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ARTICLES

# The Logic and Limits of Municipal Bankruptcy Law

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*Municipal bankruptcy's recent prominence has stimulated academic interest in the workings of Chapter 9, much of it critical, but no general framework has been developed against which scholars and policymakers can evaluate the law's performance. This Article offers a normative, economic account of municipal bankruptcy and uses that account to assess current law and suggest changes. It contends that bankruptcy's singular aim should be to preserve spatial economies—the advantages to locating within a municipality's unique geographic boundaries—when large public debts, by discouraging investment, threaten to dissipate them. Judged with this end in view, it is argued, Chapter 9 is a marked failure. The law's compass is so narrow that intervention comes, if at all, only when spatial economies are likely to have been squandered and economic dysfunction has taken hold. Municipal bankruptcy, as it now exists, serves mainly as an ad hoc and ill-conceived subsidy program. This Article outlines changes to the law that could hasten debt relief while acknowledging potential objections.*

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## INTRODUCTION

Cities and towns across the country face debt burdens of a magnitude not seen since the Great Depression. Four of the five largest municipal bankruptcies in history have been filed in the last decade,[1] and more are bound to come.[2] The perilous financial

[1] The four are Detroit, Michigan (2013); Jefferson County, Alabama (2011); and Stockton and San Bernardino, California (both 2012). The fifth is Orange County, California (1994). James Spiotto and Jeff Garceau, *Chapter 9 Municipal Bankruptcy Statistics: Use by Number, Type and Year* (MuniNet Guide, June 14, 2018), archived at http://perma.cc/6YGK-XJ83. Puerto Rico is omitted from this list because its financial restructuring is happening under a law designed specifically for the island, the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), Pub L No 114-187, 130 Stat 549 (2016), codified at 48 USC § 2101 et seq, not under the Bankruptcy Reform Act of 1978 (Bankruptcy Code), Pub L No 95-598, 92 Stat 2549, codified as amended at 11 USC § 101 et seq. That law does, however, borrow many features from Chapter 9, and the economic problems Puerto Rico faces are similar in many respects to those confronting municipalities on the mainland. For a comparison of PROMESA and Chapter 9, see Stephen J. Lubben, *PROMESA and the Bankruptcy Clause: A Reminder about Uniformity*, 12 Brooklyn J Corp, Fin & Comm L 53, 59–63 (2017).

[2] I leave it for the soothsayers to say where the next big bankruptcies are most likely. But it is worth noting that major municipalities are at risk of default when the next macroeconomic downturn comes. Hartford narrowly avoided bankruptcy in late 2017 when Connecticut's state government increased assistance in the near term, but its bonds are still junk-rated. See generally Jenna Carlesso, *Moody's: Threat of Bankruptcy Removed, but Hartford Remains "High Risk"* (Hartford Courant, Nov 1, 2017), archived at http://perma.cc/P6R4-2WMC. Bonds issued by Chicago and the Chicago Public School District are likewise junk-rated. See *Rating Action: Moody's Confirms Chicago, IL's GO at Ba1; Outlook Negative* (Moody's Investor Service, Sept 5, 2017), online at

condition of so many local governments has, among other things, stimulated academic interest in municipal bankruptcy. Scholars with a critical attitude have expressed dissatisfaction with the narrow compass of Chapter 9, the part of the Bankruptcy Code[3] that deals with government debtors,[4] and have suggested useful, incremental remedies to the law's perceived defects.[5] Missing from the academic literature, however, is a general theoretical framework against which the law, as well as suggested reforms, can be assessed. Put in other words, the literature has not sufficiently grappled with the question: What is municipal bankruptcy for?

This Article develops and applies a normative account that seeks to do for municipal bankruptcy what the "creditors' bargain" rubric has done for the law of corporate reorganization. The creditors' bargain, which Professor Thomas Jackson pioneered in the 1980s[6] and developed most prominently with Professor Douglas Baird, addressed a simple question: Given that state commercial law defines a complete set of creditor rights and remedies, what good is a corporate bankruptcy law? What economic function might it play? The answer Baird and Jackson gave was that bankruptcy might forestall a wasteful "race of diligence," a scenario in which each of multiple creditors finds private advantage in foreclosing on her claim before others do, resulting in the piecemeal destruction of an operationally sound business.[7] Bankruptcy law

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http://www.moodys.com/research/Moodys-Confirms-Chicago-ILs-GO-at-Ba1-Outlook-Negative--PR_904205228 (visited Nov 5, 2018) (Perma archive unavailable). For discussion of the plight of Chicago Public Schools in particular, see generally Douglas G. Baird, *Statutory Interpretation, Three Ways: The "Best Interests of Creditors" Test in Chapter 9* (unpublished manuscript, 2018) (on file with author). See also generally Aurelia Chaudhury, Adam J. Levitin, and David Schleicher, *Junk Cities: Resolving Insolvency Crises in Overlapping Municipalities*, 107 Cal L Rev (forthcoming 2019) (on file with author) (discussing Chicago Public Schools and the City of Chicago as examples of an overlap problem in Chapter 9).

[3] Pub L No 95-598, 92 Stat 2549, codified at 11 USC § 101 et seq.

[4] See 11 USC §§ 901–46.

[5] See Part I.B.

[6] The seminal article is Thomas H. Jackson, *Bankruptcy, Non-bankruptcy Entitlements, and the Creditors' Bargain*, 91 Yale L J 857 (1982). See notes 64–65 and accompanying text.

[7] See, for example, Douglas G. Baird and 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, 101–09 & n 40 (1984); Jackson, 91 Yale L J at 859–71 (cited in note 6).

mandates a collective proceeding so that valuable firms will not be torn apart.[8]

A rationale for municipal bankruptcy must necessarily look very different. As Professors Michael McConnell and Randal Picker pointed out in their foundational "introduction" to the subject more than twenty-five years ago, the race of diligence has no analog in the municipal context.[9] Creditors have exceedingly weak remedies under state law. They cannot foreclose on municipal property in any meaningful sense, so bankruptcy's utility, if it has any, must lie in its capacity to do something other than coordinate collection efforts. Moreover, the economic logic of the municipality is quite unlike that of most commercial firms. A municipality's value is tied to the fruits of its unique geographic territory. Its business model, so to speak, turns on the preservation and cultivation of that territory's spatial economies, by which I mean the properties of a physical location that make people and firms want to locate there.[10] Municipal governments provide infrastructure and ensure social conditions that encourage people to exploit these properties. Thus the residual beneficiaries of successful municipal government are not investors in that government (as shareholders are investors in a commercial firm) but rather are the owners of land under its authority. The significance of debt—and, indeed, the whole notion of the balance sheet—is different. The title of Jackson's seminal book on Chapter 11 bankruptcy[11] is this Article's point of reference, then, not because its diagnosis and prescriptions can be translated mechanically to the municipal context—they cannot—but in homage to its method.

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[8] In the three decades since Jackson first wrote, scholars working in the creditors' bargain tradition have identified additional problems of investor coordination that bankruptcy might ameliorate. See generally, for example, Kenneth Ayotte and David A. Skeel Jr, *Bankruptcy Law as a Liquidity Provider*, 80 U Chi L Rev 1557 (2013) (arguing that bankruptcy can remedy illiquidity caused by debt overhang and information asymmetries).

[9] Michael W. McConnell and Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U Chi L Rev 425, 429–50 (1993).

[10] Economic geographers and urban economists typically distinguish two generic kinds of spatial economy. What in this Article I call a "natural economy" refers to the savings occasioned by locating economic activity near a valuable natural resource, broadly defined. The port city's proximity to a harbor is thus a natural economy. But so, too, in my usage, is a factory's proximity to a railroad, even though railroads are a product of human, and not strictly natural, design. What in this Article I call a "density economy" refers to the savings occasioned by locating complementary people and activities near one another. The technology firm's proximity to a stable of programming talent is an example. This distinction between natural and density economy is offered as a heuristic, but notice that it is only that. As the railroad example shows, the distinction turns ultimately on an arbitrary classification. For elaboration, see Part II.A.

[11] Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard 1986).

The task is to identify, in a peculiar institutional setting, how the existence of debt is apt to pervert allocative decisions and then to articulate a role for a (federal) debt relief law that is proportionate to the disease.

My core normative claim is that municipal bankruptcy law ought to aim at preserving spatial economies when public debt otherwise threatens to dissipate them. Large municipal debts can discourage local investment, public and private alike—investment that is needed both to efficiently exploit and to sustain spatial economies.[12] Chronic underinvestment erodes the value of the land under a municipality's jurisdiction. And because locations implicitly compete for resources, underinvestment can provoke irreversible capital flight. What bankruptcy can do, at least in principle, is to rationalize investment decisions by removing the distortive effects of debt.[13]

This account can be brought to bear on current law as well as prospective reforms. And it explains why so many observers have the critical intuition that Chapter 9 is of little moment. Under current law, bankruptcy intervenes too late. Debt relief comes, if at all, only when a municipality can no longer service its debts in the near term.[14] Its spatial economies are by then likely to have been squandered, and there may be no reason for investment to return. If municipal bankruptcy is to achieve its end, I argue, it must allow write-downs, and indeed encourage them, before public debt can undermine investment and precipitate economic decline. This Article outlines some ways the law could be amended

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12 That government debt can discourage investment is not a novel observation. McConnell and Picker themselves saw that municipal bankruptcy may be grounded on a "fresh start" policy. They put the point this way: "The theory of Chapter 9 is that the burden of debt service, if sufficiently high, will affect the taxpayers of a city as it would a debt-ridden individual: it will sap initiative and depress money-generating activity." McConnell and Picker, 60 U Chi L Rev at 468–70 (cited in note 9). Their observation, that what the finance literature calls debt overhang is connected to municipal bankruptcy, is right as far as it goes. But because their aim was not to state a comprehensive agenda for municipal bankruptcy, they had no occasion to consider in detail the relationship between investment and public debt. The truth is that debt does not act on a municipality as it does on an individual. Municipal fiscal policy is reflected, or "capitalized," in the value of local real estate. Because that property is valuable quite apart from municipal activity, landowners have reason to pay down inefficiently large public debts or to substitute private investment for public investment. These dynamics are discussed at length in Part II.D.

13 What bankruptcy cannot do is remedy economic dysfunction—cases in which for whatever reason, *including chronic underinvestment*, a municipality can no longer sustainably generate revenues sufficient to cover the costs of maintaining basic infrastructure and providing basic services. See notes 96–102 and accompanying text.

14 See notes 27–31 and accompanying text.

to better accomplish its aim. It acknowledges that practical objections might, in the final analysis, make such amendments unwise. In particular, a policy of liberal debt relief can in some specifications tighten lending ex ante, provoking a choice between scenarios the costs and benefits of which are imperfectly known. A definitive resolution is impossible here, but this Article makes a start by developing plausible alternatives and setting out their competing considerations.

The balance of this Article is arranged in three parts. Part I introduces the features of municipal bankruptcy law pertinent to the main analysis and reviews the extant critical literature. Parts II and III form the Article's analytical core. Part II develops a normative framework for evaluating municipal bankruptcy law. Incorporating findings from economic geography and urban economics, it draws a conceptual distinction between two kinds of debt-burdened municipalities, one suffering economic dysfunction and the other facing merely financial distress; and it argues that bankruptcy, in its ideal form, is suited to remedy the latter but not the former. Part III applies this theoretical framework to critique existing law and to develop practical means by which bankruptcy law's promise might be realized. It outlines rule changes that would stimulate earlier debt relief—thereby better preserving spatial economies—and discusses potential drawbacks inherent in such changes.

## I. CHAPTER 9 STRUCTURE AND CRITIQUE

Municipal bankruptcy differs in key respects from bankruptcy's individual and business varieties, and understanding the thrust of these differences is important to grasping criticisms of existing law and concrete possibilities for reform. To that end, this Part furnishes background on the structure of municipal bankruptcy law needed to grasp the significance of the argument to come. It then describes the scholarly, critical literature. As a descriptive matter, the remarkable feature of municipal bankruptcy is its limited domain. Its strict eligibility conditions ensure that Chapter 9 is rarely invoked. When it is invoked, the court's authority to alter debtor policy, to say nothing of the governance parameters under which policy is formulated, is sharply curtailed. Most critical work has bracketed eligibility. Instead, the literature has been mainly concerned with the appropriate balance of power, in bankruptcy, between the federal judge overseeing the case and the local officials whom state law charges with managing municipal affairs in the ordinary course. What is almost entirely

missing from academic discourse, oddly enough, is debate about what a municipal bankruptcy law is for in the first place.

## A. Key Features of Municipal Bankruptcy

### 1. Strict eligibility conditions.

The most striking fact about Chapter 9 is how little used it is. Recent years have seen a marked increase in municipal bankruptcy's salience and economic importance. Still, filings under Chapter 9 are historically rare and remain uncommon today. To give a rough indication of its infrequency, consider that, in the 35 years between 1980 and 2015, only 293 Chapter 9 cases were filed in total.[15] The most recent census counts roughly ninety thousand local government entities,[16] meaning that only 0.3 percent of municipalities sought bankruptcy protection during an interval that included four national recessions. Moreover, those municipalities that do file are disproportionately "special purpose" entities—utilities; hospitals; water, sewer, and school districts; and the like.[17] Only fifty-three of approximately thirty-nine thousand "general purpose" cities, towns, and counties entered bankruptcy over the same thirty-five year period.[18]

Multiple factors plausibly contribute to the infrequency of municipal bankruptcy. But surely part of the story, and probably a big part, is the strictness of eligibility criteria. Chapter 9 limits who will be a debtor in three important ways.[19] First, no municipality can be a debtor unless its state "specifically authorize[s]" it to become one.[20] States vary in their approach to authorization.

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[15] See Spiotto and Garceau, *Chapter 9 Municipal Bankruptcy Statistics* (cited in note 1).

[16] *Local Governments in Individual County-Type Areas: 2012 Census of Governments* (US Census Bureau, Sept 26, 2013), online at http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=COG_2012_ORG014&prodType=table (visited Nov 6, 2018) (Perma archive unavailable) (providing a table of local governments by type and state).

[17] See Spiotto and Garceau, *Chapter 9 Municipal Bankruptcy Statistics* (cited in note 1) (showing that 58 percent of all Chapter 9 filings since 1980 have been filed by utilities and special districts).

[18] Id; *2012 Census of Governments* (cited in note 16).

[19] These do not exhaust the statutory requirements but reflect the most important structural barriers to bankruptcy court jurisdiction. For discussion of the full suite of eligibility criteria, see Laura N. Coordes, *Gatekeepers Gone Wrong: Reforming the Chapter 9 Eligibility Rules*, 94 Wash U L Rev 1191, 1216–28 (2017).

[20] 11 USC § 109(c)(2) (conditioning eligibility for bankruptcy relief on authorization under state law). This is an opt-in provision. The law originally allowed states to opt *out*, but the default rule was toggled in 1994. See Bankruptcy Reform Act of 1994, Pub L No 103-394, 108 Stat 4106, codified in various sections of Title 11.

The most permissive states authorize the governing body of any municipality to file a petition on its own initiative.[21] The most restrictive deny eligibility outright to all municipalities.[22] Between these polar approaches, many states limit eligibility to specified classes of municipality or condition eligibility on the approval of the governor, a tax commissioner, or some other representative of the state's general interests.[23] Depending on how one counts, only around half of the states currently provide a route to bankruptcy. The significance of state law contrasts sharply with consumer and business modes of bankruptcy. In these other, more familiar modes, state law frequently determines substantive recovery rules,[24] but it has no bearing on whether a mandatory collective proceeding is to be initiated.

Second, municipalities enter bankruptcy on a voluntary basis only.[25] This does not mean Chapter 9 necessarily depends on the consent of a municipality's residents or even its elected officials. State law might vest municipal power—entirely or with respect to fiscal matters only—in an emergency manager or control board, and these could invoke bankruptcy irrespective of local will. What the requirement of a voluntary petition means, rather, is that long-term creditors cannot force a municipality to confront what may be unsustainable debts. They must wait. To be sure, municipal creditors today would have little use for an involuntary mechanism because, as I discuss below, current law vests municipal debtors with broad discretion in bankruptcy over the use and disposition of property. But the lack of an involuntary mechanism, coupled as it is with weak creditor-collection rights, has important implications for the utility of proposed law reforms that seek only to alter the conduct of cases actually filed.[26]

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21 See, for example, Ala Code § 11-81-3.

