MUNICIPALITIES IN DISTRESS: A PREVENTIVE VIEW

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Introduction

The recent rising failure of municipalities has not produced the avalanche that some expected.[1] Yet concerns have been raised that the future will spawn more failures.[2] New York City and other municipalities face soaring pension, Medicaid, and retiree health care costs.[3] New York City's neighboring counties face similar challenges; Yonkers, Suffolk, and Nassau Counties each face their own set of fiscal problems.[4]

Municipalities that have failed, or are likely to fail, have raised a number of legal issues implicated by their inability to pay their debts. Some questions seem new. For example, are employees' pension benefits "debts" or are they "social obligations"?[5] The status of pensions is unclear and is being litigated.[6] Additionally, the results of default are serious and can result in loss of access to the capital markets.[7] Adding even more uncertainty to this situation, state

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1 *60 Minutes: States Budgets: Day of Reckoning* (CBS television broadcast Dec. 19, 2010), *available at* http://cbsnews.com/videos/state-budgets-day-of-reckoning (Meredith Whitney warning of impending municipal financial meltdown).

2 Jeremy Hazlehurst, *Distressed Investing: Still No Flood*, PRIVATE EQUITY INT'L (Nov. 4, 2013), http://peimedia.com/Article.aspx?aID=5817&article=74745 ("The expected deluge of distressed deals may not have happened yet—but there are plenty of reasons for investors in the space to be optimistic . . . .").

3 Paul Burton, *N.Y.'s Ravitch and Brodsky Weigh the Status of Pension Obligations*, BOND BUYER (Apr. 20, 2012, 7:12 PM), http://bondbuyer.com/issues/121_77/ravitch-brodsky-status-pension-obligations-1038831-1.html ("Cities . . . continue to struggle with unfunded pension liabilities . . . .").

4 *See id*. (detailing the credit rating downgrades of several New York counties).

5 *Id.*

6 *See id.*

7 Udaibir S. Das, Michael G. Papaioannou & Christoph Trebesch, *Sovereign Default Risk and Private Sector Access to Capital in Emerging Markets* 8 (Int'l Monetary Fund, Working Paper No. 10/10, 2010) (analyzing the

provisions about municipal bankruptcy filings vary.[8] They range from closing the door to bankruptcy proceedings to opening the door wide to them.[9]

In 2011, "Rhode Island passed a law giving bondholders first lien on revenue," which allowed a municipality to file for Chapter 9 protection.[10] Following the law's passage, "the city's receiver . . . invalidated pension agreements and finalized new settlements that cut benefits by 55%."[11] In Pennsylvania, "a federal court invalidated a Chapter 9 filing by the City Council in [the] capital city Harrisburg."[12] Despite several attempts, courts have rejected the Harrisburg City Council's efforts to move forward with bankruptcy over the opposition by several municipal constituents, including the Harrisburg mayor.[13]

Control boards are similar to bankruptcy boards. However, some argue that control boards greatly overcharge for their services, while "[b]ankruptcy brings the banks back into play."[14] These commentators further contend that "[t]here's a hidden meaning behind which mayors favor bankruptcy and which mayors favor a control board."[15]

I would like to share from the municipality debacle a few lessons for future behavior. The task is daunting because so many conflicting interests are involved. Nonetheless, it may be worth thinking about how, and creating processes by which, the conflict might be resolved.

"spillover" effects of sovereign default, as well as prevalent "capital market exclusion after sovereign defaults").

[8] *Municipal Bankruptcy & the Role of the States*, ISSUE BRIEF (Nat'l Ass'n of State Budget Officers, D.C.), Aug. 21, 2012, at 3, *available at* http://nasbo.org/sites/default/files/pdf/Municipal%20Bankruptcy%20%26%20the%20Role%20of%20the%20States.pdf.

[9] *See id.*

[10] Burton, *supra* note 3.

