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## Positive Liberty in Public Finance: State Oversight of Local-Government Debt and the North Carolina Model

Adam C. Parker

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# Positive Liberty in Public Finance: State Oversight of Local-Government Debt and the North Carolina Model

ADAM C. PARKER\*

## ABSTRACT

*This Article examines state oversight of local-government borrowing in the United States and focuses in depth on the North Carolina model. The Article considers (1) structures requiring prior approval before debt is issued by local governments; (2) different forms of state-takeover and emergency-aid provisions in case of a local-government fiscal crisis; and (3) ongoing audit and monitoring functions. Additionally, this Article discusses the history and structure of North Carolina's Local Government Commission. Finally, this Article argues that the Local Government Commission's model of ongoing monitoring, approval, and takeover authority is the preferable model of state oversight, as long as its authorities are limited to ensuring sound local-government debt practices.*

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## INTRODUCTION

In his famous essay, *Two Concepts of Liberty*,<sup>1</sup> English philosopher and political theorist Isaiah Berlin described his notion of two types of liberty: negative liberty and positive liberty.<sup>2</sup> Negative liberty or “negative freedom”

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1. ISAIAH BERLIN, *Two Concepts of Liberty*, in *FOUR ESSAYS ON LIBERTY* 118 (1969).

2. *Id.* at 122, 131.

is the notion of being “free to the degree to which no man or body of men interferes with [an individual’s] activity,” or “not being interfered with by others.”<sup>3</sup> Positive liberty is quite different, meaning “the wish on the part of the individual to be his own master,” or the wish “to be a subject, not an object; to be moved by reasons, by conscious purposes, which are [the individual’s] own, not by causes which affect [the individual], as it were, from outside.”<sup>4</sup>

While Berlin’s dichotomous concepts were aimed at explaining an individual’s freedom in a societal and political theory context, these twin concepts analogize well to governments that wish to remain autonomous, but which operate within a reality affected by the actions of other governments.<sup>5</sup>

The interrelated nature of local governments is particularly apparent within local-government debt financing and fiscal practices. Local governments sometimes design or engage in new forms of debt financing, which other units emulate in hope of facilitating community development.<sup>6</sup> Local governments mimic one another’s best practices and strive to attain fiscal health.<sup>7</sup>

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3. *Id.* at 122–23.

4. *Id.* at 131.

5. This is an imperfect analogy. Another analogy that could be drawn is that this interplay between state and local governments is simply small-scale federalism. *See* Paul E. Peterson & Daniel Nadler, *Freedom to Fail: The Keystone of American Federalism*, 79 U. CHI. L. REV. 251, 253–54 (2012). Similarly, my analogy is used with the understanding that Berlin has his critics. *See, e.g.*, PHILIP PETTIT, *REPUBLICANISM* 18 (Will Kymlicka et al. eds., 1999) (“I believe that the negative–positive distinction has served us ill in political thought.”). However, taken in the context of a local government acting as a corporation, I would argue that regulation by a dominant government structure (such as a state or the federal government) lends itself well to Berlin’s twin concepts. This analogy is meant only to demonstrate the balance that a state debt-oversight agency must strike in regulating local governments and ensuring stable market conditions within the state.

6. There are many examples of the various types of local-government financing mechanisms that have gained widespread adoption. *See generally* Laurie Reynolds, *Taxes, Fees, Assessments, Dues, and the “Get What You Pay For” Model of Local Government*, 56 FLA. L. REV. 373 (2004) (describing how special assessments, business improvement districts, and other forms of financing have supplanted much of the revenue generation that was previously created by local property taxes).

7. *See generally* KARL NOLLENBERGER ET AL., ICMA, *EVALUATING FINANCIAL CONDITION: A HANDBOOK FOR LOCAL GOVERNMENT* (4th ed. 2003) (providing local governments with advice and measurement tools to determine fiscal solvency); Ken W. Brown, *The 10-Point Test of Financial Condition: Toward an Easy-to-Use Assessment Tool for Smaller Cities*, GOV’T FIN. REV., Dec. 1993, at 21, 22, available at <http://lgc.uwex.edu/Finance/Inservices/2011/kenneth%20brown-Ten-point-test.pdf> (describing ten key ratios for predicting fiscal solvency for a smaller city); William C. Rivenbark et al., *Communicating Financial Condition to Elected Officials in Local Government*, POPULAR GOV’T, Fall 2009, at 4, 5, <http://sogpubs.unc.edu/electronicversions/pg/pgfal09/article1.pdf> (describing a fiscal-condition

Beyond sharing techniques for budgeting and borrowing, local governments are common participants in a broader marketplace of local-government bonds.<sup>8</sup> This means that one local government's debt-management practices may significantly impact perceptions of the local-government bond market, affect the cost of debt that other local governments may obtain,<sup>9</sup> and may also affect other local governments' general access to credit (as was the case in Orange County, California, in the mid-1990s).<sup>10</sup> The

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analysis tool developed by several professors that uses several ratios to determine a government's fiscal condition and solvency, including a debt-service ratio).

8. For a discussion on financing capital projects in North Carolina, particularly the marketing of capital debt, see DAVID M. LAWRENCE, FINANCING CAPITAL PROJECTS IN NORTH CAROLINA §§ 500–509, at 119–50 (2d ed. 1994). For a broad, nationally focused overview of each facet of the municipal-bond market, see NEIL O'HARA, THE FUNDAMENTALS OF MUNICIPAL BONDS (6th ed. 2012), which discusses basics, issuers, the primary and secondary markets, the investment market, credit analysis, interest rates, regulatory and disclosure requirements, and more exotic instruments, such as rate swaps. Some believe that the municipal-bond market is more easily shaken than other debt markets because municipal bonds are traditionally viewed as a safe bet for investors (which is why, along with income-tax exemptions for earned interest, local governments can offer lower rates than are available on the private bond market). See MICHAEL LEWIS, BOOMERANG 171–78 (2011) (providing a discussion of the local-government bond market's concern over defaults).

9. For example, in Israel, a large group of local governments underwent a severe financial crisis; goods were not able to be financed and “[a]bout three quarters of the local governments suffered from deficits—most of them had deficits of over 30% of their annual budgets.” Omer Kimhi, *Chronicle of a Local Crisis Foretold—Lessons from Israel*, 39 FORDHAM URB. L.J. 679, 680 (2012) [hereinafter Kimhi, *Chronicle*]. “[M]arkets view a local crisis not as an isolated event but rather as a warning sign for the condition of other localities. If a state allows the default of one locality, other municipalities might suffer from similar problems and follow suit.” *Id.* at 715 (footnote omitted). This ultimately leads to an increase in the cost “of credit for all public issuers in the state, even for those issuers that have no direct connection with the city’s default.” *Id.* (emphasis added). This pattern of increased cost of debt is borne out again and again, as the Moody’s rating service pointed out when Atlantic City was put under an emergency management team in January 2015—other local governments who were also struggling were viewed as a greater credit risk going forward. See Andrew Coen, *Moody’s: Atlantic City EM Negative for New Jersey Locals*, BOND BUYER (Jan. 27, 2015, 3:02 PM), <http://www.bondbuyer.com/news/regionalnews/moodys-atlantic-city-em-negative-for-new-jersey-locals-1069903-1.html>.

Our state debt system is also fairly unique compared to the rest of the world. For example, only twenty-five of the world’s 193 countries are federalist systems; second, only two other countries, Canada and Switzerland, do not have federally guaranteed state debt. Peterson & Nadler, *supra* note 5, at 252–53.

10. Orange County, California, is viewed as the typical example, and studies point to the effects of Orange County’s default extending to other cities in California, to the state’s ability to issue its own debt, and even to the municipal-bond market. See Dwight V. Denison, *Did Bond Fund Investors Anticipate the Financial Crisis of Orange County?*, MUN. FIN. J., Fall 2000, at 24, 24–26; John M. Halstead et al., *Orange County Bankruptcy: Financial Contagion in the Municipal Bond and Bank Equity Markets*, 39 FIN. REV. 293, 313 (2004). Orange County

extent of the impact caused by a default or other signals to the market is debatable,<sup>11</sup> but some effect undoubtedly exists.<sup>12</sup>

The interconnected nature of local governments in the local-government debt market analogizes conveniently with the concepts of negative and positive liberty.<sup>13</sup> Local governments inevitably want the freedom to manage debt as they choose and to take on more debt service if they find a buyer; local governments want administrative flexibility that is “unobstructed by others.”<sup>14</sup> However, if local-government debt management is left completely

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engaged in “heavy borrowing and risky investments in its investment pool” before becoming the largest municipal bankruptcy at that time. See Floyd Norris, *Orange County's Bankruptcy: The Overview; Orange County Crisis Jolts Bond Market*, N.Y. TIMES (Dec. 8, 1994), <http://www.nytimes.com/1994/12/08/business/orange-county-s-bankruptcy-the-overview-orange-county-crisis-jolts-bond-market.html>. Whether this phenomenon still holds true is up for debate, although a reclassification of general obligation bonds as “unsecured debt” would have a significant effect on the rates that a lender might seek. See Karen Pierog & Tom Hals, *Detroit Bankruptcy Bond Fight a Watershed for Municipal Market*, REUTERS (Feb. 17, 2014, 9:17 AM), <http://www.reuters.com/article/2014/02/17/us-usa-detroit-bankruptcy-bonds-idUSBREA1G00J20140217>.

11. Bond Girl, *Michael Lewis Falls for Meredith Whitney, While Getting the US Muni Market Totally Wrong*, BUS. INSIDER (Sept. 30, 2011, 12:17 PM), <http://www.businessinsider.com/response-to-michael-lewis-vanity-fair-piece-2011-9> (opining that an increase in rates is not as dire among local governments in the United States as it may be with other sovereigns because “state and local governments are not dependent on short-term market access in the same way the US government and European sovereigns are,” and “[w]hen municipal rates increased, state and local governments simply stopped issuing bonds”). *Id.* Indeed, only .06% of general-purpose local governments have filed for bankruptcy since 2008. See *Bankrupt Cities, Municipalities List and Map*, GOVERNING, <http://www.governing.com/gov-data/municipal-cities-counties-bankruptcies-and-defaults.html> (last updated Nov. 7, 2014).

12. This effect on market stability is perhaps further affected by recent changes to the potential yields for state and local securities as compared to federal securities. See Peterson & Nadler, *supra* note 5, at 266. Peterson and Nadler discuss state bonds in the aftermath of financial crisis as follows:

In the United States, investors were willing to accept lower interest rates on state debt securities relative to US Treasuries due to their federal-tax-exempt status. After the financial crisis, however, the yield on state bonds rose above that for comparable federal securities, as any tax advantages were overwhelmed by perceived increased risk. Rates of return on state bonds before the financial shock trailed those for Treasury securities because federal taxes need not be paid on the returns from most state and municipal bonds. But after the financial crisis, the spread between state and federal bonds turned from negative to positive, as the relative risk from state investments outweighed any tax advantages. Moreover, the yield spread between state and federal bonds varied significantly from state to state, indicating that the market perceived greater default risk in certain states.

*Id.* (footnotes omitted).

13. See *supra* notes 2–5 and accompanying text.

14. BERLIN, *supra* note 1, at 122.

unobstructed, there is the potential for harm to the individual unit, its citizens, and the broader market, if a government's finances are mismanaged.<sup>15</sup> As former Massachusetts Representative Barney Frank said, “[n]o State, no State legislators, no governor, can allow any one of its municipalities to default because then every other municipality would pay through the nose. So that is why this is not just some charity here; this is self-defense.”<sup>16</sup>

A policy solution exists to solve the problem of one government's fiscal instability affecting another government's ability to borrow at a lower rate: another actor can impose constraints on all local governments' borrowing abilities to maintain a stable market. However, to provide the positive liberty of stable and inexpensive government debt, there is an implicit tradeoff—some of a local government's ability to borrow will be curtailed to provide certainty to investors, issuers, and other parties in the market.<sup>17</sup> This tension plays out not only in intrastate borrowing habits, but also in our federalist system.<sup>18</sup>

State governments fill this role through various forms of local-government debt oversight.<sup>19</sup> One method of oversight involves an

15. See Kimhi, *Chronicle*, *supra* note 9, at 715 n.264, 716, 718 (discussing the “contagion effects” of municipal default). Generally, default is perceived to cause wide-ranging harm to municipal debt markets. See LAWRENCE, *supra* note 8, § 400, at 92 (“Default causes long-lasting harm to the unit involved and if widespread, may affect the market for securities of creditworthy governments as well. Therefore states have sought ways to prevent local governments from borrowing more than they can afford.”).

16. *Municipal Bond Turmoil: Impact on Cities, Towns, and States: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 25 (2008) (statement of Rep. Barney Frank, Chairman, H. Comm. on Fin. Servs.).

17. See BERLIN, *supra* note 1, at 132 (noting in the individual's context that while one may be “[his] own master,” one is also a “slave to nature” or to external forces).

18. See Peterson & Nadler, *supra* note 5, at 269–70. Peterson and Nadler define this sort of tension and the temptation that local governments often face as follows:

When sovereignty is divided, lower-tier governments are tempted to run debts that place themselves at grave risk of default in times of financial crisis. And central governments, both to safeguard their international credit rating and to respond to internal political pressures, cannot resist providing the assistance necessary to safeguard bondholders and other creditors from loss. Central governments do not offer a helping hand without at the same time asserting their authority, however. If they rescue states and localities they will feel more than entitled to take preventative measures designed to preclude future defaults. Irresponsibility at the state and local level thus undermines the dual sovereignty essential for the survival of competitive federalism. Celebrated in theory as an efficient government of Herculean proportions, competitive federalism is but a ten-pound weakling in practice.

*Id.* (footnotes omitted).

19. Federal regulation of state and local financing is also robust. See generally 1 JAMES A. CONIGLIO & M. DAVID GELFAND, *STATE AND LOCAL GOVERNMENT DEBT FINANCING* §§ 9:1–9:23, at 9-2 to -64 (2d ed. 2013) (discussing the role of federal securities laws within state- and

authorization of extraordinary measures to handle crises when they emerge, like in Harrisburg, Pennsylvania,<sup>20</sup> or the attempts to forestall bankruptcy in Detroit, Michigan.<sup>21</sup> Some states establish “early warning systems” to monitor and alert the state to financially troubled local governments, which often prompts state intervention before a crisis like those in Orange County, Harrisburg, or Detroit can emerge.<sup>22</sup> This auditing function requires local

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local-government debt financing). Indeed, ongoing reporting requirements from the SEC have changed in recent years. *See generally* U.S. SEC. & EXCH. COMM’N, REPORT ON THE MUNICIPAL SECURITIES MARKET (2012), [http://www.sec.gov/news/studies/2012/munireport\\_073112.pdf](http://www.sec.gov/news/studies/2012/munireport_073112.pdf) (noting several SEC recommendations regarding ongoing reporting requirements for municipal securities). This Article focuses on the oversight mechanisms of local-government debt, although the same arguments could be made for a federal oversight system that parallels a system like North Carolina’s Local Government Commission.

The oversight role is also filled by states in their authorization of local-government debt. Local governments do not have an inherent power to borrow; they receive that authority from the state. 2 CONIGLIO & GELFAND, *supra*, § 12:4, at 12-19. States impose various restraints on the categories of debt, as well as on debt limits. *Id.* at 12-19 to -20 (providing a list of various state-enabling statutes).

20. *See* Romy Varghese, *Harrisburg Sets Sale of Incinerator That Drove Insolvency*, BLOOMBERG (Nov. 25, 2013, 1:29 PM), <http://www.bloomberg.com/news/2013-11-25/harrisburg-to-sell-incinerator-that-drove-insolvency-next-week.html>.

21. *See* Caitlin Devitt, *Detroit Takeover Bodes Well for Investors, Muni Experts Say*, BOND BUYER (Mar. 1, 2013, 4:08 PM), [http://www.bondbuyer.com/issues/122\\_42/michigan-governor-rick-snyder-state-takeover-of-detroit-good-for-investors-1049250-1.html](http://www.bondbuyer.com/issues/122_42/michigan-governor-rick-snyder-state-takeover-of-detroit-good-for-investors-1049250-1.html) (describing Michigan’s takeover of Detroit).

Florida also has a “financial emergency board,” which “oversee[s] the activities of the local government entity or the district school board,” and is triggered when a local government either fails to pay debts, to transfer taxes withheld on the income of employees, to make payroll, or to address operating deficits. *See* FLA. STAT. § 218.503(3)(g)(1) (2014). These receivership structures also have their critics. *See generally* Michelle Wilde Anderson, *Democratic Dissolution: Radical Experimentation in State Takeovers of Local Governments*, 39 FORDHAM URB. L.J. 577, 578 (2012) (arguing that the changes to receivership statutes enacted in Rhode Island and Michigan do not address the underlying causes of fiscal stress in local governments, and that the statutes “enact a punishing cancelation of local democracy”).

