MUNICIPAL CAPITAL STRUCTURE AND CHAPTER 9 CREDITOR PRIORITIES

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I. INTRODUCTION

In the spring of 2016 amidst cries from many sectors to "do something" about Puerto Rico's staggering debt load, the House Committee on Natural Resources introduced a bill dubbed PROMESA, the Puerto Rico Oversight, Management, and Economic Stability Act.[1] Its sponsors quickly promoted the bill as "not Chapter 9" and indeed, with its oversight provisions, it contains a lot more than Chapter 9 of the Bankruptcy Code, the bankruptcy chapter used to adjust the debt of struggling public entities. Yet the attempts to distinguish PROMESA from Chapter 9 ring hollow – PROMESA incorporates by reference most of Chapter 9, which itself incorporates by reference a wide swath of Chapter 11.

Municipal distress in cities nationwide has revived scholarly interest in Chapter 9. Its efficacy has been debated widely with several authors lamenting the lack of operational restructuring anticipated by Chapter 9.[2] PROMESA aims to remedy this deficiency by mandating federal oversight for Puerto Rico.[3] Legislative realities aside, Congress missed a chance. Puerto Rico's unique political status made a Bankruptcy Code based process unnecessary. One aspect of PROMESA that supports the claim that it is "not bankruptcy" is its intended placement in Title 48 of the United States Code, the federal law governing territories and insular possessions.[4] Congress therefore could have designed a bespoke procedure for debt resolution for the Commonwealth and the other jurisdictions governed by the act[5] that is not rooted in bankruptcy values and policies.

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[1] H.R. 5278, 114th Congress, 2nd Sess. President Obama signed PROMESA on June 30, 2016.

[2] *See, e.g.* Clayton P. Gillette & David A. Skeel, Jr., *Governance Reform and the Judicial Role in Municipal Bankruptcy*, 125 YALE L. J. 1140 (2016); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425 (1993).

[3] PROMESA § 101 (b)(2).

[4] PROMESA § 6.

[55] Although the title of PROMESA implies that it applies only to Puerto Rico, it includes all "territories," defined as Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands. *See*

The (admittedly time-consuming) process of designing a true "non-bankruptcy" financial distress resolution procedure for Puerto Rico might have helped policy makers think through the necessary and appropriate elements of a federal process for resolving municipal financial distress. Those who have studied Chapter 9 have criticized it for borrowing plan confirmation standards from Chapter 11, the chapter of the Bankruptcy Code designed for business reorganizations.[6] Although its political status and some of the reasons for its staggering debt loads are unique, Puerto Rico and its public entities borrow in the same way that United States municipalities borrow, primarily by making promises described in terms of the efforts used to make good on them, not by pledging property to support those promises.

There is a good argument that municipal debt adjustment should not be part of a system called bankruptcy. The Bankruptcy Clause of the Constitution grants Congress the power to enact "uniform Laws on the subject of Bankruptcies."[7] Yet soon after Congress passed the predecessor to Chapter 9, some wondered whether the purview of the Bankruptcy Clause could include a law that did not contemplate the surrender of a debtor's assets in satisfaction of creditor claims.[8] Although the scope of bankruptcy legislation has expanded beyond liquidation, the goal of the bankruptcy system is to satisfy competing claims of creditors when the debtor has insufficient assets to satisfy all claims.

The foundational goal of bankruptcy does not apply to municipal entities. Public debtors are unique in that their assets are not available to creditors, thus limiting creditor remedies against municipalities.[9] The

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PROMESA §§ 5 (20) (defining "territory"); 101 (explaining that the purpose of the oversight title of the act is to provide a method for a territory to "achieve fiscal responsibility and access to the capital markets").

[6] *See* Juliet M. Moringiello, *Chapter 9 Plan Confirmation Standards and the Role of State Choices*, 37 CAMPBELL L. REV. 71, 91-105 (2015) (discussing the poor fit between the Chapter 11 confirmation standards and the goals of Chapter 9).

[7] U.S. CONST. art. 1, § 8, cl. 4.

[8] Harold Gill Reuschlein, *Municipal Debt Readjustment: Present Relief and Future Policy*, 23 CORNELL L.Q. 365, 371 n. 35 (1938).

[9] Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 429-34 (1993) (explaining that municipal assets are immune from creditor process). Municipal debtors do, however, voluntarily sell or otherwise monetize assets to satisfy creditor claims. *See In re* City of Detroit, 524 B.R. 147, 177-179 (explaining Detroit's "Grand Bargain" in which several foundations and the state of Michigan contributed money to transfer Detroit's valuable art collection to a non-city entity), 194-197 (explaining how Detroit transferred real estate to

security that supports public promises to repay is not security in the form of access to property, it is security based on trust in various types of promises. Indeed, American states and some foreign countries[10] have processes to resolve municipal debt that are not bankruptcy-based, but such processes in the United States cannot include the bankruptcy benefit of forced contract impairment on non-consenting creditors.[11]

This paper has a modest goal. Imagining a Congress unbound from the requirements of expediency and from the existing structure of Chapter 9, this paper proposes a priority scheme based not on property principles, which are largely absent in public finance law, but on contractual, legal, and social promises that form the basis of public capital structures. I do not propose an entirely new debt adjustment process. Others have already done so,[12] and in earlier work, I have advocated for a bankruptcy process combined with higher-level oversight, something that the Puerto Rico legislation does admirably but controversially.[13]

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satisfy creditor claims); HARRISBURG STRONG PLAN, August 26, 2013 at 13-21 http://www.newpa.com/download/harrisburg-strong-plan-pdf/#.V2v0aatf2Ul (explaining how the City of Harrisburg monetized its parking assets outside of bankruptcy).

