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ABSTRACT

Because so few municipalities have ever filed for bankruptcy, the Chapter 9 confirmation standards have not benefitted from extensive judicial scrutiny. The standards are particularly undeveloped as applied to cities and counties, whose debt structure and service obligations are more complicated and diverse than those of the special-purpose districts, whose cases generate the vast majority of Chapter 9 judicial opinions. The lack of clarity is not only bad for distressed cities and their creditors, but it is also undesirable from a public-policy standpoint. States can choose whether to permit their municipalities to file for bankruptcy. Clear plan confirmation standards can inform a state's decision whether to permit filing and its fashioning of a municipal financial distress resolution program.

This Article explores the relationship between the unique structure and goals of Chapter 9 and its confirmation standards in the context of the plan confirmation issues that arose in Stockton and Detroit. Congress designed municipal bankruptcy law to assist states in resolving the financial distress of their municipalities. Although several courts have made clear that once a municipality files for bankruptcy, the Supremacy Clause renders ineffective state laws governing priorities, little attention has been paid to the amount of deference that a court should give to choices that a state makes during a municipality's bankruptcy that affect the treatment of creditors. This Article proposes a clearer role for state choices in the bankruptcy process, but concedes that because states do not always participate in the financial rehabilitation of their cities, a clearer role for

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the state may not always be the answer to interpreting the Chapter 9 confirmation standards.

INTRODUCTION

Recent media headlines notwithstanding, Chapter 9 bankruptcies remain rare. Since municipal bankruptcy first entered federal law in 1934, fewer than 700 cases have been filed.[1] It is even more rare for a general-purpose municipality to seek bankruptcy protection; between 1980 and 2012, only forty-nine cities, counties, and towns had done so.[2] Detroit's bankruptcy filing was particularly historic; in terms of outstanding debt, it was by far the largest municipal bankruptcy ever filed.[3] Detroit's bankruptcy is in some ways unique. The city's iconic status in American manufacturing history ensured that even the international media would pay attention to the case.[4] Its severe population decline leaves Detroit with a geographical footprint that exceeds the needs of its residents.[5] Most interesting to the nonexpert is Detroit's art. Unlike most museums, the Detroit Institute of Art (DIA) is owned by the city, and the collection may be worth at least a billion dollars.[6] Even nonlawyers debated whether Detroit should be able to keep its art if it cannot pay its creditors in full.[7]

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1. *See* FRANCIS J. LAWALL & J. GREGG MILLER, DEBT ADJUSTMENTS FOR MUNICIPALITIES UNDER CHAPTER 9 OF THE BANKRUPTCY CODE: A COLLIER MONOGRAPH § 1, at 5 (2012) (reporting that between 1934 and 2012, fewer than 650 municipalities had filed for bankruptcy).

2. JAMES E. SPIOTTO, CHAPMAN & CUTLER LLP, PRIMER ON MUNICIPAL DEBT ADJUSTMENT C-3 (2012), *available at* http://blogs.reuters.com/alison-frankel/files/2013/12/chapmanandcutlerchapter9.pdf.

3. Matthew Dolan, *Record Bankruptcy for Detroit*, WALL ST. J. (July 19, 2013, 6:32 AM), http://online.wsj.com/news/articles/SB10001424127887323993804578614144173709204.

4. *See, e.g.*, David Taylor, *Detroit Declared Officially Bankrupt as Judge Rejects Appeal*, TIMES (London) (last updated Dec. 4, 2013, 12:01 AM), http://www.thetimes.co.uk/tto/news/world/americas/article3939315.ece.

5. Nate Cohn, *The Decline of Detroit in Five Maps*, NEW REPUBLIC (July 18, 2013), http://www.newrepublic.com/article/113946/detroit-bankruptcy-2013-maps-numbers.

6. Estimates of the collection's value range from $1.1 billion to more than $4 billion. *See* Mark Stryker, *DIA Collection Worth Up to $4.6 Billion, New Report Says*, DETROIT FREE PRESS (July 9, 2014, 11:33 PM), http://archive.freep.com/article/20140709/ENT05/307090111/DIA-arts-Detroit-Artvest-valuation-billions.

7. *See, e.g.*, Peter Schjeldahl, *Should Detroit Sell Its Art?*, NEW YORKER (July 24, 2013), http://www.newyorker.com/culture/culture-desk/should-detroit-sell-its-art (recommending that Detroit sell its collection); Peter Schjeldahl, *What Should Detroit Do With Its Art?: The Sequel*, NEW YORKER (July 26, 2013), http://www.newyorker.com/culture/culture-desk/what-should-detroit-do-with-its-art-the-sequel (retracting the recommendation that Detroit sell its collection).

Detroit's bankruptcy proceeded more quickly and smoothly than many people expected, with the court approving the city's plan of adjustment[8] fewer than sixteen months after the case was filed.[9] One of the many settlements contributing to the speed of Detroit's case[10] was the "Grand Bargain," through which a group of private foundations and the State of Michigan promised to contribute hundreds of millions of dollars to keep the art in Detroit and to pay Detroit's retirees a substantial percentage of what they are owed for pension obligations.[11] Detroit's retirees are only one group of unsecured creditors of the city, and the confirmed plan pays them a higher percentage of their claims than it does to other unsecured creditors.[12] During the case, other creditors claimed that the court could not confirm a plan of adjustment incorporating the Grand Bargain because such a plan would "discriminate unfairly" against a class of creditors, in contravention of Chapter 9 of the Bankruptcy Code (the Code).[13]

Although the Grand Bargain and the property at stake are unique, Detroit was not alone among insolvent cities in paying one group of unsecured creditors a significantly higher percentage of their claims against the city than another over creditor objections. At the same time that the

8. A plan of adjustment is the Chapter 9 counterpart to the Chapter 11 plan of reorganization. *See* 11 U.S.C. § 941 (2012).

9. Detroit filed for Chapter 9 bankruptcy relief on July 18, 2013. *See* Voluntary Petition, *In re* City of Detroit, No. 13-53846 (Bankr. E.D. Mich. July 18, 2013), *available at* http://www.mieb.uscourts.gov/sites/default/files/notices/City%20of%20Detroit%20Chapter%209%20Petition.pdf; *see also* Press Release, U.S. Bankr. Ct. for the E. Dist. of Mich. (July 18, 2013), http://www.mieb.uscourts.gov/news/city-detroit-bankruptcy-filing. The oral opinion was then entered just under sixteen months later on November 7, 2014. *See* Oral Opinion on the Record, *In re City of Detroit*, No. 13-53846 (Bankr. E.D. Mich. Nov. 7, 2014) [hereinafter Detroit Confirmation Opinion], *available at* http://www.mieb.uscourts.gov/sites/default/files/notices/Oral_Opinion_on_Detroit_Plan_Confirmation_Judge_Rhodes_FINAL_for_Release.pdf.

10. *See* Melissa B. Jacoby, *The Detroit Bankruptcy, Pre-Eligibility*, 41 FORDHAM URB. L.J. 849, 861–64 (2014) (explaining that Judge Rhodes favored mediation over litigation during the case to promote Detroit's recovery, and noting the ambitious timeline that the judge set for the case).

11. Jonathan Oosting, *Michigan Senate Approves 'Grand Bargain' in Detroit Bankruptcy Case, $195M for Pensions*, MICH. LIVE (June 3, 2014, 7:16 PM), http://www.mlive.com/lansing-news/index.ssf/2014/06/michigan_senate_approves_histo.html.

12. Detroit Confirmation Opinion, *supra* note 9, at 28–29.

13. Financial Guaranty Insurance Co.'s Pretrial Brief in Support of Objection to Plan for the Adjustment of Debts of the City of Detroit, *In re* City of Detroit, No. 13-53846 (Bankr. E.D. Mich. Aug. 27, 2014). FGIC ultimately settled with Detroit and withdrew its objections to the plan. *See* Lisa Lambert, *Major Settlement Puts Detroit Closer to Bankruptcy Exit*, REUTERS (Oct. 16, 2014, 5:05 PM), http://www.reuters.com/article/2014/10/16/us-usa-detroit-bankruptcy-fgic-idUSKCN0I51RN20141016.

court in Detroit was considering whether Detroit's plan of adjustment satisfied the Code's confirmation standards, another bankruptcy court was scrutinizing a different contested plan.[14] A year before Detroit filed for bankruptcy, the City of Stockton, California, filed.[15] At the time, Stockton was the most populous city ever to file for bankruptcy.[16] More than two years after Stockton filed, the court approved its plan of adjustment, under which the city assumed its unfunded pension obligations to the California Public Employee Retirement System (CalPERS), paying those obligations in full, while paying a small percentage of other unsecured claims.[17]

Judicial approval of the Detroit and Stockton plans adds to the scant body of case law applying the Chapter 9 confirmation standards. Both opinions illustrate a careful consideration of the efforts made by the state and city, in the case of Detroit, and by the city alone, in the case of Stockton, to use bankruptcy law to ameliorate financial distress that they could not remedy using only state law tools.[18] Because so few municipalities have ever filed for bankruptcy, these standards have not benefitted from extensive judicial scrutiny. They are particularly undeveloped as applied to general-purpose municipalities, whose debt structure and service obligations are more complicated and diverse than those of the special-purpose districts, whose cases generate the vast

14. Because Detroit entered the confirmation stage with a dissenting class of creditors, the court was forced to consider the cramdown standards. Stockton's plan was accepted by all classes, but not by all creditors, so the court had to apply fewer standards. *See* 11 U.S.C. § 943 (2012) (setting forth Chapter 9 confirmation standards and incorporating selected Chapter 11 standards); *id.* § 1129(b) (setting forth cramdown standards).

15. Voluntary Petition, *In re* City of Stockton, No. 12-32118 (Bankr. E.D. Cal. June 28, 2012), *available at* http://www.caeb.uscourts.gov/documents/Forms/Misc/Voluntary%20Petition%20-%20City%20of%20Stockton.pdf; *see also* Bobby White, *Stockton Files for Bankruptcy Protection*, WALL ST. J. (June 29, 2012, 9:48 AM), http://online.wsj.com/news/article_email/SB10001424052702304058404577495412282335228-lMyQjAxMTA0MDEwNzExNDcyWj.

16. *See* White, *supra* note 15.

17. Katy Stech & Dan Fitzpatrick, *Judge Approves California City's Bankruptcy-Exit Plan*, WALL ST. J. (Oct. 30, 2014, 5:00 PM), http://online.wsj.com/articles/stockton-faces-key-ruling-on-bankruptcy-1414679337. The court confirmed the plan over the objection of an unsecured creditor who argued that the plan violated several Chapter 9 plan confirmation standards. *See* Summary Objection of Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund to Confirmation of First Amended Plan of Adjustment of Debts of City of Stockton, California, *In re City of Stockton*, No. 12-32118 (Bankr. E.D. Cal. Feb. 26, 2014).

18. *See generally* Detroit Confirmation Opinion, *supra* note 9; Stech & Fitzpatrick, *supra* note 17.

majority of Chapter 9 judicial opinions.[19] The lack of clarity is not only bad for distressed cities and their creditors, but it is also undesirable from a public policy standpoint. States can choose whether to permit their municipalities to file for bankruptcy. Clear plan confirmation standards can inform a state in deciding whether to permit filing[20] and developing a municipal financial distress resolution program.[21]

This Article explores the relationship between the unique structure and goals of Chapter 9 and its confirmation standards. Specifically, this Article focuses on the general-purpose municipality—the city, county, or town—as debtor. A city's bankruptcy affects individuals in a deeply personal way, as residents relying on city services, as commuters spending their workdays in the city, as city employees, and as suburban residents who may or may not see the fortunes of their communities as linked to those of the bankrupt city. Moreover, states have a particular interest in the financial reputation of their cities; as Michigan's largest city, Detroit's reputation is intertwined with that of the state.