22. *See* Philip Kloha et al., *Someone to Watch Over Me: State Monitoring of Local Fiscal Conditions*, 35 AM. REV. PUB. ADMIN. 236, 237 (2005) (“[S]tates have also developed more proactive approaches in which they try to recognize problems and have mechanisms for dealing with them before they balloon into fiscal crises.”). Ohio, for example, has such a monitoring program, which also has an auditing function. *See* PUB. FIN. MGMT., STATE PROGRAMS FOR MUNICIPAL FINANCIAL RECOVERY: AN OVERVIEW 1 (2011) [hereinafter PFM WHITE PAPER], [https://www.pfm.com/uploadedFiles/Content/Knowledge\\_Center/Whitepapers,\\_Articles,\\_Commentary/Whitepapers/State%20Programs%20for%20Municipal%20Financial%20Recovery.pdf](https://www.pfm.com/uploadedFiles/Content/Knowledge_Center/Whitepapers,_Articles,_Commentary/Whitepapers/State%20Programs%20for%20Municipal%20Financial%20Recovery.pdf). In Ohio:

[T]he State Auditor’s Office monitors local governments by providing them with ratio indicators to benchmark financial performance and identify fiscal distress. The State Auditor collects financial data on local governments through the state’s Uniform Accounting Network (UAN). The UAN is a very low cost accounting

governments to submit information to the state for review.<sup>23</sup> Some states also review certain types of debt instruments and require state approval before issuing the debt.<sup>24</sup> Some states have explicit control strategies for troubled local governments, through which the state will take over the entirety of the local government at varying degrees along the spectrum of fiscal emergency.<sup>25</sup> Some states blend these approaches.<sup>26</sup> Others impose constitutional or statutory limitations on the type and amount of debt that local governments may incur, although local governments sometimes design creative ways to circumvent those limits.<sup>27</sup> Some states choose a different course, like Alabama did when its legislature chose not to intervene in Jefferson County, thus allowing the county to file for Chapter 9 bankruptcy.<sup>28</sup>

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software program provided to local governments. If a municipality decides to use the program, it must agree to allow the State auditor to access and analyze its information. More than 70 percent of Ohio's local governments use the system. The State Auditor uses the financial data to monitor their fiscal condition and may recommend that a municipality enter one of . . . three programs, based on the severity of financial distress.

*Id.* (footnotes omitted).

23. See, e.g., *Online Audit Reports*, MICH. DEP'T TREASURY, [http://www.michigan.gov/treasury/0,1607,7-121-1751\\_31038--,00.html](http://www.michigan.gov/treasury/0,1607,7-121-1751_31038--,00.html) (last visited Nov. 16, 2014) (providing financial audits in an online repository).

24. For example, Connecticut does not allow for tax increment financing (TIF) bonds that are backed by sales taxes unless the TIF bonds are approved by a joint committee of the Connecticut General Assembly. See CONN. GEN. STAT. § 32-285(f)(6) (2013) (including incremental sales, hotel, cabaret, dues, and admissions taxes for use in a TIF district). Connecticut also requires approval by its State Bond Commission before any type of TIF debt is issued. See *id.* § 32-285(g)(2).

25. See PFM WHITE PAPER, *supra* note 22, at 3–4 (discussing Massachusetts's takeover of the cities of Chelsea and Springfield, and its replacement of provisions regarding labor contract negotiation).

26. See *id.* at 5–8 (discussing several states with multifaceted debt-approval mechanisms).

27. See Note, *State Administrative Supervision of Local Government Debt: The North Carolina Model*, 1972 DUKE L.J. 487, 487–88; see also 1 CONIGLIO & GELFAND, *supra* note 19, §§ 11:1–11:6, at 11-3 to -20 (describing the historical basis for constitutional debt limits and current trends in debt limits in various states).

28. Bond Girl, *The Incredible Story of the Jefferson County Bankruptcy—One of the Greatest Financial Ripoffs of All Time*, BUS. INSIDER (Oct. 23, 2011, 8:33 AM), <http://www.businessinsider.com/the-incredible-story-of-the-jefferson-county-bankruptcy-one-of-the-greatest-financial-ripoffs-of-all-time-2011-10> (“Unlike Harrisburg, where the state of Pennsylvania moved swiftly to intervene in the city’s financial situation, the state of Alabama has resisted providing any assistance to Jefferson County over the years.”). This has also had a detrimental effect on borrowing for other Alabama local governments. See Sarah Frier, *Jefferson County Agony Means Higher Borrowing Costs for Alabama Taxpayers*, BLOOMBERG (Aug. 22, 2011, 12:01 AM), <http://www.bloomberg.com/news/2011-08-22/jefferson-county-agony-means-higher-borrowing-costs-for-alabama-taxpayers.html>.

One state's structure is unique among the various types of state-oversight mechanisms, and it is also the debt structure that arguably exerts the most control over local governments' autonomy regarding their debt-financing decisions. That structure is North Carolina's Local Government Commission (LGC).<sup>29</sup>

The LGC has its roots in remedying Depression-era defaults on local-government bonds, which were exceedingly high in North Carolina, even for an era when defaults were occurring nationwide.<sup>30</sup> What makes the LGC unique is not only its blended approach to regulating debt financing, but also the extent and reach of its various tools for regulating local-government debt.<sup>31</sup>

This Article makes two principal arguments. First, it argues that the LGC's demonstrated record of ensuring fiscal stability is proof positive that a regulatory body like the LGC can help local governments to avoid fiscal crises, and may help to quell the recent uptick in Chapter 9 bankruptcy filings going forward.<sup>32</sup> While states often employ several individual oversight

29. See *infra* notes 198–240 and accompanying text (providing a general background of North Carolina's LGC); see also Stephen C. Fehr, *North Carolina Agency is Local Government Lifeline*, PEW CHARITABLE TR. (June 6, 2012), <http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2012/06/06/north-carolina-agency-is-local-government-lifeline>.

30. See LAWRENCE, *supra* note 8, § 400, at 92 (“In 1933, for example, with the Great Depression at its worst, 62 North Carolina counties, 152 cities and towns, and some 200 special districts were in default on the principal or the interest or both, of outstanding obligations.”).

31. See PFM WHITE PAPER, *supra* note 22, at 4. One report described the LGC's approach as follows:

If needed, the Commission can negotiate with creditors to work out a plan for the municipality to repay its debts. In addition, if a municipality cannot meet its debt obligations, the Commission may order the local government to raise taxes or other revenues in adequate amounts to make the necessary debt service payments. At this stage, the Commission may review and approve a municipality's annual budget, and the State Treasurer will benchmark the municipality's finances to set its future budgetary goals.

*Id.*

32. For a counterargument that local governments should wield “fiscal home rule,” see Joni Armstrong Coffey, *The Case for Fiscal Home Rule*, FLA. B.J., Apr. 1997, at 54, 54, in which the author argues that constitutional restrictions and state oversight have limited “local government's natural creativity and responsiveness.” *Id.*; see also Omer Kimhi, *A Tale of Four Cities—Models of State Intervention in Distressed Localities Fiscal Affairs*, 80 U. CIN. L. REV. 881, 887 (2012) [hereinafter Kimhi, *Tale*]. Kimhi states:

Perhaps the best example of such proactive state involvement can be found in North Carolina. Pursuant to a general statute, North Carolina created a special state agency to supervise local government finances: the Local Government Commission (LGC). The commission monitors local governments and ensures their financial stability. When certain indicators are met, the commission creates a special board to

mechanisms and constitutional amendments,<sup>33</sup> and although other factors may step in to prevent fiscal disasters,<sup>34</sup> North Carolina involves its state regulatory agency with local governments at each step in the debt-issuing process to ensure a proactive approach. In addition, the LGC retains the ability (through an *ongoing*, rather than *emergency* authorization) to compel a municipality to pay its debt service.<sup>35</sup> This approach provides a degree of certainty to all parties in the market, keeping borrowing rates low and increasing access to credit markets for all of North Carolina's local governments.<sup>36</sup>

Second, this Article contends that the mission of the LGC is unique and should remain limited to ensuring that local governments maintain their fiscal health. Examples of functions that are not suited for the LGC include the supervision of (1) economic-development incentives, (2) pension funds, and (3) school finance. Specifically, these functions should not be administered by the LGC because they involve policy judgments, because an investment function is not well matched to the core mission of the LGC, or because the method of financing the activity makes it impossible for the LGC to exercise

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intervene in the financial affairs of the distressed municipality and help it rehabilitate its fiscal stability.

*Id.* Kimhi's article also acknowledges the exceedingly difficult set of circumstances facing local governments today, pointing to the importance of improving outcomes for local governments. *Id.* at 881. Kimhi further states:

American cities are facing the worst financial crisis since the Great Depression. Many cities have difficulties financing their expenses, and substantial deficits in local budgets are prevalent. 2011 was the fifth consecutive year in which local governments experienced a decline in revenues, and according to the National League of Cities, 57% of city financial officers report that their cities [are] less able to meet their fiscal needs compared to the previous year. Property tax receipts are down, and localities face massive pension and infrastructure obligations.

*Id.* at 882 (footnotes omitted). *See also Bankrupt Cities*, *supra* note 11 (showing a map of municipal bankruptcy filings in the United States since 2000). There have been thirty-eight filings under Chapter 9, although the filings were traditional units of government (three of those were dismissed). *Id.* The other filings were nontraditional units of government, such as water/sewer authorities. *Id.*

33. *See, e.g.*, IND. CONST. art. XIII, § 1. In Indiana, the state constitution imposes a limit on the amount of debt that may be taken out by a local unit. Indiana does not allow the amount of debt to be more than 2% of the total assessed value of a unit. *Id.*

34. For example, New York usually passes special legislation when a local government is in distress, and then the state grants unique powers to a borrowing authority to alleviate the problem, as well as to an oversight board to help guide the local government out of its dire straits. *See PFM WHITE PAPER*, *supra* note 22, at 5.

35. *See* N.C. GEN. STAT. §§ 159-36, -181 (2013) (providing the LGC with the authority to increase taxes and to remove officers who do not comply with the LGC's directive, both for local governments and for water/sewer authorities).

36. *See generally* Fehr, *supra* note 29.

sufficient control needed to bring the unit back to fiscal health.<sup>37</sup> This Article makes one final point about recent changes to the LGC’s issuing of guidelines and its method of adoption—namely that if a guideline is issued as a strict rule, the guideline should be encapsulated in the state’s administrative code or codified by statute.

Analysis proceeds in four parts. Part I surveys various states’ oversight mechanisms of local-government finance to demonstrate the different types and forms of state supervision, setting up an argument for the cohesive approach of the LGC. Part II explores the history of the LGC that led to its creation in 1931, as well as the subsequent changes that resulted in today’s LGC structure. Part III describes the current powers of the LGC, including the types of debt that require approval. Part IV considers other expansions to LGC authority concerning water/sewer districts, private financing for local-government infrastructure, economic-development projects, pension-fund oversight, and supervision of school districts. Additionally, Part IV critiques the LGC’s recent trend of adopting “guidelines” without adopting regulations through the formal rulemaking process.

#### I. A SURVEY OF OTHER STATES’ REGULATION OF LOCAL-GOVERNMENT FINANCE

This Part includes brief summaries of various states’ approaches to local-government debt oversight to highlight three common approaches that states take to oversee local-government debt.<sup>38</sup> This consideration of various state

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37. This argument relates to school finance in North Carolina. Specifically, in North Carolina, school districts are not allowed to levy their own taxes, which unduly limits the LGC’s ability to take corrective action to bring a unit back to fiscal health. *See generally* Lisa Lukasik, *Deconstructing a Decade of Charter School Funding Litigation: An Argument for Reform*, 90 N.C. L. REV. 1885, 1896 (2012). Lukasik explained:

Unlike state funding, local funds do not travel directly to the receiving charter school from their source, typically a board of county commissioners. Instead, local funding for *all* public schools—charter schools *and* traditional public schools—is provided to the local board of education. Then, the charter school statute requires the local board of education to “transfer to the charter school an amount equal to the per pupil local current expense appropriation to the local school administrative unit for the fiscal year.”

*Id.* (quoting N.C. GEN. STAT. § 115C-238.29H(b) (amended 2013)); *see also* Margaret Rose Westbrook, Comment, *School Finance Litigation Comes to North Carolina*, 73 N.C. L. REV. 2123 (1995) (describing the effect of school-finance litigation in North Carolina).

38. Oversight and intervention are not the only strategies that can be used to prevent or mitigate the damages of municipal fiscal insolvency. *See generally* Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 636 (2008) [hereinafter Kimhi, *Reviving Cities*] (discussing three types of approaches to solving municipal fiscal crises: creditors’ remedies, the Bankruptcy Code, and state financial-oversight boards).

approaches lays the table for Part III, showing how the LGC's authority compares with these various state-oversight mechanisms. The first Section describes the methods by which statewide entities approve local-government debt. The second Section describes various states' use of emergency-takeover authority during fiscal crises. The third Section discusses how other states oversee local-government debt through auditing and monitoring functions.

#### A. *Debt Approval*<sup>39</sup>

##### 1. *Louisiana*

Like North Carolina, Louisiana experienced a large number of municipal defaults in the 1930s.<sup>40</sup> This shared history likely pushed Louisiana to fashion a similar state-oversight authority in its state-approval agency, the Louisiana State Bond Commission (LSBC), which is part of the state's Department of the Treasury.<sup>41</sup> The LSBC was created in 1968 "to centralize and administer the incurring of state debt," and was later expanded to include local units of government.<sup>42</sup> These requirements are written into state statutes, but the LSBC's approval requirement was written into the state constitution as well.<sup>43</sup> The LSBC also receives applications from local governments and other political subdivisions for the ability to levy taxes.<sup>44</sup>

However, even with the LSBC as a state-oversight approval mechanism, Louisiana has not avoided all local financial difficulties. For example, in 1999, the Lower Cameron Parish Hospital Service District became the first—and so far, the only—Louisiana municipality to file for Chapter 9 bankruptcy.<sup>45</sup> In response to the filing, the Louisiana legislature required

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This Article accepts Kimhi's argument that the state financial-oversight board is the preferable approach, and then considers the various types against the LGC's structure. *Id.*

39. There are other meanings that could be given to the term "approval." For example, one treatise discusses approval by the attorney general of some states, as well as other forms of judicial validation that can be required for bonds. See ROBERT S. AMDURSKY ET AL., MUNICIPAL DEBT FINANCE LAW §§ 2.7.1–2, at 92–96 (2d ed. 2013).

40. See Marc D. Joffe, Drivers of Municipal Bond Defaults During the Great Depression 16–17, 21 (Jan. 2013) (unpublished M.P.A. thesis, San Francisco State University), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2189889](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2189889).

41. LA. REV. STAT. ANN. §§ 36:769, 36:802, 39:871 (2014).

42. *State Bond Commission*, LA. DEP'T TREASURY, <http://www.treasury.louisiana.gov/Home%20Pages/BondCommission.aspx?@Filter=BC2012> (last visited Nov. 18, 2014).

43. LA. CONST. art. VII, pt. I, § 8, para. B ("No bonds or other obligations shall be issued or sold by the state, directly or through any state board, agency, or commission, or by any political subdivision of the state, unless prior written approval of the bond commission is obtained.").

44. See *State Bond Commission*, *supra* note 42.

45. See Voluntary Petition, *In re Lower Cameron Parish Hosp. Serv. Dist.*, No. 99-21290 (Bankr. W.D. La. Nov. 18, 1999); see also Lauren M. Wolfe, Comment, *The Next Financial*

municipalities to receive approval from the LSBC before filing for bankruptcy.<sup>46</sup> Further, after Hurricane Katrina, the chair of the LSBC provided assurance to ratings agencies and bond insurers that the state treasurer would “not vote to allow any municipality in the state to enter into bankruptcy.”<sup>47</sup>

While Louisiana’s approach is similar to the LGC’s,<sup>48</sup> a key difference between the LGC and the LSBC is that the auditing functions of the LSBC are provided by a separate agency, the Louisiana Legislative Auditor,<sup>49</sup> which supports the LSBC, but is not housed in the same organizational structure. Further, the LSBC does not have the ability to dictate fiscal policy to insolvent governments; instead, the LSBC may attempt to prevent bankruptcies by insisting that a local government not file for Chapter 9 bankruptcy.<sup>50</sup> This approach forces the local government’s hand to raise additional revenues or restructure its financial affairs. However, an approach that provides direct state assistance might relieve some of the political pressures that the local governments face, and could also bring in additional expertise that might otherwise be lacking.

## 2. Nevada

The State of Nevada requires all of its counties to establish a “debt management commission.”<sup>51</sup> The Nevada Department of Taxation offers assistance to counties with populations of less than 47,500 to carry out the duties of the commission, otherwise leaving the larger counties to provide staffing and support to their respective debt-management commissions.<sup>52</sup> The state requires debt-management plans and financial statements to be sent to the State Department of Taxation,<sup>53</sup> and that notice is provided to relevant local governments that would be affected by a debt concern and by subsequent

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*Hurricane? Rethinking Municipal Bankruptcy in Louisiana*, 72 LA. L. REV. 555, 556 n.6 (2012) (citing Mary Chris Jaklevic, *Ex-CEO Pleads Guilty to Medicare Fraud: La. Hospital Exec Faces Five Years in Prison for Bilking Medicare out of \$1.4 Million*, MOD. HEALTHCARE, June 25, 2001, at 15; Mary Chris Jaklevic, *Bankrupt But Open: La. Hospital That Owes HCFA Millions Wins Reprieve*, MOD. HEALTHCARE, Oct. 16, 2000, at 50).