[10] *See, e.g.* 52 P.S. §11701.101 *et seq.* (Pennsylvania's Municipalities Financial Recovery Act, also known as "Act 47"); Lili Liu & Michael Waibel, *Subnational Insolvency: Cross-Country Experiences and Lessons*, The World Bank, Policy Research Working Paper 4496, January 2008 8-12 (explaining the municipal insolvency schemes in South Africa and Hungary, both of which specifically tailored to public entities); Frank Shafroth, *Why Cities Can't Go Bankrupt in Canada or Germany*, GOVERNING, May, 2014, at http://www.governing.com/columns/public-money/gov-municipal-debt-traps-nein.html (discussing German Haushaltssicherungskonzept).

[11] 11 U.S.C. § 903. The United States Supreme Court reinforced the scope of this section in *Commonwealth of Puerto Rico v. Franklin California Tax-Free Trust*, No. 15-233, June 16, 2016.

[12] I join a small group of others who have proposed an insolvency scheme tailored specifically to municipal governments. *See, e.g.,* Steven L. Schwarcz, *Global Decentralization and the Subnational Debt Problem*, 51 DUKE L.J. 1179 (2002) (proposing a model law, for use by countries worldwide, that adopts fundamental United States principles of bankruptcy reorganization); Samir D. Parikh, *A New Fulcrum Point for City Survival*, 57 WM. & MARY L. REV. 221 (2015) (arguing that municipal restructuring can and should be done only at the state level). *See also* Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt*, 121 YALE L.J. 188 (2012) (explaining that it is unhelpful to discuss the debt problems of U.S. states using a bankruptcy-based framework).

[13] *See* Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403 (2014). Receiverships and other forms of oversight are always controversial but often provide the political will to make hard decisions that elected officials may lack. *See* Clayton P. Gillette, *Dictatorships for Democracy: Takeovers of Financially-Failed Cities*, 114 COLUM. L. REV. 1473 (2014) (exploring the justification for state takeovers and evaluating their efficacy); Michelle Wilde Anderson, *Democratic*

To propose a different way of thinking about creditor priorities, this article proceeds as follows. In Part I, I will explain the types of promises and security that support public borrowing promises. Part II will explain public borrowing. Part III will discuss the policies and values behind bankruptcy priorities as applied to individuals and business entities. In Part IV, this article will explore and question the values of municipal insolvency law and pose some questions about how those values can inform municipal bankruptcy priorities. The article concludes by calling for more discussion.

II. PUBLIC ENTITY BORROWING: THE WHY, THE HOW, AND THE COMPETING INTERESTS

Municipalities make several different types of promises when they borrow money, and state laws attempt to enhance those promises in a variety of ways. In this section, I will discuss traditional promises and protections and the more recent innovations in municipal finance.

A. The Why

The feature that distinguishes municipal finance from other types of finance is its public purpose. The role of a municipality in providing goods and services is distinct from that of a private actor. Public entities step in to provide goods and services when private markets cannot do so.[14] Public entities are better situated to provide public goods and services than are private entities. An example is a paved road or a street light system – because everyone in the geographical area of the improvement will benefit from it, no private actor has incentive to provide it.[15] Ideally, when a public entity provides public goods and services, it does so in furtherance of its "cardinal civic responsibilities" to protect the health, welfare, and safety of its citizens.[16]

The rules governing municipal debt are based in its public purpose. State constitutions permit a municipality to incur debt only for a public

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Dissolution: Radical Experimentation in State Takeovers of Local Governments, 39 FORDHAM URB. L.J. 577 (2012) (criticizing state receivership laws in Michigan and Rhode Island as failing to address the root causes of municipal financial distress).

[14] ROBERT AMDURSKY, ET AL., MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE (2ND ED. 2015 CUM. SUPP.) § 1.1.1.

[15] ROBERT AMDURSKY, ET AL., MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE (2ND ED. 2015 CUM. SUPP.) § 1.1.1.

[16] Dep't of Revenue v. Davis, 553 U.S. 328, 342 (2008).

purpose.[17] Because a municipality may increase taxes to make bond payments, it would be considered unjust to make the public at large pay for a project for which it gains no benefit.[18] States limit the amount of debt that a municipality may incur in order to insulate future taxpayers from decisions in which they played no part.[19] Municipalities fund their public obligations by collecting taxes. A municipality's power to collect taxes is restricted by its local boundaries.[20] Municipal debt receives favorable tax treatment because of its public purpose. The funded improvements further the entity's social obligations, and as a result, municipal bonds are generally tax-exempt. Because of this exemption, the federal government and states forgo revenue in furtherance of a social good.[21]

The public purpose of municipal debt not only drives limitations on public debt but also limits the remedies to which municipal creditors can resort. Creditors of private entities have recourse to the entity's property in the event of non-payment. Creditors of public entities do not because the law considers municipal property to be held in trust for the public.[22] Access to property is a key feature in the design of creditors' rights laws, but municipal creditors have no rights to their debtors' assets. Municipal debt resolution schemes are thus fundamentally different from methods of resolving the debts of individuals and private entities.

