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## Governance Reform and the Judicial Role in Municipal Bankruptcy

**ABSTRACT.** Recent proceedings involving large municipalities such as Detroit, Stockton, and Vallejo illustrate both the utility and limitations of using the Bankruptcy Code to adjust municipal debt. In this Article, we contend that, to resolve fully the distress of a substantial city, municipal bankruptcy needs to provide more than simple debt reduction. Debt adjustment alone does nothing to remedy the fragmented decision making and incentives for expanding municipal budgets that are ingrained in municipal governance structures and that often underlie municipal distress. Unless bankruptcy also addresses governance dysfunction, the city faces a return to financial distress. Indeed, this Article demonstrates that governance restructuring has long been an essential element of corporate bankruptcy and that, given the monopoly position of local governments as providers of local public goods, it is even more important in the municipal bankruptcy context.

Some might argue that reducing a city's debt is the best that bankruptcy courts can offer, due to concerns that a more comprehensive approach would, among other things, interfere with state sovereignty and exceed the statutory authority that the Bankruptcy Code grants to courts. In our view, these concerns do not withstand scrutiny. Based on a careful analysis of the origins of the current municipal bankruptcy provisions, as well as an assessment of recent Supreme Court jurisprudence, we argue that governance reform is permitted even under existing law, and point out that minor adjustments to municipal bankruptcy law would make this conclusion even clearer. To be sure, the states themselves, rather than a bankruptcy court, ideally should be the ones to effect municipal governance reform. But political factors and the imperatives of the immediate fiscal crisis make state intervention unlikely, thus underscoring the need for a more comprehensive approach to municipal bankruptcy.

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**INTRODUCTION**

As an increasing number of municipalities take advantage of the ability to adjust their debts under Chapter 9 of the Bankruptcy Code, the utility and efficiency of that scheme has become more apparent.<sup>1</sup> Fears that Chapter 9 would be incapable of handling the fiscal distress of large cities have dissipated as bankruptcy courts have deftly managed the bankruptcies of Vallejo, San Bernardino, and Stockton, California; Jefferson County, Alabama; and Detroit, Michigan.<sup>2</sup> These episodes have revealed that bankruptcy courts can balance the interests of the various stakeholders—creditors, pensioners, the state, and residents—involved when municipalities face fiscal distress.

Less clear is whether the dexterity that bankruptcy courts display in adjusting municipal debts has lasting effects on municipal fiscal health. Courts tend to focus almost exclusively on the debt overhang problem—that is, on reducing the municipality’s debt burden to a level that permits a city to devote scarce resources to providing services rather than solely to paying creditors. To the extent that municipal distress results from a debt burden that stifles investment and diverts municipal budgets to legacy costs rather than future productivity, the ability to pare down a municipality’s debt may be sufficient.

But municipal distress—especially the distress of a substantial city—rarely is simply a matter of too much debt. Failed budget policies do not arise autonomously, disaggregated from the political environment in which they are devised. Rather, with the exception of cases in which municipalities face some exogenous shock, such as a crippling tort suit or natural disaster, or in which local governments suffer from broad economic disruptions beyond their control, local fiscal crises usually are caused by a governance structure that tolerates financial decisions in which the benefits and costs of public expenditures are misaligned. The disparity may be temporal. Local political officials concerned about electoral success or opportunities for higher office may favor programs that promise short-term benefits paid for through long-term costs. Alternatively, the mismatch may be spatial. Programs that produce highly concentrated benefits in some districts within the locality may be

1. For a thoughtful analysis of the details of the recent wave of municipal receiverships and bankruptcies, see Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1130–51 (2014).
2. For doubts about whether Chapter 9 would be adequate for the needs of large cities, see ROBIN JEWELER, CONG. RESEARCH SERV., RL33924, MUNICIPAL REORGANIZATION: CHAPTER 9 OF THE U.S. BANKRUPTCY CODE 1-2 (2007) (noting that the vast majority of Chapter 9 reorganizations are by small districts); Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 360–61 (2010) (describing Chapter 9 as “used by tiny municipalities under peculiar circumstances”).

financed by imposing costs on neighboring districts, with the result that the commons of the municipal budget faces overuse.<sup>3</sup> Or, officials may adopt policies that confer inefficient benefits on small, concentrated groups and discourage electoral redress by spreading the costs among the diffuse electorate.<sup>4</sup>

The institutions of local governance that permit these misalignments tend to be entrenched in city charters or bureaucratic regimes, and left unchallenged, they survive even after bankruptcy proceedings adjust the debts to which they have given rise. According to the conventional wisdom, Chapter 9 has little to say about these issues other than to preclude the bankruptcy court from usurping the political or governmental powers of the municipal debtor.<sup>5</sup> If the conventional wisdom is correct, Chapter 9 cannot meaningfully reduce the risk of recidivism for a financially distressed municipality. The debt adjustment provided by Chapter 9 offers temporary relief before the next crisis, not a thoroughgoing remedy aimed at the root causes of municipal distress.

This Article challenges the traditional account. We contend that municipal bankruptcy can and should address governance failures where they contribute to financial failures. We argue that this conclusion follows from an appreciation of the similarities between municipal corporations and the for-profit corporations that are reorganized in Chapter 11 of the Bankruptcy Code. Where governance failures contribute to corporate financial distress, no one would treat governance reform as irrelevant to the reorganization of a corporation. Carefully crafted governance rules were a central feature of the Chrysler bankruptcy,<sup>6</sup> and governance rules figure prominently in most other substantial Chapter 11 cases as well. From a purely functional perspective, governance reform is even more essential to an effective Chapter 9 municipal bankruptcy than it is in Chapter 11, since at least some stakeholders in insolvent municipalities are more dependent on those entities than are stakeholders in insolvent firms.

Municipal bankruptcy does not just facilitate governance reform: in many cases, the logic of the municipal bankruptcy process *requires* governance

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3. For a discussion of the metaphor of the commons as it applies to municipal budgets, see *infra* notes 153-156 and accompanying text.
  4. See CLAYTON P. GILLETTE, LOCAL REDISTRIBUTION AND LOCAL DEMOCRACY: INTEREST GROUPS AND THE COURTS 75-80 (2011).
  5. See 11 U.S.C. § 904 (2012); Kimhi, *supra* note 2, at 357.
  6. As described *infra* Section I.B, the governance reforms were especially elaborate in the Chrysler bankruptcy. The parties allocated specified numbers of seats on Chrysler's board of directors to each of its major postbankruptcy shareholders: Chrysler retirees, Fiat, Canada, and the United States.

reform. The public—and inherently political—nature of municipal debtors has traditionally been seen to preclude the use of Chapter 9 for anything other than reducing a municipality's debt.<sup>7</sup> Our position is that the political nature of municipal fiscal distress has precisely the opposite implication. The financial distress of a substantial municipality nearly always signals that its politics are dysfunctional. The same entrenched political environment that exacerbates fiscal instability may also frustrate efforts to initiate reforms necessary to escape a cycle of financial irresponsibility. That entrenchment can be overcome only by the inducement or imposition of structural reforms from outside the municipality.

Ideally, the outside catalyst would be the state, which retains substantial authority over its political subdivisions. But political entrenchment may also constrain the state from inducing or imposing structural reforms that are needed for fiscal stability. Where that is the case, and where the state accedes to a municipality's use of the federal bankruptcy courts, we conclude that the bankruptcy judge should and does have leeway to induce necessary reforms. Yet discussions of Chapter 9 consistently ignore the possibility of governance reform, even where it is essential to revive a financially failed municipality. Although conventional wisdom suggests that governance reform in bankruptcy infringes on state sovereignty, which perhaps explains its neglect, we contend that governance restructuring in Chapter 9 passes constitutional muster.

Two decades ago, Michael McConnell and Randal Picker made the most comprehensive argument to date for moving beyond the debt-adjustment model of municipal bankruptcy.<sup>8</sup> They contended that municipal bankruptcy should permit reorganization of municipal structures in ways that were analogous to the reorganization of firms in Chapter 11. For McConnell and Picker, the expanded powers of the court would include authority to mandate “politically unpopular reforms,”<sup>9</sup> such as authority to collect taxes to pay preexisting debt; to order reductions in expenditures; to sell municipal assets; and perhaps even to reorganize the boundaries of or to dissolve the debtor municipality based on applicable state-law principles.<sup>10</sup> McConnell and Picker

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7. See, e.g., Kimhi, *supra* note 2, at 353-54, 395 (arguing that Chapter 9 cannot solve political and socioeconomic problems and advocating that Chapter 9 be given the narrow role of solving creditor-holdout problems).

8. Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 472-81 (1993).

9. *Id.* at 475.

10. *Id.* at 475-77, 481-86. Michelle Anderson has also explored dissolution as a possible response to municipal distress—especially the distress of small municipalities. See, e.g., Michelle Wilde Anderson, *Dissolving Cities*, 121 YALE L.J. 1364, 1432-33 (2012); Michelle Wilde

advocated that these reforms take place in state bankruptcy proceedings rather than in federal bankruptcy court.<sup>11</sup> Implicit in McConnell and Picker's recommendations is an optimistic story of a benign state willing and able to enact reforms that facilitate municipal fiscal discipline.

We share McConnell and Picker's intuition that relief for fiscally distressed municipalities necessarily entails more than debt reduction. We focus, however, on the design of municipal decision-making institutions rather than boundaries or tax decisions, and look to the federal bankruptcy court as the catalyst for reform. Where the state intervenes to redress structural difficulties that cause fiscal distress, there may be little need for bankruptcy court intervention. But where the state fails to do so because of its own political constraints, rather than as a consequence of a deliberate decision, we find fewer reasons to preclude bankruptcy courts from filling the gap. While state political inertia has always been a concern, its salience has increased considerably in the two decades since McConnell and Picker wrote their classic article. In short, we view bankruptcy court intervention into municipal governance as an option, not a requirement. It is warranted by the same entrenchment problem that has led commentators to advocate for more intensive judicial intervention in other public arenas, such as voting rights or prison reform, where political incentives inhibit changes that one might otherwise prefer be made through the political process.<sup>12</sup> Indeed, we anticipate that the very presence of the option will make its exercise less necessary, as states otherwise politically constrained from enacting necessary reforms for distressed municipalities may prefer to do so themselves, rather than leave the task to bankruptcy courts.

The Article proceeds as follows. Part I explores the similarities between the roles of municipalities and private corporations as providers of services, but emphasizes that the monopoly position of the former justifies a greater concern for protecting municipalities' ongoing viability, rather than simply maximizing the recoveries of creditors. This distinction, which seems to be reflected in the

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Anderson, *Who Needs Local Government Anyway? Dissolution in Pennsylvania's Distressed Cities*, 24 WIDENER L.J. 149, 166-72 (2015).

11. McConnell & Picker, *supra* note 8, at 479.

12. See, e.g., Samuel Issacharoff & Richard H. Pildes, *Politics as Markets: Partisan Lockups of the Democratic Process*, 50 STAN. L. REV. 643, 699-707 (1998); Michael J. Klarman, *Majoritarian Judicial Review: The Entrenchment Problem*, 85 GEO. L.J. 491, 509-26 (1997); Richard H. Pildes, *The Supreme Court, 2003 Term—Foreword: The Constitutionalization of Democratic Politics*, 118 HARV. L. REV. 28, 153-54 (2004); Susan Sturm, *Resolving the Remedial Dilemma: Strategies of Judicial Intervention in Prisons*, 138 U. PA. L. REV. 805, 846-60 (1990); cf. *Ariz. State Legislature v. Ariz. Indep. Redistricting Comm'n*, 135 S. Ct. 2652, 2672 (2015) (reading the Elections Clause of the Federal Constitution “as a safeguard against manipulation of electoral rules by politicians and factions in the States to entrench themselves or place their interests over those of the electorate”).

greater emphasis on a fresh start in municipal bankruptcy than in Chapter 11, underscores the need to address a municipal debtor's underlying problems, rather than solely reduce the amount of its debt. Even if governance reform was unheard of in Chapter 11, there would be a powerful case for attending to governance concerns in Chapter 9. In fact, governance reform is not rare in Chapter 11; it is ubiquitous.

Part II raises the question of why, if governance reform is so common in Chapter 11, such reform does not currently occur in Chapter 9 cases. An obvious answer might be that state sovereignty precludes governance reform. However, based on a careful analysis of the history of municipal bankruptcy, starting with the first municipal bankruptcy law in 1934, we offer an alternative explanation: historical path dependence is at least as important as constitutional concerns. At key junctures, lawmakers seriously considered explicitly incorporating governance reform into Chapter 9, but the proposals were overtaken by events such as the need for immediate resolution of New York City's fiscal crisis in the 1970s.

Part III develops our affirmative case that governance reform is essential to the effective restructuring of a substantial municipality. This Part argues not only that governance reform is permissible, but that bankruptcy courts should *refuse*—on feasibility grounds—to confirm a restructuring plan that fails to reform municipal governance structures responsible for the distress that generated the Chapter 9 proceeding.<sup>13</sup> Part IV considers potential objections to our vision for Chapter 9, including the limited scope of municipal bankruptcy proceedings and constitutional concerns such as the Supreme Court's commandeering cases. In our view, none of these objections preclude governance reform in Chapter 9.

Part V takes up an equally substantial objection: that the state, not a bankruptcy court, should be the entity implementing governance reform. Although we fully endorse state intervention and agree that state reform is the optimal solution for a municipality's governance dysfunction, we argue that doctrinal constraints limit states' effectiveness to some extent and that political constraints are an even more serious obstacle to state reform. These impediments confirm the need for thoroughgoing reform in municipal bankruptcy.

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13. "[F]easib[ility]" is one of the key requirements for confirming a Chapter 9 plan. 11 U.S.C. § 943(b)(7) (2012); *see infra* notes 216-229 and accompanying text.

**I. MUNICIPAL REORGANIZATION AND CORPORATE REORGANIZATION**

In this Part, we lay the initial groundwork for our claims about the proper scope of municipal bankruptcy by considering the similarities and differences between municipalities and private corporations. If we conceptualize municipalities and private corporations as alternative vehicles for providing goods and services and consider the role of bankruptcy from this perspective, the need to include governance reform as part of the toolkit for addressing the financial distress of a substantial municipality becomes clear. Governance reform is not a new concept in bankruptcy; rather, it is already central to many Chapter 11 cases.

*A. The Need for Municipal Governance Reform*

A key objective of Chapter 11 reorganization is to restore the fiscal stability of a potentially viable firm so that it can efficiently provide valuable goods and services. Much of the corporate-bankruptcy literature focuses entirely on the benefits to creditors of this restored productivity. If creditors would be better off maintaining the firm as a going concern, according to this reasoning, then reorganization is appropriate. But if dissolving the firm maximizes the payout to creditors, then selling the assets and distributing the proceeds to creditors should be followed—even if reorganization might seem to serve the interests of current employees, equity holders, or other third parties.<sup>14</sup> Conventional literature views corporate bankruptcy solely as a mechanism for the efficient collection and payment of debts; rehabilitation of the firm for its own sake at best risks inefficiencies and at worst is “nonsense.”<sup>15</sup> The creditor collection—or creditors’ bargain, as it is usually known—conception of bankruptcy is contested,<sup>16</sup> but we take it as a given here, in order to highlight a key difference between private corporations and municipalities.

Even if compelling in the corporate context, the creditors’ bargain conception is an awkward fit for municipalities. Like private corporations,

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14. The leading theory is Douglas Baird and Thomas Jackson’s “creditors’ bargain” model of bankruptcy, which conceptualizes bankruptcy as “a collective system of creditor collection.” See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 14 (1986); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 100-01 (1984).

15. See Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173, 182 (1987).

16. See, e.g., Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 777 (1987).

municipalities provide goods and services for which there is substantial demand. And financial failure ensues when a municipality is unable to provide those goods and services at a price (the taxes imposed by the municipality) that residents are willing to pay. At that point, much like the firm that is unable to generate sufficient revenues to pay its debts, the municipality suffers insolvency as residents (the municipal equivalent of both customers and equity holders) with sufficient means emigrate to other jurisdictions, and those residents who remain are unable to make the higher tax payments necessary to service existing indebtedness.<sup>17</sup> As in the case of the insolvent firm, restructuring can be justified if it will enable creditors to recover more than they would receive if the municipality tried to pay all of its obligations in full.

Municipal corporations, however, possess other characteristics that make the case for a more extensive restructuring—restructuring that includes governance reform as well as debt adjustment—stronger than under the parsimonious view of corporate reorganization. The conception of corporate bankruptcy as a pure collection device is premised on the assumption that the troubled firm is one of numerous firms that are competing in an active marketplace. The failure of one firm in an active market does not substantially disadvantage customers, since they can purchase similar goods from competitors; nor does a firm’s failure reduce overall employment if employees can migrate to other jobs where they can be more productive.<sup>18</sup> These assumptions may reflect a somewhat romantic vision of consumer and labor mobility, but for ordinary corporations, they often are close enough to reality to justify the conclusion that rehabilitating a failed firm for its own sake is unlikely to maximize social welfare under ordinary circumstances.

Those same assumptions, however, are less plausible in the municipal context. The goods and services that municipalities provide tend to be public goods—goods that are nonrival or nonexcludable—or goods subject to a natural monopoly.<sup>19</sup> A private provider is unlikely to produce these goods,

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17. See Andrew Haughwout et al., *Local Revenue Hills: Evidence from Four U.S. Cities*, 86 REV. ECON. & STAT. 570, 583 (2004).

18. Baird, *supra* note 15, at 183-84.

19. Goods are nonrival when they can be consumed simultaneously by more than one person. Standard examples include mosquito spraying and policing. Goods are nonexcludable when the costs of excluding those who have not contributed to production are too high to justify charging users. Standard examples include uncongested roads or street paving. Goods are subject to natural monopoly when they require high entry costs and have continually decreasing average costs—“the greater the level of output, the lower the cost per unit”—as with electricity generation or water systems. See, e.g., HARVEY S. ROSEN & TED GAYER, PUBLIC FINANCE 54-56, 358 (9th ed. 2010). We do not claim that municipalities provide pure

notwithstanding substantial demand for them, due to uncertainty about the ability to recover the costs of production.<sup>20</sup> If goods with these characteristics are to be efficiently provided, governmental participation—either by direct provision or by contracting for them to be provided by third parties—is necessary, or at least appropriate.<sup>21</sup>

Local governments, rather than more centralized political entities, properly play this role when the goods at issue have a limited geographic scope (such as policing, firefighting, or street lighting) or take the form of club goods that are preferred by a limited group of residents who also are willing to pay for them (such as municipal golf courses or public playgrounds for children).<sup>22</sup> By offering distinct bundles of goods and services, local governments allow prospective residents to sort themselves according to their preferences for public goods, just as market transactions permit consumers to sort themselves by preferences in the characteristics of private goods. For example, those who prefer proximity to their workplace may live in the central city, while those who prefer low-density living may migrate to the suburbs, just as those who like whole-wheat bread can sort themselves from those who prefer sourdough by making appropriate market purchases.<sup>23</sup>

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public goods, only that they provide goods with sufficient characteristics of publicness that they are unlikely to be provided by the private market at an efficient level.

20. See LYNN A. BAKER, CLAYTON P. GILLETTE & DAVID SCHLEICHER, *LOCAL GOVERNMENT LAW: CASES AND MATERIALS* 39-50 (5th ed. 2015).
21. There is a long tradition of private provision of goods with the characteristics of publicness. For well-known examples, see Ronald H. Coase, *The Lighthouse in Economics*, 17 J.L. & ECON. 357 (1974).
22. See, e.g., TODD SANDLER, *COLLECTIVE ACTION: THEORY AND APPLICATIONS* 73 (1992) (relating “club goods” to “local public goods”).
23. See, e.g., Michael W. McConnell, *Federalism: Evaluating the Founders’ Design*, 54 U. CHI. L. REV. 1484, 1493-94 (1987) (book review). Of course, neither of these markets is perfect. Some goods may be available either in market transactions or through government services. Think of trash collection, which is sometimes provided privately and sometimes publicly. Alternatively, sometimes neither market provides needed services so that individuals cannot obtain their preferences either publicly or privately, notwithstanding both capacity and willingness to pay the cost of production. Finally, some markets fail because individuals, although willing to pay the cost of production, have insufficient assets. In these cases, redistribution of wealth will be necessary to cure inequalities of opportunity, and government (though not necessarily local government) will appropriately play that role as well as the allocative role related to the provision of public goods. But the existence of overlap and incompleteness of provision is a feature of both markets and collective decision making, rather than one that distinguishes firms from municipalities. In this regard, as with the provision of goods and services generally, the similarities in the roles of firms and municipalities prevail over the differences. See JOHN CULLIS & PHILIP JONES, *PUBLIC FINANCE AND PUBLIC CHOICE* 46-68 (2d ed. 1998).

When municipalities petition for relief under Chapter 9, they do so primarily because fiscal distress precludes the delivery of the very services that municipalities were created to provide and of which they are monopoly providers. Recognizing the distinctive nature of municipalities, several bankruptcy courts recently have focused on service delivery, not debt service alone, as a measure of whether a municipal debtor is “insolvent”<sup>24</sup> and thus eligible for municipal bankruptcy.<sup>25</sup> Similarly, a municipality that desires to exit Chapter 9 must submit to the court a plan that is “feasible,” which courts increasingly have interpreted to mean that “the debtor can accomplish what the plan proposes and provide governmental services.”<sup>26</sup> It is presumably to address the service function of municipalities that the entire structure of Chapter 9 is commonly described as providing a municipality with a fresh start as in the case of an individual bankruptcy, rather than a mechanism purely for the collection of assets to maximize the payout for creditors as in the case of corporate bankruptcy.<sup>27</sup> The increasing emphasis on service delivery suggests that bankruptcy courts recognize that failing to restore local public goods induces flight by those who pay taxes in excess of the benefits they receive from the locality, followed by the imposition of even higher taxes and fees on the remaining residents in order to pay fixed municipal costs, and followed by additional exodus.<sup>28</sup>

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24. 11 U.S.C. § 109(c)(3) (2012).

25. See *In re City of Detroit*, 504 B.R. 97, 169 (Bankr. E.D. Mich. 2013); *In re City of Stockton*, 493 B.R. 772, 789 (Bankr. E.D. Cal. 2013).

26. *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 35 (Bankr. D. Colo. 1999). The court in the *City of Detroit* bankruptcy adopted a standard of “feasibility” that considered whether the city “will be able to sustainably provide basic municipal services to the citizens of Detroit and to meet the obligations contemplated in the Plan without the significant probability of a default.” *In re City of Detroit*, 504 B.R. at 222.

27. See Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 654 (2008) (“The underlying assumption [of municipal bankruptcy] is that mitigating the city’s financial hardship provides the locality with a fresh start and enables its rehabilitation, to the benefit of both residents and creditors.”); McConnell & Picker, *supra* note 8, at 470 (“[M]unicipal bankruptcy is based on the idea of the fresh start rather than the efficient reconfiguration of assets. The theory of Chapter 9 is that the burden of debt service, if sufficiently high, will affect the taxpayers of a city as it would a debt-ridden individual: it will sap initiative and depress money-generating activity.”).

28. Courts have described this cycle of depopulation and service inefficiency as the “death spiral” of distressed municipalities. *E.g.*, *In re Sullivan Cty. Reg’l Refuse Disposal Dist.*, 165 B.R. 60, 66 (Bankr. D.N.H. 1994) (discussing how a disposal district’s tipping fees led to a “‘death spiral’ . . . whereby increased fees result[ed] in lower total dollar collections by driving away customers because of the higher fees”); *In re Pub. Serv. Co. of N.H.*, 114 B.R. 820, 831 (Bankr. D.N.H. 1990) (discussing how electricity rates set “too high” can trigger a “death spiral” of diminishing returns due to an exodus of customers).

From this perspective, Chapter 9's restrictive scope of restructuring seems anomalous. The fact that local governments provide public goods otherwise undersupplied due to market failures means that market solutions cannot remedy government failures. As a result, if the locality fails to provide desired services, immobile residents will likely be unable to obtain them. Relatively wealthy firms and individuals may be able to privatize inadequate public services; firms and some individuals may substitute private security, private education, private garbage collection, or private parks (such as country clubs) for municipal services.<sup>29</sup> But even these residents will be exposed to the consequences of service-delivery insolvency when they venture beyond their homes and places of business. For example, during Bridgeport's insolvency proceedings, the Chief of Police and the Director of Public Works testified that budget cuts to their departments would destroy Bridgeport's ability to investigate property crime, collect residential garbage, or plow snow-filled streets, creating a health and public-service emergency.<sup>30</sup> As public services deteriorate, those with the means to flee insolvent localities frequently do so.<sup>31</sup> But many residents who suffer the effects of service-delivery insolvency will be unable to migrate to an alternative jurisdiction, and the residents who remain are likely to be those least able to replace the services with even imperfect substitutes from private providers.

Given the logic of municipal decline, one might assume that municipal bankruptcy would give a municipal debtor at least as many tools, including governance restructuring, as are available to reorganize private corporations. Alas, that supposition is not borne out by municipal bankruptcy as currently conceived. Chapter 9 borrows numerous provisions from Chapter 11,<sup>32</sup> and a Chapter 9 case proceeds very much like a traditional Chapter 11 case. In Chapter 9, as in Chapter 11, the debtor negotiates with the creditors'

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29. See, e.g., Richard Briffault, *A Government for Our Time? Business Improvement Districts and Urban Governance*, 99 COLUM. L. REV. 365, 368-69 (1999); Clayton P. Gillette, *Opting Out of Public Provision*, 73 DENV. U. L. REV. 1185, 1185-86 (1996).

30. *In re City of Bridgeport*, 129 B.R. 332, 335 (Bankr. D. Conn. 1991).

31. See Jan K. Brueckner, *A Test for Allocative Efficiency in the Local Public Sector*, 19 J. PUB. ECON. 311, 312 (1982) (discussing findings that residents migrate in and out of municipalities in response to changes in levels of public spending); Clayton P. Gillette, *Dictatorships for Democracy: Takeovers of Financially Failed Cities*, 114 COLUM. L. REV. 1373, 1402-03 (2014) (discussing trends in localities suffering population losses during fiscal crises).

