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It's a pleasure to be here and to be addressing this audience. At a time when states and municipalities are facing fiscal uncertainty, when the municipal bond market is actually mentioned in the popular press, when large municipalities take advantage of Chapter 9, and when there are calls for a bankruptcy procedures for states, I am reminded of my late co-author Bob Amdursky's comment to me some 25 years ago that bond counsel are the true constitutional lawyers. Bob's view, evidenced by the events of today, was that bond lawyers protected the institutional structures of government at the state and local level. My remarks today are intended to elaborate that proposition, and to talk about the ways in which the rules that allocate risks among the various stakeholders in municipal finance can affect the quality of local governance.

My comments are intended to celebrate the role of debt in the design of governance. Public debt, in my view, is one of the great insurers of democratic rule. Debt, these days, is too readily equated with fiscal irresponsibility. Debt overhang, whether in the form of bonded obligations or obligations to make future contributions to pensioners, can certainly consume a disproportionate share of the public budget, require increases in taxes and fees, and displace the use of tax revenues for productive purposes. But both in theory and in history, the presence of a class of debt holders also ensures a degree of supervision of state and local officials against fiscal excess, for the simple reason that debt holders want to be paid and thus have incentives to exercise vigilance against fiscal policies that jeopardize that repayment. In order for debt to play that role, however, debt holders must bear responsibilities, and it is the amplification of those responsibilities on which I want to focus for the next half hour or so.

Let me begin with an account of the current uncertainty, or at least variability, in doctrines concerning the relative exposure of bondholders and residents to the consequences of local fiscal distress. I'll start with a story. For most people, at least those of a certain generation, the name Asbury Park in New Jersey conjures up images of Bruce Springsteen and maybe the Jersey Shore. For bond attorneys, the imagery is quite different. Asbury Park stands as a turning point in the debate about the allocation of losses between bondholders and residents when a locality has insufficient funds to pay both.

The story is relatively straightforward. Between 1929 and 1930 the City of Asbury Park issued bonds that were scheduled to mature between 1933 and 1935, and that would pay between 5 3/4 and 6 percent in interest. The city's timing was, shall we say, unfortunate. The bonds came to represent what Justice Frankfurter was to describe as "a familiar picture of optimistic and extravagant municipal expansion caught in the destructive grip of general economic depression: elaborate beachfront improvements, costs in excess of estimates, deficits not annually met by taxation, declining real estate values, inability to refinance a disproportionately heavy load of short-term obligations, and, inevitably, default." Sound familiar?

Faced with a choice of defeating bondholder expectations of repayment or allowing a reduction in local services, the New Jersey legislature, in its infinite wisdom, enacted a statutory regime that authorized state control over insolvent municipalities like Asbury Park. That regime allowed adjustment of the claims of *all* creditors of the municipality, as long as the plan was approved by those holding 85 per cent of the debt. In the case of Asbury Park, the plan approved by the requisite percentage of bondholders required conversion of the bonds due in 1933 to 1935 into new bonds maturing in 1966 and imposition of a lower rate of interest than was to be paid on the original bonds. Under the terms of the state legislation, the deal bound even dissenting bondholders. In short, in the contest between bondholders and residents, the latter won.

For dissenting bondholders, this was parochial politics at its worst – the externalization of costs to the bondholder community in order to save residents who had pledged to repay borrowed funds. Indeed, the bondholders could, and did, make a stronger claim. The prohibition on such parochialism was exactly what the federal constitutional Contracts Clause was all about. That clause, of course, famously prevents a state from enacting a law that impairs the obligation of contract. The clause was inserted into Article 1 of the Federal Constitution out of the very fear that large numbers of debtors would otherwise use their majority to renege on prior bargains struck with creditors. And what could be a more quintessential impairment of the obligation of contract than a state law that permitted debtors to defer repayment until some time later than specified in the original deal?

