LAW AND LEGISLATION IN MUNICIPAL BANKRUPTCY

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Corporate and consumer bankruptcy are defined by two principal features: a compulsory process and an identifiable set of priorities to debtor property. These "rule of law" features reduce borrowing costs ex ante by, among other things, discouraging rent-seeking ex post. Municipal bankruptcy, by contrast, despite apparent similarities, embodies a radically different vision of debt adjustment. Substantive priorities in Chapter 9 are riddled with uncertainty, and the very invocation of bankruptcy is subject to veto by multiple actors. Consequently, this Article contends that familiar models of bankruptcy are inadequate to explain the existing regime of municipal debt adjustment. What Chapter 9 creates is less a forum for the application of settled law, and more an ad hoc legislative venue, in which multiple political bodies seek to apportion resources by mutual consent. Political economy rather than contract enforcement theory supplies the appropriate lens. This Article traces some of the implications of this view and argues that, relative to a system of rights enforcement, municipal bankruptcy as we know it leads to too few bankruptcies and at the same time increases the costs of financing city services and impoverishes residents, employees, and retirees. Reformers would do well to keep in mind a simple slogan: more law, less legislation.

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INTRODUCTION

Bankruptcy's function is to divide resources among persons with a stake in a debtor's affairs when, by dint of bad luck or bad choices, the debtor cannot or will not pay its debts.[1] In both the corporate and individual context, the American system of bankruptcy resolves this allocation problem in a manner characterized by two principal features. First, the regime is compulsory, meaning that on a showing of the debtor's insolvency no claimant to the contested assets can unilaterally prevent the bankruptcy process from taking its course or do better by opting to sit out.[2] Second, bankruptcy law supplies identifiable rights to debtor assets. It provides relatively concrete rules describing the assets available for distribution to creditors as well as the way in which various classes of creditors will divide the distribution. The resolution of a given debtor's estate might entail some ambiguity, of course, but bankruptcy's dominant theme is the clarity of entitlements.[3]

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1 David A. Skeel, Jr., *When Should Bankruptcy Be an Option (for People, Places, or Things)?*, 55 WM. & MARY L. REV. 2217, 2222–23 (2014) (giving as one of the definitional attributes of bankruptcy a procedure that is "collective in nature").

2 By "compulsory" I do not mean that all cases of financial distress must be resolved through bankruptcy. Out-of-court "workouts" are common, as are state law receiverships and assignments for the benefit of creditors. *See* Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. LEGAL STUD. 255, 255–56 (2009). Rather, bankruptcy is compulsory in the sense that, under certain known circumstances, neither the debtor nor any creditor can hold out. Thus, pre-insolvency negotiations are conducted in the shadow of bankruptcy policy.

3 For the view that bankruptcy entitlements are less fixed than scholars have typically assumed, see generally Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235 (2013). I do not wish to suggest the

Most of the relatively sparse commentary on municipal bankruptcy has sought to understand and criticize Chapter 9 in this context—that is, in the shadow of more familiar modes of bankruptcy. This is understandable. The order of operations in a municipal case looks much like that in a corporate reorganization. Each is directed toward the creation and confirmation of a plan that modifies creditors' rights against the debtor and its assets. Indeed, Chapter 9 incorporates by reference many of the most significant provisions of Chapter 11, including its rules on the formation of creditors' committees,[4] the classification of claims and interests,[5] the solicitation and tallying of votes,[6] and the efficacy of a "cram down."[7] Municipal bankruptcy has much in common with consumer bankruptcy, too. The principal economic function of both is to grant the debtor a fresh start and thus ameliorate the costs associated with debt overhang.[8] In form, Chapter 9 resembles the law of corporate reorganization; in function, the law of individual bankruptcy.

Despite the parallels, however, this Article contends that familiar paradigms are ill-suited to reckon with Chapter 9 as a descriptive matter. Municipal bankruptcy is marked by ambiguity along two dimensions. First, the substantive entitlements of various stakeholders to municipal resources are ill-defined. This is true both of the contest between municipal residents and creditors, as a group, and that among various classes of unsecured creditors. A municipality cannot be liquidated. Apart from the value of their property interests, creditors are entitled to no particular share of resources. What substantive rights creditors have are secured by the vague "best interest" standard, which in practice allows the bankruptcy judge to impair creditors' claims by however much he thinks reasonable under the circumstances.[9] At the same time, the relative priorities of unsecured creditors are in doubt. In a corporate reorganization, as in an individual bankruptcy, the presumption is that claims of equal priority are impaired equally.[10] In municipal bankrupt-

untenable proposition that bankruptcy is a purely mechanical process devoid of strategic play. Quite obviously, rent-seeking is occurring on the margins. The question is one of degree rather than kind—or, to put it differently—the size of the margins.

4 11 U.S.C. § 901 (2012) (incorporating 11 U.S.C. §§ 1102, 1103).

5 *Id.* (incorporating § 1122).

6 *Id.* (incorporating §§ 1124, 1125, and applicable provisions of § 1126).

7 *Id.* (incorporating key provisions of § 1129).

8 *See* David A. Skeel, Jr., *Is Bankruptcy the Answer for Troubled Cities and States?*, 50 HOUS. L. REV. 1063, 1074–76 (2013) [hereinafter Skeel, *Is Bankruptcy the Answer?*]. For the seminal account of debt overhang, see generally Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977).

9 *See infra* notes 70–71 and accompanying text.

10 A plan of reorganization may not be confirmed over the objection of an impaired class if the plan "discriminate[s] unfairly" against a class of claims. 11 U.S.C. § 1129(b)(1). Courts presume that a plan discriminates unfairly if one class of claims receives a significantly greater return than another class of equal priority. *See* Richard M. Hynes & Steven D. Walt, *Fair and Un-*

cy, by contrast, the rule of proration is in doubt.[11] The upshot is that neither unsecured creditors nor municipal residents can insist on any particular resource allocation in Chapter 9.

Second, the very prospect of a bankruptcy proceeding, especially one culminating in a plan of adjustment, is uncertain. Municipal bankruptcy exhibits nothing like the compulsory quality of corporate or individual bankruptcy. Only the debtor may petition for relief; only the debtor may propose a plan of adjustment. This means a debtor municipality can block the bankruptcy process. So, too, can the legislature in the debtor municipality's state, because under Chapter 9 the state may revoke its cities' ability to petition for relief or even (arguably) to propose disfavored plans of adjustment. The state's governor, or a proxy for the executive, often has a blocking position as a matter of state law. And the bankruptcy judge, dealing as he does with Chapter 9's relatively plastic features, can typically prevent the confirmation of a plan of adjustment whose terms he disapproves. Thus, no fewer than four political institutions—the city, the state legislature, the governor, and the bankruptcy judge—typically have the power unilaterally to block a debt adjustment whether or not its terms are consistent with law.

Municipal bankruptcy for these reasons cannot be understood as a forum in which competing claims are adjudicated according to settled law. Instead, Chapter 9 is best conceived of as a kind of *legislative* process for reallocating resources—as a quasi-constitution. By this I mean that Chapter 9, like a standard constitution, works by vesting a set of po-

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fair Discrimination in Municipal Bankruptcy, 37 CAMPBELL L. REV. 25, 33–34 (2015) [hereinafter Hynes & Walt, *Fair and Unfair*]; *see also* Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227, 239–41 (1998) (examining the unfair-discrimination principle as it has been applied to corporate reorganizations). The proponent of a plan can overcome this presumption only by showing, among other things, that discrimination is "necessary" to effect a plan—a predicate of which courts are rightly skeptical. *Id.* at 240, 244 ("Although courts hold out the possibility that such treatment might be appropriate in some cases, most cases have not upheld this type of differentiation.").

11 Chapter 9 incorporates by reference Chapter 11's requirement that a plan, to be crammed down, "not discriminate unfairly." 11 U.S.C. § 901 (incorporating § 1129(b)(1)). One might suppose that the presumption of proration would apply uniformly. Yet recent cases suggest that participants in Chapter 9—including at least some bankruptcy judges—think the municipal context justifies a rule quite different in practice. In the Stockton, California bankruptcy, Judge Klein held that the city's pension obligations were subject to impairment like any other unsecured claim, yet confirmed a plan that did not impair pension obligations but paid the unsecured portion of bondholders' claims only one cent on the dollar. Opinion Regarding Confirmation and Status of CalPERS at 4, *In re* City of Stockton, 526 B.R. 35 (Bankr. E.D. Cal. 2015) (No. 12-32118-C-9). In Detroit's bankruptcy, Judge Rhodes crammed down a plan that treated certain unsecured creditors, including victims of the city's torts, far worse than other equal-priority creditors. Oral Opinion on the Record at 15, *In re* City of Detroit, 504 B.R. 97 (Bankr. E.D. Mich. 2013) (No. 13-53846). On Judge Rhodes's understanding, the "unfair discrimination" standard in Chapter 9 invokes the judge's own "experience, education and sense of morality." *Id.* at 30.

litical institutions with the power to modify by mutual consent the economic relationships of persons within its jurisdiction. Consider by analogy the formally legislative context of the United States government, where we call these agreements statutes and vest the authority to enact (or block) them in the two chambers of Congress and in the President. When an existing rule becomes unsatisfactory to one or another coalition, agitators seek to change the rule by proposing legislation. A series of formal and informal institutional actors can then block the bill from becoming law. A committee may decline to send it to the floor for a vote; either House may vote it down; the President may veto it; and so on. To change the status quo rule, the bill must survive this gauntlet of "veto gates." If it does, a new rule—a newly calibrated relationship among persons in the jurisdiction—replaces the old.

The analogy to Chapter 9 is straightforward. A proposed plan of adjustment is like a bill introduced in the Congress. The status quo policy comprises the set of rights and remedies citizens have under state law, and the plan of adjustment seeks to alter them. Any of the veto players can block a change; unanimous consent reallocates resources according to the plan's terms. Those whose claims are most directly affected, the economic stakeholders, have little ground of their own to stand on. A confirmed plan of adjustment thus represents a set of resource allocations that every veto player prefers to the status quo, rather than the inevitable product of stakeholders' defined rights under law.

If the quasi-constitution is an apt metaphor, it follows that political economy rather than doctrinal analysis supplies the appropriate tools for predicting outcomes in municipal bankruptcy. This Article traces the consequences of this view. In particular, it considers the application of veto theory to the Chapter 9 process. On this view, the persons and institutions with veto power over a plan of adjustment each have a unique preferred policy outcome. If the relevant players act sincerely, a plan of adjustment will be confirmed only if the resource allocation it contemplates is superior, in the eyes of each player, to the status quo allocation. If the players behave strategically, even some such Pareto-superior plans will languish. The theory predicts several tendencies. Two in particular are critical. First, because stakeholders are encouraged to spend resources lobbying for preferential treatment, municipal borrowing costs are higher than they would be under a regime in which entitlements are easily identified and enforced. Second, the resource allocation any given stakeholder expects to receive has greater variance than under a rights enforcement regime. If, as is almost certainly true, municipal stakeholders tend to be risk-averse, this has a secondary but importantly negative effect on municipal wealth.

This Article proceeds as follows: Part I supplies an introduction to the structure and theory of corporate and individual bankruptcy law. Its

principal aim is to show that the relative success of each is founded on the compulsory nature of the process and the identifiability of participants' substantive rights. Parts II and III form the Article's descriptive core. Part II contrasts municipal bankruptcy with corporate and individual bankruptcy, showing that Chapter 9 is riddled with substantive indeterminacy and political veto rights, such that a plan of adjustment resembles ad hoc legislation more than it does a mechanism for enforcing identifiable economic rights. Part III elaborates on the significance of imagining Chapter 9 as a quasi-constitution. It predicts that relative to a more definite system of rights enforcement, Chapter 9 should increase municipal borrowing costs and lead to a greater variance in any given stakeholder's recovery, a secondary but important and negative wealth effect for most municipal residents, employees, and retirees. Part IV suggests some avenues by which private agreement or public legislation might ameliorate the defects of municipal bankruptcy as it exists today.

I. THE BARGAIN PARADIGM AND THE STRUCTURE OF CORPORATE AND INDIVIDUAL BANKRUPTCY

To understand the peculiar qualities of municipal bankruptcy within the scheme of American debtor-creditor law, it will be helpful to review in broad outline some of the principal features of corporate and individual bankruptcy. This Part supplies a thumbnail outline of corporate reorganization under Chapter 11 and the individual debtor's case under Chapter 7.[12] The sketches are necessarily rudimentary—they simplify some complex issues and omit features that can be fundamental to a particular bankruptcy. My aim here is not to provide an exhaustive summary of bankruptcy procedure, nor to insist on the absolute nature of any particular doctrine. Rather, I hope to illustrate the ways in which corporate and individual bankruptcy law reveal two pervasive themes: namely, the compulsory nature of a collective process and the categorical definition, within that process, of defined rights to a debtor's assets.