46. See Wolfe, *supra* note 45, at 556.

47. *Id.* at 575 (quoting BUREAU OF GOV’T RESEARCH & PUB. AFFAIRS RESEARCH COUNCIL OF LA., MUNICIPAL BANKRUPTCY IN PERSPECTIVE 8 (2006), <http://www.bgr.org/files/reports/MunicipalBankruptcy4-5-06.pdf>).

48. See *infra* notes 285–93 and accompanying text.

49. See *Advisory Services*, LA. LEGIS. AUDITOR, <http://www.lla.state.la.us/localgovernment/advisoryservices/> (last visited Nov. 18, 2014).

50. Wolfe, *supra* note 45, at 572–73.

51. NEV. REV. STAT. § 350.0115 (2011).

52. *Id.* § 350.0125.

53. *Id.* § 350.013.

property tax increases.<sup>54</sup> However, it seems duplicative to give a county, rather than the state, the ability to approve its own debt through a debt-management commission.<sup>55</sup> Given the makeup of the commissions, which consist mostly of elected officials, the debt-management commission seems more like a traditional elected board<sup>56</sup> than an oversight mechanism by another level of government.<sup>57</sup>

### 3. *New Jersey*

The State of New Jersey employs a robust observation and approval mechanism,<sup>58</sup> but also shows the complicated interplay between “unfunded mandates” from state to local governments.<sup>59</sup> Like North Carolina,<sup>60</sup> New Jersey experienced many local-government defaults in the 1930s.<sup>61</sup> Also like North Carolina, New Jersey requires local governments to submit their financial statements to the state office to ensure that the budget is balanced,<sup>62</sup> and that it complies with statutory debt limits.<sup>63</sup> Moreover, the state is

54. *Id.* § 350.0135. Provisions regarding notice requirements from local governments to state agencies are also fairly common. *See, e.g.*, KAN. STAT. ANN. § 10-109 (2001); KY. REV. STAT. ANN. § 66.045 (West 2014); MO. REV. STAT. § 108.240 (2000).

55. NEV. REV. STAT. § 350.014 (“[T]he proposed incurrence or levy must receive the favorable vote of two-thirds of the members of the commission of each county in which the municipality is situated.”).

56. *Id.* § 350.0115.

57. For example, the Clark County Debt Management Commission is composed of three county commissioners, six members of municipal governing boards, and two citizens. *See Clark County Regional Debt Management Commission*, CLARKCOUNTYNV.GOV, <http://www.clarkcountynv.gov/depts/finance/Pages/RegionalDebtManagementCommission.aspx> (last visited Nov. 20, 2014). This is not necessarily problematic, but it seems to be a duplication of other governing boards—with the exception of the two members of the public. Having an intergovernmental board, however, has the potential benefits of cooperation and coordination of debt across several localities.

58. STATE BUDGET CRISIS TASK FORCE, NEW JERSEY REPORT 46–47 (2012), <http://www.statebudgetcrisis.org/wpcms/wp-content/images/2012-10-22-New-Jersey-Report-Final.pdf>.

59. *Id.* at 46. The idea that some of these mandates are pushed down from the state to the local governments is a valid cause for questioning the logic of allowing a state to control the fiscal affairs of a local government. In some ways, the ability of a local government to have complete control over its own debt financing is couched in the concept of home rule. *See AMDURSKY ET AL.*, *supra* note 39, § 2.2.2, at 64–67.

60. *See infra* notes 198–240 and accompanying text.

61. STATE BUDGET CRISIS TASK FORCE, *supra* note 58, at 46.

62. *Id.*

63. *Id.* at 47 (noting debt limits of “3.5 percent of three year equalized valuation for municipalities; 2 percent for counties; and 4 percent for school districts”). To exceed these statutory limits, a government must receive permission from the state’s Local Finance Board. *Id.*

required to maintain a “watch list” for localities that have not complied with state filing requirements, or those that receive state aid as a “distressed” municipality.<sup>64</sup> If a locality is placed on this “watch list,” the local government is required to submit its budget each year for approval by the state.<sup>65</sup>

Through its Local Finance Board, New Jersey may also assume control of a local government’s financial affairs.<sup>66</sup> In recent years, the state has assumed control of four local units’ finances: Atlantic City, Irvington, Union City, and Asbury Park.<sup>67</sup> Other oversight mechanisms include the Transitional Aid Program, which requires localities with structural issues to submit to state oversight in return for aid, as well as statutory debt thresholds, depending on the type of local government issuing the debt.<sup>68</sup> Specifically, in the distressed-communities program, the director of the New Jersey Department of Community Affairs declares that the local government is in significant financial distress, and the municipality enters into a “rehabilitation term,” under which a chief operating officer (appointed by the governor) assumes the powers of the local government.<sup>69</sup>

New Jersey and North Carolina share several similarities, but a key difference is that for all of New Jersey’s robust mechanisms, there is no requirement for debt approval by the state like the one found in North Carolina. The Transitional Aid Program requires the municipality to agree “to pursue structural budget reforms and adhere to state oversight requirements,” but it is voluntary and more of a quid pro quo—it asks local governments to cede some of their autonomy in return for state aid.<sup>70</sup> With the LGC approach, approval of debt applies across the board to healthy and financially distressed governments. While this may be an unnecessary procedural step for governments that are fiscally responsible, this step helps ensure that governments do not need to voluntarily submit to a program like New Jersey’s Transitional Aid Program, as the ongoing requirement for *all* debt to be approved helps keep local governments out of the fiscal straits that would necessitate entering the Transitional Aid Program.<sup>71</sup>

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64. *Id.* at 46.

65. *Id.*

66. *Id.* These local-government units are no longer under the state’s control. *Id.*

67. *Id.*

68. *Id.* at 47.

69. N.J. STAT. ANN. § 52:27BBB-9(f) (West 2010 & Supp. 2014).

70. STATE BUDGET CRISIS TASK FORCE, *supra* note 58, at 47.

71. This Transitional Aid Program also has the issue of being reactive in that local governments are submitting to oversight *after* they have reached a point of fiscal distress. Atlantic City, for example, entered the program, but now faces even more challenges as its revenues from casinos decreased and its infrastructure costs increased after Hurricane Sandy.

#### 4. *New York*

New York has a wide-ranging, blended approach to oversight of its local governments' financial affairs,<sup>72</sup> but there are significant differences between New York's approach and North Carolina's model. The primary difference is that New York's approval approach is reactive—the state enacts legislation granting the state approval authority to address crises as they occur.<sup>73</sup> In these individual circumstances, the authorities that are created to oversee the local government are often given “power to approve or disapprove budgets and financial plans, issue debt, and impose a wage and hiring freeze.”<sup>74</sup> New York also requires approval from its local finance boards before issuing debt,<sup>75</sup> similar to Nevada's requirement of a local board's approval.

Within New York's regulatory approach is a monitoring system for fiscal stress.<sup>76</sup> Once a unit is evaluated, the unit is assigned a grade based on several ratios relating to financial indicators, as well as environmental indicators (such as property values, population, age, and other metrics).<sup>77</sup> After making this assessment, the state comptroller will offer reviews of a unit's budget, technical assistance, financial planning over several years, training, and other resources to help the unit gain competencies in administering its local budgets.<sup>78</sup>

This system is fairly comprehensive, but it lacks the permanence of a compulsory takeover provision; instead, it enacts legislation in specific instances where default seems likely. That said, there are several layers of oversight within the system, and it appears to be a well-run system of monitoring and providing assistance to financially distressed local governments.

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See Marc Joffe, *Atlantic City Declines: Will It End in a Municipal Bond Default?*, BITVORE (July 14, 2014), <http://bitvore.com/2014/07/atlantic-city-declines-will-it-end-in-a-municipal-bond-default/>. Perhaps earlier intervention would have mitigated the issues that Atlantic City now faces by limiting the amount of debt incurred by the city.

72. PFM WHITE PAPER, *supra* note 22, at 5. Note also that Connecticut has a similar structure in which it appoints a supervisory board on an ad hoc basis. *Id.* at 5–6.

73. *Id.* at 5. This is also the case in Massachusetts. See *infra* notes 91–105 and accompanying text.

74. PFM WHITE PAPER, *supra* note 22, at 5.

75. N.Y. LOCAL FIN. LAW § 33.00 (McKinney 2012 & Supp. 2014).

76. See generally DIV. OF LOCAL GOV'T & SCH. ACCOUNTABILITY, OFFICE OF N.Y. STATE COMPTROLLER, FISCAL STRESS MONITORING SYSTEM 1, 6–7 (2014), <https://osc.state.ny.us/localgov/pubs/fiscalmonitoring/pdf/fiscalstressmonitoring.pdf> (discussing the methodology used by the state comptroller to determine whether a local school district or a local government is in fiscal distress).

77. *Id.* at 3–8.

78. *Id.* at 12.

### 5. *Other States*

Some states simply require approval for certain types of debt. For example, Connecticut employs statewide approval for tax increment financing by its state bond commission.<sup>79</sup> Other states have statutory approval requirements as a litmus test for local governments to pass—both quantitatively and qualitatively.<sup>80</sup> There are, however, limitations to using such statutory approvals, which has led a number of states to create other types of incentives to use state-run “bond banks” to place debt.<sup>81</sup>

Allowing a local government to use a state-run debt-placement group is more of a voluntary approach; there is no explicit requirement that debt must be approved by a state agency, but the agency can coerce the local government with lower rates should it submit to the state bank’s restrictions. Other states, like California, have had less formal oversight or power to control financially distressed local governments, arguably leading to a greater number of defaults and bankruptcies.<sup>82</sup>

### B. *State Takeover Provisions for Emergencies*<sup>83</sup>

#### 1. *Florida*

Generally, state takeover statutes responding to fiscal crises can be divided into two categories: (1) ad hoc responses to specific local-government crises, or (2) generally applicable statutes that are used to assist financially distressed local governments.<sup>84</sup> Florida’s statute falls into the latter category, as Florida creates a generally applicable system that subjects a local government to review and oversight by the governor.<sup>85</sup> The state auditor uses

79. See CONN. GEN. STAT. § 32-285(g)(2) (2013).

80. See Note, *supra* note 27, at 492–93 (describing the process of marketing local-government debt).

81. *Id.* at 494–95.

82. See PFM WHITE PAPER, *supra* note 22, at 10.

83. A fantastic discussion of the many facets of emergency takeovers of troubled local governments can be found in Kimhi, *Tale*, *supra* note 32, at 883 (“Indeed, most local fiscal crises since the 1970s, like the ones in New York, Cleveland, Philadelphia, Yonkers, Miami, Princeville, Chelsea, and Pittsburg, were dealt with through the creation of state boards, rather than through the help of bankruptcy procedures.”).

84. See *id.* at 886–87. The generally applicable financial-emergency statutes contain statutorily defined language that triggers takeover provisions. See Kloha, *supra* note 22, at 242–44 (discussing various factors considered by the states that employ the generally applicable emergency-takeover structures).

85. FLA. STAT. § 218.503 (2014). The oversight and review is triggered if one of four conditions is met:

several different metrics to determine whether a local-government unit is in fiscal distress,<sup>86</sup> and once the conditions for a financial emergency are met, the local government and the state work together to determine whether state assistance is needed to rectify the fiscal issues.<sup>87</sup>

Getting to the current structure involved previous financial crises in prominent Florida cities, particularly Miami. In the 1990s, Miami experienced a budget deficit of \$68 million (20% of the city's total budget).<sup>88</sup> However, at that time, rather than having the emergency-takeover powers, the state was merely acting as an advisory board and was openly mocked by Miami politicians.<sup>89</sup> When the emergency board started to take a firmer stance with the city, the process sped up, and Miami's bonds became investment grade again.<sup>90</sup> Today, Florida's system has many of the necessary features to address fiscal crises, but its troubled past also shows the delicate politics involved in a state's regulation of local-government finances.

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(a) Failure within the same fiscal year in which due to pay short-term loans or failure to make bond debt service or other long-term debt payments when due, as a result of a lack of funds.

(b) Failure to pay uncontested claims from creditors within 90 days after the claim is presented, as a result of a lack of funds.

(c) Failure to transfer at the appropriate time, due to lack of funds:

1. Taxes withheld on the income of employees; or
2. Employer and employee contributions for:
  - a. Federal social security; or
  - b. Any pension, retirement, or benefit plan of an employee.

(d) Failure for one pay period to pay, due to lack of funds:

1. Wages and salaries owed to employees; or
2. Retirement benefits owed to former employees.

*Id.* (formatting altered).

86. *Financial Condition Assessment Procedures*, ST. FLA. AUDITOR GEN., [http://www.myflorida.com/audgen/pages/fca\\_procedures.htm](http://www.myflorida.com/audgen/pages/fca_procedures.htm) (last visited Nov. 20, 2014) (including differing indicia of financial health, such as revenues divided by population).

87. FLA. STAT. § 218.503.

88. See Kimhi, *Tale*, *supra* note 32, at 894.

89. *Id.* at 894–95.

90. *Id.* at 896. As Kimhi noted:

Without coercion from the state, it is likely that the city would have continued with its dubious financial practices. If we know that such coercion is needed, however, it makes more sense to give the board adequate powers to begin with. It is possible that had the Miami board been given stronger powers from the start, the two years of economic distress after the board's creation would have been saved, and the city's rehabilitation process would have been faster and easier.

*Id.*

## 2. *Massachusetts*

The State of Massachusetts also takes over troubled municipalities, but does so on more of an ad hoc basis. The Massachusetts model is sometimes called the “state receivership” or “takeover” model, in which a state “appoints a receiver for the locality and the receiver manages the locality instead of its elected officials.”<sup>91</sup> Within this model, “[t]he receiver has complete control over local affairs, while the elected local officials are usually removed from office.”<sup>92</sup> An example of this is the receivership that the City of Chelsea was placed under in the early 1990s due to a decrease in collected revenues and a lack of decrease in expenditures by the politically elected board of Chelsea.<sup>93</sup> To rectify Chelsea’s problems, the state legislature passed an act placing Chelsea in receivership, and the operations of the city were assumed by the state.<sup>94</sup> The state receiver was then able to use this broad grant of authority to take drastic actions to repair the city’s finances, restoring Chelsea to fiscal health in six months.<sup>95</sup>

Professor Omer Kimhi, one of the few legal scholars to write about municipal insolvency oversight authorities, argues that this model has serious drawbacks; namely that there are political-opposition problems and problems of the state exerting its interests at the expense of a locality’s interests.<sup>96</sup> Professor Kimhi’s analysis points to the importance of a local government’s ability to determine its own course.<sup>97</sup> However, the case of Chelsea shows why this value should be subrogated for a time to ensure that surrounding municipalities can exercise self-determination of their own affairs, and to protect the interests of taxpayers and bondholders.

To use Professor Kimhi’s example, Chelsea experienced an exodus of high-wage families and an influx of low-income residents in the 1970s.<sup>98</sup> During this time, Chelsea remained beholden to political groups that exerted influence over the politically elected governing board.<sup>99</sup> Indeed, the political influence was so strong that the board chose “to lead the city into insolvency

91. *Id.* at 897.

92. *Id.*

93. *Id.* at 897–98.

94. *Id.* at 898–99; *see also* Act of Sept. 12, 1991, ch. 200, 1991 Mass. Acts 679 (establishing a receivership for the City of Chelsea).

95. *See* Kimhi, *Tale*, *supra* note 32, at 899.

96. *Id.* at 900–01.

97. *Cf. id.* at 906 (“State intervention in fiscal crises is needed because states are in a better position than local governments to address both the socioeconomic and the political causes of the crisis. The state is able to take actions that local officials are unable to take and its involvement provides the political backup to initiate a rehabilitation process.”).

98. *Id.* at 897.

99. *Id.* at 898.

rather than resist the unions' demands by initiating reforms."<sup>100</sup> This scenario demonstrates precisely why state supervision of a locality is acutely necessary. The city may often remain flailing in the face of its financial burdens: encumbered by local politics, unable to cut expenses, and unwilling to raise taxes to meet its debt and operating burdens until it is too late. Having a state agency step in to act as a neutral party that can restore balance to a locality's books and to take the political pressure off of the local governing body seems to alleviate many of these structural problems that normally prohibit the local governing boards from taking the necessary actions to correct their budgetary imbalances.

This is not to say that there are no critiques of Massachusetts's system. Kimhi's point is taken that the appointed receiver in Massachusetts was a political operative,<sup>101</sup> but a state could easily use an administrative appointment or form a bipartisan committee to ensure that a competent manager is put in place. A second criticism is that Massachusetts's system requires the legislature to take action by passing legislation to create a receivership in each individual circumstance.<sup>102</sup> Chelsea is not the only instance where a receivership has been appointed in Massachusetts; more recently, Springfield, a city with a population above 150,000, was placed under receivership.<sup>103</sup> Again, the receivership model worked well, changing a \$41 million deficit in fiscal year 2005 to a \$40 million fund balance in fiscal year 2009.<sup>104</sup> Still, using the receivership model was an ad hoc decision that required legislative action. Without protocols and metrics that automatically place a town in receivership, the debt market is left with the uncertainty of whether Massachusetts will place another town under receivership in the future, and if so, under what circumstances.<sup>105</sup>

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100. *Id.* (citing Ed Cyr, *Thoughts on the Chelsea Receivership*, GOV'T FIN. REV., Aug. 1993, at 23).

