Fordham Law Review

Volume 83 *Volume 83*
Issue 5 *Volume 83, Issue 5*

Article 19

2015

Time for an Update: A New Framework for Evaluating Chapter 9 Bankruptcies

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NOTES

TIME FOR AN UPDATE: A NEW FRAMEWORK FOR EVALUATING CHAPTER 9 BANKRUPTCIES

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Municipal bankruptcies have been making national news since the "Great Recession." Municipalities like Stockton, Vallejo, and Jefferson County gained notoriety for the record scale of their bankruptcy filings, only to be surpassed by Detroit shortly thereafter as the largest and most populous municipal bankruptcy filing. Historically, municipal bankruptcy occurred infrequently, leaving the nuances of many critical issues, including insolvency, asset utilization, and good faith, unexplored in case law. For example, how should a bankruptcy court analyze Detroit's city-owned art museum that houses billions of dollars of art when bondholders, pensioners, and other unsecured creditors have unpaid claims? And how should a court determine if the city's debt adjustment plan is fair at the confirmation phase, when recent proposals have left certain unsecured creditors receiving pennies on the dollar while others receive full value?

This Note proposes that courts differentiate between one-time event bankruptcies and structurally imbalanced bankruptcies to evaluate the creditor notice, insolvency, and good faith provisions. It suggests that utilization of nonessential assets should be considered in the insolvency and good faith analyses. Finally, this Note offers heuristics and examples to provide texture for the analysis of future filings.

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INTRODUCTION

Municipalities face increasing budgetary pressures for reasons including legacy pension and health care obligations, lagging revenue stemming from the "Great Recession," and unanticipated performance of financial instruments.[1] In the second quarter of 2014, the size of the U.S. municipal bond market was $3.66 trillion.[2] In 2013, unfunded pension and health care liabilities for the largest sixty-one municipalities alone were $217 billion.[3] Municipalities cannot manipulate the currency that denominates their debt to facilitate repayment—a key tool available to sovereigns, like the federal government, that control their own currency. Many municipalities also face state law constraints during efforts to raise taxes and assessments—revenue that is the lifeblood of a municipality.[4] Given these limitations, municipalities at some point have to make difficult choices on the services they provide, attempt to adjust their debts, or both.[5]

Municipalities take unique paths to reach dire straits, but generally, financial distress manifests itself in one of two ways—either a one-time event or a significant structural imbalance—that renders the municipality insolvent.[6] One-time events, including a large adverse civil judgment,[7] fraudulent behavior,[8] or investment pool losses,[9] can cause "acute and immediate" financial crisis[10] where a disproportionate financial stress renders insolvent an otherwise financially sound municipality. At the other end of the spectrum are municipalities that experience protracted structural imbalances from a combination of issues that may include shrinking population, loss of tax base, legacy pension costs, unfunded health care costs, and infrastructure costs.[11]

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1. *See, e.g.*, Jeffrey B. Ellman & Daniel J. Merrett, *Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?*, 27 EMORY BANKR. DEV. J. 365, 366–68 (2011).

2. SIFMA, US BOND MARKET ISSUANCE AND OUTSTANDING (2014), *available at* http://www.sifma.org/research/statistics.aspx.

3. *See infra* note 109.

4. *See infra* note 247 and accompanying text.

5. *See generally* Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1120–22 (2014) (describing reductions in police forces, decisions not to provide services to certain segments of a municipality, and sales of buildings and land). *See also In re* City of Detroit, 504 B.R. 97, 112–21 (Bankr. E.D. Mich. 2013) (describing Detroit's failing public services and choices the city made prior to petitioning for bankruptcy).

6. JOHN KNOX & MARC LEVINSON, MUNICIPAL BANKRUPTCY: AVOIDING AND USING CHAPTER 9 IN TIMES OF FISCAL STRESS 3–4 (Orrick, Herrington & Sutcliffe LLP 2009), *available at* http://www.orrick.com/Events-and-Publications/Documents/1736.pdf.

7. *See, e.g.*, *In re* Boise Cnty., 465 B.R. 156, 161, 164 (Bankr. D. Idaho 2011) (describing a $4 million judgment against a county with a $9.3 million yearly budget).

8. *See, e.g.*, *In re* Jefferson Cnty, 474 B.R. 228, 284–85 (Bankr. N.D. Ala. 2012) (describing fraudulent behavior that contributed to massive debt from the county's sewer reconstruction contracts).

9. *See In re* Cnty. of Orange, 179 B.R. 177, 179–80 (Bankr. C.D. Cal. 1995) (describing $524 million in losses from risky investments that resulted in large budget deficits).

10. *See id.*

11. *See generally In re* City of Detroit, 504 B.R. 97, 112–16 (Bankr. E.D. Mich. 2013); *In re* City of Stockton, 493 B.R. 772, 779–81 (Bankr. E.D. Cal. 2013).

Detroit is a prime example of such structural imbalances.[12] Economic decline, population loss, and other structural factors reduced Detroit's tax base.[13] The per capita tax burden on residents and businesses increased significantly while overall revenue collection declined due to population loss, deindustrialization, fiscal mismanagement, and other structural problems, leaving the city struggling to provide basic services for residents and businesses.[14] In 2013, debt service obligations accounted for 42.5 percent of Detroit's yearly revenue.[15] By 2017, debt service obligations are projected to rise to 65 percent of city revenues.[16]

Regardless of a municipality's path to financial trouble, states are constitutionally prohibited from adjusting a municipality's contracts, leaving Chapter 9 of the U.S. Bankruptcy Code as the sole mechanism a municipality can utilize for debt adjustment.[17] Specifically, Chapter 9 allows municipalities to restructure their debts under protection of the Bankruptcy Code.[18] To file for Chapter 9 protection, the debtor must be a municipality that is specifically authorized by the state to be a debtor.[19] Additionally, the municipality must demonstrate insolvency and the desire to adjust its debts.[20]

A federal bankruptcy court analyzes the petition at the eligibility phase and approves an eligible debtor's debt adjustment plan if it meets all Code confirmation criteria.[21] Many questions arise when analyzing eligibility: Is the entity actually a municipality that is specifically authorized to file? Is the debtor insolvent as defined in the Code? Does the municipality have nonessential (e.g., art, equivalent monetary instruments, mineral reserves, etc.) or potential assets (e.g., tax increases, assessments, insurance policies, etc.), and did the municipality utilize those resources? Has the municipality acted in good faith? For example, in *In re City of Detroit*,[22] the city owned several paintings each worth over $100 million as part of a 65,000 piece collection valued in the billions.[23] Should Detroit be forced to liquidate some or all of the art to pay creditors, including bondholders and pensioners? Should those nonessential and cash convertible assets be utilized in the insolvency calculation? Or should they be considered in the

12. *See generally* Memorandum in Support of Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code at 2, *Detroit*, 504 B.R 97 (July 18, 2013) (No. 13-53846) [hereinafter Detroit Memorandum].

13. *See id.*

14. *See* Anderson, *supra* note 5, at 1139. Basic services can include infrastructure (water, sewer, and roads), education, and safety services (fire, police, and emergency medical services). *Id.*

15. Detroit Memorandum, *supra* note 12, at 3.

16. *Id.*

17. *See infra* Part I.C.1. The U.S. Constitution forbids states from enacting any "law impairing the obligation of contract." U.S. CONST. art. I, § 10, cl. 1.

18. *See infra* Part I.C.

19. 11 U.S.C. § 109(c) (2012); *see infra* Part I.C.4.

20. 11 U.S.C. § 109(c).

21. *See* John P. McNicholas, *An Overview of Chapter 9 of the Bankruptcy Code*, 2 J. PAYMENT SYS. L. 606, 606–07 (2006).

22. 504 B.R. 97 (Bankr. E.D. Mich. 2013).

23. *See infra* note 292 and accompanying text.

good faith analysis? Finally, should these answers be the same if the bankruptcy is not a structurally imbalanced bankruptcy, like *Detroit*, but rather a municipality that suffered from a detrimental one-time event, such as a disproportionately large judgment against a municipal authority?[24]

Municipal bankruptcy involves many competing interests, from creditors, including secured and unsecured bondholders, retirees, contractors, and civil judgment holders, to city residents, who have basic service needs.[25] Some creditors are former employees and also citizens of the municipality—they worked for the municipality and expect their pensions and health care benefits as a form of deferred compensation.[26] A careful balancing is required to ensure that a municipality can provide its residents with basic services such as fire protection, clean water, garbage removal, police protection, and functioning schools, while still protecting creditors' rights. After all, "[c]ities cannot go out of business."[27] Bankruptcy courts have the unenviable task of balancing these competing interests to avoid the moral hazards that can possibly arise.[28]

This Note provides an updated framework for evaluating key portions of the Chapter 9 bankruptcy process. Part I identifies what a municipality is, the services a municipality provides to its residents, and how a municipality is financed. Part I also evaluates the reasons that municipalities become financially troubled and then pivots to outlining the fundamental framework of Chapter 9, the federal Municipal Bankruptcy Code.

Part II outlines the conflicting judicial interpretations of Chapter 9 bankruptcy factors, describing the differences between a one-time event bankruptcy and a structurally imbalanced bankruptcy. Next, it explains the factors that are particularly relevant in Chapter 9 filings, and how they relate to each other when determining whether creditors had notice, whether the municipality was actually insolvent, how the municipality utilized any nonessential or potential assets, and whether the municipality acted in good faith throughout the bankruptcy process. Part II then analyzes the different, and sometimes conflicting, approaches bankruptcy courts have applied when deciding whether a municipality has demonstrated each factor.

Part III proposes a new multipart test for analyzing whether a municipality meets the statutory conditions required for Chapter 9 municipal bankruptcy. The test tailors four factors to apply to the two main

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24. *See, e.g.*, *In re* McCurtain Mun. Auth., No. 07-80363, 2007 WL 4287604, at *6 (Bankr. E.D. Okla. Dec. 4, 2007) (describing the low-income community's financial capacity and holding that the failure to generate revenue from additional tax assessments on residents was not evidence of bad faith).

25. *See infra* Part I.B.

26. *See* Anderson, *supra* note 5, at 1123–24.

27. *In re* City of Bridgeport, 129 B.R. 332, 336 (Bankr. D. Conn. 1991) (stating that the purpose of Chapter 9 is to enable a financially distressed city to continue to provide essential services while it works out a plan to adjust its debts). *Id.*

28. As used here, "moral hazard" may be defined as "the tendency of debtors to prefer to devote their resources to their own interests instead of repaying their debts." Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 426 (1993).

types of municipal bankruptcy—one-time event bankruptcies and significant long-term structural imbalance bankruptcies. The factors weigh (1) whether creditors had notice of specific authorization; (2) whether the petition is prospective or current; (3) the pre-petition utilization of available assets; and (4) good faith at the petition and confirmation phases.

I. A "MUNICIPALITY": WHAT IT IS, WHAT IT PROVIDES, HOW IT IS FINANCED, AND HOW IT LANDS IN FISCAL TROUBLE

Part I provides an overview of a municipality, including what a municipality is, what it does, and the constraints it faces in operating. Part I.A examines the statutory definition of "municipality" in Chapter 9 of the Bankruptcy Code and reviews how bankruptcy courts implement the definition when evaluating whether an entity is in fact a municipality as defined in the Code. Part I.B. details the services that a municipality provides to its residents and outlines the methods—both traditional and recent—that municipalities use to finance their operations, and it examines the types of assets that a municipality may possess. Part I.B also analyzes the budgetary constraints and financial stressors that municipalities often face. Finally, Part I.C provides an overview of Chapter 9 of the Bankruptcy Code.

A. What Is a "Municipality"?

The dictionary defines "municipality" as "a primarily urban political unit having corporate status and usually powers of self-government,"[29] and common usage evinces thoughts of a city, county, or town. But the term municipality has a much wider definition in the Chapter 9 context.[30] The Bankruptcy Code defines "municipality" as a "political subdivision or public agency or instrumentality of a State."[31] This section analyzes how different entities are treated under the Bankruptcy Code's municipal provisions.

1. Clear Examples of a Municipality: Counties and Cities

Cities are generally considered municipalities under Chapter 9, and creditors typically do not challenge a city's status as a municipality. For example, in *Detroit*, the parties stipulated that Detroit was a municipality, which the court accepted.[32] Similarly, in *In re City of Stockton*,[33] the

29. MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 817 (11th ed. 2003).

30. *See* 11 U.S.C. § 101(40) (2012); 6 COLLIER ON BANKRUPTCY ¶ 900.02 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2014) (stating that the definition of municipality was intended to "broaden the applicability" of Chapter 9); *see also In re* Barnwell Cnty. Hosp., 471 B.R. 849, 858–59 (Bankr. D.S.C. 2012) ("[T]he Court construes broadly § 109(c)'s eligibility requirements.").

31. 11 U.S.C. § 101(40) (2012).

32. *See In re* City of Detroit, 504 B.R. 97, 129 (Bankr. E.D. Mich. 2013).

33. 493 B.R. 772 (Bankr. E.D. Cal. 2013).

objectors to Stockton's Chapter 9 eligibility conceded that Stockton was a "municipality" under Chapter 9.[34]

Counties also are generally considered municipalities, and state charter definitions of "county" fit squarely within Chapter 9's definition of "municipality."[35] For instance, in Idaho, the state charter defines "county" as a "body politic of the state," making Boise County a political subdivision of the state and thus a municipality.[36] Likewise, in *In re County of Orange*,[37] the court stated "[c]learly, the County is a municipality under the Code,"[38] noting that because Orange County was created by the State of California and had express sovereign powers, including taxation and the ability to sue and be sued, it was "by definition a municipality."[39] In *In re Jefferson County*,[40] it was apparently so clear that Jefferson County was a municipality for purposes of Chapter 9 that the court assumed that the county was a municipality without formally addressing the question.[41]

2. Special Purpose Entities: Is It a "Municipality"?

Under Chapter 9, municipalities may also include housing authorities, school districts, and toll roads.[42] For example, a bankruptcy court held that a hospital qualified as a municipality and was an "instrumentality of the state" because the city council essentially controlled the hospital's budget and board of directors.[43] In another case, a bankruptcy court held that a transit district—created under state-enabling statutes and "bearing many strong aspects of local authority and equally strong aspects of state authority"—was a hybrid organization that qualified as a municipality as defined by Chapter 9.[44]

Public control is also relevant when distinguishing between private and public agencies, as can be the case with service-providing authorities.[45] In *Ex parte York County Natural Gas Authority*,[46] the court held that the power granted by the state authorizing legislation—empowering the municipality to "purchase, lease . . . maintain and operate natural gas distribution systems" and conferring a full set of management powers and duties, as well as the power to issue revenue bonds—was sufficient to qualify the entity as a public agency under Chapter 9's municipality

34. *See id.* at 783.
35. *See In re* Boise Cnty., 465 B.R. 156, 167 (Bankr. D. Idaho 2011).
36. *Id.*
37. *In re* Cnty. of Orange, 183 B.R. 594 (Bankr. C.D. Cal. 1995).
38. *Id.* at 600.
39. *Id.* at 600 n.11.
40. 474 B.R. 228 (Bankr. N.D. Ala. 2012).
41. *Id.*
42. *See* 6 COLLIER ON BANKRUPTCY, *supra* note 30, ¶ 900.02.
43. *See In re* Barnwell Cnty. Hosp., 471 B.R. 849, 859–60 (Bankr. D.S.C. 2012).
44. *In re* Westport Transit Dist., 165 B.R. 93, 95–96 (Bankr. D. Conn. 1994) (internal quotation marks omitted). Nevertheless, the bankruptcy court concluded that the state statutes did not authorize the municipality for Chapter 9 relief. *See id.* at 96–98.
45. *See In re* Las Vegas Monorail Co., 429 B.R. 770, 784 (Bankr. D. Nev. 2010).
46. 238 F. Supp. 964 (W.D.S.C. 1965), *modified on other grounds by* Mozingo v. York Cnty. Natural Gas Auth., 352 F.2d 78 (4th Cir. 1965).

definition.[47] The court stated that "'[t]he legal test between a private or public authority or agency is whether the authority or agency is subject to control by public authority, state or municipal.'"[48]

Courts have clarified that whether an entity is a municipality depends not only on the "level of State control over the entity's organization and operations, but also the intent of the State that created it."[49] A complete absence of public control likely indicates that the entity is not a Chapter 9 municipality.[50] For example, in *In re Ellicott School Building Authority*,[51] the court held that a school building authority created under a nonprofit corporation act, which had no taxing or assessment authority and issued revenue bonds that disclosed no public control and were serviced solely with proceeds from school district rent, was not a municipality.[52] The court noted that "no governmental entity exercises any right of control" over the building agency, and thus it was not a Chapter 9 municipality.[53]

While lack of public control is strong evidence of against municipality status, the existence of public control does not automatically indicate a municipality.[54] If the control is more akin to regulatory control, as, for example, often exhibited in the gambling, energy, and taxi industries, then the entity is not a municipality.[55]

Finally, courts consider the state's statutory classification of an entity.[56] If a state designates and treats an entity as an instrumentality of the state, the court is likely to find the state's designation heavily persuasive due to the underlying state control issues.[57] In *In re Sullivan County Regional Refuse Disposal District*,[58] the court gave significant deference to how the refuse disposal district was classified under state law.[59] Similarly, in *Orange County*, when the Orange County Investment Pool (OCIP) petitioned for Chapter 9 along with the county itself, the court held that OCIP was not a municipality.[60] First, the court questioned whether OCIP was a "political subdivision," and it found that the investment pool had "neither sovereign power delegated to it by the State of California, nor [did] it have by its existence some inherent sovereign power to act."[61] Second, it held that OCIP was not a public agency, finding that the pool "was not

47. *Las Vegas Monorail Co.*, 429 B.R. at 784 (quoting *York Cnty. Natural Gas Auth.*, 238 F. Supp. at 966).