As this Article explains in more detail below, Congress designed municipal bankruptcy law to assist states in resolving the financial distress of their municipalities.[22] In another article, I explained that Congress designed Chapter 9 to encourage a state–federal partnership to alleviate municipal financial distress.[23] This Article examines how that partnership purpose might inform courts in interpreting the Chapter 9 confirmation standards. Although several courts have made clear that once a municipality files for bankruptcy, the Supremacy Clause renders ineffective state laws governing priorities,[24] little attention has been paid to the amount of deference that a court should give to choices that a state makes during a municipality's bankruptcy that affect the treatment of creditors. To frame

19. *See* 11 U.S.C. § 101(40) (defining municipality); *id.* § 109(c) (stating that an entity is permitted to file under Chapter 9 only if it is a municipality); *see also* SPIOTTO, *supra* note 2, at C-3.

20. A municipality cannot seek bankruptcy relief unless it is specifically authorized by its state to do so. *See* 11 U.S.C. § 109(c)(2); *see also* Juliet M. Moringiello, *Specific Authorization to File Under Chapter 9: Lessons from Harrisburg*, 32 CAL. BANKR. J. 237, 255–59 (2012).

21. *See* Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403, 461–78 (2014) [hereinafter Moringiello, *Goals and Governance*] (discussing state intervention programs).

22. *See infra* notes 25–37 and accompanying text.

23. *See generally* Moringiello, *Goals and Governance*, *supra* note 21.

24. Int'l Bhd. of Elec. Workers, Local 2376 v. City of Vallejo (*In re* City of Vallejo), 432 B.R. 262, 268–70 (E.D. Cal. 2010); *In re* City of Detroit, 504 B.R. 191, 254–55 (Bankr. E.D. Mich. 2013); Cnty. of Orange v. Merrill Lynch & Co. (*In re* Cnty. of Orange), 191 B.R. 1005, 1017 (Bankr. C.D. Cal. 1996).

the discussion about the relationship between the goals of Chapter 9 and its confirmation standards, Part I provides a short history of Chapter 9 and a review of its confirmation standards. Part II discusses how bankruptcy rules are generally driven by the type of person (entity or individual) that is affected by them. Part III discusses how the structure of Chapter 9 should shape the Chapter 9 confirmation standards. The conclusion advocates for a clearer role for state choices in the bankruptcy process, but concedes that because states do not always participate in the financial rehabilitation of their cities, a clearer role for the state may not always be the answer to interpreting the Chapter 9 confirmation standards.

I. AN OVERVIEW OF CHAPTER 9 AND ITS PLAN CONFIRMATION STANDARDS

A. A Delicate Constitutional Balance

Congress enacted the first predecessor to Chapter 9[25] as emergency legislation in the wake of the Great Depression.[26] When the Supreme Court upheld Chapter 9's predecessor in 1938,[27] it justified a federal municipal bankruptcy law by noting the inability of any state to resolve the financial distress of its municipalities on its own. States are restricted in doing so by the Contracts Clause of the United States Constitution, which prohibits a state from impairing the obligation of contracts.[28] Yet the federal bankruptcy process as applied to municipalities is cabined by principles of state sovereignty expressed in the Tenth Amendment to the Constitution, which reserves to the states or the people all powers not explicitly granted to the federal government nor prohibited to the states.[29] A municipality is created by and continues to exist at the pleasure of its

25. Act of Aug. 16, 1937, ch. 657, 50 Stat. 653 (current version codified in scattered sections of 11 U.S.C.).

26. *See* Moringiello, *Goals and Governance*, *supra* note 21, at 440–41 (recognizing that preceding the Great Depression, "municipal securities were more widely distributed among investors than they had ever been" as a result of "[t]housands of municipalities default[ing] on their debt obligations" during the Depression). This, combined with the fact that about 7% of all outstanding municipal debt was in default, showed that a federal solution was necessary. *Id.* at 441.

27. United States v. Bekins, 304 U.S. 27, 51–52 (1938) (upholding the Act of Aug. 16, 1937, ch. 657, 50 Stat. 653, and emphasizing cooperation between the state and federal government to resolve municipal fiscal failure).

28. U.S. CONST. art. I, § 10, cl. 1.

29. *Id.* amend. X (reserving to the states or the people all powers not explicitly granted to the federal government nor prohibited to the states).

state.[30] The structure of Chapter 9 recognizes this constitutional balance in its limitations on a bankruptcy court's powers over a municipal debtor.

This delicate constitutional balance provides the architecture of Chapter 9. Today's Chapter 9 is an amalgam of original provisions and provisions incorporated from other bankruptcy chapters. It imports selected parts of Chapters 3, 5, and 11 through § 901, and adopts rules tailored to municipal bankruptcy in the remainder of its sections.

The Code limits a court's powers over a municipality both by omission and by express commands. Many of Chapter 11's debtor-oversight provisions are absent from Chapter 9. For example, a court may not appoint a trustee or examiner in a Chapter 9 case, and a municipal debtor may use or dispose of municipal property without court approval.[31] Although these omissions appear to create a governance vacuum, Chapter 9 expresses its deference to state control over municipalities in two ways. The Code recognizes the primacy of a state's powers over its municipalities by stating that Chapter 9 does not limit the power of any state to control its municipalities in their political or governmental powers, including expenditures for municipal services.[32] Chapter 9 also prohibits the court from interfering with any of the municipal debtor's political or governmental powers, its property, and its revenues, unless the debtor consents or provides for such interference in its plan of adjustment.[33] Congress adopted §§ 903 and 904 in deference to the Supreme Court's opinion in *National League of Cities v. Usery*,[34] which held that Congress may not use its powers under the Commerce Clause to "force directly upon the States its choices as to how essential decisions regarding the conduct of integral governmental functions are to be made."[35] The *Usery* decision pronounced a stronger role for the states in our federal system than had been recognized at the time Congress enacted the original bankruptcy legislation.[36] Thus, in enacting §§ 903 and 904, Congress clarified its

30. Hunter v. City of Pittsburgh, 207 U.S. 161, 178–79 (1907), *overruled on other grounds by* Kramer v. Union Free Sch. Dist. No. 15, 395 U.S. 621 (1969).

31. *See* 11 U.S.C. § 901 (2012) (omitting §§ 363 and 1104 from Chapter 9).

32. *Id.* § 903.

33. *Id.* § 904.

34. Nat'l League of Cities v. Usery, 426 U.S. 833 (1976), *overruled by* Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528 (1985).

35. *Id.* at 855; *see also* H.R. REP. NO. 95-595, at 262–63 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6220–21.

36. *See* Bernard Schwartz, National League of Cities v. Usery—*The Commerce Power and State Sovereignty Redivivus*, 46 FORDHAM L. REV. 1115, 1115 (1978) (explaining that *Usery* was the first case since the 1930s in which the Court struck down an exercise of congressional action under the Commerce Clause).

intention that the bankruptcy court should not interfere with a state's governmental powers.

The effect of this constitutional balance on the Chapter 9 confirmation standards remains unclear. Although the legislative history to the 1976 Amendments to municipal bankruptcy law indicates that Congress codified a policy of noninterference with municipal powers in response to *Usery*, that decision was overruled less than ten years later in a decision that rejected the notion that states are immune from federal interference in the performance of "integral" or "traditional" governmental functions.[37] When a state permits its cities to file for bankruptcy, it is permitting its cities to take advantage of a federal process. Ideally, as was the case in Detroit, the state will play a role in that process. How much say a state can have in the particulars of that federal process as applied to one of its cities is an open question that this Article explores below.

B. Some Standards Imported from Chapter 11, Some Not

The confirmation standards reflect the patchwork structure of Chapter 9. Some of the confirmation standards are expressly stated in Chapter 9, and others are imported directly from Chapter 11. All plans, whether they are cramdown plans or not, must be proposed in good faith,[38] be in the best interest of creditors, and be feasible.[39] The first of those standards is imported from Chapter 11, and the other two are stated explicitly in Chapter 9. The requirement that a court can confirm a cramdown plan only if the plan does not discriminate unfairly and is fair and equitable with respect to dissenting creditor classes is incorporated into Chapter 9 from Chapter 11.[40]

The Code allows a court to confirm a Chapter 9 plan only if the debtor proposed the plan in good faith.[41] Courts in Chapter 11 cases find good faith when there is "a reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code."[42] Courts applying this test in Chapter 9 cases acknowledge that they must consider the "governmental nature and obligations" of a municipal debtor.[43] Very few courts have elaborated on the good faith

37. *See Garcia*, 469 U.S. at 546–47.

38. 11 U.S.C. § 943(b)(1) (incorporating § 1129(a)(3) through reference to § 901).

39. *Id.* § 943(b)(7).

40. *See id.* § 901(a) (incorporating §§ 1129(b)(1), (2)(A)–(B)).

41. *Id.* § 943(b)(1) (incorporating § 1129(a)(3)).

42. *In re* Madison Hotel Assocs., 749 F.2d 410, 425 (7th Cir. 1984) (quoting *In re* Nite Lite Inns, 17 B.R. 367, 370 (Bankr. S.D. Cal. 1982)).

43. *In re* Mount Carbon Metro. Dist., 242 B.R. 18, 41 (Bankr. D. Colo. 1999).

requirement. Consistent with Chapter 9's deference to state and municipal choices, one court found good faith when a plan maximized creditor recoveries "in the most practicable way given the unusual and complex nature" of the bankruptcy case.[44] On the other hand, where a plan proposed by a metropolitan taxing district appeared to benefit one creditor, a developer in the district, to the detriment of the other creditors, the court found bad faith because it viewed the plan as a ploy to "harness a governmental entity's taxing power for private profit."[45]

The Chapter 9 best interests test exemplifies some of the difficulties in translating corporate and individual bankruptcy concepts to the municipal bankruptcy context. In corporate and individual bankruptcy cases, the best interests test is satisfied if each dissenting creditor receives at least as much in a reorganization plan as it would if all of the debtor's assets were liquidated and distributed to creditors.[46] Municipal bankruptcy law does not seek to distribute a municipality's monetary value to its creditors;[47] therefore, the Chapter 9 best interests test is not based on the value of municipal assets. Courts interpret the Chapter 9 best interests test to require only that "a proposed plan provide a better alternative for creditors than what they already have,"[48] meaning that the creditors would fare better under the plan than they would outside of bankruptcy. Because only the debtor itself can propose a plan,[49] the alternative to confirmation of the debtor's plan is dismissal.[50] Moreover, it is widely believed that no one

44. *In re* Barnwell Cnty. Hosp., 471 B.R. 849, 866 (Bankr. D.S.C. 2012).

45. *In re Mount Carbon*, 242 B.R. at 42.

46. 11 U.S.C. §§ 1129(a)(7), 1325(a)(4). In Chapter 13, creditors do not vote on the plan, so all creditors must receive this liquidation value of their claims. Chapter 11 does not use the term "best interests"; instead, it codifies the judicial interpretation of the former best interests standard.