22 See, for example, Ga Code Ann § 36-80-5.

23 The law firm K&L Gates provides a useful summary table of relevant state laws as of June 2015. See generally *State Statutes Authorizing Municipal Bankruptcy* (K&L Gates, June 26, 2015), archived at http://perma.cc/R579-8EKT.

24 See *Butner v United States*, 440 US 48, 54–57 (1979).

25 See 11 USC § 301(a) (providing that Chapter 9 is commenced by the debtor's *voluntary* filing of a petition).

26 This is especially true for possibilities I suggest in this Article—in particular, bankruptcy-specific priority schemes and creditor-sponsored plans of adjustment. See notes 174–83 and accompanying text.

Third, a municipality may not invoke Chapter 9 unless it is insolvent.[27] And insolvency is narrowly defined in this context.[28] A municipal debtor is ineligible for Chapter 9 unless it is "generally not paying its debts as they become due" or is "unable to pay its debts as they become due."[29] Courts have read this formulation narrowly.[30] Most famously, after Bridgeport, Connecticut, filed a petition in 1991, the court found that the city was not insolvent and hence could not use bankruptcy because, despite its dire financial condition, it was sufficiently liquid to service debts during the coming fiscal year.[31] Just how much of a municipality's borrowing or taxing capacity it must exhaust before it is "unable" to meet current obligations is uncertain, but the thrust of the law in this area is clear: a city cannot use bankruptcy in a farsighted manner to adjust long-term debts with structural implications but must instead wait until its coffers are near empty.

2. Circumscribed judicial authority.

Aside from its eligibility criteria, two features of Chapter 9 are particularly remarkable: the debtor's broad discretion to use property as it wishes and to control the course of proceedings. Put differently, what distinguishes municipal from individual or business bankruptcy is the court's, and by extension the creditors', relative weakness.

The function of the automatic stay, which goes into effect when a bankruptcy petition is filed, is to block creditors' ordinary

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[27] 11 USC § 109(c)(3). Consumer and business debtors face no comparable limitation. Under the Bankruptcy Act of 1898, debtors were required to allege either insolvency or inability to pay debts. See Act of July 1, 1898, §§ 3a(5), 3(b), 30 Stat 544, 546, superseded by Bankruptcy Reform Act of 1978, Pub L No 95-598, 92 Stat 2549, codified as amended at 11 USC § 101 et seq. The Bankruptcy Code, enacted in 1978, omitted any such requirement. See, for example, *In re Marshall*, 403 Bankr Rptr 668, 689 (CD Cal 2009) ("[T]here has never been a requirement for a debtor to prove his or her insolvency before taking advantage of the protections of the Bankruptcy Code.").

[28] Nothing like a "balance sheet" approach is available. See 11 USC § 101(32)(A)–(C). For more on the possible meanings of insolvency, see generally J.B. Heaton, *Solvency Tests*, 62 Bus Law 983 (2007).

[29] 11 USC § 101(32)(C) (defining municipal insolvency as a "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").

[30] See Vincent S.J. Buccola, *Law and Legislation in Municipal Bankruptcy*, 38 Cardozo L Rev 1301, 1329–30 (2017).

[31] *In re City of Bridgeport*, 129 Bankr Rptr 332, 338 (Bankr D Conn 1991). See also *In re Pierce County Housing Authority*, 414 Bankr Rptr 702, 710–11 (Bankr WD Wash 2009) (approving *Bridgeport*'s construction of the insolvency standard); *In re Hamilton Creek Metropolitan District*, 143 F3d 1381, 1386 (10th Cir 1998) (same).

remedies under state law.[32] In individual and business cases, bankruptcy, having undermined creditor interests with one hand, promises with the other to protect them from debtor malfeasance or neglect by asserting judicial control over contested property. The law does this via the statutorily defined "estate,"[33] authority over which is vested in a court-appointed trustee, subject to direct judicial approval of important decisions.[34] To be sure, the managers of a business in Chapter 11 typically retain control of day-to-day matters as debtor-in-possession (just as an individual debtor retains possession of her property in Chapter 13).[35] But transactions outside the ordinary course, which have the greatest capacity to upset creditor expectations, require judicial blessing.[36] Moreover, the law prevents malingering in bankruptcy by allowing creditors to propose a viable plan if the debtor cannot or will not do so,[37] or to have the case converted to a liquidation.[38] The net effect is a regime in which the bankruptcy judge has final say-so over important dispositions and the debtor is, relative to other interested parties, at best something like the first among equals.

Not so in Chapter 9. A city's filing of its petition stays creditor collection activities but does not create an estate.[39] And there is no trustee.[40] Rather, the debtor retains during bankruptcy all of its authority to conduct its affairs as it wishes. The Code secures debtor discretion with broad language:

> Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—
>
> (1) any of the political or governmental powers of the debtor;
>
> (2) any of the property or revenues of the debtor; or

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32 See 11 USC § 362(a).

33 See 11 USC § 541.

34 See 11 USC §§ 323(a), 1104(a).

35 See 11 USC § 1107(a) (giving a debtor-in-possession under Chapter 11 most of the rights and obligations of a trustee); 11 USC § 1303 (granting an individual debtor under Chapter 13 some of the rights of a trustee); 11 USC § 1306(b) (directing that property of the estate remain in debtor's possession).

36 See, for example, 11 USC § 363 (sale of assets); 11 USC § 364 (new borrowing); 11 USC § 365 (assumption or rejection of leases and executory contracts).

37 This is true in Chapter 11 but not Chapter 13. See 11 USC § 1121(c)–(d) (specifying conditions in which parties other than the debtor may propose a plan of reorganization).

38 This is true of both Chapters 11 and 13. See 11 USC §§ 1112(b)(1), 1307(c).

39 11 USC § 922(a) (describing the automatic stay). See also 11 USC § 901(a) (excluding by reference § 541, and therefore the concept of the estate, from Chapter 9).

40 See 11 USC § 902(5) (defining "trustee" as the debtor).

> (3) the debtor's use or enjoyment of any income-producing property.[41]

Not only ordinary-course operations are insulated from judicial interference. Municipal debtors are permitted to use or dispose of property outside the ordinary course and to borrow additional funds (unless the new lender would have a priming lien)—all without seeking judicial approval.[42] Only the debtor can propose a plan of adjustment,[43] and the case can't be converted to another chapter because there is no "liquidation" of a municipality.

This is not to say the court is powerless. A municipality enters bankruptcy because it wants a debt adjustment (or in any case, the people acting on its behalf want one), and it is the bankruptcy judge's province to decide whether to approve such an adjustment.[44] Some of the criteria the judge is to consider are vague—for example, the requirement that a plan be "in the best interests of creditors and [ ] feasible"[45]—so she inevitably has latitude to deny relief. If the judge thinks it appropriate, she can dismiss the case outright. As commentators have long pointed out, a judge could leverage her discretion with respect to plan confirmation, turning it into de facto influence over debtor conduct: power exercised with "a wink and a nod."[46] So, for example, a bankruptcy judge might be able to cajole municipal authorities into imposing a new tax, even though she is prohibited from imposing one in her own name. But there are obvious limits to such roundabout authority. First, it might be thought inappropriate for a judge to do indirectly what the Code expressly declares she shall not do directly. And unseemliness impairs communication channels, if nothing else.[47] Second, municipal officials will bend

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41 11 USC § 904.

42 See 11 USC § 901(a) (excluding by reference §§ 363 and 364(a)–(b)).

43 11 USC § 941 ("The debtor shall file a plan for the adjustment of the debtor's debts. If such a plan is not filed with the petition, the debtor shall file such a plan at such later time as the court fixes.").

44 See 11 USC § 943(b) (enumerating criteria judges must apply).

45 11 USC § 943(b)(7).

46 See, for example, McConnell and Picker, 60 U Chi L Rev at 474 (cited in note 9).

47 There is a question not only about the advisability, but also about the actuality, of indirect judicial influence. Professor Melissa Jacoby's study of the Detroit case finds judicial influence ubiquitous. See generally Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 Yale J Reg 55 (2016). See also Laura N. Coordes, *Formalizing Chapter 9's Experts*, 116 Mich L Rev 1249, 1263–74 (2018) (suggesting that bankruptcy judges use mediators and other third-party expertise in part to overcome Chapter 9's formal limitations on judicial power).

only so far. Debt adjustment is worth something but not everything. In a high-profile matter, moreover, dismissal of the case is apt to be viewed as a judicial failure as much as a municipal disappointment. The court might balk, and city officials know this. The situation resembles a bilateral monopoly. Negotiations, so to speak, are unlikely to get the judge just what she wants. The plain fact is that courts in Chapter 9, compared to other forms of bankruptcy, are essentially weak and can do relatively little to influence debtor operations or policy more generally.

## B. The Critical Literature

The modern scholarly literature on municipal bankruptcy began in the early 1990s, motivated, it seems, by Bridgeport's abortive filing. Professors McConnell and Picker, in particular, set what are still the bounds of academic debate.[48] Their contribution was twofold. First, they showed that the economic problem that corporate bankruptcy was thought to solve, the creditors' "race of diligence," has no analog in the municipal context.[49] Compared with the frustrated business or, indeed, consumer creditor, McConnell and Picker observed, the municipal creditor has exceedingly weak remedies under state law.[50] A municipality cannot be dismembered, so there is no need for bankruptcy to coordinate creditor collections efforts. Second, McConnell and Picker identified two familiar properties of bankruptcy with more promising municipal analogs: its capacity to grant the debtor a "fresh start" and to improve management.[51] To the extent a person's debt burden has blunted her incentive to invest in the future, cleaning up her balance sheet can be expected to yield salutary effects.[52] And

48 McConnell and Picker, 60 U Chi L Rev 425 (cited in note 9). See also generally David L. Dubrow, *Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?*, 24 Urban Law 539 (1992) (discussing the underlying policy and constitutional bounds of Chapter 9 in light of Bridgeport's filing).

49 McConnell and Picker, 60 U Chi L Rev at 429–50 (cited in note 9).

50 Id.

51 Id at 469–70 ("The theory of Chapter 9 is that the burden of debt service, if sufficiently high, will affect the taxpayers of a city as it would a debt-ridden individual: it will sap initiative and depress money-generating activity."). See also id at 472 ("In most cases, chronic financial difficulty is a sign that ordinary political processes are not functioning properly.") (citation omitted).

52 Thoughtful observers have understood this economic rationale for the fresh start from as early as the mid-nineteenth century. See, for example, Joseph Story, 3 *Commentaries on the Constitution of the United States* 4–5 (Hilliard 1833) ("The latter course [allowing garnishment without end] obviously destroys all encouragement to industry and enterprise on the part of the unfortunate debtor, by taking from him all the just rewards of his labour, and leaving him a miserable pittance, dependent upon the bounty or forbearance of his creditors.").

to the extent a firm's managers or managerial policies are to blame for its woes, cleaning up the executive suite can do the same.[53] The translation of these functions to the municipal sphere is imperfect, McConnell and Picker saw, but they might yet ground the law.

Academic interest in municipal bankruptcy has grown considerably since the Great Recession and the wave of filings that began with Vallejo, California, in 2008. Much of the scholarship has had a descriptive ambition, meant to explicate or clarify existing law rather than to criticize it.[54] Because the application of Chapter 9 to sizeable, general purpose municipalities is still a novelty, many interesting and difficult questions of law are yet to be resolved.

Critical scholarship has focused on the second of the two functions McConnell and Picker identified—the law's capacity to improve municipal policy.[55] The most prominent critique of Chapter 9 is that it, unlike Chapter 11, lacks direct mechanisms by which the judge and creditors can correct dysfunctional governance

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[53] Bankruptcy is not a necessary precondition to either kind of change, but its reckoning may spur action.

[54] See generally, for example, Jacoby, 33 Yale J Reg 55 (cited in note 47) (documenting case administration in the Detroit bankruptcy); David A. Skeel Jr, *From Chrysler and General Motors to Detroit*, 24 Widener L J 121 (2015) (discussing similar, remarkable features of three recent Michigan bankruptcies); Richard M. Hynes and Steven D. Walt, *Fair and Unfair Discrimination in Municipal Bankruptcy*, 37 Campbell L Rev 25 (2015) (discussing equality norms among unsecured creditors); Andrew B. Dawson, *Pensioners, Bondholders, and Unfair Discrimination in Municipal Bankruptcy*, 17 U Pa J Bus L 1 (2014) (discussing the unfair discrimination standard); Vincent S.J. Buccola, *Who Does Bankruptcy? Mapping Pension Impairment in Chapter 9*, 33 Rev Bank & Fin L 585 (2014) (discussing the impact of state law on the status of pension rights); Richard M. Hynes and Steven D. Walt, *Pensions and Property Rights in Municipal Bankruptcy*, 33 Rev Bank & Fin L 609 (2014) (same); Melissa B. Jacoby, *The Detroit Bankruptcy, Pre-eligibility*, 41 Fordham Urban L J 849 (2014) (studying early case administration in the Detroit bankruptcy); C. Scott Pryor, *Municipal Bankruptcy: When Doing Less Is Doing Best*, 88 Am Bankr L J 85 (2014) (discussing contract assumption and plan confirmation standards); David Skeel, *The Meaning of Detroit* (National Affairs, 2015), archived at http://perma.cc/7ZHW-FGVR. See also, for example, David A. Skeel Jr, *What Is a Lien? Lessons from Municipal Bankruptcy*, 2015 U Ill L Rev 675, 682–84 (considering the historical and current capacity of state law to alter creditor priorities).

[55] Notable exceptions include Chaudhury, Levitin, and Schleicher, 107 Cal L Rev at *52–84 (cited in note 2) (arguing for a mechanism to ameliorate commons problem among municipal debtors with overlapping territories); Coordes, 116 Mich L Rev at 1263–65, 1274–78 (cited in note 47); Diane L. Dick, *Bondholders vs. Retirees in Municipal Bankruptcies: The Political Economy of Chapter 9*, 92 Am Bankr L J 73, 103–10 (2018) (arguing for a corrective to pension administrators' outsized influence); Buccola, 38 Cardozo L Rev at 1303, 1331–37 (cited in note 30) (arguing for reduced number of veto players and for better defined substantive entitlements); Laura N. Coordes, *Restructuring Municipal Bankruptcy*, 2016 Utah L Rev 307, 316–27, 349–50 (arguing for relaxed eligibility conditions).

norms.[56] Much of the literature in this vein starts with the premise that incompetent management and dysfunctional electoral politics (which tend to produce incompetent managers) are to blame for excessive municipal debt.[57] It follows that debt relief without a corresponding change in policy or governance is futile and that healthy policy and governance changes can have a big, long-term impact. The question, then, is what, if any, role bankruptcy should play in effecting change.[58] At one pole are those who think federal judicial intervention in local governance either inconsistent with law or more generally ill-founded. On this view, state law is the proper source of municipal reform.[59] Bankruptcy

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56 See Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 Wash & Lee L Rev 403, 421–29 (2014) (discussing scholarship critiquing the limited powers that Chapter 9 grants to bankruptcy courts). See also Andrew B. Dawson, *Beyond the Great Divide: Federalism Concerns in Municipal Insolvency*, 11 Harv L & Pol Rev 31, 32–33 (2017) (noting that relegation of governance to state control is "one of the fundamental bases for much of the criticism of the municipal bankruptcy laws").

57 See, for example, Dawson, 11 Harv L & Pol Rev at 33 (cited in note 56) ("While financial distress may result from exogenous shocks, it frequently results from poor governance."); Clayton P. Gillette and David A. Skeel Jr, *Governance Reform and the Judicial Role in Municipal Bankruptcy*, 125 Yale L J 1150, 1154 (2016) ("The financial distress of a substantial municipality nearly always signals that its politics are dysfunctional."); McConnell and Picker, 60 U Chi L Rev at 472 (cited in note 9) ("In most cases, chronic financial difficulty is a sign that ordinary political processes are not functioning properly.") (citation omitted).