32. Section 901(a) sets forth a long list of provisions from other chapters of the Bankruptcy Code and incorporates them into Chapter 9. The list includes sixteen provisions (or parts of provisions) from Chapter 11. 11 U.S.C. § 901 (2012). Chapter 9 itself consists of twenty provisions, including § 901. See *id.* §§ 901-904, 921-930, 941-946.

committee<sup>33</sup> and other constituencies over the terms of a restructuring plan;<sup>34</sup> the debtor submits the plan to its creditors for a vote;<sup>35</sup> and, if each class votes in favor and the plan satisfies a list of other confirmation requirements, the bankruptcy court confirms the plan.<sup>36</sup> Despite these similarities, Chapter 9 has a much narrower scope than Chapter 11. The latter permits governance restructuring where mismanagement is viewed as a cause of the firm's failure.<sup>37</sup> Not so in Chapter 9, at least according to the conventional wisdom treating debt reduction as the sole purpose of municipal bankruptcy. Chapter 9's system of debt adjustment addresses the immediate fiscal crisis but, as currently applied, does not address the governance structure that may have generated oppressive debt in the first instance. That is the case even though addressing underlying governance issues is more important for troubled municipalities than for private corporations.

### B. Governance Reform in Chapter 11

The discussion thus far suggests that, even if governance reform were absent from Chapter 11, it would be an essential feature of municipal bankruptcy, given the distinctive nature of the goods and services that municipalities produce. But governance reform is not absent from Chapter 11 at all. It is ubiquitous. Corporate debtors regularly take advantage of the reorganization process to reshape their governance as well as to restructure their debt. The attention given to governance issues in Chapter 11 underscores the incongruity of omitting governance reform from municipal bankruptcy.

In recent years, lenders increasingly have forced certain kinds of governance change, such as the hiring of a chief restructuring officer even

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33. In both Chapter 9 and Chapter 11, the U.S. trustee establishes a committee of creditors holding unsecured debt to represent the debtor's general creditors at the outset of the case. *Id.* § 901(a) (incorporating *id.* § 1102). The U.S. trustee can also appoint other committees, such as a committee of public employees or tort victims, but is not required to do so. *Id.*

34. In both chapters, the debtor also pursues a variety of other objectives, such as avoiding preferences and fraudulent conveyances, and deciding which executory contracts to assume. *See id.* (incorporating *id.* § 365 (executory contracts), *id.* § 547 (preferences), and *id.* § 548 (fraudulent conveyances)).

35. *See id.* (incorporating *id.* § 1126(c), stating that a class of creditors approves the plan if a majority in number and two-thirds in amount vote in favor of the plan).

36. *See id.* (incorporating parts of *id.* § 1129, the Chapter 11 confirmation provision); *id.* § 943 (detailing additional Chapter 9 confirmation requirements).

37. *See infra* Section I.B.

before a troubled company files for bankruptcy.<sup>38</sup> But more pervasive reform usually takes place only in Chapter 11 bankruptcy proceedings. Lenders may prefer that governance be addressed in bankruptcy rather than through contract alone because they fear the risk of potential liability if they are later deemed to have overreached.<sup>39</sup> Moreover, substantial governance restructuring may be nearly impossible to achieve outside of bankruptcy. Reorganization of the debtor's board or alteration of shareholder-voting rules usually requires approval of both the board of directors and the firm's shareholders.<sup>40</sup> If either constituency will be disadvantaged by the changes, as quite often will be the case, they are well positioned to thwart reform outside of bankruptcy.

Even companies whose governance is relatively effective when they file for bankruptcy may need to make significant governance adjustments as part of their restructuring process. Chapter 11 shifts control from the debtor's shareholders to its creditors, and usually transfers ownership rights to creditors as well.<sup>41</sup> These transitions create the potential for significant conflict that is best managed through carefully crafted governance rules.<sup>42</sup> In the Chrysler bankruptcy, for instance, Fiat, Chrysler retirees, and the U.S. and Canadian governments received large ownership interests as a result of the restructuring.<sup>43</sup> To protect each of these constituencies, Chrysler's new

38. Cf. Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 755 (2002) (arguing that, because today's investors allocate control rights through sophisticated contracts that already anticipate financial distress, "a law of corporation reorganizations is largely unnecessary").

39. The prospects of lender liability for overreaching or of equitable subordination of the lenders' claims in bankruptcy are particular concerns. See, e.g., Daniel E. Bogart, *Games Lawyers Play: Waivers of the Automatic Stay in Bankruptcy and the Single Asset Loan Workout*, 43 UCLA L. REV. 1117, 1224-25 (1996).

40. If the reforms require amendment of the corporation's certificate of incorporation, the board of directors and the shareholders both must approve the change. See, e.g., DEL. CODE ANN. tit. 8, § 242 (2014) (discussing the amendment of the certificate of incorporation).

41. See, e.g., David A. Skeel, Jr., *Corporate Anatomy Lessons*, 113 YALE L.J. 1519, 1555-57 (2004) (book review).

42. Chapter 11 facilitates governance reform by explicitly authorizing the debtor to amend its charter as part of the debtor's reorganization plan. 11 U.S.C. § 1123(a)(5)(I) (2012). The charter—also known as the certificate of incorporation or articles of incorporation, depending on the state—is a corporation's foundational governance document. The charter sets forth the classes of stock that a corporation is authorized to issue and, along with the bylaws (which are much easier to alter), contains the firm's governance rules.

43. For a description of the interests and the transaction generally (which technically took the form of a § 363 bankruptcy sale, rather than a traditional reorganization), see *In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009), *vacated as moot per curiam*, 592 F.3d 370 (2d Cir. 2010). Initially, the retirees held fifty-five percent of the membership interests, Fiat twenty percent, the United States eight percent, and Canada two percent. *Id.* at 112.

organizational documents specified that Fiat would designate three of Chrysler's nine directors, the retirees would designate one, the Canadian government one, and the U.S. government three.<sup>44</sup> Although Chrysler's reforms were especially elaborate, governance reforms that allocate board seats to specified constituencies, create voting trusts, or make other adjustments are a standard feature of substantial Chapter 11 cases.<sup>45</sup>

Courts do not necessarily intervene in Chapter 11 proceedings by proposing specific structural changes. More often, bankruptcy judges confirm plans that contain restructuring provisions provided by others since bankruptcy judges are responsible for approving or rejecting reorganization plans but are not permitted to propose a plan.<sup>46</sup> The negative implication of that process is that a court *could* refuse to confirm a Chapter 11 plan that did not contain structural reform. But creditors can insert themselves directly into the debtor's governance in Chapter 11 and have a strong incentive to do so. Because some creditors' claims are likely to be converted into equity in the reorganized debtor, creditors often receive a governance role to protect their interest and to reduce the risk of renewed financial distress.<sup>47</sup>

In the municipal environment, by contrast, creditors who suffer reduced entitlements in bankruptcy proceedings are not granted any decision-making role in postbankruptcy municipal governance. Even if creditors in a Chapter 9

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44. See Chrysler Group LLC, General Form for Registration of Securities (Form 10) 144-45 (Feb. 25, 2011), <http://www.sec.gov/Archives/edgar/data/1513153/000119312511047098/d1012g.htm> [<http://perma.cc/RQH8-69N9>]. The United States also figured prominently in the selection of one additional director. The three directors initially designated by the U.S. government designated a fourth director in consultation with the U.S. Treasury. *Id.* at 145.

45. When the Lear Corporation reorganized in 2009, for instance, it allocated one board seat to the current chief executive, five to its lenders, and three to its bondholders. See, e.g., Ryan Beene, *Lear Corp.'s Board of Directors Could Be Replaced After Chapter 11 Filing, Company Says*, CRAIN'S DETROIT BUS. (July 6, 2009), <http://www.crainsdetroit.com/article/20090706/FREE/907069979/lear-corp-s-board-of-directors-could-be-replaced-after-chapter> [<http://perma.cc/4LMZ-Z52A>]; see also Joel T. Hardman & Mark E. MacDonald, *Voting Trusts May Overcome Distrust of Owners, Management*, TURNAROUND MGMT. ASS'N (May 1, 2004), <http://s6.webitects.com/Publications/Articles.aspx?objectID=3170> [<http://perma.cc/GW4P-ZSED>].

46. See 11 U.S.C. § 1121(a), (c) (authorizing the debtor and parties in interest—but not the bankruptcy court—to file a plan); *id.* § 1129(a) (listing the conditions under which courts confirm reorganization plans).

47. For discussion of some of the ways in which courts and the Chapter 11 process as a whole shift authority to creditors, see generally David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992), which discusses sales of assets, shareholder requests to hold an annual meeting in bankruptcy, the leverage the Chapter 11 process gives to unsecured creditors, and other issues.

proceeding receive modified obligations, such as bonds payable in ten years to displace existing bonds due immediately, no plan of adjustment has ever granted the creditors a seat on the city council while the restructured debt was outstanding.<sup>48</sup>

But the fact that creditors do not participate directly in postbankruptcy municipal governance does not make restructuring inappropriate or unnecessary. It means only that governance reform may need to occur by other means. Creditors' inability to dislodge the current governance structure increases the need for third-party intervention to ensure that Chapter 9 fully addresses the underlying causes of municipal financial distress.

## II. WHY HASN'T GOVERNANCE BEEN A FOCUS IN CHAPTER 9?

In the last Part, we considered how corporate-bankruptcy proceedings commonly include governance reform as a means of increasing the likelihood that the firm will operate successfully once it exits Chapter 11. To our knowledge, there are no analogous cases of governance reform in Chapter 9. The primary reason for the discrepancy lies in § 904 of the Bankruptcy Code.<sup>49</sup> That provision precludes the court from interfering with any of the political or governmental powers of the debtor. But the prohibition does not apply if “the debtor consents or the plan so provides,”<sup>50</sup> suggesting a broader scope for restructuring with debtor approval.<sup>51</sup> One might think that in at least some cases, local officials would benefit from restructuring and thus would consent to its use in Chapter 9. Section 903, however, implies an additional limitation on restructuring. That provision confirms the state's power to control a municipality in the exercise of political or governmental powers and thus could be construed to disable a court from engaging in activities that affect local institutional design.<sup>52</sup>

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48. This option was never considered, for instance, in Detroit's bankruptcy. See generally *In re City of Detroit*, 524 B.R. 147 (Bankr. E.D. Mich. 2014) (describing and confirming Detroit's debt-adjustment plan).

49. 11 U.S.C. § 904.

50. *Id.*

51. For a skeptical account of the role of consent in the Detroit bankruptcy, see Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. (forthcoming 2016).

52. 11 U.S.C. § 903. The fact that a state remains able to control the powers of its municipalities, however, does not necessarily preclude bankruptcy court restructuring. It may mean only that any such court intervention is subject to defeasance by the state.

Together, these provisions suggest congressional concern with constitutional limitations on federal diminution of state sovereignty in Chapter 9 proceedings. Any such concerns might seem to preclude the exercise of independent restructuring authority by a federal bankruptcy court.<sup>53</sup> Some courts have stated explicitly that § 903 and § 904 are necessary to ensure the constitutionality of Chapter 9.<sup>54</sup> While these provisions may support the idea that Congress designed Chapter 9 to avoid interference with state sovereignty, in Section IV.C we explain why municipal restructuring does not run afoul of constitutional principles.

Before engaging in that debate, however, we revisit the history of municipal bankruptcy reform and show that constitutional concerns are not nearly as complete an explanation for the absence of governance reform in Chapter 9 as one might think. The municipal bankruptcies that gave rise to Chapter 9 and its predecessors were due either to circumstances that governance reform would not have addressed or to fiscal crises that superseded any aspirations for governance reform.

During the debates on the earliest municipal bankruptcy laws, lawmakers were preoccupied with municipalities' inability to restructure debts rendered unaffordable by the Depression, and sought to enact legislation that would reduce the immediate problem. They were not, by contrast, attempting to provide a comprehensive solution. When municipal bankruptcy returned to legislative attention four decades later, witnesses offered proposals that would have incorporated governance reform directly and explicitly into municipal bankruptcy. These proposals fell by the wayside, not because of any perceived constitutional infirmity, but because Congress chose a different, nonbankruptcy solution to the most pressing crisis of the time—New York City's financial distress. Thus, path dependence has played a more pivotal role in defining the scope of municipal bankruptcy law than investigation of constitutional principles.

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53. These concerns are independent of the requirement of § 109(c)(2) of the Bankruptcy Code to the extent that only municipalities that are "specifically authorized" by the state may file for debt adjustment. 11 U.S.C. § 109(c)(1)-(2). Sections 903 and 904 could be read to prohibit, due to constitutional restrictions, municipal restructuring by a federal bankruptcy court even if a state consents to the municipal petition for debt adjustment.

54. See, e.g., *In re N.Y.C. Off-Track Betting Corp.*, 434 B.R. 131, 140 (Bankr. S.D.N.Y. 2010) ("[Section 904] codifies the Tenth Amendment's general prohibition on a bankruptcy court's power to interfere with a state entity."); *In re Vallejo*, 403 B.R. 72, 75 (Bankr. E.D. Cal. 2009) ("Section 903 ensures the constitutionality of chapter 9, but does not provide an independent substantive limit on the application of chapter 9 provisions.").

A. *Municipal Bankruptcy in the 1930s*

The original municipal bankruptcy law was enacted in 1934 as part of the New Deal response to the wreckage of the Great Depression. In the early 1930s, thousands of municipalities defaulted as real-estate values collapsed and taxpayers were unable to pay assessed property taxes.<sup>55</sup> Although municipalities theoretically could have restructured their obligations outside of bankruptcy, holdouts often stymied these efforts. “In every instance where a governmental unit finds itself in financial difficulty and is able to make some satisfactory agreement of adjustment with a majority of its creditors,” as Congressman Mark Wilcox, the author of and leading advocate for a municipal bankruptcy law,<sup>56</sup> put it, “there is always a small minority who hold out and demand preferential treatment.”<sup>57</sup> State efforts to compel adjustment of municipal debts would founder on the shoals of the Contracts Clause of the U.S. Constitution.<sup>58</sup> But because the Contracts Clause does not bind the federal government,<sup>59</sup> federal bankruptcy law provided a plausible solution to the problem of debt overhang.

The original municipal bankruptcy law sought to solve the holdout problem by binding all bondholders, even the dissenters, if a majority voted to

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55. See, e.g., ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, CITY FINANCIAL EMERGENCIES: THE INTERGOVERNMENTAL DIMENSION 11-15 (1973).

56. 77 CONG. REC. 5,475 (1933) (statement of Rep. Condon) (referring to Congressman Wilcox as “the author of this bill”). The bill became known as the Sumners-Wilcox Municipal Bankruptcy Bill. See George H. Dession, *Municipal Debt Adjustment and the Supreme Court*, 46 YALE L.J. 199, 207 (1936); Sanders Shanks, Jr., *The Municipal Bankruptcy Act (Sumners-Wilcox Bill)*, 28 AM. POL. SCI. REV. 1072, 1072 (1934). Representative Hatton W. Sumners of Texas was chairman of the House Judiciary Committee, which held hearings on the bill. See *To Amend the Bankruptcy Act Municipal and Private Corporations: Hearing on H.R. 1670, H.R. 3083, H.R. 4311, H.R. 5009 and H.R. 5267 Before the H. Comm. on the Judiciary*, 73d Cong. 1 (1933) [hereinafter *1933 House Hearing*].

57. *1933 House Hearing*, *supra* note 56, at 22 (statement of Rep. J. Mark Wilcox). In the House debate on the bill, Congressman Wilcox contended that in his own city, a bondholder of two percent of the municipality’s indebtedness had been able to derail a plan of adjustment to which ninety percent of the creditors had agreed. The result of the failure of the plan of adjustment was the issuance of a writ of mandamus to levy a property tax amounting to \$425 per \$1,000 of valuation. See 77 CONG. REC. 5,469 (1933).

58. See generally *Ashton v. Cameron Cty. Water Improvement Dist. No. 1*, 298 U.S. 513, 531 (1936) (“The Constitution was careful to provide that ‘No State shall pass any law impairing the Obligation of Contracts.’ This she may not do under the form of a bankruptcy act or otherwise.”). The Contracts Clause provides, “No State shall . . . pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts . . . .” U.S. CONST. art. I, § 10.

59. See *Cox Cable Commc’ns, Inc. v. United States*, 992 F.2d 1178, 1182 (11th Cir. 1993).

restructure the bonds.<sup>60</sup> The proponents of the law thought that a more comprehensive framework was unnecessary. They also were well aware that their proposal was constitutionally uncertain, since Congress had never previously enacted a bankruptcy law for public entities like municipalities.<sup>61</sup> And they needed to allay the concerns of bondholders, who worried that municipal debtors would opportunistically walk away from their debt. As a result, the original 1934 law called for the equivalent of what we now refer to as a prepackaged bankruptcy—a case in which the debtor has secured the approval of its key creditors before filing for bankruptcy and files a proposed reorganization plan at the same time or shortly thereafter.<sup>62</sup> The 1934 law required the municipality to secure approval by creditors holding fifty-one percent of the municipality's debt—except with drainage districts and the like, for which the requirement was thirty percent—before filing its petition, and to file a proposed plan of adjustment with the petition.<sup>63</sup> As amended in 1937, after the Supreme Court struck down the original law,<sup>64</sup> the municipal bankruptcy provisions imposed the fifty-one percent creditor approval requirement in all cases.<sup>65</sup>

Throughout the process, Congress simply assumed, rather than analyzed, the constitutional scope of federal judicial intervention into municipal affairs. For the most part, statements made during the legislative process in defense of the bill's constitutionality were directed at complaints that any law authorizing

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60. The other alternative, advocated by the then-mayor of Detroit, Frank Murphy, and a few other witnesses, would have imposed a moratorium on repayment of the municipality's debts. See, e.g., 1933 House Hearing, *supra* note 56, at 84 (statement of Frank Murphy, Mayor, Detroit). Murphy worried that a Detroit default would cause a "complete demoralization of the services of government and of the affairs of private businesses as well" and questioned whether the Sumners-Wilcox Bill was sufficient to avoid this fate. *Id.* at 85.

61. The Attorney General's office issued a report on the proposed bankruptcy law that provided fodder for both sides in the debate. See Memorandum from Homer S. Cummings, Att'y Gen., United States, to Hatton W. Sumners, Chair, House Judiciary Comm'n (Apr. 21, 1933), in 1933 House Hearing, *supra* note 56, at 174. Although the report concluded that the legislation might be upheld, it raised significant concerns under the Tenth Amendment and Contracts Clause. See *id.*

62. The 1937 Act required fifty-one percent approval in all cases, regardless of the type of municipality. Act of Aug. 16, 1937, Pub. L. No. 75-302, § 83(a), 50 Stat. 653, 655. The 1934 Act required three-quarters acceptance for final approval; the 1937 Act lowered this to two-thirds. Compare Act of May 24, 1934, Pub. L. No. 73-251, § 80(d), 48 Stat. 798, 801, *invalidated by Ashton*, 298 U.S. 513, with § 83(d), 50 Stat. at 657.

63. § 80(a), 48 Stat. at 798-99.

64. *Ashton*, 298 U.S. at 513. As we explain *infra* Section II.B, the Supreme Court upheld the subsequent version of the law that contained only cosmetic changes from the version invalidated in *Ashton*.

65. § 83(a), 50 Stat. at 655.

municipal bankruptcy necessarily infringed unconstitutionally on state sovereignty.<sup>66</sup> Little evidence suggests that Congress was attempting to define the limits of federal bankruptcy authority. Congressman Wilcox expressed confidence that the bill as proposed protected the sovereignty of states and did not permit the federal government “to interfere in any degree with any of the governmental or political subdivisions of the local municipalities.”<sup>67</sup> David M. Wood, a lawyer representing the creditors of fifty troubled municipalities, contended that the bill had been carefully crafted to avoid the constitutional questions that would arise if municipalities were subject to involuntary bankruptcy.<sup>68</sup> During the debate on the original Act, Wilcox similarly highlighted the voluntary nature of the filing and the plan of adjustment as the hallmark of constitutionality.<sup>69</sup> Lawmakers did emphasize that judges would play a minimal role and that state authorization was necessary.<sup>70</sup> But in doing so, they were responding to specific objections that, if Congress enacted the law, cities would rush into bankruptcy to repudiate debts.<sup>71</sup> Proponents of the bill were suggesting that courts and states would serve as constraints on permissive debt avoidance. The lawmakers did not appear to be exploring the constitutional limits of federal bankruptcy jurisdiction.

True, a memorandum submitted by the Department of Justice concluded that states may not abdicate or delegate essential powers of government, and that state authorization for municipalities to file petitions under a federal bankruptcy law that “does not permit interference with the municipalities’ governmental functions would not constitute such an abdication or delegation.”<sup>72</sup> However, nothing in that memorandum explained what an unconstitutional “interference” would look like. The memorandum referred to

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66. The tenor and generality of the objections to the municipal bankruptcy law are nicely summed up in the minority views filed with the 1933 House report. “There have been many profound and exhaustive opinions by the Supreme Court and the inferior Federal courts on the nature and extent of the power of Congress under the bankruptcy clause of the Constitution,” the dissenters wrote, “but in none of them has it ever been so much as intimated that the scope of the power embraced municipal corporations and other governmental subdivisions of the States.” H.R. REP. NO. 73-207, at 4 (1933).

67. 77 CONG. REC. 5,470 (1933).

68. 1933 House Hearing, *supra* note 56, at 53 (statement of David M. Wood, Attorney).

69. 77 CONG. REC. 5,470 (1933) (“No creditor can force a municipality into the court. It must come in voluntarily, freely, of its own accord, and then only for the purpose of submitting to the court a plan of adjustment acceptable to two thirds in amount of the outstanding liabilities.”).

70. 77 CONG. REC. 5,477 (1933) .

71. 77 CONG. REC. 5,471, 5,475, 5,477-79 (1933).

72. Memorandum from Homer S. Cummings to Hatton W. Sumners, *supra* note 61, at 178.

Congress's inability "to regulate, directly or indirectly, the fiscal policies of the States or their governmental agencies,"<sup>73</sup> perhaps because that issue arose in the congressional debates. Wilcox noted that no one would want to surrender to any court the power of levying taxes, "even if it could constitutionally be done."<sup>74</sup> Wilcox later dropped this agnosticism about the constitutional limits of municipal bankruptcy, stating that an 1883 Supreme Court decision held that

[n]o court has the right . . . to interfere with the discretion of municipal officials as to the amount of money which they shall pay to the police department, or the fire department, or the sanitary department, or as to the ratio among the three, or as to any other government function.<sup>75</sup>

But even that statement appears to have been intended to provide assurances concerning the limits of the present bill, rather than a discourse on constitutional constraints. Indeed, it appears that Wilcox's reference was to the 1880 case of *Meriwether v. Garrett*.<sup>76</sup> If so, his statement of the case substantially overstates the relevant holding: that case held little more than that courts may not directly impose taxes to pay a valid claim against a municipality, but instead must, by writ of mandamus, require the officials properly designated by the legislature to levy and collect any tax available.<sup>77</sup> While the Court revealed an aversion to any "invasion by the judiciary of the Federal government of the legislative functions of the State government,"<sup>78</sup> it is less clear that a federal court exercising authority under the Bankruptcy Clause to approve restructuring of a municipality's governance would constitute such an incursion.

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73. *Id.*

74. 1933 House Hearing, *supra* note 56, at 36 (statement of Rep. J. Mark Wilcox).

75. *Id.* at 167.

76. 102 U.S. 472 (1880). It is plausible that Wilcox was referring to *Memphis Gas & Light Co. v. Shelby County*, 109 U.S. 398 (1883). In that case, the Court concluded that courts could not imply a restriction on the state's right of taxation. *Id.* at 400-01. But *Meriwether* offers a better, if imperfect, fit with the point that Wilcox was making. The opinion states that "[t]he levying of taxes is not a judicial act. It has no elements of one. It is a high act of sovereignty, to be performed only by the legislature upon considerations of policy, necessity, and the public welfare." 102 U.S. at 515. Perhaps Wilcox was extrapolating from the absence of judicial power to impose a tax to the absence of a power to mandate a budget. But even in *Meriwether*, the Court upheld the right of the judiciary to proceed by writ of mandamus to order the collection of taxes by relevant municipal officials, and thus to order indirectly what they could not do directly. 102 U.S. at 518.

77. 102 U.S. at 515-18.

78. *Id.* at 517.

Wilcox insisted that the bankruptcy court could require the municipality to levy taxes to repay bondholders. Although a bankruptcy court would not be able to determine the priority of municipal expenditures as between, for example, paying police or fire fighters,<sup>79</sup> he argued, “[S]o far as contracts or debts are concerned, the municipality having contracted a debt, or a promise to pay, that permits them to levy taxes . . . the court can itself enforce that contract by requiring the levying of whatever taxes are necessary to meet that debt.”<sup>80</sup> Wilcox envisioned, in effect, that the bankruptcy court would exercise all of the powers that are theoretically available to a court pursuant to a mandamus action outside of bankruptcy.<sup>81</sup>

Lawmakers were trying to solve a more limited problem, however, in a context where the scope of their powers under the Bankruptcy Clause of the Constitution was unclear. The statute they enacted sought to achieve a single objective—preventing holdouts from scuttling a restructuring that most creditors had approved.<sup>82</sup> Governance reform was not on their agenda.

Perhaps the reason for this was that the distress that affected municipalities during the Depression was thought to have been caused by the general economic conditions of the time, rather than by poor decision making or dysfunctional municipal governance. This view may have oversimplified the source of municipal distress. Politically opportune decisions to incur debt do seem to have been on the rise during the period immediately preceding the Depression. Total municipal debt (less sinking-fund assets) grew from just under \$3.5 billion in 1912 to over \$15 billion in 1932.<sup>83</sup> Between 1922 and 1931,

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79. 1933 House Hearing, *supra* note 56, at 167 (statement of Rep. J. Mark Wilcox).

80. *Id.* at 168.

81. Wilcox thus anticipated one of McConnell and Picker’s key proposals by sixty years. McConnell & Picker, *supra* note 8, at 475-76 (advocating that bankruptcy judges be given mandamus-like powers).

82. See, e.g., 77 CONG. REC. 5,479 (1933) (statement of Rep. Sumners) (asserting that, in his commercial experience, most creditors want to allow adjustment: “Our greatest difficulties in working out a fair, workable plan were the Shylocks. That is exactly the difficulty of these situations with regard to which these cities and their creditors have to deal.”); 77 CONG. REC. 5,477 (1933) (statement of Rep. Oliver) (“[The bill] merely gives the power that is necessary as a function of the bankruptcy court, a power to say to a minority that does not consent, ‘You are now in a bankruptcy court and as the United States Government we are clothed with full power of bankruptcy and, therefore, your consent is not necessary. . . .’”); 77 CONG. REC. 5,469 (1933) (statement of Rep. Wilcox) (“In other words, the sole purpose of this bill is to give the court jurisdiction to force the recalcitrant minority to come in and accept that which is for their own best interest, and which has been agreed to and accepted by two thirds, in amount, of the outstanding indebtedness.”).

