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Central Falls Retirees v. Bondholders: Assessing Fear of Contagion in Chapter 9 Proceedings

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CENTRAL FALLS RETIREES V. BONDHOLDERS:

ASSESSING FEAR OF CONTAGION IN CHAPTER 9 PROCEEDINGS

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I. INTRODUCTION

In August 2011, the small city of Central Falls, Rhode Island petitioned a bankruptcy court for protection under Chapter 9 of the bankruptcy code.[1] A mere fourteen months later—in October 2012—Central Falls emerged from bankruptcy in what has been described as possibly the fastest Chapter 9 proceeding in U.S. history.[2] At the time Central Falls sought protection from its creditors, it had approximately

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1. 11 U.S.C.A. § 921a-e (West 2008). As of 2010, Central Falls has only 19,376 residents. U.S. CENSUS BUREAU, CENTRAL FALLS (CITY) QUICKFACTS (2010) http://quickfacts.census.gov/qfd/states/44/4414140.html (last visited Mar. 7, 2014).

2. Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES (Sept. 7, 2012), http://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html (stating that Judge Frank J. Bailey of U.S. Bankruptcy Court remarks on "record time, and record efficiency").

$80 million in unfunded pension liabilities[3] and was running an annual budget deficit of about $5 million per year.[4] As in other recent cases of extreme municipal financial crisis, Central Falls' bondholders' rights were well protected; the restructuring that was ultimately approved imposed virtually all of the costs onto current and former municipal employees and taxpayers. Indeed, city services were slashed as an astonishing one third of public employees were fired at the same time that a 4% increase in property taxes was imposed for fiscal years 2012 through 2017. Current retirees' pension payments were reduced by approximately 55%[5] and cost of living adjustments (COLAs) were eliminated.[6] Those employees whose jobs survived the cost cutting had to contribute more and work longer in order to earn a pension.[7]

It was not a foregone conclusion that public employees, pensioners, and taxpayers would bear the cost of restructuring. Indeed, Chapter 9

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3. This is admittedly a small number compared with the eye-popping figure of $3.5 billion for the City of Detroit, which sought bankruptcy protection on July 18, 2013. Steven Yaccino & Michael Cooper, *Cries of Betrayal As Detroit Plans to Cut Pensions*, N.Y. TIMES (July 22, 2013), http://www.nytimes.com/2013/07/22/us/cries-of-betrayal-as-detroit-plans-to-cut-pensions.html?pagewanted=all.

4. MARK A. PFEIFFER, OFFICE OF THE RECEIVER, CITY OF CENTRAL FALLS, IN THE MATTER OF THE RECEIVERSHIP OF CENTRAL FALLS, RHODE ISLAND (2010) (Executive Summary), *available at* http://www.dor.ri.gov/Reports/Central%20Falls/Report%20of%20the%20State%20Receiver.pdf; Michael McDonald & David McLaughlin, *'Dire' Finances Force R.I. City Into Bankruptcy*, BLOOMBERG (Aug. 1, 2011), http://www.bloomberg.com/news/2011-08-01/-dire-situation-forces-rhode-island-city-of-central-falls-into-bankruptcy.html.

5. This figure was reduced to approximately 25% by a special assessment from the Rhode Island legislature of $2.6 million to be paid out over five years to Central Falls. 2012 R.I. Pub. Laws ch. 241, art. 22.

6. *Id*.; Dan McGowan, *Judge Gives OK to Providence Pension Deal*, WPRI (Mar. 12, 2013, 9:00 PM), http://www.wpri.com/dpp/news/local_news/providence/judge-gives-ok-to-providence-pension-deal; Robert Powell, *Public Pension Funds Face Vast Shortfall*, MARKETWATCH (Nov. 13, 2012), http://www.marketwatch.com/story/public-pension-funds-face-vast-shortfall-2012-11-13 ("[S]tates such as Colorado, Florida, Maine, Minnesota, Missouri, New Jersey, Oklahoma, Rhode Island, South Dakota, Washington and Wyoming have made or can make major cuts to the cost-of-living adjustments (COLA) pensioners were supposed to get.").

7. In 1999 and 2000, state legislatures across the United States began decreasing the age at which employees could receive full retirement benefits and shortening the years of service needed to qualify. The ultimate result was that, when these pension programs are reformed, employees are forced to contribute more, mainly due to poor decisions by legislatures in the early part of the century. *See* PEW CTR. ON THE STATES, PROMISES WITH A PRICE: PUBLIC SECTOR RETIREMENT BENEFITS 8-9 (2006), *available at* http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/State_policy/pension_report.pdf.

does not mandate such a result.[8] The Rhode Island legislature, apparently eager to avoid contagion,[9] hastily passed a statute giving bondholders preference over all other creditors and guaranteeing payment of Central Falls' debt obligations.[10] The legislature was widely viewed as anxious to avoid contagion—i.e., to reduce the possibility that other Rhode Island municipalities would find themselves unable to finance public projects by borrowing because bondholders believed Central Falls problems were "contagious" and likely to spread throughout the state.[11] This law and not

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8. Chapter 9 requires only that the debtor file a plan of adjustment and enforces no standard requirements on the plan itself. The court confirms the plan, among other formalities, if the debtor is not prohibited by law from taking any action necessary to carry out the plan, and "the plan is in the best interests of creditors and is feasible." 11 U.S.C.A. § 943 (West 2008). Judges obviously carry a large amount of discretion when it comes to determining what is in the best interest of creditors and what is feasible, making each Chapter 9 case somewhat unique. For arguments that bondholders could bear some or most of the cost of restructuring, see David A. Skeel, *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 702 (2012).

> Two constituencies in particular have been asked to bear a disproportionate percentage of the sacrifice during the recent crisis: the state's public employees and the recipients—especially the poor and lower middle class recipients—of its services. Other, similarly situated creditors such as bondholders have not been expected to bear any of the financial burden.

Id. For an account of what led to the bankruptcy filing of Bridgeport, see Dorothy Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEV. J. 625, 629 (1994-95). For a further introduction to municipal bankruptcy, see Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425 (1993).

9. Contagion refers to the possibility that a municipality's default will cause disruption in other nearby bond markets because instability in one market may be a sign of general instability in the area. Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 302 (2012); Tracy Gordon, *What the Stockton Municipal Bankruptcy Means, And Doesn't*, BROOKINGS (Apr. 2, 2013), http://www.brookings.edu/research/opinions/2013/04/02-stockton-city-bankruptcy-gordon (discussing the effects of contagion in the municipal bond market); Rabah Arezki et al., *Are There Spillover Effects from Munis?* (Int'l Monetary Fund Inst., Working Paper No. WP/11/290, 2011), *available at* http://www.imf.org/external/pubs/ft/wp/2011/wp11290.pdf (suggesting that the market for municipal bonds are "prone not to contagion but rather to flight to quality").

10. R.I. GEN. LAWS § 45-12-1 (2013), *available at* http://webserver.rilin.state.ri.us/Statutes/title45/45-12/45-12-1.HTM.

> The faith and credit, ad valorem taxes, and general fund revenues of each city, town and district shall be pledged for the payment of the principal of, premium and the interest on, all general obligation bonds and notes of the city or town whether or not the pledge is stated in the bonds or notes, or in the proceedings authorizing their issue and shall constitute a first lien on such ad valorem taxes and general fund revenues.

Id. § 45-12-10.

11. Gillette, *supra* note 9, at 302.

Chapter 9 all but guaranteed that the years of overspending and generally irresponsible financial stewardship of the city would be corrected without significant cost to the bondholders and their insurers.

If Central Falls' financial problems were isolated or peculiar and unusual, one might be forgiven for asking why it is worth focusing on the misadventures of a small city in a very small state. After years of relative obscurity, Chapter 9 is currently the focus of considerable attention[12] precisely because Central Falls' financial woes are clearly part of a larger pattern of municipal crisis. Not since the Great Depression have so many cities across the United States faced bankruptcy. Harrisburg, Pennsylvania; Stockton, California; Jefferson County, Alabama; and most recently Detroit, Michigan have made headlines as the harsh realities of imprudent financial decisions, corruption, and overspending collided. And, although the facts vary slightly from city to city, the overarching question raised in each municipal bankruptcy proceeding is similar: which creditors, if any, should be given preference as a city

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12. *See, e.g.*, Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425 (1993) ("explor[ing] the meaning of bankruptcy in the context of municipal corporations and what this has to say about the legal structure of cities and their relation to their citizens, their states, their creditors, and the courts"); Richard W. Trotter, *Running on Empty: Municipal Insolvency and Rejection of Collective Bargaining Agreements in Chapter 9 Bankruptcy*, 36 S. ILL. U. L.J. 45, 47 (2011) ("examin[ing] the depth and scope of the municipal debt crisis and assess[ing] the role of collective bargaining agreements in that crisis"); Jeffrey B. Ellman & Daniel J. Merrett, *Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?*, 27 EMORY BANKR. DEV. J. 365, 373 (2012) ("identif[ying] certain tools and strategies offered by Chapter 9 and . . . consider[ing] whether . . . they may offer a real, workable solution to the overwhelming and seemingly unassailable pension obligations of many municipal debtors"); Eric S. Pommer & Marc M. Friedman, *Municipal Bankruptcy and its Effect on Government Contractors*, 25 PUB. CONT. L. J. 249 (1996) (giving a historical overview of municipal bankruptcy legislation and Chapter 9 applicability to government contractors); Hannah Heck, *Solving Insolvent Public Pensions: The Limitations of the Current Bankruptcy Option*, 28 EMORY BANKR. DEV. J. 89, 91 (2011) ("summariz[ing] current economic factors driving the recent increased likelihood of municipal insolvency"); David A. Roby, Jr., *Municipal Bankruptcy: Will Labor be Forced to Take the Proverbial Haircut?*, 26 GA. L. REV. 959, 961 (1992) (giving a basic overview of Chapter 9, in addition to tracing the history of municipal bankruptcy law); Elizabeth M. Watkins, *In Defense of the Chapter 9 Option: Exploring the Promise of a Municipal Bankruptcy as a Mechanism for Structural Political Reform*, 39 J. LEGIS. 89, 91 (2012) (providing an "overview of Chapter 9 itself, including its benefits, costs, and causes"); Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1039 (1997) (analyzing the mechanics of a Chapter 9 proceeding and examining "municipalities' ability to use Chapter 9 and the status of investors as claimants in a Chapter 9 proceeding"); Guy R. Bissonnette, *Rhode Island Municipal Insolvency Lite*, 60 R.I. B.J. 19 (Jan./Feb. 2012) (providing a question/answer format that gives a general overview of Chapter 9 and the bankruptcy in Central Falls).

struggles to rein in spending? If the core problem is, as I've argued elsewhere,[13] a strong tendency to overpromise because of strong forces that encourage morally hazardous behavior, who should bear the cost when a municipality cannot keep the promises it made? Does it matter that municipal creditors are typically either very sophisticated—i.e., bondholders and their insurers—or possibly less savvy but often intimately involved in a long pattern of reckless spending that has directly contributed to the financial crisis—i.e., public employees and the unions that represent them?

This paper examines these questions through the lens of experience in Central Falls, Rhode Island for two reasons. First the decline in Central Falls was typical of patterns found in other cities like Stockton, Harrisburg, and Detroit. Second, Central Falls provides a unique opportunity to evaluate the principal argument in favor of protecting bondholders—the need to stop the downward spiral known as contagion. The contagion claim clearly dominated the way in which Rhode Island approached the question whether to protect bondholders or retirees and other creditors of the municipality. In Part II, I provide a short history of the economic rise and decline of Central Falls and describe the state's role in limiting the danger that Central Falls' problems would spread to other cities in the state. Part III reviews the claims of the bondholders and their insurers and considers whether those claims are inherently superior to those creditors with contractually based post-employment claims—generally, promised pension and retiree health benefits. Part IV evaluates Rhode Island's decision to avoid contagion by giving explicit preference to bondholders; this preference tied the hands of the bankruptcy court and made certain that the costs of restructuring would fall heavily on current retirees and employees. Finally, in Part V, I look closely at the lessons other cities should draw from Central Falls' experience. I conclude that the core problem in Central Falls and elsewhere is one of extreme moral hazard that is unchecked due to corruption, cynicism, and willful ignorance. Bondholders, however, are generally fully insured through a mechanism that spreads the costs of default across a wide spectrum of citizens outside of the city, so the question of whether to protect them ultimately depends on exactly where one locates fault for the city's ruined financial condition.

