Emory Bankruptcy Developments Journal

Volume 38 | Issue 2

2022

Rethinking Roadblocks to Municipal Bankruptcy

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RETHINKING ROADBLOCKS TO MUNICIPAL BANKRUPTCY

ABSTRACT

This Comment argues that Congress should remove roadblocks that prevent municipalities from easily filing for bankruptcy. It shows that statutory and ad hoc roadblocks allow states and the federal government to exert excessive pressure on fiscally distressed municipalities. Further, while scholars claim that the Bankruptcy Code provides bankruptcy courts with too little power to adjudicate municipal bankruptcies and that municipal fiscal distress should be resolved by states, this Comment argues that federal bankruptcy courts are the proper venue to resolve municipal distress and that these courts have sufficient power. This power could be used more effectively by removing chapter 9's insolvency requirement and inducing states to allow quicker access to bankruptcy courts.

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INTRODUCTION

Municipal bankruptcies necessarily involve every level of government. Municipalities are only allowed to file for bankruptcy under chapter 9 of the Bankruptcy Code (the "Code"), and chapter 9 applies only to municipalities.[1] Municipalities must be "specifically authorized" by their states to file for bankruptcy.[2] The federal government provides the forum and statutory framework under which municipal bankruptcies are litigated, and the Constitution gives Congress the power to establish "uniform Laws on the subject of Bankruptcies throughout the United States."[3] Constitutional concerns and principles of federalism have shaped the history of municipal bankruptcies[4] and continue to shape how bankruptcy courts adjudicate municipal bankruptcies.[5] All non-bankruptcy resolutions of municipal debt must involve municipalities and state governments, and some cases may also include the federal government.[6] For example, some states have financial control boards that take over distressed municipalities while trying to resolve debt issues.[7] Finally, the federal government has long been involved in municipal debt markets[8] and has intervened directly to address financial distress in Puerto Rico, Washington, D.C., and New York City.[9]

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1 11 U.S.C. § 109(c)(1) (2018) ("An entity may be a debtor under chapter 9 . . . if and only if such entity is a municipality."). Chapter 7 is restricted to certain "person[s]." *Id.* § 109(b). A municipality is not a person under the Bankruptcy Code. *Id.* § 101(41). Chapter 11 is restricted to those eligible for Chapter 7, railroads, and certain banks and clearinghouses. *Id.* § 109(d). Chapter 13 is restricted to "an individual with regular income." 11 U.S.C. § 109(e) (2018). Chapter 12 is restricted to family farmers and fishermen. *Id.* § 109(f).

2 11 U.S.C. § 109(c)(2) (2018).

3 U.S. CONST. art. I, § 8, cl. 4.

4 *See, e.g.*, Ashton v. Cameron Cnty. Water Improvement Dist., 298 U.S. 513, 531 (1936) (holding initial municipal bankruptcy legislation unconstitutional because states would "no longer [be] free to manage their own affairs"); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 457 (1993) (explaining state authorization requirement "has roots in the constitutional principle that the federal government may not interfere with the internal governance of a state or its political subdivisions").

5 *See, e.g.*, 11 U.S.C. § 904 (2018) (limiting the power of bankruptcy courts in municipal bankruptcies).

6 *See, e.g.*, Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 285 (2012) (explaining that municipal distress necessarily impacts state and federal governments).

7 *See* Note, *Missed Opportunity: Urban Fiscal Crises and Financial Control Boards*, 110 HARV. L. REV. 733, 734 (1997) ("The term 'financial control board' (FCB) refers to any state-created agency established by statute to oversee the financial affairs of a city during a fiscal crisis.") (internal citation omitted).

8 *See* David Schleicher, *Hands On! Part I: The Trilemma Facing the Federal Government During State and Local Budget Crises* 4, 15–53 (July 12, 2020) (unpublished manuscript), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3649278 (describing the federal government's history of involvement with state and local finances).

9 *See* Puerto Rico Oversight, Management, and Economic Stability Act, Pub. L. No. 114-187, § 101, 130 Stat. 549, 553 (codified at 48 U.S.C. § 2121 (2018)); District of Columbia Financial Responsibility and Management Assistance Act of 1995, Pub. L. No. 104-8, § 101, 109 Stat. 97, 100; New York City Seasonal

To file for bankruptcy, municipalities must satisfy stricter filing requirements than other debtors.[10] The strict filing requirements are coupled with specific statutory limitations on state and federal government activities as they relate to the debtor municipality.[11] The stricter requirements, and particularly the requirement that a debtor municipality be insolvent before filing, along with post-filing limitations, create a window and motive for state and federal governments to strong-arm municipalities into adopting their preferred debt resolution strategies. The restrictions also exacerbate the municipality's debt problems as they extend the time required to resolve debt issues and may force the municipality to continue adding to its pile of debt.[12]

The literature around municipal bankruptcy tends to portray distressed municipalities as having incurred too much debt and then refusing to make difficult decisions, such as tax increases and service cuts, to pay back the debt.[13] Under this view, municipalities threaten to file for bankruptcy to force state and federal governments into bailing them out.[14] State and federal governments acquiesce to these threats because failing to do so would lead to contagion in municipal bond markets or would violate implicit guarantees potentially priced into the cost for municipal credit.[15] Starting from this diagnosis, this view suggests either dramatically increasing the power of the bankruptcy court by allowing it to raise taxes, cut spending, and sell municipal property,[16] or

Financing Act of 1975, Pub. L. No. 94-143, § 4(a), 89 Stat 797, 797.

[10] Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 461 (1993). *Compare* 11 U.S.C. § 109(c) (2018) (describing when an entity may be a debtor in a chapter 9 bankruptcy), *with* 11 U.S.C. § 109(b) (2018) (describing when an individual may be a debtor in a chapter 7 bankruptcy).

[11] *See* 11 U.S.C. § 362 (2018) (providing the protections afforded by the automatic stay); *id.* § 903 (generally reserving state power but preventing states from changing composition of debt); *id.* § 904 (limiting bankruptcy court's power); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 462–63 (1993); *see also* Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEVS. J. 625, 626 (1995) (explaining how Bridgeport filing for bankruptcy prevented Connecticut from seeking a writ of mandamus to increase property taxes).

[12] *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 462–63 (1993); *see* Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEVS. J. 625, 629, 639–40 (1995) (describing Bridgeport's increased borrowing costs and the dismissal of its bankruptcy petition).

[13] *See, e.g.*, Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 282 (2012) (listing examples of municipalities rejecting tax increases or service cuts during episodes of fiscal distress).

[14] *See id.* at 283–84.

[15] *See id.* at 286–87; Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 460 (1993).

[16] *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to*

dramatically scaling back the bankruptcy court's power by allowing it only to bind creditors who holdout from resolution plans.[17]

This Comment rebuts the argument that municipalities threaten to file for bankruptcy to force federal and state governments to bail them out. Instead, federal and state governments use bailouts along with longstanding and ad hoc roadblocks to prevent municipalities from accessing bankruptcy courts. These access restrictions allow states and the federal government to exert greater control over distressed municipalities than they would have in a bankruptcy proceeding.[18] Further, these roadblocks increase the time and cost required to resolve a municipality's debt situation.[19]

This Comment further argues that bankruptcy courts have sufficient power to resolve municipal bankruptcies, and that if the federal government wants chapter 9 to be a useful tool, it should relax the statutory filing requirements and provide states with incentives to allow their municipalities easier access to bankruptcy courts. Doing so would allow municipalities timely access to bankruptcy protection and allow the municipalities to retain autonomy in the process. Those outcomes would be consistent with the goals of bankruptcy generally and with principles of federalism.

The Comment proceeds as follows: Part II provides some background on municipal bankruptcy, illustrates the roadblocks faced by municipalities trying to file for bankruptcy, discusses the policy underlying bankruptcy, and explains the literature's criticisms of municipal bankruptcy. Part III argues that federal bankruptcy courts are the proper venue for municipal debt resolution and that chapter 9's filing requirements should be relaxed. Part IV concludes.

Municipal Bankruptcy, 60 U. CHI. L. REV. 425, 475–76 (1993); Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 295–96 (2012).

[17] Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 395 (2010).

[18] Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEVS. J. 625, 626 (1995); Tami Luhby, *Troubled Harrisburg Now State's Problem*, CNN: MONEY (Nov. 23, 2011, 5:30 PM), https://money.cnn.com/2011/11/23/news/economy/harrisburg_bankruptcy/index.htm.

[19] Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993).

I. BACKGROUND

A. A Brief Overview of Municipal Bankruptcy

Chapter 9 is used infrequently. Only 29 municipalities filed for bankruptcy between 2001 and 2017.[20] Detroit, with more than $18 billion in debt, filed for bankruptcy in 2013, making it the largest municipal bankruptcy case to date.[21]

Municipalities can only file for bankruptcy through chapter 9 of the Code, and chapter 9 applies only to municipalities.[22] Congress first provided for municipal bankruptcies in 1934, with a predecessor to chapter 9, in response to the Great Depression, primarily to overcome issues posed by holdout debtors.[23] During the Great Depression, many fiscally distressed municipalities negotiated debt adjustment plans with their creditors but could not carry out those plans because of the "strategic resistance of a small minority" of creditors, or holdouts.[24] Federal municipal bankruptcy legislation allowed a court to make debt adjustment plans binding on holdout creditors.[25]

The Supreme Court held this legislation to be unconstitutional in 1936.[26] Congress enacted some minor, potentially irrelevant, revisions to the statute, which the Supreme Court upheld in 1938.[27] In 1976, responding to New York City's fiscal crisis, Congress substantially updated Chapter 9 to what we see now.[28]

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[20] Mary Murphy, *Local Governments Rarely File for Bankruptcy*, THE PEW CHARITABLE TRUSTS (Feb. 6, 2018), https://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2018/02/local-governments-rarely-file-for-bankruptcy.

[21] Danielle Kurtzleben, *Everything You Need to Know About the Detroit Bankruptcy*, VOX (Dec. 15, 2014, 12:18 PM), https://www.vox.com/2014/12/15/18073574/detroit-bankruptcy-pensions-municipal.

[22] 11 U.S.C. § 109 (2018); *see* 11 U.S.C. §§ 101(40), (41) (2018).

[23] Pub. L. No. 251, 48 Stat. 798 (1934); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 450–51 (1993); Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 364–65 (2010).

[24] Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 363 (2010).

[25] *See id.* at 364–65.

[26] Ashton v. Cameron Cnty. Water Improvement Dist., 298 U.S. 513, 531 (1936).

[27] Pub. L. No. 302, 50 Stat. 653 (1937); United States v. Bekins, 304 U.S. 27, 54 (1938); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 452–53 (1993).

[28] *See* Pub L. No. 94–260, 90 Stat. 315 (1976); Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 366–69 (2010).