[11] *Id.*

[12] *Id.*

[13] *In re* City of Harrisburg, Pa., 465 B.R. 744, 749 (Bankr. M.D. Pa. 2011) (dismissing the City Council's filing for Chapter 9 bankruptcy); *see also In re* City of Harrisburg, Pa., 462 B.R. 510, 514 (Bankr. M.D. Pa. 2011) (denying extension of time for appeal); City of Harrisburg, Pa. v. AFSCME Dist. Council 90, No. 1:11–BK–06938MDF, 2012 WL 315403, at *2 (Bankr. M.D. Pa. Feb. 2, 2012) (dismissing the City Council's appeal).

[14] Burton, *supra* note 3.

[15] *Id*.

Are municipalities unique? To some extent they are. Most are independent of the states and their governors.[16] They are subject to their own governing bodies and electorate.[17] They are, in fact, independent governments at a lower level. But they have a charter-reliant life and, thus, a perpetual existence. Some have a longer history than the states in which they reside.[18] Additionally, municipalities serve a community that is more closely connected. In the past, when their members were less mobile, municipalities were more stable. But today, their citizens may be more mobile and unified, especially if they are connected to large movable businesses that by definition are temporary citizens within the municipalities.

The first step in our inquiry is to identify most, if not all, of the parties whose interests are intertwined with municipalities. That is, the parties that contribute to, as well as claim from, the municipalities. The second step is to assign to each party the importance of its stake in the municipality. The interest of each party involves: (1) the importance of the party's stake to its well-being; (2) the amount of money due from the municipality; and (3) the date by which the amount is due. In addition, an issue of fairness may arise, relating to the circumstances in which the amounts have become due and the relative fairness-weight to be given to each claim, as compared to the claims of other parties. The fairness of the various parties' claims does not necessarily lead to preventing and resolving the repeated problems in the future. Rather, it leads to weighing the entitlement of each of the parties. Because circumstances change, fairness at the time when the claims were formed may not remain fair when the claims mature. In any event, this is not the focus of this paper; the focus of this paper is prevention.

In discussing the issue of preventing the problems that municipalities are facing, one might ignore the current legal constraints and suggest changes in the laws. However, there is no escape from considering the American culture, especially with

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[16] For a list of all independent cities in the state of Virginia alone, see VA. COMM'N ON LOCAL GOV'T, VIRGINIA'S INDEPENDENT CITIES WITH CONTIGUOUS COUNTIES 1 (Va. Dep't of Hous. & Cmty. Dev. 2001).

[17] *See, e.g.*, David K. Roberts, *Separate, But Equal? Virginia's "Independent" Cities and the Purported Virtues of Voluntary Interlocal Agreements*, 95 VA. L. REV. 1551, 1553–54 (2009).

[18] The independent city of Baltimore, Maryland, for example, was founded in 1729, some forty-seven years prior to the signing of the Declaration of Independence in 1776. *See generally* GEORGE WALKER, THE ENTERIES OF BALTEMORE TOWN (1729).

respect to government entities. Therefore, a proposal for the future will assume that the laws might be amended to accommodate the proposed plan, but will emphasize the constraints of American culture with respect to government entities. This culture will affect the government entities that are involved in this case.

Part I of this Article identifies the parties involved. Part II outlines the powers, duties, costs, and benefits of each involved party. Part III describes significant conflicts that have reached the courts and the legislatures and their solutions. The solutions are partial because the issues can be determined differently in each state. Part IV suggests a general preventive policy rule aimed at avoiding future failures of municipalities. Part V concludes.

I. The Parties Involved

A Houlihan Lokey study examined various parties for the purpose of restructuring the financial situation of municipalities.[19] The study offered "a guide for successfully navigating through the inherently confrontational process."[20] It identified the following involved parties: (1) civic officials; (2) employees, including their unions and retirees; (3) citizens of the municipality; (4) creditors of the municipality; and (5) advisers tasked with shepherding the local government.[21] My analysis tracks the same parties. When examining the parties, I focus on three important features: the money the parties receive; the money or services the parties "pay" in return; and the power the parties can exercise with respect to the these items.[22]

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[19] *See generally* HOULIHAN LOKEY, INC., RESTRUCTURING THE TROUBLED MUNICIPALITY (2011), *available at* http://hl.com/email/pdf/muni_case_study_ch_jun2011.pdf.

