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DECISION-MAKING AND THE SHAKY PROPERTY FOUNDATIONS OF MUNICIPAL BANKRUPTCY LAW

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ABSTRACT

Municipal bankruptcies are unpredictable. There are several reasons for this statement— municipal bankruptcies are rare, involvement of the state itself in the process varies according to the governing state law, and chapter 9, the Bankruptcy Code chapter governing the municipal bankruptcy process, has many gaps. Congress constructed the modern chapter 9 on a foundation of corporate bankruptcy law, a foundation whose roots—corporate finance—are significantly different from the rules governing municipal finance. In this Article, Professor Moringiello aims a spotlight on the property roots of private bankruptcy law and compares them to the promissory and statutory roots of municipal finance law and makes suggestions for a decision-making framework for chapter 9 cases.

INTRODUCTION

It is hard to overstate the importance of the Brooklyn Journal of Corporate, Financial & Commercial Law's 2017 Spring Symposium theme—Decision-Making and Legitimacy in Public Bankruptcies. The decision-makers in private and public bankruptcies are different, as are the bases on which they make their decisions. In business entity and individual bankruptcies, the decision-makers have well-defined roles, established by the Bankruptcy Code ("Code")[1] and a voluminous body of judicial decisions. The Code limits debtor and creditor choices in important ways and empowers judges to enforce those limitations. In all individual bankruptcies, a trustee is empowered to make important decisions, and in a business entity's chapter 11, the default decision-maker is corporate management in the Code-defined role as debtor in possession (DIP).[2] If the DIP's choices prove harmful to creditors the Code allows the court to replace the DIP with a trustee.[3] From the smallest individual bankruptcy to the largest chapter 11 case; the Code sections, debtor and creditor choices, and judicial actions have an important concept at their core—the value of the bankruptcy estate. Bankruptcy law is property law, and even in the most heavily negotiated chapter 11 plan, the value of the estate provides an important baseline for decision-making.

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1. 11 U.S.C. §§ 101–1532 (2012).
2. *Id.* §§ 1101(1), 1107(a).
3. *Id.* § 1104.

Municipal bankruptcy is different. The role and powers of the judge in a municipal bankruptcy case are less clear, and often said to be limited by the Tenth Amendment to the Constitution.[4] Chapter 9 of the Code, the chapter that governs municipal bankruptcies, deprives bankruptcy judges of some of the decisions that they make in private bankruptcy cases. It also lacks some of the guidance that informs parties as they develop their plans of adjustment (the chapter 9 analog to a plan of reorganization). Significantly, municipal bankruptcy law is not property law. The Code explicitly prohibits a court from interfering with a municipality's property without its consent,[5] but municipal bankruptcy law's distance from property law goes far beyond this limitation.

Municipal bankruptcy law adds a significant decision-maker: the state in which the debtor municipality is located. The Code gives the state the right to decide whether its municipalities can take advantage of chapter 9,[6] and state law defines the role of state level decision-makers in the chapter 9 process.[7] Municipal bankruptcy law omits a decision-maker with a key role in private bankruptcy: the trustee.[8] Federal law provides no independent oversight of a debtor; the decision to replace or provide supervision over a municipal government as part of a debt resolution procedure is left to the states.[9]

Many have analyzed the interplay between state law and decision-makers and federal law and decision-makers in the chapter 9 context. The starting point for the analysis is often the Tenth Amendment—because the Tenth Amendment limits the federal powers over states, the use of bankruptcy law over municipalities, which are created by and exist at the pleasure of their states, must also be limited. All who have studied chapter 9 agree that it is an imperfect tool,[10] yet they disagree on where the imperfections lie and the

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4. *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 462–63 (1993) (explaining how chapter 9's restrictions on the court's interference with a municipal debtor's property is rooted in constitutional concerns).

5. 11 U.S.C. § 904(2).

6. *Id.* § 109(c)(2).

7. *See, e.g.*, MICH. COMP. LAWS § 141.1558(1) (2013) (empowering a state-appointed emergency manager to act for a Michigan municipality during a chapter 9 case); *see also* 53 PA. STAT. § 11701.706(a)(9) (West 2014) (in Pennsylvania, if a receiver is appointed for a distressed municipality, the receiver both files the chapter 9 petition and acts for the municipality during the bankruptcy case); *see also* R.I. GEN. LAWS § 45-9-7 (Rhode Island statute giving state-appointed receiver the power to file a chapter 9 petition on behalf of a municipality and act for the municipality during the case).

8. *See* 11 U.S.C. § 902(5).

9. *See e.g.*, 53 PA. STAT. § 11701.706(a)(9) (West 2014); Juliet M. Moringiello, *Goals and Governance in Municipal Bankrutpcy,* 71 WASH. & LEE L. REV. 403, 457–58 (2014) (explaining different types of state supervision over municipalities in chapter 9).

10. For example, twenty-five years ago, two authors argued that municipal bankruptcy "serves little function at all." McConnell & Picker, *supra* note 4, at 470.

extent to which federal law and institutions can,[11] do,[12] or should[13] drive the financial restructuring of a municipality. Indeed, concerns about federal intrusion into state affairs influenced the structure of chapter 9 and all of its predecessors.[14] These sovereignty concerns have produced a statute that, while borrowing large parts of chapter 11 of the Code, is riddled with gaps, both because chapter 9 omits some provisions, notably those prescribing priorities, and because well-understood concepts applicable to private bankruptcies, such as "best interests of creditors," are inapplicable to public bankruptcies.

The structure of chapter 9 has generated a hodge-podge of judge-made law, fashioned by bankruptcy courts whose decisions do not bind even other bankruptcy courts. Regardless of the merits of these decisions, they fail to provide guidance as to what might happen in the next municipal bankruptcy. This mélange of case law might not be a cause for concern in its effect on the ground, because every city that files for bankruptcy has a unique story behind its decline. The patchwork nature of municipal bankruptcy law gives little guidance, though, to the gatekeepers for chapter 9—the state executives or legislatures who decide whether a city can file for bankruptcy at all.[15] Nor does it give comfort to the market that municipal bankruptcy law was originally developed to protect. The mere mention of the word "bankruptcy" by a mayor leads to speculation about which city or county is next.[16]

This Article shifts the discussion from the important balance between state and federal decision- making power to the equally important search for a basis for the decisions made, regardless of who makes them. In private

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11. *See, e.g.*, Andrew B. Dawson, *Beyond the Great Divide: Federalism Concerns in Municipal Insolvency*, 11 HARV. L. & POL'Y REV. 31, 89 (2017) (arguing that the commonly understood balance between state and federal power in chapter 9 is based on an outdated model of federalism); *see also* C. Scott Pryor, *Municipal Bankruptcy: When Doing Less Is Doing Best*, 88 AM. BANKR. L.J. 85, 125 (2014) (advocating for dismissal of a chapter 9 case as a key tool in the hands of the bankruptcy court if a municipality and its creditors cannot agree on a plan that appropriately balances bankruptcy fairness and creditor best interests); *see also* Stephen J. Lubben, *Puerto Rico and the Bankruptcy Clause*, 88 AM. BANKR. L.J. 553, 571–72 (2014) (questioning whether § 903 of the Code, which invalidates state laws that bind non-consenting creditors to a plan of debt adjustment, should apply to states that have opted out of chapter 9).

12. *See generally* Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55 (2016) (illustrating, through a study of every court hearing in the Detroit bankruptcy, that the bankruptcy court has many more tools to shape the outcome of a chapter 9 than commonly believed).

13. *See* Clayton P. Gillette & David A. Skeel, Jr., *Governance Reform and the Judicial Role in Municipal Bankruptcy*, 125 YALE L.J. 1150 (2016) (arguing that because governance problems are an inseparable element of municipal financial distress, courts should refuse to confirm a chapter 9 plan that does not address governance reforms).

14. For a good overview of how sovereignty concerns shaped federal municipal bankruptcy law, *see* Dawson, *supra* note 11, at 39–56.

15. A municipality cannot file for bankruptcy unless it is specifically authorized by its state. 11 U.S.C. § 109(c)(2) (2012).

16. *See* Mary Williams Walsh, *Dallas Stares Down a Texas-Size Threat of Bankruptcy*, N.Y. TIMES, Nov. 21, 2016, at A1.

bankruptcy, that basis is property. Yet property does not and cannot serve as a basis for decision-making in a public bankruptcy. Acknowledging the irrelevance of property to municipal bankruptcy's distributional scheme may alleviate some of the confusion surrounding the treatment of the different types of creditors in a chapter 9 case. Some observers of the chapter 9 process have suggested that importing well-known private property concepts into municipal finance[17] or expanding our understanding of property rights in the public finance context[18] might cure its deficiencies. Indeed, some states, notably Rhode Island, have addressed the uncertainty surrounding the priority of general obligation bondholders by enacting statutes granting security interests in tax receivables to such bondholders.[19] Removing property from the analysis can guide courts and policymakers in fashioning chapter 9 remedies that better reflect the realities of municipal finance.

In this Article, I explore state decision-making with respect to municipal borrowing, in contrast to the property-based decision-making that forms the foundation of bankruptcy generally. Individuals and business entities divide their assets among creditors by granting property interests in them, and non-bankruptcy law gives creditors who did not receive consensual property interests at the outset of the debtor-creditor relationship the right to seize a debtor's assets after the debtor's default if the creditor obtains a judgment against the debtor and complies with the applicable state's process for enforcing that judgment against the debtor's property.[20] Private (non-municipal) bankruptcy law reflects this reality, and its rules are built around preserving and dividing an estate composed of the debtor's property, even when there is no property to distribute, as is the case in most consumer liquidations.[21]

Municipal debtor-creditor law is fundamentally different. Instead of a property basis, municipal credit has a public purpose basis. The rules

17. *See* Vincent S.J. Buccola, *Law and Legislation in Municipal Bankruptcy*, 38 CARDOZO L. REV. 1301, 1338 (2017) (suggesting modifications to municipal finance practices by replacing contract promises with property promises).

18. *See generally* Christopher K. Odinet, *Of Progressive Property and Public Debt*, 51 WAKE FOREST L. REV. 1101 (2016) (advocating for a progressive account of property law in order to provide a better allocation of rights in public bankruptcy).

19. *See* R.I. GEN. LAWS § 45-12-1 (creating a statutory lien on *ad valorem* taxes and general fund revenues in favor of general obligation bondholders). David Skeel has questioned whether statutes like this create genuine liens for bankruptcy purposes. *See* David A. Skeel, Jr., *What is a Lien? Lessons from Municipal Bankruptcy*, 2015 U. ILL. L. REV. 675, 690–92 (2015) (suggesting that the lien granted by the Rhode Island statute is not a property grant, but a state priority status that should be disregarded in bankruptcy).

20. Article 9 of the Uniform Commercial Code provides the laws governing a private party's grant of an interest in personal property to secure repayment of a debt. U.C.C. §§ 9-101–709 (AM. LAW. INST. & UNIF. LAW COMM'N 2010). For an overview of the process that a creditor without a lien on property must use to collect a debt from its debtor's property, *see* ELIZABETH WARREN ET AL., THE LAW OF DEBTORS AND CREDITORS: TEXT, CASES, AND PROBLEMS 335–38 (7th ed. 2014).

