Washington and Lee Law Review

Volume 71 | Issue 1 Article 10

Winter 1-1-2014

Goals and Governance in Municipal Bankruptcy

Juliet M. Moringiello

Follow this and additional works at: https://scholarlycommons.law.wlu.edu/wlulr

Part of the Bankruptcy Law Commons

Recommended Citation

Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 Wash. & Lee L. Rev. 403 (2014), https://scholarlycommons.law.wlu.edu/wlulr/vol71/iss1/10

This Article is brought to you for free and open access by the Washington and Lee Law Review at Washington & Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington & Lee University School of Law Scholarly Commons. For more information, please contact lawref@wlu.edu.

Goals and Governance in Municipal Bankruptcy

Juliet M. Moringiello*

Abstract

The years from 2011 to 2013 were remarkable in municipal bankruptcy terms. During those years, several cities and counties took the rare step of filing for bankruptcy under Chapter 9 of the Bankruptcy Code. When Detroit filed for bankruptcy in July 2013, it became the largest city measured by both population and outstanding debt to file for Chapter 9.

The recent filings challenge the conventional wisdom that Chapter 9 is poorly tailored to the rehabilitation needs of larger cities and counties. Those who have written about Chapter 9 in the past twenty years have treated Chapter 9 and state intervention in municipal financial affairs as freestanding alternatives rather than as complementary components of a comprehensive municipal financial recovery plan. These authors compare municipal bankruptcy to corporate bankruptcy and conclude that, because Chapter 9 does not incorporate all of the Chapter 11 checks on debtor behavior, it cannot adequately promote the financial rehabilitation of a sizable general-purpose municipality. This approach ignores the original goal of Congress in enacting a municipal bankruptcy law in the aftermath of the Great Depression, which was to bring together two sovereigns, the state and the federal government, to accomplish something that neither could accomplish alone—the imposition of a plan to adjust municipal debts that would be binding on all creditors, wherever located.

This Article refocuses the discussion about the limitations of the municipal bankruptcy process by examining the goals of

---

* Professor, Widener University School of Law. Many thanks to Scott Pryor and David Skeel for their thoughtful comments on earlier drafts. I would also like to thank my research assistants, Corey Dietz and Julia Skinner, for their diligent and enthusiastic help with this article.

Chapter 9 and relating its governance provisions to those goals. A refocused discussion is particularly timely because the deteriorating financial condition of many cities has led states to reexamine their programs for resolving municipal financial distress and the conditions under which they permit their municipalities to file for bankruptcy. Chapter 9 may only be as effective as the state governance that accompanies it. Therefore, policy makers on the state and federal levels need an understanding of the role of Chapter 9 in an integrated scheme for municipal financial recovery in order to decide whether and how to assist municipalities on the state level and to decide whether reforms to Chapter 9 are necessary.

Table of Contents

I. Introduction 405

II. The Delicate Balance of State and Federal Power Preserved in Chapter 9: Does it Render Municipal Bankruptcy Useless? 410
   A. Chapter 9 and Control over the Debtor and Its Property 411
   B. Does Chapter 9 "Work?": A Survey of Recent Scholarship 416
      1. Is Chapter 9 Based on a Faulty Premise? 418
      2. Does Chapter 9 Give Too Much Power to the Debtor? 421
      3. Must Chapter 9 and State Intervention Run on Parallel Tracks? 425

III. Bankruptcy's Goal-Oriented Governance 429
   A. Bankruptcy Governance over Individuals 430
   B. Bankruptcy Governance over Entities 432
   C. Bankruptcy Governance over Municipalities 437

IV. A History of Chapter 9 from a Governance Perspective 440
   A. Why Municipal Bankruptcy? 440
   B. The 1930s Wish List and Resulting Statutes 446
   C. Congress Revisits Municipal Financial Distress in 1976 453

V. Specific Authorization to File for Chapter 9: An Invitation to Govern 457
A. Reasons for and Evolution of the Authorization Requirement 458
B. Implementation of State Authorization 461
VI. Authorization Meets Governance, Eventually: Pennsylvania's Story 471
VII. Where the Holes Are: Issues for Judicial or Legislative Resolution 478
A. Continuing Questions About the Relationship Between State and Federal Law 480
B. Debtor Governance in Weak Governance States 483
VIII. Conclusion 485

I. Introduction

Municipal bankruptcy occupies a rarely studied corner of bankruptcy law. Coverage of its governing Bankruptcy Code (Code) chapter, Chapter 9,[1] in law school casebooks and treatises is almost nonexistent,[2] and scholars turn their attention to the subject only when a high-profile case is filed.[3] There is a simple

1. 11 U.S.C. §§ 901–946 (2012).

2. *See, e.g.*, MARGARET HOWARD, BANKRUPTCY: CASES AND MATERIALS 21 (5th ed. 2012) (explaining that Chapter 9 "governs the bankruptcy of municipalities [and] is used only occasionally," and adding that "[w]e will not cover it in this casebook"); CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 116–17 (2d ed. 2009) (giving an overview of Chapter 9; the remaining coverage in the over 1,400 page treatise appears on four other pages); ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 109 (6th ed. 2009) (devoting about six pages in a 931-page casebook to a description of Chapter 9 and acknowledging that Orange County filed for bankruptcy).

3. *See, e.g.*, Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEV. J. 625, 625–26 (1994) (considering Bridgeport's Chapter 9 bankruptcy filing shortly after it happened); David L. Dubrow, *Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?*, 24 URB. LAW. 539, 539 (1992) (discussing Chapter 9 bankruptcy right after Bridgeport, Connecticut, filed for bankruptcy); Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1037 (1997) (mentioning Orange County, California's filing for bankruptcy shortly after the

reason for this lack of attention: very few municipalities have filed for bankruptcy.[4] Fewer than 700 cases have been filed since 1938,[5] when the United States Supreme Court upheld the constitutionality of a municipal bankruptcy chapter.[6] Even this number is misleadingly high; the overwhelming majority of the municipalities that have filed for bankruptcy were special-purpose districts such as water and sewer districts[7] rather than general-purpose municipalities such as cities, counties, and towns.

The years from 2011 to 2013 were therefore remarkable in municipal bankruptcy terms. During those years, several general-purpose municipalities took the rare step of filing for bankruptcy under Chapter 9. Among those filing were a small Rhode Island city, Central Falls;[8] Pennsylvania's capital city, Harrisburg (whose filing was dismissed six weeks later);[9] Jefferson County,

---

county did so); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993) (mentioning Bridgeport's 1991 filing in explaining Chapter 9); Frederick Tung, *After Orange County: Reforming California Municipal Bankruptcy Law*, 53 HASTINGS L.J. 885, 886–87 (2002) (discussing Orange County's bankruptcy filing and its historic effect).

4. *See* JAMES SPIOTTO, CHAPMAN & CUTLER, LLC, PRIMER ON MUNICIPAL DEBT ADJUSTMENT, app. C (2012), http://www.afgi.org/resources/Bankruptcy_Primer.pdf (showing the historical breakdown of municipal bankruptcies, which indicates that only 635 municipal bankruptcies have been filed between 1937 and 2012).

5. *Id.* This is a miniscule number; in 2012 alone, 1,221,091 bankruptcy petitions were filed under all chapters. U.S. COURTS, BUSINESS AND NONBUSINESS CASES COMMENCED, BY CHAPTER OF THE BANKRUPTCY CODE, DURING THE 12-MONTH PERIOD ENDING DEC. 31, 2012 (2012), http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2012/1212_f2.pdf.

6. United States v. Bekins, 304 U.S. 27, 47–48 (1938).

7. *See* SPIOTTO, *supra* note 4, at app. C (showing that the municipal utilities and special districts filings were nearly three times that of cities or counties). Under the Bankruptcy Code, a municipality may file only for Chapter 9, 11 U.S.C. § 109 (2012), and the Code defines municipality as "political subdivision or public agency or instrumentality of a State." 11 U.S.C. § 101(40) (2012). Between 1980 and January 31, 2012, 264 municipalities filed petitions under Chapter 9, only 49 of which were cities, counties, or towns.

8. *See* Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES, Sept. 7, 2012, at A21 (explaining that the court confirmed the Central Falls plan of adjustment in September 2012).

9. Michael Corkery & Kris Maher, *Capital Files for Bankruptcy*, WALL ST. J., Oct. 13, 2011, at A3; *see also In re* City of Harrisburg, 465 B.R. 744, 765 (Bankr. M.D. Pa. 2011) (dismissing the Chapter 9 case).

Alabama;[10] and Stockton, California.[11] Just over a month after Stockton filed, another California city, San Bernardino, filed for Chapter 9 protection.[12] The media described the Jefferson County and Stockton bankruptcies in superlative terms: Jefferson County as the largest municipal bankruptcy ever filed measured by outstanding debt,[13] and Stockton as the largest city measured by population ever to file for bankruptcy.[14] Both of these municipalities lost their bragging rights in July 2013 when Detroit became the largest city, measured by both population and outstanding debt, to file for Chapter 9.[15]

These recent filings challenge the conventional wisdom that Chapter 9 is poorly tailored to the rehabilitation needs of larger cities and counties. As news of impending financial doom in Harrisburg, Jefferson County, and several California cities emerged, so did scholarly articles questioning the utility of Chapter 9.[16] Authors who have written about municipal

---

10. Barnett Wright, *Jefferson County Files Largest Government Bankruptcy in U.S. History*, THE BIRMINGHAM NEWS BLOG (Nov. 10, 2011, 5:00 AM), http://blog.al.com/spotnews/2011/11/jefferson_county_files_for_lar.html (last visited Nov. 11, 2013) (on file with the Washington and Lee Law Review).

11. Bobby White, *Stockton Files for Bankruptcy Protection*, WALL ST. J., June 29, 2012, at A2.

12. *See* Steven Church, Dawn McCarthy & Michael Bathon, *San Bernardino, California, Files Chapter 9 Bankruptcy*, BLOOMBERG (Aug. 2, 2012, 7:38 PM), http://www.bloomberg.com/news/2012-08-02/san-bernardino-california-files-for-bankruptcy-protection-2-.html (last visited Nov. 11, 2013) (on file with the Washington and Lee Law Review).

13. Wright, *supra* note 10.

14. White, *supra* note 11.

15. Matthew Dolan, *Record Bankruptcy for Detroit*, WALL ST. J., July 19, 2013, at A1.

16. *See generally* Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281 (2012) [hereinafter Gillette, *Fiscal Federalism*]; Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351 (2010) [hereinafter Kimhi, *Solution*]; Richard C. Schragger, *Democracy and Debt*, 121 YALE L J. 860 (2012). The financial problems faced by cities have also generated discussion about whether states should be permitted to file for bankruptcy, something that is currently prohibited. *See generally* Adam Feibelman, *Involuntary Bankruptcy for American States*, 7 DUKE J. CONST. L. & PUB. POL'Y 81 (2012); Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. 1399 (2012); Thomas Moers Mayer, *State Sovereignty, State Bankruptcy, and a Reconsideration of Chapter 9*, 85 AM. BANKR. L.J. 363 (2011); Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy"*, 59 UCLA L. REV. 322 (2011); David A. Skeel, *States of*

bankruptcy in the past twenty years approach Chapter 9 and state intervention in municipal financial affairs as freestanding alternatives rather than complementary components of a comprehensive municipal financial recovery plan.[17] From that vantage point, they compare Chapter 9 to other bankruptcy chapters, notably Chapter 11, and then conclude that because Chapter 9 does not incorporate all of the Chapter 11 checks on debtor behavior, it cannot adequately promote the financial rehabilitation of a sizable general-purpose municipality and is thus an undesirable alternative to *ex ante* state intervention.[18] This approach ignores the original goal of Congress in enacting a municipal bankruptcy law in the aftermath of the Great Depression. When Congress passed the predecessor to Chapter 9, it did so in order to bring together two sovereigns, the state and the federal government, to accomplish something that neither could accomplish alone—the imposition of a plan to adjust municipal financial liabilities that would be binding on all the municipality's creditors, wherever located.[19]

At the same time, the deteriorating financial condition of many cities has led states to reexamine both their own programs for resolving municipal financial distress and the conditions under which they permit their municipalities to file for bankruptcy. States have unfettered discretion in allowing their municipalities to file for bankruptcy; the Code allows a municipality to be a debtor under Chapter 9 only if it is "specifically authorized" by its state to file for bankruptcy.[20] In the past few years, several states have revised their laws governing the ability of their municipalities to file for bankruptcy.[21]

Bankruptcy, 79 U. CHI. L. REV. 677 (2012).

17. Frederick Tung is the exception. *See* Tung, *supra* note 3, at 929 (concluding that a law requiring the governor to authorize municipal bankruptcy filings in California would "encourage early interaction between local and state officials and ultimately a cooperative approach to resolving local distress").

18. *Infra* Part II.B.

19. United States v. Bekins, 304 U.S. 27, 53–54 (1938).

20. 11 U.S.C. § 109(c)(2) (2012).

21. *See, e.g.*, Karol K. Denniston, *Neutral Evaluation in Chapter 9 Bankruptcies: Mitigating Municipal Distress*, 32 CAL. BANKR. J. 261, 261–62 (2012) (discussing California's Assembly Bill 506, which became effective on

In this Article, I refocus the discussion about the limitations of the municipal bankruptcy process by examining the goals of municipal bankruptcy and relating the governance provisions in Chapter 9 to those goals in order to illustrate that Chapter 9 is only as effective as the state oversight that accompanies it. The recent municipal bankruptcy filings, especially that of Detroit, illustrate that larger municipalities will resort to Chapter 9 to alleviate their financial problems. These filings reopen the discussion about the usefulness of Chapter 9. Policy makers on the state level need a better understanding of how Chapter 9 bankruptcy was designed to complement, rather than replace, state financial intervention plans. This understanding will help them develop comprehensive schemes to deal with their distressed cities, towns and counties. Policy makers on the federal level must be able to identify the deficiencies in Chapter 9 in light of this shared governance goal. Chapter 9 was never designed to be an independent solution to municipal financial problems. An understanding of the goals of Chapter 9 and its role in an integrated scheme for municipal financial recovery can assist both groups of policy makers in deciding whether and how to assist the municipalities on the state level and in deciding whether reforms to Chapter 9 are necessary.

To refocus the discussion about managing municipal financial distress, Part II discusses the constitutional underpinnings of Chapter 9's structure as well as the view that the structure eviscerates bankruptcy's effectiveness as a

---

January 1, 2012, and which requires a California municipality to participate in a neutral evaluation process before filing a Chapter 9 petition); Juliet M. Moringiello, *Specific Authorization to File Under Chapter 9: Lessons from Harrisburg*, 32 CAL. BANKR. J. 237, 248–50 (2012) (explaining that Pennsylvania revised its authorization statute in response to Harrisburg's financial distress); Katherine Newby Kishfy, Note, *Preserving Local Autonomy in the Face of Municipal Financial Crisis: Reconciling Rhode Island's Response to the Central Falls Financial Crisis with the State's Home Rule Tradition*, 16 ROGER WILLIAMS U. L. REV. 348, 377–82 (2011) (explaining that the Rhode Island General Assembly enacted a fiscal oversight statute in response to the financial problems in Central Falls); Paul Egan, *New Emergency Manager Law Signed, But Opponents Already Talking About Legal Challenge*, DETROIT FREE PRESS (Dec. 28, 2012), http://www.freep.com/apps/pbcs.dll/article?AID=2012312280118 (last visited Nov. 11, 2013) (discussing the new bill the governor signed into law regarding municipal bankruptcy and the likely legal challenges) (on file with the Washington and Lee Law Review).

municipal rehabilitation tool. Part III discusses the relationship between bankruptcy goals and bankruptcy governance in order to explain the governance structure in Chapter 9. I then discuss the history of Chapter 9 in Part IV to illustrate that the original proponents of a municipal bankruptcy chapter designed it to invite the states to manage their municipalities' use of bankruptcy. Part V discusses the extent to which states have accepted this invitation to govern their municipalities in bankruptcy. Part VI uses a specific example, that of Pennsylvania's response to Harrisburg's distress, to illustrate the confusion that reigns when state policy makers lose sight of Congress's original vision of Chapter 9 as one component of an integrated approach to municipal financial distress that incorporates both state law and federal bankruptcy law. Part VII discusses some of the open issues that remain in Chapter 9 after the governance question is answered, and I conclude by encouraging policy makers to consider the proper role of Chapter 9 as they develop more robust mechanisms to rehabilitate their cities.

II. The Delicate Balance of State and Federal Power Preserved in Chapter 9: Does it Render Municipal Bankruptcy Useless?

Constitutional concerns, coupled with municipal bankruptcy's original limited goal of solving the holdout problem, explain the somewhat skeletal nature of Chapter 9. The Tenth Amendment limits the control that a federal court can exercise over a municipality, and the Contracts Clause limits the ability of a state to force a creditor of a city to accept less than what it is owed.[22] As a result, although today's Chapter 9 is modeled more closely on Chapter 11 than were its predecessor statutes,[23] it lacks many of the elements of Chapter 11 that give creditors some control over the debtor.[24] The structure of Chapter 9

22. *See infra* notes 205–06 and accompanying text (discussing the constitutional implications of municipal bankruptcy).

23. *See* Lawrence P. King, *Municipal Insolvency: The New Chapter IX of the Bankruptcy Act,* 1976 DUKE L.J. 1157, 1157–62 (1976) (explaining the 1976 amendments to Chapter 9's predecessor statute).

24. *See* Dubrow, *supra* note 3, at 547 ("[U]nder Chapter 9 creditors have fewer tools to intervene in the reorganization process than do creditors under

appears to grant the governing body of a municipality in Chapter 9 exclusive management of the municipality's future destiny.[25] Chapter 9 does not require this state of affairs, however. Congress did not design municipal bankruptcy law to give a municipality unfettered control over its reorganization process; rather, it carefully designed the law to respect each state's ability to control the financial rehabilitation of its cities.[26] In this section, I will explain the major differences between Chapter 9 and Chapter 11 and then discuss the prevailing criticisms of Chapter 9.

A. Chapter 9 and Control over the Debtor and Its Property

Chapter 9 incorporates many elements of other types of bankruptcy, Chapter 11 in particular. An automatic stay of all actions against the debtor and the debtor's property arises immediately upon filing.[27] The debtor must propose a plan of adjustment, which is Chapter 9's version of the Chapter 11 plan of reorganization.[28] The debtor may assume or reject executory contracts, including collective bargaining agreements.[29] The municipality's creditors vote on the plan, and the voting requirements are similar to those found in Chapter 11.[30] Like Chapter 11, Chapter 9 contains a cramdown provision, which

---

Chapter 11.").

25. *See* 11 U.S.C. § 904 (2012) (limiting the power and jurisdiction of the court particularly over the "political or governmental powers of the debtor").

26. *See id.* § 903 (reserving state power to control municipalities).

27. *See id.* § 901(a) (incorporating the automatic stay provided by § 362); *see also id.* § 922 (extending the stay to actions against an "officer or inhabitant of the debtor that seeks to recover a claim against the debtor").

28. *See id.* § 941 (requiring the debtor to file a plan for the adjustment of debts).

29. *See id.* § 901(a) (incorporating § 365); *see also* King, *supra* note 23, at 1169 (explaining that labor contracts may be a partial cause of a municipality's financial problems); Barry Winograd, *San Jose Revisited: A Proposal for Negotiated Modification of Public Sector Bargaining Agreements Rejected Under Chapter 9 of the Bankruptcy Code*, 37 HASTINGS L.J. 231, 276–81 (1985) (discussing the legislative history behind the inclusion of the right to reject collective bargaining agreements in Chapter 9).

30. *See* 11 U.S.C. § 901(a) (2012) (incorporating all of the voting requirements of § 1126 except for those dealing with voting by holders of equity interests in the debtor).

provides that the plan can be imposed on nonconsenting creditors if at least one class of creditors accepts the plan and the plan is fair and equitable.[31] These elements give a municipality some of the important bankruptcy benefits available to business entities: a stay of all collection actions, the ability to reject burdensome contracts, and the ability to impose a plan on nonconsenting creditors. In other ways, Chapter 9 is significantly different from Chapter 11.

Chapter 9 explicitly respects state sovereignty. It eschews any limitation on the state's power "to control, by legislation or otherwise, a municipality of or in such state in the exercise of the political or governmental powers of such municipality,"[32] but limits this sovereignty by prohibiting states from passing laws that would bind nonconsenting creditors to a plan of debt adjustment.[33] When Congress added this limitation to the municipal bankruptcy chapter in 1946, it did so recognizing that investors throughout the country held the bonds of many municipalities.[34] Therefore, even if, as the Court had held in *Faitoute Iron & Steel Co. v. City of Asbury Park*,[35] the Contracts Clause did not prohibit a state plan of debt adjustment, Congress believed that a uniform federal process for imposing a plan on nonconsenting creditors was preferable to a mélange of state processes.[36] In further recognition that federal law cannot usurp a state's role in municipal oversight, Chapter 9 prevents the bankruptcy court from interfering with a municipality's political

---

31. *See id.* § 901 (incorporating the cramdown provisions of § 1129(b)(1) and (b)(2)(A), (B)).

32. *Id.*

33. *See id.* ("[A] State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition."). Congress added this limitation to overrule the Supreme Court's holding in *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 516 (1942), which upheld a state's ability to impose a plan of adjustment on a municipality's nonconsenting creditors. *See* McConnell & Picker, *supra* note 3, at 462 (explaining that Congress enacted § 903 to overrule *Faitoute*); Tung, *supra* note 3, at 889 n.16 (discussing the legislative history of the predecessor to § 903).

34. H.R. REP. NO. 79-2246, at 4 (1946).

35. 316 U.S. 502 (1942).

36. *See* H.R. REP. NO. 79-2246, at 4 (1946) ("[B]ankruptcy law under which bondholders of a municipality are required to surrender or cancel their obligations should be uniform throughout the 48 states . . . .").

and governmental powers and from interfering with the municipality's use of its property.[37]

This respect for state sovereignty explains the remainder of Chapter 9. The partial incorporation of Chapter 11 concepts reflects the fact that the bankruptcy court, as an arm of the federal government, must refrain from interfering with the governance of a municipality.[38] As a result, missing from Chapter 9 are many of Chapter 11's provisions designed to give creditors some control over the Chapter 11 outcome. The default rule in Chapter 11 is that the existing managers of the debtor entity remain in control of the debtor as "debtor in possession."[39] At the request of a creditor or any other party in interest, the court can replace the debtor in possession with a trustee if the court finds that the corporate managers have engaged in certain misconduct such as fraud, dishonesty, incompetence, or gross mismanagement.[40] Although the courts view the appointment of a Chapter 11 trustee as an extraordinary remedy,[41] the threat of such an appointment theoretically serves as a check on the debtor's behavior.[42] Chapter 11 also allows a court to appoint an examiner to investigate allegations of fraud and other misconduct on the part of the debtor.[43] Because Chapter 9 specifically prohibits the bankruptcy court from interfering with any of the

---

37. 11 U.S.C. § 904 (2012). The debtor may, however, consent to such interference. *See id.* (explaining that inference is blocked "[n]otwithstanding any power of the court, unless the debtor consents").

38. *See infra* notes 216–17 and accompanying text (discussing Tenth Amendment limitations in bankruptcy).