47. *See* Newhouse v. Corcoran Irrigation Dist., 114 F.2d 690, 690–91 (9th Cir. 1940) (explaining that because a municipal bankruptcy is very different from that of a private entity, the business bankruptcy principle that an entity's assets should be applied to its debts in bankruptcy is inapplicable in a municipal bankruptcy).

48. *In re Mount Carbon*, 242 B.R. at 34.

49. 11 U.S.C. § 901 (omitting § 1121(c)—which gives parties other than the debtor the authority to file a plan of reorganization—from Chapter 9); *id.* § 941 (giving the debtor the authority to file the plan of adjustment). State law determines who can act for the debtor, and in some states, an official appointed by the state must develop and file the plan of adjustment. *See, e.g.*, MICH. COMP. LAWS § 141.1558(1) (2013).

50. Cnty. of Orange v. Merrill Lynch & Co. (*In re* Cnty. of Orange), 191 B.R. 1005, 1020 (Bankr. C.D. Cal. 1996) (quoting 4 COLLIER ON BANKRUPTCY ¶ 943.03[7], at 943-40 to -41 (Lawrence P. King ed., 15th ed. 1996) (stating that to satisfy the best interests test, the Chapter 9 debtor must propose a plan that is "a better alternative to the creditors than dismissal of the case")); *In re* Sanitary & Improvement Dist., No. 7, 98 B.R. 970, 975–76 (Bankr. D. Neb. 1989) (finding that the plan met the best interests test because dismissal

can force the sale of any municipal assets outside of bankruptcy;[51] therefore, upon dismissal of the case, creditors will be forced to resort to mandamus actions to attempt to compel municipal officials to pay their claims out of tax collections or to raise sufficient taxes to pay their judgments.[52] If, upon dismissal, creditors will be left with lawsuits and ineffective collection remedies, almost any Chapter 9 plan will be better than the dismissal alternative. One court recognized as much when, in ruling that a plan met the best interests test, it acknowledged that all creditors would be harmed if they were sent back to a state court system that had no power to compromise debts without the consent of all parties.[53]

Both Chapter 9 and Chapter 11 contain a confirmation standard that requires the court to look into the future. A court can confirm a Chapter 9 plan only if it finds that the plan is feasible.[54] Chapter 11 has an analogous forward-looking test that is designed to ensure that the plan of reorganization is not followed by the debtor's liquidation (unless contemplated by the plan) or a future need for financial restructuring.[55] Like the Chapter 11 feasibility standard, Chapter 9 feasibility requires an assessment of the future; but in looking to the future under Chapter 9, courts consider the unique purpose of a municipal entity. A plan is feasible if the court finds that the debtor can make payments under the plan and provide "future public services at the level necessary to its viability as a municipality."[56] One court has described the relationship between the best interests test and the feasibility test as a floor and a ceiling: the best interests test requires, as a floor, that the debtor make a reasonable attempt at payment, and the feasibility test provides a ceiling by preventing the debtor from promising too much.[57]

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would result in creditors pursuing mandamus actions to raise taxes which, even if increased, would not be sufficient to pay bondholders).

51. *See infra* notes 139–46, 148 and accompanying text.

52. *See* Moringiello, *Goals and Governance*, *supra* note 21, at 442–43 (discussing the mandamus remedy and its deficiencies).

53. *In re Sanitary & Improvement Dist.*, 98 B.R. at 976; *see also In re Mount Carbon*, 242 B.R. at 34 (acknowledging that because of the inefficacy of creditor remedies against a municipality outside of bankruptcy, any payment in bankruptcy could be viewed as a better alternative than dismissal).

54. 11 U.S.C. § 943(b)(7).

55. *Id.* § 1129(a)(11).

56. *In re Mount Carbon*, 242 B.R. at 35; *see also In re* Connector 2000 Ass'n, 447 B.R. 752, 766 (Bankr. D.S.C. 2011) (finding the plan to be feasible because the municipal debtor would be able to pay its plan obligations and maintain its operations).

57. *In re Mount Carbon*, 242 B.R. at 34 (citing 4 COLLIER ON BANKRUPTCY, *supra* note 50, ¶ 943.03[7], at 943-39 to -41).

Chapter 9 imports its twin-pronged cramdown test directly from Chapter 11. Under that test, a court can confirm a plan of adjustment over the objection of a dissenting class of creditors if the plan is fair and equitable and does not discriminate unfairly against creditors.[58] The two components of the test reflect the capital structure of a business, the priorities among creditors both inside and outside of bankruptcy, and the bankruptcy principle of equal treatment of similarly situated creditors.[59]

The requirement that a plan be fair and equitable acknowledges the existence of payment priorities. It recognizes creditor property interests created under state law by requiring that secured claims be paid in full, and it recognizes the capital structure of businesses by requiring that unsecured creditors be paid in full before the entity's owners can receive anything.[60] Because a municipality has no shareholders, this absolute priority rule is inapplicable in Chapter 9. The definition of "fair and equitable" in Chapter 9 is therefore as elusive as the definition of "best interests." Of the very few courts that have had the opportunity to define "fair and equitable" for Chapter 9 purposes, one held that a plan was fair and equitable when it provided the creditors with all that they could reasonably expect under the circumstances,[61] a standard that appears to be identical to the Chapter 9 best interests standard articulated by some courts.[62] Congress recognized the redundant nature of the two tests in enacting the 1976 amendments to the municipal bankruptcy law, which omitted the best interests test.[63] At least one court has applied the absolute priority rule in a municipal bankruptcy case, finding that a debt adjustment plan for a hospital district was fair and equitable because no holders of equity interests in the hospital district received anything.[64] The hospital district, however, had no equity owners.[65]

58. 11 U.S.C. § 901 (incorporating 11 U.S.C. § 1129(b) into Chapter 9).

59. *See* Comm. on Bankr. & Corporate Reorganization of the Ass'n of the Bar of N.Y.C., *Making the Test for Unfair Discrimination More "Fair": A Proposal*, 58 BUS. LAW. 83, 87–88 (2002) (listing the different tests that courts use in Chapter 11 cases).

60. 11 U.S.C. § 1129(b)(2).

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

62. *See supra* notes 46–53 and accompanying text.

63. *See* Act of Apr. 8, 1976, Pub. L. No. 94-260, 90 Stat. 315 (current version codified in scattered sections of 11 U.S.C.); *see also In re* Mount Carbon Metro. Dist., 242 B.R. 18, 33–34 (Bankr. D. Colo. 1999); Kenneth W. Bond, *Municipal Bankruptcy Under the 1976 Amendments to Chapter IX of the Bankruptcy Act*, 5 FORDHAM URB. L.J. 1, 24 (1976).

64. *In re* Corcoran Hosp. Dist., 233 B.R. 449, 458–59 (Bankr. E.D. Cal. 1999).

65. *Id.* at 458.

Even in Chapter 11 cases, courts differ as to how to determine when a plan discriminates unfairly against creditors.[66] Unlike the fair and equitable test, which preserves creditor expectations related to the vertical capital structure of an organization, the unfair discrimination test preserves horizontal parity among creditors holding identical payment priorities.[67] In Chapter 11 cases, courts have struggled to determine the fairness of discrimination among creditors with the same priority status. A handful of courts have held that all discrimination is unfair.[68] Some apply a broad reasonableness test that considers whether the discrimination is proposed in good faith and is necessary to the reorganization in order to allow greater recovery to creditors such as suppliers (on the basis that trade credit is necessary to the continued vitality of the debtor)[69] and unionized employees (on the theory that they might strike).[70] Others presume that all discrimination is unfair unless the proposed distribution is based on prebankruptcy expectations, or the favored creditor provided some value to the reorganization effort.[71]

Few courts in municipal bankruptcy cases have had the opportunity to vet the unfair discrimination standard. Two Supreme Court cases from the 1940s support the position that discrimination is fair if the creditor receiving better treatment provides commensurate value to the

66. *See* Comm. on Bankr. & Corporate Reorganization, *supra* note 59, at 87–88 (listing the different tests that courts use in Chapter 11 cases).

67. *See* Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227, 227–28 (1998) ("[U]nfair discrimination is best viewed as a horizontal limit on nonconsensual confirmation, in contrast to the vertical limit imposed by the requirement that a nonconsensual plan be 'fair and equitable.'"); Stephen L. Sepinuck, *Rethinking Unfair Discrimination in Chapter 13*, 74 AM. BANKR. L.J. 341, 348 (2000) ("[I]t seems fairly clear that the unfair discrimination standard is intended to maintain equity among creditors of the same priority, much as the fair and equitable requirement preserves equity among creditors of different priorities.").

68. *See In re* Greystone III Joint Venture, 102 B.R. 560, 567 (Bankr. W.D. Tex. 1989) (discussing various courts' use of a rigid test for classification of claims), *rev'd sub nom.* Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274 (5th Cir. 1991); *see also* Comm. on Bankr. & Corporate Reorganization, *supra* note 59, at 87–88 (explaining that few courts have accepted this restrictive approach).

69. Creekstone Apartments Assocs., L.P. v. Resolution Trust Corp. (*In re* Creekstone Apartments Assocs., L.P.), 168 B.R. 639, 645 (Bankr. M.D. Tenn. 1994).

70. *In re* Kliegl Bros. Universal Elec. Stage Lighting Co., 149 B.R. 306, 309 (Bankr. E.D.N.Y. 1992).

71. *See In re* Sentry Operating Co. of Tex., 264 B.R. 850, 864 (Bankr. S.D. Tex. 2001) (finding unfair discrimination).

reorganization effort.[72] Since the 1940s, only a handful of courts have considered the unfair discrimination standard in a Chapter 9 case, and those approving discrimination among creditors of equal priority continue to do so based on contributions to the reorganization effort.[73] Therefore, in a case involving a hospital district, the court approved the separate classification of and higher payment to a medical group because the group had entered into a settlement agreement with the debtor that ended litigation between the parties and reduced the claim of the medical group.[74] The court found that the classification was justified and, in turn, that the plan did not unfairly discriminate against other creditors because it believed that, had the debtor been required to continue the litigation, it would not have been able to propose a feasible plan.[75]

Three guiding principles mark the plan confirmation standards. The first, embedded in the best interests test, is that a baseline minimum payment must be made to all creditors.[76] The second principle, that there is a hierarchy of creditor claims and equity interests, is expressed in the requirement that a plan be fair and equitable.[77] The "no unfair discrimination" test codifies the last principle, that creditors of equal rank must receive equal treatment.[78] All of these principles reflect both well-

72. Mason v. Paradise Irrigation Dist., 326 U.S. 536, 541–42 (1946) (citing Ecker v. W. Pac. R.R. Corp., 318 U.S. 448, 486–87 (1943)); Am. United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138, 144 (1940) (finding unfair discrimination in a plan that gave one of the bondholders, the city's funding agent, better treatment than others because the debtor had not shown that the funding agent's services justified the extra value given to it in the plan); *see also* Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 117, 121–22 (1939) (finding no unfair discrimination in a plan giving the Reconstruction Finance Corp. (RFC) better treatment than other bondholders because the RFC had underwritten the plan of adjustment and had provided the capital necessary to effectuate the plan); Markell, *supra* note 67, at 233 (asserting, in support of the test for unfair discrimination that now bears his name, that these two cases are "telling as to the core content of unfair discrimination").