[20] Press Release, Houlihan Lokey, Inc., Houlihan Lokey and Alvarez & Marsal to Present Case Study 'Restructuring the Troubled Municipality' in Los Angeles, New York and Chicago (May 26, 2011), *available at* http://hl.com/us/press/pressreleases/2846.aspx.

[21] *See id.*

[22] *See generally* Christine Albano, *Turnaround Firms to the Rescue*, BOND BUYER, June 22, 2011, at 1.

II. The Power and Duties; Costs and Benefits of the Involved Parties

A. Civic Officials

Civic officials offer services to the municipality. They draw salaries from the municipality, which could be significant. In addition, these officials may have a significant degree of power over the affairs of the municipality. Some officials may be corrupt. Regardless of their trustworthiness and reliability, civic officials hold significant power, if not the only power, over the financial affairs of the municipality. It should be emphasized that even though the officials are elected, some have been in office for many years, being reelected time and again.[23] Additionally, they can establish on-going relationships with powerful citizens and regain their position. For example, Harrisburg, Pennsylvania Mayor Linda Thompson sought a court order that would have indirectly retained her power.[24] She defended herself, stating, "I am fighting for my career."[25] She did not see the difference between her power position and her job.[26] Yet, civic officials are fiduciaries. They owe these duties to the municipalities and are far more restricted in their conflicts of interests and far more liable to serve professionally and avoid negligence.

B. Municipality Employees and Their Unions

Municipality employees are similar to civic officials in many respects. Employees too offer services to the municipality and draw salaries, including pensions. They too exercise power, except that their power is mostly manifested through unions.[27] Their rights are

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[23] *See, e.g.*, Alexei Barrionuevo, *Rising Price of Electricity Sets off New Debate on Regulation*, N.Y. TIMES, Feb. 17, 2007, at C1 (identifying Mayor Robert Butler of Marion, Illinois as a mayor who has served for the last fifty-one years).

[24] Paul Burton, *Harrisburg Mayor's Career on the Line*, BOND BUYER (May 20, 2013, 3:39 PM), http://bondbuyer.com/issues/122_97/reelection-of-harrisburg-pennsylvania-mayor-linda-thompson-on-the-line-1051812-1.html.

[25] *Id.*

[26] *See id.*

[27] *See* Steven Greenhouse, *The Wisconsin Legacy*, N.Y. TIMES, Feb. 23, 2014, at BU1.

contract-based, and their unions bargain freely for their own interests and the interests of their union leaders.[28] Thus, the employees and their unions do not owe the municipalities duties except the duties to perform their services. Nonetheless, some employees may also owe the municipality fiduciary duties that vary in intensity, depending on the amount of power and assets entrusted to them (e.g., the municipality treasurer).

C. Creditors of the Municipality

Municipalities that issue debt obligations create a group of creditors and turn themselves into debtors of these creditors. These municipalities receive payment from the creditors and owe them a return. By law, the tax that the creditors pay on the returns is lower than the tax on other incomes from debt securities.[29] This reduced tax is designed to draw more investors to municipal bonds and to enable municipalities to offer lower interest rates on their obligations.[30] Consequently, the municipality can raise funds at a lower rate and the amount of its obligations is lower. The relationship between the parties is contract based: that of a debtor and creditor. The process may also be subject to securities acts and in some cases to bankruptcy laws.[31] Tax authorities are also interested in the subject.[32]

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[28] *See id.*

[29] *See* Kelly Phillips Erb, *Ending Tax Breaks on Municipal Bonds Shifts Burden to the Rest of Us*, FORBES (July 16, 2013, 10:27 AM), http://forbes.com/sites/kellyphillipserb/2013/07/16/ending-tax-breaks-on-municipal-bonds-shifts-burden-to-the-rest-of-us (explaining that, to private creditors, the allure of municipal bonds as opposed to other forms of municipal financing is their tax exempt status).