39. 11 U.S.C. § 1101(1) (defining "debtor in possession"); *see also id.* § 1107 (granting to the debtor in possession all of the rights and powers of a trustee).

40. *Id.* § 1104(a)(1).

41. *In re* Euro-Am. Lodging Corp., 365 B.R. 421, 426 (Bankr. S.D.N.Y. 2007); *In re* Ionosphere Clubs, Inc., 113 B.R. 164, 167 (Bankr. S.D.N.Y. 1990).

42. *See In re* Euro-Am. Lodging Corp., 365 B.R. at 427–28 (discussing when and why a trustee should be appointed). In the early years of Chapter 11, commentators noted that despite these theoretical controls on management, corporate management was rarely ousted in Chapter 11 cases, and thus the debtor had excessive control over the proceedings. *See, e.g.*, Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code—First Installment*, 57 AM. BANKR. L.J. 99, 103 (1983) (observing that creditors in the first three years of Chapter 11 practice rarely used three tools often viewed as giving creditors control over the proceedings: involuntary petitions, creditors' committees, and creditor-proposed plans).

43. 11 U.S.C. § 1104(c) (2012).

political or governmental powers of the debtor municipality,[44] it lacks these constraints on the debtor and prevents the court from appointing a trustee or an examiner in a Chapter 9 case.[45]

The Chapter 9 mandate that the court not interfere with the municipality's management of its property is illustrated by the absence of an estate in a Chapter 9 case. Absent from the list of sections included in Chapter 9 is § 541, which provides that the commencement of a bankruptcy case creates an estate that is comprised of all "legal or equitable interests of the debtor in property as of the commencement of the case."[46] The absence of an estate, coupled with the Code's prohibition against court interference with any of the property or revenues of the municipal debtor,[47] ensures that neither the court nor any creditor can determine how a municipal debtor uses its property. No party in interest can object to the debtor municipality's use or disposition of such property; the debtor may use, lease, or sell it in Chapter 9 without asking the court for permission.[48]

Other omissions from Chapter 9 reflect the congressional decision to leave the management of an insolvent municipality to the municipality itself and its state. Most notably, only the debtor can propose a plan of adjustment.[49] Creditors have no opportunity to do so; therefore, the debtor's exclusivity period is unlimited.[50] Somewhat less importantly, given the small number of involuntary bankruptcies,[51] only the municipality itself may file

---

44. *Id.* § 904(1).

45. *See id.* § 901 (incorporating numerous Code provisions into Chapter 9 but omitting § 1104).

46. *Id.* § 541(a)(1); *see also id.* §§ 901, 902(1) (defining "property of the estate" for Chapter 9 purposes as "property of the debtor").

47. *Id.* § 904(2).

48. *See id.* § 363 (placing conditions on the debtor's use, sale, and lease of estate property); *id.* § 901 (omitting § 363 from the sections applicable in Chapter 9).

49. *See id.* § 941 (giving the debtor the authority to file a plan of adjustment).

50. *See id.* § 901 (omitting § 1121 from list of sections included in Chapter 9); *see also id.* § 1121(c) (granting parties in interest the authority to file a plan of reorganization after the expiration of the debtor's exclusivity period).

51. *See* Susan Block-Lieb, *Why Creditors File So Few Involuntary Petitions and Why the Number is Not Too Small,* 57 BROOK. L. REV. 803, 805 (2011) ("[A] surprisingly small number of involuntary petitions are filed each year.").

for bankruptcy. There is no such thing as an involuntary Chapter 9.[52]

Although the foregoing provisions are sometimes cited as giving the municipal debtor excessive control over the bankruptcy case,[53] they should be viewed less as an effort to give the management of the municipality exclusive control than to balance the constitutional powers of the state and federal governments. A common criticism of Chapter 9 is that, by excessive deference to local control, Chapter 9 presumes that a municipality will exit bankruptcy in the same form as it entered bankruptcy.[54] A more accurate approach to Chapter 9's structure is to view Chapter 9 as a sometimes-necessary component of a state or local plan for municipal financial recovery. Chapter 9 does not require a municipality to exit bankruptcy in the same form as it entered the process. Instead, Chapter 9 leaves governance decisions to entities other than the creditors and the bankruptcy judge and invites the state to provide such governance.[55] The real governance vacuum in Chapter 9 emerges when the state fails to provide any direction for the financial rehabilitation of its cities.

Unlike Chapter 11,[56] Chapter 9 has strict entry requirements.[57] These eligibility requirements, which make the

---

52. *See* 11 U.S.C. § 303(a) (2012) (authorizing involuntary petitions only in Chapters 7 and 11).

53. *See, e.g.*, Kimhi, *Solution, supra* note 16, at 380 (stating that because the court has no authority to intervene in a city's governance, the same officials that controlled the locality before the filing continue to manage it); Kordana, *supra* note 3, at 1046 (describing Chapter 9 as having a "pro-debtor" orientation).

54. *See* Gillette, *Fiscal Federalism, supra* note 16, at 297 (stating that once a state has permitted a municipality to file for bankruptcy, the exercise of the bankruptcy option lies completely in the debtor's control); Kimhi, *Solution*, *supra* note 16, at 380 (stating the same officials who managed the city prior to bankruptcy do so during and after the bankruptcy); McConnell & Picker, *supra* note 3, at 427 (identifying, as a premise of Chapter 9, that the municipality will have the same "boundaries, resources, functions, and governing structure" after bankruptcy that it did before filing for bankruptcy).

55. *See* 11 U.S.C. § 903 ("This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State . . . .").

56. *See id.* § 109(d) (stating that any person who can file for Chapter 7 may file for Chapter 11).

57. *See id.* § 109(c) (stating that to file under Chapter 9 the debtor must meet five criteria).

state the Chapter 9 gatekeeper,[58] illustrate that Chapter 9 is better viewed as a component of a state plan to resolve the financial distress of its municipalities than an independent alternative to state intervention.

A municipality may be a debtor under Chapter 9 only if it: (1) is a municipality, (2) is insolvent, (3) desires to adjust its debts, (4) has negotiated in good faith with its creditors or can show that such negotiation would be futile, and (5) is specifically authorized by its state to be a debtor under Chapter 9.[59] In addition, the court may dismiss the debtor's petition if it finds that the debtor did not file it in good faith.[60] Chapter 9's eligibility requirements provide the governance functions that further the goals of Chapter 9. The requirement that does so most explicitly is the specific authorization requirement, which shows the intent of Congress to give states the first opportunity to resolve the financial distress of their municipalities and invite the federal power to help if necessary. When states accept this invitation by making Chapter 9 a component of a comprehensive state oversight program, they provide governance that best furthers Chapter 9's primary goal of restoring municipalities to financial viability by bringing together the state and the federal government to do something that neither one could accomplish alone. When states do not accept that invitation, Chapter 9 may provide the debtor with only a fresh financial start. In those states, the eligibility requirements allow the court to assess whether the debtor should use Chapter 9 to obtain that fresh start.

B. Does Chapter 9 "Work?": A Survey of Recent Scholarship

Municipal bankruptcy scholarship comes in waves. In the 1930s, when widespread municipal defaults drove Congress to pass the first municipal bankruptcy law, scholarship about municipal bankruptcy focused on the desirability of a federal law

---

58. *See id.* § 109(c)(2) ("An entity may be a debtor under Chapter 9 of this title if such entity . . . is specifically authorized . . . by state law, or by a governmental officer . . . .").

59. *Id.* § 109(c).

60. *Id.* § 921(c).

to overcome the inability of states to comprehensively resolve the financial distress of their cities and the desired components of such a law.[61] Scholarship about municipal bankruptcy waned until the 1970s when New York City's financial crisis led Congress to amend the municipal bankruptcy chapter.[62] The scholarship from the 1970s until 1990 focused primarily on the various amendments to the municipal bankruptcy law and how they would enable larger cities to file.[63]

Beginning in the 1990s, scholars began to question both the wisdom of a federal municipal bankruptcy chapter and the efficacy of the existing law. Authors in this post-1990 era of Chapter 9 scholarship concur that Chapter 9 is a poor tool for resolving the financial problems facing municipalities in large part because of its lack of governance controls over municipal debtors.[64]

In this section, I summarize the post-1990 scholarly debate in order to refocus it. Although the recent Chapter 9 filings have exposed numerous questions about how Chapter 9 should work,[65] the open questions in Chapter 9 do not arise from the governance deficiencies identified by the post-1990 authors. I discuss the governance concerns of these authors below before I turn, in Part IV, to a discussion of the history of Chapter 9 to illustrate that Congress designed Chapter 9 to assist, rather than replace, states in resolving municipal financial distress.

---

61. *See infra* Part III (discussing the goal-oriented governance of bankruptcy law).

62. *See generally* Dubrow, *supra* note 3, at 545; *infra* notes 265–76 and accompanying text.

63. *See* Robert S. Amdursky, *The 1988 Municipal Bankruptcy Amendments: History, Purposes, and Effects*, 22 URB. LAW. 1, 2–4 (1990) (describing the history of the amendments and their purpose); *see also infra* notes 265–85 and accompanying text (discussing the amendments and scholarship).

64. *See infra* notes 66–121 and accompanying text (discussing the post-1990 scholarship regarding municipal bankruptcy).

65. *Infra* Part V.

1. Is Chapter 9 Based on a Faulty Premise?

Michael McConnell and Randal Picker wrote the first post-1990 academic municipal bankruptcy article. In their expansive article, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*,[66] they criticized both the limited goals of Chapter 9 and its efficacy in achieving those goals.[67] When McConnell and Picker wrote their article, most of the general-purpose municipalities that had filed for bankruptcy were small cities seeking to escape the collection of large judgments against them and all of those cases were dismissed.[68] The only city of any size that had filed was Bridgeport, Connecticut, and its filing had been dismissed for failure to meet the Code's entry requirements.[69] Both New York and Cleveland had experienced significant financial difficulties that were due in large part to municipal mismanagement, and neither one resorted to Chapter 9 to solve its problems.[70] McConnell and Picker's prescriptions for a better municipal bankruptcy chapter were therefore based on two observations: that very few general-purpose municipalities file for bankruptcy and the ones that do are very small, and that the one that needed reorganization, Bridgeport, was not permitted to reorganize in bankruptcy.[71]

According to McConnell and Picker, the underlying premise of Chapter 9 is flawed. They posit that Chapter 9 is based on the

---

66. *See generally* McConnell & Picker, *supra* note 3.

67. *See id.* at 427 ("[W]e suggest that bankruptcy law could serve more ambitious purposes than mere debt adjustment . . . .").

68. *See id.* at 471 (discussing the major cities to file bankruptcy up to that point and noting that Bridgeport, Connecticut, was the largest city to file); ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, BANKRUPTCIES, DEFAULTS, AND OTHER LOCAL GOVERNMENTAL FINANCIAL EMERGENCIES 8–10 (1985), http://www.library.unt.edu/gpo/acir/Reports/policy/a-99.pdf (giving an overview of the major cities to file for bankruptcy).

69. *See In re* City of Bridgeport, 129 B.R. 332, 339 (Bankr. D. Conn. 1991) (holding that the city did not prove that it was insolvent).

70. McConnell & Picker, *supra* note 3, at 472.

71. *See id.* at 470–71 (discussing the municipal bankruptcy filings between 1938 and 1972). In the more than two decades since McConnell and Picker wrote, few municipalities of any size have filed, and other authors have cited this as evidence of Chapter 9's ineffectiveness in restoring cities to fiscal health. *See, e.g.*, Schragger, *supra* note 16, at 881 ("Currently, the Bankruptcy Code seems to be of limited use.").

belief that "all the cities need is relief from their present creditors."[72] From that foundation, they reason that because Chapter 9 assumes that "the city will emerge from bankruptcy in the same form . . . with which it entered bankruptcy," Chapter 9 does not support or encourage the efficient reorganization of cities.[73] As a result, municipal bankruptcy provides only a fresh start for cities, and it does not even do that very well because by allowing a city to keep all of its assets and discharge its debts, it creates the moral hazard of permitting a city to devote its resources to itself while escaping its debts.[74] McConnell and Picker compare the fresh start goal to the Chapter 11 goal of efficient reconfiguration of assets and find the fresh start, as applied to municipalities, to be unsatisfying.[75]

Others have repeated the concern that because all Chapter 9 does is grant a fresh start to a city, it is not a useful rehabilitation tool. Those who express this concern contend that Chapter 9 assumes no operational restructuring. Michelle Wilde Anderson presented municipal dissolution as an option that states should consider in resolving the distress of cities.[76] She based her contention that bankruptcy and dissolution are "independent measures" on the assumption that municipal bankruptcy must preserve a municipality's broken form.[77] Clayton Gillette presented his criticisms of Chapter 9 as a set of concerns that the parallel state and federal systems for resolving municipal financial distress may lead to undesirable strategic behavior on the part of municipalities,[78] a criticism based on the

---

72. McConnell & Picker, *supra* note 3, at 494; *see also* David A. Skeel, Jr., *Is Bankruptcy the Answer for Troubled Cities and States?*, 50 HOUS. L. REV. 1063, 1074 (2013) [hereinafter Skeel, *Is Bankruptcy the Answer*] (making a similar point in supporting a bankruptcy mechanism for states).

73. McConnell & Picker, *supra* note 3, at 427.

74. *Id.* at 476.

75. *Id.* at 469–70.

76. Michelle Wilde Anderson, *Dissolving Cities*, 121 YALE L.J. 1364, 1365 (2012) [hereinafter Anderson, *Dissolving Cities*].

77. *Id.* at 1384–85.

78. *See* Gillette, *Fiscal Federalism*, *supra* note 16, at 319–20 ("[C]urrent local officials are likely . . . to discount the effects of future higher credit costs in favor of the political benefits of favoring residents."). Because a state can limit its municipalities' access to bankruptcy, the only likely result of a strategic threat to file might be its impact as a catalyst to legislative action. *Infra* notes 380–82 and accompanying text.

observation that "the underlying assumption [of Chapter 9] appears to be that localities should be preserved in their current form, free from judicial reorganization."[79] As an example of strategic behavior, he presents the possibility of a municipality that, when faced with the choice of a state bailout that would require structural changes to its operations, might choose bankruptcy instead, which would shift the losses to creditors and allow the municipality to operate without effecting needed structural reform.[80]

Omer Kimhi likewise begins with the Chapter 11 comparison to identify deficiencies in Chapter 9.[81] Underlying his criticism is his view that Chapter 9 is based on the assumption that once a city's financial hardship is resolved through the bankruptcy process, the city can be rehabilitated for the benefit of both its citizens and its creditors.[82] Several years later, he described Chapter 9 as "a solution in search of a problem," in part because it does "little to address the root causes of the economic deterioration" of cities.[83]

The post-1990 authors saw Chapter 9 as a puzzle. Although an insolvent municipality is an entity that should be restructured both financially and operationally in order to succeed post-bankruptcy, the goal of Chapter 9 appears to be a fresh financial start, which is the goal that bankruptcy has for individuals. Bankruptcy cannot force an individual to change her habits, but it can enable stakeholders in an entity to force changes in the debtor entity's corporate structure.[84] Therefore, there appears to

---

79. Gillette, *Fiscal Federalism*, *supra* note 16, at 292.

80. *See id.* at 286 ("[I]f bankruptcy is a plausible option for distressed municipalities . . . then local officials may use the threat of bankruptcy to reduce the conditions that states place on a proposed bailout."). Given the power of each state to prevent its municipalities from filing for bankruptcy, it is unlikely that such a strategic use would be successful. *See infra* Part VI (discussing Pennsylvania's rejection of Harrisburg's attempt to use bankruptcy in a strategic manner).

81. *See* Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 651 (2008) [hereinafter Kimhi, *Reviving Cities*] ("Similar to chapter 11's procedures, chapter 9 offers two routes for the plan's confirmation . . . .").

82. *Id.* at 654.

83. Kimhi, *Solution*, *supra* note 16, at 380.

84. *See* McConnell & Picker, *supra* note 3, at 470 ("In the case of business corporations, we readily recognize that the entity's size and scope of operations

be a mismatch between the goal of Chapter 9 and the governance that it provides: the identified goal allows for no bankruptcy governance over a debtor who may desperately need appropriate restructuring governance.[85]

The authors propose to solve their puzzle in two ways: add the missing piece by providing for more robust judicial supervision over Chapter 9 debtors[86] or scrap the puzzle altogether and leave the resolution of municipal financial distress entirely in state hands.[87] Below, I discuss both these prescriptions and the problems inherent in both.

2. Does Chapter 9 Give Too Much Power to the Debtor?

One way to solve the governance problem identified above would be to grant the bankruptcy courts enhanced powers in Chapter 9. Authors who have found the fresh start goal to be unsatisfactory suggest that a municipal bankruptcy regime should force the efficient reconfiguration of a city.[88] If a municipality is more like an entity than an individual, they reason, then perhaps Chapter 9 should be refashioned to force structural changes at the municipal level. Some scholars who have written about Chapter 9 since 1990 reject the fresh start goal and its corresponding absence of debtor governance and urge that Chapter 9 should encourage the efficient reconfiguration of a

---

can be changed, and even that the corporation can be liquidated altogether.").

85. *See id.* (noting that while bankruptcy law can dismember a private corporation, "what may be surprising is that we do not dismember municipal corporations either"); Schragger, *supra* note 16, at 881 (noting that municipal bankruptcy is of limited use because it "does not contemplate the kinds of reorganizations that are possible on the private side").

86. *See* McConnell & Picker, *supra* note 3, at 494 ("We have suggested that a more powerful bankruptcy court, grounded in state rather than federal law, would better serve the purposes of bankruptcy and improve the lot of financially troubled cities.").

87. *See id.* ("[I]t serves little use . . . by restricting state laws directed at solving the holdout problem, [it] even impedes the ability of states to institute superior schemes for dealing with cities that have gone broke.").

88. *See, e.g.*, *id.* at 482–83 (arguing that the "fresh start" rehabilitation goal is insufficient and that municipal liquidation is a feasible and appropriate alternative).

municipality's structure, just as Chapter 11 does for business entities.[89]

To support their position that Chapter 9 assumes that the structure of a city will remain the same after discharge as it was before filing, several authors point to the limited powers that Chapter 9 grants to the bankruptcy court.[90] Because of these limited powers, these critics contend that Chapter 9 grants excessive powers to the debtor itself, reducing the chances of a successful reorganization because the same elected officials who ran the city poorly will continue in office during and after the bankruptcy.[91] Moreover, those elected officials are likely to refrain from making unpopular adjustments, such as tax increases, in order to remain in their positions.[92] Likewise, because only the debtor may file a plan of debt adjustment, some fear that the municipality retains excessive leverage over its creditors in that the creditors are faced with a choice of either "languishing in bankruptcy or approving the municipality's plan."[93]

Because McConnell and Picker believe that Chapter 9 should more explicitly foster the reorganization of a city, they identify Chapter 9's fundamental flaw as its limitations on the

89. *See id.* (stating that when a municipality cannot pay its bills, something more than a fresh start may be necessary).

90. *See id.* at 472 (explaining that the Code explicitly prohibits courts from interfering with a municipal debtor's political or governmental powers); Schragger, *supra* note 16, at 881 (observing that Chapter 9 does not allow a judge to order the involuntary dissolution of a city); Tung, *supra* note 3, at 898 (stating that Chapter 9 gives a municipal debtor a "hefty club to wield over creditors, without giving creditors much in the way of protective mechanisms that are available in corporate and individual bankruptcy").

91. *See* Kimhi, *Solution*, *supra* note 16, at 380–81 (explaining that the bankruptcy court has no authority to affect the control exercised by municipal officials); Kordana, *supra* note 3, at 1046 (describing Chapter 9 as having a "pro-debtor" orientation); McConnell & Picker, *supra* note 3, at 472–73 (explaining that a city's paralyzing financial difficulties are often the result of a poorly functioning city government); Skeel, *Is Bankruptcy the Answer*, *supra* note 72 (explaining that the existing decisionmakers retain control in a Chapter 9).

92. *See* Gillette, *Fiscal Federalism*, *supra* note 16, at 320–21 (positing that local officials will value the political benefits of favoring resident interest groups like public employees over the financial benefits of favoring nonresident bondholders).

93. Kordana, *supra* note 3, at 1041.

bankruptcy court's powers.[94] From this premise, they reason that an effective bankruptcy system should give courts the power to take actions to restructure a city. Among the powers that McConnell and Picker recommend are the power to order the levy and collection of taxes, the power to order reductions in wasteful municipal expenditures, the power to seize income streams for bond repayment purposes, and the power to sell some municipal property.[95] They cite this last power as particularly important because they identify the ability of a city to discharge debt while retaining its assets as "the principal source of the moral hazard problem in municipal bankruptcy."[96]

Gillette echoes these suggestions as a solution to the possibility of a municipality using the threat of municipal bankruptcy in a strategic fashion. A bankruptcy court could refuse to confirm a plan of adjustment that did not provide for tax increases,[97] but Gillette argues that Congress should give the courts more explicit powers over city governance. He suggests that the bankruptcy court be given the power to impose adjustments to both taxes and spending in order to deter municipalities from seeking Chapter 9 protection to avoid making politically unpalatable choices that would impose the costs of financial distress on city residents rather than creditors.[98] Gillette's strategic bankruptcy argument is similar to McConnell

94. *See* McConnell & Picker, *supra* note 3, at 479 (arguing that courts in bankruptcy cases cannot successfully operate without "far-reaching power").

95. *Id.* at 475–76.

96. *Id*. Kevin Kordana doubts that municipal bankruptcy presents a significant moral hazard problem. *See* Kordana, *supra* note 3, at 1085–89 (offering empirical evidence that defaults on government debt remain rare despite the fact that creditor collection remedies against government debtors are limited because of the "dynamic game" aspects of municipal borrowing).

97. *See* 11 U.S.C. § 943(b)(7) (2012) (authorizing the court to confirm a plan of adjustment if it is in the best interest of creditors); *id*. § 1129(b)(2) (requiring that a plan be fair and equitable towards an impaired class of creditors that opposes the plan and incorporated into Chapter 9 by § 901); *see also* Fano v. Newport Heights Irrigation Dist., 114 F.2d 563, 565–66 (9th Cir. 1940) (refusing to confirm a plan of adjustment that did not raise taxes and holding that the plan was neither fair and equitable nor in the best interest of creditors).

98. *See* Gillette, *Fiscal Federalism*, *supra* note 16, at 326 (maintaining that such "resource adjustments" will effectively deter strategic use of municipal bankruptcy where "lack of political will rather than destitution explains local resistance to resource adjustments").

and Picker's moral hazard argument; in both articles, the authors express the fear that if too much discretion is left in a municipal debtor's hands, municipal debtors will seek an easy out that will allow them to escape debts without making necessary structural changes.[99]

Inherent in these criticisms of Chapter 9 is the observation that if a city files for bankruptcy, the city is in complete control of its destiny, free of external supervision. Gillette contends that once a state has permitted bankruptcy, the decision to file is exclusively within the control of the municipality.[100] Chapter 9 does not require this result, however. The Code limits the bankruptcy court's power over the municipal debtor and its property,[101] but in doing so it refrains from imposing limits on a state's powers over its municipalities.[102] Rather than leaving power in the hands of a debtor municipality, these sections, when read together with the requirement that a state specifically authorize its municipalities to file, allow the state to exercise as much control as it desires.[103]

McConnell, Picker, and Gillette recognized the legal impediments to their suggestions. The Code specifically prohibits the bankruptcy court from interfering with any of the municipality's political powers,[104] but the authors suggested that this statutory restriction be relaxed.[105] Nevertheless, they

---

99. *Id.* at 297; McConnell & Picker, *supra* note 3, at 477.