73. *In re* Corcoran Hosp. Dist., 233 B.R. 449, 457 (Bankr. E.D. Cal. 1999) (holding that a cramdown plan did not discriminate against a dissenting class, but justifying its holding on the standards for claim classification rather than those for unfair discrimination); *see also* Richard M. Hynes & Steven D. Walt, *Fair and Unfair Discrimination in Municipal Bankruptcy*, 37 CAMPBELL L. REV. 25 (2015); Andrew B. Dawson, Pensioners, Bondholders, and Unfair Discrimination in Municipal Bankruptcy 25 (Aug. 18, 2014) (unpublished manuscript) (quoting Markell, *supra* note 67, at 254), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2482608.

74. *In re Corcoran Hosp. Dist.*, 233 B.R. at 456.

75. *Id.*

76. *See supra* notes 46–53 and accompanying text.

77. *See supra* notes 60–63 and accompanying text.

78. *See supra* notes 66–71 and accompanying text.

understood nonbankruptcy rules regarding creditor entitlements and bankruptcy policies that alter those entitlements.

It is tempting to apply judicial interpretations of Chapter 11 confirmation standards to Chapter 9 plans. To some authors, this is a necessary exercise, because the Chapter 9 standards are either imported directly from Chapter 11 or use words that are well understood in the business bankruptcy context.[79] Others believe that even if the language used in different chapters is identical, the interpretation of the language must be tailored to the type of debtor.[80] I side with the second approach. Bankruptcy law is necessarily tied to the nature of the debtor, and uses the characteristics of the debtor as the foundation for its rules. The application of statutory standards takes place within a theory and policy framework, yet theory cannot be separated from "the parties that it reacts to and acts upon."[81] The next Part discusses how the unique attributes of each broad category of debtor—business entity, individual, and municipality—affected the development of the goals and rules governing that category of debtor.

II. INDIVIDUALS, BUSINESS ENTITIES, MUNICIPALITIES, AND BANKRUPTCY'S GOALS

The laws governing different types of debtors outside of bankruptcy inform the Bankruptcy Code's rules and structure. In all bankruptcy chapters, the property rights of and claims against the debtor are determined in the first instance by state law.[82] Upon filing, bankruptcy law takes over and modifies those rights and distributes the value of the debtor's assets according to bankruptcy policy that is tailored to the type of debtor involved.[83] Below is a brief summary of significant ways in which

79. *See, e.g.*, Richard M. Hynes & Steven D. Walt, *Pensions and Property Rights in Municipal Bankruptcy*, 33 REV. BANKING & FIN. L. 609, 637–38 (2014).

80. Sepinuck, *supra* note 67, at 348–50.

81. Lawrence Ponoroff, *Enlarging the Bargaining Table: Some Implications of the Corporate Stakeholder Model for Federal Bankruptcy Proceedings*, 23 CAP. U. L. REV. 441, 453 (1994).

82. *See* Butner v. United States, 440 U.S. 48, 55 (1979).

83. Juliet M. Moringiello, *(Mis)use of State Law in Bankruptcy: The Hanging Paragraph Story*, 2012 WIS. L. REV. 963, 987–89. Several commentators have noted that the rules of Chapter 11 are based primarily on policies best suited to large, publicly traded corporations and assets, and that other types of Chapter 11 debtors require adjustments to well-understood bankruptcy norms to tailor to their situations. *See, e.g.*, Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 COLUM. L. REV. 2310, 2310–15 (2005) (explaining that although the standard account of Chapter 11 "begins with a fundamental insight of corporate finance," the standard account is irrelevant to small business bankruptcy, where the focus should be on the individual owner-

business and consumer bankruptcy rules reflect the nature of business and consumer debtors.

A. Corporate Bankruptcy

Corporate bankruptcy policy and the rules implementing that policy reflect the financial structure of business debtors and the goals and purposes of business entity law. A company with no hope of rehabilitation ideally will liquidate and pay creditors from the proceeds of that liquidation.[84] On the other hand, a viable business entity will reorganize under Chapter 11, pay its creditors a going-concern premium that exceeds the liquidation value of the company,[85] and, if solvent (or if the owners of the business contribute new value to the enterprise), will distribute some value to its owners.[86]

The Chapter 11 confirmation standards reflect both these goals and purposes and creditor expectations outside of bankruptcy. The best interests of creditors test provides a floor for distribution by ensuring that each creditor receives what it would receive upon liquidation of the company, and the remaining confirmation standards govern how the reorganization surplus is divided among the creditors.[87] These remaining standards incorporate both state-law rules and bankruptcy-specific rules. The vertical priorities incorporate both bankruptcy-specific priorities expressed in the Code, and selected state priorities, such as the property rights granted to secured creditors and the rule that holders of equity interests in business entities are paid after all creditors are paid.[88] The horizontal parity codified in the proscription against unfair discrimination

entrepreneur); Brian A. Blum, *The Goals and Process of Reorganizing Small Businesses in Bankruptcy*, 4 J. SMALL & EMERGING BUS. L. 181, 185 (2000) (explaining that the provisions in Chapter 11 are based on assumptions more applicable to "publicly traded corporations with complex business operations"); Pamela Foohey, *Chapter 11 Reorganization and the Fair and Equitable Standard: How the Absolute Priority Rule Applies to All Nonprofit Entities*, 86 ST. JOHN'S L. REV. 31, 38–39 (2012) (expressing concern that the failure of courts to explore the parallels between for-profit and nonprofit entities has stifled the development of a fair and equitable standard that would further the goals of the Bankruptcy Code for both types of corporations); Theresa J. Pulley Radwan, *Keeping the Faith: The Rights of Parishioners in Church Reorganizations*, 82 WASH. L. REV. 75, 78–79 (2007) (urging that parishioners be permitted to intervene in church bankruptcy proceedings).

84. BARRY E. ADLER, FOUNDATIONS OF BANKRUPTCY LAW 108 (2005).

85. CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY § 1.2, at 6 (3d ed. 2014).

86. ADLER, *supra* note 84, at 108.

87. Markell, *supra* note 67, at 247.

88. 11 U.S.C. §§ 507, 1129(b) (2012).

incorporates the bankruptcy policy of equal treatment of similarly situated creditors.[89]

Because the nonbankruptcy treatment of creditors of a business entity is well settled, the bankruptcy rules rest on a strong foundation. A secured creditor has the right to foreclose on its collateral,[90] and an unsecured creditor must follow the procedures set forth in state law to collect any judgment against an entity debtor. State law respects the choices of corporate decision-makers; if they want to encumber all of the assets of the entity with security interests, they can. Bankruptcy law similarly respects these choices, with few exceptions.[91] When bankruptcy law modifies state entitlements in the business entity context, it operates from a recognized starting point.

B. Individual Bankruptcy

The foundations for individual bankruptcy are similarly well established. Bankruptcy gives a fresh start to the honest but unfortunate individual debtor.[92] A Chapter 13 plan must also pay each creditor at least what it would receive upon liquidation of the debtor's assets.[93] The rules governing the collection of debts from an individual outside of bankruptcy are as clear as those governing the collection of debts from an entity. Outside of the bankruptcy context, the law places few limits on an individual's ability to encumber her property, but it restricts the ability of unsecured creditors to seize property to satisfy their claims.[94] The exemption laws that prohibit judgment creditors from seizing the debtor's necessities are debtor protection laws that ensure that a debtor retains enough to live productively. Bankruptcy law respects this notion that an individual needs some property for her fresh start.[95] If the individual debtor liquidates her property, she is permitted to keep her exempt property to begin her postbankruptcy life.[96] Otherwise, creditor payment is based, in the first instance, on nonbankruptcy expectations, modified to incorporate

89. *See* TABB, *supra* note 85, § 7.7, at 662, 664 (explaining the equality principle).

90. *See, e.g.*, U.C.C. § 9-610(a) (2012).

91. *See, e.g.*, 11 U.S.C. § 510(c) (allowing a court to equitably subordinate claims).

92. Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

93. 11 U.S.C. § 1325(a)(4).

94. Every state has statutes that protect the property of individual debtors from seizure to satisfy judgments obtained by unsecured creditors. *See, e.g.*, CAL. CIV. PROC. CODE § 704.010–.210 (West 2009); 42 PA. CONS. STAT. § 8124 (2014).

95. 11 U.S.C. § 522.

96. *Id.*

bankruptcy policy. Unsecured claims receive pro rata treatment, unless Congress deemed them worthy of priority status.[97]

The law governing corporate and individual bankruptcies rests on two solid pillars. The first is a universally understood nonbankruptcy property regime that provides certain baseline rights to creditors. The second is an established set of bankruptcy goals that recognizes the nature of each type of debtor. The Bankruptcy Code expresses its goals with respect to business and individual bankruptcy in myriad provisions regarding priorities,[98] discharge,[99] asset sales,[100] debtor management,[101] and conversion of a reorganization to a liquidation if reorganization appears unlikely.[102]

C. Municipal Bankruptcy: Different Goals, Different Structure

The foundation on which municipal bankruptcy law is built was designed to balance the needs of distressed municipalities with the constitutional concerns affecting the relationship between states and the federal government.[103] The two strong pillars of corporate and individual bankruptcy are absent from municipal bankruptcy for at least two reasons: creditor rights in municipal assets are unclear, and municipal bankruptcy happens so infrequently that courts have not enunciated the clear policies that they have pronounced in corporate and individual cases.[104] The structure of Chapter 9 is also importantly different from that of Chapters 11 and 13. While the other bankruptcy chapters incorporate their policies in specific Code provisions,[105] Chapter 9 expresses its policy of minimal federal intrusion into state affairs by omission. As explained earlier, Chapter 9 allows no intrusion by the bankruptcy court in the exercise of a state's sovereign rights and duties vis à vis its cities.[106] This policy explains some of the missing Code sections, such as a priority section.[107]

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97. *Id.* § 507(a)(3).

98. *Id.* § 507.

99. *Id.* §§ 523, 727, 1141, 1328.

100. *Id.* § 363.

101. *Id.* § 1104.

102. *Id.* § 1112.

103. *See supra* notes 25–37 and accompanying text.

104. *See* LAWALL & MILLER, *supra* note 1, § 1, at 5 (noting how few municipal bankruptcies have been filed to date).

105. *See supra* notes 98–102 and accompanying text.

106. 11 U.S.C. § 904; *In re* Addison Cmty. Hosp. Auth., 175 B.R. 646, 649 (Bankr. E.D. Mich. 1994); *see also supra* notes 29–36 and accompanying text.

107. Cnty. of Orange v. Merrill Lynch & Co. (*In re* Cnty. of Orange), 191 B.R. 1005, 1020 (Bankr. C.D. Cal. 1996).

No one studies Chapter 9 until a major general-purpose municipality files for bankruptcy, and that happens infrequently. Until several authors wrote about the Chapter 9 plan confirmation standards in the wake of Detroit's filing,[108] commentary about municipal bankruptcy law in the last twenty-five years focused on whether Chapter 9 is effective at all, in part because it appears to leave the debtor in control of its destiny, free from judicial and statutory checks on its management.[109] Although Chapter 9 is not (yet) marked by the vigorous academic policy debates that surround the other chapters of the Code, its founding principle assumes state oversight and participation. From its earliest conception, the federal municipal bankruptcy legislation anticipated state involvement in the municipality's fiscal affairs.[110] When the Supreme Court upheld the second attempt at the law in 1937, it expressed this policy of cooperation explicitly, explaining that when a state authorizes one of its municipalities to file for bankruptcy, it "invites the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue."[111] The Court added that it is through the state's "cooperation with the national government [that] the needed relief is given."[112]

Chapter 9 incorporates state- and local-government law principles. Acknowledging that cities are creatures of their states, the Bankruptcy Code requires specific state authorization before a city can file for bankruptcy.[113] The specific-authorization requirement is grounded in the

108. *See, e.g.*, Dawson, *supra* note 73, at 30 (arguing that although the proscription against unfair discrimination should mean the same thing in municipal and corporate bankruptcy, a court should grant more flexibility to a municipal debtor in light of the structure and purpose of Chapter 9); Hynes & Walt, *supra* note 73 (discussing the conflict between retirees and bondholders in Chapter 9 cases); C. Scott Pryor, *Municipal Bankruptcy: When Doing Less is Doing Best*, 88 AM. BANKR. L.J. 85 (2014) (discussing the Chapter 9 plan confirmation standards through the lens of the Stockton, California, bankruptcy case).