48. *York Cnty. Natural Gas Auth.*, 238 F. Supp. at 976.

49. *Las Vegas Monorail Co*., 429 B.R. at 784.

50. *See id*.

51. 150 B.R. 261 (Bankr. D. Colo. 1992).

52. *See Las Vegas Monorail Co*., 429 B.R. at 785–86.

53. *Id.* at 786.

54. *Id.* at 785.

55. *Id.*

56. *See* 6 COLLIER ON BANKRUPTCY, *supra* note 30, ¶ 900.02.

57. *See In re* Sullivan Cnty. Reg'l Refuse Disposal Dist., 165 B.R. 60, 73 (Bankr. D.N.H. 1994).

58. *Id.*

59. *See id.* at 73.

60. *In re* Cnty. of Orange, 183 B.R. 594, 602–03 (Bankr. C.D. Cal. 1995).

61. *Id.* at 602.

organized for the purpose of maintaining or operating a revenue producing enterprise" and did not issue bonds of any type.[62] Third, the court held that OCIP was not an instrumentality of the state, because OCIP did not share the "characteristics and objectives" of the entities described in the previous versions of the Code.[63]

In summary, Congress intended, and courts apply, a relatively broad definition of municipality. The Chapter 9 definition of municipality encompasses political subdivisions including counties, cities, and towns, and it also includes entities such as toll roads, hospitals, and housing authorities if the entity satisfies a three-part analysis: (1) whether the entity has "powers typically associated with sovereignty," (2) "whether the entity has a public purpose and the level of [state] control" over its activities, and (3) the state's designation of the entity.[64]

B. Factors Giving Rise to Insolvency

A municipality may provide a broad range of services based on the statutory authorization in the state. Part I.B.1 outlines the type of services that a municipality provides and how the municipality finances the services it provides. Then, Part I.B.2 identifies typical reasons that a municipality enters into fiscal duress.

1. What Municipalities Provide and How They Finance It

Municipalities may provide very broad or relatively narrow services depending on the power granted by the state.[65] A typical city or county provides basic services to its residents and businesses—from safety services like fire, police, and emergency medical services to infrastructure, which may include water, sewer, roads, and transportation systems.[66] Other municipalities may provide a single narrow service—either public housing, or transportation systems, or health care.[67]

Municipalities have the right to acquire property, including real property and personal property, for their use and benefit.[68] The power to hold, sell, and convey property is often expressed in statutory or charter provisions, although the power to purchase and possess land and chattel is a common

62. *Id.*

63. *Id.* at 603. The court noted that the definition of "municipality" in 11 U.S.C. § 101(40) did not explain the limits of the broad statutory language, whereas earlier code versions provided a list of entities. *Id.* at 601–02. The court chose not to erode prior bankruptcy law, absent a clear contrary directive from Congress. *Id.* at 602.

64. *See supra* notes 32–63; 6 COLLIER ON BANKRUPTCY, *supra* note 30, ¶ 900.02 (citing *In re* Las Vegas Monorail Co., 429 B.R. 770, 789 (Bankr. D. Nev. 2010)).

65. *See, e.g.*, Detroit Memorandum, *supra* note 12, at 9–10. Detroit has "comprehensive home rule power under the State Constitution of 1963 . . . the Home Rule City Act and the 2012 [City] Charter . . . subject to the limitations on the exercise of that power contained in the Constitution, the Charter or applicable Michigan statute." *Id.* at 9.

66. *See* Anderson, *supra* note 5, at 1139.

67. *See supra* Part I.A.2.

68. *See* 10 MCQUILLIN MUN. CORP. § 28:2 (3d ed. 2014).

law power held by municipalities.[69] Municipalities may own "essential assets," i.e., those directly related to providing services, such as government buildings, vehicles, supplies, and infrastructure systems.[70] Municipalities may also own nonessential assets, which this Note defines as assets that the municipality owns but are not critical to providing public services. Nonessential assets may include art, equivalent monetary instruments, mineral reserves, and seized, abandoned, or unused property.[71] For example, a municipality may have art in a museum, a warehouse, or in city buildings.[72] It could have equivalent monetary reserves—such as coin or gold reserves—that have been in a municipal vault for years, which are convertible to cash. Or a municipality may have extractible mineral reserves—such as oil, diamonds, or precious metals—on or beneath public lands.[73] Finally, a municipality may own property that it has seized due to tax defaults, or that it has abandoned as no longer functional.[74]

Municipalities, whether they provide comprehensive or limited services, have to generate sufficient funding to pay for the public services they provide.[75] Municipalities have myriad methods to generate revenue depending on their authorizing statutes, but generally the methods fall into several broad categories, including taxes,[76] municipal bonds,[77] trade credit,[78] and deferred debt.[79]

Municipalities use taxes as a mechanism to raise revenue for operations. The state, possessing the power to tax, may confer or delegate taxing power

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69. *See id.*

70. *See* David S. Kupetz, *Standards for Confirming a Chapter 9 Plan of Debt Adjustment: Incorporating and Diverging from Chapter 11 Plan Standards*, 32 CAL. BANKR. J. 289, 290–91 (2012) (stating that services and programs involving "public safety, health, and welfare are likely to be viewed as essential"). Kupetz suggests that a program or service is likely to be deemed essential when the program or service: (1) is legally mandated; (2) contributes to the protection of health and safety or mitigates risk; (3) contributes to preservation of essential assets; or (4) is necessary to maintain quality of life and the "negative impact of eliminating or reducing such programs and services can be demonstrated and is significant." *Id.*

71. *See generally In re* City of Detroit, 504 B.R. 97 (Bankr. E.D. Mich. 2013); City of Shreveport v. Kahn, 194 La. 55, 76 (1939). *See also* McConnell & Picker, *supra* note 28, at 432, 462–63 (discussing pre-Bankruptcy Code historical division of municipal property into proprietary versus non-proprietary, where proprietary property was "held in [the municipality's] own right for profit or a source of revenue, not charged with any public trust or use."). Examples of proprietary property included unused vacant lots or property seized by the municipality.

72. *See generally Detroit*, 504 B.R. 97.

73. *See* 47 A.L.R.3d 19 (1973); *see, e.g.*, *Kahn*, 194 La. at 76 (1939). Municipalities may also lease oil and mineral rights pursuant to the rights and restrictions in their charter and legal restrictions.

74. *See* McConnell & Picker, *supra* note 28, at 432 n.29–30.

75. *See* 64A C.J.S. *Municipal Corporations* § 2019 (2014).

76. *See id.*

77. *See, e.g.*, NAT'L ASS'N OF BOND LAWYERS, GENERAL OBLIGATION BONDS: STATE LAW, BANKRUPTCY, AND DISCLOSURE CONSIDERATIONS 2 (2014), *available at* http://www.nabl.org/uploads/cms/documents/GENERAL_OBLIGATION_MUNICIPAL_BONDS.pdf.

78. *See generally* 64A C.J.S. *Municipal Corporations* § 2016.

79. *See infra* notes 107–10 and accompanying text.

to a municipality.[80] Taxing power is generally granted to a municipality and is essential to its existence.[81] Municipalities may levy various types of taxes depending on their statutory grant from the state, but general municipal taxes include income, transaction, and occupancy tax.[82] Other taxes may include franchise, property, convention, and tourism taxes.[83]

Although taxes are a primary way that municipalities generate funds, they also issue bonds to finance investments and expenditures.[84] In the context of municipal finance, two types of bonds—general obligation bonds and special revenue bonds—are most prevalent.[85] General obligation bonds are sold to raise capital, where the principal and interest payments are backed by the "irrevocabl[e] pledge[]" of the "full faith, credit, and resources" of the city.[86] The city is obligated in "good faith [to] use its resources as may be authorized or required by law" to ensure prompt payment.[87]

General obligation bonds can be constructed as unlimited tax general obligation bonds (UTGOs), limited tax general obligation bonds (LTGOs), and general obligation bonds payable from the issuer's general fund (GFGOs).[88] GFGOs have no specific pledge of taxing power, LTGOs are secured by a limited property tax, and UTGOs are secured by unlimited property taxes.[89] However, voter approval is generally required to issue unlimited tax obligations and sometimes is required for limited tax obligations.[90]

While general obligations are enforceable under state law, the commitment is "made against the backdrop of federal bankruptcy law,"[91] and if bankruptcy is successfully invoked, federal bankruptcy law preempts state law.[92] Additionally, although secured by the "full faith and credit" of the issuing municipality, general obligation bonds are unsecured for the purposes of Chapter 9.[93] If the issuing municipality files a Chapter 9 petition, the abilities of creditors to enforce their rights is prevented by the

80. *See* 64A C.J.S. *Municipal Corporations* § 2219.
81. *See id.*
82. *See id.* § 2260.
83. *See id.* For example, Detroit levies multiple taxes including a 2.0 percent business income tax, a 2.4 percent resident income tax, a 68.95 millage property tax, a 5 percent utility user's tax, and a 10.9 percent casino user's tax. *See infra* notes 245–49 and accompanying text.
84. *See generally* NAT'L ASS'N OF BOND LAWYERS, *supra* note 77.
85. *See* SEC, MUNICIPAL BONDS: UNDERSTANDING CREDIT RISK 1–2 (2012), *available at* http://www.sec.gov/investor/alerts/municipalbondsbulletin.pdf.
86. NAT'L ASS'N OF BOND LAWYERS, *supra* note 77, at 2.
87. *Id.* (emphasis removed).
88. *Id.* at 3.
89. *Id.* at 4.
90. *Id.*
91. Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1047 (1997). Thus, the city's pledge can be modified or discharged using a successful Chapter 9 petition.
92. *See infra* note 161 and accompanying text.
93. Kordana, *supra* note 91, at 1048.

automatic stay provisions,[94] and their ability to receive future payments is contingent on the debtor's confirmation plan.[95]

Revenue bonds are the second main source of municipal borrowing. Revenue bonds are backed by a revenue stream derived from a specific project, source, or operation.[96] The Bankruptcy Code provides that special revenues can be derived from (A) project or system ownership or operation; (B) special excise taxes on specific transactions; (C) incremental tax receipts from the area benefited from the financing; (D) other revenues from particular debtor functions; or (E) specific taxes levied for project finance.[97] Special revenues are exempt from the § 922(d) automatic stay provisions, requiring the municipality to continue providing the revenue stream to the creditor.[98]

Municipalities also contract with suppliers, contractors, and individuals to provide the materials and services that they need for operations.[99] Trade creditor agreements allow the municipality to receive goods and services and then pay for those goods and services in a specified amount of time.[100] A trade creditor can be a paper supplier, building contractor, or asphalt provider. Municipalities have a great deal of flexibility when dealing with trade creditors in bankruptcy.[101] For example, a municipality is free to determine whether it will pay pre-petition claims without bankruptcy court approval.[102] In *Jefferson County*, the commissioners decided to pay undisputed trade debts as they became due.[103] While trade creditors may fare reasonably well in city and county bankruptcy, they do not fare as well when the municipality is a special purpose municipality.[104] Trade creditors as a group are often numerous and may have widely varying debts, and

94. 11 U.S.C. §§ 362, 922(a) (2012). The automatic stay provisions prevent a creditor from the commencement or continuance of any proceeding seeking to enforce a claim against the debtor, essentially putting a creditor's efforts on hold. *See* 11 U.S.C. § 922(a)(1). However, special revenues are exempt from the automatic stay. *Id.* § 922(d).

95. *See* Kordana, *supra* note 91, at 1048.

96. *See* SEC, *supra* note 85, at 2.

97. 11 U.S.C. § 902(2).

98. *Id.* § 922(d). Chapter 9's only limitation on the special revenue stream is that the revenues are subject to the "necessary operating expenses" of the project or system. *See id.* § 928(b).

99. *See* David S. Kupetz, *Understanding the Unique Factors of Chapter 9 Municipal Bankruptcies*, *in* REPRESENTING CREDITORS IN CHAPTER 9 MUNICIPAL BANKRUPTCY: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS, COUNSELING MUNICIPALITIES, AND ANALYZING RECENT TRENDS AND CASES (2014) [hereinafter REPRESENTING CREDITORS], *available at* 2014 WL 4785315, at *4.

100. *See id.*

101. Jay Bender, *New Developments, New Issues for Creditors and Debtors in Chapter 9 Bankruptcy Cases*, *in* REPRESENTING CREDITORS, *supra* note 99, *available at* 2014 WL 4785314, at *6 (municipalities may choose to pay pre-petition trade claims without court approval).

102. *See id.*

103. *See id.*

104. *See id.* When the debtor is a special purpose municipality, it is often more critical to conserve cash to fund the continued operation of that special purpose during bankruptcy. *Id.* Cities and counties, on the other hand, need to continue operating a series of services that may not be provided by the creditor if payments are withheld. *Id.*

therefore, negotiations may be difficult without a representative creditor.[105] Regardless, Chapter 9's automatic stay still enjoins trade creditors from enforcing their contractual rights after a municipality petitions for bankruptcy, and can land them in a class of unsecured creditors in a Chapter 9 proceeding.[106]

Municipality employees with defined pensions and health care benefits are creditors of a municipality.[107] Like trade creditors, pensioners generally have numerous claimants without a specific representative to collectively represent the group.[108] Recently, a Pew Charitable Trust study of sixty-one large cities in the United States found that those cities have $217 billion in unfunded pension and health care liabilities.[109] The gap, however, was unevenly distributed, with only 40 percent of the cities maintaining funding of at least 80 percent, and four of the cities exhibiting funding levels at or below 50 percent.[110]

2. The Current Landscape: Municipal Stressors

Municipal financial stressors at a micro-level are unique to each municipality—a natural result arising from myriad factors including state and local fiscal policy, geography, educational systems, population flow, and infrastructural demands.[111] However, at a macro-level the stressors can be grouped into general issues facing each municipality. Generally, a municipality is rendered insolvent either by a disproportionate one-time financial event or a significant structural financial imbalance that occurs over a period of time.[112]

a. One-Time Financial Event Stressors

One-time events can cause an "acute and immediate" financial crisis, where the disproportionate financial stress renders insolvent an otherwise seemingly solvent municipality.[113] A one-time event can manifest itself in multiple forms based on the specific circumstances of a municipality. For instance, a large adverse civil judgment may be so substantial in relation to

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105. *See id.*

106. *See id.* at *9.

107. *See* Kupetz, *supra* note 99, at *2.

108. *See* Bender, *supra* note 101, at *11. While pensioners are generally represented by unions during their employment, when they retire, they no longer are represented by the union. Unions can intercede on behalf of the pensioners, but they need to be granted authority by the pensioners to negotiate a deal. *See id.* at *6.

109. *See* PEW CHARITABLE TRUSTS, A WIDENING GAP IN CITIES: SHORTFALLS IN FUNDING FOR PENSIONS AND RETIREE HEALTH CARE 2 (2013), *available at* http://www.pewtrusts.org /~/media/legacy/uploadedfiles/pcs_assets/2013/Pewcitypensionsreportpdf.pdf (basing the results off data from the largest city in each state and every city with a population over 500,000).

110. *See id.* at 7, 13.

111. *See supra* notes 7–11 and accompanying text.

112. *See supra* note 6 and accompanying text.