100. Gillette, *Fiscal Federalism*, *supra* note 16, at 329.

101. *See* 11 U.S.C. § 904 (mandating that the bankruptcy court cannot "interfere" with the "use or enjoyment" of any "property" or "revenues" of the debtor municipality).

102. *See id.* § 903 ("This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality . . . .").

103. McConnell and Picker recognize this, but discuss state intervention as an alternative, rather than a complement to, Chapter 9. *See* McConnell & Picker, *supra* note 3, at 462, 479 (acknowledging that Chapter 9 "explicitly protects the rights of the state to control its political subdivisions" but maintaining that "federal bankruptcy is an alternative to state reform rather than supplemental to it").

104. 11 U.S.C. § 904.

105. *See* Gillette, *Fiscal Federalism*, *supra* note 16, at 297 (arguing for the repeal of the "strictures" of Section 904 in order to explicitly authorize judicial discretion over municipal resource adjustments); McConnell & Picker, *supra* note 3, at 474–75 (arguing that the Code should be reformed to permit

conceded that such powers might violate the Tenth Amendment and concluded that perhaps a federal bankruptcy chapter is unnecessary.[106] Their conclusion that states should be empowered to enact municipal bankruptcy regimes, however, raises Contracts Clause issues.[107]

3. Must Chapter 9 and State Intervention Run on Parallel Tracks?

The authors discussed above described state intervention and federal municipal bankruptcy as parallel independent systems. McConnell and Picker stated this explicitly by describing bankruptcy as "an *alternative* to state reform rather than supplemental to it."[108] This view of Chapter 9 and state intervention as mutually exclusive alternatives is consistent with some authors' characterization of Chapter 9 as a way for a city to obtain easy debt relief without making the changes necessary to both provide essential services and avoid financial ruin in the future.[109] If that is the case, Chapter 9 is of course undesirable. No one wants a city to go through the expense and bad press of bankruptcy just to emerge from bankruptcy in the same distressed form in which it entered.

The superior ability of each state to remedy its cities' financial distress is beyond question. A state can make structural changes that can prevent or alleviate municipal financial distress, something a bankruptcy court cannot do. A state can intervene in a city's financial distress by establishing a financial

---

bankruptcy judges to exercise more discretion over municipal taxing and spending powers).

106. McConnell & Picker, *supra* note 3, at 479 ("It may well be, therefore, that federal municipal bankruptcy law is even more fundamentally misconceived than at first appeared: there shouldn't be any.").

107. *Id.* at 479–80. This, of course, would likely violate the Contracts Clause. *See* U.S. CONST. art. I, § 10, cl. 1 ("No State shall . . . make any . . . Law impairing the Obligation of Contracts . . . .").

108. McConnell & Picker, *supra* note 3, at 479.

109. *See* Gillette, *Fiscal Federalism*, *supra* note 16, at 291–92 (suggesting that the objective of Chapter 9 is "simply to allow a financially distressed city to restructure its monetary obligations, not to restructure the city government or liquidate its assets for the benefit of creditors"); Kimhi, *Reviving Cities*, *supra* note 81, at 653 (stating that bankruptcy allows municipalities to avoid paying their creditors in full by "refusing to maximize their tax-raising capacity").

control board or by extending loans,[110] and can act to mitigate the causes of municipal distress, such as suburbanization, by reforming the state tax structure.[111] A state can dissolve a municipality in order to merge it into another[112] and can appoint a receiver to impose fiscal discipline on a municipality.[113]

Recognizing this superiority, each author's view of the relationship between state intervention and Chapter 9 influenced his prescriptions for a superior system for the resolution of financial distress. For example, Gillette's article explored the interaction between Chapter 9 and state intervention; in fact, he described his contribution to the literature as an explanation of how the two systems interact using principles of fiscal federalism.[114] The interaction he described, however, assumed that the two systems run on parallel, rather than intersecting, tracks.[115] After discussing a city's motivations to choose one system over the other, Gillette ultimately suggested a grant of greater powers to the bankruptcy court that would mirror those that could be exercised by the state in order to prevent strategic uses of bankruptcy by municipalities.[116] Strategic use, therefore,

---

110. Gillette, *Fiscal Federalism*, *supra* note 16, at 310.

111. *See* Kimhi, *Solution*, *supra* note 16, at 387–88 (explaining that a state can require suburban residents to bear some of a city's tax burden).

112. *See* Anderson, *Dissolving Cities*, *supra* note 76, at 1375–84 (offering a survey of state law designed to facilitate municipal dissolution and merger); McConnell & Picker, *supra* note 3, at 481, 485 (stating that "[m]unicipal corporations can be liquidated" and that "some states might choose to merge the dissolved city into surrounding jurisdictions").

113. *See* McConnell & Picker, *supra* note 3, at 473 (noting the historical success that appointed receivers have had in "disciplining municipal budgets"). Laws providing for the appointment of receivers are highly controversial in part because they deprive the local electorate of their choice of elected officials, and they tend to affect cities with large minority populations. *See* Michelle Wilde Anderson, *Democratic Dissolution: Radical Experimentation in State Takeovers of Local Governments*, 39 FORDHAM URB. L.J. 577, 582 (2012) [hereinafter Anderson, *Radical Experimentation*] (maintaining that receivers "can enflame antagonism between state and local actors" and "disempower a beleaguered local electorate").

114. Gillette, *Fiscal Federalism*, *supra* note 16, at 286.

115. *See id.* at 293–94 (discussing the effects of Chapter 9 on local municipalities without reference to state intervention).

116. *See id.* at 326 (explaining that municipal leaders would be less likely to threaten to file for Chapter 9 in order to extract state bailouts if they knew that the bankruptcy judge had the same power to impose resource adjustments that the state did).

is possible only because Chapter 9 lacks the debtor governance that a state can provide. According to Gillette, this problem can be remedied by giving the two systems similar debtor governance provisions.[117]

In McConnell and Picker's view, the mutual exclusivity of state oversight and bankruptcy meant that there was a governance vacuum that excluded coordination between the state intervention process and the federal bankruptcy process.[118] They discussed several examples of state oversight that they characterized as successful.[119] Their prescription was to allow for parallel systems, but to allow a state that was inclined to implement an intervention scheme to opt entirely out of Chapter 9. Their opt-out went further than the opt-out that already exists in the Code, however. They explained that the constitutional objections to state-imposed bankruptcy regimes might easily be overcome by amending the Code to permit the states to impose involuntary debt adjustments, thus allowing states to not only opt-out of the Code entirely, as they can now, but to provide the same benefits that the Code provides to their cities in doing so.[120] McConnell and Picker believed that one benefit of a state-run bankruptcy regime would be that the state could commit its resources to the financial rehabilitation of a city as part of the process.[121]

Writing after the Orange County bankruptcy, Frederick Tung provided a different perspective on Chapter 9 governance. Of the post-1990 municipal bankruptcy scholars, Tung saw the

---

117. *See id.* ("[T]he ideal remedy is to make the level of local officials' authority inside and outside bankruptcy more similar.").

118. *See* McConnell & Picker, *supra* note 3, at 479 (arguing that, because federal bankruptcy is an alternative rather than a supplement to state reform, "no one is in a position to coordinate state assistance").

119. *See id.* at 473–74 (listing receiverships initiated in New York City, Chelsea, Massachusetts, and Ecorse, Michigan as "notable success[es]"). Twenty years later, however, some of these state intervention schemes have proven less successful than they had hoped. *See infra* notes 359–60 and accompanying text (discussing the mixed municipal recovery results reached under Pennsylvania's receivership statute).

120. *See id.* at 479–80 (explaining that such a scheme would not violate the Contracts Clause if it were to operate only prospectively, because its terms would be incorporated into future contracts).

121. *See id.* at 479 (insisting that states could "lend [their] credit" or their "state resources" to distressed municipalities).

greatest role for the state in the Chapter 9 process. At the time Orange County filed for bankruptcy, California authorized its municipalities to file for bankruptcy free of any restrictions in addition to those imposed by the Bankruptcy Code.[122] Tung recognized both that early cooperation between a city in financial trouble and its state is necessary, but that sometimes such cooperation, if it comes at all, comes too late to avert a financial disaster.[123] Tung's suggestions for California involved increased gubernatorial involvement in municipal bankruptcy by requiring the governor to approve all such bankruptcies.[124] As I will explain below in Part V, California has notably declined the invitation to exercise governance over its cities in financial distress.[125]

In a perfect world, a state could prevent and ameliorate the financial distress of its cities without resort to federal law. The world is not perfect, however. States are prohibited from imposing binding plans of adjustment on nonconsenting creditors by the Contracts Clause of the Constitution and by Supreme Court precedent.[126] As a result, state-supervised municipal debt adjustment plans must win the consent of all creditors. Moreover, some states lack intervention programs;[127] others may implement those programs only when a general-purpose municipality in that state falls into financial distress.[128] As such, they may not provide the proactive monitoring assistance that prevents cities from falling into financial ruin.[129] Even states that have intervention

---

122. *See* Tung, *supra* note 3, at 891–92 (discussing Sections 43739 and 53760 of the California Code and concluding that they "provide fairly broad authorization for California municipal entities to file for bankruptcy").

123. *Id.* at 907.

124. *See id.* at 921–23 (providing a menu of conditions that could be attached to such a filing depending on the needs of each city).

125. *Infra* Part V.

126. *See infra* note 206 and accompanying text (explaining the constitutional limitations placed on state power to affect unilateral adjustments of municipal debt).

127. *See* PEW CHARITABLE TRUSTS, THE STATE ROLE IN LOCAL GOVERNMENT FINANCIAL DISTRESS 9–10 (2013) [hereinafter PEW REPORT] (listing only nineteen states that have intervention programs).

128. *See infra* notes 338–51 and accompanying text (explaining how intervention programs in Rhode Island and Michigan were enacted reactively to deal with existing municipal distress).

129. *See* John C. Philo, *Local Government Fiscal Emergencies and the*

programs may find that such programs are not as effective as originally hoped.[130]

The post-1990 authors expressed important concerns about Chapter 9. Their core concern is that Chapter 9 does not provide debtor governance that is sufficient to effect structural changes in a distressed city. Their perception that Chapter 9 has more of a fresh start purpose than a rehabilitative purpose magnifies this concern. In the next section, I will discuss the relationship between bankruptcy governance and bankruptcy goals, and assert that Chapter 9 allows appropriate governance over municipal debtors by inviting states to provide the missing governance.

III. Bankruptcy's Goal-Oriented Governance

Bankruptcy governance is inextricably linked to bankruptcy goals. As a result, one cannot develop effective governance mechanisms in any chapter of the Code if that chapter's goals are unclear.[131] If the goals of a municipal bankruptcy chapter are unclear, then Chapter 9, when viewed as a freestanding municipal rehabilitation mechanism, appears to have a governance problem. When Chapter 9 acts alone, it can give a municipality only a fresh start. Yet the only other debtors who receive a bankruptcy fresh start are individuals, and the Code does not govern them in the way that it governs entities. A municipality is not an individual, however. Because a municipality is an entity that provides necessary and desirable

---

Disenfranchisement of Victims of the Global Recession, 13 J.L. SOC'Y 71, 82 (2011) (explaining that only a handful of states have general legislation enabling financial oversight of distressed cities); *cf.* Kimhi, *Solution*, *supra* note 16, at 385 (promoting a proactive supervision system that would not only help to rehabilitate distressed localities, but also "prevent local fiscal stress from becoming a crisis").

130. *See infra* notes 350–53 and accompanying text (describing a number of efficacy and impact objections to state intervention programs).

131. *See* Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations,* 72 AM. BANKR. L.J. 103, 104–05 (1998) (explaining, in the business reorganization context, that "governance questions are inextricably bound up in the broader policy question of what goals Chapter 11 should seek to promote").

public services for its residents,[132] it may require the kinds of external governance that can be exercised over a corporate debtor in bankruptcy. Yet a municipality is not analogous to a corporate entity; in every American state, a municipality is a subdivision of its state,[133] and it is therefore not owned and controlled like a private business entity.

Bankruptcy does not have one exclusive goal. Every bankruptcy case, regardless of the chapter under which it is filed, aims to resolve the claims of the debtor's multiple competing creditors and relieve the debtor from its financial past.[134] Beyond that, the bankruptcy goals for individuals and entities diverge. In this section, I discuss the different types of bankruptcy goals and governance in order to clarify the governance that Congress intended when it enacted a municipal bankruptcy chapter.

A. Bankruptcy Governance over Individuals

Consumer bankruptcy law aims to provide a fresh start to the honest but unfortunate debtor.[135] An individual manages herself, and no mechanism, whether provided by bankruptcy law or by some other law, can replace the management of an individual. Bankruptcy's governance controls over individuals, therefore, consist of mechanisms designed to ensure that only "worthy" debtors will receive bankruptcy relief.[136] When an

---

132. Gerald E. Frug, *City Services*, 73 N.Y.U. L. REV. 23, 29 (1998); Clayton P. Gillette, *In Partial Praise of Dillon's Rule, or, Can Public Choice Theory Justify Local Government Law?*, 67 CHI.-KENT L. REV. 959, 968 (1991).

133. *See* SANDRA M. STEVENSON, ANTIEAU ON LOCAL GOVERNMENT LAW § 1.02 (2d ed. 1997) ("It has been well recognized that constitutionally as well as historically, local entities are merely subdivisions of the state."); *see also* Gerald E. Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1059, 1062 (1980) (explaining that a city has only those powers that are delegated to it by its state government).

134. TABB, *supra* note 2, § 1.1.

135. *See* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) (stating that bankruptcy law "gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns *at the time of bankruptcy*, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt").

136. *See, e.g.*, Richard E. Coulson, *Consumer Abuse of Bankruptcy: An Evolving Philosophy of Debtor Qualification for Bankruptcy Discharge*, 62 ALB. L. REV. 467, 477 (1998) (describing the "debtor's honesty in disclosing and

individual files for bankruptcy, these governance controls operate both to limit the type of relief,[137] if any, for which the debtor is eligible and to deny relief to debtors who engage in some wrongdoing during the bankruptcy case.[138] Opening bankruptcy only to worthy debtors does nothing, however, to ensure that the post-bankruptcy individual debtor is better managed than her pre-bankruptcy self.[139]

One way in which the Code attempts to govern the post-bankruptcy behavior of individual debtors is by barring repeat petitions. An individual cannot file for bankruptcy if she has been in bankruptcy within six months before filing her petition if the earlier petition was dismissed because of the debtor's uncooperative behavior in the case.[140] In addition, the Code denies discharge to individuals who file too frequently. An individual debtor will be denied a discharge if she has received one in another bankruptcy case filed within two to eight years before the second petition, depending on the chapter under which both the first and second bankruptcies were filed.[141]

---

turning over assets, and general cooperation with the bankruptcy process" as constant themes in the evolution of the discharge); Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1052 (1987) (describing bankruptcy law as being "more accurately interpreted as a series of provisions reflecting ad hoc definitions of what is honest or worthy in particular situations").

137. *See* 11 U.S.C. § 707(b) (2012) (subjecting individual debtors to means testing and denying Chapter 7 relief to an individual deemed to have sufficient income to fund a Chapter 13 plan).

138. *See id.* § 727 (denying individual debtors a Chapter 7 discharge for misbehavior before or during the bankruptcy case).

139. *See* David A. Lander, Essay, *A Snapshot of Two Systems That Are Trying to Help People in Financial Trouble*, 7 AM. BANKR. INST. L. REV. 161, 174 (1999) (maintaining that bankruptcy does little to alter the "personal characteristics and life circumstances" that cause repeated insolvency).

140. *See* 11 U.S.C. § 109(g) (prohibiting an individual from filing if she voluntarily dismissed the earlier case after a request for relief from the automatic stay).

141. *See id.* § 727(a)(8) (denying a Chapter 7 discharge to an individual who was granted a Chapter 7 or 11 discharge in a case commenced within eight years before the petition was filed); *id.* § 727(a)(9) (denying a discharge to an individual who received a Chapter 12 or 13 discharge in a case commenced within six years before the petition); *id.* § 1328(f) (denying Chapter 13 discharge to a debtor who has received a Chapter 13 discharge in a case filed within two years before the date of the petition or who has received a discharge under Chapters 7, 11, or 12 in a case filed within four years before the petition).

Bankruptcy governance over individuals is therefore exercised through access and discharge restrictions. These restrictions are the only viable restrictions; there is no other way for the Code to dictate individual behavior. Bankruptcy will give an individual debtor relief from her pre-bankruptcy financial woes, but only if the debtor manages her affairs in a way that is deemed acceptable under the Code.[142] The access restrictions encourage the debtor to exercise good financial governance over herself because they limit the frequency with which an individual can receive bankruptcy relief.

B. Bankruptcy Governance over Entities

The Code itself provides governance controls over the individual debtor. As I will discuss in this section, although the judge in a Chapter 11 case has more governance powers over the case itself than she does in a Chapter 9 case, non-bankruptcy forces govern the structural rehabilitation of the debtor entity. Unlike an individual debtor, who is governed only by herself, an entity is governed by a number of individuals whose behavior is influenced by the contracts the entity has entered into, the market in which the entity operates, and laws that impose fiduciary duties on entity actors.[143] Bankruptcy law affects these elements of corporate governance when they conflict with bankruptcy goals.[144] The debtor controls included in Chapter 11 therefore provide a bankruptcy substitute for these market and contractual controls that affect corporate governance outside of bankruptcy.[145]

The goal of business bankruptcy law is to maximize the value of an entity for its creditors and other parties affected by the

---

142. *See* Coulson, *supra* note 136, at 518–19 (identifying values like "orderliness, morality and respect" on which "an open credit economy depends" as the foundations of consumer bankruptcy).

143. *See* Frost, *supra* note 131, at 110 (describing the conceptual framework of the corporate governance structure).

144. *See id.* at 112–13 (noting that the "automatic stay deprives creditors of their contractual controls over managers" and that market discipline is irrelevant when managers are fighting for the very survival of their business).

145. *See id.* at 113 (explaining that these Chapter 11 controls substitute for market and contractual governance).

entity's operations. A business entity that has no chance of survival will liquidate, either in Chapter 7 or Chapter 11, and an entity that can survive will reorganize under Chapter 11, on the theory that an entity is worth more to its creditors as a going concern than it is in a piecemeal liquidation.[146] Underlying corporate bankruptcy is the theory that a corporation can be reorganized to maximize its going-concern value for the benefit of its creditors, and if such reorganization is impossible, the corporate assets can be liquidated and distributed to the entity's creditors.[147]

The court and the debtor's creditors have several powers in Chapter 11 that they lack in Chapter 9. These powers further the goal of maximizing the value of the business debtor's assets. Bankruptcy law does not mandate the results of a successful Chapter 11; it facilitates them.[148] In the paradigmatic Chapter 11, creditors receive shares of the reorganized corporation in exchange for their claims,[149] but the Code does not require this result. Likewise, a plan can provide for the merger or dissolution of the debtor corporation, but again, the Code does not require any structural change.[150] If internal corporate governance

---

146. *See* MARK S. SCARBERRY ET AL., BUSINESS REORGANIZATION IN BANKRUPTCY: CASES AND MATERIALS 2 (4th ed. 2012) (explaining that reorganization is desirable based on the premise that preserving the entity's going concern value is better for society than liquidating the entity); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 350 (1993) (explaining the goals of business bankruptcy).

147. *See* Warren*, supra* note 146, at 350 (outlining the economic rationale underlying the methods employed by the Code to preserve value in a failing company).

148. *See* Levitin, *supra* note 16, at 1445 (explaining that all bankruptcy can do to help a firm whose business is the sale of "whale oil, corset stays, bustles, flash bulbs, slide rules [or] floppy disks" is to provide it with an orderly way to liquidate its assets and a "dignified funeral").

149. *See* Richard E. Mendales, *Intensive Care for the Public Corporation: Securities Law, Corporate Governance, and the Reorganization Process*, 91 MARQ. L. REV. 979, 1013–14 (2008) (explaining how Chapter 11 facilitates changes in corporate structure through plan confirmation and that the Code does not mandate any particular new control structure).

150. *See* 11 U.S.C. § 1123(a)(5)(C) (2012) (permitting a plan to include "merger or consolidation of the debtor" without mandating that such steps must be taken). The fact that these structural changes are largely left in the debtor's hands has led over the years to calls for enhanced judicial controls in Chapter 11 such as the mandatory appointment of a trustee or examiner, the reduction in time during which the debtor must propose a plan of reorganization, and an

can result in a successful going concern, the end result of a Chapter 11 will not be a sale of the business. If it cannot, the judge will honor a request to sell the assets to the person who can best maximize their value. Therefore, creditors in Chapter 11 can object to a debtor's sale of its property,[151] and they may propose their own plan of reorganization if the debtor does not do so within a prescribed time period.[152]

A major concern of the post-1990 municipal bankruptcy authors was the inability of the court to replace a municipality's management in Chapter 9.[153] In Chapter 11, a court may do so by appointing a trustee, but courts do so infrequently. Although a party in interest can ask the court to appoint a trustee in a Chapter 11 case and the court must do so if it finds that the debtor's management has acted in a way that is fraudulent, dishonest, or incompetent, or that it has grossly mismanaged the debtor's affairs,[154] such an appointment is considered an "extreme," not a routine, remedy.[155] Chapter 11, both by statute and in practice, embodies a presumption that existing management will remain in control of the debtor. The debtor can, at least initially, remain in control of its operations, use and sell property in the ordinary course of its business, and retain the exclusive right to propose a plan of reorganization.[156] Even when

---

early determination of plan feasibility. *See generally* Charles Jordan Tabb, *The Future of Chapter 11*, 44 S.C. L. REV. 791, 822–61 (1993) [hereinafter Tabb, *The Future*] (weighing the merits of twelve reform proposals, including trustee appointment, expedited stay relief, and required threshold feasibility findings).

151. *See* 11 U.S.C. § 363 (requiring court review of a disposition in property by the bankruptcy estate when a creditor objects after having received notice of the pending disposition).

152. *See id.* § 1121(c) (allowing a number of creditors to file a plan of adjustment when certain conditions are met).

153. *See supra* notes 88–89 and accompanying text (summarizing McConnell and Picker's argument that the "fresh start" goal implied by Chapter 9's refusal to allow for removal of municipal leadership renders Chapter 9 ineffective in dealing with municipal insolvency).

154. *See* 11 U.S.C. § 1104(a) (listing the conditions for court-ordered appointment of a trustee).

155. *See In re* William A. Smith Const. Co., Inc., 77 B.R. 124, 126 (Bankr. N.D. Ohio 1987) ("[T]he appointment of a trustee is an extraordinary remedy . . . which should not be made lightly."). *See generally* Kelli A. Alces, *Enforcing Corporate Fiduciary Duties in Bankruptcy*, 56 KAN. L. REV. 83, 96 (2007).