Disappointed bondholders of Asbury Park could point to a long history of judicial interventions to avoid what appeared to be opportunistic defaults by residents. The history of municipal finance up to that time had been filled with political efforts to circumvent borrowings that localities had come to regret, for good reasons or bad. When the City of Mobile defaulted on bonds issued in aid of the Mobile and Great Northern Railroad Company, the Alabama legislature had dissolved the city and incorporated a new municipality known as the Port of Mobile. The new municipality included approximately 95 percent of the taxable property and 14/15ths of the inhabitants of the former City of Mobile. The Port claimed that it was not responsible for the debts of the former City of Mobile. The Supreme Court saw right through that one and, without mentioning the Contracts Clause, invalidated the legislative intrusion.

Similar efforts to reduce the rights of municipal creditors by boundary changes, explicit withdrawal of municipal taxing authority, or prohibitions on payments had systematically been set aside by courts during the last half of the 19th century and the first decades of the Twentieth.

So it might have come as a surprise when the Supreme Court of the United States responded to Asbury Park's difficulties by upholding New Jersey's statutory moratorium. The rationale of the Supreme Court rested on practical realities rather than doctrinal purity. "The notion that a city has unlimited taxing power," Justice Frankfurter wrote, "is, of course, an illusion." Efforts to enforce claims against a financially distressed city through mandamus requiring the collection of unavailable taxes had proven in the past to be nothing more than "the empty right to litigate." As the New Jersey Court of Errors and Appeals had said in its disposition of the case, "a court presented with default judgments against an insolvent city and a writ of mandamus to collect additional taxes "would, no doubt, have provided some means for enforcing the judgments *so as to do no irreparable public injury*."

In short, without the state adjustment plan, bondholders had nothing because courts would prevent the destruction of the municipality to satisfy debts. Armed with the right to deferred payments, bondholders had something valuable, an obligation not in default and for which Frankfurter contended there was a robust market. In short, far from contesting New Jersey's sacrifice of bondholders on the altar of municipal services, bondholders should have celebrated New Jersey's transformation of their worthless overdue obligations into valuable, tradable instruments.

There was, of course, some basis for the practical construction of bondholder rights. The history of fiscal distress to that point was littered with failed efforts to seize property of the municipality – deemed unavailable because it was held in trust for residents rather than for the municipality itself; to seize property of individual residents – deemed unavailable outside of a few decisions of questionable viability from New England states; to seize funds in the local treasury that had been appropriated for other purposes; or even to allow one bondholder to execute on a sinking fund that was created to benefit all bondholders. Hence, the claim that holders of general obligation bonds had contractual priority over the demands of municipal residents or municipal employees was always subject to the willingness of courts to require payments that left municipalities with insufficient resources to satisfy whatever were defined as public functions.

That same exercise of judicial discretion and interpretation of doctrine has continued to limit what might initially sound like an absolute right to payment. Faced with dramatic increases for electricity ratepayers obligated to pay amounts sufficient to cover debt service in the 1980s, courts in the Pacific Northwest and in Vermont invalidated take-or-pay arrangements that supported bonds for superfluous or unexpectedly costly power plants. Even what was, to many, the surprising invalidation of the New York City Emergency Moratorium Act in 1975 in favor of creditor rights came with reservations that dramatically diluted any solace that the bondholder community could take from the decision. "Yes," the court said, the noteholders disadvantaged by that Act were entitled to relief from the state's efforts to defer their payments. But they were not, in the court's language, "entitled immediately to extraordinary or any particular judicial measures unnecessarily disruptive of the city's delicate financial and economic balance." Indeed, the court concluded that it would be "injudicious at this time to allow the extraordinary remedies in the nature of injunction and peremptory mandamus sought by plaintiff" that one might have thought should follow automatically once the court determined that the City had to pay its debts *even if tax limits had to be exceeded*. Instead, the court told the legislature to work out something less onerous for the holders of City debt than it had come up with to that point.

