THE US CHAPTER 9 PROCEDURE

- A PLEA FOR A USEFUL MODEL FOR SOLVING EXCESSIVE INDEBTEDNESS OF MUNICIPALITIES!

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I hereby declare that I have read and understood the regulations governing the submission of LLM dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.“

Dr. Maximilian Hoffmann
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I. Introduction

“There is no doubt that American cities are in dire straits and in need of a remedy.”

In recent years, with the outbreak of widespread financial crises, hardly any other topic keeps politicians, especially in industrialized nations, as busy as state financial distress. In the field of law, the issue of how to deal with state financial difficulties now and in the near future is discussed worldwide.

The City of Detroit’s historic bankruptcy in July 2013, the largest city measured by both population and outstanding debt to file for Chapter 9, turned the eyes of the American nation and the world to the problems of America's struggling post-industrial cities. Detroit's 2013 petition can be read as the coda to a dramatic yet idiosyncratic tale of economic decline. Challenges from abroad to the domestic automotive industry, rapid depopulation, and

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1 The starting point of this work is the research of the author as part of his doctoral thesis on the subject of municipal insolvency capability in Germany (M Hoffmann, Die geordnete gebiets-körperschaftliche Insolvenz am Beispiel deutscher Kommunen (The orderly insolvency of territorial entities using the example of German municipalities), 2012). In the course of this thesis the author had the opportunity to consider cursorily the solutions of other jurisdictions. The present work is dedicated to deepen the view on the US Chapter 9 proceedings and its exemplary character.


3 Especially various law review symposia, for example: Widener Law Journal Symposium “Bankruptcy and Beyond: Solving the Problem of Municipal Financial Distress” held on April 14, 2014 in Harrisburg, Pennsylvania (USA); Symposia at the University of Vienna (Austria): “State Insolvency” held on Mai 10, 2010 and June 21, 2011; Humboldt University of Berlin (Germany): “State Insolvency as point of law” held on April 8, 2011. Whereas 20 years ago the subject of municipal bankruptcy had received little attention in the legal literature, MW McConnell / RC Picker, “When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy”, 60 U. Chi. L. Rev. 425, 425 (hereinafter McConnell / Picker, 60 U. Chi. L. Rev. 425): “This subject is apparently of too little practical financial importance to attract the attention of bankruptcy scholars.”


5 “The most dramatic developments have come in the handling of municipal distress”, DA Skeel, Is bankruptcy the answer for troubled cities and states?, 50 Hous. L. Rev. 1063, 1064 (hereinafter Skeel, 50 Hous. L. Rev. 1063).

6 JM Beermann, Esolving the public pension „crisis“, 41 Fordham Urb. L. J. 999, 999 (hereinafter Beermann, 41 Fordham Urb. L. J. 999) calls it a “high-profile bankruptcy filing”
questionable leadership tell a remarkable and discomforting story.\(^7\)

But in many respects the financial problems Detroit faces today are similar, maybe currently more pronounced, to the troubles confronting many towns and cities across the country.\(^8\) In the three years before Detroit filed the largest municipal bankruptcy in United States history, several other municipalities had done so, including Jefferson County, Alabama\(^9\), Harrisburg (the capital of Pennsylvania)\(^10\) and two California cities, Stockton\(^11\) and San Bernardino\(^12\), each one generating an enormous amount of debts. Suddenly the public not just in the United States realized that the financial crisis not only affects states as a whole but also the subordinate authorities, especially the municipalities. Municipal insolvency scenarios were now no longer only hypothetically possible, but part of the reality of life.

Although each case mentioned above had its own unique history and causes, each municipality filled for bankruptcy under Chapter 9 of the US Bankruptcy Code followed by a subsequent state-supervised recovery. The accumulation of these proceedings in the United States more and more draws the attention of policy makers in other countries that also have to struggle increasingly with municipal financial difficulties. In many jurisdictions, the question that comes into focus is to what extent can one resolve municipal insolvency scenarios through a legal proceeding and if the US American Chapter 9 proceeding can serve as a role model.

\(^7\) VSJ Buccola, An ex ante approach to excessive state debt, 64 Duke L. J. 235, 236 (hereinafter Buccola, 64 Duke L. J. 235).
\(^8\) Buccola, 64 Duke L.J. 235, 236.
This work is dedicated in the first instance to the necessity of insolvency proceedings for municipalities as territorial entities. Therefore, the current debate on insolvency proceedings for states is presented briefly in an introductory overview to introduce the debate that insolvency proceedings for territorial entities has reached all levels of government worldwide. This is followed by examples of historical experience with insolvency scenarios of states and local authorities to show that insolvency scenarios at all levels of government are part of reality, and that a procedural handling is possible, but also necessary.

Based on this, the US-Chapter 9 procedure, perhaps the most well-known legal remedy for insolvent cities\textsuperscript{13}, and the most globally developed proceeding for municipal insolvencies, is taken closer into view. In the first step, the principles and mechanisms are pointed out. This is followed by a semantic preamble regarding the development of insolvency law and its public perception, a short discussion of the experience with the Chapter 9 process and last, but not least, a presentation of the key advantages of Chapter 9 proceedings. The goal is to convey that the Chapter 9 proceeding may serve as a useful tool and model for other countries to solve excessive indebtedness of municipalities. As a result, in particular, the abstract possibilities and objectives of the procedure are considered.

1. The current debate about insolvency proceedings for states

"Healthy state finances (are) the first requirement for an orderly development of the whole social and political life."\textsuperscript{14}

In times of the financial and debt crisis, this statement by the Federal Constitutional Court of Germany from 1962 displays more than ever an admonishing clarity: "The lesson from the recent crisis can be summed up in two

\textsuperscript{13} O Kimhi, 27 Yale J. on Reg. 351, 352.
\textsuperscript{14} BVerfG, Urt. v. 14. 11. 1962, 1 BvR 987/58, BVerfGE 15, 127 (141).
words: sound public finances.”

No one is able to continuously spend more than his regular fundings. At least in the mid and long term, there is a need that regular income and expenses are well-balanced. This applies to the public hand to the same extent as to individuals and businesses. Not only in households, but also in almost every state, it is now almost "en vogue" to live beyond their means. This has the consequence for the public hand that continuously increasing funding gaps must be compensated by taking out loans. What happens, however, if the credit load and thus the government debt reaches spheres where public finances are no longer "healthy" or "solid"?

In times of the sovereign debt crisis, several European countries are exposed to such a dramatic worsening of their financial problems that the remaining member states are forced to provide massive financial support in order to prevent the first national bankruptcy in the history of the European economic and monetary union. Not only Europe, the United States and Japan have also been hopelessly over-indebted. What initially began in 2007 as a crisis of the US real estate market now bothered the global community. This solidifies the impression that politics is not a means to calm the financial markets and get the exploding national debt under control.

The sovereign debt crisis reached its peak this year in Greece. A sovereign debt default, and thus the de facto bankruptcy, could so far only be prevented primarily by the joint efforts of the Member States. For nearly six years, Greece has been in such a difficult budgetary and financial crisis that it could only be saved from insolvency - at least temporarily – by the immense financial efforts of the European Union and the International Monetary Fund (IMF). These days the medium and long-term development of the Greek public finances, and thus the future of the European Economic and Monetary Union, is decreasingly foreseeable.

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As part of the current development, German Chancellor Angela Merkel and her Minister of Finance Wolfgang Schaeuble had already in May 2010 created a new plan of action. They called for the institutionalisation of an international insolvency procedure for states for the orderly handling of sovereign default scenarios.17

Thus, shocks to the global financial system should be better absorbed in the future. The international community should no longer be blackmailed to help if a country reached the limits of its financial capacity. In addition, a debt repayment system should be established, and the reorganisation of the debtor country should be placed on a firm foundation. The aim, however, was also to establish an institutionalized participation of private creditors in the costs of bankruptcy.

While the recent financial crisis in Europe does not primarily affect the options for addressing state and municipal financial emergencies in the United States, it nevertheless has important similarities.18 The European Union’s handling of the travails of Greece and other distressed European countries, and recent suggestions to move toward to a "fiscal union" or to enact a restructuring framework, raise questions about the internal dynamics of a structure that also is highly important for the situation in the United States.19

As confusing as the discussion about the long-term establishment of insolvency law for states in the Western world currently may be, it still reignited in jurisprudence in the context of the world's exploding national debt.20

Although the insolvency capability of territorial entities (countries, states, municipalities) seemed to be unthinkable in many countries for a long time, it has now been put back on the economic and jurisprudential agenda with the

18 Skeel, 50 Hous. L. Rev. 1063, 1065. In fact, a number of academics and political figures in the US have urged the Congress also to permit states to restructure or otherwise shed debt through a formal, federal bankruptcy process modeled on Chapter 9 of the Bankruptcy Code. A series of op-eds has made the case in the popular press. Meanwhile, law reviews have witnessed the growth of what one commentator dubs a "cottage industry" devoted to debating the merits and design of a state-bankruptcy regime, cf. Buccola, 64 Duke L.J. 235, 237 with further reference in n9 and n10.
19 Skeel, 50 Hous. L. Rev. 1063, 1065.
recent financial crisis. This generates a corresponding discussion as it was last seen in the context of the Argentine crisis at the beginning of the millennium.

2. Insolvencies of territorial entities - a historical overview

Not only in the European and national context, but especially in the sub-national context, there was a lively scientific discussion on the establishment and improvement of insolvency proceedings for territorial entities in the recent years.\(^{21}\) For Germany, the historical focus need not be directed to other countries in terms of the insolvency of public authorities. Germany already has enough examples in history as starting points. The fact of bankruptcy both at the local level and in the form of a two-time national bankruptcy (the third, the German Democratic Republic, not counted) after the First and Second World Wars was already implemented several times. Looking farther back into the history of territorial entity insolvency at the local level, the bankruptcy of the Prussian city Halle in 1717, the bankruptcy of the East Prussian city Arys in 1929 and in the same year the bankruptcy of the Saxon town of Glashütte has to be mentioned. These examples demonstrate that bankruptcy of territorial entities in Germany has been a long established reality.

a. Bankruptcies of a State

"Governments talk about it just as reluctantly as the modern world is talking about dying; nevertheless it has to happen once in a while."\(^{22}\)

Kratzmann stated the real existence of the alleged phenomenon of state bankruptcy in the year 1982 with just a few words sounding similarly threatening

\(^{21}\) Especially in Germany, there is a comprehensive discussion in law since the start of the financial crisis. Comprehensively this discussion is presented by the author himself, M Hoffmann, The orderly insolvency of territorial entities using the example of German municipalities, 2012. In addition, the latest publication in a scientific law journal can be found at CG Paulus, Gemeinden und Insolvenzrecht: eine nützliche Allianz (Municipalities and Insolvency Law: A beneficial Alliance), ZInsO 2014, 2464 et. sqq.

\(^{22}\) H Kratzmann, Der Staatsbankrott (The bankruotcy of the state), JZ 1982, p. 319.
and ultimate as "national bankruptcy". But it is likely that the issue of excessive indebtedness of states and the corresponding attempts to escape the burden of debt through the bankruptcy of the state are as old as the history of the states themselves. Moreover, history shows that most countries can recover after their financial ruin, even if the causes of state defaults are many.