[17] 1 GELFAND, STATE AND LOCAL GOVERNMENT DEBT FINANCING § 1.4 (database update 2015 James A. Coniglio).

[18] ROBERT AMDURSKY, ET AL., MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE (2ND ED. 2015 CUM. SUPP.) § 3.1.

[19] *See* Lonegan v. State, 819 A. 2d 395, 402-03 (N.J. 2003) (explaining that New Jersey adopted its debt limitation in 1844 to protect future generations of taxpayers and to rein in unchecked speculation by the state); ROBERT AMDURSKY, ET AL., MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE (2ND ED. 2015 CUM. SUPP.) § 4.1.1; Stewart E. Sterk & Elizabeth S. Goldman, *Controlling Legislative Shortsightedness: The Effectiveness of Constitutional Debt Limitations*, 1991 WIS. L. REV. 1301, 1315-16 (surveying different types of debt limitations).

[20] *See* Richard Briffault, *The Local Government Boundary Problem in Metropolitan Areas*, 48 STAN. L. REV. 1115, 1129 (1996) (explaining that local governments receive most of their revenue from taxes rather than from higher levels of government).

[21] *See* Fox v. U.S., 397 F.2d 119, 122 (8th Cir. 1968) (explaining that the federal tax exemption for public debt reflects "a fundamental long-standing policy of Congress that the federal government shall not impose any restraint on the borrowing power of the states or their political subdivisions for public use and benefit").

[22] *See*, *e.g.* Meriwether v. Garrett, 102 U.S. 472, 513 (1880); Little River Bank & Trust Co. v. Johnson, 141 So. 141, 143 (defining protected public property as that property "absolutely essential to the to the existence of the public corporation, or necessary and useful to the exercise and performance of governmental powers, or the performance of governmental duties").

B. *Public Borrowing: Promises not Property*

Bankruptcy law's distinctions among creditors are rooted in the non-bankruptcy borrowing and lending practices of individuals and business entities. In the private realm, bankruptcy respects the choice to partition property in such a way as to elevate one creditor over another, but does not provide the same protection to contractual promises that do not include the grant of a property interest.[23]

"Debt," as defined in municipal finance rules, is not debt as commonly understood in the commercial world. Commercial parties understand debt to mean any obligation to pay. The municipal finance definition of debt is rooted in the effect of municipal debt on the public. Debts subject to constitutional or statutory debt restrictions are those that may result in a tax increase. Other obligations, such as those payable from specific revenues and those payable from annual budget appropriations, are not considered "debt" for the purpose of debt limitation clauses. To the commercial lawyer's eye, all such obligations appear to be unsecured. Municipal finance, makes a distinction between promises that provide high assurance of payment, like the full faith and credit promise, and promises that provide less certainty, like the appropriations promise.[24]

1. The General Obligation Promise

The markets have long considered general obligation bonds to be fail-safe. Municipal finance participants describe general obligation bonds as being backed by a *pledge* of the issuer's full faith and credit, its taxing power, or both.[25] Both the grant and the promised security are not security as commonly understood by commercial lawyers. In the commercial world, a grant of security carries with it a remedy against the property interest pledged. A full faith and credit pledge, on the other hand, does not grant the recipient a lien on any municipal property.[26] Instead, the full faith and credit

[23] For example, a debtor may give a "negative pledge" promise to a creditor, whereby it promises not to grant security interests in its property to other lenders. Although this is a binding contractual obligation, the law does not consider it to be the same as a security interest in the debtor's property. *See* Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property, and Perfection,* 84 CORNELL L. REV. 305, 306-07 (1999)

[24] Lonegan v. State, 819 A. 2d 395, 406 (N.J. 2003) (acknowledging that the payment of appropriations debt was "highly likely" if only to protect the state in the bond market).

[25] National Association of Bond Lawyers, *General Obligation Bonds: State Law, Bankruptcy, and Disclosure Considerations*, August, 2014.

[26] State *ex rel.* Babson v. Sebring, 115 Fla. 176, 182 (1934).

pledge is couched in the contract language of obligation. According to one court, a full faith and credit provision "does no more than express an understanding and appreciation of the legal obligation to pay the bond according to its terms."[27] Moreover, this pledge is limited by governing law. Although the issuer may pledge (promise) to levy additional taxes, the bondholders cannot collect the taxes themselves. In other words, an issuer cannot be forced to raise taxes above statutory limits. In the municipal finance world, the pledge of full faith and credit and/or taxing power is a promise that can be enforced only by a mandamus action.

General obligation bonds are thus supported by promises protected by the Contracts Clause of the Constitution. Courts have made clear the difference between a full faith and credit pledge and a mortgage granted by an individual or business.[28] The remedies available against a non-paying municipal entity reinforce the distance between property concepts and municipal finance. Even an unsecured creditor of a private actor eventually has recourse against that entity's property if any such property is available and unencumbered. These property remedies do not exist against public entities. The best a general obligation bondholder can do is to pursue a mandamus action to force the performance of the municipal issuer's contractual promise. A municipality's primary asset is its taxing power,[29] but such power is not an asset that creditors can seize. Because public borrowing does not incorporate the property concepts embedded in private borrowing, the remedies for non-payment differ. Mandamus is a typical remedy in the public context.[30] Although mandamus is available, it is rarely used and somewhat ineffective. The goal of a mandamus action is to force a public official to apply the first funds received to pay creditors. Many state courts are unwilling to force a public official to do so if the result would be to pay a financial market creditor before a provider of essential services. Ordinary creditors of a public entity are even worse off. Even when a statute creates a lien against a debtor's property, such statute is inoperable against

[27] State *ex rel.* Babson v. Sebring, 115 Fla. 176, 183 (1934). The bonds in the cited case pledged the city's full faith, credit and resources. Even the pledge of resources did not create a lien on the municipality's property.