101. *See Chelsea City Managers After Receivership*, OLGP.NET, <https://web.archive.org/web/20121019170449/http://olgp.net/chs/mayors/manager/manager.htm> (last visited Nov. 10, 2014) (describing James Carlin's background, including the fact that he was previously appointed by Governor Edward King to serve as the Commissioner of Commerce before he was appointed as Chelsea's receiver in 1991).

102. PFM WHITE PAPER, *supra* note 22, at 3–4.

103. *Id.* at 3.

104. *Id.* at 4.

105. *Id.*

### 3. *Indiana*

One of Indiana's provisions to address fiscal emergencies relates to constitutional restrictions concerning property tax receipts.<sup>106</sup> Indiana operates under the Distressed Unit Appeals Board (DUAB),<sup>107</sup> which receives requests from local governments that expect to have reductions in received property taxes of 5% or more resulting from restrictions that were put in place in 2008.<sup>108</sup> However, Indiana also passed constitutional amendments to restrict property taxes to a certain percentage,<sup>109</sup> meaning that distressed units will have to seek other means of collecting funds to meet revenue gaps.<sup>110</sup>

In the wake of these constitutional amendments, Indiana broadened the powers of the DUAB, specifically requiring that an emergency manager be appointed if a local government is found to be a "distressed political subdivision."<sup>111</sup> The emergency manager is allowed to exercise the authority and responsibility of the local government's governing board, review the budget, review the salaries of the local-government employees, conduct an audit, create a financial plan for the unit, renegotiate labor contracts, and many other powers to correct the fiscal issues that might occur within a unit.<sup>112</sup> In other words, Indiana allows the state's emergency managers to exercise broad powers in times of financial crisis.

Perhaps most interesting about this model is that appointment of an emergency manager is *mandatory* after the DUAB determines that a political subdivision is a distressed entity.<sup>113</sup> The statute that defines "distressed entity" also has several triggering events laid down for the appointment of the emergency manager—for example, if the subdivision has a deficit of 8% of its revenues (i.e., a negative fund balance of 8%).<sup>114</sup> This is perhaps clearer than the LGC's guidelines, which are not set forth by statute, but instead are

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106. 1 CONIGLIO & GELFAND, *supra* note 19, § 11:4, at 11-14 to -17 (discussing diverse states' constitutional limits on property taxes as a percentage of total value).

107. IND. CODE § 6-1.1-20.3-4 (2010).

108. PFM WHITE PAPER, *supra* note 22, at 7.

109. *Id.*

110. For a discussion of alternative forms of collecting revenues beyond traditional property tax, see generally Reynolds, *supra* note 6, in which the author reviews special assessments and assorted forms of revenue-producing mechanisms used by local governments in instances where property tax caps are set by a state's constitution.

111. IND. CODE § 6-1.1-20.3-7.5.

112. *Id.* § 6-1.1-20.3-8.5.

113. *Id.* § 6-1.1-20.3-7.5.

114. *Id.* § 6-1.1-20.3-6.5.

determined by the agency in a somewhat informal method.<sup>115</sup> Placing these items in statutes may reduce flexibility and administrative discretion, but may also be welcomed by the local governments as a clear expectation of what precisely would lead to their loss of fiscal autonomy to state oversight. Indiana's approach also has advantages to the methods employed by Massachusetts in that there is an existing standing committee ready to handle financial concerns, and the state does not have to wait on specific legislative actions every time there is a financial crisis.

The approach is not as proactive as the LGC's method because it does not require a certain level of *positive* fund balance before debt is issued (as the LGC does); it provides definitions of a unit that has entered a situation of fiscal distress rather than preventing the unit from incurring debts that will lead to that scenario.<sup>116</sup> The Indiana Department of Local Government Finance does review the indebtedness of school districts to ensure that their appropriations are sufficient to service their incurred debt.<sup>117</sup> The Department of Local Government Finance also approves and sets property tax rates for *all* political subdivisions within the state.<sup>118</sup> This power to set property rates even when a unit is not in fiscal distress adds a state-oversight component of local-government finance not seen in many other states, but further requirements on the financial conditions of units before they incur additional debts would provide additional stability. There is also a robust staff of state employees charged with ensuring compliance with budgetary creation and data analysis of local governments in Indiana.<sup>119</sup>

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115. See *infra* notes 241–96 and accompanying text. This is not to say that the LGC does not have reasons for its fund-balance requirements or other policies, but rather that they are not put into regulatory or statutory form.

116. There are some types of debt that are subject to the constitutional limitations, and some that are not. See Erin Blasko, *Officials: Local Government Debt Under Control*, S. BEND TRIB. (Aug. 3, 2011), [http://articles.southbendtribune.com/2011-08-03/news/29848831\\_1\\_debt-limit-local-government-debt-borrowing-limit](http://articles.southbendtribune.com/2011-08-03/news/29848831_1_debt-limit-local-government-debt-borrowing-limit). For example, debt incurred by redevelopment agencies or the parks department does not count toward the constitutional limit of 2%. *Id.*

117. IND. CODE § 20-48-1-11 (2010); see also *id.* § 20-46-7-14 (forbidding the Indiana Department of Local Government Finance from approving bonds that fail to provide for principal payments in some amount, and certain other financial arrangements).

118. *Id.* § 6-1.1-17-16; see also *id.* § 6-1.1-17-8.

119. See *Department of Local Government Finance: About Us*, IN.GOV, <http://www.in.gov/dlgef/2337.htm> (last visited Nov. 30, 2014).

#### 4. *Pennsylvania*

Pennsylvania recently enacted significant modifications to its structure of local-government debt oversight on October 31, 2014.<sup>120</sup> Under the modified version of Pennsylvania's law, the previously existing four types of state-oversight programs designed to help local governments avoid and mitigate fiscal problems remain: the Early Intervention Program,<sup>121</sup> Act 47,<sup>122</sup> intergovernmental authorities,<sup>123</sup> and state receivership.<sup>124</sup> The 2014 legislation adds some new wrinkles to the state's ongoing oversight of its local governments that are experiencing fiscal distress, including a fixed time limit that a local government can remain in the Act 47 program, as well as new procedures that allow for disincorporation of local governments that cannot attain fiscal solvency.

The Early Intervention Program (EIP) is a proactive program designed "to establish short-term and long-term financial and managerial objectives that strengthen the fiscal capacity of Pennsylvania's county and municipal governments along with the integration of long term community and economic development strategies that strengthen the local government's tax base."<sup>125</sup> The EIP was formally codified in statute by the 2014 legislation.<sup>126</sup>

The EIP is similar to North Carolina's LGC in that it helps to pair Pennsylvania local-government units with advisors before a crisis occurs. A

120. See Municipalities Financial Recovery Act of 2014, No. 199 (Oct. 31, 2014) (amending scattered sections of 53 PA. CONS. STAT. ANN. § 11701.101–.501 (West 2014)), available at [http://www.legis.state.pa.us/cfdocs/legis/CH/Public/ucons\\_pivot\\_pge.cfm?session=2014&session\\_ind=0&act\\_nbr=0199.&pl\\_nbr=0000](http://www.legis.state.pa.us/cfdocs/legis/CH/Public/ucons_pivot_pge.cfm?session=2014&session_ind=0&act_nbr=0199.&pl_nbr=0000).

121. See generally PA. DEP'T CMTY. & ECON. DEV., EARLY INTERVENTION PROGRAM GUIDELINES (2004), [http://dev.pelcentral.org/wp-content/uploads/2013/04/early\\_intervention\\_program\\_guidelines-04.pdf](http://dev.pelcentral.org/wp-content/uploads/2013/04/early_intervention_program_guidelines-04.pdf) (discussing the program in detail, as well as the different financial assessment steps). The EIP is now codified in statute. See PA. HOUSE COMM. ON APPROPRIATIONS, FISCAL NOTE ON HOUSE BILL 1773, at 1 (2014), available at <http://www.legis.state.pa.us/WU01/LI/BI/FN/2013/0/HB1773P4312.pdf>.

122. Municipalities Financial Recovery Act of 1987, No. 47, 1987 Pa. Laws 246 (codified as amended at 53 PA. CONS. STAT. ANN. §§ 11701.101–.501).

123. PFM WHITE PAPER, *supra* note 22, at 8–9.

124. *Id.*

125. PA. DEP'T CMTY. & ECON. DEV., *supra* note 121, at 1. The 2014 legislation adds seven explicit objectives, including (1) providing assistance to municipalities in planning and addressing their financial difficulties, (2) engaging in a management review, (3) strengthening local governments' capacities for financial planning, (4) implementing a multiyear revenue and expenditure trend analysis, (5) promoting multiple jurisdiction regional planning, (6) supporting a municipality's adoption of best management and efficiency practices, and (7) furthering the "integration of sound community and economic development strategies to encourage" economic development and tax base growth. 53 PA. CONS. STAT. ANN. § 11701.102-A.

126. See FISCAL NOTE ON HOUSE BILL 1773, *supra* note 121, at 1.

difference between the EIP and the LGC is that the EIP's assistance is not automatically triggered—local governments must apply for assistance from the state to hire independent consultants for creating solutions to the local government's fiscal problems.<sup>127</sup> There is also no debt-approval component—the EIP simply helps units with their planning and management rather than requiring the steps be implemented.

The 2014 legislation also modified the EIP to include authorization for the Governor's Center for Local Government Services (GCLGS) to offer grants up to \$200,000 (with a required match) in the initial fiscal year to implement the goals of the EIP.<sup>128</sup> The grants provided by GCLGS are meant to implement programs that serve the purposes of the EIP, such as implementing financial forecasting modeling in a local government.<sup>129</sup> The 2014 legislation also authorized the Pennsylvania Department of Community and Economic Development (DCED) to recommend that municipalities enter into the EIP, although it did not grant the DCED the authority to require entry into the program.<sup>130</sup>

Pennsylvania passed legislation in 1987 known as Act 47 to provide for a designation of certain cities as fiscally distressed.<sup>131</sup> Act 47 includes a portion relating to “municipal financial distress,” which lists criteria for determining the financial stability of Pennsylvania local governments.<sup>132</sup> If the criteria are met, then the DCED appoints a coordinator (who is not a member of elective

127. PFM WHITE PAPER, *supra* note 22, at 8; *see also* 53 PA. CONS. STAT. ANN. § 11701.102-A.

128. *See* 53 PA. CONS. STAT. ANN. §§ 11701.103-A, .104-A. The matching amount from the local government is presumed to be a 50% match of the total amount provided by the GCLGS, and can be in-kind, although officials from the GCLGS may reduce the required match to a minimum of 10%. *See id.* § 11701.104-A(b).

129. *See id.* § 11701.104-A(c).

130. *See id.* § 11701.121(b).

131. Municipalities Financial Recovery Act of 1987, No. 47, 1987 Pa. Laws 246; *see also* Kate Giammarise, *Sweeping Changes to Act 47 Proposed in Harrisburg*, PITTSBURGH POST-GAZETTE (Aug. 31, 2014), <http://www.post-gazette.com/local/2014/08/31/Sweeping-changes-to-Act-47-proposed-in-Harrisburg-Pennsylvania/stories/201408220165>.

132. 53 PA. CONS. STAT. ANN. § 11701.201. If any of the criteria are met, the Pennsylvania Department of Community and Economic Development may begin the planning process. *Id.* Some of the criteria include, for example, the municipality maintains a deficit over a three-year period, with a deficit of 1% or more in each of the previous fiscal years; the municipality's expenditures exceed its revenues for a period of three years or more; the municipality has missed a payroll for thirty days; the municipality has accumulated and operated for each of two successive years a deficit equal to 5% or more of its revenues; or the municipality has filed a Chapter 9 municipal debt adjustment plan. *Id.* §§ 11701.201(1), (2), (4), (7), (10). The list contains a total of eleven criteria.

office)<sup>133</sup> and undertakes a planning process to help the unit cure the fiscal issues that it faces.<sup>134</sup>

The DCED's plan may be accepted or rejected by the local unit, although the local unit is required to make a separate plan that the DCED accepts if the unit rejects the initial DCED plan.<sup>135</sup> If no plan is adopted at all, then the state may withhold funds from the local government.<sup>136</sup> However, if a plan *is* adopted, the adopting local government is given priority access to state-assistance grants over other municipalities in distress, waivers of some state regulatory requirements, and access to new revenue streams, such as a local-services tax.<sup>137</sup> Another incentive for local governments to adopt such a plan is that the coordinator can set maximum thresholds for future collective bargaining agreements, which would improve the local government's bargaining position with its labor unions and help the local government control costs.<sup>138</sup> The 2014 legislation also added a provision allowing the secretary of DCED to request a declaration of financial emergency from the governor if the distressed municipality adopts no plan.<sup>139</sup>

Unfortunately, these plans do not always work as expected. If a city is insolvent or is projected to be insolvent within 180 days, is unable to provide vital and necessary services, fails to adopt the coordinator's plan, or does not adopt an alternative plan accepted by the DCED, a state of fiscal emergency can be declared by the governor.<sup>140</sup> This leads to the establishment of a receivership for the city,<sup>141</sup> as well as the enactment of a "Recovery Plan."<sup>142</sup> Once a city is under receivership, the governor and the appointed receiver have full control of the locality and may renegotiate contracts and confine wages as needed (without dissolving labor agreements entirely).<sup>143</sup>

Adding to Pennsylvania's complexity is that Philadelphia and Pittsburgh were put under the oversight auspices of separate "Intergovernmental Authorities," which have limited authority over these cities.<sup>144</sup> The

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133. *Id.* §§ 11701.221, .224.

134. *Id.* § 11701.121.

135. *Id.* § 11701.246.

136. *Id.* §§ 11701.248, .251, .264.

137. *Id.* §§ 11701.281, .282.

138. *Id.* § 11701.252.

139. *See id.* § 11701.248.

140. *Id.* § 11701.602.

141. *Id.* § 11701.702.

142. *Id.* § 11701.703.

143. *Id.* § 11701.706; PFM WHITE PAPER, *supra* note 22, at 9.

144. PFM WHITE PAPER, *supra* note 22, at 9. Note also the distinction made by the legislation in its title: Pennsylvania Intergovernmental Cooperation Authority Act for Cities of

Philadelphia authority, the Pennsylvania Intergovernmental Cooperation Authority (PICA), comprises a five-member voting board (and two additional nonvoting members); all voting members are political appointees.<sup>145</sup> Initially, the PICA board had the authority to issue bonds,<sup>146</sup> but this authority has now lapsed.<sup>147</sup> The PICA board retains the authority to approve all five-year plans until all of the debt issued under the current and prior board is repaid.<sup>148</sup> The Intergovernmental Cooperation Agreement (Pittsburgh's agreement) has similar requirements for the ICA in how it approves of Pittsburgh's annual budget and five-year plan. However, both the Intergovernmental Cooperation Authority and the PICA may not "nullify a non-compliant labor agreement."<sup>149</sup> The PICA system remains after the 2014 legislation.<sup>150</sup>

Pennsylvania's system shows why an LGC-style organization would be useful in this context. The EIP, which is analogous to the LGC's oversight of local government, appears to be a strong program of early detection. However, the EIP was, and still is, voluntary. There are also additional ways to mitigate the financial problems that a municipality faces through Act 47 provisions, but those methods only become available after the unit has already reached a point of fiscal instability. Further, the subsidies provided by Act 47 sometimes lasted for decades, which seemed to create a dependency on its features in some cases, rather than getting units back to fiscal solvency quickly.<sup>151</sup> In addition, authorities were established for the state's two largest cities, but each of those entities had its own problems associated with being composed of appointed officials from the state legislature with relatively little authority to do anything beyond approving the plans proposed by the local government.<sup>152</sup> In short, Pennsylvania's system has several different state oversight programs. Coordinating these services within one organization

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the First Class. See Act of June 5, 1991, No. 6, 1991 Pa. Laws 9 (codified at 31A PA. CONS. STAT. ANN. §§ 12720.101–709).

145. See 31A PA. CONS. STAT. ANN. § 12720.202 (noting that the two nonvoting ex officio members are the Secretary of the Budget of the Commonwealth and the Director of Finance for the City of Philadelphia).

146. *Id.* § 12720.301.

147. *Id.* § 12720.319 ("No bond shall be issued for the purpose of financing a capital project or a deficit, other than a cash flow deficit, on a date later than December 31, 1994.").

148. *Id.* §§ 12720.210, .319; PFM WHITE PAPER, *supra* note 22, at 9 ("PICA must continue to approve annual five year plans until all of the debt is repaid.").

149. PFM WHITE PAPER, *supra* note 22, at 9 & 12 n.36 (discussing Act 11, which was passed in 2004 to assist Pittsburgh with its financial hardships).

150. See FISCAL NOTE ON HOUSE BILL 1773, *supra* note 121, at 13 (excepting Philadelphia from the amendments).

151. See Giammarise, *supra* note 131 (noting that Clairton, Pennsylvania, and other Pennsylvania local governments have been under Act 47 designation for over twenty years).

152. See *supra* note 144 and accompanying text.

would likely be more efficient and would lead to better information-sharing, monitoring, and ultimately, more effective interventions during a fiscal crisis.