According to the Vice President of the International Monetary Fund in 2002, Anne Krueger, the issue of state insolvency or excessive indebtedness has occurred in about 90 cases worldwide in the last 200 years. Contrary to what one might suspect, this not only affected the so-called developing countries, but also the majority of European countries. Some of them actually have admitted to being unable to meet their liability dutifully several times. The present study cannot and does not want to make the claim of a comprehensive or detailed discussion of the history of the state insolvency scenarios. The aim of this short presentation is to show that state insolvency scenarios are not isolated phenomena, but part of the possible financial reality of each territorial entity worldwide.

aa) Argentina

The case of state insolvency in the 21st century that has received the most attention in scientific, political and public forums, is the Argentina crisis from the years 2001 to 2002. The case of Argentina is the largest to date in terms of the volume of state defaults. The country was confronted in 1999 with significant economic problems that should have been solved with the help of government bonds. After the complete collapse of the peso, combined with violent social riots and the onset of massive capital flight, Argentina finally

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23 Currently, in particular, the US economy professors Reinhart and Rogoff are dealing with the recurring phenomenon of state bankruptcy. The authors demonstrate on the basis of extensively evaluated records from eight centuries that the processes are essentially the same, CM Reinhart / K Rogoff, This times is different: Eight centuries of financial folly, 2009.
25 For a detailed survey, please refer to M Hoffmann, The orderly insolvency of territorial entities using the example of German municipalities, p. 88 et. sqq.
refused to fulfill its obligations under international bonds. Overall, this was an amount of more than 80 billion euros and 20 billion euros in unpaid interest. It was the largest bankruptcy ever and involved 500,000 creditors – bank, institutional investors and, mostly European, private investors.

With the Act of 6 January 2002, the Argentine parliament declared a public emergency and authorized the executive branch to reform the exchange rate system and the restructuring of the existing external debt. Excluded from the suspension payments were only those debts that were under Argentine law. It was not until the beginning of 2005 that Argentina submitted a final debt restructuring offer to its creditors which meant a loss of 75% of the nominal value of the bonds. Yet, it was still accepted by 76% of the creditors.

bb) Iceland

Iceland had to nationalise the three largest banks in the country (Glitnir, Kaupthing and Landsbanki) in 2008 after they had speculated with sums that exceeded the economic performance of the country many times. On 16 October 2008, the Government of Iceland announced that it was not able to repay a bond to the Glitnir Bank in the amount of 750 million US dollars. The following Monday, the interest payment for a bond of Kaupthing Bank, nearly 500 million US dollars, remained open to two investors. The onset of insolvency was only a matter of time and even the Icelandic Prime Minister warned of an impending bankruptcy. But the collapse of Iceland was turned away in November of the same year, as the International Monetary Fund approved a grant over 2.1 billion dollars and the countries of Finland, Denmark, Norway and Sweden pledged loans to Iceland in the amount of 2.5 billion US dollars.

**cc) Greece**

The latest example in terms of (impending) state insolvency scenarios in the European Union is the already mentioned Greek crisis. The threat of bankruptcy could be averted only by repeated, massive financial support from the EU and the IMF. In the short term, while an attempt is made to defuse the financial crisis in Greece, it remains to be seen whether this will be achieved in the medium and long-term point of view. The relevant assessments can be referred to as split - at least in politics and business. While some people in politics cling to the hope of being able to save Greece with another massive financial support and not jeopardise the stability of the Economic and Monetary Union, rating agencies primarily warn of a Greek default which causes strong difficulties within Europe's politicians.\(^{28}\) Greece's creditworthiness could, the rating agencies say, be equal with a bankrupt state if private creditors have to participate in the Greek bailout.

**dd) USA**

Unlike Greece, the United States always received top marks from rating agencies and therefore an excellent credit rating. However, the government had to take loans in the value of a trillion dollars for economic stimulus and back bailouts as a result of the financial crisis. Hardly any country in the world currently lives beyond its means as much as the United States. At the end of 2015, the total government outstanding debt of the United States, including federal, state and local, is estimated to be almost 21.7 trillion US dollars. As a result, the total national debt in 2014 is higher (103%) than the total economic output (GDP) a year. Even in 1981, the figure stood at just 26.3%. In Germany,

it is currently at 81%. Accordingly, the US annual government deficit in 2011 with 10.6% of the total economic output reached a figure more than three times higher than the predicted example for Germany of 3.3%. In 2011 it was actually forbidden by law for the government to get into debt with more than at least 14.3 trillion US dollars. Only a month-long negotiated compromise with the opposition made a raising of the debt ceiling at the last moment possible. If this increase had not been made, it would have been the first default in US history in early August 2011.

The massive financial problems of the most powerful economy in the world have by no means been eliminated with the increase of the authorized debt limit. Even in a decade, some scholars fear that the total debt would have doubled if the state, as in the past, spends one to two trillion dollars a year more than it earns. As a result, due to the described development, the rating agency Standard & Poor's, one of the three major international rating agencies, lowered the outlook for its rating in April 2011 initially to "negative", then deprived the US in early August 2011 of the highest grade "AAA" and warned of a further downgrade at the same time. The agency justified its step by pointing out that the measures adopted a few days earlier would be insufficient for a sustainable fiscal consolidation and also questioned the predictability of American policy processes because of the protracted dispute between the US government and opposition.29 The loss of the top score also represents, besides higher interest rates for borrowing and thus higher costs for the state budget, a sensitive prestige loss. For supposedly stable economies state insolvency scenarios are no bugbear, but in times of global financial crises, shades of the reality of life for public finance.

dd) Interim findings

Past and present show that sovereign defaults are not uncommon and are usually not synonymous with the destruction of a State. In a number of

cases, they lead rather to the rescue of the state. It must therefore be clearly noted that that the concept of State’s ability to pay is more than a bare metaphor. History shows rather that the government’s ability to pay has an actual, real existing restriction. Consequently, in the history of sovereign debt, there is hardly a country in which a sovereign default, in some form, has not already occurred, and many states have often lived through this scenario.

A relevant lesson must be at this point that politics and science no longer have to be afraid of the word "bankruptcy" in particular, and of the insolvencies of territorial entities in general. Notwithstanding the large experience of sovereign defaults in the 19th and 20th centuries, there is no successful approach - on the state level - to develop an adequate method for dealing with such a situation to the present day.

b) Subnational insolvencies

The insolvency of subnational governments is a recurring phenomenon of legal history. However, in many countries regulatory structures for dealing with relevant insolvency scenarios can be found on a subnational level which is different than in the event of state insolvencies. The best known example of this is the so-called Chapter 9 process in the United States of America, and its representation will be the focus of the present survey. In addition, one can also find such proceedings in other countries, including Brazil, Hungary, Albania, Bulgaria, Romania and South Africa.30 Based on three selected examples, in a first instance the skepticism of the organized solution of subnational payment crises will be alleviated in each of these cases discussed below.

aa) The case of the Saxon town of Glashütte (Germany)

In the discussion about a possible bankruptcy ability of German municipalities, it is mostly accessed to corresponding regulations in other jurisdictions. It is often ignored that German history provides examples of municipal bankruptcy. In particular, it is worth looking at the case of the Saxon town of Glashütte from 1929, at least insofar as the authoritative judgment of the Supreme Administrative Court Saxon\(^3\) was understood as "an administrative decision of the utmost importance".\(^4\)

Also, in the case of Glashütte there was not just one stand-alone factor: there were a series of causes, problems and failures that were crucial to the financial decline. Thus, the entire territory of the German Empire was greatly impacted by the precarious financial position. After the end of inflation, borrowing was supposedly the only way to make the necessary investments because the citizens could not be utilised more intensively after the end of the economic crisis. Very quickly, the municipalities lacked the means to shoulder the burden of interest payments on the loans.

The town of Glashütte was also affected by other individual burdens. The traditional watchmaking and industrial city had to cope with the decline of the watch industry and therefore rising social costs, which rose further by a flood disaster in 1927. In addition, local failures came along through lending to non-urban farms, which in turn had to be financed by borrowing. The result was that at some point, an interest repayment of the loans was no longer possible. The city had recently accumulated a total debt of two million Reichsmark. This led to the bankruptcy petition of the town of Glashütte by the City Council in March 1929 and to the determination of insolvency and over-indebtedness by the Ministry of the Interior in June 1929. The opening of the bankruptcy proceedings against the disposable took place on 10 July 1929.

The result of municipal bankruptcy proceedings was that creditors and debtors were finally able to reach a compromise of debt rescheduling and

\(^3\) Judgment of 3rd May of 1930. Nr. 130, 114, 171 III 1929.
\(^4\) Dresdner Anzeiger Nr. 210 (6/51930).
interest waiver on one side, and the liquidation of municipal assets on the other. With the suspension of the bankruptcy proceedings on 1 December 1931, the town of Glashütte was given the opportunity for a fresh start.

bb) The case Leukerbad (Wallis/Switzerland)

The most memorable and probably most recent example of the actual insolvency of a municipality in Europe is the case of Leukerbad in Switzerland. Debts of 346 million Swiss francs had been accumulated within a decade by the end of 1998 as a result of massive investment and mismanagement. The tourist resort of Leukerbad, with just 1,750 residents had to adjudge itself insolvent as the first Swiss community since the enactment of the Federal Law on Debt Collection against municipalities of 1947. From 1999 to February 2004 Leukerbad was under sequestration as the first Swiss municipality.

Although the creditors and the municipality of Leukerbad itself wanted to commit the canton of Valais to vouch for the outstanding payments, this request was rejected by four judgments of the Swiss Federal Supreme Court. According to the court, the governmental supervision has the aim to protect the municipality and not the creditors. In this case, the principle of autonomy is relevant - a clear decision against a possible "bailout" by the next higher level of government. The lender thereby awakened from a "century long hibernation" and thus had to - but without carrying out a formal insolvency proceedings – resign from parts of their debts (between 30 and 78%). In return, Leukerbad had to come to terms with the liquidation of parts of their assets. As part of the receivership, the expenditure was also reduced, and taxes on the maximum allowable increased and investments were partially released for liquidation. The population decreased from 1,750 to 1,400, ie by 20%. After 2003, a cantonal

34 The execution against public authorities of the cantonal law and local authorities, is regulated in Switzerland by the SchGG, "Federal law on debt collection against municipalities and other corporations under public cantonal law". It is assisted by the "Federal Law on Debt Collection and Bankruptcy" (SchKG).
35 See n. 33.
"bailout" was finally rejected and all of the assets of the municipality were sold (especially tourism infrastructure).

However, these experiences resulted in a rethinking of the lenders and a complete reorganisation of the markets for local authority loans. They now pay increased attention to the creditworthiness of the authorities. The capital market meets again its very own function by higher interest rates for higher risks. The municipality of Leukerbad itself has in its publicly available and extremely transparent "Financial Report & Financial Statements 2013" a debt of 192 million Swiss francs. While this is an enormously large sum, this is still about 165 million Swiss francs lower than another 15 years before. The current income of 12.9 million Swiss francs offsets by a current expense of 11.6 million Swiss francs. According to that, the self-generated funds (cash flow) are 1.3 million Swiss francs.

Due to the restructuring contract, the municipality is still not allowed to take out loans from third parties. For this reason, the municipality must finance their investments from their own resources. However, despite these massive restrictions, the municipality is on the right track into the future.