[28] State *ex rel.* Dos Amigos v. Lehman, 100 Fla. 1313, 1325 (1930). Courts in other states have reinforced the principle that a faith and credit pledge creates a contractual pledge unsupported by any property interest. *See* Flushing Nat'l Bank v. Municipal Assistance Corp., 40 N.Y. 2d 731, 735 (1976) (holding that the state's Emergency Moratorium Act, which suspended the right of certain bondholders to enforce their debts, violated the New York Constitution.

[29] *See e.g.* Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 509 (1942).

[30] *See* Samuel L. Bray, *The System of Equitable Remedies*, 63 U.C.L.A. L. REV. 530 (2016).

public property.[31]

The concept of a general obligation bond is not a monolithic one. Variations include the unlimited tax general obligation (UTGO) bond, the limited tax general obligation bond (LTGO) and the general fund general obligation bond (GFGO). The nature and effect of these designations vary from state to state. Although voter approval is often required for UTGO bonds, it is often not required for LTGO and GFGO bonds. This is an important distinction – voter approval is usually needed when payment of the bonds can result in risk to the taxpayers.[32] In the Detroit bankruptcy, bondholders and the city fought over whether the UTGO and LTGO obligations were "secured" or not, mapping commercial lending terms onto public finance instruments whose safety is not based on a property grant but rather on the types and amounts of taxes that can be used to pay the obligation.[33]

2. Revenue Bonds Distinguished

Reading Chapter 9 of the Bankruptcy Code, one would think that there are only two types of municipal debt: special revenue debt and other. This binary distinction mirrors the secured/unsecured distinction in other types of bankruptcy. Although on the one hand this distinction is not the crucial one in municipal financing, the fairly detailed (in Chapter 9 terms) treatment of special revenue bonds emerged from a concern that the Bankruptcy Code did not take the realities of municipal finance into account. The Code treats revenue bonds as secured debt, and when Congress revised the Bankruptcy Code in 1988, it took the needs of the municipal market into account in protecting the security interest created by revenue bonds. A security interest in special revenues extends to such revenues generated after the commencement of the bankruptcy case.[34] This rule is contrary to the rule that applies in all other types of bankruptcies – the floating lien does not float and property received by the debtor post-petition is free from pre-petition liens. This reflects the realities of municipal finance practice:

[31] *See* City of Westminster v. Brannan Sand & Gravel Co., 940 P. 2d 393 (Colo. 1997) (holding that a mechanics' lien does not attach to municipal property, noting that the "rationale for the common law's exemption of public property from mechanics' liens is to preserve essential public services and functions while protecting those who benefit from public services and facilities").

[32] National Association of Bond Lawyers, *General Obligation Bonds: State Law, Bankruptcy, and Disclosure Considerations*, August, 2014.

[33] *See* Lawrence A. Larose, *Restoring Confidence in California General Obligation Bonds*, LAW360, November 4, 2015.

[34] 11 U.S.C. § 928.

holders of special revenue bonds look to only one source of payment. That source is the revenue stream generated by the project financed. The bondholders have no recourse whatsoever against the municipal entity if the funds turn out to be insufficient. Congress also protected special revenue obligations from the automatic stay and made clear that bankruptcy law could not transform a special revenue obligation into a general obligation of the municipality.[35]

Special revenue bonds are secured in the traditional conception of the term "secured debt." The commercial definition of secured debt assumes that there is a defined property interest that is pledged to a creditor to secure the payment of an obligation.[36] The definition of security interest includes the sale of accounts receivable, which is probably the best analogy to a special revenue pledge. Just as in a sale of accounts, the security pledge in a special revenue bond is non-recourse. When a loan to a municipality is made secured by a special revenue pledge, the municipality commits to pay all of the revenues generated by a specific project in excess of amounts needed to operate the project. If the municipality fails to remit the revenues to the bondholders, the bondholders have remedies with respect to those revenues.

In its pure form, the revenue bond does not put a municipality's taxpayers at risk because payment is made solely from revenues generated from a specific project. For this reason, revenue bonds are exempt from constitutional debt limits.[37] This is a key point to keep in mind as parties argue over whether various types of general obligation bonds should be treated as secured by a tax pledge. Revenue bonds are protected as secured precisely because their risk is directly related to the financed project.

By statute, custom, and common law, municipalities are restricted in their ability to grant security interests in other property. All three of these mechanisms prohibit creditors from seizing municipal assets to satisfy claims against the municipality. As a result, municipal finance does not rest on the same property-based concepts that exist in commercial lending. Even revenue bonds are secured only by a stream of income from a project, not

[35] *See* 11 U.S.C. §§ 922 (excepting the application of pledged special revenues from the operation of the automatic stay); 927 (denying the holders of special revenue obligations the ability to be treated as holders of recourse obligations under § 1111 (b) of the Bankruptcy Code).

