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THE WATERFALL OF TIERS: A RELOCATION COST-BASED THEORY OF MUNICIPAL INSOLVENCY AND A PROPOSAL FOR A NEW MUNICIPAL BANKRUPTCY REGIME

Jonah Peppiatt*

ABSTRACT

Existing chapter 9 literature has centered on the “non-liquidation assumption”—that municipal bankruptcy law exists to provide municipalities a “breathing spell” from creditors and disallows the liquidation of municipalities. This assumption rests on the notion that chapter 9 exists solely to help municipalities continue to provide essential public services. This approach runs contrary to the prevailing theory of corporate bankruptcy: that bankruptcy exists to resolve collection action problems among creditors and maximize social welfare. This Article contends that municipalities are contractual structures with significant similarities to corporations, and explicitly rejects the “non-liquidation assumption.” This Article further applies a modified theory of municipal bankruptcy and proposes a waterfall bidding alternative municipal bankruptcy regime that looks to promote an efficient market-based allocation of resources.

INTRODUCTION

The goal of this Article is to provide an alternative to chapter 9 of the United States Bankruptcy Code that is derived from a normative theory of municipal insolvency.¹ This Article begins with a rejection of a common assumption in the limited literature of municipal bankruptcy: that cities and towns should not be liquidated.² An urban economics account of cities provides that cities exist due to economies of scale and reductions in transaction costs that arise from firms locating in close proximity to one

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¹ “Municipality” is defined herein as cities, towns, and other non-state governing bodies—“municipality” is used in the dictionary sense, not as the term of art currently used for all potential chapter 9 debtors.

² See, e.g., Michael McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 490–91 (1993).

another.³ A city's provision of public goods, funded through a tax, maximizes these benefits.⁴ Thus, there is a theoretically competitive marketplace among cities for firm investment, and cities that do a poor job of providing public goods should naturally cease to exist. However, the market failure of relocation costs prevents this result. Because cities exist in a marketplace and share other characteristics with corporations, the insolvent corporation provides a useful analogue to the municipal debtor, and theories of municipal insolvency can borrow from the corporate literature to develop a municipal bankruptcy regime that maximizes social welfare.

Part I of this Article reviews the limited existing literature of municipal bankruptcy theory and examines the near-universal assumption that cities should not be liquidated, using economic accounts of cities and research on firm location decisions to reject this assumption. Part II analogizes the insolvent city to an insolvent corporation, summarizes the "Creditors' Bargain" theory of corporate bankruptcy, and explains how that theory should be applied and altered in the municipal context due to the market failure of firm relocation costs. Specifically, this Article sets forth a modified version of the Creditors' Bargain theory that suggests that while creditors are the rightful owners of the current assets of a city, they have no claim to future revenue streams. Part III presents a proposal for a new municipal insolvency regime that consists of two components: a liquidation auction for current municipal assets and a "tiered waterfall" iterative bidding process for third parties to provide ongoing services to the liquidated city. Part IV addresses certain evident questions and implications regarding the operation of the new regime.

I. THE NON-LIQUIDATION ASSUMPTION

A. Existing Municipal Bankruptcy Scholarship

The existing literature on municipal bankruptcy is limited, highly specialized, and examines chapter 9 mainly from a positive, rather than normative, viewpoint.⁵ A practice-based cadre of scholarly articles

³ See ARTHUR O'SULLIVAN, *URBAN ECONOMICS* 1–2 (8th ed. 2011).

⁴ See McConnell & Picker, *supra* note 2, at 488.

⁵ Areas of focus in the existing scholarship include: the effect of chapter 9 and decisions thereunder on collective bargaining agreements and pensions for city employees; state sovereign control over municipal bankruptcy filings and other eligibility requirements; and descriptions of decisions or trends in the filing landscape. See, e.g., Jeffrey B. Ellman & Daniel J. Merrett, *Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?*, 27 *EMORY BANKR. DEV. J.* 365 (2011) (discussing the use of

occasionally touches on the underlying purposes of municipal bankruptcy but often only from a historical perspective.⁶ Consequently, there is a single prevailing theory of municipal bankruptcy law: that chapter 9 exists to help municipalities provide essential public services in the face of financial distress while reckoning with creditors.⁷ To do this, chapter 9 provides debtor-cities a “breathing spell”—i.e., the opportunity to continue providing services while readjusting municipal debt.⁸ Creditors have few rights in this debtor-driven process.⁹ The “breathing spell” approach explicitly rejects the prevailing normative theory of corporate bankruptcy: that bankruptcy exists to resolve a collective action problem among creditors, the resolution of which reduces the cost of credit and maximizes social welfare.¹⁰ Instead, the extant theory of municipal bankruptcy is premised upon the assumption that “liquidation is not an option for a municipality,” and thus “the role of the market is not to put ‘unprofitable’ municipalities out of business.”¹¹

This Article rejects this “non-liquidation assumption.” An urban economics account explains that cities exist for the efficient provision of public goods and

chapter 9 as a tool for solving the municipal pension problem); Daniel J. Freyberg, *Municipal Bankruptcy and Express State Authorization to be a Chapter 9 Debtor: Current State Approaches to Municipal Insolvency and What Will States Do Now?*, 23 OHIO N.U. L. REV. 1001, 1003 (1997) (discussing the variety of approaches to state authorization of municipal bankruptcy filings); Eric W. Lam, *Municipal Bankruptcy: The Problem with Chapter 9 Eligibility—A Proposal to Amend 11 U.S.C. § 109(c)(2)*, 22 ARIZ. ST. L.J. 625 (1990); Rachael E. Schwartz, *This Way to Egress: Should Bridgeport’s Chapter 9 Filing Have Been Dismissed?*, 66 AM. BANKR. L.J. 103 (1992) (examining Connecticut’s successful attempt to block Bridgeport’s bankruptcy filing, the largest municipal filing through the late 2000s); Christopher Smith, *Provisions for Access to Chapter 9 Bankruptcy: Their Flaws and the Inadequacy of Past Reforms*, 14 BANKR. DEV. J. 497 (1997) (discussing the uncertain nature of the chapter 9 authorization landscape); Richard W. Trotter, *Running On Empty: Municipal Insolvency and Rejection of Collective Bargaining Agreements in Chapter 9 Bankruptcy*, 36 S. ILL. U. L.J. 45 (2011) (discussing the implications of the financial crisis for collective bargaining agreements in chapter 9).

⁶ See, e.g., Freyberg, *supra* note 5.

⁷ David L. Dubrow, *Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?*, 24 URB. LAW. 539, 546 (1992) (“The fundamental policy goal underlying municipal bankruptcy law is to provide a legal context for distressed municipalities to be able to address their financial problems in a manner which enables them to continue to provide essential public services rather than to collapse . . .”).

⁸ See, e.g., Nicholas B. Malito, *Municipal Bankruptcy: An Overview of Chapter 9 and a Critique of the “Specifically Authorized” and “Insolvent” Eligibility Requirements of 11 U.S.C.A. § 109(c)*, 17 J. BANKR. L. & PRAC., no. 2, July 2008 (“Chapter 9 provides [a] framework to obtain a breathing spell from creditors while continuing to provide public services to its residents.”).

⁹ See generally, McConnell & Picker, *supra* note 2, at 462–65.

¹⁰ See, e.g., Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199, 1203 (2005) [hereinafter Schwartz, *A Normative Theory*] (“Society thus should want an efficient bankruptcy system because lower interest rates increase the share of good state returns that firms can keep . . .”).

¹¹ Dubrow, *supra* note 7.

the establishment of a varied market for private goods.¹² It is quite reasonable, then, to consider the liquidation of cities that fail to produce these outcomes. With liquidation on the table, the application of theories of corporate bankruptcy to municipalities is appropriate.

This Article owes a debt to two previous works of scholarship, both of which provide detailed accounts of the purpose of chapter 9. In the first, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, Michael McConnell and Randal Picker considered the possibility that cities could be liquidated, based upon various theories of city development, including a theory of contract cities similar to the economic account given in the next section of this Article.¹³ While they do not commit to any particular theory of city formation, the authors highlighted potential normative purposes for municipal bankruptcy beyond giving the debtor-city a “breathing spell.”¹⁴ The second work, Omer Kimhi’s *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, provides a thorough account of the potential causes of municipal insolvency, including a local management agency cost approach that buttresses the argument that cities that fail do so due to poor project selection.¹⁵ Though Kimhi largely rejects this project-selection narrative, his detailed discussion of city agency costs is instructive.¹⁶

The municipal insolvency theory set forth in this Article is based upon an understanding of the marketplace for cities through accounts of the economic development of cities and the market for firm location, and specifically, the view that a municipality is a contractual structure with key similarities to a corporation. A municipality can be analogized to a corporation and examined under prevailing theories of corporate insolvency for purposes of establishing a normative municipal bankruptcy law that promotes wealth maximization.

¹² See Hesham M. Abdel-Rahman & Alex Anas, *Theories of Systems of Cities*, in 4 HANDBOOK REG’L & URB. ECON. 2295, 2300 (2004) (“The first model we present relies on a public good. This is funded collectively by [a tax] . . . [t]he second model is based on . . . demand for a variety of products . . .”).