58 A narrow question that dates to McConnell and Picker is whether a bankruptcy judge should (and can) impose special taxes or spending cuts as a condition for granting debt relief. McConnell and Picker thought so. McConnell and Picker, 60 U Chi L Rev at 472–81 (cited in note 9). Others have supplemented or doubled down on their analysis. See, for example, John P. Hunt, *Constitutionalized Consent: Preemption of State Tax Limits in Municipal Bankruptcy*, 34 Yale J Reg 391, 424–28 (2017) (arguing that Congress could, if it wished, authorize municipalities in bankruptcy to impose taxes that would exceed the limits of state law); Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U Chi L Rev 281, 283–84, 326–28 (2012) (arguing that judges should be allowed to impose "resource adjustments" when political pathologies have prevented elected official from doing so). But this is by no means the unanimous view. See generally, for example, Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 Va L Rev 1035 (1997) (arguing that bankruptcy judges should not seek to levy additional taxes even if they can as a practical matter).

59 See, for example, Samir D. Parikh, *A New Fulcrum Point for City Survival*, 57 Wm & Mary L Rev 221, 277–96 (2015) (advocating for further state intervention); Moringiello, 71 Wash & Lee L Rev at 457–71 (cited in note 56) (arguing that Chapter 9 was designed to allow minimal federal intervention); Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 Yale J Reg 351, 369–85 (2010) (arguing that rationales for bankruptcy do not apply to Chapter 9); Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 BU L Rev 633, 660–72 (2008) (comparing the efficacy of state and federal interventions and finding state law superior). See also generally Clayton P. Gillette, *Dictatorships for Democracy: Takeovers of Financially Failed Cities*, 114 Colum L Rev 1373 (2014) (advocating state use of control boards to rationalize municipal policy, but not on the ground that federal intervention would be inherently illegal or inappropriate). See also Austin Murphy, *Bond Pricing in the Biggest City Bankruptcy in History: The*

ought to serve as, at most, an implement states can use to write down municipal debt notwithstanding the Constitution's Contracts Clause.[60] At the other pole, Professors Clayton Gillette and David Skeel argue that judicial intervention in bankruptcy not only is consistent with existing law but frequently is advisable, precisely because the fact of bankruptcy suggests that the levers of reform at the state level are not working.[61]

Whatever their view on the propriety of federal intervention in municipal governance, those writing critically on Chapter 9 implicitly concede a narrow sphere for municipal bankruptcy. Even Gillette and Skeel, for example, acknowledge that judicial intervention is possible only to the degree an eligible municipality's managers want debt relief.[62] If a municipality does not qualify for Chapter 9 or does not ask for a plan of adjustment, there is nothing for a court to do. Normative debate is thus very real, but because eligibility criteria are so strict, the functional significance of that disagreement has been unavoidably slim. Whether for that

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*Effects of State Emergency Management Laws on Default Risk*, 54 Intl Rev L & Econ 106, 107, 109–15 (2018) (finding evidence that emergency management in Detroit reduced city default risk but may have increased default risk of geographically proximate governments). Although not principally concerned with the scope of bankruptcy law, Professor David Schleicher also has much of interest to say about the connection between state-level policy and the shape of municipal distress. See generally David Schleicher, *Stuck! The Law and Economics of Residential Stagnation*, 127 Yale L J 78 (2017).

60 See Dawson, 11 Harv L & Pol Rev at 39–42 (cited in note 56) (describing this view and its foundations). The Constitution bars states from "impairing the Obligation of Contracts." US Const Art I, § 10. That power belongs to the federal government alone, by virtue of the Bankruptcy Clause. See US Const Art I, § 8, cl 4 (granting Congress the power to make "uniform Laws on the subject of Bankruptcies throughout the United States"). Thus, on one understanding, Chapter 9 serves only, or primarily, to enable the states effectively to write down their municipalities' debts notwithstanding the Constitution's formal prohibition. Moringiello, 71 Wash & Lee L Rev at 410–15 (cited in note 56) See also generally Juliet M. Moringiello, *Chapter 9 Plan Confirmation Standards and the Role of State Choices*, 37 Campbell L Rev 71 (2015) (arguing for greater deference to state-created priority norms). This end-around works formally because the federal court's confirmation of a plan of adjustment is understood to be the agent of impairment and not the actions of the state that generates a confirmable plan. See Buccola, 33 Rev Bank & Fin L at 591, 600–08 (cited in note 54) ("Impairment is a federal, and not a state, activity."). Whether federal law is a *necessary* aid, as a constitutional matter, is in some doubt. See, for example, Vincent S.J. Buccola, *An Ex Ante Approach to Excessive State Debt*, 64 Duke L J 235, 246–48 (2014). But federal law is surely needed in light of the existing statute. See 11 USC § 903(1) (preempting whatever authority states would otherwise have to compromise municipal debts without creditor consent).

61 Gillette and Skeel, 125 Yale L J at 1153 (cited in note 57). But see Jacoby, 41 Fordham Urban L J at 865 (cited in note 54) (suggesting that bankruptcy judges assert more control already than most have suspected).

62 Gillette and Skeel, 125 Yale L J at 1211 (cited in note 57) ("Once a state does authorize its municipalities to file, only a municipality itself can invoke Chapter 9.").

reason or another, little scope has been given to the question: What, in principle, might a sensible municipal bankruptcy law achieve?[63]

## II. Framing an Objective for Municipal Bankruptcy

The economic function of bankruptcy, in general, is to cure allocative distortions that follow from high levels of debt. Debt alters behavior, and when it becomes overwhelming, it can induce people to forgo valuable opportunities. In a frictionless world, investors would bargain around debt so as not to leave surplus on the table—the Coasean nirvana—but in the real world they cannot always do so. Bankruptcy cuts the knot. By cleaning up a debtor's balance sheet, it encourages people to make investment decisions in accord with the underlying value of available resources.

The creditors' bargain model, the leading normative framework for understanding corporate bankruptcy, is an application of this insight. The question that model addresses is: How does debt generate allocative inefficiencies *in the corporate setting*? The answer, which Professor Jackson gave and elaborated with Professor Baird in the 1980s, is that a firm's default can lead to a creditor run, dismembering specific investments and thereby destroying joint value.[64] What bankruptcy can do is forestall grab

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[63] Commentators might alternatively have felt constrained by what are often assumed to be narrow constitutional bounds in this domain. See, for example, Gillette, 114 Colum L Rev at 1379–80 (cited in note 59) (advocating for state "takeover boards" because, among other things, "the scope of federal bankruptcy for municipalities may be constrained by federalism and Tenth Amendment considerations"); Gillette, 79 U Chi L Rev at 293 (cited in note 58) ("[S]ome suggest that the noninterference principle preserves the constitutionality of a federal bankruptcy law directed at municipalities by minimizing the role of federal actors in matters best left to state consideration."); McConnell and Picker, 60 U Chi L Rev at 472–81 (cited in note 9) (suggesting that bankruptcy judges might force governance and tax changes by conditioning debt relief but also that, given constitutional doubts, it might be sensible to scrap federal intervention altogether). Even those who are bullish on federal power tend to condition their claims on state consent. See Gillette and Skeel, 125 Yale L J at 1202–06 (cited in note 57) (arguing that bankruptcy judges can, under existing law, condition relief on governance modifications and that such conditioning is consistent with the Constitution *because of* the prerequisite of state consent and the maintenance of state authority over municipal governance); Michelle W. Anderson, *The New Minimal Cities*, 123 Yale L J 1118, 1152 (2014) (suggesting that bankruptcy is not as helpful as it might be because "[f]or Tenth Amendment reasons, this option is available only where the [municipality's] state has 'specifically authorized' the municipality . . . to [ ] file"). See also generally Hunt, 34 Yale J Reg 391 (cited in note 58) (arguing that bankruptcy law could permit judges to impose new taxes and that such power would be consistent with the Constitution *because of* the prerequisite of state consent). My current research, still in progress, finds that Congress has a much freer hand than observers have assumed.

[64] The seminal paper is Jackson, 91 Yale L J 857 (cited in note 6). Important early elaborations include Douglas G. Baird and Thomas H. Jackson, *Bargaining after the Fall*

races when investors would, if they could coordinate cheaply, opt to keep a firm intact. That is, bankruptcy can help investors not waste the value associated with an indebted firm's peculiar configuration of resources. Here is the law's logic and also its limit.[65]

This Part identifies a corresponding objective toward which municipal bankruptcy law might be directed. Its motivating question, then, is: How does debt generate allocative inefficiencies *in the municipal setting*? The answer will take some pages to unpack, but in principle it can be simply put: High levels of government debt can lead to underinvestment, both public and private, in infrastructure within a municipality's territorial limits. This in turn threatens to dissipate spatial economies associated with the location.[66] What bankruptcy can do, even if existing law does it poorly, is preserve these economies by writing down debts likely to discourage local investment. What bankruptcy cannot do, on the other hand, is equally clear. Just as surely as debt can cause spatial economies to be dissipated, it can also be a consequence, or symptom, of their natural decay. One city has too much debt; another city has too much debt because the once-prosperous mine near which it sits has become defunct. It is familiar to talk of "disruptive" technologies undermining once-vibrant *businesses*. But the same process, although celebrated with less fanfare, has the capacity to undermine once highly productive *places*, too. When a location cannot generate revenues sufficient to pay for basic social services, it is tragic but not a matter bankruptcy is calibrated to resolve. Law reform should be undertaken with this logic in mind.[67]

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*and the Contours of the Absolute Priority Rule*, 55 U Chi L Rev 738 (1988); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J Legal Stud 127 (1986); Douglas G. Baird and Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 Vand L Rev 829 (1985); Thomas H. Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, 14 J Legal Stud 73 (1985); Baird and Jackson, 51 U Chi L Rev 97 (cited in note 7); Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 Stan L Rev 725 (1984); Douglas G. Baird and Thomas H. Jackson, Kovacs *and Toxic Wastes in Bankruptcy*, 36 Stan L Rev 1199 (1984).

65 Consider Ayotte and Skeel, 80 U Chi L Rev 1557 (cited in note 8) (identifying creditor-coordination problems other than the grab race and arguing that bankruptcy appropriately addresses them, too).

66 See Part II.D.

67 Just what kind of policy response locational decline calls for is an open and much debated question, with recent volleys having been launched in the *Yale Law Journal Forum*. Compare generally Schleicher, 127 Yale L J F 78 (cited in note 59), with Naomi Schoenbaum, *Stuck or Rooted? The Costs of Mobility and the Value of Place*, 127 Yale L J F 458 (2017); Michelle W. Anderson, *Losing the War of Attrition: Mobility, Chronic Decline, and Infrastructure*, 127 Yale L J F 522 (2017). For a recent review of the economic rationales for,

### A. The Economic Function of Cities and Towns

Why do people and firms locate where they do? What is the use of cities and towns? These are the central questions of economic geography and urban economics. Here is not the place to explore the state of the art in those fields, but it will be helpful, in trying to understand the significance of government debt, to bear a few ideas in mind.[68] Modern theory on the question of location is usually traced to Alfred Marshall. People and industry tend to concentrate in a particular location, Marshall saw, for two generic reasons—either to exploit natural advantages associated with the place or to benefit from proximity to complementary people and activities.[69] I call these reasons "natural" and "density" economies, respectively, and I use the term "spatial" economies to refer generically to either.[70]

Natural economies refer to the cost savings to be had by locating activity close to valuable natural resources. These resources vary widely in character. They include endowments such as rich soil, proximity to mines or quarries, or access to transportation networks. No exhaustive catalog is possible because what counts as a natural advantage depends ultimately on contingent facts about technology and culture. What is advantageous in one time and place is a function of given modes of production and consumption. Thus, Marshall's illustrations of natural advantage are distinctive of and specific to the England of his time:

> Straw plaiting has its chief home in Bedfordshire, where straw has just the right proportion of silex to give strength without brittleness; and Buckinghamshire beeches have afforded the material for the Wycombe chairmaking. The Sheffield cutlery

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and efficacy of, place-based subsidies, see generally David Neumark and Helen Simpson, *Place-Based Policies*, in Gilles Duranton, J. Vernon Henderson, and William C. Strange, eds, 5B *Handbook of Regional and Urban Economics* 1197 (Elsevier 2015). My point here is only that bankruptcy, which is expensive, uncertain, and ad hoc, is poorly calibrated to deliver the kind of results proponents of place-based subsidies want.

68 In discussing the "economic" function of cities and towns, I am neither privileging market-mediated production and consumption activities nor ignoring sentimental and other personal attachments to place. Idiosyncratic attachments to place are a species of spatial amenity, discussed below, albeit a peculiar sort (because they are valued by only a small number of people). I use the descriptor "economic" only to emphasize that the flourishing of a location, like the flourishing of a firm, depends on human choice under conditions of scarcity.

69 See Alfred Marshall, *Principles of Economics* 269–75 (Macmillian 8th ed 1920). Marshall focused attention on concentration within an industry, but the factors he outlined are useful to explain location decisions more generally.

70 What I am calling density economies are variously referred to in other literatures as "agglomeration" or "aggregation" economies.

> trade is due chiefly to the excellent grit of which its grindstones are made.[71]

Natural economies are not only about production strictly understood. Place-based amenities such as fair weather and access to mountains or beaches also help to explain location decisions.[72] Again these are defined contingently. For example, temperatures along the Sun Belt in the southern United States became an amenity only with the advent of cheap and reliable air conditioning.

Density economies refer to the savings to be had by locating complementary activities near one another and so reducing transport costs. Marshall posited three advantages to industrial clustering, corresponding to the need of transporting goods, labor, and ideas, respectively.[73] These advantages are usually described today as input sharing, labor pooling, and knowledge spillover,[74] and empirical investigation confirms the influence of each on observed patterns of industrial concentration.[75] Input sharing refers to the capacity of proximately situated firms to split the fixed costs of factors of production on which each relies. Broadly understood, it also describes the process by which a place's residents split the fixed costs of consumption or cultural goods—for example, the costs of maintaining an opera or a football club or an array of dining options. Labor pooling refers to the advantage to firms of having many workers to choose from, and to workers of having many employers to choose from. There are benefits to matching as well as implicit insurance.[76] Knowledge spillover refers to the tendency of know-how and the fruits of innovation to spread through informal channels among persons or firms in a place.

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71 Marshall, *Principles of Economics* at 223 (cited in note 69).

72 Consumption amenities cannot be isolated from production processes, as they may affect wage demands.

73 Marshall, *Principles of Economics* at 269–75 (cited in note 69). I use "density" economies in favor of terms like "agglomeration," "localization," or "urbanization" economies because I wish to avoid adjudicating the subtleties of their technical and nontechnical usages. "Density economy" also emphasizes the source of the surplus—namely, the nearness of economic actors to each other.

74 See Arthur O'Sullivan, *Urban Economics* 45–64 (McGraw-Hill 8th ed 2012).

75 See generally Glenn Ellison, Edward L. Glaeser, and William R. Kerr, *What Causes Industry Agglomeration? Evidence from Coagglomeration Patterns*, 100 Am Econ Rev 1195 (2010) (estimating the contribution of each factor to observed agglomeration patterns).

76 Labor matching is sometimes described as a distinctive advantage to urbanization that cuts across industries. See O'Sullivan, *Urban Economics* at 55–58 (cited in note 74).

Knowledge spillovers are thought to be especially important in explaining technology clusters.[77]

It is not easy, and might be impossible, to pronounce definitively on the relative importance of each source of economy.[78] What does seem clear, however, is that path dependence mediates natural and density economies and, in so doing, explains much about the location of thriving cities and towns. Purely natural economies are less of a factor in the modern American economy than they once were. (Movement off the farm and advances in transportation and communication technology ensure that.[79]) And density economies, by definition, do not depend on a specific location; they require only that *some* place be a focal point of concentration.[80] History connects these ideas. In a simple model, people initially cluster in a place endowed with natural advantages—a favorable location on a navigable river, say—and agglomeration persists or accelerates, long after the endowment has become obsolete, on account of the fact of the initial clustering.[81] Put simply, returns to scale may become self-reinforcing up to a point.[82] This means, however, that, if the density economies in a place are dissipated, there might be no continuing natural economies on which to fall back.

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77 For an overview, see Enrico Moretti, *The New Geography of Jobs* 138–44 (Houghton Mifflin 2012).