To wit, despite these various programs existing for more than a decade, Pennsylvania's unique approach enabled a near-default on \$3.3 million in bonds by Harrisburg in 2010.<sup>153</sup> Harrisburg and other cities likely reached a point of near-default for the simple fact that default was seen as an option. The mayor of Harrisburg even admitted to defaulting on bonds to preserve services,<sup>154</sup> which shows that while these defaults may be a problem of adequate resource-allocation, they are likely "the consequence of an absence of political will."<sup>155</sup> While the mayor of Harrisburg made a valid point that a bond payment may not be as important on a micro level as something like police or fire services, on a macro level, the defaulting of a city may negatively affect the ability of surrounding localities to provide the very types of services that he wanted to preserve. Harrisburg's issues continued, and in 2011, the city entered receivership after first attempting to enter into bankruptcy without state approval.<sup>156</sup>

Pennsylvania's story, like Harrisburg's, has changed over the last two years. In 2013, the "Harrisburg Strong Plan" was adopted.<sup>157</sup> The plan allowed for the sale of the incinerator that was at the heart of many of the city's financial troubles.<sup>158</sup> Additionally, the Harrisburg Strong Plan allowed Harrisburg to create new revenue streams from partnerships with the state and with local economic development groups.<sup>159</sup> Harrisburg has now exited

153. Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 282 (2012).

154. *Id.* ("To disrupt [services] because we can't make a bond payment would just be unconscionable. And as a leader I couldn't do it . . .") (quoting Romy Varghese, *Harrisburg Surrender: Why Pennsylvania's Capital Skipped Its Debt Payment*, WALL ST. J., Sept. 8, 2010, at C1 (statement of Harrisburg Mayor Linda Thompson)).

155. *Id.* at 283. There are people who argue for federal intervention as well. *See id.* at 308–09.

156. Judah Bellin, *Can Harrisburg Come Back?*, CITY J. (Oct. 14, 2014), <http://www.city-journal.org/2014/eon1014jb.html>.

157. *See* Emily Previti, *State Officials File 'Harrisburg Strong Plan' for Resolving City's Debt*, PATRIOT NEWS (Aug. 26, 2013, 11:33 PM), [http://www.pennlive.com/midstate/index.ssf/2013/08/harrisburg\\_debt\\_plan\\_filed.html](http://www.pennlive.com/midstate/index.ssf/2013/08/harrisburg_debt_plan_filed.html) ("The plan begins by detailing the sale of the Harrisburg incinerator that's become a monument to those destructive political and financial habits for which the city is infamous."); *see also* Walker v. City of Harrisburg, No. 569 M.D. 2011, slip op. at 6 (Pa. Commw. Ct. Sept. 23, 2013), *available at* <http://www.pacourts.us/assets/files/setting-651/file-3053.pdf?cb=8e8741> (confirming the Harrisburg Strong Plan).

158. *See Walker*, slip op. at 3.

159. *See id.* at 3–4; Previti, *supra* note 157.

receivership, and some have observed that elements of the Harrisburg Strong Plan have become part of the statewide Pennsylvania model of receivership.<sup>160</sup>

Other changes have occurred in Pennsylvania as well. One of the biggest changes is that time limits are now placed on a local government's enjoyment of the Act 47 provisions.<sup>161</sup> Now, municipalities that enter distressed status under Act 47 will have a five-year limit to this status.<sup>162</sup> If a municipality is already in distressed status, the five-year period begins to run from the effective date of the municipality's most recent recovery plan or amendment to its recovery plan.<sup>163</sup> If the municipality's current recovery plan is set to expire within one year or less of the effective date of the 2014 amendments, the municipality is granted a one-time automatic three-year extension.<sup>164</sup>

Lastly, the amendments to Act 47 have created a somewhat radical new option: disincorporation of nonviable municipalities.<sup>165</sup> This procedure requires the secretary of DCED to determine whether a municipality is viable.<sup>166</sup> In making this determination, the secretary of DCED must find that (1) the municipality cannot provide essential services to its residents; (2) the municipality's economy and tax base have collapsed, and all reasonable efforts to restore the economic health of the community have failed; and (3) the municipality cannot merge with a neighboring municipality or such a merger would not solve the unit's issues.<sup>167</sup>

After the secretary of DCED makes a finding of nonviability, one of two processes may initiate a disincorporation: (1) the municipality's governing board may initiate a disincorporation proceeding itself within forty-five days of the secretary's finding, or (2) a petition of 51% of the electorate who voted in the last gubernatorial election may be submitted to the court of common pleas within sixty days after the municipality's governing body's forty-five-day window, if the governing body does not initiate proceedings on its own.<sup>168</sup> If neither the governing body of the municipality nor the majority petition are

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160. See *Pennsylvania Governor Corbett Announces Commonwealth Court Has Granted Application to Vacate Receivership for the City of Harrisburg; Rescinds Fiscal Emergency*, PA. DEP'T CMTY. & ECON. DEV. (Feb. 26, 2014, 3:37 PM), <http://www.newpa.com/newsroom/governor-corbett-announces-commonwealth-court-has-granted-application-vacate-receivership-for-city-h>; see also William C. Rhodes et al., *Act 47: Pennsylvania Says Enough Is Enough. Or Is It?*, BALLARD SPAHR LLP (Oct. 31, 2014), <http://www.ballardspahr.com/alertspublications/legalalerts/2014-10-31-act-47-pennsylvania-says-enough-is-enough-or-is-it.aspx>.

161. See 53 PA. CONS. STAT. ANN. § 11701.254 (West 2014).

162. See *id.*

163. *Id.*

164. See *id.*

165. See *id.* §§ 11701.431, .446.

166. See *id.* § 11701.431.1.

167. *Id.*

168. *Id.* § 11701.432.

filed, or if a reviewing court finds that the municipality should not be disincorporated, the secretary of DCED then determines whether the municipality should continue under a recovery plan, whether the municipality should be placed into receivership, whether the municipality's distressed status should be terminated, or whether the municipality should initiate a bankruptcy proceeding.<sup>169</sup>

After the court of common pleas or the secretary of DCED determines that disincorporation is appropriate, a service district administrator is appointed by the secretary of DCED and given broad powers to change the fiscal complexity of a municipality prior to final disincorporation of the municipality.<sup>170</sup> The administrator may sell or convey municipal assets; repay debts, bonds, or other obligations; seek a writ of mandamus against the municipality to carry out a disincorporation; approve, disapprove, and negotiate contracts for services; identify essential services for residents; apply for grants; establish fees; and hire professionals to aid in her duties.<sup>171</sup>

The administrator must put forth her essential-services plan within ninety days of being appointed. This plan provides for necessary public services, emergency management, payment of debt obligations, and establishes the unincorporated service district that will replace the municipality.<sup>172</sup> There is an initial plan, a notice and comment period, and then a final plan, which also has a notice period.<sup>173</sup>

Prior to disincorporation, the municipality must pass a budget that funds the municipality's obligations until the municipality is disincorporated.<sup>174</sup> The municipality must also provide for the transfer and administration of municipal pension obligations to another private or public pension fund.<sup>175</sup>

Once the municipality is disincorporated, the terms of the essential-services plan end, the terms of the elected officials end, municipal ordinances are nullified, and the corporate powers of the municipality terminate.<sup>176</sup> All remaining property of the municipality becomes property of the Commonwealth of Pennsylvania, held in trust until such a time that the unincorporated service district merges with another municipality or is

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169. *Id.* § 11701.433.1.

170. *Id.* § 11701.434.

171. *Id.*

172. *Id.* § 11701.436.

173. *Id.* §§ 11701.437, .438.

174. *Id.* § 11701.435.

175. *Id.*

176. *Id.* § 11701.439. However, the zoning ordinances that were in existence within the municipality are required to be adopted by the county where the municipal boundaries existed. *Id.*

reincorporated.<sup>177</sup> The service district does not enjoy the powers of a traditional municipality, such as the taxing authority or the power to establish elected offices.<sup>178</sup>

The effect of the 2014 amendments is to provide Pennsylvania municipalities with additional tools to help its financially distressed cities emerge from fiscal distress, and to set a time limit on remaining within a “fiscally distressed” status. Both of these measures are positive steps.

One possible further step remains for Pennsylvania, however: Pennsylvania could allow for an administrative agency to oversee *all* public-debt issuances and require approval of *all* public debt prior to issuance.<sup>179</sup> By monitoring and approving debt *before* a local government reaches the level of voluntarily entering the EIP, the local government might avoid the intervention altogether. While an early intervention is thankfully still, by its definition, early in the process of a municipality experiencing fiscal stress, keeping local governments out of a fiscal area that requires intervention is a better outcome for all parties.

### C. State Auditing and Monitoring Functions

To discuss some of the potential front-end monitoring solutions, this Section briefly considers the auditing procedures of Georgia, Michigan, and Ohio.

#### 1. Georgia<sup>180</sup>

In Georgia, the Department of Community Affairs has the task of conducting an annual review of local-government budgets and financial

177. *Id.* § 11701.441.

178. *Id.*

179. Pennsylvania already has constitutional provisions relating to debt limits. *See* PA. CONST. art. IX, §§ 10, 12. There is no limit set on debt that is approved by the electorate. *See* 53 PA. CONS. STAT. ANN. § 8021. Nonelectoral debt is subject to a “borrowing base” calculation. *See id.* § 8022(a); *see also* Juita-Elena (Wie) Yusuf et al., *State Fiscal Constraints on Local Government Borrowing: Effects on Scale and Cost*, in HANDBOOK OF LOCAL GOVERNMENT FISCAL HEALTH 475, 479 (Helisse Levine et al. eds., 2013). Philadelphia is not subject to the same debt limits as the rest of the state; instead, its debt limits are specifically set forth in Pennsylvania’s state constitution. *See* PA. CONST. art. IX, § 12.

180. Interestingly, Georgia does not allow a municipality to file for bankruptcy; instead, the unit of government is dissolved, and all of its assets are transferred to the county where it is located. GA. CODE ANN. § 36-68-1 (2012). Georgia is one of only two states that prohibit municipal bankruptcy in its entirety. The other state, Iowa, does have a filing exception for “insolvency caused by debt involuntarily incurred not covered by insurance proceeds.” JAMES E. SPIOTTO, CHAPMAN & CUTLER LLP, PRIMER ON MUNICIPAL DEBT ADJUSTMENT D-2 (2012) (citing IA. CODE ANN. § 76.16A), *available at* [http://www.afgi.org/resources/Bankruptcy\\_Primer.pdf](http://www.afgi.org/resources/Bankruptcy_Primer.pdf).

statements.<sup>181</sup> Units that do not comply with generally accepted accounting principles are required to undergo an audit, losing their ability to receive state grant funds if they do not comply with the accounting requirement.<sup>182</sup>

The Department of Community Affairs has other functions as well. For example, the department administers several federal grants and assists with urban- and rural-development planning.<sup>183</sup> Additionally, the department is tasked with overseeing local-government authorities (such as a business improvement district or a water/sewer authority as opposed to the actual local governments), which are required to register with the Department of Community Affairs.<sup>184</sup>

On balance, Georgia's decision to withhold state funds is a different strategy for ensuring local compliance. Local governments depend greatly on state aid and resources—to deprive them of these financial lifelines is a great incentive to push local governments to improve deficient financial reporting.<sup>185</sup>

## 2. Michigan

Perhaps in response to critics alleging a lack of accountability and oversight,<sup>186</sup> Michigan enacted legislation in 2011 to improve its ability to

181. GA. CODE ANN. § 36-81-8.

182. *Id.* §§ 36-81-7, -8.1.

183. *Id.* § 50-8-3.

184. *Id.* § 36-80-16.

185. There are several noncompliant cities and twelve noncompliant counties. See Memorandum from Greg S. Griffin, State Auditor of Georgia, to State Agency Heads (Sept. 19, 2014), available at [http://www.audits.ga.gov/NALGAD/Files/September\\_2014\\_memo\\_with\\_listing.pdf](http://www.audits.ga.gov/NALGAD/Files/September_2014_memo_with_listing.pdf).

186. See *Study: Crucial Information Lacking on Local Government Debt*, MICH. ST. U. TODAY (Feb. 4, 2011), <http://msutoday.msu.edu/news/2011/study-crucial-information-lacking-on-local-government-debt/>. For example, one study concluded that “Michigan should create a better system for keeping tabs on the debt incurred by local governments—especially in these tough economic times.” *Id.* That conclusion came as a result of economist Eric Scorsone’s attempt to measure the health of Michigan’s municipal-bond market. *Id.* Scorsone “was unable to finish the job due to a lack of state-level information on the debt owed by local governments.” *Id.* As the study explained:

Through municipal bonds, Michigan’s 1,800 local governments borrow billions of dollars and pay off the debt largely through property tax revenue. But this revenue has plummeted as home values have fallen, . . . “and the aftermath of its impact will continue in the public sector for some time to come.”

*Id.* (quoting Scorsone). Scorsone stated that “[m]uch of the local government revenue base is predicated on those home values,” and “these falling revenue streams are the foundation for much of the municipal bond repayment system.” *Id.*

track data, and provided the measurements to the voters of the state.<sup>187</sup> The new legislation requires local governments to take action if fiscal issues arise—an emergency-response function as highlighted above<sup>188</sup>—and also provides procedures for more-extensive financial reviews if, after an initial survey by a state auditor, the state determines there is a fiscal emergency.<sup>189</sup>

Michigan's reforms are wide-ranging and should not be viewed *solely* through the limited context of auditing functions. Indeed, the reforms actually bring the state close to the types of authorization that the LGC enjoys in North Carolina, although there is a requirement that the audit is initiated by the local government, a petition of 5% of the locality's voters, a creditor that was not paid for over six months, or the employee pension fund.<sup>190</sup> This initiation requirement differs from the LGC, but the threshold needed to begin the process appears to be relatively low.

While Michigan's reforms are certainly helpful to bring local governments out of fiscal insolvency, some critics point to the political issues of allowing wholesale agency authority over local-government finance: specifically, some critics dislike the removal of "choice" by forcing the government to choose from four options, effectively curtailing the ability to file for Chapter 9 bankruptcy.<sup>191</sup> This argument could certainly be levied toward the LGC, perhaps with greater acrimony, as the LGC's authority is more far-reaching than Michigan's.

Ultimately, one would hope that the relationship between state and local governments is mutually beneficial. Many view the LGC, which provides assistance in marketing debt for its localities, as a helpful partner for local

187. See Act of Mar. 16, 2011, No. 5, sec. 303, 2011 Mich. Pub. Acts xxix (codified as amended at MICH. COMP. LAWS § 141.2303 (2013)).

188. See Eric Scorsone, *Frequently Asked Questions About the New Michigan Local Financial Emergency Law*, MICH. ST. U. 2 (Jan. 2013), <http://msue.anr.msu.edu/uploads/236/25914/FAQ-WhyNewLawWasPassed.pdf>. Scorsone's report lists "factors that may trigger a state financial review of a local government or school district," including "[m]issed payroll or bond payments," "[f]ailure to comply with a state-ordered deficit elimination plan," "[v]iolation of local government debt or budgeting rules," "[i]mposition of a court-ordered tax levy," "[a] very low credit rating," and "[a]ny other facts that, in the state treasurer's estimation, may threaten the fiscal stability of the local government." *Id.*

189. *Id.* at 3.

190. See PFM WHITE PAPER, *supra* note 22, at 7; see generally Scorsone, *supra* note 188 (discussing the similarly structured legislation that passed after voters rejected the initial legislation).

191. *A Comprehensive Look at Michigan's New(est) Emergency Manager Law, Now with Stability and Choice!*, ECLECTABLOG (Feb. 21, 2013), <http://www.eclectablog.com/2013/02/a-comprehensive-look-at-michigans-newest-emergency-manager-law-now-with-stability-choice.html>.

governments.<sup>192</sup> However, because the state agency dictates the policy of a local body and potentially limits that locality's autonomy, there will always be a fundamental tension between state and local governments under such state-led arrangements.

### 3. *Ohio*

Ohio employs a fairly robust system of monitoring its local governments. Through the State Auditor's Office, Ohio monitors its local governments and provides them with ratio indicators and benchmarks to assess financial stability.<sup>193</sup> Ohio offers its local governments low-cost accounting software. However, if a locality chooses to use the software, the locality agrees to give the state free access to analyze its financial information.<sup>194</sup>

The state auditor of Ohio uses the information gathered through the software to determine whether and how far localities fall into differing levels of fiscal distress. The first and least serious level of distress is "fiscal caution."<sup>195</sup> The second level, known as "fiscal watch," may be requested by the governor or can be triggered by a number of statutory conditions.<sup>196</sup> The most serious category is labeled "fiscal emergency" and occurs if expenses exceed revenues by one-sixth of the prior year's revenues or through other triggering events.<sup>197</sup>

### D. *Summary*

This Part provided a brief survey of other states' practices to identify the types of state oversight of local-government finance. Several states have engaged in significant reforms to buttress the power of their local-government debt-monitoring authorities, yet as Parts II and III will show, other states do not place as much power in their institutions as North Carolina grants to the

192. K. Lee Carter, Jr., *State Oversight of Local Government Finance*, in *STATE AND LOCAL GOVERNMENT RELATIONS IN NORTH CAROLINA* 71, 77–78 (Charles D. Liner ed., 2d ed. 1995).

193. OHIO REV. CODE ANN. § 118.05 (West Supp. 2014).

194. See PFM WHITE PAPER, *supra* note 22, at 1–2; *Uniform Accounting Network*, OHIOAUDITOR.GOV, <https://ohioauditor.gov/uan.html> (last visited Nov. 16, 2014).