83. A.M. HILLHOUSE, MUNICIPAL BONDS: A CENTURY OF EXPERIENCE app. A, at 485 tbl.XXXII (1936).

the net municipal debts of seventeen states more than doubled.<sup>84</sup> Only in frugal Minnesota and North Dakota did debt levels decline during this period.<sup>85</sup> Yet the 1934 legislation was premised on the view that even for Detroit, the city whose financial plight was most serious, the Depression was the problem, not municipal governance.<sup>86</sup>

Even those commentators who concluded that municipalities had taken on too much debt did not identify flawed governance as the explanation. For example, writing in 1936, Albert Miller Hillhouse, the Director of Research of the Municipal Finance Officers' Association,<sup>87</sup> criticized the fiscal overextension of many municipalities, but attributed it to an overly optimistic view that the real-estate boom of the prior decade would continue, rather than to the politics behind those miscalculations.<sup>88</sup> Yet Hillhouse's analysis suggests that political arrangements were an important causal element. He noted that "[b]oth civic-minded and non-civic-minded pressure groups sponsor new or expanded services in prosperous times, many of which are very necessary. . . . The combined pressure of these groups constitutes a real driving force. No increase in government service is advisable, however, if the community cannot afford it."<sup>89</sup> Hillhouse therefore revealed a sentiment that today might be cast in more concrete public-choice terms concerning the relationship between "pressure groups" and the size of government. Focus on that relationship might have

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84. *Id.* at 486 tbl.XXXIII.

85. *Id.*

86. 1933 *House Hearing*, *supra* note 56, at 24 (statement of Rep. J. Mark Wilcox) ("In 41 States there are now counties, cities, or tax districts which are in default, and these defaults are not the result of deliberate action or dishonesty, but are occasioned by the fact that shrinkage in values, loss of business, and general depression in world affairs have produced a condition which has resulted in practical bankruptcy."). The 1933 *House Hearing* focused on Detroit, although that city was seen as an example of large cities in distress rather than the sole objective of the proposed legislation for debt adjustment. *See id.* at 31, 52, 57, 81. Although some witnesses preferred a different municipal bankruptcy bill—a bill known as the McLeod Bill, which would have provided a moratorium on the municipality's obligation to repay its debts—they, too, assumed that the problem was excess debt. *See, e.g., id.* at 78 (statement of Edward A. Zimmerman) (arguing that, if Detroit can postpone repayment, "the integrity of the municipality is preserved and its property values and its people (the turnips out of which the creditors desire to wring blood at this time) are at least preserved for future dealings by and with the creditors").

87. HILLHOUSE, *supra* note 83, at iii.

88. For example, Hillhouse concluded that Detroit's "phenomenal growth" was responsible for its increase in debt prior to the Depression. *Id.* at 247. But Hillhouse noted that the determination of the city's future needs was predicated on careful, if inaccurate, studies and that "[n]o one foresaw that a turn in economic conditions would bring so drastic a slump in the city's economic and industrial life." *Id.* at 248.

89. *Id.* at 249.

allowed more direct attention to solutions that could forestall municipal distress, even in times of widespread economic crisis. But there appears to have been little consideration of the possibility that the design of governmental decision making could reduce recidivism, much less that the bankruptcy process should be the means for accomplishing that objective.

*B. Ashton to Congress to Bekins*

In *Ashton v. Cameron County Water Improvement District No. 1*,<sup>90</sup> the Supreme Court invalidated the 1934 municipal bankruptcy law, based on an extraordinarily broad interpretation of the Tenth Amendment as precluding any federal authority over municipalities, and on the grounds that the Act violated the Contracts Clause.<sup>91</sup> The opinion has largely been discredited.<sup>92</sup> The statute provided that only voluntary petitions by the distressed municipality were cognizable in bankruptcy.<sup>93</sup> Moreover, the statute rejected any federal intent to limit or impair the power of states, including “the power to require the approval by any governmental agency of the State of the filing of any petition hereunder and of any plan of readjustment,” and denied the right to file a bankruptcy petition to any political subdivision over which the state had assumed supervision or control.<sup>94</sup> These provisions led Justice Cardozo to conclude in his dissent in *Ashton* that the statute “has been framed with sedulous regard to the structure of the federal system.”<sup>95</sup> Nevertheless, the *Ashton* majority opinion endorsed a view of federalism so strict that Congress could not enact a bankruptcy law that covered municipalities even with the consent of the state.<sup>96</sup> That position was taken on the non sequitur that such consent would constitute a violation of state sovereignty and an unlawful enlargement of the powers of Congress, notwithstanding that states “may voluntarily consent to be sued; [and] may permit actions against [their]

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90. 298 U.S. 513 (1936).

91. *Id.* at 531.

92. See, e.g., *In re City of Stockton*, 478 B.R. 8, 17-18 (Bankr. E.D. Cal. 2012) (stating that, although particular statutory terms might violate constitutional principles, the Supreme Court subsequently “repudiated” *Ashton*’s structural objection to municipal bankruptcy); McConnell & Picker, *supra* note 8, at 452 (“Even granting the underlying constitutional premise of dual federalism (which is no longer given strict application), the *Ashton* decision seems unnecessary and misguided.”).

93. Act of May 24, 1934, Pub. L. No. 251, 48 Stat. 798, *invalidated by Ashton v. Cameron Cty. Water Improvement Dist. No. 1*, 298 U.S. 513 (1936).

94. § 80, 48 Stat. at 802-03.

95. 298 U.S. at 538 (Cardozo, J., dissenting).

96. *Id.* at 531 (majority opinion).

political subdivisions to enforce their obligations” without violating that same principle.<sup>97</sup> To permit Congress to legislate bankruptcy proceedings for a political subdivision of the state would be tantamount, the Court concluded, to permitting Congress to tax states or their political subdivisions, an activity that all understood as violating constitutional principles of federalism.

Congress responded by essentially reenacting the law that the Supreme Court had invalidated. The revised statute itself changed little, other than to exclude counties and to include a legislative history that acknowledged the “sweeping character” of the holding in *Ashton* and effectively rejected it.<sup>98</sup> Nevertheless, Congressman Wilcox went to lengths to indicate the narrow scope of the legislation, its limited impact on the states, and the voluntary nature of the municipal bankruptcies it authorized.<sup>99</sup> Given the continued requirement that a majority of creditors agree to a composition in order to obtain relief, Wilcox indicated that the bill constituted “purely and simply a composition, acceptable to the petitioning district and the majority creditors, and that no governmental function is involved.”<sup>100</sup> Wilcox stressed that “this is not a bill designed to superimpose the will of Congress onto the will of the municipality or the district.”<sup>101</sup> Nor was it a bill “to dictate to a municipality or taxing unit how it should operate its business.”<sup>102</sup> Wilcox emphasized the composition aspect because, as he read *Ashton*, the decision was predicated on a mistaken belief that Congress was “imposing its will on a municipality.”<sup>103</sup> The new bill, in Wilcox’s view,

made it plain enough that neither the Court nor the Congress nor anybody has any right or power to say to any municipality, after it goes

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97. *Id.*

98. See Act of Aug. 16, 1937, Pub. L. No. 75-302, § 81, 50 Stat. 653, 654 (not including counties on its list of the types of municipalities permitted to file for bankruptcy). Wilcox was unable to contain his displeasure with the Supreme Court ruling in *Ashton*, calling it “the most ill-advised, ill-considered, and utterly ridiculous opinion ever rendered by any court in the history of modern jurisprudence.” *Hearing on H.R. 2505, H.R. 2506, H.R. 5403 and H.R. 5969 Before the Subcomm. on Bankr. and Reorg. of the H. Comm. on the Judiciary*, 75th Cong. 24 (1937) (statement of Rep. J. Mark Wilcox) [hereinafter *1937 House Hearing*]. Wilcox went on to note that he had difficulty drafting a bill that conformed to the ruling in *Ashton* without making changes in the invalidated Act because “the original act is a perfect answer to every argument made by Mr. Justice McReynolds” in that case. *Id.*

99. *1937 House Hearing*, *supra* note 98, at 32 (statement of Rep. J. Mark Wilcox).

100. *Id.* at 144 (statement of Rep. J. Mark Wilcox).

101. *Id.* (statement of Rep. J. Mark Wilcox).

102. *Id.* at 145 (statement of Rep. J. Mark Wilcox).

103. *Id.* at 146 (statement of Rep. J. Mark Wilcox).

into court, “We will order you to do thus and so”, [sic] or “We are going to change your method of payment, or your system of taxation,” or anything else.<sup>104</sup>

Thus, Wilcox was concerned about meeting the *Ashton* opinion on its own terms, not arguing that it was wrong as a constitutional matter.

Only two years after the Court decided *Ashton*, it upheld the “new” law in *United States v. Bekins*.<sup>105</sup> State consent, which had been deemed insufficient in the 1934 law, formed the primary basis on which the Supreme Court upheld the revised version of the legislation.<sup>106</sup> Wilcox’s effort at clarification obviously was successful, as the Court concluded that the new law

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.<sup>107</sup>

Virtually all commentators have concluded that the differences in the two statutes were solely cosmetic, and that politics—the Supreme Court’s famous “switch-in-time”—rather than changes in legislative language explains the shift from *Ashton* to *Bekins*.<sup>108</sup> The availability of a federal forum for debt

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<sup>104.</sup> *Id.* at 146-47 (statement of Rep. J. Mark Wilcox).

<sup>105.</sup> 304 U.S. 27 (1938).

<sup>106.</sup> Ironically, the state-consent requirement was arguably less expansive in the 1937 Act than in the 1934 Act (neither of which explicitly required state consent). But the Supreme Court concluded that the distinctions were immaterial. *See id.* at 49.

<sup>107.</sup> *Id.* at 51.

<sup>108.</sup> The “switch-in-time” term is often used to refer to the Supreme Court’s upholding of New Deal legislation after President Roosevelt proposed increasing the number of Justices. Indeed, during the hearings on the 1937 legislation, Representative Walter Chandler suggested to Representative Wilcox that “[w]e might accomplish the things that you have in mind by enlarging the size of the Court.” 1937 *House Hearing, supra* note 98, at 33 (statement of Rep. Walter Chandler, Chairman, Subcomm. on Bankr. & Reorganization). For recent commentary attributing the Court’s shift in *Bekins* to the switch-in-time, see, for example, Daniel J. Goldberg, *Municipal Bankruptcy: The Need for an Expanded Chapter IX*, 10 U. MICH. J.L. REFORM 91, 94 (1976); Thomas Moers Mayer, *State Sovereignty, State Bankruptcy, and a Reconsideration of Chapter 9*, 85 AM. BANKR. L.J. 363, 369-71 (2011); and Michael W. McConnell, *Extending Bankruptcy Law to States*, in *WHEN STATES GO BROKE:*

adjustment to overcome the Contracts Clause obstacle for states was represented as an example of federal-state cooperation rather than one of conflict.<sup>109</sup> But even *Bekins* said little about the constitutional scope of municipal bankruptcy. While the Court emphasized that the law did not “impinge on the sovereignty of the State” and allowed the state to maintain control of “its fiscal affairs,” the opinion also stressed that sovereignty includes the capacity to make contracts in which the states “give consents upon which the other contracting party may rely with respect to a particular use of governmental authority.”<sup>110</sup>

Of course, even more has changed in the balance struck by principles of federalism since *Bekins*. While direct taxation of states remains outside the congressional purview, congressional regulation and taxation of state fiscal activities have been upheld.<sup>111</sup> Though the parameters of congressional authority to regulate state policies through the Commerce Clause remain murky,<sup>112</sup> the more specific nature of the Bankruptcy Clause has systematically been held to grant Congress substantial authority over the scope of bankruptcy proceedings, even where the results of those proceedings affect states or their subdivisions.<sup>113</sup>

### C. *New York City and the 1970s Amendments*

The next major period of municipal bankruptcy reform came four decades later.<sup>114</sup> Whereas the distress that prompted the original municipal bankruptcy

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(Peter Conti-Brown & David Skeel eds., 2012).

109. *Bekins*, 304 U.S. at 53-54. The theme of municipal bankruptcy as a form of federal-state cooperation was pervasive in the municipal bankruptcy literature in the 1930s. For a discussion of the theme, see generally Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403, 446-53 (2014).
110. *Bekins*, 304 U.S. at 51-52.
111. See, e.g., *South Carolina v. Baker*, 485 U.S. 505 (1988) (upholding federal regulations limiting the tax exemption on municipal debt to instruments issued in a specified form); *Willcuts v. Bunn*, 282 U.S. 216 (1931) (allowing federal taxation of capital gains on municipal bonds).
112. We discuss the Supreme Court’s commandeering and unconstitutional conditions jurisprudence *infra* Section IV.C.
113. See, e.g., *Cent. Va. Cmty. Coll. v. Katz*, 546 U.S. 356, 379 (2006) (upholding the application of the Federal Bankruptcy Code in an action between a debtor and a state agency).
114. In 1946, Congress added a provision designed to overrule the Supreme Court’s decision in *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942), which had held that a New Jersey law altering an insolvent municipality’s obligations to creditors did not conflict with Congress’s bankruptcy power. Congress’s new provision, which is now part of § 903,

law was nationwide, the 1970s crisis centered on a single city: New York City. Inefficient and interest-group-dominated municipal governance was widely recognized as a root cause of New York City's financial distress.<sup>115</sup> New York City had long lived beyond its means, in large part to cement political support by traditional politically influential groups. Fiscal distress increased as the civil-rights movement empowered new groups to demand a share of municipal resources that they had previously been denied and to which city officials acceded without reducing other expenditures. Total city spending rose forty-seven percent in a two-year period in the mid-1960s, largely as a consequence of previously negotiated settlements with public labor unions.<sup>116</sup> Spending on welfare doubled in the same period, and Medicaid spending quadrupled.<sup>117</sup> While spending stabilized in subsequent years and new revenue sources—including additional state grants—brought some budgetary stability, by the end of the decade, recession made spending levels unsustainable. The city's response, however, was not to attempt to undo obligations but to obfuscate their costs, which were "pasted over with new taxes, gimmicks, and wishful thinking."<sup>118</sup> At bottom, New York City's predicament stemmed from a governance structure that tolerated or encouraged generous expenditures to politically influential groups, fostered by a politically entrenched budgetary system. The New York City crisis of the 1970s raised the issue of governance reform much more directly than the 1930s deliberations had.

Starting in 1974, state and local officials in New York actively intervened, ultimately establishing several different oversight boards and providing \$2.3 billion in rescue financing.<sup>119</sup> New York Governor Hugh Carey, who had

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limits state restructuring laws. 11 U.S.C. § 903 (2012). The restriction figures prominently in Puerto Rico's current debt crisis but is less salient to the issues that concern us in this Article. For an overview of the 1946 amendment and the Puerto Rico crisis, see, for example, Stephen J. Lubben, *Puerto Rico and the Bankruptcy Clause*, 88 AM. BANKR. L.J. 553, 568-78 (2014).

115. Donna E. Shalala & Carol Bellamy, *A State Saves a City: The New York Case*, 1976 DUKE L.J. 1119, 1122-23.

116. CHARLES R. MORRIS, *THE COST OF GOOD INTENTIONS: NEW YORK CITY AND THE LIBERAL EXPERIMENT, 1960-1975*, at 138 (1980).

117. *Id.*

118. *Id.* at 145.

119. In late 1974, a group of financial leaders formed the Financial Community Liaison Group (FCLG) with the encouragement of Mayor Abe Beame. Intended to consolidate the advice of the financial community, the FCLG had no formal authority and a perceived lack of democratic accountability and proved ineffectual as a result. In early 1975, the state legislature established the Municipal Assistance Corporation (MAC). The MAC was given control over New York City's sales tax and securities fees, as backing for its issuance of new bonds. This gave the MAC significant funding authority—and thus valuable carrots to

previously been a congressman for many years, made several trips to Washington to lobby for federal assistance for New York City.<sup>120</sup> President Ford balked, insisting in remarks at the National Press Club on October 29, 1975 that the real responsibility for New York City's crisis lay with the city itself and grumbling that responsibility was being dumped on the federal government.<sup>121</sup> Rather than a federal bailout, Ford concluded, New York City should consider filing for municipal bankruptcy.<sup>122</sup> The *New York Daily News* summed up his remarks with the now famous headline: "FORD TO CITY: DROP DEAD."<sup>123</sup>

Several weeks before Ford's remarks, the House Judiciary Committee held the first of a series of hearings on proposed amendments to the municipal bankruptcy provisions in the bankruptcy laws. Although a major bankruptcy reform effort that would culminate in overhaul of the entire bankruptcy statute in 1978 was well underway, the impetus for the October 1975 hearings was the New York City crisis. A recurring question was whether New York City could plausibly use the existing municipal bankruptcy laws to restructure its obligations. Every witness who raised the question agreed that it would be impossible for New York City to obtain the approval of fifty-one percent of its creditors in time for a bankruptcy filing, as required by the then-current municipal bankruptcy provisions.<sup>124</sup>

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entice reform—but relatively little direct oversight power. That came with a third intervention, the state's enactment of the Financial Emergency Act, which created the Emergency Financial Control Board (EFCB). In addition to launching the EFCB, the legislation provided for \$750 million in state rescue funding as part of a \$2.3 billion rescue package, codified a recent New York City wage freeze, and established a special deputy comptroller for the city to report to State Comptroller Arthur Levitt. Under the terms of its enactment, the EFCB was authorized to devise and approve a three-year budget to return the city to solvency, to exercise veto power over city borrowing, to supervise the use of all city revenues, to file for bankruptcy and propose a reorganization plan, and to implement the wage freeze. Among the best accounts of the drama are ROBERT W. BAILEY, *THE CRISIS REGIME: THE MAC, THE EFCB, AND THE POLITICAL IMPACT OF THE NEW YORK CITY FINANCIAL CRISIS 1-12* (1984); SEYMOUR P. LACHMAN & ROBERT POLNER, *THE MAN WHO SAVED NEW YORK: HUGH CAREY AND THE GREAT FISCAL CRISIS OF 1975*, at 75-166 (2011); and MARTIN SHEFTER, *POLITICAL CRISIS/FISCAL CRISIS: THE COLLAPSE AND REVIVAL OF NEW YORK CITY 127-37* (1985).

120. LACHMAN & POLNER, *supra* note 119, at 150-55.

121. *Id.* at 155-56.

122. *Id.* at 155.

123. Frank Van Riper, *Ford to City: Drop Dead*, N.Y. DAILY NEWS, Oct. 30, 1975, at A1.

124. Even a representative of municipal creditors, who would have favored retention of the fifty-one percent approval requirement, acknowledged this: "It is I think fairly clear from a reading of the newspapers presently and a review of the New York City situation that it would be very difficult to obtain the approval of 51 percent of the creditors in sufficient time

Two developments in the hearings are particularly revealing of the relationship between bankruptcy and municipal governance. First, several weeks after the initial hearing, the Ford Administration proposed that Congress enact a new, separate Chapter XVI designed solely for major cities like New York.<sup>125</sup> The new chapter, which was considered in a hearing two days after Ford's National Press Club remarks, would have applied only to cities with at least one million residents.<sup>126</sup> It also would have eliminated the fifty-one percent creditor-approval prerequisite for eligibility, while retaining the requirement that the city file a preliminary restructuring proposal with its bankruptcy petition.<sup>127</sup> Finally, the new chapter would have required the municipality to show explicitly how it would balance its revenues and costs going forward.<sup>128</sup>

Then-Assistant Attorney General Antonin Scalia, who testified on behalf of the proposal, emphasized that the new chapter would ensure "more substantial use of Federal judicial authority in overseeing reestablishment of the fiscal integrity of the petitioning city."<sup>129</sup> Scalia contended that active judicial intervention was essential for an effective financial restructuring of a substantial city and that enacting a separate chapter for big cities would minimize the risk of constitutional objections. Because the default of a large city "might seriously disrupt banking, financial and commercial activities nationwide," Scalia reasoned, Congress could draw on the Commerce Clause as well as the Bankruptcy Clause for authority.<sup>130</sup>

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to enable the city to avail itself of the protections of the Bankruptcy Act." *Hearings on S. 235 and S. 236 Part II Before the Subcomm. on Improvements in Judicial Mach. of the S. Comm. on the Judiciary*, 94th Cong. 688 (1975) (statement of Haven N.B. Pell, Attorney, Kutak Rock Cohen Campbell Garfinkle & Woodward) [hereinafter *1975 Senate Hearing (Part II)*].

125. A transmittal letter from President Gerald Ford and the text of the proposed Chapter XVI are reprinted in *Hearing on S. 235, S. 236, S. 582 and S. 2597 Before the Subcomm. on Improvements in Judicial Mach. of the S. Comm. on the Judiciary*, 94th Cong. 186-192 (1975) [hereinafter *1975 Senate Hearing (Part III)*].

126. S. 2597, 94th Cong. § 803(a) (1975).

127. *Id.* § 804(b). Then-Assistant Attorney General Antonin Scalia defended the requirement that the municipality file a plan at the outset of the case as necessary to prevent filing by a city that was not serious about addressing its obligations. *See, e.g., 1975 Senate Hearing (Part III)*, *supra* note 125, at 209 (statement of Antonin Scalia, Assistant Att'y Gen. of the United States) (noting that the creditors' right to challenge the initial plan as inadequate would ensure that the municipality was genuinely committed to restructuring by "render[ing] the risk of a frivolous plan not worth the taking").

128. S. 2597 § 804(b).

129. *1975 Senate Hearing (Part III)*, *supra* note 125, at 199 (statement of Antonin Scalia, Assistant Att'y Gen. of the United States).

130. *Id.* at 207 (statement of Antonin Scalia, Assistant Att'y Gen. of the United States).

The second relevant feature of the hearings was a repeated emphasis on the need for municipal bankruptcy to facilitate governance reform. The most interesting proposal in this regard came from Judge Patchan, a bankruptcy judge in Cleveland. Patchan's proposal had two parts. The first was greater flexibility for courts to shape the restructuring process. "With due regard for state sovereignty," he said, "the federal courts should be granted a more active role within the design of the municipal bankruptcy chapter of the Act presently contemplated by Congress."<sup>131</sup> Patchan maintained that "where the debtor alone cannot design a workable plan or where functional restructuring is needed, the court should serve as a catalyst to bring necessary parties together to produce such a plan."<sup>132</sup> He advocated that the court be given continuing jurisdiction to ensure that the municipality carried out its restructuring plan.<sup>133</sup>

Patchan's second proposal sought to facilitate governance reform that a municipal debtor might not be able to carry out on its own. "I would suggest," Patchan told the lawmakers, "that consideration be given to a means by which State officials, or local officials outside the debtors' administration, can be brought into the formulation of a plan and given standing in court. In that way the city may gain necessary State house support for possible restructuring of local government functions."<sup>134</sup> Patchan proposed that the bankruptcy judge be authorized to form a committee of relevant officials and to give the committee the power to propose a restructuring plan.<sup>135</sup>

Another witness, representing the then-new municipal bond insurance business, offered a less fully developed proposal for governance reform.

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131. *Bankruptcy Act Revision: Hearing on H.R. 31 and H.R. 32 Before the Subcomm. on Civil & Constitutional Rights of the H. Comm. on the Judiciary*, 94th Cong. 647 (1975) (statement of Judge Joseph Patchan) [hereinafter *1975 House Hearings*].

132. *1975 Senate Hearing (Part III)*, *supra* note 125, at 230 (statement of Judge Joseph Patchan).

133. *Id.* at 230-31 (statement of Judge Joseph Patchan) ("Retention of jurisdiction until substantial compliance with plan should be mandatory. . . . Unless there is mandatory retention of jurisdiction there is little assurance that succeeding city administrations will honor a demanding plan.").

134. *1975 House Hearings*, *supra* note 131, at 649 (statement of Judge Joseph Patchan).

135. *Id.* at 650 (statement of Judge Joseph Patchan). Judge Patchan also anticipated a key point we will make *infra* Section II.D about the unique governance issues of large cities:

We have, however, the equivalent of chapter XI [the bankruptcy provisions for small businesses] for a small city and small local governmental taxing units here, and needed is the capability to handle and help large cities, the equivalent perhaps of chapter X [the bankruptcy provisions for large corporations] for larger entities, which may need pervasive treatment. Neither the present law, nor the provisions of the proposed bills which are before you provide sufficiently for the larger cities; there are additional provisions required.

*Id.* at 649 (statement of Judge Joseph Patchan).

Referring explicitly to the New York City crisis, he argued that the “bankruptcy judge should have the benefit of the expertise of an advisory board similar to the ‘Big Mac’ board to assist him in evaluating the likelihood of success of a [restructuring] plan.”<sup>136</sup>

Neither lawmakers nor the witnesses in the hearings seemed to doubt that Congress had the authority to include provisions like these in its municipal bankruptcy amendments. Then-Assistant Attorney General Scalia, who extolled the proposed Chapter XVI as assuring federal judicial oversight, as noted earlier, was confident that the new chapter would be constitutionally sound.<sup>137</sup> Harvard Law professor Vern Countryman, who dismissed the proposed Chapter XVI as pointless “shadow-boxing” between President Ford and New York officials, was especially insistent that any state sovereignty concerns were overstated.<sup>138</sup>

But the focus quickly shifted away from New York and its governance issues. The New York City crisis was moving too fast to be resolved by a hastily drafted new bankruptcy chapter, and it was far from clear that the proposed Chapter XVI would have been adequate in any event. Persuaded that the enactment of a moratorium law by the state of New York reflected an acknowledgment by New York City that it was in default, President Ford announced his support for more than two billion dollars in federal loan guarantees for New York several weeks later.<sup>139</sup> Congress enacted the necessary legislation shortly thereafter, and the President signed it on December 15, 1975.<sup>140</sup>

With New York’s immediate cash crunch averted, lawmakers scrapped the proposal for a new Chapter XVI and set aside the more ambitious governance-oriented proposals. Congress did, however, enact the most extensive reforms to the existing municipal bankruptcy laws since the 1930s. The signature change

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136. 1975 Senate Hearing (Part II), *supra* note 124, at 690 (statement of Haven N.B. Pell, Attorney, Kutak Rock Cohen Campbell Garfinkle & Woodward); *see also supra* note 119 and accompanying text (describing the functions of the MAC board).

137. Scalia based his confidence on the fact that the proposed chapter would be premised on both the Bankruptcy Clause and the Commerce Clause. 1975 Senate Hearings (Part III), *supra* note 125, at 199 (statement of Antonin Scalia, Assistant Att’y Gen. of the United States).

138. *See id.* at 234, 237 (statement of Vern Countryman, Professor, Harvard Law School) (complaining that the proposal “defer[s] too much to outmoded notions of state sovereignty”).