An entity can file for bankruptcy under chapter 9 "if and only if such entity":[29]

> (1) is a municipality;
> (2) is specifically authorized . . . by State law. . .;
> (3) is insolvent;
> (4) desires to effect a plan to adjust such debts; and
> (5)
>> (A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class . . .;
>> (B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors . . .;
>> (C) is unable to negotiate with creditors because such negotiation is impracticable; or
>> (D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable . . ..[30]

Relative to other debtors, municipalities must satisfy more requirements before filing for bankruptcy. As Professor Melissa Jacoby notes, "[i]t is very, very difficult for a municipality to be eligible for bankruptcy."[31] Non-municipal debtors do not have be authorized by state law or be insolvent, nor are they required to negotiate with creditors prior to filing for bankruptcy.[32] However, also unlike other chapters, chapter 9 only allows a municipality, and not its creditors, to file a plan to adjust its debts.[33]

The Code places significant limits on what a bankruptcy court can do when adjudicating a municipal bankruptcy relative to what it can do in other bankruptcies.[34] A bankruptcy court cannot, without the municipal debtor's consent, interfere with the debtor's political or governmental powers, property

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[29] 11 U.S.C. § 109(c) (2018).

[30] *Id.*

[31] Danielle Kurtzleben, *Everything You Need to Know About the Detroit Bankruptcy*, VOX (Dec. 15, 2014, 12:18 PM), https://www.vox.com/2014/12/15/18073574/detroit-bankruptcy-pensions-municipal.

[32] Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 455–57 (1993). *Compare* 11 U.S.C. § 109(c) (2018) (listing requirements to file for municipal bankruptcy), *with* 11 U.S.C. § 109(b) (2018) (broadly allowing most entities to file for chapter 7 bankruptcy).

[33] *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 463 (1993). *Compare* 11 U.S.C. § 941 (2018) (stating that the debtor shall file a plan), *with* 11 U.S.C. § 1121(c) (2018) (stating that any party in interest may file a plan).

[34] *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 462 (1993) (noting that "a major difference between municipal and private bankruptcy is the degree of control exercised by the court over the debtor" and illustrating this difference with specific examples of what courts can – or cannot – do in both contexts).

or revenues, or use or enjoyment of income-producing property.[35] This means that a bankruptcy court cannot unilaterally order a municipal debtor to raise taxes, cut public services, or sell municipal property.[36] The Code also recognizes and specifically preserves a state's power to control a municipality.[37] However, it restricts the state from modifying the composition of the municipality's debt without the consent of the municipality's creditors.[38] Further, like non-municipal debtors, once a municipality files for bankruptcy, it is protected from external actions by the Code's automatic stay provisions.[39] Among other restrictions, the automatic stay prevents creditors from collecting on their debts and executing liens and prevents the state from raising taxes on the municipality's residents.[40] The structure of the Code, therefore, makes it difficult for a municipality to file in the first instance, but once it clears those hurdles, the municipality has significant control over the proceeding.[41]

1. The Specific Authorization Requirement Makes States Into Gatekeepers To Municipal Bankruptcy

Chapter 9 requires that a municipality filing for bankruptcy be "specifically authorized . . . to be a debtor under [chapter 9] by State law."[42] The specific authorization provision of the Code makes states explicit gatekeepers for municipalities attempting to access the bankruptcy court.[43] The state authorization provision might be required to preserve a state's power over its municipalities, and it may be unconstitutional to prevent states from deciding how or if their municipalities can file for bankruptcy.[44]

States have adopted various approaches in deciding if or how their municipalities can file for bankruptcy.[45] Some states, like Texas, provide a

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35 11 U.S.C. § 904 (2018).

36 *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 474 (1993).

37 11 U.S.C. § 903 (2018).

38 *Id.* § 903(1).

39 *Id.* § 362; *see also id.* § 901 (making the automatic stay applicable to chapter 9).

40 *See* 11 U.S.C. §§ 362(2), (4), (7) (2018); *see also* Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEVS. J. 625, 626 (1995).

41 Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 356–57 (2010); *see* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 463 (1993).

42 11 U.S.C. § 109(c)(2) (2018).

43 *Id.*

44 *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 457 (1993).

45 M. Heith Frost, Comment, *States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific*

blanket authorization for municipalities to file for bankruptcy, while others, such as Georgia, explicitly prohibit their municipalities from filing.[46]

Other states use complex, multi-step processes which must be exhausted before turning to chapter 9.[47] Michigan's process is a common example of the complex process a municipality must navigate before filing for bankruptcy.[48] Upon the occurrence of one or more of nineteen events, including a request from local government officials, a low enough credit rating, and "the state treasurer's sole discretion," "the state financial authority may conduct a preliminary review to determine the existence of probable financial stress within a local government."[49] The state financial authority prepares a report for "the local emergency financial assistance loan board," which determines if there is "probable financial stress."[50] Then the governor appoints a team made up of representatives of state executive and legislative leadership to review the municipality's finances again and prepare another report.[51] After receiving that report, the governor finally determines whether the municipality is facing a financial emergency, a decision which the municipality can appeal.[52] If the determination stands, the municipality can choose from a menu of four options, which include entering into a consent agreement, having an emergency manager appointed, entering into a "neutral evaluation process," or filing for chapter 9.[53] But the municipality can only choose chapter 9 if the governor specifically approves the filing.[54] Approval can come with conditions, such as appointing

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Authorization, and Protection of Municipal Economic Health, 84 MISS. L.J. 817, 834 (2015).

[46] *See id.* at 835–38. *Compare* TEX. LOC. GOV'T CODE ANN. § 140.001 (West 2021) (providing blanket authorization for municipalities to file for bankruptcy), *with* GA. CODE ANN. § 36-80-5 (West 2021) (disallowing municipalities from filing for bankruptcy).

[47] *See* M. Heith Frost, Comment, *States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 838–48 (2015).

[48] *See id.* at 844–48.

[49] MICH. COMP. LAWS ANN. § 141.1544(1) (West 2020); *see* M. Heith Frost, Comment, *States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 844, n.130 (2015).

[50] MICH. COMP. LAWS ANN. § 141.1544(3) (West 2020); *see* M. Heith Frost, Comment, *States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 845 (2015).

[51] MICH. COMP. LAWS ANN. § 141.1544(4) (West 2020); MICH. COMP. LAWS ANN. § 141.1545(3) (West 2020); *see* M. Heith Frost, Comment, *States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 845 (2015).

[52] M. Heith Frost, Comment, *States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 845 (2015); *see* MICH. COMP. LAWS ANN. § 141.1545 (West 2020).

[53] MICH. COMP. LAWS ANN. § 141.1547(1) (West 2020); *see* M. Heith Frost, Comment, *States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 845–48 (2015).

[54] MICH. COMP. LAWS ANN. § 141.1547(1)(d) (West 2020); MICH. COMP. LAWS ANN. § 141.1566 (West

someone to act on behalf of the municipality in chapter 9.[55] Denial requires the municipality to choose from the remaining three options.[56] If the city chooses to have an emergency manager appointed, the emergency manager can recommend and request approval from the governor to file for chapter 9, if "no reasonable alternative" exists."[57] Similarly, if the neutral evaluation process does not resolve disputes between the municipality and creditors, the municipality can request the governor's approval to file for chapter 9.[58]

In Detroit's bankruptcy case, the city had an emergency manager who requested the governor's approval for chapter 9.[59] The governor approved this request.[60] Objectors argued that this authorization was deficient since the act establishing the process for a Michigan municipality to file for bankruptcy violated the state's constitution.[61] The court dismissed the objections, upheld the constitutionality of the underlying act, and found that Detroit was specifically authorized to file for bankruptcy, as required by chapter 9.[62]

At other times, states alter authorization statutes to prevent a specific bankruptcy filing. In December 2010, Pennsylvania found, after a request from Harrisburg, that Harrisburg was in "'municipal financial distress.'"[63] Then, while Harrisburg and Pennsylvania were negotiating resolution plans, Pennsylvania enacted a one-year ban on certain municipalities filing for bankruptcy, just a few months before Harrisburg's city council ultimately filed.[64] Thus a filing that may well have been permitted in June 2011 was clearly prohibited in July.[65] Pennsylvania later amended its code so that municipalities could no longer directly file for bankruptcy.[66] Instead, they now have to apply

2020); *see* M. Heith Frost, Comment, *States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 848 (2015).

55 MICH. COMP. LAWS ANN. § 141.1566(2) (West 2020); *see* MICH. COMP. LAWS ANN. § 141.1547(1) (West 2020); M. Heith Frost, Comment, *States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 848 (2015).

56 MICH. COMP. LAWS ANN. § 141.1566(3) (West 2020).

57 *Id.* § 141.1558(1).

58 *Id.* § 141.1565(23).

59 *In re* City of Detroit, 504 B.R. 191, 248 (Bankr. E.D. Mich. 2013).

60 *Id.* at 248.

61 *Id.* at 248–49.

62 *Id.* at 261.

63 *In re* City of Harrisburg, 465 B.R. 744, 750 (Bankr. M.D. Pa. 2011).

64 *Id.* at 750–52.

65 *Id.* at 754–55.

66 *Compare* 53 PA. STAT. AND CONS. STAT. ANN. § 11701.261 (West 2020), *with* 53 PA. STAT. AND CONS. STAT. ANN. § 11701.261 (West 2012).

to and receive permission from Pennsylvania's Department of Community and Economic Development before filing for bankruptcy.[67]

2. The Insolvency Requirement Prevents Distressed Municipalities From Receiving Bankruptcy Protection

The insolvency requirement functions as a significant roadblock between municipalities and the bankruptcy court.[68] The Code provides two tests for insolvency, and a municipality must satisfy one of these two tests: the municipality must show that it either is "generally not paying its debts as they become due," or "unable to pay its debts as they become due."[69] The former test asks whether the municipality is currently insolvent and "requires *general* nonpayment of debts as they become due."[70] A municipality that is not paying a single claim, or a "single category of claims" would not qualify as insolvent under this test.[71]

The latter insolvency test is based on cash flow.[72] The municipality would have to show that it will not be able to pay debts maturing in the future.[73] In *Bridgeport*, the court restricted the time horizon for future insolvency to the current or next fiscal year, a decision that has been followed in subsequent municipal bankruptcies.[74] Ascertaining whether a municipality will become insolvent is an exercise in weighing various financial projections. The ambiguity in administering the test, cloaked as "mathematical precision," has led to the development of the "'service delivery insolvency' test."[75] This test is "typically defined in terms of a significant reduction in the availability of city services."[76]

By contrast, non-municipal entities, which are not required to be insolvent to file for bankruptcy, are defined as insolvent if their debt is greater than the

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67 53 PA. STAT. AND CONS. STAT. ANN. § 11701.261 (West 2020); *id.* § 11701.103.

68 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993) ("The insolvency standard delays and discourages municipal bankruptcy filings and thus serves as an effective gatekeeper.").

69 11 U.S.C. § 101(32)(C) (2018) (listing two tests); *see also In re* Bridgeport, 129 B.R. 332, 336 (Bankr. D. Conn. 1991) (noting "[t]he two parts of § 101(32)(C) are joined by the disjunctive 'or'.").

70 *In re* Boise Cnty., 465 B.R. 156, 171 (Bankr. D. Idaho 2011) (emphasis in original).

71 *Id.* at 171.

72 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993).

73 *See id.* at 456 ("[B]ills will arrive in six months and cannot be paid then.").