109. *See, e.g.*, Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 283, 297 (2012) (suggesting that once a state authorizes its municipalities to file for Chapter 9, it may invite undesirable strategic behavior on the part of a distressed municipality); Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 353–54 (2010) (arguing that "bankruptcy law, at least in its current form, is not a sensible solution for urban economic crises"); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 494 (1993) (identifying the grounding premise of Chapter 9 as the notion that all distressed cities need is relief from their current creditors).

110. *See* Moringiello, *Goals and Governance*, *supra* note 21, at 450–51.

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

112. *Id.*

113. 11 U.S.C. § 109(c)(2) (2012).

Tenth Amendment to the United States Constitution, which states that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."[114] Although the law governing the relationship between cities and their states provides the design of Chapter 9, few scholars have explored in depth the role of state choices in the interpretation of the Chapter 9 confirmation standards.[115]

If corporate structure and the nature of individuals influence the bankruptcy rules that apply to those types of debtors, municipal structure and the laws governing that structure should have some influence on the interpretation of Chapter 9's provisions. Although a municipality is an entity, its capital, management structure, and duties differ from those of a business entity. A city must provide basic municipal services, and relies in large part on taxes to do so. Its ability to tax is limited both by caps imposed by state law and by economic and demographic realities.[116] Moreover, a city's capital structure does not include equity securities. Instead, it issues only debt securities to finance its obligations.[117] Unlike a business entity, a city cannot make the decision to wind down an unprofitable division or to cease doing business entirely.[118] Although a municipality can merge with a surrounding municipality or be dissolved into its surrounding county, its ability to do so is governed by state law, which might not permit a municipality to change its structure in the way that its population might desire.[119] Municipal managers may be less

114. U.S. CONST. amend. X.

115. There are exceptions. *See generally* Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1122 (2014) [hereinafter Anderson, *Minimal Cities*] (characterizing the identification of the appropriate level of municipal services in an insolvent city as a humanitarian question, as well as a doctrinal challenge); C. Scott Pryor, *Who Bears the Burden? The Place for Participation of Municipal Residents in Chapter 9*, 37 CAMPBELL L. REV. 161 (2015) (discussing the role of municipal residents in the determination of whether a plan of adjustment is feasible).

116. Christine Sgarlata Chung, *Government Budgets as the Hunger Games: The Brutal Competition for State and Local Government Resources Given Municipal Securities Debt, Pension and OBEP Obligations, and Taxpayer Needs*, 33 REV. BANKING & FIN. L. 663, 676–78 (2014) (noting that the overwhelming tax burden shouldered by residents of Detroit is one factor that makes tax increases unrealistic).

117. *Id.* at 683.

118. Christine Sgarlata Chung, *Zombieland/The Detroit Bankruptcy: Why Debts Associated with Pensions, Benefits, and Municipal Securities Never Die . . . and How They Are Killing Cities Like Detroit*, 41 FORDHAM URB. L.J. 771, 779–80 (2014).

119. *See* Michelle Wilde Anderson, *Dissolving Cities*, 121 YALE L.J. 1364, 1375–84 (2012) [hereinafter Anderson, *Dissolving Cities*] (explaining the range of dissolution laws, and explaining that some states limit the ability to dissolve to municipalities with very small

sophisticated than those of business entities; particularly in smaller- and medium-sized municipalities, officials tend to serve on a part-time or volunteer basis.[120] Either because of a lack of sophistication or short-term political motivations, public entities overextend themselves with debt in ways similar to some consumers.[121]

Courts have articulated the purposes of municipal bankruptcy in a way that illustrates the distinct role and structure of municipal entities. In some respects, the goal of Chapter 9 is the same as that of Chapter 11: to allow the debtor to have some breathing room, free from creditor collection efforts, to work out a plan to pay its creditors.[122] In others, the goals of Chapter 9 diverge from those of Chapter 11. At least one court read the legislative history of Chapter 9 to imply that municipal bankruptcy law was not designed to balance the rights of the municipal debtor and its creditors, but rather "to meet the special needs of a municipal debtor."[123] Those special needs include the need to remain in existence rather than liquidate,[124] and the need to continue providing public services. [125]

The remainder of this Article discusses the skeletal architecture of Chapter 9 and the status of a municipality as a creature of its state within the framework of two plan confirmation concepts. The first, found in the requirement that the plan be in the best interests of creditors, is that there is

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populations, and that others, like Pennsylvania, do not provide for dissolution at all because the state has no unincorporated land).

120. Charles Chieppo, *Fixing Municipal Finance, By the Book*, GOVERNING (Sept. 20, 2012), http://www.governing.com/blogs/bfc/col-municipal-finance-pioneer-institute-guide-sound-fiscal-management.html (reporting that municipal officials and members of municipal finance committees often serve on a volunteer basis, particularly in small and medium-sized communities); Stephan Whitaker, *Financial Innovations and Issuer Sophistication in Municipal Securities Markets* 6–7 (Fed. Reserve Bank of Cleveland, Working Paper No. 14-04, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2446979 (explaining that municipal-securities issuers range from small entities with part-time elected officials and no staff to states that hire finance professionals with advanced degrees).

121. *See* David A. Skeel, Jr., *Is Bankruptcy the Answer for Troubled Cities and States?*, 50 HOUS. L. REV. 1063, 1074 (2013) [hereinafter Skeel, *Answer*] (analogizing state financial distress to that of individuals and suggesting that Congress might, in a bankruptcy chapter for states, assert similar controls over a state, such as a proscription against serial filing, as it does over individuals); David A. Skeel, Jr., *When Should Bankruptcy Be an Option (for People, Places, or Things)?*, 55 WM. & MARY L. REV. 2217, 2228 (2014) [hereinafter Skeel, *Option*] (illustrating the similarities between the justifications for consumer bankruptcy and those for state bankruptcy).

122. *In re* Addison Cmty. Hosp. Auth., 175 B.R. 646, 649 (Bankr. E.D. Mich. 1994).

123. *In re* Richmond Unified Sch. Dist., 133 B.R. 221, 225 (Bankr. N.D. Cal. 1991).

124. *In re Addison Cmty. Hosp. Auth.*, 175 B.R. at 650.

125. *In re* Mount Carbon Metro. Dist., 242 B.R. 18, 41 (Bankr. D. Colo. 1999).

some minimum amount that must be distributed to each creditor. The second concept is equality, which runs through the requirements that a plan must be fair and equitable, and that it not discriminate unfairly. Although courts appreciate that the principles applicable in corporate and individual bankruptcy are of "limited assistance" in Chapter 9, the guiding Chapter 9 principles remain elusive.[126] Both of these concepts, as applied to a city as the debtor, raise broad questions about the rights of creditors in municipal property, the underexplored role of state decision-making in Chapter 9, and the meaning of bankruptcy in the municipal context.

III. PLAN CONFIRMATION STANDARDS AND THE ROLE OF THE STATE IN A CITY'S REHABILITATION

Although municipal bankruptcy law was originally conceived to provide federal enhancement to state municipal rehabilitation efforts, the role of state choices in the bankruptcy process has not been well articulated. This Part identifies areas where the ambiguity and omissions in Chapter 9 may permit a court to defer to state choices in determining whether a Chapter 9 plan of adjustment satisfies the Code's confirmation requirements.

A. Best Interests and the Distributional Goals of Chapter 9

The best interests test provides a floor for distributions to creditors in bankruptcy.[127] The property of business entities and individuals is available to satisfy creditor claims. The distributional baseline in Chapters 11 and 13, therefore, is the liquidation value of the debtor's assets.[128] Those chapters require that each creditor receive at least the baseline amount.[129] The Chapter 9 best interests test does not refer to individual claims; rather, it simply requires that the plan be "in the best interests of creditors."[130] All courts acknowledge that Chapter 9's distributional baseline is not the liquidation of municipal assets, but they have not identified an alternative baseline other than a vague dismissal analysis.[131]

126. *In re Richmond Unified Sch. Dist.*, 133 B.R. at 225 ("[T]he principles that apply in the other chapters of the Bankruptcy Code are of limited assistance in construing of Chapter 9.").

127. *See supra* note 87 and accompanying text.

128. *See supra* note 87 and accompanying text.

129. 11 U.S.C. §§ 1129(a)(7)(A)(ii), 1325(a)(4) (2012).

130. *Id.* § 943(b)(7).

131. *See supra* notes 48–53 and accompanying text.

The dismissal analysis is unworkable because it is impossible to predict how creditors would fare outside of bankruptcy, either upon dismissal or if bankruptcy had never happened. Even states with intervention statutes often take no active role in resolving a city's distress until a bankruptcy filing appears imminent. The Detroit Grand Bargain could have happened without a bankruptcy filing, but it was not until Detroit filed that both the state and foundations offered money to shield the art from the city's creditors.[132] Likewise, Harrisburg, Pennsylvania, resolved its debts outside of bankruptcy with rigorous and sometimes controversial state oversight, but the state implemented the structures supporting that oversight only after Harrisburg's failed bankruptcy filing.[133] Moreover, the nonbankruptcy entitlements of important municipal creditors remain unsettled. Some states have constitutional protections for pensions, yet the impact of those protections in a default scenario is untested.[134] Likewise, although participants in the municipal bond market have long assumed that a pledge of a municipality's taxing power to support a general obligation bond was the equivalent of a security interest, the principal collection remedy available to bondholders is a mandamus action to compel the levy and collection of sufficient taxes to pay the bonds, and the efficacy of that remedy is uncertain at best.[135]

If the value of a city's assets is irrelevant, then perhaps the correct baseline for the best interests test is the amount that the city needs to spend on its services. This approach reflects a similarity between consumer bankruptcy and municipal bankruptcy.[136] Like an individual, a municipality

132. *See* Brent Snavely, *The 10 Key Events that Helped Detroit Exit Bankruptcy*, DETROIT FREE PRESS (Nov. 10, 2014, 12:01 AM), http://www.freep.com/story/news/local/detroit-bankruptcy/2014/11/09/detroit-bankruptcy-events/18722223/ (explaining that the discussions that led to the Grand Bargain began four months after Detroit filed its bankruptcy petition).

133. Moringiello, *Goals and Governance*, *supra* note 21, at 471–78.

134. *See In re* City of Detroit, 504 B.R. 97, 149–54 (Bankr. E.D. Mich. 2013) (explaining the history of Michigan's constitutional pension protection).