[30] *See id.* ("Traditionally, municipal bonds have attracted investors because the interest income is tax exempt for federal income tax purposes.").

[31] *E.g.*, *In re* Las Vegas Monorail Co., 429 B.R. 770, 800 (Bankr. D. Nev. 2010) (holding that the non-profit organization in question was not an instrumentality of the state, and therefore, ineligible for Chapter 9 relief); *see also In re* City of Bridgeport, 128 B.R. 688, 695–96 (Bankr. D. Conn. 1991) (finding that, under the circumstances, the city could declare bankruptcy under federal bankruptcy law).

[32] Patrick Temple-West, *Treasury Seeks More Authority: Bill Would Let Feds Stop Firms' Failures*, 367 BOND BUYER, Mar. 26, 2009, at 1 (describing recent federal legislative interest in debtor-creditor relations).

D. Citizens of the Municipality

Municipality citizens pay taxes to the municipality and receive services that are performed either by the municipality's employees or by independent contractors. The duty to pay taxes is subject to specific laws and procedures including fines.[33] The citizens of the municipality have power to vote for and against the municipality officials. However, in some municipalities the citizens' power may be weak, as it is when they are too poor, too uneducated, or too old.

E. Businesses Residing in the Municipality

The impact of entities that do business in a particular municipality should not be underestimated. They attract employees, create jobs, negotiate and affect the taxes and the development of public facilities in the municipality, and enter into binding agreements with municipalities.[34]

F. Advisers Tasked with Shepherding the Local Government

There are a number of persons who advise municipalities' civic officials.[35] The advisers may offer "a guide for successfully navigating through the inherently confrontational process."[36] They are the experts and have power especially when the civic officials are not experts in particular areas. Among these areas of expertise are finance and accounting.[37]

When do municipalities face problems? Like any other entity, municipalities have financial problems when their spending is

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[33] *See* First Nat'l Bank of Atlanta v. P. E. Blum, 233 S.E.2d 835, 837 (Ga. Ct. App. 1977) (holding that citizen faced immediate penalties resulting from his delinquent tax payments to the City of Atlanta).

[34] *See, e.g.*, Rod Boshart, *Iowa Business Interests Lobby for Tax Changes*, SIOUX CITY J. (Dec. 11, 2013, 1:07 PM), http://siouxcityjournal.com/news/local/state-and-regional/iowa-business-interests-lobby-for-tax-changes/article_44d659a7-c9a4-5cf4-accc-a67edbdea50a.html.

[35] *See, e.g.*, HOULIHAN LOKEY, INC., *supra* note 19, at 78.

[36] Press Release, Houlihan Lokey, Inc., *supra* note 20.

[37] *See id.*

higher than their income.[38] That is, when municipalities' tax revenues and other sources of income do not match the cost of the municipal services they are providing and the debts they are incurring. This is especially so when the cost of municipal projects is high and long-term, while the use of these projects, which increasingly depends on a mobile and fickle citizenship, are short-term. Therefore, conservative estimates are necessary.

Who decides the allocation of the financing and services? Currently, the usual decision-makers are civic officials, employee-managers, and elected officials. The power balance varies and politics determine some of the choices.

III. Significant Conflicts Among the Various Actors; Courts' and Legislatures' Solutions

The chart below lists the parties involved. It highlights, using the + sign, whether they receive money from the municipality and what they offer in consideration for the money; some offer services, others offer money. In addition, the signs used indicate the degree of powers that each of the groups exercises. Thus, the focus is on three important features: the money the parties receive; the money or services the parties "pay" in return; and the power the parties can exercise with respect to these items.

