling, and sewers. Some of their taxes will be going to pay off old bondholders, but they will not be receiving corresponding benefits from the failed investment of the funds raised by those bonds.

A moderate tax increase is not likely lead to a mass exodus,

\(^{307}\) This Article thus takes exception with the views expressed by McConnell & Picker, supra note 13, at 442 ("[T]he ability to require a tax levy to pay debts, which approximates the rule of pro-rata liability, may very well be an efficient outcome.").

\(^{308}\) Charles M. Tiebout, A Pure Theory of Local Expenditures, 64 J. Pol. Econ. 416 (1956). Tiebout explained that consumers will sort themselves into municipalities depending on their preferences for public goods—each municipality will offer a different blend of taxation and public good provision. Thus, mobility reveals preferences for public goods, which can then be effectively provided. See id. at 416, 418; Bruce W. Hamilton, Tiebout Hypothesis, in 4 The New Palgrave, supra note 161, at 640.

\(^{309}\) A point observed well before Tiebout, by Adam Smith:

When, by different taxes upon the necessaries and conveniences of life, the owners and employers of capital stock find, that whatever revenue they derive from it, will not, in a particular country, purchase the same quantity of those necessaries and conveniences which an equal revenue would in almost any other, they will be disposed to remove to some other.

2 Smith, supra note 198, at 464.

\(^{310}\) Cf. supra note 107 and accompanying text (discussing futility of ordering bankrupt corporation to increase prices).
because there are costs to relocating.\(^3\) In this sense, the municipality would, by increasing taxes, be expropriating the transaction-specific investments of its residents.\(^3\) Such an outcome would be likely to cause residents (of that and other municipalities) to be more cautious to make such investments in the future by, for example, renting instead of purchasing a home.\(^3\) However, there will always be some infra-marginal residents, businesses, and investors who will leave because of the tax increase.\(^3\)

And, importantly, residents and investors considering which location to move to will certainly be less likely to choose such a "loser" municipality. Finally, higher taxes will increase the number of residents unable to pay their taxes, and will perhaps even cause some of them to abandon their property. This abandoned property will fetch but a relatively low price at a tax sale, due to the combination of high property taxes and greatly reduced demand as residents leave the municipality and few new ones arrive.\(^3\)

\(^{31}\) Indeed, if municipal residents could costlessly relocate, the specter of moral hazard would again reappear, as residents would not need to concern themselves with the municipality's future prospects. Note that in such a situation, however, compulsory tax increases would also be futile, because they could be avoided by (costlessly relocating) residents.

\(^{32}\) See supra note 240.

\(^{33}\) This decision is, of course, already distorted in the opposite direction by the failure to tax the imputed rental income of owner-occupied housing. See Graetz, supra note 290, at 152-53, so the efficiency implications of an incentive to rent rather than own might not be negative.

\(^{34}\) Such effects are commonly seen today outside of the municipal bankruptcy context. See, e.g., Chad Peterson, Yale May Face Battle to Remain Tax-Exempt, Yale Daily News, Feb. 6, 1995, at 1 ("'We're getting to a point where the [property] tax rate is so high that people can't pay' .... A property tax increase could also hurt many of New Haven's businesses, perhaps resulting in more shop owners voting with their feet and moving out. . . ."); John McCarron, That Sinking Feeling, Chi. Trib., Oct. 9, 1995, at 15 (discussing hollowing out of Chicago's southern suburbs as they continue to raise property tax rates).

\(^{35}\) See Hearings Before Special Subcomm. on Bankruptcy and Reorganization of the Comm. on the Judiciary, House of Representatives, on H.R. 4307, 79th Cong. 2d Sess., 18 (1946) (statement of J. Bowers Campbell, Municipal Section of the ABA) ("[I]n various [municipalities] where [residents] could not pay the high taxes they made up their minds that they would live there until they were put off by the sheriff and then go to some other place. . . . [A]ssessments were so high under bond issues . . . [that] they would not try to meet any of them.").

Recall that in Fano v. Newport Heights Irrigation Dist., 114 F.2d 563, 565 (9th Cir. 1940), the delinquency rate was quite low at the time the court ordered a tax increase. See text accompanying supra note 129.
While it might be tempting to downplay the significance of this "Tiebout effect," an examination of the historical record demonstrates that compulsory tax increases arising out of municipal defaults have had severe negative consequences. As we saw above, outside of municipal bankruptcy the creditors of a defaulting municipality can seek a writ of mandamus ordering municipal officials to increase taxes.316 The remedy was so woefully inadequate in practice, however, that the Supreme Court characterized it as an "empty right to litigate."317 The Court discussed "the spectacle of taxing officials resigning from office in order to frustrate tax levies through mandamus, and officials running on a platform of willingness to go to jail rather than to enforce a tax levy... and evasion of service by tax collectors, thus making impotent a court's mandate."318 Indeed, the bleak record of mandamus actions led Depression-era courts to begin to emphasize the discretionary aspect of the remedy.319

That the "Tiebout effect" militates strongly against the compulsory imposition of taxes on a defaulting municipality was recognized explicitly by a Depression-era government report on municipal bonds. The report stated "high taxes, excessive

316 See supra note 37 and accompanying text.
318 Id. at 511. For numerous examples of these activities, see A.M. Hillhouse, Lessons from Previous Eras of Default, in Municipal Debt Defaults: Their Prevention and Adjustment 10, 12-13 (Carl H. Chatters ed., 1933). In one case taxpayers promptly replaced the Iowa Supreme Court's justices with "judges already committed to their [anti-bondholder] viewpoint." Id. After these new judges made anti-bondholder rulings of "unenviable solitude and notoriety," the U.S. Supreme Court intervened to overrule them, in spite of the admittedly state-law nature of the claims, stating "[w]e shall never immolate truth, justice, and the law, because a State tribunal has erected the altar and decreed the sacrifice." Gelpcke v. City of Dubuque, 68 U.S. (1 Wall.) 175, 206-07 (1864).