135. *See* NAT'L ASS'N OF BOND LAWYERS, GENERAL OBLIGATION BONDS: STATE LAW, BANKRUPTCY AND DISCLOSURE CONSIDERATIONS 11–12 (2014), http://www.nabl.org/uploads/cms/documents/GENERAL_OBLIGATION_MUNICIPAL_BONDS.pdf.

136. Others have suggested similarities between the goals of consumer bankruptcy and the goals of municipal bankruptcy and sovereign bankruptcy. *See, e.g.*, McConnell & Picker, *supra* note 109, at 468–71 (surmising that the goal of Chapter 9 might be more akin to the fresh start for individuals than to the operational restructuring supported by Chapter 11); Robert K. Rasmussen, *Integrating a Theory of the State into Sovereign Debt Restructuring*, 53 EMORY L.J. 1159, 1179–85 (2004) (explaining that the law of individual bankruptcy could inform sovereign debt restructuring because the effect of sovereign financial distress could have an impact on citizens that is similar to their own financial distress); Skeel, *Answer*, *supra* note 121, at 1074 (analogizing state financial distress to that

must continue in existence, satisfying basic needs.[137] Just as bankruptcy law requires an individual to pay creditors only an amount that exceeds her necessary expenses,[138] a best interests test that takes necessary city services into account might better accommodate the nature of a city that must provide services to its residents. This analysis raises two more questions. The first is whether the value of municipal property is always irrelevant to a best interests analysis. The second asks how the appropriate level of city services should be determined.

1. The Relevance (or Not) of Municipal Assets

It is often said that creditors outside of bankruptcy may not seize municipal assets to satisfy debts.[139] If this is true, then even if Detroit, as owner of its art, can sell it free from any trust restrictions,[140] creditors have no nonbankruptcy expectancy interest in the art. This immunity from creditor process is one that is often stated but thinly supported. Case law on the issue is old and scant, and the legal foundation for immunizing municipal assets from seizure by creditors is based on the theory that a municipality holds its assets in public trust for its residents.[141] Courts protecting municipal property under this public trust doctrine have distinguished between property that the city holds for its own private uses and that which the city holds for the public,[142] but they tend to take an expansive view of public use. One court described protected property as that property "absolutely essential to the existence of the public

of individuals and suggesting that Congress might, in a bankruptcy chapter for states, assert similar controls over a state, such as a proscription against serial filing, as it does over individuals); Skeel, *Option*, *supra* note 121, at 2228 (illustrating the similarities between the justifications for consumer bankruptcy and those for state bankruptcy).

137. Sepinuck, *supra* note 67, at 351 (citing the individual's need to satisfy basic needs as one reason that the Chapter 13 unfair discrimination test should be different from that in Chapter 11).

138. 11 U.S.C. § 1325(b)(1) (2012).

139. McConnell & Picker, *supra* note 109, at 433–34.

140. The Michigan Attorney General has argued that the city has no such right. *See* Conveyance or Transfer of Detroit Institute of Arts Collection, Mich. Op. Att'y Gen. No. 7272, at 13 (June 13, 2013), *available at* http://media.mlive.com/news/detroit_impact/other/AGO %207272.pdf.

141. Little River Bank & Trust Co. v. Johnson, 141 So. 141, 143 (Fla. 1932) (citing City of Oakland v. Oakland Water-Front Co., 50 P. 277, 286 (Cal. 1897); City of Alton v. Ill. Transp. Co., 12 Ill. 38, 60 (1850); City of Salem v. Lane & Bodley Co., 90 Ill. App. 560, 563 (1900); Carter v. Louisiana, 8 So. 836, 836 (La. 1890); Egerton v. Third Municipality of New Orleans, 1 La. Ann. 435, 437–38 (La. 1846); Darling v. Mayor of Balt., 51 Md. 1, 11–12 (1879)).

142. Meriwether v. Garrett, 102 U.S. 472, 513 (1880); HOWARD S. ABBOTT, A TREATISE ON THE LAW OF PUBLIC SECURITIES 715–18 (1913).

corporation, or necessary and useful to the exercise and performance of governmental powers, or the performance of governmental duties."[143] There is one clear outer limit. When a municipality holds property only for investment or sale, a court will allow seizure of that property to satisfy claims against the municipality.[144]

The Detroit case threatened to test the public trust theory. Detroit's emergency manager Kevyn Orr believed that creditors would claim an entitlement to the DIA artwork, a fear that proved to be correct.[145] Although courts in municipal bankruptcy cases have accepted the public trust doctrine, they have done so primarily in cases involving special-purpose municipalities.[146] Shielding all municipal assets from creditor reach makes sense when the debtor is an irrigation district; seizure of the assets would mean termination of an entity created by the state to provide services to the public. A rule denying creditors access to all municipal assets makes less sense when a city is the debtor, especially when the city owns artwork worth hundreds of millions of dollars.[147]

Even if creditors cannot force a municipality to sell assets, the municipality may do so voluntarily. If it does so in a Chapter 9 case, the court will consider the sale price in applying the best interests test.[148] *In re Barnwell County Hospital*[149] was one of two simultaneously filed Chapter 9 cases designed to culminate in the privatization of two county hospitals.[150] In holding that the plan of adjustment met the best interests test, the court first acknowledged the complex nature of the case, and then found that the test was satisfied because the debtor had received a fair price for its hospital assets, the proceeds would be distributed to the debtor's creditors, and the debtor would be able to sell the hospital as a going concern.[151] Important to the court's best interests determination was the fact that the

143. *Little River Bank & Trust Co*., 141 So. at 143.

144. City of New Orleans v. Home Mut. Ins. Co., 23 La. Ann. 61, 62 (La. 1871).

145. Nathan Bomey et al., *How Detroit Was Reborn: The Inside Story of Detroit's Historic Bankruptcy Case*, DETROIT FREE PRESS, http://www.freep.com/longform/news/local/detroit-bankruptcy/2014/11/09/detroit-bankruptcy-rosen-orr-snyder/18724267/ (last visited Jan. 17, 2015).

146. *See, e.g.*, Lorber v. Vista Irrigation Dist., 127 F.2d 628, 637 (9th Cir. 1942) (quoting Newhouse v. Corcoran Irrigation Dist., 114 F.2d 690, 690–91 (9th Cir. 1940)).

147. For that reason, objecting creditors in Detroit have asked the court to distinguish between property that is essential for public service and that which is not. *See* Financial Guaranty Insurance Co.'s Pretrial Brief, *supra* note 13.

148. *In re* Barnwell Cnty. Hosp., 471 B.R. 849, 869 (Bankr. D.S.C. 2012).

149. *Id.*

150. *Id.* at 853.

151. *Id.* at 869.

plan preserved healthcare services in the affected county.[152] Thus, the court considered the purpose of the municipality and the needs of the residents in determining that the value received by the debtor was sufficient to satisfy the best interests test.[153]

Detroit's Grand Bargain raised both the question of the availability of municipal assets to satisfy creditor claims and that of the appropriate valuation of those assets if the debtor chooses to monetize them. Ultimately, Detroit did not shield its assets from creditors. It monetized its art collection through the Grand Bargain,[154] and parted with several real property assets in its settlements with its financial creditors.[155] As a result, the question of whether all municipal assets are truly immune from creditor process remains unanswered. The public trust doctrine, by shielding assets "necessary and useful" to a city's exercise of its public powers, should allow the city, and its state, to determine the assets necessary for the success of a city's future. The bankruptcy court does not, and should not, engage in urban planning. Only the municipality, either through choices made by its own local government or through choices made by the state in cooperation with the city, can guide the structural rehabilitation of a city, and municipal assets play a key role in any such rehabilitation.

2. Determining a City's Necessary Expenditures

Today's distressed cities reflect the economic and racial fragmentation of many American metropolitan regions: the affluent residents are in the suburbs and the poor populate the urban core.[156] Poor, shrinking cities may have small governments that are unable to provide any level of services beyond basic public safety. This reality has led to a call for enhanced state–local cooperation in ameliorating municipal problems.[157] Only a state can decide whether to keep a municipality in existence, and it may be the case that smaller municipalities should be absorbed into a larger

152. *Id.*

153. *Id.*

154. Detroit Confirmation Opinion, *supra* note 9, at 12–13 (discussing the settlement made with the Detroit Institute of Arts wherein the DIA will make $100 million in contributions to pensions over the next twenty years and other charitable organizations will contribute $366 million to the pension programs in exchange for the art within the museum to be transferred to a corporation that will hold the art in perpetual trust for the benefit of the citizens of Michigan).

155. *Id.* at 17–19 (explaining the city's settlements with Syncora and FGIC).

156. *See* Anderson, *Minimal Cities*, *supra* note 115, at 1136–41; Richard Briffault, *Our Localism: Part II—Localism and Legal Theory*, 90 COLUM. L. REV. 346, 446 (1990).

157. *See* Anderson, *Minimal Cities*, *supra* note 115, at 1217–18; Briffault, *supra* note 156, at 453.

municipality better able to provide basic services.[158] There is no agreement on the appropriate level of municipal services, and there cannot be, without considering the type of city and the goals of such services.

A bankruptcy court might defer to state choices. A state could decide what property is necessary for a distressed city based on its goals in supporting the rehabilitation of that city. In Detroit, the state, by participating in the Grand Bargain, made a decision about the necessity of the art to Detroit's recovery, and about the appropriate value of the art given the state's desire that the art remain in Detroit.[159] The court agreed with the state's choices in finding that the plan of adjustment satisfied the best interests test, citing the role that the DIA collection plays in the city's values of culture, education, civic pride, regional cooperation, and economic development.[160] The Detroit plan illustrates that monetization of city assets may be crucial to a successful plan, but that a city or state's choices about how to monetize the assets will likely be honored by a court. Nothing in Chapter 9 explicitly requires a court to honor these decisions, but the history of municipal bankruptcy law indicates that a high level of deference is appropriate.

B. Are Municipal Creditors More Equal Than Others?

1. What is the Meaning of Bankruptcy?

If municipal bankruptcy law was originally designed to facilitate a state's efforts to rescue a municipality, one could argue that the bankruptcy court may only rubber stamp a state's choices with respect to the treatment of a municipality's creditors. If that is true, there should be no problem with the Grand Bargain—if Detroit wants to save its art, and pay its pensioners, it can. Chapter 9 preserves a state's powers over its cities. The legislative history to the Code explains that § 904 reinforces the Chapter 9 policy against interference with municipal affairs by stating that a bankruptcy court "may not interfere with the choices a municipality makes as to what services and benefits it will provide to its inhabitants."[161] The "bankruptcy court as rubber stamp" position is an extreme one, however, and it ignores the fact that the state, having failed to rehabilitate its distressed municipality on its own, resorted to a federal process to do so. That federal process has always placed conditions on debtors. Those

158. Anderson, *Dissolving Cities*, *supra* note 119, at 1367 (asserting that municipal dissolution may have an appropriate place in the life cycle of cities).

159. *See* Detroit Confirmation Opinion, *supra* note 9, at 10–12.

160. *Id.* at 23–24.

161. H.R. REP. NO. 95-595, at 398 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6354.

conditions include the plan confirmation standards; when an individual or entity debtor files for bankruptcy, it gives up the right to make unbounded choices about how much it will pay each creditor. Up to this point, I have emphasized the state side of the municipal bankruptcy equation. Below, I address the federal side.

