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## Municipal Bankruptcy: The Need for an Expanded Chapter IX

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## MUNICIPAL BANKRUPTCY: THE NEED FOR AN EXPANDED CHAPTER IX

New York City's default crisis in 1975 presented to Congress and the nation the possibility of a major municipality's entering the federal bankruptcy court.<sup>1</sup> Chapter IX of the Bankruptcy Act, as recently amended by Congress,<sup>2</sup> provides the exclusive remedy by which local governmental units<sup>3</sup> may obtain relief from burdensome indebtedness. Unlike certain other chapters of the Bankruptcy Act, Chapter IX is limited to a voluntary composition or extension of indebtedness.<sup>4</sup> In recent years municipalities have developed complex systems of financing, while experiencing unprecedented expansion in the services which they must provide. Accordingly, a mere composition of municipal indebtedness is no longer adequate, because a composition can only reduce the debt or postpone the default. In order to solve the problems which precipitate a particular financial crisis, a complete reorganization of municipal finances may be necessary.<sup>5</sup> However, under Chapter IX bankruptcy courts are not empowered to effectuate such a comprehensive reorganization as a part of the relief available through a municipal bankruptcy proceeding.<sup>6</sup> This article will

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<sup>1</sup> In addition to New York City, many other cities are finding it increasingly difficult to provide existing levels of services while maintaining a balanced budget. Tax bases are shrinking at the same time that demands for wages, fringe benefits, pensions and goods are spiraling. *City Financial Emergencies: The Intergovernmental Dimension*, REP. NO. A-42, ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS 31 (1973) [hereinafter cited as *Financial Emergencies*].

<sup>2</sup> Bankruptcy Act, ch. 9, Pub. L. No. 94-260, 90 Stat. 315 (to be codified as 11 U.S.C. §§ 401-418) (1976).

<sup>3</sup> The current Chapter IX lists a wide variety of government units including towns, counties, improvement districts, school districts and incorporated authorities. Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 81, 90 Stat. 315 (to be codified as 11 U.S.C. § 401 (1976)). Although this article focuses upon the needs of cities or towns, the arguments are equally applicable to all types of local governmental units. This article will use the terms city, municipality and petitioner interchangeably to describe the petitioning governmental entity.

<sup>4</sup> 5 W. COLLIER, BANKRUPTCY, ¶ 81.27 (4th ed. 1975). A composition is an agreement between a debtor and his creditors where the latter agree to accept less than the whole amount of their claims. BLACK'S LAW DICTIONARY 357 (rev. 4th ed. 1968). An agreement on the part of a debtor to pay his debts in full but with a postponed maturity date is termed an extension. *Id.* at 694.

<sup>5</sup> See *Financial Emergencies*, *supra* note 1, at 85-86.

<sup>6</sup> Bankruptcy Act, ch. 9, Pub. L. 94-260, § 83, 90 Stat. 316 (to be codified as 11 U.S.C. § 403, (1976)), limits the power of the court: "Nothing contained in this chapter shall be construed to limit or impair the power of any State to control, by legislation or otherwise, any municipality or any political subdivision of or in such State in the exercise of its political or governmental powers, including expenditure therefore. . . ." See also Bankruptcy Act, ch. 9, Pub. L. 94-260, § 82(c), 90 Stat. 316 (to be codified as 11 U.S.C. § 402(c) (1976)).

explore the desirability of granting more comprehensive powers to bankruptcy courts and will consider the constitutional authority for such an expansion of Chapter IX. It will also advance specific suggestions for this modification of Chapter IX.

## I. THE HISTORY OF CHAPTER IX

The basic premise of the law of municipal corporations is that a municipality is "a creature of the State."<sup>7</sup> It is created by charter granted by the state legislature, and its power is derived from and dependent upon the sovereign power of the state.<sup>8</sup> Although the municipality exercises sovereign power, that power is delegated to it by the state, and may be withdrawn at will.<sup>9</sup>

The tenth amendment protects the sovereign power of the state, including its control over its municipal corporations, from usurpation by the federal government.<sup>10</sup> Although the power to enact bankruptcy laws is an enumerated federal power under article I, section 8 of the Constitution,<sup>11</sup> the tenth amendment may limit Congress in the enactment of federal legislation dealing with municipal bankruptcies. At issue is the extent to which a federal bankruptcy court may permissibly direct or control the affairs of a municipality without infringing upon the sovereign power of the State.

In enacting the original Chapter IX in 1934,<sup>12</sup> Congress merely provided a procedure by which a local governmental unit could voluntarily enter the bankruptcy court with a plan of readjustment. If it could obtain acceptances from two-thirds of its creditors, the petitioning governmental unit could get a readjustment plan confirmed by the court and have it enforced against nonconsenting

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<sup>7</sup> 1 E. McQUILLAN, MUNICIPAL CORPORATIONS, ¶ 3.02 (3d ed. 1971).

<sup>8</sup> *Id.*

<sup>9</sup> Ashton v. Cameron County Water Improvement Dist., 298 U.S. 513, 529 (1936).

<sup>10</sup> The tenth amendment provides: "The powers not delegated to the United States by the Constitution, nor prohibited to it by the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X. The exercise of a power not granted to the Congress by the Constitution (*e.g.*, education) may be exercised by the state. Congress cannot take these sovereign powers from the state. See 1 E. McQUILLAN, MUNICIPAL CORPORATIONS ¶ 1.45 (3d ed. 1971). A state may, however, consent to federal interference with its sovereign powers. See United States v. Bekins, 304 U.S. 27, 52 (1938).

<sup>11</sup> U.S. CONST. art. I, § 8, says, "The Congress shall have Power to . . . establish uniform Laws on the subject of Bankruptcies throughout the United States. . . ."

<sup>12</sup> Act of May 24, 1934, ch. 345, 48 Stat. 798.

creditors.<sup>13</sup> Significantly, Chapter IX also provided that the state could require its approval or consent to the proceedings.<sup>14</sup>

In *Ashton v. Cameron County Water Improvement District No. One*,<sup>15</sup> the Supreme Court held that this original enactment of Chapter IX, as applied to a water district, violated the tenth amendment by impairing the sovereign power of the state, since implementation of Chapter IX procedures “might materially restrict” the water district’s control over its fiscal affairs.<sup>16</sup> Chapter IX was sufficiently related to the topic of bankruptcies to be within the scope of Congress’ enumerated bankruptcy power. Nevertheless, the Court concluded that Chapter IX constituted a threat to the “independence of the States”<sup>17</sup> in violation of the tenth amendment. In order to preserve the independence of the states, “the means and instrumentalities employed for carrying on the operations of their governments, for preserving their existence, . . . should be left free and unimpaired.”<sup>18</sup> The Court found the consent of the state to a Chapter IX proceeding to be insufficient to preserve its sovereignty and to validate the constitutionality of Chapter IX. Relying upon *United States v. Butler*,<sup>19</sup> the Court reasoned that the powers of Congress could not be enlarged by the consent of the states to such an extent, since Congress could only exercise powers which were expressly granted to it.<sup>20</sup> Further-