Another Depression-era commentator, who had served as counsel to both bondholders and defaulting municipalities, argued "that any effective solution of the problem of the enforcement of creditors' rights against an insolvent municipality will leave the public in control of the only asset of the debtor in which the creditor has any interest, its taxing power." Edward J. Dimock, Legal Problems of Financially Embarrassed Municipalities, 1935 A.B.A. Sec. Mun. L. Proc. 12, 13. Dimock went on to discuss the bleak record of mandamus actions. Id. at 14-15.

319 E.g., City of Asbury Park v. Christmas, 78 F.2d 1003, 1004 (3d Cir.), cert. denied, 296 U.S. 624 (1935); see H.R. Rep. No. 75-517, at 3 (1937) ("[T]he trend of recent decisions has been to deny the writ of mandamus wherever sound judicial discretion justifies denial.").
[property tax] delinquency, or both, constitute the normal proximate cause of default, [so] . . . prolific use of [mandamus to raise taxes] must be productive only of still higher tax levies and higher delinquencies.” Indeed, tax rates sometimes reached “astounding,” even absurd, levels. This past experience is further evidence that the risk of economic downturns is better borne by municipal bondholders than by residents.

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321 Hillhouse, supra note 37, at 280 (property tax rate reached 42.5% of assessed value in West Palm Beach, Florida); Spiotto, supra note 45, at 1193 n.6.

As one might expect, if a rate cap were added after the debt was incurred, that cap can be overridden in favor of debtholders. Von Hoffman v. City of Quincy, 71 U.S. 4 Wall. 535, 555 (1867) (“[T]he act of 1863 [imposing a tax rate cap] is, so far as it affects these bonds [issued in the 1850s], a nullity”) Most tax rate caps, though, affect only property (and sometimes sales) taxes, see M. David Gelfand & Peter W. Salsich, Jr., State and Local Taxation and Finance 5 (1985); M. David Gelfand, Seeking Local Government Financial Integrity Through Debt Ceilings, Tax Limitations, and Expenditure Limits, 63 Minn. L. Rev. 545, 571, 586-87, 591 (1979) (discussing how New York’s limit “has been side-stepped by the adoption of corporate and personal income, sales, and user taxes”), while tax increases are possible on a wide range of items. Indeed, property taxes, which accounted for nearly three-fourths of state and local revenue in 1900, now contribute less than one-fourth of such revenue. Amdursky & Gillette, supra note 54, at 181 n.1. The sources of taxation available to municipalities today often include “service charges, user fees, excise taxes, income taxes, and sales taxes.” Id. at 181. Many of these potential sources of taxation, with the possible exception of income taxes, might be expected to exhibit an even more pronounced “Laffer effect” than property taxes; so for these items maximum revenue would be obtained at a tax rate considerably less than 100%. For example, as sales taxes became too high, municipal residents might make nearly all their purchases in neighboring municipalities.
IV. CONCLUSION

Bankruptcy judges should not try to replicate the state law mandamus remedy in the context of a Chapter 9 proceeding. The value-added of federal municipal bankruptcy law (which states may condition the ability of their municipalities to utilize) is to provide a mechanism that allows lenders to precommit not to engage in a bitter and costly attempt to obtain full payment from a municipality with dire financial problems. The lenders (or their insurers) agree to bear some of the risk of future financial mishaps, much as do lenders to a corporation or other business entity. The interposition of federal law is necessary because once a mishap occurs it may well be in creditors’ interests, in any given instance, to collect as much as possible under state law. That is, even though ex ante creditors would agree to bear risk, ex post they will fight for a tax increase. Since states cannot impair contracts, the precommitment device must be, and this Article argues has been, provided by federal law.

Municipal bankruptcy commentators have been too focused on the putative need to constrain the moral hazard allegedly inherent in municipal borrowing. There is a danger that courts taken with such a view could override the seeming command of 11 U.S.C. § 904 and, relying on Rep. Edwards’ statement in the legislative history, read into Chapter 9 the mandamus remedy compelling a bankrupt municipality to raise taxes.

This Article has shown that moral hazard is constrained by the “dynamic game” aspect of borrowing. Therefore, a municipality should be allowed to make a decision between paying the price for defaulting (which may be minimal, due to risk-shifting).
and making itself a less desirable place in which to live, work, invest, and do business by raising taxes to pay its bondholders off in full. We should not use Chapter 9 to protect municipal bondholders from risk. As did lenders to sovereign nations even in the troubled 1930s, municipal bondholders are able to profit from their portfolios without requiring judicial interference with municipalities' governmental powers.