113. *See In re* Cnty. of Orange, 179 B.R. 177, 179 (Bankr. C.D. Cal. 1995).

a municipality's budget that it cannot make currently due payments.[114] Other one-time circumstances include fraudulent behavior, where once discovered causes an immediate financial stress that prevents a municipality from paying its bills,[115] and investment pool losses, where a municipality makes unfortunate investment decisions that lead to disproportionately large losses in relation to the municipality's budget.[116]

For example, Orange County entered dire fiscal straits in 1991 due to investment pool losses triggered by investments that were "risky, volatile, and lacked liquidity."[117] The strategy involved short-term borrowing to purchase long-term securities, constructed around a bet that interest rates would remain low.[118] When short-term rates rose, the value of the investment portfolio dropped while, simultaneously, the creditors called the short-term debt, causing losses from the early liquidation of the collateral.[119] The treasurer was essentially gambling that interest rates would not rise, and when that bet failed, the investment portfolio collapsed.[120]

Financial fraud on the part of public employees, their agents, or both, can rapidly deteriorate a municipality's finances and lead to a one-time event bankruptcy.[121] The most egregious recent example of this was Jefferson County, Alabama, where a special revenue warrant structure was used to finance an updated sewer system, but many of the agreements were obtained as a result of bribery and fraud committed by county employees.[122]

While the above examples are hardly comprehensive, the basic concept encompasses any specific circumstance that causes a financial shock that directly impacts solvency, as compared to a structurally imbalanced insolvency, which manifests itself over a significant period of time due to multiple factors.

b. Structurally Imbalanced Municipality Liabilities

At the other end of the spectrum, municipalities experience protracted structural imbalances from a combination of issues. This section describes legacy pension and health care costs, analyzes deindustrialization and the corresponding effects on a municipality, outlines reduced tax revenue, and reviews poor fiscal mismanagement.[123]

114. *See, e.g.*, *In re* Boise Cnty., 465 B.R. 156, 163 (Bankr. D. Idaho 2011).
115. *See In re* Jefferson Cnty., 474 B.R. 228, 284–85 (Bankr. N.D. Ala. 2012).
116. *See Cnty. of Orange*, 179 B.R. at 179–80.
117. *In re* Cnty. of Orange, 183 B.R. 594, 597 (Bankr. C.D. Cal. 1995).
118. *See id.* at 597–98. The investment was set up as a "reverse repo," where the county "borrowed" by selling a security with an agreement to purchase the security in a short period of time, essentially "leveraging" their portfolio. *Id.* at 598 n.4.
119. *See id.* at 598.
120. *See id.*
121. *See generally In re* Jefferson Cnty., 474 B.R. 228, 239 (Bankr. N.D. Ala. 2012).
122. *See id.* at 239–40.
123. *See generally In re* City of Detroit, 504 B.R. 97 (Bankr. E.D. Mich. 2013).

i. Public Pensions and Health Care

Public pensions remain a major and growing stressor to municipal budgets, as the promise of deferred benefits became politically popular[124] and life expectancy concurrently increased.[125] Public unions became popular in the late 1950s and early 1960s, when municipal governments increasingly authorized unionization.[126] Between 1960 and 2010, life expectancy leaped from 69.7 years to 78.7 years.[127] Unlike their private sector counterparts that are regulated by the Employee Retirement Income Security Act of 1974[128] (ERISA), public pensions are not regulated by federal law nor are they protected by the Pension Benefit Guaranty Corporation (PBGC).[129] Although subject to state level controls, municipalities operate with significant freedom to authorize and implement funding methods and policies.[130] In previous years, negotiations with unions often resulted in generous deferred benefit packages that combined politically palpable promises involving less short term budgetary impact with a "less-than-rigid" fiscal approach to paying those deferred benefits.[131] For example, in Stockton, California, the police pension plan allows officers to retire at age 50 with pensions amounting to up to 90 percent of their salary, including yearly cost of living adjustments.[132]

ii. Deindustrialization

Deindustrialization is common to many cities and counties that experience fiscal difficulties and is often an underlying cause of bankruptcy.[133] Cities that were constructed around a predominant industrial employer that has since left or significantly changed experience a vacuum of jobs and tax revenue.[134] Older cities on the West Coast, previously supported by military bases, experienced the loss of a main employer when that base was decommissioned.[135] Several of the recent California Chapter 9 petitions were made by cities with origins as commercial ports and military bases.[136] San Bernardino was home to Norton Air Force Base, a

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124. *See, e.g.*, Philip Greenspun, *History of Public Employee Unions*, PHILIP GREENSPUN'S WEBLOG (Sept. 7, 2009), http://blogs.law.harvard.edu/philg/2009/09/07/history-of-public-employee-unions/.

125. *See, e.g.*, *Life Expectancy at Birth by Race and Sex, 1930–2010*, INFOPLEASE, http://www.infoplease.com/ipa/A0005148.html (last visited Mar. 25, 2015).

126. *See* Greenspun, *supra* note 124.

127. *See Life Expectancy at Birth by Race and Sex, 1930–2010*, *supra* note 125.

128. Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001–1461 (2012) and scattered section of 26 U.S.C.).

129. *See* Ellman & Merritt, *supra* note 1, at 368.

130. *See id.*

131. *Id.*

132. Mary Williams Walsh, *Judge Approves Bankruptcy Exit for Stockton, Calif.*, N.Y. TIMES (Oct. 30. 2014, 8:46 PM), http://dealbook.nytimes.com/2014/10/30/judge-approves-bankruptcy-exit-for-stockton-calif/?_r=0.

133. *See* Anderson, *supra* note 5, at 1128–34.

134. *See id.*

135. *See id.* at 1134–35.

136. *See id.* at 1134.

major logistics and freight transport facility, for fifty-three years.[137] Stockton, a commercial port, also housed a Naval Reserve Center for the duration of the Cold War, until decommissioning in 1996.[138] And Vallejo developed around Mare Island Naval base—an employer of 50,000 workers in World War II—that eventually was also decommissioned in 1996.[139] In the Midwest, municipalities recorded significant population decreases as industrial output declined and people shifted to the suburbs, different parts of the country, and overseas.[140] Deindustrialization can lead directly and indirectly to reduced tax revenue.[141]

iii. Reduced Tax Revenue

A city's tax revenue is a variable revenue stream that can change due to macro-level effects, such as a financial recession, or local effects including deindustrialization, population loss, and the resultant reduced property values.[142] After the "Great Recession" in 2008–2009, the remnants of the financial crisis caused the 112 largest U.S. cities to experience per capita revenue reductions of 5 percent between 2007 and 2011.[143] Concurrently, average real per capita expenditures were 2.6 percent higher in 2011 than 2007.[144]

City by city, the effect can be more dramatic—for example, Detroit's income tax revenues declined 30 percent between 2002 and 2013, while property tax revenues declined 10 percent between 2012 and 2013 alone.[145]

iv. Fiscal (Mis)management

Fiscal mismanagement can also precipitate financial problems, either in conjunction with other financial stressors or on its own.[146] Fiscal mismanagement can be related to collective bargaining agreements discussed above, or it can be related to other bad contracts, financial investments, or infrastructure costs.[147] For instance, some municipalities utilize interest-rate swap agreements to hedge against higher interest

137. *See id.* at 1134–35.

138. *See id.*

139. *See id.*

140. *See generally* Michael J. Minkus, *Fighting Uncertainty: Municipal Partnerships with Redevelopment Agencies Can Mitigate Uncertainty to Encourage Brownfield Redevelopment*, 1 GOLDEN GATE U. ENVTL. L.J. 267, 272 (2007).

141. *See id.* at 299 n.221 (deindustrialization may "leav[e] communities with withering infrastructures and bereft of tax revenue" (internal quotation marks omitted)).

142. *See generally* Detroit Memorandum, *supra* note 12.

143. *Newly Released Data Show Long-Lasting Impact of the Great Recession on Cities*, PR NEWSWIRE, http://www.prnewswire.com/news-releases/newly-released-data-show-long-lasting-impact-of-the-great-recession-on-cities-259268141.html (last visited Mar. 25, 2015).

144. *Id.*

145. *In re* City of Detroit, 504 B.R. 97, 119 (Bankr. E.D. Mich. 2013).

146. *See, e.g.*, *In re* Jefferson Cnty., 474 B.R. 228, 235–45 (Bankr. N.D. Ala. 2012).

147. *See, e.g.*, *In re* Cnty. of Orange, 183 B.R. 594 (Bankr. C.D. Cal. 1995).

rates.[148] Swaps are effective hedges against high interest rates, but some critics worry that elected officials do not have a full understanding of swap products and their ramifications when compared to their investment banker counterparties.[149] The swap agreement is generally arranged so the municipality exchanges its floating interest rate for a fixed interest rate.[150] Municipalities enter the agreements because floating rates are lower than fixed rate debt.[151] When rates fall and stay low—as has been the case in the United States since 2008—the swaps can cost municipalities significant money.[152] The counterpoint is that municipalities benefitted when rates turned in their favor, and with an effective hedging technique, the swaps can be advantageous to municipal borrowers.[153]

Fraudulent behavior or risky financial investments, as discussed in the one-time event bankruptcies of Orange County and Jefferson County,[154] can be part of the equation in structurally imbalanced bankruptcies as well. When fraudulent behavior or risky investments are present in a structurally imbalanced bankruptcy, they simply compound an already bleak financial condition. Regardless of how a municipality's financial trouble arises, the U.S. Bankruptcy Code provides a mechanism to adjust its debts.

C. The Bankruptcy Code: An Overview

The U.S. Bankruptcy Code is separated into chapters which outline general provisions (Chapter 1), relate to case administration (Chapter 3), provide provisions dealing with the creditors, debtor, and estate (Chapter 5), as well as adjustment of a municipality's debts (Chapter 9) and business reorganization (Chapter 11).[155] Chapter 9 excludes all provisions of the Code except Chapter 1 and Chapter 9, although § 901 does invoke particular Code sections in Chapters 3, 5, and 11.[156]

Chapter 9 is the focus of Parts II and III.

1. Historical Underpinnings and Constitutional Limits

Municipal bankruptcy legislation in the United States is a relatively new phenomenon, originating in the 1930s in response to rapidly deteriorating

148. Interest-rate swaps trade a stream of interest payments for payments based on a fixed principal. Generally, a floating interest rate is traded for a fixed interest rate to hedge risk. *See* BLACK'S LAW DICTIONARY 937 (10th ed. 2014).

149. Aaron Lucchetti, *Interest-Rate Deals Sting Cities, States*, WALL ST. J. (Mar. 22, 2010), http://online.wsj.com/articles/SB10001424052748703775504575135930211329798.

150. *See id.*

151. *See id.*

152. *See id.* For example, if a municipality swapped a variable interest rate of 6 percent for a fixed interest rate of 8 percent, and the variable interest rate then goes down to 3.5 percent, the municipality is "losing" 4.5 percent on each payment relative to what it would have paid without the swap.

153. *See id.*

154. *See supra* Part I.B.2.a.

155. 1 WILLIAM L. NORTON, JR. & WILLIAM L. NORTON III, NORTON BANKR. L. & PRAC. § 11:1 (3d. 2014).

156. *See* 11 U.S.C. §§ 103(e), 901 (2012).

municipal finances during the Great Depression.[157] Prior to federal municipal bankruptcy law, a creditor's remedy was generally limited to a mandamus order to raise taxes, which often had deleterious effects because of the massive financial strain, resulting in defaulted assessments as tax sales drove down property values and exacerbated tax delinquency.[158] States, when they ratified the Constitution, granted bankruptcy regulatory powers to the federal government, specifically providing Congress with the power "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."[159] The U.S. Constitution's Supremacy Clause provides that federal law "shall be the supreme Law of the Land" and specifies that states shall be bound by federal law.[160] Essentially, if the federal government's exercise of power is proper, federal law will preempt any and all conflicting or inconsistent state law.[161]

Since the Municipal Bankruptcy Code's inception, it has walked the tenuous line between the federal powers and state sovereignty provided by the Constitution.[162] In 1936, the U.S. Supreme Court, in *Ashton v. Cameron County Water Improvement District*,[163] held that the 1934 municipal bankruptcy legislation unconstitutionally interfered with state sovereignty.[164] The Court expressed concern that if a federal bankruptcy court could engage in readjustment of debt obligations of a state, or one of its "political subdivisions," that state would be "no longer free to manage their own affairs," and the material restriction of a state's control over their fiscal affairs was thus declared unconstitutional.[165]

In response to *Ashton*, Congress enacted, and the Supreme Court upheld in *United States v. Bekins*,[166] a revised Municipal Bankruptcy Act.[167] In *Bekins*, the Court noted Congress was "especially solicitous" to ensure that the revised Act would "afford no ground for [constitutional] objection."[168] During the legislative process, the House Judiciary Committee Report

157. *See* Hannah Heck, *Solving Insolvent Public Pensions: The Limitations of the Current Bankruptcy Option*, 28 EMORY BANKR. DEV. J. 89, 98 (2011).

158. *See* United States v. Bekins, 304 U.S. 27, 45 (1938).

159. U.S. CONST. art. I, § 8, cl. 4.

160. U.S. CONST. art. VI, cl. 2.

161. Francisco Vazquez, *Examining Chapter 9 Municipal Bankruptcy Cases*, *in* CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS, COUNSELING MUNICIPALITIES, AND ANALYZING RECENT TRENDS AND CASES (Jo Alice Darden ed., 2011), *available at* 2011 WL 5053640, at *4.

162. *See Chapter 9: Municipality Bankruptcy*, U.S. COURTS, http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter9.aspx (last visited Mar. 25, 2015). The Constitution expressly forbids states from enacting any "Law impairing the Obligation of Contracts." U.S. Const. art. I, § 10, cl. 1. Concurrently, however, the Tenth Amendment establishes limits on federal power by reserving the powers not delegated by the Constitution to the states, thus preserving state sovereignty. *Id.* amend. X.

163. 298 U.S. 513 (1936).

164. *See id.* at 532.

165. *Id.* at 531.

166. 304 U.S. 27 (1938).

167. *See id.* at 54.

168. *Id.* at 50.

stated the committee's mindfulness of the *Ashton* holding, and its belief that the Revised Act was in compliance with the *Ashton* holding, noting:

> The bill here recommended for passage expressly avoids any restriction on the powers of the States or their arms of government in the exercise of their sovereign rights and duties. No interference with the fiscal or governmental affairs of a political subdivision is permitted. The taxing agency itself is the only instrumentality which can seek the benefits of the proposed legislation. No involuntary proceedings are allowable, and no control or jurisdiction over that property and those revenues of the petitioning agency necessary for essential governmental purposes is conferred by the bill . . . . There is no hope for relief through statutes enacted by the States, because the Constitution forbids the passing of State laws impairing the obligations of existing contracts. Therefore, relief must come from Congress, if at all. The committee [is] not prepared to admit that the situation presents a legislative no-man's land.[169]

The Senate Judiciary Committee adopted the House Committee Report.[170] The Supreme Court, when upholding the constitutionality of the Municipal Bankruptcy Act, noted that the statute was "carefully drawn so as not to impinge on the sovereignty of the State," and that the power is exercised only when authorized by state law.[171] The Court stated that the Tenth Amendment "protected, and did not destroy, [a state's] right to make contracts and give consents."[172]

2. The Municipal Bankruptcy Code Evolves

For forty years, the Municipal Bankruptcy Act remained largely unchanged, until municipal financial developments in the 1970s, including New York City's financial crisis in 1976, prompted Congress to amend the Municipal Bankruptcy Code.[173] Before 1976, bankruptcy courts were required to find that the adjustment plan was "for the best interests of the creditors" and "fair and equitable" prior to confirmation.[174] "Feasibility was embedded into the 'fair and equitable' requirement," and courts were required to analyze projected expenditures and revenues, and make express findings whether it was probable that after adjustment, the debtor could pay the creditors' claims.[175] Courts understood that the "fair and equitable" requirement meant that a municipality had to generally demonstrate a balanced budget in a reasonable time period after adjustment confirmation.[176] The 1976 revisions expressly required a feasibility determination but removed the fair and equitable requirement as redundant

169. *Id.* at 51.
170. *See id.* at 50.
171. *See id.* at 51.
172. *See id.* at 52.
173. *See* Heck, *supra* note 157, at 98 n.70.
174. *In re* Mount Carbon Metro. Dist., 242 B.R. 18, 33 (Bankr. D. Colo. 1999) (citing Act of June 28, 1940, ch. 438, 54 Stat. 667, 669–70 (1940); H.R. REP. NO. 94-686, at 32 (1975)).
175. *See id.*
176. *See id.*

with the best interests of creditors test.[177] The best interest of creditors requirement of § 943(b)(7) is often easy to establish because creditors often have limited recourse outside of bankruptcy—they cannot propose a payment plan, cannot convert proceedings to a Chapter 7 liquidation, cannot appoint a trustee, and cannot force municipal asset sales.[178] Generally, a creditor's only recourse if it fears the Chapter 9 debtor's plan is to litigate for dismissal of the Chapter 9 petition.[179] With limited leverage and other options, creditors may accept a Chapter 9 plan to avoid other non-bankruptcy alternatives.[180]

In 1988, Congress updated the definition of "insolvency" to the current cash flow definition, where the municipality must demonstrate its inability to pay bills as they become due.[181] Chapter 9's definition is in contrast with the Code's definition of insolvency for non-municipality entities, which employs a balance sheet approach.[182] Congress updated Chapter 9's definition because a balance sheet methodology would result in most municipalities' liabilities exceeding the value of its nonexempt assets, making many municipalities technically insolvent and thus eligible for Chapter 9 bankruptcy relief.[183]

3. Bankruptcy Courts' Interpretation of Congressional Purpose

The "purpose of chapter 9 is to temporarily protect a debtor from collection actions so that it may establish a repayment plan with its creditors."[184] Chapter 9 allows a municipality to preserve critical jobs and keep the municipal debtor economically viable.[185] The statute is arranged to provide the debtor with a "breathing spell"—provided by the automatic stay provisions under §§ 922(a) and 362(a)—to adjust its debt.[186] However, the purpose of a Chapter 9 petition may not "simply be to buy time or evade creditors."[187] Other bankruptcy courts have noted that the court's jurisdiction "should not be exercised lightly . . . in light of the interplay between Congress' bankruptcy power and the limitations on

177. *See id.* at 33–34. The "fair and equitable" requirement is now incorporated through 11 U.S.C. § 1129(10)(b) in certain situations. *Id.* at 34.

178. *See id.*

179. *See id.*

180. *See id.*

181. *See* 5 NORTON & NORTON, *supra* note 155, § 90:5.

182. The balance sheet approach is defined as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation." 11 U.S.C. § 101(32)(A) (2012).

183. *See* 1 NORTON & NORTON, *supra* note 155, § 17:8.

184. *In re* N.Y.C. Off-Track Betting Corp., 427 B.R. 256, 280 (Bankr. S.D.N.Y. 2010) (citing *In re* Hamilton Creek Metro. Dist., 143 F.3d 1381, 1386 (10th Cir. 1998)).