74 *In re* Bridgeport, 129 B.R. 332, 338 (Bankr. D. Conn. 1991); *see, e.g.*, *In re* Boise Cnty., 465 B.R. 156, 172 (Bankr. D. Idaho 2011).

75 Clayton P. Gillette, *How Cities Fail: Service Delivery Insolvency and Municipal Bankruptcy*, 2019 MICH. ST. L. REV. 1211, 1214, 1218 (2019).

76 *Id.* at 1218.

value of their assets.[77] The definition of insolvency is different for municipal and non-municipal debtors because the municipality's physical assets are not considered available to creditors.[78] The insolvency requirement often prevents municipalities from receiving bankruptcy protection.[79]

In *Bridgeport*, the decision on insolvency rested on whether the court believed the state's description of the situation or the city's.[80] To make the finding that Bridgeport would be able to pay its bills as they came due in the current fiscal year, the court reasoned Bridgeport could use funds available to plug a $16,000,000 deficit which would have to be paid back in the next two fiscal years.[81] The later of the next two fiscal years was outside the court's time horizon, while Bridgeport did not have a budget for the next fiscal year which could be used for a cash flow analysis.[82] Thus, while it was clear that "Bridgeport was undoubtedly in deep financial trouble," it would have to take on more debt since its financial troubles did not rise to the level of insolvency. [83] Similarly, the court in *Boise County* found the county not to be insolvent since it could cobble together funds from various potentially restricted funds to pay a judgment against it.[84] However, it is likely that if the service delivery insolvency test were applied to Bridgeport, which the court noted could not adequately collect garbage, plow snow, sweep streets, clean public buildings, or keep branch libraries open more than one day a week, it too would have been found to be insolvent.[85]

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77 11 U.S.C. §§ 101(32)(A), (B) (2018).

78 *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993).

79 *See, e.g.*, *In re* Bridgeport, 129 B.R. 332, 339 (Bankr. D. Conn. 1991) (dismissing Bridgeport's bankruptcy petition because "financial difficulties short of insolvency are not a basis for chapter 9 relief."); *In re* Boise Cnty., 465 B.R. 156, 180 (Bankr. D. Idaho 2011) (dismissing Boise County's bankruptcy petition because "the County has not established it was insolvent").

80 *See In re* Bridgeport, 129 B.R. 332, 337 (Bankr. D. Conn. 1991); *see also* Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEVS. J. 625, 638–39 (1995).

81 *In re* Bridgeport, 129 B.R. 332, 337 (Bankr. D. Conn. 1991) ("If in fact there is a budget gap, Bridgeport will be
obligated to reimburse the contingency funds used to balance the budget, but it may do so in fiscal year 1992-1993
or fiscal year 1993-1994."); *see* Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 293 (2012).

82 *See In re* Bridgeport, 129 B.R. 332, 338 (Bankr. D. Conn. 1991) (noting "there is not even a proposed budget" for the 1992–1993 fiscal year).

83 *Id.* at 339.

84 *In re* Boise Cnty., 465 B.R. 156, 180 (Bankr. D. Idaho 2011).

85 *See In re* Bridgeport, 129 B.R. 332, 335 (Bankr. D. Conn. 1991); Clayton P. Gillette, *How Cities Fail: Service Delivery Insolvency and Municipal Bankruptcy*, 2019 MICH. ST. L. REV. 1211, 1225 (2019).

In *Detroit*, the court found Detroit was insolvent under both tests. First, it found that Detroit was not paying its debts as they became due as it deferred or otherwise failed to make payments on pension obligations that were due.[86] In rejecting the argument that failure to make pension payments indicated a "'purposeful refusal to make a few payments comprising a relatively small part of the City's budget,'" the court reasoned the default was "particularly serious" since "it put in jeopardy the City's access to . . . one of the City's few reliable sources of income."[87]

The court further held Detroit was insolvent on a cash-flow basis.[88] But, instead of relying on budget projections as the *Bridgeport* court did, the *Detroit* court noted that "many services in the City . . . do not function properly as a result of the City's financial state."[89] This "firmly support[ed]" the holding that Detroit was "unable to pay its debts as they became due."[90]

Only after the court found Detroit to be eligible did the work of restructuring its debts begin. In the end, the court confirmed a plan which discharged $7 billion in debt.[91] The "centerpiece" of the plan was a Grand Bargain which prevented creditors from selling off art held by the Detroit Institute of Arts ("DIA") by gathering the state and private donors to make contributions to Detroit's pension system.[92]

B. States and the Federal Government Often Set Up Ad Hoc Roadblocks Preventing Municipalities From Filing for Bankruptcy

States and the federal government also set up ad hoc diversions from bankruptcy, or otherwise influence the outcome of bankruptcy proceedings. Sometimes these diversions come at the behest of municipalities, lending some credence to the argument that municipalities may be using the threat of bankruptcy to extract bailouts from states and the federal government.[93] One

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86 *In re* City of Detroit, 504 B.R. 191, 262–63 (Bankr. E.D. Mich. 2013).

87 *Id.* at 263.

88 *Id.* at 263.

89 *Compare In re* City of Detroit, 504 B.R. 191, 263 (Bankr. E.D. Mich. 2013) (quote source), *with In re* Bridgeport, 129 B.R. 332, 337 (Bankr. D. Conn. 1991).

90 *In re* City of Detroit, 504 B.R. 191, 263 (Bankr. E.D. Mich. 2013).

91 Monica Davey & Mary Williams Walsh, *Plan to Exit Bankruptcy Is Approved for Detroit*, N.Y. TIMES (Nov. 7, 2014), https://www.nytimes.com/2014/11/08/us/detroit-bankruptcy-plan-ruling.html.

92 Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55, 106; *see* Randy Kennedy, *'Grand Bargain' Saves the Detroit Institute of Arts*, N.Y. TIMES (Nov. 7, 2014), https://www.nytimes.com/2014/11/08/arts/design/grand-bargain-saves-the-detroit-institute-of-arts.html.

93 *See* Jeff Nussbaum, *The Night New York Saved Itself from Bankruptcy*, NEW YORKER (Oct. 16, 2015), https://www.newyorker.com/news/news-desk/the-night-new-york-saved-itself-from-bankruptcy ("New York's

such example is that of New York City in the 1970s. After initially refusing to bailout New York, President Ford signed a bill providing New York with $2.3 billion in loans, allowing it to avoid filing for bankruptcy.[94] New York City's experience led to changes in the Code which formed substantially the chapter 9 we have now.[95]

Sometimes states create policies to essentially control the outcome of a future municipal bankruptcy proceeding. For example, after Central Falls, Rhode Island went into receivership, but shortly before it filed for bankruptcy, the Rhode Island legislature gave general obligation bondholders a statutory lien on tax revenues.[96] The effect was that throughout and after its bankruptcy, Central Falls' bondholders continued to be paid in full, while some retirees saw their pensions cut up to 55%.[97]

C. *The Policy Behind Bankruptcy Requires Keeping in Mind the Interests of Residents of Distressed Municipalities and Allowing Quicker Access to the Bankruptcy Court*

The Code exists to provide debtors a fresh start.[98] Chapter 9 may specifically be "based on the idea of the fresh start rather than the efficient reconfiguration of assets."[99] Giving a debtor a fresh start means reducing the debtor's debt burden so that it can "rehabilitate."[100] A fresh start would allow a municipality

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leaders continued to petition for federal help.").

94 David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 728–29 (2012); New York City Seasonal Financing Act of 1975, Pub. L. No. 94-143, 89 Stat. 797 (1975); Martin Tolchin, *8% Interest Rate*, N.Y. TIMES, (Nov. 27, 1975), https://www.nytimes.com/1975/11/27/archives/8-interest-rate.html.

95 Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 366–69 (2010).

96 David A. Skeel, Jr., *What is a Lien? Lessons from Municipal Bankruptcy*, 2015 U. ILL. L. REV. 675, 687–88 (2015); Michael Corkery, *Bondholders Win in Rhode Island*, WALL ST. J., (Aug. 4, 2011, 12:58 PM), https://www.wsj.com/articles/SB10001424053111903885604576486610528775994; *see* Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES (Sept. 6, 2012), https://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html.

97 Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES (Sept. 6, 2012), https://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html. Professor Skeel asserts that a bankruptcy court could possibly have ignored the statute by "conclude[ing] that the 'lien' created by the Rhode Island lien statute [was] not a genuine lien." David A. Skeel, Jr., *What is a Lien? Lessons from Municipal Bankruptcy*, 2015 U. ILL. L. REV. 675, 692.

98 Marrama v. Citizens Bank of Mass., 549 U.S. 365, 367 (2007).

99 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 470 (1993).

100 Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 372 (2010) (relating the "fresh start" to municipal bankruptcy filings by noting that, "[t]hrough bankruptcy, the municipality is able to decrease its debt burden, which helps it to recover and resume financial stability").

to potentially reduce taxes and increase services, making it a more attractive place to live.[101]

Then-Professor Elizabeth Warren, while writing in the context of business bankruptcies, takes a broad view of the policies underlying bankruptcy.[102] In effect, bankruptcy serves as a sort of "escape valve" to avoid debts under "sufficiently compelling circumstances."[103] She contrasts bankruptcy to state collection laws, explaining that state collection law works well in dealing with a single debt.[104] However, in a case where the debtor is collapsing, state collection laws may not work well because faster creditors may collect a debtor's assets before slower creditors can get to the courthouse.[105] In contrast, bankruptcy is designed to deal with situations where the debtor may default on not one, but all of their debts.[106] Bankruptcy then distributes shares of a too-small pie to multiple creditors by treating creditors equally and considering creditors' capacity to bear such costs.[107] Critically, Warren points out that the Code "serves the distributional interests of many who are not technically 'creditors' but who have an interest in a business's continued existence."[108] Judge Steven Rhodes, the judge presiding over Detroit's bankruptcy, echoed these views by noting that "[t]he residents of the city had a great stake in [the] outcome of the case," and that he "'recognize[d] and appreciate[d] the enormous public interest in this case.'"[109]

Warren's discussion is in conversation with views described by Professors Douglas Baird and Thomas Jackson. In the latter's view, the policy underlying bankruptcy is much narrower and serves to promote the interests of creditors as a group.[110] Baird and Jackson agree that state collection laws are "grab" laws which promote the interest of an individual creditor over the interest of all creditors.[111] Bankruptcy then serves the narrow purpose of preventing individual

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101 *Id.* at 373; *see* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 470 (1993).

102 Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 777–78 (1987).

103 *Id.* at 779.

104 *Id.* at 782.

105 *See id.* at 782.

106 *Id.* at 785.

107 *See id.* at 790–91.

108 *Id.* at 787.

109 Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55, 95.

110 *See* Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy,* 51 U. CHI. L. REV. 97, 103 (1984).