139. *See, e.g.,* LACHMAN & POLNER, *supra* note 119, at 164 (describing the Ford Administration’s conclusions “that the Moratorium Act was tantamount to a declaration of voluntary default” and that “the state and city were jointly facing up to their years of fiscal irresponsibility”).

140. New York City Seasonal Financing Act of 1975, Pub. L. No. 94-143, 89 Stat. 797 (codified as amended at 31 U.S.C. §§ 1501-1510 (2012)); *see* Shalala & Bellamy, *supra* note 115, at 1131.

was the removal of the requirement that a municipality secure the approval of fifty-one percent of its creditors to an initial restructuring proposal before filing.<sup>141</sup> Congress made a number of other important changes as well, one of which explicitly authorized municipal debtors to assume or reject collective bargaining agreements and other executory contracts.<sup>142</sup>

#### *D. Selection Bias in Municipal Bankruptcy Filings*

In one sense, the historical evidence described in Section II.B and Section II.C only deepens the mystery we are trying to solve: if lawmakers understood the importance of governance reform, and assumed that municipal bankruptcy could be used for this purpose, why do we see so little of it in actual Chapter 9 cases? Lingering concerns about constitutionality no doubt played some role, but we think the heart of the explanation lies elsewhere.

The first thing to note is that significant obstacles remained, even after 1976, for a municipality that wished to file for Chapter 9. Federal bankruptcy courts were available only to those municipalities whose states authorized a Chapter 9 petition, and even today, only half the states have granted the requisite permission.<sup>143</sup> Although they no longer were required to secure fifty-one percent approval before filing for bankruptcy, municipal debtors still had to demonstrate, among other things, that they were insolvent, which is uniquely defined for Chapter 9 purposes to mean failure to pay debts as they become due or inability to pay debts as they become due.<sup>144</sup> Since municipalities have access to tax revenues, the insolvency requirement can be very difficult to meet, even for a municipality in dire financial straits. For example, Bridgeport, Connecticut's effort to adjust debts in bankruptcy during a period of extreme fiscal distress foundered on the court's determination that

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141. See Bankruptcy Act, Pub. L. No. 94-260, 90 Stat. 315 (1976), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

142. See *id.* § 82(b)(1), 90 Stat. at 316 (codified as amended at 11 U.S.C. § 904 (2012)).

143. See CHAPMAN & CUTLER LLP, MUNICIPALITIES IN DISTRESS? HOW STATES AND INVESTORS DEAL WITH LOCAL GOVERNMENT FINANCIAL EMERGENCIES app. B (2012) (identifying twelve states as unconditionally authorizing municipalities to file for Chapter 9, and fifteen more as permitting Chapter 9 under specified conditions). The state-consent requirement was changed from a "general" to a "specific" authorization in 1994. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 402, 108 Stat. 4106, 4141 (codified at 11 U.S.C. § 109(c)(2)). The change appears to have been the result of a desire to resolve a split among federal courts as to whether express statutory authorization by state law was necessary in order for a municipality to file for bankruptcy. See 140 CONG. REC. H10,771 (daily ed. Oct. 4, 1994) (statement of Rep. Brooks).

144. 11 U.S.C. § 101(32)(C).

the city was not insolvent because it was still capable of borrowing and had not yet run out of cash.<sup>145</sup> The stigma of a bankruptcy filing also has a chilling effect, especially for large and complex municipalities. No mayor wants to be the one who has put his or her city in bankruptcy.

Due to these obstacles, together with states' ability to intervene in a variety of ways, there has long been a striking (and oft-noted) selection bias in actual municipal bankruptcy cases. Until recently, financially distressed sewer and water districts filed for Chapter 9, but substantial cities simply did not.<sup>146</sup> Of the 650 or so municipalities that filed for bankruptcy between 1997 and 2009, the vast majority have been special districts, such as irrigation districts that failed to attract expected development or small towns crippled by a lawsuit or unexpected catastrophe.<sup>147</sup> Thus, financial infeasibility, rather than dysfunctional governance, motivated these bankruptcy petitions. Until the recent spate of municipal bankruptcies, the only large jurisdiction other than Bridgeport that had sought the protection of Chapter 9 was Orange County, California, which suffered from its treasurer's losing bets on derivatives contracts.<sup>148</sup>

Much more than constitutional concerns, this selection bias explains why governance has figured more prominently in legislative debates than in actual cases. To return to our Chapter 11 analogy, the parallel situation would arise in the corporate context if the only firms that filed for Chapter 11 were small restaurants and other closely held corporations, not large businesses like Chrysler or United Airlines. When a closely held corporation files for Chapter 11, it ordinarily is either reorganized with its existing owners intact, or liquidated.<sup>149</sup> Governance reform plays little or no role. It is only with more complex businesses that we see the carefully calibrated governance reforms described in Part I.

The same logic applies in Chapter 9. Because the municipalities that filed for bankruptcy before 2008 tended to be special districts, it is hardly surprising that we do not find efforts to use Chapter 9 to effect governance reform. While

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<sup>145.</sup> *In re City of Bridgeport*, 129 B.R. 332, 337-38 (Bankr. D. Conn. 1991); *see also* ROBERT S. AMDURSKY ET AL., *MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE* 428 (2d ed. 2013).

<sup>146.</sup> *See* Kimhi, *supra* note 2, at 359-60, 359 n.43.

<sup>147.</sup> *See* CHAPMAN & CUTLER LLP, *supra* note 143, at 49; Kimhi, *supra* note 2, at 359 n.44.

<sup>148.</sup> *See In re County of Orange*, 183 B.R. 594, 597-98 (Bankr. C.D. Cal. 1995); MARK BALDASSARE, *WHEN GOVERNMENT FAILS: THE ORANGE COUNTY BANKRUPTCY* 2 (1998).

<sup>149.</sup> *See generally* Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 636-37 (2009) (presenting evidence that, although most small corporate debtors liquidate in Chapter 11, a significant percentage of small corporate debtors that can plausibly reorganize do reorganize).

filings by substantial municipalities still make up a small fraction of Chapter 9 petitions,<sup>150</sup> the frequency of filings by such entities has increased.<sup>151</sup> Because the financial distress of many municipalities stems in large part from obligations such as pensions that cannot easily be restructured outside of bankruptcy, additional filings can reasonably be anticipated.<sup>152</sup>

We draw two conclusions, one descriptive and one normative, from Chapter 9's new prominence as a restructuring option for substantial cities. First, we predict that, as more cities make use of Chapter 9, there will be increased pressure to include substantial governance reform as part of the reorganization process. Second, we believe that governance reform should be—indeed, must be—incorporated into Chapter 9. We take up the latter point in Part III.

### III. AN AFFIRMATIVE CASE FOR GOVERNANCE REFORM

As discussed in Part II, problems with the city's governance are nearly always a major factor when a substantial city falls into financial distress. In this Part, we take a closer look at some of the governance tendencies that can exacerbate a city's financial difficulties and stymie efforts to reverse a downward spiral. Not only can Chapter 9 governance reform counteract these tendencies, but a restructuring plan that does not address the governance dysfunction may be destined to fail. Indeed, to put the point more strongly, if a city's governance dysfunctions are severe, a bankruptcy judge should not confirm a restructuring plan that leaves the governance crisis unaddressed.

#### A. *Fragmented Governance as a Source of Distress*

The most common governance problem—our principal focus in the discussion that follows—is a fragmented local decision-making structure.<sup>153</sup>

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150. See CHAPMAN & CUTLER LLP, *supra* note 143, at 50 (noting that, of the 262 filings between 1980 and early 2012, only five have involved municipalities of significance).

151. For a partial list of recent filings by substantial municipalities, see *supra* notes 1-2 and accompanying text.

152. Pension obligations frequently constitute contracts under state law, meaning that the Contracts Clause of the Federal Constitution restricts the capacity of the state to impose any change that would reduce fiscal distress. Thus, only federal bankruptcy intervention can effectively force an adjustment of the debts owed to pensioners. See, e.g., *In re City of Detroit*, 524 B.R. 147, 272 (Bankr. E.D. Mich. 2014); Amy B. Monahan, *State Fiscal Constitutions and the Law and Politics of Public Pensions*, 2015 U. ILL. L. REV. 117.

153. See WALLACE S. SAYRE & HERBERT KAUFMAN, *GOVERNING NEW YORK CITY: POLITICS IN THE METROPOLIS* 710-12 (1960); Robert P. Inman & Michael A. Fitts, *Political Institutions and*

One of us has recently considered the fragmentation issue in a related context.<sup>154</sup> We therefore only summarize the issue here. We begin by briefly describing four general patterns of municipal governance fragmentation, then consider how a bankruptcy court could counteract the fragmentation.

In a fragmented budgetary system, fiscal policy is decentralized in a manner that allows decision makers to determine expenditures without simultaneously internalizing their costs.<sup>155</sup> As a result, the municipal budget takes on the characteristics of a common pool from which various actors can obtain benefits, while sharing the costs with other participants. Because those who utilize the common resource fail to internalize the full costs of their activity, there is a tendency for overuse.<sup>156</sup> In the municipal context, the misalignment between costs and benefits through fragmentation could arise from any of numerous sources.

First, different branches of the municipal bureaucracy could have authority over spending and be inattentive to the manner in which their spending decisions affect the overall budget. The mayor, for instance, may wish to concentrate spending on a small number of projects each of which, as a consequence of scale, has a high expected value for the municipality. City-council members may prefer to spend the same amount of money on numerous small projects, each of which has a positive, but relatively low expected value within a member's district, and the aggregate of which does not equal the expected value of the smaller number of large projects favored by the mayor. Departments within the municipality may have interests in maximizing their share of the municipal budget rather than providing efficient service. If their costs are opaque to legislators, bureaus may obtain a level of funding in excess of that preferred by the median legislator or the median voter.<sup>157</sup>

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*Fiscal Policy: Evidence from the U.S. Historical Record*, 6 J.L. ECON. & ORG. 79, 81-82 (1990); Omer Kimhi, *A Tale of Four Cities—Models of State Intervention in Distressed Localities Fiscal Affairs*, 80 U. CIN. L. REV. 881, 892-93, 914-17 (2012); Kimhi, *supra* note 2, at 378-79; Guntram B. Wolff, *Fiscal Crises in U.S. Cities: Structural and Non-Structural Causes* (ZEI, Working Paper No. B 28-2004, 2004), <http://www.econstor.eu/dspace/bitstream/10419/39523/1/478945442.pdf> [<http://perma.cc/5KUY-TGU6>].

154. See Gillette, *supra* note 31, at 1420-133.

155. See Roberto Perotti & Yianos Kontopoulos, *Fragmented Fiscal Policy*, 86 J. PUB. ECON. 191, 194 (2002).

156. In the standard example, fishermen overfish an area because each fisherman obtains the benefit of his full catch while sharing the costs with other fishermen. The tragedy-of-the-commons nomenclature is attributed to Garrett Hardin, *The Tragedy of the Commons*, 162 SCI. 1243 (1968).

157. See William A. Niskanen, *Bureaucrats and Politicians*, 18 J.L. & ECON. 617, 630-35 (1975) (summarizing studies that suggest the monopoly power of governments and bureaus increases expenditures above what is preferred by the median legislator or median voter).

Second, different individuals *within* a governmental branch could have authority over spending and engage in negative-sum logrolling to support each other's favored projects, notwithstanding that those projects do not return net local fiscal benefits. Trades among city-council members in order to favor projects for the districts from which they are elected may take this form. The desire of city-council members to appeal to constituents within their respective districts and the subsequent tendency for logrolling suggests that city expenditures per capita will increase with the number of districts. Barry Weingast, Kenneth Shepsle, and Christopher Johnsen formalized this effect with the law of  $1/n$ , which assumes that a citywide tax is used to finance a project in a specific district.<sup>158</sup> As the share of the project's cost in the district decreases, the law of  $1/n$  predicts that the number and cost of projects will increase.<sup>159</sup> Subsequent empirical work by Reza Baqir;<sup>160</sup> Laura Langbein, Philip Crewson, and Charles Brasher;<sup>161</sup> and John Charles Bradbury and E. Frank Stephenson<sup>162</sup> supported the existence of a positive relationship between council size and expenditures. More recently, however, Lynn MacDonald has attempted to control for the possibility that the relationship between council size and spending is endogenous, and has concluded that the relationship is "not definitively positive."<sup>163</sup> Of course, even empirical work that does not support the law of  $1/n$  does not necessarily indicate the absence of adverse effects from decentralized districts. Within a fixed budget, if expenditures are used for projects that do not have positive citywide effects, fiscal stability could suffer. New York City's fiscal crisis, for example, was not simply a function of

158. Barry R. Weingast, Kenneth A. Shepsle & Christopher Johnsen, *The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics*, 89 J. POL. ECON. 642, 654 (1981).

159. *Id.*

160. Reza Baqir, *Districting and Government Overspending*, 110 J. POL. ECON. 1318 (2002).

161. Laura I. Langbein, Philip Crewson & Charles Niel Brasher, *Rethinking Ward and At-Large Elections in Cities: Total Spending, the Number of Locations of Selected City Services, and Policy Types*, 88 PUB. CHOICE 275, 285 (1996). The authors find, however, that the relationship between spending and district representation varies with different kinds of projects. Those projects that are appealing to all constituents throughout the city receive more expenditures regardless of the system for electing council members, while projects that may be undesirable but that are demanded by a concentrated group tend to receive more funding where districts exist. *Id.* at 289-90. The authors suggest that attention to different types of projects explains some conflicting findings about the relationship between city-council size and spending in other literature. *Id.*

162. John Charles Bradbury & E. Frank Stephenson, *Local Government Structure and Public Expenditures*, 115 PUB. CHOICE 185 (2003).

163. Lynn MacDonald, *The Impact of Government Structure on Local Public Expenditures*, 136 PUB. CHOICE 457, 470 (2008).

high expenditures, but also of the use of expenditures for groups that had substantial political power and did not necessarily represent the interests of the city at large.<sup>164</sup> In addition, the empirical work also does not distinguish between healthy and distressed localities; it is plausible that the effects of the law of  $1/n$  are more pronounced in distressed cities than in the average city within the studies.

Third, bureaucrats with expenditure authority who do not coordinate may make budgetary decisions that either duplicate efforts or conflict with each other. If both the city council and the mayor's office form subdivisions for tasks such as city planning or environmental review, the different constituencies of those offices could generate more redundancy and conflict than collaboration. The consequences for the fiscal condition of municipalities have been captured in accounts of cities such as New York and Chicago.<sup>165</sup> Fragmentation in budget making and expenditures in those cities tends to generate redistribution of wealth to groups that are able to influence the entity with expenditure authority, and the plethora of such authorities leads to increases in the size of government.<sup>166</sup>

Even after its bankruptcy, Detroit's governance appears to reflect the third type of fragmentation, burdening the city's decision making with costly redundancies. Although the causes of Detroit's decline over the second half of the twentieth century are multifaceted, fragmented governance and reduced budgetary flexibility may have diluted the city's capacity to adjust to the decline of the auto industry, white flight, and other challenges.<sup>167</sup> For example, Detroit's separate planning departments report separately to the mayor's office and to the city council. This arrangement invites review of plans both by the mayor, who is responsible to the city as a whole, and by individual city-council members, who consider the interests of particular electoral districts. Similarly, while Detroit's City Charter provides for an office of corporation counsel, the charter also authorizes the city to obtain the opinion or advice of an attorney in any matter pending before it, and to retain an attorney to represent the council in a matter where there exists a conflict of interest with another branch of

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164. See, e.g., SHEFTER, *supra* note 119, at 95-96 (documenting expenditures made to civil-service unions in order to ensure that public-employee strikes would not interfere with an electoral campaign).

165. See *id.* at 127-37; see also ESTER R. FUCHS, *MAYORS AND MONEY: FISCAL POLICY IN NEW YORK AND CHICAGO* (1992) (discussing effects of mayoral authority on the ability of cities to withstand fiscal shocks); SAYRE & KAUFMAN, *supra* note 153 (discussing the role of political groups and agencies in influencing government activity).

166. Cf. Baqir, *supra* note 160, at 1318-20.

167. For an account of Detroit's decline even prior to its recent fiscal crisis and bankruptcy, see THOMAS J. SUGRUE, *THE ORIGINS OF THE URBAN CRISIS* (1996).

government.<sup>168</sup> Although the charter seems to envision that additional legal assistance will be obtained only in special circumstances, the city council created a permanent legal division that frequently conflicts with the Office of Corporation Counsel.<sup>169</sup>

The process for selecting Detroit's police chief reflects a fourth form of fragmentation in that it decentralizes appointive authority over city officials, with equally dire implications for Detroit's financial health. The empirical literature on business mobility reveals that crime rates figure prominently in firms' decisions to move or expand their business, though they lag behind cost factors in significance.<sup>170</sup> This evidence suggests that low crime rates contribute to municipal fiscal health.<sup>171</sup> Courts are well aware of the link between effective policing and municipal financial health. In both the Detroit and Stockton bankruptcy cases, for instance, the bankruptcy judge pointed to cutbacks of police services as evidence of municipal crisis.<sup>172</sup> Thus, one might conclude that the selection of the person charged with choosing among plausible policing strategies (e.g., aggressive quality-of-life enforcement, community policing, or increasing police presence) could significantly affect a municipality's fiscal stability. Perhaps for this reason, city charters in major cities tend to confer on the mayor the exclusive authority to appoint or to nominate the chief of police.<sup>173</sup> Detroit's City Charter, by contrast, substantially constrains the

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168. DETROIT, MICH., CODE pt. 1 §4-121 (2012); see *id.* § 7.5-312 (providing for a special counsel in the instance of a conflict of interest with the Inspector General).

169. See Report on the Elimination of Redundancy in City Government 13 (2013) (unpublished manuscript) (on file with author).

170. See Lisa L. Love & John L. Crompton, *The Role of Quality of Life in Business (Re)Location Decisions*, 44 J. BUS. RES. 211, 219 (1999).

171. For evidence of particular policing strategies that have proven effective, see, for example, John E. Eck & Edward R. Maguire, *Have Changes in Policing Reduced Violent Crime? An Assessment of the Evidence*, in THE CRIME DROP IN AMERICA 207 (Alfred Blumstein & Joel Wallman eds., 2000); and Rafael Di Tella & Ernesto Schargrodsky, *Do Police Reduce Crime? Estimates Using the Allocation of Police Forces After a Terrorist Attack*, 94 AM. ECON. REV. 115 (2004).

172. See, e.g., *In re City of Stockton*, 493 B.R. 772, 789-90 (Bankr. E.D. Cal. 2013) ("The evidence demonstrates that the police department has been decimated. The crime rate has soared."); *In re City of Detroit*, 504 B.R. 191, 213 (Bankr. E.D. Mich. 2013). See also Bankruptcy Act, Pub. L. No. 94-260, 90 Stat. 315 (1976), repealed by Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

173. See e.g., DENVER, COLO., CODE §2.2.6(a) (2015) (with confirmation by city council); ATLANTA, GA., CODE pt. 1 §3-305(a) (2015) (with confirmation by city council); INDIANAPOLIS, IND., CODE, §181-501(e) (2015); BALT., MD., CITY CHARTER art. IV §6(a) (2014) (with confirmation by city council); N.Y.C., N.Y., CHARTER, ch. 18 §431(a) (2009); CLEVELAND, OHIO, CODE ch. 25 §116 (2005); PITTSBURGH, PA., CODE, art. 2 §209 (2009) (subject to approval by city council).

selection of that official. Detroit's charter provides for a Board of Police Commissioners consisting of eleven members, seven of whom are elected from the City's council districts.<sup>174</sup> The Board's responsibilities include establishing policies, rules, and regulations for the police department and approving the departmental budget.<sup>175</sup> Perhaps most importantly, the Board identifies candidates for the city's chief of police, and the mayor may only select the chief from the list that the board submits.<sup>176</sup>

Even in the abstract, this arrangement suggests that the mayor has limited control over the selection of policing strategies. In practice, the fragmentation is even more severe, because the Board has traditionally been heavily populated by commissioners who are themselves former police officers.<sup>177</sup> While the experience that they bring to the office may sometimes ensure greater understanding of the competing policies, there is also some risk that commissioners whose background involves policing will identify with the preferences of police officers rather than with the policies that would best serve the municipality.

It is unlikely that internal politics would generate reform of any of these structural inducements to fiscal excess. Bureaus that benefit from serving client groups can be expected to resist centralization of budgets that would limit their discretion or their funding.<sup>178</sup> City-council members will rarely abandon practices that allow them to provide services to constituents who maximize electoral chances or post-public service opportunities. Mayors are not inclined to welcome oversight of their decisions. For example, even when the New York City Charter was amended after the fiscal crisis of the 1970s to create the

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174. See DETROIT, MICH., CODE pt. 1 §7-802 (2012). The City Charter actually provides that the Board consists of eleven members, "seven of whom shall be elected from each non at-large district." Notwithstanding the linguistic challenge presented by the City Charter language, the understanding is that one member shall be elected from each of the seven council districts. See *Board of Police Commissioners*, CITY DET., <http://www.detroitmi.gov/Boards/BoardOfPoliceCommissioners> [<http://perma.cc/2H3G-SDSS>] (listing eleven current police commissioners).

175. DETROIT, MICH., CODE pt. 1 §7-803 (2012).

176. *Id.* §7-805.

177. The 2014 *Annual Report of the Detroit Board of Police Commissioners* indicates that five of the seven district representatives on the Detroit Board of Police Commissioners (Commissioners Willie Bell, Lisa Carter, Richard Shelby, Reginald Crawford, and Ricardo Moore) are former police officers. There are also four commissioners appointed by the mayor, none of whom appears to be a former police officer. See DETROIT BD. OF POLICE COMM'RS, 2014 ANNUAL REPORT, <http://corktownconnection.org/448-detroit-board-of-police-commissioners-2014-annual-report> [<http://perma.cc/7HMP-8SAA>].

178. See Niskanen, *supra* note 157, at 618-19.

Independent Budget Office (IBO), successive mayors sought to defund it<sup>179</sup> and provided funding only after losing court battles over withheld funding.<sup>180</sup> Entrenched political authority that favors fragmented decision making means that any reforms would have to emerge from some third party that has the authority to restructure governing institutions.

Under the approach we advocate, a bankruptcy judge could play this role when the consequences of fragmentation have become sufficiently severe that a municipality files for bankruptcy. A bankruptcy judge who construed Chapter 9 as including governance reform could induce revision of the city charter in a manner that defragmented municipal decision making by, for example, placing appointive power over the police department exclusively within the mayor's jurisdiction.

Alternatively, assume fiscal distress has been generated by negative-sum logrolling among city-council members, each of whom has secured funding for projects within his or her district at the expense of overall local welfare. At least three changes in institutional design could reduce the problem. First, the city council could be elected on an at-large basis rather than by district. Second, the number of city-council members could be reduced. Third, the mayor could be given a strong veto power that would permit her to deny funding to a project that appeared inconsistent with municipal welfare. Entrenchment could frustrate intramural efforts to enact any of these (or other meaningful) antilogrolling reforms. Again, a bankruptcy judge could spur redesign of municipal governance by encouraging one of these (or some other) reforms.<sup>181</sup>

More radically, a court could encourage a more thorough alteration of the existing form of government. Cities in the United States typically take either a council-manager form of government or a mayor-council form of

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179. Lynne A. Weikart, *Monitoring the Fiscal Health of America's Cities*, in HANDBOOK OF LOCAL GOVERNMENT FISCAL HEALTH 387, 396-97 (Helisse Levine et al. eds., 2013).

180. See, e.g., *N.Y. Pub. Interest Research Grp. v. Dinkins*, 632 N.E.2d 1255, 1259 (N.Y. 1994); *N.Y. Pub. Interest Research Grp. v. Giuliani*, 644 N.Y.S.2d 38, 39 (App. Div. 1996).

181. The choice among these alternatives would need to take into account factors such as the potential effect on minority representation. If replacing council districts with an at-large approach would reduce the likelihood of minority candidates being elected, for example, one of the other alternatives might be preferable. At least that is the case if one values the possibility that minority groups may have distinct interests that should be represented in the deliberative process of legislatures, even if representation takes the form of vote trading. See Lynn A. Baker, *Direct Democracy and Discrimination: A Public Choice Perspective*, 67 CHI.-KENT L. REV. 707, 727-28 (1991); Pamela S. Karlan, *Maps and Misreadings: The Role of Geographic Compactness in Racial Vote Dilution Litigation*, 24 HARV. C.R.-C.L. L. REV. 173, 181-82 (1989); Binny Miller, *Who Shall Rule and Govern? Local Legislative Delegations, Racial Politics, and the Voting Rights Act*, 102 YALE L.J. 105, 192 (1992).

government.<sup>182</sup> The former involves an elected council that hires a professional city manager. The city may have a mayor, but the council retains authority over policy and budget.<sup>183</sup> In the mayor-council form of government, both the mayor and council are elected. The mayor serves as chief executive and may have substantial administrative, budgetary, and appointive authority, as well as veto power over legislative enactments.<sup>184</sup>

The literature concerning the comparative fiscal performance of these forms of government is equivocal. It is not clear whether different methodologies, the different time periods in the studies, or some other variable explains these differences. There is theoretical support for each of the findings.<sup>185</sup> Stephen Coate and Brian Knight find that mayor-council forms of government have approximately nine percent lower per capita spending, and that spending falls following switches from council manager to mayor council and rises following switches in the other direction.<sup>186</sup> Lynn MacDonald concluded from a twenty-year study of political structure and fiscal-policy outcomes that council-manager cities had lower spending in the 1980s, but the effect disappeared in later years.<sup>187</sup> Earlier studies ran the gamut from showing higher spending under mayor-council forms of government,<sup>188</sup> to lower spending under that structure,<sup>189</sup> to the absence of any effect.<sup>190</sup>

Mayors who are elected citywide and have veto power may resist expenditures that only benefit a specific district. Managers may better control spending because they are not subject to political pressures from interest groups. But managers may spend as much as or more than mayors because managers are accountable to council members who may be subject to pressures

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182. BAKER ET AL., *supra* note 20, at 55.

183. *Id.*; see also Stephen Coate & Brian Knight, *Government Form and Public Spending: Theory and Evidence from U.S. Municipalities*, 3 AM. ECON. J. 82, 82 (2011).

184. BAKER ET AL., *supra* note 20, at 55.

185. For discussion of the various theories that underlie various findings, see Coate & Knight, *supra* note 183, at 83-84.

186. *Id.* at 83.

187. MacDonald, *supra* note 163, at 468.

188. See, e.g., Bernard H. Booms, *City Governmental Form and Public Expenditure Levels*, 19 NAT'L TAX J. 187, 192 (1966).

189. See, e.g., Edgar L. Sherbenou, *Class, Participation, and the Council-Manager Plan*, 21 PUB. ADMIN. REV. 131, 134 (1961).