13. Maria O'Brien Hylton, *Combating Moral Hazard: The Case for Rationalizing Public Employee Benefits*, 45 IND. L. REV. 413 (2012).

II. PAINFUL CHANGE IN CENTRAL FALLS

Central Falls is the smallest and most densely populated city in the State of Rhode Island.[14] Only 1.29 square miles in total, it is more densely populated than the city of Boston. The basic statistics tell a rough tale. More than 27% of the population of Central Falls lives below the poverty level. Set along the Blackstone River, Central Falls began as a textile mill town and is located just north of its larger and more prosperous neighbor, Providence. Although the mills are long gone, Central Falls has continued to offer cheap housing and to draw significant numbers of immigrants—mostly from Central and South America.

In 1990, local politicians, eager for a revenue source, proposed building a jail to house nonviolent federal detainees.[15] The idea was that the jail would provide a reliable stream of income that would help the city avoid financial collapse. In order to build the facility, Central Falls issued $30 million in bonds that were ultimately used to construct the Donald W. Wyatt Detention Facility (Wyatt).[16] A few years later, the city refinanced this loan that required another $38 million bond issue.[17]

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14. *See* U.S. CENSUS BUREAU, *supra* note 1.

15. *See* Nina Bernstein, *City of Immigrants Fills Jail Cells With Its Own*, N.Y. TIMES, (Dec. 27, 2008), http://www.nytimes.com/2008/12/27/us/27detain.html?pagewanted=all&_r=2&.

> The city was nearly bankrupt in 1990 when developers made a proposition: Build a profit-making jail for two or three hundred nonviolent federal detainees, and guarantee a steady stream of money and jobs for Central Falls. But the deal that emerged, like many elsewhere, proved better at paying private investors than generating public revenue.

Id.; *see also History of the Facility*, DONALD W. WYATT DETENTION FACILITY, http://www.wyattdetention.com/index.cfm?pg=20&pgtitle=History (last visited Mar. 19, 2014).

16. *See* Bernstein, *supra* note 15 ("The municipal corporation borrowed $30 million through a state bond issue to build Wyatt, and hired the Cornell company to run it."); *see also* Eileen Norcross, *Behind the Scenes in Central Falls: Correctional Facilities as Economic Development?*, MERCATUS CENTER AT GEO. MASON U. (Aug. 2, 2011), http://neighborhoodeffects.mercatus.org/2011/08/02/behind-the-scenes-in-central-falls-correctional-facilities-as-economic-development.

> In 1991, the city, operating through a newly-created state entity, "the Central Falls Detention Facility Corporation" (CFDFC) made an intergovernmental agreement with the U.S. Marshals Service to operate the Wyatt Detention Facility in order to "pursue economic development through the acquisition or construction of correctional facilities."
>
> Wyatt is tax-exempt and is supposed to make an annual payment to the city, [sic] "In this way, Wyatt would still provide the City with the benefit of economic development—tax revenue for the City—but would do so in the form of an impact fee payment rather than through taxes."

The plan for Wyatt was straightforward: the city would receive revenue subject to a per capita fee arrangement—i.e., as the inmate population increased, the city's revenue would likewise increase.[18] Early on, the revenue from Wyatt proved disappointing.[19] After the terrorist attacks of September 11, 2001, and with the federal government's increased focus on illegal immigration, Wyatt's inmate count began to rise.[20] Encouraged by this trend, then-mayor Charles Moreau supported a plan in 2005 that more than doubled the maximum occupancy of Wyatt. This expansion cost the city another $47 million.[21] (One of the many

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> The quasi-public CFDFC was to oversee Wyatt which now houses about 700 detainees. Building of the facility was financed by $30 million in revenue bonds, and a 2005 expansion financed by another $106 million in bonds. Per diem payments from the U.S. Marshals Service were to repay the bonds. But, a decreased number of detainees from Immigration and Customs Enforcement (due to the death of a detainee), led to a decrease in projected revenues at the facility. Thus, CFDFC suspended payments to Central Falls. A fact compounded by Central Falls' inability to accurately budget for the loss (they continued to budget as if they would receive payments).

Id.

17. *See, e.g.*, Bernstein, *supra* note 15 ("Six years later, the municipal body borrowed $38 million to refinance, buying back most of the bonds at a premium that gave the original bondholders a lump-sum return of 28.5 percent on their investment in addition to 9 percent annual interest.").

18. Central Falls was due to receive per diem payments from the U.S. Marshals Service to help repay the bonds. In addition, although tax-exempt, Wyatt was supposed to make an annuals payment to the city based on the number of detainees. *See* Norcross, *supra* note 16.

19. *See* Bernstein, *supra* note 15 ("At best, Wyatt paid Central Falls $2 to $3 a day for each detainee—less than $400,000 in the good years—to offset its use of city services."). In December 2008, Immigration and Customs Enforcement (ICE) halted the placement of federal immigration detainees at Wyatt due to an investigation surrounding the treatment of a Chinese computer engineer who died in custody at Wyatt. Decreased numbers of detainees resulted in decreased revenues that did not match projections. Central Falls compounded on this error by failing to re-budget for the loss. *See* Nina Bernstein, *Detention Center Facing Inquiry Will Get No More Immigrant Detainees,* N.Y. TIMES (Dec. 6, 2008), http://www.nytimes.com/2008/12/06/nyregion/06detain.html; *see also* Norcross, *supra* note 16.

20. After the creation of ICE in 2003, Wyatt became one of 654 facilities used to temporarily house federal immigration detainees prior to transfer or deportation. The number of detainees transferred out of Wyatt to other ICE facilities increased by over 800% between 2000 and 2008. *Detainees Leaving ICE Detention from the Wyatt Detention Center*, TRANSACTIONAL REC. ACCESS CLEARINGHOUSE, SYRACUSE U., http://trac.syr.edu/immigration/detention/200803/WYATTRI/tran/ (last visited Mar. 19, 2014) (providing data from October 1998 to March 2008); *see also* Bernstein, *supra* note 15 ("The payoff came after 9/11 in an accelerating stream of new detainees: foreigners swept up by the nation's rising furor over illegal immigration."); *Overview*, ICE, http://www.ice.gov/about/overview/ (last visited Mar. 19, 2014).

21. *See, e.g.*, *History of the Facility*, *supra* note 15.

ironies of the Wyatt project is that its expansion directly and personally affected residents of Central Falls; numerous families consisted of parents who were in the United States illegally and children who were U.S. citizens. Parents as taxpayers expected benefits from the revenue stream that Wyatt promised; at the same time, Wyatt posed a direct threat to those same taxpayers whose immigration status was compromised.)[22]

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22. *See* Bernstein, *supra* note 15. For example,

> Few in this threadbare little mill town gave much thought to the Donald W. Wyatt Detention Facility, the maximum-security jail beside the public ball fields at the edge of town. Even when it expanded and added barbed wire, Wyatt was just the backdrop for Little League games, its name stitched on the caps of the team it sponsored.
>
> Then people began to disappear: the leader of a prayer group at St. Matthew's Roman Catholic Church; the father of a second grader at the public charter school; a woman who mopped floors in a Providence courthouse.
>
> After days of searching, their families found them locked up inside Wyatt—only blocks from home, but in a separate world.
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> . . . .
>
> If anything, the people of Central Falls saw Wyatt as the economic engine that city fathers had promised, a steady source of jobs and federal money to pay for services like police and fire protection. Even that, it turns out, was an illusion.
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> . . . .
>
> [Maynor Canté, 26,] spoke near-fluent English, and had spent thousands of dollars trying to legalize his status. Mornings, he cleaned a factory for $8 an hour. Evenings, he worked at his nephew's new clothing shop on Dexter Street, one of several Latino businesses that had revived a bleak stretch of vacant storefronts.
>
> Then, early one morning in October 2007 when he headed out the door for his cleaning job, five immigration agents hustled him into a van. That night, as frightened relatives tried to find him, he was delivered to Wyatt in chains.
>
> . . . .
>
> In Central Falls, the crackdown sowed panic. At the public charter school two blocks from Wyatt, parents, already afraid to be photographed at school events, were now reluctant to drive to meetings, said Sarah Friedman, a founder of the school.
>
> An 8-year-old girl, one of the school's high-scoring students, stopped speaking in class when her father disappeared into detention, the girl's mother said. Without his income, mother and daughter, United States citizens, were almost evicted from their apartment.
>
> At Central Falls High School, some students stopped coming to class because their families had gone into hiding, said Margie Cruz, a school-home liaison: "The child was born here, the child is legal. But the family has to hide because the father will be deported."
>
> "I've seen students stopped for a traffic violation and the whole family got deported," she added. "Children that were here for years. I watched them grow up."

Id.

In the fall of 2012, Mayor Moreau resigned and pled guilty to federal corruption charges.[23] Moreau's downfall was a scheme that involved offering lucrative contracts to board up abandoned homes to one Michael Bouthillette, a close friend. The city paid Bouthillette $14,000 to $16,000 per home even though the going rate for this kind of work was closer to $5000 per home.[24] Moreau was sentenced to two years in prison; Mr. Bouthillette received three years probation.[25]

By the time Moreau went to prison, Wyatt was barely generating enough cash to cover the required payments to bondholders; revenue for the city was nearly zero.[26] In March 2012, attorneys for the city's bondholders sent a letter to Wyatt "emphatically" noting that bondholders must be compensated and Wyatt's reserve accounts must be replenished before the city could collect any money.[27]

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23. *See, e.g.*, Jess Bidgood, *Rhode Island: Central Falls Mayor Quits and Is to Plead Guilty to Corruption*, N.Y. TIMES, Sept. 20, 2012, at A21, *available at* http://www.nytimes.com/2012/09/20/us/rhode-island-central-falls-mayor-quits-and-is-to-plead-guilty-to-corruption.html.

24. NBC News and Wire Services, *Mayor of Bankrupt Central Falls, RI, Resigns, Set to Plead Guilty to Corruption*, NBC NEWS (Sept. 19, 2012, 1:53 PM), http://usnews.nbcnews.com/_news/2012/09/19/13964989-mayor-of-bankrupt-central-falls-ri-resigns-set-to-plead-guilty-to-corruption.

25. *Id.*; Erika Niedowski, *Former Central Falls Mayor Gets Two Years in Prison*, BOSTON.COM (Feb. 12, 2013), http://www.boston.com/news/local/rhode-island/2013/02/12/former-central-falls-mayor-gets-years-prison/Fb98rVGBsl2u7nDTE18yIO/story.html.

26. *See generally* W. Zachary Malinowski, *Wyatt Jail Bondholders Will Not OK Impact Fees to Central Falls*, PROVIDENCE J. (Mar. 16, 2012), http://news.providencejournal.com/breaking-news/2012/03/wyatt-jail-bond.html (explaining that Wyatt must pay bondholders and replenish reserve accounts before Central Falls can get any money).

27. CENTRAL FALLS DETENTION FACILITY CORPORATION, MEETING MINUTES (Mar. 13, 2012), *available at* http://sos.ri.gov/documents/publicinfo/omdocs/minutes/4440/2012/26330.pdf.

> Chairman Hartford said that Mr. Fair received a letter from Mintz-Levin [the bondholder attorneys]. Basically, as long as the Bondholders consider us to be in technical default of the indenture of trust, they are not going to allow the payment of impact fees to the City. We will have to revisit this at a later time.
>
> Attorney Fracassa commented that we have not violated the indenture to-date. We have simply asked the Bondholders to make the payment of impact fees through the mechanism that we have available to do that.
>
> Chairman Hartford commented that, if we were not in an adversarial relationship with the Bondholders before, we are now. They are forestalling us from being able to provide revenues to the City.

Id. at 3; *see also* Malinowski, *supra* note 26 (reporting that the law firm representing the bondholders sent the letter "in response to a request by Michael V. Fair, the jail's chief executive officer, who sought advice on whether the jail can pay the city $25,000-a-month").