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<sup>13</sup> *Id.* The petition had to be accompanied by a plan of readjustment that had been accepted by creditors holding not less than 51 percent in amount of its outstanding obligations (30 percent in the case of drainage, irrigation, reclamation, and levee districts). After the plan had been approved by the judge, it was to be submitted to the creditors for their acceptance. It could not be confirmed until it had been accepted by creditors holding two-thirds in amount of the claims against it. Although it is unclear exactly how or when the requirement applied, the statute appears to have included an additional requirement of acceptance by 75 percent in amount of the claims of all creditors. *Id.* 48 Stat. 801. Because of the statute’s brief period of existence, there does not appear to have been any discussion of when these two standards were applicable. This 75 percent requirement was absent from the statute’s language when it was re-enacted in 1937. See Act of August 16, 1937, ch. 657, § 83(d), 50 Stat. 657. The 1934 statute contained a “cram-down” provision which eliminated the need for the vote of any creditor or class of creditors if its claims were not affected by the plan or if the plan made provision for protection or payment of their claims. Once a plan had been confirmed, it was binding upon the municipality and all of its creditors. Act of May 24, 1934, ch. 345, 48 Stat. 798. See generally *Ashton v. Cameron County Water Improvement Dist.*, 298 U.S. 513, 524-26 (1936).

<sup>14</sup> Act of May 24, 1934, ch. 345, § 80(k), 48 Stat. 802. The statute contemplated the filing of a petition against a municipality only by its creditors. See *id.*, § 80(a), 48 Stat. 798.

<sup>15</sup> 298 U.S. 513 (1936).

<sup>16</sup> *Id.* at 530.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 528. The Court relied heavily upon the analogy to the tax-exempt status which the water district’s bonds enjoyed, and inferred that this status reflected the constitutional limitation against interference in a state’s fiscal affairs. The majority perceived a similar limitation upon Chapter IX and, therefore, found it to be unconstitutional in its entirety. *Id.* at 528-30.

<sup>19</sup> 297 U.S. 1 (1936).

<sup>20</sup> 298 U.S. at 531.

more, the Court, citing *United States v. Constantine*,<sup>21</sup> held that state sovereignty could not be surrendered by consent or legislation.<sup>22</sup>

In dissent, Justice Cardozo argued that the statutory consent provision required that Chapter IX be sustained as a constitutional exercise of the bankruptcy power.<sup>23</sup> He analogized the bankruptcy power to the taxing power, citing authority to the effect that a state may consent to taxation by the federal government.<sup>24</sup> Thus, while the majority relied upon the analogy to the taxing power to declare Chapter IX unconstitutional,<sup>25</sup> Cardozo concluded that this analogy compelled the opposite result.

After the *Ashton* decision Congress enacted a second Chapter IX which was virtually identical to its predecessor.<sup>26</sup> In *United States v. Bekins*,<sup>27</sup> the Supreme Court upheld the constitutionality of the second Chapter IX, distinguishing *Ashton* on the grounds that the new Chapter IX was "carefully drawn so as not to impinge upon the sovereignty of the State."<sup>28</sup> In particular, the Court referred to the section of the act expressly prohibiting restrictions on the power of the state to control the debtor municipality.<sup>29</sup> The Court

<sup>21</sup> 296 U.S. 287 (1935).

<sup>22</sup> 298 U.S. at 531. Neither of the precedents cited by the Court compelled the result reached in *Ashton*, since both dealt with taxes which the Court held to be beyond the power of Congress to impose. *Butler* dealt with a tax levied upon the processors of farm products which the Court held to be a regulation of agricultural production beyond the power given by the taxing clause. *Constantine* held that the acquiescence of the state could not enlarge the power of Congress in order to allow it to levy an excise tax solely on liquor dealers who violated state liquor taxes. In *Ashton* the question was not one of power, since the Court had already acknowledged that Congress' bankruptcy power extended to such a setting. Rather the issue involved a blending of the legitimate interests of the state and federal governments. *Butler* can be further distinguished in that it involved the consent of an individual as opposed to that of a sovereign.

<sup>23</sup> 298 U.S. at 541 (Cardozo, J., dissenting).

<sup>24</sup> *United States v. California*, 297 U.S. 175 (1936).

<sup>25</sup> See note 18 *supra*.

<sup>26</sup> Act of August 16, 1937, Pub. L. No. 302, 50 Stat. 653. In this act counties were omitted from the class of petitioners eligible for relief. (They were again added to the Act in 1940. Act of June 28, 1940, Pub. L. No. 669, 54 Stat. 667.) The draftsmen of the 1937 Act believed that counties were more necessary arms of state government and hence possessed a greater degree of sovereignty than improvement districts or cities. This omission was viewed as the crucial distinction between the new Chapter IX and the old one. *Proposed Amendments to the Bankruptcy Act: Hearings on H.R. 2505 Before the Subcommittee on Bankruptcy and Reorganization of the House Committee on the Judiciary*, 75th Cong., 1st Sess. 31, 51-52 (1937).

The former act provided for a "Plan of Adjustment," while the new act provided for a "Plan of Composition." Instead of requiring consent on the part of an agency of the state, the new act required that "the petitioner is authorized by law to take all action necessary . . . to carry out the plan." Act of August 16, 1937, Pub. L. No. 302, § 83(e)(6), 50 Stat. 658. See generally Patterson, *Municipal Debt Adjustments Under the Bankruptcy Act*, 90 U. PA. L. REV. 520, 526-30 (1942). In substance, the new act, like its predecessor, was confined to measures essential for the proposal, acceptance and confirmation of a plan of composition binding upon all creditors affected by the plan. 5 W. COLLIER, BANKRUPTCY ¶ 81.27 (4th ed. 1975).

<sup>27</sup> 304 U.S. 27 (1938).

<sup>28</sup> *Id.* at 51.

<sup>29</sup> *Id.*

further emphasized that the act expressly prohibited bankruptcy court interference with the debtor municipality's political or governmental powers, property, or revenues essential for governmental purposes, and income-producing property.<sup>30</sup> Unlike *Ashton*, *Bekins* suggested that the tenth amendment permitted the states to consent to federal interference in their affairs.<sup>31</sup> Moreover, the *Bekins* Court adopted the analogy between the taxing power and the bankruptcy power which Cardozo had advanced in his *Ashton* dissent. Thus, the Court concluded that the provision for state consent to a Chapter IX proceeding invited "the intervention of the bankruptcy power" in order to save a municipal corporation which the state was "powerless to rescue."<sup>32</sup>

Since *Bekins*, Chapter IX has served as the basic framework for municipal bankruptcy legislation. In 1976 it was revised in response to the fiscal crisis facing New York City.<sup>33</sup> This revision eliminated the requirement that the petition be accompanied by the written consent of 51 percent of the municipality's creditors, a restriction which had effectively precluded many major municipalities from relief under Chapter IX.<sup>34</sup> The revision also made available to the petitioner, pursuant to court approval, specific powers to be used in reordering the financial affairs of the municipality.<sup>35</sup> It is expected that more extensive changes may be

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<sup>30</sup> *Id.*

<sup>31</sup> *Id.* at 52.