¹³ See McConnell & Picker, *supra* note 2, at 487–94 (discussing and rejecting a theory of contract cities in the municipal bankruptcy context).

¹⁴ See generally *id.*

¹⁵ See generally Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351 (2010).

¹⁶ *Id.* at 376–80.

B. *An Economic Account of Cities*

The following account of cities explains why firms choose to locate in close proximity rather than at distance, how firms make location decisions, and how cities compete with one another for firm investment.¹⁷ This inquiry attempts to answer two questions: Why do cities exist? And, how do cities attract company investment? The answers to these questions suggest that some cities should be allowed to fail.

1. *Why Do Cities Exist?*

Cities exist for two reasons, both of which increase trade and maximize wealth: (1) economies of scale and (2) the reduction of transaction costs.¹⁸ Cities create economies of scale primarily through the concentration of people, equipment, and processes in a single location.¹⁹ These location advantages also reduce transactions costs.²⁰ By reducing transportation costs, communication costs, and other frictions present in a diffusely located market, cities make it easier to conduct business.²¹ For this reason, whole industries tend to cluster in cities, a phenomenon known as urban agglomeration.²²

Explanations of urban agglomeration are based on cities' ability to provide both public goods and access to a varied private goods market.²³ Cities provide public goods to resolve a collective action problem. For example, if several businesses would benefit equally from a road between them, but cannot work

¹⁷ Mario Polèse, *Five Principles of Urban Economics: Things We Know and Things We Don't*, CITY J., Winter 2013, http://www.city-journal.org/html/five-principles-urban-economics-13531.html?goback=gde_97473_member_225822603 (“[C]ities . . . face particularly fierce competition for mobile resources . . .”).

¹⁸ O’SULLIVAN, *supra* note 3, at 1. (“The two main forces identified by economists that lead to spatial concentration of jobs are scale economies and agglomeration economies. . . . Transportation costs also influence where a firm locates . . .”); *Why Cities Exist and How They Have Formed*, ECONPORT, <http://www.econport.org/content/handbook/Urbanecon/exist.html> (“For there to be a place with no cities, there must be . . . constant returns to scale in production . . . [and] exchange.”). An economy of scale exists when the cost of producing a good decreases with an increase in production volume. *Economies of Scale and Scope*, THE ECONOMIST (Oct. 20, 2008), <http://www.economist.com/node/12446567>. A classic example is Henry Ford’s assembly line, where each worker specializes in making one part of the car rather than having to work on several parts of the car. Not having to have workers with a broad array of skills makes labor cheaper, and specialization allows each worker to produce more in less time; as a result, the cost of producing each car goes down as the company produces more and more cars in a given time period. *Id.*

¹⁹ See O’SULLIVAN, *supra* note 3, at 4–5.

²⁰ See *id.* at 2.

²¹ See *id.* at 6, 10, 15.

²² See *id.* at 2.

²³ Abdel-Rahman & Anas, *supra* note 12. The latter is essentially a product of successful deployment of the former, so this Article will refer simply to the provision of public goods as the purpose of cities.

together, the road will not be built because no firm is willing to bear the expense of constructing it alone—all firms would prefer to “free ride” off of the investment of whichever firm takes the initiative. Instead, if the firms work together and agree to each pay an equal amount to get the road built, all are better off, and social welfare is maximized. The road is the public good, and the city is the mechanism through which the money gets collected and the road built. Public goods, such as property protection and infrastructure, also reduce transaction costs and decrease input costs for firms.²⁴ Thus, cities exist to allow firms to reap the benefits of agglomeration, including reduced transaction costs, through the provision of public goods.²⁵

2. *How Do Cities Attract Investment?*

Given these reasons for city formation, how does a firm decide where to locate? One paradigm for describing this market is the “location tournament,” in which “governments compete [using] tax [subsidies] and other short-run incentives.”²⁶ One empirical study conducted in the 1990s (in the international context) concludes that tax and other incentives, though influential, are unlikely to win out over long-run agglomeration advantages that are “sufficiently powerful” attractors of firms.²⁷ The study highlights “good infrastructure development, specialized input suppliers, and an expanding . . . market” as keys to winning the tournament through agglomeration benefits.²⁸ “Good infrastructure development” is a euphemism for useful public goods; “specialized input suppliers” reflect a varied private goods market.²⁹ Thus, if the market for cities is efficient, cities that use tax revenue to fund the efficient provision of public goods will attract firm investment.

Cities that do a poor job of providing public goods will invest tax revenue in negative expected value projects. If cities exist to produce public goods efficiently, these poor-selection cities should go “out of business.” In an efficient market for cities, firms will flock to cities that invest in high-return projects and flee cities that choose lower or negative return projects, resulting

²⁴ See O’SULLIVAN, *supra* note 3, at 1–3.

²⁵ See *id.* at 5–7.

²⁶ David Wheeler & Ashoka Mody, *International Investment Location Decisions: The Case of U.S. Firms*, 33 J. INT’L ECON. 57 (1992).

²⁷ *Id.* at 66. Urban economics literature equally applies this view. See Polèse, *supra* note 17.

²⁸ Wheeler & Mody, *supra* note 26.

²⁹ *Id.*

in the dissolution of poorly run cities as a matter of course. This does not occur because of a market failure: firm relocation costs.

If there were no relocation costs, firms would be able to relocate from one city to another based on profitability alone—i.e., based on the return on investment of tax dollars spent on public goods—and would locate in cities that use tax revenue to invest wisely in public goods. Many location theories recognize, however, that the transaction costs associated with firm relocation are significant.³⁰ For example, behavioral location theory highlights search costs, capital reconstruction costs, and hiring and training costs as inhibiting firm relocation.³¹ A 2003 empirical study shows that a number of factors, including firm size, firm age, market size, changes in firm growth, and external growth (i.e., mergers, acquisitions, and takeovers) affect the likelihood of firm relocation.³² That firm size and age are powerful predictor variables suggests the presence of relocation costs; indeed, a higher cost of relocation for large firms is cited in the study as the main reason for this result.³³

In sum, an efficient market for cities that produce public goods would and should allow cities to go “out of business.” However, firm relocation costs prevent cities that choose projects poorly from meeting with an appropriate end. Instead, because creditors know that relocation costs render many city taxpayers “immobile,” creditors may lend to the city even if the city will select projects with a negative expected return on investment. Society should thus want creditors to contract, *ex ante*, for an insolvency-state mechanism that will discourage inefficient investment in cities. In the corporate bankruptcy context, the cost of credit formulation of the Creditors’ Bargain Theory suggests that bankruptcy regimes should maximize payouts to creditors to promote efficient investment. If sufficient similarities exist between a debtor-city and an insolvent corporation, an insolvency regime for cities should likewise focus on cost of credit reduction.

³⁰ Aleid E. Brouwer, Ilaria Mariotti & Jos N. van Ommeren, *The Firm Relocation Decision: An Empirical Investigation*, 38 ANNALS OF REG’L SCI. 335, 337 (2004). Neoclassical firm location theory, however, rejects relocation costs because firms are believed to have full information *ex ante* in making an initial location decision. *Id.*

³¹ *Id.*

³² *See generally id.*

³³ *Id.* at 338–39, 342, 345.

II. CORPORATE BANKRUPTCY THEORY IN THE MUNICIPAL CONTEXT

A. *The Municipality as a Firm*

This Article analogizes an insolvent municipality to an insolvent business, treating the municipality primarily as a contract through which investors (e.g., bondholders, taxpayers, pensioners) supply capital that the municipality uses to fund the projects (various kinds of public goods) in which it invests³⁴ to produce a profit (i.e., increased economies of scale) for those investors. Three similarities between cities and corporations further the analogy:

- 1) a municipality exists in a marketplace of municipalities;
- 2) a municipality does not have a finite life and can be dissolved; and
- 3) a municipality separates “ownership” and control, resulting in agency costs.³⁵

1. *A Municipality Exists in a Marketplace of Municipalities*

Absent market failures, cities that maximize wealth attract firm investment.³⁶ Like a corporation, a municipality has two choices of what to do with investment proceeds; it can either pursue projects—such as roads, police and fire, and sewer systems—or return cash to investors via a bond redemption or tax cuts. In an efficient market, firm migration patterns should reflect the value of city project selection.

³⁴ See generally McConnell & Picker, *supra* note 2, at 485–92 (discussing contract cities).

³⁵ Implicit in the choice to analogize municipalities to businesses is the decision not to analogize municipalities to the other common debtor in bankruptcy proceedings: the individual. The three similarities described herein are characteristics that the city shares with the corporation but does not share with an individual debtor. A fourth similarity, that municipalities (like corporations) often have complex debt and bonding arrangements, is worthy of brief mention because it suggests that a municipal insolvency regime based on chapter 11 would be well-equipped to deal with these complicated financial arrangements. See, e.g., Patrick Callahan, *Municipal Debt Financing and Capital Improvements Planning* (Dec. 20, 2012), www.ci.marshalltown.ia.us/media/getMedia/MediaID/2542; Rowan Miranda, Ronald Picur, & Doug Straley, *Elements of a Comprehensive Local Government Debt Policy*, <http://www.gfoa.org/downloads/GFRElementsofDebtPolicy.pdf>. By contrast, individuals generally do not issue complex series of bonds. Consumer debt in the United States comes in four basic forms: revolving obligations such as credit card debt, mortgages, car loans, and student loans. The terms of these types of loans are often standardized and relatively straightforward (at least to a sophisticated party). Liz Zuliani, *A Dozen Alarming Consumer Debt Statistics*, ECON. WATCH (May 21, 2011), <http://www.economywatch.com/economy-business-and-finance-news/a-dozen-alarming-consumer-debt-statistics.21-05.html>.