Throughout the entire Wyatt episode, Central Falls never missed a bond payment; it managed to stay current on the municipal debt primarily by failing to fund pensions promised to its public employees.[28] By the time the city sought bankruptcy protection, its unfunded pension and retiree health obligations exceeded $80 million.[29] Although the Central Falls story clearly involved political malfeasance and corruption, it is also a story of bondholders that made loans of questionable quality[30] and public employees that continued to push for and receive promises for future benefits that clearly were unaffordable.[31]

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28. *See* Office of the Governor, R.I., Governor Lincoln D. Chafee Announces Moody's Upgrade of Central Falls Bond Rating (Oct. 26, 2012), *available at* http://www.ri.gov/press/view/17735 (explaining that Central Falls never missed a debt service payment); *see also* Daniel Fisher, *Muni Bankruptcies Set Up War Between Pensioners and Bondholders*, FORBES (Apr. 3, 2013), http://www.forbes.com/sites/danielfisher/2013/04/03/muni-bankruptcies-set-up-war-between-pensioners-and-bondholders/ (explaining that Central Falls reworked pension obligations in bankruptcy, and there is mounting opposition to this practice among labor unions).

29. Erika Niedowski, *Central Falls, R.I., Files for Bankruptcy; Layoffs Loom*, USA TODAY (Aug. 1, 2011), http://usatoday30.usatoday.com/money/economy/2011-08-01-central-falls-bankruptcy_n.htm.

30. Moody's Investors Service downgraded Central Falls credit rating three times in thirteen months, going from a Baa1 rating in May 2010 to a Caa1 rating in June 2011. MOODY'S CORP., CENTRAL FALLS, RI – MOODY'S RESEARCH REPORTS (May 2010-July 2013), *available at* http://www.municipalbonds.com/bonds/moodys_reports_by_issuer/153447/.

31. *See* Jack M. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE. L. REV. 3, 87 (2013):

> If workers or their unions understood that their contributions were based on projected returns that were way out of line with the market, it might not seem unfair to make them bear some of the pain of the shortfall that has resulted, . . . state and local workers were induced to accept and remain in their jobs in part based on the pension promises that were continually made during their employment.

Id.; *see also* Mary Williams & Abby Goodnough, *A Small City's Depleted Pension Fund Rattles Rhode Island*, N.Y. TIMES (July 12, 2011), http://www.nytimes.com/2011/07/12/business/central-falls-ri-faces-bankruptcy-over-pension-promises.html?pagewanted=all&_r=0.

> [O]ver the years [Central Falls] has promised police officers and firefighters retirement benefits like those offered in big, rich states like California and New York. These uniformed workers can retire after just 20 years of service, receive free health care in retirement, and qualify for full disability pensions when only partly disabled.
>
> . . . .
>
> . . . It is hard to see how anyone thought such an impoverished tax base could come up with an additional $80 million for retirement benefits. If the city were contributing the recommended amount to the plan each year, it would take 57 percent of local property tax revenue.

While each municipal bankruptcy case is unique with respect to the precise missteps that led to its financial crisis,[32] the modern cases share numerous similarities. As many have noted,[33] bondholders are typically described as "sophisticated" and well positioned to evaluate and price the risk associated with any particular municipality's debt. Except in cases of

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> Daniel L. Beardsley Jr., executive director of the Rhode Island League of Cities and Towns, said it was not the city's idea. Other states limit what can be decided in collective bargaining, but Rhode Island's law says that for police and firefighters, "wages, hours and any and all terms or conditions of employment" are subject to negotiation.
>
> "That means even the length of a mustache," said Mr. Beardsley, who over many years has represented Central Falls and other municipalities in contract negotiations. Talks broke down more often than not, he said, and then the same state law called for binding arbitration, which for many years was a clubby process that emphasized comparable benefits all across the state more than any city's ability to pay.
>
> "It was a domino effect," he said, leaving Rhode Island with the nation's highest per capita spending for fire services and sixth-highest for policing. (The binding arbitration law does not apply to public workers other than police officers and firefighters in the state, although some want it extended to teachers.).

Id.; Catherine Welch, *Rhode Island City Starts Fiscal Year In The Red*, NPR (July 13, 2011, 4:00 AM), http://www.npr.org/2011/07/13/137811877/rhode-island-city-starts-fiscal-year-in-the-red.

> There were some questionable transactions between politicians and their friends. And when the state-appointed receiver combed the city's books he found no evidence of any financial planning in the last several years. So to raise cash, he hiked property taxes by a whopping 19 percent, which few could afford.
>
> . . . .
>
> Central Falls hasn't fully funded the pension in six years.

Id.

32. *See generally* Michael Cooper, *An Incinerator Becomes Harrisburg's Money Pit*, N.Y. TIMES, May 21, 2010, at A14, *available at* http://www.nytimes.com/2010/05/21/us/21harrisburg.html?_r=0 (reporting that Harrisburg, Pennsylvania filed Chapter 9 largely due to a failed trash incinerator project); Melinda Dickinson, *Alabama County Files Biggest Municipal Bankruptcy*, REUTERS (Nov. 10, 2011), http://www.reuters.com/article/2011/11/10/us-usa-alabama-jeffersoncounty-idUSTRE7A94CP20111110 (reporting that Jefferson County, Alabama filed Chapter 9 almost entirely due to a failed sewer system project). See, for example, Brown, *supra* note 8, for a general discussion of the events that led Bridgeport which included "cost overruns at the city-owned nursing home".

33. *See, e.g.,* Gordon, *supra* note 9 ("[S]hocks are transmitted slowly through the system. More educated institutional investors are probably able to sort good apples from bad; other investors simply 'buy and hold.'"); *see also* Arezki, *supra* note 9.

alleged fraud,[34] some have argued that bondholders should bear the burden in the event of municipal default because a city's other creditors simply cannot afford to.[35] In addition, although less frequently noted, bondholders carry insurance that protects them in the event of default; other municipal creditors typically have nowhere to turn when the city cannot meet its obligations to them.

A. Insurers of Municipal Debt

The market for insurance for bondholders is currently dominated by two underwriters: Assured Guaranty Municipal[36] (AGM) and Build America Mutual[37] (BAM). AGM and BAM issue what is commonly

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34. In Jefferson County, bonds were backed by sewer system revenue. However, there was also an agreement with county commissioners to keep rates high enough to meet their obligations. Jefferson County largely ignored this promise and further exacerbated the issue by voting to reduce rates in 2009. Four out of the five people on the county commission have since been convicted of taking bribes and sentenced to prison. The fifth was convicted of obstructing justice. Floyd Norris, *Portent of Peril for Muni Bondholders*, N.Y. TIMES (June 7, 2013), http://www.nytimes.com/2013/06/07/business/bankruptcy-in-alabama-county-offers-warning-for-other-municipalities.html?pagewanted=all. For a similar example of a monoline insurer claiming a city is not dealing in good faith, see Steven Greenhut, *California Bankruptcies Shield Retirees, Not Bondholders*, BLOOMBERG (Aug. 9, 2012), http://www.bloomberg.com/news/2012-08-09/california-bankruptcies-shield-retirees-not-bondholders.html.

> Stockton's attempt to transfer the cost of lucrative, above-market employee wages and benefits granted when tax revenues were flush to capital markets creditors by haircutting bond principal is unprecedented, a contortion of the bankruptcy process and will foreclose Stockton's access to the capital markets for the foreseeable future.

Id.

35. *See* Beermann, *supra* note 31, at 92 ("[T]he possibility of a large-scale bailout should at least be part of the conversation. Retirees are entitled to at least as much consideration as financial institutions and government bondholders."); *see also* Skeel, *supra* note 8.

36. "Assured Guaranty Ltd. is a Bermuda-based insurance holding company that trades on the New York Stock Exchange with the ticker symbol AGO." *About Us*, ASSURED GUARANTY, http://assuredguaranty.com/about-us (last visited Feb. 2, 2014). For an example of Chapter 9 related litigation in which AGM is currently involved, see *In re* City of Stockton, Cal., 486 B.R. 194 (Bankr. E.D. Cal. 2013); *see also In re* Jefferson Cnty., Ala., 491 B.R. 277 (Bankr. N.D. Ala. 2013); *see also In re* City of Harrisburg, PA, 462 B.R. 510 (Bankr. M.D. Pa. 2013).

37. Build America Mutual is a relatively new insurer (launched July 2012) that "insures municipal bonds exclusively and as a result, claims to have no legacy exposure to mortgage-backed bonds, derivatives or other structured financings." *BAM Q&A*, BUILD AMERICA MUTUAL, http://buildamerica.com/wp-content/plugins/statementUploader/uploads/BAMQA.pdf (last visited Mar. 6, 2014).

referred to as monoline insurance, which dates back to at least 1971.[38] Prior to the subprime mortgage crisis, there were six monoline insurers that carried an "AAA" rating, the highest rating possible: Ambac, CIFG Guaranty (CIFG), Financial Guaranty Insurance Company (FGIC), Financial Security Assurance (FSA), National (formerly MBIA), and XL Capital Assurance (XLCA).[39] In 2008, Assured Guaranty Ltd. acquired FSA to form AGM, and it remains the only monoline insurer of the six continuing to write new business. BAM is the newest underwriter of monoline policies and describes itself as the industry's "first mutual bond insurer," which apparently means that unlike AGM, BAM is owned by the very creditors it insures and not by stockholders.[40] In 2012, AGM accounted for 99.8% of the $13.2 billion of new municipal debt.[41] Although some have suggested that BAM is on the rise,[42] AGM's market share has made it, in effect, the only carrier in the market at the present time.[43]

As the sole carrier, one would expect AGM to exercise significant monopoly power with respect to setting rates for insureds. For the past several years, bondholders have had almost no ability to shop competitively for monoline insurance, although this is changing as BAM's market share continues to grow.[44] Under these conditions, it is

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38. *See* WELLS FARGO ADVANTAGE FUNDS, DETERIORATION OF MONOLINE INSURANCE COMPANIES AND THE REPERCUSSIONS FOR MUNICIPAL BONDS (2008), *available at* http://www.wellsfargoadvantagefunds.com/pdf/whitepapers/monoline_insurance_muni_bonds.pdf.

39. *See id*.

40. *See BAM Q&A*, *supra* note 37.

41. U.S. SECURITIES & EXCHANGE COMMISSION, ANNUAL REPORT FOR THE FISCAL YEAR ENDED DECEMBER 31, 2012–ASSURED GUARANTY LTD. 75 (2013), *available at* http://www.sec.gov/Archives/edgar/data/1273813/000127381313000006/ago-12312012x10k.htm.

42. *See* Alan Schankel, *Build America Mutual Assurance: Janney Fixed Income Strategy*, JANNEY MONTGOMERY SCOTT LLC, Mar. 12, 2013, at 3-4, *available at* http://www.janney.com/File%20Library/Unassigned/BAB-Mutual-Assurance_3_2013.pdf ("Much as Burger King and McDonalds often benefit when their fast food locations exist on the same corner, by drawing more potential customers, the competition between BAM and Assured will energize the bond insurance proposition, with each company participating in a growing insurance market.").

43. *See, e.g.*, U.S. SECURITIES & EXCHANGE COMMISSION, *supra* note 41 (reporting that AGM represented 99.8% of municipal bond insurance market share in 2012 and 100% of the market share in both 2011 and 2010).

44. *See* Schankel, *supra* note 42, at 3.

> BAM will only insure fixed rate bonds (no floating rate, put bonds, swaps etc.). At least one public, underlying investment grade rating from one of the rating agencies is required. The benefit of an underlying rating is the additional third party surveillance provided by the rating agency. . . .

reasonable to assume that bondholders currently pay a significant premium to obtain insurance like all customers in a market dominated by a single monopolist.[45] As recently as 2007, the monoline market consisted of six carriers.[46] Many withdrew from the market during the recent recession in response to a large volume of claims and attendant losses.[47]

Monoline insurance rates are largely determined by the overall health of the issuing municipality but are also affected by their own rated health.[48] AGM relies on rating agencies and other available data in order

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> In the initial few months of its participation in the insurance marketplace, BAM has already generated a more competitive environment. . . .
>
> Through mid March BAM insured 87 new issues totaling $559 million compared to 105 issues adding up to $965 million for Assured. . . .
>
> Assured Guaranty faces challenges from both an aggressive new competitor in BAM and the recent rating downgrade from Moody's, but retains advantages in both its strong brand recognition and solid capital base. In round numbers, BAM's $500 million in capital well covers its approximately $550 million of insurance in force, but of course this nearly one to one ratio of exposure to capital will grow as BAM writes more business.

Id.