<sup>32</sup> *Id.* at 54. As other commentators have observed, it is difficult to reconcile *Ashton* and *Bekins* on any meaningful grounds because the two acts are so similar. See, e.g., Note, *Reform of Creditor Participation Procedures in Municipal Bankruptcy*, 85 YALE L.J. 423, 436 n.80 (1976). It is arguable that these two decisions simply illustrate the shift in the Court's view of the scope of federal power that occurred at that time. Compare, e.g., *Carter v. Carter Coal Co.*, 298 U.S. 238 (1936); *United States v. Butler*, 297 U.S. 1 (1936); *Hammer v. Dagenhart*, 247 U.S. 251 (1918); with *United States v. Darby*, 312 U.S. 100 (1941); *Helvering v. Davis*, 301 U.S. 619 (1937); *Steward Machine Co. v. Davis*, 301 U.S. 548 (1937); *NLRB v. Jones & Laughlin Steel Corp.*, 301 U.S. 1 (1937). For a discussion of these and other such cases, see Stern, *The Commerce Clause and the National Economy*, 1933-1946, pts. 1 & 2, 59 HARV. L. REV. 645, 883 (1946).

<sup>33</sup> Bankruptcy Act, ch. 9, Pub. L. No. 94-260, 90 Stat. 315 (to be codified as 11 U.S.C. §§ 401-418 (1976)).

<sup>34</sup> The identity of many creditors who hold bearer bonds is unascertainable. Klein, *The New Chapter IX of the Bankruptcy Act*, PRAC. LAW., June 1, 1976, at 76. Instead of the written consent requirement, the municipality must satisfy one of four less stringent requirements. Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 84, 90 Stat. 317 (to be codified as 11 U.S.C. § 404 (1976)).

<sup>35</sup> Bankruptcy Act, ch. 9, Pub. L. No. 94-260, §§ 82(b), 85(g), 85(h), 90 Stat. 316, 317 (to be codified as 11 U.S.C. §§ 402(b), 405(g), 405(h) (1976)). The powers which are available to the petitioner in proceedings under other chapters of the Bankruptcy Act are: (1) the power to reject executory contracts and unexpired leases; (2) the power to issue first priority certificates of indebtedness; (3) the power to avoid fraudulent transfers; and (4) the power to set aside voidable preferences. Klein, *supra* note 34, at 77. For a summary of the provisions of the new statute, see King, *Municipal Insolvency: Chapter IX, Old and New; Chapter IX Rules*, 50 AM. BANKR. L.J. 55 (1976).

made in 1977 or 1978, as Congress considers a comprehensive revision of the entire Bankruptcy Act.<sup>36</sup>

## II. FUTURE FINANCIAL STABILITY CANNOT BE ASSURED BY A COMPOSITION ALONE

For a financially embarrassed municipality relief under the Bankruptcy Act is a remedy of last resort.<sup>37</sup> The filing of a Chapter IX petition has a drastic impact on the availability of short term credit and on the market demand for municipal bonds, thus militating against the filing of frivolous petitions.<sup>38</sup> A Chapter IX proceeding is warranted only where efforts to resolve the crisis outside the bankruptcy process have already failed.

Under the current act, as amended, and under the bills pending in the Congress, the role of the bankruptcy court is limited to the confirmation or disapproval of a composition plan submitted by the municipality.<sup>39</sup> Chapter IX provides for a simple composition of debt without any other supervision by the bankruptcy court.<sup>40</sup> Interference in the fiscal affairs of a Chapter IX petitioner is essential to the success of a Chapter IX proceeding. However, Chapter IX proceedings are expressly designed to preclude the independent management or control of fiscal policy which is often necessary to facilitate the restructuring of the finances of an embarrassed municipality.<sup>41</sup> Thus, the court is often unable to prevent future defaults

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<sup>36</sup> In 1973, the Commission on the Bankruptcy Laws of the United States made its report proposing a new bankruptcy statute. See H.R. Doc. No. 93-127, 93d Cong., 1st Sess. Pt. II (1973) [hereinafter cited as Proposed Bankruptcy Act]. This bill represents a major reworking of the structure of the present bankruptcy legislation.

In 1977, a bill was introduced into the Congress which adopted many of the suggested changes of the Commission, but retained much of the present statute's structure. H.R. 6, 95th Cong., 1st Sess. (1977) [hereinafter cited as House Bill].

The revised Chapter IX, which will be relabeled as Chapter VIII by the Proposed Bankruptcy Act, relies largely upon the present statute. The arguments presented here apply with equal force to this new legislation. Where there are pertinent differences they will be noted.

<sup>37</sup> *Financial Emergencies*, *supra* note 1, at 85.

<sup>38</sup> *Id.* at 84.

<sup>39</sup> Section 82(c) of Chapter IX, (to be codified as 11 U.S.C. § 403(c) (1976)), prevents the court from interfering with a petitioner's: (a) political or governmental powers; (b) property or revenues necessary for essential governmental purposes; or (c) any of the petitioner's income-producing property, unless the plan so provides. The purpose of section 83(c) is to restrict the power of the bankruptcy judge to mere approval or disapproval of a proposed plan.

<sup>40</sup> *Financial Emergencies*, *supra* note 1, at 85.

<sup>41</sup> Dession, *Municipal Debt Adjustment and the Supreme Court*, 46 *YALE L.J.* 199, 216 (1936).

and bankruptcy petitions because it is powerless to remedy inept fiscal management by a municipality's elected officials.<sup>42</sup>

Inasmuch as debt adjustment without court supervision is not permitted under other chapters of the Bankruptcy Act, Chapter IX is an anomaly.<sup>43</sup> Allowing a petitioner to avail itself of the benefits of a composition proceeding while remaining in complete control of its affairs is contrary to the traditions and the fundamental sense of equity which theoretically permeate the bankruptcy proceeding.<sup>44</sup> The confirmation of a composition plan in these circumstances might be viewed as an abuse of the court's jurisdiction, because the mismanaged municipality receives not only judicial protection from suits by its creditors,<sup>45</sup> but also a partial discharge from its debts.<sup>46</sup> In effect, the court binds nonconsenting creditors to a plan formulated by a debtor which cannot be compelled to rid itself of financial mismanagement.<sup>47</sup> Unfairness is inherent in such a situation, and remedial inadequacy is practically assured.<sup>48</sup>

Moreover, a composition without meaningful supervision is unfair to holders of certificates of indebtedness issued by the court as

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<sup>42</sup> The limited power of the bankruptcy court is illustrated by the case of one Texas municipality which has undergone four Chapter IX proceedings since the early 1930's. The courts have been unable "to force a changing cast of elected officials to comply with voluntarily accepted settlements of the past." *Financial Emergencies*, *supra* note 1, at 85.