³⁶ See generally Wheeler & Mody, *supra* note 26.

Consider property protection. Suppose a given municipality can choose to invest in one of two “property protection” projects: it can either contract with a neighboring municipality to provide police surveillance or establish its own police force. In each case, one of these options will provide better value for the cost than the other; it may be that a large city should elect to create a police force, while a small town with limited tax revenue should contract with a neighboring entity.

Assume that the municipality makes the wrong choice. If a large city contracts to add only a small security detail from a neighboring town, crime will rise. If a small town tries to build its own police force, it will have to raise additional taxes to fund the project. In both cases, investing firms will feel the impact of the municipality’s poor choice. If a city repeatedly invests in poor projects, firms will move away, and the city will be forced to choose more efficient projects or watch tax revenue decline below the amount needed to fund existing obligations, rendering the city insolvent.

If the city were a publicly traded firm, disinvestment would be relatively easy: investors with timely information could sell their stock or bonds and invest in a better city. However, relocation costs limit the ability of municipal investors to do this.

The city’s non-taxpaying investors, its lenders, face different obstacles depending on lender type. Bondholders can disinvest relatively easily (i.e., almost without costs) by selling their bonds. This should cause bond prices to drop. Like resident firms, bondholders face transactions costs; these result from a semi-liquid bond market, poor disclosure mechanisms, and tax distortions.³⁷ Recent research on municipal bonds suggests that these risks are already factored into bond prices.³⁸ This Article assumes that bondholders can exit the trade relatively easily.

³⁷ See SEC, REPORT ON THE MUNICIPAL SECURITIES MARKET (2012), <https://www.sec.gov/news/studies/2012/munireport073112.pdf> (discussing market failures in the municipal securities market) [hereinafter, REPORT ON MUNICIPAL SECURITIES MARKET]; Junbo Wang, Chunchi Wu, & Frank X. Zhang, *Liquidity, Default, Taxes, and Yields on Municipal Bonds*, 32 J. BANKING & FIN. 1133 (2008) (presenting a model that includes the effects of liquidity, default, and taxes into bond yields and showing that all three factors have an impact on bond yields).

³⁸ See generally Wang, Wu, & Zhang, *supra* note 37. Still, many commentators point to the opacity of the municipal bond market and the lack of information. REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 37, <https://www.sec.gov/news/studies/2012/munireport073112.pdf>. Additionally, municipal bondholders can take advantage of municipal bond tax exemption, which, in certain circumstances, can be used as part of a comprehensive tax reduction plan. As a result, municipal bonds have value beyond the investment returns they generate, causing investors to purchase and hold them even if they are not generating

Pensioners, on the other hand, cannot transact out of their debt holdings with the city; they are locked-in. In addition, cities regularly underfund pension plans.³⁹ Currently, existing pension obligations for cities are large and, in the case of cities facing insolvency, likely to be greatly impacted by any bankruptcy regime in the short-to-medium-term.⁴⁰ However, the pension problem is beyond the scope of this Article, which will proceed under the assumption that other lenders, including pensioners, can exit the trade as bondholders can.⁴¹

Thus, the marketplace for investment in cities is similar to the marketplace for corporations in that cities compete with one another for both “equity” (firm location) and debt. However, unlike corporate investors and lenders, who can exit their trade with minimal costs, municipal investors face higher transaction costs.

2. *A Municipality Does Not Have a Finite Life and Can Be Dissolved*

Traditional bankruptcy jurisprudence recognizes three fundamental purposes for bankruptcy: (1) to provide the individual debtor with a “fresh start;” (2) to provide a debt collection mechanism for creditors; and (3) to preserve the going concern value of financially distressed but economically viable firms that would be liquidated under nonbankruptcy debt collection law.⁴² In particular, corporate bankruptcy theorists have emphasized the debt collection function and the need for bankruptcy to simulate a hypothetical bargain among creditors to reduce the cost of credit and thus maximize wealth.⁴³ Because corporations can be dissolved, the fresh start consideration

satisfactory returns. See Merle Erickson, Austan Goolsbee & Edward Maydew, *How Prevalent is Tax Arbitrage? Evidence from the Market for Municipal Bonds*, 56 NAT. TAX J. 259, 259 (2003); Penelope Lemov, *The Latest Wrinkles in the Muni Bond Market*, GOVERNING (May 24, 2012), <http://www.governing.com/columns/public-finance/col-latest-wrinkles-municipal-bond-market.html>.

³⁹ See CONG. BUDGET OFFICE, CBO-22042, THE UNDERFUNDING OF STATE AND LOCAL PENSION PLANS, ISSUE SUMMARY (2011), <https://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12084/05-04-pensions.pdf> [hereinafter UNDERFUNDING OF PENSIONS].

⁴⁰ See generally *id.* In theory, pensioners should be able to develop a trade-out option for their pensions through a default swap insurance scheme—trading their future pension cash flows for cash flows paid out by the insurer. Despite the market-correcting potential of such a trade, this option does not appear to exist for pensioners currently.

⁴¹ The pension issue will be briefly discussed *infra* Part IV.

⁴² TODD J. ZYWICKI, *Bankruptcy*, CONCISE ENCYCLOPEDIA OF ECON., (David R. Henderson ed., 2d ed. 2008), <http://www.econlib.org/library/Enc/Bankruptcy.html>.

⁴³ Schwartz, *A Normative Theory*, *supra* note 10. But see Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 780–81 (1987) (discussing the bankruptcy system’s role in a broader regime of debt collection, and rejecting the Creditors’ Bargain formulation as a simple answer to explain all of bankruptcy).

recedes in the business bankruptcy context; the result should be no different for debtor-cities.⁴⁴

One could argue that cities deserve a fresh start because noneconomic interests—cultural, historical, political, and social—warrant the preservation of certain cities and the stability of cities generally. This Article does not dispute the validity of such interests but suggests that they are not the proper subjects of a purposeful bankruptcy law. Furthermore, the justification of the fresh start runs much deeper in the individual context as a means of both an optimal, wealth-maximizing deployment of human capital⁴⁵ and prevention of an unending “peonage” of the debtor to his or her creditors.⁴⁶ Neither of these fresh start imperatives carries much weight when the debtor is a municipality and not a human being.

3. *A Municipality Separates Ownership and Control, Resulting in Agency Costs*

Like a corporation, cities and towns face a separation between ownership and control, whereby the city’s residual beneficiaries leave control of finances in a manager’s hands. A city’s beneficiaries periodically vote to either retain or replace management.⁴⁷ Economic theories of public administration, such as public choice theory, have long documented the agency costs associated with municipal governance.⁴⁸ The proposition is simple—elected officials and bureaucrats alike will pursue self-interest over the public good. The individuals who possess decision-making power over municipal project choices are subject to capture by special interest groups, susceptible to bribery, and, in the case of elected officials, focused on winning re-election rather than advancing the public good.⁴⁹

⁴⁴ Barry Adler & Lawrence Weiss, *The Debacle of Corporate Bankruptcy*, REG., Summer 1992, at 54.

⁴⁵ When an individual debtor’s income is immediately passed along to creditors, the debtor no longer seeks to maximize his or her own wealth.

⁴⁶ Margaret Howard, *Bankruptcy Bondage*, 2009 U. ILL. L. REV. 191, 195 (likening creditors’ control over debtors to “involuntary servitude”).

⁴⁷ In the corporation, the voting mechanism is direct. In the city, firms do not vote, but those who work for them may.

⁴⁸ LISA SCHULTZ BRESSMAN, EDWARD L. RUBIN & KEVIN M. STACK, *THE REGULATORY STATE* 86–87 (1st ed. 2010) (“[A]ctual political choices [will be] determined by the efforts of individuals and groups to further their own interests.”) (quotation marks omitted).

⁴⁹ *Id.* Even a less jaundiced view of public administration would likely posit that elected officials focus on re-election and bureaucrats focus on keeping their jobs, in addition to loftier motives.