190. See, e.g., Kevin T. Deno & Stephen L. Mehay, *Municipal Management Structure and Fiscal Performance: Do City Managers Make a Difference?*, 53 S. ECON. J. 627, 639 (1987); Kathy Hayes and Semoon Chang, *The Relative Efficiency of City Manager and Mayor-Council Forms of Government*, 57 S. ECON. J. 167, 176 (1990).

from those same groups.<sup>191</sup> The variations in these studies, however, should not preclude judicial consideration of a switch in government in a particular bankruptcy case. The studies consider cities generally, and it remains plausible that more systematic differences between forms of government exist for cities that are fiscally distressed. Given the theoretical explanations for why one form of government may be more fiscally stable than another, a court that concluded that the variables that generate high expenditures were present in a distressed city with one form of government could reasonably contemplate inducing a switch to the alternative. For example, a court that concluded that a manager exercised little discretion over implementation of council policies, and that those policies reflected disproportionate expenditures to groups that provided electoral support to legislators, might exert pressure for adoption of a strong mayor-council structure that permitted centralized budgeting and executive vetoes.<sup>192</sup>

In other contexts, a bankruptcy court might be convinced that the locality has too few, rather than too many, mechanisms for constraining fiscal profligacy. A bankruptcy judge could condition plan confirmation on the appointment of a financial control board that provided expertise in reviewing (and perhaps approving) city budgets and that increased the transparency of the budgetary process. Puerto Rico's recent proposal for restructuring the debt of the commonwealth and some of its public corporations included creation of a control board that would oversee the budgetary process and be authorized to levy sanctions for noncompliance with approved budgets.<sup>193</sup> As we have noted, New York City revised its City Charter to create the IBO.<sup>194</sup> That nonpartisan agency issues a forecast of revenue and spending for the coming year, performs a comprehensive review of the mayor's preliminary budget, and creates an analysis of the executive budget that focuses on changes from the preliminary budget. The IBO also issues detailed fiscal briefs on critical issues facing the city, prepares technical background papers, and outlines annual budget options for increasing revenue and saving costs.<sup>195</sup> The objectivity of the Office is

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191. See Deno & Mehay, *supra* note 190, at 628.

192. Cf. Richard C. Feiock & James Clinger, *Municipal Representation, Executive Power, and Economic Development Policy Activity*, 15 POL'Y STUD. J. 211, 214-15 (1986) (noting that cities with strong mayors, characterized by veto power and weak councils, have greater capacity to initiate economic-development policies).

193. See *Puerto Rico Fiscal and Economic Growth Plan*, WORKING GROUP FOR FISCAL & ECON. RECOVERY P.R. 53-54 (2015), <http://assets.documentcloud.org/documents/2388398/puerto-ricos-debt-plan.pdf> [<http://perma.cc/G4SL-3SQ6>].

194. See *supra* text accompanying notes 179-180.

195. For descriptions of the work of the IBO, see N.Y.C. INDEP. BUDGET OFF., <http://www.ibo.nyc.ny.us> [<http://perma.cc/NV2A-2BRQ>].

enhanced by a complicated process for appointment of a director that inhibits capture by any particular group within the city.<sup>196</sup> In addition, the independence and professionalism of the IBO are secured by a requirement that it receive funding in proportion to the budget office of the mayor.<sup>197</sup> While the success of the New York City IBO may be a function of its capacity to draw from a substantial talent pool of individuals with expertise in public finance, a bankruptcy judge plausibly could conclude that another municipality had sufficient access to human capital to make a similar body an effective agent for analyzing and publicizing budgetary issues as a municipality seeks to escape fiscal distress postbankruptcy.

To the extent that municipal distress is attributable to a temporal misalignment of costs and benefits of municipal expenditures, a bankruptcy court could demand structural reforms of institutions that exacerbate the externalization of costs to future residents. For example, several commentators have suggested that municipal difficulties arise from the use of defined benefit pension plans, rather than defined contribution plans, for municipal employees.<sup>198</sup> If elected officials can obtain electoral support by offering substantial pension benefits to public-sector unions, while deferring the related costs to a later time, they may resist reform.<sup>199</sup> A bankruptcy court that concluded that these incentives substantially contributed to the fiscal distress of an insolvent municipality might condition confirmation on the adoption of a local ordinance to require that future contracts with public sector unions permit only defined contribution plans. The State of Michigan imposed a similar requirement on the City of Detroit when it agreed to provide state funding in return for the creation of a state advisory board prior to the City's filing for bankruptcy.<sup>200</sup> One term of that agreement was that any future collective-bargaining agreement would provide that newly hired employees of the city would have "a defined contribution retirement health care benefit."<sup>201</sup>

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196. N.Y.C., N.Y., CITY CHARTER § 259(a) (2004).

197. *Id.* § 259(b).

198. See, e.g., T. Leigh Anenson et al., *Reforming Public Pensions*, 33 YALE L. & POL'Y REV. 1, 51 (2014); 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, 784, 846 (2014); Natalya Shnitser, *Funding Discipline for U.S. Public Pension Plans: An Empirical Analysis of Institutional Design*, 100 IOWA L. REV. 663, 668 (2015).

199. See Monahan, *supra* note 152, at 128-29.

200. See *Financial Stability Agreement*, CITY DET. & MICH. DEP'T TREASURY 4-5 (2012), [http://www.michigan.gov/documents/treasury/Detroit\\_Fiscal\\_Stability\\_Agreement\\_382287\\_7.pdf](http://www.michigan.gov/documents/treasury/Detroit_Fiscal_Stability_Agreement_382287_7.pdf) [<http://perma.cc/3ZYN-A8UV>].

201. *Id.* Annex D.

Although the bankruptcy court has less authority over a city's relationship with the surrounding communities, a judge also could spur regional reform in some contexts, such as sewer and water services that encompass the city and nearby counties.<sup>202</sup> A regional water arrangement was one of the few structural governance reforms that was in fact achieved in the Detroit bankruptcy case.<sup>203</sup>

Finally, one could also imagine a bankruptcy court encouraging more creative reform. For example, some municipalities have permitted groups within the locality to form business improvement districts (BIDs) or neighborhood improvement districts that allow firms or neighbors to fund a higher level of public services than the municipality provides generally and to impose assessments on recalcitrant members if a majority or supermajority approves.<sup>204</sup> These districts are controversial,<sup>205</sup> but there is at least some evidence that they reduce crime<sup>206</sup> and, at least for well-funded BIDs, increase commercial property values.<sup>207</sup> They plausibly discourage exit, because they ensure that members can use fees for services from which they benefit directly in the same way that they would if they emigrated to less redistributive suburbs. A bankruptcy court might conclude that such efforts are worth undertaking in an effort to revitalize a city and, where that is the case, could expect the municipality to enact the legislation necessary to establish the districts.

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202. Gerald Frug is the best known proponent of regionalization. See, e.g., Gerald E. Frug, *Beyond Regional Government*, 115 HARV. L. REV. 1763 (2002).

203. See, e.g., Nathan Bomey & Matt Helms, *Detroit, Suburbs OK Regional Water Deal; \$50 Million Yearly to Upgrade System*, DET. FREE PRESS (Sept. 9, 2014), <http://archive.freep.com/article/20140909/NEWS01/309090084/Detroit-bankruptcy-water-deal> [<http://perma.cc/CZ6G-TBMC>].

204. BIDs exist in forty-eight states; major cities that have adopted BIDs include Chicago, Houston, Los Angeles, New York City, and Philadelphia. See JERRY MITCHELL, *BUSINESS IMPROVEMENT DISTRICTS AND THE SHAPE OF AMERICAN CITIES* 3 (2009); Leah Brooks, *Unveiling Hidden Districts: Assessing the Adoption Patterns of Business Improvement Districts in California*, 60 NAT'L TAX J. 5, 6 (2007).

205. See Briffault, *supra* note 29, at 371; Gillette, *supra* note 29, at 1190.

206. See Leah Brooks, *Volunteering To Be Taxed: Business Improvement Districts and the Extra-Governmental Provision of Public Safety*, 92 J. PUB. ECON. 388 (2008); John MacDonald et al., *The Effect of Business Improvement Districts on the Incidence of Violent Crimes*, 16 INJ. PREVENTION 327 (2010); Amy Ellen Schwartz et al., *What Do Business Improvement Districts Do for Property Owners?*, 99TH ANN. CONF. ON TAX'N 431 (2006).

207. Ingrid Gould Ellen et al., *The Impact of Business Improvement Districts on Property Values: Evidence from New York City*, 2007 BROOKINGS-WHARTON PAPERS ON URB. AFF. 1, 29.

*B. Bankruptcy as a Governance Corrective*

In this Section, we propose that the current Bankruptcy Code, and in particular, the requirement that a plan of adjustment be “feasible,”<sup>208</sup> provides the doctrinal basis for a bankruptcy court serving as a catalyst for governance reform. Before explaining that issue more fully, we note that bankruptcy filings may alter political dynamics that frustrate reform, even without judicial prodding for specific organizational structures.

First, although a city’s leadership may be reluctant to endorse reform under ordinary conditions, given the political costs of challenging beneficiaries of the existing system, fiscal distress that is severe enough to require a bankruptcy filing is likely to diminish the leverage of proponents of the status quo; and a mayor who files for bankruptcy may feel that there is little more to lose, given the political costs she will already have incurred by declaring the need for bankruptcy. If the state has special provisions for distressed cities and local officials have been replaced by an emergency manager, as in Detroit,<sup>209</sup> the willingness to pursue structural reform may be even greater. Bankruptcy may thus create political opportunities that did not previously exist. Indeed, one benefit of permitting structural reform in bankruptcy may be that the existence of the option makes its exercise unnecessary since the locality may prefer to restructure on its own rather than risk external imposition.<sup>210</sup>

Second, and relatedly, bankruptcy can centralize decision-making authority and diffuse opposition. Outside of bankruptcy, a proposal to change governance arrangements would need to be vetted with the city’s voters and with the officials that would be affected, even if neither had formal veto power over reform. From their perspective, reform may have significant downsides and little immediate upside. In bankruptcy, the reforms can be included as part

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208. 11 U.S.C. § 943(b)(7) (2012).

209. MICH. COMP. LAWS §§ 141.1547(1)(b), 141.1549(2) (2014); see also Kevyn D. Orr, *Emergency Manager City of Detroit, Order No. 1: Restoration of Salary and Benefits of Mayor and City Council* (Mar. 25, 2013), <http://www.detroitmi.gov/Portals/0/docs/EM/Order1.pdf> [<http://perma.cc/7BZA-ME8A>].

210. Recent evidence of this possibility may be apparent in the current efforts of Puerto Rico to restructure its debt. As we noted above, *supra* text accompanying note 193, the plan advanced by a working group created by the Governor of the Commonwealth recommended a control board that would be authorized to approve or disapprove a five-year fiscal and economic growth program, assess budgetary compliance with the plan, and impose “severe” sanctions for failure to comply. The board would also be authorized to “[i]mplement[] structural reforms that restore economic growth and competitiveness.” WORKING GROUP FOR FISCAL & ECON. RECOVERY P.R., *supra* note 193, at 54. While the scope of that authority is not made clear, it could certainly include the possibility of governmental restructuring. See *id.* at 54-56.

of a single package that also includes a substantial reduction of the city's debt load. For voters especially, reform may be more palatable as part of the combined proposal. Overall, incorporation of governance into municipal bankruptcy would considerably strengthen the hand of city leaders who wish to effect reform (and weaken the hand of leaders who are themselves an impediment to reform), since city leaders could rightly say that they have no choice but to include governance reform in their restructuring proposal.<sup>211</sup>

Suppose, however, that the municipal decisionmakers are reluctant to pursue reform, even after the municipality has filed for bankruptcy. How can the bankruptcy court intervene? Chapter 9 makes clear that the debtor alone has authority to file a plan of adjustment.<sup>212</sup> Thus, under current law, the bankruptcy court would not be entitled to dictate the terms of structural reform. Nevertheless, the bankruptcy court is permitted to confirm the plan only if it satisfies certain criteria, and courts can use those criteria to induce—or effectively compel—debtors to propose desirable reforms.<sup>213</sup> Some legislative history suggests that plan-confirmation standards would incorporate the principles of cases in which courts considered whether the debtor was

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211. An analogy might be drawn to the reactions of city officials who have been subjected to the state imposition of financial control boards. In at least some situations, local officials have conceded that control boards provided political cover for taking unpopular actions. See, e.g., DAVID R. BERMAN, *LOCAL GOVERNMENT AND THE STATES* 116–17 (2003) (describing use of a Pennsylvania control board to provide political cover for local officials to make unpopular decisions); Mike DeBonis, *D.C. Still Haunted by Federal Takeover*, WASH. POST (Jan. 31, 2011), <http://www.washingtonpost.com/wpdyn/content/article/2011/01/30/AR2011013004444.html> [<http://perma.cc/75EW-CREY>] (recounting former District of Columbia Mayor Marion Barry's conclusion that the financial control board "was able to do some things that needed to be done that, politically, [Barry] would not do, would not do, would not do," including among other things firing about two thousand human-service workers). One might be concerned that the ability to circumvent normal political processes for political restructuring could induce city officials to enter Chapter 9 too readily. The eligibility requirements for Chapter 9, however, serve as a substantial safeguard against its abuse. In particular, § 109(c)(3) of the Bankruptcy Code requires a municipality to prove insolvency as a prerequisite to entering Chapter 9. 11 U.S.C. § 109(c)(3).

212. *Id.* § 941. The statutory provisions of § 1121, which authorizes other parties to propose plans under some circumstances in Chapter 11, are not incorporated into Chapter 9. See *id.* § 901(a) (omitting § 1121 in the sections incorporated into Chapter 9 from elsewhere in the Bankruptcy Code).

213. See, e.g., *Fano v. Newport Heights Irrigation Dist.*, 114 F.2d 563 (9th Cir. 1940). In *Fano*, the appellate court rejected a plan of adjustment that did not impose tax-rate increases on district residents, given the absence of a showing that the district had inadequate taxing power. The court concluded that the failure to impose such increases and placement of the entire burden of adjustment on bondholders meant that the plan did not satisfy the requirements that the plan be "equitable," "fair," or in the "best interest of the creditors." *Id.* at 565–66.

making full use of its taxing powers.<sup>214</sup> While isolated statements in the legislative history of what is now Chapter 9 are not by themselves strong evidence that courts can mandate municipal tax increases,<sup>215</sup> both the logic and language of Chapter 9 suggest that a bankruptcy judge can reject a plan that fails to address obvious governance dysfunction.

McConnell and Picker concluded that the requirement that a plan be “in the ‘best interests of the creditors’” provides the most obvious basis for judicial leverage but were skeptical that the clause was intended to give the court broad discretion to second-guess the city’s financial arrangements.<sup>216</sup> We focus instead on the requirement that a proposed restructuring plan cannot be approved unless it is “feasible.”<sup>217</sup> If fragmented governance has contributed to fiscal irresponsibility in the first instance, then a bankruptcy judge cannot properly conclude that the debtor’s restructuring plan is feasible if it leaves in place a political structure that threatens to return the municipality to insolvency. Even if the municipality adjusts its balance sheet dramatically, dysfunctional governance will encourage a prompt return to fiscal profligacy. Indeed, this very risk became an issue in the Detroit bankruptcy proceedings. The bankruptcy judge appointed an independent expert to assess the feasibility of Detroit’s restructuring proposal. The expert defined feasibility in terms of the following question:

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214. See 124 CONG. REC. 34,003 (1978) (statement of Sen. DeConcini) (invoking *Fano*); 124 CONG. REC. 32,403 (1978) (statement of Rep. Edwards) (same).

215. See Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1060-63 (1997).

216. McConnell & Picker, *supra* note 8, at 474-75. The meaning of the phrase is somewhat ambiguous in municipal bankruptcies. It is taken from the private sphere, where it has been interpreted to mean that creditors will not receive less from the plan than they would through liquidation. *Id.* at 465. But given that municipalities cannot be liquidated by creditors, the meaning of the phrase remains amorphous. Courts have given it narrow scope, concluding that it means only that a proposed plan provide a better alternative for creditors than what they already have. Since creditors can neither propose a plan nor liquidate municipal assets, they “already have” very little. Hence, a proposed plan of almost any sort is likely to make them better off. See, e.g., *In re City of Detroit*, 524 B.R. 147, 212-13 (Bankr. E.D. Mich. 2014); *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 34 (Bankr. D. Colo. 1999).

217. 11 U.S.C. § 943(b)(7). In the Detroit bankruptcy, the court interpreted feasibility to require that the debtor “will be able to sustainably provide basic municipal services to the citizens . . . and to meet the obligations contemplated in the Plan without the significant probability of a default.” *In re City of Detroit*, 524 B.R. at 222; see also *In re Mount Carbon Metro. Dist.*, 242 B.R. at 35 (defining feasibility as “whether it is probable that the debtor can both pay pre-petition debt and provide future public services at the level necessary to its viability as a municipality”).

Is it likely that the City of Detroit, after the confirmation of the Plan of Adjustment, will be able to sustainably provide basic municipal services to the citizens of Detroit and to meet the obligations contemplated in the Plan without the significant probability of a default?<sup>218</sup>

Although the feasibility expert concluded that Detroit's plan met this standard, she raised concerns about Detroit's failures to incorporate governance reform into the restructuring. "This bankruptcy has been largely focused on deleveraging the City," she noted, "often to the exclusion of fixing the City's broken operations."<sup>219</sup> As a result, she concluded, "[T]he operational restructuring that often occurs with commercial reorganizations will be left largely to Mayor Duggan and his managers for the post confirmation period."<sup>220</sup> Implicit in that statement was a view that, absent additional governance reform, there remained serious questions about the feasibility of Detroit's restructuring. A perceived lack of authority to address those issues, rather than their irrelevance, perhaps explains why the independent expert and ultimately the bankruptcy judge deferred to local officials to redress some of the core causes of Detroit's distress.

At first glance, there may seem to be a temporal mismatch between the feasibility requirement and concerns about the consequences of poor governance. "Feasibility," on this understanding, would be concerned only with short-term financial viability; while the effects of poor governance are likely to fester over multiple years of deficits, mismanagement, and inappropriate expenditures before crisis reemerges.<sup>221</sup> Thus, governance reforms that are intended to forestall long-term distress might seem to be a poor fit for a test that focuses on the near future. Indeed, even the parties themselves may not seem to have incentives to respond to judicial

218. Expert Report of Martha E.M. Kopacz Regarding the Feasibility of the City of Detroit Plan of Adjustment at 13, *In re City of Detroit*, 524 B.R. 147 (No. 13-53846) (emphasis omitted).

219. *Id.* at 23.

220. *Id.* at 26.

221. The much-debated phenomenon of repeat Chapter 11 filings—so-called Chapter 22s—in the 1990s might seem to confirm this perspective. But the repeat filings were quite controversial. Compare LYNN M. LOPUCKI, *COURTING FAILURE* (2005) (condemning the repeat filings, and attributing them in part to bankruptcy judges' lax interpretation of the feasibility requirement), with Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425 (2006) (reviewing LOPUCKI, *supra*) (offering an efficiency-based rationale for the pattern). Repeat filings appear to have become much less common since the 1990s. See Douglas G. Baird, *Chapter 11's Expanding Universe*, 87 TEMP. L. REV. 975 (2015). Moreover, many of the corporate debtors that filed a second Chapter 11 case were liquidated, which is not a realistic option for a substantial municipal debtor.

recommendations of long-term governance restructuring because they receive no benefit from the effort.<sup>222</sup>

But feasibility for a municipality inherently requires attention to long-term financial solvency. The need to consider the long term is most obvious where restructuring existing obligations entails deferring payments rather than simply eliminating them. New York State's efforts to restructure New York City debt, for example, included an exchange of short-term notes for bonds with a maturity of up to twenty years.<sup>223</sup> Detroit issued \$1.28 billion of new bonds, with maturities ranging from eight to thirty years, as part of its plan of adjustment.<sup>224</sup> Confirmation of a plan that restructures existing debt or requires the issuance of new long-term debt implies that the debtor will be able to make debt service payments when due. A plan cannot be considered genuinely feasible if it extends maturities but does nothing to increase the probability that payments will be forthcoming at the new maturity date. Creditors who accept extended maturities will expect the municipality to take measures to avoid the need for additional adjustment during the period when their bonds are outstanding. The same is true of other stakeholders, such as pensioners, whose obligations may have been adjusted in bankruptcy, but who remain entitled to postbankruptcy payments into the long-term future for services already rendered.<sup>225</sup> Given their long-term stake, creditors who are the beneficiaries of restructured obligations have good reason to respond to judicial suggestions or even to offer recommendations for restructuring without judicial prompting once it becomes apparent that there is legal authority for incorporating such measures into a plan.

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222. For a discussion of the concern that public officials consider short-term, electoral effects of policies rather than long-term effects that may better serve constituents, see Claire S.H. Lim, *Preferences and Incentives of Appointed and Elected Public Officials: Evidence from State Trial Court Judges*, 103 AM. ECON. REV. 1360 (2013); William D. Nordhaus, *The Political Business Cycle*, 42 REV. ECON. STUD. 169, 182 (1975); and Edward A. Zelinsky, *Tax Incentives for Economic Development: Personal (and Pessimistic) Reflections*, 58 CASE W. RES. L. REV. 1145, 1149 (2008).

223. See *Flushing Nat'l Bank v. Mun. Assistance Corp.*, 379 N.Y.S.2d 978, 982 (Sup. Ct. 1976), *aff'd*, 382 N.Y.S.2d 764 (App. Div. 1976), *rev'd on other grounds*, 358 N.E.2d 848 (N.Y. 1976).

224. See Caitlin Devitt, *Leaving Bankruptcy, Detroit Takes on \$1.28B of New Debt*, BOND BUYER (Dec. 11, 2014), <http://www.bondbuyer.com/news/regionalnews/leaving-bankruptcy-detroit-takes-on-1b-of-new-debt-1068692-1.html> [<http://perma.cc/VN92-88D6>].

225. Under Detroit's debt-adjustment plan, Detroit pension beneficiaries' pensions were restructured, but some of the (modest) reductions will be restored if the pension plans hit specified funding targets in the future. See Supplemental Opinion Regarding Plan Confirmation, Approving Settlements, and Approving Exit Financing at 37, *In re City of Detroit*, 524 B.R. 147 (Bankr. E.D. Mich. 2014) (No. 13-53846).

Once we recognize that municipal bankruptcy is not solely intended to restructure debt but to permit revival of municipal services,<sup>226</sup> the case for a long-term view of feasibility becomes even stronger. As the court in the Detroit bankruptcy noted, “feasibility” in the municipal context includes not simply avoiding default but also the ability “to sustainably provide basic municipal services to the citizens of Detroit . . . .”<sup>227</sup> Just as degradation of services from poor governance is likely to occur slowly, emergence from service-delivery insolvency also takes time. Reestablishing a tax base after a long period of depopulation, rebuilding dilapidated infrastructure, and scaling up a municipal workforce that may have been decimated during a period of fiscal distress require long-term arrangements.<sup>228</sup> As in the case of extended-debt obligations, if feasibility involves obligations that can only be satisfied in the long term, it is appropriate to include within the remedial scheme measures that themselves will return benefits on a similarly extended time horizon.

While we recognize that our proposal varies significantly from the common understanding of the pure debt adjustment function of Chapter 9 and could conflict with a broad interpretation of § 904’s prohibition of nonconsensual judicial interference with any of the debtor’s political or governmental powers, our proposal is less radical than it initially appears. First, as we have noted, it is commonly recognized that bankruptcy courts have the capacity to do indirectly what they cannot do directly by refusing to confirm plans that do not include details such as tax increases that the municipality might otherwise reject.<sup>229</sup>

Second, as discussed more fully in Part IV, the structural interventions that we propose reflect a difficult but manageable balance between state and federal law.<sup>230</sup> Chapter 9 itself imposes a limitation on the ability of federal bankruptcy law to trump state law. Section 943(b)(4) allows confirmation of a plan only if, among other things, “the debtor is not prohibited by law from taking any action necessary to carry out the plan.”<sup>231</sup> Thus, without amendment of that

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226. See *supra* text accompanying notes 26–29.

227. *In re City of Detroit*, 524 B.R. at 222.

228. During Bridgeport, Connecticut’s bankruptcy proceedings, the City’s Chief of Police testified that there were 341 police officers of the 430 necessary to provide adequate service. See *In re City of Bridgeport*, 129 B.R. 332, 335 (Bankr. D. Conn. 1991). The court in the Stockton, California bankruptcy concluded that there was service-delivery insolvency based on testimony that the city’s workforce had decreased by twenty-five percent from 2008 to 2011 and that the police department had about 1.10 officers per one thousand residents, compared to a national standard of 2.7 per one thousand residents. See *In re City of Stockton*, 493 B.R. 772, 780–81 (Bankr. E.D. Cal. 2013).

229. See, e.g., Kordana, *supra* note 215, at 1042–43; McConnell & Picker, *supra* note 8, at 474.

230. See *infra* Sections IV.A, IV.B, IV.C.

231. 11 U.S.C. § 943(b)(4) (2012).

provision, a court could not, for example, require a municipality to adopt an at-large election system for the local legislature if state statutes require such elections to occur by districts.

But assume that the locality's decision to use district elections were embodied in the city charter rather than in a state statute. Would § 943(b)(4) also prevent judicial modification of that document as a condition of plan confirmation? Here, a municipal debtor appears to have more flexibility, especially if the restructuring plan requires that governance reforms will only be implemented if the city charter is amended through the ordinary charter amendment process.<sup>232</sup> Of course, that course of action, which may include a voter referendum,<sup>233</sup> provides opportunities for those who benefit from the status quo to oppose reforms. But they may have difficulty doing so without revealing their self-interested positions and without at least providing opportunities for proponents of reform to explain why proposed amendments were included in the Chapter 9 plan.

Third, structural requirements imposed by the bankruptcy court need not be permanent. That is because municipal governance structures, at least for home-rule municipalities, tend to be imposed through the same city charters that may have to be amended in order to implement proposed reforms. While charters essentially form the constitution for the municipality, they are typically subject to amendment far more readily than are constitutions of more centralized governments. Thus, what is accomplished through the bankruptcy process can be undone if opponents of reform are able to gather sufficient support for the pre-bankruptcy regime. To be sure, as we have just noted, state law frequently requires substantial effort, including voter approval, in order to amend a city charter.<sup>234</sup> Some charters also contain temporal limitations on amendment or revision.<sup>235</sup> The result is that structural reforms imposed by the

232. As discussed more fully *infra* note 252, in the *Stockton* case, the court suggested in dicta that ordinary amendment processes would need to be followed. Opinion Regarding Confirmation and Status of CalPERS at 35-36, *In re City of Stockton*, No. 12-32118-C-9 (Bankr. E.D. Cal. Feb. 4, 2015), *amended by* 526 B.R. 35 (Bankr. E.D. Cal. Feb. 27, 2015).