111 *Id.* at 100.

creditors from taking actions that benefit an individual creditor over all creditors as a group.[112] In arguing that bankruptcy law should focus only on "the interests of those . . . who, outside of bankruptcy, have property rights in the assets of the firm,"[113] the Baird-Jackson view explicitly rejects the Warren view that a bankruptcy court should consider the interests of non-creditors.[114] For Baird and Jackson, other concerns, such as negative impacts on employees and localities, should be dealt with "through broad changes in the substantive law."[115]

This Comment now turns to exploring the policy goals behind municipal bankruptcies specifically. Like other entities, municipalities sometimes find themselves in situations where they cannot pay their debts. Congress enacted the first municipal bankruptcy legislation in response to widespread municipal distress during the Great Depression and revised it in response to New York City's fiscal crisis.[116] The setup of municipal bankruptcy, specifically the roles played by state and federal governments, is the result of competing constitutional principles.[117] Congress has the power to enact bankruptcy legislation.[118] But when it comes to states and municipalities, the bankruptcy court is limited by the Tenth Amendment.[119] At the same time, states cannot impair contracts, and so would not be able to discharge a municipality's debt.[120]

There is some argument over the states' power to impair contracts as it relates to municipal bankruptcies. In 1942, the Supreme Court, in *Faitoute*, upheld a New Jersey statute which bound unwilling creditors to a municipal debt adjustment plan.[121] The Court held that the debt adjustment, which consisted of replacing old bonds with new ones, was not a violation of the Contracts Clause.[122] However, the Code explicitly disallows states from binding non-consenting creditors.[123] While acknowledging the Code overturns *Faitoute*'s

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112 *See id.* at 106.

113 *Id.* at 103.

114 Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 787–88 (1987).

115 Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 103 (1984).

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

117 NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 986–87 (1997).

118 U.S. CONST. art. I, § 8, cl. 4.

119 *See* NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 986–87 (1997) ("Tenth amendment concerns in legislating municipal bankruptcy provisions remain as vital today as in 1937."); *see* U.S. CONST. amend. X.

120 U.S. CONST. art. I, § 10, cl. 1.

121 Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 508–09 (1942).

122 *Id.* at 514–16.

123 11 U.S.C. § 903 (2018).

"specific holding," McConnell and Picker argue that *Faitoute* may still be good law.[124] Yet, solutions related to municipal fiscal distress should not rely on *Faitoute* for several reasons. First, without being able to bind dissenting creditors, states and municipalities would find themselves struggling to address the holdout problem which first gave rise to municipal bankruptcy legislation.[125] Second, state-level municipal bankruptcy legislation would necessarily not be "uniform" as the Constitution contemplates bankruptcy legislation to be.[126] Third, the statute in *Faitoute* simply replaced old bonds with new bonds; it did not, as a bankruptcy court could, discharge a municipality's debt.[127] Without discharging debt, it is difficult for a municipality to truly have a fresh start.[128] Finally, solutions to municipal debt problems should start from first principles of policy instead of trying to find constitutional and statutory loopholes. That is to say, it is possible to address chapter 9's flaws in a manner that is uniform across municipalities, that does not ask a bankruptcy court to violate the Tenth Amendment and does not require states to find creative ways to impair contracts.

Warren's insight about considering the distributional interests of non-creditors[129] is particularly useful in the case of municipal bankruptcies. Among examples of non-creditors with an interest in the debtor's outcome, Warren mentions the debtor's employees, "nearby property owners who would have suffered declining property values, and states or municipalities that would have faced shrinking tax bases."[130] The observation that bankruptcy can and should consider non-creditors' interests is particularly relevant to municipal bankruptcies because of the unique position of municipal residents. Residents are neither creditors nor owners of the municipality, but surely have a stake in how the municipality deals with its debt.[131] While residents do not have a legal right to a city's revenues, "everyone (liberal, conservative, and libertarian alike) assumes that residents have some claim to share in a city's present and future revenues."[132] This does not mean payouts from the municipality, but that

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124 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 454 n. 127, 479–80.

125 Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG 351, 363–65 (2010).

126 U.S. Const. art. I, § 8, cl. 4.

127 Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 507 (1942).

128 *See* DAVID G. EPSTEIN ET AL., BANKRUPTCY: DEALING WITH FINANCIAL FAILURE FOR INDIVIDUALS AND BUSINESSES 37 (4th ed. 2015).

129 Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 787–88 (1987).

130 *Id.*

131 *See* Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 358 (2010).

132 Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1123 (2014).

consistent with municipal insolvency laws, residents expect continued access to the police, firefighters, water, and trash pickup.[133] Ignoring residents' interests in municipal distress could, rather than fixing the underlying problem, make the problem worse. For instance, favoring creditors by increasing taxes or reducing services beyond a point which is acceptable to residents could lead to residents moving out or the municipality becoming unattractive for others to move into.[134] Even if creditors are not interested in a sufficient level of services for residents "because they are simply people," they should be interested "because they are the city's taxpayers, the ones who can make creditors whole over the long run."[135]

The discussion about residents and the services they expect suggests that it is important that an understanding of what municipalities should do guides municipal bankruptcy outcomes. Professor Michelle Wilde Anderson sheds some light on what municipalities should do.[136] She observes that there is broad agreement that even distressed municipalities should provide "minimum services 'consistent with public health and safety.'"[137] Then, as part of understanding how much a municipality can pay its creditors, it is necessary to understand how much money is required for the municipality to provide minimum services. Anderson develops a framework centered around a municipality's habitability.[138] At a high level, "[h]abitability is . . . a commitment to the safety and comfort of a neighborhood's residents."[139] Specifically, that comes down to "collective conditions, such as crime rates, fire risk, emergency response times, access to clean water, access to wastewater disposal systems, and street lighting."[140] To assess how much money would be required to maintain a habitable municipality, Anderson suggests extrapolating from land use laws, building codes, and environmental regulation.[141] Further, she suggests looking to regional indicators for police and fire departments response times as well as considering the adequacy of the city's education system in determining whether the city can provide minimum services.[142]

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[133] *Id.* at 1122–23.
[134] *See id.* at 1169 (asking whether creditors, among others, would be better off if cities continued owning public property).
[135] *Id.* at 1123.
[136] *See id.* at 1118.
[137] *Id.* at 1123.
[138] *Id.* at 1197.
[139] *Id.* at 1198.
[140] *Id.* at 1198.
[141] *Id.* at 1197–1202.
[142] *Id.* at 1202–04.

Regardless of the specific metrics used, the point is that when the municipal pie is being divided up, an adequate share has to be reserved for its residents.

Surveying the policy underlying chapter 9 suggests that bankruptcy should provide municipal debtors with a fresh start,[143] ensure residents have access to certain minimum services that promote habitability,[144] and protect the interests of creditors as a group.[145] One way to promote all these interests is to, at any given point, stop the situation from getting worse. As a municipality's fiscal situation gets worse, it continues to take on more and more expensive, unpayable debt, making it costlier to get a fresh start.[146] The increased debt load puts the municipality's creditors in a precarious position.[147] At the same time, the municipality starts raising taxes, selling public property, and cutting services, making residents worse off.[148]

D. Criticisms of Municipal Bankruptcies Are Not Well-founded

Most of the literature surrounding chapter 9 discusses its shortcomings.[149] In response, to these shortcomings, Professors McConnell and Picker, and Professor Gillette suggest that bankruptcy courts should raise taxes and reduce municipal services.[150] Professor Kimhi suggests that chapter 9 should be scaled back to deal just with the holdout problem, while most municipal debt resolution should be handled by the state.[151]

Professors McConnell and Picker suggest that Section 904's limitations on bankruptcy judges should be relaxed.[152] Specifically, they argue a bankruptcy

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143 *See* Marrama v. Citizens Bank of Mass., 549 U.S. 365, 367 (2007).

144 Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1195–99 (2014).

145 Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy,* 51 U. CHI. L. REV. 97, 100–01 (1984).

146 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456–57 (1993).

147 *Id.*

148 Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1153 (2014).

149 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 470 (1993) ("Under the present municipal bankruptcy regime, bankruptcy serves . . . . little function at all."); Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 353–54 (2010) ("[B]ankruptcy law . . . is not a sensible solution for urban economic crises.").

150 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 472 (1993); Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 288 (2012).

151 Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 395 (2010).

152 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to*

court should be able to order tax increases, reductions in services, pledge revenue streams to repayment, and sell municipal property.[153] While conceding that these powers would explicitly violate Section 904,[154] they argue that a bankruptcy judge could implicitly exercise these powers by rejecting restructuring plans that do not include resource adjustments.[155] They further argue that as a result of giving the bankruptcy court resource adjustment powers, "bankruptcy would displace democratic decisionmaking."[156] But because they claim that municipal distress is a function of dysfunctional politics, this displacement may be a benefit.[157] Expanded bankruptcy powers would also be akin to state receivership, which McConnell and Picker view favorably.[158] In effect then, expanded bankruptcy powers could make the bankruptcy court a type of super-receiver.

There are drawbacks to this approach. One apparent issue is how much of these resource adjustment powers bankruptcy courts should exercise. McConnell and Picker suggest that a bankruptcy court not be allowed to sell "[p]ublic trust" property" which "provide[s] a genuine public good."[159] But they cite favorably a state receiver who closed libraries to balance a city budget.[160] Is a library not a public good? Perhaps the more substantial drawback is that it is not clear whether allowing a bankruptcy court to exercise resource allocation powers is constitutional.[161] In response to these constitutional concerns, McConnell and Picker suggest a solution is to allow states set up their own municipal bankruptcy systems.[162] Separately, allowing the bankruptcy court to

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Municipal Bankruptcy, 60 U. CHI. L. REV. 425, 472 (1993); *see* 11 U.S.C. § 904 (2018).

153 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 475–76 (1993); Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 283 (2012). Following Professor Gillette, I refer to these as "resource adjustments." Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 283 (2012).

154 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 472 (1993); 11 U.S.C. § 904 (2018).

155 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 474 (1993); Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 295–96 (2012) (suggesting 11 U.S.C. § 904 should be repealed).

156 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 472 (1993).

157 *Id.* at 472–73.

158 *See id.* at 473.

159 *Id.* at 477.

160 *Id.* at 473.

161 *Id.* at 478–79.

162 *Id.* at 479.

sell assets while the municipality is distressed could result in lower prices in the short term and greater costs to replace sold resources in the long term.[163]

II. ARGUMENT

A. Federal Courts Are the Proper Venue for Municipal Debt Resolution

As Warren notes, bankruptcy courts often consider impacts on non-creditors.[164] With respect to municipal bankruptcies, the Code facilitates that goal by allowing municipalities relative control over their bankruptcy proceedings.[165] Because municipal residents are a special class of impacted non-creditors, a bankruptcy court should be mindful of their interests. A municipality is in the best position to determine how much money is required to provide residents with minimum services. Thus, allowing only the municipality to prepare debt reorganization plans allows the municipality to bake these costs into the plan before distributing funds to creditors.[166] Unlike a state receiver, a municipality's elected government is more likely to be attuned and responsive to the needs of its residents.[167] This might be in part because of electoral demands, and in part because the state is likely to be more concerned with the cost of borrowing across municipalities.[168]

Even if bankruptcy should only consider the interests of creditors, quicker access to the bankruptcy court still makes sense. Unlike private creditors, municipal creditors do not run to the courthouse at the first sight of municipal distress because courts cannot provide them much relief.[169] Instead, creditors run to the state legislature.[170] State legislatures are more concerned with borrowing costs across the state than they are with conditions in any particular

163 Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1167–68 (2014).