<sup>43</sup> For example, Chapter X provides for the appointment of an independent trustee to operate the business under the close supervision of the court. 11 U.S.C. §§ 586-591 (1970). Chapter XI contemplates continued operation of the business by the debtor, 11 U.S.C. § 743. However, upon initiating a Chapter XI proceeding, the debtor becomes a "debtor in possession" and his power over the business is markedly changed due to the control of the court. *See generally* 8 W. COLLIER, *supra* note 4, ¶¶ 6.30-6.32.

<sup>44</sup> *See* American United Mutual Life Ins. Co. v. City of Avon Park, 311 U.S. 138, 146 (1940); *Pepper v. Litton*, 308 U.S. 295, 304 (1939); *Local Loan Co. v. Hunt*, 292 U.S. 234, 240 (1934); Bankruptcy Act § 2(a), 11 U.S.C. § 11(a) (1970). *See also* Glenn, *Essentials of Bankruptcy: Prevention of Fraud, and Control of Debtor*, 23 VA. L. REV. 373 (1937).

<sup>45</sup> Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 85(c), 90 Stat. 318 (to be codified as 11 U.S.C. § 405(e) (1976)), sets up an automatic stay on suits by creditors at the filing of a Chapter IX petition. *See also* Proposed Bankruptcy Act, *supra* note 36, §§ 4-501, 8-101; House Bill, *supra* note 36, § 944.

<sup>46</sup> *See* Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 95(b), 90 Stat. 323 (to be codified as 11 U.S.C. § 415(b) (1976)). *See also* Proposed Bankruptcy Act, *supra* note 36, § 8-308(b); House Bill, *supra* note 36, § 944.

<sup>47</sup> *See* Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 95(a), 90 Stat. 323 (to be codified as 11 U.S.C. § 415 (a) (1976)). In addition to this power to bind nonconsenting creditors, the 1976 amendments to Chapter IX grant additional powers to be used by the municipality in reorganizing its financial affairs. *See* note 35 *supra*.

<sup>48</sup> In a straight bankruptcy proceeding involving an individual, the debtor receives a discharge from his dischargeable debts, but he is also forced to liquidate his nonexempt property for the benefit of his creditors. A municipality cannot be forced to liquidate its property in this manner, but since it may reduce its debts even as to nonconsenting creditors, equity should require local officials to implement sound financial measures as a *quid pro quo* for the discharge of indebtedness. Under current Chapter IX, however, a municipality cannot be compelled to reform its unsound financial policies. *See* notes 39-42 and accompanying text *supra*.

part of the bankruptcy proceedings<sup>49</sup> and to those future creditors of the municipality who thereafter extend credit to the municipality only to see it founder again in future years. Any future creditor can be said to have relied solely upon his own perception of the municipality's fiscal stability in extending credit. However, when a bankruptcy court approves the issuance of certificates of indebtedness, it is possible that some takers will perceive this approval as a determination by the court that the municipality will be financially rehabilitated and will be able to repay these certificates when no such determination has been made.

The court is not completely without weapons in combating these inequities. Under the present Chapter IX "feasibility" is a condition for confirmation of a plan.<sup>50</sup> If the bankruptcy judge finds that the petitioner's plan is not feasible, he can refuse to confirm it. This prevents enforcement of the plan against nonconsenting creditors and prevents the discharge of dischargeable claims.<sup>51</sup> However, the feasibility requirement is not an effective solution to Chapter IX problems for three reasons. The feasibility condition is only intended to ensure that the petitioner will have adequate tax revenues to make required payments to creditors under the plan.<sup>52</sup> Accordingly, the prospects of future default and the chances of financial rehabilitation are not required to be considered. Second, it is arguable that a bankruptcy court's nonconfirmation of a municipality's plan, because of the failure of local officials to develop a sound fiscal policy, would constitute interference with the municipality's political or governmental functions. Such an interference is expressly prohibited by the act.<sup>53</sup> Finally, public policy considerations compel an expedited proceeding. Citizens who are dependent upon the petitioner's services should not be subjected to extended periods of uncertainty while the court bargains with city officials in an effort to develop an acceptable plan.

<sup>49</sup> The power to issue first priority certification of indebtedness was among those given to a petitioner by the 1976 amendments. See note 35 *supra*. The Commission's proposed revision of this chapter does not explicitly provide for certificates of indebtedness, although the House Bill does. See House Bill, *supra* note 36, §§ 364, 901.

<sup>50</sup> Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 94(b)(1), 90 Stat. 323 (to be codified as 11 U.S.C. § 414 (b)(1) (1976)). In the context of Chapter XI proceedings this term has been construed to mean merely that the provisions of the plan will actually be performed. 9 W. COLLIER, BANKRUPTCY ¶ 9.18[1] (4th ed. 1976). "The test is whether the things which are to be done after confirmation can be done as a practical matter under the facts." *Id.*

<sup>51</sup> See Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 95, 90 Stat. 323 (to be codified as 11 U.S.C. § 415 (1976)). The Bankruptcy Act expressly provides that no state law prescribing a method of composition can be binding on any creditor without his consent. Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 83, 90 Stat. 316 (to be codified as 11 U.S.C. § 403) (1976).

<sup>52</sup> H. R. REP. NO. 94-686, 94th Cong., 2d Sess. 32 (1976). See also note 50 and accompanying text *supra*.

<sup>53</sup> See Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 82(c), 90 Stat. 316 (to be codified as 11 U.S.C. § 402(c) (1976)).

In short, to prohibit additional judicial control over the municipality's fiscal affairs is "to forbid a restructuring of the City's fiscal system which may be essential to any successful plan of debt adjustment."<sup>54</sup> Even without malfeasance or incompetent fiscal management, municipal policymakers may be politically reluctant to take the drastic steps necessary to solve the city's financial problems. In contrast, an independent federal court can assume responsibility for the required restructuring.<sup>55</sup> To undertake this role the bankruptcy court must have more control over the debtor's fiscal affairs, provided that control is consistent with constitutional limitations.

### III. THE MUNICIPAL BANKRUPTCY POWER AND THE TENTH AMENDMENT

The power to establish laws on the subject of bankruptcy is one of the enumerated powers of the federal government granted by the Constitution.<sup>56</sup> The enumerated powers are regarded as plenary in nature.<sup>57</sup> Accordingly, where a subject is properly within the scope of an enumerated power, Congress can legislate preemptively, thus effectively depriving states of power to deal with the same subject.<sup>58</sup> In the area of bankruptcy legislation, federal preemption is well established.<sup>59</sup> Thus the congressional power over bankruptcy is plenary in nature and may, in the discretion of Congress, be extended to all types of debtors.<sup>60</sup>

The scope of an enumerated power, however, may be limited by other provisions of the Constitution. With respect to congressional legislation affecting municipal bankruptcies the tenth amendment

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<sup>54</sup> *Hearings on S. 2597 Before the Committee on the Judiciary*, 94th Cong., 1st Sess. 17 (1975) (statement of Prof. Vern Countryman).