156. *See* Michael Bradley & Michael Rozensweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1045 n.9 (1992) (compiling a list of Bankruptcy

a court appoints a trustee in a Chapter 11 case, the trustee is usually appointed not to manage the business but to sell the business.[157] Some courts have more specifically tailored the trustee remedy to the corporate governance problems of the debtor corporation by appointing a trustee to work with, rather than replace, corporate management when the skills of the corporate managers are necessary to the continued viability of the enterprise, despite the wrongdoing that led to the trustee appointment.[158]

This balance that leaves governance powers in the management of the debtor entity in most cases furthers the goals that Congress had in mind when it enacted Chapter 11. A policy of encouraging financially stressed entities to submit to a bankruptcy proceeding while their operations could be salvaged drove the enactment of Chapter 11 in 1978.[159] Chapter 11 changed prior corporate bankruptcy practice. Under the Bankruptcy Act, Chapter X, the reorganization chapter for large public companies, required that the court appoint a trustee.[160] Congress favored control by corporate management, and made a choice, in enacting Chapter 11, to leave corporate control in management hands.[161] Congress made this decision to leave control in management hands to further the rehabilitative policy

---

Code provisions that allow for continued debtor management); Warren, *supra* note 146, at 372 (compiling a similar list).

157. *See* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy,* 71 TEX. L. REV. 51, 72 (1992) (explaining that corporate management remains in control in a Chapter 11 so that the corporation can continue to operate and that a trustee will not be appointed to operate a business with which she is not familiar).

158. *See* Alces, *supra* note 155, at 106–07 (giving examples of cases in which the courts appointed a trustee to supervise the financial management of the debtors but allowed existing managers to stay in their positions because of their business development or creative talents).

159. *See* Warren, *supra* note 146, at 371–72 (explaining that both debtors and creditors believed that the reorganization provisions under the 1898 Act were ineffective, debtors because they did not trust that they could save their businesses in bankruptcy and creditors because they believed that "the system dissipated assets and delayed payouts unnecessarily").

160. *See* Alces, *supra* note 155, at 91–92 (explaining bankruptcy governance under the Bankruptcy Act).

161. John Wm. Butler, Jr., Chris L. Dickerson, & Stephen S. Neuman, *Preserving State Corporate Governance Law in Chapter 11: Maximizing Value Through Traditional Fiduciaries*, 18 AM. BANKR. INST. L. REV. 337, 337 (2010).

behind Chapter 11. If the management remained in control, stockholders, creditors, and the community would fare better than they would if the business were liquidated.[162]

Even if bankruptcy serves to reorganize a large corporate debtor efficiently, many bemoan the lack of governance controls over small business entities. Small businesses make up the bulk, in number, of Chapter 11 filings, yet many believe that Chapter 11 is not effective with respect to small businesses.[163] This criticism illustrates that the Chapter 11 governance paradigm is one specifically tailored to one type of business: the large business. It does not mean, however, that a rehabilitation bankruptcy chapter cannot work for other entities. Other types of entities may be successfully rehabilitated using the bankruptcy process if the rehabilitation process includes governance provisions appropriate to the debtor.[164]

---

162. *See* Brian A. Blum, *The Goals and Process of Reorganizing Small Business in Bankruptcy,* 4 J. SM. & EMERGING BUS. L. 181, 226 (2000) (arguing that the Chapter 11 structure is ultimately designed to benefit the "community as a whole"). The shift in practice from a mandatory trustee to presumed debtor control has led to decades of debate about whether Chapter 11 gives creditors too little control over the reorganization process. *See, e.g.*, Bradley & Rozensweig, *supra note* 156, at 1088–89 (1992) (concluding that corporate managers use Chapter 11 as a shield from unwelcome management interference by creditors); Frost, *supra* note 131, at 155–56 (concluding that although Chapter 11 provides an oversight structure that could remedy an insolvent corporation's governance problems, the reality tells a different story); Lynn M. LoPucki, *The Debtor in Full Control: Systems Failure Under Chapter 11 of the Bankruptcy Code* (pt. 2)*,* 57 AM. BANKR. L.J. 247, 271–73 (1983) (concluding, based on an empirical study of bankruptcy filings in the Western District of Missouri, that the Code's mechanisms designed to improve or replace poor debtor management did not work as intended); Tabb, *The Future, supra* note 150, at 792–802 (surveying the criticisms of Chapter 11 and the suggestions for improvement).

163. *See* Blum, *supra* note 162, at 196–201 (arguing that the typical characteristics of failed small businesses impede quick and successful reorganization under Chapter 11); Robert M. Lawless & Elizabeth Warren, *The Myth of the Disappearing Business Bankruptcy*, 93 CAL. L. REV. 743, 788 (2005) (explaining the mismatch between existing bankruptcy laws and the needs of the entrepreneur with a failing business); Hon. A. Thomas Small, *If You Fix It, They Will Come: A New Playing Field for Small Business Bankruptcies*, 79 AM. BANKR. L.J. 981, 981 (2005) ("Chapter 11 contains too many obstacles, and the reorganization of small businesses under Chapter 11 is simply too difficult for many businesses.").

164. *See, e.g.*, Pamela Foohey, *Bankrupting the Faith,* 78 MO. L. REV. (forthcoming 2014) (suggesting a modified view of Chapter 11 to account for the unique governance characteristics of religious institutions); Margaret E.

C. Bankruptcy Governance over Municipalities

Viewed in the context of bankruptcy goals and governance, the absence of many debtor controls from Chapter 9 makes sense. A perceived problem with Chapter 9's control allocation is that it removes creditor control without providing a substitute restraint on the debtor.[165] That restraint cannot be imposed by the bankruptcy court, both because of constitutional considerations and because of the clear statement in Chapter 9 that the bankruptcy court may not interfere with the debtor municipality's "political or governmental powers," its "property or revenues," or its "use or enjoyment of [its] income-producing property."[166]

Creditors of a municipality are likewise unable to impose debtor restraints in bankruptcy. One cannot talk about the value of a municipality to creditors in the same way as one discusses the value of an entity to creditors.[167] Creditors can force an entity to liquidate, either piecemeal as a result of state law creditor remedies that allow creditors to seize private assets, or through the bankruptcy process.[168] There is no comparable liquidation scheme for municipalities.[169] Most municipal assets are immune

---

Juliano, Comment, *Stalemate: The Need for Limitations on Regulatory Deference in Electric Bankruptcies*, 20 BANKR. DEV. J. 245, 248–50 (2003) (arguing that the rehabilitative goals of the bankruptcy code are both appropriate and necessary in the electric utility context, provided that additional governance provisions are added to procedurally and substantively constrain electric utility regulators).

165. *See, e.g.*, Kimhi, *Solution*, *supra* note 16, at 355–59 (summarizing the gaps between creditor controls in Chapter 9 and Chapter 11 and noting that Chapter 9 provides municipalities with "relatively easy debt relief" because a "municipality has greater powers than a regular corporate debtor does").

166. 11 U.S.C. § 904 (2012); *see also* U.S. CONST. amend. X (implying that powers to interfere with municipal political affairs are reserved to the states because the Constitution does not delegate such powers to the federal government).

167. *See* Kimhi, *Solution*, *supra* note 16, at 370–72 (explaining that creditors who would otherwise pursue common pool debtor assets in corporate bankruptcy are barred from doing so in municipal bankruptcy because of state law and sovereignty issues).

168. *See supra* note 146 and accompanying text (explaining how and why the Bankruptcy Code endorses liquidation in the Chapter 11 context).

169. *See In re* Richmond Unified Sch. Dist., 133 B.R. 221, 225 (Bankr. N.D. Cal. 1991) ("A municipal unit cannot liquidate its assets to satisfy its creditors totally and finally." (citation omitted)).

from creditor process outside of bankruptcy;[170] therefore, giving creditors the power to force such sales inside of bankruptcy would be counter to the general bankruptcy policy that respects state law property rights "unless some federal interest requires a different result."[171] The value of a municipality to its creditors is its ability to repay those creditors.

Because municipalities are political instrumentalities, elected officials manage their functions, and therefore creditors have no ability to replace management, either inside or outside of bankruptcy. A municipality is not a profit-making enterprise that can be dismantled and distributed if it ceases to be successful; rather, it exists to provide "essential governmental services."[172] It does not have shareholders who, as residual owners, bear the risk of its failure. Instead, a municipality has citizens who depend on its services. As a result, the Code provisions that provide debtor governance over a dysfunctional corporate entity would be inappropriate in a municipal context. Allowing a bankruptcy court to replace municipal management with a trustee would not only give creditors and other parties in interest far more rights in bankruptcy than they would have outside of bankruptcy but would fall afoul of the Tenth Amendment.[173]

In some respects, municipal bankruptcy shares goals with business bankruptcy, and where the two types of bankruptcy share goals, they also share governance provisions. Bankruptcy law gives corporate managers the breathing room they need to make organizational decisions[174] and some of the tools necessary to do so, such as the power to assume or reject executory contracts.[175] A municipal debtor likewise receives these bankruptcy benefits.[176] Bankruptcy also allows both categories of

---

170. *See* McConnell & Picker, *supra* note 3, at 429–34 (explaining that municipal assets are immune from creditor process).

171. Butner v. United States, 440 U.S. 48, 55 (1979).

172. Dubrow, *supra* note 3, at 546.

173. *See* U.S. CONST. amend. X (reserving for the states all powers not delegated to Congress by the Constitution).

174. *See* 11 U.S.C. § 362(a) (2012) (providing an automatic stay of actions to collect debts from the debtor and the debtor's property).

175. *See id.* § 365 (allowing the manager of the bankrupt entity to "assume or reject any executory contract or unexpired lease of the debtor").

176. *See id.* § 901 (incorporating 11 U.S.C. §§ 362, 365).

debtors to impose a plan of debt restructuring on nonconsenting creditors.[177] As a result, Chapter 9 borrows plan confirmation provisions from Chapter 11.[178]

Because corporate reorganization implies a transfer of assets to the persons best able to maximize their value, the goal of corporate reorganization does not seem to apply well to municipal bankruptcy. Chapter 9, without state intervention in the debtor municipality's affairs, can provide only debt relief and a fresh start. Bankruptcy law therefore governs municipal debtors in a manner that is closer to individual governance than entity governance and leaves rehabilitative governance to state law. Just as the Code manages an individual debtor's behavior through its entry and discharge rules, it governs municipal debtors primarily through its entry rules.[179] If the state wants to participate in the Chapter 9 case, it can do so by conditioning its Chapter 9 authorization on the debtor's participation in a state oversight program.[180] If the state does not want to do so, the court can ensure that only worthy municipalities—those that are insolvent and that have negotiated in good faith with their creditors—can file.[181]

The proponents of the original municipal bankruptcy legislation had no intention of creating a governance vacuum. Instead, they recognized that a federal procedure was necessary only to provide the relief that a state alone could not provide to a municipal debtor.[182] They did not ignore organizational governance over the debtor; rather, they designed the federal

---

177. *See id.* § 1129(b)(1) (providing for cramdown plans); *id.* § 901 (incorporating § 1129(b)(1)).

178. As I explain below, however, it remains unclear how these provisions will work in a Chapter 9. *Infra* notes 179–81 and accompanying text.

179. *See* 11 U.S.C. § 109(c) (2012) (establishing criteria for qualification as a debtor under Chapter 9).

180. *See id.* § 109(c)(2) (noting that a municipal debtor qualifies for Chapter 9 only if it is "specifically authorized" as a municipality, or it qualifies under state law).

181. *See id.* § 109(c)(5) (requiring that municipalities seeking to file under Chapter 9 engage, when possible, in good faith negotiations with creditors or make agreements on amounts owed).

182. *See* A.M. HILLHOUSE, MUNICIPAL BONDS: A CENTURY OF EXPERIENCE 351–52 (1936) (noting that state law alone was "inadequate" because the states could not compel creditors to accept agreements).

bankruptcy law to provide the federal benefits of debt relief as a complement to state-led efforts to rehabilitate municipalities.[183] In the next section, I will explain that history to show how Congress intended that municipal financial relief be provided by a system integrating state governance over municipalities with federal debt relief.

IV. A History of Chapter 9 from a Governance Perspective

A. Why Municipal Bankruptcy?

In 1934, Congress enacted the predecessor statute to today's Chapter 9 in emergency legislation passed as the United States was recovering from the Great Depression.[184] Thousands of municipalities defaulted on their debt obligations during the Depression,[185] and in 1933, about seven percent of the municipal debt outstanding was in default.[186] Although municipalities started to issue bonds in the early 1800s,[187] in the years

---

183. *See id.* at 351–53 (discussing the complementarity between state and federal legislation).

184. In 1934, Congress amended the Bankruptcy Act of 1898 to include Chapter IX, titled *Provisions for the Emergency Temporary Aid of Insolvent Public Debtors and to Preserve the Assets Thereof and for Other Related Purposes*. *See* Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 73-251, 48 Stat. 798 (1934) (codified at 11 U.S.C. §§ 301, 303 (2012)), *invalidated by* Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513 (1936). In *Ashton v. Cameron County Water Improvement District*, the Supreme Court ruled the original Municipal Bankruptcy Act to be unconstitutional and Congress replaced it in 1937. *Ashton*, 298 U.S. at 531–32. The Court upheld the 1937 Act in *United States v. Bekins*, 304 U.S. 27, 51–52 (1938). Congress made municipal bankruptcy law a permanent part of bankruptcy law in 1946. *See* Kenneth N. Klee, *Introduction*, 32 CAL. BANKR. J. 221, 221 (2012) (explaining the early federal legislation).

185. *See* Philo, *supra* note 129, at 80 (explaining that 4,770 cities defaulted on their debt during the Great Depression).

186. *See* Harold Gill Reuschlein, *Municipal Debt Readjustment: Present Relief and Future Policy*, 23 CORNELL L.Q. 365, 365 (1938) (reporting that "out of $14,000,000,000 invested in securities of local state governmental units, $1,000,000,000 were reported to be in default").

187. *See* HILLHOUSE, *supra* note 182, at 30 (stating that although the exact date of the first municipal bond is unknown, New York City began to issue bonds in about 1812).

preceding the Depression, municipal securities were more widely distributed among investors than they had ever been.[188]

The distribution of municipal securities among a wide range of investors increased the need for federal involvement in the resolution of municipal financial distress for two reasons. First, because many types of investors held such securities, the effect of a municipal default would be felt throughout the nation's economy.[189] Second, creditors began to appreciate the benefits of a collective proceeding to collect municipal debts over the uncontrolled use of lawsuits by creditors seeking to be the first to collect their claims.[190]

Municipal finance experts in the 1930s recognized that traditional creditor remedies were ineffective to deal with the problem of municipal defaults. The nature of a municipality as a public service provider has several debt collection ramifications. The first is that a municipality cannot be liquidated in the traditional sense. A state might have a mechanism by which to dissolve and consolidate municipalities, but that is not a remedy that creditors can pursue.[191] While creditors of private entities can seize and sell the assets of the defaulting entity to satisfy their claims through processes such as levy and execution,[192] creditors of a municipality are barred from seizing municipal assets because municipalities are deemed to hold their assets devoted to public use in trust for their citizens.[193] Because a

---

188. *See* Reuschlein, *supra* note 186, at 365 n.5 (setting forth the distribution of municipal and state bonds among individuals, banks, insurance companies and other entities in December 1932).

189. *See id.* at 365 (noting that "the spread of holdings of municipal securities" results in widespread effects of economic collapse).

190. *See* Edward J. Dimock, *Legal Problems of Financially Embarrassed Municipalities*, 22 VA. L. REV. 39, 40–41 (1935) [hereinafter Dimock, *Legal Problems*] (comparing the creditors of private corporations to those of municipalities and explaining that the need of corporate creditors for a collective proceeding led to the development of the equity receivership).

191. *See id.* at 1376 (noting that municipalities can be dissolved by the state, local initiative, consent, or inactivity).

192. *See* 1 HON. WILLIAM HOUSTON BROWN, LAW OF DEBTORS AND CREDITORS § 6:53 (Nov. 2012) (discussing the postjudgment use of the writ of execution).

193. *See* Reuschlein, *supra* note 186, at 367 (discussing the inability of creditors to obtain properties used for "public purpose"); *see also* Jeff B. Fordham, *Methods of Enforcing Satisfaction of Obligations of Public*

municipality's assets are often immune from creditor process, they are worthless to the creditors of the municipality.[194] A municipality's taxing power is valuable to creditors, but creditors cannot assume control over that power.[195]

In the 1930s, as now, the only viable collection remedy against a municipality was the mandamus action. Creditors brought mandamus actions against municipalities to force the responsible municipal officers to either pay the creditor's claim out of tax collections or to levy a sufficient tax to pay the creditor's judgment.[196] These actions had the potential to place the municipality's essential services in peril.[197] Although the mandamus remedy was available to creditors, it was effective mainly as a threat device; sometimes the officers subject to the mandamus action would leave the jurisdiction in order to avoid the writ or allow themselves to be jailed for contempt of court.[198] The benefit of mandamus was therefore primarily in its value as a catalyst to negotiation and settlement among the municipality and its creditors.[199] Even that benefit was limited; a court would

---

Corporations, 33 COLUM. L. REV. 28, 28–30 (1933) (discussing statutes and case law that protected municipal assets from seizure by creditors).

194. *See* City of Chicago v. Hasley, 25 Ill. 495, 595 (1861) (explaining that the seizure of city assets could cause great harm to a city's residents); Buell v. Arnold, 102 N.W. 338, 339 (Wisc. 1905) (explaining that the property of municipal corporations cannot be seized or sold upon execution); McConnell & Picker, *supra* note 3, at 429–34 (explaining laws prohibiting the seizure of municipal assets).

195. *See* Dimock, *Legal Problems*, *supra* note 190, at 40 (recognizing that "we are unwilling in this country to permit the creditors to determine what shall be spent for those municipal services and what shall be applied upon their debts").

196. *See* Fordham, *supra* note 193, at 39–47 (explaining the different types of mandamus actions).

197. *See* Dimock, *Legal Problems*, *supra* note 190, at 40–41 (discussing the high costs of litigation in mandamus actions and the resulting interference with competent municipal governance).

198. *See* Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 511 (1942) (discussing the lengths to which municipal officers would go to avoid mandamus); Reuschlein, *supra* note 186, at 367 n.19 ("One Kansas county chose its officials upon condition that they should remain in hiding and appear in the jurisdiction to transact the county's business only by night.").

199. *See* Reuschlein, *supra* note 186, at 368 (discussing the ineffectiveness of the mandamus remedy and the various types of negotiated agreements between municipalities and creditors).

refuse to issue an order of mandamus if the failure to pay debts was due to the inability to do so rather than the unwillingness to do so, or if the municipality had already reached its constitutional or statutory tax limits.[200]

In the 1930s, lawyers recognized that they could look to the states, the federal government, or both for a solution to the problem of widespread municipal defaults. Both sovereigns were limited in their ability to solve the problem. A state could actively supervise the finances of its municipalities either by imposing a receivership[201] or by establishing a municipal finance commission.[202] A receiver or commission could actively manage a city's budget and supervise its borrowing.[203] As one commentator at the time explained, the state could provide "the very kind of active, aggressive leadership in rehabilitating the finances of an insolvent [municipality] that is needed."[204]

Although the states could impose fiscal discipline on their municipalities, their ability to impose a plan of composition on dissenting creditors was constitutionally suspect for two reasons. The first was the Contracts Clause of the Constitution, which prohibits states from "passing any Law impairing the Obligation of Contracts."[205] The Contracts Clause therefore prohibits the states from passing laws that would force a creditor to accept less than what it is owed on a claim without that creditor's consent. Although the Contracts Clause does not prohibit a state from passing a law prospectively impairing contracts because all contracts executed after the enactment of such a law would

---

200. *See* Comment, *Administration of Municipal Credit*, 43 YALE L.J. 924, 963–64 (1934) (noting that courts cannot enforce a municipality to gather more revenue to pay creditors); Reuschlein, *supra* note 186, at 368 (discussing the extreme difficulties creditors faced when trying to collect payment from debtor municipalities).

201. *See* Reuschlein, *supra* note 186, at 352 (explaining the benefits and limitations of a receivership).

202. *See* Edward J. Dimock, *Progress in Solving Municipal Insolvency Problems*, 27 VA. L. REV. 193, 194–96 (1940) [hereinafter Dimock, *Progress*] (discussing the New Jersey Municipal Finance Commission); Reuschlein, *supra* note 186, at 368 (discussing the general powers of such commissions).

203. *See* HILLHOUSE, *supra* note 182, at 353 (discussing the broad reach of state receivership programs).

204. *Id.*

205. U.S. CONST. art. 1, § 10, cl. 1; *see also* McConnell & Picker, *supra* note 3, at 427–29 (explaining the history of the Chapter 9).

incorporate such an impairment,[206] municipalities were in crisis in the 1930s and needed a mechanism to adjust their existing debts, not the obligations that they would incur in the future.[207]

Even a state proceeding that would operate only prospectively was suspect. A state proceeding could relieve a debtor municipality from its obligations only if it could bind all of the municipality's creditors, wherever located. Yet a long line of cases beginning with the Supreme Court's opinion in *Ogden v. Saunders*[208] had held that a discharge from debt granted pursuant to one state's laws could not be enforced against a creditor from another state who did not participate in the discharge proceeding.[209] As a result, a collective proceeding under state law would be effective to bind only those out-of-state creditors who voluntarily participated in the proceeding.

A federal collective proceeding to resolve municipal financial distress was not free from constitutional objections, however. Under the Bankruptcy Clause, Congress has the power to pass "uniform Laws on the subject of Bankruptcies throughout the United States."[210] Commentators expressed some skepticism as to whether a federal process to adjust the debts of a municipality was within the purview of the Bankruptcy Clause, positing that the "subject of bankruptcies" was limited to "proceedings contemplating surrender of the debtor's assets for distribution to his creditors and discharge of the debtor."[211] Because a municipality's assets cannot be forcibly distributed to its creditors, it was possible that a municipal debt adjustment

206. *See* McConnell & Picker, *supra* note 3, at 480 (discussing constitutional limits on state insolvency legislation).

207. *See Administration of Municipal Credit*, *supra* note 200, at 969–70 (discussing the emergence of the Sumners Bill and the national economic emergency).

208. 25 U.S. 213 (1827).

209. *See, e.g.*, Cook v. Moffat & Curtis, 46 U.S. 295, 309 (1847) (finding that a state cannot pass a law affecting contracts beyond its territory); Hawley v. Hunt, 27 Iowa 303, 314 (1869) (concluding that "if the creditor is a non-resident of the State, a discharge under a State law cannot affect him unless he voluntarily becomes a party to the proceeding"); Hornick, More & Porterfield v. Farmers' & Merchs.' Bank, 227 N.W. 375, 379 (S.D. 1929) (stressing that *Ogden* limits "the power of states to act adversely upon the rights of citizens of other states").