Party	**Receive: Dollars**	**Offer: Services**	**Pay: Dollars**	**Power[39]**
Civic Officials	+	+	0	+
Employees and Unions	+	+	0	+
Citizens	+	0	+	-
Creditors	+	0	+	-+
Advisers	+	+	0	-+
Businesses	0	0	+	++

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[38] *See, e.g.*, Michael Connor, *More U.S. Cities Set to Enter Default Danger Zone*, REUTERS (Apr. 17, 2012, 4:43 PM), http://reuters.com/article/2012/04/17/usa-defaults-outlook-idUSL1E8EN2V520120417.

[39] Powers are designated by - (very weak), -+(medium), + (strong), and ++ (very strong).

Of course, this chart is not as precise as it seems. It is designed to illustrate the analysis. The servicers all offer services and receive payment. The payers are the citizens and the creditors. However, the citizens' power is far less legally weighty and binding than that of the lenders. The true power of the citizens is to move out of the municipality.[40] If the citizens are also employees of the businesses in the municipality, then the businesses have an enormous, and perhaps the greatest, impact on the well-being of the municipalities.

Considering the parties' power, one might note that civic officials have contracts and are subject to regulation and citizen voting as well as political relationships.[41] Employees and unions have contracts and bargaining powers. Creditors have contracts and laws, such as bankruptcy laws. Advisers have contracts. Businesses have a relative freedom to negotiate or move. We can say they have the market power. The citizens have the power to move, although it might be far weaker than that of the businesses, and each citizen is relatively less powerful unless he or she occupies some other power position in the municipality and its politics.

A view of the laws related to municipalities demonstrates both absence of uniformity and a strong desire on the part of many parties to preserve the powers of the local communities. Therefore, we must take for granted that changing to centralized, uniform governance of municipalities on a national federal level is most unlikely.

When and how do financial problems in municipalities arise? For context, we look to the city of Detroit. Detroit—the world's "traditional" automotive center—is "the largest US city ever to move for bankruptcy, with a liability running into $18 billion."[42] The city has dramatically deteriorated. In 2010, "the city had a population of 713,777, more than a 60% drop down from a peak population of over 1.8 million at the 1950 census."[43] This suggests a

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[40] *See* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418 (1956) (illustrating the idea that residents can vote with their feet).

[41] *See generally* Tamar Frankel, *The Governor's Private Eyes*, 49 B.U. L. REV. 627 (1969).

[42] *When Detroit, the World's Traditional Auto Capital, Files for Bankruptcy*, MONEYLIFE (July 19, 2013, 4:10 PM), http://moneylife.in/article/when-detroit-the-worlds-traditional-auto-capital-files-for-bankruptcy/33708.html.

[43] *Id.*

serious and "long-running decline of Detroit's economic strength."[44] Unfortunately, "[t]he fiscal realities confronting Detroit have been ignored for too long" and "Detroit does not have the revenues to meet those obligations and provide an adequate level of services to its people, who pay the highest taxes per capita in Michigan."[45] Detroit's citizens include "[m]ore than half of the owners of Detroit's 305,000 properties [who] failed to pay their 2011 tax bills, exacerbating the city's financial crisis."[46]

Even though there may be numerous reasons for the problems, one important problem is the exit of business from the municipality accompanied by the exit of citizens and other services. This change, together with continuing services and other practices, can bring a municipality like Detroit to bankruptcy. There may be other changes that create potential problems. One feature that all distressed municipalities experience is a gradual evolution of the same or similar problems. When a municipality experiences a disastrous one-time event, it is likely that federal and state authorities will come to help, but small changes in the wrong direction do not bring outside help.

Small negative changes are like a virus. A vaccine might lead to immunity. No reaction might lead to death. Small changes can be arrested by small reductions of costs and attention to where the next might come as well as examinations of new revenues and approaches. Continuing on the same path as if nothing has changed or will change is the road to self-destruction. To be sure, it is difficult to change an organization. But just as corporations have a high-level officer to help recognize and take precautions against adverse change, so can municipalities. Negation of change can be catastrophic, as has been proven time and again.