<sup>55</sup> *Financial Emergencies*, *supra* note 1, at 85.

<sup>56</sup> *See* note 11 *supra*.

<sup>57</sup> *See, e.g.*, *International Shoe Co. v. Pinkus*, 278 U.S. 261 (1929). *See also* *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408 (1946) (involving the commerce power); *Board of Trustees of the Univ. of Ill. v. United States*, 289 U.S. 48 (1933) (involving the foreign commerce power).

<sup>58</sup> *See, e.g.*, *Northern States Power Co. v. Minnesota*, 405 U.S. 1035 (1972), involving the Atomic Energy Commission's preemption of state regulation of nuclear power plants.

<sup>59</sup> In *International Shoe Co. v. Pinkus*, 278 U.S. 261, 265 (1929), which held that the Bankruptcy Act superseded an inconsistent state insolvency law, the Court declared that the "power of Congress to establish uniform laws on the subject of bankruptcies . . . is unrestricted and paramount."

<sup>60</sup> Note, *The Constitutionality of the Municipal Debt Readjustment Act*, 35 COLUM. L. REV. 428, 431 (1935).

constitutes a possible limitation.<sup>61</sup> The tenth amendment has traditionally not been viewed as imposing a limitation upon the exercise of the enumerated powers.<sup>62</sup> Rather, the Supreme Court has observed that the tenth amendment “states but a truism that all is retained [by the states] which has not been surrendered.”<sup>63</sup>

The purpose of the tenth amendment, however, is the preservation of the bifurcation of sovereign power between centralized government and the several states.<sup>64</sup> Thus, in *Fry v. United States*,<sup>65</sup> the Court, upholding the constitutionality of the wage freeze of the Economic Stabilization Act of 1970<sup>66</sup> on the basis of the commerce clause, stated that the tenth amendment requires Congress to respect the integrity of the states and their place in the federal system.<sup>67</sup> *National League of Cities v. Usery*<sup>68</sup> reiterated the *Fry* conception of the tenth amendment.<sup>69</sup> *National League of Cities* held that the 1974 amendments to the Fair Labor Standards Act, which extended minimum wage and overtime pay provisions to local government employees, were not within the authority granted to the Congress by the commerce clause.<sup>70</sup> The Court stated that the FLSA amendments operated “to directly displace the States’ freedom to structure integral operations in areas of traditional governmental functions.”<sup>71</sup> Accordingly, this exercise of congressional authority was held not to comport with the federal system embodied in the Constitution,<sup>72</sup> since it would impair the ability of states to function effectively in a federal system.<sup>73</sup>

The Court distinguished *Fry*, which upheld the application of the 1970 wage freeze to employees of the state.<sup>74</sup> First, the Court noted

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<sup>61</sup> See note 10 *supra*.

<sup>62</sup> In *Fernandez v. Wiener*, 326 U.S. 340, 362 (1945), the Court averred that “[t]he Tenth Amendment does not operate as a limitation upon the powers, express or implied, delegated to the national government.” This case upheld under the commerce clause the enforcement of national labor standards against a manufacturer of goods who shipped in interstate commerce.

<sup>63</sup> *United States v. Darby*, 312 U.S. 100, 124 (1941). The Court additionally noted: There is nothing in the history of its adoption to suggest that it was more than declaratory of the relationship between the national and state governments as it had been established before the amendment or that its purpose was other than to allay fears that the new national government might seek to exercise powers not granted and that the states might not be able to exercise fully their reserved powers.

*Id.*

<sup>64</sup> See *Indian Motorcycle Co. v. United States*, 283 U.S. 570, 575 (1931).

<sup>65</sup> 421 U.S. 542 (1975).

<sup>66</sup> Act of August 15, 1970, Pub. L. No. 91-379, 84 Stat. 799.

<sup>67</sup> 421 U.S. at 547 n.7. “The Amendment expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States’ integrity or their ability to function effectively in a federal system.” *Id.*

<sup>68</sup> 96 S.Ct. 2465 (1976).

<sup>69</sup> *Id.* at 2470.

<sup>70</sup> *Id.* at 2474.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 2474-75.

that the Economic Stabilization Act dealt with a serious problem that could be solved only by federal action. Furthermore, the statutory provisions at issue in *Fry* were drafted so that federal interference with the states' freedom was for a very limited period of time. Third, the congressional enactment in *Fry* neither displaced the states' choices as to the structure of governmental operations, nor did it force the states to reassess choices already made. Finally, the act considered in *Fry* operated to reduce pressures on state budgets rather than to increase them.

Chapter IX, like the statute challenged in *Fry*, deals with a serious problem for which only the national government can supply a remedy. A Chapter IX proceeding infringes upon the states' power in only a limited way and for only a limited period of time. Additionally, Chapter IX is carefully drafted to preserve the freedom of the state in the ultimate decisions regarding the structure of municipal operations.<sup>75</sup> Finally, Chapter IX operates to relieve state fiscal pressures, not to increase them. In short, Chapter IX affects the states' power over their political subdivisions only in an incidental manner.<sup>76</sup>

Additionally, an expanded Chapter IX would be consistent with the limitations of the tenth amendment since the state retains the power to prevent a municipal corporation from filing a Chapter IX petition.<sup>77</sup> Chapter IX recognizes that the state must grant to the municipality the power to avail itself of a debt readjustment pro-

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<sup>75</sup> See note 6 and accompanying text *supra*.

<sup>76</sup> Arguably, however, the proposed expansions of Chapter IX powers, see Part IV *infra*, might violate the tenth amendment limitation on the exercise of federal power over the states recognized in *National League of Cities v. Usery*, 96 S. Ct. 2465 (1976). In *National League* the Court stated that "there are attributes of sovereignty attaching to every state government which may not be impaired by Congress, not because Congress may lack an affirmative grant of legislative authority to reach the matter, but because the Constitution prohibits it from exercising the authority in that manner," 96 S.Ct. at 2471 (emphasis added). In determining whether the proposed expansion of Chapter IX powers would exceed the tenth amendment limit, the crucial issue is whether the increased control of the bankruptcy court over the municipal debtor is a usurpation of "functions essential to separate and independent existence" of the states. *Id.* Arguably, control by the bankruptcy court over the fiscal problems of a municipal debtor would displace "state policies" as to the manner in which "the States and their political subdivisions . . . will structure delivery of those governmental services which their citizens require." *Id.* at 2472. With respect to its impact upon "traditional aspects of state sovereignty," the proposed expansion of Chapter IX powers might be analogized to the 1974 FLSA Amendments voided in *National League*, rather than to the 1970 Economic Stabilization Act upheld in *Fry*. However, such an application of the *National League* rationale to the proposed expansion of Chapter IX powers insufficiently considers the federal interest in protecting the creditors of the municipal debtor and rehabilitating the municipal debtor. Therefore, until the scope of the *National League* rationale is further delineated by the Court, such an expansive interpretation of the tenth amendment should be eschewed as inconsistent with the "balancing approach" advanced by Mr. Justice Blackmun in his *National League* concurrence.