45. For a detailed introduction to monopoly power and pricing in a non-competitive market, see Andreas G. Papandreou, *Market Structure and Monopoly Power*, 39.5 AM. ECON. REV. 883 (1949).

46. WELLS FARGO ADVANTAGE FUNDS, *supra* note 38. Before any monoline insurer suffered a downgrade, there were six insurers that carried a "AAA" rating, the highest rating possible: Ambac, CIFG, FGIC, FSA, MBIA, and XLCA. FSA was acquired and merged into AGM and is the only remaining insurer continuing to write new business. *See* GALLIARD CAPITAL MGMT., QUICK TAKES: MONOLINE INSURANCE COMPANIES 1 (Nov. 2007), *available at* http://www.galliard.com/_literature_66371/Monoline_Insurance_Companies.

47. The two largest monoline insurers historically are National (formerly MBIA) and Ambac. National continues to be solvent, but it is not writing new business pending litigation. *See* Schankel, *supra* note 42, at 4. Ambac's major downfall came not from municipal bonds but guaranteeing subprime mortgage securities prior to the economic recession of the late 2000s. *See* Shira Ovide, *Read Ambac Financial's Bankruptcy Filing*, WALL ST. J. (Nov. 8, 2010, 5:54 PM), http://blogs.wsj.com/deals/2010/11/08/read-ambac-financials-bankruptcy-filing/.

48. *See* JAMES P. MCNICHOLS, CASUALTY ACTUARY FORUM, MONOLINE INSURANCE & FINANCIAL GUARANTY RESERVING 231, 234-35 (2003), *available at* http://www.casact.org/pubs/forum/03fforum/03ff231.pdf.

> Financial guarantee insurance provides investors with guaranteed payment of timely interest and ultimate principal in the event that a debt issuer is unable to meet its financial obligations. The insurance guarantee is irrevocable and unconditional (and waives all defenses, including fraud) and results in the guarantor stepping into the shoes of the issuer in that it guarantees payments ha accordance with the original transaction schedule on a timely basis. In the event the issuer fails to pay the coupon and/or principal on a timely basis the investor has recourse to the [financial guaranty] insurer who will pay the

to evaluate the creditworthiness of a particular project and the financial health of the city offering the debt.[49] In Detroit, Jeff Wattrick writes that

> mayors and city councils have been floating the city's budget with the municipal equivalent of payday loans. . . . "The debt sales cost Detroit $474 million, including underwriting expenses, bond-insurance premiums and fees for wrong-way bets on swaps,

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> timely interest and/or ultimate principal in accordance with the terms of the affected bond . . . . In [financial guaranty] insurance you pay the investor now and argue with the issuer later. Absent that type of insurer performance, (known as a "capital market" standard), investors would have no incentive to buy "wrapped" bonds.
>
> The established primary financial guarantors are rated AAA (or their equivalent) by each of Standard & Poors, Moodys and Fitch and, by virtue of the guarantee, securities they wrap inherit their AAA rating.
>
> Such AAA ratings provide the issuer with reduced borrowing costs (as the pricing benefits outweigh the cost of the guarantee) and better marketability of the bonds. As a general rule, monolines target roughly 2/3rds of the available spread as the required insurance premium. Investors benefit from enhanced security and liquidity of the insured bonds. They also benefit from the credit monitoring expertise of the guarantor and the comfort that the insurer is sharing the risk by lending its credit quality to the issue.
>
> The most important strengths of the primary monoline insurers are their ratings. As a consequence, they work closely with the rating agencies to preserve them. Capital adequacy and solvency obviously play a key role in the rating agencies' credit assessments. In addition, rating agencies require that all potential transactions be of investment grade quality (i.e., at least BBB- or equivalent) before any insurance wrap is considered. Therefore, each transaction generally receives a "shadow" (non-public) rating by at least two of the three major rating agencies and, thus, a full deal rating agency review.

Id.; *see also* WELLS FARGO ADVANTAGE FUNDS, *supra* note 38 (explaining that monolines had to maintain AAA ratings to secure business and that anything less would effectively shut them down because investors would not pay for the lower-rated guarantee.).

49. *See* NEIL O'HARA, SEC. INDUS. & FIN. MKT. ASS'N (SIFMA), THE FUNDAMENTALS OF MUNICIPAL BONDS (6th ed. 2011).

> [M]onolines had to maintain their AAA ratings to secure business; investors were looking for nothing less than AAA-rated guarantees on the debt they were buying. What good was an AA-rated insurance provider for an AA-rated municipal bond? It added nothing to the deal. On top of that, municipal bonds were already on a higher credit quality scale than the corporate ratings scale, meaning that an A-rated municipal bond had less likelihood of default than an A-rated corporate bond, or an A-rated insurance company for that matter. Municipals had better overall credit profiles and were put on a customized ratings scale with a downward bias to give some context across the different deals.

WELLS FARGO ADVANTAGE FUNDS, *supra* note 38, at 6; *see generally* McNichols, *supra* note [48].

> according to data compiled by Bloomberg. That almost equals the city's 2013 budget for police and fire protection."[50]

In Central Falls, Moody's Investors Service downgraded the small city's credit rating three times in thirteen months, going from a Baa1 rating in May 2010, to a Caa1 rating in June 2011.[51]

As one would expect, cities in generally poor financial health find that they must promise higher rates of interest in order to attract buyers for their debt. Likewise, the cost of insuring this debt is inversely related to a municipality's fiscal status.[52]

B. Default

Since 1981, forty-four municipalities in the U.S. have filed for bankruptcy protection. Thus far, no bankruptcy has concluded with a requirement that bondholders take less than the full amount of the debt owed. (In the newly filed Detroit case, numerous arguments have been made to the effect that it is time for bondholders to share in the cost of restructuring.[53]) It appears that the not-yet-concluded bankruptcy in

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50. Jeff Wattrick, *Detroit Doesn't Just Have A Debt Problem, It Has A Borrowing Addiction*, DEADLINE DETROIT (Mar. 14, 2013, 9:53 PM), http://www.deadlinedetroit.com/articles/4103/detroit_doesn_t_just_have_debt_problem_it_has_a_borrowing_addiction#.UfyKU6K1Ftk.

51. MOODY'S, *supra* note 30.

52. *See generally* SYLVAN G. FELDSTEIN & FRANK J. FABOZZI, THE HANDBOOK OF MUNICIPAL BONDS (1st ed. 2008); *see also* McNichols, *supra* note 48, at 257-61 ("Monoline pricing constraints . . . [are] ultimately a function of risk management (i.e. underwriting) and capital management.").

53. *See* Daniel Fisher, *Detroit's Bankruptcy Is Just Politics by Other Means*, FORBES (July 19, 2013), http://www.forbes.com/sites/danielfisher/2013/07/19/detroits-bankruptcy-is-just-politics-by-other-means/ ("Among other things, that judge will have to tackle the politically charged question of whether the city's public employees can jump ahead of bondholders and other creditors to collect pension payments that vastly exceed both financial reserves and the city's likely ability to repay."); see also *State of Pay*, ECONOMIST (June 22, 2013), http://www.economist.com/news/finance-and-economics/21579861-what-do-woes-detroit-mean-muni-bonds-state-pay (explaining that both Detroit, Michigan and Jefferson County, Alabama are proposing plans to emerge from bankruptcy that involve taking creditors for losses); Yaccino & Cooper, *supra* note 3 ("Detroit . . . wants to spread the losses to investors as well as pensioners, and hopes to find cheaper ways to cover retirees through the subsidized health exchanges being created by President Obama's health care law.").

Jefferson County, Alabama may become the first case in which a court forces bondholders to accept less than the full amount of debt owed.[54]

Central Falls followed the more common practice of protecting bondholder and monoline insurer interests completely. In Rhode Island, the legislature and various observers explicitly acknowledged the need to contain the crisis in Central Falls and to avoid a scenario in which other Rhode Island cities were denied access to the bond market in order to finance public projects.[55] This view—that it was appropriate for the state to ensure access for other municipalities to the bond market no matter

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54. Jefferson County, which was the largest municipal bankruptcy on record until Detroit filed on July 18, 2013, is buried in $4.2 billion in debt. JP Morgan is the county's largest creditor with $1.22 billion outstanding. The current plan filed with the bankruptcy court will require JP Morgan to settle for 31% of what it is owed. Steven Church & Dawn McCarty, *Jefferson County Files to End Bankruptcy, Adjust Debt*, BLOOMBERG (July 1, 2013, 3:47 PM), http://www.bloomberg.com/news/2013-06-30/jefferson-county-files-to-end-bankruptcy-adjust-debt.html.

> Less than $100 million of [Jefferson] county's $4.2 billion in debt will be paid with no changes to the terms of the original lending documents. Sewer warrant holder JPMorgan Chase & Co. (JPM) will collect 31 percent of what it is owed, while some general obligation bondholders will lose the right to collect penalty fees and a higher, default interest rate.

Id.

The same plan calls for the monoline carriers to accept $165 million in satisfaction of $315 million owed. *Id*. Any bondholder with a warrant (a security option used to enhance the yield of the bond) that is owed more than $500 million must choose between collecting 65 cents on the dollar or 80 cents on the dollar if they forego their right to make a claim with their monoline carrier. *Id*.; Norris, *supra* note 34. The idea is to incentivize bondholders to relieve some of the pressure on the insurer. A hearing is currently scheduled for November 2013 for U.S. Bankruptcy Judge Thomas Bennett to consider whether or not to approve this plan. Melinda Dickinson & Verna Gates, *Bankrupt Alabama County Makes Another Deal Ahead of Final Plan*, CHI. TRIB. (June 27, 2013), http://articles.chicagotribune.com/2013-06-27/news/sns-rt-us-usa-jeffersoncounty-20130627_1_bankrupt-alabama-biggest-municipal-bankruptcy-jefferson-county.

55. *See* R.I. GEN. LAWS § 45-12-1 (2013); *see also* Cate Long, *This Class is Unimpaired by the Plan*, REUTERS (Sept. 26, 2011), http://blogs.reuters.com/muniland/2011/09/26/this-class-is-unimpaired-by-the-plan/.

> In a new and surprising move the state of Rhode Island passed General Laws § 45-12-1 and enshrined in law that bonds are secured by a Rhode Island statutory lien on property taxes and general fund revenues. In essence the state created a post-facto super senior preference for bondholders. The state changed the rules after the game was underway.
>
> The stated concern of state officials was that if Central Falls bondholders were "haircut" in bankruptcy court then bond market access for all cities in the state would close or be severely curtailed. In essence the state wanted to ring fence the assets of the bondholders assets against any harm that a bankruptcy proceeding would subject them to.

Id.

how severe the crisis in Central Falls—guaranteed that the costs of restructuring would fall on taxpayers (already some of the poorest residents of the state) and current and former public employees.

For months the local press offered up real life examples of retirees whose pension and health care benefits were reduced dramatically. For example, the pension of former Central Falls acting fire chief, Gerard Dion, dropped from over $75,000 annually to just over $34,000.[56] The absolute smallest reduction went to Michael Long, whose pension dropped from $11,522 annually to $10,000, a cut of 13%.[57] Because these retirees never participated in the Social Security retirement program[58] that is mandatory for most U.S. workers, the stories were especially poignant. Older retirees, often disabled and unlikely to be able to reenter the workforce, simply had to make due with huge cuts to their income and health care benefits—all in the midst of the worst recession since the 1930s.

For those who favored absolute protection for the insured creditors, this was painful but necessary medicine. They pointed out that many public employees had, in effect, enjoyed years of over-compensation. The moral hazard story at the core of this view is a familiar and, I think, an accurate one. Short-sighted politicians, eager to please and attract support at the polls, routinely made long-term financial commitments with taxpayer dollars that were overly generous by any measure. Well-organized public employee unions delivered votes in return for modest short-term gains (i.e., increases to current salary) and substantial long-term gains (pension enhancements and expensive retiree health benefits without so much as a co-pay or deductible). In effect, both the political representatives and public employees decided that an optimal strategy was to borrow from future taxpayers. In a world where incomes and tax revenue are rising, this kind of arrangement may be sustainable at least for a while; in a place like Central Falls, where incomes were stagnant or falling and the tax base was eroding, such an arrangement was

56. Ted Nesi, *C. Falls Slashes Dozens of Pensions by 55%; One Gets Cut $41K,* WPRI, (Sept. 2, 2011, 2:30 PM), http://blogs.wpri.com/2011/09/02/c-falls-slashes-dozens-of-pensions-by-55-one-gets-cut-41k/.