**cc) The case of Orange Country (California/USA)**

As already mentioned, the insolvency proceedings for municipalities (so-called Chapter 9 process) in the USA is regulated by law since 1937. Its greatest achievement is that so far it has rarely been used by municipalities. However, critical stardom, in particular the case of Orange County, California, has acquired in 1994. The Chapter 9 process of Orange County was the largest insolvency proceeding in the history of municipal bankruptcy in the United States in terms of financial volume until 2013 when Detroit filed for bankruptcy under Chapter 9. Under nominal debt of 7.6 billion US dollars by speculation a loss in value of 1.64 billion US dollars had been caused.

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36 Available at www.leukerbad.org (last accessed: 20/5/2015).
A trigger for the insolvency proceedings was governmental funding restrictions on long-term bonds, which meant that these were offset by short-term and risky loans. There were also declining tax revenues together with rising expenditures, a well known phenomenon. But ultimately crucial was certainly a variety of "soft" factors, such as lack of policy coordination, voter distrust and government mismanagement. After initially chaotic conditions due to the petition for insolvency proceedings in December 1994, an insolvency plan was submitted in December 1995 and the process came to conclusion in June 1996.

Sharp budget cuts and significant staff reductions were required in order to advance its budget reorganisation and to perform the debt service. Though the complexity of this concrete proceeding in the case of Orange County's bans a detailed explanation herein, the focus of this work will be the explanation of the general conditions and the aims and advantages of the American Chapter 9 process. At this point it should only be noted that already more than 500 US communities took the road through an orderly insolvency procedure in the past.

But even in the present, as a result of the economic downturn there are many financially stricken US cities and municipalities or associations on the verge of bankruptcy or have already declared their inability to pay. For example, the National League of Cities has already explained in the spring of 2010 that the American municipalities by the year 2012 will probably have to cope with a budget deficit of up to 83 billion US dollars - a wave of municipal bankruptcies was feared between 2010 and 2020.

As already mentioned above, this has already occurred not just in a variety of small towns such as Westfall in Pennsylvania, but also in Detroit, which filed the largest municipal bankruptcy in United States history, and several other municipalities including Jefferson County, Harrisburg (the capital of Pennsylvania) and two California cities, Stockton and San Bernardino, each one generating an enormous amount of debts. But among the possible bankruptcy candidates, you also find some more well-known cities such as Miami and Los

39 For more details compare Frederick Tung, 53 Hastings L.J. 885.
Angeles. Miami is facing such big financial problems that they are considering whether to declare themselves bankrupt. The situation is even worse in Los Angeles, where it is expected that the city must declare itself insolvent at the latest in one or two years, as the pension obligations of the city have reached an overwhelming amount - more than half of the available funds will be applied for this purpose – and further increase of 2.5 billion US dollars is expected in the coming years. As the the second largest city in the USA, Los Angeles already has to shoulder a budget shortfall of 500 million US dollars annually.41

**dd) Interim findings**

The historical reality has very little in common with the image of a community with inexhaustible financial power. Rather, the history of almost every state is characterised by the history of its crises and thus its financial crisis. Therefore insolvency scenarios belong, as shown in the illustrated historical experience, on all levels of government to the reality of life of the past and the present.

For a variety of municipalities there is the danger - not only, but also - due to the financial crisis, to get into the de facto bankruptcy. This can usually be prevented only by a strenuous consolidation effort. The sellout of municipal assets has already begun, services are canceled, and the staff and administration costs are drastically reduced. While this in many ways may result in quite positive and acceptable effects, many local authorities nevertheless see themselves no longer in a position for further cost-cutting measures. However, the legal history also shows at the local level that a regulated bankruptcy proceeding usually is an instrument for the turnaround. Therefore, it is worth the effort to restabilise municipalities on a financial basis and thus to create the chance for a new start.

41 "I think your city of Los Angeles is probably two to three years away from being in the same position that Detroit is where there is not enough money to pay the bills," Says California Pension Reform President Daniel Pellissier, available at http://www.huffingtonpost.com/2013/07/24/la-bankruptcy-california-pension-reform-president_n_3642054.html (last accessed: 20/5/2015).
3. The necessity of insolvency proceedings for municipalities – Chapter 9 as a model

It doesn`t satisfy the importance of this debate by locating it in the context of historical experience alone. In reality, many cities and towns, especially in the last years, are standing on the edge of financial collapse. Many municipalities are at the end of their ability to act and there are growing fears of frequent occurrences of municipal defaults. Moreover, considering the long-term development of municipal budgets, it can be assumed that the process of collective municipal insolvency scenarios is only at its beginning. The financial crisis of the affected communities is based not only on simple mismanagement and unsustainable living beyond their means, but also on the congestion of local authorities by federal and state governments, especially due to increased allocation of financial intensive tasks without the insuring of adequate funding.

Taking the insolvency of public authorities in this focus, this is first of all not a phenomenon of the state level. Much more natural is a look at the municipal insolvency which illustrates the framework of public insolvency scenarios in the past and present. The local governments are in fact the authorities which been hit hard by the current financial crisis - more and more becoming a debt crisis of public budgets. The municipal insolvency, and thus the threat of municipal bankruptcy, is no more an extraordinary phenomenon.

Consequently, the citizens will encounter first on this lowest "state" level insolvency related consolidation measures and spending cuts. A bankruptcy as a comprehensive debt default, which probably currently still seems rather unlikely in most of the countries at the state level, is imminent - not just occasionally - at the local level.

Experience shows that municipalities can become insolvent. But the lack of a formal insolvency proceedings in many countries for public authorities turns a insolvency into a debt trap with no way out.

“When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open and avowed bankruptcy is always the measure which is both least
dishonourable to the debtor, and least hurtful to the creditor.\textsuperscript{42}

Already in 1776, the Scottish professor of moral theology Adam Smith suggested the introduction of a bankruptcy procedure for states. However, there is a pressing need worldwide for an effective approach of insolvency proceedings for municipalities. Commonly, the US-american Chapter 9 proceedings of the Bankruptcy Code is used as a procedural model.

II. Overview of the principles of the Chapter 9 procedure

In the jurisprudential discussion of the perspectives of a municipal bankruptcy, the comparison with the insolvency of public authorities in the United States with special reference to the so-called Chapter 9 proceeding plays a considerable role. The Bankruptcy Code provides in Chapter 9, the provisions for the performance of a debt settlement process for public debtors.\textsuperscript{43} It is an insolvency proceeding, in which the legal status of the debtor is given special consideration.\textsuperscript{44}

1. Guiding principles of the procedure

The regulatory framework is exclusively dedicated to the handling of public debtors in bankruptcy. Deeply rooted in the American legal tradition, this proceeding has been practiced since 1937, when it was adopted in response to rife municipal defaults during the Great Depression.\textsuperscript{45} Close references are to

\textsuperscript{43} A complete description of the process appears difficult because Chapter 9, as it is usual in the American legal system, is only very slightly abstract formulated, but is instead focused on the provisions of various case variations.
\textsuperscript{44} General explanations on Chapter 9 for example at D Dubrow, The Urban Lawyer 1992, 439; D Kupetz, The Urban Lawyer 1995, 531; JB Stuart, Journal of Commercial Lending 1995, 46.
\textsuperscript{45} Already in 1934 a proceeding (L. No. Pub. 251, 48 Stat. 798 (1934)) was attempted by the US Congress in the wake of the Great Depression set up to handle local financial crises. However, this failed to constitutional concerns of the US Supreme Court (Aston vs. Cameron County Water Improvement Dist. No. 1, 298 US 513 (1936). Only in 1937, a renewed attempt of the US Congress was successful, the relevant law withstood the judicial review of the Supreme Court (United States vs. Bekins, 304 US 27 (1938) and entered into force. Only in 1946, the law, which should initially apply only temporarily, found as Chapter 9 its way into the Bankruptcy Act (today:
the well known Chapter 11 proceedings of the Bankruptcy Code, which regulates the reorganisation in the form of an insolvency plan. Nevertheless, the Chapter 9 proceeding has a slightly different orientation. Although also a plan-proceeding, the goal of the chapter 9 proceeding is not just reorganisation but also adjustment of debts.46

This is due to the fact that the core of a comprehensive reorganisation, as already illustrated by the term, is always requiring a significant redesign and reorganisation of the respective debtor. But a comprehensive reorganisation would result in unacceptable and profound intervention in the personal responsibility of the municipality. Accordingly, there are other problems in the context of the insolvency of public debtors than in a private law insolvency. The protection of territorial autonomy of the debtor and the public interest in maintaining the capacity of the debtor is also to be mentioned. Therefore, the theme of the procedure under Chapter 9 cannot be just the total reorganisation of the municipal debtor, but rather the comprehensive settlement of debts.

By means of the Chapter 9 proceeding, the public debtor is given the possibility to run through insolvency proceedings with a discharge of residual debt and thus the chance of a restart ("fresh start") at the end. A warranty obligation of the relevant state for the debts of its municipalities is not required by law in the United States.47 In cases where the state refuses voluntary help, the Chapter 9 proceeding offers the debtor the option of using their own resources to find a way out of the financial crisis.

Fundamental challenges during the process are to maintain the debtor's ability to act and thus ensure the public exercise of functions of the municipality. This is taken into account with the extensive standstill of the proceeding ("automatic stay") right from the opening of the proceedings.48 As a result, the public debtor is protected against the uncontrolled access of creditors.

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46 Tung, 53 Hastings L.J. 885, 893.
48 Tung, 53 Hastings L.J. 885, 893.
Simultaneously, a status quo is created for the elaboration of an insolvency plan.

The aim of the Chapter 9 proceedings is the financial rehabilitation of public debtors associated with the ongoing maintenance of the fulfillment of their essential tasks. Accordingly, the municipal debtor is subject to far fewer restrictions in comparison to the debtor of Chapter 11 proceedings and is much more easily enabled to obtain the approval of the responsible court for the elaboration of an insolvency plan and continuing municipal activities. This of course comes at the expense of the opportunities for participation of the creditors on the restructuring process and the elaboration of the plan. This measure is justified by the special constitutional position of the public debtor, whose task is not merely to making profits, but the performance of public obligations.

However, there is according to US legal conception, at least psychologically, a comparability between municipal and private insolvency. In the absence of a discharge of residual debt, the debtor would stop quickly its economic productivity if he has to submit all of his income to his creditors. But if he is disburdened from his debt, it is hoped that he can actively participate in economic life again. This motivational set is also used for the municipalities as a justification for granting a discharge of residual debt. It is believed that the financial burden initially results in tax increases. If the tax burden is too high, the lack of motivation presented above occurs within the citizens. This should be prevented inter alia by the Chapter 9 proceedings.