21. *See* Pamela Foohey et al., *"No Money Down" Bankruptcy*, 90 S. CAL. L. REV. 1055, 1062 (2017) (explaining that more than 90% of consumer chapter 7 cases are "no asset" cases).

surrounding municipal credit reflect this purpose. States restrict the amount of money that municipalities can borrow as well as the purposes for which they can borrow.[22] Municipal property is generally unavailable to satisfy obligations to creditors.[23] Many states have mechanisms that give the state enhanced control over municipal finances when a municipality falls into financial distress.[24] Instead of pledging property to support debts, municipalities support their obligations by promises described in terms of the efforts used to make good on them.[25] Priorities in public finance do not start with property; instead, statutory and constitutional provisions in some states grant payment priorities to defined types of public debt.[26]

The existing body of scholarship on chapter 9 contains excellent observations about the efficacy of chapter 9 and suggestions for improving the statute and its interpretation. In this Article, I build on and add to those suggestions by changing the focus a bit. Instead of trying to reform property concepts to accommodate municipal finance, I shift the focus away from property. Instead, I will illustrate that property concepts as commonly understood play a scant role in municipal finance and discuss how recognizing that fact can guide judges and policymakers in making decisions in chapter 9 cases.

To propose a different way of thinking about the relationship among creditors in a municipal bankruptcy case, this Article proceeds as follows. In Part I, I explain how bankruptcy law is based in property law and how the Bankruptcy Code partially recognizes the lack of a property foundation for chapter 9. In Part II, I explain that lack of a property foundation in greater detail and outline the statutes that provide the foundation for municipal transactions. In Part III, I explain bankruptcy policies as they relate to priorities. In Part IV, I give suggestions for determining priorities in the absence of property rights, and illustrate how the plan confirmation opinion in Detroit provides an example of how these suggestions can be carried out.

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22. *See* Nadav Shoked, *Debt Limits' End*, 102 IOWA L. REV. 1239, 1251–56 (2017) (providing an excellent summary of how states limit their municipalities' borrowing power).

23. *See infra* Part II-A.

24. *See* THE PEW CHARITABLE TRUSTS, THE STATE ROLE IN LOCAL GOVERNMENT FINANCIAL DISTRESS 18–22 (2013), http://www.pewtrusts.org/~/media/assets/2013/07/23/pew_state_role_in_local_government_financial_distress.pdf (listing laws that allow states to intervene in the financial affairs of their municipalities and explaining several examples of such laws).

25. *See infra* notes 141–156 and accompanying text.

26. *See* David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 694–97 (2012) (explaining the special priorities given by states to certain types of public debt, and observing that these priority schemes are incomplete).

I. BANKRUPTCY LAW AS PROPERTY LAW

A. PROPERTY LAW AS THE FOUNDATION OF PRIVATE BANKRUPTCY LAW

For as long as there has been bankruptcy law, there have been spirited debates about the goals and purposes of such a law. Whether one believes that bankruptcy law is an orderly process for distributing state law entitlements[27] or a system that modifies those entitlements in furtherance of bankruptcy-specific goals;[28] entitlements, defined within a property framework, lie at the heart of the debate.[29]

The Code incorporates this property foundation into its rules governing the actions of debtors and creditors in a bankruptcy case. The filing of a bankruptcy petition creates an estate comprised of all the debtor's interests in property at the moment of filing,[30] ensuring that there is a common pool of assets available to a debtor's creditors. The estate is the basis of a bankruptcy case—as Charles Tabb explains, "[t]he fundamental importance of 'property of the estate' is that it establishes the 'what' in the core question of 'who gets what' in the bankruptcy distribution."[31]

Many bankruptcy rules are designed around the estate. One category of rules is designed to preserve the estate as a common pool of assets for creditors. These rules prevent creditors from obtaining estate assets after the debtor files for bankruptcy,[32] restrict the debtor's ability to use or dispose of estate property,[33] and allow the trustee to recover for the estate pre-bankruptcy transfers that were unperfected,[34] made within a short period before the bankruptcy petition,[35] or that were deemed fraudulent.[36] Bankruptcy's rules permit one category of creditor, the secured creditor, to

27. *See, e.g.*, Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L. J. 857, 858 (1982) (providing a justification for the "time-honored proposition that non-bankruptcy entitlements, such as security interests, should be recognized in bankruptcy").

28. *See, e.g.*, Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 788 (1987) (asserting that "Congress intended bankruptcy law to address concerns broader than the immediate problems of debtors and their identified creditors . . .").

29. *See* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 824 (1987) (defining bankruptcy law as "a procedure in which the actions of those with rights to the assets of a firm are stayed and the affairs of the firm are sorted out in an orderly way"); *see* Warren, *supra* note 28, at 785 (explaining that bankruptcy disputes center on the division of an inadequate pool of assets among creditors).

30. 11 U.S.C. § 541(a) (2012).

31. CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 396 (4th ed. 2016).

32. 11 U.S.C. § 362(a) (automatic stay against all acts to obtain possession of and create, perfect, or enforce any lien against property of the estate).

33. *Id.* § 363(b)(1) (requiring court approval of certain dispositions of estate property).

34. *Id.* § 544(a)(3).

35. *Id.* § 547(b)(4)(a).

36. *Id.* § 548.

opt out of the common pool if that creditor created and perfected its interest in the debtor's assets pre-bankruptcy in accordance with state law.[37]

The second important category of property rules in the Code sets the value of property as the baseline for creditor distributions. The liquidation value of the bankruptcy estate sets the floor for distributions in both chapter 11[38] and chapter 13.[39] Although a chapter 11 plan is often the result of complex negotiations among the interested parties, the value of the estate sets the baseline for negotiations in a chapter 11 case. Chapter 11 is designed to allow the parties to negotiate over the allocation of the difference between the liquidation value and the going concern value of the debtor enterprise.[40] As a result, significant chapter 11 disputes center on valuation of the debtor firm and its assets.[41]

Some Code sections incorporate non-bankruptcy rules for division of a debtor's property. An example is the Code's treatment of security interests. Secured creditors receive the value of the assets securing their claims, and the Code recognizes that no other claims give their holders rights in specific property of the debtor.[42] Other Code sections allocate the estate's property in a bankruptcy-specific manner. To implement various bankruptcy policies, the Code sets forth priorities in distribution,[43] and in liquidation, all non-priority claims share equally in any remaining estate property, unless there is some reason, such as late filing, to subordinate the claim to other non-priority claims.[44]

The above-described components of the Code recognize that in individual and business transactions, property is the basis of payment. In those private transactions a borrower is free to give priority in the form of a security interest to a creditor, and creditors who did not receive such a priority must battle other unsecured creditors for the borrower's unencumbered property if the borrower fails to pay. The Code's priorities allow some of those unsecured creditors to obtain a greater recovery than others based on

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37. *Id.* § 541(a) brings only the debtor's interest in property into the estate, giving the secured party the value of its lien. *See also id.* § 506(a)(1) (describing the extent of a lender's secured claim); *see also id.* § 544(a)(2) (allowing a trustee in bankruptcy to set aside a security interest that was not properly perfected under the applicable state law).

38. *Id.* § 1129(a)(7)(ii) (requiring that each holder of an impaired claim that does not accept the plan of reorganization receive property worth at least as much as that creditor would have received in a chapter 7 liquidation).

39. *Id.* § 1324(a)(4) (requiring that all claim holders receive at least what they would have received in a liquidation).

40. *See* H.R. REP. NO. 95-595 (1977).

41. *See generally* Bruce A. Markell, *Fair Equivalents and Market Prices: Bankruptcy Cramdown Interest Rates*, 33 EMORY BANKR. DEV. J. 91 (2016) (discussing valuation in the cramdown context).

42. 11 U.S.C. § 506(a).

43. *Id.* § 507.

44. *Id.* § 726(a), (b).

policy decisions about the worthiness of those creditors, as I discuss in Part III-C below.

B. CHAPTER 9 PARTIALLY RECOGNIZES ITS LACK OF A PROPERTY FOUNDATION

As illustrated above, individual and business entity bankruptcy is designed to allocate a common pool of assets among the debtor's creditors. Municipal finance is not asset-based, a fact that contributed to the legislative discomfort about the desirability of including debt adjustment in a federal bankruptcy law. Lawmakers, judges, and observers have questioned the compatibility of municipal debt adjustment and federal bankruptcy law since before the enactment of the predecessor to chapter 9. In the hearings on the first attempt[45] at a municipal bankruptcy statute in 1933, several members of Congress expressed concern about the lack of a property foundation for municipal financial relief. Legislators were concerned that a municipality seeking bankruptcy would give up nothing, therefore receiving debt relief without a corresponding obligation to part with any property.[46]

These questions did not abate after Congress passed the first municipal bankruptcy law, with some observers wondering whether the purview of the Bankruptcy Clause could include a law that did not contemplate the surrender of a debtor's assets in satisfaction of creditor claims.[47] Although the scope of

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45. The United States Supreme Court struck down Congress' first attempt at a municipal bankruptcy law as an impermissible encroachment on state sovereignty. Ashton v. Cameron Cty. Water Improvement Dist., 298 U.S. 513, 531 (1936) ("If obligations of states or their political subdivisions may be subjected to [a federal bankruptcy law], they are no longer free to manage their own affairs; the will of Congress prevails over them . . . . And really, the sovereignty of the state, so often declared necessary to the federal system, does not exist."). After Congress adopted a slightly modified version of the statute, the Court upheld the power of Congress to enact a municipal bankruptcy law, holding that such a law did not violate the Tenth Amendment because, in allowing a municipality to file for bankruptcy protection, the state acts "in aid, and not in derogation of its sovereign powers." United States v. Bekins, 304 U.S. 27, 54 (1938).

46. 77 CONG. REC. 5472 (1933) ("[I]n bankruptcy proceedings heretofore the bankrupt was always compelled to give up all the property which the bankrupt possessed. In this case, the city gives up nothing at all, and tries to get out of its indebtedness."). During the same hearing, Congressman Cannon of Wisconsin read into the record a letter from the chief counsel of the Northwestern Mutual Life Insurance Co., which described the bill as a misnomer because "[i]n the bankruptcy courts the assets of a bankrupt are turned over to a trustee and disposed of for the benefit of the creditors." *Id.* at 5478.

47. *See* Harold Gill Reuschlein, *Municipal Debt Readjustment: Present Relief and Future Policy*, 23 CORNELL L.Q. 365, 371–72 n. 35 (1938); Max Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1, 9 (1940) ("Whatever purposes bankruptcy attempts to carry out, it does so by working on the creditors primarily, by *compelling* them to reorganize their relations *to the debtor or to each other in regard to the debtor's property*.") (emphasis added). Garrard Glenn posited that a law is not a bankruptcy law unless there is a controllable debtor. Along those lines, he suggested that municipal bankruptcy is not bankruptcy because there is no such control, and cites *Ashton* as confirmation of this. Control means opening up books and property to the court, primarily with the goal of exposing the fraudulent debtor. Garrard Glenn, *Essentials of Bankruptcy: Prevention of Fraud and Control of Debtor*, 23 VA. L. REV. 373, 375–77 (1937).

bankruptcy legislation has expanded beyond liquidation,[48] as explained above, the amount of property available to a debtor's creditors plays a critical role in bankruptcy law and policy. Because municipal finance is not property-based, chapter 9 lacks some, but not all, of the property preservation and distribution mechanisms that drive private bankruptcy law.