<sup>77</sup> See notes 31-32 and accompanying text *supra*.

ceeding before it can file a petition.<sup>78</sup> Moreover, no involuntary petitions are allowed to be filed against the municipality.<sup>79</sup> A bankruptcy court, therefore, cannot assert jurisdiction over a municipality if a state prohibits the petitioner from filing a voluntary petition. By granting a city the power to file a Chapter IX petition, the state should be deemed to have consented to federal intervention in the fiscal affairs of the debtor municipality.<sup>80</sup>

In order to ensure financial stability, the federal bankruptcy court must have the power to interfere in the fiscal affairs of a petitioning municipality.<sup>81</sup> Judicial control of the finances of the petitioner would not constitute interference with the delegation of powers provided for by state law. A judicially supervised financial reorganization of a municipality would not impair the integrity of the state or its ability to function in a federal system.<sup>82</sup> In addition to the fact that the court acts with the consent of the state, there is no reason why the plan of reorganization need interfere in the political or electoral processes of the city.<sup>83</sup> The tenth amendment should impose no limitation upon the exercise of the bankruptcy power with respect to municipal debtors beyond the preservation of state power over local government and the prevention of interference with local political or elective processes.<sup>84</sup> Thus, the ex-

<sup>78</sup> See notes 31-32 and accompanying text *supra*.

<sup>79</sup> See Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 85(a), 90 Stat. 317 (to be codified as 11 U.S.C. § 405(a) (1976)).

<sup>80</sup> In order to satisfy the tenth amendment, Chapter IX preserves the power of the state to delegate governmental power. Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 83, 90 Stat. 316 (to be codified as 11 U.S.C. § 403 (1976)). See note 6 *supra*. Concomitant with the preservation of state power, the municipality's political processes must be protected from federal interference under Chapter IX. Thus, a federal bankruptcy court cannot become involved in the local election process, even though the election jeopardizes the plan of composition or adjustment. *Spellings v. Dewey*, 122 F.2d 652 (8th Cir. 1941). Furthermore, the court in a Chapter IX proceeding must respect the delegation of any municipal powers to other state agencies. See, e.g., *Reynolds v. Sims*, 377 U.S. 533, 575 (1964), holding that the state has absolute discretion respecting the scope of a municipality's powers. See also 1 E. McQUILLAN, MUNICIPAL CORPORATIONS ¶ 3.02 (3d ed. 1971).

<sup>81</sup> See generally Part II *supra*.

<sup>82</sup> See notes 71-73 and accompanying text *supra*.

<sup>83</sup> See note 80 *supra*.

<sup>84</sup> In his *Ashton* dissent, Mr. Justice Cardozo noted that the history of bankruptcy reveals that the concept of bankruptcy power is an expanding one. 298 U.S. at 535. Broader judicial control over a municipal debtor should be viewed as simply another stage in the development of the bankruptcy clause.

The argument presented in this section assumes that Chapter IX as presently written is constitutional. In view of the decision in *National League of Cities v. Usery*, 96 S. Ct. 2465 (1976), it is possible, however, that Chapter IX will come under constitutional attack. This issue is raised and discussed in Note, *Municipal Bankruptcy, the Tenth Amendment and the New Federalism*, 89 HARV. L. REV. 1871 (1976).

The note suggests that in view of the state government's role in a federal system, one of decentralizing governmental power and of serving as a "laboratory" for experimentation and change, it is the state's "autonomy interests," i.e., "the state's role as an independent legal and political entity," which must be protected to ensure that congressional legislation will be constitutionally upheld. *Id.* at 1886-87. Clearly the state's lawmaking functions must

pansion of judicial control in a Chapter IX proceeding over the financial reorganization of a local municipality herein suggested should not be precluded.

#### IV. PROPOSALS FOR REFORM

The Supreme Court has succinctly stated the goals of a bankruptcy proceeding, indicating that “[l]iquidation is not the objec-

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be protected, but in other areas the distinction between protected and unprotected interests is much less evident.

When one moves from such basic elements of statehood to the functions of the states in collecting revenues and providing services, however, clear facial identification of autonomy interests are no longer possible. Certainly, the state must be free to collect some revenue to support its continued existence and to provide basic governmental services. In the economic context, however, the state necessarily functions in a complex environment of interacting state and national policies, and the basic purposes of federalism do not require the complete isolation of the state as an economic actor. Congressional legislation affecting this environment, however, may in some cases so constrict the structural or fiscal operations of the state as to threaten the state's ability to enact and enforce its laws, maintain its governmental structure, or provide critical and necessarily public services.

*Id.* at 1887.

The note proposes that any statute which infringes upon state autonomy interests must satisfy two tests in order to be constitutional. *Id.* at 1888-91. First, the procedure utilized must allow state interests to be fully considered. The suggestion is made by the author that the present Chapter IX effectively allows state concerns to be raised because only the municipality may initiate a proceeding, and because the plan of adjustment is formulated and submitted to the court by the municipality. The second requirement is that the federal legislation must ensure substantive protection of the state's autonomy interests utilizing a test much like the “least restrictive alternative” test used in other constitutional areas.

So long as adequate process is provided and the accommodation requirement is met — in other words, so long as the interests of the states have been considered and represented as fully as possible in the federal forum — then the purposes of judicial scrutiny have been fulfilled and the federal legislation should be considered constitutional, regardless of its implications for state autonomy.

*Id.* at 1890.

Although Chapter IX definitely represents an intrusion upon some of the state's autonomy interests, the author of the note concludes that it satisfies the constitutional test which he has suggested. This conclusion relies heavily upon the prohibitions contained in Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 82(c), 90 Stat. 316 (to be codified as 11 U.S.C. § 402(c) (1976)), and the ability of the municipality to formulate the plan of adjustment to be used, Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 84, 90 Stat. 317 (to be codified as 11 U.S.C. § 404 (1976)). Even in the absence of these two provisions, however, Chapter IX should be upheld as constitutional.

State “autonomy interests” are ultimately protected because Chapter IX does not allow the filing of an involuntary petition against the municipality. The municipality has the initial choice of preventing any federal interference in its fiscal affairs and the bankruptcy court cannot interfere until the municipality has decided to seek the relief which bankruptcy proceedings offer. Even if the court is given more control in the formulation of the plan, the state's interests are additionally protected in that the municipality will be heard and will be allowed to make objections and suggestions to the court before any plan of adjustment is confirmed.