2. Essential regulatory content in broad terms

The proceedings of Chapter 9 can be divided into three sets of provisions - the regulation of the general rules is followed by the rules which regulate the actual procedure itself, and finally the insolvency plan rules. Add to that the first

49 Tung, 53 Hastings L.J. 885, 893.
51 McConnell / Picker, Municipal Bankruptcies, P. 82.
52 McConnell / Picker, Municipal Bankruptcies, P. 82.
rule of Chapter 9, Sec. 901 BC, which regulates which rules in addition to Chapter 1 (according to Sec. 103 (f) BC always full application), from the general provisions in Chapter 3 and 5, but especially from the Chapter 11 process, come to application. Finally Sec. 902 BC provides some basic definitions in view of the proceedings under Chapter 9.

a) Initiation of the proceedings (“Petition filling requirements”53)

In accordance with Sec. 109 (c) (2) BC, basically each municipality is entitled to the demands of the Chapter 9 proceedings.54 This includes both "government units" and "Instrumentalities of a state", see Sec. 101 (40) BC, therefore subnational public authorities as well as and irrigation districts, school districts, state hospitals, etc.55

The application for the opening of the proceedings may be made only on a voluntary basis and only by the debtor itself.56 An application at the initiative of the creditors or even the higher state is therefore not possible, Sec. 109 (c) (4)

53 McConnell / Picker, 60 U. Chi. L. Rev. 425, 455 et. sqq.
54 Section 109(c) provides that:
(c) An entity may be a debtor under chapter 9 of this title if and only if such entity --
(1) is a municipality;
(2) is generally authorized to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter;
(3) is insolvent;
(4) desires to effect a plan to adjust such debts; and
(5) (A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
(B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
(C) is unable to negotiate with creditors because such negotiation is impracticable; or
(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.
55 “The states themselves do not have a bankruptcy option, no matter how bleak their circumstances may be. In 2010, a brief discussion erupted as to whether Congress should erect some kind of restructuring framework for financially distressed states. At the end, both Democrats and Republicans rejected the idea although for quite different reasons...” Skeel, 50 Hous. L. Rev. 1063, 1064.
56 Tung, 53 Hastings L. J. 885, 900 et. sqq.
BC in conjunction with Sec. 301 and 303 BC.\textsuperscript{57} According to Sec. 109 (c) (4) BC, the declared ambition of the application must be to draw and implement a plan for debt restructuring. This must be evident in the application. This is to ensure that the Chapter 9 proceedings is sought solely for this and not for other reasons.

Another requirement for a permissible application is stated in Sec. 109 (c) (5) BC by way of a set of requirements, which, however, must only be alternatively met. The first possible condition is the approval of a simple majority (measured by the debt volume) of each class of creditors affected by a bankruptcy plan within the meaning of Chapter 9. Since the debt restructuring under Chapter 9 will be mostly associated with debt waivers, it is hardly surprising that this possibility is in practice hardly significant. If such consent, therefore, cannot be achieved, the municipality must have seriously and honestly tried to work out a extrajudicial plan to organize the debts with the creditors in a preliminary negotiation, or credibly demonstrate that such a preliminary hearing is impractical.

Another way to initiate the procedure without requiring the consent of the majority of the creditors is the reasonable assumption of the municipal debtor, that a creditor is seeking an impermissible favoritism of his claim, for example by the transfer of rights in rem. This is to ensure that the process of Chapter 9 is taken only as a last resort, having exhausted all less restrictive measures, including extrajudicial solutions.

In addition, the applicant must be authorized by law or specific consent of an authorized public official of the particular state to submit a debtor to the proceedings of Chapter 9 - here is the crucial link between the Bankruptcy Code as federal law and relevant regulations of the individual states.\textsuperscript{58}

Material condition for the initiation of the proceedings is the insolvency of

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\textsuperscript{57} 11 USC § 303(a) (limiting involuntary petitions to cases under Chapter 7 or 11).
\textsuperscript{58} There are several models: While some states expressly deny the municipalities to apply by law, there are other states that have explicitly allowed it. In the majority of cases, however, the consent of the individual state must be obtained prior to application, cf. J Cohen, Declining health of U.S. Cities raises new interest in chapter 9 (1991), National law journal, 15 et. sqq.; EW Lam, Municipal Bankruptcy: The Problem With Chapter 9 Eligibility— A Proposal to Amend 11 U.S.C. § 109(c)(2), 22 Ariz St L J 625, 631 et. sqq.
\end{flushleft}
the municipal debtor. The decisive criterion for this is the so-called "cash flow insolvency test". Thus, it is necessary that the municipality either is not able to pay current (undisputed) liabilities by due date or can not pay future liabilities, Sec. 109 (c) (3) BC in connection with Sec. 101 (32) BC. Unlike other proceedings, the indebtedness is therefore neither necessary nor an independent cause for insolvency. This means that already with regard to the insolvency cause, some access restriction is made. If the borrowing possibilities are not exhausted completely and are therefore liquidity constraints not to be expected in the near future, the initiation of the Chapter 9 proceedings is not possible. This means that a more or less abstract threat of insolvency cannot be considered as an insolvency reason.

b) Consequences of the Initiation

If, in accordance with Sec. 921 (c) and (d) BC, the proceedings are initiated by the bankruptcy court of the relevant judicial district, the already mentioned "automatic stay" occurs by law (Sec. 362 BC in connection with Sec. 922 BC). This “automatic stay” causes an extensive standstill of the proceedings and thus makes the simple enforcement of creditors into insolvency assets impossible. This is one of the key legal consequences of the approved application and fulfills a double protection function: the debtor is at least temporarily relieved from the (impending) access of creditors and gets the necessary time to develop a corresponding insolvency plan. But also the body of creditors is protected from access by individual creditors into the debtor's insolvency assets.59

Despite the opening of proceedings by the court, the supervision of the debtor remains with the particular state. In addition, the court may not intervene without the consent of the municipal entity in its political responsibilities or powers of administration, its assets or its income, cf. Sec. 90360 and 90461 BC.62

59 For more details compare Tung, 53 Hastings L.J. 885, 893 - 894.
60 § 903. Reservation of State power to control municipalities
This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such
Unlike Chapter 7 or Chapter 11, there is no setting up of a “trustee” or external auditor. The municipal debtor must therefore continue to manage its assets itself and shall also be entitled to continue to incur debts, Sec. 364c BC et. sqq.. The court, which plays a central role in the proceeding under Chapter 7 (liquidation) or Chapter 11 (reorganisation process) has in the Chapter 9 proceedings only a very limited room for maneuver.63

In court, it remains to monitor the maintenance or withdrawal of executory contracts of the debtor, to monitor the compliance of a possible new indebtedness with existing standards and debt rescheduling agreements, and especially to agree to the debt settlement plan submitted by the municipality and to monitor or reject it. Finally, the court retains jurisdiction through the termination of the proceedings.

c) Insolvency assets

A key question also for insolvency under Chapter 9 is which assets are insolvency assets. This is not clearly defined by law, because Sec. 901 BC does not refer to key provisions Sec. 541 – 543 BC in this regard. By contrast, Sec. 902 (1) BC, however states, that the assets of the municipal debtor are insolvency assets in the Chapter 9 proceedings. In the first instance all the assets of the debtor seem to be available for liquidation.

However, limitations arise primarily from the extensive case law. Here, a
distinction is made between generally available assets, related to the economic activity of the municipality and generally unavailable assets, which are dedicated to the public functions and activities. This differentiation is based on the objective of the Chapter 9 proceedings: the debtor should be offered the possibility of debt adjustment while maintaining its public functions. Thus, in practice, only those assets are available that cannot be associated with a public interest or public use.

In addition, the municipal debtor remains almost fully in control of the proceedings under Chapter 9. He elaborates the insolvency plan, and thus sets - within the specified limits - even the framework for the available assets. The possibilities of exercising influence of the creditors, but also of the court, are very limited. For that reason, the liquidation of assets, which serves the public exercise of functions, is virtually eliminated.

d) Insolvency plan

“The heart of the Chapter 9\textsuperscript{64} proceedings is the so called „insolvency plan“- or more precise - the debt adjustment plan. A total of eight rules of the Chapter 11 proceedings will be applied (cf. Sec. 901 BC) and are concretised or adjusted to the specific needs of a municipal insolvency proceedings by Sec. 941 to 946 BC. Comparable to the Chapter 11 plan proceedings, the proceedings are divided into three phases by Chapter 9: Elaboration of the plan, vote by the affected creditor groups and finally the confirmation by the court.

The right of initiative, as previously mentioned, remains with the debtor, Sec. 941 BC. It thus is an exclusive right of the municipal debtor. In addition, the municipal debtor has considerable more time to prepare the reorganisation plan, as is the case in the Chapter 11 proceedings. The municipality can also carry out any amendments until the confirmation of the plan, Sec. 942 BC. The inclusion of creditors in the elaboration of the plan is provided at no time; however, the plan must meet certain procedural and substantive requirements that result from the applicable standards of Chapter 11 and special standards of

\textsuperscript{64} McConnell / Picker, 60 U. Chi. L. Rev. 425, 463.
Chapter 9.65

The creditors who are affected by the plan draft of the municipality must be divided into groups according to similar claims. The result of this classification is that all claims are treated equally within the same group, except the affected creditor agrees expressly to different treatment with a negative impact, Sec. 1123 (a) (3) and (4) BC. In the same groups then, the vote on the insolvency plan prepared by the municipality is carried out. The group formation is a crucial element in the insolvency plan and thus for the success or failure of the entire Chapter 9 process, cf. Sec. 1122-1124 BC. Before the plan is confirmed by the court, it is to be submitted to the creditors together with a so-called "disclosure statement" for a vote, cf. Sec. 1125 BC. The latter refers to a written disclosure of the financial circumstances of the municipal debtor which serves the creditors to form an opinion with regard to the voting on the insolvency plan. The successful vote on the plan, which takes place only within the respective groups, and requires, in accordance with Sec. 1126 (c) BC generally, the approval of a simple head majority and a sum total majority of two thirds of the creditors.

The confirmation of the plan by the court in accordance with Sec. 1129 (a) (8) BC generally requires the approval of all creditor groups. However, the consent of individual groups of creditors - under certain conditions - in accordance with Sec. 1129 (b) BC can be replaced by the court. These are the so-called cram-down powers of the court. First of all it is necessary that at least one affected group has agreed to the plan (Sec. 1129 (a) (10) BC) and that the plan does not contain "unfair discrimination" of a certain group. It has to be "fair and equitable". This competence includes, on the one hand, the largest influence of the court within the Chapter 9 proceedings and leads on the other hand to considerable losses and risks of the relevant creditors.

65 The municipal debtor controls the plan and has the exclusive right to file it, McConnell / Picker, 60 U. CHI. L. REV. 425, 463.
66 S Pryor, "When doing less is doing best", 88 Am. Bankr. L. J. 85, 114 et seq. (hereinafter Pryor, 88 Am. Bankr. L. J. 85), examines some crucial bankruptcy confirmation issues: What protections do the two requirements of "fair and equitable" and no "unfair discrimination" and the mandate of "best interests of creditors" provide for creditors? And what does it mean that a municipal plan of adjustment must not propose actions prohibited by law? Finally, what should the court do when these requirements collide?
If the plan has the approval of all creditor groups, or has been replaced by the court in the sense of the "cram-down power" in particular cases, and the plan does not violate applicable law, Sec. 943 (b) (7) BC requires as a last condition for the certification by the court, that the plan is “feasible” and in the “best interest" of creditors. The latter condition is primarily used to ensure a minimum standard for the protection of the outvoted within a group of consenting creditors.

In contrast to the Chapter 11 proceedings in which the rate from a hypothetical liquidation proceeding is taken as a yardstick for the "best interests tests", the creditor should not be subjected to worse conditions under the terms of the reorganisation plan than when performing a liquidation proceeding. The rule of thumb in the "best interests test" in the Chapter 9 proceedings is that all creditors must be paid as much as can be expected under the certain circumstances. This specific nature of the Chapter 9 proceedings lies in the fact that the liquidation of a municipal debtor is excluded from the first. Therefore a hypothetical liquidation quota is hardly detectable and comparison in this regard makes little sense. Thus the "best interests test" in the course of the Chapter 9 proceedings includes a proportionality test in the discretion of the court under consideration of the specific interests of the creditors and the debtor. The insolvency plan is also feasible and therefore realistic if the municipality presumably can make the specified payments to the creditors without sacrificing the necessary exercise of public functions.