IV. Learning from Good and Bad Solutions

Not all solutions to the municipalities' problems are successful or fit into a preventive paradigm. However, one list of

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[44] *Id.*
[45] *Id.*
[46] *Id.* ("The state governor declared a financial emergency in March 2013, appointing an emergency manager. 'Bankruptcy is the only feasible option to fix the city's finances and do what is right for the 700,000 people of Detroit,' Snyder said.").

solutions stood out in my research and offers suggestions for preventive measures.[47]

Cooperation makes a big difference. The Rhode Island city of "Central Falls, population 19,000 and merely one square mile" in area, filed for a Chapter 9 bankruptcy and emerged after thirteen months.[48] The city established a six-year financial plan.[49] The parties negotiated rather than litigated.[50] The city was also empowered to overhaul its pension obligations.[51] Significantly, the negotiators looked to the future, not only the past. Similarly, Pittsburgh, Pennsylvania reduced its debt and established a debt policy—a "pay-as-you-go capital investment budget" and "a shared financial management system"—with another county.[52] The unions worked with the negotiators as well recognizing that "everyone underst[ood] that the long-term goal [wa]s for the city to be on good financial footing."[53] Despite having "been in a dark place," Pittsburgh was "looking to be in a better place."[54] Thus, bankruptcy may be a better solution for some, like Central Falls, but not others. That is because bankruptcy may create "winners and losers" rather than a compromise solution.[55]

There is also the "people's factor."[56] Particularly when compared to the "in-fighting" that occurred in Harrisburg's bankruptcy proceedings, the examples set by Stockton, Detroit, and Central Falls illustrate a better way to restructure debt. Exemplifying Pennsylvania's "in-fighting," a city council president of a small town declared on television that he would not vote for the mayor's proposal "because [he] hate[d] him."[57] In-fighting, however, does not

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[47] *See* Paul Burton, *Municipalities in Fiscal Distress Find There's No Easy Way Out*, BOND BUYER, Mar. 18, 2013, at 1.
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.* at 2.
[53] *Id.*
[54] *Id.*
[55] *See id.* at 3.
[56] *Id.* ("Harrisburg has been synonymous with political in-fighting that borders on slapstick, notably between Mayor Linda Thompson and the City Council. Thompson, on city website postings, called her opponents 'unfit to hold office,' while Bill Cluck, president of the Harrisburg Authority public works agency, called her 'mentally ill' in a recent local video spot.").
[57] *Id.*

produce winners. The better approach is to compromise and seek the best outcome for the most people. As one expert artfully stated, "People ask what side I'm on. I'm on the side of a solution."[58] Comparatively, "[t]he Rhode Island approach to distressed communities is very different from" the approach taken "in Pennsylvania, where the governor [Tom Corbett] ha[d] essentially taken a sink-or-swim attitude toward the municipalities."[59]

The reasons for distress vary. One reason could be leverage: distress may come with a "crisis of liquidity," especially when the economy "is going the wrong way and revenues are not coming in as well as anticipated."[60] Another reason could be mismanagement.[61] And an "adversarial relationship of state versus local" government can be devastating as well.[62] Harrisburg, for example, built an incinerator and incurred a debt of over $300 million.[63] The municipality engaged in other deals, which some considered imprudent. Ultimately, "[t]he common thread is that the governments affected did not analyze and keep track of these formidable costs. Neither the municipal side nor the union side did anything like sensitivity analyses fifteen years ago . . . . Municipalities have to keep track of what they owe and how much they can pay."[64]

Is bankruptcy the only way? As noted above, bankruptcy is expensive, but control boards might be expensive as well.[65] The law is not uniform and neither is the difference between control boards and bankruptcy process.