195. OHIO REV. CODE ANN. § 118.025 (providing fiscal-caution guidelines for local governments); *id.* § 3316.031 (West 2012) (providing fiscal-caution guidelines for school districts).

196. *Id.* §§ 118.021–.023 (West 2002 & Supp. 2014); PFM WHITE PAPER, *supra* note 22, at 1–2. As of 2011, three cities were under fiscal watch, and eleven cities had graduated from that status. *Id.* at 2.

197. OHIO REV. CODE ANN. § 118.03 (West 2002). In 2011, twenty-four municipalities were under the "fiscal emergency" status, and thirty-five had graduated from that status. PFM WHITE PAPER, *supra* note 22, at 2.

LGC. The remainder of this Article considers the history of the LGC, its powers, and possible or problematic extensions of LGC authority.

## II. THE LOCAL GOVERNMENT COMMISSION: A BRIEF HISTORY

### A. *Events Leading to the Creation of North Carolina's Local Government Commission*

The LGC has its origins in the overall restructuring of North Carolina's county governments. Counties began to assume more responsibility for roads, schools, maintenance of law and order, and operating the courts in the early 1900s.<sup>198</sup> To administer these and other functions of county government, different boards and commissions were created in the model of county school boards.<sup>199</sup> This resulted in a decentralized system of government in which county boards raised funds for various governmental functions, and then turned over the funds to the respective boards to expend.<sup>200</sup> Additionally, after the cessation of World War I, constituents began to request higher quality services, even if it meant paying additional taxes.<sup>201</sup>

In early 1931, the total debt of all local-government units exceeded \$350 million, an increase from less than \$50 million before World War I.<sup>202</sup> This increase in debt was problematic for several reasons: bonds were issued haphazardly with little regard for maturity schedules, inadequate provisions were taken to address payments of principal, and the Depression's accompanying decline in property values decreased local governments' ability to repay their debt service.<sup>203</sup> Further, North Carolina courts began to apply a liberal construction of article V, section 4, of the North Carolina constitution,<sup>204</sup> which led local governments to take on a much greater load of debt.<sup>205</sup> The state had little to no authority to regulate debt, and the State Sinking Fund Commission also lacked the power to handle bond defaults.<sup>206</sup>

Several reports were issued that pointed to potential solutions to these looming problems, including reports from the North Carolina Association of

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198. JOHN ALEXANDER MCMAHON, N.C. ASS'N CNTY. COMM'RS, THE NORTH CAROLINA LOCAL GOVERNMENT COMMISSION 1 (1960), available at <http://babel.hathitrust.org/cgi/pt?id=mdp.39015081948138;view=1up;seq=16>.

199. *Id.* at 1–2.

200. *Id.*

201. *Id.* at 2.

202. *Id.* at 4.

203. *Id.* at 5–6.

204. N.C. CONST. art. V, § 4, cl. 2.

205. MCMAHON, *supra* note 198, at 5.

206. *Id.* at 6.

County Commissioners, the North Carolina Tax Commission, and the Institute for Government Research at the Brookings Institution.<sup>207</sup> Generally, these reports pointed to the need for uniform practices, and for state oversight of debt issuance, management, and accounting.<sup>208</sup>

*B. Formation of the Local Government Commission*

When the General Assembly convened in 1931, it formed the LGC by passing the Local Government Act for the express purpose of reigning in the issuances of debt by local governments.<sup>209</sup> The LGC originally consisted of nine members: the state auditor, the state treasurer, the commissioner of revenue, and six members appointed by the governor, one of whom was the director of local government.<sup>210</sup> The LGC was given seven major tasks:

1. approve all bonds and notes proposed for issuance by a local government;
2. sell all bonds and notes;
3. ensure the proper accounting of local governments' funds;
4. ensure local governments pay interest and principal promptly;
5. provide for uniform accounting practices among local governments;
6. supervise local audits of financial statements; and
7. prevent the intermingling of public officers' personal funds from the funds of governments.<sup>211</sup>

Another feature of the Local Government Act was to make *all* cities, towns, and counties subject to these requirements and to LGC oversight.<sup>212</sup>

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207. *Id.* Particularly well known is the Brookings Institution report, which Governor Max Gardner solicited and which has been seen as the genesis of the LGC. INST. FOR GOV'T RESEARCH, BROOKINGS INST., REPORT ON A SURVEY OF THE ORGANIZATION AND ADMINISTRATION OF THE STATE GOVERNMENT OF NORTH CAROLINA 301-02 (1930), available at <http://babel.hathitrust.org/cgi/pt?id=coo.31924014070506;view=1up;seq=5> (calling for the creation of the Department of Local Government Finance, complete with an accounting and debt administration function). A second report summarized many of the actions taken thereafter. See A. T. ALLEN ET AL., BROOKINGS INST., STATE CENTRALIZATION IN NORTH CAROLINA 80-115 (Paul V. Betters ed., 1932), available at <http://babel.hathitrust.org/cgi/pt?id=mdp.39015065170725;view=1up;seq=7>.

208. See MCMAHON, *supra* note 198, at 6.

209. *Id.* at 7.

210. *Id.*

211. *Id.* at 8-9.

212. *Id.* at 9.

The LGC was also tasked with reviewing the qualifications of all individuals appointed as town accountants.<sup>213</sup>

In 1933, there was a small reorganization of the LGC, which made the state treasurer the ex officio director of local government, and changed the membership composition to four ex officio members and five appointees of the governor.<sup>214</sup> Two additional pieces of legislation in 1933 affected the LGC's operations: the first allowed local governments to issue term bonds in the event of funding or refunding difficulties. The term bonds were to provide needed flexibility in working out maturity schedules, and a separate provision allowed holders of 51% of the bonds of a unit of government one year after a default by the unit to demand that the LGC appoint a financial administrator of the local government unit via the consent of a superior court judge.<sup>215</sup>

In 1935, the LGC was given authority to negotiate with creditors and with the unit of government if the government had been in default for six months.<sup>216</sup> The LGC was also allowed to prepare a refunding plan, to approve a refunding plan suggested by the unit or its creditors, and to put the approved plan into operation.<sup>217</sup> Additionally, the director of local government was to approve and supervise unit budgets for as long as necessary.<sup>218</sup>

In 1936, there was a large change to local-government finance that fundamentally changed the LGC's role. A constitutional amendment was passed that, in effect, required that "95% of all bond issues (other than funding and refunding issues) . . . be approved by the voters" of an issuing local government unit.<sup>219</sup> This led the LGC to act as more of an advisor than an approver of debt, since the General Assembly made clear that voters were to be the final decision-makers when local governments were considering the authorization of new debt.<sup>220</sup>

In spite of the changes, the LGC was very successful during this period in reducing the amount of debt incurred by local governments. Total outstanding bond indebtedness reached a peak of \$362 million in mid-1932, and a low of \$241 million by mid-1946.<sup>221</sup> Because of the strict nature of LGC oversight, local-government indebtedness decreased by more than \$30 million between 1931 and 1936.<sup>222</sup> Upon undertaking a more advisory role

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213. *Id.*

214. *Id.*

215. *Id.*

216. *Id.* at 10.

217. *Id.*

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.*

222. *Id.* at 11.

after 1936, the LGC worked to proactively address potential defaults in the pre-issuance phase.<sup>223</sup> The LGC also sold a number of bonds on behalf of local governments during this period, selling over \$803 million in bonds over its first thirty years (\$618 million of which was new debt).<sup>224</sup> The LGC's power to approve refinancing plans also paid dividends: at the peak of defaults in 1933, 62 counties, 152 cities and towns, and 200 districts had defaulted on their bonds.<sup>225</sup> By 1942, only six small towns were still in default.<sup>226</sup> The LGC also corrected problems with inadequate securitization of sinking fund assets and improper investments.<sup>227</sup> Moreover, the LGC implemented controls over local audits and developed uniform systems of accounting during this period.<sup>228</sup>

### C. *The Local Government Commission Today*

The LGC has changed considerably since the period of defaults that necessitated its existence. Today there are three sections of the LGC: the Authorizations and Negotiated Bond Sales Section, the Competitive Bond Sales and State and Local Government Debt Records Section, and the Fiscal Management Section.<sup>229</sup> The LGC underwent a significant restructuring in the 1990s, primarily due to a proliferation of types of debt that went beyond traditional general obligation bonds. These types included revenue bonds, special obligation bonds, and installment purchase financing.<sup>230</sup> The LGC also handles industrial revenue bonds, issues for higher-education entities, and issues for private nonprofit hospitals.<sup>231</sup>

In working with these transactions, the LGC holds a pre-issuing conference where the LGC discusses the appropriate debt instruments, capital plans, revenue streams, tax-collection rates, and other indicia of a unit's ability to repay its proposed debt.<sup>232</sup> The staff of the LGC is primarily involved in this stage of the negotiations, and the LGC itself ultimately decides whether or not the debt will be issued.<sup>233</sup> The LGC also sells and markets the bonds

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223. *Id.*

224. *Id.* at 12–13.

225. *Id.* at 15.

226. *Id.*

227. *Id.* at 15–16.

228. *Id.* at 16–17.

229. *See Carter, supra* note 192, at 76.

230. *Id.*

231. *Id.* at 77.

232. *Id.*

233. *Id.*

through its Bond Sales Division, and then monitors the unit's ability to repay the debt through its Fiscal Management Section.<sup>234</sup>

The LGC's influence has continued to prevent bond defaults in North Carolina. Since 1942, after refinancing the Depression-era defaults, no local-government unit has failed to meet a bond obligation.<sup>235</sup> Further, all three ratings agencies that determine the creditworthiness of state- and local-government bonds have provided North Carolina with consistently high ratings, stating that "North Carolina's oversight model is one of the strongest of any state."<sup>236</sup>

Lastly, while the LGC prefers to act in an advisory role rather than a regulatory role,<sup>237</sup> it has used its power to assume control of three towns' finances: the Town of East Spencer in 2001,<sup>238</sup> Enfield, and Princeville.<sup>239</sup> The LGC often avoids assuming control of a town's finances by issuing warning letters to towns that are suffering from fiscal difficulties (as it has recently in the Town of Maxton, Scotland County, and Chowan County),<sup>240</sup> but the LGC has shown that it will take action if a town is in danger of defaulting on its debt.

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234. *Id.* at 77–78.

235. *See* Fehr, *supra* note 29.

236. *Id.* (quoting Andrew Teras, an associate director of the Standard & Poor rating agency). This is in part because of a policy requiring high levels of fund balance (between 5% and 15%, with a recommended level of 8%). *Id.*

237. *See* Carter, *supra* note 192, at 80.

238. *See* Fehr, *supra* note 29.

239. Mark Wineka, *State Takes Control of East Spencer's Finances*, SALISBURY POST (Oct. 24, 2001), <https://web.archive.org/web/20061103042245/http://www.salisburypost.com/2001oct/102401m.htm>. Princeville remains in financial distress, and was taken over again in July 2012. *See* John Frank, *Princeville Mayor Arrested on Embezzlement Charges*, NEWS & OBSERVER (Aug. 7, 2013), [http://www.newsobserver.com/2013/08/07/3089729\\_princeville-mayor-arrested-on.html?rh=1](http://www.newsobserver.com/2013/08/07/3089729_princeville-mayor-arrested-on.html?rh=1).

240. *See* Fehr, *supra* note 29 (noting that the former town manager overestimated revenue for several years and refused to cut expenditures after these errors were identified). Leading officials in Maxton recently laid off two public safety employees and are currently considering what else should be done to return the town to solvency. *Id.* Scotland County received a warning letter when its fund balance fell from 9% to 6% in one year. *Id.* The LGC barred new debt issuances to Chowan County after several years of inaccurate revenue calculations. *Id.*

## III. POWERS OF THE LOCAL GOVERNMENT COMMISSION

A. *Approving Debt*1. *The LGC's Process for Approving Debt*

Approval of debt is one of the three primary missions of the LGC.<sup>241</sup> This is a unique proactive feature of the LGC compared to several other state-oversight mechanisms. As discussed earlier, there are at least two states that require local governments to obtain approval from a state administrative agency before allowing the local government to issue debt: Louisiana and North Carolina.<sup>242</sup> Indiana is another state that may require approval by a state agency, but ten or more taxpayers must first file an objection to the local bond issue.<sup>243</sup> Control boards also sprang up in the wake of the issues in Orange County, California, for specific jurisdictions.<sup>244</sup>

The LGC differs in that it is legally responsible for the approval of nearly all local-government debt.<sup>245</sup> There are several steps involved in the LGC's

241. See *About the Local Government Commission*, N.C. DEP'T ST. TREASURER, <http://www.nctreasurer.com/slgl/Pages/Local-Government-Commission.aspx> (last visited Nov. 14, 2014). The other two primary responsibilities of the LGC are marketing debt after approval and regulating the annual financial reporting done by local government units. *Id.*

242. See LA. CONST. art. VI, pt. II, § 33; N.C. CONST. art. V, § 4(2); LA. REV. STAT. ANN. §§ 36:769, 36:802, 39:871 (2014) (requiring approval from the State Bond Commission, which is part of the Department of Treasury); N.C. GEN. STAT. § 159-172 (2013) (requiring all local-government notes to be approved by the Local Government Commission before issuance); see also NEV. REV. STAT. §§ 350.0115, .014 (2011) (requiring prior approval from Debt Management Commission for the *county* in which local government is located).

243. IND. CODE ANN. § 6-1.1-20-6 (West 2010).

244. Barbara Flickinger & Katherine McManus, *Bankruptcy Aftershocks: Have Public Finance Foundations Been Shaken?*, PUB. MGMT., Jan. 1996, at 16, 21–22 (discussing control boards in Washington, D.C., New York City, Philadelphia, Cleveland, Yonkers, Bridgeport, New Haven, and Chicago). Indeed, when some of these cities gave up their finance and budgeting decisions to the control board, their debt ratings were positively affected. *Id.* at 22. For a discussion of the difficulties faced by Orange County, California, see *supra* note 10 and accompanying text.

245. See Charles K. Coe, *Preventing Local Government Fiscal Crises: The North Carolina Approach*, PUB. BUDGETING & FIN., Fall 2007, at 39, 41. This Article uses the term “nearly all” in the context of local-government debt because there are certain types of local-government debt that do not require the LGC's approval, although Professor Coe cites to Professor David Lawrence's text for the proposition that *all* North Carolina debt must be approved by the LGC. *Id.* I did not read Professor Lawrence's text to say that *all* North Carolina local government debt must be approved, but that most types of debt require LGC approval. See LAWRENCE, *supra* note 8, § 400, at 93 (noting that the LGC “must review and approve most proposed borrowings by local governments, and the commission's explicit concern is with the unit's capacity to repay the proposed debt”). Part III.A.2 provides a discussion of the types requiring approval.

approval of debt, but the majority of these considerations are not within the statute.<sup>246</sup> The statutory-approval requirements of the LGC often overlap: for example, the statutory-approval mechanism of the LGC itself appears in sections 159-50 to -53 of the North Carolina General Statutes, as well as within the regulations promulgated by the state treasurer.<sup>247</sup>

Before consideration of the local government's debt approval, the LGC must first follow through on a number of basic steps. With general obligation bonds, for example, the LGC first conducts a preliminary conference with the issuing local government unit to discuss the proposed debt issuance.<sup>248</sup> The local government must then publish notice of its intent to apply to the LGC.<sup>249</sup> If the bond is for school construction, the school board or a board of trustees proposing to issue a school bond must adopt a resolution.<sup>250</sup> If a local government is seeking to issue the bonds, the governing board must adopt a resolution. The local unit then makes its application to the LGC.<sup>251</sup>

Each individual bond type also has different metrics when being considered for approval, although there are overlaps within the process. For example, when examining general obligation bonds, the statute provides that the LGC may consider the following factors:

- Whether the undertaking is necessary or expedient.
- The nature of the unit's outstanding debt.
- The unit's debt management policies and procedures.
- The unit's tax and special assessment collection record.
- The unit's compliance with the Local Government Budget and Fiscal Control Act.
- Whether the unit is in default on its debt obligations.
- The unit's present tax rates and necessary increases to pay its obligations.
- The unit's property values.
- The ability of the unit to sustain additional taxes, if necessary.

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246. The majority of the indicators used by the LGC are not within the statute. *See* Kimhi, *Reviving Cities*, *supra* note 38, at 680 n.256. The LGC's seven indicators were developed by the staff of the organization. *See id.* ("[T]he LGC uses the following types of indicators: three indicators examine the local revenues and expenditures, two examine the localities' operating position, one examines unfunded liabilities, and one examines legal or technical violations.").

247. *See* LAWRENCE, *supra* note 8, § 402A, at 95.

248. N.C. GEN. STAT. § 159-51 (2013).

249. *Id.* § 159-50.

250. *Id.* §§ 115C-503, -521.

251. *Id.* § 159-51.