Similarly, although they are agents of the corporation's owners, corporate directors often pursue their own self-interest when possible.⁵⁰ While incentive pay, independent directors, and legal restriction may reduce these agency costs, the persistence of self-interested behavior among managers is well-documented.⁵¹

In *The Untenable Case for Chapter 11*, Bradley and Rosenzweig describe the loss in social welfare that results from allowing managers subject to these agency costs to control a firm's decision to declare bankruptcy and to direct the firm's behavior throughout the reorganization process.⁵² "Chapter 11 . . . may be seen as a kind of management defensive tactic against corporate debtholders which . . . enhances management's wealth . . ." ⁵³ In effect, the agency costs of management and the safe haven of chapter 11 allow firm managers to pursue an inefficient mix of debt and equity and use the excess cash to enrich themselves while driving the firm towards an insolvent future state.⁵⁴

In the municipal context, the agency costs highlighted by public choice theorists can also cause those in control of municipal finances to drive a city towards insolvency. City officials in situations of distress often cover up indicators of insolvency through accounting measures rather than report the true financial status to the public.⁵⁵

B. Summary of the Prevailing Theories of Corporate Bankruptcy

1. The Creditors' Bargain

To paraphrase Alfred North Whitehead, the safest general characterization of American corporate bankruptcy literature consists of a series of footnotes to

⁵⁰ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Agency costs are prevalent in corporate separations between ownership and control. *Id.*

⁵¹ See, e.g., David Yermack, *Do Corporations Award CEO Stock Options Effectively?*, 39 J. FIN. ECON. 237 (1995).

⁵² Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1048 (1991) ("[E]xisting bankruptcy law fails to provide managers with appropriate incentives to allocate corporate resources to their highest-valued uses.").

⁵³ *Id.* at 1049–50.

⁵⁴ *Id.* at 1047.

⁵⁵ Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 643 (2008) (discussing case studies in which "officials constantly overestimated the forthcoming revenues and underestimated the city's fund reserves problem, and so they justified large spending that had no real connection to the city's actual economic base").

the “Creditors’ Bargain” theory.⁵⁶ The theory, first expounded by Thomas Jackson, states that bankruptcy law exists to resolve the collective action problem faced by the creditors of a firm teetering on the brink of insolvency.⁵⁷ This problem arises due to the “first-come, first-served” nature of nonbankruptcy debtor-creditor law,⁵⁸ which frequently leads to a “race to the courthouse” that can result in the “piecemeal liquidation” of firms that “[are] more valuable [as] [] going concern[s],” and thus destroy value available for the creditors’ recovery.⁵⁹

The role of bankruptcy law under the Creditors’ Bargain theory is to solve this problem through an insolvency regime that reflects the bargain that creditors would have struck *ex ante* if transaction costs and bounded rationality did not prevent them from doing so.⁶⁰ Thus tied to the mast by insolvency law, creditors are forced to engage in a court-supervised negotiation that minimizes value destruction by allowing the debtor to continue to function as a going concern.⁶¹ Accordingly, as Jackson and others argue, a wealth-maximizing regime of bankruptcy law should comport entirely with this fundamental purpose.⁶²

The premise that creditors are the sole “owners” of the insolvent firm—or at least, of all of its assets—is essential to the Creditors’ Bargain.⁶³ Otherwise, the “bargain” that a normatively desirable bankruptcy law is meant to reflect would not be a *creditors’* bargain at all, but rather a bargain among various stakeholders.⁶⁴ Jackson and others conclude that creditors alone own the firm because they have bargained for the right to withdraw assets in the event of the

⁵⁶ ALFRED NORTH WHITEHEAD, *PROCESS AND REALITY: AN ESSAY IN COSMOLOGY* 39 (David Ray Griffin & Donald W. Sherburne eds., corrected ed. 1978).

⁵⁷ Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain*, 91 *YALE L.J.* 857, 861–63 (1982) (“First, [bankruptcy] eliminates strategic costs that would otherwise be associated with a race to the courthouse. Second, even if no such race would occur, the collective proceeding reduces variance in recoveries . . .”).

⁵⁸ Barry Adler, *A Theory of Insolvency*, 72 *N.Y.U. L. REV.* 343, 346 (1997) (citing THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 12–13 (1986)).

⁵⁹ Jackson, *Bankruptcy*, *supra* note 57, at 862; *see* Adler, *supra* note 58.

⁶⁰ *See generally* Jackson, *Bankruptcy*, *supra* note 57, at 859–64.

⁶¹ *See generally id.*

⁶² *See generally id.*; Douglas Baird, *The Uneasy Case for Corporate Reorganizations*, 15 *J. LEGAL STUD.* 127, 132 (1986) [hereinafter Baird, *The Uneasy Case*].

⁶³ *See* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 *MICH. L. REV.* 336, 352 (1993) [hereinafter Warren, *Imperfect World*].

⁶⁴ *See, e.g., id.* at 355 (proposing an alternative view to the Creditors’ Bargain and arguing that the Bankruptcy “Code accounts for the rights of other parties that a business failure affects . . . [and] . . . carries out a deliberate distributional policy in favor of all those whom a business failure would have hurt”).

business's failure to meet its obligations.⁶⁵ From this point of view, the bargain of bankruptcy law should only reflect creditors' desires;⁶⁶ a normative bankruptcy law would do so by staying the itchy trigger finger of foreclosure creditors and allowing the firm to continue doing business while creditors as a group figure out precisely who has a right to which assets.⁶⁷

2. *Extensions of and Rejoinders to Creditors' Bargain Theory*

Jackson's description of the debt-collection dilemma facing creditors has spawned a deluge of scholarship that comes mainly in one of three flavors: (1) extensions of Creditors' Bargain theory advocating for alterations to the Bankruptcy Code either for the sake of freedom of contract or to allow market-based forces to function properly;⁶⁸ (2) extensions of Creditors' Bargain theory of bankruptcy that advocate in favor of a market-based system that eschews court intervention;⁶⁹ and (3) rejections of the Creditors' Bargain theory or its extensions with respect to bankruptcy's underlying purpose.⁷⁰

Market-based-system approaches focus on establishing a bankruptcy system that would best replicate the bargain creditors would seek *ex ante*.⁷¹

⁶⁵ See Jackson, *Bankruptcy*, *supra* note 57, at 859–64; Baird, *The Uneasy Case*, *supra* note 62 (“Bankruptcy . . . does not give senior investors an opt-out right that they did not already have. Senior investors invariably insist . . . that they be allowed to withdraw[] assets when the firm has failed to meet its payout obligations.”).

⁶⁶ Cf. Warren, *Imperfect World*, *supra* note 63, at 355 (stating that the Code accounts for other parties' desires as well as creditors).

⁶⁷ Whether a bankruptcy regime is needed to (or can) achieve this end is subject to significant debate; some have argued that free contracts addressing insolvency state outcomes are better suited than legal regimes for establishing the parameters of such a bargain. See, e.g., Adler, *supra* note 58, at 344 (“Unless initial investment contracts provided otherwise, a firm's failure to make good on its obligations would trigger a liquidation . . .”). Others counter that because contracts are inevitably adjudicated under a legal regime (i.e., state debtor-creditor law, the Bankruptcy Code), the relevant contractual question should be one of choice of law. See Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1808–09 (1998) [hereinafter Schwartz, *A Contract Theory*] (“This essay shows that parties could improve on this solution with contracts that induce the use of the [bankruptcy] system that is optimal in their particular circumstances.”).

⁶⁸ See generally Adler, *supra* note 58; Douglas Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633 (1993) [hereinafter Baird, *Revisiting Auctions*]; Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983).

⁶⁹ See, e.g., Schwartz, *A Contract Theory*, *supra* note 67.

⁷⁰ See, e.g., Warren, *Bankruptcy Policy*, *supra* note 43, at 812–13.

⁷¹ See generally Adler, *supra* note 58 (an “efficient nonprotection” regime); Baird, *Revisiting Auctions*, *supra* note 68 (cost-reducing auction-of-the-going-concern regime); Bebchuk, *supra* note 68 (regime involving the auction of new securities in a bankrupt firm); Roe, *supra* note 68 (regime involving the auction of new securities in a bankrupt firm).

Approaches eschewing traditional bankruptcy suggest a repeal of prohibitions on bankruptcy-contingent contracting, allowing sophisticated parties to come to a Creditors' Bargain *ex ante*, and relegating the role of courts to a "structural" means of enforcing such contracts.⁷²

Finally, opponents of the Creditors' Bargain framework have articulated a variety of theories that they believe either provide a better justification for bankruptcy law as it currently functions or take into account a host of competing needs and interests to expand bankruptcy beyond a fundamental purpose of facilitating investment through orderly debt collection.⁷³ These theorists, including Elizabeth Warren, view debt collection as only one of a broader set of policy imperatives, all of which share a goal of allocating loss based on societally recognized values.⁷⁴

In sum, proponents of the Creditor's Bargain theory tend to agree that insolvency regimes for corporate debtors can maximize wealth by establishing a "collective, compulsory" mechanism that reduces transaction costs for creditors and thus lowers the cost of credit.⁷⁵ This allows the market to function more smoothly, resulting in appropriate levels of investment in companies.⁷⁶ Whether the United States Bankruptcy Code, or any insolvency regime at all, is suitable for this purpose is still left to significant debate.⁷⁷

In *A Normative Theory of Business Bankruptcy*, Alan Schwartz provides one of the most straightforward accounts of how the Creditors' Bargain theory maximizes social welfare.⁷⁸ Society wants firms to "pursue every project for which credit can be raised," because those projects will always "generate positive expected returns."⁷⁹ This is because in the insolvency state creditors "bear the full costs of a firm's failure" and will thus "only finance projects whose expected gains at least equal their costs."⁸⁰ At the same time, however, "debt-financed firms pursue fewer projects than society prefers because firms

⁷² Schwartz, *A Contract Theory*, *supra* note 67.