[36] UNIF. COMM. CODE. § 1-102 (b)(35) (defining security interest as "[a]n interest in personal property or fixtures which secures payment or performance of an obligation").

[37] ROBERT AMDURSKY, ET AL., MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE (2ND ED. 2015 CUM. SUPP.) § 1.3.

by the physical project itself.

3. Beyond General Obligation and Revenue Bonds

A comparison of general obligation and revenue bonds illustrates how market expectations in the municipal context are sometimes the reverse of those in the commercial context. Market participants consider general obligation bonds to be safe because there are numerous payment sources available for their repayment.[38] Revenue bonds are considered less safe because they are payable out of a distinct set of funds. Yet revenue bonds are secured by a property right in the form of a dedicated source of funds. They are non-recourse, however, so unsatisfied creditors may not proceed against other funds of the municipality.

Increasingly, or most notably in the recent distress cases of Detroit and Harrisburg, local governments have been engaging in the sorts of practices that marked the subprime lending crisis. Just as homeowners could buy a previously unaffordable house by deferring the obligation to pay as long as possible, municipalities engaged in a number of lending practices that deferred the obligation to pay as long as possible. One example of a debt obligation that provides no new value to the municipality is the "scoop and toss" refunding. Such a refunding allows an issuing municipality to defer imminent debt service and add it to the back end of the debt service schedule. Municipalities in distress tend to engage in a series of such refundings, resulting in a very large debt over time.[39] Other financing arrangements that may ultimately harm municipalities include swaptions and capital appreciation bonds.[40]

C. The Competing Interests

Priorities matter only when a municipality falls into distress. It is only at that point when we see questions about whether a bondholder will be paid before firefighters or police. Local governments exist for several reasons: they provide services, they hold land in the public interest, and they regulate for public health, safety, and welfare.[41] The obligations of local

[38] ROBERT AMDURSKY, ET AL., MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE (2ND ED. 2015 CUM. SUPP.) § 1.3.3.

[39] David Unkovic, *Municipal Financial Distress: Causes and Solutions, The Bond Buyer's* Second Symposium on Municipal Financial Distress, March 2013.

[40] For an explanation of a variety of potentially abusive financing arrangements, *see* Tom Sgouros, *Predatory Public Finance*, 17 J.L. SOC'Y 91 (2015).

[41] Commissioners of Albany County v. Laramie County, 92 U.S. 307, 308 (1875) ("[c]counties, cities and towns . . . are usually invested with certain subordinate legislative

governments are labor-intensive, therefore they will have large obligations for salaries, pensions, and health benefits. Like general obligation bonds, all of these service claims on municipal resources are unsecured in the commercial or property sense.

In the next section of this paper, I discuss bankruptcy rules and values to illustrate how Congress assigned priorities in the Bankruptcy Code. This discussion will lay the foundation for a discussion of the values that can inform the assignment of priority treatment in any federal procedure for municipal debt resolution.

III. BANKRUPTCY POLICIES AND PRIORITIES (OR THE VALUES OF BANKRUPTCY)

Creditors of individuals and private entities have a number of methods by which they can ensure that their claims are paid before others outside of bankruptcy. The first is to ensure that the debtor's assets are partitioned in such a way that no other creditors can have a plausible claim to them.[42] Another is to obtain a property interest in the debtor's assets. Last is to be a beneficiary of a statutory or constitutional priority. This last category includes statutes that grant property interests in the debtor's assets such as mechanics' lien statutes. The Bankruptcy Code respects the first two methods, and although it recognizes statutory liens, it allows the trustee to set aside certain statutory liens as contrary to bankruptcy policy.[43]

A. What is Bankruptcy?

There has long been a robust debate about the nature of bankruptcy law. Generally, however, bankruptcy is recognized as an orderly collective proceeding that is designed to mitigate the harm to creditors that inures when each creditor pursues its individual remedies when there are insufficient assets to satisfy all.[44] Although bankruptcy rules are based on property concepts, in a large percentage of individual bankruptcies, there is

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powers . . . to promote the general welfare of the municipality." *See also* Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1158 (2014).

[42] David Skeel has explored the various types of liens and lien substitutes. *See* David A. Skeel, Jr., *What is a Lien? Lessons from Municipal Bankruptcy*, 2015 U. ILL. L. REV. 675.

[43] Even state laws that grant liens to creditors can be disregarded in bankruptcy. *See* 11 U.S.C. § 545 (allowing the trustee to set aside landlord's liens and statutory liens that arise upon bankruptcy).

[44] Thomas H. Jackson, *Statutory Liens and Constructive Trusts in Bankruptcy: Undoing the Confusion*, 61 AM. BANKR. L.J. 287, 288 (1987).

no property to distribute. Even in those bankruptcies, there is a notion of "worthier" promises that is embodied in the Bankruptcy Code through the rules on non-dischargeability. As a result, bankruptcy priority rules reflect the realities of finance and incorporate distinct bankruptcy policies and values. The key to bankruptcy distribution is based on property concepts, and the distinction between secured and unsecured claims is critical.