The court must confirm the plan if it corresponds to the conditions set forth herein, Sec. 943 (b) BC. It is then for the debtor and all creditors, including those who have not agreed to the draft plan, to make it binding (Sec. 944 (a) (3) BC). If the court, however, vetos the draft plan and does not confirm it, the proceeding is terminated, and the debtor must, as far as he is willing to do

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69 For a detailed description of the plan confirmation compare JM Moringiello, “Chapter 9 Plan Confirmation Standards and the Role of State Choices”, 37 Campbell L. Rev. 72, especially 76 et. sqq. (hereinafter Moringiello, 37 Campbell L. Rev. 72).
so, submit a modified or new plan.

e) Discharge of residual debt

According to Sec. 944 (b) BC, discharge of residual debts of the debtor of a Chapter 9 proceeding requires, in addition to the confirmation of the insolvency plan by the court, that the debtor deposit all that is to be distributed under the plan at a authorized representative selected by court. The court then determines that the securities provided by the debtor are sufficient and provide legally binding precautions for payment or for securing the payment. After the discharge, the court shall exercise its responsibility as long as it is necessary to successfully implement the insolvency plan, Sec. 945 (a) BC. According to Sec. 945 (b) BC, it terminates the process by order, if the implementation of the insolvency proceedings is completed.

3. Summary of Procedural aspects

As been shown, the Chapter 9 proceedings - different than the purpose of the reorganisation proceedings under Chapter 11 – are not first and foremost dedicated to the achievement of a consensus between debtors and creditors. Rather, the numerous discrepancies in the procedural rules in Chapter 9 ensure that the special needs of the municipal debtor come to the fore. The aim of the Chapter 9 proceedings is therfore the financial rehabilitation of public debtors, coupled with the ongoing maintenance of the fulfillment of their necessary public duties. The ensuring of a balance between the legitimate interests of both parties is not in the focus anymore. In other words, in many cases, the creditor must cut back so that the independent nature of the municipal debtor which is to remain intact even during the bankruptcy proceedings can be guaranteed.
III. Chapter 9 as a model for other jurisdictions

As already indicated in the introduction, these days the question that arises in a variety of countries is whether municipal bankruptcy in general and the Chapter 9 proceeding in concrete actually represents a sensible policy for dealing with the difficulties of distressed municipalities. In other words, can municipalities benefit from filing in the same way that commercial corporations and private citizens do? The prevailing answer to this question, at least in the American, but also in non-American legal literature, seems to be yes. Scholars that address this issue increasingly in recent years tend to focus on municipal bankruptcy as the remedy for local fiscal crises. Some scholars criticize the current Chapter 9\(^{70}\), while others take a more favorable approach, but the underlying assumption of this article is that municipal insolvency should be dealt with through bankruptcy law.\(^{71}\)

1. Semantic Preamble - From Insolvency to “Resolvency“

a) The Stigma of Bankruptcy

Particularly in times of financial and economic crisis the Insolvency Law received steadily increasing attention not only in research and practice, but also in public. This is accompanied by a flood of modernization proposals in the orbit of the existing insolvency law, as well as with regard to the municipal insolvency discussed here. But supposedly progressive reform efforts must not obscure that the insolvency law regularly emerges as a return to old legal concepts with a new look. This is why the present case is important because traditional notions

\(^{70}\) Significant criticism in American Literature of Chapter 9 has been in recent years that the burden of municipal restructuring had been mostly borne by the citizens and especially the municipal employees. In particular, they had to suffer massive pension cuts in many processes in the course of the insolvency plan. However, this criticism will not be discussed in more detail below, as this seems to be a uniquely American problem that is less anchored in the structure of Chapter 9 proceedings, but rather in its practical application in individual cases. For a more detailed presentation, see in particular: Beermann, 41 Fordham Urb. L.J. 999.

\(^{71}\) Kimhi, 27 Yale J. on Reg. 351, p. 2.
often have the stamina to block innovation experiments permanently although they work towards the public welfare. In effect, this is the talk of the psychological phenomenon of the "stigma of bankruptcy".\textsuperscript{72}

Notwithstanding any remedial options, which the bankruptcy law now provides, the term of bankruptcy is a taboo, at least in the European context, not only with regard to public authorities, because presumably it is still flawed. In the context of an impending insolvency, the view has always been addressed on the economic failure of the debtor and the impending loss of demand of creditors, but the possibility of a fresh start is, if at all, only second in line.

In the course of time, the associated, internalized, moral condemnation of insolvency can thereby be demonstrated with examples from the literature, but also in actual legal rules and events in the past and present. A current example here also represents the Greek crisis and the subsequent efforts to establish a permanent protection shield for over-indebted European countries and the intensification of the EU stability pact. In this context, the German government under Angela Merkel, as already mentioned, demanded in the first instance a international insolvency / bankruptcy procedure for states. Half a year later, the government only referred to this approach as a "crisis mechanism" that should allow an orderly debt settlement and settle the liability and private creditors in the event of bankruptcy.\textsuperscript{73} Ultimately, they wanted to establish an insolvency proceeding in a broader sense, but apparently that term should be avoided at all costs.

In the private environment, the "stigma of bankruptcy" even to this day often means that, as prominent examples prove, insolvent debtors often see no other choice than to commit suicide because they sense their bankruptcy as a

\textsuperscript{72} For a detailed discussion of the development of the „stigma of bankruptcy“ and its development within the Insolvency law refer to Hoffmann, The orderly insolvency of territorial entities using the example of German municipalities, p. 212 et. sqq. \textsuperscript{73} "And we all are ready, including Germany, to say that we now need a permanent crisis mechanism to protect the euro" The Washington Post (25/11/2010), available at http://www.washingtonpost.com/wp-dyn/content/article/2010/11/25/AR2010112503663.html (last accessed: 20/5/2015).
libel. They consider themselves to be stigmatized.\textsuperscript{74} The economic death was and is, shockingly, still often at the same time the social death because it leads in many places, at least perceived subjectively, to condemnation of the debtor and his family.

Ultimately already the etymology of the word "bankrupt" clarifies almost metaphorically the moral stigma associated: The term (Italian: banca rottta, "broken or empty bank") is from the moneylenders or moneychangers in medieval northern Italy.\textsuperscript{75} These sat on Sundays in front of the church on small benches and actuated their financial transactions. Could one of those moneylenders not make his payments anymore, his bank was broken, this was then consequently a "banca rottta". So the shame of the moneylender was publicized and demonstrated that he was no longer allowed to operate on the market from now on.

It is not incomprehensible that over a long period of time, the obvious reaction to the refusal of performance of the debtor was punishment. After all, he had not kept his promise to pay. Therefore it is also hardly surprising that the debtor once had no rights. This is especially expressed in the Roman Twelve Table law dating back to 451 BC:

"\textit{When a debt has been acknowledged or a judgment has been pronounced in court, 30 days must be the legitimate grace period. Thereafter, arrest of the debtor may be made by the laying on of hands. Bring him into court. If he does not satisfy the judgment (or no one in court offers himself as surety on his behalf) the creditor may take the debtor with him. He may bind him either in stocks or fetters, with a weight of no less than 15 lbs. (or more if he desires).} [After 60 days in custody, the case is returned to the court, and if the debt is not then paid, the debtor can be sold abroad as a slave, or put to death.]\textsuperscript{76}"

Therefore, it should not be underrated that it is considered a great achievement of

\textsuperscript{74} For Example Paul Bhattacharjee, who starred in James Bond film Casino Royale and EastEnders, was declared bankrupt just days before he took his own life at cliffs in East Sussex. “He was also a "proud" man who would not have wanted the bankruptcy becoming public knowledge, his partner Emma McKie said.”, The Telegraph (14/11/2013), available at http://www.telegraph.co.uk/news/10449893/James-Bond-actor-Paul-Bhattacharjee-declared-bankrupt-before-suicide.html (last accessed: 20/5/2015).

\textsuperscript{75} Online etymology dictionary www.etymonline.com (last accessed: 20/5/2015).

\textsuperscript{76} Table III. 1. The Twelve Tables are earliest attempt by the Romans to create a Code of Law.
Roman law 350 years later that it moved from the personal execution on to the real execution and thus averted the primary act of revenge and instead moved the access to the assets to the fore. Thus the first breakthrough for modern insolvency law was the so-called "missio in bona".\footnote{Missio in bona - in Roman law was a judicial form of foreclosure, better known as missio in possessionem.}

But the revenge aspect has not yet been completely removed, because the imposition of „infamia“, the social ostracism, was connected with the implementation of bankruptcy proceedings. Thus, the insolvency was still per se a criminal behavior because the debtor had disparaged himself by supposedly bad economies regardless because of his fault or because of bad luck and therefore innocent. This very personal „infamia“ is to this day - albeit mostly only subconsciously perceived – the "stigma of bankruptcy" which was found to modern times in almost all insolvency laws.

At the time when Christ was born the "cessio bonorum", i.e., the ability of the debtor to be released from „infamia“ by voluntary surrender of all goods had been introduced. However, the result was not necessarily a reduction of scorn. Thus, at least a scorn attribute usually was not waived - be it the obligation to appear naked in public at a city’s famous place to announce the assignment of his property, or by wearing a green or white cap or by the order, to appear bareheaded and with completely open clothes before the judge.

The "stigma of bankruptcy" persisted. Whoever could not satisfy his creditors, for whatever reason, was widely equated with an impostor: "Fallitit sunt et deceptores fraudatores". Accordingly, for instance, the Augsburg criminal code from 1571 imposed extensive humiliations and thereby gives testimony about the general view of the time, according to which the mere fact of bankruptcy proceedings is slanderous:

"Who is in bankruptcy, must go at the end of funerals and weddings and must be placed next to the women or remain at home."

In the 19th century, the strict medieval mores gave way to a refined type
of penalty. The merging of insolvency and fraud was abandoned in favor of a moral evaluation, but it still revealed the "stigma of bankruptcy" and called on the honor of an honest businessman:

"(...) that any insolvent businessmann the full enjoyment of civil and political rights should be denied until he has reached a formal rehabilitation, caused by the complete satisfaction of his creditors. This view is deeply rooted in the conditions of the trading class. Every honest trader will feel complained in his conscience and will consider its reputation to be impaired as long as he has to carry the consciousness to have failed to fulfill its obligations. The punctual payment of any debt liabilities is the essential condition of the personal loan and this in turn is one of the main foundations of commercial honor; Both requirements are necessary shaken by the outbreak of bankruptcy. "78

b) The paradigm shift

It is hardly surprising that in view of such a constant tradition of condemnation, an at least psychological stigma of insolvency is still mentioned today, which is not conducive to the evaluation of a municipal bankruptcy in the first place. In the Middle Ages, bankruptcy had shameful and slanderous consequences, even earlier, life and limb-threatening consequences. Just 100 years ago the debtor - at least in Europe – had to face within the legal system an expressly laid defined, moral disapproval.