78 One study finds that measured natural advantages explain approximately 20 percent of observed industrial agglomerations and conjectures that, in combination with all that is unmeasured, natural advantages could explain 50 percent. Glenn Ellison and Edward L. Glaeser, *The Geographic Concentration of Industry: Does Natural Advantage Explain Agglomeration?*, 89 Am Econ Rev 311, 315–16 (1999). But estimates of this sort depend as a matter of course on definitions that may prove arbitrary in the final analysis. The determinants of agglomeration economies are likewise elusive. See Patricia C. Melo, Daniel J. Graham, and Robert B. Noland, *A Meta-analysis of Estimates of Urban Agglomeration Economies*, 39 Regional Sci & Urban Econ 332, 332, 337–41 (2009) (finding, among other things, "that agglomeration estimates for any particular empirical context may have little relevance elsewhere").

79 See Edward L. Glaeser, *Agglomeration Economics* 7 (Chicago 2010):

> A century or more ago, when shipping goods was expensive, cities like Chicago and New York formed around ports and rail yards. Over the twentieth century, the cost of moving goods declined enormously, and few modern agglomerations seem built on the easy movement of physical output. Today, the bulk of urban growth, at least in the United States, appears to be in far-flung places that seem to have little advantage in the shipment of goods.

80 See Hoyt Bleakley and Jeffrey Lin, *History and the Sizes of Cities*, 105 Am Econ Rev 558 (2015) ("Intuitively, if endogenous amenities are important for location decisions, then agglomerations might be possible at *many* sites, especially if they share similar exogenous natural characteristics.").

81 See id at 558–60. See also generally Hoyt Bleakley and Jeffrey Lin, *Portage and Path Dependence*, 127 Q J Econ 587 (2012).

82 See generally Paul Krugman, *The Self-Organizing Economy* (Blackwell 1996).

The growth of Chicago during the nineteenth century, from a fur-trading outpost to one of the world's leading cities, illustrates the way natural and density economies can depend on one another.[83] When the city was founded in 1837, its site at the mouth of the Chicago River was no accident. The harbor there, although poor in absolute terms, was the best to be found in the south part of Lake Michigan, and the River's upstream limit was only about a dozen miles from a ridge separating the watersheds of the Great Lakes from those of the Mississippi. As a portage, Chicago stood to be an obvious trading place for goods moving across the country, from New York to New Orleans. A canal built during the 1840s connected the Atlantic and Gulf by inland waters, in the process expanding Chicago's effective hinterlands and increasing its value as a marketplace. Beginning in the 1850s, the railroads superseded the canal for the shipment of most goods; but the railroads were built to Chicago precisely because it was already a regional center. By the time of the World's Fair in 1893, the economies initially provided by the harbor and river were essentially irrelevant. The city's place at the hub of a hub-and-spokes rail system now defined its endowment, a kind of "second nature," but that system was itself a product of the density economies that could be traced back to the fur trade.

An individual deciding where to locate might reasonably take the existence of spatial economies as given. But as the example of Chicago suggests, only the rawest natural economies are spontaneously generated. For the most part, the development and exploitation of spatial economies requires capital. Investment is needed.

Which brings us, at last, to the municipality. The economic function of municipal government is to develop local spatial economies—by direct investment and by acting as a spur to private investment (supplying social regulation and conditions conducive to investment). In principle, municipal government is unnecessary. In principle, private investment can fund infrastructure. And in principle, state and federal governments can ensure the public safety necessary to make that investment viable.[84] But in

83 This account is drawn from the excellent book by William Cronon, *Nature's Metropolis: Chicago and the Great West* (Norton 1991).

84 This insight was the basis of Professor Robert Ellickson's discussion of private associations as alternatives to city governments. See generally Robert C. Ellickson, *Cities and Homeowners Associations*, 130 U Pa L Rev 1519 (1982). More recent experiments with the "private city" model are in this vein. For an introduction, see Alex Tabarrok and Shruti

fact, at least in the United States, local government has always been intimately tied up in local development.[85] And this generally seems a sensible arrangement.[86] Government, with its coercive tax power, has an advantage in solving freeriding problems; and local governments, in particular, are responsive to those who stand to gain (and lose) most from investments in infrastructure.[87] As a result, municipal governments are generally well positioned to provide efficient levels of public and quasi-public goods—street repair, sanitation, police and fire protection, and so forth.[88] All does not always go well, however, and a municipality may find itself under a mountain of debt.

## B. Economic and Financial Distress

A central notion in corporate bankruptcy theory, perhaps *the* central notion, is the distinction between economic and financial distress. Economically and financially distressed firms alike face

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Rajagopalan, *Designing Private Cities, Open to All* (NY Times, Mar 16, 2015), archived at http://perma.cc/RV9V-8WLM.

85 This has been true at least since the mid-nineteenth century, when municipal governments became major sponsors of local railroad construction. The practice caused controversy, not least among lawyers, for many years. See generally, for example, Cecil, *On Municipal Subscriptions to the Stock of Railroad Companies*, 2 Am L Reg 1 (1853); C.A. Kent and S.T., *Municipal Subscriptions and Taxation in Aid of Railroads*, 18 Am L Reg 649 (1870); W.B.J., *County Subscriptions to Railroad Corporations*, 20 Am L Reg 737 (1872).

86 See Robert P. Inman, *Financing Cities*, in Richard J. Arnott and Daniel P. McMillen, eds, *A Companion to Urban Economics* 311, 313–15 (Blackwell 2006) (making a case for the efficiency of some municipally provided services and infrastructure).

87 This, at any rate, is the thesis of William A. Fischel, *The Homevoter Hypothesis: How Home Values Influence Local Government Taxation, School Finance, and Land-Use Policies* (Harvard 2001). The same responsiveness means that local governments are also generally well positioned to supply valuable regulation of development. Think tax credits on one hand and zoning on the other.

88 I do not mean to slight other municipal functions or to suggest that municipal governments are strict maximizers. It should go without saying that optimization stories are usually crude models. No complex organization is strictly maximizing along any dimension. But an optimization model can help to explain long-term and general patterns of behavior. Most of what municipal governments do is provide local public goods and other infrastructure. Redistribution efforts at the municipal level can and often do fail, as the taxes needed to fund them spur mobile, wealthy residents to leave. See generally Andrew F. Haughwout and Robert P. Inman, *Fiscal Policies in Open Cities with Firms and Households*, 31 Regional Sci & Urban Econ 147 (2001) (modeling mobility). See also Andrew F. Haughwout, et al, *Local Revenue Hills: Evidence from Four U.S. Cities*, 86 Rev Econ & Stat 570, 575 (2004) (finding that three of four cities studied—Houston, New York, and Philadelphia—have nearly revenue-maximizing policies). See also O'Sullivan, *Urban Economics* at 108 (cited in note 74) (observing that tax increases used to fund public services—infrastructure, education, public safety—tend to increase a city's attractiveness, while increases used to fund redistribution tend to reduce a city's attractiveness). See also generally L. Jay Helms, *The Effect of State and Local Taxes on Economic Growth: A Time Series–Cross Section Approach*, 67 Rev Econ & Stat 574 (1985).

unsustainable debts, but the significance of their debts differs. A company in economic distress lacks a viable business model. The demand for its products or services is insufficient to cover costs at anything like current scale. A restaurant that prepares lousy food at high cost is the prototype. Its few loyal (and idiosyncratic) patrons do not eat enough to pay for the labor, rent, ingredients, and so forth that go into the meals, and the disparity between receipts and costs must be covered by borrowing. Even well-managed and once-profitable companies can find themselves in economic distress. The advent of the word processor, for example, spelled the end for typewriter manufacturers of long standing.[89] In a market economy, these firms are doomed. Relief from creditors will not save them. It will at most delay a reckoning, and all bankruptcy can do is to structure the inevitable liquidation and disbursal of proceeds.

A company in financial distress, by contrast, has a viable business model—its revenues are sufficient to cover operating costs—but its cash flows are inadequate to cover costs *and* service outstanding debt. Its balance sheet needs recapitalization, but its peculiar combination of real resources is operationally sound. The nineteenth-century railroads furnish the classic example.[90] A struggling railroad's bondholders might value keeping its tracks together even if the railroad's revenues will not satisfy their claims in full. (Railroad ties sold for their second-best use, as firewood, would be unlikely to fetch a superior return.) Because any one impaired lender might nevertheless find it privately advantageous to levy on the wood and steel comprising the railroad, as she was entitled to do under ordinary legal principles, a debt restructuring mechanism could produce value. Fundamentally, bankruptcy can prevent *the fact of debt* from destroying the surplus associated with a particular configuration of assets.[91]

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89 See, for example, Laurence Zuckerman, *Smith Corona, a Computer Victim, Files for Bankruptcy* (NY Times, July 6, 1995), archived at http://perma.cc/TH4R-W6W8.

90 Indeed, the logic was so apparent that courts of equity were willing to validate a series of new legal fictions, jointly known as the equity receivership, in order to effect reorganization rather than piecemeal liquidation. For description and analysis of the receivership mechanism, see Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 Cornell L Rev 1420, 1440–52 (2004); Douglas G. Baird and Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 S Ct Rev 393, 397–408; David A. Skeel Jr, *Debt's Dominion: A History of Bankruptcy Law in America* 56–60 (Princeton 2001).

91 Note that economic and financial distress are polar concepts, ideal types rather than directly observable conditions. Even the sagest observer confronts a probabilistic landscape. Future cash flows could be greater or lesser than one expects. As a matter of logic, then, the definitive categorization of a distressed firm is impossible—one observer's

The concepts of economic and financial distress map imperfectly onto the municipal context. A city occupies a fixed geographic territory as a matter of law, and creditors cannot in any meaningful sense foreclose on or liquidate its property.[92] And while the owners of locally situated real estate are, after a fashion, the residual beneficiaries of municipal policy and action, and in that sense resemble corporate stockholders,[93] their property cannot be seized to satisfy entity-level creditors.[94] So the particular risk-return profile the residual beneficiaries face is quite different. Nevertheless, it will be useful to effect a conceptual translation, to emphasize a parallel ambiguity in the significance of municipal and corporate debt. A local government, like a company, has a kind of business model.[95] It offers a suite of services, charges for them, and can sustain unbalanced budgets only as long as its credit will last. That credit depends, in turn, on the perceived viability of the business model.

### C. Municipal Economic Distress: Productivity Shock → Debt

A municipality is economically distressed when it is in debt and its sources of revenue—taxes, fees, and reliable grants-in-aid—are insufficient to pay for the scale of services it has been known to provide or that most Americans demand unconditionally. Such a municipality cannot increase its long-run revenues because the

insolvency is another's mere illiquidity. As a matter of practical judgment, on the other hand, one or the other label adequately describes many firms. But not all. If a firm's horizons are sufficiently opaque or subject to disagreement, the attempt to classify it as financially or economically distressed is misguided.

92 For discussion of creditors' remedies under state law, see McConnell and Picker, 60 U Chi L Rev at 427–50 (cited in note 9).

93 See Joseph Gyourko and Joseph Tracy, *Local Public Sector Rent-Seeking and Its Impact on Local Land Values*, 19 Regional Sci & Urban Econ 493, 495 (1989) ("Landowners are the equity holders in a locality.").

94 Once upon a time, the New England states allowed municipal creditors to levy on privately held property. See McConnell and Picker, 60 U Chi L Rev at 437–42 (cited in note 9).

95 Not for nothing, observers have long remarked on the similarity between municipal governments and consumer cooperatives. See, for example, Kordana, 83 Va L Rev at 1055–56 (cited in note 58) ("[A] municipality is, in important ways, similar to a corporation. Or more precisely, a corporation and a municipality represent different ways of achieving a similar task: creating and delivering goods and services more efficiently through the creation of an enterprise."); Ellickson, 130 U Pa L Rev at 1520–26 (cited in note 84) ("Although cities are considered 'public' and homeowners associations 'private,' I discern only one important difference between the two forms of organization—the sometimes involuntary nature of membership in a city versus the perfectly voluntary nature of membership in a homeowners association.").

act of raising tax rates or imposing new fees will generate offsetting delinquency and flight.[96] Nor can it balance its long-run operating budget by reducing services or skimping on capital maintenance because this too will cause flight—and moreover, many municipal services are mandated by state law if not by good conscience. In short, this is a municipality whose business is cooked. Despite what is sure to be cheap real estate, the location no longer attracts economic activity on a scale sufficient to pay the bills.

How does a city or town come to find itself in economic distress? Chronic mismanagement and political dysfunction can do the job. The dominant story is not, however, about malfeasance or even negligence, but about technological and cultural change.[97] The world changes in ways that undermine a place's spatial economies, the reasons for people's being there, and debt is a frequent byproduct.

A process culminating in municipal economic distress often begins with a negative productivity shock—a change, whether local or macroeconomic, that makes locating within the municipality less valuable than before. Even a major shock—for example, the exhaustion of an important natural resource—does not cause municipal operations to shutter immediately, however. Local life continues because infrastructure is durable. Professors Edward

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96 The theory is discussed, and four budgets are analyzed in depth, in Haughwout, et al, 86 Rev Econ & Stat 570 (cited in note 88). Land itself cannot flee, of course, and a municipality can foreclose on abandoned property to protect its tax liens. But foreclosures diminish the value of nearby real estate and so can further erode the tax base.

97 Economic geographers understand the connection between innovation and locational decline. See, for example, Sukkoo Kim and Robert A. Margo, *Historical Perspectives on U.S. Economic Geography*, in J.V. Henderson and J.F. Thisse, eds, 4 *Handbook of Regional and Urban Economics* 2981, 2983 (Elsevier 2004) ("New industries develop and, for technological or other reasons, find it profitable to situate in different locations than old industries. Transportation networks emerge, linking far-flung markets, within and across countries, again potentially altering the spatial distribution of resources."); Paul Krugman, *The Gambler's Ruin of Small Cities (Wonkish)* (NY Times, Dec 30, 2017), archived at http://perma.cc/6RML-3LA5 ("In the modern economy, which has cut loose from the land, any particular small city exists only because of historical contingency that sooner or later loses its relevance."). The relationship has largely escaped notice in the legal literature, a notable exception being Schleicher, 127 Yale L J F at 578–79 (cited in note 67):

> Just as we have different firms in the S&P 500 than we did a hundred years ago, the variety and sizes of regions and cities required by a dynamic economy and society change over time. We cannot stop some cities from declining and other cities from growing without stopping the economy or society from changing and improving.

Glaeser and Joseph Gyourko capture the dynamic in an important model of urban decline.[98] The model's logic starts with the familiar observation that a place's spatial economies are reflected, or "capitalized," in the price of local real estate.[99] A negative shock to the magnitude of these economies induces the mobile residents who are most sensitive to the effects of productivity changes to leave for more lucrative opportunities.[100] But the population does not immediately decrease. Instead, housing prices are bid down, and new residents, less vulnerable to the effects of productivity loss and more sensitive to housing cost, move in to replace the departed.[101] Population declines only as the housing stock and complementary infrastructure are exhausted.[102]

Versions of this story have played out across the United States for a long time. Sometimes the agent of change is industry-specific and therefore concentrated in particular regions or localities. Reversals in the coal industry hit parts of Appalachia hardest, for example, and the decline of the timber industry disproportionately affected the Pacific Northwest. But other changes alter patterns of clustering more generally. Consider for example the many market towns that once thrived as trading hubs in agricultural regions. When a large fraction of the population was "on the farm" and travel was slow, a relatively large number of relatively small market towns flourished. Developments in agriculture and transportation shocked the spatial equilibrium. As the number of agricultural workers and the cost of travel fell, it became inevitable that many once-vibrant cultural hubs would decline.[103]

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98 See generally Edward L. Glaeser and Joseph Gyourko, *Urban Decline and Durable Housing*, 113 J Polit Econ 345 (2005).

99 This idea is at the heart of the spatial equilibrium models of Professors Jennifer Roback and Sherwin Rosen. Jennifer Roback, *Wages, Rents, and the Quality of Life*, 90 J Polit Econ 1257, 1259–64 (1982); Sherwin Rosen, *Wage-Based Indexes of Urban Quality of Life*, in Peter Mieszkowski and Mahlon Straszheim, eds, *Current Issues in Urban Economics* 74 (Johns Hopkins 1979).