[12] Readers versed in these bodies of law may wish to skip to Part II. Corporate bankruptcies can be administered under either Chapter 7 or 11. Individual bankruptcy can proceed, depending on the debtor's characteristics, under Chapter 7, 11, or 13. In the interest of brevity, I focus here only on the Chapter 11 corporate reorganization and the Chapter 7 individual bankruptcy, each of which has attributes that will be useful to understanding municipal bankruptcy.

A. *Corporate Reorganization Under Chapter 11*

Chapter 11 proceedings begin with the filing of a petition for relief.[13] Typically the debtor itself files the petition to stymie impending collection efforts by one or more of its creditors. The debtor's management may think that delay will yield the breathing space needed to turn around the direction of business, but reorganization is not only, or even mainly, for the benefit of the debtor. One of its chief functions is to preserve value for creditors by avoiding inefficient liquidations that might result were individual creditors to pursue their state law collection rights without resort to collective action. Thus, the Bankruptcy Code denies the debtor's management the power to eschew bankruptcy—or hold out for favors—by simple inaction. Instead, any three creditors can petition to institute an "involuntary" case if the debtor has defaulted.[14] No one in particular has the power to keep an insolvent debtor out of bankruptcy. To be sure, many cases of corporate financial distress are resolved out of court in a "workout" among the interested parties.[15] But precisely because bankruptcy is certain to follow a failure to resolve things consensually, creditors and the debtor's management can be expected to negotiate a resolution in the shadow of Chapter 11.[16]

The filing of a petition for relief effects an automatic stay of collection-related activities.[17] The stay bars creditors from seeking to attach debtor assets and requires them to cease all ongoing collection efforts. To maximize its recovery from the debtor, each creditor must act within the bankruptcy process. No single creditor can destroy the value of the collective process by opting out.[18]

Bankruptcy's central function is to divide a pool of assets among a debtor's creditors (and sometimes its shareholders). The assets available to satisfy creditors comprise the debtor's "estate," the boundaries of which are described by the Code in great detail.[19] At a high level of generality, a corporate debtor's estate consists of "all legal or equitable in-

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[13] 11 U.S.C. § 301.

[14] The conditions on an involuntary petition are more complicated than this, but the details are irrelevant here. *See* 11 U.S.C. § 303(b). For an explanation of the involuntary petition rules, see Steven J. Winkelman, Comment, *A Dispute over Bona Fide Disputes in Involuntary Bankruptcy Proceedings*, 81 U. CHI. L. REV. 1341, 1343–48 (2014).

[15] *See* Morrison, *supra* note 2, at 255–57.

[16] Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 867 (1982).

[17] 11 U.S.C. §§ 301, 362.

[18] A secured creditor whose property interest in collateral is not "adequately protected" may seek to lift the stay, but it must prove the case to the bankruptcy judge's satisfaction. 11 U.S.C. § 361.

[19] 11 U.S.C. §§ 541–562.

terests of the debtor in property as of the commencement of the case," irrespective of where the property is or who holds it.[20] A trustee is appointed to administer the estate for the benefit of creditors. In most corporate reorganizations, however, the debtor itself assumes the powers and responsibilities of the trustee, and in this capacity is known as the "debtor in possession."[21]

The trustee administers estate assets, but also has the power to augment the estate by pursuing rights that, absent the bankruptcy petition, would have belonged to the debtor. This the trustee may do by generally pursuing positive-value causes of action. The trustee is also charged with avoiding preferences and fraudulent transfers that a hypothetical judgment creditor would be able to avoid.[22] Since at least the sixteenth century, Anglo-American law has recognized that a strategic debtor facing insolvency could divest himself of assets in order to benefit friends, family, or favored creditors.[23] Were this kind of strategic play permitted, it could destroy the compulsory nature of a bankruptcy proceeding. The amount of assets available to satisfy creditors would depend on the debtor's whim. Meanwhile, creditors would compete for preferential treatment—including by making side deals to return some share of assets to the debtor or its insiders. But such gamesmanship is not tolerated. The trustee is empowered to undo certain transfers of the debtor's property that make the transferee better off than he would have been participating in the reorganization. When the trustee is in fact the debtor in possession, of course, one might suspect that management would pursue questionable transfers with less than full verve. After all, the same managers who made the preferential or fraudulent transfer may well be running things as management of the debtor in possession. Here again the Code has an answer. It authorizes creditors to enforce the trustee's right where the trustee unjustifiably refuses to do so.[24] Again, the theme is that neither the debtor nor any particular creditors can scuttle the expectations of the group by removing assets other than through a collective proceeding regulated by identifiable, substantive rules of priority.

During the pendency of a Chapter 11 proceeding, the debtor in possession can make a number of discretionary decisions about the en-

[20] 11 U.S.C. § 541(a)(1).

[21] 11 U.S.C. § 1101(1).

[22] 11 U.S.C. §§ 544, 547, 548.

[23] Statute of 13 Elizabeth 1571 (Eng.), 13 Eliz., ch. 5; Twyne's Case (1601), 76 Eng. Rep. 809 (Star Chamber).

[24] *See* 11 U.S.C. § 1103(c)(5). Such is the view of the majority of courts, anyway. *See, e.g.*, Unsecured Creditors Comm. v. Noyes (*In re Noyes*), 779 F.2d 901, 904 (2d Cir. 1985). *But see In re* Cybergenics Corp., 226 F.3d 237, 245 (3d Cir. 2000) (holding that a trustee alone may pursue derivative claims on behalf of the estate).

terprise's business. It can, for example, choose to assume or reject executory contracts and leases,[25] and sell debtor assets to raise cash for distribution under the terms of a plan of reorganization.[26] Importantly, however, these discretionary choices are subject to the bankruptcy judge's review lest they become avenues to prefer one or another creditor.

Chapter 11 culminates in the plan of reorganization. The plan sets out the rights to which creditors (also known as "claimants") will succeed upon confirmation by the bankruptcy judge and discharge of the debtor's pre-petition obligations. In effect, the plan determines who has rights to how much of the debtor's estate, and what form these interests will take. In keeping with the general tenor of the reorganization rules, the Code prescribes strict rules on the proposal and acceptance of a plan. In so doing, the Code discourages two forms of ex post opportunism that frequently plague collective decision-making: first, expropriation of a minority creditor class by a majority coalition (at times including the debtor); and second, expropriation of the majority by a minority holdout (including the debtor). Each is critical to the establishment of relatively settled expectations.

For 120 days after the Chapter 11 petition is filed, the debtor has the exclusive right to propose a plan.[27] For good cause, the bankruptcy judge can extend this exclusivity period by up to fifteen additional months.[28] But delay will not permit a debtor to extract major concessions from its creditors. After the exclusivity period, creditors may submit their own proposed plans. This threat encourages debtors to propose a plan they believe can be confirmed.

A proposed plan divides claimants into classes and proposes a particular treatment for each class.[29] Membership within a class is premised on commonality of creditor interests. Creditors with claims of differing legal priority are classified separately,[30] and often so too are creditors of equal priority who for practical reasons are not similarly situated. For example, a debtor's trade creditors, tort claimants, and holders of its

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[25] 11 U.S.C. § 365. Collective-bargaining agreements, which are a species of executory contract, have special protections. *See* 11 U.S.C. § 1113; NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984).

[26] 11 U.S.C. § 363. Sales of substantially all of a debtor's assets have become increasingly commonplace.

[27] 11 U.S.C. § 1121(b).

[28] 11 U.S.C. § 1121(d).

[29] 11 U.S.C. § 1123(a).

[30] The existence and priority of a creditor's claim is often undisputed, but the responsibility for determining each is vested in the bankruptcy judge. 11 U.S.C. § 502.

long-term bonds may all have simple, unsecured claims, yet may prefer to be paid in different coin.[31]

If all classes impaired under a proposed plan vote to accept it, the bankruptcy judge will typically confirm the plan.[32] If, however, a class votes not to accept a plan, the bankruptcy judge must decide whether he can and should "cram down" the plan over objection. Here the creditors' substantive entitlements take center stage. Two rules in particular shape the bankruptcy judge's analysis. First is the "absolute priority" rule: a plan may not be confirmed over a class's objection if the plan proposes to provide value to interests junior to the objecting class without paying it in full.[33] The priority of each class, on which the absolute priority rule is parasitic, is given by law. Typically a creditor's "rank" in this respect is an artifact of state law.[34] But in some instances the Code displaces state law entitlements. To take just one example, the Code prefers unsecured claimants "engaged in the production or raising of grain" to unsecured claimants who, say, cultivate legumes.[35] Some bankruptcy-specific priorities are difficult to justify as a matter of first principles, they being rather obviously the consequence of interest group politics. Critically, though, the priorities are identifiable long before a debtor reaches insolvency, and consequently the terms on which voluntary investors extend credit can be expected to reflect them.

Absolute priority allows creditors to insist on "vertical" differentiation among claims, typically according to creditors' non-bankruptcy ex-

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31 As a check on gerrymandering, the Code requires that all claims in a single class receive the same value and kind of consideration. For example, a plan may not propose to pay some members of a single class in cash and others in notes. Yet two creditors of equal priority may prefer to receive different forms of consideration. In such a case, joint welfare is increased by classifying them separately.

32 A class is deemed to have voted in favor of a plan if the plan is accepted by creditors "that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class." 11 U.S.C. § 1126(c). Notwithstanding acceptance by each impaired class, a single creditor may object to the plan on the ground that it is not in "the best interest of creditors." *See infra* notes 71–72 and accompanying text. This rule permits an individual creditor to insist on being paid at least what he would take under a Chapter 7 liquidation.

33 11 U.S.C. § 1129(b) (stating that the plan must be "fair and equitable"); Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 116 (1939) (stating that the absolute priority rule is the fixed principle for evaluating reorganization plans). There are exceptions—for example, the "new value" rule—but this is a central organizing principle of bankruptcy.

34 The seminal case in this area is *Butner v. United States*, 440 U.S. 48 (1979). It has generally been interpreted to stand for the proposition that state law rights are effective in bankruptcy absent a bankruptcy-specific need to overlook them. *See generally* Douglas G. Baird & Anthony J. Casey, *Bankruptcy Step Zero*, 2012 SUP. CT. REV. 203.

35 11 U.S.C. § 507(a)(6)(A). This example is merely funny. Some bankruptcy-specific priority rules may, however, be quite destructive. For a discussion of one such rule, see Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539 (2011) (arguing that the rule allowing derivatives counterparties to seize assets from a bankrupt estate encouraged excessive use in the run-up to the recent financial crisis).

pectations. Securing "horizontal" equality is the rule that a plan may not be crammed down over a dissenting class's objection if it "discriminate[s] unfairly" among classes.[36] This rule allows a class to invoke a presumption that the plan not favor another class of equal priority.[37]

The net effect of the confirmation rules is to secure to each class of creditor a share of debtor assets commensurate with its entitlement under (typically) non-bankruptcy law and, at the same time, to prevent a coalition of creditors from holding out for more than its just deserts. If all creditor classes accept a proposed plan, the plan likely does the work it is supposed to do. After all, an aggrieved class could be expected to dissent if its treatment differed from its entitlement by more than the expected cost of litigating. Yet because the bankruptcy judge may cram down a qualifying plan, hopeful creditors are discouraged from holding out unreasonably.

Increasingly, Chapter 11 plans resemble glorified auctions.[38] Substantially all of the debtor's assets are sold, either during the pendency of the bankruptcy or pursuant to the plan's terms. In such cases, the priority rules are relatively easy to assess. In a bona fide reorganization, however, where the debtor enterprise survives more or less as a going concern, some creditor classes may be "paid" with securities issued by the reorganized debtor. Difficult valuation questions naturally arise, and the bankruptcy judge must decide whether a dissenting class of creditor is being swindled or is holding out for excessive compensation. But critically the rules defining the nature of the estate and setting out creditor priorities seek to limit the magnitude of uncertain treatment in a corporate reorganization.

B. *Individual Bankruptcy Under Chapter 7*

The economic justifications for discharge of an individual's debts under Chapter 7 are in many respects quite different from the standard rationales given for corporate reorganization under Chapter 11. Not surprisingly, these differences mandate different procedures. Yet the features assuring compulsory process and establishing identifiable rights to property look very similar.