185. *See* Judith Elkin, *A "Time Out" for Municipalities: The Recent Workings of Chapter 9 of the Bankruptcy Code*, *in* CHAPTER 9 BANKRUPTCY STRATEGIES, *supra* note 162, *available at* 2011 WL 5053638, at *1.

186. *In re* City of Detroit, 504 B.R. 97, 187 (Bankr. E.D. Mich. 2013) (citing *In re* Cnty. of Orange, 183 B.R. 594, 607 (Bankr. C.D. Cal. 1995)).

187. *See* 6 COLLIER ON BANKRUPTCY, *supra* note 30, ¶ 900.02.

federal power under the Tenth Amendment," and that access to Chapter 9 was designed to be an "intentionally difficult task."[188]

4. Eligibility Requirements and Limits

Chapter 9 provides certain eligibility requirements to qualify for protections at the petition phase.[189] Section 109(c) provides that "an entity may be a debtor under Chapter 9 of this title if and only if such entity[:] (1) is a municipality; (2) is specifically authorized . . . to be a debtor . . . by State law . . . ; (3) is insolvent; [and] (4) desires to effect a plan to adjust such debts."[190] Section 109 further provides that the debtor must either (A) have obtained an agreement of creditors holding a majority in amount of claims of each class, (B) have negotiated in good faith with creditors but failed to obtain an agreement of the majority in amount of the claims of each class, (C) be unable to negotiate with creditors because negotiation is impracticable, or (D) reasonably believe that a creditor may attempt to obtain a transfer that in avoidable under § 547.[191] The petitioner bears the burden of proving—by a preponderance of the evidence—that the entity satisfies the eligibility criteria.[192] Courts have held that § 109(c)'s eligibility requirements should be "construed broadly" to promote the underlying policies of the Bankruptcy Code—that is, to provide municipalities with the access to relief.[193] The Bankruptcy Code requires that a municipality's Chapter 9 bankruptcy petition must be submitted in good faith or the court *may* dismiss the petition altogether, denying any relief to the municipality.[194]

Chapter 9 also provides that the debtor's debt adjustment plan must conform to multiple statutory provisions to be eligible for confirmation by the court.[195] The debtor remains in exclusive control over the proposed plan, subject to the requirements of § 943 and to confirmation by the court.[196] However, the debtor carries the burden of proof for the confirmation plan requirements by a preponderance of the evidence.[197]

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188. *In re* Sullivan Cnty. Reg'l Refuse Disposal Dist., 165 B.R. 60, 82 (Bankr. D.N.H. 1994); *see also N.Y.C. Off-Track Betting Corp.*, 427 B.R. at 264 (stating that eligibility should be determined with a "jaded eye" due to dual sovereignty concerns).

189. *See* 11 U.S.C. § 109(c) (2012).

190. *Id.*

191. *Id.*; *see also id.* § 547. Section 547 prevents transfer of property to or for the benefit of the creditor when certain statutory conditions are met. *Id.*

192. *See, e.g.*, *In re* City of Stockton, 493 B.R. 772, 794 (Bankr. E.D. Cal. 2013).

193. *In re* Valley Health Sys., 383 B.R. 156, 163 (Bankr. C.D. Cal. 2008); *see also In re* Barnwell Cnty. Hosp., 471 B.R. 849, 858–59 (Bankr. D.S.C. 2012); *In re* Pierce Cnty. Hous. Auth., 414 B.R. 702, 710 (Bankr. W.D. Wash. 2009); *In re* Cnty. of Orange, 183 B.R. 594, 601 (Bankr. C.D. Cal. 1995).

194. 11 U.S.C. § 921(c). ("[T]he court, after notice and a hearing, may dismiss the petition if the debtor did not file the petition in good faith or if the petition does not meet the [statutory requirements].").

195. *See id.* § 943.

196. *See* 6 COLLIER ON BANKRUPTCY, *supra* note 30, ¶ 941.02.

197. Allan H. Ickowitz & Robert S. McWhorter, *Understanding the Unique Challenges of Chapter 9 Cases*, *in* REPRESENTING CREDITORS, *supra* note 99, *available at* 2014 WL 4785318, at *8.

Section 943(b)(1) requires that the plan comply with Code provisions made applicable by §§ 103(a) and 901(a). Section 901(a) makes applicable the § 1129(a)(3) requirement that the debt adjustment plan be proposed in good faith.[198] Section 943(b)(7) requires that the plan be in the "best interest" of creditors, but courts have interpreted this simply to mean "better than the alternatives."[199] Chapter 9 also requires that the plan must not "discriminate unfairly" with respect to each class of claims and must be "fair and equitable."[200] With respect to unsecured claims, § 1129(b)(2) requires that either creditors receive a value equal to their claim or that no creditor whose claims are junior to the claims of a class receives or retains any property.[201] However, case law shows varying interpretation of this language, and many plans have been confirmed where various unsecured bond obligations are classified separately from other unsecured creditors or even other unsecured bond obligations.[202] Courts allow separate classification based on multiple criteria "including economic justifications, settling [versus] non-settling creditors, or other appropriate grounds."[203] At the confirmation stage, creditors can challenge the creditor class structure, since confirmation requires a majority vote of each class of creditors, and the classes may not be arbitrarily or coercively put together to provide disproportionate benefits to certain classes.[204]

II. CONFLICTING AND INCONSISTENT CHAPTER 9 INTERPRETATIONS AND RESULTS

Part II outlines the conflicting judicial interpretations of Chapter 9 bankruptcy factors relating to eligibility for Chapter 9 relief and confirmation of the Chapter 9 exit plan. The judicial interpretations create uncertainty for municipalities and creditors alike. In particular, uncertainties in municipality treatment, asset usage, insolvency calculations, and good faith analysis cause problems for both debtors and creditors.[205] Municipal debtors may face increased borrowing costs, contagion issues,[206] and uncertain eligibility for relief, while creditors have limited recourse once the petition is accepted, as the municipal debtor can spend and borrow without court approval and bind creditors to a confirmed plan.[207] With uncertain treatment on a case-by-case basis, there is room to clarify the application of Chapter 9 by differentiating between one-time and

198. *See* 11 U.S.C. §§ 901(a), 943(b)(1).

199. Ickowitz & McWhorter, *supra* note 197, at *14.

200. 11 U.S.C. § 1129(b)(1); *see* Ickowitz & McWhorter, *supra* note 197, at *15.

201. 11 U.S.C. § 1129(b)(2); *see also* Ickowitz & McWhorter, *supra* note 197, at *15.

202. *See* Ickowitz & McWhorter, *supra* note 197, at *16.

203. *Id.*

204. *See* Vazquez, *supra* note 161, at *6.

205. *See generally* Mark A. Cody, *Creditors' Rights in Chapter 9 Bankruptcy*, *in* REPRESENTING CREDITORS, *supra* note 99, *available at* 2014 WL 4785319, at *1–2.

206. 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, 816 (2014).

207. *See In re* Richmond Unified Sch. Dist., 133 B.R. 221, 224–25 (Bankr. N.D. Cal. 1991).

structurally imbalanced bankruptcies and providing context to key outcome-determinative factors.

As discussed above, municipal bankruptcies generally fall into one of two categories: one-time event bankruptcies or significant long-term structural imbalance bankruptcies.[208] Part II.A describes the difference between the two types. The current bankruptcy precedent does not employ guidelines to differentiate between the one-time event bankruptcy and long-term structural imbalance bankruptcy, leading to inconsistent and uncertain results. Part II analyzes this tension.

When courts analyze the bankruptcy petition, they face several challenges. First, municipalities have to receive specific authorization from the state to file for bankruptcy.[209] Currently, courts simply examine whether a municipality is legally authorized to file.[210] Municipalities with uncertainty as to their legal ability to file leave creditors only with notice of Chapter 9 generally, but without notice of whether a municipality is actually a municipality and whether a specific municipality will be authorized for a Chapter 9 filing. During significant financial stress, there is much uncertainty as to how the state and municipality are going to act, thus increasing credit risk and borrowing costs for solvent municipalities because creditors are uncertain of Chapter 9 availability.[211]

Second, municipal bankruptcy petitions authorize either current or prospective insolvency.[212] Courts currently do not have a concrete rule for how far into the future is too far for a prospective analysis and utilize an ad hoc approach, which creates difficulties when determining eligibility.[213] Additionally, municipalities may have assets that are not recognized under a cash flow insolvency analysis but remain relevant to a municipality's financial position.[214] Without the ability to force liquidation of assets, the cash flow insolvency methodology potentially allows a city with significant nonessential assets to be cash flow insolvent, and thus file for Chapter 9, while maintaining the nonessential assets. Potential assets are another issue. Municipalities generally have taxing and assessment powers, and the question often arises in a bankruptcy proceeding—under the insolvency calculation and the good faith analysis—whether that ability has been reasonably deployed.[215] Courts are split whether implementing taxes and

208. *See supra* notes 7–11 and accompanying text.

209. 11 U.S.C. § 109(c)(2) (2012).

210. *See id.*; *see also* 6 COLLIER ON BANKRUPTCY, *supra* note 30, ¶ 900.02 (noting that the statute requires specific authorization in capacity as a municipality, by name, by an authorized government officer, and by a state empowered organization).

211. Frederick Tung, *After* Orange County*: Reforming California Municipal Bankruptcy Law*, 53 HASTINGS L.J. 885, 903 n.87 (2002) (stating that the structure of a state authorization system may affect borrowing costs).

212. *See* Elkin, *supra* note 185, at *3.

213. *See, e.g.*, *In re* City of Bridgeport, 129 B.R. 332, 337–38 (Bankr. D. Conn. 1991).

214. *See supra* notes 71–74 and accompanying text.

215. *Compare In re* Sullivan Cnty. Reg'l Refuse Disposal Dist., 165 B.R. 60, 83 (Bankr. D.N.H. 1994) (failing to ever consider using taxing power is evidence of bad faith), *with In re* McCurtain Mun. Auth., No. 07-80363, 2007 WL 4287604, at *6 (Bankr. E.D. Okla. Dec. 4, 2007) (failing to assess citizens is not necessarily evidence of bad faith).

assessments is evidence of bad faith, with corresponding implications in the insolvency analysis.[216] Differentiation of nonessential assets and potential assets seems to have significant relevance to one-time event bankruptcy since the debt is known and the question is simply whether the municipality can reasonably pay its bills.

Finally, courts have to determine if a municipality's petition and subsequent behavior are in good faith. Good faith elements exist in every aspect of the bankruptcy—from the situations and conditions leading up to the petition, the accounting and projections, and the negotiations with the proper parties.

A. Bankruptcy Types: The One-Offs and the Structurally Imbalanced

This section examines one-time event municipal bankruptcies and structurally imbalanced municipal bankruptcies. It first outlines a typical one-off bankruptcy which can be caused by one-time events such as a large adverse civil judgment, fiscal mismanagement behavior, or investment pool losses,[217] using Jefferson County as an example. It then describes a typical structurally imbalanced bankruptcy, using Detroit as an example.

1. One-Time Event Bankruptcy

A one-time event bankruptcy is caused by a disproportionate financial stress occurring at a singular time that renders insolvent an otherwise seemingly solvent municipality. As briefly outlined above, Jefferson County, notorious for the second largest municipal bankruptcy filing in U.S. history, exemplifies a quintessential one-time event bankruptcy. Its bankruptcy petition resulted from the concurrence of invalidated state taxes and crushing debt from the reconstruction of the County's neglected sewer system.[218] The sewer debt was exacerbated by failed swap and interest rate stabilization agreements that converted fixed interest rates to adjustable rates while simultaneously utilizing a swap structure to control the adjustable rates.[219] The sewer system's financing was obtained in part by several agreements that involved bribery and fraud by multiple actors, including construction contractors, municipal financiers, and investment bankers.[220] In evaluating the bankruptcy, the court suggested that the "[c]ounty's inhabitants are in the midst of a perfect financial storm brought on by the convergence of prohibited, unethical and bad conduct by public and private persons and entities all while some were supposedly under the supervision of and regulation by state and federal agencies."[221] The perfect storm of events that causes "acute and immediate" financial crisis is

216. *See supra* note 215 and accompanying text.
217. *See supra* notes 7–9.
218. *See In re* Jefferson Cnty., 474 B.R. 228, 239 (Bankr. N.D. Ala. 2012).
219. *See id.* at 237.
220. *See id.* at 239–40.
221. *Id.* at 240.

characteristic of a one-time event bankruptcy, and that storm generally happens with little prior notice.[222]

2. Structurally Imbalanced Bankruptcy

A structurally imbalanced bankruptcy is caused by protracted financial stress created by structural conditions including shrinking population, loss of tax base, legacy pension costs, unfunded health care costs, poor management, and infrastructure costs.[223] Cities like Detroit, a quintessential structurally imbalanced bankruptcy, display the difficulties of a municipality with significant financial imbalances emanating from multiple sources manifesting themselves over a significant time period.[224] Economic decline, population loss, and other structural factors reduced Detroit's tax base.[225] Detroit's population has dropped a dramatic 63 percent since the city's mid-twentieth-century heyday, and has dropped 26 percent in the new millennium.[226] The per capita tax burden on residents and businesses has increased significantly, while the stresses from population loss, deindustrialization, and fiscal mismanagement left the city struggling to provide basic services—infrastructure (water, sewer, and roads), education, and safety services (fire, police, and emergency medical services)—for residents and businesses.[227]

Detroit had massive debts: $5.85 billion in special revenue bonds,[228] $6.4 billion in post-employment benefit liabilities, $3.5 billion in unfunded pension liabilities, $1.43 billion in pension certificates, $1.13 billion in secured and unsecured general obligation bonds, $296 million in swap liabilities, and $300 million in other liabilities.[229] In 2013, debt service obligations represented 42.5 percent of Detroit's yearly revenue, and by 2017, debt service obligations are projected to rise to 65 percent of city revenues.[230]

Detroit was unable to provide services to its constituents, a condition that some commentators and bankruptcy judges refer to as "service delivery insolvency."[231] Detroit has 78,000 abandoned or blighted structures and nearly 66,000 blighted lots.[232] Half a century of economic difficulties and

222. *See In re* Cnty. of Orange, 179 B.R. 177, 179 (Bankr. C.D. Cal. 1995).

223. *See, e.g.*, *In re* City of Detroit, 504 B.R. 97, 112–21 (Bankr. E.D. Mich. 2013).

224. *See id.*

225. *See* Detroit Memorandum, *supra* note 12, at 24–25.

226. *See* Disclosure Statement with Respect to Plan for the Adjustment of Debts of the City of Detroit, *Detroit*, 504 B.R. 97 (Feb. 21, 2014) (No. 13-53846) [hereinafter Detroit Disclosure Statement], *available at* 2014 WL 834782, at *38.

227. *See generally id.*

228. The Bankruptcy Code defines special revenues inter alia as receipts derived from specific projects, functions, or systems of the debtor. 11 U.S.C. § 902(2) (2012).

229. Detroit Memorandum, *supra* note 12, at 2–3.

230. *Id.*

231. *See In re* City of Stockton, 493 B.R. 772, 788–91 (Bankr. E.D. Cal. 2013). Service delivery insolvency examines the municipality's ability to provide services at the "level and quality that are required for the health, safety, and welfare of the community." *Id.* at 789; *see also* Anderson, *supra* note 5, at 1192–93.

232. *See In re* City of Detroit, 504 B.R. 97, 120 (Bankr. E.D. Mich. 2013).

mismanagement prevented Detroit from making critical investments, resulting in critical city departments, including police, fire, emergency medical services, being unable to adequately serve its population.[233] Detroit's violent crime rates were five times the national averages and the case clearance rate[234] is significantly below the national average.[235] Detroit's average response time for top priority crimes was 58 minutes, over five times the national average.[236] Forty percent of the city's streetlights do not function.[237] In 2009, Detroit closed 210 of its 317 parks, and it has announced an additional 50 park closings.[238] The number of jobs in the city has declined 50 percent—from approximately 735,000 jobs in 1970 to approximately 346,000 jobs in 2012.[239] The unemployment rate has swiftly risen, from 6.3 percent in 2000 to 18.3 percent in 2012, with a peak of 23.4 percent in 2010.[240] Detroit's information technology, payroll, tax, and financial reporting systems are functionally obsolete.[241]

Detroit's revenues are also declining—income tax revenues declined to $276 million, 30 percent less than 2002, and property tax revenues declined 10 percent, to $135 million, from 2012 to 2013 alone.[242] Revenue from the utility user's tax was $39.8 million in 2012, a 28 percent decrease from a decade ago.[243] Concurrently, the city had operating deficits—$115 million in 2012 alone.[244]

Detroit's income tax rates of 2.4 percent for residents and 2.0 percent for businesses are the highest in the state.[245] Detroit's property tax rates are the highest among Michigan cities with populations exceeding 50,000.[246] Income and property taxes are levied at Michigan's statutory maximum, prohibiting Detroit from possibly raising additional revenue through increased taxation.[247] A 5 percent utility user's tax, levied on utility services, is also set at the statutory maximum.[248] The city also has a 10.9 percent casino tax that generates approximately $175 million, but new casinos in Ohio are expected to erode these tax receipts.[249]

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233. *See* Detroit Memorandum, *supra* note 12, at 23.
234. *See Uniform Crime Reports*, FBI, http://www.fbi.gov/about-us/cjis/ucr/crime-in-the-u.s/2010/crime-in-the-u.s.-2010/clearances (last visited Mar. 25, 2015). Generally, the case clearance rate is defined as the ratio of crimes where an offender is arrested, charged, and referred to the prosecutor compared to the total number of crimes. *Id.*
235. *See* Detroit Memorandum, *supra* note 12, at 24.
236. *Id.* at 24 n.7.
237. *See Detroit*, 504 B.R. at 120.
238. *Id.*
239. *Id.* at 119.
240. *Id.*
241. *See id.* at 120–21.
242. *Id.* at 118.
243. *Id.*
244. *See id.* at 119.
245. *See* Detroit Memorandum, *supra* note 12, at 28.
246. *See id.* at 28–29.
247. *See id.* at 29.
248. *See id.*
249. *See Detroit*, 504 B.R. at 118; *see also* CITIZENS RESEARCH COUNCIL OF MICH., DETROIT CITY GOVERNMENT REVENUES, REPORT 382 (2013), *available at* http://www.crcmich.org/PUBLICAT/2010s/2013/rpt382.pdf.