⁷³ Warren, *Bankruptcy Policy*, *supra* note 43, at 777.

⁷⁴ *Id.* ("I see bankruptcy as an attempt to reckon with a debtor's multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing—and sometimes conflicting—values in this distribution."); *see, e.g., Zywicki, supra* note 42.

⁷⁵ *See* JACKSON, LOGIC, *supra* note 58.

⁷⁶ *See* Schwartz, *A Normative Theory*, *supra* note 10, at 1203–04.

⁷⁷ *See generally* Baird, *The Uneasy Case*, *supra* note 62; Jackson, *Bankruptcy*, *supra* note 57.

⁷⁸ Schwartz, *A Normative Theory*, *supra* note 10 ("Society thus should want an efficient bankruptcy system because lower interest rates increase the share of good state returns that firms can keep . . .").

⁷⁹ *Id.* at 1203, 1211.

⁸⁰ *Id.* at 1211.

must surrender bad state returns to creditors, but must share good state returns with them.”⁸¹ Thus, the bankruptcy system should “reduc[e] the wedge between the socially efficient project set and the project set that debt financed firms will pursue.”⁸²

This Article accepts the Creditors’ Bargain theory, and its explanation through the cost of credit metric, as a normatively appropriate foundation for business insolvency regimes. Because municipal debtors resemble corporate debtors in many respects, the Creditors’ Bargain theory may also be an appropriate mechanism for understanding and developing a municipal bankruptcy regime. However, when applied in the municipal context, the Creditors’ Bargain theory must be modified to account for the crucial market failure of firm relocation costs.

C. Creditors’ Bargain Theory Applied to Municipalities

1. Maximizing Insolvency-State Returns to Creditors

If the analogy of the municipality to the corporate debtor holds fully, a municipal insolvency regime based on the Creditors’ Bargain theory should reflect a bargain that creditors would wish to make ex ante if transaction costs were not prohibitive. Because a municipality’s ability to repay creditors depends entirely upon tax revenue, and thus, in effect, upon a town’s population and tax tolerance, the ideal solution for creditors would be to raise taxes until the debts are paid. However, raising taxes above some threshold will drive some inhabitants away, resulting in a disproportionate loss for town “investors” with high relocation costs, and, ultimately, a lower recovery for creditors. As the tax base and town assets dwindle, creditors will find themselves “owners” of an empty town with fixed assets that no one will buy at auction.⁸³ Unless taxpayers are forced (or enticed) to stay put, such a regime would fail to solve the race to foreclose among creditors or reduce the cost of credit. Thus, unless society wants to establish a “locational indentured servitude” approach to bankruptcy, the Creditors’ Bargain in its pure form cannot be applied here.

⁸¹ *Id.* at 1203.

⁸² *Id.*

⁸³ See McConnell & Picker, *supra* note 2, at 448 (“Wealthier citizens and business are not only very sensitive to changes in tax rates but are also the groups most capable of relocating in order to escape the new tax burden.”).

2. *The Nonliquidation Assumption*

In many ways, this is the unspoken approach of chapter 9. As currently written, chapter 9 serves four basic functions: (1) it limits the circumstances in which a debtor-city can file for bankruptcy;⁸⁴ (2) it halts any attempts by creditors to collect (via the automatic stay);⁸⁵ (3) it provides an orderly process for the establishment of claims (through the operation of Code provisions not specific to chapter 9);⁸⁶ and (4) it allows the municipality to entirely control the bankruptcy process and propose a plan.⁸⁷ In essence, chapter 9 summarily recognizes creditors' state law and contractual entitlements while simultaneously allowing a debtor-city that meets the filing requirements of § 109(c) to essentially pursue any treatment of creditor claims it chooses, including nonpayment.⁸⁸

Creditor entitlements should not be so easily dismissed. The conventional wisdom is that municipal assets are immune to creditors and that creditors are aware of this.⁸⁹ However, the logic behind this presumption is faulty at best because it requires the implausible assumption that creditors are both astute students of the history of early, non-code “bankruptcy” law and unaware of both Congressional policymaking and modern Supreme Court bankruptcy jurisprudence.

First, chapter 9 does not explicitly limit municipal creditors' recourse to assets other than delaying their ability to foreclose post-petition through the automatic stay.⁹⁰ Instead, the assumption that creditors cannot recover municipal assets comes from the common law view, prevalent in the nineteenth and early twentieth centuries, that municipal property is “held in trust for the public and hence can no more be sold to settle the debts of a city . . . than can any other trust property be sold to settle the individual debts of any other trustee.”⁹¹

Municipal bankruptcy law, however, comes not from common law but from the Bankruptcy Code. The Congress that enacted chapter 9 viewed the

⁸⁴ 11 U.S.C. § 109(c) (2012).

⁸⁵ 11 U.S.C. § 922.

⁸⁶ 11 U.S.C. § 901(a).

⁸⁷ 11 U.S.C. §§ 941–43.

⁸⁸ 11 U.S.C. § 109(c).

⁸⁹ See McConnell & Picker, *supra* note 2, at 433–34.

⁹⁰ 11 U.S.C. § 922.

⁹¹ McConnell & Picker, *supra* note 2, at 431 (quotation marks omitted).

aims of municipal bankruptcy law quite differently at its inception in 1933. Those championing the 1933 Bankruptcy Act emphasized that the bill was meant to provide the debtor with its proverbial breathing room and prevent holdouts by minority creditors.⁹² In other words, the law resembled an *ex ante* bargain among creditors to prevent one creditor from taking actions that would harm the others.

In addition to chapter 9's legislative history, Supreme Court decisions regarding pre-Code (pre-1978) bankruptcy practice assume that creditors are meant to lack recourse to municipal assets. The Court has repeatedly noted that the 1978 Code⁹³ "was intended to modernize the bankruptcy laws" and "Congress intended 'significant changes from'" pre-Code practice.⁹⁴ In the post-1978 environment, it is unrealistic to expect creditors to internalize nineteenth century public trust doctrine while ignoring the Supreme Court's assertion that, essentially, bankruptcy law begins with the 1978 Code.

Furthermore, because this Article attempts to elucidate a normative theory and regime of municipal insolvency rather than taking a positivist approach, concerns of windfalls to creditors resulting from existing assumptions are not necessarily appropriate.

3. *Insolvency State Returns and Relocation Costs*

So where does this leave us? In a world where a perfect municipal-corporate analogy exists, the application of the Creditors' Bargain theory without alteration might make sense. However, providing creditors with post-insolvency ownership of municipal assets is unlikely to yield sufficient insolvency-state returns to reduce the cost of credit. Creditors would have no real use for public goods in a dissolved city that has no tax base or revenue stream because a city's public goods are rarely portable or fungible. The municipal-corporate analogy, though apt, is imperfect.

Many business bankruptcy proposals based on the Creditors' Bargain theory hypothesize a world in which the prices of equity securities in a

⁹² *Id.* at 450–51; Malito, *supra* note 8.

⁹³ See Kenneth N. Klee, A Short History of Municipal Bankruptcy 6–7 (2012) (unpublished manuscript) (on file with Samford University Cumberland School of Law), <http://cumberland.samford.edu/files/Short%20History%20of%20Municipal%20Bankruptcy.pdf>. Chapter 9 was enacted, in part, in response to the near-bankruptcy of New York city in the 1970s. *Id.*

⁹⁴ See *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 239 (1989) (quoting *N. Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 52–53 (1982)).

corporation “precisely and accurately reflect the discounted net cash flows of its current and future investment decisions.”⁹⁵ In this “perfect market” world, equity markets have no transaction costs.⁹⁶ Whether such a situation exists in the United States market for corporate control of public companies is a subject of prolonged and continuing debate, but the exploration of the corporate-municipal analogy in Part II shows that the market for cities is not fully efficient. The theory of municipal insolvency put forth in this Article nevertheless begins with the Creditors’ Bargain theory and the premise of an efficient market for cities and then adjusts for certain dissimilarities between corporations and cities, including the market failure of relocation costs. A regime that recognizes these costs might further a market-based allocation of city investment—encouraging companies to locate in cities that pursue efficient projects—and simultaneously maximize payouts to creditors, reducing the cost of credit.

If firms could freely relocate, and there were no debt, cities selecting positive-expected-value projects would attract investment, and negative return cities would fail. In an efficient market, the amount of investment in a city—i.e., the amount of tax revenue it generates—would always be an optimal reflection of the city’s ability to select projects.

Once debt is introduced, a welfare-maximizing society wants cities to pursue every project for which credit can be raised because the tax revenue that can be exacted from the city to pay for the project must be enough, on an expected-value basis, to pay back creditors. In this hypothetical, non-relocation cost world, a city’s insolvency would be a reflection of its inability to choose projects that increase the value of firms located there. Under the Creditors’ Bargain theory, as in the corporate paradigm, the cost of credit will be lowest when the bankruptcy system maximizes insolvency-state payouts to creditors. Further, no actual system of reorganization would be necessary—at the point of insolvency, new tax revenue would be zero (because taxpayers would have left for cities that were more efficient at project selection), and creditors would simply receive the proceeds of a liquidation of any remaining assets.