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[36] 11 U.S.C. § 1129(b).

[37] Under the courts' understanding of this rule, a plan proponent may overcome the presumption of proration by showing, among other things, that the contemplated discrimination is "necessary" to a successful reorganization. *See* Hynes & Walt, *Fair and Unfair*, *supra* note 10, at 34–43; Markell, *supra* note 10, at 239–41.

[38] Vincent S.J. Buccola & Ashley C. Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 GEO. MASON L. REV. 99 (2010); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003).

As in a Chapter 11 proceeding, an individual debtor's case under Chapter 7 begins with a petition for relief. This can be voluntary or not.[39] In either event the petition does two things: it effects an automatic stay of creditor collection activities[40] and creates an estate comprising all of the debtor's assets.[41] Unlike the firm in Chapter 11, however, the individual in Chapter 7 is entitled to file a schedule of "exempt" assets. These the debtor may keep even if his creditors are not paid in full. The particular exemptions the Code permits are important, but their details are not important here. What matters is that they are specified.

When a Chapter 7 petition is filed, a trustee is appointed to administer the case. As in Chapter 11, the trustee enjoys the powers of a hypothetical lien creditor to avoid certain asset transfers that otherwise could undermine the collective nature of bankruptcy.[42] The trustee's chief job, however, is to gather and sell the debtor's nonexempt assets.[43] If all the debtor's assets are exempt or subject to valid liens, the trustee will normally file a "no asset" report with the court, and there will be no distribution to unsecured creditors. But if the case appears to be an "asset" case at the outset, unsecured creditors will be paid only if they timely file their claims with the court.

Assuming the trustee is able to reduce estate assets to money, he must then distribute the value recovered to holders of the allowed claims. Once again, claimants' priorities are generally clear. If a secured creditor is over-secured (such that the trustee can seize and sell the collateral), the secured creditor is paid first. After lienholders' claims have been satisfied, the trustee doles out proceeds of the estate in order of classifications set out in the Code. For example, allowed claims for domestic support obligations are paid first.[44] A person holding such a claim has the right to be paid in full before anyone junior to him takes anything—a rule of absolute priority. When the money runs out, claimants of equal priority share losses pro rata.[45]

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Corporate reorganizations and individual bankruptcies are often thought to have distinct aims. Reorganization law seeks to resolve a classic prisoners' dilemma. It aims to hold together, for the creditors' collective benefit, assets worth more as a going-concern than sold off piecemeal. Were no collective proceeding available, each creditor might

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[39] 11 U.S.C. §§ 301, 303.
[40] 11 U.S.C. § 362.
[41] 11 U.S.C. § 541.
[42] 11 U.S.C. §§ 544, 547–549.
[43] 11 U.S.C. §§ 701, 704.
[44] 11 U.S.C. § 726(a); 11 U.S.C. § 507(a)(1).
[45] 11 U.S.C. § 726(b).

reasonably think its interests best served by levying on assets without regard to their value in corporate solution. Ideally, the reorganization process resolves the dilemma by forcing coordination.[46] Individual bankruptcy, on the other hand, can be understood to ameliorate the familiar problem of debt overhang. When a person is heavily indebted, investment is hard to come by. Knowing that proceeds from investment must be split ratably with existing creditors, potential lenders become less likely to extend credit, even to finance positive expected value investments such as job training. For the same reason, the debtor himself is discouraged from investing in human capital or otherwise seeking financially remunerative work. By clearing the slate, bankruptcy can resolve this problem. It can give the debtor a "fresh start." And indeed many view the fresh start as a standalone good, irrespective of its tendency to stimulate debtors' economic activity.

Yet despite these divergent rationales, corporate and individual bankruptcy share a critical function—the orderly distribution of investment losses—and hence share a common structure. The fundamental properties of American bankruptcy law, for firms and individuals alike, are its compulsory nature and its establishment of substantive, relative rights to property that are knowable ex ante, before the debtor has become unable to repay its debts.[47] Frequently the substantive rules derive from non-bankruptcy law, especially from state law of property, contract, and tort—and for good reason.[48] Priorities can be, however, and sometimes are, established by invocation of the bankruptcy process itself. But critically, the existence of bankruptcy-specific substantive rights are knowable at the time credit is extended,[49] and therefore are presumably reflected in the price of credit.

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[46] The nineteenth century railroads are the paradigmatic example. Some commentators have argued that reorganization has other important benefits—that, for example, it can provide liquidity when credit markets are right. *See* Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557 (2013).

[47] The definiteness of entitlements can of course be overstated. *See* Roe & Tung, *supra* note 3. Disputes over relative rights are commonplace and represent the lion's share of bankruptcy litigation. Often, though, these disputes concern case-specific facts: whether, for example, a creditor exercised control over the debtor in bad faith, and should therefore have its claim subordinated. *See* 11 U.S.C. § 510. And of course, bankruptcy does not promise creditors a sum certain, only an expectation about "relative entitlements vis-a-vis other creditors." Jackson, *supra* note 16, at 861 n.23. The point here concerns the relative certainty of expectations.

[48] Symmetry of rights in and out of bankruptcy eliminates the incentives of creditors and debtors to forum shop—to seek resolution under the legal regime in which one's private losses are minimized irrespective of the regime's effect on investors as a group. *See* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987).

[49] Congress periodically amends the Code, of course, and can thereby upset creditor expectations. For examples, see Roe & Tung, *supra* note 3. But typically, and almost always when a property interest is involved, significant amendments are prospective in application.

This specification of substantive rights among parties in privity of contract has led commentators to think of bankruptcy as a forum for the enforcement of a hypothetical, multi-party contract. Such is the premise of the "creditors' bargain" model, which for thirty years has been the standard law and economics paradigm through which to understand bankruptcy law's aspiration. On this theory, bankruptcy ought to replicate the hypothetical agreement for dividing a debtor's assets that would be reached by the parties if they were able to negotiate a deal ex ante.[50] A voluminous literature exhaustively analyzes individual provisions of the Code by reference to their fit with the theory, in each instance the question being whether the particular feature of the Code is indeed efficient.[51]

I leave these fascinating debates to one side in order to focus attention on the economic effects of certainty itself. This is worth doing because, I will argue, a problem with existing municipal bankruptcy law is that it lacks these properties, and therefore accomplishes less than it otherwise could. The principal consequence of certain enforcement is to reduce party incentives to spend resources seeking rents, which are a deadweight loss. The so-called "race to the courthouse" is one example. Creditors might also spend resources monitoring one another for signs of foul play. And, as we shall see, bankruptcy rent-seeking can involve more explicit lobbying efforts of the kind familiar to students of political process. The net result in any event is wasted resources, which are shared in some combination by creditors (in the form of reduced recoveries) and debtors (in the form of increased borrowing costs).[52] Certainty of priority among creditors and debtors reduces the variance of returns a given creditor can expect ex ante. Even assuming

50 Despite its literal implication, the creditors' bargain is best understood to approximate the hypothetical agreement not only of consensual creditors, but also of the debtor itself. Although some commentators have overlooked this critical feature, it has been part of the theory since Jackson coined the term. Jackson, *supra* note 16, at 861 & n.21; *see also* Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 100 n.15 (1984) ("Those with rights include not only secured creditors, but also, for example, shareholders . . . ."). Among other things, the exemptions and discharge an individual debtor receives in Chapter 7 make sense within the bargain heuristic only if the debtor's cost structure is taken into account. The relevant bargain is one that would maximize the joint surplus of all parties, including the debtor, who stands to benefit from an efficient regime in the form of reduced borrowing costs. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

51 For critiques of the creditors' bargain paradigm, see, for example, Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 348–50 (1993).

52 Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759 (2011); Jackson, *supra* note 16, at 861.

(counterfactually) that all creditors are equally good at seeking rents, risk-averse creditors will be more likely to advance credit, and at better rates, as the variance in their expected returns is reduced.

II. INDETERMINATE RIGHTS AND VETO GATES IN CHAPTER 9

Cities cannot be liquidated. A creditor cannot respond to municipal default by seizing city hall, the roadways, or the power to tax.[53] As others have noted, this basic fact suggests that the economic rationale for municipal debt forgiveness recalls the case of the individual rather than the corporate debtor.[54] One worries not about inefficient liquidation as creditors scramble to foreclose on productive assets, but instead about the ramifications of significant debt overhang. A heavily indebted city has trouble raising funds, whether through borrowing or taxation, to fund even the most promising investments in infrastructure or city services.[55] Wiping the slate clean with a "fresh start," or at least reducing the debtor's burden, can help to rationalize a city's investments just as it can an individual person's.

If municipal bankruptcy's functional ambition calls to mind the individual debtor's case, its structure resembles more nearly that of the corporate reorganization.[56] Indeed, Chapter 9 explicitly incorporates many of Chapter 11's most prominent features.[57] The debtor enters bankruptcy with its management typically intact, resolves ongoing and

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[53] In theory, creditors in some states might have the power to force the imposition of a tax sufficient to pay the municipality's debt. *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 445–50 (1993). But this power, if it was ever more than de jure, seems to have long since disappeared as a practical matter. *See, e.g.*, Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 509 (1942) ("The principal asset of a municipality is its taxing power and that, unlike an asset of a private corporation, can not be available for distribution. An unsecured municipal security is therefore merely a draft on the good faith of a municipality in exercising its taxing power.").

[54] Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 292 (2012) [hereinafter Gillette, *Fiscal Federalism*] ("[M]unicipal bankruptcy serves as a mechanism by which localities can obtain the equivalent of the fresh start available to individuals in bankruptcy, rather than the 'efficient reconfiguration of assets' characteristic of corporate bankruptcy."); McConnell & Picker, *supra* note 53, at 426–27; Skeel, *Is Bankruptcy the Answer?*, *supra* note 8, at 1074.

[55] Vincent S.J. Buccola, *An Ex Ante Approach to Excessive State Debt*, 64 DUKE L.J. 235 (2014) (showing that residents are less likely to acquiesce in tax hikes as the proportion of revenue allotted to debt servicing increases).

[56] Richard M. Hynes & Steven D. Walt, *Pensions and Property Rights in Municipal Bankruptcy*, 33 REV. BANKING & FIN. L. 609, 632 (2014) [hereinafter Hynes & Walt, *Pensions and Property Rights*].

[57] *See* 11 U.S.C. § 901 (2012) (incorporating a number of Chapter 11's most important provisions).

unsustainable operations, subject to more or less judicial oversight, and finally seeks confirmation of a plan modifying creditors' rights against the debtor's assets. To the extent all parties agree to their proposed treatment, so much the better; but in both cases the bankruptcy judge is empowered to force an adjustment on holdout creditors and, in this way, to realize the ostensible benefits of debt adjustment to the debtor and creditors as a group.

Yet in critical respects municipal bankruptcy looks like a very different beast than either the corporate or individual variety—sufficiently so, I want to suggest, that it is a mistake to conceive of municipal bankruptcy as an analogous mode of (hypothetical) contract enforcement. Two differences in particular are paramount. First, Chapter 9 does little to establish identifiable rights to debtor assets. In some instances, the relative priorities of creditors are well established, but in other cases not so. And indeed the very rights of creditors as a group vis-à-vis municipal residents are opaque or at best ambiguous. Second, and more importantly, Chapter 9 lacks mechanisms that could make resorting to its process compulsory in cases of financial distress. On the contrary, the Code vests a series of political actors with the power to veto debt adjustment for good cause, bad cause, or no cause at all. To be confirmed, a plan must beat the nonbankruptcy status quo in the eyes of each of these "veto players." Securing their consent rather than enforcing preexisting bargains is the order of the day. In short, municipal bankruptcy is best conceived as creating a regime in which institutional political actors seek to legislate an ad hoc solution to the debtor's financial woes. Chapter 9 is best conceived as a quasi-constitution.

A. *Indeterminate Substantive Rights*

To date, most scholarly analysis has understood the central economic tension in a Chapter 9 case as a resource fight between the residents of a municipality and its creditors.[58] This view is sensible enough as an historical matter. Chapter 9 was enacted in an era when the lion's share of municipal debt was owed to bondholders secured only by the issuer's full faith and credit.[59] The critical question bankruptcy could

58 *See, e.g.*, Clayton P. Gillette, *Bondholders and Financially Stressed Municipalities*, 39 FORDHAM URB. L.J. 639, 654, 667–69, 677 (2012); Richard C. Schragger, *Citizens Versus Bondholders*, 39 FORDHAM URB. L.J. 787, 787–88 (2012). *See generally* Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035 (1997).