Although the present legal system usually refrains from a moral assessment of insolvency, it is still common among the widespread population to avoid a bankrutcy scenario at all costs because of this traditional stigma. The remedial options of insolvency proceedings often disappear in today's stigma of bankruptcy and attract scant interest. It is even more interesting in this context that the relevant discussion in the insolvency law is dominated for years by the question of a particular debtor's friendly redevelopment option as part of the

78 Explanatory statement to the Prussian Bankruptcy Act of 8 May 1855 which was the model for the German Bankruptcy Act until 1998.
orderly bankruptcy, and in this context a new "Insolvency culture" or a "change of mentality" is required to see the mechanisms of insolvency law even more as an opportunity for a fresh start. For quite some time the bankruptcy procedure itself has had no prescribed method of personal discrimination or even punishment yet social stigma still remains.

A more drastic paradigm shift seems scarcely conceivable - from ostracism and draconian punishment towards the rescue and reorganization of the debtor. Therefore, the Insolvency Law is in development towards an economically oriented, independent method for an economically meaningful cleanup of insolvency. The fear of contact with bankruptcy reorganisation is unfounded. It is instead a chance and opportunity for a "fresh start". Specifically, this means the opportunity to shed ballast and to change outdated structures. The suspected effects of bankruptcy as a "death penalty of civil law" at the beginning of the 20th century, which destroyed the economic survival of the bankrupt in a legal way of bankruptcy, are no longer true in today's Insolvency law. Rather the Bankruptcy initiates now the possibility of a "process of creative destruction".

Noteworthy in this regard are the historical reasons for the emergence of alternative rehabilitation under Bankruptcy Law. The crucial factor for that was not a well-intentioned altruism of creditors towards the debtor, but simply the recognition that in many cases, the liquidation of the debtor's assets was not profitable and that the reorganisation of the debtor could be for creditors' benefit. At this point, a quick look into the past is worthwhile again. As noted above, the Roman Emperor Augustus enacted at the beginning of the 1st century the Lex Iulia, which - first of all - gave the Senators the opportunity by the "cessio bonorum" to escape from "infamia", despite bankruptcy. The liberation of the senators from the stigma of infamy allowed them to remain Rome as senators. Apparently, Augustus could no longer afford to lose senators because of the social ostracism of bankruptcy. A trigger for basic insolvency law changes to protect the debtor is so often the mundane fact that the unreflective use of conventional mechanisms can no longer be afforded.

It remains that "insolvency" or "bankruptcy" in no way means that the
municipal authority bows out of the exercise of public functions. The orderly, scheduled bankruptcy under Chapter 9 is intended primarily to disarm the (financial) existential threat of local authorities as a responsible body of state tasks.

c) From liquidation of the debtor's assets to the debtors restructuring

The bankruptcy was dominated for centuries by the liquidation, i.e., the destruction of the debtor's assets and the payment of creditors from the sale proceeds. Even if the creditor today decides to take the road of liquidation of the debtor's assets, the liquidator shall continue the task of selling the debtor's assets and distributing the sale proceeds as part of the statutory order to the creditors. A main objection to the application of insolvency legislation on legal persons of public law in general, and local authorities in particular, and thus decisive argument for the non-insolvency ability of those entities, is consequently always that the insolvency proceedings are aimed at the liquidation and termination of the (economic) existence of the debtor. This conclusion contradicts the public interest of the municipalities, because the local authority can no longer fulfill its public duties after liquidation. Thus, bankruptcy is not a solution for distressed municipalities in the form of the liquidation proceedings.

But this objection is unfounded because of the current possibilities of insolvency proceedings and especially in view of the specific form of Chapter 9 proceedings. Rather, the main objection against the implementation of legal regulations on insolvency for insolvent public authorities - the State cannot be liquidated – is now largely pointless.

The initial situation which always underlies insolvency law remains unchanged. There is a debtor and at least one creditor who cannot be satisfied by the former. Ostensibly, the next closely associated reaction pattern is always the access to the debtor's assets and its liquidation or utilisation for the purpose of subsequent distribution of proceeds among the creditors. The possibility of liquidation of insolvency law is therefore the vanishing point of the mentioned
stigma of bankruptcy. There is the scenario manifested that describes the economic and sometimes social Exitus and should therefore be avoided as far as possible. But in addition to the process of the liquidation of the debtor’s assets, there also occurs the ability to reorganise the debtor. Creditors should be given the option to not just attain at least proportionate satisfaction of their claims by the mere liquidation of the debtor’s assets, but to bring the debtor back to a successful market participation. In addition, the honest debtor is given a chance to get rid of its remaining liabilities. Thus insolvency proceedings are now also in the interests of the debtor. For centuries, insolvency law was almost only about the ostracism and punishment of the debtor, but nowadays, the attention that comes to the fore is how insolvency law can assist the debtor in the restructuration - a more comprehensive paradigm shift is hard to imagine.

The reorganisation of the debtor in the US was first established in the mid-19th century. Decisive at that time was the financial incapacity of some railway companies. The state was so dependent on these companies that a simple liquidation was not possible. Consequently, it allowed them a debt adjusted restart.

Today, the possibility of bankruptcy reorganisation in a private legal environment proves particularly in the tertiary sector, i.e., the service sector, as a blessing. In the event of insolvency, there can be found little assets for liquidation. Typical values of the tertiary sector as expertise, customer base or social skills are very tied to the persons concerned so that it can be difficult to quantify and even more difficult to sell. The creditor is therefore not helped with a mere liquidation, but the debtor must be given the opportunity, to successfully participate again in the economy.

A relevant aspect of the proceedings is then usually the reorganisation of the debtor. In this way, the prospect is opened that the previously stigma afflicted insolvency can be used as a chance for remediation. By no means does this require an altruistic demeanor of the creditors, since the rehabilitation of the financially stricken debtor is in their own economic interest. Thus, the private law practice and the Chapter 9 proceedings evolved a mechanism in the event of economic impossibility to satisfy all claims and to minimise the losses of all
those involved.

2. Experience with the mechanisms of the Chapter 9 procedure

There is very extensive experience with the insolvency of sub-national authorities/municipalities under the regime of Chapter 9 of the Bankruptcy Code. Since 1937, approximately 550 cases have been documented, only half of which occurred in the years 1937-1950. Until 2008, relatively few municipalities had to choose the path of debt discharge on the Chapter 9 proceedings (2006: 5; 2007: 6; 2008: 4), however, the economic and financial crisis of 2008 increased the usage of these proceedings by the American municipalities.

The causes for municipal insolvency in the United States were and are multifarious. They range from inept financial management, lack of government control, financing from unreliable sources of revenue and changes in the economic environment to political and general social factors. Equally diverse are the consequences of illiquidity and thus the trigger of the Chapter 9 proceedings. One municipality was not able to execute their required pension payments, the other no longer had sufficient resources to finance the police - not even enough emergency personnel was available. Although municipal crises are usually distinguished by slow and steplike economic degeneration, municipal bankruptcy filings were also often caused by a one-time sudden exogenous event.\[^{79}\] This event created a solvency problem that finally resulted in bankruptcy. “In many cases, the event that led to the filing was simply the loss of a large lawsuit. The locality did not have the resources to pay the awarded damages and had to file for bankruptcy”.\[^{80}\]

Interestingly, in the past most of the municipalities that did file for Chapter 9 were very small. The average size of those municipalities was about 1000 residents, and most of the municipalities that filed had less than 10,000 residents. Although larger cities, including metropolises such as New York, Miami, Philadelphia, and Washington, D.C. also experienced serious financial

\[^{79}\] Kimhi, 27 Yale J. on Reg. 351, 360.
\[^{80}\] Kimhi, 27 Yale J. on Reg. 351, 360.
problems, with a few notable exceptions, such as Orange County, they did not file for bankruptcy.\footnote{Kimhi, 27 Yale J. on Reg. 351, 360.} Municipal bankruptcy seemed to appeal more to small towns than to the average or large city.\footnote{R Jeweler, Cong. Research Serv., RL33924, Municipal Reorganization: Chapter 9 of the U.S. Bankruptcy Code 1-2 (2007); Kimhi, 27 Yale J. on Reg. 351, 360.} As mentioned in the introduction that phenomenon changed in recent times. The past few years have seen a drumbeat of bankruptcy filings of average and large cities: Jefferson County, Alabama; Central Falls\footnote{Just fourteen months after Central Falls petitioned a bankruptcy court for protection under chapter 9 it emerged from bankruptcy. That has been described as possibly the fastest Chapter 9 proceeding in U.S. history, M O’Brien Hylton, “Central Falls v. bondholders: Assessing fear of contagion in Chapter 9 proceedings”, 59 Wayne L. Rev. 525, 525 (hereinafter O’Brien Hylton, 59 Wayne L. Rev. 525).}^{83}, Rhode Island; Harrisburg\footnote{O’Brien Hylton, 59 Wayne L. Rev. 525, 547 et. sqq.}^{84}, Pennsylvania; Stockton, California; and San Bernardino, California. In other words, a flurry of Chapter 9 filings, with the case of Detroit as a temporary peak, called this apparently settled wisdom into question.\footnote{Skeel, 50 Hous. L. Rev. 1063, 1064; JM Moringiello, “Goals and Governance in Municipal Bankruptcy”, 71 Wash & Lee L. Rev. 403, 407 (hereinafter Moringiello, 71 Wash & Lee L. Rev. 403).}

3. Chapter 9 as component of a comprehensive municipal financial recovery plan

Scholars who have written about municipal bankruptcy in the past twenty years often “approach Chapter 9 and state intervention in municipal financial affairs as alternatives rather than complementary components of a comprehensive municipal financial recovery plan”.\footnote{Moringiello, 71 Wash & Lee L. Rev. 403, 408.} From that point of view, as Moringiello mentions, they compare Chapter 9 especially to Chapter 11, and then conclude that because Chapter 9 does not contain all of the Chapter 11 checks on debtor behaviour, it cannot adequately promote the financial rehabilitation of a sizable general-purpose municipality and is thus an unrequested alternative to a state intervention. This approach disregards the original aim of Congress in enacting a municipal bankruptcy law after the Great Depression.\footnote{Moringiello, 71 Wash & Lee L. Rev. 403, 408.}
Moringiello argues, that when Congress passed the predecessor to Chapter 9, it did so in order to bring together two sovereigns, the state and the federal government, to achieve the imposition of a plan to adjust municipal financial liabilities that would be binding on all creditors of the municipality, wherever located. Chapter 9 bankruptcy therefore was designed to supplement, not to replace, state financial intervention plans. 88 Constitutional concerns, coupled with municipal bankruptcy's original limited aim of solving the holdout problem, explain the essence of Chapter 9. As Moringiello mentions, Chapter 9 limits the control that a federal court can exercise over a municipality, and the Contracts Clause limits the ability of a state to force a creditor of a municipality to accept less than what it is owed. 89 “As a result, although today's Chapter 9 is modeled more closely on Chapter 11 than were its predecessor statutes, it lacks many of the elements of Chapter 11 that give creditors some control over the debtor.” 90

The framework of Chapter 9 seems to grant the public authorities of a municipality in Chapter 9 exclusive control of the municipality’s future fortune. This and no more is the objective of Chapter 9 proceedings. By contrast, this should not and cannot alone afford the Chapter 9 municipal finances extensive refurbishment. Chapter 9 was never designed to provide a extensive scheme to solve (structural) municipal financial problems. It was in fact designed to supplement state endeavours to solve those problems. A municipal insolvency proceeding doesn’t have more options because it can only react to individual municipal financial difficulties. For that reason, Chapter 9 does indeed anticipate reorganisation governance over a municipal debtor, but in the hands of the state, not in the hands of a bankruptcy court or under the influence of the creditors. 91 “Chapter 9 may only be as effective as each state's plan for municipal fiscal oversight. This conclusion does, however, allow researchers and policy makers to focus on the role of each state in developing an effective mechanism to not only resolve the financial distress of its municipalities but

88 Moringiello, 71 Wash & Lee L. Rev. 403, 408.
89 Moringiello, 71 Wash & Lee L. Rev. 403, 408.
90 Moringiello, 71 Wash & Lee L. Rev. 403, 408.
91 Moringiello, 71 Wash & Lee L. Rev. 403, 408.
develop sensible structures for their municipalities going forward. This mechanism should include both robust state oversight and the safety valve of Chapter 9 if necessary to overcome holdout creditors.  