A. General Preventive Policy-Rules to Avoid Future Failures of Municipalities

Americans are often suspicious of government and prefer instead to focus on protecting the efficiency of the private sector. Based on this American culture with respect to government power, Americans, at some level, intentionally create and maintain an

[58] *Id.*
[59] *Id.*; *see also* Williams v. Corbett, 916 F. Supp. 2d 593, 597–600 (M.D. Pa. 2012) (dismissing plaintiffs' challenge to the constitutionality of Pennsylvania's Financially Distressed Municipalities Act).
[60] Burton, *supra* note 47, at 2.
[61] *Id*.
[62] *Id*.
[63] *Id*.
[64] *Id*. at 4.
[65] Burton, *supra* note 3.

inefficient government. For example, merely observe the police and security arrangements in the U.S., and you will undoubtedly find duplication and bifurcation that renders security forces competitors. Therefore, we must accept the conclusion that the balance of power between federal, state, and municipal governments is unlikely to change in the near future. We might assume that solutions will be implemented piecemeal when, or perhaps only after, a severe problem arises. This will result in a patchwork process with patchwork solutions. Currently, the bankruptcy and restructuring process arises only after severe problems have mushroomed. At this point we find municipalities' and participants' problems facing rigid, old, and inappropriate rules lacking in flexibility.[66] As one expert observed, "[s]tate governments have had a major role in how municipalities deal with severe fiscal distress."[67] This approach may be rational, but it is unlikely to earn universal acceptance in the near future.

A second aspect of American culture that is unlikely to change is the tendency to resort to litigation. There is a drive to win rather than compromise. There is a tendency to sue. To court we go! Therefore, when change is required that may reduce the benefits of some players involved in municipal distress, there might be strong resistance in the form of an attempt to assert the parties' rights in court. Even at the cost of the entity's existence, some groups may prefer to rush to court to prevent losing their state-provided benefits. "Winning all" for one interest group, however, may cause "losing all" for both other groups and the municipality as a whole. This approach is too destructive in the long-term. Therefore, a mechanism must be installed to force all parties to the negotiation table, to arbitration, or to mediation, before rushing to court.

One such mechanism is forced negotiations and mediation. The U.S. has a history of the use of such a mechanism and a related mechanism—arbitration. However, arbitration is far more coercive and final. Moreover, arbitration can produce unfair results to some parties, especially if the rationales for the results are not publicly disclosed. It has been argued that disclosure of the results and the

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[66] Robert Slavin, *Larkin: State Actions Are Key to Local Bankruptcies*, BOND BUYER (Aug. 3, 2012, 5:00 PM), http://bondbuyer.com/issues/121_150/larkin-says-state-actions-are-key-to-local-bankruptcy-1042644-1.html ("In 22 states municipalities cannot declare themselves bankrupt . . . .").

[67] *Id.*

reasons behind an arbitrator's decision is costly, and neither the arbitrators nor the lawyers, and sometimes the parties, wish to bear the costs.[68] However, when small changes are negotiated, the parties may, but need not, disclose their reasons. In the case of arbitration, when one or more parties are losers, the incentives for disclosure and reasons for the decision differ with respect to the winners and the losers. This issue may be left to each municipality either in each case or in principle. In any event, the topic requires a far more detailed discussion, which is beyond the scope of this Article.

Forced arbitration and mediations with municipal employees has raised criticisms. There are complaints about costly mediators that are imposed on municipalities in financial straits.[69] About twenty states impose such binding arbitration on their local governments.[70] Arguably, this system was established when public employees had little power.[71] Today, however, where unions are powerful and organized, the system may often be biased against taxpayers and result in large awards.[72] That is why unions press to expand this system, especially if the cities cannot afford to pay the awards. This pits the taxpayers and creditors against the public employees.[73] The solution, therefore, may lie in the identity of the arbitrators, the rules that they must follow, and the openness of the process.

B. Recommendations

In sum, I propose the following changes to be applied in every municipality.