233. See, e.g., CAL. CONST. art. XI, § 3(a); MO. CONST. art. 6, § 32(a); OHIO CONST. art. XVIII, § 9; TEX. CONST. art. 11, § 5(a); COLO. REV. STAT. ANN. § 31-2-210 (West 2002); FLA. STAT. ANN. § 166.031(2) (West 2000); MICH. COMP. LAWS § 117.21(1) (2015); N.Y. MUN. HOME RULE LAW §§ 36(5)(d), 37(13) (McKinney 1994); 53 PA. STAT. AND CONS. STAT. ANN. § 13110 (West 1998).

234. See, e.g., CAL. CONST. art. XI, § 3(a) (voter approval required); MO. CONST. art. 6, § 32(a) (voter approval required); OHIO CONST. art. XVIII, § 9; R.I. CONST. art. 13, § 8 (voter approval required); COLO. REV. STAT. ANN. § 31-2-210 (West 2002) (voter approval required); FLA. STAT. ANN. § 166.031(2) (West 2000) (voter approval required); 53 STAT. AND CONS. STAT. ANN. § 13110 (West 1998) (voter approval required).

235. See, e.g., MICH. COMP. LAWS § 117.18 (2015); W. VA. CODE ANN. § 8-4-7 (LexisNexis 2012).

bankruptcy court could not be undone without difficulty but would also be subject to their own reform should they prove to be less desirable than anticipated. They would however be subject to amendment and revision just as any other matter addressed within the city charter.<sup>236</sup>

#### IV. OBJECTIONS TO GOVERNANCE REFORM IN CHAPTER 9

We have outlined what we think is a compelling case that governance reform needs to be added to the Chapter 9 menu, and indeed, that a substantial municipality often will not be able to propose a feasible reorganization plan in the absence of governance reform. In this Part, we address potential objections to such a major shift from the conventional understanding of municipal bankruptcy. We focus first in this Part on the structure of Chapter 9 itself. Several key provisions in Chapter 9 seem to limit its scope to financial restructuring. We take up each of these provisions, concluding that they reflect the conventional wisdom but do not preclude governance reform. We also address a weighty constitutional objection to our proposal: the argument that governance reform would violate the unconstitutional conditions doctrine, even if Chapter 9 purported to allow it. The final two Sections consider two important practical objections: (1) the question whether bankruptcy judges are competent to induce or oversee governance reform; and (2) the possibility that the prospect of governance reform will discourage Chapter 9 filings.

##### *A. Bankruptcy Courts Cannot Interfere with Municipal Powers*

When the original municipal bankruptcy laws were challenged in the 1930s, much of the discussion centered on claims of impermissible interference with the prerogatives of the states as protected by the Tenth Amendment.<sup>237</sup> (The other principal concern, the constitutional prohibition against impairment of contracts, is implicated by a city's restructuring of its debt but not by the governance reforms we advocate here.) Three different

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<sup>236</sup> It also would be possible to include a sunset provision providing, for instance, that the governance reforms would be reversed after five or ten years unless the citizens of the city explicitly voted to retain the reforms.

<sup>237</sup> In *Bekins*, the case that upheld the 1937 municipal bankruptcy law, the Court quoted the assurance in the House Report that the law “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.” *United States v. Bekins*, 304 U.S. 27, 51 (1938) (quoting H.R. REP. NO. 75-517 (1937)).

provisions of Chapter 9 are designed to assuage these concerns.<sup>238</sup> The first prohibits a municipality from filing for bankruptcy unless its state explicitly authorizes it or municipalities like it to do so.<sup>239</sup> The second prohibits the use of Chapter 9 to limit or impair a state's control over its municipalities.<sup>240</sup> And the third prohibits the bankruptcy court from interfering with a municipality's political or governmental powers, property or revenues, or use of income producing property "unless the debtor consents or the plan so provides."<sup>241</sup> Our proposal implicates only the third of these protections.

On first glance, the restriction on bankruptcy court authority over the municipality's political or governmental powers seems to preclude precisely the kinds of reforms we have advocated. But there are several responses to that criticism. First, as Steven Walt and Richard Hynes have demonstrated, the constraint that § 904 imposes is less absolute than it initially appears.<sup>242</sup> For example, notwithstanding § 904, the court is still entitled "to appoint a trustee to exercise . . . avoidance powers if the municipality refuses to do so"<sup>243</sup> and to determine whether the debtor is permitted to secure "post-petition financing with collateral,"<sup>244</sup> each of which interferes with the debtor's property and powers. Although those exceptions exist pursuant to explicitly delineated authority in the Bankruptcy Code, they at least dilute any claim that the constitutional principles embodied in § 904 mandate a strict separation of bankruptcy powers and state sovereignty.

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238. Still other provisions address these concerns indirectly. Chapter 9 does not create an "estate" overseen by the bankruptcy court, for instance, and the court authorization is not required when the city sells assets. 11 U.S.C. § 901(a) (2012) (not incorporating § 363 (sales) or § 541 (estate)).

239. 11 U.S.C. § 109(c)(2) (2012).

240. 11 U.S.C. § 903 (2012) ("This chapter does not limit or impair the power of the State to control by legislation or otherwise, a municipality of or in such State . . ."). Section 903 does qualify this noninterference principle in a very important way, prohibiting state restructuring ("composition") laws and the enforcement of judgments entered under such laws. For discussion of this qualification, see *supra* note 114.

241. 11 U.S.C. § 904 (2012). Chapter 9 also permits only voluntary filings, which precludes a municipality from being thrown into bankruptcy by its creditors. 11 U.S.C. § 109(c)(4) (2012).

242. Richard M. Hynes & Steven D. Walt, *Pensions and Property Rights in Municipal Bankruptcy*, 33 REV. BANKING & FIN. L. 609, 624-27 (2014) (arguing for a "moderate understanding of section 904" that allows a court to interfere with a municipality's use of assets or "undo political decisions" in some situations).

243. *Id.* at 624 (citing 11 U.S.C. § 926(a) (2012)). For a description of a trustee's avoiding powers, see 11 U.S.C. §§ 544-548 (2012), incorporated into Chapter 9 by 11 U.S.C. § 901(a) (2012).

244. Hynes & Walt, *supra* note 242, at 625 (citing 11 U.S.C. § 364(c) (2012)). Section 364(c) is incorporated into Chapter 9 by 11 U.S.C. § 901(a) (2012).

Second, and much more importantly, the noninterference provision includes a large escape hatch that could make major governance reforms possible in many cases. If the “debtor consents” to the interference or if “the plan so provides,” the prohibition does not apply.<sup>245</sup> The first term—debtor consent—seems to contemplate consent by the debtor at any point in the bankruptcy case. For example, shortly after Detroit filed for bankruptcy, the bankruptcy court appointed a fee examiner to oversee Detroit’s bankruptcy lawyers’ fees. Detroit consented to this oversight that might otherwise have been deemed to interfere with Detroit’s political or governmental powers.<sup>246</sup> Because only the debtor itself can propose a restructuring plan,<sup>247</sup> the debtor’s consent also is a prerequisite to the use of the plan to effect changes that might otherwise be viewed as interference with political or municipal powers. The escape hatch thus gives the bankruptcy court the power to implement governance reforms so long as the debtor agrees to the changes.

In the bankruptcy context, debtor consent has multiple features. We first address the question of who among various elected officials has the authority to speak on behalf of the debtor. We then turn to the possibility that broader popular consent would be required to enact particular reforms. The issue of which elected officials speak for the debtor may seem superfluous. If elected officials have resisted efforts to restructure their government prior to bankruptcy, it is unlikely that they would consent to a procedure that allowed the bankruptcy court to motivate the same results that those officials have eschewed. Nevertheless, there may be circumstances in which the resistance of local officials matters less. Where, prior to bankruptcy, governance of the municipality has been turned over to a state-appointed financial control board, entrenchment will serve as less of a constraint. For instance, under Michigan law, Detroit’s emergency manager had sweeping, unilateral authority that

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245. 11 U.S.C. § 904 (2012).

246. See, e.g., Steven Church, *Detroit Fee Examiner Gets Paid To Second-Guess Bills*, BLOOMBERG NEWS (Oct. 21, 2013), <http://www.bloomberg.com/news/articles/2013-10-21/detroit-fee-examiner-gets-paid-to-second-guess-bills> [<http://perma.cc/3EKX-EVYS>]. As Melissa Jacoby has analyzed in careful detail, the consent exception enabled the Detroit bankruptcy judge to exercise extensive control over the Detroit restructuring process. Jacoby, *supra* note 51. We share Jacoby’s discomfort with some of the actions taken by the bankruptcy judge and his chief mediator in the Detroit case—especially the secretive maneuvering by the mediator—and question some of the rulings made in the case. See, e.g., David Skeel, *The Meaning of Detroit*, 22 NAT’L AFF. 3, 21-22 (2015). But in our view, a bankruptcy judge’s unwillingness to confirm a restructuring plan that fails to address obvious governance dysfunction does not undermine the legitimacy of the debtor’s decision to propose a plan that includes governance reform.

247. 11 U.S.C. § 941 (2012) explicitly states that “[t]he debtor shall file a plan.”

displaced both the mayor and city council.<sup>248</sup> As a result, neither fractured authority nor entrenchment was a concern in Detroit's bankruptcy. Similarly, under New York law, an emergency control board that has been appointed to oversee a municipality can file a petition under Chapter 9.<sup>249</sup>

One could also imagine that a mayor who both had unequivocal authority to give the requisite consent under § 904 and believed that bankruptcy courts would use that provision to strengthen mayoral authority would consent to judicial intervention. But if a municipal debtor has both a mayor and a city council, the question of which one can provide the necessary "consent" for purposes of § 904 may depend on state law that dictates the division of local powers between local executives and legislatures. To answer the related question of whether the proper city officials had filed a bankruptcy petition in the case involving Harrisburg, Pennsylvania, for example, the court relied on state law and the local city charter to conclude that only the mayor had authority to file the petition.<sup>250</sup> Consent is less likely to be forthcoming where the proposed "interference" affects the incumbents themselves in ways that they perceive as threatening their authority.

As we have suggested above, where structural reforms affect city charter provisions, the issue of consent becomes more complicated, not necessarily because of entrenchment but because consent under state law could be interpreted to require the same charter commission and electoral process that is necessary to amend or revise a charter outside of bankruptcy. Indeed, even if the official who speaks for the municipality in bankruptcy agreed to include charter reform in the plan, it is not clear that such consent would bind the municipality, since that official would have had no authority to restructure the municipality's governance structure outside of bankruptcy.

One plausible technical solution to the obstacle of popular consent may exist in current law. Among the provisions of Chapter 11 incorporated into Chapter 9 is § 1123(a)(5).<sup>251</sup> That provision authorizes the debtor to make charter amendments in its reorganization plan, subject only to bankruptcy's plan confirmation process. One could, therefore, interpret the reference to "charter" to apply to municipal as well as corporate organic documents and allow bankruptcy law to circumvent state law restrictions on charter revision. We recognize, however, that this interpretation is aggressive (and perhaps normatively objectionable). Chapter 9 also contains a democracy-preserving

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248. See MICH. COMP. LAWS ANN. § 141.1549(2) (West 2012).

249. See N.Y. LOCAL FIN. LAW § 85.80 (McKinney 2009).

250. *In re City of Harrisburg*, 465 B.R. 744, 764-65 (Bankr. M.D. Pa. 2011).

251. See 11 U.S.C. § 901(a) (2012) (incorporating § 1123(a)(5)).

provision that allows a plan to be confirmed only if “regulatory or electoral approval necessary under applicable nonbankruptcy law in order to carry out any provision of the plan has been obtained, or such a provision is expressly conditioned on such approval . . . .”<sup>252</sup> Presumably that provision requires that any restructuring proposal in a reorganization plan must be approved through a local referendum when the same proposal would have required a referendum outside the bankruptcy context. Alternatively, the potential for impasse may suggest the need for more explicit avenues for reform. These could include express amendment of Chapter 9 to trump city charter amendment provisions, or, perhaps more palatably, to require submission of governance reform proposals to the normal charter revision process.

Perhaps the more important constraint on § 904 is the capacity of the bankruptcy judge to withhold confirmation of a plan that fails to incorporate certain measures that the court deems necessary for fiscal success. As we have already noted, the authority to withhold confirmation permits a bankruptcy court to do indirectly what § 904 prohibits being done directly.<sup>253</sup> A court required to consider the feasibility of a plan and the best interests of creditors prior to confirmation<sup>254</sup> could conclude that continuing the existing municipal governance structure substantially increased the probability of recidivism or impeded the delivery of services. The court could therefore deny confirmation of a plan that failed to restructure. This veto power increases the likelihood that each of the relevant decision makers will consent to needed reforms.

*B. Only the “Adjustment of Debts” Is Permitted in Chapter 9*

The second statute-based objection to governance reform is semantic but equally serious. Unlike Chapter 11, which explicitly contemplates governance reform, one might contend that Chapter 9 only provides for financial restructuring. Whereas Chapter 11’s title is “Reorganization,” Chapter 9 is called “Adjustment of Debts of a Municipality.” Similarly, Chapter 11 says

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252. 11 U.S.C. § 943(b)(6) (2012). The question is whether this requirement would apply to charter changes included in the plan itself, or only to steps taken subsequently. A recent decision in the Stockton bankruptcy suggests, in dicta, that § 943(b)(6) applies both to the initial plan and to post-confirmation efforts to carry out the plan. See *In re City of Stockton*, No. 12-32118-C-9, 526 B.R. 35, 54 (Bankr. E.D. Cal. Feb. 4, 2015) (distinguishing “basic requirements of government and political polity,” which must be honored, from “financial and employment relations,” which are governed by bankruptcy).

253. See *supra* text accompanying notes 245-247.

254. 11 U.S.C. § 943(b)(7) (2012) (providing for court confirmation if “the plan is in the best interests of creditors and is feasible”).

simply that the debtor may file a “plan,”<sup>255</sup> whereas Chapter 9 states that “[t]he debtor shall file a plan for the adjustment of the debtor’s debts.”<sup>256</sup> This language seems to envision that a Chapter 9 debtor will restructure only its balance sheet, not its governance.

Although balance sheet restructuring has traditionally been Chapter 9’s focus, which is reflected in the references to “adjustment of debts,” these labels do not preclude governance reform. The first thing to note is that the “adjustment of debts” language is a legacy of the concerns that shaped the original municipal bankruptcy laws. As discussed earlier,<sup>257</sup> the drafters’ principal concern in the 1930s was enabling stressed municipalities to restructure their bond debt, at a time when it was unclear whether Congress’s bankruptcy powers extended at all to public entities such as a municipality. It is therefore unsurprising that the principal provision of the earliest act referred to “municipal-debt readjustments.”<sup>258</sup> Lawmakers were reluctant to use the word “bankruptcy” or words such as “reorganization” that connoted bankruptcy, and they wanted the new law to seem as narrow as possible. With only minor modifications,<sup>259</sup> this label has been retained, even as the key concerns in municipal bankruptcy have evolved.

The historical origins of the term do not justify a conclusion that Chapter 9 permits governance reform, of course. But they provide a context for thinking about several other considerations that do seem to make that case. First, as we have been emphasizing throughout this Article, effective, long-term fiscal rehabilitation of the municipality, for the benefit of both residents and creditors, may not be possible unless it includes governance reform as well as adjustment of current debts. Debt adjustment and governance reform may go hand-in-hand. The adjustment of a municipality’s debts may in this sense imply governance reform as well.

The second consideration is the noninterference provision we considered in the prior Section.<sup>260</sup> As we have seen, even if construed broadly, the provision does not forbid a bankruptcy court from “interfering” with a

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<sup>255.</sup> 11 U.S.C. § 1121(a) (2012).

<sup>256.</sup> 11 U.S.C. § 941 (2012). The headings were within the congressionally-enacted statute and were not simply added during the codification process. *See* Bankruptcy Reform Act of 1978, Pub. L. No. 95–598, 92 Stat. 2549 (1978).

<sup>257.</sup> *See supra* Section II.A.

<sup>258.</sup> Act of May 24, 1934, Pub. L. No. 73–251, § 80, 48 Stat. 798, 798–803.

<sup>259.</sup> One of the minor modifications was dropping the “re” from municipal debt “readjustment.” For example, the current title of Chapter 9 is “Adjustment of Debts of a Municipality.” *See* 11 U.S.C. § 901 (2012).

<sup>260.</sup> 11 U.S.C. § 904 (2012).

municipal debtor's political or governmental powers under all circumstances.<sup>261</sup> It only precludes interference to which the debtor has not consented and that is not contained in the restructuring plan. This suggests that, notwithstanding the ostensibly restrictive language in the title, the technical language of Chapter 9 does not foreclose efforts to address the debtor's municipal political or governmental structure through the plan for adjustment. Even if § 904 is read to limit the conditions under which courts may "interfere," the fact that some such conditions exist belies the notion that the language of "debt adjustment" alone restricts the court or the plan to fiscal issues, narrowly defined.

### C. *Commandeering and Unconstitutional Conditions*

The Chapter 9 provisions that have occupied our attention in the last two Sections were designed to ensure that Chapter 9 does not interfere with state sovereignty under the Tenth Amendment and related constitutional protections. But perhaps the provisions do not go far enough. Even if permitted by Chapter 9, governance reform could be challenged as commandeering or as imposing unconstitutional conditions on state and local decisionmakers, under a line of Supreme Court cases that have taken on heightened significance after the first major Affordable Care Act case, *National Federation of Independent Business v. Sebelius (NFIB)*.<sup>262</sup> The concern that governance reform would violate the Constitution, even if Chapter 9 permits it, is the most serious obstacle to our proposed rethinking of municipal bankruptcy.

Eighty years ago, state sovereignty questions cast a cloud over all of Chapter 9. Elements of that claim remain. Objectors to Detroit's eligibility for municipal bankruptcy, for example, contended that Chapter 9 violated the requirement of the Bankruptcy Clause that bankruptcy laws be "uniform."<sup>263</sup> Even if Chapter 9 itself is no longer in jeopardy, the prospect that it might be used to reform municipal governance introduces a new complication.

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<sup>261.</sup> See *supra* Section IV.A.

<sup>262.</sup> 132 S. Ct. 2566 (2012) (holding that Congress may not "penalize States that choose not to participate in that new program by taking away their existing Medicaid funding").

<sup>263.</sup> *In re City of Detroit*, 504 B.R. 97, 136 (Bankr. E.D. Mich. 2013). More recently, Judge Thomas Bennett, the bankruptcy judge who oversaw the Chapter 9 case of Jefferson County, Alabama, has pointed out that the municipal bankruptcy framework upheld by the Supreme Court in *Bekins* was much narrower and less intrusive than current the Chapter 9 framework and speculated that the consent by a municipal debtor that files for Chapter 9 bankruptcy may not be sufficient to satisfy state sovereignty concerns with some of the provisions of Chapter 9. Thomas B. Bennett, *Consent: Its Scope, Blips, Blemishes, and a Bekins Extrapolation Too Far*, 37 CAMPBELL L. REV. 3, 9 (2015).

In *New York v. United States*,<sup>264</sup> Justice O'Connor identified two general principles that run through this line of cases. First, Congress can attach conditions when it directs funds to the states under its Spending Clause powers, so long as the conditions are sufficiently related to the purposes of the funding.<sup>265</sup> Second, Congress also can give states the option either to regulate in accordance with federal standards or to face preemption.<sup>266</sup> In each case, federal influence on state decision making is permissible if "the residents of the State retain the ultimate decision as to whether or not the State will comply."<sup>267</sup>

Prior to *NFIB*, the Court routinely upheld federal legislation that imposed conditions on state decisionmakers when it involved federal spending, since "Congress has no obligation to use its Spending Clause power to disburse funds to the States,"<sup>268</sup> while casting a colder eye on federal intervention in other contexts.<sup>269</sup> In *NFIB*, Chief Justice Roberts made clear that the anti-commandeering principle imposes limits—in practice, not just in theory—even on Congress's power to attach strings to its funding programs: "The legitimacy of Congress's exercise of the spending power . . . rests on whether the State voluntarily and knowingly accepts the terms of the 'contract.'"<sup>270</sup> The Court concluded that the healthcare law's extension of Medicaid benefits to new recipients, which gave states the option either to carry out the extension or to forfeit all of their federal funding under the existing Medicaid program, did not meet this standard. "In this case," the Chief Justice wrote, "the financial

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<sup>264.</sup> 505 U.S. 144 (1992).

<sup>265.</sup> *Id.* at 167 (citing *South Dakota v. Dole*, 483 U.S. 203, 206-08 (1987)). *New York v. United States* involved both Spending Clause and non-Spending Clause challenges. *Id.* at 154. The Court upheld under the Spending Clause a provision of the Low-Level Radioactive Waste Policy Amendments Act of 1985 that gave escrowed funds to states that complied with the statute's radioactive waste requirements. But the Court found that the "take title" provision of the law, which offered states a choice of either accepting ownership of waste or regulating according to the instructions of Congress, unconstitutionally commandeered the legislative processes of the States by compelling them to enact and enforce a federal regulatory program. *Id.* at 175-77.

<sup>266.</sup> *Id.*

<sup>267.</sup> *Id.* at 168.

<sup>268.</sup> *Coll. Sav. Bank v. Fla. Prepaid Postsecondary Educ. Expense Bd.*, 527 U.S. 666, 686 (1999).

<sup>269.</sup> *New York v. United States*, 505 U.S. 144 (1992). In *Printz v. United States*, 521 U.S. 898 (1997), a pure commandeering case, the Court struck down the gun control statute known as the Brady Handgun Violence Prevention Act, which instructed the chief law enforcement officer of each local jurisdiction to conduct background checks on prospective handgun purchasers.

<sup>270.</sup> *Nat'l Fed'n Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2602 (2012).

‘inducement’ Congress has chosen is much more than ‘relatively mild encouragement’ – it is a gun to the head.”<sup>271</sup>

If we are reading the implications of *NFIB* correctly,<sup>272</sup> the same general principles apply in Spending Clause and other commandeering cases, although the Court presumably will continue to apply them more forcefully outside of the Spending Clause context. Since Congress enacted Chapter 9 under the Bankruptcy Clause, not the Spending Clause, governance reform could be subject to particularly skeptical review. Yet in many respects, Chapter 9 functions quite similarly to federal spending, and congressional conduct pursuant to the Spending Clause therefore provides the best analogy to Congress’s authority under the Bankruptcy Clause. Although Congress does not disburse funds from the federal treasury under Chapter 9, discharge from debt gives municipalities financial resources they could not obtain outside of bankruptcy. The discharge therefore provides municipalities with the functional equivalent of a direct grant that the federal government is not obligated to provide to distressed municipalities.<sup>273</sup> Assume, for example, that Congress offered a financially distressed municipality a grant sufficient to pay its outstanding debts, but the grant was contingent on the municipality’s adoption of a form of government that was understood to reduce the risk of fiscal profligacy. If the Supreme Court precedents suggest that such a conditional grant would fall outside the realm of commandeering, then adjustments in bankruptcy that had the same effect should be treated no differently.<sup>274</sup>

In both the spending and the general commandeering contexts, the Court seems most concerned that states have a genuine option whether or not to accept the incursion on their lawmaking authority. The Court’s principal objection to the Medicaid extension was the severe penalty it exacted on states

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271. *Id.* at 2604.

272. Always an “if” with the unconstitutional conditions cases. For a top scholar’s refreshingly candid perplexity with the cases, see Frederick Schauer, *Too Hard: Unconstitutional Conditions and the Chimera of Constitutional Consistency*, 72 *DENV. U. L. REV.* 989 (1995).

273. In *Florida Prepaid*, the Court characterized interstate compact cases, such as *Petty v. Tennessee-Missouri Bridge Commission*, 359 U.S. 275 (1959), as analogous to the Spending Clause, since states cannot form interstate compacts unless Congress expressly agrees. 527 U.S. at 686. Municipal bankruptcy is quite similar.

274. As discussed below, the analogy is not perfect. One important difference is that Congress is not required to make payments when it provides a discharge, and thus does not fully internalize the cost. In this sense, Chapter 9 is more like a decision on interstate compacts.

that declined to embrace the extension.<sup>275</sup> Included in the Court’s distinction between coercion and legitimate consent is a concern (much criticized by commentators but oft-repeated by the Court) that the absence of genuine consent also could undermine political accountability by making it difficult to determine whether state or federal decision makers are responsible.<sup>276</sup> “[W]here the Federal Government directs the States to regulate, it may be state officials who will bear the brunt of public disapproval, while the federal officials who devised the regulatory program may remain insulated from the electoral ramifications of their decision.”<sup>277</sup>

With Chapter 9 governance reform, state and local officials have far more authority—a more legitimate choice—than with the federal initiatives the Court has struck down as commandeering. Most obviously, a municipality cannot even file for Chapter 9 unless authorized to do so by state law.<sup>278</sup> Once a state does authorize its municipalities to file, only a municipality itself can invoke Chapter 9; creditors are prohibited from throwing a city into Chapter 9 involuntarily.<sup>279</sup> States’ actual behavior underscores the absence of any federally-imposed obligation that states feel to confer the requisite authority. Only half of the states have enacted the requisite authorization, and of those, more than half have imposed conditions on a municipality’s right to file for

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275. See *Nat’l Fed’n Indep. Bus.*, 132 S. Ct. at 2604 (“A State that opts out of the Affordable Care Act’s expansion in health care coverage thus stands to lose not merely ‘a relatively small percentage’ of its existing Medicaid funding, but *all* of it.”).

276. Mitchell Berman points out, for instance, that “a federal offer that gives states ‘no choice’ but to accept [and thus seems to implicate the Court’s concerns about compulsion] threatens accountability *less* than does an offer that puts substantial pressure on the states but leaves them some choice in the matter.” Mitchell N. Berman, *Conditional Spending and the Conditional Offer Puzzle*, in *THE AFFORDABLE CARE ACT DECISION: PHILOSOPHICAL AND LEGAL IMPLICATIONS* 257, 261 (Fritz Allhoff & Mark Hall eds., 2014).