The Code acknowledges the special nature of municipal finance in its eligibility requirements for chapter 9. Unlike other Code chapters, chapter 9 places strict entry conditions on municipalities that wish to seek bankruptcy protection.[49] One is that the state in which the municipality is located give specific authorization to the municipality to file.[50] This reflects both that a municipality is a creature of the state in which it is located and, as I will discuss in Part II below, that municipal transactions are strictly defined and limited by state laws.

The insolvency requirement for eligibility also reflects the lack of a property basis in municipal finance. Unlike other debtors, a municipality that wants bankruptcy protection must prove that it is insolvent in order to file.[51] An individual or entity is insolvent when its liabilities exceed its assets.[52] The definition of insolvency for municipalities is different—a municipality is insolvent when it is either generally not paying its debts as they become due or unable to pay such debts.[53] Courts in recent chapter 9 cases have recognized that although the Code standard is a financial standard, a municipality's ability to pay debts as they become due is tied to a status unique to municipalities—the ability to provide essential government services going forward.[54] These courts have coined the term "service delivery insolvency" to describe the inability to provide these services and support a finding of insolvency as defined in the Code.[55]

A chapter 9 filing does not create a bankruptcy estate. The omission of an estate,[56] combined with explicit prohibitions on judicial interference with municipal assets and governance,[57] solidify congressional deference to a state's power over its cities. These features also reflect the reality of

48. Even a traditional reorganization could be viewed as a liquidation, however. *See* Jackson, *supra* note 27, at 893–94 (suggesting that a chapter 11 reorganization can be viewed as a liquidation in which the debtor is sold to its creditors).

49. 11 U.S.C. § 109(c).

50. *Id.* § 109(c)(3); Juliet M. Moringiello, *Specific Authorization to File Under Chapter 9: Lessons from Harrisburg*, 32 CAL. BANKR. J. 237, 244–45 (2012).

51. 11 U.S.C. § 109(c)(3).

52. *Id.* § 101(32)(A), (B).

53. *Id.* § 101(32)(C).

54. *See* C. Scott Pryor, *Who Bears the Burden? The Place for Participation of Municipal Residents in Chapter 9*, 37 CAMPBELL L. REV. 160, 164–66 (2015) (observing that "[t]he concept of service delivery insolvency . . . is of recent vintage in chapter 9 analysis").

55. *See In re* City of Detroit, 504 B.R. 191, 263–64 (Bankr. E.D. Mich. 2013); *see also In re* City of Stockton, 493 B.R. 771, 789–90 (Bankr. E.D. Cal. 2013).

56. *See* 11 U.S.C. § 901 (omitting § 541 from the Code sections included in chapter 9); *see also id.* § 902 (defining "property of the estate" as "property of the debtor" for chapter 9 purposes).

57. 11 U.S.C. §§ 903, 904.

municipal finance law. Creating an estate from which creditors can share in chapter 9 would expand the non-bankruptcy property rights of creditors, something that the bankruptcy process does not do.

The lack of creditor control over municipal property is reflected in other omissions from chapter 9. For example, chapter 9 does not require that a municipal debtor obtain court approval before disposing of property.[58] Moreover, it specifically preserves municipal control over its property.[59] Tenth Amendment aside, these omissions are rooted in the public trust nature of municipal property.

While chapter 9 omits some sections of the Bankruptcy Code that grant the court control over a municipal debtor's property, some such sections remain. For example, chapter 9 not only incorporates the Code's preferential and fraudulent transfer provisions,[60] but it also includes, as an alternative condition to filing, an attempt by a creditor to obtain a preference.[61] The essence of a preference is that the creditor receiving the preferential transfer has done something to obtain property from the common pool available to all creditors within ninety days before the debtor's bankruptcy filing.[62] If a municipality has control over its property to the exclusion of its creditors, then a preferential transfer is impossible. Chapter 9 likewise incorporates the power to avoid unauthorized post-petition transfers of municipal property.[63] Because chapter 9 does not mandate court approval of post-petition transfers and protects a municipality's control over its property from bankruptcy court interference,[64] such a transfer would never be unauthorized. Yet chapter 9 allows a court to appoint a trustee to exercise the municipality's power to avoid preferential and other avoidable transfers if the municipality itself fails to do so.[65]

Confusingly, chapter 9 incorporates two plan confirmation concepts that are well-known in other types of bankruptcy as property-based distribution concepts. A court may confirm a chapter 9 plan only if it is in the best

58. *Id.* § 901 (omitting § 363 from the list of Code sections that apply in chapter 9).

59. *Id.* § 904 (prohibiting bankruptcy court control over a municipal debtor's property without consent).

60. *Id.* § 901 (including §§ 547 and 548 in the list of Code sections applicable in chapter 9).

61. *See id.* § 109(c)(5)(D) (if a municipality has met all of the other requirements for filing but has not either obtained the agreement of creditors holding a majority of impaired claims, negotiated in good faith with its creditors pre-filing, or demonstrated that such negotiation is impracticable, a municipality may file for chapter 9 if it reasonably believes that a creditor may attempt to obtain a transfer that would be avoidable as a preferential transfer under § 547).

62. *See id.* § 547(b)(5) (including, as a necessary element of a preference, the requirement that the transfer of the debtor's property allow the creditor to receive a greater distribution in a chapter 7 case than it would have had the transfer not been made).

63. *Id.* § 901 (incorporating § 549).

64. *See supra* note 59 and accompanying text.

65. *See* 11 U.S.C. § 926; *see also* Richard M. Hynes & Steven D. Walt, *Pensions and Property Rights in Municipal Bankruptcy*, 33 REV. BANKING & FIN. L. 609, 620–28 (2014) (noting chapter 9's confusing incorporation of property-based rules and providing a detailed analysis of the facial contradictions between § 904 and the avoiding powers).

interests of creditors.[66] "Best interests" is a well-known term in bankruptcy parlance, and although the Code does not use the term in chapters 11 or 13, the requirement that a claim holder receive at least as much as it would in a chapter 7 liquidation is known as the "best interests" test.[67] Chapter 9 uses the term "best interests" without defining it.[68] Courts applying the test in chapter 9 find that the best interests test is satisfied if the creditors would receive more under the plan of adjustment than they would if the case were dismissed.[69]

Creditors sometimes argue that a plan of adjustment can satisfy the best interests test only if the municipality sells or otherwise monetizes available assets. This was a key point of contention in Detroit's bankruptcy case because of the city's ownership of the Detroit Institute of Arts.[70] Municipalities do in fact monetize assets to satisfy outstanding debts.[71] Yet, as Judge Rhodes stressed in the Detroit confirmation opinion, because the creditors would have had no ability to seize the art or any other city asset to satisfy their claims, the value of city property was irrelevant to the best interests analysis.[72]

In chapter 9 the best interests standard does not stand alone—it is paired with the requirement that the plan be feasible.[73] The common understanding of this pairing is that it provides a floor and a ceiling with the best interests test requiring only that the creditors receive at least as much as they would outside of bankruptcy (perhaps nothing) and the feasibility test preventing the municipality from promising too much.[74] In denying confirmation of a plan of adjustment, the court in *In re Mount Carbon Metropolitan District* acknowledged the difference between chapter 11 feasibility and chapter 9

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66. 11 U.S.C. § 943(b)(7).

67. *See id.* §§ 1129(a)(7), 1325(a)(4); *see also* TABB, *supra* note 31, at 1135, 1252 (explaining the best interest standard in chapters 11 and 13).

68. 11 U.S.C. § 943(b)(7).

69. *See, e.g.*, *In re* City of Detroit, 524 B.R. 147, 213 (Bankr. E.D. Mich. 2014) (defining the best interests inquiry as one in which the court must determine "whether the available state law remedies could result in a greater recovery for the City's creditors than confirmation of the plan"); *see also In re* Mount Carbon Metro. Dist., 242 B.R 18, 34 (Bankr. D. Colo. 1999) (defining the best interest standard as "requiring that a proposed plan provide a better alternative for creditors than what they already have").

70. *See, e.g.*, Brian L. Frye, *Art & the "Public Trust" in Municipal Bankruptcy*, 93 U. DET. MERCY L. REV. 627 (2016) (explaining the dispute over the Detroit Institute of Arts in the Detroit bankruptcy in detail); *see also* Jacoby, *supra* note 12, at 107 (explaining that some creditors questioned whether the "Grand Bargain" that protected the art from creditors and reduced pension cuts generated enough value for the creditors).

71. For example, Harrisburg, Pennsylvania, as part of its state-supervised non-bankruptcy restructuring, monetized its parking system to satisfy debts. *See* PENNSYLVANIA DEP'T OF CMTY. & ECON. DEV., HARRISBURG STRONG PLAN 13–21 (August 26, 2013), http://dced.pa.gov/download/harrisburg-strong-plan-pdf/?wpdmdl=57498 [hereinafter HARRISBURG STRONG PLAN].

72. *In re City of Detroit*, 524 B.R. at 218–19.

73. 11 U.S.C. § 943(b)(7).

74. 6 COLLIER ON BANKRUPTCY ¶ 943.03[7] (Alan J. Resnick & Henry J. Sommer eds., 16th ed.).

feasibility. The chapter 11 feasibility standard directs a court to confirm a plan only if the confirmation is "not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor . . . ."[75] The *Mount Carbon* court viewed this as a purely financial standard and stressed that because the purpose of chapter 9 is not profit, but the continued provision of public services, the feasibility standard must reflect that purpose.[76] The court therefore refused to confirm the proposed plan in the absence of a showing that the debtor would be able to both pay its plan obligations and provide future public services.

As is the case in chapter 11, if a class of creditors objects to the plan, the court can confirm the plan only if it does not discriminate unfairly and is fair and equitable with respect to each dissenting class.[77] The history of the "fair and equitable" standard predates corporate reorganization law, having acquired term of art status in railroad reorganizations.[78] Fair and equitable as a bankruptcy term of art is rooted in the fundamental property principle that equity holders are the residual owners of the assets of a business enterprise and therefore cannot be paid until all creditors are paid in full.[79] This principle, the absolute priority rule, is irrelevant to municipal insolvency because a municipality has no residual owners.[80]

Although chapter 9 incorporates the fair and equitable standard, it omits the definition of "fair and equitable" that most clearly does not apply to municipalities; because there are no ownership interests in a municipality, the provisions in the chapter 11 "fair and equitable" test that apply to ownership interests are not imported into chapter 9.[81] Even with that omission, however, the search for a clear fair and equitable standard in chapter 9 comes up short. Even the truncated chapter 9 fair and equitable standard references priorities that are hard to find. If a class of claims objects to the plan, the court will not confirm the plan unless either each claim in the dissenting class is paid in full or no junior class of claims receives or retains anything under the plan.[82] The concept of junior and senior claims is a priority concept, and priority is related to entitlements in a debtor's property upon liquidation of that property.[83]

75. 11 U.S.C. § 1129(a)(11).

76. *See In re* Mount Carbon Metro. Dist., 242 B.R. 18, 33–37 (Bankr. D. Colo. 1999).