In considering Chapter 9 in its deliberations preceding the Code's enactment in 1978, Congress recognized that the term "bankruptcy," as applied to municipalities, is not bankruptcy as we know it in the corporate and consumer sense. The legislative history acknowledges that "the term 'bankruptcy' in its strict sense is really a misnomer for a [C]hapter 9 case."[162] The legislative history of the Code could be read to give a municipal debtor enormous leeway in developing a plan. The House Report acknowledged that a municipality does not liquidate its assets to satisfy creditor claims, and concluded that the "primary purpose of [C]hapter 9 is to allow the municipal unit to continue operating while it adjusts or refinances creditor claims."[163]

Must bankruptcy incorporate equal treatment? The Constitution gives Congress the power to enact uniform bankruptcy laws,[164] and the Supreme Court has held that municipal bankruptcy is within that power.[165] State debtor–creditor law can adequately address the relationship between a defaulting debtor and one creditor, but bankruptcy's proper role is in adjusting a debtor's relationship with multiple creditors. Bankruptcy law does not, in fact, treat all creditors equally; all chapters other than Chapter 9 are rife with priority provisions. For instance, in both consumer and corporate bankruptcy, creditors that are deemed less able to spread the risk of the debtor's financial failure, such as ex-spouses, children, and employees, receive priority in payment.[166]

There must be some significance to the state's choice to opt for bankruptcy for its distressed city, however. Municipal bankruptcy came into existence because states were powerless to solve the problems of their municipalities on their own.[167] The federal system allows cities to impair their contracts and to impose payment plans upon nonconsenting creditors.[168] The definition of bankruptcy, however, informs the content of a plan of adjustment. Bankruptcy law should not give states (or cities, if

162. *Id.* at 263, 1978 U.S.C.C.A.N. at 6221.

163. *Id.*

164. U.S. CONST. art. I, § 8, cl. 4.

165. *See* United States v. Bekins, 304 U.S. 27, 54 (1938).

166. 11 U.S.C. § 507(a)(1)(A) (2012).

167. *See supra* notes 25–26 and accompanying text.

168. *See* 11 U.S.C. § 901 (incorporating the cramdown provision of § 1129(b) by reference).

the state, like California, takes a hands-off approach to municipal financial distress) unlimited discretion as to the amount that creditors are paid.

By permitting a municipality to file for bankruptcy, a state consents to a federal procedure. This federal procedure is distinguished by several attributes. It is collective, it culminates in a discharge of some or all of the debtor's unpaid obligations, and it is facilitated and governed by federal law.[169] One author has placed only two limits on the congressional power to enact a bankruptcy law: the law must deal with insolvent debtors, and it must adjust relationships only between the debtor and its creditors, to the exclusion of third-party interests.[170] Although businesses and individuals need not be insolvent to file for bankruptcy, a municipality must be.[171] Therefore, because a city that files for bankruptcy, by definition, cannot pay all of its bills in full, Chapter 9 assumes some adjustment of debts. Adjustment, however, implies some measure of equality.[172] Chapter 9 embraces notions of equality in its incorporation of preference-avoidance powers and strong-arm powers.[173] Early in the life of the federal law of municipal bankruptcy, the Supreme Court stated that municipal bankruptcy law "envisage[d] equality of treatment of creditors."[174]

The argument that a state can fashion bankruptcy rules, unbounded by any federal power, is not supported by the cases interpreting Chapter 9. Although states have considerable leeway in conditioning their municipalities' entry into Chapter 9, courts have placed a limit on that discretion: once a state has authorized a Chapter 9 filing, it may not "cherry pick" among the Bankruptcy Code's provisions.[175] Judge Rhodes gave one example of such prohibited cherry picking in the Detroit eligibility opinion when he stated that if the state had conditioned Detroit's filing on a

169. Skeel, *Option*, *supra* note 121, at 2222–23.

170. Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487, 492 (1996).

171. 11 U.S.C. § 109(c)(3).

172. G. Eric Brunstad, Jr., *Bankruptcy and the Problems of Economic Futility: A Theory on the Unique Role of Bankruptcy Law*, 55 BUS. LAW. 499, 525 (2000).

173. 11 U.S.C. § 109(c) (allowing a municipality to bypass the requirement that it negotiate with its creditors if a creditor may attempt to obtain a transfer that may be avoidable as a preference); *id.* § 901 (incorporating §§ 544 and 547).

174. Am. United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138, 147 (1940).

175. Mission Indep. Sch. Dist. v. Texas, 116 F.2d 175, 176–78 (5th Cir. 1940); *In re* City of Stockton, 475 B.R. 720, 727–29 (Bankr. E.D. Cal. 2012); *In re* City of Vallejo, 403 B.R. 72, 75–76 (Bankr. E.D. Cal. 2009), *aff'd*, 432 B.R. 262 (E.D. Cal. 2010); Cnty. of Orange v. Merrill Lynch & Co. (*In re* Cnty. of Orange) 191 B.R. 1005, 1021–22 (Bankr. C.D. Cal. 1996).

promise to pay its pension obligations in full, that condition would likely have been invalid.[176]

Even in Chapter 9, which, for constitutional reasons, explicitly honors many state choices, a state law is preempted if it conflicts with federal bankruptcy law.[177] The state has a choice: prohibit its municipalities from filing for bankruptcy, or permit them to file, and thus, subject them to the Bankruptcy Code "as is," unmodified by state preferences. Because of the skeletal nature of Chapter 9, however, there are questions as to what "as is" means. Although municipal bankruptcy law today is far more comprehensive and detailed than it was in the 1930s,[178] Chapter 9, because of its ambiguous confirmation standards and almost nonexistent priority scheme, leaves ample room for the exercise of state discretion.

2. Some Thoughts on the Lack of a Chapter 9 Priority Scheme

In both the Detroit and Stockton bankruptcies, the court approved a plan of adjustment that gave different payment percentages to creditors that appeared to have equal priority as unsecured creditors.[179] Several authors have discussed whether Chapter 9 permits such disparate treatment, with conclusions ranging from yes, because the pension creditors are more sympathetic than the bond insurers,[180] to maybe, if the court interprets the confirmation standards in light of the unique purpose of Chapter 9,[181] to no, because the Code does not contain a specific priority for pension claimants.[182]

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176. *In re* City of Detroit, 504 B.R. 97, 162 (Bankr. E.D. Mich. 2013).

177. *In re Cnty. of Orange*, 191 B.R. at 1017 (citing Elliot v. Bumb, 356 F.2d 749, 755 (9th Cir. 1966)).

178. *See generally* Lawrence P. King, *Municipal Insolvency: The New Chapter IX of the Bankruptcy Act*, 1976 DUKE L.J. 1157, 1157–58 (explaining the changes made in 1976 to municipal bankruptcy law to accommodate the possibility that a large city might file).

179. *See generally* Detroit Confirmation Opinion, *supra* note 9; Stech & Fitzpatrick, *supra* note 17.

180. *See* Jack M. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3, 92 (2013) (arguing that generally, the "human case in favor of a [pension] bailout is compelling"); David A. Skeel, Jr., *Can Pensions Be Restructured in (Detroit's) Municipal Bankruptcy?* 19 (Federalist Soc'y, White Paper, 2013), *available at* http://www.fed-soc.org/publications/detail/can-pensions-be-restructured-in-detroits-municipal-bankruptcy.

181. Dawson, *supra* note 73, at 33 (arguing that higher payouts for pension creditors could be justified under a new value rule that recognizes the unique characteristics of municipal bankruptcy).

182. Hynes & Walt, *supra* note 79, at 660 (explaining that in the absence of a property right under state law or an enumerated bankruptcy priority status, pension creditors cannot be elevated over other unsecured creditors in Chapter 9).

Very little has been written on the absence of priorities from Chapter 9, and there is no legislative history explaining their omission.[183] Only one category of claim, the administrative expense claim, is entitled to statutory priority in Chapter 9.[184] Maybe Chapter 9 should incorporate priorities. On the other hand, perhaps the Tenth Amendment limits the ability of Congress to prescribe Chapter 9 priorities.[185] The omission leads to two possible conclusions—that there is even more equality among Chapter 9 creditors than there is among Chapter 11 creditors, or that the priority decision is left to someone else, the city, or its state.

As explained above, Congress drafted Chapter 9 and its predecessors to respect state sovereignty.[186] The skeletal structure of Chapter 9 omits a number of Chapter 11 provisions that give the court and creditors some control over a debtor. Omitted provisions include the power of a court to appoint a trustee in the event of debtor mismanagement and the power of a court to approve the sale of the debtor's property.[187] Those management powers are also explicitly denied to the court by the operation of § 904. Can § 903 be read to require a court to honor a state's priority choices in a plan of adjustment?

At first glance, the answer seems obviously to be no. Several courts have ruled that state statutes preferring one set of creditors over another fall away in bankruptcy via the Supremacy Clause and the Bankruptcy Clause.[188] In the Detroit eligibility opinion, Judge Rhodes made it very clear that a state law immunizing a category of debt from impairment would not be enforceable in bankruptcy.[189] That holding reflects one universally accepted purpose of bankruptcy law: the impairment of contracts.[190] The inability of a state to impair contracts is the entire raison

183. *See* Dawson, *supra* note 73, at 6.

184. 11 U.S.C. § 943(b)(5) (2012) (requiring that claims under § 507(a)(2), which provides statutory priority for administrative expenses under § 503(b), be paid cash for such claim on the effective date of the plan).

185. U.S. CONST. amend. X ("The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.").

186. *See supra* notes 25–37 and accompanying text.

187. *See* 11 U.S.C. § 901 (omitting §§ 363 and 1104).

188. *See supra* notes 172–76 and accompanying text.

189. *In re* City of Detroit, 504 B.R. 97, 161 (Bankr. E.D. Mich. 2013) ("[I]f a state consents to a municipal bankruptcy, no state law can protect contractual pension rights from impairment in bankruptcy, just as no law could protect any other types of contract rights.").

190. Sturges v. Crowninshield, 17 U.S. 122, 191 (1819).

d'être of municipal bankruptcy law;[191] if a state could resolve the problems of its cities on its own, there would be no reason for a federal statute permitting the impairment of contracts.

One of the creditors in the Orange County bankruptcy argued that the absence of bankruptcy priorities in Chapter 9 meant that state statutory priorities controlled in bankruptcy.[192] The court's response to this argument illustrates the tension between a state's ability to control its municipalities and the existence of a federal law governing municipal bankruptcy. The court conceded that Congress excluded the Code's priorities for employee wages and benefits from Chapter 9 because, by affecting a municipality's relationship with its employees, those priorities would interfere with the ability of a municipality to govern its operations.[193] The court also stressed that allowing a state to rewrite priorities would make the best interests of creditors test, as applied in Chapter 9, hard to satisfy, presumably because if state law applied in bankruptcy, the creditors' distribution in bankruptcy would be identical to their distribution if the case were dismissed.[194]

Supremacy Clause considerations aside, it makes sense that a state cannot export its own priority scheme into Chapter 9. Bankruptcy is designed to resolve the debts of an insolvent debtor in a collective proceeding. State laws granting creditor priorities are not drafted with bankruptcy goals in mind. Once a state has permitted bankruptcy, it has given up the opportunity to impose those categorical priorities.[195] Yet Chapter 9 preserves the power of a state to control its municipalities in the exercise of their political and governmental powers.[196] In holding that Detroit was eligible for bankruptcy, Judge Rhodes hinted at the difference between acknowledging that nonbankruptcy statutory priorities disappear in bankruptcy and applying the Chapter 9 plan confirmation standards to a city's ultimate plan of adjustment.[197] Just because a city may impair pension obligations due to the primacy of federal law over state priorities does not mean that it must do so. Judge Rhodes made this clear when he wrote that at plan confirmation time, the requirements of Chapter 9 will

191. United States v. Bekins, 304 U.S. 27, 54 (1938); Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S. 513, 530 (1936); Ass'n of Retired Emps. v. City of Stockton (*In re* City of Stockton), 478 B.R. 8, 16 (Bankr. E.D. Cal. 2012).