The role of the bankruptcy judge is also very important in balancing the competing federal and state interests involved in a municipal bankruptcy proceeding. See Note, 89 HARV. L. REV., *supra* at 1905. His consideration of the issues should continue to accord the greater deference and respect to state interests which are more important here than in a proceeding involving a private individual. This role would not be diminished by any of the proposals set forth in this article. See Part IV *infra*.

tive" of the reorganization proceeding, but "[r]ather, the aim is by financial restructuring to put back into operation a going concern."<sup>85</sup> If the liquidation of a municipality were a valid objective of a Chapter XI proceeding, then a mere composition would be sufficient to ensure a fair and equitable distribution to creditors. The bankruptcy court in a Chapter IX proceeding, of course, cannot liquidate a municipality. Nevertheless, it should ensure that the proceedings result in rehabilitating the fiscal structure of the municipality. Proposals to make a Chapter IX proceeding more effective should emphasize two goals: (1) a fair and equitable distribution to the city's creditors; and (2) the rehabilitation of the municipal corporation into a viable operating entity.

### A. *Elimination of the Section 82(c) Prohibitions*

The three prohibitions of section 82(c)<sup>86</sup> must be removed from the Act if the court is to do more than merely approve the petitioner's plan of composition. These prohibitions are not essential for a municipal debt proceeding to satisfy the requirements of the tenth amendment.<sup>87</sup> The retention of these provisions precludes the judicial control over the debtor which is required for the success of the proceeding. Even without other statutory changes, the removal of these prohibitions will significantly increase the court's power over the debtor.<sup>88</sup>

The bankruptcy legislation which has been proposed by the Commission on Bankruptcy Laws does not contain a provision similar to section 82(c).<sup>89</sup> Since no explanation for the deletion is offered in the accompanying commentaries,<sup>90</sup> it may be assumed that no major policy shift was envisioned. Bankruptcy courts have traditionally possessed inherently broad equitable powers which do not depend upon express statutory provisions.<sup>91</sup> Thus, without

<sup>85</sup> *Baker v. Gold Seal Liquors, Inc.*, 417 U.S. 467, 470 (1974). *Baker* dealt with the reorganization of a railroad, a process raising issues of public policy similar to those presented by the Chapter IX petitioner, since the services involved are essential to the public. Therefore, the goal of such a reorganization proceeding serves as an appropriate model for an expanded Chapter IX proceeding in which the finances of the municipality are similarly adjusted.

<sup>86</sup> Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 82(c), 90 Stat. 316 (to be codified as 11 U.S.C. § 402(c) (1976)). See note 39 *supra*.

<sup>87</sup> See Part III *supra*.

<sup>88</sup> Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 82(b)(3), 90 Stat. 316 (to be codified as 11 U.S.C. § 402(b)(3) (1976)), provides that "... the court may ... exercise such other powers as are not inconsistent with the provisions of this chapter."

<sup>89</sup> See Proposed Bankruptcy Act, *supra* note 36, Ch. VIII. *But see* House Bill, *supra* note 36, § 904.

<sup>90</sup> See COMMUNICATION FROM THE EXECUTIVE DIRECTOR, COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, 93d Cong., 1st Sess., Pts. I & II (1973).

<sup>91</sup> *American United Mut. Life Ins. Co. v. City of Avon Park*, 311 U.S. 138, 146 (1940).

the prohibitions of section 82(c), bankruptcy courts will be free to exercise their powers more extensively, provided they act within the limits of section 83(c) and the tenth amendment. Nevertheless, in order to ensure this result, Congress should enact statutory provisions consistent with the proposals advanced in this article.

### B. *Judicial Control of Finances and Budgets*

Supervision of a debtor's financial affairs is the *sine qua non* of successful financial rehabilitation. As a general rule the parties, not the courts, formulate the plans of adjustment under the various chapters of the Bankruptcy Act.<sup>92</sup> For a variety of administrative and constitutional reasons, the bankruptcy judge is not the proper authority to make the ultimate decisions regarding municipal programs.<sup>93</sup> Nevertheless, in a Chapter IX proceeding, the court should be empowered to make certain determinations which would provide a framework for subsequent decisions by local officials.

There are several ways in which the bankruptcy court can make important contributions without undermining the responsibility of public officials to determine the level of public services to be provided. For example, the valuation of anticipated revenues is essential to the formulation of any successful plan, just as determining "reorganization value" is critical in corporate reorganizations.<sup>94</sup> The court should require that the municipality use accurate accounting methods in order to ensure that a realistic determination of anticipated annual revenue is utilized in formulating the

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<sup>92</sup> See 11 U.S.C. §§ 569, 570, 723 (1970).

<sup>93</sup> See notes 100 & 101 and accompanying text *infra*.

<sup>94</sup> Reorganization value is determined by the court in a reorganization proceeding to ensure that the plan meets the requirements for confirmation. 6A W. COLLIER, BANKRUPTCY ¶ 11.05 (4th ed. 1976). This value is used in determining whether an entity is solvent or insolvent, which classes of creditors will be allowed to participate in the reorganization, and whether a rehabilitation is possible or liquidation is the only reasonable alternative. *Id.* The determination of this value is based upon a reasonably informed judgment of the earning capacity of the business as a going concern followed by a capitalization of these projected earnings. *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 525-26 (1941).

Reorganization value is not, however, used merely to assure that the respective priorities of creditors are upheld. "A basic requirement of any reorganization is the determination of a capitalization which makes it possible not only to respect the priorities of the various classes of claimants but also to give the new company a reasonable prospect for survival." *Group of Inst. Investors v. Chicago, M., St. P., & Pac. R.R. Co.*, 318 U.S. 523, 540 (1943).

Although a bankruptcy court cannot force a municipality into liquidation proceedings, it must still respect the relative priorities of each class of creditors in a municipal debt adjustment proceeding. See note 106 and accompanying text *infra*. An accurate valuation of the city's anticipated revenues is also necessary for the court to determine whether the plan provides the city with a financial structure which will lead to future fiscal stability.

plan. Such judicial supervision will discourage the debtor municipality from engaging in short term borrowing based upon an inflated estimate of anticipated revenues.<sup>95</sup>

Nonetheless, short term borrowing may be a useful tool in the administration of municipal finances, since the need for cash often arises before anticipated revenues are realized.<sup>96</sup> To a financially struggling municipality, these cash flow problems can be critical. Accordingly, Chapter IX empowers the court to permit the issuance of certificates of indebtedness, thereby allowing the petitioner to raise cash before it realizes its anticipated revenues.<sup>97</sup> It follows that the court should have sufficient authority to ensure that realized revenues are actually applied to the outstanding short term debt.<sup>98</sup>

Since the court is currently prohibited from interference with "any of the property or revenues of the petitioner,"<sup>99</sup> it is difficult to prevent a municipality from issuing certificates of indebtedness beyond the amount of its yearly income. In addition, the court is powerless to prevent a city from borrowing from other sources, even when such borrowing jeopardizes the composition plan. The court should be granted the authority to prevent irresponsible borrowing, and Chapter IX should be revised to facilitate such an objective.