Detroit is a classic, but not the only, structurally imbalanced bankruptcy. Other structurally imbalanced bankruptcies include Stockton and Vallejo, cities afflicted by a combination of legacy liabilities, deindustrialization, fiscal mismanagement, and reduced tax revenue, which manifest themselves over a period of time to create major financial stress.[250]

B. Is It a Municipality—And Authorized for Bankruptcy?

Public entities, creditors, and rating agencies alike can be uncertain in the two-step process of whether an entity is a "municipality" and if so, whether that municipality is specifically authorized to petition for bankruptcy. Pre-lending notice is relevant to the creditor's ability to understand the risk when providing credit to an entity.[251] The first issue is whether the entity is a municipality at all.[252] Sophisticated creditors of cities and counties are very likely aware that the entity is a municipality.[253] However, with respect to housing authorities, power plants, toll roads, and the like, a creditor may be uncertain of the municipality's status.[254] A creditor then has to examine the factors outlined above, including the amount of public control over an entity, the entity's taxing and assessment power, and the state's statutory classification of the entity.[255] With creditor uncertainty of a municipality's status, credit risk can rise, making it more difficult to issue debt and increasing the cost of servicing the debt.[256]

Further, the Bankruptcy Code requires that a municipality be specifically authorized by the state to file for bankruptcy.[257] Currently, the Code does not contain a provision requiring a state to predetermine a municipality's specific authorization status for Chapter 9 prior to financial crisis.[258] Certain states provide wide statutory authority for their municipalities to petition for Chapter 9 relief.[259] However, not every state grants its municipalities authorization to access Chapter 9.[260] Twenty-six states

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250. *See generally In re* City of Stockton, 493 B.R. 772 (Bankr. E.D. Cal. 2013); *In re* City of Vallejo, 408 B.R. 280 (B.A.P. 9th Cir. 2009).

251. *See, e.g.*, Ickowitz & McWhorter, *supra* note 197, at *7 (noting creditors' rights are limited in Chapter 9 bankruptcy); MOODY'S INVESTOR SERV., WITHIN CHAPTER 9 FRAMEWORK, RECOVERY LEVELS VARY WIDELY 15 (2014), *available at* http://www.stocktongov.com/files/2_26_2014_Chapter9_Doc_1274_ExhibitsA_B_InSupportofFranklinHighCityConfirmationFirstAmendedPlan.pdf (noting that recent bankruptcy results deviate substantially from creditor expectations). Without notice of ability to utilize Chapter 9, creditors have less ability to rationally price the credit risk.

252. *See supra* notes 29–64 and accompanying text.

253. *See supra* notes 32–41 and accompanying text.

254. *See supra* notes 42–64 and accompanying text.

255. *See supra* notes 45–64 and accompanying text.

256. *See* Cody, *supra* note 205, at *13 ("[I]t is important for creditors to understand the nature of their claims and their potential sources of recovery.").

257. *See* 11 U.S.C. § 109(c) (2012). The rationale for the specific authorization requirement is rooted in Congress's deference to the Supreme Court's *Ashton* ruling, which principally was concerned with state sovereignty rights derived from the Tenth Amendment. *See supra* notes 164–70 and accompanying text.

258. *See* Elkin, *supra* note 185, at *2.

259. *See id.*

260. *See id.*

prohibit Chapter 9 filing, and if a municipality wants access to Chapter 9 in those states, it would have to petition the state legislature to change the law.[261] Other states, such as Connecticut, allow the filing but require "secondary special permission," usually from the governor or legislature.[262] Thus there is uncertainty from both the creditor's and municipality's standpoint regarding whether a municipality will be specifically authorized for filing.

The current rules also allow a state to authorize filing or disallow filing at any time prior to a Chapter 9 petition.[263] In one-time event bankruptcies, the lack of clarity of specific authorization eliminates all notice of the availability of Chapter 9. Municipalities and creditors alike are forced to operate with the backdrop of federal bankruptcy law, without knowing in many instances if the state will provide specific authorization.[264]

In structural imbalance bankruptcies, municipalities and creditors have more notice of financial struggles but still may be uncertain of the availability of Chapter 9, for the same reasons as one-time event bankruptcies.[265] The Code only requires specific authorization from the state, but that authorization can come any time prior to the filing, including just before the filing.[266] In this situation, the creditor will not know whether the municipality will have specific authorization from the state to file, but the creditor must operate with the backdrop that a Chapter 9 petition is possible.

C. Measuring "Insolvency"

Multiple variables play into the Chapter 9 insolvency calculation. This section details the insolvency requirement, beginning with the accounting methodology, and then illustrates how a municipality can demonstrate insolvency using either a current or prospective calculation. Finally, this section describes the tension between creditors and debtors regarding the inclusion of nonessential assets and potential assets in an insolvency calculation.

1. Current or Prospective, and If So, How Far?

Insolvency is measured differently in different sections of the Bankruptcy Code.[267] Unlike a business in Chapter 11, a municipality must be insolvent to be eligible for Chapter 9 protection.[268] In contrast to Chapter 11's

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261. *See id.*
262. *See id.*
263. Juliet M. Moringiello, *Specific Authorization to File Under Chapter 9: Lessons from Harrisburg*, 32 CAL. BANKR. J. 237, 255 (2012).
264. *See* Kordana, *supra* note 91, at 1044–45.
265. *See supra* notes 251–64 and accompanying text.
266. *See* Moringiello, *supra* note 263, at 255. The state also can revoke its specific authorization at any time prior to filing. *Id.*
267. *See supra* notes 181–83 and accompanying text.
268. 11 U.S.C. § 109(c)(3) (2012).

balance sheet insolvency method,[269] Chapter 9 uses a cash flow analysis, where, to be considered insolvent, a municipality must demonstrate that it is generally not paying, or will be unable to pay, debts as they become due.[270] Chapter 9 requires that insolvency be "real and not transitory," such that the municipality is in "bona fide financial distress that is not likely to be resolved without use of federal bankruptcy power to impair contracts."[271]

The "will not be able to pay" insolvency test is a prospective standard, thereby allowing a municipality to seek protection prior to running out of money.[272] The Code does not provide a methodology for prospective insolvency determination, leaving courts to analyze prospective insolvency on a case-by-case basis.[273]

The date of filing currently serves as a reference for the insolvency analysis based on precedent originating from *In re City of Bridgeport*,[274] as debts may fluctuate depending on the financial stressors that precipitated the filing.[275] In *Bridgeport*, the judge noted that "neither § 101(32)(C)(ii) nor its legislative history provide guidance on how far into the future [the insolvency analysis] should go."[276] In 2012, the *Stockton* proceedings confirmed "how far one looks into the future to discern insolvency has not been settled."[277]

Clearly, the further the projection is into the future, the less accurate it will be. In *Bridgeport*, the court identified many of the variables affecting a municipality's fiscal condition, including the health of the local, national, and international economy; state and federal aid; labor concessions; voluntary tax abatements; tax increases; tax collection rates, and the success of borrowing attempts.[278] The court ultimately dismissed the Chapter 9 petition, holding that the city had not demonstrated insolvency because of the uncertainty in the city's projected budget deficit and cash position.[279] *Bridgeport* is representative of problems with projected insolvency, where a city is attempting to protect assets but is uncertain whether it will qualify as insolvent without more definitive statutory guidance or consistent precedent from the courts.

Additionally, Chapter 9's cash flow insolvency analysis essentially ignores asset valuation, including nonessential assets as discussed below.

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269. *See supra* note 182 and accompanying text (detailing Chapter 11's balance sheet approach—where the liabilities of an entity are subtracted from the assets to determine insolvency).

270. 11 U.S.C. § 101(32)(C)i–ii; *see also In re* Mount Carbon Metro. Dist., 242 B.R. 18, 32–35 (Bankr. D. Colo. 1999).

271. *See In re* City of Stockton, 493 B.R. 772, 773 (Bankr. E.D. Cal. 2013).

272. *See In re* City of Bridgeport, 129 B.R. 332, 336 (Bankr. D. Conn. 1991).

273. *See id.* at 337.

274. 129 B.R. 332 (Bankr. D. Conn. 1991).

275. *See id.* at 337–38.

276. *See id.* at 337.

277. *See In re* City of Stockton, 493 B.R. 772, 788 (Bankr. E.D. Cal. 2013).

278. *See Bridgeport*, 129 B.R. at 338.

279. *See id.* at 339. The Bridgeport government had not approved next year's budget at the time of the petition, compounding the uncertainty. *Id.*

2. Nontraditional Asset Classes and Potential Assets

Part II.C.1 outlined how bankruptcy courts apply cash-flow methodology to determine whether a municipality is either currently or prospectively cash flow insolvent.[280] The cash flow analysis could allow a city with significant nonessential assets to be considered insolvent, and thus file for Chapter 9, while maintaining those assets.[281] Currently, § 904 prevents courts from interfering with the debtor's political or governmental powers, property or revenues, or the use or enjoyment of any income-producing property.[282] Unlike Chapter 11, Chapter 9 does not provide any provision for liquidation of the debtor's assets or distribution of those assets to creditors.[283] Section 903 explicitly provides that the Bankruptcy Code does not limit or impair the state's power to control its municipalities.[284]

Detroit has an interesting asset situation. The Detroit Institute of Art (DIA) is owned by the city and currently houses 65,000 works of art that are collectively considered one of the most prominent art museums in the United States.[285] Detroit owns a "significant portion" of the DIA Collection, which was acquired in three ways: (1) a 1919 asset transfer,[286] (2) art that was purchased by the city, and (3) art donated to the city after the asset transfer.[287] In 1930, with the city's collection growing to 12,000 works, the city financed and constructed the current museum building.[288]

In anticipation of its Chapter 9 proceedings, Detroit retained Christie's to appraise the fair market value of the artwork that Detroit acquired using city funds.[289] The appraisal consisted of 2781 works, with a total appraisal value of $454 million to $866 million.[290] Christie's classified 406 of the appraised items as "most valuable works"—items with individual values greater than $50,000—and noted that the most valuable works represented more than 99 percent of the total appraisal value.[291] Interestingly, eleven of the appraised works represented 75 percent of the total estimated value, and just three represented more than half the value: Pieter Bruegel the Elder's *The Wedding Dance* ($100–$200 million), Vincent Van Gogh's *Self*

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280. 9 AM. JUR. 2D *Bankruptcy* § 45 (2015).

281. *See, e.g.*, *In re* City of Detroit, 504 B.R. 97 (Bankr. E.D. Mich. 2013).

282. *See* 11 U.S.C. § 904 (2012).

283. *Chapter 9: Municipality Bankruptcy*, U.S. COURTS, http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter9.aspx (last visited Mar. 25, 2015).

284. *See* 11 U.S.C. § 903.

285. *See* Detroit Disclosure Statement, *supra* note 226, at 26.

286. From 1885 to 1919, the museum was a separate corporation, but in 1919 the museum transferred ownership of the 4400 works of art, along with the property and original museum structure, to the City of Detroit pursuant to Michigan Public Law and the Detroit City Charter. *Id.* The transferor-corporation remained in existence after the transfer, contracting with Detroit to operate the museum. *Id.*

287. *See id.*

288. *See id.*

289. *See id.*

290. *See id.* at 75. The smaller number denotes a conservative price and the higher number represents the most advantageous estimate.

291. *Id.*

Portrait with Straw Hat ($80–$150 million), and Rembrandt's *The Visitation* ($50–$90 million).[292]

Christie's report recommended several options that the city could use to generate revenue from the collection absent selling any of the artwork, including (1) pledging some or all of the art as collateral for a loan, (2) generating revenue by leasing the masterpieces to other art museums, (3) creating a "masterpiece trust,"[293] (4) selling artwork to a philanthropist or charity on the condition that they permanently lend the work to the Detroit Institute of Art, or (5) mounting a travelling exhibition of masterpiece works.[294]

Multiple creditors, including Syncora Guarantee Inc. and Financial Guarantee Insurance Company (FGIC), contended that the city should be required to monetize its nonessential assets or receive loans to pay off creditors that are secured by art assets, which Detroit opposes.[295] Detroit's position was that any art sale would irreparably harm the DIA and that the options to generate revenue while retaining title were not viable.[296]

In 2014, during the confirmation phase of the bankruptcy proceedings, the City of Detroit and the Detroit Art Institute commissioned Artvest Partners to perform a complete appraisal of the entire collection, irrespective of the title acquiring method. Artvest's appraisal returned an estimate range between $2.76 billion and $4.61 billion.[297] However, Artvest's report identified a series of additional factors that it considered likely to reduce the generated revenue, including unsold rates, the impact of immediate liquidation, or alternatively a "blockage discount"—a reduction in sale price when selling a large group of similar items—and issues with a large offering with the main art auction houses.[298] Artvest also noted legal obstacles and corresponding litigation of the asset sales that may cloud the title and prevent the receipt of more than the deposit.[299] Based on those discount factors, Artvest estimated that the collection would sell for "$1.1 billion for the present value of an orderly sale after a prolonged litigation . . . to $1.8 billion for the present value of an orderly liquidation without litigation."[300] Further, it countered each of Christie's monetization suggestions, generally concluding that the solutions were not viable.[301] Artvest's report concluded "[r]ather than being a source of cash to creditors

292. *Id.*

293. *See id.* This unprecedented arrangement would transfer city-owned art into a trust, with minority trust interest sold to individual museums, entitling them to borrow works for finite predetermined amounts of time. *Id.*

294. *See id.*

295. Khalil AlHajal, *Opening Argument in Detroit Bankruptcy Trial: Selling Art, Raising Taxes Aren't Reasonable Options*, MLIVE (Sept. 3, 2014, 8:33 AM), http://www.mlive.com/news/detroit/index.ssf/2014/09/opening_argument_in_detroit_ba.html.

296. *See infra* note 307 and accompanying text.

297. ARTVEST, EXPERT WITNESS REPORT OF MICHAEL PLUMMER 19 (2014), *available at* http://archive.freep.com/assets/freep/pdf/C422218479.pdf.

298. *Id.* at 26–30.

299. *See id.* at 31–32.

300. *Id.* at 37.

301. *See id.* at 42–47.

or a burden on the current city, in fact the DIA is the single most important cultural asset the City currently owns for rebuilding the vitality of the city."[302]

The creditors extrapolated the value of the Christie's appraisal to imply that the residual 95 percent of the collection[303] could be valued from "$11 billion to as much as $21 billion."[304] That report indicated that "instead of continuing to burden Detroiters, a DIA de-accessioning offers the potential for asset value realization that the City might use to consensually satisfy creditor claims while liberating . . . reinvestment [capital]" to utilize for city rehabilitation.[305]

The use of nonessential assets, such as art, particularly when the value is substantial compared to the budget deficit, is relevant in both the insolvency analysis and the confirmation phase "fair and equitable" analysis. In Detroit's confirmation proceedings, Judge Rhodes asked Detroit's emergency manager, "Why not monetize the art?"[306] The emergency manager responded that he believed that selling the art would "harm [the DIA] irreparably."[307] While Chapter 9 does not require the city to sell assets, the nonessential assets are considered by applying the good faith requirement to the insolvency analysis discussed in Part II.C and the good faith analysis discussed in Part II.D. This is particularly relevant in a situation like Detroit's, where Detroit's 2013 budget deficit of $125 million was less than the average appraisal value of Pieter Bruegel the Elder's *The Wedding Dance* ($100–200 million).[308]

While the Detroit bankruptcy is perhaps the most interesting case involving assets in a Chapter 9 proceeding, other cases have also examined the assets of a municipality and how their use relates to the various issues in a bankruptcy petition. In *In re Pierce County Housing Authority*,[309] the court addressed the creditor's argument that the Housing Authority was not insolvent because it had assets consisting of fourteen buildings and other equipment worth approximately $44 million as of the petition date.[310] *Pierce County* involved a one-time event bankruptcy, where tort liability from a class of plaintiffs claiming damage from mold at one of defendant's

302. *Id.* at 48.

303. Christie's appraised 2726 of the 65,000 pieces, or approximately 5 percent, of the artwork. *See supra* notes 285–90 and accompanying text.

304. Motion of Creditors for Entry of an Order Pursuant to Section 105(a) of the Bankruptcy Code Directing the Debtor to Cooperate with Interested Parties Seeking to Conduct Due Diligence on the Art Collection Housed at the Detroit Institute of Arts, *In re* City of Detroit, 504 B.R. 97 (Bankr. E.D. Mich. Apr. 9, 2014) (No. 13-53846), *available at* http://www.mieb.uscourts.gov/sites/default/files/detroit/docket3925.pdf, at *2.