59 Vincent S.J. Buccola, *Who Does Bankruptcy? Mapping Pension Impairment in Chapter 9*, 33 REV. BANKING & FIN. L. 585, 586 (2014). Until the middle of the twentieth century, employee retirement benefits were generally understood as "gratuities" rather than contractual obligations and so did not form a significant legal obstacle to debt adjustment. For an account of the

answer was how much bondholders should be paid in light of the deleterious effects of tax hikes or cuts to municipal services. Today, however, an equally important tension exists between different kinds of creditors, in particular bondholders and current and former employees of the municipality, whose retirement benefits are generally understood to constitute unsecured obligations. Existing law is deeply unsettled along both dimensions. Unlike in the corporate and individual contexts, the municipal assets on which creditors as a group are entitled to levy are indeterminate. No list of "exempt" assets guides expectations, and consequently neither creditors nor residents can confidently demand a minimum share of resources. At the same time, the relative rights of unsecured creditors to whatever resources are available are in significant doubt.[60] As the law has developed to date, anyway, creditors of formally equal priority do not seem to have the right to insist on equal treatment in a plan of adjustment.[61]

Begin with the contest between a city's residents and its creditors. In corporate and individual bankruptcy, recall, the filing of a petition establishes an estate comprising all of the debtor's property, with limited and specified exemptions in the case of the individual bankrupt.[62] A trustee is appointed to manage the estate on behalf of creditors and is empowered to augment the estate by avoiding certain liens and transfers and, more generally, by pursuing the debtor's available remedies. No analogous mechanisms exist in Chapter 9 to ensure resources are culled for the creditors' benefit.[63] The municipality's managers continue to run the city's affairs, and no corpus exists against which creditors can measure their collective right to recovery. The bankruptcy judge is expressly prohibited from interfering with the debtor's "political or governmental powers" or its use of "property or revenues."[64]

To be sure, the municipal debtor holds title to identifiable property. It typically owns buildings, park lands, a fleet of automobiles, and so on. In theory, these could be sold off to pay down municipal debts. Cities might also generate cash by privatizing city services—for example, the monopoly right to collect garbage or to receive future parking fees.[65]

historical evolution of pension treatment under state law, see generally Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL'Y. 617 (2010).

60 The Code recognizes a payment priority in creditors secured by "special revenues." 11 U.S.C. §§ 928, 902(2) (defining "special revenues").

61 *See infra* notes 83–88 and accompanying text.

62 *See supra* Part I.

63 11 U.S.C. § 901 (not incorporating Code provisions relating to the trustee or debtor's estate).

64 11 U.S.C. § 904.

65 For discussion of the privatization of city services, including recent examples of the same, see generally Julie A. Roin, *Privatization and the Sale of Tax Revenues*, 95 MINN. L. REV. 1965 (2011).

Yet creditors in Chapter 9 have no obvious right to insist on the liquidation of assets or the restructuring of city services. In many cases, the most valuable municipal asset may be the power to tax. By increasing rates, the municipality may be able to generate additional revenue. But here again creditors lack any right to "foreclose" on the taxing power to satisfy their claims. In short, municipal bankruptcy supplies creditors with no right to particular or identifiable debtor assets, nor even a right to their prudent management.[66]

In a corporate reorganization, the absolute priority rule allows a class of dissenting creditors to block any plan that gives value to the firm's residual claimants, the shareholders, without compensating them in full.[67] Formally, absolute priority operates in Chapter 9, too.[68] A city's residents might be analogized to the shareholders of a corporation: they select the collective's managers and are the ostensible beneficiaries of its borrowing. One might therefore suspect that the absolute priority rule would ensure the payment of creditors before residents. This is not, however, the way the rule has been understood to operate in Chapter 9.[69]

To the extent Chapter 9 protects creditors from expropriation by a debtor municipality, it does so via a thoroughly ambiguous doctrine. A plan of adjustment can be confirmed only if it is in the creditors' "best interests."[70] This phrase is a term of art in bankruptcy. In Chapters 11 and 13, it signifies the rule that a plan can be confirmed only if it gives each creditor at least what he would recover from a liquidation of assets under Chapter 7.[71] Municipalities are ineligible for Chapter 7, however.

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[66] I speak here of a municipality's general unsecured creditors. Lien creditors do, of course, enjoy rights to identifiable assets. *See* David A. Skeel, Jr., *What Is a Lien? Lessons from Municipal Bankruptcy*, 2015 U. ILL. L. REV. ONLINE 675, 685 [hereinafter Skeel, *What Is a Lien?*].

[67] 11 U.S.C. § 1129; Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 116 (1939) (stating that the absolute priority rule is the fixed principle for evaluating reorganization plans); N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 502 (1913) ("[A] transfer by stockholders from themselves to themselves cannot defeat the claim of a non-assenting creditor.").

[68] 11 U.S.C. § 901 (incorporating the relevant part of § 1129).

[69] Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 652 (2008) ("Despite the formal incorporation of the absolute priority rule, unsecured creditors may have difficulty protecting themselves from reorganization plans that harm their basic interests."); McConnell & Picker, *supra* note 53, at 464.

[70] 11 U.S.C. § 943(b)(7); *see also* McConnell & Picker, *supra* note 53, at 464–67 (describing the concept's history in municipal bankruptcy).

[71] The phrase "best interest of creditors" is not to be found in today's Chapter 11 or 13. Nevertheless, those Chapters codify a rule, commonly referred to as the "best interests" rule, which encompasses the phrase's historical meaning. *See* 11 U.S.C. § 1129(a)(7) (conditioning confirmation of a plan providing to the holder of claim in each class value "that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7"); *id.* § 1325(a)(4) (conditioning confirmation of a plan providing value to each secured claim that "is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7").

No liquidation benchmark exists. The legislative history of Chapter 9 recognizes this and suggests a plausible interpretation consistent with at least some case law predating Chapter 9's enactment: a plan of adjustment is in creditors' best interests only if the municipality could not generate a greater recovery by the imposition of a special tax.[72] This understanding has not carried the day, however. Instead, courts have understood the "best interest" standard to guarantee creditors "something better" than a non-bankruptcy alternative.[73]

But uncertainty is a two-edged sword. Precisely because the "best interest" standard is so elusive, Chapter 9 provides residents of a debtor municipality little bankable protection. To be sure, the bankruptcy judge may not unilaterally require a debtor municipality to sell assets, privatize services, reduce spending, or levy additional taxes to pay off creditors.[74] The judge may, however, refuse to confirm a plan that contemplates what are in his view insufficient "resource adjustments."[75] The size of recovery to which creditors are entitled under a plan of adjustment is an open question in every municipal bankruptcy.

Relative rights among creditors are more clearly defined but still contestable in important ways. As in Chapter 11, the absolute priority rule protects senior creditors' interests by ensuring they be paid in full before junior creditors take value. Security interests in tangible property are less common in municipal than in corporate finance. Under the public trust doctrine, creditors may not seize municipal property that is

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72 Representative Edwards hazarded a view of the phrase as it pertains to municipal bankruptcy:

> The best interest of creditors test does not mean liquidation value as under chapter XI of the Bankruptcy Act. In making such a determination, it is expected that the court will be guided by standards set forth in *Kelley v. Everglades Drainage District*, 319 U.S. 415 (1943) and *Fano v. Newport Heights Irrigation Dist.*, 114 F.2d 563 (9th Cir. 1940), as under present law, the bankruptcy court should make such findings as detailed as possible to support a conclusion that this test has been met.

124 CONG. REC. 32,403 (1978) (remarks of Rep. Edwards); McConnell & Picker, *supra* note 53, at 465–67 (discussing the legislative history and the cited cases).

73 *In re* Pierce Cty. Hous. Auth., 414 B.R. 702, 718 (Bankr. W.D. Wash. 2009) ("The 'best interest of creditors' requirement of § 943(b)(7) is 'generally regarded as requiring that a proposed plan provide a better alternative for creditors than what they already have.'" (quoting *In re* Mount Carbon Metro. Dist., 242 B.R. 18, 34 (Bankr. D. Colo. 1999))); *In re Mount Carbon Metro. Dist.*, 242 B.R. at 34 ("The 'best interest' requirement of § 943(b)(7) is generally regarded as requiring that a proposed plan provide a better alternative for creditors than what they already have. This is often easy to establish. Since creditors cannot propose a plan; cannot convert to Chapter 7; cannot have a trustee appointed; and cannot force sale of municipal assets under state law, their only alternative to a debtor's plan is dismissal." (footnote omitted)).

74 11 U.S.C. § 904.

75 Gillette, *Fiscal Federalism*, *supra* note 54, at 293 ("[T]he apparently clear rule that the court may not require resource adjustments becomes more opaque once one considers the discretion that a court does have to condition the grant of relief in Chapter 9 on the political will of residents to accept them.").

in some sense "public." Courts have construed the scope of the doctrine broadly to cover not only traditionally public places such as wharves and roadways, but indeed to any municipal property held for a "public purpose."[76] Creditors have understandably been wary of accepting as collateral an asset that will later be ruled subject to the public trust. The more common way by which creditors attain a property interest, and thus seniority, is through a lien on municipal revenues. Claims secured by a lien on revenues are entitled to adequate protection and are paid before the holders of general unsecured claims. Holders of claims secured by so-called "special revenues"—generally, revenues associated with a specific municipal project or revenue stream[77]—are not even subject to the automatic stay.[78]

The relative treatment of various classes of unsecured creditors is less sure. This is critical because the majority of claims, by value, in a typical municipal case are unsecured.[79] The general rule in bankruptcy is that claims of equal priority are to be impaired ratably. In Chapter 11, this norm is embodied in the rule preventing confirmation of a plan of reorganization that "discriminate[s] unfairly" against an objecting class of creditor.[80] Classes of equal priority may be paid in different coin, but the value of their takes ought to be equal absent special circumstances. Meanwhile, Chapter 7, which contemplates cash payments to creditors, expressly states that recoveries among claimants of equal priority must be pro rata.[81]

One might suspect that such a rule would hold in Chapter 9. After all, municipal bankruptcy incorporates by reference Chapter 11's rule prohibiting unfair discrimination.[82] And the rationale for proration is sound as a matter of bankruptcy policy[83]: one of the objectives of bankruptcy is to prevent inefficient rent-seeking, as each claimant seeks the debtor's affection in the hope of getting an outsized share.

Yet the evidence suggests that the rule applies at best unevenly in Chapter 9. One need only look at recently confirmed plans of adjust-

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76 *See* McConnell & Picker, *supra* note 53, at 429–34 (explaining that very little municipal property has been understood as proprietary and hence subject to seizure).

77 "[S]pecial revenues" are defined by 11 U.S.C. § 902(2).

78 11 U.S.C. § 922(d).

79 *See* Skeel, *What Is a Lien?*, *supra* note 66, at 685 (explaining that general obligation bondholders "secured" by a municipality's full faith and credit are unsecured as a legal matter).

80 11 U.S.C. § 1129(b)(1).

81 11 U.S.C. § 726(b).

82 11 U.S.C. § 901.

83 *Compare* Hynes & Walt, *Pensions and Property Rights*, *supra* note 56 (arguing that a pro rata rule should obtain), *with* David A. Skeel, Jr., *Can Pensions Be Restructured in (Detroit's) Municipal Bankruptcy?* 19, 24–26 (Federalist Soc'y White Paper Series, U. Pa. Inst. for Law & Econ., Research Paper No. 13-33 2013) (arguing that what is "unfair" in a Chapter 9 context might differ from a Chapter 11 case).

ment to see that the rule's contours are in doubt. In the Central Falls bankruptcy, for example, a plan of adjustment was confirmed that impaired the claims of retirees differently, in violation of the proration norm, depending on the claimants' age and salary—criteria that cannot have been "necessary" to the consummation of a plan.[84] The plans confirmed in Stockton and Detroit provide clearer evidence, if only because the monetary stakes were great enough to justify legal wrangling. In Stockton, the bankruptcy judge held that pension obligations were unsecured claims, yet nevertheless confirmed a plan that paid these claims in full while paying certain other unsecured claims only a penny on the dollar.[85] Detroit initially proposed a plan under which unsecured claims held by some creditors, such as Syncora and FGIC, would recover only roughly a quarter of the value provided to the unsecured claims associated with pension obligations. The plan also sought to treat a class of miscellaneous claimants (including some lessees and tort victims) on terms far inferior to retirees. After a summer of outraged rhetoric, the bond insurers agreed to settle their claims for slightly more consideration, but nowhere near the pensioners' recovery.[86] The class of miscellaneous creditors rejected Detroit's proposed plan, forcing Judge Rhodes to rule on the question of unfair discrimination. He held that despite the plan's vastly disparate treatment of equal priority claims, it did not unfairly discriminate against the politically weak tort victims. The judge's own "experience, education, and sense of morality" counseled the result.[87]

The Central Falls and Stockton plans were agreed by all classes, so one cannot be sure how the bankruptcy judge in either case would have interpreted the unfair discrimination rule had a disappointed class voted against confirmation. But signs point to judicial skepticism of a deter-

[84] *See* Order Confirming Fourth Amended Plan for the Adjustment of Debts of the City of Central Falls, R.I., *In re* City of Central Falls, No. 11-13105 (Bankr. D.R.I. July 27, 2012), http://www.americanbar.org/content/dam/aba/events/state_local_government/2013/08/Bankruptcy_materials.authcheckdam.pdf.