164 Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 787–88 (1987).

165 11 U.S.C. § 904 (2018).

166 *See id.* § 941.

167 *See, e.g.*, Michael Corkery, *Capital Files for Bankruptcy*, WALL ST. J. (Oct. 13, 2011), https://www.wsj.com/articles/SB10001424052970204002304576626752997922080 (noting "tensions between city officials and state lawmakers, who draw much of their power base from the suburbs.").

168 *See id.*; Maria O'Brien Hylton, *Central Falls Retirees v. Bondholders: Assessing Fear of Contagion in Chapter 9 Proceedings*, 59 WAYNE L. REV. 525, 527 (2013); David A. Skeel, Jr., *What is a Lien? Lessons from Municipal Bankruptcy*, 2015 U. ILL. L. REV. 675, 687 (2015); Michael Corkery, *Bondholders Win in Rhode Island*, WALL ST. J. (Aug. 4, 2011, 12:58 PM), https://www.wsj.com/articles/SB10001424053111903885604576486610528775994.

169 David A. Skeel, Jr., *What is a Lien? Lessons from Municipal Bankruptcy*, 2015 U. ILL. L. REV. 675, 690 (2015).

170 *See, e.g.*, Michael Corkery, *Bondholders Win in Rhode Island*, WALL ST. J. (Aug. 4, 2011, 12:58 PM), https://www.wsj.com/articles/SB10001424053111903885604576486610528775994.

municipality.[171] As a result, creditors with more political power end up better off than those with less.[172] In the Central Falls case, the Rhode Island legislature thought it was better to protect bondholders who lent to municipalities across the state than to protect a local pension which lent to only one municipality.[173] These state dictated plans favor one class of creditor over other classes, running counter to the aims of bankruptcy. Further, as McConnell and Picker note, waiting until a municipality is insolvent adds to a municipality's debt load and makes creditors as a group worse off in the end.[174] Crucially, the time between when municipal distress becomes apparent and when the municipality becomes insolvent is a window for creditors to lobby state legislators for preferential treatment.

1. *The Federal Government Has Long Been Involved in Municipal Debt Crises*

Federal bankruptcy courts are the proper venue to resolve municipal debt problems. The federal government has long been involved in municipal debt markets.[175] Its interest in municipal distress is apparent from the creation of chapter 9 itself. More specifically, "the federal government is *aggressively* in favor of state and local debt."[176] In fact, it subsidizes municipal debt by exempting interest paid on municipal bonds from federal income taxes.[177] This encourages municipalities to take on debt to build infrastructure that the federal

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171 *See, e.g.*, Maria O'Brien Hylton, *Central Falls Retirees v. Bondholders: Assessing Fear of Contagion in Chapter 9 Proceedings*, 59 WAYNE L. REV. 525, 527 (2013); David A. Skeel, Jr., *What is a Lien? Lessons from Municipal Bankruptcy*, 2015 U. ILL. L. REV. 675, 687 (2015); Michael Corkery, *Bondholders Win in Rhode Island*, WALL ST. J. (Aug. 4, 2011, 12:58 PM), https://www.wsj.com/articles/SB10001424053111903885604576486610528775994.

172 Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES (Sept. 6, 2012), https://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html (noting that creditors may have been treated equally in bankruptcy if not for statutory preference for bondholders).

173 Michael Corkery, *Bondholders Win in Rhode Island*, WALL ST. J. (Aug. 4, 2011, 12:58 PM), https://www.wsj.com/articles/SB10001424053111903885604576486610528775994 ("State officials and lawmakers say the law is needed to lure investors to bonds that will be sold by other Rhode Island municipalities.").

174 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456–57 (1993).

175 David Schleicher, *Hands On! Part I: The Trilemma Facing the Federal Government During State and Local Budget Crises* 1 (July 12, 2020) (unpublished manuscript), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3649278.

176 *Id.* at 12.

177 26 U.S.C. § 103 (2018); David Schleicher, *Hands On! Part I: The Trilemma Facing the Federal Government During State and Local Budget Crises* 12 (July 12, 2020) (unpublished manuscript), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3649278.

government does not build, or in the case of municipal pensions, to provide retirement benefits to employees not covered by Social Security.[178]

While the federal government has consistently encouraged municipalities to borrow, it has responded to municipal fiscal distress in unpredictable and inconsistent ways.[179] After the Revolutionary War, the federal government assumed the states' war debts.[180] But in the 1830s and 1840s, the federal government refused to bailout states that had overextended themselves by building canals and other infrastructure, causing these states to default on its bonds.[181]

In response, many states enacted debt limits and reduced its infrastructure investments.[182] As state governments reduced its borrowing, local governments began borrowing heavily, often to entice railroads to come to its towns.[183] Subsidies to railroads, funded by municipal debt, complemented the federal policy of having trains run from sea to shining sea.[184] When many of these municipalities faced default, sometimes because of chicanery and sometimes because of economics, the Supreme Court stepped in to require municipalities to pay their debts to protect municipal debt markets nationally.[185] Sometimes the Supreme Court overrode a state supreme court's interpretation of its own constitution in order to require the municipality to pay.[186]

Around the same time, and in contrast to its position on municipal railroad bonds, the Supreme Court often disallowed creditors from collecting debts from many southern states, sympathizing with "white-dominated 'Redeemer' governments," while "punish[ing] lenders for working with racially-mixed Reconstruction era governments."[187] Partially as a result, northern, midwestern, and western cities accessed municipal bond markets to build "[m]any of the

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178 David Schleicher, *Hands On! Part I: The Trilemma Facing the Federal Government During State and Local Budget Crises* 12–13 (July 12, 2020) (unpublished manuscript), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3649278; Danielle Kurtzleben, *Everything you need to know about the Detroit bankruptcy*, VOX (Dec. 15, 2014, 12:18 PM), https://www.vox.com/2014/12/15/18073574/detroit-bankruptcy-pensions-municipal ("some of the city's public-sector retirees aren't eligible for Social Security benefits").

179 *See* David Schleicher, *Hands On! Part I: The Trilemma Facing the Federal Government During State and Local Budget Crises* 15 (July 12, 2020) (unpublished manuscript), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3649278.

180 *Id.* at 15–16.

181 *Id.* at 16–19.

182 *Id.* at 19.

183 *Id.* at 21–22.

184 *Id.* at 21–22.

185 *Id.* at 22, 26–31.

186 *Id.* at 26–27.

187 *Id.* at 39–40.

greatest pieces of urban infrastructure," while southern states were locked out of the municipal bond market for years.[188]

During the Depression, around the same time Congress was enacting municipal bankruptcy legislation, Arkansas was on the brink of default.[189] This time the federal government withheld federal funds to force the state to negotiate in an "onerous" restructuring with its existing creditors.[190] The federal government later bought new bonds from Arkansas allowing it to pay off the restructured debt.[191]

The federal government's response to New York City's fiscal crisis is discussed *supra* in Part II B, while the government's responses to fiscal crises in Washington, D.C. and Puerto Rico are outside the scope of this Comment.

The federal government's long involvement in municipal debt markets, particularly its history of responding to municipal fiscal crises, makes a compelling case for municipal distress to be adjudicated in federal bankruptcy courts. Further, while the federal government's response has historically been inconsistent, sometimes preferring creditors and sometimes preferring municipal debtors, bankruptcy provides a standard framework in which municipal debt resolution can be resolved in a "uniform" manner.[192]

2. *Federal Courts Are Not Powerless When Adjudicating Municipal Bankruptcies*

A bankruptcy court may not be as powerless as McConnell and Picker suggest. While the bankruptcy court is statutorily limited in what it can impose on the municipality without the municipality's consent, the court still retains significant persuasive authority and can have a significant impact on the case's outcome based on how it manages and structures the case.[193] This influence begins with the appointment of the judge overseeing the case. Unlike in other bankruptcies, the chief judge of the region's federal circuit court of appeals appoints a judge to preside over a municipal bankruptcy.[194] This selection can

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188 *Id.* at 35–36, 40.

189 *Id.* at 41.

190 *Id.* at 45.

191 *Id.* at 46.

192 U.S. CONST. art. I, § 8, cl. 4.

193 *See* Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55, 59 (2016).

194 11 U.S.C. § 921 (2018); Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55, 59 (2016).

shape the outcome of the case. An experienced judge can more easily lead a case to a thoughtful resolution. As Professor Melissa Jacoby explains, the bankruptcy court in Detroit's case played a significant role in the proceeding.[195]

The court's involvement began with the appointment of a bankruptcy judge. The Sixth Circuit's Chief Judge, Alice Batchelder, herself a former bankruptcy judge,[196] appointed Judge Steven Rhodes to preside over Detroit's bankruptcy case, based on his "'outstanding *administrative and case management skills*,'" and his judicial views.[197] Judge Rhodes specifically delayed his retirement to preside over Detroit's bankruptcy case.[198] Contrary to those who believe a bankruptcy judge has a very limited role in a municipal bankruptcy, Judge Rhodes "was an active participant, with deep substantive engagement, at the micro and macro levels."[199] He began by entering an aggressive scheduling order that went beyond the Code's requirements.[200] Rhodes also effectively used tools well within the court's power to prevent Detroit from dragging its feet with respect to resolution.[201] For example, when the city dithered on dealing with tort claims, Rhodes made it clear that he would lift the automatic stay with respect to tort claimants if the city did not "make substantial progress on a comprehensive plan for all tort claimants in thirty-five days."[202] The threat worked, and the city filed a plan "[a]s if on cue."[203]

Rhodes also proposed that the parties use Chief Judge Gerald Rosen of the Eastern District of Michigan as a mediator in the case.[204] The parties understood, and Rhodes accepted, that he had appointed Rosen to reduce delay, produce a debt adjustment plan that could be confirmed, and, in general, to "'crack heads.'"[205] Indeed, Rosen cracked heads by threatening to hold creditors in contempt, securing funding for Detroit from private foundations, convincing the state to match the private funding, and leaning on the city manager over a

195 *See generally* Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55 (2016).

196 FEDERAL JUDICIAL CENTER, https://www.fjc.gov/history/judges/batchelder-alice-moore (last visited Feb. 7, 2022).

197 Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55, 73–74 (2016) (italics in original).

198 *Id.* at 103.

199 *Id.* at 81.

200 *Id.* at 75.

201 *See id.* at 77–78.

202 *Id.* at 77.

203 *Id.* at 77.

204 *Id.* at 81.