When relocation costs exist, an insolvency regime is needed for two reasons. First, as long as the inefficiencies produced by the city’s choices are less than the cost of relocation, taxpayers will remain even when they recognize that the city is poor at project selection. Creditors will extend

⁹⁵ Bradley & Rosenzweig, *supra* note 52, at 1053.

⁹⁶ *Id.*

additional credit to municipalities based on those future revenue streams, regardless of whether the city selects negative expected value projects.⁹⁷ Further, managers of the city's finances will engage in agency cost-producing behavior, disguising the true state of city finances. The net effect is socially inefficient investment that eventually results in insolvency.

Second, in the insolvency state, taxpayers continue to provide a dedicated revenue stream; insolvent cities are able to inefficiently reinvest new taxpayer money to repay creditors that extended credit for bad projects. However, such revenue is not something to which creditors are necessarily entitled. At the point of insolvency, if taxpayers could relocate without costs, creditors would be left with the city's current assets but no future revenue streams.

Thus, a wealth-maximizing bankruptcy regime for municipalities should maximize payouts for creditors to reduce the cost of credit, but only out of the city's current assets. New tax revenue should not be used to repay old debts arising from negative-expected-value projects.

Current and proposed municipal insolvency regimes satisfy neither of these requirements. Instead, they provide a debtor municipality with breathing room, maintain existing levels of services to remaining taxpayers, and allow current management to retain control of city investment decisions while renegotiating debt instruments with creditors. A new approach to municipal insolvency that actually attempts to maximize social welfare is sorely needed.

III. A PROPOSAL FOR A NEW MUNICIPAL BANKRUPTCY REGIME

A market-based municipal insolvency regime that both maximizes payouts to creditors and resolves the relocation cost problem would have two components: (1) a liquidation procedure that auctions off a city's existing assets and distributes proceeds to creditors, and (2) a city contract-bidding mechanism to provide public goods to the city's remaining taxpayers, financed by future revenue from that same tax base.⁹⁸ This two-part regime would

⁹⁷ See, SEC Investor Bulletin Pub. No. 134, <https://www.sec.gov/investor/alerts/municipalbondsbulletin.pdf> (“[I]n many instances . . . the issuer or other governmental entity responsible for repaying the [general obligation municipal] bonds has the unlimited authority to tax residents to pay bondholders . . .”).

⁹⁸ This bidding mechanism would effectively be conducted as a reverse auction in which the lowest bid wins; for a general discussion of auction types, including reverse auctions, see generally Paul Klemperer, *Auction Theory: A Guide to the Literature*, 13 J. ECON. SURVS. 227, 233 (1999) (explaining that in an optimal auction the winner is the bidder with the highest “marginal revenue,” in other words, the bidder who can extract the most value from the object being sold), <http://www.econ.nyu.edu/user/debraj/Courses/GameTheory2003/Readings/KlempererSurvey.pdf>.

replace chapter 9 of the Bankruptcy Code as it pertains to cities, towns, and similar governmental units.⁹⁹ The interplay between a liquidation of existing assets and bidding based on new tax revenue would maximize payouts to creditors while encouraging more efficient project selection for the benefit of firms with high relocation costs.

A. Liquidation Mechanism

Both the timing and the treatment of creditors in this proposed municipal liquidation mechanism would resemble the mandatory auction process described by Douglas Baird in *Revisiting Auctions in Chapter 11*.¹⁰⁰ The auction would be a mandatory, automatic event that takes place shortly after a city files a bankruptcy petition. Proceeds from the auction would be placed into an escrow account. Provisions in prepetition contracts would determine inter-creditor disputes, such as contests over priority, and cash would be dispersed according to parties' property rights. As in Baird's proposal, this haste is justified by the costs of the bankruptcy process to relevant parties; the longer a city remains in bankruptcy, the more it drains captive taxpayer money that could be better used elsewhere.¹⁰¹ In addition, a speedy liquidation ensures that wasting assets in the city's control are put to better use as quickly as possible and allows creditors to reinvest auction proceeds in a relatively timely manner. In short, the process does a better job of recognizing the time value of money than current municipal bankruptcy systems.¹⁰²

Some have argued that speedy auctions reduce value because such haste may make it difficult for "new players" to show up and bid, particularly in a context that might be considered akin to foreclosure.¹⁰³ However, in the municipal context (as discussed herein), most players would already be well aware of the bankruptcy auction; further, the contract bidding component of

⁹⁹ Whether this mechanism is appropriate for other "municipalities" as that term is defined in judicial decisions under chapter 9 is a subject for further inquiry.

¹⁰⁰ See generally Baird, *Revisiting Auctions*, *supra* note 68; Roe, *supra* note 68.

¹⁰¹ See Baird, *Revisiting Auctions*, *supra* note 68, at 641 (discussing the costs of bankruptcy as a rationale for preferring auctions over judicially supervised reorganization); Roe, *supra* note 68.

¹⁰² Roe, *supra* note 68, at 536 ("Existing law does not take the time value of claims into account to the extent that it might.").

¹⁰³ See Baird, *Revisiting Auctions*, *supra* note 68 ("The case for mandatory auctions is hard to make precisely because it depends crucially on a new player entering the picture who does not exist now."); Roe, *supra* note 68, at 653; see also John P. Harding, Eric Rosenblatt, & Vincent W. Yao, *The Foreclosure Discount: Myth or Reality?*, 71 J. URB. ECON. 204, 205 (2012) ("[Most] estimates of the foreclosure discount [in academic research] . . . are in the range of 20–25% . . .").

the auction increases the likelihood of buyer participation by tying the sale of specific-value assets to contract bids.

B. Contract Bidding Mechanism

Simultaneously with the auction of all a municipality's current assets,¹⁰⁴ the newly proposed bankruptcy regime contemplates an iterative government contract bidding process for all services previously provided by the municipality. The bidding process contains four steps: (1) the total amount of projected new tax revenue based on the city's current and projected future inhabitants will be estimated;¹⁰⁵ (2) this total will be divided proportionally by the percentage of the city's current budget that each service (i.e. public good) the city provides occupies;¹⁰⁶ (3) services in the budget will be ranked into tiers based on need for the service (in other words, important services, such as policing, will be in the highest tier or tiers); and (4) parties, including third parties, will then be invited to bid on each project, irrespective of those tiers, with the divided budget revenue numbers as a bid ceiling. The competitive, sealed-bid nature of the bidding process will induce competitive bidding that results in obtaining the lowest price possible for a given service.¹⁰⁷

Of course, if the size of the city's budget vastly dwarfs the available tax revenue, one could predict an initial result of the auction—no one bids because the maximum prices are too low. For this reason, the bidding process will be iterative. Once a first bid is made, the contract purchaser will be locked into its

¹⁰⁴ The auction would involve judicial supervision similar to a § 363 sale but for procedural purposes and basic quality control only. 11 U.S.C. § 363 (2012).

¹⁰⁵ This assumes that tax rates will be held constant throughout the process. The projected tax revenue will of course require some estimation and assumptions with respect to the potential relocation of firm's as a result of the city's insolvency. Such potential relocation will of course be inhibited by enforcement costs, and also highlights the necessity for a speedy process.

¹⁰⁶ This requires the assumption that the city, at the point of insolvency, is equally inefficient at the provision of all public goods, rather than good in some areas and bad in others.

¹⁰⁷ The issue of a full privatization of a municipality's services may raise quality control concerns. See, e.g., Ana Hardoy & Ricardo Schusterman, *New Models for the Privatization of Water and Sanitation for the Urban Poor*, 12 ENV'T & URBANIZATION 63, 63–70 (2000), <http://eau.sagepub.com/content/12/2/63.full.pdf+html> (discussing quality control and cost issues relating to private service provision to low-income urban areas). This auction process is a slightly simplified version of the process that would actually take place. Under court supervision, the debtor municipality would be tasked with showing that the party with the winning bid will satisfy quality control standards. One more-nuanced approach likely to yield positive results for insolvent municipalities is use of a multi-attribute auction mechanism. See, e.g., Ching-Hua Chen-Ritzo, et al., *Better, Faster Cheaper: An Experimental Analysis of a Multi-Attribute Reverse Auction Mechanism with Restricted Information Feedback*, 51 MGMT. SCI. 1753 (2005) <http://dx.doi.org/10.1287/mnsc.1050.0433>.

bid price (essentially, an option contract).¹⁰⁸ However, no bids will be converted into agreements for the provision of services in a lower tier of the public goods “waterfall” until all tiers above that tier are full.¹⁰⁹ If all services contained in higher tiers have not received qualifying bids (bids meeting price and other requirements), the lowest tier in the waterfall will be “stripped” off of the waterfall (though the option contract will remain viable), and maximum prices reconfigured based on the same revenue pool. Such iterative “stripping” will continue until the highest tier in the waterfall has been fully satisfied (i.e., qualifying bids have been received for all services).