100 I focus on productivity shocks, but essentially the same story can be told of shocks to level of amenities. Arguably the move of population from the American Northeast to the South and Southwest is due in large part to an amenity shock. Warm weather became more valuable after air conditioning was perfected. Put differently, the *disamenity* of cold weather was magnified.

101 See Glaeser and Gyourko, 113 J Polit Econ at 348–53 (cited in note 98) (furnishing evidence for the claim that negative shocks, such as wage decreases, are followed by large decreases in housing prices but little change in population).

102 See id at 370 ("The supply side of the housing market helps explain why cities decline so slowly even though they can grow at very fast rates. Durable housing can also explain the striking persistence of urban decline.").

103 Paul Krugman put the idea well in a recent column in the *New York Times*. See Krugman, *The Gambler's Ruin* (cited in note 97) ("[O]nce upon a time dispersed agriculture ensured that small cities serving rural hinterlands would survive. But for generations

The conditions following a major negative productivity shock put pressure on a municipality's budget. Although population remains constant for a time, revenues shrink because the tax base is impaired. Incomes are lower, property worth less, and the dollar volume of taxable transactions diminishes. At the same time, demand for government services may increase because those least sensitive to productivity may require more public aid. It stands to reason, for example, that the elderly and the infirm are on average less sensitive to productivity because they are not seeking employment. Thus, "[a]s tax revenues are falling, spending needs are rising."[104] Moreover, when population eventually declines, the cost of providing a fixed level of services may increase as former scale economies are lost.[105] In principle, economic decline need not lead to large public debts. If managers can adjust quickly and nimbly enough by scaling back spending on margins formerly, but no longer, in high demand and cultivating subsidies and charitable aid, they might be able to "wind down" operations.[106] But this is no easy task, and for obvious reasons the adjustments needed to avoid chronic deficits will often be unpalatable to the voting electorate. Debts grow.

Under these conditions, there is little for bankruptcy to do. An initial shock or series of shocks has set in motion adjustments that, in equilibrium, leave a degraded tax base and increased demand for public services. If the magnitude of the shock or shocks is large enough, the municipality finds itself unable to raise revenues sufficient to cover basic services such as police, fire, and sanitation. Unsustainable debt may be one consequence, but it is a product rather than cause of distress. There is no reason to think debt relief or a bankruptcy judge's intervention in local governance will stimulate new investment.

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we have lived in an economy in which smaller cities have nothing going for them except historical luck, which eventually tends to run out.").

[104] Robert P. Inman, *Anatomy of a Fiscal Crisis*, Fed Res Bank Phila Bus Rev 15, 19–20 (1983) (describing the relationship between declining private economy and municipal fiscal distress).

[105] Hence, arguments for shrinking governance in cities that have lost population. See, for example, Anderson, 123 Yale L J at 1126–27 (cited in note 63) (discussing the concept of "shrinking governance" for cities facing rapid population decline and increasingly concentrated poverty).

[106] The parallel is to the failed restaurant financed entirely with the entrepreneur's equity.

D. Municipal Financial Distress: Debt → Underinvestment

The degree to which spatial economies are exploited depends on complementary capital investment, physical as well as human. For example, the area near deep and still water becomes valuable as a port location only when docks are built; the area near a mineral deposit becomes valuable as a mining location only when extraction facilities are built; the area near a ski mountain becomes valuable as a resort location only when a lodge is built, trails are cleared, and lifts installed. Likewise, a functioning road system makes a city a more valuable place to congregate, a more useful focal point for interaction. Spatial economies are likely to depend as well on investments in goods such as schools, sanitation, law enforcement, and real estate improvements of all kinds, as well as investments not mediated by market exchange, such as the founding of clubs and religious and cultural associations. All else equal, most people prefer to be clean, safe, and comfortably housed. These goods are costly, of course, and the law of diminishing marginal returns defines an upward limit on the wisdom of their procurement, but the fact is that investment is needed to enhance and exploit spatial economies.

A corollary to this proposition is that underinvestment threatens to erode or dissipate spatial economies. The port whose harbor is inadequately dredged becomes a less valuable conduit of trade; the city whose roads have too many potholes becomes, on the margin, a less useful place to congregate. Locations compete with one another for economic activity, whether explicitly or not. As a location's spatial economies are dissipated by underinvestment, the people and firms most sensitive to its productivity loss will be tempted to leave. In other words, underinvestment is one path to economic dysfunction.

Large public debts can cause underinvestment. Municipal financial distress describes the condition when they threaten to do so. What bankruptcy can do, in principle, is truncate those debts and so prevent financial distress from turning into, or creating, economic distress. But one needs to be careful about the mechanism. As Part III explains, the wisdom of a more aggressive municipal bankruptcy regime depends on the ability to identify cases of financial distress accurately, and to do that, one needs to grasp how exactly municipal debt is apt to discourage investment. The propensity for underinvestment has a public and a private side, and I take these in order.

1. Public underinvestment.

The place to start is with the proposition that large municipal debts discourage public investment in valuable infrastructure. It is because a city faces so much debt, the thought goes, that it skimps on cost-justified expenditures on transit and police and the like—penny-wise savings that are pound-foolish because underinvestment erodes spatial economies. This, at any rate, is an effect municipal bankruptcy could in principle ameliorate.

Why should debt have such an effect? The general mechanism is given by what the corporate finance literatures calls "debt overhang." Debt overhang describes a condition in which an entity's existing obligations blunt investors' willingness to contribute new capital to finance new investment.[107] This can cause it to fail to exploit even opportunities that all investors expect to be socially valuable. Speaking generally, is a consequence of the fact that existing creditors have first dibs on cash flows. Junior investors, because they do not fully internalize the creditors' interests, are disinclined to fund the gamble.

To illustrate, start with a simple example in the corporate setting. Suppose that Acme Corporation is deciding whether to raise capital for a new investment. The project costs 80 today and will pay out either 200 or nothing tomorrow, after which Acme's investors will settle their affairs. Success and failure of the project are equally likely.

If Acme has no debt, then its stockholders will expect the investment to make them better off by 20:

$$[0.5(200) + 0.5(0)] - 80 = 20.$$

[107] The identification of debt overhang is usually traced to Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J Fin Econ 147 (1977). Somewhat confusingly, the term has sometimes been used in the development economics literature to signify a related but different phenomenon. See, for example, Paul Krugman, *Financing vs. Forgiving a Debt Overhang*, 29 J Dev Econ 253, 254–55 (1988) (defining a country as having a debt overhang problem "when the expected present value of potential future resource transfers [to creditors] is less than its debt"). The conception in the corporate finance literature is broader than Krugman's conception, which applies only to scenarios in which a debtor is "balance-sheet" insolvent—that is, when in expectation the borrower will be unable to pay its debts in full. As I use the term, consistent with its use in corporate finance, debt overhang describes any case in which the fact of outstanding debt blunts investment incentives. A debtor need not be insolvent for its debt to have this effect. Consider Vincent S.J. Buccola, *Beyond Insolvency*, 62 U Kan L Rev 1 (2013) (discussing implications for law of recognizing solvency as a continuous rather than discrete variable).

Stockholders who are indifferent to risk will want to contribute the necessary capital because the project will, in expectation, generate revenues in excess of costs.

But if, on the other hand, Acme has debt, then its stockholders might wish to forgo the new investment. Suppose that Acme owes its creditors 50 at the time the new project is considered. If the project is undertaken and proves successful, the creditors will lay claim to 50 of the proceeds, leaving 150 for the stockholders. If the project is undertaken and proves unsuccessful, then, of course, the creditors and stockholders both take 0.[108] On this specification, Acme's stockholders will not wish to contribute the necessary capital because they expect the investment to make them worse off by 5:

$$[0.5(200 - 50) + 0.5(0)] - 80 = -5.$$

The project is socially valuable, but the stockholders, to the extent they are in control, will prevent the investment from being made.[109] More generally, debt overhang implies that risk-neutral stockholders will seek to invest in a new project only to the extent its expected value is positive *net of* the face value of the company's debts.[110] The bigger those debts are relative to the company's equity cushion, the more valuable investment opportunities the company is likely to pass up.

The translation of a corporate model of debt overhang to the municipal context is imperfect but important to effect because, in many relevant respects, firms and towns can be expected to behave similarly. After all, in both cases, the primary residual beneficiaries of successful investment elect officials to mediate relationships

[108] The stockholders in this example are assumed to have limited liability. If they were liable for Acme's debts, the debt overhang problem would disappear. This is because debt overhang arises from the fragmentation of investors' interests in the company's success. See Myers, 5 J Fin Econ at 156–57 (cited in note 107) (specifying limited liability as a property of the debt contracts underlying the basic model).

[109] Note that this is so only if Coasean bargaining is impossible. In an ideal world, the creditors would "bribe" the stockholders to undertake the project, perhaps in the form of partial debt relief, or would loan Acme funds to pursue the project. The project is worth 25 to the creditors in expectation. (If the project is undertaken, they have a 50 percent chance of receiving 50; if it is not undertaken, they have no chance of receiving anything.) A bargain between them and the stockholders would yield a surplus of 20—that is, the social value of the project.

[110] For the same reason, new debt financing is hard to come by unless it takes priority over existing debt. One function of bankruptcy is to relax the liquidity constraint associated with existing debt by authorizing new, priming loans subject to judicial approval. See 11 USC § 364. For discussion of the tradeoff associated with priming loans, see generally George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 Vand L Rev 901 (1993).

between and among themselves and the entity's lenders, employees, and other constituents. In the corporate case, stockholders bear the primary residual interest in activities overseen by the board of directors they choose because the value of equity depends on the profitability of corporate investment. In the municipal case, residents and (especially) landowners bear the primary residual interest in activities overseen by the mayor or council they elect because the value of local real estate depends on, among other things, the relationship between taxes and the municipal infrastructure they procure.[111] The value of operations is capitalized in equity securities in one case and in real estate in the other.[112] In both cases, those with a residual interest in operations will tend to support investments they believe are likely to enhance the value of what they have, even if they must "pay for" these investments, and will tend to disapprove investments whose costs they expect to exceed the benefits *to them*.[113]

This is just what is needed to produce debt overhang in the face of large entity-level debts. Because, under these conditions, creditors stand to capture a disproportionate share of the value of new investments, those who are junior to them in the pecking order may find it in their private interest not to fund even valuable new projects. In the corporate context, stockholders decline to contribute new capital to fund profitable projects. In the municipal context, residents and (especially) landowners decline to support taxes to develop or renew cost-justified infrastructure and

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[111] There are important differences between contexts, of course. Municipalities have no stockholders, and they don't typically return the profits from public investments to their taxpayers or residents. Indeed, one of the principal reasons for public investment is that the benefits of infrastructure are difficult to capture fully in market transactions. The costs and benefits of municipal investments are unevenly distributed both across geographic territory and among those who are able to influence municipal policy. The franchise is ascribed according to residency, even though landowners bear a disproportionate financial interest in the residual value of municipal investment. These differences mean that highly stylized models of the corporate setting appear to fit the municipality poorly. But the differences may be less important than one suspects. Stylized models are, after all, inaccurate in the corporate setting, too. In fact, stockholders do not necessarily benefit ratably from corporate action, and they certainly do not exert equal influence over policy. And while a wedge between residents and landowners can and probably does sometimes complicate the picture, available evidence suggests that landowners participate disproportionately in local politics. See generally, for example, Fischel, *The Homevoter Hypothesis* (cited in note 87).

[112] This is an approximate statement. All constituents can be expected to benefit to some extent from a growing surplus.

[113] This logic is most fully elaborated, in accessible terms, in Fischel, *The Homevoter Hypothesis* (cited in note 87).

other quasi-public goods. Debt overhang can thus lead to underinvestment in both contexts, at least in principle.

Scholars have long recognized a version of this insight, and some have sought to justify municipal bankruptcy partially in reference to it.[114] An important qualification to the analogy between stockholders and landowners needs to be made, however. Compared to stockholders, landowners have relatively strong private reasons to pay down entity-level debts, through special assessments if necessary, if they believe that those debts are likely to thwart efficient public investments.

To see why, recall that the basic model of corporate debt overhang is driven by stockholders' limited liability.[115] The stockholders have reason to forgo profitable new corporate investment opportunities only because they are not personally responsible for the company's debts.[116] If they were so responsible, they would fully internalize the harmful effect underinvestment has on the company's creditors. Put differently, it is just because stockholders' exposure to the consequences of poor corporate performance is truncated that they do not bear the full consequences of underinvestment.[117]

Landowners have limited liability, too, of course, in the sense that they are not held to personal account for a municipality's debts.[118] But landowners are financially exposed to poor municipal performance well apart from their responsibility for municipal debts. This is because their investment, real estate, is apt to have value independent of municipal behavior—it would have value even if the municipality were to vanish.[119] Unlike a stock, whose

114 McConnell and Picker were the first to identify something like debt overhang in the municipal context. They located a basis for bankruptcy in the "fresh start" policy, which could be useful because, as they put it, "the taxpayers of a city will cease to pay taxes if rates are too high and the citizens get none of the benefit." McConnell and Picker, 60 U Chi L Rev at 470 (cited in note 9).

115 See note 108.

116 See note 107 and accompanying text.

117 For the most thorough, recent discussion of stockholder limited liability, see generally Stephen M. Bainbridge and M. Todd Henderson, *Limited Liability: A Legal and Economic Analysis* (Edward Elgar 2016).

118 But see McConnell and Picker, 60 U Chi L Rev at 437 (cited in note 9) (discussing the New England rule, now outmoded, under which residents' property could be seized to make good on municipal debts).

119 For example, suppose that the efficient provider of drinking water to a particular parcel of real estate is the municipality. If the municipality provides the water, the parcel is worth 100. This does not mean the value goes to zero if the municipality ceases to provide water. Instead the property owner is likely to switch to a second-best method of getting water—drilling a well, say, or arranging for periodic delivery from a tanker. The parcel's value drops to 90, say, not to 0. To be sure, real estate values may approach zero in cases of extreme economic distress. Tales of nearly free real estate are common in such cases.

worth is wholly derivative of the issuer's financial condition, a parcel of land may be desirable for its natural beauty, for the use-value of improvements built on it, or for other reasons. Landowners' downside in case of municipal economic distress is apt to be extensive, and consequently they have an incentive to see public debts paid down if doing so can be expected to spur cost-justified public investment.[120] At first approximation, then, even large municipal debts should not be expected to produce public underinvestment.

This qualification suggests that, when municipal debt overhang becomes a practical problem that bankruptcy could usefully address, it is likely to be accompanied by some other economic or political pathology, or a combination of multiple.[121] There are a number of possible explanations. One kind of explanation looks to facts about a municipality's residents and especially its landowners; another looks to sources of political dysfunction. The following are four important species of political friction:

*a) Liquidity constraints*. A municipality's taxpayers and landowners may be liquidity constrained. They may see that paying down municipal debts would be wise, because new public investments would be valuable, yet lack the funds to do so. This kind of explanation is most plausible in times of macroeconomic stress, especially when, as in the Great Depression, liquidity constraints are coupled with deflation. Between 1930 and 1932, the dollar deflated by approximately 30 percent.[122] Because bonds

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See, for example, Drew Philp, *Why I Bought a House in Detroit for $500* (BuzzFeed, Jan 9, 2014), archived at http://perma.cc/JH5E-B7F3. This just means that landowners' downside exposure to municipal performance is extensive but not unlimited.

[120] This is just a way of saying that landowners ought to be, and generally are, willing to pay taxes, the proceeds of which will be used to invest in infrastructure that, in turn, will increase the land values. See generally Fischel, *The Homevoter Hypothesis* (cited in note 87). Theory coincides with a sizeable empirical literature that suggests more is capitalized than casual observers would probably suspect. For example, there is evidence that expected rent-seeking by public-sector unions is capitalized in real estate. See generally Gyourko and Tracy, 19 Regional Sci & Urban Econ 493 (cited in note 93). On the other hand, there is some evidence that unfunded pension obligations are not fully capitalized. See Dennis Epple and Katherine Schipper, *Municipal Pension Funding: A Theory and Some Evidence*, 37 Pub Choice 141, 147–51 (1981). See also generally Robert P. Inman, *Public Employee Pensions and the Local Labor Budget*, 19 J Pub Econ 49 (1982).