210. U.S. CONST. art.1, § 8, cl.4.

211. Reuschlein, *supra* note 186, at 371 n.35.

statute was not within the subject of bankruptcies.[212] This view of the Bankruptcy Clause was not limited to its extension to municipal insolvency; Congress also added railroad reorganizations and corporate reorganizations to the bankruptcy laws in the 1930s[213] and its power to do so was similarly questioned.[214] One objection to the extension of the federal bankruptcy to corporate and railroad reorganizations was that the power to legislate on the subject of bankruptcies did not include the power to adjust the obligations of entities that were merely insolvent in the sense that they could not meet their obligations but did not meet the common law definition of bankrupt.[215]

Given the expansion of the term "bankruptcy" from its original eighteenth century meaning, the Bankruptcy Clause objection to a federal law to resolve municipal financial distress was fairly weak. A much more serious objection to extending Congress' bankruptcy power to municipalities was rooted in the Tenth Amendment. The Tenth Amendment of the Constitution reserves to the states all powers not granted to the federal government nor prohibited to the states by the Constitution.[216] When a private entity files for bankruptcy, all of its property becomes part of the bankruptcy estate, over which the court has some control.[217] Because a federal proceeding could intrude on a

---

212. *See* Asa G. Briggs, *Shall Bankruptcy Jurisdiction be Extended to Include Municipalities and Other Taxable Subdivisions?*, 19 A.B.A. J. 637, 637–38 (1933) ("No one ever intended to give to Congress power to extend the bankruptcy law to municipalities . . . ."). For a contrary view at the time, see Dimock, *Legal Problems supra* note 190, at 53 ("Congress in the exercise of its bankruptcy power is not confined to giving to the federal courts the power to make adjudications and to grant discharges.").

213. *See* Hon. Samuel L. Bufford, *What is Right About Bankruptcy Law and Wrong About Its Critics*, 72 WASH. U. L.Q. 829, 837–38 (1994) (discussing the 1933 and 1934 amendments to the Bankruptcy Act of 1898).

214. *See* James R. Morford, *Federal Legislation for Corporate Reorganizations: A Negative View*, 19 A.B.A. J. 702, 704 (1933) (discussing the constitutionality of the expansion of the federal bankruptcy laws to railroad corporations).

215. Albert K. Stebbins, *Constitutionality of the Recent Amendment to the Bankruptcy Law*, 17 MARQ. L. REV. 163, 171–73 (1933); Morford, *supra* note 214, at 704.

216. U.S. CONST. amend. X.

217. *See* 11 U.S.C. § 363 (2012) (limiting the power of the debtor to use property of the estate without the court's approval); *id.* § 541 (providing that

state's power to govern its cities, some feared that a bankruptcy chapter for municipalities would violate the Tenth Amendment.[218]

The constitutional restrictions on both the state and federal powers to resolve a municipal debt crisis that had the potential to contaminate the national economy led to calls for a combination of state and federal action. States could provide active fiscal oversight, but could not impose binding debt adjustments on nonconsenting creditors. Federal legislation could force debt reductions on creditors but could not provide the active fiscal guidance that was needed to ensure that a municipality could both resolve its current problems and avoid future problems.[219] In the 1930s, therefore, experts in municipal finance recognized a need for a combination of federal and state action to resolve a municipal debt crisis that had the potential to contaminate the economy of the entire country.[220] Those experts recognized that cooperative action could overcome the legal limitations placed on each sovereign.[221] As a result, they designed the original bankruptcy legislation to be just one component of their desired mechanism for resolving the financial crisis then facing American municipalities.

B. The 1930s Wish List and Resulting Statutes

Chapter IX, the original municipal bankruptcy statute, allowed any municipality or any other political subdivision of a

---

upon the filing of a bankruptcy petition, an estate is created consisting of all interests of the debtor in property at the time the petition is filed).

218. *See* McConnell & Picker, *supra* note 3, at 427 (discussing the role of federalism in the development of bankruptcy laws).

219. *See* Reuschlein, *supra* note 186, at 385 (recognizing municipal debt crisis would not be resolved if debt readjustment was not accompanied by state plans controlling local credit).

220. *See* HILLHOUSE, *supra* note 182, at 353 (noting that "there is a definite need for concurrent action by both the federal and state governments").

221. *See, e.g.*, *id.* (urging complementary measures because each sovereign could "supply the major limitation in the other"); *Administration of Municipal Credit*, *supra* note 200, at 1005 (recognizing that federal legislation and "careful state supervision of local credit are both essential to proper solution of the vital and complex problem presented by . . . municipal insolvencies").

state to file a voluntary petition for readjustment of its debts.[222] Congress had a modest goal, that of solving the holdout problem, in passing the legislation.[223] The Act required the debtor municipality to prepare and acquire consent from a prescribed number of creditors to the plan of adjustment before filing for bankruptcy.[224] Although the Act contained no automatic stay of litigation against the municipality,[225] the court could order a stay of actions both against the municipality and against its officers who might be the targets of a mandamus action.[226] The court could approve a plan upon the vote of the necessary number of creditors, so long as the plan was "fair, equitable, and for the best interests of creditors."[227] A confirmed plan would bind all creditors, including those who did not accept the plan.[228] The law explicitly rejected any limits on the power of states to control their municipalities and also allowed the states to decide whether their municipalities could take advantage of its provisions.[229]

Two years later, the Supreme Court struck down the 1934 Act as unconstitutional. In *Ashton v. Cameron County Water*

---

222. Act of May 24, 1934, Pub. L. No. 73-251, § 80(a), 48 Stat. 798 (codified at 11 U.S.C. §§ 301, 303), *invalidated by* Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513 (1936).

223. *See* Wylie Kilpatrick, *Federal Regulation of Local Debt*, 26 NAT'L MUN. REV. 283, 288 (1937) (arguing that the municipal bankruptcy act was not a well-balanced approach to the municipal debt problem precisely because of its modest goal in binding dissenting creditors to a plan of adjustment).

224. *See* Act of May 24, 1934, Pub. L. No. 73-251, § 80(a), 48 Stat. 798 (codified at 11 U.S.C. §§ 301, 303), *invalidated by* Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513 (1936) (requiring, as a prerequisite to filing, the acceptance of the plan by the holders of at least 30% of the debt of drainage, irrigation, reclamation and levee districts and 51% of the debt of all other taxing authorities).

225. At the time, no bankruptcy petition under any chapter of the 1898 Act imposed an automatic stay of all actions against the debtor and the debtor's property. The first automatic stay was included in farm-debtor relief legislation in 1933. *See* Frank R. Kennedy, *The Automatic Stay in Bankruptcy*, 11 U. MICH. J.L. REFORM 175, 179 (1978) (explaining the history of the automatic stay).

226. Act of May 24, 1934, Pub. L. No. 73-251, § 80(c)(9), 48 Stat. 798 (codified at 11 U.S.C. §§ 301, 303), *invalidated by* Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513 (1936).

227. *Id.* § 80 (d), (e).

228. *Id.* § 80(f).

229. *Id.* § 80(k).

Improvement District,[230] the Court found the original municipal bankruptcy legislation to be "inconsistent with the idea of sovereignty."[231] The fact that states retained the power to prevent their municipalities from filing for bankruptcy did not remedy the Act's constitutional infirmities, for the Court stressed that "neither consent nor submission by the States can enlarge the power of Congress."[232] In the Court's view, allowing the federal courts to interfere with the obligations of states and their political subdivisions was impermissible, even with state consent.[233]

During the short life of Chapter IX, 88 municipalities filed for bankruptcy, 24 of which were cities, towns, or counties.[234] One writer on municipal finance, A.M. Hillhouse, observed that the mere existence of the legislation alleviated the problem of holdout creditors because the knowledge that a municipality might resort to a bankruptcy filing to force a plan on such creditors was enough to bring recalcitrant creditors to the bargaining table.[235] The utility of the Act as a vehicle for cooperation between a state and the federal court went untested, however. One of the many petitions pending at the time of the *Ashton* opinion was that of North Bergen, New Jersey.[236] By the time North Bergen filed for bankruptcy in 1936, the New Jersey Municipal Finance Commission had assumed control over the township's fiscal affairs.[237] Most commentators at the time called for complementary state and federal legislation to address municipal financial distress; to them, North Bergen could have been an ideal case.[238] Had the case been allowed to proceed, it might have provided some guidance on questions regarding the relationship between the federal court and the state oversight commission as

230. 298 U.S. 513 (1936).

231. *Id*. at 531.

232. *Id.*

233. *See id.* (noting that state sovereignty "cannot be surrendered").

234. HILLHOUSE, *supra* note 182, at 387–88.

235. *Id.* at 388–89.

236. *Id.* at 392.

237. *Id.*

238. *Id.*

well as the nature of the commission's control both during and after the case.[239]

Both before Congress passed the first municipal bankruptcy act and after the Court held it to be unconstitutional, commentators suggested components of an ideal system to resolve the municipal debt crisis. An early commentator on municipal insolvency, Edward J. Dimock,[240] set forth the essential elements of any comprehensive scheme to alleviate municipal financial distress.[241] He analogized his ideal municipal debt resolution process to the equity receivership that had been developed in the late nineteenth century to restructure financially troubled railroads during a period in which there was no uniform federal bankruptcy statute.[242] Dimock's list of elements included: outside control of the insolvent debtor's finances,[243] concerted action by all creditors, accompanied by a stay of litigation to secure a "period of peace" to develop and evaluate a plan of debt adjustment,[244] and a settlement binding on all creditors.[245]

Dimock and others recognized that both state and federal action were needed for a well-balanced approach to the municipal debt problem. Some federal action was clearly necessary, whether it be by granting full faith and credit to state debt adjustment proceedings or by extending Congress's bankruptcy power to municipalities.[246] The federal power was

239. *Id.*

240. Edward Dimock was a leading bond lawyer and bar leader who later became a judge on the United States District Court for the Southern District of New York. *Edward J. Dimock Appointed to Federal Bench*, 37 A.B.A. J. 674, 674 (1951).

241. *See* Dimock, *Legal Problems*, *supra* note 190, at 43–44 (noting that the three elements of equity receivership are also necessary to deal with private and municipal insolvencies).

242. *See id.* at 43 (suggesting that the equity receivership system serve as a model to modify the municipal insolvency laws); DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 56–60 (2001) (explaining the history of the equity receivership); Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States,* 3 AM. BANKR. INST. L. REV. 5, 21–22 (2005) (explaining why equity receiverships developed).

243. Dimock, *Legal Problems*, *supra* note 190, at 44.

244. *Id.* at 46–47.

245. *Id.* at 50.

246. *See id.* at 51–52 (discussing suggested ways to invoke federal

necessary for one reason—to overcome the "obdurate minority" of dissenting creditors.[247]

The early commentary makes clear, however, that although a municipal bankruptcy chapter may have been a necessary tool to resolve the national municipal debt crisis, it was an implement with a very limited use.[248] The writers in the 1930s called for robust state intervention in municipal fiscal affairs. They recognized that the binding debt adjustment facilitated by a bankruptcy chapter would be useless without some plan to control local finances.[249] Only a state could provide the necessary administrative supervision over its localities in order to enable the municipalities to maximize revenues and borrow money at reasonable rates.[250] Although commentators recognized that some might object to oversight of a municipality by state officials unfamiliar with local conditions, they also recognized the possibility that the problems of one municipality could have a negative impact on

---

bankruptcy power in regulating municipal debt).

247. E.H. Foley, Jr., *Recent Developments in Federal-Municipal Relationships,* 86 U. PA. L. REV. 485, 511 n.156 (1938); *see also* Reuschlein, *supra* note 186, at 368 (noting that a state could not enforce a debt adjustment plan against dissenting creditors because of the Contracts Clause of the Constitution).

248. *See* HILLHOUSE, *supra* note 182, at 353 (noting that state control of municipal defeat is broad but with one fatal flaw: that it cannot compel agreement by creditors, therefore necessitating federal legislation to fill that gap).

249. *See* Dimock, *Progress*, *supra* note 202, at 204–05 (writing that, in order for bankruptcy to provide the same benefits for municipalities that it does for private entities, the state power to control municipalities must supplement the federal bankruptcy process); Reuschlein, *supra* note 186, at 385 (warning that debt adjustment without a state plan to control local credit might lead to "more serious predicaments" than doing nothing).

250. *See* HILLHOUSE, *supra* note 182, at 353 (explaining that the state can "collect taxes, revise the local budget and approve or disapprove all new borrowing"); Kilpatrick, *supra* note 223, at 287 (observing that even if federal courts were constitutionally permitted to exercise fiscal oversight, they are poorly equipped to do so); Reuschlein, *supra* note 186, at 386 (noting that a readjustment plan cannot establish permanent mechanisms for the supervision of fiscal management).

the credit of other municipalities in the same state.[251] Only state oversight could mitigate this possibility of contagion.[252]

Several commentators called for formal cooperation between the states and the federal courts in municipal bankruptcy proceedings. Some suggested that the debt adjustment apparatus provided by federal law be available only to municipalities in states in which the state government exercised positive oversight with respect to local defaults.[253] Others promoted a mechanism through which the state would be involved both before bankruptcy in formulating the plan of adjustment and after bankruptcy in supervising the municipality until its finances sufficiently improved.[254] Experts considered state oversight such an essential complement to federal legislation that some suggested that the state be given the power to file the bankruptcy petition for its municipality.[255]

Although experts expressed an appetite for a formal role for states in the federal municipal bankruptcy framework, Congress's second attempt at municipal bankruptcy legislation, passed in 1937,[256] was very similar to its first. Despite the similarities between the two acts, the Supreme Court in *United States v. Bekins* upheld the second.[257] In upholding the 1937 Act, known as Chapter X, the Court stressed that in order for a court to approve a debt readjustment plan, the debtor municipality

---

251. *See* Reuschlein, *supra* note 186, at 386–87 (discussing the effects of "purely local" conditions).

252. *See id.* (finding that the levels of administrative organization can adequately account for local conditions).

253. *See* Kilpatrick, *supra* note 223, at 289 (suggesting that the federal process be made available only in states "taking positive action to control and cure local defaults"); *Administration of Municipal Credit*, *supra* note 200, at 969–70 (proposing state administrative oversight of local credit as a prerequisite to federal relief).

254. *See* HILLHOUSE, *supra* note182, at 354–55 (discussing the utility of a state administrative body).

255. *See id.* at 355 (suggesting that the state and municipality together petition the court for relief); *Administration of Municipal Credit*, *supra* note 200, at 996–99 (proposing that a permanent state agency should be given supervisory authority over municipalities).

256. Act of Aug. 16, 1937, Pub. L. No. 75-302, 50 Stat. 653 (codified at 11 U.S.C. §§ 401, 402 (2012)).

257. *See* United States v. Bekins, 304 U.S. 27, 51–52 (1938) (upholding the Act of Aug. 16, 1937).

must have been authorized by state law to take all action necessary to implement the plan.[258] Moreover, the Court recognized that the statute, by deferring to the states' control over their fiscal affairs, was narrowly drawn so as not to interfere with state sovereignty.[259] Therefore, federal bankruptcy law did not unconstitutionally constrain the states' powers to govern their municipalities. The Court emphasized the policy of cooperation implied by the bankruptcy law, explaining that the state "invites the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue," adding that through the state's "cooperation with the national government the needed relief is given."[260] Mindful of the municipal debt crisis facing the nation, the Court refused to hold that the Constitution had rendered both the states and the federal government helpless to alleviate the problem.[261]

The foregoing discussion illustrates that the early municipal bankruptcy commentary called for cooperation between states and the federal government in dealing with municipal financial failure. Congress fashioned the predecessor to Chapter 9 within this framework in order to solve the one problem that states alone could not: the holdout problem.[262] No one intended for federal legislation to operate alone to solve the municipal debt problem; as Edward Dimock noted in his 1940 article assessing the progress made in addressing the municipal debt crisis, there was "plenty left to be done . . . when trouble comes again."[263] Trouble came again in the 1970s when New York City fell into financial disrepair, presenting a municipal default scenario

---

258. *Id.* at 49.

259. *Id.* at 51.

260. *Id.* at 54.

261. *Id.*

262. *See* Fred E. Neef, *Consent of State as Affecting Jurisdiction in Municipal Bankruptcy*, 15 DICTA 301, 302 (1938) (observing that as a result of the early municipal bankruptcy legislation the "defeat of a fair composition agreement by a selfish minority cannot be accomplished"); *Administration of Municipal Credit*, *supra* note 200, at 974 ("[S]ome method of enforcing readjustments of municipal debt structures against minority creditors seems essential, and . . . utilization of the federal bankruptcy power appears to be the most feasible device for accomplishing such enforcement . . . .").

263. Dimock, *Progress*, *supra* note 202, at 204.

potentially as serious as the one the United States faced in the aftermath of the Depression.[264]

C. Congress Revisits Municipal Financial Distress in 1976

Three decades passed without any attention to municipal bankruptcy. Very few municipalities filed for bankruptcy during that period, and the municipalities that filed were special-purpose districts rather than large general-purpose municipalities.[265] The financial crisis facing New York City in the mid-1970s, however, caused policymakers to take a fresh look at the federal municipal bankruptcy legislation.[266] When its crisis hit in 1975, closing the municipal bond markets,[267] experts considered bankruptcy an unsuitable option for a city of New York's size.[268] Indeed, several elements of the federal municipal bankruptcy statute, then known as Chapter IX, made its use by a large city impractical.[269]

The main concern about Chapter IX was that its entry requirements made its use by cities such as New York unfeasible. The law required a municipality to submit, with its bankruptcy petition, its plan of debt adjustment, agreed to by a majority in dollar amount of its creditors.[270] Many saw this requirement as an impediment to speedy relief for a municipality because by the

---

264. *See* Joseph Patchan & Susan B. Collins, *The 1976 Municipal Bankruptcy Law*, 31 MIAMI L. REV. 287, 289 (1977) (discussing the severity of the new financial crisis).

265. *See id.* at 289 n.13 (stating that only sixty-four municipalities filed for bankruptcy between 1946 and 1976); Winograd, *supra* note 29, at 273 (stating that public sector bankruptcies between the 1940s and 1970s typically involved small entities formed to perform specific functions).

266. Patchan & Collins, *supra* note 264, at 291.

267. *See generally* Donna E. Shalala & Carol Bellamy, *A State Saves a City: The New York Case*, 1976 DUKE L.J. 1119 (1976).

268. Patchan & Collins, *supra* note 264, at 291.

269. *See, e.g.*, King, *supra* note 23, at 1158 (explaining that the then-existing municipal bankruptcy legislation was not "realistically available to major public entities"); Patchan & Collins, *supra* note 264, at 291–92 (explaining that structural deficiencies in the municipal bankruptcy chapter, such as its lack of an automatic stay and its requirement that the debtor municipality submit a plan of adjustment with its petition, made its use by large cities impracticable).

270. King, *supra* note 23, at 1158; Patchan & Collins, *supra* note 264, at 290.

1970s, many cities had a large number of bondholders, many of whom held their bonds in bearer form and were therefore difficult to identify.[271]

The 1976 Act simplified the entry requirement. Rather than requiring a prepetition plan, the 1976 legislation made a plan one of four alternative prerequisites to filing. If the debtor municipality did not negotiate a plan with its creditors before filing for bankruptcy, it could still file if it showed that it negotiated in good faith with its creditors before filing or that negotiating with its creditors was impracticable.[272]

Loosening the entry requirement addressed the major concern about the utility of Chapter IX for a large city such as New York.[273] Congress went further, however, and incorporated several features of private entity reorganization into the municipal bankruptcy chapter. The 1976 amendments added an automatic stay, which by then was a feature of other chapters of the Bankruptcy Act and which allowed the municipal debtor to avoid the extra time and expense of separately petitioning the court to stay proceedings against it.[274] Congress also added avoiding powers to Chapter IX that mirrored the trustee's power in other bankruptcy chapters to avoid prepetition transfers of the debtor's property shown to be fraudulent, preferential, or unperfected.[275] The power to avoid preferential transfers proved problematic with respect to municipal bonds when Cleveland fell into financial distress in 1979, leading to further amendments to municipal bankruptcy law in 1988 to inject some certainty into the treatment of municipal bondholders in Chapter 9.[276]

---

271. *See* King, *supra* note 23, at 1158 (noting that many bonds were bearer bonds with unidentified holders); Patchan & Collins, *supra* note 264, at 291 (discussing how the New York crisis highlighted the deficiencies of the Act).

272. *See* King, *supra* note 23, at 1161 (listing some of the new entry criteria). There was also a fourth alternative: the debtor could file without negotiation if it had a reasonable fear that a creditor would attempt to recover a preferential transfer. *Id.*

273. *See* Patchan & Collins, *supra* note 264, at 294 (noting that the new Chapter IX alleviated previous difficulties).

274. King, *supra* note 23, at 1165–66.

275. *Id.* at 1166–68.

276. *See generally* Robert S. Amdursky, *The 1988 Municipal Bankruptcy Amendments: History, Purposes, and Effects*, 22 URB. LAW. 1 (1990).

One rehabilitative provision added to Chapter IX in 1976 was the power of the debtor to reject executory contracts. This power was available to private debtors in other bankruptcy chapters[277] but was potentially controversial when exercised by public debtors. From its initial enactment, the federal municipal bankruptcy chapter respected and yielded to each state's right to govern its cities,[278] and the 1976 Act did not change this. Like its predecessors, the 1976 municipal bankruptcy act provided that nothing in the Act "shall be construed to limit or impair the power of any State to control, by legislation or otherwise, any municipality or any political subdivision of or in such State in the exercise of its political or governmental powers."[279] Because the power to reject executory contracts encompassed the power to reject labor contracts, which are often subject to state collective bargaining laws, this new power created a potential federalism problem.[280]

Although Kimhi suggested that the inclusion of the power to reject executory contracts was evidence of Chapter 9's broader restructuring goal,[281] there is another way to look at the 1976 additions to the municipal bankruptcy chapter. By the 1970s, the

277. Patchan & Collins, *supra* note 264, at 299.

278. *Supra* notes 257–61 and accompanying text.

279. Act of Apr. 8, 1976, Pub. L. No. 94-260, § 83, 90 Stat. 315, 316–17 (1976) (codified at 11 U.S.C. § 903 (2012)) (providing for voluntary reorganization procedures for the adjustment of the debts of municipalities).

280. *See* King, *supra* note 23, at 1169 (recognizing that the inclusion of the power to reject executory contracts could be controversial in the municipal bankruptcy context); Patchan & Collins, *supra* note 264, at 299–300 (explaining a potential conflict between bankruptcy law and a state law prohibiting rejection of pension agreements); Winograd, *supra* note 29, at 277–80 (discussing the congressional debates about the application of the debtor's power to reject executory contracts to labor contracts subject to state law restrictions).

281. *See* Kimhi, *Solution*, *supra* note 16, at 367 ("The new chapter was no longer confined to setting a majority voting rule for the approval of debt readjustment plans, but rather adopted a comprehensive bankruptcy procedure designed to help distressed localities, such as New York, survive and deal with financial crises."). Kimhi argues that the change of the bankruptcy procedures themselves, including the power to reject executory contracts, is evidence of Chapter 9's broader restructuring goal. *Id.* at 368. The legislative history of the 1976 amendments can be read to support his contention because Congress expressed the goal of providing a federal procedure by which a municipality could "restructure its indebtedness in such fashion as to avoid continuing insolvency." Preamble to Pub. L. No. 94-260, 90 Stat. 315, 315 (1976).

municipal bankruptcy law drafted in the 1930s was unsuitable for larger cities, largely because of its entry requirements. When Congress liberalized the entry requirements, it also added some elements of private bankruptcy law, such as the automatic stay and the powers to avoid preferential and fraudulent transfers. All of these powers relate to debt adjustment, not to reorganizational governance. By giving a municipal debtor some additional bankruptcy benefits, Congress provided the states with additional tools for resolving the financial distress of their cities if they chose to accept the assistance of federal law.[282] Rather than rejecting Congress's original municipal bankruptcy goal of solving the holdout problem, the 1976 amendments strengthened it.