77. *See* 11 U.S.C. § 901 (incorporating § 1129(b)(A) and (B)).

78. *See* TABB, *supra* note 31, at 1151–56 (explaining the history of the fair and equitable standard).

79. *See* Case v. L.A. Lumber Prods., 308 U.S. 106, 113–19 (1939).

80. *In re Mount Carbon,* 242 B.R. at 37.

81. *See* 11 U.S.C. § 901 (omitting § 1129 (b)(2)(C)).

82. *See id.* § 1129(b)(2).

83. *See In re* Frascella Enters., Inc., 360 B.R. 435, 442 (Bankr. E.D. Pa. 2007) (in discussing similarity of claims for classification purposes, the court identified the key question as "whether the claims in a class have the same or similar legal status in relation to the assets of the debtor").

C. BANKRUPTCY LAW IN THE ABSENCE OF PROPERTY

Chapter 9 cram down plans are rare, complicating the search for a fair and equitable standard applicable to municipal bankruptcies. The Detroit case illustrates how application of the standard falls apart when there are no property priorities to use as a baseline. In confirming the plan of adjustment over the objection of two classes of unsecured creditors—those with contract claims against the city, and those with statutory, tort, and constitutional claims against the city—Judge Rhodes noted that, because a municipality has no shareholders, "the absolute priority rule provides unsecured [chapter 9] creditors no protection."[84] After noting how little work an absolute priority rule does in municipal bankruptcy, he turned his focus to the language of the Code that states the fair and equitable requirement *includes* but is not synonymous with the absolute priority rule,[85] and then proceeded with an analysis that he described as shaped by the purpose of municipal bankruptcy.[86]

The analysis of the cram down standards in the Detroit confirmation opinion illustrates why the search for a proper foundation for municipal bankruptcy law is so important. In the absence of a property basis upon which to determine whether the plan did not discriminate unfairly against the dissenting creditor classes and was fair and equitable with respect to those classes, Judge Rhodes relied upon a "judgment of conscience."[87] After explaining that this judgment was informed by the purposes of chapter 9 and the court's sense of morality, he then pointed to the privileged position of pension obligations in the Michigan constitution as a reason why the plan discrimination in favor of pension creditors was justified.[88] A judgment of conscience gives no certainty to the markets and to those transacting business with a city.[89] Notice given by a state constitution, however, does.

The overall design of chapter 9 reflects the difficulty of fashioning a bankruptcy process for a debtor that has no property available to creditors exercising collection remedies. There was probably no need, however, for Judge Rhodes to even mention a judgment of conscience in approving Detroit's prioritization choices. As I will explore in the next section, municipal transactions take place in an environment defined by constitutional provisions, statutes, and payment promises that are unrelated to property

84. *In re* City of Detroit, 524 B.R. 147, 260 (Bankr. E.D. Mich. 2014).

85. *See id.*

86. *See id.* at 261 ("[T]he Court's analysis of the fair and equitable requirement must focus on the purposes of chapter 9. . . . [It] must therefore analyze whether imposing the plan on dissenting classes of creditors is an appropriate and necessary means to achieve that purpose.").

87. *Id.* at 256.

88. *Id.* at 257.

89. For a criticism of this approach that advocates for an interpretation of the fair and equitable standard that hews more closely to chapter 11 in order to provide more predictability in chapter 9, *see* Andrew B. Dawson, *Pensioners, Bondholders, and Unfair Discrimination in Municipal Bankruptcy*, 17 U. PA. J. BUS. L. 1, 5 (2014) [hereinafter Dawson, *Pensioners*].

grants. This is consistent with the nature and purposes of a municipality—it is created by the state to provide the services for which the state is responsible.[90] In private transactions it makes sense to prioritize creditors according to their property rights. In public transactions considerations not based on property concepts dictate payment priorities.

As discussed above, bankruptcy law is designed to create, protect, and divide a common pool of assets among creditors. These bankruptcy goals do not apply to municipal entities. Bankruptcy law excludes assets granted to a creditor by way of a security interest or other lien from that common pool, thus ensuring the priority of creditors who obtained pre-bankruptcy interests in a debtor's property.[91] Public debtors are unique in that their assets are not available to creditors. Not only does this limit creditor remedies against municipalities,[92] it deprives the bankruptcy system of its traditional baseline against which to measure a municipality's ability to pay creditors. The security that supports public promises to repay is not security in the form of access to property, it is security based on trust in various types of promises. The priority value of these promises is rarely if ever tested because municipalities seldom default on their obligations.[93]

The capital structure of municipalities does not mirror that of private entities. Not only do municipalities lack shareholders, they do not engage in secured lending in the same way that private entities do. The Bankruptcy Code generally respects the decisions made by individuals and business entities in granting priorities in their assets. The most important claim dichotomy in private bankruptcy distinguishes secured claims from unsecured claims.[94]

Although property lies at the core of bankruptcy procedure and policy, a bankruptcy process can operate without reference to property. For example, an important goal of individual bankruptcy is to provide relief to the honest but unfortunate debtor.[95] Bankruptcy law routinely provides this relief to

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90. *See* RICHARD BRIFFAULT & LAURIE REYNOLDS, CASES AND MATERIALS ON STATE AND LOCAL GOVERNMENT LAW 7 (8th ed. 2016).

91. 11 U.S.C. § 541 (2012) brings all "interests of the debtor in property as of the commencement of the case" into the bankruptcy estate.

92. *See* McConnell & Picker, *supra* note 4, at 429–34 (explaining that municipal assets are immune from creditor process). Municipal debtors do, however, voluntarily sell or otherwise monetize assets to satisfy creditor claims. *See In re* City of Detroit, 524 B.R. at 177–79 (explaining Detroit's "Grand Bargain" in which several foundations and the state of Michigan contributed money to transfer Detroit's valuable art collection to a non-city entity), 194–97 (explaining how Detroit transferred real estate to satisfy creditor claims); *see also* HARRISBURG STRONG PLAN, *supra* note 71, at 13–21 (explaining how the City of Harrisburg monetized its parking assets outside of bankruptcy).

93. *See generally* Pengjie Gao et al., *Municipal Borrowing Costs and State Policies for Distressed Municipalities*, J. FIN. ECON. 11 (*forthcoming* 2017), *available at* https://www3.nd.edu/~pgao/papers/muni%20default%2004-20-17.pdf (comprehensive study of municipal bonds issued between 1999 and 2010, revealing that 0.5% of such bonds experienced a default).

94. *See* 11 U.S.C. § 506.

95. *See* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

debtors with no assets to distribute to creditors.[96] The chapter 7 discharge is unrelated to how much property is distributed to creditors; so long as an individual plays by the Code's rules, that individual can emerge from bankruptcy free from the burden of her prepetition debts.[97] Another goal of bankruptcy is to deal with competing claims arising out of multiple defaults and distribute the consequences of those defaults.[98] Bankruptcy law achieves this latter goal in bankruptcies large and small through various mechanisms. In chapter 11 the debtor solicits consent for its proposed plan and in the absence of consent bankruptcy deals with the problem of holdout creditors through its cram down procedures.[99] In chapter 7 cases bankruptcy deals with multiple defaults through its distribution priorities and discharge provisions.[100]

In its original conception, municipal bankruptcy law was designed primarily to deal with the problem of holdouts.[101] This is a particularly knotty problem in the absence of a property baseline for negotiation. Chapter 11 deals with dissenting creditors by imposing a best interests test for plan confirmation that requires that each creditor who votes to reject a plan receive at least what that creditor would receive in a chapter 7 case,[102] and deals with dissenting creditor classes by imposing the absolute priority rule explained above.[103] Both of these mechanisms are based on the property rights that provide the foundation for a private capital structure. In the next section, I will discuss some of the concepts that underlie the capital structure of municipalities and their lending practices in order to search for a set of guiding principles for chapter 9 plan confirmation that recognizes the absence of property in municipal finance.

96. *See* Dalié Jimenez, *The Distribution of Assets in Consumer Chapter 7 Cases*, 83 AM. BANKR. L.J. 795, 797 (2009) (finding that 93% of individual chapter 7 debtors had no assets that could be distributed to unsecured creditors).

97. *See* 11 U.S.C. §§ 546(a) (explaining effect of discharge), 727(a) (setting forth grounds for denial of discharge).

98. *See* Warren, *supra* note 28, at 777. Whether those consequences should be distributed strictly according to state law entitlements is a matter of spirited debate. *See, e.g.*, Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 103 (1984).

99. *See* Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 663, 694–98 (2009).

100. *See* 11 U.S.C. §§ 726, 727.

101. *See* Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 362 (2010).

102. 11 U.S.C. § 1129(a)(7).

103. 11 U.S.C. § 1129(b)(2); *see also supra* notes 76–79 and accompanying text.

II. THE LACK OF A PROPERTY FOUNDATION FOR MUNICIPAL FINANCE LAW

> "To employ a seeming paradox, private municipal activities are all of them public. What has been called private in municipal activity is, nevertheless, public when contrasted with purely private enterprise and adventure."[104]

The quote above distills the problems inherent in adapting a law written to address corporate failures to municipal distress into a core issue—everything that a municipality does is directed in some way by a governmental entity and affects members of the public. When a municipal entity borrows money, buys goods, hires employees, or enters into a plethora of transactions, public policy concerns are relevant.[105] Recognizing this fact is key to providing some certainty in municipal bankruptcy outcomes. Rather than drawing analogies to secured debt and relying on judgments of conscience, courts can judge plans of adjustment based on the expectations of parties that transact with municipalities. Those expectations are based not in property rights, but on the web of promises, defined and buttressed by statutes that support municipal obligations. Although it is famously difficult to determine relative priorities in the municipal capital structure,[106] thinking of creditor priorities in terms of the strength of promises, the notice given by statutes and constitutions, and the purposes of a municipality can give some guidance in determining the fairness of creditor treatment in a chapter 9 plan of adjustment.

A. MUNICIPAL PROPERTY: THE PUBLIC TRUST AND BEYOND

Municipalities do not own property in the same way that individuals and business entities own property. Property theory is based on private ownership, and property rules protect private entitlements.[107] A municipality does not hold property for itself as an entity, it holds property for the residents of the municipality. As a result, public entities cannot lose their property rights under circumstances that would cause a private party to lose its rights.

One example of how traditional property rules protect the public interest in municipal land is found in adverse possession law. All states have a statute

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104. Wood v. Detroit, 155 N.W. 592, 596 (Mich. 1915).

105. *See* Janice C. Griffith, *Local Government Contracts: Escaping from the Governmental/Proprietary Maze*, 75 IOWA L. REV. 277, 318 (1990). For example, statutes govern transactions by public entities and require competitive bidding if the cost of a project exceeds a certain dollar amount. *See, e.g.*, IND. CODE ANN. § 36-1-12 (West 2011) (Indiana public construction law); *see also* WASH. REV. CODE § 39.04 (2008) (Washington public works law).

106. The ongoing disputes in resolving Puerto Rico's debt crisis provide an example of these difficulties. *See, e.g.*, Mary Williams Walsh, *Hedge Fund Sues to Have Puerto Rico's Bankruptcy Case Thrown Out*, N.Y. TIMES, Aug. 8, 2017, at B6 (explaining that the bankruptcy-like procedure to resolve Puerto Rico's debt problems is "extremely complex" because "the hierarchy of creditors is unclear").