Bankruptcy rules reflect the core goals and values stated above. The Bankruptcy Code's rules promote an orderly and collective debt relief proceeding that provides predictability to markets and transacting parties. The stay of collection proceedings that arises immediately upon the filing of a bankruptcy petition promotes orderliness.[45] The migration of causes of action to one forum, the Bankruptcy Court, as well as rules ensuring the equal treatment of similarly situated creditors promotes the collective nature of the proceeding.[46] The Bankruptcy Code promotes predictability by setting forth clear priorities.[47] Bankruptcy's predictability also springs from its uniformity, but the constitutional uniformity mandate requires only that debtors within each state be treated uniformly, not that debtors nationwide be treated in a uniform manner.[48] Bankruptcy provides debt relief through discharge, and solves the holdout problem through its cram down provisions.

B. First-Level Priorities: Secured and Unsecured Claims

The Bankruptcy Code respects security interests. Some courts, including the Supreme Court, have implied that the only way that a creditor can ensure itself of full payment in bankruptcy absent a Code priority is by obtaining a security interest in some of the debtor's assets.[49] This security interest can either been a consensual one governed by the Code or one granted statutorily. The Supreme Court recognizes that states may grant statutory secured priority.[50] One reason that the Code respects security interests is the Fifth Amendment to the Constitution, which prohibits the

[45] 11 U.S.C. § 362.

[46] *See* 11 U.S.C. §§ 726 (b) (mandating *pre rata* sharing); 1122 (allowing a Chapter 11 debtor to place claims in the same class only if the claims are substantially similar).

[47] 11 U.S.C. § 507.

[48] *See* 11 U.S.C. § 522 (b)(2) (recognizing that a state may require that individual debtors take advantage of state property exemptions rather than federal property exemptions); Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 190 (1902) (the bankruptcy system is uniform in the constitutional sense when "the trustee takes in each State whatever would have been available to the creditors had the bankrupt law not been passed").

[49] *See* Ohio v. Kovacs, 469 U.S. 274, 286 (1985) (O'Connor, J., concurring).

[50] *See* Ohio v. Kovacs, 469 U.S. 274, 286 (1985) (O'Connor, J., concurring).

taking of private property without just compensation. There has been robust debate, however, about both the Fifth Amendment foundations of the primacy of secured credit in bankruptcy and its desirability from a business perspective.

As all law students are taught, "property" does not mean an asset itself; rather, "property" means the relationship among persons with respect to assets. Commercial law rules tend to turn on whether a party has property rights in an asset or not. They also tend to differentiate between property and contract rights without acknowledging the blurry line between the two. Several authors have explored the edges of this distinction.[51]

On the first level, commercial law recognizes secured and unsecured debt and nothing in the middle.[52] Those who have explored negative pledges in depth decry the bipolar distinction between secured and unsecured creditors, claiming that there are several status positions between the two poles. The negative pledge calls up the property/contract distinction, and thus the priority questions, that are raised by various promises in municipal bonds.

C. Second-Level Priorities Among Unsecured Creditors: The Worthy

1. Priorities as an expression of worthiness

In individual and business entity cases, the Bankruptcy Code prioritizes among unsecured creditors based on various notions of creditor worthiness. Although priorities apply to unsecured claims, their existence is rooted in the property aspects of bankruptcy. If an insolvent debtor, by definition,[53] does not have sufficient assets to pay the claims against it in full, then some particularly worthy creditors will not receive full payment of the claims against them. As a result, the Bankruptcy Code provides that some of those creditors must be either paid before all others (in the case of a Chapter 7 liquidation) or paid in full in order for a plan to be confirmed (in the case of

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[51] *See, e.g.* Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property, and Perfection,* 84 CORNELL L. REV. 305 (1999); Peter Coogan, *et al., The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements,* 79 HARV. L. REV. 229 (1965).

[52] Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property, and Perfection,* 84 CORNELL L. REV. 305, 313 (1999)

[53] *See* 11 U.S.C. § 101 (32) (defining insolvency for all debtors other than a municipality and a partnership as a "financial condition such that the sum of such entity's debts is greater than all such entity's property").

repayment/reorganization bankruptcies).

Where unsecured creditors are concerned, the only categorical priorities that are permitted are the ones set forth in the Bankruptcy Code. Chapter 9 of the Bankruptcy Code contains no priorities, however. The reasons for this omission are unclear but believed to be born of Tenth Amendment concerns. In other types of bankruptcy, which incorporate priorities, courts may not fashion their own using equitable principles. [54]

2. Non-Dischargeability as an Expression of Worthiness

The Bankruptcy Code also distinguishes particularly worthy promises through its rules on dischargeability. The goal of all (non-municipal) bankruptcies is to discharge all pre-bankruptcy debt, but the Bankruptcy Code excepts some debt from discharge. Examples from individual bankruptcy include student loan debt and debts for domestic obligations.[55] The dischargeability rules express the bankruptcy policy that some debts should not be avoided through the use of the bankruptcy process.

D. Rarely-Used Non-Priorities: The Unworthy

The Bankruptcy Code reserves a place for the unworthy creditor by the vehicle of equitable subordination.[56] Equitable subordination is a close relative of equitable reclassification, in which a capital contribution by an insider designed as a loan is re-cast as an equity investment. The effect of such a reclassification is to subordinate the insider to creditors.

Equitable subordination is rarely used, and when it is, it remains twinned with equitable reclassification in the sense that courts are reluctant to use the tool to subordinate outside creditors.[57]

IV. DESIGNING A MUNICIPAL INSOLVENCY STATUTE IN THE ABSENCE OF PROPERTY RIGHTS (OR THE VALUES OF MUNICIPAL BANKRUPTCY)

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[54] U.S. v. Noland, 517 U.S. 535 (1996).