New York did not resort to bankruptcy. Instead, the state legislature established the Municipal Assistance Corporation (MAC) and authorized the MAC to issue debt for the city and draft a rescue program for the city.[283] The city's finances were placed under the supervision of a control board that included city and state officials, and the federal government deemed New York's problems to be significant enough nationally to enter into a credit agreement with the city.[284] New York's recovery was successful because the state acted quickly and drastically.[285]

The 1970s saw two parallel developments. In one, New York State, with the financial help of the federal government, orchestrated a recovery plan for New York City without resort to the bankruptcy laws. In the other, Congress amended the bankruptcy law to make its municipal bankruptcy chapter a workable alternative for large general-purpose municipalities and in the process, added some features of corporate bankruptcy. At the same time, the municipal bankruptcy scholarship focused primarily on what the federal bankruptcy law standing alone could do for cities, and thus differed from the 1930s scholarship, which promoted a federal municipal bankruptcy chapter as a complement to state intervention.[286] Although two commentators

---

282. *See* King, *supra* note 23, at 1165–71 (discussing stays, avoiding powers, and rehabilitative provisions).

283. Shalala & Bellamy, *supra* note 267, at 1127–28.

284. *Id.* at 1129–31.

285. *Id.* at 1132.

286. *See supra* notes 249–55 and accompanying text (discussing the 1930s' scholarship and the need for a combination of federal and state action to resolve

pronounced the 1976 Act as deficient in that it did not provide a mechanism to involve the state in the formulation of a city's bankruptcy plan,[287] two writers involved in the rescue of New York City attributed the city's avoidance of bankruptcy in part to "the strong belief that elected and not appointed officials ought to put the city's fiscal matters in order."[288] After the 1970s, scholarship about municipal bankruptcy tended to present it as an alternative to state intervention,[289] and because of some of its differences from Chapter 11, a poor alternative at that.

This turn in the scholarship is unfortunate, because it leaves state policymakers with few recent resources as they decide whether and how to allow their municipalities to file for bankruptcy. Detroit's filing is likely to lead other states with struggling cities to reevaluate the conditions that they place on Chapter 9 filings. It is important that states not lose sight of the role of Chapter 9 in an integrated state–federal approach to municipal financial distress. In the next section, I explain how Congress has invited states to play a role in Chapter 9 debtor governance and the extent to which states have chosen to do so.

V. Specific Authorization to File for Chapter 9: An Invitation to Govern

The specific authorization requirement gives the states a gatekeeper role by allowing the states to choose whether, and under what conditions, their municipalities can file for bankruptcy. Chapter 9 does not grant municipalities the power to file for bankruptcy; rather, it presents to the states the choice of giving their municipalities the power to seek bankruptcy

---

municipal debt crises).

287. *See* Patchan & Collins, *supra* note 264, at 305 (recognizing that a state might play a crucial role in developing a bankruptcy plan for one of its municipalities).

288. Shalala & Bellamy, *supra* note 267, at 1132.

289. *See, e.g.*, Dubrow, *supra* note 3 (writing about Chapter 9 as one alternative for resolving municipal financial distress, using the filing of Bridgeport, Connecticut, as an example); *supra* notes 3, 16 and accompanying text; *cf.* Tung, *supra* note 3, at 916 (suggesting that California require the governor to approve all municipal bankruptcy petitions as a way of encouraging cooperation between the state and the distressed municipality).

protection.[290] By granting the states this gatekeeper role, Congress not only exercised care to ensure that the municipal bankruptcy chapter passed constitutional muster, it also provided a mechanism for state participation in the federal bankruptcy process.

The authorization requirement is a governance control that reflects the hybrid fresh start–rehabilitation goal of Chapter 9. All Chapter 9 can do on its own is give debt relief.[291] Combined with state intervention, however, Chapter 9 can both give debt relief and facilitate municipal rehabilitation. Although the original intention of Congress was for Chapter 9 to support state governance over the debtor, the invitation to states to exercise that governance was not explicit until Congress amended Chapter 9 in 1994 to condition entry on specific, rather than general, authorization by the state.[292] In this section, I explain the evolution of the authorization requirement and the role that it plays in inviting state governance over Chapter 9 debtors.

A. Reasons for and Evolution of the Authorization Requirement

A municipality may file for bankruptcy only if it is "specifically authorized, in its capacity as a municipality or by name, to be a debtor [under Chapter 9] by State law or by a governmental officer or organization empowered by State law" to authorize a Chapter 9 filing.[293] The requirement that a state authorize its municipalities to file is one that has developed over the lifetime of the municipal bankruptcy law. The act that the *Bekins* Court found to be constitutional contained no requirement of state authorization, but the Court nevertheless found that the statute was consistent with the Tenth Amendment because it

290. *See* 11 U.S.C. § 109(c)(2) (2012) (providing that "[a]n entity may be a debtor under chapter 9 of this title if and only if such entity" is "specifically authorized"); *In re* City of Bridgeport, 128 B.R. 688, 692 (Bankr. D. Conn. 1991).

291. *See* Tung, *supra* note 3, at 888–89 ("The basic purpose for federal municipal bankruptcy law—Chapter 9 of the Bankruptcy Code—is the same as for private corporations reorganizing under Chapter 11: to allow a debtor a breathing spell from creditors' collection efforts and to enable it to formulate a repayment plan with creditors.").

292. *See id.* at 890 (discussing the Bankruptcy Reform Act of 1994).

293. 11 U.S.C. § 109(c)(2).

prohibited "interference with the fiscal or governmental affairs" of a municipality and because it required that the debtor municipality be permitted by state law to carry out its plan of adjustment.[294] Courts after *Bekins* interpreted the municipal bankruptcy law as an opt-out statute: a state was not required to affirmatively authorize a municipality to file for bankruptcy, but it could prohibit its municipalities from doing so.[295]

The 1976 amendments to Chapter IX included state authorization as a requirement for entry into the municipal bankruptcy process. As a result of those amendments, a municipality was required to allege that it was generally authorized by state law to file for bankruptcy.[296] Lawrence King, a leading bankruptcy scholar at the time, viewed this as an opt-in requirement that necessitated an affirmative state act.[297] He expressed concern that the general authorization requirement might deprive a state of flexibility in determining whether a municipality within the state should file. King speculated that a city facing an unexpected financial crisis in a state that had no authorizing legislation on its books might unnecessarily languish in its financial crisis while the state legislature acted to pass the

---

294. United States v. Bekins, 304 U.S. 27, 51 (1937). The debtor in *Bekins* had been authorized by its state, California, to file for bankruptcy. *Id.* at 47.

295. *See* Faitoute Iron & Steel Co. v. Asbury Park, 316 U.S. 502, 508–09 (1942) (discussing the law of the state of New Jersey, which "expressly prohibits any municipality to avail itself of a federal bankruptcy act" unless approved by the New Jersey Municipal Finance Commission); Mission Indep. Sch. Dist. v. Texas, 116 F.2d 175, 177 (5th Cir. 1940) (stating that a state "can forbid its creature to seek a bankruptcy composition," making the legislature "the judge of whether a composition should be sought, rather than leave the question to the governing body of the subdivision"); *see also* King, *supra* note 23, at 1159 (explaining that prior to 1976, bankruptcy law did not require states to affirmatively authorize municipal bankruptcy filings but that states could prohibit their municipalities from filing for bankruptcy).

296. *See* Act of Apr. 8, 1976, Pub. L. No. 94-260, § 84, 90 Stat. 315, 317 (1976) (codified at 11 U.S.C. § 404 (1976)) ("Any State's political subdivision or public agency or instrumentality, which is generally authorized to file a petition under this chapter by the legislature, or by a governmental officer or organization empowered by State law to authorize the filing of a petition, is eligible for relief under this chapter . . . ."); King, *supra* note 23, at 1160 (stating that Section 84 "provides that there must be *general* authorization to file a petition under Chapter IX" (emphasis added)).

297. *See* King, *supra* note 23, at 1160 (explaining that "[t]he general authorization can be accomplished by state legislation at any time; it need not be enacted specifically in response to a particular situation").

necessary legislation.[298] According to King, the prior requirement that a city could file unless prohibited from filing was a superior way to ensure that states played an affirmative role in deciding how to resolve their cities' financial crises.[299]

Not all courts interpreted the general authorization requirement as a mandate that a state opt in to the federal bankruptcy regime, resulting in a non-uniform standard for state consent. Although some courts interpreted the general authorization requirement to require an affirmative act by the state allowing municipalities to file,[300] others found authorization to file for bankruptcy if the state had authorized a municipality to borrow money, enter into contracts, or sue and defend suits.[301] When Bridgeport filed for bankruptcy, the court found that the city was authorized to file, despite objections by both the state attorney general and a review board that the state created to oversee the city's finances.[302] The bankruptcy court held that although the general authorization requirement necessitated some affirmative act by the state to allow the city to file for bankruptcy, the state had given such authorization by granting the city home rule authority over its borrowing, finances, and property.[303]

---

298. *Id.*

299. *See id.* (stating that the law of "prohibition" should have been retained because "states would have retained the power to determine whether they should permit their [municipalities] to utilize the Bankruptcy Act" without "requiring an affirmative act of the legislature which at times may be difficult . . . to accomplish").

300. *See In re* Carroll Twp. Auth., 119 B.R. 61, 63 (Bankr. W.D. Pa. 1990) (interpreting the legislative history to the 1976 amendments as requiring an affirmative act by the state); Dubrow, *supra* note 3, at 555–56 (explaining the differing interpretations of the general authorization requirement).

301. *See, e.g.*, *In re* Vills. at Castle Rock Metro. Dist. No. 4, 145 B.R. 76, 82 (D. Colo. 1990) (concluding that a special district was generally authorized to file for bankruptcy because Colorado law allowed it to, among other things, bring suits, borrow money, and manage, control, and supervise all of its business affairs); *In re* Greene Cty. Hosp., 59 B.R. 388, 391 (Bankr. S.D. Miss. 1986) (interpreting the legislative history to require a broad reading of the general authorization requirement).

302. Dubrow, *supra* note 3, at 555.

303. *In re* City of Bridgeport, 128 B.R. 688, 696 (Bankr. D. Conn. 1991). The court later dismissed Bridgeport's petition because it found that the city, when it filed its petition, was not insolvent as required by § 109(c)(3). *In re* City of Bridgeport, 129 B.R. 332, 339 (Bankr. D. Conn. 1991).

Congress resolved the confusion over the meaning of the general authorization requirement in 1994. The 1994 amendments to the Code added the current requirement that a municipality be specifically authorized by its state to file for bankruptcy.[304] The specific authorization requirement implements the original vision for a municipal bankruptcy chapter as stated by the Court in *Bekins*: it allows the state to "invite[] the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue."[305] A state may impose its own conditions on access to Chapter 9 and thus design a framework for state participation in developing a rehabilitation plan for its municipalities with the help of the bankruptcy court. In the next section, I discuss the various ways in which states have implemented this specific authorization requirement and discuss how they further, or fail to further, the goals of Chapter 9.

B. Implementation of State Authorization

Although Congress enacted the original municipal bankruptcy law to allow states to invite the power of federal law to remedy financial problems that the states, on their own, could not remedy, not all states have laws that reflect this purpose. Twenty-seven states permit at least some of their municipalities to file for bankruptcy.[306] The remaining states have no statute addressing the issue, with the exception of Georgia, which prohibits its municipalities from filing,[307] and Illinois, which does not authorize its cities to file but gives a Financial Planning and Supervision Commission the power to recommend that a

---

304. *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994) (codified at 11 U.S.C. § 109(c)(2) (2012)) (amending § 109(c)(2) of Title 11 by striking "generally authorized" and inserting "specifically authorized, in its capacity as a municipality or by name"); Tung, *supra* note 3, at 890 (discussing the 1994 amendments).

305. United States v. Bekins, 304 U.S. 27, 54 (1938).

306. *See* H. SLAYTON DABNEY, JR. ET AL., MUNICIPALITIES IN PERIL: THE ABI GUIDE TO CHAPTER 9, at 75–88 (2d ed. 2013) (providing a list of state statutes authorizing Chapter 9 filings).

307. GA. CODE ANN. § 36-80-5 (2013).

municipality file a Chapter 9 petition.[308] Many states that do not authorize their municipalities to file for bankruptcy also lack a state program to intervene in municipal financial distress.[309]

Even in states that authorize their municipalities to file for Chapter 9, bankruptcy authorization and state oversight do not always go hand in hand. Several states allow their municipalities to file for bankruptcy without any restrictions other than those imposed by the Bankruptcy Code.[310] These statutes contemplate no pre-bankruptcy state fiscal oversight, nor do they mandate any role for the state during the Chapter 9 case. The absence of a pre-bankruptcy state oversight requirement does not mean that the state cannot provide fiscal oversight in bankruptcy,[311] but it means that the extent of such oversight will be uncertain until a municipality files for bankruptcy. It is in the states that require no state involvement in a municipality's decision to file for bankruptcy that the fear that Chapter 9 will do nothing to remedy the conditions that led to a municipality's financial ills rings most true. Alabama, the home of the largest municipal bankruptcy ever filed until Detroit's filing, is one of those states.[312] Not only does Alabama lack a municipal oversight program but the state refused to intervene to help Jefferson

---

308. 50 ILL. COMP. STAT. 320/9(b)(4) (2013).

309. *See* PEW REPORT, *supra* note 127, at 9–10 (providing a state-by-state listing of bankruptcy authorization and state oversight programs).

310. *See, e.g.*, ARIZ. REV. STAT. ANN. § 35-603 (2013) (authorizing any taxing district in the state to file for bankruptcy); KY. REV. STAT. ANN. § 66.400 (West 2013) (authorizing municipalities other than counties to file for bankruptcy without any conditions); MO. REV. STAT. § 427.100 (2013) (authorizing any municipality or political subdivision to file for bankruptcy); OKLA. STAT. tit. 62, § 283 (2013) (authorizing municipal corporations and political subdivisions to file for bankruptcy).

311. 11 U.S.C. § 903 (2012) (providing for the reservation of state power to control municipalities).

312. *See* ALA. CODE § 11-81-3 (2013) (declaring that the governing body of any county, city, town, or municipal body has the power to file a bankruptcy petition and giving the state's permission for such a filing). The language of this statute raised an eligibility question in Jefferson County's case because the statute allows municipalities that "shall authorize the issuance of funding or refunding bonds" to file for bankruptcy, and Jefferson County had issued warrants, not bonds. *In re* Jefferson Cnty., Ala., 469 B.R. 92, 98 (Bankr. N.D. Ala. 2012).

County resolve its financial difficulties without filing for bankruptcy.[313]

Some states impose stronger bankruptcy governance controls by requiring a municipality to obtain the approval of a public official before filing for bankruptcy. Some of these statutes are unclear as to the level of governance that the state will provide. For example, Connecticut's statute requires that a municipality obtain the written consent of the governor before filing for bankruptcy, but the statute says nothing about the state's involvement in a Chapter 9 case.[314] Louisiana's statute requires both the governor and the attorney general to approve the petition before any municipality can file for Chapter 9.[315] The Louisiana statute also requires the governor and attorney general to approve the plan of adjustment, although it does not require that the governor and attorney general be involved in developing the plan.[316] Moreover, the Louisiana statute provides no guidelines for the approval or disapproval of a petition or plan.[317] In these states, there is a loose tie between state oversight and bankruptcy authorization in that the state must be involved in the municipality's decision to file for Chapter 9, although it does not appear that bankruptcy is incorporated into a state municipal oversight program.

---

313. PEW REPORT, *supra* note 127, at 9, 27. In one important respect, the state of Alabama exacerbated Jefferson County's financial problems when it refused to allow the county to impose an occupational tax. *See In re* Jefferson Cnty., Ala., 474 B.R. 228, 237 (Bankr. N.D. Ala. 2012) (explaining the rejection of the county's tax by the Alabama Supreme Court and the legislature's subsequent refusal to enact a replacement tax).

314. *See* CONN. GEN. STAT. § 7-566 (2013) (requiring the written consent of the governor).

315. *See* LA. REV. STAT. ANN. § 39:619 (2012) (prohibiting a municipality from filing for bankruptcy "without the consent, approval and authority of the state through the governor and the Attorney General").

316. *See id.* § 39:620 (giving the governor and attorney general the discretion to approve or disapprove the plan of readjustment). The statute raises an interesting federalism issue in that it allows the state officials to reject a plan of adjustment after its confirmation by the bankruptcy court.

317. *Id.*; *see also* Lauren M. Wolfe, Note, *The Next Financial Hurricane? Rethinking Municipal Bankruptcy in Louisiana*, 72 LA. L. REV. 555, 577 (2012) (explaining that the statute lacks any factors for the State Bond Commission to consider in deciding whether a municipality should file for Chapter 9).

Several states have oversight programs that allow the state to intervene in municipal finances. North Carolina, whose municipal financial oversight program is considered to be the "gold standard" for such programs, and New Jersey, which is also known for providing more assistance to its cities than most states, implemented their programs soon after the Great Depression brought a wave of municipal bond defaults.[318] These programs provide budget oversight and intervention in the event of a default on the part of a municipality.[319] Kentucky also has a Depression-era statute that allows the state to "assist counties whose financial affairs have become so involved that they have seemed to be beyond local solution and . . . to curb deplorable practices due to inefficiency, carelessness, or in some instances, quasi criminality in the handling of county finances in utter disregard of the public welfare."[320]

Kentucky and New Jersey have integrated the bankruptcy process into their state oversight programs. In Kentucky, a county may file for bankruptcy only if two state officials approve its petition and proposed plan of adjustment.[321] Once the county files, it may amend its plan only if the same state officials approve of the amendments. [322] Although Kentucky law does not require that a county participate in a state oversight program before filing for bankruptcy, a county may ask the state for its assistance in

318. PEW REPORT, *supra* note 127, at 33–36; Natalie Cohen, *Intergovernmental Theater: Spotlight on Michigan*, Wells Fargo Securities Municipal Securities Research Municipal Commentary, Jan. 16, 2013.

319. *See* N.C. GEN. STAT. §§ 159-7 to -42 (2013) (codifying the North Carolina Local Government Budget and Fiscal Control Act); *id.* § 159-176 (authorizing the North Carolina Local Government Commission to assist a local government in refinancing or adjusting its debt); Donald H. Elliott, *Proposed Fiscal Monitoring Legislation in New York: A Comparative Analysis*, 8 FORDHAM URB. L.J. 109, 113–19 (1979) (explaining New Jersey's fiscal oversight of its municipalities).

320. Lincoln Nat'l Bank v. Cnty. Debt Comm'n, 172 S.W.2d 463, 467 (Ky. 1943). *See generally* Glenn D. Morrow, *County Debt Difficulties in Kentucky* (pts. 1 & 2), 31 KY. L.J. 122, 242 (1942–1943), for an early explanation of the law.

321. *See* KY. REV. STAT. ANN. § 66.400 (West 2013) (providing that "the state local debt officer and the state local finance officer" must approve the petition and proposed plan of adjustment before "[a]ny taxing agency or instrumentality, as defined in Chapter IX of the Federal Bankruptcy Act," may file a petition as provided in the Federal Bankruptcy Act).

322. *Id.*

restructuring county debt, and the state may intervene in a county's finances if the county is in default on any indebtedness.[323] New Jersey has a similar statute, which requires the state's municipal finance commission to approve both the petition[324] and the plan of adjustment.[325] A municipality that is unable to pay its debts can apply for state oversight,[326] and the state can place a defaulting municipality under state supervision on the request of the holder of the unpaid bonds or notes.[327] When a municipality is placed under state oversight, the municipal finance commission appoints an auditor to recommend a budget for the municipality and to approve contracts and capital improvements.[328]

The existence of a state oversight program does not necessarily mean that the state integrates Chapter 9 into that program. North Carolina requires approval of the Local Government Commission before any municipality can file for bankruptcy, but the statute is unclear regarding any involvement by the commission in the Chapter 9 case.[329] Moreover, some

---

323. *Id.* § 66.320.

324. *See* N.J. STAT. ANN. § 52:27-40 (West 2013) (providing that "[a]ny county, municipality, school district or other political subdivision of this State" shall not file a petition under the municipal bankruptcy act "unless the approval of the municipal finance commission . . . be first had and obtained").

325. *See id.* § 52:27-42 ("No plan of readjustment filed with or in the proceedings upon any such petition shall be approved by the court or put into temporary effect or finally confirmed without the approval of the commission.").

326. *Id.* If a "municipality is not in a position to meet its obligations when due," it may institute a civil action in the Superior Court. *Id.* If the court finds that "the municipality is so unable to meet its obligations, it may enter judgment to that effect." *Id.* Upon such entry, "the commission shall function in such municipality with all the powers and duties conferred by this chapter." *Id.*

327. *Id.* The "holder of any notes or bonds of any municipality of this State" may institute an action against a municipality that is unable to pay its debts. *Id.* If the court finds that the municipality is in default, then it may enter judgment to that effect, and the commission will then exercise its powers and duties over the defaulting municipality. *Id.*

328. *See id.* § 52:27-13.1 (describing the powers and duties of an auditor).

329. *See* N.C. GEN. STAT. § 23-48 (2013) (allowing a North Carolina municipality to obtain the approval of the Local Government Commission before filing for bankruptcy); *id.* § 159-176 (allowing the Local Government Commission to assist a municipality in adjusting its debts after a default and allowing the commission to petition a state court for an order directing the municipality to carry out the plan). Largely due to robust state oversight, no North Carolina municipality has defaulted on a bond obligation since 1942. PEW REPORT, *supra* note 127, at 33.

states that have an intervention program have no legislation authorizing their municipalities to file for Chapter 9.[330]

Recent municipal bankruptcies and threats of same have caused some states to revisit their authorizing legislation. California amended its authorization statute after Vallejo filed for bankruptcy. Vallejo's bankruptcy was expensive and time-consuming, and some question whether it brought any benefits at all to the city.[331] California's statute, enacted at the behest of the public employee unions,[332] requires that a municipality contemplating bankruptcy must first enter into a confidential mediation process with its creditors.[333] Although its detractors criticize the statute for potentially delaying a necessary Chapter 9 filing for a distressed city,[334] its supporters contend that if a municipality is required to negotiate in good faith with its creditors before filing, it might either avoid Chapter 9 or develop a prenegotiated plan, thus reducing the duration and cost of the Chapter 9 case.[335] California continues to eschew state oversight of municipal finances; during the legislative process

---

330. *See* PEW REPORT, *supra* note 127, at 9–10 (listing bankruptcy authorization statutes and state intervention programs state-by-state).

331. *See* Denniston, *supra* note 21, at 273 (explaining that Vallejo's Chapter 9 took 3 years, cost $13 million, and left a $3.4 million shortfall in the city's first post-bankruptcy budget).