The power to determine anticipated annual revenues, coupled with the power to oversee borrowing, enables the court to delineate the parameters of the municipality's budget. However, the use of such powers should not permit judicial direction of the manner in which revenues are spent in the delivery of municipal goods and services.<sup>100</sup> This latter type of control might realistically be viewed as a form of interference with state sovereignty which the tenth amendment forbids.<sup>101</sup> However, the power to determine fiscal parameters could ensure that the municipality presents to the

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<sup>95</sup> Borrowing on the basis of an inflated estimate of anticipated revenues is not an uncommon municipal practice. It is also a major cause of financial collapse. *Financial Emergencies*, *supra* note 1, at 62.

<sup>96</sup> *Id.*

<sup>97</sup> Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 82(b)(2), 90 Stat. 316 (to be codified as 11 U.S.C. § 402(b)(2) (1976)).

<sup>98</sup> This overseer capacity would entail retention of jurisdiction by the court after confirmation. *See* Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 96(e), 90 Stat. 325 (to be codified as 11 U.S.C. § 416(e) (1976)).

<sup>99</sup> Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 82(c)(2), 90 Stat. 316 (to be codified as 11 U.S.C. § 402(c)(2) (1976)).

<sup>100</sup> The only exception to this limitation would be the court's capacity to ensure that certificates of indebtedness are repaid. *See* note 98 and accompanying text *supra*.

<sup>101</sup> *See* note 76 *supra*.

court a balanced budget based upon realistic estimates of available resources.<sup>102</sup>

### C. *The Financial Rehabilitation*

In order for a plan of composition to be confirmed, the present Bankruptcy Act requires that a plan be "feasible" and "fair and equitable."<sup>103</sup> Feasibility is simply intended to mean that the debtor can satisfy the plan's requirements with respect to the repayment of creditors.<sup>104</sup> Application of this standard requires a judicial determination that the creditors will actually receive what the plan offers them.<sup>105</sup> The feasibility test is inadequate because it does not ensure financial rehabilitation, which should be a principal objective of the municipal debt adjustment proceeding.

Similarly, requiring a fair and equitable plan does not compel the court to evaluate the prospects of future fiscal improvement. Rather, this provision embodies the rule established in early reorganization cases that the priorities of creditors be respected and that creditors with a priority be fully paid before subordinate interests are allowed to benefit from the debt adjustment proceedings.<sup>106</sup> Furthermore, the fair and equitable standard in Chapter IX requires the municipality to exercise its taxing power to the greatest practicable extent. Finally, it ensures that the plan results from an open bargain without any overreaching.<sup>107</sup>

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<sup>102</sup> The minority report to the Bankruptcy Act amendments of 1976 expresses the view that the municipal debt adjustment procedure should require that a balanced budget be presented to the court as part of the plan:

The purpose of municipal bankruptcy is to give the municipality an opportunity to get its house in order and make whatever adjustments or arrangements are indicated with existing indebtedness so that it may emerge from the bankruptcy under circumstances in which it can survive. No municipality can survive unless its projected revenues, regardless of source, and projected expenditures, regardless of purpose, are in balance. We do not think that Congress intends to make available the extreme remedies of a stay of all adverse proceedings and involuntary compositions of the debts of objecting creditors and of other benefits of Chapter IX in the absence of a clear municipal intent to balance its budget.

H.R. REP. NO. 94-686, 94th Cong., 2d Sess. 59, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 811.

<sup>103</sup> Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 94(b), 90 Stat. 323 (to be codified as 11 U.S.C. § 414(b) (1976)). The proposed bankruptcy acts continue the "fair and equitable" standard, and although they do not expressly require that the plan be "feasible," they do require that "all amounts to be paid by the debtor . . . are reasonable." Proposed Bankruptcy Act *supra* note 36, § 8-307(c); House Bill, *supra* note 36, § 943(3).

<sup>104</sup> See notes 50-53 and accompanying text *supra*. See also H.R. REP. NO. 94-686, 94th Cong., 2d Sess. 33, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 811.

<sup>105</sup> *In re American Trailer Rentals Co.*, 325 F.2d 47, 53 (10th Cir. 1963), *rev'd on other grounds sub nom.* SEC v. American Trailer Rentals Co., 379 U.S. 594 (1965).

<sup>106</sup> See, e.g., *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939); *Northern Pac. Ry. v. Boyd*, 228 U.S. 482 (1913).

<sup>107</sup> H.R. REP. NO. 94-686, 94th Cong., 2d Sess. 33, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 811.

The municipal bankruptcy statute should be amended to require that judicial evaluation of the plan will include a determination that future financial reorganization or rehabilitation is likely to be unnecessary.<sup>108</sup> Judicial control over the borrowing and budgetary limits of the municipality<sup>109</sup> will facilitate the evaluation of the plan, because the control will enable the court to more accurately predict future revenues and expenditures. Chapter IX should be expanded to embrace this concept, because public policy favors the financial rehabilitation of municipalities.

#### D. Joinder of Overseeing State Agencies

Many states provide for the appointment of a receiver or an agency to oversee various affairs of financially embarrassed municipalities.<sup>110</sup> If state law vests the power to govern municipal finances in an independent agency, a Chapter IX proceeding will be inadequate unless the agency is a party, since in these jurisdictions local officials lack the power to implement the plan.<sup>111</sup> Therefore, the Bankruptcy Act should permit joinder of such agencies as necessary parties to Chapter IX proceedings. Alternatively, the municipality's right to petition could be conditioned on the filing of an accompanying voluntary petition by the overseeing agency.

### V. CONCLUSION

Constitutional authority exists for expanded judicial control in Chapter IX proceedings. The tenth amendment does not bar the type of federal expansion proposed in this article. Yet Congress has not adequately extended the powers of the federal bankruptcy court in Chapter IX proceedings.

It must be recognized that the purpose of a Chapter IX proceeding is not merely to adjust the debt of the municipality, but also to institute a plan which will lead to financial rehabilitation. The

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<sup>108</sup> In Chapter VII of the Proposed Bankruptcy Act, which deals with reorganizations, this standard is incorporated as a requirement for confirmation: "The court shall confirm a plan if . . . the plan is feasible and not likely to be followed by the liquidation of, or a need for further financial reorganization . . ." Proposed Bankruptcy Act, *supra* note 36, § 7-103(d).

<sup>109</sup> See Part IV B *supra*.

<sup>110</sup> *Financial Emergencies*, *supra* note 1, at 77.

<sup>111</sup> The Bankruptcy Act precludes confirmation of any plan if the petitioner is prohibited by law from taking any of the actions required to implement it. Bankruptcy Act, ch. 9, Pub. L. No. 94-260, § 94(b)(6), 90 Stat. 323 (to be codified as 11 U.S.C. § 414(b)(6) (1976)). This condition is carried over to the proposed acts. Proposed Bankruptcy Act, *supra* note 36, § 8-307(c)(6); House Bill, *supra* note 36, § 943(5).

Chapter IX petitioner should be required to receive relief only on such terms. Otherwise, the claims of creditors are compromised, and future creditors investing in a “rehabilitated” entity are likely to be misled. If the Bankruptcy Act is to provide effective assistance to financially troubled municipalities, Congress must extend the powers of the federal courts in dealing with municipal debtors.

—*Daniel J. Goldberg*