PENN IUR **POLICY BRIEF**

Policy Brief: Can Courts Resolve the Trilemma? A Response to David Schleicher

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Can Courts Resolve the Trilemma?

David Schleicher's terrific new book, In a Bad State, offers a novel and cohesive account of the various objectives (bailout, austerity, measured default) that the federal government might pursue in the face of state and local fiscal crisis, and compellingly analyzes the impossibility of simultaneously achieving all of those goals. By providing a roadmap to the manner in which academics and policy makers must think about actual and potential distress, David's insight, which amounts to an Arrow's Theorem for fiscal crisis, stands as a major contribution to the literature.

I want to focus on the role of courts in addressing or resolving David's trilemma. David treats the courts, especially the Supreme Court, as an equal partner in structuring a federal response. I am less confident that courts play the role that David attributes to them, in part because of the limited function of courts and in part because of their relationship with the executive and legislative branches. In short, I want to suggest that while David is certainly correct in focusing on courts as major players in confronting the trilemma, they are structurally and functionally different from the other relevant actors. And those differences bring into question whether courts can play a coherent, intentional role in resolving the trilemma, or whether their contributions only fortuitously coincide with one or more of the objectives of other federal branches.

Courts, of course, have little capacity to bail out distressed localities because they cannot mandate that more centralized governments provide bailout funding to distressed decentralized units. Of course, courts could provide a form of bailout by invalidating debt and leaving the issuer with funds that alleviate distress, which is essentially what some courts did in the railroad bond era. But that is not a bailout in the sense that David is using it, that is, to provide funding that would make creditors whole while simultaneously preserving local capacity to fund local infrastructure and services.

Courts can more easily address the second and third lemmas. They can avoid moral hazard by mandating debt payments and invalidating state efforts to impair those obligations. That is essentially what David suspects the Supreme Court did in the late 19th century when states attempted to rescue distressed localities, or what the New York Court of Appeals did when it struck down the state's Moratorium Act during New York City's fiscal crisis in the 1970s. And courts can facilitate default and manage loss sharing, notwithstanding the resulting effects on subsequent investment, by upholding state schemes to compromise debt. Examples here include the Supreme Court's tolerance of mortgage moratorium acts during the Depression. Or, courts can manipulate legislatively granted bankruptcy to spread the risks associated with a managed default.

So in theory, courts could be a significant partner in addressing and resolving the trilemma, even if not a full partner given their inability to provide or require funding. But I wonder whether court participation in the process counts as a deliberate intervention to achieve one or more of the objectives of the trilemma or a more coincidental by-product of other judicial functions. When the executive or legislative branches intervene in a fiscal crisis, whether by providing funding, refusing to provide funding, or creating a bankruptcy alternative, they do so quite specifically, intentionally, and presumably with an understanding of how their decisions impact the competing interests in the trilemma.

Courts might act the same way. There have been times when courts have revealed that they are quite cognizant of the fiscal and investment implications of their decisions in narrow cases. The famous Charles River Bridge case, for example, was nominally about whether an exclusive license to operate a bridge must remain in perpetuity or could be circumvented when the government licensor found an allegedly superior alternative. But the state and federal judges who addressed that narrow question quite explicitly addressed the effects of their decision on the willingness of entrepreneurs to make socially productive investments in new technologies, such as railroads and canals. Courts, that is, are not necessarily oblivious to the consequences of their decisions.

Yet, I am hesitant to attribute that foresightedness and rigor to the decisions that David discusses. Perhaps when judicial decisions advance one of the lemmas in David's puzzle, that is simply a necessary effect of some other function the court is attempting to pursue. After all, what was the Supreme Court trying to accomplish when it elevated creditors' rights over state and municipal solvency in the late 19th century? Were the justices and the state and federal judges who followed that line of decisions primarily concerned with consequences for subsequent infrastructure investment? Perhaps. But the language of the opinions was often much loftier, as when the Court said, in Wolff v. City of New Orleans that a legislative scheme to limit taxes that secured outstanding bonds offended the "inviolability of contracts," and perhaps judges meant what they said, that they were simply engaged in enforcing promises, indifferent to the consequences for any specific promise. Maybe, as Erik Monkkonen has argued, judges were opposed to debtors whom courts perceived had defaulted for political rather than fiscal reasons. Or perhaps, as Vincent and Allison Buccola have argued, the cases tell a complicated story in which the Supreme Court decided cases in a nuanced manner consistent with an information cost explanation. If grounds for bond invalidity were easily accessible to bondholders, e.g., compliance with a requirement that residents vote for the bond issue, then bondholders bore the validity risk. If those same bondholders could not easily access information that confirmed validity, e.g., suspect bonds were issued in excess of state constitutional debt limits, then a recital within the bonds that there had been compliance with the legal prerequisites for issuance would estop the issuer from denying validity.

That conclusion would be consistent with a story in which courts are attempting to impose losses on that group that is in the best position to have avoided the crisis in the first instance. I have argued elsewhere that creditors rather than residents of distressed municipalities often occupy that position. Where that is the case, we might do better to allow localities to default, thus sending a signal to creditors to take advantage of their superior position to avoid the next crisis. But that has little to do with the interests recognized in the trilemma. Or perhaps, judges who invalidated bonds simply shared Judge Dillon's animosity towards public funds being used for redistributive purposes, including subsidizing private enterprise, regardless of potential positive effects for local economies.