[85] First Amended Plan for the Adjustment of Debts of City of Stockton, California, as Modified, *In re* City of Stockton, No. 2012-32118 (Bankr. E.D. Cal. Aug. 8, 2014), http://www.ci.stockton.ca.us/files/8_8_2014_Chapter9_Doc_1645_FirstAmendedPlanForAdjustment OfDebtsAsModified.pdf. The class encompassing the jilted creditors voted to approve the plan—hence there was no formal inquiry into unfair discrimination—but only because healthcare claims held by many of the same people who held pension claims were classified together.

[86] Eighth Amended Plan for the Adjustment of Debts of the City of Detroit at 59, *In re* City of Detroit, No. 13-53846 (Bankr. E.D. Mich. Oct. 22, 2014), https://www.michigan.gov/documents/treasury/Detroit_-_Eighth_Amended_Plan_of_Adjustment_476086_7.pdf.

[87] Oral Opinion on the Record at 30, *In re* City of Detroit, No. 13-53846 (Bankr. E.D. Mich. Nov. 7, 2014), https://www.mied.uscourts.gov/PDFFIles/DBOralOpinion.pdf; *see also* Melissa Jacoby, *Detroit's Bankruptcy: End(s) and Means*, CREDIT SLIPS (Nov. 10, 2014, 9:09 AM), http://www.creditslips.org/creditslips/2014/11/detroits-restructuring-ends-and-means.html.

minate rule. The bankruptcy judge in Stockton avoided ruling on unfair discrimination only by allowing the city to classify health care benefit claims along with general unsecured claims—despite the retirees' strong interest in confirming a plan that would pay pension obligations in full. Whatever the propriety of Judge Klein's decision in this regard, its unmistakable purpose was to generate a consensus plan (according to the Code's voting formula) where unsecured claims were in fact given massively different treatment. In both Stockton and Detroit, moreover, a series of institutional unsecured creditors settled their claims on highly disadvantageous terms (assuming a pro rata baseline). The terms of these settlements indicate something about the institutional creditors' *beliefs*, anyway, with respect to unfair discrimination. They *believe* a highly discriminatory plan could be crammed down. The Detroit creditors were right. And given the subtlety with which a bankruptcy judge can signal his predilections, the smart money says the Stockton creditors were right, too.

The upshot of these features is simple enough. The primary economic stakeholders in a city's Chapter 9 proceeding are its residents, its bondholders and other commercial lenders, and its current and former employees. None of these has a clear resource entitlement. None can insist on an identifiable minimum recovery.

B. *Veto Players*

The natural proliferation of case law might be expected to resolve some of the indeterminacy surrounding substantive rights over time—especially the indeterminacy of inter-creditor priorities. Much would be clarified if, for example, courts were to construe the rule against unfair discrimination to guarantee pro rata recoveries to creditors of equal priority. Yet, in another and perhaps more important sense, a fundamental doubt about economic rights would persist. This is because the very invocation of Chapter 9 is doubtful, as is the prospect that, if invoked, it will lead to a confirmed plan of adjustment. In particular, a series of political actors—some individual, some collective institutions—can unilaterally veto a plan of adjustment and insist on the status quo, namely the parties' respective non-bankruptcy rights and remedies. This means that even articulable "paper rights" in bankruptcy are worth little.

Veto powers are constituted in part by the structure of Chapter 9 and in part by state law. The analysis below focuses on four key actors who enjoy veto power in many states: the legislature, the city government, the governor or financial stability board, and the bankruptcy judge. It is conceptually possible to add additional actors to the tally. Congress, for example, can repeal or replace Chapter 9 at will, and in

this sense can veto municipal debt adjustment categorically. Arguably one could also think of the court of appeals supervising the bankruptcy judge as holding an additional veto. My purpose here is not to exhaust possibilities. Rather I aim simply to show how veto powers shape the nature of municipal bankruptcy in the ordinary case.

1. State Legislatures

A municipality may invoke Chapter 9 only if it is "specifically authorized" to do so under state law.[88] Currently, about half of the states allow their municipalities to become bankrupts. Some states condition eligibility on approval by the governor or another agency; others grant permission carte blanche. But nothing prevents a state from changing course—supplying (or revoking) authorization to proceed in Chapter 9 after creditors have advanced loans and employees have accepted the terms of a bargaining agreement. Thus, the legislature enjoys a veto over a municipality's use of Chapter 9 to adjust debts. One might expect the law in this domain to be relatively stable and hence the veto power weak. Rules are sticky when only a majority in each legislative chamber, plus acquiescence by the governor, can change them. Depending on the rules peculiar to a given state's legislative process, a small minority may be able to defeat even legislation with strong support.

Yet state law concerning municipal bankruptcy eligibility is not as stable as one might suppose. The geographical diffusion of legislators across a state might explain this fact. A supermajority of legislators in any particular state is likely to hail from outside a distressed municipality's district. These legislators may think their own constituents' interests to be aligned against the interests of residents in the distressed city, making legislative bargaining easier than in some other contexts. Whatever the reason, state legislatures appear able at times to exercise their bankruptcy veto.

The recent history of Harrisburg, Pennsylvania illustrates the point. Harrisburg's finances deteriorated precipitously in the early 2000s. Financial distress rarely emanates from a single source, but in Harrisburg's case many pointed the finger at a dubious project to refurbish a trash incinerator.[89] To finance improvements, Harrisburg borrowed to

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[88] 11 U.S.C. § 109(c)(2) (2012) ("An entity may be a debtor under chapter 9 of this title if and only if such entity . . . is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter . . . .").

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

the tune of hundreds of millions of dollars. The project generated much less revenue than its proponents had expected (or at least claimed to expect), leaving the city in a deep hole.[90] By 2010, city officials were talking about bankruptcy,[91] which then-existing law allowed the city to seek.[92] But in 2011, before the city could file, the Pennsylvania legislature amended its fiscal code. The amendments barred "third class" cities, such as Harrisburg, from seeking Chapter 9 protection.[93] A majority of Harrisburg's city council caused a bankruptcy petition to be filed notwithstanding the legislation, but the bankruptcy court properly held it ineligible.[94] The legislature had vetoed Harrisburg's use of bankruptcy. Harrisburg eventually entered state receivership, the net economic effect being—in the eyes of some, at least—to spare creditors at the expense of residents.[95]

Short of precluding access to Chapter 9 altogether, a state legislature might be able to block particular adjustments that it disfavors. It might, for example, be able to prevent the confirmation of a plan that impairs retirees' pension rights. The bankruptcy judge in the Stockton case rejected this notion, but it remains an open question. By its terms, Chapter 9 reserves to the states their power to control the "political or governmental" powers of a debtor municipality, including by legislation.[96] By way of example, a California statute declares that no debtor municipality may reject a contract with its pension administrator.[97]

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90 *Id.* ("Costs ran over estimates, the contractor was fired, and taxpayers ended up owing more than $300 million for a project that was supposed to cost $64.2 million and generate a total surplus of $57.4 million by 2028, according to a 2001 projection cited in the audit.").

91 Michael Cooper, *An Incinerator Becomes Harrisburg's Money Pit*, N.Y. TIMES (May 20, 2010), http://www.nytimes.com/2010/05/21/us/21harrisburg.html?_r=0.

92 Act of July 10, 1987, § 261, 1987 Pa. Laws 246, No. 47.

93 Act of June 30, 2011, § 1601–D.1, Pa. Laws 159, No. 26 ("Notwithstanding any other provision of law, including section 261 of the Municipalities Financial Recovery Act, no distressed city may file a petition for relief under 11 U.S.C. Ch. 9 (relating to adjustment of debts of a municipality) or any other Federal bankruptcy law, and no government agency may authorize the distressed city to become a debtor under 11 U.S.C. Ch. 9 or any other Federal bankruptcy law.").

94 *In re* City of Harrisburg, 465 B.R. 744, 754–55, 764–65 (Bankr. M.D. Pa. 2011).

95 Mary Williams Walsh & Jon Hurdle, *Harrisburg Sees Path to Restructuring Debts Without Bankruptcy Filing*, N.Y. TIMES (July 24, 2013), http://www.nytimes.com/2013/07/25/us/harrisburg-sees-path-to-restructuring-debts-without-bankruptcy-filing.html?_r=0 ("'All the pain is on Harrisburg city residents,' said the city controller, Dan Miller. He said Chapter 9 bankruptcy would have forced bondholders and other financial creditors to share more of the pain of the restructuring, as Detroit is proposing to do. Bankruptcy would have also allowed Harrisburg to void expensive union contracts, Mr. Miller said.").

96 11 U.S.C. § 903 (2012) ("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 . . . .").

97 CAL. GOV'T CODE § 20487 (West 2016) ("Notwithstanding any other provision of law, no contracting agency or public agency that becomes the subject of a case under the bankruptcy provisions of Chapter 9 . . . shall reject any contract or agreement between that agency and the

Formally speaking, it is the federal government, not the debtor, that adjusts debts, so impairing contractual obligations is not a "political or governmental" power of the municipality.[98] On the other hand, the act of *proposing* a plan of adjustment might be such a power. If it is, a legislature, acknowledging that only the municipality may propose a plan, might allow Chapter 9 relief generally while vetoing particular forms of relief it disfavors. The law is admittedly vague on this score, and courts have not given it definitive meaning. But the argument is reasonably straightforward.

Finally, a legislature might be able to veto disfavored adjustments by altering the substantive law directly. This is precisely what the Rhode Island legislature did on the eve of the Central Falls bankruptcy.[99] Shortly before the city filed its petition, the legislature enacted a law granting bondholders a statutory lien on town revenues.[100] The law changed formerly unsecured creditors into secured creditors, preventing the impairment of their rights and forcing losses onto trade creditors and current and former city employees.[101] The plan of adjustment was ultimately adopted by the consent of all classes, so it is not entirely clear that the statutory liens would have held up to legal challenge.[102] In any

board pursuant to Section 365 of Title 11 of the United States Code or any similar provision of law . . . .").

98 Buccola, *supra* note 59, at 598–608.

99 This is not obviously a formal veto gate. It goes to the substance of the parties' rights. But it might also be deployed as a threat against some other kind of outcome in bankruptcy.

100 45 R.I. GEN. LAWS § 45-12-1 (West 2011) ("The faith and credit, ad valorem taxes, and general fund revenues of each city, town and district shall be pledged for the payment of the principal of, premium and the interest on, all general obligation bonds and notes of the city or town whether or not the pledge is stated in the bonds or notes, or in the proceedings authorizing their issue and shall constitute a first lien on such ad valorem taxes and general fund revenues."). For thoughtful commentary on the Central Falls case, see generally C. Scott Pryor, *Municipal Bankruptcy: When Doing Less Is Doing Best*, 88 AM. BANKR. L.J. 85 (2014); see also Clayton P. Gillette, *Bankruptcy and Its By-Products: A Comment on Skeel*, 50 HOUS. L. REV. 1129, 1143 (2013); Hynes & Walt, *Pensions and Property Rights*, *supra* note 56, at 631–32.

101 Order Confirming Fourth Amended Plan for the Adjustment of Debts of the City of Central Falls, R.I., *In re* City of Cent. Falls, No. 11-13105 (Bankr. D.R.I. July 27, 2012), http://www.americanbar.org/content/dam/aba/events/state_local_government/2013/08/Bankruptcy_materials.authcheckdam.pdf; *see also* Hynes & Walt, *Pensions and Property Rights*, *supra* note 56, at 649–51 (arguing that states, if they wish retirees to take priority in a bankruptcy, can grant an analogous property right).