192. Cnty. of Orange v. Merrill Lynch & Co. (*In re* Cnty. of Orange), 191 B.R. 1005, 1019–20 (Bankr. C.D. Cal. 1996).

193. *Id.* at 1019 n.19.

194. *Id.* at 1020.

195. *See supra* note 175 and accompanying text.

196. 11 U.S.C. § 903 (2012).

197. *In re* City of Detroit, 504 B.R. 97, 154 (Bankr. E.D. Mich. 2013).

require the court's "judicious legal and equitable consideration of the interests of the City and all of its creditors, as well as the laws of the State of Michigan."[198]

Chapter 9 leaves debtor governance to the states.[199] Some states, such as California, have no municipal fiscal oversight programs, but others, such as Pennsylvania and Michigan, anticipate that the state will have an oversight role in a Chapter 9 case.[200] Perhaps the omission of priorities from Chapter 9 means that a bankruptcy court should defer to a state's choice in prioritizing creditors if the state makes that choice in connection with the bankruptcy case after considering the rehabilitation needs of the municipality. In approving Detroit's plan, which provided for a higher payout to pension claimants than to other unsecured creditors, Judge Rhodes applied a test that reflects this approach. He described the higher payout as justified by the city's mission as a municipal-service enterprise, and by the state's message, expressed in its laws that were displaced by Chapter 9, that the rights of pension creditors are distinct from other unsecured claims.[201]

There are several possible objections to the position that a state's priority choices in formulating a plan of adjustment deserve deference. The first is based on the scant commentary to the Chapter 9 discharge section, which implies that the debtor can choose to except a debt from discharge in its plan.[202] No opinions have analyzed this section, and the little commentary that exists on the section cautions courts from fashioning discharge exceptions on a case-by-case basis.[203]

Another objection, raised in the Orange County bankruptcy case, is based on uniformity. The court in *County of Orange* was concerned about uniformity among states in applying the Bankruptcy Code.[204] That hurdle is easily overcome; the constitutional requirement of uniform bankruptcy laws is generally understood to require that all debtors within a state be

198. *Id.* The court in the *Stockton* case came to a similar conclusion, and despite a statement one month before confirmation that bankruptcy law trumped a state law protecting CalPERS, the court ultimately honored the city's choice not to impair its obligations to CalPERS. *See* Stech & Fitzpatrick, *supra* note 17.

199. 11 U.S.C. § 903.

200. *See* Moringiello, *Goals and Governance*, *supra* note 21, at 468–78 (discussing the oversight roles contemplated by Michigan and Pennsylvania).

201. Detroit Confirmation Opinion, *supra* note 9, at 30–31.

202. 11 U.S.C. § 944(c).

203. 6 COLLIER ON BANKRUPTCY ¶ 944.04, at 944-10 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2014).

204. Cnty. of Orange v. Merrill Lynch & Co. (*In re* Cnty. of Orange), 191 B.R. 1005, 1020 (Bankr. C.D. Cal. 1996).

treated in a uniform manner.[205] This intrastate uniformity requirement is the more difficult hurdle. If state statutes are rendered ineffective by the Supremacy Clause and a state has the ability to fashion different priority rankings for different cities based on the characteristics of the cities involved, municipal debtors within a state will not be treated uniformly. Maybe that is not a cause for concern; municipalities include both special-purpose districts and the entire range of cities, counties, and towns. A large city such as Detroit, which entered bankruptcy after decades of industrial decline and fraught racial relations, has different rehabilitation needs than a smaller city that might have been forced to file for bankruptcy because of a corrupt bond deal.

A related objection is based on predictability. Bankruptcy should be somewhat predictable,[206] and allowing a state to make ad hoc choices in bankruptcy diminishes predictability. Bankruptcy's predictability must be balanced against its flexibility, however. Chapter 11 gives debtors flexibility in classifying creditors, with courts upholding classifications if they are based on a reasonable purpose.[207] States are concerned about being perceived as predictable and fair in order to maintain credit ratings for all of their municipalities.[208] If the purpose of Chapter 9 is to provide a minimal amount of federal compulsion to assist states in reviving their municipalities, then state choices deserve some deference.

Yet another objection is based on precedent that does not allow a court to grant categorical priorities that contravene the Code's mandates. The argument that a court cannot grant a priority in contravention of the Code's priority scheme is a compelling one.[209] The Supreme Court held in *United States v. Noland*[210] that a court could not equitably subordinate an entire category of claims. In the Chapter 9 case of Central Falls, Rhode Island, however, the court honored a priority fashioned by the state because the priority was in the form of a lien.[211] These two cases imply that a court

205. Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 190 (1902).

206. *See* Comm. on Bankr. & Corporate Reorganization, *supra* note 59, at 102.

207. 11 U.S.C. § 1122 (incorporated in Chapter 9 by § 901); *In re* Armstrong World Indus., Inc., 348 B.R. 136, 159 (D. Del. 2006).

208. Christine Sgarlata Chung, *Municipal Securities: The Crisis of State and Local Government Indebtedness, Systemic Costs of Low Default Rates, and Opportunities for Reform*, 34 CARDOZO L. REV. 1455, 1472 (2013); Maria O'Brien Hylton, *Central Falls Retirees v. Bondholders: Assessing Fear of Contagion in Chapter 9 Proceedings*, 59 WAYNE L. REV. 525, 544 (2013).

209. For an excellent defense of this position, see Hynes & Walt, *supra* note 73.

210. United States v. Noland, 517 U.S. 535, 536 (1996).

211. *See* City of Cent. Falls v. Cent. Falls Teachers' Union, R.I. Island Counsel 94 (*In re* City of Cent. Falls), 468 B.R. 36, 80 (Bankr. D.R.I. 2012); *see also* David A. Skeel, Jr., *What is a Lien? Lessons from Municipal Bankruptcy*, U. ILL. L. REV. (forthcoming 2015)

cannot grant a priority to an entire class of claims that is not specifically granted that priority in the Code, but may honor prebankruptcy property rights granted by the state to favor a particular class of creditors. This statement is consistent with the general view of the interaction between state and federal law in all types of bankruptcy; state law determines property rights at the moment a bankruptcy petition is filed, and bankruptcy law determines how those rights are distributed.[212] In an early municipal bankruptcy case, however, courts honored a municipality's priority choices as consistent with the requirement that a Chapter 9 plan be fair and equitable because the favored creditor had given extra value to the municipality's reorganization.[213]

This is where the purpose of Chapter 9 and the role of the state with respect to its cities meet. When a state agrees to permit a municipality to file for bankruptcy, it has made the choice to invite federal law to work together with state efforts to resolve the city's distress. Michigan did exactly that when it permitted Detroit to file. Although it could have engineered the Grand Bargain outside of bankruptcy, it did not. Bankruptcy provided the impetus for the parties involved in the Grand Bargain to come to the table. States have a great interest in the bond ratings for their cities; they know that if they are believed to treat financial creditors unfairly, they will be punished in the market.[214] This is one reason to leave the in-bankruptcy priority choice to the state; it can decide, based on the circumstances of the bankruptcy filing, whether it can take the risk of favoring one class of creditors over another. That is not the role of bankruptcy law. Although perhaps the Code could dictate priorities without violating the Tenth Amendment, doing so would not take into account the unique characteristics of each filing city. Because the state must continue to provide some level of services to city residents, either by permitting the city to do so, or by dissolving the city into another municipal entity, taking the special circumstances of each debtor into account is appropriate.

(manuscript at 14–15), *available at* http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2388&context=faculty_scholarship.

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

213. Mason v. Paradise Irrigation Dist., 326 U.S. 536, 541–42 (1946) (citing Ecker v. W. Pac. R.R. Corp., 318 U.S. 448, 486–87 (1943); Case v. L.A. Lumber Prods. Co., 308 U.S. 108, 117, 121–22 (1939)).

214. *See* Hylton, *supra* note 208, at 544.

CONCLUSION

Although my position is that the state should fill some of the gaps in Chapter 9 through its participation in the bankruptcy case, the role of state choices is murkier in states that do not exercise any oversight over distressed cities. Chapter 9 leaves debtor governance to the states. Some states, such as Pennsylvania and Michigan, anticipate that the state is going to have an oversight role in bankruptcy,[215] but others, such as California, have no municipal fiscal oversight program.[216] Stockton received its Chapter 9 plan approval more than two years after it filed for bankruptcy,[217] and another California city, San Bernardino, has been in bankruptcy for more than two years.[218] The most recent California city to complete Chapter 9, Vallejo, continues to struggle with its pension obligations as a result of its decision not to challenge CalPERS.[219] If the state is a crucial player in the resolution of municipal financial problems, perhaps a city should not be permitted to file for bankruptcy without state assistance. The Bankruptcy Code does not contain that restriction, however. Perhaps such a city is left to the bankruptcy default rule of equal treatment of creditors. Or perhaps the city's choices deserve the same deference as state choices, and if the state is unhappy with the way its cities conduct Chapter 9 cases, the state can implement an appropriate municipal fiscal oversight program. The proper role of Chapter 9 in resolving the distress of a city that files with no state supervision is one that deserves further study.

Although there are different opinions of the role of bankruptcy law, all can agree that bankruptcy, as a substantive body of law, does not stand on its own. It is hard to argue with the statement that bankruptcy law is challenging because "understanding how it works depends on a mastery of the broad universe of substantive legal rules that must then be translated into a new procedural forum."[220] In the municipal bankruptcy sphere, it is important to understand not only the substantive legal rules under which

215. *See* Moringiello, *Goals and Governance*, *supra* note 21, at 468–78.

216. *See id.*

217. *See* Stech & Fitzpatrick, *supra* note 17.

218. *See* Tim Reid, *Bankrupt San Bernardino Repaying Millions in Arrears to Calpers*, REUTERS (Nov. 4, 2014, 6:48 PM), http://www.reuters.com/article/2014/11/04/us-usa-municipals-sanbernardino-idUSKBN0IO2F120141104.

219. *See, e.g.*, Melanie Hicken, *Once Bankrupt, Vallejo Still Can't Afford Its Pricey Pensions*, CNN MONEY (Mar. 10, 2014, 10:44 AM), http://money.cnn.com/2014/03/10/pf/vallejo-pensions/; Tim Reid, *Two Years After Bankruptcy, California City Again Mired in Pension Debt*, REUTERS (Oct. 1, 2013, 1:06 PM), http://www.reuters.com/article/2013/10/01/usa-municipality-vallejo-idUSL2N0HM05C20131001.

220. Thomas H. Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, 14 J. LEGAL STUD. 73, 114 (1985).

cities operate, but the various theories of what a city is and should be. The Detroit confirmation opinion shows us that at least one court has taken the nature of a city very seriously in determining whether a Chapter 9 plan could be confirmed—an approach that recognizes that Chapter 9 can be a useful tool in the municipal recovery toolkit.