[121] Moreover, municipal residents and landowners might be able to finance efficient investment with revenue bonds or by having a "special purpose entity" chartered even if the municipality's general obligations are swollen. See also Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 Cornell L Rev 1399, 1433–38 (2012) (making a similar point with respect to state rather than municipal governments).

[122] See Stephen G. Cecchetti, *Prices during the Great Depression: Was the Deflation of 1930–1932 Really Unanticipated?*, 82 Am Econ Rev 141, 141 (1992).

were written in nominal terms, municipal debts jumped proportionally in real terms. This effect, combined with the general reduction in output, meant that many debts simply could not be paid.[123] And this notwithstanding whatever residents might have thought about the merits of infrastructure investment.[124]

*b) Leveraged ownership.* Landowners in a municipality might have leveraged positions in their real estate. Concretely, much of the value of their property might be mortgaged to a lender so that the owner herself has little equity in the land. This is not the same as saying the land has little value, as in the case of an economically distressed location. The land could be valuable, but if much of the claim to that value is mortgaged, then titleholders, who hold the immediate political influence, face relatively little downside to municipal dysfunction and so can be expected to behave like stockholders under conditions of debt overhang.

*c) Legal barriers to taxation.* State law might make raising taxes difficult or impossible and so prevent a municipality's residents and landowners from paying down public debts efficiently. California's Proposition 13 is only the most well-known friction of this kind.[125] That constitutional amendment limited the rate at which property in the state could be taxed,[126] with certain exceptions, as well as the rate at which the assessed value of such property could increase.[127] California law permits municipalities to levy other kinds of taxes and special assessments with voter (often supermajority) approval,[128] and these could be used as imperfect substitutes for a tax on real estate. But because landowners are the primary residual beneficiaries of municipal investment, it is they who have the greatest interest in resolving excessive public debts. More generally, legal barriers to a municipality's raising revenue magnify the significance of its debt.

[123] See id. And these two phenomena appear to go together. See Irving Fisher, *The Debt-Deflation Theory of Great Depressions*, 1 Econometrica 337, 342 (1933).

[124] The first municipal bankruptcy law was enacted in 1934. Act of May 24, 1934, 48 Stat 798. When it was introduced in Congress, the case made for it was precisely this prototypical scenario. See generally *Amend the Bankruptcy Act—Municipal Indebtedness*, HR Rep No 207, 73d Cong, 1st Sess 1 (1933).

[125] See Cal Const Art XIII A (codifying Proposition 13).

[126] Cal Const Art XIII A, § 1(a) ("The maximum amount of any ad valorem tax on real property shall not exceed One percent (1%) of the full cash value of such property. The one percent (1%) tax to be collected by the counties and apportioned according to law to the districts within the counties.").

[127] Cal Const Art XIII A, § 2(b) (allowing assessed values to increase at a capped annual inflationary rate).

[128] See, for example, Cal Const Art XIII A, § 4 ("Cities, Counties and special districts, by a two-thirds vote of the qualified electors of such district, may impose special taxes on such district.").

*d) Political barriers to taxation.* The vicissitudes of electoral politics might prevent excessive debts from being paid down even when no legal barrier outright prohibits efficient taxation. Municipal voters are not a homogeneous bloc. They do not share equally from the gains associated with efficient investment; they do not share equally in the costs associated with paying for investment; some may lose coming and going. The central lesson of coalition formation is that multiple equilibria are possible. Moreover, some systems of municipal government are more apt than others to produce inefficient budget practices.[129]

2. Private underinvestment.

Spatial economies are sustained not only by the public or quasi-public goods traditionally provided by the public sector, such as roads and police, but also by goods traditionally provided by the private sector. Improvements to real estate—residential, commercial, industrial—are the most important examples.[130] If large public debts discourage private investment, whether by incumbent residents or prospective new entrants, as well as public investment, this effect would be an important feature of municipal financial distress. And there is reason to think public debts can have just such an effect, especially on relatively fixed investments. Two channels are apparent:

*a) Fear of debt overhang.* The first is a derivative of the problem just discussed—namely public underinvestment. Suppose our friend Acme Corporation is deciding where to locate a new headquarters. It must choose between two municipalities, Springfield and Shady Grove, identical in every respect but one: Springfield has large debts; Shady Grove has none. Where will Acme choose to invest?

At first approximation, Acme should be indifferent. The expectation of future tax burdens in Springfield ought to be higher because the town's expected future revenue needs will be higher; and this fact ought to make the purchase price of land in Springfield

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[129] See generally Clayton P. Gillette, *Can Municipal Political Structure Improve Fiscal Performance?*, 33 Rev Bank & Fin L 571 (2014); Gillette, 114 Colum L Rev 1373 (cited in note 59).

[130] Private investment is also an (imperfect) substitute for public investment. This is true both because the private sector can provide public and quasi-public goods, even if less efficiently than government, and also because private goods are partial substitutes for public and quasi-public goods. For example, my well-tended garden is an imperfect substitute for a well-tended but much larger public park.

cheaper than an identical parcel in Shady Grove by an amount equal to the present value of the difference in expected future taxes. But as we have seen, first approximations might be misleading. Frictions might exist such that Springfield's debt overhang in fact leads to public underinvestment in valuable infrastructure. Springfield's roads or schools or water quality might deteriorate relative to Shady Grove's. Shady Grove's spatial economies might in turn come to dominate Springfield's.

This future is uncertain, of course. But uncertainty augurs in favor of Shady Grove. One might expect the price of real estate in Springfield to reflect the greater risk associated with its fortunes and so be correspondingly cheaper than it otherwise would be, restoring parity. And indeed uncertainty might be capitalized in land prices to some extent. But uncertainty discourages relatively fixed investments, like physical plant, more than it does relatively mobile investments for the (definitional) reason that mobile investments can be repurposed if, in the future, an unfavorable state of the world is realized. To illustrate, suppose the property Acme is considering is a large warehouse complex. Acme's plan is to refit the complex into state of the art office space at a cost of millions of dollars. An alternative potential buyer, Logistics Incorporated, would use the existing structures as a shipping depot. It would house millions of dollars of merchandise there at any given time, all of which could be loaded into trucks on short notice. Even if office space is the more valuable use of the land, *on average*, Logistics may be the high bidder under uncertainty because it can simply reroute its shipments if municipal conditions become dire. If things turn south, Logistics will lose only the warehouses' purchase price; Acme will lose that plus the millions of dollars in renovation costs it must also spend. Uncertainty costs Acme more because its proposed investment is relatively fixed. In this way, large public debts can be expected to discourage valuable *fixed* private investments in particular.[131]

[131] The underinvestment in this example, and indeed the underinvestment that follows debt overhang more generally, can be understood as a consequence of Tieboutian sorting. See generally Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J Polit Econ 416 (1956). Residents' exposure to municipal debt is a legal phenomenon, a policy dimension according to which mobile capital providers can be expected to sort themselves. In the hypothetical, Logistics is less sensitive than Acme to municipal debt and so locates where the debt is bigger—even though this location choice might fail to fully exploit spatial economies. Professor Schleicher has shown that policy-based sorting *in general* can undermine agglomeration economies. See generally David Schleicher, *The City as a Law and Economic Subject*, 2010 U Ill L Rev 1507. See also generally David Schleicher, *City Unplanning*, 122 Yale L J 1670 (2013) (showing how zoning rules in particular can undermine agglomeration economies). Debt can thus be understood as a special case of a more

*b) Fear of discrimination.* Large public debts might alternatively discourage the most valuable private investments by inducing fear of discriminatory treatment. If Springfield must pay down a large debt, it might need to increase revenues. This it can do most effectively by taxing the owners of immobile capital disproportionately. Fixed investments are easier to tax because, by definition, they are less prone to flight from the jurisdiction in case of a rate increase.[132] Projecting that endgame, potential investors of relatively fixed capital, like Acme, might prefer less indebted locations. The result is that local real estate systematically stays in the hands of less productive enterprises.

If these channels of private underinvestment seem abstract, consider the location choice Amazon faced for its so-called "HQ2." The $5 billion the company plans to spend building a new campus[133]—or two—is a highly immobile investment. It follows that Amazon needed to evaluate not only the geographic attributes of potential locations, their spatial economies, but also what it calls "[a] stable and business-friendly environment and tax structure."[134] Places that are too heavily indebted risk being unable to promise stability and so become unattractive sites for investment. Amazon's prospective investment is unusually big, but the basic mechanism affects the location choices of individuals and smaller businesses as well.

* * *

Where, then, do we stand? When a municipality such as Springfield faces large debts, these debts can discourage investment and so lead over time to the dissipation of the qualities that make the place productive. In such cases, stagnation and decline represent a wasted opportunity for municipal constituents as a group—including sometimes for creditors.[135] It follows that mu-

general phenomenon, in which a place's geographic and legal characteristics trade off against one another in parties' location calculus.

132 An immense literature considers the relationship between capital mobility and fiscal policy. For an introduction to the problem in the municipal context, see generally Richard C. Schragger, *Mobile Capital, Local Economic Regulation, and the Democratic City*, 123 Harv L Rev 482 (2009).

133 See *Amazon Announces Candidates for HQ2* (Business Wire, Jan 18, 2018), archived at http://perma.cc/PD7J-H84X.

134 *Amazon HQ2 RFP* *5 (Amazon), archived at http://perma.cc/5W6X-635V.

135 Consider in this regard the numerical example of debt overhang provided above in Part II.D.1. See also Part III.A.

nicipal constituents could, in principle, bargain around debt's pernicious effects. But for familiar reasons, coordination is difficult and frequently impossible. This is when bankruptcy in its ideal form would intervene to write down claims against the municipality—when debt threatens investment, long before spatial economies are so eroded that servicing debt in the near term is impossible. The real world is not ideal, however, and it remains to be considered how the law might nevertheless be useful.

## III. CHAPTER 9 RECONSIDERED

If municipal bankruptcy is to be more than an unpredictable, ad hoc, and expensive to deliver subsidy mechanism, it needs to target the debt of local governments in financial, not economic, distress. To date, however, the general purpose cities and towns that have entered Chapter 9 have been economically distressed.[136] In her study of the twenty-eight local governments that entered bankruptcy or receivership between 2008 and 2013, Professor Michelle Wilde Anderson finds that widespread poverty was a consistent theme.[137] The bankruptcies also tended to follow significant depopulation.[138] Thus, Anderson reports that half of the cities and towns she studied had more than a quarter fewer residents than they had fifty years earlier.[139] Because depopulation typically lags behind large negative productivity shocks,[140] these data paint a bleak picture of the economic viability of the general purpose municipalities that enter Chapter 9 (at least on a familiar scale of operations). As things stand, then, we can conclude that intervention comes only after debt has metastasized and, along with other factors, caused economic dysfunction. The rub is

[136] Most Chapter 9 cases, by number although not by social importance, involve "special purpose" instrumentalities and taxing districts. See note 17 and accompanying text. These present different considerations. They frequently resemble the commercial firms that file under Chapter 11 more than they do general purpose municipalities. Indeed, it is sometimes hard to tell whether such a debtor is better classified as a business or a municipal entity. Compare *In re Las Vegas Monorail Co*, 429 Bankr Rptr 770, 795–800 (Bankr D Nev 2010) (holding that, although debtor's bonds were tax exempt, debtor did not possess characteristics of municipality for Chapter 9 eligibility), with *In re New York City Off-Track Betting Corp*, 427 Bankr Rptr 256, 265–66 (Bankr SDNY 2010) (holding that debtor, a public benefit corporation, was a municipality for Chapter 9 eligibility). Chapter 9 may work reasonably well for most special purpose debtors.

[137] See Anderson, 123 Yale L J at 1124–26 (cited in note 63) (reporting the results of a study of municipalities with populations above fifteen thousand that entered bankruptcy or receivership between 2008 and 2013).

[138] See id.

[139] Id at 1137–38.

[140] See Glaeser and Gyourko, 113 J Polit Econ at 346–47 (cited in note 98). See also notes 98–101 and accompanying text.

that, by the time a city has become unable to deliver basic services, such as law enforcement and sanitation, its density economies are likely to have dissipated. Mobile people and capital will have left for greener pastures, and they may have no reason to return. Debt relief must come sooner to be effective.

At the same time, the case for liberal municipal debt relief is not straightforward. One needs to reckon with the costs and benefits a more liberal regime would likely entail and trade them off against one another. This is not a simple task. A change in the availability of debt relief is of course likely to affect borrowing costs for municipalities going forward. But one cannot even say a priori what directional effect it is likely to have. If, for example, the law were to permit a debtor to cancel debts at will for good reason, bad reason, or no reason at all, lenders would understandably become slower to lend. Compared to a world in which debt relief is unavailable, a rule of unilateral jubilee could be expected to depress the likelihood of full repayment and, consequently, lenders would need to charge higher interest rates, or deny credit to more borrowers, or both to compensate. But debt relief rules can also *increase* creditors' expected recoveries compared to a world in which debt relief is unavailable and so make municipal borrowing a cheaper prospect.

The wisdom of a particular bankruptcy regime depends on its real-world capacity to distinguish cases. The remainder of this Part addresses this difficulty. It begins by setting out in general terms the costs and benefits debt relief can entail under real-world conditions—that is, when facts about the debtor's prospects cannot be established with certainty. I then argue that modern patterns of municipal finance and operations, which in terms of complexity dwarf those of the era when Congress first established municipal bankruptcy, have heightened both the risks and potential benefits associated with more liberal debt relief. Finally, I outline some concrete changes to the law that could be expected to hasten debt relief and so help municipal bankruptcy better achieve its aim. These I offer not as uniquely optimal rule changes but in the spirit of suggestion, as a spur to further thought and analysis.

### A. The Prospect of Debt Relief: General Considerations

A debt relief rule can manifest in three basic ways:

First, debt relief can act as a simple wealth transfer from creditor to debtor, reducing creditors' expected recoveries without

much improving investment incentives (Scenario 1). This is easy to imagine. It is what debtors try to accomplish when they make fraudulent transfers, and, from the economic perspective, it is lose-lose relative to a world in which debt relief is unavailable. It increases the cost of capital ex ante and does nothing to improve investment incentives ex post.

Second, debt relief can improve investment incentives and increase creditors' expected recoveries (Scenario 2). This scenario is less intuitively obvious but follows from the possibility of debt overhang. To illustrate, let us return to Acme Corporation and the project it considered and rejected above.[141] To refresh: Acme faced an investment opportunity that would cost its stockholders 80 today and would pay out either 200 or 0, with equal likelihood, tomorrow. Because Acme owed its creditors 50, the project had a negative expected value *for the stockholders*, and they declined to contribute the needed capital:

$$[0.5(200 - 50) + 0.5(0)] - 80 = -5.$$

The creditors in this scenario recovered nothing (and there was no investment).

But now suppose bankruptcy were to intervene and write down three-fifths of Acme's debts. Acme now owes its creditors only 20, and the stockholders will find the investment profitable:

$$[0.5(200 - 20) + 0.5(0)] - 80 = 10.$$

The creditors are better off for having had their debts written down. Because the stockholders have been induced to invest, the creditors now have a 50 percent chance of recovering 20 instead of a 100 percent chance of recovering nothing.

This kind of debt relief is win-win relative to a world in which debt relief is unavailable. It reduces borrowing costs ex ante and encourages efficient investment decisions ex post.[142] An example of this kind of adjustment can be found in the facts of an important case from the Great Depression, *Faitoute Iron & Steel Co v City of Asbury Park*.[143] In the 1920s, Asbury Park borrowed extensively to fund improvements to its boardwalk. The Depression led the city to default. Under New Jersey law at the time, the

141 See Part II.D.1.

142 Notice that in this hypothetical a range of levels of debt relief will induce the efficient investment. The investment will be made as long as Acme's debt is less than 40. From the economic point of view, the distribution of the surplus achieved by making the efficient investment is immaterial. But the allocation of more or less of the surplus to the creditors will affect borrowing costs.