102 At least one commentator thinks the legislation valid. *See* Skeel, *What Is a Lien?*, *supra* note 66, at 688–90. I am not so sure. Section 545 of the Code permits the avoidance of statutory liens fixed on debtor property if the lien "first becomes effective against the debtor when the debtor becomes insolvent . . . ." 11 U.S.C. § 901 (2012) (incorporating § 545 by reference). How exactly this provision should be understood is debatable. On one reading, only a springing lien is avoidable—that is, a lien that attaches *because of* the debtor's insolvency. But the provision could also be read to invalidate any lien that first attaches when the debtor is insolvent; and there is little doubt that Central Falls was insolvent by the time the Rhode Island legislation took effect.

event, a change in substantive law can act as a legislative veto of adjustments the legislature's members disapprove.

2. City Governments

A Chapter 9 case starts with a petition by the municipal debtor.[103] Unlike in the corporate or consumer context, creditors have no power to force the municipality into Chapter 9 against its will—however that is determined under state law.[104] As an initial matter, this means the city government can credibly threaten to stick creditors with the collection remedies provided under state law. That would tend to favor creditors whose claims have already been, or soon will be, matured and reduced to judgment. To the extent a collective proceeding would be best for creditors as a group, in the sense of generating a surplus relative to non-bankruptcy collections practice, the city can leverage its veto power to gain concessions from disfavored creditors.

Even after a Chapter 9 proceeding has begun, the city can prevent any particular flavor of debt adjustment. Only the city can propose a plan of adjustment,[105] meaning that no adjustment will occur unless it be on terms agreeable to the city. And if at any time it becomes clear that the municipality no longer is actively seeking to adjust debts through a plan, the bankruptcy judge is charged to dismiss the petition.[106] Knowing this, the municipal debtor may be able to extract value from the creditors. But the amount, and from whom, depends on the particulars of a case.

A municipality's veto power is, however, defeasible at the will of its state legislature, which can divest the municipality's elected officials of their holdout threat, typically through the agency of an emergency manager or control board. Detroit provides a good example. In 1990, Michigan's legislature enacted the Local Government Fiscal Responsibility Act, also known as Public Act 72. The Act mandated a series of procedures, commencing with the state treasurer's certification of a serious financial problem and culminating in the investiture of an emergency manager empowered to act "for and in the place and stead of the governing body and the office of chief administrative officer of the local

103 11 U.S.C. § 301(a).

104 11 U.S.C. § 303(a) (stating that involuntary petitions may be had only against debtors eligible for Chapters 7 and 11, and only under those Chapters).

105 This is in contradistinction to Chapter 11, where the debtor enjoys an "exclusivity period" after which, if no plan can be confirmed, creditors may propose plans. 11 U.S.C. § 901 (excluding from Chapter 9 the rule of 11 U.S.C. § 1121).

106 11 U.S.C. § 930(a).

government."[107] Under Michigan law, the emergency manager has "broad powers in receivership" to rectify financial emergency,[108] and in particular may recommend, subject to the governor's approval, that the city file for Chapter 9 relief.[109]

3. Governors/Financial Control Boards

As I have said, the law of many states permits municipalities to petition for Chapter 9 relief as an exercise of its elected officials' discretion. In some states, however, the municipality's ability to file is conditioned on the approval of a representative of the state—often the governor or a financial stability commission. Needless to say, the details vary. What is important to see for present purposes is that such statutory schemes introduce an additional player who can veto resort to Chapter 9 altogether.

In some instances, the governor or financial control board might also be able to veto particular plans by placing conditions on authorization to file. Conditional authorization is expressly the law in Michigan, for example, where the governor is permitted to "place contingencies on a local government in order to proceed under chapter 9."[110] The governor could, for example, declare that a municipality may be a debtor only so long as it does not propose a plan of adjustment impairing retiree benefits. As it turned out in Detroit's case, Governor Snyder declined to attach any contingencies to the city's filing.[111] According to his authorization, "[f]ederal law already contain[ed] the most important contingency—a requirement that the plan be legally executable."[112] As with a state legislature's grant of contingent authorization, it is not entirely clear that a bankruptcy court would respect a governor's limitations. Being a part of federal law, the Code trumps inconsistent state law.[113] Yet in broad terms the Code itself reserves to the state the power to regulate

107 MICH. COMP. LAWS ANN. § 141.1549(2) (West 2005). The process is cumbersome. The state treasurer has to certify as a preliminary matter that a financial emergency exists. Then the governor appoints a board to take a closer look and try to negotiate a deal with the municipal government. If this proves unworkable, the board certifies that an emergency exists, and the governor can seek to have an emergency manager appointed. Although the scheme includes multiple levels of discretionary review, the governor's power of appointment may ensure that he gets the permissions he prefers.

108 *Id.*

109 *Id.* § 141.1566(1).

110 *Id.* § 141.1558(1).

111 *In re* City of Detroit, 504 B.R. 97, 128 (Bankr. E.D. Mich. 2013).

112 *Id.* (citing 11 U.S.C. § 943(b)(4) (2012)).

113 U.S. CONST. art. VI, cl. 2.

the political and governmental functions of a debtor municipality.[114] A difficult question of statutory interpretation lurks here.[115]

Even if bankruptcy ignores a governor's contingencies (or the governor lacks formal power as a matter of state law), the governor might be able to block disagreeable plans informally with carrots and sticks. Governors often have discretion to allocate funds for investments they deem useful for the general public. The governor could make clear to a municipal government that such funds will not be forthcoming if the city tries to force through a plan of adjustment he dislikes or, in the alternative, that a proposed infrastructure project looks promising if the city confirms a plan more amenable to his preferences. As a functional matter, bargaining leverage can look very similar to a formal veto power.

4. Bankruptcy Judges

Normative analyses of municipal bankruptcy typically begin with the bankruptcy judge's supposed impotence in Chapter 9 relative to other modes of bankruptcy.[116] And to be sure, the bankruptcy judge has little authority directly to regulate a municipal debtor during the pendency of Chapter 9 proceedings. Section 904 positively forbids a court from interfering with the "political or governmental powers of the debtor," the "property or revenues of the debtor," or the "debtor's use or enjoyment of any income-producing property."[117] The court cannot order a tax increase, a divestment of property, or indeed any significant reorganization of the municipality's operations.[118] In addition to these general prohibitions, Chapter 9 conspicuously omits oversight powers that are effective in every other kind of bankruptcy proceeding. Thus, the bankruptcy judge lacks the power under § 363 to supervise a municipality's decision to sell assets outside the ordinary course.[119] Nor, apparently, can the judge exercise much oversight of a municipal debtor's

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[114] 11 U.S.C. § 903.

[115] For a thoughtful take on the reservation of political and governmental powers, see Hynes & Walt, *Pensions and Property Rights*, *supra* note 56, at 624–27.

[116] *See* Kimhi, *supra* note 69, at 653 ("[T]he court's powers are limited to confirming or rejecting the plan the locality submits."); McConnell & Picker, *supra* note 53, at 462–63.

[117] 11 U.S.C. § 904.

[118] Professors Gillette and Skeel have argued that bankruptcy judges should have significantly more governance authority than they exercise presently. *See generally* Clayton P. Gillette & David A. Skeel, Jr., *Governance Reform and the Judicial Role in Municipal Bankruptcy*, 125 Yale L.J. 1150 (2016); *see also* Gillette, *Fiscal Federalism*, *supra* note 54, at 295–96 (arguing that bankruptcy judges should have authority to levy unpopular taxes).

[119] 11 U.S.C. § 901 (not incorporating § 363).

choice whether to assume or reject executory contracts under § 365.[120] This last restriction is especially important because collective-bargaining agreements often account for a large part of the long-term liabilities on the debtor's ledger.

But to focus on the bankruptcy judge's limited powers of direct regulation would be a mistake. Like the other actors identified above, the bankruptcy judge has the power to nix a plan of adjustment at multiple stages.[121] The judge can use this power to exert substantial influence over a debtor's operations and the adjustment plan it ultimately will propose. One set of powers can block a city's petition in the first instance. The bankruptcy judge can use other doctrines to shape a potential plan. Precisely because substantive rights in Chapter 9 are less clear than in other forms of bankruptcy, these powers clothe the court with a remarkable discretion.[122]

Consider first the bankruptcy judge's gatekeeping role. If a creditor objects to a municipality's Chapter 9 petition, the bankruptcy judge must conduct a hearing and decide on the municipality's eligibility for relief.[123] Some of the eligibility criteria are straightforward in the context of a conventional town or city: the debtor must, for example, qualify as a "municipality"[124] and desire "to effect a [debt-adjustment] plan."[125] Other criteria are more elastic. Chief among these is the requirement that a debtor municipality be "insolvent."[126] The Code adopts a cash-flow measure of insolvency: a municipality is insolvent if it either is "generally not paying its debts" or is "unable to pay its debts as they become

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120 Obligations assumed under § 365 enjoy the status of an administrative expense, and thus are entitled to payment ahead of general obligations. Section 365 applies nominally in Chapter 9 proceedings, but in light of § 904, the court should not be able to supervise this particular choice. 11 U.S.C. §§ 901(a), 904. *But see* Hynes & Walt, *Pensions and Property Rights*, *supra* note 56, at 624–27 (arguing that § 365 is more specific than § 904 and thus would be a nullity in Chapter 9 unless the court can supervise).

121 This may sound like cheating. After all, the bankruptcy judge is a player in corporate and individual bankruptcy practice, too. Without the prospect of a searching review, he can decline to cram down a plan of reorganization in Chapter 11 or grant a discharge in Chapter 7. Nevertheless, the relative certainty of substantive rights in those contexts tends to limit his discretion. The difference between his role in Chapter 9 and Chapter 11 is one of degree rather than kind, but is, I think, remarkable enough to merit the attention here given.

122 Gillette, *Fiscal Federalism*, *supra* note 54, at 293 ("[T]he apparently clear rule that the court may not require resource adjustments becomes more opaque once one considers the discretion that a court does have to condition the grant of relief in Chapter 9 on the political will of residents to accept them.").

123 11 U.S.C. § 921(c). For a persuasive argument that Congress ought to relax eligibility conditions, and therefore restrict the bankruptcy judge's veto power ab initio, see Laura N. Coordes, *Gatekeepers Gone Wrong: Reforming the Chapter 9 Eligibility Rules*, 94 WASH. U. L. REV. (forthcoming 2017), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2721876.

124 11 U.S.C. §§ 101(40), 109(c)(1).

125 *Id.* § 109(c)(4).

126 *Id.* § 109(c)(3).

due."[127] It is not hard to see whether a city is in fact paying its debts; the harder question is determining its *ability*, going forward, to pay debts. Some commentators have suggested a narrow reading of the insolvency condition—that a municipality *can* pay its debts if it can either reduce spending or increase revenue by a magnitude sufficient to compensate creditors.[128] Courts have not so understood the rule, but they have at times stretched it to preclude resorting to bankruptcy. Most famously, in the case of Bridgeport, Connecticut, the bankruptcy judge held that a city is insolvent only if it will run out of cash within the fiscal year.[129] This temporal limitation is nowhere to be found in the Code's text. Yet the court blocked Bridgeport, which by all accounts was in dismal financial condition, from proceeding in bankruptcy.

A bankruptcy judge can, however, exert significant control over the municipality's affairs without blocking eligibility in the first instance. The law of plan confirmation supplies the bankruptcy judge with a veto over debt adjustments of which the judge disapproves. Precisely because the substantive rights of the bankrupt's stakeholders are uncertain (as the preceding Section argued), the bankruptcy judge has a wide berth in which to exercise this veto. To be sure, if the impaired classes of creditor unanimously support a proposed plan, and if no creditor objects that the plan is not in its "best interest," then confirmation will typically be forthcoming. The bankruptcy judge could in theory decide on his own motion that a plan is not feasible or in the creditors' interest, but to do so would be unseemly. More realistically, the judge can signal to a disfavored class or kind of creditor that its objection would be well taken, and thus indirectly generate the need for a cram down hearing, at which the result would be easy enough to predict.[130] The debtor's representatives are aware of this power, of course, and so are unlikely to propose a plan the court has signaled would by its lights be unacceptable. This veto power arguably constrains not only the kind of plan a debtor is likely to propose, but also the way it uses its discretionary authority during the pendency of the proceedings. For example, a bankruptcy judge might

127 *Id.* § 101(32)(C) (defining insolvency as, "with reference to a municipality, financial condition such that the municipality is—(i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due").