If all tiers below a given tier have been stripped, all tiers above that same tier have been filled, and the tier has gone through a round of bidding without receiving qualifying bids for the services within that tier, the services for which the municipality has received no qualifying bids will be removed from the waterfall, “reserved,” and reassessed at the end of the bidding process. Once a tier of services—minus “reserved” services—is full, all of the lowest¹¹⁰ bids will be accepted, the tier will be “closed,” and the next tier down in the waterfall, if previously stripped off, will be returned to the waterfall, with any previous bids still valid (including bids that were not previously qualifying bids but may now qualify based on available revenue). Available revenue (and thus maximum bid settings for each service) will be adjusted based on the funds now remaining in the revenue pool (after accounting for bids accepted in closed tiers). This process will continue until the revenue pool is dry. At the end of the process, all public goods tiers above the “marginal” tier¹¹¹ will be full, excluding reserved services, and all tiers below the marginal tier will be empty. The marginal tier itself will have contracts for some of the services within it, but not for others.

Finally, potential service providers will be allowed to place contingent bids on the assets of the city available in the liquidation auction. By conducting the liquidation auction concurrently with the iterative bidding process, the municipality is able to maximize the city-specific value of the assets while driving down the cost of services.¹¹²

¹⁰⁸ An option contract is an offer that cannot be revoked prior to its expiration date. *See* JOHN DOWNES & JORDAN ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 517 (9th ed. 2014).

¹⁰⁹ Similar to the “absolute priority rule” in chapter 11. *See* 11 U.S.C. § 1129(b)(2)(B)(ii).

¹¹⁰ *See* Hardoy & Schusterman, *supra* note 107.

¹¹¹ The “marginal” tier is the highest tier that is not closed when revenue runs out.

¹¹² This is because certain assets, such as in-place real estate or city-branded equipment, may have greater intrinsic value to service providers operating within the municipality than to buyers who will take the assets away for use in another geographic location.

The competition for bids also will bring more third parties into play in the auction of city assets. Notably, service providers bidding for contracts and in the auction will likely come from one of three portions of the market for cities. The first is the existing private providers of services in the city itself—such providers will likely have to improve cost efficiencies to win the new contract, but they will also be most likely to show up to the auction because they would otherwise lose the city’s business entirely. The second is private providers of services from other cities—these providers will likely possess economies of scale that may drive down costs and allow them to compete with existing providers. The third is neighboring cities and towns—at least in the case of certain specialized services seldom provided by private entities, such as police and fire. These providers are likely to have significant opportunities to achieve economies of scale and extract new revenue for low marginal costs. Additionally, if such neighboring cities and towns are not failing, they are more likely than the debtor-municipality to be providing such services on a cost-effective basis.

To understand what this bidding system would look like, consider the example of a town that provides three services to those located within its borders: police, road construction and repair, and waste collection. The town has done a poor job of managing its costs and selecting projects, and it spends far too much on all of these services. In the town’s budget, each service costs \$3, including allocations of debt service, for a budget total of \$9. However, the town’s projected annual tax revenue for the coming fiscal year is only \$3. Insolvent and unable to issue debt, the town decides to file for bankruptcy under the new regime.

The town’s assets are put into the auction for liquidation, and the separate contract bidding mechanism has three tiers: (1) Police, (2) Roads, and (3) Waste; each tier has a maximum bid amount of \$1, totaling \$3 projected revenue. The bids start coming in, but no service providers are willing to provide either police or roads for less than \$1.01. However, waste collection bids come in, including one as low as \$0.50. Because no bids came in for either Tier 1 or 2, Tier 3 is then “stripped off” the waterfall (with the option contract for \$0.50 extant), and the bidding starts over, with maximums of \$1.50 for both police and roads. Roads get a number of bids, including one for \$1.25, but still no service providers bid on police. Tier 2 is accordingly stripped off, and bidding commences only for providing police services, with a ceiling of \$3. Bids come in and police services are ultimately procured for \$1.75. Bidding now happens again for Tier 2 with a maximum bid of \$1.25

(giving bidders a second opportunity to go lower and win the contract). If a lower bid comes in, the residual revenue can be used for waste; otherwise, the town will no longer be able to provide waste collection services—an efficient result given the current tax base of the town.

This system will maximize creditor recoveries and minimize the negative impact of relocation costs, the twin goals of a municipal bankruptcy regime outlined above. The auction mechanism maximizes payouts to creditors on current assets of the city and thus lowers the cost of credit.¹¹³ Additionally, the elimination of the uncertainty following default for municipal creditors and the inability of municipalities to merely use bankruptcy as a means of judicially countenanced nonpayment will encourage creditors to actually evaluate the likelihood of default *ex ante* and extend credit based on the expected value of projects. Meanwhile, the bidding mechanism will minimize the effects of high relocation costs for firms investing in a city (since there is no way for an *ex post* regime to reduce actual relocation costs for a firm) by reallocating an insolvent municipality's limited resources to the provision of essential public goods for which taxpayers are willing to pay, thus improving the city's overall project selection.

IV. QUESTIONS AND IMPLICATIONS

A. Lingering Procedural Questions and Decision-Making Authority

Both the auction component and bidding mechanism of this new insolvency regime give rise to several procedural questions, many of which demand a level of detail beyond the scope of this Article. However, for the regime to be successful, three key procedural questions must be addressed: (1) Who will determine the ranking of the tiers? (2) Who will control the decision to file for bankruptcy? (3) And, what will be the governance structure of the city post-liquidation?

1. Who Will Determine the Ranking of the Tiers?

The first question arises from the bidding mechanism itself: Who will determine the ranking of the tiers in the waterfall? There may be a case for designating certain “essential” services (police, fire, etc.) to be ranked in the

¹¹³ See generally Klemperer, *supra* note 98 (explaining that in an optimal auction the winner is the bidder with the highest “marginal revenue,” in other words, the bidder who can extract the most value from the object being sold).

initial tier regardless of any decision-making authority. However, outside this subset of public goods—assuming such a subset is necessary—creditors should be allowed a proportional vote on the ranking of public goods. At first blush, allowing creditors with economic interests tied only to the maximization of their auction payout to cast these votes may appear to provide a perverse incentive to creditors to rank highly those services with the most underlying, city-specific assets available for use, so that those assets might extract maximum value in the liquidation auction.

In fact, this outcome is desirable. If auction participants are simultaneously bidding up the cost of assets in the liquidation pool, while bidding down the cost of the service to the municipality, the final price of the asset will be the marginal cost, over the asset price, of providing the service to the city. If the asset is of no use to the city, because third parties can provide the service through economies of scale using outside assets, which would be a benefit to the city, the asset will be priced at auction without city-specific value because it has none.

Creditor control of the ranking process also comports with the assumption, noted in Part II, that the city is equally bad at project selection across the board. Under that assumption, the city would overinvest equally in all projects, so the highest value projects to the city would be those that utilize the most of the city's existing assets.

2. *Who Will Control the Decision to File for Bankruptcy?*

The second question poses a familiar problem in the bankruptcy landscape: Who controls the decision to file bankruptcy? Under current municipal bankruptcy law, the choice is not made by a unitary decision-maker; rather, the state must provide authorization, the city's executive must take steps to file a petition, and a judge must act as gatekeeper to ensure that a municipality meets other requirements of the current law.¹¹⁴ A discussion of current law and its limits is not appropriate in the context of a normative elucidation of municipal bankruptcy structures.¹¹⁵ Instead, the normative question is: To whom should

¹¹⁴ See generally Freyberg, *supra* note 5.

¹¹⁵ Under current law, there are three choices for state authorization: blanket prohibition on municipal filings, blanket authorization of municipal filings, and a procedure for requesting permission to file from the state government. From a normative viewpoint, there is no reason to maintain the roadblock of a state authorization requirement; however, constitutional state sovereignty concerns require its inclusion in the Code. *Id.* at 1008–16. Accordingly, under the new regime, all states should adopt blanket authorization of municipal bankruptcy filings.

the right to make the bankruptcy decision be allocated in the interests of reducing the cost of credit and recognizing the problem of relocation costs?

While creditor control makes sense for purposes of asset ranking, it is inappropriate here. Although *ex ante* creditors and society might prefer the liquidation of all insolvent cities, especially absent agency costs, *ex post* creditors will try to extract as much captive taxpayer revenue as possible and resist default.¹¹⁶ Similarly, the incentives for city managers to delay a filing are clear. If, however, increased reporting requirements and accounting restrictions can increase transparency in municipal finances, the agency costs associated with insolvency-state city manager behavior would be greatly reduced, and managers would likely become the best available choice for control over the bankruptcy decision.¹¹⁷

3. *What Will Be the Governance Structure of the City Post-Liquidation?*

The third question is structural: Will the taxpayers who fund these new services be part of a municipality that goes by the same name, an unincorporated municipality, or be absorbed by either a neighboring town or county? As a normative matter, this question has no significance for the purposes of the municipal bankruptcy regime because it should not impact the cost of credit or the relocation cost market failure. There may be other concerns, however, relating to the administration of taxes and the ability of taxpayers to vote.