107. *See* JOSEPH WILLIAM SINGER, PROPERTY 3 (5th ed. 2016) ("We tend to think of property as an individual entitlement.").

of limitations for actions to recover possession of real property. Every law student learns that if an owner of land does not take action to recover her land within the statutory period, a trespasser whose actions indicate that he is using the land productively can receive good title to the land.[108] A different rule applies to land held by public entities—all states observe the rule that title to publicly-owned land dedicated to a public purpose cannot be transferred by adverse possession.[109] Some states, however, finding the distinction between municipal land held for a public purpose and that held for a non-public purpose to be artificial, protect all publicly held land from transfer by adverse possession.[110] In several states, the statutory protection for all municipal land is explicit.[111] Yet even in some states in which statutes protect municipal land from adverse possession only if the land is held for a public purpose, courts have recognized that any municipal ownership of land is for a public purpose unless the municipality declares its intention to abandon its plans to develop the land for public use.[112] The special adverse possession rules protect the public; residents should not use the use of public assets because of the negligence of public employees.[113]

Public assets are similarly protected from the creditor process. Some point to the public trust doctrine as the basis for this protection, as did the lawyers for the Detroit Institute of Arts in arguing successfully that the court could not require sale of the city-owned art to satisfy creditor claims.[114] There is very little authority on the doctrine as it applies to protection of municipal assets from creditors; most authority on the public trust doctrine relates to protecting natural resources such as waterways and other real estate such as city parks, from private development.[115] Because of the limited scope of this authority, some have argued that the public trust doctrine has no application to chattels owned by municipalities.[116] Yet opinions protecting municipal assets from seizure emphasize that municipalities hold assets "in trust for the

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108. *See* Paula R. Latovick, *Adverse Possession Against the States: The Hornbooks Have It Wrong*, 29 U. MICH. J. L. REFORM 939, 940 (1996).

109. *See generally* Paula R. Latovick, *Adverse Possession of Municipal Land: It's Time to Protect This Valuable Asset*, 31 U. MICH. J. L. REFORM 475 (1998).

110. *See generally id.*

111. *See* N.H. REV. STAT. ANN. § 477:34 (2017) (protecting all "public ground" from adverse possession).

112. *See* American Trading Real Estate Props., Inc. v. Trumbull, 574 A.2d 796, 802 (Conn. 1990) ("[P]roperty that is held in fee simple ownership by municipalities must be presumed to be held for public use.").

113. *See* State v. Owen, 41 A.2d 809, 812 (N.J. 1945).

114. Response of the Detroit Institute of Arts to Objections to the City's Amended Plan of Confirmation at 19, *In re* City of Detroit, No. 13-53846 (Bankr. E.D. Mich. 2014).

115. For a survey of the variations on the public trust doctrine, *see* Thomas W. Merrill, *The Public Trust Doctrine: Some Jurisprudential Variations and Their Implications*, 38 U. HAW. L. REV. 261 (2016).

116. *See* Frye, *supra* note 70, at 659–60 (explaining that although the public trust doctrine should not have protected the art in the Detroit Institute of Arts, the court was correct to recognize that the city should not be forced to liquidate the art to satisfy creditor claims).

public,"[117] and that as a result, a municipality has no property that can be taken by a creditor exercising its remedies.[118] Whether a municipality owns property in public trust or not, most agree that seizure of public property by creditors would impair the ability of a public entity to carry out its obligations.[119]

The remedies available against a non-paying municipal entity reinforce the distance between property concepts and municipal finance. Even an unsecured creditor of a private actor eventually has recourse against that entity's property if any such property is available and unencumbered.[120] These property remedies do not exist against public entities. A municipality's primary asset is its taxing power,[121] but such power is not an asset that creditors can seize. Because public borrowing does not incorporate the property concepts embedded in private borrowing, the remedies for non-payment differ. Mandamus is a typical remedy in the public context.[122] Although mandamus is available, it is rarely used and somewhat ineffective. The goal of a mandamus action is to force a public official to apply the first funds received to pay creditors. Many state courts are unwilling to force a public official to do so if the result would be to pay a financial market creditor before a provider of essential services.[123] Ordinary creditors of a public entity are even worse off. Even when a statute creates a lien against a debtor's property, such statute is inoperable against public property.[124]

Hard assets of a municipality, whether real estate or chattels, enjoy some immunity from seizure by creditors. Municipal creditors therefore do not rely on these hard assets as potential payment sources. They do, however, rely on municipal revenues. As explained below, municipalities make promises to their creditors to apply some portion of their revenues to payment of their debts. The characteristics of municipal revenues are different from those of revenues of private entities, however. Municipal revenues consist of taxes, charges for using municipal assets such as sewers, and intergovernmental aid, all of which have an impact on residents, visitors, and persons employed in a

117. Meriwether v. Garrett, 102 U.S. 472, 513 (1880).

118. South Dakota v. North Carolina, 192 U.S. 286, 318–19 (1904).

119. *See* Roosevelt Park v. Norton Twp., 47 N.W.2d 605, 606 (Mich. 1951); *see also* McConnell & Picker, *supra* note 4, at 431.

120. *See supra* note 20 and accompanying text.

121. *See, e.g.*, Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 509 (1942).

122. *See* Samuel L. Bray, *The System of Equitable Remedies,* 63 UCLA L. REV. 530, 542 (2016).

123. *See* John Patrick Hunt, *Taxes and Ability to Pay in Municipal Bankruptcy*, 91 WASH. L. REV. 515, 535–37 (2016) (explaining that although a creditor can pursue a writ of mandamus to force a tax increase, mandamus is an ineffective remedy).

124. *See* City of Westminster v. Brannan Sand & Gravel Co., 940 P.2d 393, 395 (Colo. 1997) (holding that a mechanics' lien does not attach to municipal property, noting that the "rationale for the common law's exemption of public property from mechanics' liens is to preserve essential public services and functions while protecting those who benefit from public services and facilities").

municipality.[125] The next section explains how this public character of municipal revenues limits the freedom of a municipality to encumber those revenues. In the world of private transactions, property and freedom are intertwined.[126] A private borrower can easily encumber most or all of its property as security for a loan, subject to few or no legal restrictions,[127] and if that borrower cannot pay, the borrower itself bears the pain. Because municipal borrowing imposes costs on all municipal residents, public entities lack a similar freedom to use and dispose of property.

B. PUBLIC ENTITY BORROWING: THE WHY, THE HOW, AND THE COMPETING INTERESTS

Municipalities make several different types of promises when they borrow money, and state laws attempt to enhance those promises in a variety of ways. In this section, I will discuss traditional promises and protections and the more recent innovations in municipal finance. I will also discuss promises unrelated to borrowing, such as pension promises.

1. The Why

The feature that distinguishes municipal finance from other types of finance is its public purpose. The role of a municipality in providing goods and services is distinct from that of a private actor. Public entities step in to provide goods and services when private markets cannot do so.[128] Public entities are better situated to provide public goods and services than are private entities. An example is a paved road or a street light system—because everyone in the geographical area of the improvement will benefit from it, no private actor has incentive to provide it.[129] Ideally, when a public entity provides public goods and services, it does so in furtherance of its "cardinal civic responsibilities" to protect the health, welfare, and safety of its citizens.[130]

The policy statement above pervades, informs, and shapes the statutes governing municipal debt. Unlike a private enterprise, a municipality is

125. For a discussion of local government revenue sources, *see* M. David Gelfand, *Comparative Urban Finance: Are the London and Brooklyn Bridges Falling Down?*, 55 TUL. L. REV. 651, 676–90 (1981).

126. *See* Jedediah Purdy, *A Freedom-Promoting Approach to Property: A Renewed Tradition for Old Debates*, 72 U. CHI. L. REV. 1237, 1252 (2005) (explaining Adam Smith's description of commercial relationships as "those founded on private property, mediated by contract, and bounded by exit").

127. Steven L. Harris & Charles W. Mooney, Jr., *A Property Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2021–22 (1994) (an article in which the two reporters for the revision of Article 9 of the Uniform Commercial Code describe debtor freedom to encumber property as an important Article 9 policy).

128. *See* ROBERT AMDURSKY ET AL., MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE § 1.1.1 (2d ed. 2015).

129. *See id.*

130. Dep't of Revenue of Ky. v. Davis, 553 U.S. 328, 342 (2008).

limited in its ability to increase revenues. A municipality's ability to increase its revenues is restricted by its local boundaries.[131] Municipalities pay their obligations primarily from tax revenues, and because of the effect that tax rates have on taxpayers, municipal lending takes place in a heavily regulated environment. State constitutions permit a municipality to incur debt only for a public purpose.[132] Because a municipality may increase taxes to make bond payments, it would be considered unjust to make the public at large pay for a project for which it gains no benefit.[133] Municipalities fund their public obligations by collecting taxes so states limit the amount of debt that a municipality may incur in order to insulate future taxpayers from decisions in which they played no part.[134] Municipal debt receives favorable tax treatment because of its public purpose. The funded improvements further the entity's social obligations, and as a result, municipal bonds are generally tax-exempt. Because of this exemption, the federal government and states forgo revenue in furtherance of a social good.[135]

The public purpose of municipal debt not only drives limitations on public debt but also limits the remedies to which municipal creditors can resort. Creditors of private entities have recourse to the entity's property in the event of non-payment.[136] As discussed above, creditors of public entities do not.[137] Access to property is a key feature in the design of creditors' rights laws, but municipal creditors have no rights to their debtors' assets. This reality takes property out of the laws governing creditors' remedies and also removes it as a bankruptcy distribution baseline.

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131. *See* Richard Briffault, *The Local Government Boundary Problem in Metropolitan Areas*, 48 STAN. L. REV. 1115, 1129 (1996) (explaining that local governments receive most of their revenue from taxes rather than from higher levels of government).

132. James A. Coniglio, *Borrowing Authority of State and Local Governments: State Debt*, in 1 STATE AND LOCAL GOVERNMENT DEBT FINANCING § 1.4 (2d ed.) (database updated Nov. 2016).

133. *See* AMDURSKY ET AL., *supra* note 128, at § 3.1.

134. *See* Lonegan v. State of N.J., 819 A.2d 395, 402–03 (N.J. 2003) (explaining that New Jersey adopted its debt limitation in 1844 to protect future generations of taxpayers and to rein in unchecked speculation by the state); *see also* AMDURSKY ET AL., *supra* note 128, at § 4.1.1; *see also* Stewart E. Sterk & Elizabeth S. Goldman, *Controlling Legislative Shortsightedness: The Effectiveness of Constitutional Debt Limitations*, 1991 WIS. L. REV. 1301, 1315–16 (surveying different types of debt limitations).

135. *See* Fox v. U.S., 397 F.2d 119, 122 (8th Cir. 1968) (explaining that the federal tax exemption for public debt reflects "a fundamental long-standing policy of Congress that the federal government shall not impose any restraint on the borrowing power of the states or their political subdivisions for public use and benefit").

136. *See, e.g.*, U.C.C. § 9-601(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010) (allowing a secured creditor to foreclose on collateral in the event of a debtor default).