143 316 US 502 (1942).

state's supreme court was permitted to effect a composition of municipal debts if 85 percent of the bondholders (by value) consented. The court did just that after Asbury Park procured the requisite consents, and the Supreme Court of the United States affirmed the decree over dissenting bondholders' Contract Clause objections.[144] The justices leaned heavily on the fact that a supermajority of bondholders had accepted the restructuring, their acquiescence being evidence that investors could not realistically have hoped for more absent the adjustment.[145] Reducing the bonds' nominal value had, the Court observed, increased their market value.

Third, debt relief can improve investment incentives but reduce (at least some) creditors' expected recoveries (Scenario 3). This can occur if creditors are unable to reach the fruits of the investments that debt relief encourages due to contracting or other frictions. Suppose, for example, a debtor has cash flows sufficient to pay near-term obligations in full but only at the expense of investments that will yield benefits in the long term. Even a modest haircut to the short-term creditor will reduce her recovery. Yet that might be just what is needed to induce valuable investments that could forestall municipal decline. It may be theoretically possible but practically unworkable to compensate the frustrated creditor with a long-dated, zero-coupon claim. Debt relief in this scenario can be lose-win. It can increase borrowing costs ex ante—but efficiently so, in the sense that the higher cost of capital may preserve a valuable option to default ex post.

In an ideal world, bankruptcy would provide relief in cases resembling Scenario 2, and perhaps Scenario 3, but not Scenario 1. In the real world, however, sorting cases may not be so easy. It is one thing to draw up hypotheticals that stipulate the range of possible investments, the probability distributions of payouts of those investments, and unanimous opinion about the same. It is quite another to discover these facts in the real world, where much is unknown and the parties may have private reasons to hide or mislead about the rest. The basic difficulty of a more liberal municipal debt relief regime is the prospect of strategic filings, by which I mean the invocation of bankruptcy machinery to effect a wealth transfer (Scenario 1) rather than to resolve financial distress (Scenarios 2 or 3). Strategic filings are at heart a

[144] See id at 515–16.

[145] Congress quickly abrogated the decision, leaving federal law as the sole means to effect a composition of municipal debt. See 11 USC § 903.

problem of limited information. The practical utility of more liberal municipal bankruptcy law will depend on bankruptcy's capacity to weed out cases of strategic default or, put differently, to accurately identify cases of bona fide financial distress.

## B. Municipal Capital Structures and the Design of Chapter 9

When Congress introduced municipal bankruptcy for the first time, at the height of the Great Depression, the law was well calibrated to distinguish cases of bona fide financial distress from those of opportunistic default.[146] The law's primary target was the debt of a vast number of improvement districts—special purpose municipalities incorporated to build agricultural and other infrastructure—hobbled by the macroeconomic downturn and especially the collapse of commodity prices.[147] These districts usually had simple capital structures. They were financed primarily by unsecured bonds, the principal and interest on which were to be paid out of the surplus property tax revenues the infrastructural improvements were expected to generate as a matter of course. This meant that creditors would face a straightforward calculation in the event of a proposed debt composition. Was the debtor

[146] The first municipal bankruptcy law was enacted in 1934. Act of May 24, 1934, 48 Stat 798. The Supreme Court held the law unconstitutional two years later. *Ashton v Cameron County Water Improvement District No 1*, 298 US 513, 530–32 (1936). Congress quickly responded with a new law nearly identical to the first. Act of Aug 16, 1937, 50 Stat 653 (1937 Act). This time the Court upheld the law's constitutionality. See *United States v Bekins*, 304 US 27, 51 (1938).

[147] Municipalities of every description were included in the law's ambit, but the agricultural sector, hard hit by declining commodity prices, was the impetus. The 1937 Act's enumeration of the subjects of its protection is telling. The law extended to the composition of debt of:

> (1) Drainage, drainage and levee, levee, levee and drainage, reclamation, water, irrigation, or other similar districts commonly designated as agricultural improvement districts or local improvement districts, organized or created for the purpose of constructing, improving, maintaining, and operating certain improvements or projects devoted chiefly to the improvement of lands therein for agricultural purposes; or (2) local improvement districts such as sewer, paving, sanitary, or other similar districts, organized or created for the purposes designated by their respective names; or (3) local improvement districts such as road, highway, or other similar districts, organized or created for the purpose of grading, paving, or otherwise improving public streets, roads, or highways; or (4) public-school districts or public-school authorities organized or created for the purpose of constructing, maintaining, and operating public schools or public-school facilities; or (5) local improvement districts such as port, navigation, or other similar districts, organized or created for the purpose of constructing , improving, maintaining, or operating ports and port facilities; or (6) any city, town, village, borough, township, or other municipality.

1937 Act § 81, 50 Stat at 654.

trying to default opportunistically, or was there a genuine debt overhang problem? Scenario 1 or Scenario 2? Individual creditors might reach different conclusions, but the question posed was itself uncomplicated. And because creditors typically shared a financial interest, the law could sensibly overcome holdout problems by binding all to a supermajority vote.

Cameron County Water Improvement District Number One, the subject of the first constitutional challenge to municipal bankruptcy legislation,[148] was for most of the last eighty years also the paradigmatic municipal debtor. In the late nineteenth century, the economy around Brownsville, Texas, depended principally on ranching and trade (especially as a point of departure for smuggling operations into Mexico). In 1904, however, the St. Louis, Brownsville, and Mexico Railway connected Cameron County with parts north and encouraged farmers from the Midwest to settle the region. (Cameron County's population quintupled between 1900 and 1930.[149]) The Texas legislature incorporated the district to accommodate the migration, as a vehicle to finance the irrigation of more than forty thousand acres previously suitable only for cattle.[150] To raise funds for a canal system, the district sold two issues of 6 percent bonds with face value of approximately $800,000 in total.[151] Irrigation would allow ranchlands to be turned to more profitable uses, especially to the production of citrus fruits and cotton. Landowners would then use (some of) their newfound productivity to pay down the bonds. But the Depression frustrated plans. Commodity prices plummeted, and local farmers found it difficult or impossible to pay their taxes. Many preferred to surrender their land outright rather than work it for the benefit of bondholders, and the district defaulted and sought a reprieve.[152]

The question for the district's bondholders, as for the creditors of so many special districts, was what to do. Were they better off writing down some of the debt in the hope that doing so would encourage local farmers to stay and work the land? Or should they continue to demand full payment and hope that the economy would turn around or that the farmers were bluffing? The law

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[148] See generally *Ashton*, 298 US 513.

[149] See Alicia A. Garza and Christopher Long, *Cameron County* (Texas State Historical Association, June 12, 2010) archived at http://perma.cc/F2QG-9SMP.

[150] *Ashton*, 298 US at 523, 527; id at 533 (Cardozo dissenting).

[151] Id at 523, 527.

[152] See id at 533 (Cardozo dissenting).

encouraged resolutions to questions like this in two ways. It mandated, first, that all of a municipality's general unsecured creditors receive equal treatment under a plan of composition and, second, that the creditors vote together as a single class on the plan's advisability.[153] Because all general unsecured creditors would be treated alike, there was no use in anyone trying to jockey for special treatment by threatening to scuttle a sensible plan. Moreover, facts on the ground were relatively easy to observe. Tax delinquencies and foreclosures, to say nothing of prevailing agricultural prices, were matters of public record, and creditors could plausibly be charged with reaching a judgment about the significance of these facts for the outlook on their bonds. In short, in the setting for which municipal bankruptcy was initially designed, the law likely did a good job identifying cases of debt overhang and distinguishing them from cases of opportunistic default.

Much in the landscape has changed, and the changes suggest both (i) that distinguishing strategic filings from filings designed to relieve debt overhang may be more difficult than it once was and also (ii) that Scenario 3 cases have become much more plausible. Circumstances today furnish a stronger case for the efficiency of municipal debt relief even when some, and perhaps even a large fraction of, creditors correctly anticipate that debt relief will harm *them*. The risk associated with a more forgiving municipal bankruptcy law is thus likely greater than it once was, but the social reward from such a law is also likely much greater.

Part of the change is traceable to the simple fact that general purpose towns, cities, and counties, some quite large, now access bankruptcy as well as special purpose districts. This first became conceivable in 1976. Before then, a municipality could not even file a petition until it had lined up support from the holders of 51 percent of all securities to be affected by a composition.[154] This

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[153] 1937 Act § 83(b), 50 Stat at 656:

> [T]he judge shall classify [a debtor's] creditors according to the nature of their respective claims and interests: *Provided, however*, That the holders of all claims, regardless of the manner in which they are evidenced, which are payable without preference out of funds derived from the same source or sources shall be of one class.

In cases with a capital structure like the district's, a simple two-thirds vote of all creditors was sufficient to accept a composition (subject to judicial discretion). 1937 Act § 83(d), 50 Stat at 657.

[154] See 1937 Act § 83(a), 50 Stat at 655–56. The 1976 amendments permitted a municipality to file if it had made a good faith attempt to negotiate with creditors holding 51 percent of affected claims *or* if "such negotiation [was] impracticable." Act of Apr 8, 1976 § 84, Pub L No 94-260, 90 Stat 315, 317, codified as amended at 11 USC § 109(c).

requirement alone foreclosed the possibility of bankruptcy for all but the most rudimentary general purpose municipalities. But whatever the theoretical possibility, bankruptcy remained the province of special districts until Bridgeport tried and Orange County succeeded in making a case in the 1990s.

The operational and financial complexity of the modern, general purpose municipality effectively guarantee genuine (as opposed to merely strategic) disagreement among investors about the municipality's affairs. A city's capital structure was always more complex than an irrigation district's. But the financing arrangements of even modestly sized municipalities have become increasingly fractured. A large share of most municipalities' obligations are owed not to financial creditors but to current and former employees (or their representatives), in the form of pension and healthcare obligations. Even limiting the picture to financial creditors, municipal capital structures have become far more complex than they once were. The full story is beyond the scope of this Article, but it is worth noting just some of the important developments: reliance on short-term credit markets; sale-leaseback transactions; derivative investments; certificates of participation; and revenue bonds (which support project finance without the need for incorporating a special purpose district).

The interests of these various claimants are apt to diverge in the event of a city's financial distress. Some constituents wear multiple hats. Municipal employees, for example, frequently are also residents and homeowners, and this complicates their aims *as creditors*. Even creditors who wear a single hat face differential prospects. Their contracts may promise payment at different times, from different pools of funds, with different interest rates, with different kinds of recourse, and subject to different conditions. A plan of adjustment need not treat these various creditors uniformly even if they enjoy equal formal priority.[155] (And a plan that does grant uniform treatment may be good for some creditors and bad for others.) Because this is true and known to be true, holdup reemerges as a real barrier to consensual debt restructuring. The key thing to see is that, in the modern setting, there are lots of ways for a negotiated debt relief plan to fail even when relief would increase total wealth. The Coasean bargain is simply difficult to broker. And this means there are potentially many

[155] For discussion of the significance of priority equality in Chapter 9, see David A. Skeel Jr, *The Empty Idea of "Equality of Creditors"*, 166 U Pa L Rev 699, 718–20 (2017); Hynes and Walt, 33 Rev Bank & Fin L at 635 (cited in note 54).

cases in which municipal decline could be nipped in the bud if the legal infrastructure were in place to facilitate debt adjustment.

The same factors make it difficult to know, however, whether a plea for debt relief is strategic. A third-party observer such as a judge can no longer, as in the past, infer much from the creditors' professed attitudes.[156] And the municipal setting is potentially rich soil for strategic gambits. This is because municipal bankruptcy lacks the notion of the "estate,"[157] an identifiable pool of resources to which creditors are entitled to look for satisfaction.[158] Instead, all is up for grabs, with the bankruptcy judge assigned the task of deciding whether a proposed debt adjustment is in creditors' "best interests."[159] Too easy a policy of debt relief risks licensing mere wealth transfers to the ultimate detriment of lenders and borrowers alike. Yet the risk of strategic municipal bankruptcy can easily be overstated. Strategic filing is not unique to the municipal context. Bankruptcy judges have been dealing with it in the consumer and corporate settings for a long time.[160] Experience with the basic dynamic probably means bankruptcy judges

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[156] But see Vincent S.J. Buccola, *The Janus Faces of Reorganization Law*, 44 J Corp L 1, 23–27 (2018) (setting out conditions under which bankruptcy judges can rationally infer facts about the efficiency of debtor conduct from creditors' professions).

[157] See 11 USC § 541.

[158] For an excellent discussion of the notable lack of recourse to property in municipal finance, and of the implications of such a regime for bankruptcy, see generally Juliet M. Moringiello, *Decision-Making and the Shaky Property Foundations of Municipal Bankruptcy Law*, 12 Brooklyn J Corp, Fin & Comm L 5 (2017).

[159] See Buccola, 38 Cardozo L Rev at 1318–22 (cited in note 30) (discussing "best interests" standard as it applies to Chapter 9). For the view that "best interests" has an ambiguous sense as applied to Chapter 9, see generally Baird, *Statutory Interpretation* (cited in note 2).

[160] In the consumer setting, for example, one thinks of the scandalous use of generous homestead exemptions in some cases before 2005. The debtor in these cases was able to pay her debts without compromising future earning potential, but she preferred not to pay and sought a discharge instead. The Bankruptcy Code allows individual debtors to exempt certain property from the bankruptcy estate, from which creditors are paid. 11 USC § 522(b). Depending on the contours of state law, debtors may choose between a slate of *federal* exemptions and a slate of *state* exemptions. 11 USC § 522(b)(3). Before 2005, some states offered a homestead exemption that allowed debtors to exempt an unlimited amount of equity in a home. A heavily indebted but solvent debtor could strategically invoke bankruptcy to write down debts while sheltering millions of dollars in a newly purchased Florida or Texas mansion. In 2005, Congress capped the homestead exemption for debtors whose homesteads were purchased shortly before bankruptcy. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 § 308, Pub L No 109-8, 119 Stat 23, codified as amended at 11 USC § 522. Fewer opportunities for strategic bankruptcy are available in the corporate setting because creditors are entitled to payment in full before equity investors retain value, 11 USC § 1129(b), but some opportunism persists. Consider, for example, lien stripping and similar practices that appropriate option value belonging to others outside bankruptcy.

are better at identifying it than many would suppose.[161] Moreover, people generally prefer to pay their debts. Even for strictly game theoretical reasons, repeat players in the capital markets are often best served paying their debts whether they feel obliged to or not.[162] A rough parallel to the sovereign debt markets is worth drawing. Sovereign borrowers can default without even needing to persuade a bankruptcy judge of the soundness of their reasons. Yet they default remarkably rarely.[163] Whether this empirical regularity is best explained by national honor or rational calculation is uncertain. But it is a regularity.

### C. Encouraging Earlier Debt Relief

Financial distress precedes economic distress. For some municipalities, the dissipation of spatial economies may occur swiftly and irreversibly. Consider a mill town after the local timber industry moves abroad. As soon as the mill shutters, proximity to it loses appeal. But for other municipalities, there may be a longer period of financial distress during which density economies are slowly eroded by chronic underinvestment. Take, for example, Chicago? Bankruptcy must intervene before economic distress takes root if it is to help resolve financial distress, and that means it may need to intervene before conditions on the ground look dire.

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[161] The court's handling of the bankruptcy of Boise County, Idaho, is exemplary. At the close of 2010, rural Boise County, population seven thousand, was tagged with a $4 million judgment on a suit brought under the Fair Housing Act. *In re Boise County*, 465 Bankr Rptr 156, 161 (Bankr D Idaho 2011). It soon filed a Chapter 9 petition seeking to write down all but $500,000 of the amount owed. Id at 166. (The Fair Housing Act judgment together with contested attorneys' fees represented fully three-quarters of the county's total debts. See id at 163–64.) The county's liquid assets were more than $2 million in excess of its debts, but it argued that it could not pay the judgment while continuing operations. Id at 169–70, 172–73. The court dug into the financials and came to a different conclusion, dismissing the case on the ground that the county could use warrants to cover the difference between its projected revenues and costs during the present fiscal year. Id at 174–75. The decision concerned solvency as the Bankruptcy Code currently defines it, of course, not the county's financial distress. But Chief Judge Terry L. Myers's conclusion seems to have rested on something like the view that the county's filing was strategic. See id at 179 ("In short, the County has not convinced the Court of legal impediments to the issuance of registered warrants, the creation of a warrant redemption fund, and the transfer, at the appropriate time under the statute, of the surplus moneys."). To pay the judgment, the county would have to assess its residents more than they would like and more than they were used to giving; but there was no reason to think the one-time charge would dissipate investment in the county.