305. *See id.* at *5.

306. Nathan Bomey, *Detroit Bankruptcy Judge: 'Why Not Monetize the Art?'* USA TODAY (Oct. 3, 2014), http://www.usatoday.com/story/news/nation/2014/10/03/detroit-bankruptcy-judge-why-not-monetize-the-art/16675813/.

307. *Id.*

308. *See supra* note 292 and accompanying text.

309. 414 B.R. 702 (Bankr. W.D. Wash. 2009).

310. *Id.* at 711.

affordable housing facilities precipitated the Chapter 11 filing.[311] However, the court found that thirteen of the fourteen buildings were subject to liens, and the debtor could not increase rents to generate revenue because of state law restrictions.[312]

In *In re City of Vallejo*, unions challenged Vallejo's petition by asserting, among other things, that the city's Comprehensive Annual Financial Report (CAFR) reflected total assets of $1 billion and $624 million of net assets in excess of liabilities.[313] Vallejo held its unrestricted assets in a general fund account that it used to bridge deficits in different accounts.[314] However, the general fund recorded multimillion dollar deficits in the prior three years—as a result, the general fund was depleted, and a projected deficit of $17 million was projected for 2007–2008, with labor costs alone exceeding revenues.[315] State law prevented the general fund from borrowing from restricted accounts without demonstrating a balanced budget and the ability to repay the restricted fund within a year.[316] The union objectors advanced an argument that Vallejo was not insolvent, and the city should have "pillaged all of its component agency funds, ignor[ed] bond covenants, grant restrictions, and normal [accounting] practices . . . to subsidize its General Fund."[317] While the bankruptcy appellate panel[318] noted that the city "cannot squirrel away money it can use for operations in a fund, argue the fund is restricted and then claim insolvency,"[319] the court held that using restricted funds was impermissible and that the union's other suggestions, including an offer that would prevent bankruptcy this year but apply "onerous" terms in future years, would "leave Vallejo more debilitated tomorrow than it is today," as restricted funds would be exhausted while revenues plunged and expenses surged.[320] The appellate court thus held that the bankruptcy court's insolvency findings were "supported by the record."[321]

In contrast, *In re Ellicott School Building Authority*, the court found that the building authority had not satisfied its burden in demonstrating insolvency, where the entity had alternative sources to successfully make its debt payments, including reserve funds and a defaulted rent payment.[322]

311. *See id.* at 706–08.

312. *See id.* at 711–12.

313. *In re* City of Vallejo, 408 B.R. 280, 285 (B.A.P. 9th Cir. 2009). Vallejo was a structural bankruptcy—revenue was steadily declining and labor and expenses were rising, leading to an unstainable economic condition.

314. *See id.* at 286.

315. *See id.*

316. *See id.*

317. *See id.* at 290–91.

318. Bankruptcy appellate panels are three-judge panels that hear bankruptcy appeals. The panels are part of the federal appellate court system. *See Bankruptcy Appellate Panels*, U.S. COURTS, http://www.uscourts.gov/FederalCourts/UnderstandingtheFederalCourts/CourtofAppeals/BankruptcyAppellatePanels.aspx (last visited Mar. 25, 2015).

319. *See Vallejo*, 408 B.R. at 290.

320. *See id.* at 293–94.

321. *See id.* at 294. The court noted that a bankruptcy court's findings are reviewed only for "clear error." *Id.*

322. *Ellicott Sch. Bldg. Auth.*, 150 B.R. 261, 265 (Bankr. D. Colo. 1992).

Specifically, the authority did not show that it was unable to collect the defaulted rent payments that it was owed, and it had sufficient reserve funds to make the payment.[323]

In *In re City of Stockton*, the bankruptcy court considered the debtor municipality's failure to go to voters with tax increases under a creditor's insolvency objection rather than a bad faith objection.[324] The court found that Stockton was service delivery insolvent, and that while cash insolvency is the controlling Chapter 9 criterion for insolvency, the "degree of inability to fund essential government services" is relevant to the assessment of degree and duration of that insolvency, and evidence that the insolvency is not of a "mere technical insolvency."[325] The court held that failure to place a tax increase on the ballot is not persuasive of solvency, noting, "[p]utting the fiscal house in order so that voters might be willing to entertain tax increases is the whole point of chapter 9."[326]

Boise County's bankruptcy petition, a one-time event bankruptcy caused by an adverse tort judgment,[327] was dismissed because the bankruptcy court held that Boise had not established insolvency per § 101(32)(C)(ii).[328] Boise conceded that it was paying all debts as they became due,[329] but filed a Chapter 9 petition when it became fearful that the tort creditor would execute on the county's accounts and thus interfere with county operations.[330] The petition listed assets of $27.7 million and liabilities of $7.3 million, including the judgment and litigation fees.[331] Boise County had $2.05 million in unrestricted "trust accounts" and nearly $10 million in cash and investments in a series of restricted accounts.[332]

Further, while Idaho law generally prohibited expenditures exceeding the adopted budget, it allowed Boise to issue registered warrants paid by tax increases to "meet mandatory expenditures required by law."[333] The court held that among the unrestricted trust accounts, the surplus restricted accounts, and the ability to issue warrants, that Boise had sufficient funds to pay the judgment, and had not established insolvency under § 101(32)(C)(ii).[334]

These examples demonstrate that the courts take a fact intensive approach when determining what role the utilization of nonessential and potential assets should play in the insolvency calculation. Thus, because

323. *See id.*

324. *In re* City of Stockton, 493 B.R. 772, 790 (Bankr. E.D. Cal. 2013). The court noted the state law constraints on raising taxes (Proposition 13) requires voters to approve any tax increase and also caps that increase. *Id.*

325. *Id.* at 789, 791.

326. *Id.* at 790.

327. *In re* Boise Cnty., 465 B.R. 156, 161 (Bankr. D. Idaho 2011).

328. *See id.* at 180.

329. *See id.* at 171.

330. *See id.*

331. *Id.*

332. *Id.* at 164. The court also found that the county had not established that surplus funds in the restricted accounts were inaccessible. *See id.* at 180.

333. *Id.* at 173, 178–79 (emphasis removed).

334. *Id.* at 180.

compelled utilization of certain assets may be precluded by statutory law and insolvency results are largely fact dependent, a municipality's good faith plays an important role in bankruptcy eligibility and plan confirmation.

D. Good Faith

Chapter 9 requires good faith at both the petition phase and the confirmation phase. The Bankruptcy Code requires that a municipality's petition be submitted in good faith or the court may dismiss the petition altogether.[335] The purpose of the statutory good faith requirement is to prevent manipulation and abuse of the process.[336] However, courts have interpreted this power to be permissive, not mandatory, providing the court with a great deal of discretion as the gatekeeper for Chapter 9 proceedings.[337] Congress, in both the enacted statute and the legislative history, was silent on the definition of good faith, leaving the meaning of good faith in this context to be interpreted by the courts.[338] Courts have interpreted the good faith requirement to "preserve the protection of the Code for those which it was actually intended,"[339] and accordingly have developed a series of factors that may be considered in the good faith analysis.[340]

In *New York City Off-Track Betting Corp.*,[341] the court applied a series of factors derived from Collier on Bankruptcy to analyze a municipality's good faith, including: a municipality's subjective beliefs; the scope and nature of municipality's financial distress; the ability to address the municipality's financial distress under Chapter 9; the municipality's motivation for filing Chapter 9; the municipality's pre-petition negotiations with creditors; and alternatives to Chapter 9.[342] The court also looked to Chapter 11 appellate precedent to determine factors that indicate bad faith.[343] Courts in other circuits also utilize Chapter 11 appellate precedent

335. *See supra* note 194.

336. *In re* City of Detroit, 504 B.R. 97, 180 (Bankr. E.D. Mich. 2013).

337. *See In re* Sullivan Cty. Reg'l Refuse Disposal Dist., 165 B.R. 60, 79–80 (Bankr. D.N.H. 1994).

338. Vazquez, *supra* note 161, at *10 (citing *Sullivan Cty. Reg'l Refuse Disposal Dist.*, 165 B.R. at 80).

339. *See id*.

340. *See In re* N.Y.C. Off-Track Betting Corp., 427 B.R. 256, 279 (Bankr. S.D.N.Y. 2010).

341. *Id.*

342. *Id.*

343. *See id.* In a Chapter 11 filing, the Second Circuit bad faith analysis identifies eight factors that are "indicative of a bad faith filing," including: (1) debtor only has one asset; (2) debtor has only few unsecured creditors and unsecured claims are disproportionately small compared to secured claims; (3) debtor's one asset is subject to a foreclosure action resulting from default or late payment; (4) debtor's financial condition is essentially a two-party dispute that could be resolved in state foreclosure action; (5) timing of debtor's filing is evidence of intent to delay or frustrate secured creditors' legitimate enforcement rights; (6) debtor has negligible or nonexistent cash flow; (7) debtor cannot pay current expenses including personal property payments and real estate taxes; and (8) debtor does not have employees. *Id.*

for good faith analysis, including the Ninth Circuit which employs a "'totality-of-the-circumstances' analysis," and "determine[s] a debtor's good faith on a case-by case basis, taking into account the particular features of each plan."[344]

1. Good Faith at the Petition Phase

Courts have rejected municipal bankruptcy filings at the petition phase on the grounds of bad faith. In *In re Sullivan County Regional Refuse Disposal District*, the municipal debtors owed payments to a private incinerator stemming from a joint venture agreement between the municipality and the private facility operator.[345] The debtors did not attempt to exercise their pre-bankruptcy assessment powers to require their constituents to meet the burgeoning debt.[346] The bankruptcy court noted that the "hurdles to Chapter 9 were undoubtedly designed to prevent [] 'capricious filing,'" and held that municipalities petitioning for Chapter 9 must, at a minimum, demonstrate that they used their taxing and assessment powers to a "reasonable extent, or in their pre-petition negotiations have committed to the use of those powers as part of a comprehensive and appropriate work out of their financial problems."[347]

Other bankruptcy courts have declined to invoke this type of mandate. In *In re McCurtain Municipal Authority*,[348] the debtor, a water service provider in a small rural town, owed the contractor of its waste water system monies from a state court judgment regarding disputed payments at the end of the construction contract.[349] The debtor's Chapter 9 petition was challenged by the creditor on grounds that the debtor had unrestricted cash and grant money, and had failed to assess citizens or impose higher rates even though it had the authority to do so.[350] The court found that the failure to exercise that authority did not necessarily indicate bad faith, relying on evidence that rates were higher than in surrounding areas and that the area was low-income, and thus it was unlikely that imposing higher rates would have generated sufficient funds to cover the debt.[351]

In *Detroit*'s petition phase, creditors challenged the filing on the grounds that the city did not act in good faith.[352] Objectors argued that Detroit's filing was a culmination of city and state efforts to impair pension rights through a bankruptcy filing, by reducing state revenue sharing, suppressing

344. Westamerica Bank v. Mendocino Coast Recreation & Park Dist. (*In re* Mendocino Coast Recreation & Park Dist.), No. 12-02591, 2013 WL 5423788, at *7 (N.D. Cal. Sept. 27, 2013) (citing *In re* Sylmar Plaza, L.P., 314 F.3d 1070, 1075 (9th Cir. 2002) (internal quotation marks omitted)).

345. *See In re* Sullivan Cnty. Reg'l Refuse Disposal Dist., 165 B.R. 60, 63 (Bankr. D.N.H. 1994).

346. *See id.* at 82.

347. *Id.* at 82–83.

348. No. 07-80363, 2007 WL 4287604 (Bankr. E.D. Okla. Dec. 4, 2007).

349. *See id.* at *1.

350. *See id.* at *5.

351. *See id.* at *6.

352. *See In re* City of Detroit, 504 B.R. 97, 181 (Bankr. E.D. Mich. 2013).

information about the city's valuable assets, and concealing the objective of state laws passed shortly prior to the bankruptcy petition.[353] The court acknowledged that "many people in Detroit hold to this narrative," and noted that some evidence that supported this view, including a pitch from a leading law firm on a roadmap to Chapter 9.[354] The pitch included the idea of "establishing a good faith record of negotiations," using an emergency manager for "political cover," and warning against pre-petition asset monetization to insure insolvency.[355]

The court ultimately held that Detroit's filing was in good faith, noting that the financial problems are the "type contemplated for chapter 9 relief," the reasons are consistent with the purpose of Chapter 9, the city made efforts to improve its finances, and city residents would be severely prejudiced if the case was dismissed.[356] The court noted that of paramount importance was that the residents would be "severely prejudiced," while referencing the fact that the city's accelerating debt service obligations would utilize 65 percent of the city's budget by 2017.[357]

2. Good Faith at the Confirmation Phase

Good faith issues also arise at the confirmation stage.[358] Section 1129 requires that for confirmation of a plan, the plan must have "been proposed in good faith and not by any means forbidden by law."[359] Section 1129(b)(2) requires that a plan be "fair and equitable" with respect to each class of creditors.[360] Thus, good faith is implicated when reviewing an adjustment plan for unfair discrimination that arises when "providing materially disparate treatment to two classes of bonds having substantially similar legal rights."[361]

In *In re Mount Carbon Metropolitan District*,[362] the court held that the debt adjustment plan was not proposed in good faith, where the plan ignored the municipality's current and future obligation to provide public services to its constituents.[363] The debt adjustment plan had included full payment over forty years, but had effectively transferred the municipality's taxing powers to a landowner, which "unfairly favored" itself and disadvantaged the others, and thus the plan fell "outside the policy and purpose of Chapter 9."[364]

353. *See id.* at 182.
354. *See id.* at 184.
355. *See id.*
356. *Id.* at 187.
357. *See id.* at 188–89.
358. *See In re* Mount Carbon Metro. Dist., 242 B.R. 18, 39 (Bankr. D. Colo. 1999).
359. 11 U.S.C. § 1129(a)(3) (2012).
360. *Id.* § 1129(b)(2).
361. Gary M. Kaplan, *Understanding the Chapter 9 Process and Strategies for Representing Creditors and Other Key Constituents in a Municipal Bankruptcy Case*, *in* REPRESENTING CREDITORS, *supra* note 99, *available at* 2014 WL 4785316, at *5.
362. 242 B.R. 18 (Bankr. D. Colo. 1999).
363. *See id.* at 41.
364. *Id.*

While not couched in terms of "good faith" per se, the court in *Stockton* reviewed the confirmation plan for unfair discrimination between creditor classes.[365] The bankruptcy judge confirmed Stockton's plan to exit bankruptcy.[366] Stockton, as with all municipalities that reorganized in Chapter 9, had a significant amount of control over the proposed debt adjustment plan.[367] Stockton's proposal allocated to several bond creditors pennies on the dollar, while leaving the California Public Employees' Retirement System (CalPERS) contribution untouched.[368] Moody's Investor Service commented that Stockton's "[p]roposed recovery rates for lease revenue and other general-fund supported bonds range from [1 percent to 100 percent] . . . [and] [b]etween these two extremes, holders of pension obligation bonds, which are secured by a bare contractual repayment obligation, would see a 50 [percent] recovery."[369] Moody's noted that the exit plan proposal may "deviate from what the bankruptcy code provides for certain classes of debt."[370]

Creditors—including two Franklin Municipal Bond Mutual Funds ("Franklin")—argued that the city failed to provide Franklin a reasonable recovery, focusing on, among other things, the city's refusal to confront pension obligation issues.[371] Franklin argued that Stockton lacked good faith as the plan provided combined recoveries of over 70 percent to retirees while proposing that Franklin receive one quarter of one percent.[372] Further, Franklin argued that the exit plan unfairly discriminated by providing similarly situated unsecured creditors with disproportionate recoveries.[373]

Franklin noted that in the pre-bankruptcy neutral evaluation, the city proposed to use public facility fees (PFFs) to pay off 54.5 percent of the Franklin debt.[374] At that time, the city apparently recognized that its failure to maximize available PFFs for Franklin would be "a sign of bad faith."[375] Franklin also argued that Stockton's "wholesale assumption of its single

365. *See* Walsh, *supra* note 132.
366. *See id.*
367. *See supra* note 196 and accompanying text.
368. *See* Walsh, *supra* note 132. Previously, the court had ruled that Stockton would have been free to modify its contract with CalPERs, holding that CalPERs would be classified as a mere unsecured creditor. *See id.* Stockton argued that if pensions were cut, workers—and particularly the police—would exit the force in search of similar pensions in adjacent cities. *See* Alison Vekshin & Michael Bathon, *Stockton's Costly Bankruptcy May Not Tempt Other Cities*, BLOOMBERG (Oct. 31, 2014, 12:01 AM), http://www.bloomberg.com/news/articles/2014-10-31/stockton-s-costly-bankruptcy-may-not-tempt-other-cities.
369. *See* Summary Objection of Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Mutual Fund to Confirmation of First Amended Plan of Adjustment of Debts of the City of Stockton, Cal., *In re* City of Stockton, No. 12-cv-32118, at 48 (E.D. Cal. May 12, 2014) (citing MOODY'S INVESTOR SERV., *supra* note 251, at 15).
370. *Id.* at 48.
371. *Id.* at 2.
372. *See id.* at 4.
373. *See id.* at 3.
374. *See id.* at 23.
375. *See id.* at 53.

largest liability—unfunded pensions—further evidence[d] that the Plan lack[ed] the good faith basis necessary for confirmation."[376] Franklin noted that, if the city was truly interested in "treat[ing] all interested parties fairly" and "provid[ing] creditors the potential for the greatest economic return from its assets," it would have addressed its pension problem.[377]

Finally, Franklin contended that the city disregarded Vallejo's bankruptcy confirmation—another town on the San Francisco Bay—where long-term obligations were not sufficiently modified to reduce fiscal imbalance.[378] The *Stockton* court approved Stockton's plan, with the judge stating, "I've looked long and hard at this case and the responses that have been made, including the alternative of putting the whole situation back to Square 1, which is what would be required" if he rejected Stockton's plan.[379] In his ruling, the judge noted that some concessions were made with respect to legacy benefits, including the cancellation of the retiree health plan.[380]

In Detroit's adjustment plan, the city, the state, and certain creditors negotiated a "Grand Bargain"—an agreement that raises approximately $816 million over twenty years from foundations, the DIA, and the State of Michigan.[381] The Grand Bargain allocates the funds towards Detroit's pension obligations and transfers ownership of the DIA to an independent nonprofit.[382] The agreement was contingent on votes from pensioners and

376. *Id.* at 54.