332. *See* Editorial, *Cities Could Find Budget Fire Escape Blocked,* ORANGE COUNTY REG. (Sept. 14, 2011), http://www.ocregister.com/articles/union-317114-bankruptcy-pension.html (last visited Oct. 31, 2013) (explaining that the bill was backed by two public employee unions) (on file with the Washington and Lee Law Review); Ed Mendel, *In Looming Stockton Bankruptcy, Pensions Won't Be Cut,* CAPITOL WEEKLY (June 7, 2012), http://capitolweekly.net/in-looming-stockton-bankruptcy-pensions-wont-be-cut/ (last visited Oct. 18, 2013) (explaining that the unions backed the legislation because they feared, after Vallejo's bankruptcy, that cities filing for bankruptcy would break their labor contracts) (on file with the Washington and Lee Law Review).

333. CAL. GOV'T CODE § 53760(a) (West 2013). A municipality may avoid this process by declaring a fiscal emergency. *Id.* § 53760(b).

334. *See* Christine A. Schleppegrell, Ad Hoc *Legislation Creates Barriers to A Chapter 9 Filing*, 32 AM. BANKR. INST. J. 48, 48 (2013) (criticizing new state restrictions on Chapter 9 as creating "an unpredictable pathway to bankruptcy").

335. Denniston, *supra* note 21, at 261. Ms. Denniston helped draft Assembly Bill 506 (AB 506). AB 506 has not eliminated eligibility fights. *See In re* City of Stockton, 493 B.R. 772, 795 (Bankr. E.D. Cal. 2013) (holding, over the objection of the capital markets creditors, that the city was eligible for Chapter 9 because it had negotiated in good faith with its creditors).

preceding the enactment of the new statute, state leaders insisted that the bill could not increase the financial burdens on the state.[336] Therefore, although California accepted the Bankruptcy Code's invitation to place conditions on the ability of its municipalities to file, its legislation does nothing to further the foundational goal of municipal bankruptcy law, which was to invite the federal power to solve a problem that the state could not solve on its own.

Other states whose cities have suffered financial threats have modified their authorization statutes to more explicitly link the authorization to file for bankruptcy with state oversight. The Rhode Island legislature enacted its Fiscal Stability Act out of a concern that Central Falls' 2010 receivership petition would lead to other receivership petitions by Rhode Island municipalities.[337] A Rhode Island city cannot file for bankruptcy without taking three intermediate steps, each of which requires the city to submit to increasing levels of fiscal oversight.[338] It is only after the appointment of a receiver, the third and last of the intermediate steps, that a city can file for bankruptcy, and the authorizing statute grants the receiver the power to file the Chapter 9 petition.[339]

---

336. Denniston, *supra* note 21, at 282.

337. Kishfy, *supra* note 21, at 350.

338. *See* R.I. GEN. LAWS §§ 45-9-5 to -7 (2013) (providing three intermediate steps that a Rhode Island city or town must take before being able to file for bankruptcy). First, "[t]he fiscal overseer shall report in writing to the division of municipal finance if the fiscal overseer concludes that the city or town" meets one of four conditions, and "[i[f the fiscal overseer believes, at any time, that a budget commission should be appointed, the fiscal overseer may report that belief to the division of municipal finance." *Id.* § 45-9-5. Second, a budget commission can be established. *Id.* § 45-9-6. Third, "[i]f the budget commission established by § 45-9-5 concludes that its powers are insufficient to restore fiscal stability to the city or town, it shall notify the director of revenue;" when the director of revenue receives a statement of the reasons why the budget commission is unable to restore fiscal stability to the city or town, "the director of revenue shall appoint a receiver for the city or town for a period as the director of revenue may determine." *Id.* § 45-9-7.

339. *Id.* § 45-9-7. The statute allows the state to bypass the intermediate steps in some circumstances. *See id.* § 45-9-8 (allowing the state's director of revenue to appoint a receiver for a city facing a fiscal emergency if circumstances do not permit the appointment of a fiscal overseer or budget commission).

Michigan's law has a tortured history. In 1988, to respond to the effects that the 1980s recession had on its cities, Michigan enacted a law that allowed the state to appoint an emergency financial manager for a municipality experiencing a financial emergency.[340] Although the statutory allocation of authority between the emergency financial manager and the municipality's elected officials was somewhat unclear, it was widely understood that the law permitted local officials to exercise all of their powers other than the budget and fiscal powers that the statute gave to the emergency financial manager.[341] In 2011, as the financial picture in Detroit and other Michigan cities became increasingly dire, Michigan enacted a law transforming the emergency financial manager into an emergency manager.[342] The effect of that law was to allow the state to replace all of a financially stressed municipality's elected officials with an official appointed by the governor.[343] Under that law, only the emergency manager had the power to file a bankruptcy petition for the municipality with the governor's approval.[344] Michigan voters rejected that law in 2012 and the legislature quickly responded with a statute that gives a financially distressed city four choices: the appointment of an emergency manager, Chapter 9 bankruptcy, mediation with its creditors, or a consent agreement with the state to reduce its debt.[345]

---

340. *See* Philo, *supra* note 129, at 83 (describing the enacted law).

341. *Id.* at 84.

342. *See id.* at 85 (discussing the Local Government and School District Fiscal Accountability Act).

343. *See* Anderson, *Radical Experimentation*, *supra* note 113, at 586–91 (explaining the evolution of Michigan's law and explaining that it had a disproportionate effect on cities with large African-American populations).

344. *See* MICH. COMP. LAWS § 141.1515(4) (repealed 2012) (stating that "[u]pon the confirmation of a finding of a financial emergency, the governor shall declare the local government in receivership and shall appoint an emergency manager to act for and in the place and stead of the governing body and the office of chief administrative officer of the local government"); *id.* § 141.1523 (stating that if the emergency manager determines there is "no reasonable alternative to rectifying the financial emergency of the local government," then the emergency manager may recommend to the governor and state treasurer that the local government be authorized to proceed under Title 11 of the United States Code). The governor must approve this recommendation in order for the local government to become a debtor under Title 11. *Id.*

345. *See id.* § 141.1547 (providing four local government options to address a financial emergency). Once a financial emergency is confirmed, the governing

Michigan law grants the emergency manager broad powers. As under the 2011 law, the emergency manager replaces all of the affected municipality's elected officials, who possess only the powers granted to them by the emergency manager.[346] As was illustrated in the Detroit case, if an emergency manager is appointed, the emergency manager decides whether to file a Chapter 9 petition for the city, and can only do so with the approval of the governor.[347] Only the emergency manager has the authority to act for the municipality during the Chapter 9 case.[348] A city in Michigan can file for bankruptcy even if it does not choose the emergency manager option, but it needs the governor's approval to do so. The governor may condition approval on the appointment of someone to act for the municipality in its Chapter 9 case.[349]

---

body of the local government must by resolution, "within 7 days after the confirmation of a finding of a financial emergency," select one of four local government options to address the financial emergency. *Id.*; Chris Christoff, *Michigan Lawmakers Approve New Emergency Manager Law*, BLOOMBERG (Dec. 27, 2012), http://www.bloomberg.com/news/2012-12-27/michigan-lawmakers-approve-new-emergency-manager-law.html (last visited Nov. 1, 2013) (discussing the repeal of the 2011 law, which "gave the state the power to appoint an emergency manager or impose a consent agreement" and was criticized as "undemocratic and an attempt to bust unions") (on file with the Washington and Lee Law Review). On March 14, 2013, the governor of Michigan appointed an emergency manager for Detroit. Matthew Dolan & Jeff Bennett, *Manager Tapped for Detroit*, WALL ST. J., Mar. 15, 2013, at A2.

346. MICH. COMP. LAWS § 141.1549(2) (2013).

347. *See id.* § 141.1558(1) ("If, in the judgment of the emergency manager, no reasonable alternative to rectifying the financial emergency of the local government which is in receivership exists, then the emergency manager may recommend to the governor and the state treasurer that the local government be authorized to proceed under chapter 9."). The governor must approve the emergency manager's recommendation in order for the local government to proceed under Chapter 9. *Id.* Upon approval, the emergency manager is empowered "to act exclusively on the local government's behalf in any such case under chapter 9." *Id.* Immediately before Detroit filed for bankruptcy, several suits were filed in state court by city workers, retirees, and pension boards, claiming that the Michigan Constitution does not allow the governor to authorize a bankruptcy filing because doing so could cause pension benefits to be modified in contravention of the constitution. Brent Snavely, *Pension Funds Filed Lawsuit Earlier than Planned to Beat Detroit Bankruptcy*, DETROIT FREE PRESS (July 18, 2013), http://www.freep.com/article/20130718/NEWS01/307180125/pension-funds-lawsuit-chapter-9-bankruptcy-kevyn-orr (last visited Nov. 1, 2013) (on file with the Washington and Lee Law Review).

348. MICH. COMP. LAWS § 141.1558(1) (2013).

349. *Id.* § 141.1566.

The Rhode Island and Michigan approaches to Chapter 9 illustrate that some of the academic concerns about Chapter 9 governance can be and have been alleviated by states. In these states, the question is not whether there is restructuring oversight of a dysfunctional city, it is whether the oversight is appropriate. Receivership and emergency manager statutes have been criticized and challenged on several grounds: such statutes violate home rule statutes that give the citizens of municipalities the right to govern themselves;[350] they have a disproportionate impact on communities with large poor[351] and African-American[352] populations; and they do not anticipate or facilitate the kind of nonfinancial structural reform, such as the consolidation of municipalities, that might be necessary to truly alleviate a city's financial distress.[353] Although these are important criticisms, they are unrelated to the efficacy of Chapter 9. When viewed alone, all Chapter 9 can do is reduce a municipality's debt. In enacting municipal bankruptcy legislation, however, Congress did not intend for bankruptcy law to stand alone in resolving municipal financial distress. In the next section, I explain Pennsylvania's still-evolving process of revising its distressed municipalities statute in order to illustrate what happens when business and political leaders lose sight of

---

350. *See, e.g.*, Moreau v. Flanders, 15 A.3d 565, 574–75 (R.I. 2011) (challenging the Rhode Island oversight statute); Kishfy, *supra* note 21, at 369–77 (explaining Rhode Island's home rule tradition); Lyle Kossis, Note, *Examining the Conflict Between Municipal Receivership and Local Autonomy*, 98 VA. L. REV. 1109, 1121–28 (2012) (explaining the incompatibility of home rule and municipal receivership).

351. *See* Philo, *supra* note 129, at 101–05 (arguing that Michigan and Rhode Island's "statutes suspend citizens' right to vote in poorer communities that are particularly vulnerable to economic cycles and corresponding downturns"). "The laws suspend the right to vote, by replacing local elected officials with state appointed managers and receivers." *Id.* at 101.

352. *See* Anderson, *Radical Experimentation*, *supra* note 113, at 590 ("The four cities already approved for intervention have proportionately large African-American populations: Benton Harbor is 91.4% African-American, Flint is 59.5%, Pontiac is 55.3%, and Ecorse is 48.6%.").

353. *See id.* at 582 (explaining that granting fiscal control over a city to the state does nothing to "ameliorate structural causes of financial distress, like concentrated poverty, the loss of middle-class jobs across a region, or local borders that fragment a single metropolitan area into socioeconomically segregated cities").

the fact that Chapter 9 was enacted to assist, rather than thwart, state efforts to rehabilitate their municipalities.

VI. Authorization Meets Governance, Eventually: Pennsylvania's Story

The story of Pennsylvania's response to its capital city's financial problems contains several lessons about municipal bankruptcy. It shows how confusion reigns when little-used laws are dusted off and considered as tools to solve pressing problems. Because Chapter 9 is so rarely used, decisionmakers may be unaware of its interplay with state oversight laws. Harrisburg's business and government leaders viewed bankruptcy and state intervention as competing, rather than complementary, methods for resolving municipal financial distress. Their misunderstanding of the interaction between Chapter 9 and state recovery schemes led, for a short time, to an undesirable legislative result in Pennsylvania.

Pennsylvania's body of law regarding authorization to file for bankruptcy illustrates both the reactive nature of state oversight laws and their interplay with bankruptcy authorization. The bankruptcy authorization rules for most cities, counties, and towns in Pennsylvania are found in the Municipalities Financial Recovery Act, also known as Act 47.[354] Enacted in 1987 to address the municipal financial distress caused by the contraction of the steel industry in the western part of the state,[355] Act 47 established a financial intervention program administered by the Pennsylvania Department of Community and Economic Development (DCED).[356] A municipality that receives a distress

354. 53 PA. CONS. STAT § 11701.101 (2013). Philadelphia is the exception. It cannot file for bankruptcy without the Governor's approval, a restriction placed upon the city in 1991, when the state enacted a recovery statute for that city. *Id.* § 12720.211; *see also* Drew Patrick Gannon, Comment, *An Analysis of Pennsylvania's Legislative Programs for Financially Distressed Municipalities and the Reaction of Municipal Labor Unions,* 98 DICK. L. REV. 281, 291–94 (1994) (explaining the history of the Pennsylvania Intergovernmental Cooperation Authority Act for Cities of the First Class).

355. *See* Gannon, *supra* note 354, at 281 (explaining the history of Act 47).

356. *See* 53 PA. CONS. STAT. § 11701.103 (defining "Department" as "[t]he Department of Community Affairs of the Commonwealth"). The Department of Community Affairs was merged with the Department of Commerce in 1996 to

determination must work with a coordinator appointed by the state to develop a financial recovery plan.[357] Although commentators lauded Act 47 as an example of proactive state oversight over its cities,[358] it has not been a great success in reviving Pennsylvania's municipalities. The state has accepted twenty-seven municipalities into the program, but only six have exited.[359] Six cities have been in the program for more than twenty-five years.[360]

The original proponents of Act 47 did not design the program as an exclusive alternative to Chapter 9. The legislature revisited Pennsylvania's bankruptcy authorization statute at the time it developed Act 47 and included the preconditions for Chapter 9 filing in Act 47.[361] Before June 2011, municipalities could file for

---

become the Department of Community and Economic Development. *See* 71 PA. CONS. STAT. § 1709.301(a)(9) (transferring the powers of the Department of Community Affairs under the Municipalities Financial Recovery Act to the Department of Community and Economic Development).

357. 53 PA. CONS. STAT. § 11701.221. A municipality in the program may receive permission to raise its taxes above the legal limits and is eligible for loans and grants from the state. *Id.* § 11701.123.

358. *See* McConnell & Picker, *supra* note 3, at 473 (explaining some of the benefits of state intervention, using Scranton's Act 47 status as an example). In 2002, Fred Tung cited Act 47 as possibly "particularly instructive insofar as it has actually gotten some use," and also used Scranton as an example. Tung, *supra* note 3, at 917 n.146.

359. *List of Act 47 Distress Determinations*, PA. DEP'T OF CMTY. & ECON. DEV. (Oct. 7, 2013), http://www.newpa.com/local-government/services-we-provide-local-governments/request-assistance/list-of-act-47-distress-determinations (last visited Oct. 15, 2013) (on file with the Washington and Lee Law Review). Twenty years after its entry into Act 47, Scranton not only remained distressed but was frequently reported to be considering a Chapter 9 filing. *See, e.g.*, David Falchek, *Some Tout Bankruptcy as Scranton's Way Out, Others Say It's No Picnic,* SCRANTON TIMES-TRIBUNE (June 27, 2012), http://thetimes-tribune.com/news/some-tout-bankruptcy-as-scranton-s-way-out-others-say-it-s-no-picnic-1.1335580 (last visited Oct. 15, 2013) (discussing Scranton's bankruptcy) (on file with the Washington and Lee Law Review); *Municipal Bankruptcy: The Sadness of Scranton*, THE ECONOMIST (July 21, 2012), http://www.economist.com/node/21559382 (last visited Oct. 15, 2013) (same) (on file with the Washington and Lee Law Review); Mary Williams Walsh, *Crushed by Promises*, N.Y. TIMES, June 26, 2012, at B1 (same).

360. *See List of Act 47 Distress Determinations*, PA. DEP'T OF CMTY. & ECON. DEV. (Oct. 7, 2013), http://www.newpa.com/local-government/services-we-provide-local-governments/request-assistance/list-of-act-47-distress-determinations (last visited Dec. 25, 2013) (listing six cities that joined the program before January 9, 1989) (on file with the Washington and Lee Law Review).

361. *See J. Pub. Hearing on Act 47 Before the H. Urban Affairs Comm., H.*

Chapter 9 if one of five conditions was met, and the law at that time allowed a municipality to file for bankruptcy without the prior approval of any state officer.[362] Not only does Act 47 set forth the conditions under which a municipality may file for Chapter 9,[363] it mandates that if a city is not in the Act 47 program at the time it files for bankruptcy, the bankruptcy filing will trigger a distress determination that will place the city in the program.[364] The distress determination allows the state to appoint an Act 47 coordinator, who must develop a debt adjustment plan that can be confirmed by the bankruptcy court.[365] Act 47 therefore anticipated both that a municipality under state oversight might be required to resort to bankruptcy, and that a municipality not yet under state oversight that decided to file for bankruptcy would then receive state guidance in the bankruptcy. The original Act 47 included the possibility of a municipal bankruptcy filing as a necessary component of a municipal financial recovery scheme with the state providing the necessary reorganizational governance in Chapter 9.

The possibility of a bankruptcy filing by Harrisburg started to emerge in the press roughly two years before the city filed its petition.[366] The mere mention of Chapter 9 triggered a deluge of

---

Local Gov't Comm., S. Cmty., Econ. & Recreational Dev. Comm., and S. Local Gov't Comm., 2011 Leg., 195th Sess. 14 (Pa. 2011) [hereinafter *Act 47 Hearing*] (statement of Michael Gasbarre, Exec. Dir., Local Gov't Comm'n of the Pa. Gen. Assembly) (explaining that one of the original objectives of the task force that proposed Act 47 was the "creation of an updated procedure to enable distressed municipalities to file for municipal debt readjustment action under Federal law").

362. *See* Moringiello, *supra* note 21, at 249 (explaining Pennsylvania law before June 30, 2012).

363. *See* 53 PA. CONS. STAT. § 11701.261 (2013) (authorizing municipalities "to file a municipal debt adjustment action pursuant to the Bankruptcy Code" if one of four conditions is met).

364. *Id.* § 11701.262. This provision of the statute has been used only once, in the bankruptcy of Westfall Township, a small municipality that was rendered insolvent by a large judgment. *See Act 47 Hearing*, *supra* note 361, at 89 (statement of James H. Roberts) (explaining that Westfall Township was the first municipality in the history of Act 47 to invoke its bankruptcy provisions).

365. 53 PA. CONS. STAT. § 11701.262.

366. *See* Editorial, *Harrisburg: Where Does City Go From Here?*, HARRISBURG PATRIOT-NEWS (Sept. 14, 2009), http://www.pennlive.com/editorials/index.ssf/2009/09/where_does_city_go_from_here.html (last visited Oct. 15, 2013) ("Harrisburg has three viable options: Sell assets, enter the state's 'distressed

opposition from state officials and business leaders. Sprinkled throughout those press accounts were reports of high-level misunderstandings about the effects of a bankruptcy filing.[367] Business leaders and politicians seemed unable to distinguish bankruptcy from insolvency, expressing concern about the effect of a Chapter 9 filing on the city's bond rating when Harrisburg's bonds had been rated five grades below investment grade for over a year.[368] The very highest level of state government revealed a fundamental misunderstanding of Act 47's integration of bankruptcy law and state oversight when then-Governor Ed Rendell warned that if Harrisburg filed for bankruptcy, a bankruptcy judge, not the citizens of Harrisburg, would control the city's destiny.[369]

---

city' program or declare bankruptcy.") (on file with the Washington and Lee Law Review).

367. For example, the mayors of three distressed Pennsylvania cities, Harrisburg, Reading, and Scranton, described bankruptcy "as creating a perception to the business community, the people and the rest of the world that Harrisburg isn't solvent and would be unable to pay its bills." Scott La Mar, *Mayors of Harrisburg, Reading, and Scranton Say that Bankruptcy Is Not the Answer*, WITF SMART TALK (Nov. 1, 2011), http://www.witf.org/smart-talk/2011/11/mayors-of-harrisburg-reading-and-scranton-say-banjruptcy-niot-the-sn wer.php (last visited Nov. 10, 2013) (on file with the Washington and Lee Law Review); *see also* Sharon Smith, *Bankruptcy for Harrisburg Could Help Taxpayers But Taint Region, State*, HARRISBURG PATRIOT-NEWS (June 13, 2011), http://www.pennlive.com/midstate/index.ssf/2011/06/bankruptcy_could_help_tax payer.html (last visited Nov. 10, 2013) (quoting David Black, the president and CEO of the Harrisburg Regional Chamber of Commerce as saying that "[t]he impact of bankruptcy is more than just the city of Harrisburg. It's on the commonwealth of Pennsylvania, and it's on every municipality in Pennsylvania") (on file with the Washington and Lee Law Review).

368. *See* Dunstan McNichol, *Harrisburg, Pennsylvania, Bond Rating Cut by Moody's*, BLOOMBERG (Feb. 10, 2010), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=apS4yfEwYa9E (last visited Oct. 15, 2013) (reporting on the downgrading of Harrisburg's municipal bonds) (on file with the Washington and Lee Law Review).

369. *See* Heather Long, *Harrisburg and Bankruptcy: The Facts and The Myths*, HARRISBURG PATRIOT-NEWS (Sept. 18, 2010), http://www.pennlive.com/editorials/index.ssf/2010/09/harrisburg_and_bankrtupcy_the.html (last visited Oct. 15, 2013) (quoting Governor Rendell as saying "if the city goes into bankruptcy, it will be the bankruptcy judge who decides. This step is to be avoided so that Harrisburg and its elected officials can control their own destiny") (on file with the Washington and Lee Law Review). As explained above, nothing could be farther from the truth.

When Harrisburg entered the Act 47 program a year before it filed for bankruptcy, political leaders at the state and local level split into two camps: the Act 47 camp and the bankruptcy camp.[370] Business leaders were firmly in the Act 47 camp.[371] This split illustrates the fact that even in states like Pennsylvania, where the authorization to file for bankruptcy is contained within the statute providing for state intervention in the fiscal affairs of its municipalities, policy makers can lose sight of the relationship between state intervention and Chapter 9. Harrisburg's city council was at an impasse; a majority of the council members were unable to agree with the mayor on almost anything, having rejected both the Act 47 coordinator's proposed plan as well as an alternative Act 47 plan proposed by the mayor.[372] The standoff culminated in a late-night bankruptcy filing unsupported by the mayor that was dismissed six weeks later because of the city's failure to meet the Chapter 9 eligibility requirements.[373] For that reason, the state was justifiably concerned that a bankruptcy proceeding would burn through money without a successful resolution. If the council could not agree on whether to file for bankruptcy, it certainly would not have been able to agree on a Chapter 9 plan to adjust the city's debts.

In June 2011, three and a half months before Harrisburg filed for bankruptcy, the state legislature passed a law prohibiting Harrisburg and other cities that had received a distress determination from the DCED pursuant to Act 47 from filing for Chapter 9 altogether.[374] The proponents of the ban

---

370. *See* Charles Thompson, *Most at Harrisburg Fiscal Hearing Want Bankruptcy,* HARRISBURG PATRIOT-NEWS (Oct. 20, 2010), http://www.pennlive.com/midstate/index.ssf/2010/10/most_at_harrisburg_fiscal_hear.html (last visited Oct. 15, 2013) (identifying the mayor of Harrisburg as supporting entering Act 47, but "most of the dozen or so constituents who testified" as supporting proceeding straight to bankruptcy) (on file with the Washington and Lee Law Review).