First, every municipality should employ a financial manager, either internal or external.[74] The manager must be imposed with

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[68] *See, e.g.*, Amy J. Schmitz, *Ending a Mud Bowl: Defining Arbitration's Finality Through Functional Analysis,* 37 GA. L. REV. 123, 158 (2002) (stating that "privacy of arbitration . . . promotes its efficiency goals").
[69] Steven Malanga, *Death by Arbitration*, CITY J., Autumn 2012, *available at* http://city-journal.org/2012/22_4_snd-arbitration.html ("Critics, including many mayors in affected states, continue to call for repeal or reform of mandatory arbitration, largely without success.").
[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] *See, e.g.*, Keeley Webster, *Insolvent San Bernardino Hires New City Manager*, BOND BUYER (Feb. 21, 2013, 4:57 PM), http://bondbuyer.com/issues/122_36/san-bernardino-california-city-manager-allan-parker-

strict fiduciary duties and have the power to point to signals of distress and suggest some prophylactic measures. This manager may have a position of a business judge and perhaps tenure of some years. The manager should evaluate both short- and long-term risk assessment plans, thereby avoiding hitting while the iron is hot and dispensing with the belief that tomorrow will take care of itself.

Second, the manager's identified problems should be addressed by appropriate experts and lead—within a fixed period of time—to changes to resolve the problems. Accordingly, "[m]unicipalities must keep track of their finances: what they owe and how much they can pay."[75]

Third, if proposed changes are not acceptable to the relevant parties, negotiations or arbitration should take place within a fixed period of time.

Fourth, the changes should be subject to existing legal rights and duties, provided the affected parties agree to abrogation of their legal rights (but not of their legal duties).

Fifth, unless there is a good reason to close the doors to the public, the proceedings should be publicly conducted.

V. Conclusion: An Opportunity to Clean House

The crisis in the municipalities offers an opportunity to clean house—identify the wrongful activities that may have abused the public trust and establish stricter compliance rules within the municipal and taxpayer domains. Some of these wrongs are being uncovered and pursued in the courts.[76] Specifically, "Providence, R.I.'s lawsuit accusing an actuary of miscalculating city savings on pension benefits reflects the increasing exposure of city advisors and vendor firms to liability, municipal and legal experts say."[77]

Most of the proposed changes outlined in this paper should be accepted voluntarily by the involved parties. However, there

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new-contract-1048924-1.html ("The San Bernardino City Council on Tuesday approved the contract for its new city manager, Allen Parker, agreeing to pay him $221,976 per year, according to the San Bernardino Sun.").

[75] Burton, *supra* note 47, at 1.

[76] *See, e.g.*, Paul Burton, *Providence Suit Intrigues Municipal, Legal Experts*, BOND BUYER (Feb. 27, 2013, 3:14 PM), http://bondbuyer.com/issues/122_40/providence-suit-intrigues-municipal-legal-experts-1049137-1.html.

[77] *Id.*

should be an exception in the following cases, where the changes should become mandatory. The following are very broad-line suggestions, which might lead to many exceptions once they are viewed in detail.

First, if a municipality does not accept and practice these conditions, and if it fails to pay its debts, then it can be declared bankrupt and be subject to bankruptcy law.[78] Second, a bankrupt municipality may be required by the bankruptcy court to increase its taxes on its current citizens, as well as on those businesses that left the municipality within one year before bankruptcy. The purpose of the exception is to involve the parties to ensure that the failure of the municipality will affect all of them and not only others.

This proposal is intentionally left broad. If considered, it must be subject to many conditions, and perhaps tailored to fit different municipalities. The main purpose of this proposal is to impose on all beneficiaries of the municipalities' services a similar incentive to avoid the municipality's bankruptcy and to work together to make them successful both financially and humanely—hallmarks of any good government.

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[78] *In re* City of Stockton, Cal., 478 B.R. 8, 13 (Bankr. E.D. Cal. 2012) ("The retired employees of the City of Stockton want this court to order the City to keep paying for their health benefits during this chapter 9 case.").