128 *See* McConnell & Picker, *supra* note 53, at 438, 466 (suggesting that a municipality may be unable to pay debts only if it has exhausted its taxing power); *see also* John P. Hunt, *Taxes and Ability to Pay in Municipal Bankruptcy*, 91 WASH. L. REV. 515 (2016) (arguing that a municipality is insolvent if and only if tax rates as high as those of any peer cities would be insufficient to pay obligations).

129 *In re* City of Bridgeport, 129 B.R. 332, 338 (Bankr. D. Conn. 1991). For an elaboration of the decision, see Gillette, *Fiscal Federalism*, *supra* note 54, at 293.

130 Gillette, *Fiscal Federalism*, *supra* note 54, at 294–95; McConnell & Picker, *supra* note 53, at 474.

signal to the debtor that its decision to assume a particular labor contract would be looked upon skeptically at the confirmation phase—that the decision could amount to illegal, creeping confirmation.[131]

III. IMPLICATIONS OF VETO-PLAYER THEORY

The analysis so far has suggested that, as it exists today, Chapter 9 ought to be imagined as a quasi-constitution rather than a forum for the enforcement of identifiable rights to assets. Chapter 9, in effect, constitutes a regime in which a series of political actors and institutions legislate how resources in a town or city are to be allocated between lenders, employees and retirees, residents, and others. This legislation, which we call the "plan of adjustment," originates with the municipal debtor unless another institution precludes resort to bankruptcy altogether. Roughly, then, the municipal government can be understood as the agenda setter singularly capable of presenting legislation for an up-or-down vote. If every institution with veto power consents to the plan, it displaces whatever entitlements would have prevailed under non-bankruptcy law. If, however, one or more of these institutions rejects a proposed plan, the status quo non-bankruptcy entitlements persist. The municipality's discretion over the application of resources is thus sharply curtailed. To alter the status quo, it must persuade each veto player at least to acquiesce in the change. Negotiation takes center stage.

This Part considers some of the implications of such a view. It begins with a brief overview of veto theory, then connects this theory with municipal bankruptcy. In particular, this Part argues that Chapter 9's quasi-constitutional structure has at least three significant consequences relative to a contract enforcement model of bankruptcy: (1) it leads to a suboptimal number of confirmed plans, measured by the perspective of the veto players themselves; (2) it encourages stakeholders to lobby veto players for support, reducing net wealth and therefore increasing municipal capital costs; and (3) it implies that the allocation of resources in any particular bankruptcy is difficult to predict before the fact, increasing municipal capital costs to the extent creditors and taxpayers are risk averse.

In the language of political theory, a veto player is a person or institution that can unilaterally nix proposed changes to the policy status

[131] For a possible example of such signaling, see *In re* City of Stockton, 486 B.R. 194 (Bankr. E.D. Cal. 2013). Signals may be subtle, such that they may escape outsiders' notice. It is therefore difficult to say one way or another how significant signaling is in practice.

quo.[132] Veto players are a feature of most, and perhaps all, constitutions. For a bill to become the law of our national government, for example, it must garner the assent of the House of Representatives, the Senate, and the President (subject to override by two-thirds of the members of each house).[133] The formal and informal rules of each chamber create additional, extra-constitutional checks on legislation: the Chair of the relevant House committee can sit on a bill and kill it by delay; the Speaker of the House can refuse to call for a floor vote, and so on.[134]

The first thing to notice about the veto power is that its proliferation tends to reduce opportunities for legislation.[135] To see this, consider two contrasting legislative regimes. First, suppose that each citizen of the United States were constitutionally empowered to scuttle proposed legislation. It is hard to imagine any legislation surviving this gauntlet, even assuming implausibly that each citizen would vote sincerely. Unless every citizen believed he would benefit from a proposed policy change more than he would suffer, no new law would be enacted. At the limit, then, the veto power is a rule of unanimity.[136] Now suppose a rule under which only one citizen could veto a law—that is, no individual or collective actor could stop legislative changes supported by this privileged citizen. Here the limit is dictatorship. The status quo would exert practically no effect, and the law could be expected to conform to the dictator's will. Real constitutions fall somewhere between these extremes. They imbue one or more institutions with veto power. In combination with their rules on the exercise of the veto—for example, whether a supermajority of the institution's members must agree to veto—constitutions thereby regulate to some degree the expected rate of policy change.

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132 GEORGE TSEBELIS, VETO PLAYERS: HOW POLITICAL INSTITUTIONS WORK 2 (2002) (defining veto players as the "individual or collective actors [who] have to agree to the proposed change"). McNollgast, *Positive Canons: The Role of Legislative Bargains in Statutory Interpretation*, 80 GEO. L.J. 705 (1992), introduced the term "veto gate" to denote the same concept, and it is probably the dominant usage. I prefer the to speak about veto *players*, however, because the "gate" metaphor suggests a chronologically linear process belied by the game theoretic assumptions each holder of veto power can be expected to make.

133 U.S. CONST. art. I, § 7.

134 For an enumeration of extra-constitutional veto gates in today's Congress, see William N. Eskridge, Jr., *Vetogates and American Public Law*, 31 J.L. ECON. & ORG. 756, 758–59 (2015).

135 This is true, anyway, of legislation changing policy on a single dimension. Indeed, Madison cited this effect as a mark in favor of the Constitution's bicameral structure. *See* THE FEDERALIST NO. 62 (James Madison); *see also* CHARLES DE SECONDAT, BARON DE MONTESQUIEU, THE SPIRIT OF LAWS 195 (1750) ("The legislative body being composed of two parts, one checks the other, by the mutual privilege of refusing."). If bargaining costs are small enough, logrolling can mask this effect.

136 Hence the useful comparison between multi-cameral regimes and supermajority voting requirements. *See* Saul Levmore, *Bicameralism: When Are Two Decisions Better than One?*, 12 INT'L REV. L. & ECON. 145, 146, 148 (1992).

The numerosity of veto players is, however, only one factor affecting the likelihood of policy change. The dispersion of the players' policy preferences is another. Two players function as one if they have perfectly overlapping preferences. Each would veto and assent to the same policy changes. Thus, an unanimity rule in the Senate would not slow policy change at all if each senator shared the same view of the good, the beautiful, and the true. On the other hand, legislation becomes increasingly unlikely as the veto players' preferences diverge. Even setting aside the familiar pathologies of negotiation in the real world, there are apt to be times when no amendment to the status quo would improve one player's lot without making another's less tolerable.

Veto games are in no way specific to formally legislative contexts. They are ubiquitous in our law, existing wherever legal change is conditioned on Pareto superiority. The bulk of contract law, for example, turns on application of the veto power.[137] Suppose I offer to mow your lawn for ten dollars. My offer is equivalent to the proposal of legislation. If we both agree to the deal, the now-effective offer alters our legal obligations. Yet I have no recourse if you decline (veto) the offer. And for that reason, I do not propose deals that would not plausibly benefit you. We therefore say that a hypothetical contract is likely to become real only if the change in entitlements it contemplates is Pareto-superior to the status quo: everyone with power to reject the deal is better off under the new order than the old.

We must pause here to confront Ronald Coase. Absent transaction costs, you and I can be expected to reach a deal if we can exchange any set of entitlements such that the exchange will increase our joint surplus. In the language of economics, we will strike a bargain as long as some change from the status quo would be Kaldor-Hicks efficient. To continue the rudimentary example above, suppose my mowing your lawn is not worth ten dollars to you. At the same time, you would be willing to pay more than five dollars to have your garden weeded. We might settle on a price of fifteen dollars for both landscaping services. Indeed, absent transaction costs we would settle on precisely that deal which would maximize our joint interests.

The same principles apply in the formally legislative context. Imagine for the moment that each chamber of the Congress could be understood to have a collective, coherent set of policy preferences along some dimensions, x and y.[138] In other words, imagine that the House of Rep-

[137] One might additionally say that the veto power forms the boundary between property and liability rules.

[138] Students of public choice are forgiven for snickering at the implausibility of this assumption. For an example from the vast literature explaining why the expressed preference of a collective body is usually indeterminate, see Kenneth J. Arrow, *A Difficulty in the Concept of Social*

resentatives and the Senate were entities with identifiable, stable preferences. And suppose that the preferences of the House, the Senate, and the President along these dimensions were such that no legislation addressing either dimension alone is possible. The Senate or the President would veto any bill proposed by the House to amend only *x* or *y*. Nevertheless, it is possible that an omnibus bill altering the status quo with respect to both *x* and *y* would satisfy all three veto players. Just as in the private case of contract, the legislators can logroll to achieve unanimity where none is possible along a single policy dimension.[139] Indeed, absent transaction costs this hypothetical legislature would logroll until the joint surpluses of the Congress and President were maximized.

In reality, of course, the problem of insincerity and the persistent difficulty of negotiation mar legislative as well as contractual changes that would in fact be Pareto-superior to the status quo. And as the number of veto players increases, so too does the magnitude of transaction costs. But for the purpose of understanding municipal bankruptcy, it is equally important to see that logrolling and vote trading are the usual mechanisms for overcoming even sincere policy disagreements among veto players. Chapter 9 is a one-off event, and its "legislative" jurisdiction is narrowly circumscribed to cover only the allocation of local resources. The bankruptcy judge does not expect to be in negotiations with the state legislature over, say, funding for the construction of a road or a bridge he wants to see built. Thus, the limited jurisdiction of Chapter 9 legislation acts as a rule of single-subject lawmaking and effectively precludes most logrolling.[140]

What, then, does veto theory imply about the efficacy of municipal bankruptcy? One consequence follows naturally from what I have just said. Because horse trading among the veto players is difficult or indeed impossible, a plan of adjustment is likely to be adopted only if it is immediately (that is, in the absence of a side-payment from the others) Pareto-efficient from each player's perspective. From the perspective of the veto players, Chapter 9 will generate a suboptimal number of plans of adjustment because that number excludes plans that are Kaldor-Hicks

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Welfare, 58 J. POL. ECON. 328 (1950); *see also* TSEBELIS, *supra* note 132, at 41–45 (explaining in particular why the application of a collective veto power will often be ambiguous). This fact's importance to the would-be prognosticator cannot be overstated, but it is beside the point for this basic exposition.

139 Eskridge, Jr., *supra* note 134 (showing how veto gates designed to block legislation tend to yield logrolls through omnibus bills). For models in which omnibus legislation is used to facilitate logrolling, see Clifford J. Carrubba & Craig Volden, *Coalitional Politics and Logrolling in Legislative Institutions*, 44 AM. J. POL. SCI. 261 (2000); Glen S. Krutz, *Tactical Maneuvering on Omnibus Bills in Congress*, 45 AM. J. POL. SCI. 210 (2001).

140 For discussion of single-subject rules and their relationship to logrolling, see Robert D. Cooter & Michael D. Gilbert, *A Theory of Direct Democracy and the Single Subject Rule*, 110 COLUM. L. REV. 687, 706–07 (2010).

efficient but that would require side-payments to make every player whole. A few words of clarification are necessary. First, the degree to which Chapter 9's legislative structure can be expected to block plans of adjustment depends on how many veto players are active in the case and the distribution of their preferences. Recall that the power of some veto players is defeasible (or fails to emerge at all) at the will of the state legislature.[141] One could imagine a state system that reduced the number of players to a minimum of two. In this hypothetical regime, a municipality would be eligible to seek bankruptcy relief only after the legislature installed an emergency manager of its choosing to run the city's affairs. Presumably such a manager would reflect the legislature's preferences[142] with respect to possible debt adjustments. The governor would have no role. In this hypothetical system, the number of veto players would be reduced to two: the legislature and the bankruptcy judge. On the other hand, one can imagine a proliferation of veto players in a different hypothetical system. The point is that the particular structure of a state's law affects the degree to which blocking positions will tend to get in the way of debt adjustment.

A second and more important clarification hinges on the fact that the veto players of Chapter 9 are mere proxies or stand-ins, so to speak, for the economic interests of claimants on municipal resources. It is not the lenders' committee that has a veto right, or the neighborhood association, or the employees' union.[143] The veto, rather, is held by persons and institutions that may more or less favor the interests of any particular constituency. Rarely would one expect a veto player to identify entirely with a single class of stakeholder. A veto player's preference set is more likely a compromise of some kind or another. This means that although Chapter 9 may lead to a suboptimal number of plans from the veto players' perspectives, its relationship to the optimal amount of debt adjustment is, from the principal *economic* players' standpoints, ambiguous. Imagine, for example, a situation in which debt reduction would

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141 *See supra* Section II.B.