Bondholders, of course, have effectively sought ways to reduce judicial discretion and to strengthen their hand in the battle for limited municipal assets. Much of this has been achieved at the state constitutional level. Georgia's constitution, for instance, requires the legislature to impose taxes and to appropriate funds necessary to pay outstanding general obligation bonds, and requires the state fiscal officer to cure any deficiency in the sinking fund for such bonds by setting aside for bondholders the first revenues thereafter received in the state's general fund.

Maryland requires that any debt be accompanied by a tax sufficient to pay principal and interest and prohibits the repeal of such tax or the diversion of its proceeds to other purposes until the debt has been discharged. Minnesota requires the state auditor to levy an annual tax sufficient to pay principal and interest on faith and credit bonds of the state that come due in any year and through the first half of the next year.

But bondholders have also benefitted from statutory constraints on municipal efforts to favor other claimants to a fund insufficient to satisfy all. The federal Bankruptcy Act effectively overrules the decision in *Asbury Park* by prohibiting states from prescribing a method of composition of indebtedness of a municipality that binds nonconsenting creditors. Virginia statutorily requires the state to pay the holder of any general obligation bond of a locality that is in default and to withhold all payments of state funds to the locality until the state has been repaid.

Perhaps the most interesting recent example of this phenomenon involves Rhode Island. Confronted with the prospect of bankruptcy filings by Central Falls and other municipalities, prospects that were ultimately realized, the legislature adopted a statute that purports to transform the city's tax receipts into a revenue stream on which holders of general obligation bonds have a statutory lien. The effect of the statute is to allow the bondholders priority over other claimants to municipal taxes, such as city employees or pensioners, during bankruptcy proceedings. Perhaps for this reason, when Central Falls, whose website is burnished with the motto "A City with a Bright Future," emerged from bankruptcy last month, its general obligation bondholders walked away with their obligations unimpaired. Pension claimants had their claims reduced up to 55% and employees suffered a reduction in compensation and benefits that presumably translate into reduced services for residents. The allocation of losses differed from that of Vallejo, where some debt holders suffered substantial haircuts, but city employees maintained salaries and avoided additional job reductions.

Now at this point, and faced with these various allocations of risk between residents and creditors, we could get into an interesting debate about the relative blameworthiness of the players in this interesting but dangerous game of dividing a shrinking fiscal pie. We could, for example, establish priority to payment depending on whether we identify the financial burdens that preclude full payment to all as a consequence of residents who – through their elected officials – have volitionally agreed to repay improvidently borrowed funds; rapacious employees who have obtained above-market health and pension benefits by exploiting the willingness of elected officials to trade long-term municipal fiscal stability for short-term political support; or avaricious underwriters who have convinced naïve local officials to incur unsustainable indebtedness for infeasible projects. We could find in recent examples of municipal fiscal distress a poster child for each of these assertions, and use that example as an indicator of the general problem.

My objective, however, is to move away from the ex post analysis of how to allocate the loss that materializes when municipalities confront a fiscal crisis. Instead, I believe it is worthwhile to take an ex ante approach to the problem. Our objective, that is, should not be the optimal allocation of losses once they materialize. Rather, what I want to claim is that our objective should be to allocate losses in such a way as to prevent fiscal crisis from materializing in the first instance.

Such an approach takes as a given that municipal officials suffer from a series of incentives that are at odds with the fiscal health of their localities. Local officials frequently can obtain short-term benefits by embracing programs that entail long-term costs, so that the excessive burdens materialize only when subsequent officials are in office. This has long been the fear about excessive debt, which 150 years ago led to the holy trinity of state constitutional limitations on debt – debt restrictions, explicit public purpose requirements, and prohibitions on lending of credit. But those restrictions have never served as measures of the optimal level of debt that a locality should bear. They vary too much from jurisdiction to jurisdiction to suggest that they have any relationship either to municipal need or municipal fiscal capacity.