Therefore, the criticism is unfounded when some scholars deny effectiveness and meaningfulness of a insolvency proceedings for municipalities in general or the Chapter 9 proceeding in concrete terms, because it cannot solve (structural) municipal payments crises. The Chapter 9 process is in fact not designed to do this alone. Rather it is and it must be part of a comprehensive mechanism for ensuring a (structural) municipal sound financial situation. In the opinion of the author, this is imperative.

4. Singular debt settlement vs. Long term reorganisation

Omer Kimhi asks: „Bankruptcy no doubt helps the city with its short-term liquidity problems, but does it present a viable solution for dealing with fiscal problems of municipalities? He answers that question with a resounding "No", because the corporate bankruptcy process, on which municipal bankruptcy is based, is designed solely to address the problems of financially, as opposed to economically, distressed debtors. He argues that Chapter 9 can’t provide a cure for the problems of distressed municipalities.

Municipal corporations are designed to supply public goods. They provide essential services to their residents (services such as police and fire protection, education, and water and sewage), and the provision of these services must continue even when a locality is facing serious financial difficulties. In his opinion, it is the residents’ right to receive adequate services from the government, and this right persists notwithstanding a local fiscal crisis. From this he concludes: First, it is in the context of insolvency proceedings hardly possible to liquidate assets of the municipality, because it is mandatory for the exercise of public functions. Second, the exercise of public functions can be guaranteed only if the structural and socio-economic reasons of local financial

92 Moringiello, 71 Wash & Lee L. Rev. 403, 485.
93 Kimhi, 27 Yale J. on Reg. 351, 375.
difficulties are solved. Local authorities regularly don’t have to face self-inflicted financial difficulties, because they simply meet their public obligations and functions. However, this problem can not be solved by the Chapter 9 proceedings; rather, it is a purely short-term mechanism to restore the solvency of the municipality. For that reason, he argues that only a proactive supervision system of local finance by the state can help rehabilitate distressed municipalities, and, even more importantly, it can help prevent local fiscal problems from becoming a crisis. In order to efficiently supervise local finances, the state should evaluate the localities’ condition on an ongoing basis. To the extent the state concludes that a certain locality has entered into financial distress, it then creates a special state board that monitors the distressed locality more closely. The board, comprised of several state representatives, prepares a rehabilitation plan that includes both actions on the part of the locality (in particular, cost cutting) and actions on the part of the state (such as tax reforms or state aid). The board then follows the implementation of the plan, and if the process is successful, the city will be able to recover.94

He points out that unless otherwise stipulated in the state’s constitution, the state can take any action with regard to its local governments, whereas the municipalities have only those competences delegated to them by the state. These state powers, combined with the fact that the state controls a larger geographical area than each of its cities, enable the state to better address the problems faced by cities.

However, it must be noted here that Kimhi drastically underestimates the influence of local political reasons for the financial situation of municipalities. Additionally, he is mistaken when he says that the entire municipal assets are not recoverable, since this serves solely mandatory and rational public functions. Internal political circumstances play a dominant role regarding the financial situation of almost every distressed municipality. Quite often reckless and sometimes even corrupt politicians implement unwise financial and accounting practices, which eventually result in financial calamity.95

94 Kimhi, 27 Yale J. on Reg. 351, 385 et. sqq.
95 Joan K. Martin, Urban Financial Stress: Why Cities Go Broke (1982), p. 129 (underlining the
Although many assets can not be liquidated in the course of municipal bankruptcy, this does not apply to all assets. Therefore, as mentioned above, the Chapter 9 proceedings differentiate explicitly in this aspect. Last but not least, there is a major constitutional and democratic problem with a proactive supervision system – and Kimhi mentions this problem without solving it: The coin with which the municipality pays for the state supervision is a temporary loss of its local autonomy due to the state's intervention in its local affairs. During the time a board is in place, the locality must comply with the board's instructions, and the local officials may be prohibited from taking certain actions. The infringement on the local autonomy is particularly problematic – and that seems to be not acceptable from a democratic point of view - because the board members are nominated and not elected by the residents. The board members are not politically accountable to any constituency, and are not required to respect the residents' constitutional rights and the correspondent duty of the municipal for public goods and services.

Thus, Kimhi is correct when he sends a reminder that structural problems in municipal financial resources need to be addressed, but this does not automatically deny the Chapter 9 proceedings its right to exist and its capability for a constitutional recovery of a disstrressed municipality. Instead, it can and must go hand in hand with broader reforms and the resolution of socio-economic difficulties.

5. Can insolvency proceedings solve political problems?

Some scholars argue that “bankruptcy is poorly designed to solve political problems”. They worry that bankruptcy law invites serial bankruptcy filings without facing the real problems of the municipality. There definitely is an importance of local managers’ accounting manipulations of the local fiscal situation). Camden, New Jersey provides a good example. Three out of the five mayors whose terms preceded Camden's bankruptcy faced legal problems while in office (or soon thereafter), AM Vassallo, “Note, Solving Camden's Crisis: Makeover or Takeover?“, 33 Rutgers L.J. 185, 190 n. 31.

Skeel, 50 Hous. L. Rev. 1063, 1071

97 AJ Levitin, Fiscal Federalism and the Limits of Bankruptcy, 214, 214. (in When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis 191 (Peter
element of truth to this objection. The capacity of a insolvency proceeding to restructure a municipals public operations is limited. Chapter 9 cannot displace municipal executives or dictate municipal public policy. But this does not implies that an insolvency proceeding has no effect. In other words, the possibility that insolvency proceedings might not always solve the municipal’s stress is not a good argument to forego its use at all.

Even if Chapter 9 cannot solve a political crisis, it helps to come up against some structural problems in municipal finance. “One obvious political dysfunction is the tendency to over-rely on borrowed funds. Borrowing enables politicians to spend the money in the short term - often on a popular project - while deferring the costs to the future. If bankruptcy increases the likelihood that a municipality will restructure its obligations and decreases the likelihood of a federal bailout in the event of severe financial distress, it could counteract politicians’ short-term incentives on the margin.”

The mere existence of municipal insolvency proceedings changes the behavior of lenders, which impacts on lending, collateralisation and interests, as the lender must expect a certain risk of default of the granted credit. The immediate consequence is that borrowers have to pay higher interest with gradually increasing debt and will not get any new loans in the more extreme cases. These instruments of interest increase and credit rationing is not the expression of a market failure, but rather disciplinary mechanism for otherwise irresponsible acting borrowers. Debt financing would be slightly more expensive, which would alienate its use, especially as municipal fortunes declined.

Municipal debtors have the chance to present themselves in good shape on the

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99 Skeel, 50 Hous. L. Rev. 1063, 1072.
100 RB Pollard, "Bankruptcy and beyond: Exploring the causes of and solutions to municipal financial distress: Feeling insecure – As state view of wether investores in municipal general obligation bonds have a mere promise to pay or a binding obligation", 24 Widener L.J. 19.
101 Skeel, 50 Hous. L. Rev. 1063, 1067 et. sqq.
102 Skeel, 50 Hous. L. Rev. 1063, 1072.
credit markets and represent their means transparent. Thus, the Chapter 9 proceeding is not only effective, but also a law-saving debt settlement tool. It rewards reasonable municipalities with an interest rate reduction and punishes untrustworthy and low-sustainable municipalities with a potentially sensitive higher interest rate. This is done solely on the natural mechanisms of the credit market and requires no law and no intervention of political actors. The credit market itself moves the municipalities to a sustainable fiscal policy. Also, “consumer debtors tend to overemphasize the short-term benefits of borrowing and to underestimate the long-term costs”. Chapter 9 cannot fix these problems. Unlike a corporation, whose managers can be ousted, an insolvency proceeding cannot force a municipality to make better decisions. But it can help them to reorganise debt if it becomes entirely unsustainable and give the debtor’s creditors an incentive to monitor their decisionmaking. Thus it can be said that both creditors and debtors benefit from the ex-ante efficiency of the Chapter 9 proceedings.

6. Chance for a fresh start vs. Moral hazard!?

Some scholars repeat the objection that because all Chapter 9 does is grant a fresh start to a municipality, it is not a beneficial reorganisation instrument. Those who enunciate this objection argue that Chapter 9 provides no operational restructuring. McConnell and Picker, who wrote the often quoted municipal bankruptcy article “When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy“, criticised the limited aims of Chapter 9 and its efficacy in accomplishing those aims. They postulate that Chapter 9 is based on the

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103 “The first purpose of the framework is to credibly signal to lenders that debt restructurings will be predictable and equitable and signal to borrowers that irresponsible fiscal behavior entails consequences.” Liu / Waibel, Subnational Insolvencies, p. 336.
104 Skeel, 50 Hous. L. Rev. 1063, 1074.
105 Skeel, 50 Hous. L. Rev. 1063, 1074.
107 The author is geared in the following two paragraphs primarily to Moringiello, 71 Wash & Lee L. Rev. 403, 419 et. sqq.
belief that "all the cities need is relief from their present creditors."\textsuperscript{108} From that background, they argue that because Chapter 9 presumes that "the city will emerge from bankruptcy in the same form . . . with which it entered bankruptcy," Chapter 9 does neither support nor encourage the efficient reorganisation of municipalities.\textsuperscript{109} As a result, municipal bankruptcy could only provide a fresh start for municipalities, "and it does not even do that very well because by allowing a city to keep all of its assets and discharge its debts, it creates the moral hazard\textsuperscript{110} of permitting a city to devote its resources to itself while escaping its debts."\textsuperscript{111}

But those authors make a mistake by describing state intervention and federal municipal bankruptcy as parallel independent systems.\textsuperscript{112} For example McConnell and Picker demonstrated that explicitly by describing bankruptcy as "an alternative to state reform rather than supplemental to it."\textsuperscript{113} This perspective of Chapter 9 and state intervention as reciprocal exclusive alternatives is compatible with some scholars' characterisation of Chapter 9 as a way for a municipality to receive easy debt dispensation without making the necessary changes to provide essential services and avoid financial distress in the future.\textsuperscript{114} If that would be the case, Chapter 9, of course, would be undesirable. No one wants a municipality to go through the damages and bad press of bankruptcy just to emerge from bankruptcy in the same distressed form in which it entered.\textsuperscript{115}

In a perfect world, a state could prevent and ameliorate the financial distress of its cities without resorting to federal law. The world is not perfect,
however. In the United States, there is no general liability of the relevant states for their cities and towns. Nevertheless, the state often takes voluntary care of municipalities with financial difficulties and in some cases covers for the insolvent municipalities due to the possible negative impact on the overall interest of the state. If this is not the case, the proceedings under Chapter 9 open up the option of debt settlement for municipalities. The specific authorization requirement to file for Chapter 9 “gives the states a gatekeeper role by allowing the states to choose whether, and under what conditions, their municipalities can file for bankruptcy under Chapter 9. By granting the states this gatekeeper role, the Congress not only exercised care to ensure that the municipal bankruptcy chapter passed constitutional muster, it also provided a mechanism for state participation in the federal bankruptcy process.”