Finally, courts might simply be somewhat woodenly following their view of what the law requires of them, consequences be damned. In some sense, of course, that is exactly what we expect of courts, at least where legislatures have been sufficiently directive in making political decisions. David recounts an explicit example of this in Central Falls, Rhode Island, where the legislature, at the behest of bondholders, enacted a statute that gave bondholders a first lien on the property taxes that secured their bonds, thus preventing pensioners and residents of reaching those revenues during the city's bankruptcy. Bond counsel have recommended such first lien statutes broadly and many jurisdictions have adopted them. Unless a court were to hold that such a lien did not constitute the kind of statutory lien that deserves protection in bankruptcy, those statutes sorely constrain courts in choosing which lemma to pursue.

So while I am confident that David is correct in including courts, especially federal courts, in the litany of players who address and resolve the trilemma, I am reluctant to attribute much intentionality to judicial decisions, and I am less confident that courts consider the global implications of their decisions. That does not dilute David's main point about the effects of judicial intervention, but it does tell us something about the extent to which we can rely on courts to strike the balance that David sees as the objective of federal actors generally.

But there is one additional role that courts play that I believe is worth considering. Courts create entitlements around which debtors and creditors can bargain. When courts address disputes about the validity of debt, they frequently are doing more than allocating losses in a zero-sum game about whether debts will be paid or not. Instead, debtors and creditors have traditionally sought judicial resolution after a state has intervened to assist a distressed political subdivision in a manner that disadvantages creditors. This was the case with the 19th century state acts to reallocate assets initially pledged by distressed localities and with 20th century moratorium acts. But a careful reading the relevant cases reveals that states did not simply intervene to divert municipal assets from creditors. Rather, those legislative interventions tended to occur after debtors and creditors had entered into ultimately unsuccessful negotiations about partial payments that would spread the loss of financial distress in the way that David suggests may be appropriate. Without a bankruptcy law to compromise debts, creditors could hold out for substantial payments regardless of consequences for debtor services. States responded by giving debtors an advantage, sometime by dissolving the indebted municipality. But the states that did so frequently recognized that their decisions were contingent on subsequent negotiations with creditors, sometimes going so far as to include a reservation price for adjusting the debt. In effect, the states attempted to assign an entitlement, one of nonpayment, that would give debtor municipalities an advantage over holdout creditors in subsequent Coasean bargaining. Courts that invalidated the state schemes were essentially reversing that entitlement, assigning it instead to creditors who would then have an advantage in the subsequent negotiations.

Perhaps the most blatant example of courts playing the role of establishing a default rule and allowing bargaining to allocate losses occurred in New York when the Court of Appeals invalidated the state's Moratorium Act. One would have thought that the upshot of that decision was that New York City had to pay its debts immediately without reservation. But here's what the court said after holding that the moratorium on NYC note payments was unconstitutional: "In order to minimize market and governmental disruptions which might ensue it would be injudicious at this time to allow the extraordinary remedies in the nature of injunction and peremptory mandamus sought by plaintiff. Plaintiff and other noteholders of the city are entitled to some judicial relief free of throttling by the moratorium statute, but they are not entitled immediately to extraordinary or any particular judicial measures unnecessarily disruptive of the city's delicate financial and economic balance. It is significant too that the Legislature will shortly meet in regular annual session and will be in a position once again to treat with the city's problems and to seek a fiscal solution in the light of the holding in this case. It would serve neither plaintiff nor the people of the City of New York precipitately to invoke instant judicial remedies which might give the city no choice except to proceed into bankruptcy." Fostering loss-sharing negotiations around a default rule may be the most useful role that a court can play in resolving the trilemma.

I have one last thought about the ambiguous judicial role in this area. As David so thoroughly demonstrates, the trigger for many crises in our history involves debt limits that state constitutions impose on states and their political subdivisions. These debt limits not only constrain states and localities in their efforts to construct necessary infrastructure, but also force those entities into expensive, if creative, efforts to circumvent debt limits with multiple authorities, sale and leasebacks, revenue bonds that have no special revenue, and other mechanisms that obfuscate the debt position of states and localities. Similarly, debt limits induce courts to undertake mental gymnastics to define what obligations are within and without the limits so that, as David indicates, general obligations count, but pension obligations to be paid out of the same revenues do not. David correctly suggests that debt limit need reform. That might be useful if debt limits were set to some ideal measure of affordability. But debt limits vary so much in their baseline and their calculation that they belie any claim that they are related to ideal affordability. Perhaps if, as David and others have suggested, we demanded more transparency in the debt position of states and localities and avoided the artificial debt limits, we would increase monitoring by residents and markets that would allow pricing and political accountability to signal impending fiscal crisis. That might be a consequence of eliminating debt limits and the subsequent need for peculiar judicial constructions of their scope. I'm not sure of that. After all, resident monitoring suffers from a classic collective action problem, and institutional investors may be more likely to handle risk through diversified portfolios than by costly monitoring of individual issuers. But to the extent that artificial debt limits contribute to, rather than avoid fiscal crisis, it may be time to rethink their antiquarian status and utility.