205 *Id.* at 87–88 n.233.

weekend to delay a proposed pension freeze.[206] Judge Rosen was also instrumental in designing the Grand Bargain which formed the "centerpiece" of Detroit's debt adjustment plan.[207] Having Rosen lead the mediation "put the federal court in a profoundly powerful position, with continuous opportunities to shape municipal reform."[208]

Judge Rhodes also appointed an expert to testify about whether the proposed plan was feasible.[209] In addition, he appointed a non-testifying consultant to advise him on the plan's feasibility.[210] Rhodes also allowed members of the public to speak and ask questions during the bankruptcy proceedings.[211] These interactions provided Rhodes with significant information regarding Detroit's condition beyond formal court filings.[212] This offered the court "opportunities to weigh in on local policy and personnel matters."[213] Rhodes used these opportunities to examine the city's water delivery and advocate for the city to continue to retain its emergency manger.[214]

Many of the bankruptcy court's proposed actions require consent from the municipal debtor.[215] While securing the required consent seems like a high bar to clear, the *Detroit* court did not have much difficulty with this requirement.[216] As Jacoby notes, while nearly every issue at stake in the bankruptcy proceeding went to mediation, "there is no sign that consent was specifically elicited for each matter."[217] Further, Rhodes needed Detroit's consent to install an examiner to review the fees professionals were charging Detroit.[218] In part, he received this consent by "express[ing] hope that the city would not object," in open court.[219] Thus, Jacoby suggests that while the court might often need a municipality's consent, the municipality might find it difficult to object.[220]

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206 *Id.* at 84–85.
207 *Id.* at 106.
208 *Id.* at 88.
209 *Id.* at 90–92.
210 *Id.* at 92.
211 *Id.* at 95.
212 *Id.* at 95–98.
213 *Id.* at 96.
214 *Id.* at 96–97.
215 *See* 11 U.S.C. § 904 (2018).
216 *See* Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55, 87 (2016).
217 *Id.* at 83–84.
218 *Id.* at 88–89.
219 *Id.* at 89.
220 *See id.* at 64.

While it is debatable whether, in some instances, Judge Rhodes coerced Detroit into accepting certain provisions, the bankruptcy court also served as a check on creditors. Judge Rosen, the mediator, at one point threatened to hold a creditor in contempt if it did not accept an offer.[221] Fear of angering the mediator led creditors back to the negotiating table.[222] Bankruptcy courts have a larger arsenal of tools than states or other entities when dealing with municipal creditors. Only bankruptcy provides the automatic stay preventing creditors from collecting from the debtor.[223] Only the bankruptcy court can order debt to be discharged or otherwise impair contracts underlying the debt.[224] And only the bankruptcy court can bind holdout creditors to a debt adjustment plan and prevent dissenting creditors from hobbling a resolution plan.[225] Finally, a bankruptcy court is not constrained by what the effects of a discharge for one municipality would mean for another. In these ways, the bankruptcy court is much more powerful than states when it comes to municipal debt resolution.

Detroit's example suggests that a bankruptcy court, contrary to conventional wisdom, can exercise significant discretion in a municipal bankruptcy case. The appointment of the presiding judge, the presiding judge's "suggestion" of another judge as a mediator, and ultimately, a plan in part designed by the mediator, all suggest some level of judicial stage-managing of the Detroit bankruptcy.[226] The Detroit experience negates the McConnell-Picker argument that federal bankruptcy courts do not have enough power to make municipal bankruptcies effective.[227]

3. *The Bankruptcy Code's Restrictions on Bankruptcy Courts Result in Creative Solutions*

Detroit's example also shows that the Code's consent requirements can be used to design more thoughtful outcomes. For example, Detroit's creditors (including pensioners) wanted the city to sell art owned by the city and held by the DIA.[228] Instead, the mediator was able to negotiate a deal in which private

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221 *Id.* at 84.

222 *Id.* at 87.

223 11 U.S.C. § 362 (2018).

224 *Id.* § 944(b).

225 *Id.* § 944(a)(3).

226 *See* Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55, 103 (2016).

227 *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 472 (1993).

228 Maureen B. Collins, *Pensions or Paintings? The Detroit Institute of Arts from Bankruptcy to Grand Bargain*, 24 U. MIAMI BUS. L. REV. 1, 2–3 (2015).

donors, foundations, and the state would contribute money to pay pensioners, transfer the museum to a trust, and prevent it from having to sell of its art collection.[229]

In Detroit's case, the state attorney general issued an opinion stating none of the art could be sold to pay the city's debt.[230] The Emergency Manager, Kevyn Orr, thought only some of the art could be sold, and creditors thought all the art could be sold.[231] The valuation for the art Orr thought could be sold ranged from \$454 to \$867 million.[232] The valuation of the entire collection ranged from \$1.1 billion to over \$8 billion.[233] In a routine bankruptcy case, the art would have entered the bankruptcy estate and the whole collection could have been sold to pay off creditors.[234] Here, it was clear that the emergency manager (and, accordingly, the city) would not consent to the entire collection being sold, and the state may well have restricted the city manager from allowing any of the art to be sold.[235] Additionally, given the public impact of a municipal bankruptcy case, the court may have been constrained by public opinion more than it would have been in a non-municipal bankruptcy.

The "Grand Bargain" emerged against this background.[236] Judge Rhodes seemed mindful of the public benefit provided by the art and wary of the idea that selling the art would help the city.[237] Judge Rosen, the mediator, then gathered philanthropic leaders and "asked [them] to donate hundreds of millions of dollars to alleviate the municipal deficit faced by the City's pension funds."[238]

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229 Maureen B. Collins, *Pensions or Paintings? The Detroit Institute of Arts from Bankruptcy to Grand Bargain*, 24 U. MIAMI BUS. L. REV. 1, 23 (2015).

230 *Id.* at 16–17.

231 *Id.* at 16–17. Although, it is questionable if the city manager, appointed by the state, could agree to selling the art in violation of the state attorney general's opinion.

232 *Id.* at 17.

233 *Id.* at 18.

234 *Cf.* 11 U.S.C. § 541 (2018). Section 541 governs the content of a bankruptcy estate – all of a debtor's legal and/or equitable property interests, which include proceeds, products, rent, and property interests of the estate. 11 U.S.C. § 541 (2018). Section 363(b) allows debtor organizations to sell substantially all of their assets to qualified purchasers outside the scope of ordinary business, thereby allowing debtor organizations to pay off creditors. 11 U.S.C. § 363(b) (2018).

235 *See* Maureen B. Collins, *Pensions or Paintings? The Detroit Institute of Arts from Bankruptcy to Grand Bargain*, 24 U. MIAMI BUS. L. REV. 1, 16–17 (2015).

236 *Id.* at 23.

237 *See* Randy Kennedy, *Fate of Detroit's Art Hangs in the Balance*, N.Y. TIMES (Dec. 3, 2013), https://www.nytimes.com/2013/12/04/us/fate-of-detroits-art-hangs-in-the-balance.html (speculating how Judge Rhodes likely felt that selling the art "would not have helped Detroit to avoid bankruptcy."); *see also* Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55, 80 (2015) (discussing Judge Rhodes' consideration of the museum's value to the community based on witness testimony when evaluating the merits of the plan).

238 Maureen B. Collins, *Pensions or Paintings? The Detroit Institute of Arts from Bankruptcy to Grand*

Rosen was able to secure over $300 million in pledges from the foundations, DIA raised $100 million, and the state-approved $200 million in funding.[239] These funds were then used to pay pensioners.[240] The resulting deal left pensioners in a better position than originally expected without auctioning off the DIA's collection.[241]

The Grand Bargain represents an innovative and creative solution that materialized partly because of the restrictions placed on municipal bankruptcies. Giving courts too much resource adjustment power may well have led to a thoughtless liquidation of an invaluable art collection for the benefit of municipal creditors.

B. Congress Should Remove Roadblocks to Municipal Bankruptcy

Removing barriers to bankruptcy courts provides a municipality with a better chance at a fresh start. Further, because a municipality is best suited to understand the needs of its residents, allowing it to remain in charge of its bankruptcy proceeding would lead to better outcomes for its residents. Finally, removing roadblocks to municipal bankruptcy would leave creditors, as a group, in a better position than they otherwise would be.

With respect to a fresh start, removing barriers to bankruptcy would allow debts to be discharged earlier rather than later. This would save considerable resources between the time a municipality becomes distressed and when it is insolvent. At the outset, this allows the municipality into the bankruptcy process in a better position than it otherwise would be. Starting from this relatively stronger position, the municipality has a better chance of emerging from bankruptcy in a better position than when it entered it.

1. Barriers to Municipal Bankruptcies Allow the State and Federal Government to Exercise Excessive Control Over Municipalities

Often, municipalities are not trying to extract bailouts from states, but states want to impose bailouts because they give states greater leverage; states can use their authority to prevent bankruptcy petitions or exploit the twilight zone between when a municipality is in "dire financial straits," but not yet insolvent,

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Bargain, 24 U. MIAMI BUS. L. REV. 1, 23 (2015).

239 *See id.* at 23–25.

240 *See id.* at 26.

241 *See id.* at 26 ("The effect of the Grand Bargain on those receiving city pensions was a positive one under the circumstances. As a result of the Grand Bargain, 'pension reductions for retirees . . . are now significantly less than the City has originally concluded would be necessary.'").

to exert control over municipalities.[242] In fact, states are able to exert more control over a municipality outside of bankruptcy than they are in the bankruptcy process.[243]

Through debt resolution processes, such as appointing emergency managers and implementing receiverships, states often take control of their municipalities.[244] For example, in Pennsylvania, once a court confirms a receiver's municipal debt resolution plan, the municipality's elected and appointed officials' authority is suspended "to the extent that the power would interfere with the powers granted to the receiver or the goals of the recovery plan."[245] Further, a receiver may order a municipality's officials to take, or refrain from taking, actions to implement the receiver's debt modification plan.[246] If the officials refuse, the receiver can obtain a writ of mandamus from a court.[247] Similarly, Rhode Island allows receivers to exercise powers of a municipality's elected officials, and specifically provides "that the powers of the receiver shall be superior to and supersede the powers of the elected officials of the city."[248]

In Pennsylvania, Harrisburg's city council voted to reject a state bailout when faced with financial distress.[249] Part of the disagreement between the city and the state was over how to raise revenue to pay off debt – the city council wanted to pass a commuter tax, while the state wanted the city to sell and lease assets.[250] After its bankruptcy petition was dismissed, Harrisburg was placed into state receivership and its situation was resolved in line with the state's plan.[251] Along the way, the receiver obtained a writ of mandamus to require

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242 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993).

243 *See, e.g.*, Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEVS. J. 625, 638 (1995) (explaining that the state board's actions to raise taxes after the Bridgeport municipality filed for bankruptcy had no effect on the municipality because of the automatic stay).

244 *See* M. Heith Frost, Comment, *States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 846 (2014).

245 53 PA. STAT. AND CONS. STAT. ANN. § 11701.704(a)(2) (West 2020).

246 *Id.* § 11701.708(a).

247 *Id.* § 11701.709.

248 R.I. GEN. LAWS § 45-9-7(c) (2020).

249 Michael Corkery, *Capital Files for Bankruptcy: In Fight With State, Harrisburg, Pa., Rejects Governor-Backed Plan to Sell Assets*, WALL ST. J. (Oct. 13, 2011), https://www.wsj.com/articles/SB10001424052970204002304576626752997922080.