277. *Nat’l Fed’n Indep. Bus.*, 132 S. Ct. at 2602 (quoting *New York v. United States*, 505 U.S. 144, 169 (1992)); see also Samuel R. Bagenstos, *The Anti-Leveraging Principle and the Spending Clause after NFIB* 101 *GEO. L.J.* 861, 880-81 (2013); Andrew B. Coan, *Commandeering, Coercion, and the Deep Structure of American Federalism*, 95 *B.U. L. REV.* 1, 13-15 (2015); Nicole Huberfeld, Elizabeth Weeks Leonard & Kevin Outterson, *Plunging into Endless Difficulties: Medicaid and Coercion in National Federation of Independent Business v. Sebelius*, 93 *B.U. L. REV.* 1, 34 (2013) (“Cooperative federalism programs have been criticized for obscuring political accountability; the federal government enacts the programs but leaves states bearing the brunt of any political opposition to program operations and costs.”).

278. 11 U.S.C. § 109(c)(2) (2012) (permitting municipalities to alternatively be authorized by “a governmental officer or organization empowered by State law”).

279. See 11 U.S.C. § 901 (2012) (listing the Bankruptcy Code provisions that apply in Chapter 9 and omitting 11 U.S.C. § 303, the provision authorizing involuntary bankruptcy).

Chapter 9.<sup>280</sup> Only *after* its state has authorized municipal bankruptcy, and *after* a city voluntarily files for bankruptcy, would the city face a more constrained choice: either reform its governance or run the risk that the bankruptcy judge will decline to approve the city's debt adjustment plan. Even this choice is more meaningful than the state's options under the Medicaid extension in *NFIB*, since a municipality that declined to implement governance reform would not be forced to give up federal benefits it had previously enjoyed.

Under nearly any ordinary understanding of coercion and consent, the governance reform proposals we have advocated neither coerce nor compel state and local decision makers.<sup>281</sup> Even if one accepted the proposition that federal taxation for federal programs could impose the same constraints on states as direct commandeering by crowding out the states' capacity to raise their own taxes for their own purposes,<sup>282</sup> conditions imposed on a debt

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280. See, e.g., CHAPMAN AND CUTLER LLP, *supra* note 143, at 51 (noting that twelve states provide unconditional authorization, twelve other states authorize filing conditioned on additional state action, and three other states grant "limited authorization").

281. Under the definition of coercion Mitchell Berman advocates in his recent critiques of the Supreme Court's case law, Chapter 9 governance reform is a closer call than it is under the Court's treatment of the term. Berman defines coercion as improper pressure on a state's exercise of its rights, and frames one dimension of the inquiry in terms of whether Congress would wish to supply a benefit even without the inducement it has attached. See Berman, *supra* note 276, at 268. In an important new article, Einer Elhauge develops a somewhat similar theoretical framework, distinguishing between contrived threats and uncontrived warnings. *Contrived Threats v. Uncontrived Warnings: A General Solution to the Puzzles of Contractual Duress, Unconstitutional Conditions, and Blackmail*, 83 U. CHI. L. REV. (forthcoming 2016) (manuscript at 21) (on file with authors). In the Chapter 9 context, this could be construed as asking whether Congress would provide a Chapter 9 discharge even if municipalities did not reform their governance. The answer could be "yes," although Congress also might be reluctant to offer the discharge to a substantial city whose failure to reform its governance undermines the prospects for a successful recovery. See Mitchell N. Berman, *Coercion, Compulsion, and the Medicaid Expansion: A Study in the Doctrine of Unconstitutional Conditions*, 91 TEX. L. REV. 1283, 1343-44 (2013) ("Even if Congress would have some affirmative reason to provide an offered benefit notwithstanding the state's noncompliance with a condition, non-provision of the benefit does not amount to a proscribed penalty if the reasons that militate against providing the benefit, and that Congress treats as overriding, do not depend upon making the state's exercise of its rights more costly.").

282. The dissenters in *National Federation of Independent Businesses* relied on the relationship between federal and state taxation as part of their argument for invalidating the Affordable Care Act. Nat'l Fed'n Indep. Bus., 132 S. Ct. at 2662 n.13 (Scalia, J., dissenting). Similar arguments previously appeared in the academic literature. See, e.g., Matthew D. Adler & Seth F. Kreimer, *The New Etiquette of Federalism*: New York, Printz, and Yeskey, 1998 SUP. CT. REV. 71, 107; Lynn A. Baker, *Conditional Federal Spending After Lopez*, 95 COLUM. L. REV. 1911, 1935-47 (1995); Lynn A. Baker & Mitchell N. Berman, *Getting off the Dole: Why the*

adjustment plan in bankruptcy do not entail any federal taxation. Governance reform, at least where related to the risk of profligacy, also is directly related to Chapter 9's financial objectives and thus does not raise germaneness concerns.<sup>283</sup> Finally, by their very nature, conditions created by a federal judge on a case-by-case basis to fit the circumstances of an individual municipality in a Chapter 9 proceeding (itself an infrequent phenomenon) impose a much lower threat to federalism principles than congressional action that simultaneously applies to all states and their political subdivisions. To the extent that the value of federalism lies in experimentation and variety in the provision of goods, services, or government institutions,<sup>284</sup> or in the capacity of those with different preferences to sort themselves into hospitable jurisdictions,<sup>285</sup> little is lost should federal action induce a single municipality to alter its governance structure.

Nevertheless, and notwithstanding our analogy to the Spending Clause, there are dissimilarities between federal grants and federally approved debt adjustment, and these dissimilarities point in different directions with respect to the legitimacy of federal intervention in restructuring local governments. As commentators have argued, spending from a federal treasury subject to a budget constraint assumes a zero-sum quality that requires legislators to internalize the costs of their decisions because they must pay for even conditional spending by either sacrificing other budget items or raising taxes.<sup>286</sup> In theory, spending from a fixed budget also induces potential recipients to monitor overall spending to ensure that they obtain a fair share of expenditures. Either argument indicates that there are political limits to the federal government's capacity to pursue its own policies at the expense of the states. Federal bankruptcy control over municipalities, however, does not have the same zero-sum quality. Thus, there is greater risk of federal overstepping of

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*Court Should Abandon Its Spending Doctrine, and How a Too-Clever Congress Could Provoke It To Do So*, 78 IND. L.J. 459 (2003); Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267, 430-31 (1998). For doubts that federal taxation has a negative effect on state revenue raising, see Brian Galle, *Does Federal Spending "Coerce" States? Evidence from State Budgets*, 108 NW. U. L. REV. 989 (2014).

283. See, e.g., Baker, *supra* note 282, at 1966-74; Elhauge, *supra* note 281, at 49-50 (discussing germaneness and characterizing non-germane conditions as likely to be impermissible threats).

284. See *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.").

285. See McConnell, *supra* note 23, 1501-07.

286. See, e.g., Brian Galle, *Getting Spending: How to Replace Clear Statement Rules with Clear Thinking About Conditional Grants of Federal Funds*, 37 CONN. L. REV. 155, 185-91 (2004).

boundaries. On the other hand, the availability to states of alternatives to federal bankruptcy dilutes the claim that the federal government is commandeering an operation in which states could not otherwise engage on their own terms. States remain free to deal with municipal insolvency by negotiating with creditors for consensual adjustments or providing assistance, perhaps accompanied by financial control boards or other arrangements that address the problem of moral hazard that might otherwise imperil bailouts. These mechanisms may be less efficient and more costly than federal bankruptcy law. But the experiences of municipalities that resolved substantial financial distress without bankruptcy—such as New York City, Philadelphia, and Cleveland—demonstrate that viable, if less desirable, alternatives to federal involvement exist.<sup>287</sup>

We acknowledge, however, that two additional considerations could make our case a closer call. The first is political accountability. Suppose a bankruptcy judge threatened to deny confirmation unless a city reformed its governance, but did not provide any specific guidance. If the city proposed, for example, to privatize its sanitation department by contracting with private providers as part of its debt adjustment plan, city voters might not know for sure whether to treat city officials or the federal bankruptcy judge as responsible for the new governance framework. Interestingly, these accountability concerns counsel in favor of giving bankruptcy judges authority to mandate governance reform directly, rather than relying on their indirect power under current law to veto a plan that lacks governance reform as infeasible.<sup>288</sup> Either way, so long as bankruptcy judges are explicit about their expectations for governance reform, the lines of accountability seem sufficiently clear to assuage concerns about blurred responsibility. Moreover, Chapter 9 governance reform is subject to an important check that is entirely absent under true commandeering: as noted earlier, if municipal voters do not like the governance reform, they could remove it after the bankruptcy case. Any reforms would be fully reversible, subject only to the constraints that state law or the city charter put on governance change. We anticipate that such reversals would be infrequent, both because of the stickiness of the new status quo and because, if the governance reform does translate into fiscal responsibility, residents will prefer

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287. See *Actions Taken by Five Cities to Restore Their Financial Health: Hearing Before the Subcomm. on D.C. of the H. Comm. on Gov't Reform & Oversight*, 104th Cong. (1995) (recounting efforts taken by states and localities to deal with fiscal distress in Chicago, Cleveland, New York City, Philadelphia, and Yonkers).

288. “[I]n such a case,” as Justice O’Connor put it in *New York v. United States*, “it is the Federal Government that makes the decision in full view of the public, and it will be public officials that suffer the consequences if the decision turns out to be detrimental or unpopular.” 505 U.S. 144, 168 (1992).

it to the prior government structure. But the possibility of reversal does retain some autonomy for the municipality, which is lacking in the commandeering decisions.

Despite these protections, one might still worry that the rights bankruptcy interferes with are so important that even meaningful state and local consent to the reforms are not sufficient. “Where Congress exceeds its authority relative to the States,” Justice O’Connor explained in *New York v. United States*, “the departure from the constitutional plan cannot be ratified by the ‘consent’ of state officials.”<sup>289</sup> Indeed, *Ashton* was predicated in part on the proposition that “[n]either consent nor submission by the States can enlarge the powers of Congress.”<sup>290</sup> The right of the state to determine the governance structure of its cities could be seen, in a sense, as inalienable.<sup>291</sup>

In our view, this final objection is the most serious concern with our governance proposal. The first thing to note in response is that courts have traditionally been less deferential to local governments than state governments. The Supreme Court has long construed the Eleventh Amendment as prohibiting lawsuits against states and state officials, for instance, but not against local officials.<sup>292</sup> In other areas as well, the Court has adopted a less deferential approach to local government. Municipalities are “persons” for purposes of civil rights liability under 42 U.S.C. § 1983;<sup>293</sup> states are not.<sup>294</sup> Further, states enjoy broader antitrust immunity than their political subdivisions.<sup>295</sup> It is also important to point out once again that deep financial distress is emblematic of the failure of a city’s democratic processes. Displacement of those processes in an effort to restore the financial stability

289. *Id.* at 182. The Court has made similar statements in other cases. See, e.g., *Bond v. United States*, 131 S. Ct. 2355, 2364 (2011).

290. *Ashton v. Cameron Cty. Water Improvement Dist. No.1*, 298 U.S. 513, 531 (1936).

291. We borrow this characterization from a classic article by Seth Kreimer. See Seth F. Kreimer, *Allocational Sanctions: The Problem of Negative Rights in a Positive State*, 132 U. PA. L. REV. 1293, 1378 (1984). Although she critiques the inalienability concept, Kathleen Sullivan incorporates somewhat similar concerns into her theory of unconstitutional conditions. See Kathleen M. Sullivan, *Unconstitutional Conditions*, 102 HARV. L. REV. 1413, 1489-1504 (1989) (advocating an emphasis on preserving private ordering, ensuring evenhandedness, and preventing constitutional caste).

292. See, e.g., *Monell v. Dep’t of Soc. Serv.*, 436 U.S. 658, 690 n.54 (1978); *Mt. Healthy City Sch. Dist. Bd. of Educ. v. Doyle*, 429 U.S. 274, 280-81 (1977).

293. See *Monell*, 436 U.S. at 658.

294. See *Will v. Mich. Dep’t of State Police*, 491 U.S. 58, 71 (1989).

295. Compare *Town of Hallie v. City of Eau Claire*, 471 U.S. 34, 40 (1985) (holding a municipality enjoys antitrust immunity only if the state has clearly authorized a restraint), with *Parker v. Brown*, 317 U.S. 341, 351 (1943) (holding the Sherman Act does not apply to states).

that a well-functioning democracy would pursue arguably is far less problematic than it might be with a city that is already providing the local public goods that localities are created to deliver.<sup>296</sup>

*D. Will Bankruptcy Judges Make Matters Worse?*

Even if governance reform is legally permissible under both Chapter 9 and the Constitution, some might raise prudential objections, arguing that bankruptcy court intervention could do more harm than good. The first reason for skepticism concerns an empirical difficulty. Even if it is appropriate to use Chapter 9 for structural reform where governance issues are a cause of bankruptcy, are bankruptcy judges competent to distinguish cases in which fiscal distress emerges from internal dysfunction rather than exogenous circumstances? It is, for example, plausible that Detroit's decline was caused as much by the exit of the auto industry, an increase in energy prices that drove industry to the Sun Belt, and high labor costs as by municipal policies.<sup>297</sup> One might question whether courts can disaggregate the various causes of fiscal distress or distinguish symptom from cause. Given that judicial intervention would interfere with democratic governance, restructuring would be appropriate only when political failure was clearly a major contributor to fiscal failure.

Despite their limitations, bankruptcy judges will often be able to determine whether fiscal instability is due to some exogenous event or to political dysfunction. The bankruptcy filing in Harrisburg, Pennsylvania, for example, was precipitated by an investment in a failed incinerator project that did not

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296. Arguably cutting the other way is the novelty of our proposal to use Chapter 9 to achieve governance reform. See Kreimer, *supra* note 291, at 1359 (identifying the historical status quo as one of three baselines courts should take into account in assessing whether conditions are permissible). But cities with substantial governance problems have not filed for bankruptcy in the past, so the governance issues that concern us also are quite new.

297. Population changes suggest that the decline of Detroit was not fully attributable to exit induced by external forces. The population of Detroit declined from 951,270 in 2000 to 680,250 in 2014. See *State & County QuickFacts: Detroit (City), Michigan*, U.S. CENSUS BUREAU (Dec. 2015), <http://quickfacts.census.gov/qfd/states/26/2622000.html> [<http://perma.cc/7FGX-P73Y>] (estimating population in 2014); *American Fact Finder*, U.S. CENSUS BUREAU (2000), <http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.html> [<http://perma.cc/4JS5-TW89>] (providing population in 2000). But the population of Oakland County, which borders Detroit, increased from 1,194,156 to 1,237,868 during the same period. *State & County QuickFacts: Oakland County, Michigan*, U.S. CENSUS BUREAU (Sept. 2015), <http://quickfacts.census.gov/qfd/states/26/26125.html> [<http://perma.cc/QW46-SF6Q>]. Exit from Detroit did not necessarily mean exit from the metropolitan area.

necessarily reflect broad-based fiscal impropriety.<sup>298</sup> But even municipalities that suffer exogenous shocks have opportunities to recover or to adjust to new circumstances. Failure to do so may be a consequence of entrenched decision-making structures rather than of the initial event.

Some evidence of political dysfunction may be inferred where bankruptcy has been preceded by a period of decline in tax revenues and population without offsetting reductions in expenditures and with heavy reliance on borrowing. Some evidence suggests that high debt levels and high spending levels are correlated with political relationships rather than with structural factors outside the control of city officials.<sup>299</sup> Therefore, increasing debt-to-revenue ratios or increasing deficits over a period of years may demonstrate a lack of political will to confront long-term distress in order to serve short-term interests. Increases in workforce or expenditures to groups that have an advantage in organizing may also be indicia that politics rather than resident demand has been driving unsustainable budgetary decisions.<sup>300</sup> For example, at the height of its fiscal crisis in 1976, New York City's municipal public employment levels and labor costs per capita were significantly above those of virtually all other major municipalities (with the exception of the District of Columbia), perhaps indicating the strength of interest groups rather than service demand.<sup>301</sup> Detroit's decline was characterized by inefficiencies in the delivery of municipal services—such as reduced collection rates of property taxes, redundancy in municipal functions, mismanagement of grant funding,

298. See Sabrina Tavernise, *Governor Moves To Take Fiscal Control of Pennsylvania's Capital*, N.Y. TIMES (Oct. 20, 2011), <http://www.nytimes.com/2011/10/21/us/governor-corbett-of-pennsylvania-moves-to-take-control-of-harrisburg.html> [http://perma.cc/D3MD-JGHK]. The bankruptcy of Jefferson County, Alabama may be a closer case. That petition was also precipitated by a singular event—debt issued to finance construction and repair of a county sewer system as required by a consent decree entered into to abate pollution. But both the disrepair that necessitated the new construction and the financing necessary to remediate it were characterized by political dysfunction, including graft and fraud by county commissioners. For a brief history, see *In re Jefferson County*, 474 B.R. 228, 237-40 (Bankr. N.D. Ala. 2012).

299. See Guntram B. Wolff, *Fiscal Crises in U.S. Cities: Structural and Non-Structural Causes* 11 (Ctr. for European Integration Studies, Univ. of Bonn, Working Paper No. B 28-2004, 2004), <http://repec.org/res2004/Wolff.pdf> [http://perma.cc/58SV-2QCU] (purporting to demonstrate that extreme fiscal outcomes are the result of nonstructural factors such as mismanagement, union-power in public administrations, and weak mayors).

300. See Robert P. Inman, *How to Have a Fiscal Crisis: Lessons from Philadelphia*, 85 AM. ECON. REV. 378, 383 (1995) (attributing fiscal decline in Philadelphia to two factors: an increasingly poor population and rising public-employee compensation).

301. See SHEFTER, *supra* note 119, at 118-19. Shefter also finds that “[a]gain with the exception of Washington, municipal labor costs relative to the local economy loomed from 1.4 to 6.9 times greater in New York than in any of the nation's other major cities.” *Id.* at 119.

and public employee work rules based on seniority—rather than simply insufficient revenues.<sup>302</sup> Therefore, it appears that, notwithstanding frequent ambiguity about the causal relationship between governance and fiscal distress, even a court wary of interfering with municipal structures would be able to identify situations in which the link is sufficiently clear to justify remedial efforts.

Causation difficulties, however, do not exhaust the potential objections to allocating the responsibility to bankruptcy courts. A second difficulty involves the unintended consequences of any proposed governance reform. In this version of the “grass is greener” fallacy, the court may compare an existing, failed governance structure with an untried but romantic one. It is plausible that courts desirous of doing *something* to address a distressed city’s political dysfunction could advocate structural reform that is ill-suited to the situation. We have, for example, indicated that the empirical literature on the relationship between government structure and fiscal performance is not monolithic.<sup>303</sup> Thus, it is plausible that a recommended reorganization will not have the anticipated effects.

The variety of governance structures in both private and public realms suggests that no costless version of governance exists. Instead, different structures generate different costs and benefits. As we have noted, centralized governance promotes unified decision making in a manner that considers the interests of all constituents and thus avoids the adverse effects of fragmentation.<sup>304</sup> But centralization simultaneously creates a risk of political monopoly and disenfranchisement of those with minority views, and those features can also lead to problematic financial effects. Centralized local governments, for example, can direct public expenditures to a political base even though the overall effect is to dilute the financial stability of the locality as a whole.<sup>305</sup> There is a risk that the institutions selected to address the governance failures to which a bankruptcy judge attributes fiscal distress will simply generate new difficulties that are different from, but not necessarily less serious than, those that the court purports to remedy.

Even institutional structures that increase financial stability may generate offsetting costs in terms of democratic governance or misallocation of resources

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302. See *Proposal for Creditors*, CITY OF DETROIT 61-78 (2013), <http://archive.freep.com/assets/freep/pdf/C4206913614.pdf> [<http://perma.cc/9XMH-GD5R>].

303. See *supra* notes 161-165, 186-191 and accompanying text.

304. See *supra* Section III.A.

305. See Edward L. Glaeser & Andrei Shleifer, *The Curley Effect: The Economics of Shaping the Electorate*, 21 J.L. ECON. & ORG. 1 (2005) (recounting episodes of redistribution to favored groups).

to a new, but no more deserving, class of favored beneficiaries. A strong mayor may have the capacity to eliminate expensive projects that the majority of residents find too costly, but may also eliminate projects that the majority supports.<sup>306</sup> Some structural reforms could frustrate positive change by handing power to a group disinclined to implement it, such as if at-large council members turned out to favor the status quo more than those elected from districts.

While we acknowledge the risk, it is also important to recognize that similar uncertainties underlie restructuring of firms under Chapter 11.<sup>307</sup> Moreover, a court that induces consideration of structural reforms can hear arguments and evidence about existing political dysfunction and the propriety of reorganization in a particular case, shedding light on issues that Chapter 9 cases currently ignore, even in spite of their relevance to fiscal stability. Where a locality suffers political conditions sufficiently dysfunctional to precipitate debt adjustment in bankruptcy and sufficiently entrenched to resist internal reform, it may be desirable to accept the risk of unintended consequences over the certainty of structurally induced fiscal distress.

*E. Will Governance Reform Discourage Bankruptcy Filings?*

A final concern is that the prospect of governance reform might have a chilling effect on municipal bankruptcy filings. Municipalities may be more reluctant to file for Chapter 9 relief because those who are currently charged with making that decision will be disinclined to initiate a process that could dilute their authority. Relatedly, states, which have full discretion to prevent their municipalities from filing for Chapter 9 relief, could be reluctant to grant the requisite specific authority<sup>308</sup> necessary to allow even a willing municipality to enter Chapter 9 because the state prefers to maintain control over the

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<sup>306</sup>. Indeed, some commentators use that possibility to explain the continued existence of both mayor-council and council-manager forms of local government. See Coate & Knight, *supra* note 183, at 83.

<sup>307</sup>. There is, for example, a substantial debate in the literature concerning the fiscal effects of staggered terms for boards of directors. See, e.g., Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 410, 430 (2005) (finding staggered boards established in corporate charter reduce firm value more than those established in bylaws); Morgan J. Rose, *Heterogeneous Impacts of Staggered Boards by Ownership Concentration*, 15 J. CORP. FIN. 113, 115, 127 (2009); Lucian A. Bebchuk et al., *Staggered Boards and the Wealth of Shareholders: Evidence from Two Natural Experiments* 23 (Nat'l Bureau of Econ. Research, Working Paper No. 17127, 2011), <http://nber.org/papers/w17127> [<http://perma.cc/SXL7-ZHZN>].

<sup>308</sup>. See 11 U.S.C. § 109(c)(2) (2012).

governance of its political subdivisions. In either case, the effect would be to deny a fiscally distressed municipality the benefits from debt adjustment only available in Chapter 9. Perhaps it would be preferable to permit the limited relief available under the current regime and hope that recidivism will not occur rather than to risk municipal or state avoidance of an imperfect, but useful, debt adjustment process.

Although these concerns are real, we doubt that the risk of governance restructuring within bankruptcy would alter the calculus of either municipal or state officials concerning the decision to enter or permit a Chapter 9 filing. From the perspective of municipal officials, the possibility of diminished power looms large. But the officials of a municipality that is on the cusp of bankruptcy face a highly uncertain future; if debt adjustment is necessary to avoid further deterioration of the local economy and subsequent deterioration of officials' political future, then even self-interested officials may consider Chapter 9 to be the best alternative, notwithstanding the possibility of restructuring. As we noted above with respect to the possibility of obtaining consent under § 904, to the extent that the local executive would be the beneficiary of centralized decision making that we have associated with fiscal stability, a mayor is likely to prefer restructuring that would permit consolidation of budgetary decisions under his or her auspices to the status quo.<sup>309</sup> City council members, who are more likely to lose patronage and power under any movement toward a strong mayor system, might be more likely to oppose a Chapter 9 filing that risks restructuring.<sup>310</sup> In at least some cases, any objections of the city council will be irrelevant because other parties have the relevant authority when the municipality faces sufficient distress to warrant a Chapter 9 petition. New York, Michigan, and Rhode Island, for example, may place fiscally distressed localities under the supervision of a financial control board or emergency manager.<sup>311</sup> Once appointed, those authorities may recommend to state officials that the local government be authorized to file a Chapter 9 petition, as Detroit's emergency manager did,<sup>312</sup> or may directly file such a petition.<sup>313</sup>

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309. See *supra* text accompanying note 250.

310. A brief review of authorizing statutes suggests that the legislative body of the municipality typically must vote to permit a bankruptcy filing. Pennsylvania is thus an exception in this regard, since it has enacted a special framework for distressed cities of the first class that ultimately vests the filing decision with the governor. 53 PA. STAT. AND CONS. STAT. ANN. § 12720.211(b) (West 1998).

311. MICH. COMP. LAWS ANN. § 141.1549 (West 2013); N.Y. LOCAL FIN. LAW § 85.80 (McKinney 2009); 45 R.I. GEN. LAWS § 45-9-7 (2009).

312. MICH. COMP. LAWS ANN. § 141.1558(1) (West 2013).

313. N.Y. LOCAL FIN. LAW § 85.80 (McKinney 2009).

Moreover, if governance restructuring were otherwise considered an appropriate role for a federal bankruptcy court, the potential tendency of city councils to avoid filings in order to retain authority could be overcome by an amendment to the Bankruptcy Code that placed filing authority in the hands of the local executive.

To be sure, a state may consider such intervention to be an intrusion on its own prerogative to determine the governance structure of its political subdivisions and forbid its municipalities from filing for Chapter 9. But the political economy of municipal fiscal distress is more complicated. The experiences of Detroit and New York City reveal that state officials may be reluctant to interfere with municipal political processes because local officials and constituencies may blame state officials for the diminution of local autonomy.<sup>314</sup> State officials, therefore, may prefer that any such diminution be imposed by a third party. The ability of state officials to “blame” a federal bankruptcy judge for redesigning institutions that enhance local (and state) fiscal stability may be sufficiently attractive to make Chapter 9 more appealing rather than less.<sup>315</sup>

Moreover, the threat that municipal restructuring poses to the state’s plenary authority over its political subdivisions is perhaps more limited than initially appears to be the case. As we discuss below, the state retains the capacity to impose governance structures that render bankruptcy court intrusion unnecessary.<sup>316</sup> Even within bankruptcy, the state is likely to play a significant role in formulating the plan that the debtor municipality submits for confirmation. In addition to its other authority over a municipality, the state will typically be the source of substantial capital infusions that will be necessary to make any plan feasible.<sup>317</sup> Of course, the state’s plenary authority over its localities survives bankruptcy so that the state presumably could also

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314. See, e.g., JONATHAN SOFFER, ED KOCH AND THE REBUILDING OF NEW YORK CITY 120 (2010) (reporting that Koch’s reaction to the imposition of a financial control board was “if I were the Mayor, I would never have gone along with it: I don’t think I could have accepted a state of affairs that made me one-seventh of a mayor.”); Chris Savage, *The Scandal of Michigan’s Emergency Managers*, THE NATION (Feb. 15, 2012), <http://www.thenation.com/article/166297/scandal-michigans-emergency-managers> [<http://perma.cc/2XYX-FNKV>].