137. *See, e.g.*, Meriwether v. Garrett, 102 U.S. 472, 513 (1880); *see also* Little River Bank & Trust Co. v. Johnson, 141 So. 141, 143 (Fla. 1932) (defining protected public property as that property "absolutely essential to the existence of the public corporation, or necessary and useful to the exercise and performance of governmental powers, or the performance of governmental duties"); *supra* notes 114–124 and accompanying text.

2. Public Borrowing: Promises Not Property

"Debt," as defined in municipal finance rules, is not debt as commonly understood in the commercial world. This is an important point to consider—bankruptcy law is written on a foundation of private contracts; public contracts use a different language and are subject to a distinct set of rules. Commercial parties understand debt to mean any obligation to pay. The municipal finance definition of debt is rooted in the effect of municipal debt on the public.[138] Debts subject to constitutional or statutory debt restrictions are those that may result in a tax increase. Other obligations, such as those payable from specific revenues and those payable from annual budget appropriations, are not considered "debt" for the purpose of debt limitation clauses.[139] A commercial lawyer tends to think of all of these obligations in terms of the property, or lack of property, supporting them. In the absence of a property grant, all are unsecured. Municipal finance, by contrast, distinguishes among promises. Some promises are understood to provide high assurance of payment, like the full faith and credit promise; others provide less certainty, like the appropriations promise.[140]

a. The General Obligation Promise

The markets have long considered general obligation bonds to be fail-safe. Municipal finance participants describe general obligation bonds as being backed by a *pledge* of the issuer's full faith and credit, its taxing power, or both.[141] Both the grant and the promised security are not security as commonly understood by commercial lawyers. In the commercial world, a grant of security carries with it a remedy against the property interest pledged. A full faith and credit pledge, on the other hand, does not grant the recipient a lien on any municipal property.[142] Instead, the full faith and credit pledge is couched in the contract language of obligation. According to one court, a full faith and credit provision "does no more than express an understanding and appreciation of the legal obligation to pay the bond according to its terms."[143] Moreover, this pledge is limited by governing law. Most states

138. *See* Burgos v. State, 118 A.3d 270, 291 (N.J. 2015) (stating that debt limits exist to "save the state from itself" and protect future taxpayers from legislative acts).

139. *See, e.g.*, Wilmington Med. Ctr., Inc. v. Bradford, 382 A.2d 1338, 1346–47 (Del. 1978) (explaining that there is no pledge of state credit without incurring a liability backed by the taxing power of the state); State Hwy. Comm'r v. Detroit City Controller, 49 N.W.2d 318, 325 (Mich. 1951) (explaining that obligations payable out of specific non-tax revenues are not debt subject to statutory and constitutional debt limits); *see also* Shoked, *supra* note 22, at 1253–54.

140. *See* Lonegan v. State of N.J., 819 A.2d 395, 406 (N.J. 2003) (acknowledging that the payment of appropriations debt was "highly likely" if only to protect the state in the bond market).

141. NAT'L ASS'N OF BOND LAW., GENERAL OBLIGATION BONDS: STATE LAW, BANKRUPTCY, AND DISCLOSURE CONSIDERATIONS (Aug. 2014), http://www.nfma.org/assets/documents/other.orgs/nabl.gobonds.8.14.pdf [hereinafter GENERAL OBLIGATION BONDS].

142. *See* State *ex rel.* Babson v. Sebring, 155 So. 669, 672 (Fla. 1934).

143. *See id.* The bonds in the cited case pledged the city's full faith, credit and resources. Even the pledge of resources did not create a lien on the municipality's property.

place a cap on the amount of debt that their municipalities can incur, often expressed as a percentage of the value of that municipality's taxable real estate. An issuer cannot be forced to raise taxes above these statutory limits.[144] In the municipal finance world, the pledge of full faith and credit and/or taxing power is a promise that can be enforced only by a mandamus action.

General obligation bonds embody contract promises. As such, they are protected by the Contracts Clause of the Constitution.[145] Courts have made clear the difference between a full faith and credit pledge and a mortgage granted by an individual or business, affirming that a full faith and credit pledge conveys no property interest.[146]

The concept of a general obligation bond is not a monolithic one. Variations include the unlimited tax general obligation (UTGO) bond, the limited tax general obligation bond (LTGO), and the general fund general obligation bond (GFGO). The nature and effect of these designations vary from state to state, but unlike general obligation bonds payable from an issuer's general fund, UTGO and LTGO bonds are backed by a promise to levy taxes.[147] In the Detroit bankruptcy, bondholders and the city fought over whether the UTGO and LTGO obligations were "secured,"[148] mapping commercial lending terms onto public finance instruments whose safety is not based on a property grant but rather on the types and amounts of taxes that can be used to pay the obligation.

b. Revenue Bonds Distinguished

Reading chapter 9 of the Bankruptcy Code, one would think that there are only two types of municipal debt: special revenue debt and other. This binary distinction mirrors the secured/unsecured distinction in other types of bankruptcy. Although on the one hand, this distinction is not the crucial one in municipal financing, the fairly detailed (in chapter 9 terms) treatment of special revenue bonds emerged from a concern that the Bankruptcy Code did not take the realities of municipal finance into account. The Code treats revenue bonds as secured debt, and when Congress revised the Bankruptcy Code in 1988, it took the needs of the municipal market into account in protecting the security interest created by revenue bonds. The Senate Judiciary Committee report specifically notes the difficulties and bad results

144. Shoked, *supra* note 22, at 1253.

145. U.S. CONST. art. I, § 10, cl. 1.

146. *See* State *ex rel.* Dos Amigos v. Lehman, 131 So. 533, 538 (Fla. 1930). Courts in other states have reinforced the principle that a faith and credit pledge creates a contractual pledge unsupported by any property interest. *See* Flushing Nat'l Bank v. Mun. Assistance Corp., 358 N.E.2d 848 (N.Y. 1976) (holding that the state's Emergency Moratorium Act, which suspended the right of certain bondholders to enforce their debts, violated the New York Constitution).

147. GENERAL OBLIGATION BONDS, *supra* note 141, at 4.

148. *See In re* City of Detroit, 524 B.R. 147, 187–90 (Bankr. E.D. Mich. 2014) (explaining creditor's argument that the UTGO bonds were special revenue bonds).

"created by the incorporation of general commercial finance concepts into the municipal bankruptcy provisions."[149] A security interest in special revenues extends to such revenues generated after the commencement of the bankruptcy case.[150] This rule is contrary to the rule that applies in all other types of bankruptcies—the floating lien does not float, and property received by the debtor post-petition is free from pre-petition liens.[151] This reflects the realities of municipal finance practice: holders of special revenue bonds look to only one source of payment. That source is the revenue stream generated by the project financed. The bondholders have no recourse whatsoever against the municipal entity if the funds turn out to be insufficient. Congress also protected special revenue obligations from the automatic stay and made clear that bankruptcy law could not transform a special revenue obligation into a general obligation of the municipality.[152]

Special revenue bonds are secured in the way that commercial lawyers understand the term "secured debt." The commercial definition of secured debt assumes that there is a defined property interest that is pledged to a creditor to secure the payment of an obligation.[153] The definition of security interest includes the sale of accounts receivable, which is probably the best analogy to a special revenue pledge.[154] Just as in a sale of accounts, the security pledge in a special revenue bond is non-recourse. When a loan to a municipality is secured by a special revenue pledge, the municipality commits to pay all the revenues generated by a specific project in excess of amounts needed to operate the project. If the municipality fails to remit the revenues to the bondholders, the bondholders have remedies with respect to those revenues.[155]

In its pure form, the revenue bond does not put a municipality's taxpayers at risk because payment is made solely from revenues generated from a specific project. For this reason, revenue bonds are exempt from constitutional debt limits.[156] This is a key point to keep in mind as parties argue over whether various types of general obligation bonds should be treated as secured by a tax pledge. Revenue bonds are protected as secured precisely because their risk is directly related to the financed project. Even

149. S. REP. NO. 100-506, at 4 (1988).

150. *See* 11 U.S.C. § 928 (2012).

151. *See id.* § 552(a).

152. *See id.* §§ 922 (excepting the application of pledged special revenues from the operation of the automatic stay), 927 (denying the holders of special revenue obligations the ability to be treated as holders of recourse obligations under § 1111(b) of the Code).

153. U.C.C. § 1-201(b)(35) (AM. LAW INST. & UNIF. LAW COMM'N 2010) (defining security interest as "[a]n interest in personal property or fixtures which secures payment or performance of an obligation").

154. *Id.*

155. Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1049–50 (1997).

156. AMDURSKY ET AL., *supra* note 128, at § 1.3.

revenue bonds are secured only by a stream of income from a project, not by the physical project itself.

3. Beyond General Obligation and Revenue Bonds

A comparison of general obligation and revenue bonds illustrates how market expectations in the municipal context are sometimes the reverse of those in the commercial context. Market participants consider general obligation bonds to be safe because there are numerous payment sources available for their repayment.[157] Revenue bonds are considered less safe because they are payable out of a distinct set of funds. Yet revenue bonds are secured by a property right in the form of a dedicated source of funds. They are non-recourse, however, so unsatisfied creditors may not proceed against other funds of the municipality. Increasingly, or most notably in the recent distress cases of Detroit and Harrisburg, local governments have been engaging in the sorts of practices that marked the subprime lending crisis. Just as homeowners could buy a previously unaffordable house by deferring the obligation to pay as long as possible, municipalities engaged in a number of lending practices that deferred the obligation to pay as long as possible. One example of a debt obligation that provides no new value to the municipality is the "scoop and toss" refunding. Such refunding allows an issuing municipality to defer imminent debt service and add it to the back end of the debt service schedule. Municipalities in distress tend to engage in a series of such refunding, resulting in a very large debt over time.[158] Other financing arrangements that may ultimately harm municipalities include swaptions and capital appreciation bonds.[159] Moreover, sometimes municipalities find creative ways to avoid clear statutory restrictions on their transactions.[160]

4. The Competing Interests

Priorities matter only when a municipality falls into distress. It is only at that point when we see questions about whether a bondholder will be paid

157. *Id.* at § 1.3.3.

158. *See* David Unkovic, Municipal Financial Distress: Causes and Solutions 8, presented at The Bond Buyer's Second Symposium on Distressed Municipalities, March 2013 (explaining how the debts of a Pennsylvania school district increased exponentially through the use of exotic financial instruments).

159. For an explanation of a variety of potentially abusive financing arrangements, *see* Tom Sgouros, *Predatory Public Finance*, 17 J.L. SOC'Y 91 (2015).

160. The forensic audit conducted of the City of Harrisburg's finances during its state-supervised recovery provides some examples. A notable one relates to the contract to retrofit the trash-to-energy incinerator whose debt was guaranteed by the city. The city awarded the contract without a competitive bidding process and failed to require a performance bond from the contractor, relying instead on "alternative security." *See* DOUGLAS F. SCHLEICHER ET AL., THE HARRISBURG AUTHORITY RESOURCE RECOVERY FACILITY FORENSIC INVESTIGATION REP. 22–25, 66–67 (Jan. 12, 2012), http://harrisburgcitycontroller.com/wp-content/uploads/Harrisburg-Report.pdf.

before firefighters or police. Local governments exist for several reasons: they provide services, they hold land in the public interest, and they regulate for public health, safety, and welfare.[161] The obligations of local governments are labor-intensive, therefore they will have large obligations for salaries, pensions, and health benefits. Like general obligation bonds, all of these service claims on municipal resources are unsecured in the commercial or property sense.