57. *Id*.

58. The Social Security retirement program works by having employees pay into the fund while one is working and then receive benefits later upon retirement. The program includes retirees, as well as disability and survivor benefits. The earliest you can start collecting Social Security retirement benefits is age 62, even if you retire before that, and the latest is age 70. 42 U.S.C.A. §§ 301-1397 (West 2008). If you are covered only by your state or local pension plan, you can opt out of the Social Security program. *Id.* § 302; *Retirement Planner: State and Local Government Employment*, U.S. SOC. SECURITY ADMIN., http://www.ssa.gov/retire2/stateandlocal.htm (last visited Mar. 19, 2014).

guaranteed to result in financial collapse. There was, in the end, no magic money and no way for a poor and working class city to honor all of the promises it made to both its employees and its other creditors.[59]

Bondholders must have known that the trajectory in Central Falls was unsustainable;[60] the city's political representatives—at least those that were focused on anything other than their own corrupt schemes for self-advancement—also knew. Only the taxpayers, especially the non-English speakers and those unfamiliar with the nature of municipal finance in the United States who made up a majority of the residents in Central Falls[61] can credibly claim that they were surprised by the city's financial collapse.

Culpability for the mess in Central Falls certainly resides with the political actors who, aided and abetted by public employees, promised benefits far beyond what the poor town could afford;[62] however, the bondholders, emboldened by their insurers, must bear some share of the blame for continuing to finance imprudent projects like Wyatt. The lack of any truly innocent party (except, perhaps, for the ill-informed taxpayer) makes the imposition of the costs of bankruptcy on all parties save the bondholders truly remarkable.

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59. *See* Mary Williams Walsh & Michael Cooper, *Faltering Rhode Island City Tests Vows to Pensioners*, N.Y. TIMES, Aug. 13, 2011, at A1, *available at* http://www.nytimes.com/2011/08/13/us/13bankruptcy.html.

> Cities and local governments make lots of promises: to their citizens, workers, vendors and investors. But when the money starts to run out, as it has in Central Falls, some promises prove more binding than others. Bond lawyers have known for decades that it is possible, at least in theory, to put bondholders ahead of pensioners, but no one wanted to try it and risk a backlash on Election Day.

Id.

60. *Contra* WELLS FARGO ADVANTAGE FUNDS, *supra* note 38, at 3.

> Insured municipal bonds were viewed as AAA-rated quality with essentially no need to even measure their underlying credit profiles, because all monolines were AAA-rated companies and none had ever failed to make a payment. Therefore, payments to investors were guaranteed, regardless of whether or not the municipality could make them. In short, confidence was high in monoline-backed municipal bonds. As a result, many investors did little due diligence on the credit quality or the insurance that backed the bonds.

Id.

61. *See supra* text accompanying notes 14-29.

62. *See* Williams & Goodnough, *supra* note 31.

III. EVALUATING CONTAGION

The conventional answer to the question of why bondholders should be protected above all other creditors is fear of contagion.[63] If contagion claims are real—i.e., both the distressed city and possibly others in the same state or region will be denied access to capital and the ability to finance routine projects—then protecting bondholders at the expense of taxpayers and current and former employees may make sense. Bondholders and insurers routinely (and as expected) raise the specter of contagion post-default during negotiations with struggling municipalities.[64] What is less clear is whether bondholders actually make good on their threats to cut off debt-ridden cities.

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63. *See* Chris Brune & Pu Liu, *The Contagion Effect of Default Risk Insurer Downgrades: The Impact on Insured Municipal Bonds*, 63 J. ECON. & BUS. 492, 501 (2011) ("Due to a contagion effect, countless insured municipal bonds were affected, regardless of whether they were insured by the downgraded insurer."); *see* also John M. Halstead et al., *Eastern Finance Association, Orange County Bankruptcy: Financial Contagion in the Municipal Bond and Bank Equity Markets*, 39.2 FIN. REV. 293, 295 (2004) ("Current literature on financial contagion suggests that economic shocks of this magnitude could potentially spread to other local governments not directly exposed to the original shocks for both fundamental (rational) and irrational reasons."); *see* also Williams & Goodnough, *supra* note 31 ("[W]hen local governments have veered toward bankruptcy—Orange County, Calif., in 1994; Cleveland in 1978—neighboring municipalities have found it harder to sell their own debt. During the New York City fiscal crisis of 1975, New Jersey suddenly found its bonds harder to sell.").

64. *See* Greenhut, *supra* note 34.

> "Chapter 9 was not intended to be used as a sword to prefer one class of similarly situated creditor over another," said Assured Guaranty in an Aug. 1 statement. "Stockton's attempt to transfer the cost of lucrative, above-market employee wages and benefits granted when tax revenues were flush to capital markets creditors by haircutting bond principal is unprecedented, a contortion of the bankruptcy process and will foreclose Stockton's access to the capital markets for the foreseeable future."

Id.; *see also* Walsh & Cooper, *supra* note 59.

> Bond lawyers have known for decades that it is possible, at least in theory, to put bondholders ahead of pensioners, but no one wanted to try it and risk a backlash on Election Day. Now the poor, taxed-out city of Central Falls is mounting a test case, which other struggling governments may follow if it succeeds.
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> . . . .
>
> In Central Falls, the pension plan for the police and firefighters is projected to run out of money in October. But officials there say short-changing the bondholders will not bring relief. The next time the city needs to borrow money, investors will simply demand more in interest, and they might decide all Rhode Islanders were a bad risk and charge all cities more.

Id.

It is important to note at the outset of any discussion about the consequences of default that many bondholders are also retirees because public (and private) pension plans hold so much public debt.[65] Thus, the often-discussed tension between bondholders and retirees[66] is in one sense a false one: retirees lose when bondholders lose. The problem, of course, with this analysis is that it fails to take into account the presence of insurance that is available only to the bondholders. As Central Falls so clearly demonstrates, a direct cut to public pension income is almost impossible for an older retiree to recoup. Bondholders, however, are entitled to full payment from the monoline carrier in the event of default.[67] Likewise, public pension plans (which are overwhelmingly defined benefit plans[68]) also benefit from any reduction in obligations to retirees.

To see this more clearly, consider a seventy-year-old retiree who is receiving a pension income of $4000 per month prior to her pension plan's forced restructuring in Chapter 9. If this retiree's income came from one of the Central Falls plans, her income would be reduced to

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65. As of June 2013, state and local government debt, including pension funds, account for $703.5 billion worth of the overall U.S. public debt. Similarly, private pension funds account for $605 billion in public debt. Overall, fifteen percent of public debt is held by mutual funds, private pensions, savings bonds, or treasury notes. Kimberly Amadeo, *Who Owns the U.S. National Debt?*, ABOUT.COM (June 3, 2013), http://useconomy.about.com/od/monetarypolicy/f/Who-Owns-US-National-Debt.htm.

66. *See* Jacob Gershman, *Bondholders, Public Pensioners Square Off in Detroit*, WALL ST. J. (July 18, 2013), http://blogs.wsj.com/law/2013/07/18/bondholders-public-pensioners-square-off-in-detroit/ ("The bankruptcy case in Detroit could be titled Bondholders v. Pensioners. The city's emergency manager has said his goal is to spread the pain around."); *see also* Abby Goodnough, *City in Rhode Island Asks Retirees to Sacrifice*, N.Y. TIMES (July 20, 2011), http://www.nytimes.com/2011/07/20/us/20centralfalls.html ("CENTRAL FALLS, R.I.—The retirees came from near and far, gathering in a muggy auditorium here to listen to an urgent pitch: give back a big chunk of your pension or risk losing it all."); *see also* Greenhut, *supra* note 34 ("The recent war of words between the California Public Employees' Retirement System and a Bermuda-based bond-insurance company called Assured Guaranty Ltd. has made it clear that California officials would rather stiff bondholders than trim even the most generous pension benefits promised to public-sector workers.").

67. Unless, of course, the monoline insurer collapses, which many did after the subprime mortgage crisis. *See* Norris, *supra* note 34 ("Another risk, probably never considered, was that the monoline insurance companies, which routinely guaranteed munis for a fee, would collapse.").

68. ORRIN HATCH, U.S. SENATE COMM. ON FIN., STATE AND LOCAL GOVERNMENT DEFINED BENEFIT PENSION PLANS: THE PENSION DEBT CRISIS THAT THREATENS AMERICA (2012), *available at* http://www.hatch.senate.gov/public/_cache/files/ecfaf678-a3ec-45a4-a2bf-3bca4fe9475d/Hatch%20Report%20-%20The%20Pension%20Debt%20Crisis%20that%20Threatens%20America.pdf ("It has been estimated recently that aggregate underfunding of state and local defined benefit pensions plans may exceed $4 trillion.").

approximately $2000 per month. Her only options for replacing the lost income are reentry into the labor force (problematic for most seventy-year-olds), a steady drawdown on private savings (if available), or assistance from family or friends. Even though, in the long run, her defined benefit plan[69] may in fact be healthier because its obligations to retirees have shrunk dramatically, it is impossible to see how the individual retiree is better off.

Now, compare the situation of the bondholder and the plan itself to that of the retiree. In Central Falls, the bondholders' expected stream of income is effectively protected through increased taxes and reductions in payments to retirees; even if the bondholder is forced to share in some of the loss, as in Jefferson County,[70] insurers will make the bondholders whole. Finally, the municipality's defined benefit plan's liabilities have been reduced. Although plan representatives may publicly bemoan benefit cuts,[71] it cannot be denied that the plan itself is in far better financial shape following a 50% reduction in its liabilities.

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69. A defined benefit plan (DB Plan) is a retirement account for which an employer promises a set amount of money upon retirement, usually based on salary and length of employment. This is in contrast to a defined contribution (DC) plan, like a 401(k), in which an employee invests his own money for retirement. The key distinction is that a plan sponsor bears the risk with a DB plan and a participant bears the risk with a DC plan. For a vast amount of information on defined benefit and defined contribution plans, see Joseph Comprix & Karl A. Muller III, *Pension Plan Accounting Estimates and the Freezing of Defined Benefit Pension Plans*, 51 J. ACCT. & ECON. 115, 117 (2011) ("Defined contribution plans require employers to make specified contributions towards employees' retirement plans. Investment risk then falls upon the employee, with the employer having no further pension obligation after the contribution has been made. In contrast, defined benefit plans represent a formal promise that the employer will pay pre-determined benefits upon retirement."); *see also* James Poterba et al., *Defined Contribution Plans, Defined Benefit Plans, and the Accumulation of Retirement Wealth*, 91 J. PUB. ECON. 2062 (2007) ("Wealth accumulation in DC plans depends on a participant's contribution behavior and on financial market returns, while accumulation in DB plans is sensitive to a participant's labor market experience and to plan parameters."); *see also* Jonathon Barry Forman, *Public Pensions: Choosing Between Defined Benefit and Defined Contribution Plans*, 1999 L. REV. MICH. ST. U. DET. C. L. 187 (Spring 1999); *see also* Tomas Dvorak, *Timing of Retirement Plan Contributions and Investment Returns: The Case of Defined Benefit Versus Defined Contribution*, 12 B. E. J. ECON. ANALYSIS & POL'Y (2012); *see also Ultimate Guide to Retirement,* CNN MONEY, http://money.cnn.com/retirement/guide/pensions_basics.moneymag/index.htm?iid=EL (last visited Feb. 2, 2014).

70. The proposed plan in Jefferson County has bondholders sharing the loss with retirees. The plan will be reviewed for final order in November 2013. *See* Steven Church, *Jefferson County to Turn Deal into Bankruptcy Plan*, BLOOMBERG (June 5, 2013, 2:27 PM), http://www.bloomberg.com/news/2013-06-05/jefferson-county-to-turn-deal-into-bankruptcy-plan.html.

71. For an example of trustees complaining about reductions to retirees, see Sona Mkrttchian, *Central Falls on Track to Emerge from Bankruptcy*, BROWN DAILY HERALD

The sense of abandonment and isolation that Central Falls retirees expressed[72] as the city prepared to emerge from Chapter 9 was objectively reasonable. The burden of correcting the city's finances fell solely on the shoulders of retirees and taxpayers—the status of bondholders, insurers, and even the city's defined benefit plans[73] was unaffected or improved following bankruptcy.