- The ability of the Commission to market the proposed bonds at reasonable interest rates.
- If the proposed contract is for utility or public service, what the net revenues of the undertaking will be.
- Whether the amount of the proposed debt will be adequate to accomplish the purpose for which it is incurred.
- If the proposed bond issue is for a water system, whether the unit has prepared a water supply plan.<sup>252</sup>

The LGC is to approve the application if it can determine:

- The proposed bond issue is necessary or expedient.
- That the amount proposed is adequate and not excessive for the purpose.
- That the unit's debt management policies are sound and that the unit will meet its obligations.
- That, if necessary, [any] increase in taxes to meet the contractual obligations will not be excessive.
- That the proposed bonds can be marketed at reasonable rates of interest.<sup>253</sup>

Approval for revenue bonds has a very similar type of approval structure, although it removes the language discussing sufficient tax revenues (revenue streams from the funded enterprise, rather than the taxing power, is the object of the pledge) and adds language regarding whether the proposed project is feasible.<sup>254</sup> If the LGC approves the debt, the local government then undertakes formal steps to officially approve the debt, and may even conduct an election if a general obligation bond is under consideration.<sup>255</sup>

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252. *Id.* § 159-52(a).

253. *Id.* § 159-52(b).

254. *Id.* § 159-161.

255. *See id.* § 159-54 (providing for a local government to set a hearing date for the bond issue); *id.* § 159-55 (requiring the local government to file a statement of debt with the clerk to the board); *id.* §§ 159-56 to -57 (requiring the local government to publish a bond order and notice of hearing); *id.* § 159-57 (requiring the local government to hold a public hearing and adopt a bond order); *id.* § 159-61 (requiring the local government to publish a notice of the referendum for a general obligation bond). Sections 159-61, 163-182.5, and 163-302 provide for election requirements. For a convenient chart of this process, see LAWRENCE, *supra* note 8, § 202B, at 44–45.

## 2. *The Types of Debt that Require LGC Approval*

There are four types of local-government debt that *always* require LGC approval: general obligation bonds,<sup>256</sup> revenue bonds,<sup>257</sup> special obligation bonds,<sup>258</sup> and project development financing bonds.<sup>259</sup> Other types of debt financing typically, but do not always, require LGC approval.<sup>260</sup> These include installment purchase debt,<sup>261</sup> certain contracts relating to leases, the acquisition or construction of capital,<sup>262</sup> and other financial arrangements.<sup>263</sup>

256. See N.C. CONST. art. V, § 4; N.C. GEN. STAT. §§ 159-43 to -79; see also *id.* §§ 159-160 to -165, 159G-40.

257. See N.C. GEN. STAT. §§ 153A-210.1 to .7 (set to expire July 1, 2015); *id.* §§ 159-80 to -97, -161; *id.* §§ 160A-239.1 to .7 (set to expire July 1, 2015).

258. See *id.* §§ 159-53, -86, -148, 159I-13, -15, -30. Moreover, if there is an additional security pledged for the special obligation bond, it may be subject to LGC approval. See *id.* §§ 159-148, 159I-30. Section 159-148 requires LGC oversight if all of the following conditions are met:

- (1) [The bond contract] extends for five or more years from the date of the contract . . . .
- (2) [The bond contract] [o]bligates the unit to pay sums to another, without regard to whether the payee is a party to the contract.
- (3) [The bond contract] [o]bligates the unit over the full term of the contract, including periods that may be added to the original term through the exercise of options to renew or extend:
  - (a) For baseball park districts, to at least \$500,000.
  - (b) For housing authorities, to at least \$500,000 or a sum equal to \$2,000 per housing unit owned and under active management by the housing authority, whichever is less.
  - (c) For other units, to at least \$500,000 or . . . one tenth of [1%] of the assessed value of property subject to taxation by the contracting unit, whichever is less.
- (4) [The bond contract] [o]bligates the unit, expressly or by implication, to exercise its power to levy taxes either to make payments falling due under the contract, or to pay any judgment entered against the unit as a result of the unit's breach of the contract.

*Id.* § 159-148.

259. See N.C. CONST. art. V, § 14; N.C. GEN. STAT. §§ 159-48, -103, -105.

260. For a comprehensive blog post describing the different types of debt that require LGC approval, see Kara Millonzi, *Local Government Commission (LGC) Approval of Contracts, Leases, and Other (Non-Debt) Financing Agreements*, COATES' CANONS: N.C. LOC. GOV'T L. BLOG (Aug. 9, 2012), <http://canons.sog.unc.edu/?p=6786>.

261. See N.C. GEN. STAT. §§ 115C-528, 115D-58.15, 159-148, -151, 160A-20; Wayne Cnty. Citizens Ass'n for Better Tax Control v. Wayne Cnty. Bd. of Comm'rs, 399 S.E.2d 311, 313-14 (N.C. 1991).

262. N.C. GEN. STAT. § 159-148.

263. *Id.*; see also *id.* §§ 159-153, 160A-20(e). These include financings "whereby a local government entity approves or otherwise participates in the incurrence of indebtedness (or a similar financing arrangement) by another entity on the local government entity's behalf."

Installment purchase contracts must comply with the provisions contained in section 159-148 of the North Carolina General Statutes relating to contract length and amount before they are required to have LGC approval.<sup>264</sup> Similarly, for contracts relating to lease, acquisition or capital construction projects, there are minimum thresholds for the amount of financing that is required before the debt needs LGC approval.<sup>265</sup> Lastly, there are specific financing agreements exempted from LGC approval under section 160A-20(e) of the General Statutes regarding contracts with the federal and state governments, motor vehicle contracts, voting machine contracts, and loans with the North Carolina Solid Waste Management Program.<sup>266</sup>

An urban redevelopment commission, administered by the local government, is another method by which a local government may issue debt without LGC approval.<sup>267</sup> By statute, cities and counties may act as urban redevelopment commissions, which includes the ability to borrow money from federal, state, or local governments, or from *any other source* without being subject to approval by the LGC.<sup>268</sup>

### 3. *The LGC's Criteria for Approving Debt*

By statute, the LGC must consider the factors listed for each type of debt.<sup>269</sup> These factors, however, are somewhat vague and leave a considerable amount of interpretation to the LGC staff. The North Carolina Administrative

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Millonzi, *supra* note 260, at 3. An example of this type is where a nonprofit corporation borrows money to construct a facility and then conveys the property to a local government at the end of a financing, which the government approves. *Id.* Section 153 also includes a “catch-all provision” to cover future transactions that are similar to a local government borrowing money, but that are not explicitly listed in the statute. *Id.*

264. For a discussion of the section 159-148 requirements, see *supra* note 258 and accompanying text.

265. *Id.*

266. N.C. GEN. STAT. §§ 159-148, -153, 160A-20(e).

267. *Id.* § 160A-505.

268. *Id.* §§ 160A-512(8), -516. One reading of the North Carolina statutes is that if a local government acts as a redevelopment commission, it assumes the place of the redevelopment commission within the urban-redevelopment law under section 160A-505. The local government, acting as a commission, could then issue debt under sections 160A-512(8) and 160A-516 that is not subject to LGC approval. Taken one step further, if the purposes of the urban-redevelopment law are defined broadly, a local government would have wide discretion in how it spends these funds. The redevelopment commission may also provide several types of security for bonds, including a pledge of all gross rents, fees, and revenues, a mortgage on its property, future revenues, or other securities that make the bonds marketable. *Id.* § 160A-517; see also DAVID M. LAWRENCE, ECONOMIC DEVELOPMENT LAW FOR NORTH CAROLINA LOCAL GOVERNMENTS 80–81 (2000) (discussing this method of local-government financing).

269. See, e.g., *supra* note 253 and accompanying text.

Code provides some guidance concerning what the LGC will discuss with a local unit at its preliminary conference concerning debt obligations,<sup>270</sup> along with requirements for all documents submitted to bond counsel in connection with the sale of these bonds.<sup>271</sup>

There are many other internal processes used by the LGC to ensure that local governments maintain strong financial health. The LGC's staff places communities that are in the "worst fiscal shape" on a "watch list."<sup>272</sup> A key indicator used to determine these distinctions is fund balance, which is simply a level of reserves (or savings) maintained by a local government.<sup>273</sup> The LGC requires 8% of operating expenses to be held in fund balance to protect against unanticipated events, like natural disasters or budgetary shortfalls, and the LGC will not approve a bond issue if fund balance is below that threshold.<sup>274</sup> The LGC also sends letters to local governing boards to draw their attention to financial concerns as needed, and to provide assistance to local governments currently experiencing difficulties.<sup>275</sup>

#### B. *Marketing and Selling Debt*

The Competitive Bond Sales and State and Local Government Debt Records Section of the LGC helps to conduct all bond sales on behalf of local governments, which is especially beneficial for smaller local governments that might otherwise have difficulty budgeting their debt.<sup>276</sup> This division handles the sale and delivery of competitively sold bonds, including the preparation of the "official statements," which act as marketing tools for these debt instruments.<sup>277</sup> Other states have a more extensive function in which they couple and sell debt in packages, also known as "pooling programs";<sup>278</sup>

270. 20 N.C. ADMIN. CODE 3.0202(a) (2014). That provision states that if a preliminary conference is held, it may include (1) "the proposed uses for proceeds of the bond issue," (2) "the legality or appropriateness of the bond issue," (3) "the adequacy of the accounting and internal control systems of the governmental unit," (4) "the application procedure and the documents required," and (5) any "other matters as the Secretary deems appropriate." *Id.*

271. *Id.* r. 3.0203.

272. *See* Fehr, *supra* note 29.

273. *Id.* Note, however, that many local governments in North Carolina retain a fund balance *greater* than 8%. *Id.*

274. *Id.*

275. *See* Coe, *supra* note 245, at 42–43.

276. *See* Carter, *supra* note 192, at 78.

277. *Id.*; *see also* Note, *supra* note 27, at 509–10 (describing the process of marketing local-government debt).

278. *See, e.g., Indiana Bond Bank: Pool Program*, IN.GOV, <http://www.in.gov/tos/bond/2409.htm> (last visited Nov. 16, 2014) (describing a "bond bank" in Indiana that assists smaller communities with long-term debt financing and requires projects larger than \$100,000 to be designed as seven- to thirty-year financings).

however, this is not a current feature of the LGC (although it is a ripe consideration for a future addition to the LGC).<sup>279</sup>

### C. *Auditing Debt*

Debt auditing is a common function across many states, and it remains a function of the LGC.<sup>280</sup> The Local Government Budget and Fiscal Control Act requires that two reports are made to the LGC: (1) a report concerning the status of deposits and investments in the unit,<sup>281</sup> and (2) the Annual Financial Information Report (sometimes also known as a Comprehensive Annual Financial Report, or a CAFR),<sup>282</sup> which contains information that the LGC makes public,<sup>283</sup> and which is also used by the LGC to determine whether any violations have occurred.<sup>284</sup>

### D. *Removal and Takeover Provisions*

The LGC can order local governments to issue semiannual reports on deposits and investments.<sup>285</sup> Additionally, the LGC can order a local government to appropriate additional funds to cover its debt-service obligations if the locality is behind in its payments.<sup>286</sup> If the LGC finds faulty controls within a local government's financial structure, it can also order improvements to certain processes.<sup>287</sup>

279. Another example can be found in Vermont, where the state operates the Vermont Bond Bank. See VT. MUN. BOND BANK, <http://www.vmbb.org> (last visited Nov. 16, 2014).

280. Auditing functions are not as cut-and-dried as they might seem. Facing fiscal distress, several local and state governments have engaged in practices that some argue are “gimmicks” to make a government's balance sheet appear in better health than it truly is. See generally Eileen Norcross, *Fiscal Evasion in State Budgeting* (Mercatus Ctr. at George Mason U., Working Paper No. 10-39, 2010), available at <http://mercatus.org/sites/default/files/publication/Norcross.Fiscal%20Evasion.%20State%20Budget%20Gimmicks.%20Updated%2008.23.10.pdf> (describing the manifold issues that state governments encounter when auditing local governments).

281. N.C. GEN. STAT. § 159-33 (2013).

282. *Id.* § 159-33.1.

283. The local governments' information is published on the State Treasurer's website. See *Financial Analysis Tools and Reports*, N.C. DEP'T ST. TREASURER, <https://www.nctreasurer.com/slg/lfm/financial-analysis/Pages/default.aspx> (last visited Nov. 16, 2014).

284. N.C. GEN. STAT. § 159-33.1; see also DAVID M. LAWRENCE, LOCAL GOVERNMENT FINANCE IN NORTH CAROLINA § 1202, at 242–43 (2d ed. 1990).

285. N.C. GEN. STAT. § 159-33.

286. *Id.* § 159-36.

287. *Id.* § 159-25(c). Under section 159-25(c),

The [LGC] has authority to issue rules and regulations having the force of law governing procedures for the receipt, deposit, investment, transfer, and disbursement of money and other assets by units of local government and public authorities, may

Further, knowingly refusing to obey an LGC order may result in criminal penalties.<sup>288</sup> The LGC may also remove individuals from office.<sup>289</sup> Additionally, if the local unit is not cooperative, the LGC may impound the entity's financial records and assume control of its financial affairs.<sup>290</sup> These standing takeover powers are a unique function of the LGC compared to other states' oversight mechanisms, and while they are used sparingly, they have been exercised to avert financial crises in a small number (four) of local-government entities.<sup>291</sup> Finally, a local government *cannot* file for bankruptcy unless the LGC approves such a filing.<sup>292</sup> Since the LGC began overseeing local-government debt, there has only been one filing by a nontraditional unit of government: the South Brunswick Water and Sewer Authority.<sup>293</sup>

*E. A Holistic Approach to Local-Government Debt Oversight*

The LGC is extensively involved at every step of the debt-approval process. By design and through its administrative procedures, the LGC offers thoughtful, proactive regulation of local-government debt at every step of a local government's budgetary process for debt management. The LGC has built-in functions for continued oversight, including the ability to dictate a local government's fiscal decisions if necessary. The LGC staff evaluates debt before it is issued, considers financial statements and debt ratios while the debt is outstanding, and guides the debt issues to their eventual conclusion.

The certainty surrounding the agency has created a form of "credit enhancement" for ratings agencies when they view North Carolina's local-government debt, and also provides a level of certainty for local governments to operate within.<sup>294</sup> This is especially comforting to investors, as even the

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inquire into and investigate the internal control procedures of a local government or public authority, and may require any modifications in internal control procedures which, in the opinion of the [LGC], are necessary or desirable to prevent embezzlements or mishandling of public moneys.

*Id.*

288. *Id.* § 159-181.

289. *Id.* § 159-182.

290. *Id.* § 159-181.

291. For example, the Town of Princeville has twice been taken over by the LGC and is currently being investigated for improper financial reporting. See Beau Minnick, *SBI Investigating Spending by Princeville Officials*, WRAL.COM (Apr. 12, 2013), <http://www.wral.com/sbi-investigating-spending-by-princeville-officials/12316307/>; Coe, *supra* note 245, at 44-45 (discussing four instances where the LGC assumed control over a local government: Princeville, Enfield, East Spencer, and the South Brunswick Water and Sewer Authority).

292. N.C. GEN. STAT. § 23-48.

293. See Voluntary Petition, *In re* S. Brunswick Water & Sewer Auth., No. 04-09053-8-JRL (Bankr. E.D.N.C. Nov. 19, 2004).

294. See Fehr, *supra* note 29.

most secure forms of public debt—general obligation bonds—have recently faced uncertainty.<sup>295</sup> The number of “emergencies” that the LGC has had to respond to have also been limited, as the LGC takes care of most instabilities on the front end by denying approval for debt or working with the local government in its preliminary conference.<sup>296</sup> Laying out the ground rules for all local governments and imposing fiscal responsibility for their actions—as opposed to the vague notion that the state will bail the locality out if distress is great enough—creates an environment where political leaders take a higher level of responsibility for their financial decision-making.

#### IV. RECENT CHANGES TO THE LGC AND OTHER POSSIBLE FUNCTIONS

This Part considers the arguments for extension of the LGC’s authority into different areas, drawing upon specific examples in North Carolina. Additionally, this Part examines legislation passed by the General Assembly in 2013 that altered the LGC’s authority to assume control of water and sewer systems. This Part also argues that delegating oversight to the LGC over pension funds, economic-development activities, and school boards is not appropriate for the LGC’s structure. Specifically, this Part argues that state-run investment funds gain little by applying a lateral level of oversight, that some decisions relating to economic development are political in nature and thus fall outside the scope of the LGC’s proper authority, and that revenue-collection limitations within school boards make LGC control less practical and less effective. Finally, this Part critiques a recent move by the LGC, in which it offered “guidelines” by imposing a categorical bar against certain types of debt financing, rather than adopting regulations or proposing legislation.

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295. See NAT’L ASS’N BOND LAWYERS, GENERAL OBLIGATION BONDS: STATE LAW, BANKRUPTCY AND DISCLOSURE CONSIDERATIONS i (Aug. 2014), [http://www.nabl.org/uploads/cms/documents/GENERAL\\_OBLIGATION\\_MUNICIPAL\\_BONDS.pdf](http://www.nabl.org/uploads/cms/documents/GENERAL_OBLIGATION_MUNICIPAL_BONDS.pdf). The National Association of Bond Lawyers described this uncertainty surrounding general obligation bonds:

Recent events, including the bankruptcy filings by Jefferson County, Alabama, and the City of Detroit, Michigan, have raised questions about the security of general obligation bonds and challenged the commonly held general assumptions [about general obligation bonds]. It has become apparent that all general obligations bonds do not enjoy the same security or the same remedies for enforcement of the promise to pay under state or local law. Further, the treatment of general obligation bonds in a Chapter 9 bankruptcy case is uncertain and will depend on the security provided by applicable state law.

*Id.*

296. See Fehr, *supra* note 29 (discussing the LGC’s denial of loan requests from the Town of Navassa, Scotland County, and Chowan County).