250 *Id.*

251 *See* Kris Maher, *Harrisburg Will Exit State Receivership: Judge Determines Capital City's Fiscal Emergency Is Over,* WALL ST. J. (Feb. 26, 2014, 6:38 PM), https://www.wsj.com/articles/SB10001424052702304709904579407431943602344; *see also* Romy Varghese, *Harrisburg Set to Exit Pennsylvania's First City*

Harrisburg to increase its income tax over the city council's opposition.[252] Had Harrisburg's bankruptcy proceeding continued, the city would have had a much greater say in its debt resolution;[253] only Harrisburg would have been allowed to submit plans on how it wanted to resolve its debts.[254] Further, a bankruptcy court could not have imposed an income tax increase or sold Harrisburg's property without the city's consent, since that would have violated Section 904's prohibition on interfering with a municipality's political powers and properties.[255]

States may also be trying to circumvent the Code's automatic stay provisions by preventing municipalities from declaring bankruptcy. The automatic stay prevents entities from commencing or continuing "a judicial, administrative, or other action or proceeding against the debtor."[256] Among other things, it prevents "all entities" from engaging in "any act to create, perfect, or enforce any lien against property of the estate."[257]

In 2011, Rhode Island was concerned with the contagion associated with Central Falls' declaration of bankruptcy.[258] The town was already in receivership, and the state-appointed receiver had the power to file for

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Receivership, BLOOMBERG (Jan. 15, 2014, 11:55 AM), https://www.bloomberg.com/news/articles/2014-01-15/harrisburg-set-to-exit-pennsylvania-s-first-city-receivership.

252 *See Walker v. City of Harrisburg*, 2012 Pa. Commw. LEXIS 260, at *7 (Commw. Ct. Aug. 27, 2012); *see also*
Nick Malawskey, *Judge Approves Harrisburg Earned Income Tax Increase; Rules Against City's Need for a Spokesman*, PENNLIVE (Aug. 27, 2012, 9:28 PM), https://www.pennlive.com/midstate/2012/08/judge_harrisburg_earned_income.html (stating that the receiver was able to force an income tax rate increase from 1% to 2%).

253 *Cf.* Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 356–57 (2010) (explaining how the bankruptcy court has relatively little power over debtor municipalities once a bankruptcy filing under Chapter 9 is approved).

254 *See* 11 U.S.C. § 941 (2018).

255 *See id.* § 904; *cf.* Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 357 (2010) ("The court may not instruct local officials to take any action (such as a tax increase or an expenditures cut) . . . ."); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 474 (1993) ("To be sure, the court may not order reductions in expenditure, sale of property, renegotiation of contracts, or increase in taxes.").

256 11 U.S.C. § 362(a)(1) (2018).

257 *Id.* § 362(a)(4).

258 *See* Maria O'Brien Hylton, *Central Falls Retirees v. Bondholders: Assessing Fear of Contagion in Chapter 9 Proceedings*, 59 WAYNE L. REV. 525, 527 (2013); David A. Skeel, Jr., *What is a Lien? Lessons from Municipal Bankruptcy*, 2015 U. ILL. L. REV. 675, 687 (2015); *see also* Michael Corkery, *Bondholders Win in Rhode Island*, WALL ST. J. (Aug. 4, 2011, 12:58 PM), https://www.wsj.com/articles/SB10001424053111903885604576486610528775994 (Rhode Island Revenue Director, Rosemary Booth stated, "[w]e didn't want bondholders to think this state was not a good place to put their money," when discussing the rationale behind the law's enactment).

bankruptcy.[259] He did so on August 1, 2011.[260] Just a few weeks earlier, Rhode Island enacted a statute providing general obligation bondholders a statutory lien on a city's tax and general fund revenues.[261] Prior to the enactment of this statute, Central Falls' bondholders and pensioners were unsecured creditors and would have been dealt with equally in bankruptcy.[262] Instead, Rhode Island secured the bondholders' debts, ensuring they would be paid in full, even before the pensioners had been paid at all.[263] Had Central Falls declared bankruptcy before the lien was enacted, the automatic stay would have prevented Rhode Island from creating the lien.[264]

In the 1970s, New York City requested federal assistance to avoid bankruptcy.[265] The federal government provided loans to New York City, which were secured by liens on the city's income.[266] Further, the loans came with conditions specifying when the city had to try to again sell bonds on the market.[267] Outside bankruptcy, the federal government was able to impose these terms on New York; however, if New York had access to present-day chapter 9, a bankruptcy court could not have imposed these terms since they interfered with New York's enjoyment of its income and with its political and governmental powers.[268]

By being able to control if and when a municipality can file for bankruptcy, and aided by the high bar of showing insolvency, states are able to exert significant control over their municipality's debt resolution planning.

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[259] *See* R.I. GEN. LAWS § 45-9-7(b)(3) (2020).

[260] *See* Martha Kessler, *City of Central Falls, R.I., Files Chapter 9 Petition; Governor Calls Situation 'Dire'*, BLOOMBERG L. (Aug. 3, 2011, 3:23 PM), https://news.bloomberglaw.com/bankruptcy-law/city-of-central-falls-ri-files-chapter-9-petition-governor-calls-situation-dire.

[261] R.I. GEN. LAWS § 45-9-7(b)(3) (2020); *see* Michael Corkery, *Bondholders Win in Rhode Island*, WALL ST. J. (Aug. 4, 2011, 12:58 PM), https://www.wsj.com/articles/SB10001424053111903885604576486610528775994.

[262] Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES (Sept. 6, 2012), https://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html.

[263] *See* David A. Skeel, Jr., *What is a Lien? Lessons from Municipal Bankruptcy*, 2015 U. ILL. L. REV. 675, 687 (2015).

[264] *See* 11 U.S.C. § 362(a)(4) (2018) (preventing "any act to create . . . any lien against property of the estate").

[265] *See* Jeff Nussbaum, *The Night New York Saved Itself from Bankruptcy*, NEW YORKER, Oct. 16, 2015, https://www.newyorker.com/news/news-desk/the-night-new-york-saved-itself-from-bankruptcy (as of 1974, "New York's leaders continued to petition for federal help.").

[266] *See* Martin Tolchin, *8% Interest Rate*, N.Y. TIMES (Nov. 27, 1975), https://www.nytimes.com/1975/11/27/archives/8-interest-rate.html.

[267] U.S. Dep't of Treasury, No. 3276, Annual Report of the Secretary of the Treasury on the State of the Finances, Fiscal Year 1978 (1979) at 37.

[268] *See* 11 U.S.C. § 904(1) (2018) (restricting the court from interfering with "any of the political or governmental powers of the debtor").

2. *The Salience of Moral Hazard Is Overstated*

Proponents of current roadblocks to municipal bankruptcy argue that the statutory requirements prevent moral hazard.[269] Moral hazard can be defined as "the lack of incentive to avoid risk where there is protection against its consequences."[270] In the context of a municipality, this could mean filing for bankruptcy instead of taking politically inconvenient steps such as increasing taxes or reducing services.[271] Indeed, Bridgeport filed for bankruptcy to avoid a tax increase.[272] Similarly, Harrisburg tried to avoid increasing taxes on its residents and selling its property.[273] Proponents of the insolvency requirement believe it "reduces the moral hazard of easy debt relief" by making it difficult to enter the bankruptcy process and obtain a debt discharge.[274] Specifically, a municipality should be more careful about getting into debt if it knows it will have to pay it back.[275]

Professor Kevin Kordana rebuts the McConnell-Picker resource adjustment proposal by arguing persuasively against the salience of a moral hazard in municipal bankruptcy.[276] He suggests state level caps on the maximum interest rate at which municipalities can issue bonds limits moral hazard as these caps could shut out especially risky municipalities from bond markets.[277] Kordana continues by analogizing municipal debt to sovereign debt, and analyzing game theoretical models and empirical results around sovereign debt defaults.[278] The analogy between municipal and sovereign debt makes sense because creditors to both municipalities and countries have limited recourse if their borrowers

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269 *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993).

270 Moral Hazard, *OED ONLINE*, https://www.oed.com.proxy.library.emory.edu/view/Entry/122086?redirectedFrom=moral+hazard& (last visited Dec. 21, 2021).

271 *See* Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 283 (2012); Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1068 (1997).

272 *See* Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEVS. J. 625, 626 (1995).

273 Michael Corkery, *Capital Files for Bankruptcy*, WALL ST. J. (Oct. 13, 2011), https://www.wsj.com/articles/SB10001424052970204002304576626752997922080.

274 *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993).

275 *See* Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1068 n.162 (1997).

276 *See generally id.* at 1070–89.

277 *Id.* at 1070–71; *see* CAL. GOV'T. CODE § 53531 (West 2020) (current statute capping interest rates).

278 *See* Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1070–71 (1997).

default.[279] The upshot of the theoretical analysis is that for a variety of reasons including reputation, desire to keep low interest rates, and inability to credibly threaten default, countries have reasons to keep paying their debts even if moral hazard concerns would suggest otherwise.[280] The empirical results, in line with the theoretical results, do not find evidence that moral hazard is a salient concern.[281] While Professor Kordana uses the critique of moral hazard to counter arguments that bankruptcy courts should be allowed to raise taxes, the same concern underlies strict filing requirements and other roadblocks to municipal bankruptcy.[282] This evidence suggests that concern is "misplaced."[283] Further, the fact that federal government policy towards municipal debt encourages "even small local governments to issue substantial amounts of debt"[284] undercuts the argument that the insolvency requirement is a federal statutory limitation on moral hazard.

Even taking concerns about moral hazard at face value, statutory roadblocks provide opportunities to bailout and control municipal distress. It is possible that these bailouts raise their own, slightly different, moral hazard concerns. Municipal lenders often believe that state and federal governments are implicitly backing their loans to municipalities.[285] By bailing out municipalities, state and federal governments may be strengthening the implicit guarantee and making it into a de facto guarantee. State and federal governments that have previously bailed out one municipality may lack the credibility to suggest they would not bail out another.[286] Thus, the statutory roadblocks may not be mitigating the municipality's moral hazard but instead creating moral hazard for bondholders.[287]

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279 *See id.* at 1072.

280 *See generally id.* at 1071–85.

281 *See id.* at 1085–89.

282 *See id.* at 1038–39; Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993).

283 Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1038 (1997).

284 David Schleicher, *Hands On! Part I: The Trilemma Facing the Federal Government During State and Local Budget Crises* 4 (July 12, 2020) (unpublished manuscript), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3649278.

285 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 460 (1993); Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 286–87 (2012).

286 *See* Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1083 (1997).

287 Bondholders also have insurance on their municipal bonds, which may further increase their moral hazard problem. *See* Maria O'Brien Hylton, *Central Falls Retirees v. Bondholders: Assessing Fear of Contagion in Chapter 9 Proceedings*, 59 WAYNE L. REV. 525, 536 (2013).