[162] See Kordana, 83 Va L Rev at 1077 & n 204 (cited in note 58).

[163] See Michael Tomz and Mark L.J. Wright, *Empirical Research on Sovereign Debt and Default*, 5 Ann Rev Econ 247, 255–63 (2013).

The following suggestions are consequently directed at encouraging bankruptcy's use, so that unsustainable debts can be written down before they manifest in underinvestment, and at encouraging responsible parties to take advantage of those relaxed standards.

The principal obstacle to earlier municipal debt relief is the Bankruptcy Code's requirement that a Chapter 9 debtor be "insolvent" to seek relief.[164] Insolvency in this context is defined to mean the financial condition in which a municipality either is "generally not paying" or is "unable to pay its debts as they become due."[165] As I have explained, bankruptcy courts have plausibly read a temporal specification into the definition. If a municipality will run out of money within a fiscal year, it is insolvent. If, on the other hand, a municipality can scrape together enough liquidity to service its debts for another year, it is ineligible for Chapter 9.[166] This hard standard was perhaps relaxed modestly in the Stockton and Detroit cases, which introduced the notion of "service delivery insolvency."[167] If, the judges in these cases held, a municipality can service its debts in the near term only at the expense of basic municipal functions, such as providing sanitation and police and fire protection, then the municipality is "unable to pay its debts" within the Code's meaning. But this innovation, such as it is, just acknowledges that, at some point before operations have ceased entirely, a municipality will have eaten enough seed corn to merit relief.

In any case, the Code's definition of insolvency is too restrictive. It could be loosened or better yet discarded altogether. Individuals and businesses are eligible for bankruptcy relief without being insolvent, to say nothing of measuring their insolvency under the restrictive standard municipalities face, and bankruptcy works tolerably well for them.[168] The basic problem is that financial distress is likely to cause underinvestment long before a municipality runs out of property it can tax, services it can cut, or

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[164] 11 USC § 109(c)(3).

[165] 11 USC § 101(32)(C).

[166] See notes 27–31 and accompanying text.

[167] See *In re City of Stockton*, 493 Bankr Rptr 772, 789 (Bankr ED Cal 2013); *In re City of Detroit*, 504 Bankr Rptr 97, 169–70 (Bankr ED Mich 2013).

[168] Rather than condition eligibility on insolvency in these cases, the Code permits bankruptcy judges to dismiss petitions prosecuted in bad faith—that is, for a purpose other than resolving financial distress. See, for example, *In re Integrated Telecom Express, Inc*, 384 F3d 108, 118–20 (3d Cir 2004) (construing 11 USC § 1112(b)); *In re Myers*, 491 F3d 120, 125 (3d Cir 2007) (construing 11 USC § 1307(c)). A good faith requirement applies explicitly in Chapter 9. 11 USC § 921(c). Bankruptcy judges could use it rather than a solvency test to weed out cases prosecuted for reasons other than dealing with debt overhang.

franchises it can sell.[169] Debt relief must come sooner to be useful.[170] The insolvency requirement was meant to prevent strategic filings. It has achieved that end, but mainly by preventing meritorious filings, too, and so ensuring that municipal bankruptcy has a limited office. The insolvency requirement must be relaxed if Chapter 9 is to become a serious tool for addressing municipal financial distress.

Even if the insolvency requirement were repealed, municipal bankruptcy would be underused. Additional changes to the law are probably needed. This is because current law vests multiple people and institutions with effective veto power, the unilateral ability to block a filing or plan of adjustment if they believe the terms would be unfavorable to them or their constituents.[171] The most prominent "veto players" are municipal and state officials. A mayor or city council can decline to file a petition; a state legislature can cancel their ability to file; under the law of many states, the governor or another appointed official can also unilaterally block access to bankruptcy.[172] And the bankruptcy judge herself has ample discretion to prevent a debt adjustment she disfavors. The result is a regime in which bankruptcy can restructure municipal obligations only if each of multiple institutions agrees, after the fashion of legislation in a multicameral body.

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169 Privatization is a source of liquidity that can be tapped irrespective of its efficiency consequences. For an excellent discussion, see generally Julie A. Roin, *Privatization and the Sale of Tax Revenues*, 95 Minn L Rev 1965 (2011).

170 Sometimes, as I have noted, financial distress derives from a municipality's political failure to raise taxes rather than from the strict *inability* of its residents and landowners to pay down public debts. For this reason, debt relief can in principle involve the imposition of a tax as well as the reduction or restructuring of amounts owed. Some commentators think it might be wise policy to allow bankruptcy judges to impose taxes. See, for example, Gillette, *Fiscal Federalism*, 79 U Chi L Rev at 291–92, 326–29 (cited in note 58). And some think such a power would be constitutionally permissible. See generally, for example, Hunt, 34 Yale J Reg 391 (cited in note 58). On the latter issue I am not persuaded. The imposition of a tax has been traditionally understood as a legislative function. This is why creditors' remedy against a recalcitrant municipality has always been a writ of mandamus directing a competent official to impose a tax sufficient to pay the debt, *not* a decree imposing the tax directly. See McConnell and Picker, 60 U Chi L Rev at 445–50 (cited in note 9). And it is why the Supreme Court has repeatedly held that federal courts cannot appoint a receiver to take control of municipal affairs. See, for example, *Meriwether v Garrett*, 102 US 472, 520–21 (1880); *East St. Louis v Zebley*, 110 US 321, 324 (1884). But see *Supervisors v Rogers*, 74 US (7 Wall) 175, 180 (1868) (finding an exception when state law affirmatively permitted jilted creditor to seek appointment of a receiver in any court of competent jurisdiction).

171 See Buccola, 38 Cardozo L Rev at 1322–37 (cited in note 30) (identifying Chapter 9 veto players and discussing implications of their veto rights).

172 See id.

Would-be holdouts need persuade only one veto player of the righteousness of their cause to scuttle a deal that would be advantageous for municipal constituents as a group. On top of the prospect of capture, elected officials appear to be systematically unwilling even to acknowledge major fiscal problems, let alone to hasten a restructuring process that might end their political tenure.[173] Reducing the number of veto players is a worthy goal.[174]

To that end, two related innovations ought to be considered: introducing involuntary bankruptcy for municipalities and establishing bankruptcy-specific creditor priorities.[175] In combination, they could lead to timelier and in that sense more useful reckonings.

An involuntary mechanism would permit creditors to initiate bankruptcy, irrespective of what state or local officials might want, and to propose a plan of adjustment if the debtor is unable or unwilling to propose a viable plan itself. There are a number of ways such a mechanism might look, but the involuntary procedures already in place for reorganizing business debtors provide a useful model. The Bankruptcy Code allows creditors holding at least $10,000 of claims to put a debtor into Chapter 11.[176] Under current law, the bankruptcy judge is to issue an order for relief over the debtor's objection only if the debtor "is generally not paying [its] debts as such debts become due."[177] This limitation would need to be relaxed for municipal debtors. It is the same formulation that defines municipal insolvency, and we have just seen why it is too restrictive. A metric aimed at determining *future* ability to pay, such as a ratio between annual revenues and total outstanding debt, or a suite of such metrics, is more suitable for municipalities.

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173 See Julie A. Roin, *Retroactive Taxation, Unfunded Pensions, and Shadow Bankruptcies*, 102 Iowa L Rev 559, 560–61, 573–74 (2017).

174 In this sense, the legislation introduced in 2017 by then-Congressman John Conyers would move the law in exactly the wrong direction. See Protecting Employees and Retirees in Municipal Bankruptcies Act of 2017, HR 139, 115th Cong, 1st Sess, in 163 Cong Rec E4 (Jan 3, 2017) (giving union representatives veto power over plans of adjustment that modify collective bargaining agreements, and heightening evidentiary requirement for proof of municipal eligibility).

175 Some will think any proposal for involuntary municipal bankruptcy flatly illegal, and not for nothing. The Supreme Court held the first municipal bankruptcy statute unconstitutional, in a 1936 opinion never formally overruled, precisely because it asserted too much federal control over a state creation—and that was a *voluntary* bankruptcy law. See *Ashton*, 298 US at 530–32; note 146. My research, still in progress, suggests otherwise, and I plan to publish an argument that the Constitution permits an involuntary municipal bankruptcy law.

176 See 11 USC § 303(b)(1)–(2) (setting out criteria for involuntary cases under Chapters 7 and 11).

177 11 USC § 303(h)(1).

Once a case begins in earnest, whether voluntary or not, the recalcitrant debtor cannot win by sandbagging. A Chapter 11 debtor has the exclusive right to propose a plan of reorganization for 120 days.[178] After that, or earlier if the judge so orders,[179] any party in interest may propose a plan.[180] Creditor-sponsored plans are uncommon, but only because their prospect spurs managers to assert agenda control by proposing a viable plan first. The rules for plan confirmation are the same whether a case is voluntary or not. The aim of an involuntary proceeding is not to change substantive entitlements, only to force a reckoning. In particular, Chapter 9's criteria for plan confirmation needn't change to capture the benefits of an involuntary mechanism.

Involuntary business bankruptcies are exceedingly rare,[181] and one might be tempted to infer that involuntary processes are by nature useless. That would be wrong. The infrequency of involuntary business cases is a function of the background norms of creditor-debtor law. Business creditors, enjoying as they do relatively robust collection rights under state law, are usually happy to pursue their interests unilaterally rather than in a bankruptcy forum. Anticipating the practical effectiveness of individual creditors' remedial powers, the managers of distressed businesses are apt to file for relief themselves—if not to delay the inevitable, then at least to choose the time and place of reckoning. It stands to reason that an involuntary mechanism would be more prominent in the municipal context, precisely because creditors' collection rights under ordinary state law are so weak. In business cases, a generic creditor can usually maximize her personal recovery by unilaterally foreclosing, or suing, or threatening to do one or the other. But in municipal cases, a creditor's best hope might be to have *other* debts written down, thereby reducing the debtor's leverage and the competition for its scarce resources.

Which brings us to bankruptcy-specific priorities. An involuntary procedure can reduce municipal debt in a timely fashion only to the extent creditors—or at least a subset of them—are keen on the idea. Someone must invoke the process and drive the case. That may be unlikely given the uncertain priority scheme

178 11 USC § 1121(b).

179 11 USC § 1121(d)(1).

180 11 USC § 1121(c). See also 11 USC § 941 (permitting only the debtor to file a plan).

181 See Richard M. Hynes and Steven D. Walt, *Bankruptcy Bounties* *22 (University of Virginia School of Law, Law and Economics Paper Series 2018-15, Oct 30, 2018), archived at http://perma.cc/E8KB-HF5T.

now in place. In particular, an involuntary mechanism is unlikely to induce earlier filings in what above I call Scenario 3 cases—in which debt relief is expected to stimulate investment but to *decrease* creditor recoveries. Especially if creditors believe a bailout is possible if conditions deteriorate far enough, they may rationally prefer a wait-and-see strategy. Things could always turn around; and anyway someone else might be left holding the bag.

If Scenario 3 cases seem likely, a bankruptcy-specific priority scheme is worth considering. This would stratify categories of municipal debt in bankruptcy that are treated outside bankruptcy as having identical priority (for example, as general unsecured obligations).[182] The idea is to privilege certain creditors and so give them special reason to prefer the bankruptcy forum, to cause an involuntary petition to be filed or to lobby for a voluntary one. The standard economic wisdom objects to bankruptcy-specific priorities for just this reason: they give an incentive to those most advantaged by the special rules to jockey for bankruptcy administration.[183] But that would be precisely the aim of this intervention. It would induce those who do best under a bankruptcy reckoning to seek one before time dissipates too many local resources.[184]

A plausible priority rule might, for example, give pension claims priority over general obligation bonds.[185] The rule would provide that a plan of adjustment, to be confirmable over the objection of an impaired class, must wipe out general obligation

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[182] Bankruptcy-specific priorities are staples of the Bankruptcy Code. For example, the Code declares that the unsecured claims of people "engaged in the production or raising of grain" have priority over the unsecured claims of "governmental units" even though the two kinds of claims have identical status outside bankruptcy. Compare 11 USC § 507(a)(6)(A), with 11 USC § 507(a)(8).

[183] See, for example, Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U Chi L Rev 815, 817–18 (1987).

[184] A priority scheme might have the added benefits of reducing uncertainty and improving lender monitoring against fiscal irresponsibility and distress. See Buccola, 38 Cardozo L Rev at 1316–22 (cited in note 30) (arguing that uncertainty about creditors' substantive entitlements in Chapter 9 increases municipal borrowing costs ex ante); Clayton P. Gillette, *Bondholders and Financially Stressed Municipalities*, 39 Fordham Urban L J 639, 654–70 (2012) (arguing that municipal bondholders are superior monitors to residents of the municipality). But see Richard C. Schragger, *Citizens versus Bondholders*, 39 Fordham Urban L J 787, 789–93 (2012) (arguing that municipal bondholders are weak monitors).

[185] For normative arguments that bondholders ought to bear the risk of municipal default, see Gillette, 39 Fordham Urban L J at 654–70 (cited in note 183); Schragger, *Citizens versus Bondholders*, 39 Fordham Urban L J at 789–93 (cited in note 183).

bond debt before impairing pensions claims at all.[186] The rule's primary effect would be to ensure pensioners that their own claims will not be affected by an adjustment of the municipality's overall debt burden. Its secondary effect, but from the economic point of view the crucial one, would be to encourage pensioners to lobby for earlier bankruptcy. If in a given case reducing outstanding bond debt could be expected to stimulate local infrastructure investment (Scenarios 2 or 3), then pensioners would view themselves as better off for having caused a reckoning early, if only because the reckoning increases the chance they will encounter a solvent municipality in the future.[187] This result would, of course, affect the terms on which municipalities can sell bonds; but the prospect of Scenario 3—municipal financial distress, really—implies that higher borrowing costs might be preferable.

## CONCLUSION

The process of technological and cultural change implies that once-prosperous municipalities, like business firms, will sometimes go bust. Serious social dislocations can follow, as many people are unable or unwilling to adjust. Law may have a role to play in dampening the effect of such dislocations. Whether place-based subsidies or person-based supports make wiser policy is an open question. But in any case, one needs to reckon with reality. In a market economy, local decay is as inevitable as innovation. Some places will become unable to generate the wealth needed to pay for infrastructure and public goods that most Americans deem

[186] In principle, of course, the use of secured debt and the pledge of special revenues could undermine the effectiveness of a bankruptcy-specific priority scheme. But in practice, most municipalities have limited property that can be effectively encumbered.

[187] An alternative, bankruptcy-specific priority scheme would do the opposite and subordinate unfunded pension liabilities to general obligation debt. As Professor David Skeel has argued, such a rule might induce public employees to lobby for the full funding of their postemployment benefits, unwinding some of the agency problems associated with public-sector bargaining and, perhaps, encouraging more balanced government budgets. See, for example, David A. Skeel Jr, *States of Bankruptcy*, 79 U Chi L Rev 677, 692–93 (2012) (suggesting that the restructuring of pension obligations at the state level might have this salutary effect); David A. Skeel Jr, *Is Bankruptcy the Answer for Troubled Cities and States?*, 50 Houston L Rev 1063, 1073–74 (2013) (same). This alternative scheme suggests a possible downside to subordinating general obligation debt: an incremental disincentive for public employees to attend to the adequacy of pension funding. But in my view, the subordination of public-employee benefits, however theoretically satisfactory a strategy, is politically unthinkable ex post when push comes to shove—at least on a wide scale. And if that is true and known to be true (in other words, a matter of common knowledge), then the supposed incentive benefits of declaring ex ante that unfunded pension liabilities will be subordinated are likely to be illusory.

mandatory, and bankruptcy, which cannot change that fact, is an ill-fitting bandage.

What municipal bankruptcy can do, this Article has argued, is preserve natural and density economies that public debt, by discouraging investment, threatens to dissipate. Chapter 9, as it now stands, does little to accomplish this aim, however, because it fosters debt adjustment only after financial distress is likely to have metastasized into full-blown economic distress. To fulfill its economic function, bankruptcy needs to intervene long before a municipality finally has become unable to service its debts.