One option for resolving these issues is to include “administrative services” in the tier of “essential” services. Neighboring municipalities could bid for the tax revenue associated with providing administrative services, and the debtor-municipality would be absorbed into its neighbor for administrative and political purposes. Other services would still be provided according to the bidding mechanism results, but the neighboring municipality would be responsible for tax collection, paying bills of service providers, and negotiating contracts. Alternatively, the administrative role could be played by the county in which the debtor-municipality is located—the political entity of the debtor-municipality would be dissolved completely and left unincorporated. The third option is a *de facto* merger with a neighboring municipality. This merger

¹¹⁶ Creditors usually attempt to block a municipal filing under the current chapter 9 and would likely still do so under this regime.

¹¹⁷ Some have proposed states as more effective actors in this context. *See, e.g., Kimhi, Chapter 9, supra* note 15.

would occur if the neighboring municipality bids on both administrative services, as an “essential” service, and several other of the services in the budget. Mergers have become a more frequent event for towns and cities nationwide—the results of municipal mergers are still being debated.¹¹⁸

B. Potential Implications of a New Regime for Service Sharing and Mergers

One likely result of this new municipal insolvency regime is an increase in service sharing between municipalities. Service sharing is desirable under an economic view of cities because it leads to economies of scale in the provision of public goods, and already takes place, to varying degrees, in many states.¹¹⁹ Research indicating the benefits of shared service arrangements has existed since the early 1990s.¹²⁰ Most studies today focus on specific methods of service sharing, accepting that sharing has beneficial effects.¹²¹

Although the regime’s structure generally contemplates the provision of services from different entities for the unincorporated unit of taxpayers, it is also possible that a single bidder, such as a neighboring town, will be the winning bidder for several services at once. This would result in a de facto merger between the two towns, a result that may involve significant economies of scale.¹²² Though no significant research has been conducted on municipal mergers in the United States, a series of studies in Finland, the Netherlands, Switzerland, and Denmark has yielded mixed results.¹²³

¹¹⁸ See SEBASTIAN BLESSE & THUSHYANTHAN BASKARAN, CTR. FOR EUROPEAN GOVERNANCE & ECON. DEV. RESEARCH, DO MUNICIPAL MERGERS RESULT IN SCALE ECONOMIES? EVIDENCE FROM A GERMAN FEDERAL STATE 5 (2013), <http://webdoc.gwdg.de/ebook/serien/lm/CEGE/176.pdf>.

¹¹⁹ See, e.g., Lorraine Cortés-Vázquez, *The Framework for Municipal Cooperation and Sharing Services*, 9 GOV’T, LAW & POL’Y J. 6 (2007), http://www.dos.ny.gov/LG/publications/Framework_Muni_Coop.pdf; S. COMM’N ON SHARED MUN. SERVS. (R.I. 2010), http://www.rilin.state.ri.us/Reports/Senate_Commission_on_Municipal_Shared_Services_Analysis_052410.pdf.

¹²⁰ See, e.g., Shawna Grosskopf & Suthathip Yaisawarng, *Economies of Scope in the Provision of Local Public Services*, 43 NAT. TAX J. 61 (1990).

¹²¹ See, e.g., OFFICE OF THE N.Y. ST. COMPTROLLER, DIV. OF LOC. GOV’T & SCH. ACCOUNTABILITY, LOC. GOV’T MGMT. GUIDE: SHARED SERVICES IN LOC. GOV’T (2009) (stating that shared services can help municipalities increase effectiveness and efficiency in their operation).

¹²² See BLESSE & BASKARAN, *supra* note 118.

¹²³ See Sune Welling Hansen, *Common Pool and Project Size: An Empirical Test on Expenditures Using Danish Municipal Mergers*, 159 PUB. CHOICE 3 (2014); Sune Welling Hansen, Kurt Houlberg & Lene Holm Pedersen, *Do Municipal Mergers Improve Fiscal Outcomes?*, 37 J. SCANDINAVIAN POL. STUD. 196 (2014); Antti Moisio, *The Impact of Municipal Mergers on Local Public Expenditures in Finland*, 3 PUB. FIN. & MGMT. 148 (2013); Reto Steiner, *The Causes, Spread and Effects of Intermunicipal Cooperation and Municipal Mergers in Switzerland*, 5 PUB. MGMT. REV. 551 (2003). One study noted that “compulsory” mergers tend to produce better results than voluntary mergers. See BLESSE & BASKARAN, *supra* note 118 at 24. Though, in the European context, compulsory generally means state-imposed, it is possible that a merger

The merger response to municipal budget problems is being tentatively encouraged in a number of states, including California, Indiana, Michigan, New Jersey, and New York.¹²⁴ While residents in some towns resist mergers, local and state officials often argue in favor of mergers, particularly for towns where independent public good creation is blatantly inefficient.¹²⁵ Finally, one could envision a “prepackaged” merger, where a service pricing deal is reached by two cities and the insolvency regime is used as a market test.

C. *Unaddressed Concerns: Pensions and Tax Code Distortions*

In addition to the above procedural questions, two issues that have a significant impact on municipal solvency are beyond the scope of this Article but cannot go entirely unmentioned: pensions and the beneficial tax treatment afforded municipal bonds. These issues should be resolved through alternative political processes, not bankruptcy law.

1. *Pensions*

As noted above in Part II, pensions are one of the two types of creditors holding the lion’s share of municipal debt.¹²⁶ Unlike bonds, however, holders of pension obligations cannot, by and large, transfer their right to receive payment on the pension; the market borders on illiquid.¹²⁷ Undoubtedly, because the new system addresses the relocation cost problem without contemplating the inability of pensioners to trade out of their debt holdings, the impact on pension-based creditors will be poor. However, the treatment of pension creditors should not be addressed through the Bankruptcy Code.

arrived at through the competitive bidding process could have a similar “compulsory” effect, having been “compelled” by market forces.

¹²⁴ See William Alden, *Municipal M&A: Budget Woes May Force Cities Like Detroit, Hamtramck To Combine*, HUFFINGTON POST (Apr. 22, 2011, 2:54 PM), http://www.huffingtonpost.com/2011/04/22/municipal-merger-detroit_n_852312.html; Megan Demarco, *After Princeton Towns’ Consolidation, Are More N.J. Mergers on the Way?*, NJ.COM (Nov. 10, 2011 3:54 PM), http://www.nj.com/news/index.ssf/2011/11/after_princeton_towns_consolid.html; *Locals Concerned as Cuomo Pushes Municipal Mergers*, WPTZ (Feb. 22, 2014, 1:58 PM), <http://www.wptz.com/news/vermont-new-york/plattsburgh/locals-concerned-as-cuomo-pushes-municipal-mergers/24617888>; Richard Perez-Pena, *New Jersey’s Tiniest Towns Fight Push to Merge*, N.Y. TIMES, Nov. 26, 2010, at MB1, <http://www.nytimes.com/2010/11/28/nyregion/28teterboro.html>.

¹²⁵ See Perez-Pena, *supra* note 124.

¹²⁶ See generally UNDERFUNDING OF PENSIONS, *supra* note 39.

¹²⁷ A product called a “mirrored pension,” which trades an up-front, lump sum payment for the right to receive the pensioner’s income stream when they retire, does exist, but fees for these deals are significant, and FINRA has warned that such trades may be fraudulent. See Susan Tompor, *Be Wary of Trading Away Your Pension*, DETROIT FREE PRESS (July 22, 2013 12:01 AM), <http://www.buffalonews.com/business/retirement/be-wary-of-trading-away-your-pension-20130722>.

Developing a different treatment for specific types of creditors would run counter to both the basic underpinnings of the Creditors' Bargain theory and longstanding bankruptcy norms, such as the equality of distribution among creditors. Locating a solution to the pension problem within the Bankruptcy Code could only comport with a distribution-based theory of bankruptcy law.

2. *Tax-Free Bonds*

The second is the tax code distortion created by the tax-free status of municipal bonds.¹²⁸ Some studies on the pricing of such bonds have found that the tax discount itself is priced by the market, such that overinvestment does not result directly from the disparate tax treatment of these bonds.¹²⁹ Still, the ability of investors to use municipal bonds as part of a portfolio-based tax arbitrage strategy means that such bonds' tax-free status may still result in overinvestment.¹³⁰ How to resolve this problem is unclear, but propagators of a municipal bankruptcy regime should be aware of the incentives this may create for municipal lenders.

CONCLUSION

This Article set out to elucidate a new theory of municipal insolvency based on an economic account of cities and the analogy of the municipality to the corporate debtor. From a wealth-maximization standpoint, a Creditors' Bargain theory of municipal insolvency that takes relocation costs into account provides a more robust response to municipal insolvency than the "breathing room" approach that undergirds the current bankruptcy regime. The tiered waterfall bidding system, though not a panacea for a market-based allocation of resources for bankrupt cities, will hopefully provide a template for new approaches to resolving problems of municipal insolvency.

¹²⁸ See 26 U.S.C. § 103 (2012).

¹²⁹ See generally Wang, Wu, & Zhang, *supra* note 37; REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 37.

¹³⁰ REPORT ON THE MUNICIPAL SECURITIES MARKET, *supra* note 37.