371. *See id.* (recognizing the president of the chamber of commerce as favoring Act 47 because it could "provide just the guidance that city leaders need to get past their political and personal divisions and begin focusing on solutions").

372. *See* Moringiello, *supra* note 21, at 243–44 (discussing the circumstances leading up to Harrisburg's filing).

373. *Id.*

374. Act of June 30, 2011 (Act 26), P.L 159, No. 26 § 1.5 (using a tax code amendment to prohibit cities "of the third class" from filing a petition for relief

claimed that Harrisburg could adequately solve its problems in Act 47.[375] Rather than strengthening its financial governance over its distressed cities, Pennsylvania left its most troubled cities to languish in a state program of dubious success without the leverage over recalcitrant creditors that a bankruptcy threat can provide. In hindsight, the state government was trying to solve an obvious governance problem; the mayor of Harrisburg and the majority of the City Council were at an impasse, and they could not agree on an Act 47 plan. If they could not agree on an Act 47 plan outside of bankruptcy, it was unlikely that they could ever agree on a Chapter 9 plan of adjustment with their creditors.

Act 47, in its pre-2011 form, left the mayor and other members of the municipality's government in their roles with full powers in all cases. On the one hand, this feature of Act 47 respected the democratic process by allowing those chosen by a municipality's residents to govern the municipality. On the other, however, Act 47 presumed the existence of a functioning city government led by leaders who agreed to cooperate with state intervention. The reality in Harrisburg did not mirror these assumptions. As a result, Pennsylvania moved to strengthen governance over its distressed cities shortly after Harrisburg filed for bankruptcy. Immediately after Harrisburg filed for bankruptcy, the legislature passed a bill allowing the governor to appoint a receiver for a city if that city is insolvent and has not adopted an Act 47 plan.[376] At the time that law was passed, the

---

under Chapter 9 "or any other Federal bankruptcy law," despite the provisions of Act 47). Pennsylvania classifies its cities by population, and this prohibition was limited to cities of the Third Class. *Id.* Although most Pennsylvania cities are cities of the Third Class, the prohibition was enacted as a reaction to Harrisburg's financial crisis. *See In re* City of Harrisburg, 465 B.R. 744, 763 (Bankr. M.D. Pa. 2011) (explaining the temporary prohibition on filing applicable to cities of the Third Class); *see also* Moringiello, *supra* note 21, at 243 (discussing the legislation changes Pennsylvania made as a result of the financial crisis in Harrisburg).

375. *See* Marc Levy, *Bill to Stop Harrisburg Bankruptcy Goes to Corbett*, YORK DISPATCH (July 8, 2011), http://www.yorkdispatch.com/news/ci_18387764 (last visited Oct. 15, 2013) (identifying state senator Jeffrey Piccola as supporting the proposition that "[t]he city can address its problems through a law called Act 47") (on file with the Washington and Lee Law Review).

376. *See* 53 PA. CONS. STAT. § 11701.702 (2013) (providing for the appointment of a receiver by the Governor); *see also* Moringiello, *supra* note 21, at 243 (discussing the timeline of legislative action related to Harrisburg's bankruptcy proceedings).

bankruptcy ban was still in place. Today, if a receiver is appointed, only the receiver can file a Chapter 9 petition for the city.[377]

Receiverships are controversial. They should be; they remove the choice of leaders from the residents of a city.[378] Pennsylvania, however, had an almost toothless state intervention scheme. The state was unable to do anything to resolve Harrisburg's problems because of the acrimony on the City Council. The drafters of Act 47 never anticipated that a city would reject a plan.[379] The receivership provision therefore provided governance controls that were missing from the state intervention program. Although Pennsylvania has strengthened its ability to intervene in a city's financial matters, Act 47 still does nothing to address the problems that arise from the state's highly fragmented municipal structure in which thousands of municipalities, some very small, each provide their own public services.[380]

Pennsylvania's story clarifies a rationale that some authors have ascribed to municipal bankruptcy. Several scholars have suggested that Chapter 9 exists as a political tool: both Adam Levitin, writing about the wisdom of a bankruptcy chapter for states, and Clayton Gillette, writing about Chapter 9, have surmised that one use of a bankruptcy chapter for public entities could be to provide political cover for state or city officials in making unpopular decisions.[381] Gillette has cited Harrisburg's

---

377. 53 PA. CONS. STAT. § 11701.706. Today, no municipality in Pennsylvania may file for bankruptcy without the approval of DCED. *Id.* § 11701.261.

378. *See supra* notes 350–53 and accompanying text (discussing receiverships).

379. *See Act 47 Hearing, supra* note 361, at 19 (statement of Michael Gasbarre, Exec. Dir., Local Gov't Comm'n of the Pa. Gen. Assembly) ("It is an accurate statement that those who crafted Act 47 never envisioned a situation where a distressed municipality would fail to adopt either the coordinator's solvency plan or an alternative that could be drafted by a municipality's chief executive officer or governing body.").

380. *See* PA. ECON. LEAGUE, BEYOND ACT 47: A CALL TO ACTION (2013), http://pelcentral.org/wp-content/uploads/2013/07/Beyond-Act-47-_revised_.pdf ("Pennsylvania's municipalities are broken into thousands of little puzzle pieces with each one offering—and funding—its own distinct brand of public safety and public works services.").

381. *See, e.g.*, Gillette, *supra* note 16, at 319–20 (discussing the strategic use of municipal bankruptcy); Levitin, *supra* note 16, at 1446 (discussing bankruptcy as a political tool).

failed bankruptcy as an example of a strategic use of Chapter 9 by a city to escape unfavorable conditions placed by the state on its assistance.[382] Bankruptcy can indeed be a political tool, but in a different way from that suggested by Gillette and Levitin. A city's credible threat to file for Chapter 9 can serve as a wake-up call to state officials who have paid little attention to their state's authorization statutes. In Pennsylvania, a state with many distressed municipalities, the bankruptcy threat by the state capital did just that. Harrisburg's dispute with the state led to a short-lived absolute ban on bankruptcy filings by certain cities, but it also forced the state to grapple with the governance deficiencies in its municipal distress intervention program. Once the state restored Chapter 9 as an option, which it did in November 2012, Harrisburg's creditors moved towards an out-of-bankruptcy resolution of the city's debt problems.[383]

VII. Where the Holes Are: Issues for Judicial or Legislative Resolution

Because so few general-purpose municipalities of any size had filed for Chapter 9 before Vallejo, California, filed in 2008, it is difficult to evaluate, as an empirical matter, the success of Chapter 9 in relieving a city of its financial distress so that the city, with the help of its state, can return to viability. Vallejo, a city in a state that has refused to provide reorganizational oversight, continues to struggle,[384] and the bankruptcy of Central

---

382. Clayton P. Gillette, *Bankruptcy and Its By-Products: A Comment on Skeel*, 50 HOUSTON L. REV. 1129, 1141 (2013); *see also* Gillette, *supra* note 16, at 286 ("[L]ocal officials may use the threat of bankruptcy to reduce the conditions that states place on a proposed bailout."). As explained above, Pennsylvania placed more restrictive controls on Harrisburg after it made good on its threat to file for bankruptcy.

383. *See* Donald Gilliland, *Why Not Bankruptcy for Harrisburg's Debt? A Closer Look at The Receiver's Strategy,* PENNLIVE.COM (July 24, 2013, 1:05 PM), http://www.pennlive.com/midstate/index.ssf/2013/07/why_not_bankruptcy_for_harrisb.html (last visited Oct. 15, 2013) (explaining how the availability of Chapter 9 as an option helped the receiver for Harrisburg to negotiate with the city's creditors) (on file with the Washington and Lee Law Review).

384. *See* Bobby White, *In Vallejo, Scars Still Visible*, WALL ST. J. (Jan. 19. 2012), http://online.wsj.com/article/SB10001424052970204555904577167013455352608.html (last visited Oct. 17, 2013) (explaining the cuts in public services that persist after Vallejo's filing and the attendant concerns about crime; also

Falls, in a state that provided robust rehabilitative governance, had a positive effect on that city's credit and that of other Rhode Island cities.[385] Harrisburg is on track to solve its problems under Pennsylvania's strengthened oversight statute without resort to bankruptcy.[386]

The foregoing illustrates that Chapter 9 may only be as effective as the state municipal oversight structure within which it operates. This is not a new observation; in the 1930s, the original proponents of a municipal bankruptcy law feared that any such law would be useless without it being integrated into state plans for municipal rehabilitation.[387] Because the design of municipal bankruptcy law anticipates that the states will provide reorganizational governance over the debtor, concerns about the effectiveness of Chapter 9 should not focus on its absence of Chapter 11-style governance controls. Rather, questions about the efficacy of Chapter 9 should fall into three categories: those about each state's acceptance of the Code's invitation to exercise

---

pointing out that because Vallejo did not scale back its pension payments in bankruptcy, it may be unable to make them in the future) (on file with the Washington and Lee Law Review).

385. *See, e.g.*, *Central Falls Bankruptcy Credit Positive for Rhode Island Cities: Moody's*, REUTERS (Sept. 13, 2012), http://www.reuters.com/article/2012/09/13/rhodeisland-central-falls-moodys-idUSL1E8KDITQ20120913 (last visited Oct. 17, 2013) (quoting a Moody's commentary that approval of Central Falls bankruptcy "is a credit positive for other distressed Rhode Island cities because it shows a path to emerging from bankruptcy without defaulting on G.O. debt") (on file with the Washington and Lee Law Review); *Moody's Upgrades Formerly Bankrupt Central Falls, R.I.*, REUTERS (July 18, 2013), http://www.reuters.com/article/2013/07/18/usa-rhodeisland-centralfalls-rating-idUSL1N0FO27920130718 (last visited Oct. 17, 2013) (reporting that Moody's belief "that Central Falls will maintain its structural balance and keep making its full annual pension obligations") (on file with the Washington and Lee Law Review). Robust governance was not the only reason the bond market responded positively to the Central Falls bankruptcy. Shortly before the city filed, the state enacted a law granting secured status to general obligation bonds, thus giving them priority over obligations to employees and retirees. R.I. GEN. LAWS. § 45-12-1 (2013).

386. *See* Emily Previti, *State Officials File 'Harrisburg Strong Plan' for Resolving City's Debt*, HARRISBURG PATRIOT-NEWS (Aug. 27, 2013), http://www.pennlive.com/midstate/index.ssf/2013/08/harrisburg_debt_plan_filed.html (last visited Oct. 17, 2013) (explaining that the receiver for Harrisburg filed a debt adjustment plan with the Commonwealth court on August 26, 2013) (on file with the Washington and Lee Law Review).

387. *See supra* notes 249–55 and accompanying text (discussing municipal bankruptcy legislation and scholarship from the 1930s).

Chapter 9 governance; those about what the state is accepting if it allows its cities to file for Chapter 9; and those about the extent to which a court can exercise bankruptcy governance over a municipal debtor if a state allows municipal bankruptcy but declines the invitation to participate in the debtor's rehabilitation. In Part V above, I addressed the first category of questions. In this section, I will address the second and third categories.

A. Continuing Questions about the Relationship Between State and Federal Law

The relationship between state law and bankruptcy law is one that scholars have studied and questioned for decades. Uncertainty about the relationship between the two is not unique to municipal bankruptcy; over thirty years ago, shortly after the passage of the current Code, Theodore Eisenberg pronounced the Code a failure because of its "inadequate coordination with preexisting federal and state laws."[388] The proper function of all types of bankruptcy depends on the interplay between bankruptcy law and myriad state and other federal laws.[389]

Uncertainty surrounds Chapter 9 because its rare use has produced few published judicial opinions interpreting and applying its provisions. The history of Chapter 9 illustrates an attempt to strike a careful balance between state and federal interests, and as large municipalities file for bankruptcy, the relationship between state and federal law in resolving municipal financial distress requires further refinement.

The constitutional foundations of municipal bankruptcy law raise a question of how far bankruptcy law can go to upset state law entitlements. For example, before Detroit filed for

---

388. Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953, 953 (1981).

389. *See* Karen Gross, *A Response to J.J. White's* Death and Resurrection of Secured Credit*: Finding Some Trees But Missing the Forest*, 12 AM. BANKR. INST. L. REV. 203, 216–17 (2004) (explaining that all Chapter 11 cases "involve the interplay of other bodies of law, other disciplines and the market"). There are many examples of bankruptcy law's dependence on state law. Perhaps the two most prominent are the Code's definitions of property of the estate, 11 U.S.C. § 541 (2012), and of claims, 11 U.S.C. § 502 (2012).

bankruptcy, several groups sued in state court claiming that because the Michigan constitution protects employee pensions,[390] a bankruptcy filing would be unconstitutional.[391] Although the mere act of filing for Chapter 9 should not violate this constitutional provision because a plan of adjustment does not necessarily impair pension rights, the Emergency Manager's stated intention to reduce pensions[392] will ensure that questions regarding the relationship between state and federal law will not disappear.

Two bankruptcy courts have provided an answer to this question. Retirees in Stockton, California, claimed that the contracts clause in the California constitution protected their health benefits even in bankruptcy.[393] In that dispute, the court looked at bankruptcy authorization as an all-or-nothing proposition: If a state authorizes municipal bankruptcy, it must accept all of Chapter 9's provisions, which include the possibility of a cramdown plan that forces creditors to accept less than what they are owed.[394] In short, a state can condition its cities' entry into Chapter 9, but it cannot revise it.[395] In his ruling that Detroit met the eligibility requirements for Chapter 9, Judge Steven Rhodes relied on the reasoning in *Stockton* to hold that Chapter 9 allows Detroit to impair its pension obligations, notwithstanding the prohibition on doing so found in the Michigan Constitution.[396]

---

390. *See* MICH. CONST. art. IX, § 24 ("The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby.").

391. Bill Vlasic, *Federal Judge Halts Legal Challenges in Detroit Bankruptcy Case,* N.Y. TIMES, July 25, 2013, at A14.

392. CITY OF DETROIT, PROPOSAL TO CREDITORS 109 (2013), http://www.freep.com/assets/freep/pdf/C4206913614.PDF.

393. *See* Ass'n of Retired Emps. v. City of Stockton, Cal. (*In re* City of Stockton, Cal.), 478 B.R. 8, 13 (Bankr. E.D. Cal. 2012) ("The retirees contend they have vested contractual rights that are protected from impairment by the Contracts Clause of the United States Constitution, a similar clause in the California Constitution, and by other provisions of California law.").

394. *See id.* at 16 ("A state cannot rely on the § 903 reservation of state power to condition or to qualify, i.e. to 'cherry pick,' the application of the Bankruptcy Code provisions that apply in Chapter 9 cases after such a case has been filed.").

395. *Id.* at 17.

396. Opinion Regarding Eligibility at 74–80, *In re* City of Detroit, 9:13-bk-

Assuming that a state must accept Chapter 9 *in toto*, it is often unclear exactly what total acceptance means. Where Chapter 9 incorporates Chapter 11 standards, the incorporation is sometimes poorly tailored to the realities of municipal financial distress. For example, in order for a Chapter 9 plan to be confirmed, the plan must be "in the best interests of creditors."[397] To meet that standard, a Chapter 11 plan must pay all creditors at least what they would receive in a Chapter 7 liquidation.[398] That standard is unworkable in a Chapter 9 case because a municipality cannot be liquidated, nor can its assets be sold outside of bankruptcy in a forced sale.[399] As a result, courts hold that a plan of adjustment meets the best interests standard when the plan is better than all alternatives.[400]

Although Chapter 9 permits a cramdown plan, a court may confirm such a plan only if it is "fair and equitable."[401] In Chapter 11, that standard requires that unsecured creditors be paid in full before shareholders get anything.[402] The standard does not translate well to Chapter 9; cities do not have shareholders. Courts have therefore interpreted it to mean that Chapter 9 creditors will receive all that they "'can reasonably expect under the circumstances.'"[403] There is very little case law

53846-SWR (Bankr. E.D. Mich. entered Dec. 5, 2013) (No. 1945), http://content.foxtvmedia.com/wjbk/pdf/OPINION-REGARDING-ELIGIBILITY.pdf.

397. 11 U.S.C. § 943(b)(7) (2012).

398. *Id.* § 1129(a)(7)(A)(ii).

399. *See supra* notes 192–200 and accompanying text (discussing municipality features).

400. *See In re* Sanitary & Improvement Dist. No. 7, 98 B.R. 970, 974 (Bankr. D. Neb. 1989) (ruling that 11 U.S.C. § 943(b)(7) "simply requires the Court to make a determination of whether or not the plan as proposed is better than the alternatives").

401. 11 U.S.C. § 943(b)(1) (incorporating the "fair and equitable" standard of 11 U.S.C. § 1129(b) through 11 U.S.C. § 901(a)).

402. *Id.* § 1129(b)(2)(A); *see also* 7 COLLIER ON BANKRUPTCY ¶ 1129.04[3] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2013) (explaining that § 1129(b) requires full payment to an unsecured creditor; if the unsecured creditor cannot be paid in full, "they have to be assured that no junior creditor or equity participant receive anything under the plan").

403. Lorber v. Vista. Irrigation Dist, 127 F.2d 628, 639 (9th Cir. 1942) (quoting Bekins v. Lindsay-Strathmore Irrigation Dist., 114 F.2d 680, 685 (9th Cir. 1940)).

interpreting the standard, however, justifying creditor incertitude about Chapter 9 treatment. The vague confirmation standards may play a key role in encouraging creditor cooperation in Chapter 9.[404]

The confirmation standards also implicate the relationship between state and federal law. The Code states that in order for a Chapter 9 plan to be confirmed, the debtor must not be "prohibited by law from taking any action necessary to carry out the plan."[405] That raises the question of whether a municipal debtor in a state with constitutional pension protections can propose a plan that modifies pensions that will be confirmed by the court. If bankruptcy authorization is an all-or-nothing proposition, the answer should be yes, but again, case law is scant. In one of the few cases interpreting this requirement, the court held that reading it to prohibit a plan of adjustment from reducing payments to bondholders in contravention of state law would defeat the entire purpose of Chapter 9.[406] According to that court, the plan going forward must comply with state law.[407] As a result, Detroit should be able to restructure its pension obligations in its Chapter 9 plan, but any restructured employee benefits would be subject to Michigan's constitutional protections after plan confirmation.

B. Debtor Governance in Weak Governance States

Although municipal bankruptcy law was designed to facilitate state rehabilitation schemes, Chapter 9 does not require that a state play any role in a municipal bankruptcy case other than to authorize filing. Some states, such as Alabama and

---

404. *See* B. Summer Chandler & Mark S. Kauffman, *Maybe Taxes Aren't So Certain: What is "Fair and Equitable" in a Chapter 9 Plan?*, AM. BANKR. INST. J., Feb. 2013, at 12, 70 (noting that the "uncertainty may motivate a municipality and its creditors to reach agreement on debt relief, rather than turning to a court to decide the issue").

405. 11 U.S.C. § 943(b)(4) (2012).

406. *See In re* Sanitary & Improvement Dist. No. 7, 98 B.R. 970, 974 (Bankr. D. Neb. 1989) (stating that under such a ruling, "the whole purpose and structure of Chapter 9 would be of little value").

407. *See id.* (ruling that new bonds issued pursuant to the debtor's plan of adjustment "must be issued in conformance with state law").

California, have declined to exercise reorganizational governance over their Chapter 9 debtors.[408] In those states, a Chapter 9 filing can only result in a fresh start unless the municipality itself has a plan to resolve the structural problems that led to the filing.

If the fresh start is the goal of Chapter 9 in states that do not provide reorganizational governance, it may be up to the bankruptcy courts to ensure that only worthy municipal debtors file for bankruptcy, just as they do when an individual files for bankruptcy. The Code lets them do so; although some of the entry requirements are objectively determinable, such as whether the debtor is insolvent[409] and whether it is authorized by its state to file,[410] others leave more discretion in the bankruptcy judge. The Chapter 9 eligibility requirements both invite the state to provide rehabilitative governance over the debtor and allow a court to exercise a measure of bankruptcy governance.[411] For example, a municipality can be a debtor only if it "desires to effect a plan to adjust" its debts,[412] if it first negotiates in good faith with its creditors,[413] and if it files its petition in good faith.[414] These entry requirements give a court some discretion in determining whether a filing is likely to have some benefit for the city or will simply result in a drawn-out process with little benefit to the debtors or its creditors.[415] When the state plays no role in the bankruptcy, the court may play a larger role in encouraging negotiation, such as by the appointment of a mediator.[416] Each

408. *See supra* notes 312–13, 333 and accompanying text (discussing municipal bankruptcy governance in Alabama and California).

409. 11 U.S.C. § 109(c)(3) (2012).

410. *Id.* § 109(c)(2).

411. *See supra* notes 59–60 and accompanying text (detailing the eligibility requirements for Chapter 9).

412. 11 U.S.C. § 109(c)(4).

413. *Id.* § 109(c)(5). The municipality may be excused from this requirement if it shows that negotiation with creditors would be impracticable. *Id.* § 109(c)(5)(C).

414. *See id.* § 921(c) (allowing the court to dismiss a petition that is not filed in good faith).

415. *See In re* City of Stockton, Cal., 493 B.R. 772, 794 (Bankr. E.D. Cal. 2013) (stating that the good faith requirement "serves a policy objective of assuring that the Chapter 9 process is being used in a manner consistent with the reorganization purposes of the Bankruptcy Code").

416. *See id.* at 783 (referencing the court-ordered mediation process for Stockton's municipal bankruptcy); *see also In re* City of Detroit, Mich., No. 13-

state must decide whether municipal bankruptcy should facilitate more than a fresh start; in states where the fresh start is the only goal of a Chapter 9 case, the court must ensure that the case can achieve that goal.

VIII. Conclusion

A city's descent into financial distress forces a new look at rarely used laws. Municipal bankruptcies are rare, and because Chapter 9 filings are few and far between, the body of case law that has developed to govern them is small. Because decades passed between the passage of the first municipal bankruptcy legislation and the possibility that a major city would have to use it, the original purpose of Chapter 9 was forgotten.

Chapter 9 was never intended to serve as a comprehensive scheme to solve municipal financial problems; it was designed to complement state efforts to solve those problems. Chapter 9 does indeed anticipate restructuring governance over a municipal debtor, but in the hands of the state, not in the hands of a bankruptcy judge. That governance concession is consistent with the original goals of the predecessor to Chapter 9.

Concluding that Chapter 9 accommodates appropriate debtor governance, however, does not answer the question of whether Chapter 9 is an effective financial restructuring tool for cities. Chapter 9 may only be as effective as each state's plan for municipal fiscal oversight. This conclusion does, however, allow researchers and policy makers to focus on the role of each state in developing an effective mechanism to not only resolve the financial distress of its municipalities but develop sensible structures for their municipalities going forward. This mechanism should include both robust state oversight and the safety valve of Chapter 9 if necessary to overcome holdout creditors.

53846 (Bankr. E.D. Mich. Aug. 13, 2013) (order appointing a mediator and submitting the case to mediation). In the latter case, the state is responsible for developing the Chapter 9 plan through Detroit's Emergency Manager. *See supra* notes 340–49 and accompanying text (discussing Detroit's use of an emergency manger).