377. *See id.* Franklin also argued that, like pensioners, many of the fund's holders are retirees that rely on Franklin funds for income. *See id.* at 57.

378. *See id.* at 56. Recent press accounts speculate that Vallejo risks entering "Chapter 18"—a euphemistic expression for entering Chapter 9 a second time—because of current budget difficulties. *Id.* Moody's reported that "Vallejo substantially restructured its compensation structure, including significant cuts to retiree health care benefits, but by failing to address its pension liabilities it remains vulnerable to increasing annual payments." *Moody's: Bankrupt California Cities Face Steep Climb to Solvency Without Pension Relief*, MOODY'S INVESTORS SERV. (Feb. 20, 2014), https://www.moodys.com/research/Moodys-Bankrupt-California-cities-face-steep-climb-to-solvency-without--PR_293349. However, Vallejo's city finance officer stated, "We are not on the brink of [a second] bankruptcy . . . [w]e are not going there," concurring with the Mayor Davis who opined, "'We are doing everything we can to try to make the ends meet,' Davis said, 'It's going to be a tough struggle, but I'm sure we will get there.'" Ed Mendel, *Vallejo Bankrupt Again? "We Are Not Going There,"* PUBLICCEO (Mar. 17, 2014), http://www.publicceo.com/2014/03/vallejo-bankrupt-again-we-are-not-going-there/.

379. *See* Walsh, *supra* note 132. Until 2008, Stockton had promised every city worker and their dependents free retirement health care but had not set aside any money to fund the health benefits. *See id.*

380. *See id.* CalPERs had argued that Stockton's termination of the plan would trigger a $1.6 billion fee, equal to the sum of all current and future obligations. The judge ruled that federal law preempted state law, and once Stockton petitioned for bankruptcy, it was able to modify its contract with CalPERs, subject to conformance with the requirements of the Bankruptcy Code. *See id.*

381. Mark Stryker, *Detroit Museum Announces $26.8 Million in Gifts*, DETROIT FREE PRESS (July 16, 2014), http://archive.freep.com/article/20140716/ENT05/307160042/detroit-institute-of-arts-grand-bargain-gilbert.

382. *See id.*

other creditors,[383] and on July 11, 2014, the pensioner classes voted yes, while the secured and unsecured creditors voted no.[384]

The largest opponents of the Grand Bargain were bond insurers, including FGIC and Syncora, which control $1.4 billion in pension certificate debt.[385] The creditors challenged, among other things, that the plan was not "legal, fair and feasible," in that it unfairly discriminated against the bond creditors in favor of the pension creditors.[386] Eventually, Syncora agreed on a settlement that included $25 million, a thirty-year parking garage lease, and other benefits.[387] After a series of court-mandated mediation sessions, FGIC agreed to settle for 13 cents on the dollar and the rights to develop a new mixed-use complex in downtown Detroit.[388] Two other dissenting classes, including civil claimants and rejected contract and lease claims, opposed confirmation to the end.[389]

In November 2014, Judge Rhodes ruled on the adjustment plan, noting that "whether discrimination is unfair turns on 'matters of conscience,' informed by factors such as the [congressional] purpose of municipal bankruptcy and the judge's 'experience, education and sense of morality.'"[390] The judge stated that the city's treatment of the pension claimants "demonstrated a substantial mission-related justification" by attempting to preserve relationships with employees and maintain their motivation.[391] With respect to the dissenting classes, Judge Rhodes found no similar justification.[392] The court concluded that if each settlement within a plan is reasonable, "then the resulting discrimination in the plan must be fair."[393]

Commentators worry that the "[unfair discrimination] test's reliance on settlement could write unfair discrimination out of the statute altogether."[394]

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383. Nathan Bomey & Matt Helms, *Detroit Pensioners Back Grand Bargain in Bankruptcy Vote, Creditors Object*, DETROIT FREE PRESS (July 22, 2014, 12:47 AM), http://archive.freep.com/article/20140721/NEWS01/307210176/Detroit-bankruptcy-pension-grand-bargain-vote.

384. *See id.*

385. *See id.*

386. *Id.* The plan proposed a negligible recovery for bondholders while providing a 60 percent combined recovery for unsecured pension creditors.

387. Joe Guillen, *Bankruptcy Trial Resumes As Creditors Make Their Case*, DETROIT FREE PRESS (Oct. 14, 2014, 6:01 AM), http://www.freep.com/story/news/local/detroit-bankruptcy/2014/10/14/bankruptcy-trial-resumes/17217977/.

388. Joe Guillen, *Detroit Council OKs FGIC Bankruptcy Settlement*, DETROIT FREE PRESS (Oct. 23, 2014, 5:29 PM), http://www.freep.com/story/news/local/michigan/detroit/2014/10/23/council-approves-fgic/17789601/.

389. Melissa Jacoby, *Detroit's Bankruptcy: End(s) and Means*, CREDIT SLIPS (Nov. 10, 2014, 9:09 AM), http://www.creditslips.org/creditslips/2014/11/detroits-restructuring-ends-and-means.html#more.

390. *Id.*

391. *See* Oral Opinion on the Record at 30, *In re* City of Detroit, No. 13-53846 (Bankr. E.D. Mich. Nov. 7, 2014) [hereinafter Detroit Oral Opinion], *available at* http://www.mieb.uscourts.gov/sites/default/files/notices/Oral_Opinion_on_Detroit_Plan_Confirmation_Judge_Rhodes_FINAL_for_Release.pdf.

392. *See* Jacoby, *supra* note 389.

393. Detroit Oral Opinion, *supra* note 391, at 32.

394. *See* Jacoby, *supra* note 389.

Further, with the focus on accepting classes rather than dissenting classes, it is easy to apply, but if one focuses on involuntary creditors—those with tort or civil rights claims—it is more difficult to understand what their "reasonable expectations" were.[395]

E. The Problem with the Current Structure for Both Debtors and Creditors

The uncertainties in municipality treatment, asset usage, insolvency calculations, and the method in which good faith is applied to analyze the proceedings cause problems for both debtors and creditors. For municipal debtors, increased borrowing costs, contagion issues, and uncertain eligibility for relief are detrimental.

Creditors have limited recourse once the petition is accepted, as the municipality can spend and borrow without court approval while not being subject to the reporting or other general duties of the Chapter 11 debtor.[396] A municipality is able to propose and bind all creditors to a confirmed plan, while avoiding "preferences, fraudulent conveyances and other transfers."[397] With uncertain treatment on a case-by-case basis, there is additional room to clarify the application of Chapter 9 by differentiating between one-time event and structurally imbalanced bankruptcies.

III. CLARIFYING CHAPTER 9

Part III proposes a new multipart test for analyzing whether a municipality meets the statutory conditions required for Chapter 9 municipal bankruptcy. The test entails four factors to apply to the two main types of municipal bankruptcy: one-time events and significant long-term structural imbalance bankruptcy. One time bankruptcies, including *Ellicott School District*, *Pierce County Housing Authority*, *Sullivan County Regional Refuse*, *Jefferson County*, *Orange County*, and *Boise County*, should be analyzed under a different framework than *Detroit*, *Stockton*, and *Vallejo*—their structural imbalance counterparts. The four factors weigh (1) whether the petition is prospective or current; (2) whether creditors had notice of specific authorization; (3) whether the debtor utilized available assets pre-petition; and (4) whether the debtor acted in good faith. Good faith has two related prongs, the good faith of the debtor at the petition phase and maintenance of that good faith in the confirmation phase. Part III evaluates how the four factors apply in the context of a one-time event bankruptcy and a structurally imbalanced bankruptcy.

A. The "Municipality" and "Eligibility" Certainty Factor

The first factor that bankruptcy courts always have to consider is whether the entity is a municipality that is specifically authorized for Chapter 9 bankruptcy.[398] This factor is most relevant in the context of a one-time

395. *See id.*
396. *See supra* note 207 and accompanying text.
397. *In re* Richmond Unified Sch. Dist., 133 B.R. 221, 224 (Bankr. N.D. Cal. 1991).
398. *See supra* note 189 and accompanying text.

event bankruptcy. One-time event bankruptcies generally run the entire gamut of cities, counties, and towns all the way to infrastructure entities, hospitals, and housing authorities.[399] For special purpose municipalities—infrastructure entities, hospitals, and housing authorities—it is often more questionable whether the entity is a municipality for the purposes of Chapter 9.[400] Uncertainty as to whether an entity is a municipality further increases uncertainty as to whether that entity will be specifically authorized to utilize Chapter 9. When evaluating a bankruptcy petition and confirmation plan in a one-time event bankruptcy, courts should consider whether the state specifically authorized Chapter 9 for all municipalities, whether that authorization was contingent on additional state action, and the timing of authorization, i.e., whether the state authorized the Chapter 9 petition right before the filing without previously authorizing Chapter 9 filings in any capacity.[401] The less notice the creditor had with respect to the ability for a municipality to utilize Chapter 9, the more critically the court should examine whether the municipality acted in good faith in the petition and confirmation stage.

Structurally imbalanced municipalities are generally cities or counties, and thus there is more certainty that the entity qualifies as a municipality for Chapter 9. The court can immediately move to evaluate the level of notice that a state's laws provided creditors. As with one-time event bankruptcies, the less notice of Chapter 9 eligibility a creditor has, the more critically the bankruptcy court should review whether the municipality acted in good faith in the petition and at the confirmation stage.

Finally, Congress could consider adding a requirement that states identify whether an entity is a municipality specifically authorized for Chapter 9 prior to a certain date. A statute requiring states to classify their municipalities prior to a certain date would likely be upheld if challenged under the Tenth Amendment. The state retains complete control over the authorization decision, and the state could still revoke the authorization at any time, which is likely beneficial from a creditor's standpoint. While a congressional mandate would impose initial compliance costs for states, this mechanism would provide municipalities and creditors with clarity regarding an entity's Chapter 9 eligibility.

B. The Insolvency Factors

Calculating insolvency is of critical importance to Chapter 9. First, this section discusses current insolvency versus prospective insolvency and suggests that there are certain situations where courts should permit prospective insolvency petitions and other situations where the court likely should permit only current insolvency petitions. Next, this section suggests that utilization of nonessential assets and potential assets should be considered heavily in one-time event bankruptcies. Lastly, it argues that

399. *See supra* Part I.A.
400. *See supra* Part I.A.2.
401. *See supra* notes 260–62.

utilization of potential assets is less important in structurally imbalanced bankruptcies, and that utilization of nonessential assets should be considered in the insolvency calculation if those assets can overcome a substantial portion of the structural imbalance.

1. Current Insolvency, Prospective Insolvency, or Both?

In a one-time event bankruptcy, the debts of an entity are generally known and the real question is how to measure the assets and project future cash flows. In *Boise County*, the court evaluated Boise's assets and its ability to issue warrants for future payment in relation to the adverse judgment, and calculated that Boise had not established insolvency.[402] In *Ellicott*, the court found that the school building authority had alternative sources to successfully make its debt payments, including reserve fund assets and a defaulted rent payment.[403] In *Pierce County Housing Authority*, the court noted that nearly all the assets of the authority were subject to liens and thus it could not monetize its assets to avoid insolvency, and therefore was insolvent.[404]

In a one-time event bankruptcy, current insolvency should be favored. As the debt is relatively quantifiable in these bankruptcies, particularly those caused by an adverse judgment or a bad contract, the municipality should be able to show that it is currently insolvent to receive relief. If a municipality in a one-time event bankruptcy attempted to show prospective insolvency instead of current insolvency, the court should be wary of the petition. Otherwise, a financially sound entity may be able to simply project future insolvency to discharge debt, without making sufficient effort to avoid the petition. Of course, a municipality making these projections still would have to show that they negotiated in good faith and desired to effect a plan to adjust its debts pursuant to § 109(4),[405] but it is difficult to demonstrate that prospective estimates are incorrect.

Given the uncertainty of future projections, for one-time events, prospective insolvency should be considered as a significant negative against a one-time petition. Even in the event where a municipality could argue that it does not know the extent of the problem, like the *Jefferson County* fraud,[406] it is better for the municipality to understand the fraud pre-petition. However, if a municipality has debts that are accelerating and still uncertain—similar to *Orange County*, where losses resulted from bad investments and swaps—unless the losses can be stopped by opting out of the investment or swap, that situation should be treated more prospectively with respect to insolvency.

In a structurally imbalanced bankruptcy, the insolvency determination can be weighted less heavily, as other factors, such as good faith, should be

402. *See supra* note 334 and accompanying text.
403. *See In re* Ellicott Sch. Bldg. Auth., 150 B.R. 261, 265 (Bankr. D. Colo. 1992).
404. *See supra* note 312 and accompanying text.
405. *See supra* notes 190–91 and accompanying text.
406. *See supra* note 122 and accompanying text.

allocated a higher weight. If a structurally imbalanced municipality is currently insolvent, then insolvency is satisfied unless the calculation is manipulated or assets are shielded—which would implicate good faith and asset valuation respectively. If a structurally imbalanced municipality under severe financial stress files a prospective insolvency petition, it is likely simply a question of the date of the future insolvency, because the structural imbalance has already manifested itself over a lengthy period of time. In the structurally imbalanced prospective insolvency case, the court should treat the projections less strictly, as the city will continue to hemorrhage funds and dissipate assets if by technicality it is prevented from utilizing Chapter 9.

2. Asset Valuation in One-Time Event Bankruptcies

Asset valuation and use in one-time event bankruptcies is another important consideration for the bankruptcy court. While § 904 prevents bankruptcy courts from interfering with the debtor's property or revenues, or the use or enjoyment of any income-producing property,[407] it does not prevent a bankruptcy court from evaluating a municipality's good faith utilization of an asset. Assets can be considered essential, nonessential, and potential.

This Note previously defined essential assets as assets that are used to provide services to residents, including government buildings, vehicles, supplies, and infrastructure systems, as well as land generally.[408] Land is included as essential because it is specifically what Congress was protecting when it included § 904.[409] In response to the Supreme Court's *Ashton* ruling, where the Court expressed worry that a state may be "no longer free to manage their own affairs,"[410] Congress enacted § 904 to protect "property." When Congress instituted the Bankruptcy Code in the 1930s, many municipalities in consideration were municipalities making large infrastructure investments. *Ashton*, for example, concerned the Cameron County Water Improvement District.[411] *Bekins*, the case that affirmed the constitutionality of Chapter 9 bankruptcy, concerned an irrigation district.[412] Both precedent-setting cases focused on municipalities that were financing the expansion of essential assets to provide services to residents. Thus, essential assets generally should not be considered in the Chapter 9 analysis.

Nonessential assets were likely not contemplated as heavily, if at all, by Congress. This Note previously defined nonessential assets as assets that are not critical for a municipality to provide public services, and it identified examples of nonessential assets as art, equivalent monetary instruments, mineral reserves, and seized, abandoned, or unused

407. *See* 11 U.S.C. § 904 (2012).
408. *See supra* note 70 and accompanying text.
409. *See supra* notes 166–72 and accompanying text.
410. *See supra* note 165.
411. *See id.*
412. *See* United States v. Bekins, 304 U.S. 27, 45 (1938).

property.[413] The bankruptcy court should consider nonessential assets in the context of the insolvency and good faith analyses. It seems fair to consider valuable mineral reserves beneath municipal lands if the extraction of these assets could be completed in an environmentally neutral way. For example, if the municipality is fortuitously located above precious metal reserves in an unutilized section of the municipality, it would likely be unfair to shield these assets from consideration in the insolvency and good faith analyses. Of course, arguments for monetization of mineral reserves should not be extended to argue for applications like logging or stripping top-soil, because these applications likely interfere too much with a municipality's property.

Fairness seems to dictate that seized property should be considered in the insolvency and good faith analyses. Because a municipality generally seizes private property resulting from failure to pay monetary taxes, the seized property should be included in insolvency calculation and in the good faith plan confirmation analysis. Similarly, abandoned and unused property should be considered, particularly where the property served no public use other than in service delivery and no future public use was planned. For example, if a municipal property used to serve as an equipment lot and maintenance depot, but has been abandoned by a municipality, this type of property should be considered. Park land, on the other hand, serves a public use and generally should not be considered in any insolvency or good faith analyses.