(Sept. 20, 2012), http://www.browndailyherald.com/2012/09/20/central-falls-on-track-to-emerge-from-bankruptcy/ (reporting a dialogue with the president of the Central Falls Police Retirees Association); *see also Union Leader says Central Falls Firefighters are Among Lowest Paid in Rhode Island*, PROVIDENCE J. POLITIFACT (Aug. 28, 2011), http://www.politifact.com/rhode-island/statements/2011/aug/28/joseph-andriole/union-leader-says-central-falls-firefighters-are-a/.

72. For examples of Central Falls retirees expressing themselves over lost pensions, see Hilary Russ, *Bankruptcy Saves Tiny Rhode Island City, but Leaves Scars*, REUTERS (Sept. 3, 2012, 8:06 PM), http://www.reuters.com/article/2012/09/04/us-usa-rhodeisland-centralfalls-bankrupt-idUSBRE88300220120904.

> "We've been pilfered and beaten down," said Bruce Ogni, president of the Central Falls police retirees organization. "We didn't have the power, the money, to fight it."
>
> . . . .
>
> [Thomas] Cawley was a Central Falls police officer for 26 years, retiring as a sergeant in 1986, the same year Rolling Stone magazine labeled the city the biggest cocaine hub in the Northeast.
>
> At his dining room table, Cawley gazes through thick glasses at a pile of letters. One, from September 2011, informed him that after making payments for a $20,000 life insurance policy for 24 years, his policy had been canceled as part of the city's austerity plan.
>
> Cawley's annual pension payment was slashed to $18,274 from $27,073 and his health insurance was moved to Medicare from Blue Cross at a cost to him of $100 a month.
>
> He, like other Central Falls employees, gets no Social Security benefits from his city job, though he receives about $6,000 a year in Social Security payments from old part-time jobs.
>
> He and his wife are angry, but the retirees didn't have the money or power to fight it, they said. "We have to live on what we're getting," he said. "What else can you do?"

Id.

73. *See* Williams & Goodnough, *supra* note 31 ("Mike Andrews, president of the local firefighters' union, said about one in four of his men now qualified for retirement, but were afraid to retire, concerned that their pensions would be chopped in bankruptcy."). For a similar example, see Monica Davey & Mary Williams Walsh, *Chicago Sees Pension Crisis Drawing Near*, N.Y. TIMES (Aug. 6, 2013), http://www.nytimes.com/2013/08/06/us/chicago-sees-pension-crisis-drawing-near.html ("Illinois lawmakers, who make key financing and benefit choices for Chicago's pension system, have wrestled for months without agreement on the politically troublesome matter of cutting the benefits of public sector retirees to save money.").

A. The Lessons of Harrisburg

The bankruptcy of the impoverished city of Harrisburg, Pennsylvania is sometimes cited as a cautionary tale about the consequences of ignoring contagion. In 2003, Harrisburg's city trash incinerator was shut down by the federal government due to toxic air pollution.[74] In a unanimous vote, Harrisburg City Council voted to approve a rebuild and expansion that would ultimately cost the city $345 million and force them into default.[75] Constant delays, setbacks, and cost overruns turned what was supposed to be a moneymaker into a major liability for city finances.

In January 2013, the Wall Street Journal reported that Harrisburg was in default on its bonds and was "effectively shut out of the municipal-debt market."[76] City officials were described as going door-to-door in search of lenders, none of whom wanted to risk loaning money when the city might seek protection under Chapter 9 at any moment.[77] In June 2011, the Pennsylvania state legislature passed a law preventing third-class municipalities from filing for Chapter 9 through July 1, 2012.[78] As a result, Judge Mary France had no real choice other than to reject Harrisburg's bankruptcy as an illegal filing.[79] In Harrisburg, lenders withdrew even in the absence of a bankruptcy filing.

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74. Cooper, *supra* note 32.

75. Mary Williams Walsh & Jon Hurdle, *Harrisburg Sees Path to Restructuring Debts Without Bankruptcy Filing*, N.Y. TIMES (July 25, 2013), http://www.nytimes.com/2013/07/25/us/harrisburg-sees-path-to-restructuring-debts-without-bankruptcy-filing.html.

76. Michael Corkery, *Bottom Falls Out of Debt-Ridden City*, WALL ST. J. (Jan. 31, 2013), http://online.wsj.com/article/SB10001424127887323926104578276044132947694.html.

77. A similar scenario is playing out at the state level in Illinois where bondholders are demanding extraordinarily high interest rates in order to loan money. For example, Illinois was expected to sell $1.3 billion in bonds in late June 2013 to improve highways, rebuild a train line, and acquire land for an airport. Brian Battle, the director of Performance Trust Capital Partners in Chicago, estimated that the state "will pay more than $18 million in extra interest each year than states such as Virginia or Maryland which have high credit ratings." Sara Burnett, *Illinois' Bad Credit Costing Taxpayers Millions*, YAHOO! NEWS (June 25, 2013, 3:23 AM), http://news.yahoo.com/illinois-bad-credit-costing-taxpayers-millions-071545200.html (emphasis added) (noting that Illinois has now replaced California as the state with the lowest credit rating in the country).

78. 2011 Pa. Laws 318, No. 79, *available at* http://www.legis.state.pa.us/WU01/LI/LI/US/HTM/2011/0/0079..HTM.

79. Harrisburg may have found another way out of debt. *Harrisburg, PA, Close to Deal on Debt-laden Incinerator Sale,* REUTERS (July 24, 2013), http://www.reuters.com/article/2013/07/24/usa-harrisburg-incinerator-idUSL1N0FU0OF20130724 (reporting that Harrisburg said they have reached an

Is there evidence of contagion when a city goes bankrupt—the spread of risk from one city to another? The answer is mixed. Immediately after a default, there is evidence of bondholders demanding increased rates of return in nearby jurisdictions. In a 2005 study of local responses to municipal bankruptcies, Stowe and Maloney concluded that "closely matching jurisdictions also pay a risk premium, though one not quite as large. . . . While one might be tempted to call this a contagion effect, it is more likely indicative of an initial period of economic uncertainty."[80] This fear of increased borrowing costs for nearby

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agreement to sell the trash incinerator to Lancaster County Solid Waste Management, and although the price was not finalized, they hoped to get $130 million).

80. KRISTIN STOWE & M.T. MALONEY, CLEMSON UNIV., THE RESPONSE OF THE DEBT MARKET TO MUNICIPAL FINANCIAL DISTRESS (2005), *available at* http://myweb.clemson.edu/~maloney/papers/muni-financial-distress.pdf.

> This study adds to our understanding of the impact of municipal bond default and bankruptcy. Municipalities that go through a financial crisis pay risk premiums higher than a control group of municipalities both before and after their default. Risk premiums rise before a crisis occurs for a subset of the defaulters and fall modestly afterwards for most.
>
> We measure this risk premium in a novel way. We construct a yield premium by taking the difference between the reoffering yield on newly issued municipal bonds and the maturity matched average yield on AAA-rated municipal debt. However, because the structure of debt changes before and after default, and is different for defaulters compared to the control group, the raw yield premium is not indicative of the true cost of borrowing. Defaulters are paying for the structure of their debt, and the cost of their borrowing is best seen in the interest rate that they would be charged if they issued "naked" bonds, that is, bonds with no credit validation. To account for this, we estimate a yield premium regression holding constant the structure of debt, the distance in time from the default, and controlling for the selection effect, that is, controlling for the ways that defaulters systematically differ from the average municipality. The true cost associated with default is then measured by the intercept, the time effect, and the selection coefficient.
>
> We find that the risk premium paid by defaulters prior to default is substantial. Special districts paid over 8 percentage points higher interest, including the selection and time effects. This is, if the average special district had tried to issue debt without any credit validation in the month prior to its financial crisis, the reoffering yield would have been 820 basis points higher than the Aaa-rated municipal interest rate. The risk premium for cities and counties excluding Orange County is estimated to be 552 basis points. For the special districts, we see a run up in the risk premium indicating that the deteriorating financial condition was apparent, on average, to the bond market. However, default for cities and counties in our sample, including and excluding Orange, seems to have come as a shock in that there is no run up.
>
> Following default, jurisdictions that reenter the bond market face a risk premium of around 400 basis points. It is not that the risk premium declines following default, but rather that only the most credit-worthy jurisdictions are able to reenter the debt market. Again, this is the excess reoffering yield that

communities might be especially concerning for a small state like Rhode Island in which every city is relatively near every other.

Others have suggested that the municipal bond market is just too inefficient and slow to be affected by contagion no matter what the circumstances. Tracy Gordon[81] has argued that because municipal bonds have a "traditional mom-and-pop structure" and few transactions, many buyers pay different prices for the same bond. The market is also characterized by relatively low levels of disclosure, which means that shocks to the system (e.g., a bankruptcy filing) take time to trickle down. Gordon argues that during this slow process, "educated institutional investors are probably able to sort good apples from bad" while other investors "simply buy and hold." If this is true (and Gordon points to the run toward U.S. treasury bonds following the 2008 financial crisis to support his claim), then it may be that nearby jurisdictions actually benefit when a neighbor defaults and enters Chapter 9.

A December 2011 International Monetary Fund working paper suggested that the market for municipal bonds is "not prone to contagion but rather to flight to quality."[82] This means that in the event of default,

> they would be forced to pay if they issued debt without any credit validation. Even though they almost always issue debt with credit validation, we expect that they are paying a price for this service which is approximately equal to what it is worth in reduced interest charges. There is statistically weak evidence that the risk premium declines over time. Descriptive analysis of post-default borrowers indicates that they are a mixed bag. Some jurisdictions recover naturally, some undergo managerial reorganization, some issue debt only for the purpose of settling the default. Because of this, it is not surprising that the time effect following default is measured imprecisely.
>
> Finally, we estimated the risk premium for a sample of jurisdictions that closely match the defaulters in terms of location, size, and purpose. From this sample we get a sense of the degree of inherent risk faced by the defaulters. The closely matching jurisdictions also pay a risk premium, though one not quite as large as their neighbors. In the period before default, neighbors of the defaulters paid a risk premium of around 300 basis points but, as we might expect, there was no run-up in their borrowing cost. After the neighboring financial collapse, the closely matched group also experiences a drop in risk premium, and one that does go down with time. While one might be tempted to call this a contagion effect, it is more likely indicative of an initial period of economic uncertainty in the region and then long term growth in the tax base at least for those jurisdictions that entered the debt market following the neighbor's default.

Id.

81. Gordon, *supra* note 9.

82. Arezki, *supra* note 9, at 7-10.

> Overall, the results indicate that during a period of volatility, investors seek "safer" municipal investments—a sort of "flight to safety" that occurs during financial crises when investors (domestic and international) become less

creditors move their money to nearby, more stable municipalities and not out of the market entirely.

B. Can Bondholders (and Insurers) Distinguish Between the Healthy and the Sick?

Gordon's work and the IMF study findings are consistent with recent claims made by Clayton Gillette,[83] who has noted that "contagion should not occur because investors will distinguish financially healthy jurisdictions from distressed ones."[84] Gillette argued that because the market for municipal securities functions with a relatively low level of disclosure, it lacks the ability to perfectly segment a jurisdiction in default from other nearby cities.[85] In other words, a lack of information creates a situation in which investors view the default of a city as a signal of new (and unfavorable) information about general municipal financial stability.

It would appear that in Central Falls the legislature felt obligated to do exactly what Gillette suggested they would—"forestall municipal defaults in order to avoid perceptions of more general fiscal fragility."[86] When the default could no longer be avoided and bankruptcy was the only viable option, the legislature, still focused on appearances and perceptions, rushed to protect bondholders.

> concerned about yield and more concerned about the safety of their funds and buy U.S. Treasury securities, long considered one of the world's safest investments. In other words, an increase in borrowing costs in one U.S. state results in better borrowing conditions for other states. We find that other states benefit through lower borrowing costs (bond yields) when a few of the largest municipal issuers—such as the states of California (the largest of all), Georgia, and Maryland and the City of New York—experience problems (in other words, the spillover is negative).
>
> . . . .
>
> This study suggests that [the] markets for individual U.S. state bonds are prone not to contagion but rather to flight to quality, which implies that the problems in one state did not make matters worse for other states and thus did not increase systemic risk.