142 The unitary legislature in this sketch is, of course, a fiction. In fact, the state legislative process involves its own multiple holdup problem. I ignore this difficulty for now, although an exhaustive model of municipal bankruptcy legislation would need to take it into account. For example, it might turn out that legislatures are weak veto players in municipal bankruptcy. Because something like a supermajority of legislators is needed to effect the institution's collective veto, it may be that the veto is unused even where the median representative would clearly favor blocking a plan.

143 Congressman Conyers introduced a bill that would have strengthened the hand of municipal employees and retirees. H.R. 5133, 113th Cong. (2014). Interestingly, and consistent with this Article's descriptive thesis, the bill did so not by providing any particular substantive right to payment. Instead, it would condition the confirmation of a plan on its acceptance by union heads and representatives of retirees with vested pension and other benefits. The bill would have added labor, broadly speaking, to the list of veto players. *Id.*

create a net social loss: the benefit of relief from debt overhang is swamped by reputational costs, for example. Nevertheless, if for whatever reason the Chapter 9 veto players were each strongly identified with a particular class of creditor or resident, their unity of interest could lead to a restructuring that would be inefficient by any measure.

Recognizing that Chapter 9 veto players are proxies for the stakeholders' underlying economic interests leads to a second conclusion. Municipal bankruptcy's legislative structure should lead to inefficient stakeholder rent-seeking. Lobbying is often vilified but always present in formally legislative contexts. Interest groups are apt to spend on lobbying until the marginal, private benefits of influence equal its marginal cost. One can expect the same with respect to municipal bankruptcy. Bondholders hoping to prevent a write-down might seek to influence a governor or powerful legislators. Public employees' unions might do the same. And indeed residents and owners of fixed assets within a municipality's boundaries might urge the same actors to acquiesce in the debtor's favored resolution. Municipal resources available for distribution are more or less fixed by the time bankruptcy comes on the scene. Local policy and broader economic reversals can add or subtract resources over time, but the "pie" subject to allocation at a given moment is fixed if not precisely known. From an efficiency perspective, then, changes in the distribution of resources that result from lobbying should be a wash. But the cost associated with lobbying is itself deadweight loss in respect of the municipality and its primary stakeholders. The yield on a bond is lower than it otherwise would be if the bondholder expects to spend on lobbying in some proportion of cases—even if the bondholder knew to a certainty the kind of treatment the bond would ultimately receive. Assuming a competitive credit market, this expense will be reflected in higher borrowing costs ultimately borne by municipal residents.[144] Residents along with employees and retirees also face their own direct costs of lobbying.

In truth, though, neither general obligation bondholders nor any other of a municipality's stakeholders can predict with much accuracy the way they will be treated if the municipality suffers financial distress. This is an artifact of the legislative nature of a plan of adjustment. Not only is the impact of lobbying efforts ambiguous; more critically, people cannot know who the veto players will be at the time they buy a bond, accept employment, purchase real estate, or otherwise take a stake in the municipality's future. Elections determine the composition of state legislatures and the identity of governors and mayors. The chief judge of the federal judicial circuit in which a municipality is located selects the

[144] *See* Jackson, *supra* note 16, at 861 & n.21; Jensen & Meckling, *supra* note 50.

bankruptcy judge who will preside over a given Chapter 9 case.[145] Only a seer could predict the particular sympathies of future incumbents.

This latent uncertainty impoverishes cities. If potential stakeholders were indifferent to risk, increased variance would not change levels of investment. They could settle on an expected, average treatment and act accordingly. And perhaps some institutional bond buyers are indeed close to risk-neutral. Their portfolios of municipal bonds may be diversified sufficiently that they are indifferent to the variance of outcomes associated with any particular case. Most residents, employees, and retirees, on the other hand, are predictably averse to risk. In many cases the bulk of their savings—in the form of home equity and pension expectations, first and foremost—are investments in the municipality's success. Unable to diversify, the typical resident, employee, and retiree will see risk as a significant cost and demand a greater expected "return" in compensation. On the margin, then, uncertainty of treatment ought to increase labor costs and depress the price of real estate and other relatively fixed assets.

IV. BREAKING THROUGH VETO GATES

So far I have focused on what most would agree are socially costly implications of a "legislative" bankruptcy regime. This is not to say that such a regime is indefensible. Chapter 9 is fundamentally a process by which the agreement of a variety of political institutions yields an ad hoc redistribution of resources. Those who take an optimistic view of representative government, or a pessimistic view of contract, or who tend to think policies agreed on by the People's representatives inherently legitimate irrespective of their social costs, will find much to commend in Chapter 9. Moreover, and from a different perspective, one may in fact sensibly wish to increase municipal borrowing costs.[146] City governments might over-borrow. If they do, then a debt resolution process in which multiple constituencies face uncertain payouts, and hence will charge more to extend credit, could ultimately reduce municipal reliance on debt financing and create incentives for a more muscular system of political monitoring.

Yet for those who think municipal bankruptcy ought to minimize the combined costs of borrowing and debt overhang, it is worth concluding with a few thoughts on the ways in which municipal bankruptcy could be improved. One set of possibilities lies not in Chapter 9 itself,

145 11 U.S.C. § 921(b) (2012).

146 For an expression of the thought that minimizing cost of capital might not always be a good idea, see Skeel, *supra* note 1, at 2222.

but in the way municipalities borrow. These contractual, or market-based, solutions are likely to involve the substitution of property interests for contract obligations. Where municipalities today tend to issue promises to pay, they may increasingly borrow against more substantial collateral, particularly in the form of revenue liens and trusts. As we have seen, the unsecured creditor in Chapter 9 has little leverage to demand concessions from municipal residents (especially in the form of tax increases), and she is practically uncertain about her theoretical parity with other unsecured creditors. A creditor with a lien on streams of municipal revenue, on the other hand, takes priority over residents and unsecured creditors alike by virtue of its property interest.[147] To the extent liens secure "special revenues"—that is, revenue tied to particular, identifiable streams of municipal income—the lienholder is not even subject to the automatic stay. In theory, anyway, liens could be used to secure the interests of bondholders and other commercial lenders, employees, trade creditors, or any combination of these creditor classes.[148]

Alternatively, creditors might secure their priority structurally, by way of asset partitioning.[149] The idea here would be to create special-purpose municipal entities that relate to a "parent" city in a fashion analogous to the way corporate subsidiaries relate to a corporate parent. The subsidiary's assets and revenue streams answer in the first instance to the subsidiary's own creditors and only after they are paid to the parent's creditors. A version of this strategy may already be starting to shape the legal structure of municipal life.[150] One sees all around a variety of revenue-generating, special-purpose municipalities: tollway authorities, sewage districts, and even school districts can be seen as varia-

147 A plan that did not compensate a secured creditor to the full extent of the value of its collateral could amount to an unconstitutional taking without just compensation. For a discussion of the role of property interests in Chapter 9, see Hynes & Walt, *Pensions and Property Rights*, *supra* note 56, at 642–59.

148 The creation of a trust is an alternative property-based solution to ill-defined substantive rights. The trust would seem especially useful in securing retirement benefits to employees in places where municipalities pay benefits on a current basis. In California, to take a counterexample, each municipality participating in the California Public Employees' Retirement System (CalPERS) periodically contributes an amount actuarially determined by the administrator. CalPERS holds the funds and invests them on behalf of the beneficiaries. Once contributed, they can be used only for the employees' benefit. The idea of a trust would be to imitate a system like California's by segregating assets. The trust can ensure but a partial security, however. An employee in the early years of tenure might have little confidence that the municipality will continue to fund the trust in the future.

149 Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1, 7–14 (2013) (explaining how firms and lenders can tailor monitoring incentives and priority rights by partitioning assets among subsidiary corporate entities).

150 Richard M. Hynes, *State Default and Synthetic Bankruptcy*, 87 WASH. L. REV. 657, 663–65 (2012) (describing the use of special-purpose municipal entities to accomplish particular governmental aims).

tions on the theme.[151] Some special-purpose municipalities are constituted as such because they overlap geographically with multiple cities, and in this sense they fit only uncomfortably with the analogy to a corporate subsidiary. But other special-purpose municipalities are coterminous with, or enveloped by, a single city. What explains this kind of structure? There may be a number of explanations, but one can understand the structure as being driven, at least in part, by the lenders' desire for certain priority in a legal regime marked by nothing more than ambiguity.

Of course, the creation of property interests and structural priorities carries a downside, too. These strategies work because they create (property) rights that, unlike contract rights, bankruptcy cannot impair. But this imperviousness is a vice as well as a virtue. Property rights do more than establish one creditor's priority over another. They also advantage the creditor relative to municipal residents.[152] To see the problem, suppose that a municipality were to issue revenue liens in support of all of its borrowing. Upon the occurrence of financial distress, bankruptcy law would be incapable of modifying the creditors' interests. In effect, the decision to borrow entirely against collateral amounts to a decision to opt out of the possibility of debt adjustment altogether. A world in which all creditors are secured by liens is a world where Chapter 9 is irrelevant. This could be a first-best solution only if the scourge of debt overhang were a mere fiction. Presumably, though, debt relief is sometimes the desirable course. Most real-world municipalities are unlikely to borrow exclusively against collateral. But this means only that the downside of using property interests is not so extreme.

A different kind of reform would take aim directly at the structure of Chapter 9. Congress would have to be the first actor. The discussion in Parts II and III points to a clear set of priorities. Legislative reform should seek to clarify substantive priorities and to reduce the number of veto players. A rule requiring pari passu treatment of unsecured claims—or, on the contrary, a rule privileging some unsecured claimants over others—would go a long way toward settling expectations (and constraining the bankruptcy judge's veto). One or another rule of this sort might be best, but *any* rule is likely to be better than none. A rule defining the minimum level of resources on which municipal gov-

[151] Krishnamurthy V. Subramanian & Frederick Tung, *Law and Project Finance*, 25 J. FIN. INTERMEDIATION 154 (2016) (showing that project finance serves as a substitute for creditor-protection laws, especially in jurisdictions where creditor-protection laws are weak). Project finance verifies cash flow and control, but reduces manager flexibility regarding allocation of cash flows; traditional borrowing is more flexible for the manager, but makes identifying and controlling cash flows more difficult. *Id.* at 155.

[152] Hynes & Walt, *Pensions and Property Rights*, *supra* note 56, at 652–59.

ernments can insist, and therefore, reciprocally, an amount of assets creditors can demand, would also be valuable. Doubtless this latter kind of rule poses some difficulties. Measurement problems abound, especially when the municipality's *capacity* to tax or otherwise raise revenue is the most valuable asset. Yet a coherent, if imperfect, rule seems possible. Congress might, for example, define the city's estate to comprise some fraction of the value of all real property in its territory.

By clarifying substantive rights, Congress would, among other things, eliminate (or at least reduce) the bankruptcy judge's veto power. This would be a positive step. But Congress might also abrogate the city's (and even the state's) veto power by authorizing something like the involuntary petition that exists for recalcitrant corporate and individual debtors. The more difficult it is for any one party to opt out of the collective proceeding, the more meaning substantive entitlements have. To be sure, the Supreme Court has held a municipal bankruptcy law unconstitutional on the theory that it encroached too far on the states' sovereignty.[153] *Ashton v. Cameron County Water Improvement District* would seem to preclude involuntary bankruptcy for cities.[154] But I am not so sure. *Ashton* was decided in 1936. Much has changed in the constitutional landscape since then. Under modern understandings, Congress might well be able to create universal eligibility as it has done with respect to another kind of state-chartered entity, namely the business corporation. Congress might even be able to create an involuntary bankruptcy regime for the states themselves.[155]

CONCLUSION

The policy prescriptions offered in this Article are offered in the spirit of suggestion. Before we can evaluate the utility of various possible changes, we need a firm sense of the existing law's fundamental structure and the private incentives the structure creates. To that end, my ambition in this Article has been primarily descriptive. I have sought to show that Chapter 9, despite apparent similarities to more familiar modes of bankruptcy, embodies a radically different approach to debt relief. Rather than being a forum in which competing legal claims to assets are adjudicated, municipal bankruptcy as it exists today establishes a kind of lawmaking process, in which political actors rather than private right-holders seek to apportion resources by mutual consent. On

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153 Ashton v. Cameron Cty. Water Improvement Dist., 298 U.S. 513, 531 (1936).

154 *Id.*

155 *See generally* Adam Feibelman, *Involuntary Bankruptcy for American States*, 7 DUKE J. CONST. L. & PUB. POL'Y 81 (2012).

this view, Chapter 9's virtues are the virtues of political deliberation—but such, too, are its vices.