A significant creditor class in chapter 9 bankruptcies is made up of individuals holding pension claims. Like the claims of general obligation bondholders, these claims are not supported by any property, and should, to a commercial lawyer, be viewed as unsecured claims.[162] Yet, as is the case with bond obligations, most states make special provisions for these obligations either in their statutes or in their constitutions. The constitutions of several states provide that pension benefits "shall not be impaired."[163] To further enhance the security of pension benefits, state laws contain pension funding mandates.[164]

Another common creditor class in the larger general-purpose municipality bankruptcies is the class of individuals holding civil rights claims. Numerous laws aimed at protecting vulnerable individuals bind cities.[165] Yet because municipal obligations to persons harmed by municipal actors are not backed by any property, courts tend to view these as low-level claims undeserving of any special priority.[166]

161. *See* Comm'rs of Albany Cty. v. Laramie Cty., 92 U.S. 307, 308 (1875) ("Counties, cities and towns . . . are usually invested with certain subordinate legislative powers . . . to promote the general welfare of the municipality."); *see also* Michelle Wilde Anderson, *The New Minimal Cities,* 123 YALE L.J. 1118, 1158 (2014).

162. *See* Jack M. Beermann, *Solving the Public Pension "Crisis*,*"* 41 FORDHAM URB. L.J. 999, 1002–04 (2014) (explaining how the Central Falls, Rhode Island chapter 9 plan of adjustment favored bondholders over pension creditors and acknowledging that both groups of creditors were unsecured).

163. *See* Darryl B. Simko, *Of Public Pensions, State Constitutional Contract Protection, and Fiscal Constraint*, 69 TEMP. L. REV. 1059 (1996) (explaining the constitutional protections in several states).

164. Such mandates often prove unenforceable and the failure to comply has led to drastically underfunded pensions throughout the United States. For a discussion of these mandates and the woeful state of pension funding despite these mandates, *see generally* Amy B. Monahan, *State Fiscal Constitutions and the Law and Politics of Public Pensions,* 2015 U. ILL. L. REV. 117 (2015).

165. For an overview, *see* Melissa B. Jacoby & Mary Ellen Goode, *Who Pays for Police Misconduct in Bankrupt Cities?*, (UNC Legal Studies Research Paper No. 2796582, 2017), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2796582.

166. *See In re* City of Detroit, 524 B.R. 147, 258–59 (Bankr. E.D. Mich. 2014) (confirming chapter 9 plan over the objection of the class of civil rights claimholders, explaining that there is no "mission-related justification" for the city to discriminate in their favor); *see also* Silver Sage Partners, Ltd., v. City of Desert Hot Springs, 339 F.3d 782, 791–92 (9th Cir. 2003) (addressing the intersection of the Federal Fair Housing Act and chapter 9 bankruptcy and concluding that "there is no evidence that Congress felt that the objectives of the former were more important than the latter").

In the next section of this Article, I discuss bankruptcy policies to illustrate how Congress assigned priorities in the Bankruptcy Code. This discussion will lay the foundation for a discussion of the policies that can inform the assignment of priority treatment in any federal procedure for municipal debt resolution.

III. BANKRUPTCY POLICIES AND PRIORITIES

Creditors of individuals and private entities have a number of methods by which they can ensure that their claims are paid before others outside of bankruptcy. The first is to ensure that the debtor's assets are partitioned in such a way that no other creditors can have a plausible claim to them.[167] Another is to obtain a property interest in the debtor's assets. Last is to be a beneficiary of a statutory or constitutional priority. This last category includes statutes that grant property interests in the debtor's assets, such as mechanics' lien statutes. The Bankruptcy Code respects the first two methods, and although it recognizes statutory liens, it allows the trustee to set aside certain statutory liens as contrary to bankruptcy policy.[168]

Bankruptcy law's distinctions amongst creditors are rooted in the non-bankruptcy borrowing and lending practices of individuals and business entities. In the private realm, bankruptcy respects the choice to partition property in such a way as to elevate one creditor over another, but does not provide the same protection to contractual promises that do not include the grant of a property interest.[169]

Although bankruptcy rules are based on property concepts, in a large percentage of individual bankruptcies there is no property to distribute. Even in those bankruptcies, there is a notion of "worthier" promises that is embodied in the Bankruptcy Code through the statutory priorities and the rules on non-dischargeability.[170] As a result, bankruptcy priority rules reflect the realities of finance and incorporate distinct bankruptcy policies and values.

Bankruptcy rules reflect several core goals and values. The Code's rules promote an orderly and collective debt relief proceeding that provides predictability to markets and transacting parties. The stay of collection proceedings that arises immediately upon the filing of a bankruptcy petition

167. David Skeel has explored the various types of liens and lien substitutes. *See* Skeel, *supra* note 19, at 680.

168. Even state laws that grant liens to creditors can be disregarded in bankruptcy. *See* 11 U.S.C. § 545 (2012) (allowing the trustee to set aside landlord's liens and statutory liens that arise upon bankruptcy).

169. For example, a debtor may give a "negative pledge" promise to a creditor, whereby it promises not to grant security interests in its property to other lenders. Although this is a binding contractual obligation, the law does not consider it to be the same as a security interest in the debtor's property. *See* Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property, and Perfection*, 84 CORNELL L. REV. 305, 306–07 (1999).

170. 11 U.S.C. §§ 507, 523.

promotes orderliness.[171] The migration of causes of action to one forum, the Bankruptcy Court, as well as rules ensuring the equal treatment of similarly situated creditors promotes the collective nature of the proceeding.[172] The Bankruptcy Code promotes predictability by setting forth clear priorities.[173] Bankruptcy's predictability also springs from its uniformity, but the constitutional uniformity mandate requires only that debtors within each state be treated uniformly, not that debtors nationwide be treated in a uniform manner.[174] Bankruptcy provides debt relief through discharge, and solves the holdout problem through its cram down provisions.[175] All of these goals can be accomplished without reference to property rights.

A. First-Level (Property-Based) Priorities: Secured and Unsecured Claims

In private bankruptcies, the Code respects private finance practices in granting the first level of priority to security interests. Commercial law rules tend to turn on whether a party has property rights in an asset. They also tend to differentiate between property and contract rights, without acknowledging the blurred line between the two.[176] The only way that a creditor can ensure itself of full payment in bankruptcy absent a Code priority is by obtaining a security interest in some of the debtor's assets.[177] This security interest can either be a consensual one created by contract or one granted by statute.[178] One reason that the Code respects security interests is the Fifth Amendment to the Constitution, which prohibits the taking of private property without just compensation.[179]

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171. *See id.* § 362.

172. *See id.* §§ 726(b) (mandating pro rata sharing), 1122 (allowing a chapter 11 debtor to place claims in the same class only if the claims are substantially similar).

173. *See id.* § 507.

174. *See id.* § 522(b)(2) (recognizing that a state may require that individual debtors take advantage of state property exemptions rather than federal property exemptions); *see also* Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 190 (1902) (The bankruptcy system is uniform in the constitutional sense when "the trustee takes in each State whatever would have been available to the creditors had the bankrupt law not been passed.").

175. 11 U.S.C. §§ 524, 1129.

176. Several authors have explored the edges of this distinction. *See, e.g.*, Bjerre, *supra* note 169; *see also* Peter Coogan et al., *The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements*, 79 HARV. L. REV. 229 (1965).

177. *See* Ohio v. Kovacs, 469 U.S. 274, 286 (1985) (O'Connor, J., concurring).

178. *See id.*

179. U.S. CONST. amend. V. There has been robust debate, however, about both the Fifth Amendment foundations of the primacy of secured credit in bankruptcy and its desirability from a business perspective. *See, e.g.*, Steven L. Harris & Charles W. Mooney, *Measuring the Social Costs and Benefits and Identifying the Victims of Subordinating Security Interests in Bankruptcy*, 82 CORNELL L. REV. 1349 (1997) (suggesting that the costs of subordinating security interests in bankruptcy would impose unacceptable costs and burdens on commercial transactions); *see also* Lawrence L. Ponoroff & F. Stephen Knippenberg, *The Immovable Object Versus the Irresistible Force: Rethinking the Relationship between Secured Credit and Bankruptcy Policy*, 95 MICH. L.

On the first level, commercial law recognizes secured and unsecured debt, and nothing in the middle.[180] Those who have explored negative pledges in depth decry the bipolar distinction between secured and unsecured creditors, claiming that there are several status positions between the two poles.[181] The negative pledge calls up the distinction between property and contract, and thus the priority questions, that are raised by various promises in municipal bonds.

The Code singles out security interests for protection both because of Fifth Amendment concerns and respect for commercial practices. Bankruptcy law has not always rejected state law non-property priorities. Until the Chandler Act in 1938, federal bankruptcy law incorporated non-property priorities provided for by state law.[182] Fearing that honoring such priorities would leave little or nothing for a debtor's unsecured creditors, the Chandler Act shifted the state priority focus to liens.[183] As a result, today's bankruptcy law honors state property priorities but not other state-created priorities. Yet liens play no role in municipal finance, except for in revenue bond financing. Although some states have passed laws granting general obligation bondholders a lien on taxes,[184] liens, and lien analogies, may not be a useful tool in determining municipal priorities.

Although holders of secured claims have top priority in a debtor's assets, they are not the only favored parties in bankruptcy. Statutory priorities ensure payment to certain favored creditors in reorganizations, and non-dischargeability provides some protection to others in the absence of property.

B. SECOND-LEVEL PRIORITIES AMONG UNSECURED CREDITORS: THE WORTHY

1. Priorities as an Expression of Worthiness

Property priorities are the only state law priorities incorporated in the Code. In individual and business entity cases, the Code grants non-property priorities to certain unsecured creditors based on various notions of creditor

REV. 2234, 2236 (1997) (acknowledging the tension between state law under Article 9 of the Uniform Commercial Code, which permits a debtor to fence off all of its property, and the rehabilitative policies of the Bankruptcy Code); *see also* Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1375 (1997) (questioning why the law would permit two parties, by contract, to bargain away rights of a party not at the bargaining table).

180. *See* Bjerre, *supra* note 169, at 313.

181. *Id.*

182. *See* Hynes & Walt, *supra* note 65, at 645 (explaining that the Bankruptcy Act of 1898 before the Chandler Act amendments included a fifth priority to "persons entitled to priority by state or federal non-bankruptcy law").

183. *See* Skeel, *supra* note 19, at 682.

184. *See id.*

worthiness. If an insolvent debtor, by definition,[185] does not have sufficient assets to pay the claims against it in full, then some of its creditors will not receive full payment of the claims against them. As a result, the Code provides that specified creditor claims must be either paid before all others (in the case of a chapter 7 liquidation),[186] or paid in full in order for a plan to be confirmed (in the case of repayment/reorganization bankruptcies).[187] These "worthy" claims include those of employees, ex-spouses for alimony and support, and governments for taxes.[188]

Where unsecured creditors are concerned, the only categorical priorities permitted are the ones set forth in the Bankruptcy Code. In the Code chapters governing private bankruptcies, which incorporate priorities, courts may not fashion their own using equitable principles.[189] Chapter 9 contains only one priority, however, that for administrative claims.[190] The reasons for omitting the other priorities are unclear but may arise from Tenth Amendment concerns.[191] The absence of priorities in chapter 9 may give courts the flexibility to fashion priorities based on the statutory protections given to some types of municipal obligations by state and federal law.