Id.

83. *See* Gillette, *supra* note 9, at 303 ("Contagion is a consequence of a perception that one municipality's default would generate external effects, not of the fact that those effects would necessarily materialize. Those perceptions are likely to be promoted by representatives of the distressed locality in their efforts to procure some form of bailout.").

84. *Id*.

85. *Id*.

86. *Id*.

Central Falls was not alone in this approach. It appears to be fairly common for state governments to scramble to avoid a municipal bankruptcy.[87] In Jefferson County, Alabama, for example, the governor of the state made serious efforts to avoid bankruptcy after experts advised him that "a Chapter 9 filing by the state's most populous county would spook the municipal bond market."[88] State governments appear to be worried about the *perception* of contagion (as opposed to actual contagion). Actual contagion requires proof of negative effects in otherwise financially healthy nearby cities, and there is little evidence of this.

There is evidence, however, of hasty state efforts to combat the impression of spreading financial gloom. As Lauren Wolfe has noted,[89] long-term contagion is more likely to come from not filing for Chapter 9 than from pursuing it. When Chapter 9 is unavailable, a municipality is forced to cut services in order to repay debtors. As in Central Falls, this creates a domino-like effect when lack of funding for police, fire, library, hospital, prison, and sanitation services results in higher crime as well as overcrowded prisons and hospitals. This, in turn, can cause a spillover effect on neighboring cities and towns that may be much more difficult to overcome than a temporary decrease in credit rating.[90]

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87. *See* 2011 Pa. Laws 318, No. 79 (preventing Harrisburg from filing for Chapter 9 for one year); *see also* Monica Davey, *Bankruptcy Lawyer is Named to Manage an Ailing Detroit*, N.Y. TIMES (March 4, 2013), http://www.nytimes.com/2013/03/15/us/gov-rick-snyder-kevyn-orr-emergency-manager-detroit.html (reporting that Michigan officials appointed Kevyn Orr as an emergency manager with a goal of avoiding bankruptcy in Detroit); *see also* David White, *Alabama Governor Robert Bentley Pledges to Help Jefferson County Avoid Bankruptcy*, BIRMINGHAM NEWS (June 29, 2011, 8:30 AM), http://blog.al.com/spotnews/2011/06/alabama_governor_robert_bentle_1.html (reporting that Alabama Gov. Robert Bentley pledged to do "everything possible" to help Jefferson County avoid bankruptcy).

88. Mary Williams Walsh & Campbell Robertson, *Just Before Deadline, County in Alabama Delays Bankruptcy Move*, N.Y. TIMES (July 29, 2011), http://www.nytimes.com/2011/07/29/business/economy/alabamas-jefferson-county-postpones-a-decision-on-bankruptcy.html.

89. Lauren M. Wolfe, *The Next Financial Hurricane? Rethinking Municipal Bankruptcy in Louisiana*, 72 LA. L. REV. 555, 588-89 (2012).

> Although a municipal bankruptcy may have a contagion effect on its neighbors and the State by temporarily downgrading their bond credit ratings, there may be long-term contagion effects that result from not allowing the municipality to pursue Chapter 9.
>
> . . . .
>
> . . . Municipal bankruptcy should not be embraced as a panacea, but it should remain available as an option of last resort.

Id.

90. *Id*. at 88 ("Neighboring towns will feel the consequences . . . . Furthermore, these effects may be felt much longer than the temporary decrease in the municipality's credit

The problem is that even with a Chapter 9 filing, a city may still have to make drastic cuts, especially when the state has moved to insulate one class of creditors—bondholders—from absorbing any losses. Conditions were so extreme in Central Falls that some degree of loss was inevitable for taxpayers and retirees. However, the cutbacks to city services and pensions could have been ameliorated had the bondholders been forced to contribute too. Given the mixed empirical and theoretical support for contagion, the Rhode Island legislature's efforts to protect bondholders seem overly generous and unnecessary.

IV. IS CENTRAL FALLS A MODEL FOR OTHER STRUGGLING MUNICIPALITIES?

Judge Frank J. Bailey of the U.S. Bankruptcy Court in Rhode Island said of Central Falls, "It's record time and record efficiency . . . . In a way, I think this is an example—for not only Rhode Island, but maybe the nation—on how to run a Chapter 9."[91] After the calamitous losses suffered by taxpayers and retirees in Central Falls, the question is should Rhode Island be viewed as a shining example of efficiency or a cautionary tale? All indications are that municipal bankruptcy is on the rise. Central Falls was managed corruptly and with astonishing mendacity for years. But many other cities have received poor service from their elected officials, over-paid for services, and made stupid Wyatt-like investments too.[92]

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rating. In the long run, it will benefit the State and its political subdivisions to afford a financially distressed municipality access to Chapter 9.").

91. Bidgood, *supra* note 2 (quoting Judge Frank J. Bailey).

92. *See* CHARLIE LEDUFF, DETROIT: AN AMERICAN AUTOPSY 80-81 (2013).

> [T]here is the thought that Detroit was simply a boomtown that went bust, a city that began to fall apart the minute Henry Ford began to build it. The car made Detroit and the car unmade Detroit. Detroit was built in some ways to be disposable. The auto industry allowed for sprawl. It allowed a man to escape the smoldering city with its grubby factory and steaming smokestacks.
>
> Detroit actually began its decline in population during the 1950s, precisely the time that Detroit—and the United States—was at its peak. And while Detroit led the nation in per capita income and home ownership, automation and the beginnings of a foreign competition were forcing the automobile companies like Packard to shutter their doors. That factory closed in 1956 and was left to rot, pulling down the east side, which pulled down the city.
>
> By 1958, 20 percent of the Detroit workforce was jobless. Not to worry, the city, rich with manufacturing revenue, had its own welfare system—a decade before Johnson's Great Society. The city provided health care, fuel, and rent and gave $10 every week to adults for food; $5 to children. Word of the free milk and honey made its way down South and the poor "Negros" and

The Central Falls story is one in which "every stakeholder except the bondholders . . . [was] suffering."[93] The only way that such a result makes sense is if fear of contagion is so real (as it may be in Harrisburg, for example) that asking bondholders to absorb a loss is just too dangerous. Concrete evidence of contagion is mixed; indeed, in Rhode Island there is little to suggest that the market would have been incapable of distinguishing between fundamentally healthier cities and places like Central Falls.

> "Hillbillies" flooded in by train. If it wasn't for them, the city's population would have sunk further than it did.

Id.; *see also* Charlie LeDuff, *Detroit's Bankruptcy and What it Means for America*, DALLAS NEWS (July 29, 2013), http://www.dallasnews.com/opinion/latest-columns/20130728-charlie-leduff-detroits-bankruptcy-and-what-it-means-for-america.ece.

> [I]t was just 99 years ago that Henry Ford offered the workingman $5 a day and profit-sharing. How, in less than a century, did it come to this?
>
> The short answers: municipal mismanagement, race riots, white flight, black flight. Overreaching unions and management that couldn't balance a ball. Proof? The multibillion-dollar bailout of the auto industry. Thank you, American taxpayers!
>
> Then there is our spectacular civic corruption: A former mayor, Kwame M. Kilpatrick, waits for a bed in federal prison, convicted of extortion, racketeering and bribery. He looted the city of millions of dollars and stole the future of thousands of children.
>
> So Detroit files for bankruptcy. What does this mean? Pay close attention because it may be coming to you soon, Los Angeles, Baltimore, Chicago, Philadelphia. In 2011, Moody's calculated the unfunded liabilities for Illinois' three largest state-run pension plans to be $133 billion. (It is expected to be even larger this year.) That's the size of six Detroit bankruptcies—give or take a few hundred million.
>
> Of Detroit's debt of at least $18 billion, about $7 billion is secured by collateral like casino revenues and utility taxes. That means creditors—big banks—will get paid. Of the remaining $11 billion or so in unsecured debt, about $9 billion is owed to retirees and current municipal workers, people like firefighters and police officers. These debts come in the form of promised pension checks and health care benefits, all backed by a false, unsecured promise. These are the people who are likely to lose out.

Id.

93. Michael Conner, *Alabama County Files Exit Plan to End $4.2 Billion Bankruptcy*, REUTERS (June 30, 2013), http://www.reuters.com/article/2013/06/30/us-usa-jeffersoncounty-idUSBRE95T0G020130630. *See also* Jess Bigood, *Plan to End Bankruptcy in Rhode Island City Close to Approval*, N.Y. TIMES, Sept. 6, 2012, at A21, *available at* http://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html. Theodore Orson, the lawyer for Central Fall's receiver noted that in spite of the heavy burden on taxpayers and retirees, "we're taking a city that was completely dysfunctional and making it fully functional." *Id.*

A. Structural Change

One of the painful lessons of Central Falls (and, I suspect, of Detroit a few years hence) is the widespread and fundamental lack of respect for taxpayer dollars demonstrated by so many actors. Politicians are well known for their cavalier attitude toward "other people's money."[94] Central Falls illustrates that bondholders too (emboldened no doubt by monoline protection and state officials persuaded of the need to avoid contagion) are willing to lend money for frivolous projects unlikely to benefit the taxpayer.[95] Stripped of insurance protection and the contagion

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94. *See* William N. Eskridge, Jr., *Politics Without Romance: Implications of Public Choice Theory for Statutory Interpretation*, 74 VA. L. REV. 275, 286 (1988) ("The free rider problem means that social and economic difficulties will not always stimulate group formation, especially for large, diffuse groups like consumers and taxpayers, and that (in contrast) small, elite groups might more easily organize."); *see also* Kelley L. Ross, *Rent-Seeking, Public Choice, and the Prisoner's Dilemma*, FRIESIAN, http://www.friesian.com/rent.htm (last visited Feb. 2, 2014).

> Public Choice theory is about the different incentives and processes that operate when goods are sought through political means rather than through purely economic means. The essential point is about the distribution of costs and benefits. The political appropriation and distribution of goods is attractive because it concentrates its benefits and disperses its costs. Many people can be taxed only a small amount and then a small number of people can be given large sums. This means that the many hardly notice the wealth that they have lost, while the few become active partisans of their own benefits. Politicians hear nothing from the many and a lot from the few, who also have some money to contribute to the politicians, money that may actually be, or be freed up by, the benefits they receive—like the money teachers' unions get from compulsory union dues, from the money paid by the government to teachers. Thus, constituencies and interest groups are created for each particular political benefit program, and it becomes nearly impossible to get rid of them. The rent-seeking aspect of this is that the beneficiaries receive rents on the basis of their participation in the interest group. They benefit because of who they are, not because of what they do or what they own in a more conventional sense.
>
> Individually, these political rents are not damaging to the whole—in the 2012 election we just heard about how little "Big Bird" costs individual taxpayers, who are forced to support the Public Broadcasting System, which is actually used as a front for the Democratic Party—but each group of people which sees another obtain benefits then seeks to create some program for itself. Such things are hard for politicians to resist, since it holds the promise of a group of dedicated voters beholden for their own program.

Id.

95. *See Cooper*, *supra* note 32 (reporting that Harrisburg, Pennsylvania filed Chapter 9 largely due to a failed trash incinerator project); *see also* Dickinson, *supra* note 32 (reporting that Jefferson County, Alabama filed Chapter 9 almost entirely due to a failed sewer system project); *see also* Norcross, *supra* note 16 (investigating Central Falls, Road Island and its use of Wyatt Detention Center as economic development).

threat, it is hard to believe any rational lender would have loaned millions to Central Falls over and over again. The sad truth is that bondholders, like elected officials, happily risked taxpayer funds for their own personal gain.[96]

The guilty role played by public employees and their representatives is by now so well understood that it requires little further explanation.[97] Suffice it to say that the public employee/legislator relationship was beneficial to all concerned save the current and future taxpayer.[98]

Can the elected official/lender/public employee axis be broken? The only way forward appears to be some combination of structural changes and increased transparency. A variety of proposals have been advanced in recent years;[99] terminating public defined benefit plans and moving

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96. For example, after default in Jefferson County, four out of the five people on the county commission have since been convicted of taking bribes and sentenced to prison. The fifth was convicted of obstructing justice. Furthermore, the litigation surrounding the upgraded sewer system brought about bribery and fraud charges that led to twenty-two convictions. *See* Norris, *supra* note 34; *see also* Conner, *supra* note 93. For another example, see Niedowski, *supra* note 25 (reporting that resigned Central Falls mayor, Charles Moreau, was sentenced to two years in prison on corruption charges).