Moreover, smart underwriters and bond lawyers have demonstrated great facility in drafting arrangements that circumvent or eviscerate the constitutional restrictions. Courts have been complicit in the relaxation of constitutional restrictions on debt. Notwithstanding occasional judicial resistance to circumvention of debt limits – and here, recall the Oregon Supreme Court's depiction of a state building authority engaged in a lease-purchase program that allegedly did not entail state debt as a "gutless intermediary" whose fiscal independence from the state "would fool only a lawyer" – more recently judges have excluded multiple forms of debt, most glaringly, non-appropriation debt, from constitutional constraints.

If municipal officials are the problem, then one might think that municipal residents are the solution. After all, residents, especially homeowners whose largest asset is immobile, should object to wasteful expenditures, to promises of future payments that can destabilize housing values in later years, or to excessive indebtedness or collective bargaining agreements that threatens costly default or tax or fee increases that don't return productive local benefits. If we want to constrain short-sighted local officials, the argument goes, what better way to do it than to impose losses caused by officials' misfeasance on the residents who elect them and who already should care about fiscal performance to protect their homes, their businesses, and their communities?

That question assumes that the issue of allocating the risk of municipal default should be addressed by identifying the party who can best constrain officials responsible for local fiscal health. After all, in an ideal world, it really wouldn't matter who bears that responsibility; the assignment of the entitlement will simply affect the price at which debt is sold. If bondholders bear the risk of default, presumably they will charge a higher price for the bonds. If residents bear the risk, they will pay less. If residents are superior monitors of local fiscal propriety, therefore, all parties should want the residents to take that burden, because they would otherwise have to pay interest rates in excess of the expected losses that they would incur from doing the job themselves.

But notwithstanding the intuition that residents are well positioned to monitor the fiscal conduct of their officials, there are reasons to doubt that they can play that role. Sometimes, others know more about us than we know about ourselves. Our cell phone carriers probably know the way we use our phone better than we do. It is on that basis that the FCC has proposed that cell phone service providers notify cell phone users when they are about to approach their contractual time limits, although one might have thought that users could figure that out themselves. Or think about the Congressional mandate that credit card issuers consider whether prospective card holders will be able to pay their bills, even though one might believe that applicants for cards have that information. In both situations, the justification for the anti-intuitive regulation is that providers have sufficient information about users that is more accurate than the user's own speculation about himself. In short, the assignment of priority to residents over creditors may reflect a standard resolution of a problem of asymmetric information in which we induce parties with superior information to disclose or act on that information in order to allocate risks that might otherwise fall on parties less able to avoid or bear them.

For residents, the task of monitoring against fiscal distress may simply confront too many obstacles. Meaningful information about local budgets is difficult to obtain or to decipher. Different residents have different interests, different time horizons, and vote on too great of a range of issues to conclude that their votes reflect their overall perception of or reaction to local fiscal health. Even if I fear that current local policies present some risk to my home value, I am unlikely to invest much in auditing the budget. If the schools are decent, the roads are paved, and the sidewalks are clean, I am likely to vote in favor of incumbents – if not, not. Monitoring local fiscal health, for most residents, is simply a game not worth the candle. Even those professional monitors on whom residents might free ride, such as the press, seem to show little interest in documenting fiscal health, until the situation has gotten so bad that reporting constitutes mostly local history about how the municipality got into its disgraceful condition. Scandal may sell, but an increase in pension contributions to the janitors' union likely will not.

Can creditors, bondholders, step into the void? Certainly not bondholders as a class. Individuals who own about 70 percent of municipal bonds either as discrete investments or through mutual funds, are unlikely to invest in the effort. Creditors cannot be expected to monitor against fiscal distress unless the personal benefits that they realize from the effort is worth the cost. I don't mean to suggest that we need more municipal defaults rather than fewer, but with a historical default rate for all municipal bonds of about 1/10th of 1 percent, few bondholders are likely to invest in warding off disaster. Monitoring is costly, and even in today's environment the risk of default is extraordinarily low and there are numerous cheaper alternatives to monitoring.