Art should be considered in a good faith analysis under certain circumstances. In the simplest case, where valuable art is not accessible to the public and is simply being held by the municipality, the asset likely should be included in the insolvency and good faith analyses. However, most valuable art falls into a trickier category where it is held in an art museum or otherwise available for the public. Art museums serve the public as attractions and also may generate visits to the municipality as a tourist attraction, thus operating as an indirect method[414] of revenue generation for a municipality. For example, the DIA had 594,000 unique visits, and Artvest's report compared the DIA to New York City's Metropolitan Museum of Art in terms of its status as a city attraction.[415] It is less clear under those circumstances whether the entirety of a collection should be monetized to pay creditors. But it is hard to imagine that selling, for example, three out of 65,000 pieces of art for $230 to $440 million would deplete the overall cultural significance of the museum.[416]

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413. *See supra* note 71 and accompanying text.

414. And, in some cases, a direct method if the museum is owned by the municipality and it is profitable.

415. *See* ARTVEST, *supra* note 297, at 40–41.

416. *See supra* note 292 and accompanying text. *The Wedding Dance*, *Self Portrait with Straw Hat*, and *The Visitation* represent between $230 and $440 million. Of course, in certain instances a museum has a famous anchor piece, like the *Mona Lisa* in the Louvre, that represents their collection and people travel in large numbers to view. In Detroit's case, the most significant works associated with the museum are likely the murals by Diego Rivera, commissioned by the city in the 1930s, that are designated as a national historic

Naturally, there is also tension between several of the sympathetic creditors, such as pensioners, when those classes receive reduced recoveries so that a $200 million painting can stay in an art museum.

Potential assets—such as taxes—should be considered strongly in one-time event bankruptcies in conjunction with the good faith analysis. With the sum certain shortfall, monetization of potential assets has the ability to alleviate the financial stress without creating a spiraling situation, where a tax increase is available to the municipality outside of bankruptcy. If the municipality did not pursue a reasonable potential tax increase to address the one-time stress, electing instead for bankruptcy, this may be treated as evidence that the municipality did not exhibit good faith.

3. Asset Valuation in Structurally Imbalanced Bankruptcies

In a structurally imbalanced bankruptcy, utilization of nonessential assets should be weighted highly, particularly if the nonessential assets are significant enough to fully remedy the financial situation. For example, if a county in Texas has $1 billion in unfunded liabilities and $5 billion in easily obtainable mineral assets, then the municipality's utilization of those assets should be considered by the court in the context of the insolvency and good faith analyses. However, if the nonessential assets cannot address the structural imbalance, then nonessential asset utilization need only to be considered in the good faith analysis at the confirmation stage. Finally, in a structurally imbalanced bankruptcy, if a municipality acquired nonessential assets using municipal funds, this would weigh toward finding that those specific assets should be utilized in the confirmation phase as evidence of good faith. For example, if a municipality acquired a Picasso for $100 million in 1990 using taxpayer money and desired to petition for Chapter 9 several years later, the court should at a minimum analyze the monetization of that nonessential asset in the context of good faith in the confirmation plan.

It is important to note that in both one-time event and structurally imbalanced bankruptcies, the utilization of nonessential assets should be analyzed with consideration to the liquidity of markets. The idea is that a municipality, when contemplating Chapter 9 or devising a confirmation plan, should, in certain situations, have its utilization of cash-convertible assets analyzed by the courts. This should not be extrapolated to require a municipality to monetize every nonessential asset regardless of whether there is a real market for that asset, nor is it an argument that a municipality should monetize the entirety of their libraries or historical societies. But when certain high value nonessential items are in the mix, a municipality's utilization of those assets should be considered as described above.

Potential assets should be given low weight in structural imbalance bankruptcy. In a structurally imbalanced bankruptcy, the short-fall is

landmark. *See* ARTVEST, *supra* note 297, at 20. In this case, particularly if the work is historically linked to the museum, the anchoring piece likely should be retained to maintain the city attraction.

accelerating and is not likely to be solved by raising taxes on the population. This likely should be the case where the municipality has poorer residents already subjected to significant taxes. An exception to potential asset utilization in structural imbalanced bankruptcies would be a municipality with a comparatively low tax rate, where the application of an average tax rate would solve the underlying structural imbalance.

C. The Funnel to the "Good Faith" Factor

Good faith is prevalent throughout the Chapter 9 process, from petition to confirmation, as a financially troubled municipality attempts to adjust its debts. However, bankruptcy courts' analyses of good faith sometimes fail to connect the dots, leading to questionable results that may have implications on future municipality and creditor behavior. In the petition phase, Collier's good faith factors provide helpful texture to analyze good faith.[417]

In one-time event bankruptcies, good faith tends to be highly important overall. It is also specifically significant in the utilization of nonessential and potential assets and in the calculation of insolvency. In a one-time event bankruptcy, the analysis is relatively straightforward when utilizing the Collier factors. As was evident in *Boise County*, the county was essentially solvent but was trying to dismiss a controversial judgment.[418] Boise attempted to demonstrate insolvency by showing that it was not paying debts as they became due, but the accounting utilized speculative debt and failed to account for surplus funds and its ability to use warrants to raise capital.[419] Applying the Collier factors, the scope and nature of the financial distress was a large, but not monumental, controversial judgment; alternatives existed outside of Chapter 9; and its motivation was possibly tainted. Similarly, in *In re Sullivan County Regional Refuse Disposal District*, the refusal to contemplate legal tax increases was evidence of bad faith.[420] Applying the Collier factors, alternatives existed outside of Chapter 9 and the financial distress was not extraordinarily deep. In one-time filings, the Collier factors can be applied in a straightforward manner at the petition phase.

In structurally imbalanced bankruptcies, the good faith analysis becomes more complicated, as there are typically more interested parties involved and rational recourse outside of Chapter 9 may be less likely. At the petition phase, a good faith challenge can apparently be rebuffed, as it was in *Detroit*, if the financial problems are the "type contemplated for Chapter 9 relief," the reasons are consistent with the purpose of Chapter 9, the city made efforts to improve its finances, and city residents would be severely

417. *See supra* note 342 and accompanying text.

418. *See* Eileen Norcross, *Boise County, Idaho files for Bankruptcy*, MERCATUS CTR. AT GEORGE MASON UNIV. (Mar. 4, 2011), http://neighborhoodeffects.mercatus.org/2011/03/04/boise-county-idaho-files-for-bankruptcy/.

419. *See supra* notes 328–34 and accompanying text.

420. *See supra* note 345.

prejudiced if the case was dismissed.[421] The *Detroit* court acknowledged that some evidence that supported a lack of good faith, but noted that the fact that residents would face "severe prejudice" weighed heavily toward finding good faith.[422] If a petition, like Detroit's, is described by the judge as a "foregone conclusion,"[423] then the good faith at the petition phase is not being given much weight in current practice. Further, in Detroit, the judge found that the city did not meet the § 109(d)(2) "good faith" negotiations test, but alternatively that the city satisfied the § 109(d)(3) test that negotiations were impracticable.[424]

If a municipality has not advanced a plan to adjust its debts prior to the bankruptcy petition, and a creditor's pre-petition good faith challenge is easily overcome in a structurally imbalanced bankruptcy, then good faith at the confirmation phase becomes even more paramount. Further, after the initial eligibility determination, debtors have a significant amount of leeway in the details of the plan and the treatment of each creditor class.[425] The Code requires that the bankruptcy court confirm the debt adjustment plan only if "the plan has been proposed in good faith."[426]

The application of good faith at the confirmation stage is erratic, as plans tend to favor certain unsecured creditors over others. Favored treatment may result from political pressure from constituents that may be voters, taxpayers, and pension recipients at the same time, or simply sympathy for the "plight of pensioners who are part of the local community."[427] This, "[c]oupled with the dynamics of voter and tax-payer constituency," may cause municipal managers and elected officials to exhibit bias toward those constituencies as opposed to the "faceless" bondholders.[428] For example, Detroit's confirmation plan initially proposed less than a 10 percent recovery for unsecured bondholders while providing a 60 percent combined recovery for unsecured pension creditors.[429] Similarly, Stockton's proposal allocated several bond creditors pennies on the dollar, while leaving Stockton's pension payments untouched. Creditors in both *Stockton* and *Detroit* challenged the plan on the grounds of "unfair discrimination," arguing that the debt adjustment plans provided materially disparate treatment to two classes of bonds having substantially similar legal rights. On its face, this appears to run afoul of the § 1129(b)(2) requirement that no unsecured junior creditors receive or retains any property before senior creditors are paid and also appears to "unfairly discriminate" between certain classes of unsecured creditors. But case law has permitted this, yielding to the realities of complex municipal situations and recognizing that not every creditor situation is created equally. Thus, a careful, non-

421. *See supra* notes 354–56 and accompanying text.
422. *See supra* note 357.
423. *See In re* City of Detroit, 504 B.R. 97, 186 (Bankr. E.D. Mich. 2013).
424. *See id.* at 177–79.
425. *See supra* note 196 and accompanying text.
426. *See supra* note 359 and accompanying text.
427. Bender, *supra* note 101, at *8.
428. Heck, *supra* note 157, at 97.
429. *See supra* note 386.

biased good faith analysis is paramount to achieving a fair result for the municipality and its varying creditors.

A good faith analysis in a structurally imbalanced bankruptcy naturally has many levels of texture to consider. For example, if a municipality is financially undermined by a complex derivative structure that it entered into in good faith, a smaller recovery for the derivative holder as compared to pensioners may make sense in the good faith context. However, if the municipality was significantly damaged by promising overly generous deferred compensation plans to city employees, and in bankruptcy chooses not to modify their unsecured debt while providing less than ten percent recovery to bondholders, would generally indicate bad faith on two fronts. First, choosing not to modify one of the main forcing functions of the filing in the first place, particularly when that unfunded liability will grow post-confirmation, seems to indicate a lack of good faith. After all, the bankruptcy court is not only required to find that the bankruptcy does not unfairly discriminate at the confirmation stage, but also has to find that it desires to effect a plan to adjust its debts. And if the debt adjustment plan does not appear to solve the fundamental issues, questions arise as to whether the municipality desired to effect a plan to adjust its debts in the first place.

This situation seems analogous to Stockton, where the average firefighter cost to Stockton was $157,000 a year in pay and benefits, with the ability to retire at age 50.[430] Typical pension benefits in Stockton were 90 percent of an employee's highest yearly salary plus nearly free lifetime health benefits.[431] With $800 million in unfunded liabilities and only $300 million in general fund–backed debt, the unfunded legacy liabilities are 2.6 times greater than the general fund debt, and that ratio would continue to climb without modification because of increasing legacy costs, whereas some other capital expenses can be deferred.

Stockton's situation can be contrasted with Providence, Rhode Island, for example, which was able to avoid bankruptcy in a situation where it faced a $30 million annual structural deficit combined with $900 million in unfunded pension liabilities.[432] Providence's city council voted to cap pension benefits at 150 percent of median household income and suspend yearly cost-of-living benefit adjustments.[433] The state legislature implemented this measure because it was worried about contagion effects in other municipalities within the state. A previous bankruptcy filing, the 2010 Central Falls, Rhode Island petition operated as a backdrop to the Providence bankruptcy avoidance. Central Falls, a city of 19,000 residents, had $80 million in unfunded liabilities due to population reduction,

430. *See Down and Out in Stockton*, WALL ST. J., June 28, 2012, at A16.
431. *See id.*
432. *See id.*
433. *See id.*

recession impacts, and legacy benefits.[434] Prior to bankruptcy, the Rhode Island legislature provided a statutory lien to secure general obligation bonds to have priority in bankruptcy.[435] Rhode Island was concerned that if the bondholders were not paid the state municipal bond market would risk exhibiting a "contagion effect," and bondholders would be unwilling to invest without significant interest rate increases.[436] In the bankruptcy, the unsecured pension creditors took cuts up to 55 percent, with a minimum yearly floor, and general unsecured creditors will receive 45 percent maximum.[437] Pensioners agreed to the deal after the state agreed to augment their pensions for five years.[438]

A bankruptcy court could easily apply the type of common sense analysis used by the Rhode Island legislature to analyze good faith in the context of bankruptcy proceedings. In a situation where legacy benefits are a primary driver of insolvency, analyzing pension recoveries in the context of median municipality income provides context to whether the deferred benefits were overly generous and how much they can be modified without "severe prejudice" to those employees. Once compared to median income, the court can turn to the disparity of recovery percentages between the pensioners and the remaining unsecured creditors—including bondholders, trade, and tort creditors—to determine if the plan "unfairly discriminates."

To apply this concept, we can use Stockton and Detroit as examples. A city like Stockton is in contrast to Detroit, where the city arguably acted in good faith in the modification of pensions and health benefits. In Detroit, the average pension was not lavish, averaging approximately $19,000 per employee and $30,000 for its police and fire retirees, as compared to Detroit's median income of $24,820.[439] In Detroit, the sheer numbers of retirees and lack of pre-funding fueled the massive unfunded liabilities.[440] In contrast, Stockton's average benefits were median household income is $47,246,[441] while the typical police and fire retiree benefits cost the city approximately $141,000, nearly three times greater than the median household income. Evidence of disproportionate benefits to public employees combined with a plan's failure to address underlying structural

434. Dunstan Prial, *In Rhode Island Bankruptcy, Bondholders Came First*, FOXBUSINESS (July 24, 2013), http://www.foxbusiness.com/government/2013/07/24/in-rhode-island-bankrputcy-bondholders-came-first/.

435. *See id.*

436. *See id.* For every percentage increase on a thirty-year bond, the municipality will pay 30 percent more in interest expense over the life of the loan.

437. Steven Church & Steve Ludsin, *Central Falls, Rhode Island, Bankruptcy Exit Approved*, BLOOMBERG (Sept. 7, 2012), http://www.bloomberg.com/news/articles/2012-09-06/central-falls-rhode-island-bankruptcy-exit-approved.

438. *See id.*

439. *See* Christine MacDonald & Mike Martindale, *Michigan Incomes Rise for First Time Since 2007*, DETROIT NEWS (Sept. 18, 2014), http://www.detroitnews.com/story/news/local/michigan/2014/09/18/michigan-household-income-census/15814085/.

440. *See* Chad Halcom & Kirk Pinho, *Detroit Ch. 9 May Set Pension Precedent*, CRAIN'S DETROIT BUS. (Aug. 4, 2013), http://www.crainsdetroit.com/article/20130804/NEWS/308049961/detroit-ch-9-may-set-pension-precedent.

441. *See Stockton (City), California*, U.S. CENSUS BUREAU, http://quickfacts.census.gov/qfd/states/06/0675000.html (last visited Mar. 25, 2015).

problems while allocating pennies on the dollar to bondholders is the type of unfair discrimination that, in conjunction with the municipality's total control over the plan, seems to be indicative of a lack of good faith.

From a public policy perspective, adopting a system where disproportionate benefits bestowed from the public coffer are scrutinized heavily during a Chapter 9 proceeding will inform public employee bargaining in the future. This type of system will promote current compensation rather than deferred compensation. Of course, retirement and future health care could still be accommodated using a defined contribution rather than a defined benefit system, thereby reducing the risk of disproportionately large future payments and giving individuals more control over their benefits. Also, if a generous deferred compensation plan is negotiated with this type of legal precedent in place, sophisticated unions will be able to evaluate the credit risk of a municipality in the same way sophisticated bondholders evaluate credit risk, and courts can then reach fair and equitable outcomes that meet the expectations of all creditors.

CONCLUSION

Municipalities face financial pressures for many reasons, including but not limited to legacy pension and health care costs, deindustrialization, reduced tax revenue, and poor fiscal management.[442] Municipal debt is at record highs and funding levels among municipalities are unevenly distributed. With growing and concentrated financial pressures, municipal bankruptcies will continue to occur and likely will increase in size and frequency. Recent municipal bankruptcy decisions have led to questionable and inconsistent results, and the area is ripe for a refined method of analysis.

Analyzing municipal bankruptcy by categorizing the bankruptcy as a one-time event bankruptcy or a structurally imbalanced bankruptcy lends clarity to the analysis at both the petition and confirmation stage. In a one-time event bankruptcy, the court should place more weight on prospective versus current insolvency and it should be wary of any prospective insolvency one-time event petitions. Likewise, the pre-petition utilization of potential and nonessential assets should be weighted heavily in the current insolvency calculation, particularly if utilization could effectively remedy the financial crisis. Good faith at the petition and confirmation stage can be analyzed using the Collier factors for a one-time event bankruptcy.

In a structurally imbalanced bankruptcy, the court should be more inclined to permit prospective bankruptcy as long as the future projections have reasonable clarity. Nonessential and potential assets should be considered at the petition phase of a structurally imbalanced bankruptcy if utilization could completely remedy the problem, and utilization should be considered in the confirmation plan in the good faith context. Good faith should play an extremely important role in a structurally imbalanced

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

bankruptcy, particularly at the confirmation phase, and can be informed using common sense methods such as analyzing legacy benefits with respect to median income. The good faith analysis also should consider whether the municipality's debt adjustment plan will realistically solve the structural imbalance and lean against confirming a plan that may result in another future filing.

The factors addressed herein are intended to provide context to the analysis of Chapter 9 bankruptcy proceedings relating to the most frequent situations that arise. Grouping the bankruptcy situations into one-time event versus structurally imbalanced bankruptcies illuminates the critical issues that relate to insolvency, nonessential asset usage, specific authorization, and good faith. The test provides bankruptcy courts with an additional framework to consider as they exercise their judgment in Chapter 9 proceedings.