97. *See, e.g.*, Ross, *supra* note 94.

> [C]onstituencies and interest groups are created for each particular political benefit program, and it becomes nearly impossible to get rid of them . . . . They benefit because of who they are, not because of what they do or what they own in a more conventional sense.
>
> . . . .
>
> . . . [E]ach group of people which sees another obtain benefits then seeks to create some program for itself. Such things are hard for politicians to resist, since it holds the promise of a group of dedicated voters beholden for their own program.

Id.

98. *See* R.I. GEN. LAWS § 45-12-1 (2013) (giving bondholders first lien during a municipal default); *see also* 2011 Pa. Laws 318, No. 79 (preventing Harrisburg from filing for Chapter 9).

99. *See* Mike Cherney, *Providence, R.I., Readies First Bond Sale Since Pension Reform*, WALL ST. J. (Feb. 15, 2013), http://online.wsj.com/article/BT-CO-20130215-712502.html (reporting pension reform passed by Rhode Island that suspended COLA for ten years, changed pension calculations and modified retiree health care); *see also* Lynn Hume, *Hatch Offers Pension Reform Bill; Experts Say It Wouldn't Work*, BOND BUYER (July 9, 2013, 4:27 PM), http://www.bondbuyer.com/issues/122_131/hatch-to-unveil-pension-bill-tuesday-afternoon-1053518-1.html (reporting proposed legislation reform introduced by Senator Orrin Hatch that would allow state and local governments to invest in annuity contracts with private life insurance companies for employee retirement benefits); Collin Levy, *No Pension Reform, No Pay*, WALL ST. J. (July 10, 2013, 2:08 PM), http://online.wsj.com/article/SB10001424127887323740804578597683905687760.html (reporting a more traditional approach in which Illinois lawmakers are attempting to impose a progressive income tax rather than the state's current flat tax to stave off increasing pension debt).

employees to defined contribution arrangements similar to the private sector's 401(k) vehicle is among the most promising.[100] Modest reforms include requiring public plans to use realistic, market-based rates of return when making assumptions about asset growth that directly impact the size of future liabilities.[101]

More radical, but perhaps not unreasonable in extreme situations such as Central Falls or Detroit,[102] is the call to simply bar legislators from negotiating with public unions about pensions and/or retiree health benefits.[103] The tragic mess in Central Falls—by no means isolated—

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100. The main benefit for a defined contribution plan is that one is in control of one's money. Investment options, how much to save, etc., are all up to the contributor. Similarly, when you leave your place of employment, the funds come with you. However, the negatives are a consequence of the benefits. If one invests his or her money poorly or too conservatively, a defined contribution plan may not grow fast enough to keep up with inflation. Because retirement benefits in a defined contribution plan are not guaranteed, this could result is a real financial problem for some retirees. *See* Diane Stevens, *Defined Benefit vs. Defined Contribution Pension Plans*, ZACKS INVESTMENT RES., http://finance.zacks.com/defined-benefit-vs-defined-contribution-pension-plans-2770.html (last visited Feb. 2, 2014).

101. In the past, pension funds typically relied on expected strong investment returns to allow reduction in the amount of money put into funds up front. More recently, some states like Illinois have enacted a reform based on reducing the estimated rates of return to reasonably expectable levels. However, see Matthew Glans, *Illinois' Pension Rate of Return Changes Don't Go Far Enough*, HEARTLAND INST. (Oct. 4, 2012), http://blog.heartland.org/2012/10/illinois-pension-rate-of-return-changes-dont-go-far-enough; *see also* Lynne Marek, *State Teachers Pension Board Lowers Expected Rate of Return*, CRAIN'S CHI. BUS. (Sept. 21, 2012, 3:20 PM), http://www.chicagobusiness.com/article/20120921/NEWS02/120929946/state-teachers-pension-board-lowers-expected-rate-of-return (explaining that although reducing the expected rate of return can give the appearance of increasing pension liability, it is actually a vehicle for insuring that a municipality retains enough funding to adequately cover its pension liability at any given time).

102. Detroit is currently in a major battle with unions who claim that the city is not insolvent and more than capable of funding 96% of the pension. *See* Nancy Kaffer et al., *Detroit: How the Motor City Went Bust*, USA TODAY (July 19, 2013), http://www.usatoday.com/story/news/nation/2013/07/18/detroit-files-for-bankruptcy/2567159/; *see also* Chad Livengood, *Orr: Police, Fire Unions May Regret Claiming Pensions are 96% Funded*, DETROIT NEWS (July 27, 2013), http://www.detroitnews.com/article/20130727/METRO01/307270020. For a historical background of Detroit's union dealings, see Mike Smith, *"Let's Make Detroit a Union Town": The History of Labor and the Working Class in the Motor City*, 27.2 MICH. HIST. REV. 157 (Fall 2001).

103. Chris Edwards of the Cato Institute has argued, for example, that collective bargaining by public employees "should be outlawed." Chris Edwards, *Public Sector Unions,* TAX AND BUDGET BULL. (Cato Institute, Washington D.C.), Mar. 2010, *available at* http://www.cato.org/sites/cato.org/files/pubs/pdf/tbb_61.pdf. Wisconsin was the first state to permit public sector collective bargaining in 1959. Wisconsin again made history in 2011 with perhaps the most interesting real life battle over this issue when Republican

would seem to demand an equally drastic response in order to avoid recurrence. I doubt that taxpayers will muster the political will to limit the subjects of public sector bargaining in places like Rhode Island or Michigan. Even though they were clearly a part of the problem, the public unions in Central Falls successfully characterized the entire episode leading up to the bankruptcy filing as the fault of both local and state government actors.[104] While true up to a point, this position fails to accept public employees' own role in cannibalizing the city.[105]

B. Transparency

Alone or in addition to structural changes, increased transparency (designed to inform and rouse the taxpayer) may offer another avenue for pushing back against the strong tendency of lenders and others to "play"

Governor Scott Walker proposed dramatically reducing the ability of that state's public unions to negotiate to just base wages. Known as Wisconsin Act 10, bargaining over health care, working hours, or vacations was prohibited. After plenty of theatrics, Governor Walker prevailed. The governors of Ohio and Indiana have expressed support for a ban or, at minimum, severe restrictions on public sector bargaining. *See generally* Monica Davey & Steven Greenhouse, *Wisconsin May Take an Ax to State Workers' Benefits and Their Unions*, N.Y. TIMES (Feb. 12, 2011), http://www.nytimes.com/2011/02/12/us/12unions.html?_r=0; Steven Greenhouse, *A Watershed Moment for Public Sector Unions*, N.Y. TIMES (Feb. 19, 2011), http://www.nytimes.com/2011/02/19/us/19union.html. Of course, some states, for example, Texas, have never allowed public unions the right to bargain with the state.

104. In Central Falls, the teachers union successfully characterized the city's problems as a failure of state and local government that they gained the public support of President Obama. Obama made a statement that ultimately led to Central Falls High School rehiring everyone after the unions failed to make concessions. *See* Eric Tucker, *Central Falls High School Will Rehire Everybody After Firing All Teachers*, HUFFINGTON POST (May 16, 2010, 11:42 PM), http://www.huffingtonpost.com/2010/05/16/central-falls-high-school_n_578085.html. Police and firefighter unions refused to make concessions to their pension plan as well, ultimately being the straw that caused Central Falls to file for Chapter 9. Only two of the city's 141 retirees voted for reducing benefits. *See* Michael McDonald et al., *Central Falls Bankruptcy Casts Shadow Over Rhode Island Pensions*, BLOOMBERG (Aug. 2, 2011, 11:50 AM), http://www.bloomberg.com/news/2011-08-02/central-falls-bankruptcy-driven-by-pensions-casts-shadow-over-rhode-island.html; *see also* Bob Ruplenas, *Weymouth The Jaundiced Eye: Lobster, Nuclear Waste and Central Falls, R.I.*, WEYMOUTH NEWS (Aug. 29, 2011), http://www.wickedlocal.com/weymouth/newsnow/x1688627811/Weymouth-The-jaundiced-eye-Lobster-nuclear-waste-and-Central-Falls-R-I ("The town's union refused to make any concessions, so Central Falls went belly-up. It won't be the last town to do so."); *see also Bankrupt City*, WATERTOWN DAILY TIMES (Aug. 19, 2011), http://www.watertowndailytimes.com/article/20110819/OPINION01/708199994.

105. *See, e.g.*, Ross, *supra* note [94].

with public dollars.[106] Regular reporting of debt levels, credit ratings, and relative tax burdens, available in a format comprehensible to the average citizen, ought to lead over time to better informed (and more skeptical) citizens. Every future promise for public pension or retiree health coverage should come with an accurate and explicit price tag to mitigate the tendency to promise now and worry about paying later.[107]

Without some combination of structural changes and improved transparency in the public sector, it is not unreasonable to assume that the Central Falls scenario will occur again and again.

The hard truth of Central Falls is that it was appropriate for current and former employees and taxpayers to bear some degree of pain. All were complicit to some degree in the city's mismanagement. Taxpayers must learn or be forced to pay attention and insist on accountability from the political class. Once bankruptcy is a reality, though, there do not appear to be good reasons for sparing the quick-to-lend bondholders.

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106. There has been a call for reform under a financial accounting standard known as GASB 45, which requires entities to recognize the cost of post-employment benefits other than pensions over the course of an employee's career rather than at retirement. *See* Rebecca A. Sielman et al., *GASB 45: A Wake-Up Call for Public Plan Sponsors*, MILLIMAN (Nov. 1, 2009), http://insight.milliman.com/article.php?cntid=6112.

> [T]he intent of GASB 45 is to get employers thinking about the size of their OPEB [other-than-pension postemployment benefits] liability—and what can be done to manage it. The most significant OPEB is retiree medical benefits. In creating the disclosure requirements, GASB wanted to address a growing concern over the potential magnitude of employer obligations. With an aging population and escalating medical costs, the old "pay-as-you-go" approach will leave taxpayers across the country on the hook for astronomical benefits costs.

Id.; *see also OEBB Members – GASB 45 Group Project FAQ*, STATE OF OR. (2012), http://www.oregon.gov/oha/OEBB/docs/GASB/2012_13/OEBBmemberQA2012.pdf. For a detailed discussion on GASB 45, see generally Hylton, *supra* note 13, at 423-36.

107. *See Special Report, Sinkhole! How Public Pension Promises are Draining State and City Budgets*, BLOOMBERG BUSINESSWEEK MAG. (June 12, 2005), http://www.businessweek.com/stories/2005-06-12/sinkhole.

> One major category of cost isn't disclosed at all: how much retiree health care has been promised to public retirees. No one can estimate how much these promises will add up to, but they're sure to be in the tens of billions, and only some states seem to have put aside reserves for them, according to bond analysts. That's chilling, given how quickly medical costs are rising. After a pitched battle, the Governmental Accounting Standards Board (GASB), the independent accounting standards-setter for state and local governments, has finally begun to require states to disclose these liabilities. Numerous unions and state government representatives objected to the change, says GASB member Cynthia B. Green, "not because [unions and states] didn't think these were important, but because they thought once the governments did their studies and found what the price tag was, they would be concerned or, if not concerned, staggered."

Id.; *see also* Sielman et al., *supra* note 106.

Certainly the complete protection afforded to Central Falls' insured creditors appears unwarranted and unfair.[108] The unfolding model in Jefferson County, Alabama, which spreads the cost of restructuring widely, looks promising and may yet prove wiser than imposing the whole burden on the uninsured actors in Central Falls.

V. CONCLUSION

Modern Chapter 9 litigation has been characterized by extraordinary protections for municipal bondholders, and Central Falls is no exception. Although not well understood by politicians, fear of contagion has encouraged the adoption of legal arrangements that have limited the bankruptcy courts' ability to include bondholders in the cost of restructuring municipal debt. This preference for bondholders (and, by extension, their insurers) has meant increased misery for taxpayers and retirees. Given that all of these actors appear to have been complicit to some degree in the creation and maintenance of the fiscally imprudent conditions that triggered bankruptcy and that evidence of true contagion is modest, it is hard to justify special protections for bondholders.

108. *See, e.g.*, Russ, *supra* note 72.