A. *Recent Changes from 2013 and 2014*

In 2013, legislation was introduced to allow the LGC to assume control of a water/sewer enterprise if “for three consecutive fiscal years, the audited financial statements of the unit” had any of three conditions: (1) negative working capital; (2) a quick ratio of less than 1.0; or (3) the unit or public authority experienced a net loss of revenue.<sup>297</sup> The LGC must find that the impacts of these three items, in tandem, create instability in the financial affairs of the unit and that the public authority or unit of government has failed to take corrective measures.<sup>298</sup> Finally, the LGC must provide warnings and notice to any authority or unit of government lacking compliance under the statute. This legislation passed without opposition in 2013.<sup>299</sup>

A large concern regarding the new law is that the nature of an enterprise, such as a water/sewer entity, usually requires special expertise to administer.<sup>300</sup> However, the new law concerns a utility that is typically operated by a local unit of government, or by a group of local governments through an interlocal agreement or other regional governmental entities.<sup>301</sup> One might assume that the ability to set rates, to rely on technical expertise of the water system’s staff, and the similarity in nature to a local government would make these types of governmental water authorities appropriate for LGC oversight.<sup>302</sup>

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297. S.B. 207, 2013 Gen. Assemb., 2013-2014 Sess. (N.C. 2013). The bill provides that “‘working capital’ means current assets, such as cash, inventory, and accounts receivable, less current liabilities, determined in accordance with generally accepted accounting principles, and the phrase ‘quick ratio of less than 1.0’ means that the ratio of liquid assets, cash and receivables, to current liabilities is less than 1.0.” *Id.*

298. *Id.*

299. Act of June 19, 2013, ch. 150, § 1, 2013 N.C. Sess. Laws 358, 358 (codified at N.C. GEN. STAT. § 159-181(d) (2013)).

300. For an example of the complexities that come with administering water- and wastewater-management systems, see *Projects and Programs*, UNC ENVTL. FIN. CTR., <http://www.efc.sog.unc.edu/content/projects-and-programs> (last visited Nov. 16, 2014) (discussing several considerations regarding rate structures, business models, irrigation policies, and more).

301. For a discussion of these regional water entities, see Shadi Eskaf, *Tips on Regionalization: Crafting Interlocal Water Agreements and Water System Interconnections*, UNC ENVTL. FIN. CTR. (Sept. 20, 2012), [http://www.efc.sog.unc.edu/sites/www.efc.sog.unc.edu/files/TipsforRegionalization\\_0.pdf](http://www.efc.sog.unc.edu/sites/www.efc.sog.unc.edu/files/TipsforRegionalization_0.pdf). Note that the private water systems would not be included in the proposed legislation. See *supra* note 297 and accompanying text.

302. One other change from the General Assembly is that the LGC now also oversees loan applications from the State Department of Transportation from the infrastructure-banking program. N.C. GEN. STAT. § 136-18.

B. *Pension Oversight by the LGC*

Oversight of pensions in North Carolina is handled entirely by the State Treasurer's Office,<sup>303</sup> of which the LGC is a part. While pension obligation bonds are fraught with issues, both pension obligation bonds and the pension fund involve investment functions<sup>304</sup> that an LGC-style organization is not suited to handle. The LGC is essentially designed to audit, correct, and market local-government debt—the group is not an investment house designed to grow a portfolio. Additionally, the state treasurer administers local-government retirement benefits<sup>305</sup> via an opt-in provision.<sup>306</sup> Tasking the LGC with this oversight seems redundant and may create a conflict of interest<sup>307</sup> between two parts of the same statewide office.<sup>308</sup> If a system is administered by the state, it may make sense for the federal government to oversee and impose requirements on pension systems to ensure solvency and to appropriate fund balances, benefits offered, and investment strategies.<sup>309</sup>

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303. *Get the Facts: The North Carolina Pension System*, N.C. DEP'T ST. TREASURER 1, <https://www.nctreasurer.com/ret/Active%20Employees/PensionFactSheet.pdf> (last visited Feb. 3, 2015) (noting that the North Carolina pension system “supports the more than 820,000 current and former public employees in North Carolina” and that the “pension fund is managed by the North Carolina Department of State Treasurer”). The fund is \$72.4 billion in size and is the fourteenth largest in the United States, as well as the thirty-second largest in the world. *Id.*

304. See Eric Schulzke, *Pension Obligation Bonds: Risky Gimmick or Smart Investment?*, GOVERNING (Jan. 2013), <http://www.governing.com/topics/public-workforce/pensions/gov-pension-obligation-bonds-risky-or-smart.html> (“[Pension obligation bonds] are a financing maneuver that allows states and local governments to ‘wipe out’ unfunded pension liabilities by borrowing against future tax revenue, then investing the proceeds in equities or other high-yield investments.”). Schulzke asserts that pension obligation bonds “have bankrupted whole cities.” *Id.*

305. See N.C. GEN. STAT. §§ 128-21 to -38.10.

306. *Id.* § 128-33.

307. *But cf.* 2 CONIGLIO & GELFAND, *supra* note 19, § 12:13, at 12-53 to -55 (discussing state oversight of state bonds and notes).

308. This is not to say that there should be no state assistance and oversight where local governments administer their own pension system. For examples of how some local governments have mismanaged pension funds, see Schulzke, *supra* note 304 (describing two California cities that issued overly generous pensions and subsequently went bankrupt).

309. See generally Allan Beckmann, *Pension Obligation Bonds: Are States and Localities Behaving Themselves or Do the Feds Need to Get Involved?* (Spring 2010) (unpublished M.P.A. capstone paper, University of North Carolina at Chapel Hill), available at <http://www.mpa.unc.edu/sites/www.mpa.unc.edu/files/AllanBeckmann.pdf> (arguing that the federal government should coordinate with the Government Finance Officers Association to encourage states issuing pension obligation bonds to follow “best practices” and to consider whether current regulations are appropriate). Indeed, some convincingly argue that pension obligations in certain states have led to increased costs of borrowing for states and local governments due to the strength of public sector employee unions. See Peterson & Nadler, *supra* note 5, at 264–68.

C. *Oversight of School Finance*

Unsuccessful legislation was offered to provide local school districts in North Carolina with the ability to impose property taxes, and also for the LGC to oversee how those local school districts spent their revenues.<sup>310</sup> A local school district would be more analogous to a local unit of government if it possessed the statutory authority to impose taxes. In their current form, however, North Carolina schools do not possess this power.<sup>311</sup> The LGC model is an improper fit for North Carolina schools as they currently operate because a forced takeover of a school district would not bring with it the ability to raise revenues *and* decrease expenditures.<sup>312</sup>

This lack of flexibility would give the LGC only one tool to balance a school system's budget in the event the county or state fails to supply more property tax funds of their own volition—to cut expenses. This also puts the LGC squarely into a political fight, whereby it will have to lobby another board for funds to solve a fiscal crisis. One only need look to the early examples in Florida for a worst-case scenario of that conversation.<sup>313</sup>

D. *LGC Oversight of Economic-Development Activities*

Others call for the LGC to have greater oversight authority over economic-development activities of local governments.<sup>314</sup> Supporters of this suggestion, which particularly target tax increment financing (TIF) within North Carolina as an area for greater LGC oversight, want the LGC to

310. See H.B. 955, 2013 Gen. Assemb., 2013-2014 Sess. (N.C. 2013) (referred to the H. Comm. on Rules, Calendar, and Operations of the House two days after the bill was filed, with no further action taken during the remainder of the 2013-2014 Session).

311. See T. Keung Hui, *N.C. Bill Would Block School Boards from Suing County Commissioners for More Money*, NEWS & OBSERVER (Apr. 21, 2013), <http://www.newsobserver.com/2013/04/21/2841341/nc-bill-would-block-school-boards.html> (“North Carolina school districts don’t have taxing authority so they request money from their county board of commissioners for facility needs. School boards also ask commissioners to supplement amounts they get from the state and federal government for day-to-day needs in the operating budget.”).

312. Some support providing school districts with taxing authority because it would make the school accountable for its policy choices. See Renee Chou, *Calls Grow to Give School Boards Taxing Authority*, WRAL.COM (Mar. 21, 2008), <http://www.wral.com/news/local/story/2614055/>.

313. See *supra* note 90 and accompanying text.

314. JOHN LOCKE FOUND., SPOTLIGHT NO. 350, COMMON-SENSE TIF REFORMS 1–3 (May 28, 2008), <http://www.johnlocke.org/acrobat/spotlights/spotlight-350-tifreforms.pdf> (calling for greater oversight by the LGC regarding the feasibility of projects).

examine the feasibility of the project, along with the other traditional indicia of financial solvency that the LGC uses.<sup>315</sup>

The problem with this approach is that these reforms essentially ask the LGC to wade into political waters: rather than simply determining whether a project is financially feasible, the LGC is being asked to determine whether a project is *advisable*. While the LGC may already informally remark on the wisdom of such projects, asking the LGC to deny local-government debt when it has sufficient assurances that the debt will be paid off defeats the purpose of the organization. If the LGC is meant to keep local governments from defaulting on their debt obligations, thereby keeping debt service rates low for all local governments, it has done its job in areas such as Roanoke Rapids, which is often held up as a reason to adjust the LGC structure in North Carolina.<sup>316</sup>

Going beyond the LGC's purpose to prohibit financially sound debt-management schemes based on whether or not the LGC agrees with the purported use of the debt is a step too far, and it restricts local governments' abilities to finance new projects on the basis of normative judgments made by an unelected arm of a state agency.<sup>317</sup> Rather, local governing boards and the General Assembly—not the LGC—are better suited to weigh the advisability of a proposed project.

In other words, this approach exerts *too much* positive liberty at the expense of local-government flexibility, or negative liberty. Incentives, unwise development projects, and successful forms of economic development do not necessarily impact the ability of other governments to provide their own incentives or to engage in debt financing to spur economic development

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315. *Id.*

316. *Id.* For a discussion of the Roanoke Rapids TIF in North Carolina, see Adam C. Parker, Comment, *Still as Moonlight: Why Tax Increment Financing Stalled in North Carolina*, 91 N.C. L. REV. 661, 697–700 (2013). Roanoke Rapids has experienced significant difficulties with its TIF structure since the initial theater tenant, Randy Parton and the Moonlight Bandits, were dismissed from their managerial duties. *Id.* at 663. Multiple attempts to sell the theater failed, although the town has now successfully partnered with a tenant for two years who also intends to purchase the theater from the city. See Khai Hoang, *City, HSV Entertainment Strike New Lease Agreement on Theater*, DAILY HERALD (Roanoke Rapids, N.C.) (July 4, 2014, 6:00 AM), [http://www.rdailyherald.com/news/city-hsv-entertainment-strike-new-lease-agreement-on-theater/article\\_a03f5460-030f-11e4-890c-001a4bcf887a.html](http://www.rdailyherald.com/news/city-hsv-entertainment-strike-new-lease-agreement-on-theater/article_a03f5460-030f-11e4-890c-001a4bcf887a.html).

317. One may argue that because the state treasurer is elected, this point about an unelected body making decisions for an elected local-government board is moot. Ultimately, denying financing based on personal preference and “best judgment” seems to violate the state treasurer's functions and core purposes in this area, which involve the issuance and monitoring of all local-government debt, including the amount of debt. See *State and Local Government: Local Debt*, N.C. DEP'T ST. TREASURER, <http://www.nctreasurer.com/slg/Pages/Local-Debt.aspx> (last visited Nov. 16, 2014).

as long as there are no defaults or bankruptcies. If anything, a local government's fiscal decisions—good or bad—will offer a competitive advantage to surrounding governments by spurring neighboring localities of prosperous units to achieve the same prosperity or by granting a competitive edge to neighboring localities of units suffering from unwise fiscal planning.

#### E. *One Area of Criticism*

For a number of years, the LGC has operated in a space where it enjoyed the administrative flexibility to approve or disapprove debt without offering public statements explaining its decision.<sup>318</sup> Rather than approving administrative regulations through rulemaking or other legislative processes, the LGC worked with units informally or issued “guidelines” about local-government practices.<sup>319</sup>

Recently, the LGC has put forth additional “guidelines” (which are in effect more similar to codified “rules”) to advise bond attorneys and local governments about its decision-making process.<sup>320</sup> Even so, the LGC has not yet engaged in a rulemaking proceeding, which it is likely required to do if the LGC intends for these “guidelines” to have any legal effect.<sup>321</sup> Additionally, some of these policies have been enforced in a non-uniform way, particularly within the area of refinancing debt initially purchased by the United States Department of Agriculture (USDA).<sup>322</sup> Despite its informal method of

318. See Note, *supra* note 27, at 498–99 (noting that the LGC could approve or disapprove debt under thirteen broad bases, and that approval was often, in practice, determined via an informal conference before the full-commission vote). The ability to override the LGC was also unlikely to be successful, as a sale of bonds disapproved of by the LGC was likely to be seen as less marketable. *Id.* at 499–500.

319. See, e.g., *Guidelines on Debt Issuance (Revised)*, N.C. DEP'T ST. TREASURER (Mar. 27, 2007), <https://www.nctreasurer.com/slg/Debt%20Management/GuidelinesforDebtIssuanceFinal2.pdf>.

320. See Bob Jessup, *The LGC's Proposed Maturity Guidelines Are Unfair*, N.C. PUB. FIN. (Feb. 24, 2014), <http://ncpublicfinance.com/2014/02/24/the-lgcs-proposed-maturity-guidelines-are-unfair/>.

321. N.C. GEN. STAT. § 150B-2(8a) (2013) (“‘Rule’ means any . . . statement of general applicability . . . that describes the procedure or practice requirements of an agency.”).

322. See Bob Jessup, *An Update on the LGC Maturity Guidelines Project—Still No Freedom to Refund*, N.C. PUB. FIN. (June 6, 2014), <http://ncpublicfinance.com/2014/06/06/an-update-on-the-lgc-maturity-guidelines-project-still-no-freedom-to-refund/> (noting that eighteen months after announcing the guideline that encourages local governments not to apply for refinancing of USDA debt, the Town of Tabor City had that exact type of financing approved, despite others being denied due to the “guideline”). This particular debate has even led to a bit of “forum-shopping” with LGC staffers, as Jessup notes: “Some outside the LGC have suggested that you may be able to get these applications approved if you send the material to the right staffer and don’t mention a conflict with the guidelines. I think we can all agree that’s no way for the system to operate.” *Id.*

administration, the LGC's relationship with local governments remains important because the LGC approves and helps to market local-government debt, which perhaps lessens the local governments' appetites to draw the LGC into litigation.

Nonetheless, although a rulemaking process may prove cumbersome or onerous to pass into legislation, the LGC should engage in a formalized process. The alternative is to keep administrative discretion in the hands of the LGC staff, enabling them to determine whether a project is feasible on a case-by-case basis by weighing the useful life of an asset, realized savings, costs of financing, and other relevant factors.

The creation of "guidelines" with non-uniform enforcement is effectively neither of these options and should be discontinued. It seems unlikely that a local government would litigate this matter for two reasons. First, *all* local governments have an interest in maintaining a positive relationship with the LGC. After all, the LGC determines whether it will approve a local government's debt and also helps market their debt. Additionally, the cost savings from such a refinancing may not be worth the litigation hassle or expense. USDA financings are constrained to low-population areas and have extended repayment periods so that rural units can afford the project.<sup>323</sup> This is another way to say that the units that could least afford to litigate the issue are the units affected by the guideline.

#### CONCLUSION

This Article proposes a simple solution to a mounting problem of local-government fiscal insolvency in the United States.<sup>324</sup> It supports the nationwide application of the multifaceted approach taken by North Carolina's Local Government Commission, but only as long as the application does not extend its reach further than necessary to non-taxing governmental authorities or to the use of economic-development incentives.

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These guidelines are fairly new and well intentioned. However, a *statute* that says the LGC will not approve state refinancing of USDA debt would be a much better vehicle and would remove ambiguity regarding the "guideline." One need only look to the LGC's success in gaining oversight of water-sewer systems, which included definitions of "quick ratios" and other financial indicators, in allowing the LGC to assume control of near-insolvent water and sewer systems. N.C. GEN. STAT. § 159-181. The legislation granting this new authority passed without a single vote against the bill. *Senate Bill 207/S.L. 2013-150: Maintaining Water and Sewer Fiscal Health*, N.C. GEN. ASSEMBLY, <http://www.ncga.state.nc.us/gascripts/BillLookUp/BillLookUp.pl?Session=2013&BillID=S207> (last visited Nov. 15, 2014).

323. See *Water and Waste Disposal Guaranteed Loans*, U.S. DEPT. OF AGRIC., <http://www.rurdev.usda.gov/UWP-dispguaranteedloan.htm> (last visited Nov. 15, 2014).

324. See *supra* note 32 and accompanying text.

Exerting state control at the expense of local governments is extraordinarily difficult and comes with political hurdles, but North Carolina's experience has shown that such a system keeps local-government interest rates low and helps avert fiscal crises. However, as this Article also explains, there is a limit to the control that states should exert in these matters: local governments need the flexibility to make decisions to positively affect their communities. If a local government wishes to take on debt, it should also be allowed to do so, as long as the local-government unit has both the political will and financial capability—not necessarily because the project is popular in the rest of the state. The current structure of the LGC provides what this Article argues is a useful model for other states to emulate.