Even with the decimation of the municipal bond insurance industry, bondholders may prefer to reduce the consequences of default through a diversified portfolio rather than by active supervision of local budgets. Mutual funds, which hold about 35 percent of municipal bonds, are also unlikely to engage much in monitoring.

But arguably bondholders have proxies who have low cost access to fiscal information and who, if their clients faced greater risks of nonpayment in the event of default, would be induced to use that information to monitor fiscal health of issuers. I am talking, of course, about underwriters who – given obligations created by Rule 15c2-12, due diligence defenses, and reputational constraints – are pretty well positioned to obtain information, analyze it, and publicize it. These obligations may exist only with respect to the pre-borrowing period, but for repeat players in the credit markets, continual ex ante screening may be tantamount to ex post monitoring.

But if we are to induce underwriters to fully exploit their position as recipients and analysts of information concerning local fiscal health, and thus to monitor in ways that cannot be replicated by residents, then the best incentive available is to place them at risk when fiscal matters go awry. If they are not first in line when the limited pie gets divided, they have greater reason to ensure that the pie is at least as large as it can be.

I am not suggesting that residents should not bear part of the burden of avoiding or relieving fiscal distress. To the contrary, one might think that bankruptcy judges should have even more authority than they do now to impose additional tax increases as a condition of confirming plans in Chapter 9 proceedings to avoid strategic behavior by bankrupt cities. And I don't mean to impose blameworthiness on underwriters when I describe them as well-positioned to serve the function I am attributing to them. It certainly is true that where matters have gone badly, ex post investigations have tended to allocate some responsibility to underwriters who had access to information long in advance of fiscal crisis. That is the case in the SEC Reports on New York City some 35 years ago and on the Washington Public Power Supply System. Indeed, sometimes – as in the Jefferson County debacle – there are allegations of more active underwriter misconduct. There is nothing new about these types of allegations. A. M. Hillhouse's classic work on municipal debt published 75 years ago spoke of "houses of issue and of distribution" that, "in order to show a profit . . . have been known to encourage newly proposed municipal issues, thereby helping to hurry localities on to financial ruin."

The approach that I am advocating for the allocation of default risk, however, does not rely on any claim of impropriety. Indeed, my assumption is that imposing greater default risks on bondholders as a class will mean that underwriters and bondholder will charge municipalities for the privilege of monitoring. If I am correct about who is best positioned to undertake the task of averting fiscal crisis, then those costs will be less than the expected costs that residents will incur if they are assigned the responsibilities that they are less well positioned to execute.

Such an allocation of risks, however, does mean that strict interpretations of the Contracts Clause that require payment come hell or highwater should be reconsidered in light of the desirability of imposing losses on bondholders. It means that statutes such as the Rhode Island provision that insulates bondholders from exposure to default are unfortunate, and that bankruptcy courts might seriously consider whether the liens created by such statutes should qualify as the kind of statutory lien envisioned by the Bankruptcy Act's priority scheme. Such measures dilute the incentives of creditors to monitor, when it is creditor monitoring that we might need the most.

For bond counsel, my analysis reverts to the old, continuing, and perhaps unanswerable question about who is our client? I have always been attracted by the notion that bond counsel represents "the situation" rather than any particular party. It has always seemed to me that that position empowers bond counsel to consider the analysis into the identity of the superior bearer of risk in municipal finance, a position that aligns the "situation" with the outcome that coincides with social benefit. That bond counsel have the opportunity, indeed, the obligation, to consider that position vindicates Bob Amdursky's observation long ago that bond counsel are inherently implicated in the questions of institutional design that underlie state constitutional frameworks. It is an enviable and challenging time to have the privilege of that obligation, because in times of fiscal crisis, enough is at stake that parties can become intransigent in efforts to pursue their interests. It is perhaps a task that would be appropriate for "only a bond lawyer."

Many thanks for your kind attention.