[55] 11 U.S.C. § 523.

[56] 11 U.S.C. § 510.

[57] I explore the use of equitable subordination in more detail in Juliet M. Moringiello, *Mortgage Modification, Equitable Subordination, and the Honest But Unfortunate Creditor*, 79 FORDHAM L. REV. 1599 (2011), in which I advocate for its use to punish subprime mortgage lenders.

A. Defining Values

Property does not provide the foundation for municipal insolvency law. The Bankruptcy Code incorporates that idea in several places. Unlike other debtors, a municipality must be insolvent to file for bankruptcy.[58] For Bankruptcy Code purposes, individuals and entities are insolvent when their debts exceed their assets. A municipality is insolvent, on the other hand, when it is unable to pay its debts as they become due.[59] For all debtors other than municipalities, a bankruptcy estate consisting of all of the debtor's interest in property is created at the moment a bankruptcy petition is filed.[60] A Chapter 9 filing does not create such an estate.[61]

As discussed above, a foundational value of bankruptcy law is the fair and orderly distribution of an insolvent debtor's property. The lack of a property foundation is just one of the complications in designing a municipal insolvency law. An even bigger hurdle is the Tenth Amendment of the U.S. Constitution, which limits the power of the federal government over states. Although congressional power to enact a municipal bankruptcy law has been held to fall within the Bankruptcy Clause of the Constitution, bankruptcy means many different things, even for individuals and business entities. To think about an appropriate design of municipal bankruptcy law, it is first necessary to define its values.

Some of the values of municipal bankruptcy are identical to those of individual and corporate bankruptcy. Any municipal insolvency regime should provide predictability and certainty, it should establish a binding collective proceeding, it should eliminate debt overhang, and it should solve the problem of holdout creditors.

The underlying values diverge, however, in governance. The state has the first say on whether and how a municipality can file for bankruptcy.[62] In another article, I question whether bankruptcy courts should defer to state choices regarding the treatment of municipal creditors.[63] Unlike a corporation, a municipality must remain in existence in some form to provide services. Municipal insolvency has a severe impact on residents,

[58] 11 U.S.C. § 109 (c).
[59] 11 U.S.C. § 101 (32)(C).
[60] 11 U.S.C. § 541.
[61] 11 U.S.C. §§ 901, 902.
[62] 11 U.S.C. § 109 (c).
[63] *See generally* Juliet M. Moringiello, *Chapter 9 Confirmation Standards and the Role of State Choices*, 37 CAMPBELL L. REV. 71 (2015).

and the municipal bankruptcy law requires that the court consider the impact of any plan of debt adjustment on the ability of the municipality to provide services to its residents.[64]

Bankruptcy uniformity may play a role in municipal insolvency. One of the motivating forces behind the enactment of a federal municipal insolvency statute in the 1930s was the need to address the concerns of bondholders scattered throughout the country.[65] If uniformity means only uniformity within a state, then perhaps each state can determine its own priorities.

The notion of creditor worthiness informs the priority scheme in the Bankruptcy Code. The question then arises as to whether federal law should impose notions of creditor worthiness on states. The Puerto Rico legislation leaves priorities to the Commonwealth's own laws, stating that a fiscal plan must "respect the lawful priorities or lawful liens, as may be applicable, in the constitution, other laws, or other agreements of a covered territory."[66] Although many are likely troubled by the fact that Puerto Rico law appears to elevate bondholder repayment over the provision of public services, those priorities may not, at least in Chapter 9, be a matter of federal concern. On the other hand, the protection of federal laws may involve some trade-offs, and municipal insolvency law might incorporate some core values such as the desirability of continued public services.

B. Values and Priorities

Bankruptcy law has not always rejected state law priorities. Until the Chandler Act in 1938 federal bankruptcy law incorporated non-property priorities provided for by state law.[67] Fearing that honoring such priorities would leave little or nothing for a debtor's unsecured creditors, the Chandler Act shifted the state priority focus to liens. As a result, today's bankruptcy law honors state property priorities but not other state-created priorities. Yet liens play no role in municipal finance except for in revenue bond financing. Although some states have passed laws granting general

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[64] 11 U.S.C. § 943 (b)(7) (requiring that a plan of adjustment be feasible); *In re* City of Detroit, 524 B.R. 147, 219 (Bankr. E.D. Mich. 2014) (explaining that the feasibility requirement prevents a municipal debtor from promising more than it can deliver).

[65] *See* Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy,* 71 WASH. & LEE L. REV. 403, 440 (2014).

[66] PROMESA § 201 (b)(1)(N).

[67] *See* Richard M. Hynes & Steven D. Walt, *Pensions and Property Rights in Municipal Bankruptcy,* 33 REV. BANKING & FIN. L. 609, 645 (2014)(explaining that the Bankruptcy Act of 1898 before the Chandler Act amendments included a fifth priority to "persons entitled to priority by state or federal non-bankruptcy law).

obligation bondholders a lien on taxes,[68] liens, and lien analogies, may not be a useful tool in determining municipal priorities.

Priority based on property rights has been lauded for many reasons, one of which is ease of administration. Because property rights generally must be publicized in order to carry with them priority rights, it is fairly simple to determine who has the prior right to a debtor's property. Yet there are many ways to give notice of priority in addition to public filing or recording offices. Statutory priorities and protections can work just as well as a recording system in ordering priorities.