The authorisation precondition is a governance control that reflects the “hybrid fresh start-rehabilitation goal” of Chapter 9. All Chapter 9 can do on its own is give debt dispensation. Combined with state intervention, however, Chapter 9 can both give debt relief and facilitate municipal rehabilitation.

Every municipality that files for bankruptcy has insufficient revenues to meet its expenses. Of course, a bankruptcy filing cannot fix the income problem, but it can enable a municipality to decrease its expenses. Along the way, the municipality can fulfill their necessary public functions without significant intervention by the court and especially without the risk of enforcement by the creditors (“automatic stay”). This means that the Chapter 9 proceedings prove at least with respect to its target bearing a notable example in dealing with municipal insolvency scenarios. The debtor will be helped by using the Chapter 9 proceedings for a "breather" and thus opens up the opportunity to create a more stable financial fundament for the future. Through bankruptcy, the municipality is able to decrease its debt burden and its tax rates, and to enjoy a

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116 Moringiello, 71 Wash & Lee L. Rev. 403, 428.
119 Moringiello, 71 Wash & Lee L. Rev. 403, 458.
120 Moringiello, 71 Wash & Lee L. Rev. 403, 458 - 459.
121 JM Moringiello, Bankruptcy and beyond: Exploring the causes of and the solutions to municipal financial distress: Introduction, 24 Widener L. J. 1, 2 (hereinafter Mornigiello, 24 Widener L. J. 1).
fresh start that will hopefully increase its productivity and boost economic development.\textsuperscript{122} Consequently, the municipality improves the services it provides to its residents. Residents do not have to donate such a significant portion of their income to the city, and as a result they have a greater incentive to generate economic activity.\textsuperscript{123}

Therefore, Chapter 9 is not designed to improve the creditors' collection remedies, but rather to help the municipality itself to rehabilitate. The "bankruptcy privileges" of Chapter 9 enables a municipality to pressure, or even to force, its creditors to waive part of its debts or at least to extend the debt's maturity date. However, this is not a new phenomenon of Chapter 9 proceedings, but has already been created in the principles of any Insolvency act. Although the debtor has much less power in the bankruptcy proceedings for companies and individuals, the implementation of an insolvency proceeding nevertheless in most cases leads to significant losses for the creditors. The noticeably stronger position of the municipal debtor in Chapter 9 proceedings, due to its constitutional position, may increase this position in some cases. However, there are not completely new aspects arising.

Certainly, Chapter 9 was never designed to serve as a extensive regime to solve municipal financial distress on its own, but it was intended to recruit state efforts and state intervention to solve those problems.\textsuperscript{124} For that reason, Chapter 9 supplies cities with comparatively easy debt dispensation. The municipality stays autonomous, while executing a debt restructuring plan from a position of strength. Due to these benefits, distressed municipalities can use Chapter 9 to handle financial distress. Filing for Chapter 9 allows the municipality to shake off at least part of its debts, and proceed to act with a reduced debt service.

\textsuperscript{122} Kimhi, 27 Yale J. on Reg. 351, p. 2.
\textsuperscript{124} Moringiello, 71 Wash & Lee L. Rev. 403, 485.
7. Interim findings

Insolvent municipalities regain through a market-based "crisis mechanism" within the meaning of the Chapter 9 proceeding their political action and decision latitude and the local leaders are encouraged to more budgetary discipline, at least with a view to the future. The primary goal of the Chapter 9 proceedings is the settlement of the municipal debt of the past and thus the possibility of a debt-adjusted municipal fresh start. On no account is the extensive liquidation and thus dissolution of the municipal debtor intended. Purpose, and not just mere consequence of this debt settlement, is therefore the mandatory creditor participation. They are involved in the process to contribute - often in the form of at least proportionate loss of claims - to provide for the rehabilitation of the municipal debtor. This will serve, in the best case, to not only the solution of current municipal insolvency scenarios, but also the prevention of future cash crises and thus lead to a discipline of the creditors for the future, as these are required to elaborate the municipal creditworthiness.

The overall objective of Chapter 9 proceedings is the claim to transfer the municipal financial responsibility on the current players, which are in any case responsible for the present situation, and thus to make a step towards greater intergenerational equity.

IV. Conclusion and perspective

The Chapter 9 proceeding has a long legal tradition, and is regarded as extremely successful in practice. Nevertheless, it has consistently experienced criticism. In recent times, this is less directed against the underlying approach of the proceedings rather than against the concrete implementation. Surprisingly, it may also be that the loss of the rights of the creditors, which corresponds to the additional freedoms of the municipal debtor, is given little importance.

But ultimately, the mechanisms of the Chapter 9 proceeding can only be an effective restructuring tool for (almost) insolvent municipalities when the
public perception of insolvency as a serious tool for rehabilitation of the debtor wins recognition. It is of crucial importance in this context that insolvency is no longer stigmatized as an inevitable end of corporate or municipal activity, but is seen as an opportunity for a successful restart. The recent municipal bankruptcies have, in a sense, extended this market-oriented approach in two aspects. “First, they have signaled that Chapter 9 is indeed an option - and an alternative to rescue financing. The conventional wisdom that significant municipalities do not file for Chapter 9 is no longer accurate. Secondly, the scope of restructuring has expanded considerably.”125 As the American investor Warren Buffett has enunciated it, the stigma is disappearing.126

What is left of the former "stigma of insolvency" in modern insolvency law is, at most, the taint of economic or financial failure. However, a certain residual stain is quite desirable so that insolvency is not abused as a welcome tool to disengage from contractual obligations and to correct economic and financial mistakes. Anyway, this residual taint is suited to trigger a disciplining effect in the form of an “ex-ante” efficiency. It is secured by long experience in insolvency law, that the existence of insolvency proceedings shows constraining effects for all involved. The mere reference to the enormous numbers of the annual insolvency statistics cannot weaken this knowledge: No insolvency law, and probably not any sort of legal system, can eliminate the phenomenon of "insolvency" entirely. However, it can reduce its occurrence.

By making a clear cut and attacking the debt problem head-on, the Chapter 9 proceedings transfers the responsibility and risk of non-recovery of the existing claims against the municipality to current players who bear the responsibility for the current debt situation in contrast to the future generation.127 Thus, the Chapter 9 proceeding fulfills last but not least an important

125 Skeel, 50 Hous. L. Rev. 1063, 1082.
127 O'Brien Hylton, 59 Wayne L. Rev. 525, 554 - 555, mentions that "one of the painful lessons of the bankruptcy of Central Falls and Detroit is the widespread and fundamental lack of respect for taxpayer dollars demonstrated by so many actors. Both, politicians and bondholders are well known for their cavalier attitude toward "other people’s money". 
contribution to intergenerational equity and sustainability.

The absence of the Chapter 9 proceeding would, however, mean that the municipalities could indeed not be insolvent in the formal sense, but would still be illiquid.\textsuperscript{128} On the one hand, this would entice the lenders of the municipalities to grant credit in economically unjustifiable extent and thus continues to drift into debt. On the other hand, distressed municipalities would increasingly fall to the state collective burden.

Especially in economic regard, the Chapter 9 proceeding has thus a crucial task, not the least because delaying the solution of a debt problem causes other costs by the ever-increasing interest that makes the debts continue to grow. But the only sensible solution - the settlement of debts in the context of insolvency proceedings - is often mistakenly considered to be too expensive. This drives the claims of creditors in even higher dimensions, but they are thereby more recoverable by no means. A debt reduction can therefore be delayed, but ultimately not be prevented.

An early, more precisely on time conducted debt settlement is therefore economically advantageous. Someone who is overwhelmed by his debts, makes no contribution to debt reduction, but rather becomes a burden of the general public and future generations.

The allegation that the Chapter 9 proceeding interferes only later and at the most leads to the corrections but not to prevention of mistakes, has to be accused of lacking draft itself. Chapter 9 works especially by its existence rather than by its actual implementation. It forces the involved debtor and creditors to take precautions to prevent insolvency and develops its authoritative function especially with the incentive to avoid their actual occurrence. If those assets which are available in the event of insolvency are specified, as well as those that are essential to fulfill the public service mission, this automatically leads to a more careful handling of the participants.

Since the amount of the municipal debt is associated with the dispositive estate of the municipality, this often a triggers a local-public discussion on the

\textsuperscript{128} That is for example still the legal situation in Germany, compare: M. Hoffmann, The orderly insolvency of territorial entities (2012).
cost of municipal debt and increases the pressure on policy makers. If the local citizens are faced with the fact that in the case of municipal insolvency predominantly sporting, cultural and leisure facilities are under consideration, they realise that excessive and uncontrolled debt has a very direct impact on civic life. The democratic, especially in the results of the local elections reflected demand for a rethinking of the (debt) policy, is often the direct result. The concrete political responsibility is strengthened. Consequently, the municipal decision-makers need to make major consolidation efforts to avoid prestige injurious proceedings.

The often conjured risk of frivolous demands of the Chapter 9 proceedings is relativised alone by the comparatively rare opening of proceedings in the United States. Far too much is the threat of loss of reputation of the municipal debtor, which has to face greatly increased costs on the capital market with the initiation of the proceedings.

Ultimately, however, it must be noted that regardless of how effective the discussed Chapter 9 proceeding is, it is certainly suitable to provide ordered structures only for individual local reorganisation in financial emergencies. If, however, already existing long-term structural crises of municipal financial structures should be prevented in the future, it can only happen through far-reaching institutional reforms which can only be made by the states. The task of the Chapter 9 proceedings is therefore also to develop a problem awareness by the comprehensive and transparent analysis of municipal finances during the drafting of the insolvency plan and especially by the relentless exposure of the funding gaps in the performing part of the plan. Thus, the political decision makers are made aware of the structural weaknesses of the municipal finance system in general and in particular the under-funding of the transferred municipal responsibilities. Hereby, the Chapter 9 proceeding is not only conducted to a medium-term degradation of the individual municipal debt and the “resolvenzy” of the concrete municipality, but also to the aim to take long-term steps for the reduction of the municipal debt in general. The aim of such reforms is not damage limitation in each individual case, but to ensure "healthy state

129 Moringiello, 24 Widener L.J. 1, 3.
An insolvency proceedings for municipalities does not eliminate once and for all the problem of over-indebted municipalities, but much is gained if the phenomenon is reduced. Thus, the Chapter 9 proceeding and especially its underlying objectives carries the possibility of a model character for relevant regulations in other countries. Although a direct transfer of Chapter 9 will be neither possible nor advisable in other jurisdictions. However, it is worth – this was the aim of this survey- thinking about the implementation of individual elements of Chapter 9, in particular about the very existence and necessity of such an insolvency regime. This can, under certain circumstances, enforce the realisation that insolvency proceedings are reasonable and feasible not only at a local but also at the state level.


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