Rhode Island's creation of a statutory lien for general obligation bondholders did just that.[288] Even as Central Falls was placed into receivership and moving towards bankruptcy, the statutory lien made Central Falls attractive to bondholders.[289]

3. Gatekeeping Lengthens the Time to and Cost of Resolution

Gatekeeping lengthens the time from distress to resolution.[290] Municipal distress is apparent before a municipality is insolvent. Therefore, the Code's insolvency requirement "postpones the day of reckoning, while the city continues to pile on new debt at ever-increasing interest rates, further burdening the municipal budget and guaranteeing that each creditor will receive less value in bankruptcy."[291] At the same time, delaying what may be inevitable necessarily means reducing services offered to residents and laying off municipal employees.[292] In addition, the political conflict created by misaligned incentives between the municipality, the state, and the federal government can also lengthen the resolution process while adding to the ultimate cost. As Professor Dorothy Brown points out, the cost of borrowing increased for both Bridgeport and Connecticut while the city and state argued over the best course to resolve the city's financial distress.[293]

4. Congress Should Remove the Insolvency Requirement

Congress should remove chapter 9's insolvency requirement. The requirement rests on shaky theoretical grounds and is difficult to administer. The difficulty in administering the insolvency tests wastes time as the municipality's situation deteriorates.

Non-municipal debtors do not have to be insolvent to file for bankruptcy.[294] Of course, the Code treats municipalities differently in the amount of control it allows them to exercise over their bankruptcy proceedings.[295] Those differences are explained by constitutional concerns over how much power the federal

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[288] Michael Corkery, *Bondholders Win in Rhode Island*, WALL ST. J., (Aug. 4, 2011, 12:58 PM), https://www.wsj.com/articles/SB10001424053111903885604576486610528775994.

[289] *Id.*

[290] Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993).

[291] *Id.* at 456–57.

[292] Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1153 (2014).

[293] Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEVS. J. 625, 640 (1995).

[294] *Compare* 11 U.S.C. § 109(c) (2018), *with* 11 U.S.C. § 109(b) (2018).

[295] *Compare* 11 U.S.C. § 904 (2018), *with* 11 U.S.C. § 105 (2018).

government can exert over municipalities.[296] But those concerns do not explain the insolvency requirement. Instead, the literature suggests that the insolvency requirement is needed to prevent moral hazard.[297] But as this Comment discussed earlier, moral hazard concerns are overstated.[298] Just as a proper understanding of risk of moral hazard reduces the need for resource adjustments,[299] so too does it reduce the need for the insolvency requirement.

In addition to being built on a shaky theoretical foundation, the insolvency requirement is also difficult to administer. The code provides that a municipality is insolvent if it is "not paying its debts as they become due" or is "unable to pay its debts as they become due."[300] The first element would be met if "the bills arrive and cannot be paid."[301] The second element would be met if the municipality would not be able to pay bills that have yet to come due.[302] Chapter 9 does not specify the time horizon in which the municipality would have to be unable to pay its debts,[303] but at least one court has suggested it must be either in the current or next fiscal year.[304]

Despite Bridgeport being in "dire financial straits,"[305] the court found it was not insolvent, because it had access to a bond fund to pay its upcoming debts, even though using those funds would require the city to repay them.[306] Professor Gillette argues that having observed that the funds that could be used to plug the current deficit would have to be repaid in the next two fiscal years, "[t]he court . . . could have concluded that the prospective test was satisfied."[307] He goes on

296 Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 356–57 (2010).

297 *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993).

298 *See* Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1070 (1997).

299 *See id.* at 1038–39.

300 11 U.S.C. § 101(32)(c) (2018).

301 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993).

302 *Id.* at 456; *see In re* Bridgeport, 129 B.R. 332, 338 (Bankr. D. Conn. 1991).

303 *In re* Bridgeport, 129 B.R. 332, 337 (Bankr. D. Conn. 1991) ("Although the beginning point of the analysis is the date the petition was filed, neither § 101(32)(C)(ii) nor its legislative history provide guidance on how far into the future it should go.").

304 *Id.* at 338; Vincent S.J. Buccola, *The Logic and Limits of Municipal Bankruptcy Law*, 86 U. CHI. L. REV. 817, 864 (2019).

305 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993).

306 *In re* Bridgeport, 129 B.R. 332, 336–37 (Bankr. D. Conn. 1991); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993); Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEVS. J. 625, 638–39 (1995).

307 Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79

to suggest that the state's opposition to Bridgeport's bankruptcy filing "may have been influential" in finding Bridgeport was not insolvent.[308] Thus the insolvency test forces municipalities and courts to show just how bad their bad fiscal situation is. As a result, the insolvency requirement becomes the "principal obstacle to earlier municipal debt relief,"[309] and the test's ambiguity allows for extraneous concerns to drive the final analysis.[310]

The service delivery insolvency test does not resolve the test's overall ambiguity; instead, it leaves open the question of what baseline level the current level of service is to be compared to.[311] While judges applying the cash-flow test may have to compare competing financial projections, judges applying the service delivery insolvency test would have to decide whether a municipality's lack of services is lacking enough to warrant a finding of insolvency. This again leaves open the possibility of allowing extraneous considerations to enter the analysis.

Further, the insolvency requirement creates bad incentives for creditors. As the Bridgeport example suggests, a creditor could offer a municipality a loan with stringent terms and thus prevent it from accessing bankruptcy relief.[312] In *Bridgeport*, the available funds came from a municipal bond fund which would have had to be replenished.[313] It would not be a stretch for a court to conclude then that a city must exhaust all available lines of credit to meet current debt payments. A creditor may find it preferable to offer more credit to a city struggling to meet its obligations than let the city file for bankruptcy and potentially discharge its debt. On the other hand, a preferred creditor, such as a bondholder in Rhode Island,[314] could withhold new loans, potentially forcing a municipality to seek discharge of non-preferred loans, before lending it more money.

U. CHI. L. REV. 281, 293 (2012).

308 *Id.* at 326.

309 Vincent S.J. Buccola, *The Logic and Limits of Municipal Bankruptcy Law*, 86 U. CHI. L. REV. 817, 864 (2019).

310 *See* Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 328 (2012).

311 *See* Clayton P. Gillette, *How Cities Fail: Service Delivery Insolvency and Municipal Bankruptcy*, 2019 MICH. ST. L. REV. 1211, 1214, 1220 (2019).

312 *See In re* Bridgeport, 129 B.R. 332, 337 (Bankr. D. Conn. 1991).

313 *Id.*; *see* Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 293 (2012).

314 *See* Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES (Sept. 6, 2012), https://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html.

Only municipalities must be insolvent to file for bankruptcy.[315] The assumptions underlying this unique requirement are misstated. Further, the requirement's tests are difficult and time-consuming to carry out and may provide cover for decisions based on extraneous reasons. Finally, the insolvency requirement provides improper incentives to municipal creditors. Removing the insolvency requirement would allow a municipality to begin adjusting its debts earlier rather than later. Moreover, it would allow a bankruptcy court to assist in this process, instead of trying to draw a distinction between whether a municipality's condition is bad, or really bad. Reducing the time between the onset of a fiscal crisis and resolution will probably leave the municipality and its creditors in a better position. The municipality is likely to have more space to negotiate with creditors even shortly before it becomes insolvent. Even those who support the insolvency requirement based on the moral hazard argument agree that it ends up making debtors and creditors worse off.[316] Allowing a municipality access to the bankruptcy court also reduces the time during which a state can take over or impose a stringent bailout on a municipality. For these reasons, Congress should remove the insolvency requirement from chapter 9.[317]

5. *The Federal Government Should Induce States Into Allowing Their Municipalities Easier Access to Bankruptcy Proceedings*

The federal government should induce states into allowing their municipalities easier access to bankruptcy courts. Eric Lam's suggestion along these lines is to relax the state authorization requirement in Section 109(c)(2).[318] Specifically, starting from an older version of the statute, which required general, as opposed to specific, authorization, Lam suggests allowing municipalities to file for bankruptcy as long as they are "'not prohibited'" by state law.[319] Instead, Congress went in the opposite direction, leaving us the "specifically authorized" language we have today.[320] Lam's suggestion could

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[315] Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 455–56 (1993).

[316] *Id.* at 456. Incidentally, McConnell and Picker suggest removing the insolvency requirement if bankruptcy courts could engage in resource adjustment. *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 477 (1993).

[317] *See also* Vincent S.J. Buccola, *The Logic and Limits of Municipal Bankruptcy Law*, 86 U. CHI. L. REV. 817, 864–65 (2019) (arguing that "[t]he insolvency requirement must be relaxed if Chapter 9 is to become a serious tool for addressing municipal financial distress.").

[318] Eric W. Lam, *Municipal Bankruptcy: The Problem with Chapter 9 Eligibility – A Proposal to Amend 11 U.S.C. § 109(c)(2) (1988)*, 22 ARIZ. ST. L.J. 625, 637 (1990); 11 U.S.C. § 109(c)(2) (2018).

[319] Eric W. Lam, *Municipal Bankruptcy: The Problem with Chapter 9 Eligibility – A Proposal to Amend 11 U.S.C. § 109(c)(2) (1988)*, 22 ARIZ. ST. L.J. 625, 637 (1990); 11 U.S.C. § 109(c)(2) (1988).

[320] 11 U.S.C. § 109(c)(2) (2018).

possibly alleviate some of the gatekeeping the state authorization requirements impose. This might allow municipalities in states without authorizing statutes to access the bankruptcy court.[321] But because so many states have created processes that precede bankruptcy filings, it is unlikely that this suggestion would end up having a material effect on access to the bankruptcy court.[322]

While changing the state authorization requirement to allow municipalities to file in the absence of a state prohibition[323] may be a step in the right direction, it alone will not bring about much change. Instead, the federal government needs to implement a framework that would alleviate states' costs associated with municipal distress.

CONCLUSION

It is uniquely difficult for municipalities to file for bankruptcy. These difficulties allow state and the federal government to act as gatekeepers and prevent municipalities from accessing bankruptcy protection and securing a fresh start. The literature is concerned with maintaining barriers that supposedly mitigate moral hazard and the bankruptcy courts' supposed lack of power to ensure proper debt resolutions. This Comment shows that federal and state governments use gatekeeping methods to exert control over a municipality. In addition, the assertion that federal bankruptcy courts are too weak to properly carry out municipal bankruptcies is incorrect. In fact, bankruptcy courts are uniquely positioned to guide municipalities in reforming their finances and grant them a fresh start. These observations suggest that municipalities should have easier access to the bankruptcy court. Increased access to the bankruptcy court would comport with federal policy underlying municipal finances and policy goals underlying the Code. It would also result in more efficient municipal debt resolutions. Greater access to the bankruptcy court can be achieved by removing statutory roadblocks, specifically the requirement that municipalities be insolvent before filing for bankruptcy, as that requirement is difficult to administer and rests on a shaky theoretical foundation. Finally, because municipal access to bankruptcy courts requires state approval, the federal

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321 *See* M. Heith Frost, Comment, *States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 849–52 (2015).

322 *See id.* at 838–48 (discussing prerequisites to filing for municipal bankruptcy in many states).

323 Eric W. Lam, *Municipal Bankruptcy: The Problem with Chapter 9 Eligibility – A Proposal to Amend 11 U.S.C. § 109(c)(2) (1988)*, 22 ARIZ. ST. L.J. 625, 637 (1990).

government should develop incentives to induce states to allow their municipalities easier access to bankruptcy courts.

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