Discarding rules of property-based priority does not mean that an insolvency statute for municipalities should yield completely to state priority preferences. Leaving Tenth Amendment concerns aside for a moment, remember that when a state authorizes one of its municipal entities to file for Chapter 9, it is conceding that its own processes are not sufficient to get the struggling municipality back on its feet. It is thus consenting not only to a federal process that adds compulsion to the state's own processes, it is consenting to a state collective proceeding. Although bankruptcy law recognizes property rights created by state law as a starting point for determining creditor entitlements, that recognition yields when some federal interest otherwise requires.[69]

The Supreme Court's decision in *Butner* is probably over-cited for the proposition that bankruptcy law respects state created property rights. The proposition is both an overstatement and an understatement. It is an overstatement because bankruptcy law modifies property rights all the time. It is an understatement as well – contract rights are also respected in the first instance in order to determine claims against a debtor. The question is then "is there any federal value that should be incorporated in municipal insolvency law?" Perhaps the focus should not be on federal values. If, as some have stated, the only role of federal municipal bankruptcy law is to solve the holdout creditor problem, perhaps there are no essential federal priority values.

Although property and priority rights need not go hand-in-hand, in commercial law as applied to private entities, they do. One way to justify the Bankruptcy Code's bipolar secured/unsecured distinction is that it reflects (almost) universally accepted principles in the commercial world.

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

[69] Butner v. United States, 440 U.S. 48 (1979).

Some lenders have a claim to the debtor's property; others do not. Fifth Amendment aside, many would likely bristle at a bankruptcy regime that ignored the one mechanism that parties use to avoid the sting of bankruptcy. Bankruptcy law in the private sphere thus respects several core principles of American commercial law. A debtor can encumber all of its assets, creditors have the right to seize those assets upon default, and unsecured creditors are entitled to no priority rights.

In the municipal world, however, property rights and priority rights are uncoupled. No creditors have a right to municipal property to satisfy their claims.[70] The Bankruptcy Code includes a set of priorities that are based principles of fairness that apply to all debtors, regardless of their state of domicile. In the municipal context, it is necessary to seek universally held beliefs about worthiness. Should some basic level of services be provided before other creditors are paid? Most people would probably say yes, although Puerto Rico law says no. Many municipal bonds enjoy a federal tax exemption that expresses a view, on the federal level, that bond debt incurred to improve a municipality deserves favored treatment. Some municipal bonds, for example, pension obligation bonds, do not enjoy that favored tax treatment.

Because municipal bankruptcies are so rare, there are no universally recognized methods of bankruptcy proofing. More precisely, these methods do not exist in the sense of bankruptcy proofing property. A private party can shield its assets from general creditors by granting a security interest or by placing property in trust. Shielding municipal assets from creditors is a useless exercise.

Commercial priorities are sometimes said to be based on value added to the borrower. Purchase-money security interests fall into this category. In commercial law, added value means an increase in assets in which all creditors can, in theory, share. Added value must mean something different in municipal finance. Commercial finance law, although uniform state law, is state law. If state law elevates one type of security interest over another, the Bankruptcy Code will respect that ordering. In the municipal realm, therefore, there may not be a reason to override state ordertin.

Subordination of harmful debt is virtually unused in the commercial world. If otherwise, it might have been a tool used by bankruptcy courts in

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[70] Municipal entities often monetize assets to satisfy claims. Some thus question whether the idea of "best interests" in the municipal context should include the requirement that a municipal debtor monetize some assets.

the recent mortgage fueled financial crisis. Perhaps such a tool should be revived in the municipal insolvency context.

The terms "best interests" and "fair and equitable" are often questioned in the municipal context. "Best interests of creditors" is a term that should be stricken from the municipal insolvency lexicon. Bankruptcy courts interpret the term to mean that creditors would fare better than they would have otherwise,[71] which is meaningless and gives no guidance to creditors. Analogizing different types of unsecured bond debt to secured commercial debt is no more helpful – it is an exercise in mapping commercial concepts onto a capital structure that does not incorporate those concepts.

Because property rights do not play the same roles in municipal finance as they do in private finance, the bankruptcy rules for determining priority in payment need some rethinking. Congress enacted the first predecessor to Chapter 9 in the 1930s to respond to an emergency precipitated by the Great Depression. Since them, municipal insolvency legislation on both the state and federal levels has been reactive. The recent and ongoing crises in places like Detroit, Puerto Rico and Atlantic City have led to a combination of judge-made law and reactive legislation. In the Detroit confirmation opinion, Judge Rhodes described the treatment of pension creditors as a judgment of conscience and explained that the pension protections in the Michigan constitution deserved some deference although they did not control in bankruptcy.[72] If there is no municipal bankruptcy value that would cause state priorities to yield to federal priorities, perhaps courts should honor state pronouncements on creditor worthiness.

V. CONCLUSION

Several years of municipal bankruptcies and a bespoke statute for Puerto Rico have given policymakers the opportunity to think about what a municipal bankruptcy regime should look like. It is now time to try and identify core municipal bankruptcy values in order to design an approach to public entity insolvency that will be predictable and take the realities of municipal finance promises into account.

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[71] *In re* City of Detroit, 524 B.R. 147, 216 (Bankr. E.D. Mich. 2014).
[72] *In re* City of Detroit, 524 B.R. 147, 256-57 (Bankr. E.D. Mich. 2014).