2. Non-Dischargeability as an Expression of Worthiness

The Code also incorporates the idea of worthier promises through its rules on dischargeability. The goal of all (non-municipal) bankruptcies is to discharge all pre-bankruptcy debt, but the Code excepts some debts incurred by individuals from discharge either because the debt arose out of bad debtor behavior or because the creditor is particularly deferring of repayment.[192] Some examples from individual bankruptcy include student loan debt and debts for domestic obligations.[193] The dischargeability rules demonstrate the policy that some debts should simply not be avoided through the use of the bankruptcy process.

185. *See* 11 U.S.C. § 101(32) (2012) (defining insolvency for all debtors other than a municipality and a partnership as a "financial condition such that the sum of such entity's debts is greater than all such entity's property").

186. *Id.* § 726(a).

187. *See id.* §§ 1129(a)(9), 1322(a)(2).

188. *Id.* § 507(a).

189. *See generally* United States. v. Noland, 517 U.S. 535 (1996).

190. 11 U.S.C. § 943(b)(5).

191. *See* Dawson, *Pensioners*, *supra* note 89, at 7–9 (cataloguing a number of possible reasons for the omission of priorities from chapter 9).

192. Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1056–58 (1987).

193. *See* 11 U.S.C. § 523(a)(5).

C. RARELY-USED NON-PRIORITIES: THE UNWORTHY

The Bankruptcy Code reserves a place for the unworthy creditor by the vehicle of equitable subordination.[194] Equitable subordination is a close relative of equitable reclassification, in which a capital contribution by an insider designed as a loan is re-cast as an equity investment.[195] The effect of such a reclassification is to subordinate the insider to creditors.

Equitable subordination is rarely used, and when it is, it remains twinned with equitable reclassification in the sense that courts are reluctant to use the tool to subordinate outside creditors.[196] Yet this too could be a useful tool in municipal bankruptcy cases, particularly when city actors fail to comply with laws in such a way that their actions harm taxpayers.

IV. APPLYING BANKRUPTCY RULES TO MUNICIPAL ENTITIES IN THE ABSENCE OF PROPERTY RIGHTS

A. THE ROLES OF FEDERAL AND STATE LAW IN PROVIDING A FOUNDATION FOR BANKRUPTCY DISTRIBUTION

Some of the goals of municipal bankruptcy are identical to those of individual and corporate bankruptcy. Any municipal insolvency regime should provide predictability and certainty, establish a binding collective proceeding, eliminate debt overhang, and solve the problem of holdout creditors. Federal law provides the procedure to carry out these goals.

State law, however, provides the substantive foundation on which the process to achieve these goals operates. State property rules pervade private bankruptcy; although federal law determines whether a debtor's rights in property enter the bankruptcy estate, the rights themselves are defined by state law.[197] Congress' constitutional authority to enact "uniform Laws on the subject of Bankruptcies throughout the United States"[198] is also constrained by state choices. Long ago, the Supreme Court ruled that bankruptcy uniformity means uniformity within a state.[199] In the private realm, this insures that the bankruptcy process will, at the moment a debtor

194. *See id.* § 510(a).

195. *See* Lawrence Ponoroff, *Whither Recharacterization*, 68 RUTGERS L. REV. 1217, 1228–31 (2016) (explaining the history of recharacterization).

196. I explore the use of equitable subordination in more detail in Juliet M. Moringiello, *Mortgage Modification, Equitable Subordination, and the Honest But Unfortunate Creditor*, 79 FORDHAM L. REV. 1599 (2011), in which I advocate for its use to punish subprime mortgage lenders.

197. 11 U.S.C. § 541(a); Butner v. United States, 440 U.S. 48, 54 (1979); *see generally* Juliet M. Moringiello, *When Does Some Federal Interest Require a Different Result: An Essay on the Use and Misuse of* Butner v. United States, 2015 U. ILL. L. REV. 657 [hereinafter, Moringiello, *Federal Interest*].

198. U.S. CONST. art. 1, § 8, cl. 4; *see also* Gillette & Skeel, *supra* note 13, at 1210 (explaining that Congress enacted chapter 9 under the Bankruptcy Clause).

199. *See* Stellwagen v. Clum, 245 U.S. 605, 613 (1917).

enters bankruptcy, respect the choices that states make with regard to property rights. Bankruptcy law can modify those rights, but the question of whether those rights exist at all is a matter of state law.[200]

The state plays a large role in municipal bankruptcy. The state has the first say on whether and how a municipality can file for bankruptcy,[201] and it also has the only say as to whether a municipal government will receive any oversight in the chapter 9 process.[202] In another Article, I questioned whether bankruptcy courts should defer to state choices regarding the treatment of municipal creditors.[203] The bankruptcy system should incorporate state choices insofar as they govern how a municipality can borrow money. If a statute or constitutional provision sends a signal to third parties that the recipient of the payment promise is more likely to receive full payment than other promises, courts in chapter 9 should respect that signal in much the same way as they respect the signal sent by a perfected security interest. In the next section, I illustrate how Judge Rhodes incorporated some of those signals in approving the Detroit plan of adjustment.

B. PRIORITIES IN THE ABSENCE OF PROPERTY: DETROIT AS AN EXAMPLE

It is easy to administer a priority system based on property rights. Because property rights generally must be publicized in order to carry with them priority rights, it is fairly simple to determine who has the prior right to a debtor's property.[204] Filing in a public place is not the only way to give notice of a property right; the Code likewise honors liens created by statute and by judicial processes that require a public official to seize an asset in order to fix a judgment creditor's rights in the asset.[205] One benefit of recognizing primarily property-based priorities is the notice function that property plays. Throughout the law of property, a holder of rights can be certain that those rights will be good against the entire world only if there is some notice of them. Bankruptcy law recognizes these notice rules; a holder of an unperfected security interest will likely end up unsecured in bankruptcy.[206]

In the municipal world, however, property rights and priority rights are uncoupled. No creditors have a right to municipal property to satisfy their

200. *See generally* Moringiello, *Federal Interest*, *supra* note 197 at 659.
201. *See* 11 U.S.C. § 109(c)(1).
202. *See supra* notes 6–9 and accompanying text.
203. *See generally* Juliet M. Moringiello, *Chapter 9 Confirmation Standards and the Role of State Choices*, 37 CAMPBELL L. REV. 71 (2015).
204. *See* U.C.C. §§ 9-317, 322 (AM. LAW. INST. & UNIF. LAW COMM'N 2010) (granting priority to perfected security interests), 9-501 (requiring filing in a public office).
205. *See* 11 U.S.C. §§ 101(36) (defining judgment lien), (37) (defining lien), (53) defining statutory lien), 506(a) (recognizing the secured status of lienholders).
206. *See* 11 U.S.C. §§ 544, 545.

claims.[207] Both bankruptcy and state law provide methods for fixing creditor priorities in the absence of property rights. The Detroit confirmation opinion is replete with references to statutory signals that gave some creditors a greater expectation of payment than others. Although Judge Rhodes stated that determining whether the plan of adjustment discriminated unfairly against certain classes of creditors involved a judgment of conscience, he in fact relied on signals provided by Michigan statutory law to justify higher payments to some creditor classes. For example, he pointed to the pension protections in the Michigan constitution to justify higher payments to pension creditors, noting that the Michigan constitution gave notice to all creditors that pension obligations were entitled to special treatment.[208]

Judge Rhodes relied on similar signals in approving the favorable treatment of the UTGO and LTGO bondholders. The UTGO creditors and the city argued over whether the UTGO claims were secured by tax revenues. A Michigan statute required voter approval for the additional taxes levied to pay the bond debt and also required that the city keep the proceeds of those taxes in a segregated account.[209] Whether this requirement created a statutory lien is perhaps irrelevant; the statute sends a message to the creditor community that the UTGO bondholders had a greater chance of repayment. The LTGO creditors argued that a statute requiring the city to set aside sufficient tax revenues to make payments on the bonds as a "first budget obligation" gave them priority over the holders of other unsecured claims.[210] Although Judge Rhodes recognized that the relative priorities granted to the UTGO and LTGO bondholders by statute was unclear, he deferred to the city's view that the statutes gave the UTGO bondholders a "more robust" claim to full payment than the LTGO bondholders.[211]

Notice in municipal finance is not as clear as the notice given by the laws governing security interests in real and personal property. It is possible, however, to allocate priorities based on the requirements placed on a bond issuer by statute. To do so, it is necessary to consider the effect of statutory payment provisions both on the issuer, in terms of whether the payment provisions make an issuer more likely to set aside funds for payment, and on the public generally to determine how statutory language affects the price of bond obligations. For example, Professor Amy Monahan has analyzed whether constitutional pension funding requirements have led to better pension funding.[212] This kind of research with respect to statutory and

207. Municipal entities often monetize assets to satisfy claims. Some thus question whether the idea of "best interests" in the municipal context should include the requirement that a municipal debtor monetize some assets.

208. *See In re* City of Detroit, 524 B.R. 147, 256–57 (Bankr. E.D. Mich. 2014).

209. *Id.* at 189.

210. *Id.* at 191.

211. *Id.* at 191–92.

212. Professor Monahan's conclusions regarding whether constitutional funding requirements lead to fiscal discipline were mixed, in part because some states imposed such funding requirements

constitutional protections of a variety of municipal obligations would be helpful in guiding courts in fashioning chapter 9 priorities based on statutory signals.

Subordination of harmful debt is virtually unused in the commercial world. If otherwise, it might have been a tool used by bankruptcy courts in the 2008 mortgage fueled financial crisis.[213] Perhaps such a tool should be revived in the municipal insolvency context when cities take on debt in violation of governing laws.

Because property rights do not play the same role in municipal finance as they do in private finance, the rules for determining priorities in chapter 9 should be tailored to take into account municipal finance practices. These practices are embodied in statutes that limit the types and amount of debt that municipal entities can incur and that purport to strengthen the payment promises made. Bankruptcy law permits such reliance on statutory signals; indeed, it incorporates them in private bankruptcies.

CONCLUSION

Several significant municipal bankruptcies over the past ten years have given policymakers the opportunity to think about what a municipal bankruptcy regime should look like. The web of statutes governing municipal transactions gives notice to parties dealing with cities that some types of debts are privileged. Although this notice is not nearly as clear as notice given by recording systems and indeed seems contradictory, it provides some basis for clarifying priorities in municipal bankruptcy cases. Just as private financing practices provide the basis for value allocation in individual and entity bankruptcy, municipal financing practices, which rest on a shaky or non-existent property foundation, should guide decision-makers in fashioning chapter 9 rules.

fairly recently in response to funding problems. *See* Amy B. Monahan, *State Fiscal Constitutions and the Law and Politics of Public Pensions*, 2015 U. ILL. L. REV. 117, 134–39 (2015).

213. *See supra* notes 208–210 and accompanying text.