315. This suggests that some state officials may actually prefer that bankruptcy judges be given explicit authority to require governance change – or at the least, that judges clearly signal the governance changes they believe to be necessary to a feasible restructuring plan.

316. See *infra* Part V.

317. See Gillette, *supra* note 31, at 1414-16. Under the terms of the proposed plan for adjusting the debts of Detroit, the State of Michigan contributed \$98.8 million to the city’s General Retirement System and \$96 million to the city’s Police and Fire Retirement System. *In re City of Detroit*, 524 B.R. 147, 170 (Bankr. E.D. Mich. 2014).

intervene subsequent to the municipality's exit from bankruptcy to readjust the local governance structure. As a result, any action taken by the bankruptcy court that conflicted with state preferences could be temporary.

The state might not object for yet another reason as well. The state could effectively pre-empt federal bankruptcy court intervention if the state itself took action that addressed governance issues in fiscally distressed localities. Indeed, one benefit of allowing a federal bankruptcy court to restructure municipal governance is that the threat of judicial intervention could induce states to act more expeditiously in addressing local structural defects and thus avoid the need for a bankruptcy court to take any measures. In short, the very presence of the power to restructure municipal governance in bankruptcy could render its exercise superfluous.

That possibility, however, raises a related question: If states have the capacity to alter municipal governance structures, why not leave that task to the state and limit the bankruptcy court to the traditional role of adjusting debts? It is to that question that we next turn.

#### V. WHY NOT THE STATE?

In this Part, we address the capacity of states, rather than bankruptcy courts, to restructure dysfunctional local governments. We begin by acknowledging that states have political and institutional advantages over courts for this purpose. But we contend that there will be occasions when the state is disabled from exploiting those advantages. Restrictions on state intervention result from two sources. First, legal doctrines that define the relationship between the state and its political subdivisions may prevent state interference with local governmental structures. Those doctrines typically arise from principles of home rule that grant municipal governments immunity from state interference with respect to local internal organization. Second, the political economy of state intervention may render it difficult for states to intervene in local institutional design, even when the state has the legal authority to do so.

If governance restructuring is vital to municipal fiscal health, the natural question to ask is why the state, rather than a federal bankruptcy court, is not the appropriate entity to impose governance restructuring in the face of recalcitrant local officials. After all, standard legal doctrine provides that states can exercise plenary power over their political subdivisions, constrained only by federal or state constitutional law.<sup>318</sup> State legislatures, which deal with local

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318. See BAKER, GILLETTE & SCHLEICHER, *supra* note 20, at 245-56.

governmental powers on a regular basis, appear to have a comparative advantage over courts, including federal bankruptcy courts, in designing institutions that affect the welfare of municipal residents. As Omer Kimhi has argued, the state is well positioned to deal with municipal fiscal distress because it has greater control over the socioeconomic or political causes of crisis and has the capacity, by conditional bailout, direct state takeovers, or the imposition of local governance mechanisms, to resolve it.<sup>319</sup> Moreover, to the extent that local fiscal distress threatens to spill over to other jurisdictions in the state—either by reducing the faith of credit markets in the fiscal health of neighboring jurisdictions or by threatening consequences in the metropolitan economy—the state has the appropriate motivation to intervene.<sup>320</sup> Finally, it is more consistent with principles of federalism to permit the state to dictate forms of governance than to invite the intervention of a federal bankruptcy court.

For each of these reasons, it is preferable that the state design and dictate structural change for municipalities. We are concerned, however, with the very common case in which the state has not addressed the question of institutional design in the face of fiscal distress.<sup>321</sup> If inaction is the consequence of a deliberate decision that state intervention would entail costs in excess of the benefits of enhanced fiscal stability, there may be little reason for a federal bankruptcy court to revisit the inquiry. If, however, the state's inaction is motivated by factors unrelated to questions of institutional design, then it may be desirable to have a third party, such as a federal bankruptcy court, induce appropriate structural change. Of course, ad hoc explanations for state inaction in a particular case are difficult to discern and thus invite courts to engage in messy speculation about state political processes. To determine whether or not bankruptcy courts should abstain from municipal governance reform we

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319. See Kimhi, *supra* note 27, at 664-72. On bailouts, see Robert P. Inman, *Transfers and Bailouts: Enforcing Local Fiscal Discipline with Lessons from U.S. Federalism*, in *FISCAL DECENTRALIZATION AND THE CHALLENGE OF HARD BUDGET CONSTRAINTS* 35, 48-49 (Jonathan A. Rodden et al. eds., 2003). On state takeovers, see Gillette, *supra* note 31. State constitutions and statutes permit the legislature to dictate the terms of or amend city charters. See, e.g., MICH. COMP. LAWS ANN. §117.3 (West 2012) (mandatory provisions in city charters); *City of Ecorse v. Peoples Cmty. Hosp. Auth.*, 58 N.W.2d 159 (Mich. 1953). Some restrictions may arise when home rule authority is deemed to affect the form of government. See *infra* text accompanying notes 332-342.

320. See Gillette, *supra* note 31, at 1416-19.

321. We are not, for example, aware of any efforts by the state to restructure local governments in well-publicized cases of fiscal distress, such as Detroit or Vallejo. Financial control boards in New York City imposed budgeting requirements on New York City, but did not otherwise reorganize the city government.

therefore will need to consider what, as a general matter, explains state inaction rather than what occurred in a particular case.

For two very different reasons, states may often fail to impose appropriate governance structures on a fiscally distressed municipality. The first, a relatively benign story, involves legal doctrines that dictate the relationships between the state and its political subdivisions.<sup>322</sup> These doctrines limit the state's authority to intervene, although the constraints are much weaker than might initially seem to be the case. The second, perhaps a more complicated and malign explanation, involves the political economy of those same relationships.<sup>323</sup> The political impediments are much more significant, and confirm the need for bankruptcy court intervention.

Our discussion of state intervention focuses on the capacity of state legislatures to restructure local government. In theory, state courts with authority to resolve municipal distress could make restructuring part of a state insolvency process and perhaps circumvent some of the political economy obstacles that we attribute to legislatures. Indeed, McConnell and Picker argued for displacement of federal municipal bankruptcy law with state municipal bankruptcy law.<sup>324</sup> We have little disagreement about the institutional capacity of a state bankruptcy regime to address matters of municipal governance. But, as McConnell and Picker recognized, current law restricts that option since the Bankruptcy Code limits states' ability to enact laws that impose debt adjustments on unwilling creditors.<sup>325</sup> McConnell and Picker concluded that elimination of that provision would permit states to enact their own adjustment laws.<sup>326</sup> They rejected the obvious response that the Contracts Clause precludes states from impairing the obligation of contract.<sup>327</sup> We are less certain. McConnell and Picker relied on the Supreme Court's decision in *Faitoute Iron & Steel v. City of Asbury Park*, which upheld a state municipal insolvency statute against a Contracts Clause challenge on the grounds that the law created no impairment if it allowed a creditor a greater probability of recovery than would otherwise have been possible.<sup>328</sup> A debt adjustment plan that promises a creditor of a bankrupt municipality something

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322. See *infra* Section V.A.

323. See *infra* Section V.B.

324. See McConnell & Picker, *supra* note 8, at 479.

325. 11 U.S.C. § 903(1) (2012) (“[A] State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition”).

326. McConnell & Picker, *supra* note 8, at 479-80.

327. *Id.* U.S. CONST. art. I, § 10, cl. 1.

328. 316 U.S. 502, 508, 511 (1942).

rather than the nothing that would otherwise be forthcoming will satisfy that standard. But subsequent Contracts Clause jurisprudence allows such exceptions only in the face of a “broad, generalized economic or social problem.”<sup>329</sup> Certainly the Great Depression, during which Asbury Park fell into insolvency, qualified. Fiscal distress that imperils the solvency of a major city and threatens substantial national effects might similarly qualify. But it is less certain that distress attributed to the profligate pension arrangements of a city with less national importance would.<sup>330</sup> In any event, the ad hoc determination that would be required concerning the constitutionality of impairment in a particular situation makes a state municipal restructuring law too uncertain to be a basis for reliance.

McConnell and Picker may stand on stronger ground when they contend that state insolvency laws in effect at the time municipal distress materializes would not violate the Contracts Clause because those laws become part of subsequently negotiated contracts.<sup>331</sup> But that solution requires initial legislative intervention of the type that, in this Part, we suggest has a low likelihood of materializing prior to the fiscal crisis that it is intended to redress. Indeed, to the extent that state legislatures have recently addressed the possibility of municipal insolvency, they have demonstrated more sympathy for creditors than municipalities by granting bondholders liens that would arguably withstand reduction even in federal bankruptcy proceedings.<sup>332</sup> We thus concentrate on the capacity and incentives of legislators to require structural reform outside of municipal debt adjustment.

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329. *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 250 (1978). While the Court has allowed a broader range of impairments for private contracts, it has not done so with respect to public contracts. See *Exxon Corp. v. Eagerton*, 462 U.S. 176 (1983); *Energy Reserves Grp., Inc. v. Kan. Power & Light Co.*, 459 U.S. 400 (1983).

330. See *In re City of Stockton*, 493 B.R. 772, 779 (Bankr. E.D. Cal. 2013). One might contend that the pension crisis was exacerbated by the fiscal crisis that began in 2008, and that the crisis created an exogenous shock equivalent to the Great Depression for purposes of the Contracts Clause. But to the extent that the pension crisis has been a function of unrealistic assumptions concerning returns, preceded the fiscal crisis of 2008, and has had varying effects depending on the practices of various states and cities, it is more difficult to grant it the same status as the Great Depression. See *The Trillion Dollar Gap: Underfunded State Retirement Systems and the Roads to Reform*, PEW CTR. ON THE STATES, 1-2 (2010), [http://www.pewtrusts.org/~media/legacy/uploadedfiles/pes\\_assets/2010/trilliondollargapunderfundedstateretirementsystemsandtheroadstoreformpdf.pdf](http://www.pewtrusts.org/~media/legacy/uploadedfiles/pes_assets/2010/trilliondollargapunderfundedstateretirementsystemsandtheroadstoreformpdf.pdf) [<http://perma.cc/A75H-HKHG>] (summarizing the gap between value of obligations to retirees and available funding as of 2008).

331. See McConnell & Picker, *supra* note 8, at 480.

332. See, e.g., 45 R.I. GEN. LAWS § 45-12-1 (2009) (granting bondholders of general obligations issued by cities and towns in Rhode Island first lien on ad valorem taxes upon all the taxable property).

A. *Doctrinal Constraints on State Design of Municipal Governance*

Notwithstanding the traditional view that a state can exercise plenary power over its political subdivisions, state constitutional doctrines place constraints on the state's interference with local autonomy.<sup>333</sup> A legislature that respected those constraints and thus refused to restructure municipal institutions of governance may simply be adhering to a settled allocation of responsibility between states and their political subdivisions. Violation of those constraints by dictating forms of governance could be seen as imposing costs on local autonomy in excess of the benefits of redressing even a serious fiscal crisis.

The most powerful limitation on state authority gives municipalities the authority to exercise home rule in the design of their own governance structures. Home rule, however, is not a monolithic concept. In some jurisdictions, it provides a municipality only with initiative authority; the municipality can legislate in an area designated as "local concern" or "municipal affairs" even without prior legislative authorization.<sup>334</sup> In other jurisdictions, home rule authority provides a broader level of local autonomy by immunizing the locality from state intervention, again with respect to matters denominated as involving purely "municipal affairs."<sup>335</sup> In the first set of jurisdictions, the exercise of home rule is always subject to state intervention; there is no area in which the locality is entitled to trump a conflicting state statute. In such a jurisdiction, the state could always impose a form of government on one of its municipalities, even if the municipality preferred an alternative. For example, Michigan's Home Rule City Act requires a city charter to contain provisions for the election of specified officers for specified terms.<sup>336</sup> A municipality that preferred a different set of local officials, or different terms for them, would be unable to trump the state, notwithstanding home rule status. State inaction in such a jurisdiction cannot be explained as a function of a doctrinal requirement that the state be excluded from designing municipal institutions.

In the second set of jurisdictions, there is a stronger claim that home rule status precludes the state from intervening in matters that involve an insufficient degree of statewide concern. If the structure of municipal

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333. See BAKER, GILLETTE & SCHLEICHER, *supra* note 20, at 245-87 (discussing a state's plenary power over municipalities and exceptions).

334. See, e.g., N.Y. CONST. art. IX, § 2(c); GA. CODE ANN. § 36-35-3 (2012).

335. See, e.g., CAL. CONST. art. XI, § 5(a); COLO. CONST. art. XX, § 6.

336. See Public Act No. 7, 2012 Mich. Legis. Serv. 7 (West) (amending MICH. COMP. LAWS ANN. §§ 117.3-117.4 (West 2015)).

governance falls into that category, then municipal choices trump the state's, as several courts have held. The Arizona Supreme Court recently opined that, notwithstanding general ambiguity about the dividing line between matters of state concern and local concern, it "is absolutely clear that charter city governments enjoy autonomy with respect to structuring their own governments."<sup>337</sup> Thus, a state statute that provided for partisan ballots did not displace a municipal charter requirement of non-partisan elections;<sup>338</sup> a state prohibition on partisan elections did not bar local partisan elections for charter cities;<sup>339</sup> and a local residency requirement for political candidates trumped a more stringent state statute.<sup>340</sup> Other states have similarly concluded that the governance structures of home rule municipalities, at least insofar as they involve elections, trump conflicting state laws.<sup>341</sup> The New Mexico Supreme Court concluded that a state statute that dictated a set number of city commissioners did not bind home rule municipalities.<sup>342</sup>

None of these decisions, however, have been rendered in the face of an effort to impose institutions on a municipality that faces fiscal distress. Distress could alter the calculus because home rule authority is limited to matters of local concern, and fiscal distress may entail extramural effects. At least in part for this reason, courts have permitted states to alter the governance structure of home rule municipalities by appointing receivers or financial control boards, although these courts have also emphasized the temporary nature of the intervention.<sup>343</sup> It is somewhat unclear whether a state that otherwise grants localities full autonomy with respect to its local affairs would be permitted to dictate institutional design of a more longstanding nature for a municipality if the state made capital infusions or if the municipality's fiscal distress led to higher borrowing costs elsewhere in the state.

In addition to home rule limitations, constraints on special legislation may seem to restrict a state's authority. Most state constitutions preclude the

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337. *City of Tucson v. State*, 273 P.3d 624, 628 (Ariz. 2012).

338. *Strode v. Sullivan*, 236 P.2d 48, 54 (Ariz. 1951).

339. *City of Tucson*, 273 P.3d at 628.

340. *Triano v. Massion*, 513 P.2d 935, 939 (Ariz. 1973).

341. See, e.g., *Ex parte Boalt*, 260 P. 1004, 1010 (Or. 1927) (concluding that the election of a municipal judge was of purely local concern).

342. *State ex rel. Haynes v. Bonem*, 845 P.2d 150, 158 (N.M. 1992). A New Mexico appellate court subsequently concluded that a state statute that imposed term limits on city counselors was prohibited by a state constitutional clause that established qualifications for elective office. *Cottrell v. Santillanes*, 901 P.2d 785, 787 (N.M. Ct. App. 1995). To the same effect, see *Hoerger v. Spota*, 997 N.E.2d 1229, 1231 (N.Y. 2013).

343. See, e.g., *Powers v. Sec'y of Admin.*, 587 N.E.2d 744, 748 (Mass. 1992); *Moreau v. Flanders*, 15 A.3d 565, 578 (R.I. 2011).

enactment of special legislation that imposes unique burdens affecting only some of the state's political subdivisions.<sup>344</sup> The aversion to imposition of unique burdens is implicit in those constitutions that permit special legislation to be enacted only if the affected locality agrees. The Michigan Constitution, for example, only permits special legislation if it has been approved by two-thirds of "members elected to and serving in each house and by a majority of the electors voting thereon in the district affected."<sup>345</sup> The consent prerequisite in the Michigan constitutional clause, which has common analogues in other state constitutions,<sup>346</sup> effectively precludes the legislature from enacting laws that will specially burden a particular locality. The special legislation prohibition seems to limit the capacity of the legislature to tailor a governance structure to those municipalities that suffer fiscal distress.

Nevertheless, like home rule, the special legislation prohibition serves as a relatively weak constraint. Courts have systematically allowed legislatures to enact legislation that affects only a subset of municipalities as long as the classification is rationally related to a permitted state purpose.<sup>347</sup> In this sense, special legislation analysis essentially follows equal protection analysis under the federal Constitution. Thus, legislation that imposes government structures on municipalities that have required state financial assistance, that have been placed into receivership, or that fail to maintain a balanced budget for a particular period of time could arguably avoid invalidation, even though they apply only to a class of municipalities. Moreover, both courts and state constitutions have occasionally allocated to the legislature itself the capacity to determine whether proposed legislation is "special" within the meaning of the prohibition.<sup>348</sup> Thus, fear of invalidation is unlikely to restrain a legislature

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344. See, e.g., Justin R. Long, *State Constitutional Prohibitions on Special Laws*, 60 CLEV. ST. L. REV. 719, 721 n.6 (2012) (listing state constitutional provisions); Anthony Schutz, *State Constitutional Restrictions on Special Legislation as Structural Restraints*, 40 J. LEGIS. 39, 48 nn.38-41 (2013) (same).

345. MICH. CONST. art. IV, § 29.

346. See MASS. CONST. amend. art. LXXXIX, § 8; MINN. CONST. art. XII, § 2; N.Y. CONST. art. IX, § 2(b)(2).

347. See John M. Winters, *Classification of Municipalities*, 57 NW. U. L. REV. 279, 286-87 (1962).

348. See, e.g., N.J. State Bar Ass'n v. State, 902 A.2d 944, 954-55 (N.J. Super. Ct. App. Div. 2006); Lake Cty. Bd. of Elections & Registration v. Millender, 727 N.E.2d 483, 487 (Ind. Ct. App. 2000). The Illinois Constitution of 1970, on the other hand, explicitly allocates the determination of whether legislation is "special" to the judiciary. ILL. CONST. art. IV, § 13. The prior version of the state constitution had conferred on the legislature final constitutional authority for determining whether legislation could be general. See *In re Belmont Fire Prot. Dist.*, 489 N.E.2d 1385, 1387-88 (Ill. 1986).

otherwise convinced of the propriety of intervention in the governance of a distressed municipality.

The limited scope of the special legislation prohibition may have conflicting implications for a state's ability to require governance reform in distressed municipalities. On the one hand, the state's ability to circumvent the constitutional limitation through creative classification suggests that there is less need to rely on bankruptcy courts to reform dysfunctional governance structures. On the other hand, statutory reforms that appear directed at an individual locality necessarily raise questions about legislative motivation and are more susceptible to judicial invalidation. A recent example involves legislation enacted by the Michigan legislature in the wake of Detroit's efforts to exit bankruptcy proceedings. One of those laws required a city with a population of six hundred thousand or more to establish the position of chief financial officer, to be appointed by the mayor subject to the approval of the governing body of the city, and if applicable, any financial review commission that has authority over budgetary matters in the city.<sup>349</sup> At the time that the legislation was enacted, Detroit's population was just under seven hundred thousand, but had been falling substantially in the four years prior.<sup>350</sup> The next largest city in Michigan has a population of less than two hundred thousand.<sup>351</sup> Thus the population figure appears to be a substitute for inserting into the legislation the word "Detroit," a measure that would likely have run afoul of Michigan's prohibition on special legislation where a general law is possible.<sup>352</sup>

349. MICH. COMP. LAWS ANN. § 117.4s (West 2014).

350. See *State & County QuickFacts: Detroit (City), Michigan*, U.S. CENSUS BUREAU (Dec. 2015), <http://quickfacts.census.gov/qfd/states/26/2622000.html> [<http://perma.cc/7FGX-P73Y>] (estimating 2014 population at 680,250).

351. See *2014 Population Estimates for Michigan Cities*, U.S. CENSUS BUREAU, <http://factfinder.census.gov/faces/nav/jsf/pages/index.xhtml> (Search "2014 Population Estimates for Michigan Cities" under "Community Facts" and hit "Go"; select "Annual Population Estimates" under "2014 Population Estimates Program"; hit "Download" to view table) (Grand Rapids has the second largest estimated population in 2014 with approximately 194,000 residents).

352. See MICH. CONST. art. 4, § 29 ("The legislature shall pass no local or special act in any case where a general act can be made applicable, and whether a general can be made applicable shall be a judicial question."). Although one could argue that a chief financial officer is more essential for large distressed cities, due to the complexity of their budgets, the distinction seems tenuous in Michigan, where the state has deemed a number of substantial municipalities—including Flint (population 99,002, see *State and County QuickFacts*, U.S. CENSUS BUREAU (Dec. 2, 2015), <http://quickfacts.census.gov/qfd/states/26/2629000.html> [<http://perma.cc/H5A5-4F23>]), Hamtramck (population 22,099, see *State and County QuickFacts*, U.S. CENSUS BUREAU (Dec. 2, 2015), <http://quickfacts.census.gov/qfd/states/26/2636280.html> [<http://perma.cc/BN6Y-32ZC>]), and Lincoln Park (population 37,231, see *State and County QuickFacts*, U.S. CENSUS BUREAU (Dec. 2, 2015), <http://quickfacts.census>

Presumably, the legislature did not believe that it was appropriate to dictate municipal officials for all cities or even for all large cities; perhaps more realistically, localities would have resisted such intrusion into local governance. While the Michigan legislature was willing to risk invalidation to enact a statute that would impose governance constraints on Detroit, and only Detroit, either less salient cases of fiscal imprudence or more aversion to circumventing constitutional constraints could induce legislatures to take a more conservative approach and avoid imposing governance reforms even on distressed localities.

*B. The Political Economy of Structural Reform*

The prior Section suggested that legal doctrine provides some, albeit minor, constraints on the capacity of the legislature to dictate forms of governance to the state's municipalities. Where legal constraints operate, bankruptcy court intervention to restructure municipal governance might be seen as improper rebalancing of the priorities that the state had struck between the interests in local autonomy and the risk that a municipality or the state would suffer as a consequence of flaws in the design of municipal governance. The limited scope of constitutional restrictions on state legislatures during municipal fiscal crisis, however, indicates that those doctrines do not substantially foreclose impinging on local decisions. The explanation for legislative inertia must lie elsewhere.

It is, of course, plausible that the state would have been willing to intervene in municipal structure in an appropriate case, but that the legislature made a considered determination that such drastic action was undesirable in the specific case of the municipality that had entered Chapter 9. The case for restructuring depends on balancing the costs and benefits of governance reform, and the legislature could have made a good faith determination that the costs of restructuring were excessive. In that case, judicial revisiting of the decision would appear inappropriate, given the legislature's comparative (if imperfect) advantage in defining the limits of municipal authority and the proper allocation of state and local responsibilities. Thus, the area in which judicial intervention would appear to be appropriate would be those cases in which the legislature not only had failed to deploy measures that would enhance fiscal stability for the municipality, but had failed to do so for less benign reasons than a considered judgment of the value of restructuring.

It is, of course, difficult to the point of fruitless to determine legislative intent in the case of legislative inaction. As William Eskridge has

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<http://www.fiscalfairness.org/qfd/states/26/2647800.html> [<http://perma.cc/3E72-N4W5>] – sufficiently distressed to require an emergency manager.

demonstrated, legislative inertia may result from different degrees of intensity in favor of acting as well as from insufficient support for action.<sup>353</sup> Assume, for example, that state legislators responded to fiscal instability in a municipality in the following manner: forty percent of the legislators desired no tampering with the municipality's governance structure; forty percent desired requiring the municipality to move to a strong mayor model; and twenty percent favored disincorporating the city and merging it with the county surrounding it. Assume further that each of these positions was resistant to compromise. Under that scenario, there would be a solid majority for taking action about municipal governance, but the result would be inaction. It would be difficult to argue that a bankruptcy court should intervene to correct the result, because the legislature had not failed to consider restructuring; it simply failed to achieve consensus on the form restructuring should take. Nor could the court assume that the existence of a majority for some form of restructuring provided the court with authority to select a restructuring option and impose it in the name of achieving majority will. Assume, for example, that the forty percent that favored a strong mayor also favored no action over disincorporation, and that the twenty percent that favored disincorporation also favored no action over a strong mayor. Under those circumstances, a court could not correctly conclude that any form of restructuring was a majoritarian preference compared to no restructuring.

Uncertainty about legislative process and intent does not, however, necessarily leave a court helpless or mired in unfettered speculation. Legislative history, although sparser in the state context than in the federal one, should reveal whether any discussion of restructuring has occurred. Even in the absence of legislative history, one might conclude that the state's failure to act is the result of considered judgment if inertia is inconsistent with incentives that the state otherwise has to intervene. Given the structure of the state government, the state legislature should be willing, if not anxious, it might seem, to impose a governance structure on municipalities that are experiencing fiscal distress. This is true for two reasons. First, as Roderick Hills has argued, the state has incentives to expand the scope of its jurisdiction and therefore to invade areas that might properly be allocated to localities.<sup>354</sup> If state legislatures desire to expand their jurisdiction, fiscal distress provides an opportunity to act on "imperialist" tendencies. Second, as we have suggested above,<sup>355</sup> fiscal

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353. William N. Eskridge, Jr., *Interpreting Legislative Inaction*, 87 MICH. L. REV. 67, 104-13 (1988).

354. Roderick M. Hills, Jr., *Compared to What? Tiebout and the Comparative Merits of Congress and the States in Constitutional Federalism*, in *THE TIEBOUT MODEL AT FIFTY* 239 (William A. Fischel ed., 2006).

355. See *supra* text accompanying note 343.

distress could generate negative externalities sufficient to overcome objections that principles of home rule preclude a state role in municipal affairs.

In addition, municipal fiscal distress that is sufficiently severe to attract legislative attention traditionally involves major cities, and the traditional story of state/local relationships suggests widespread suburban and rural hostility to urban areas.<sup>356</sup> Thus, one can infer that the legislature will be more likely to exploit local fiscal distress to discipline or embarrass a municipality that was often the target of statewide animosity. Given these apparent incentives to intervene, a state's failure to intervene could, theoretically, reflect legislative judgments – to which bankruptcy courts should defer – rather than inertia or a political impasse.

In reality, however, inertia or impasse is more likely to be the principal explanation for inaction. Begin with the contention that the state legislature is likely to exploit opportunities to discipline or embarrass the distressed municipality. Recent scholarship indicates that the relationship between urban areas and the state legislature is more complicated than the traditional story of hostility. Cities that desire additional authority from the legislature often obtain it; indeed, empirically minded students of state processes conclude, “State legislatures have routinely deferred to local governments.”<sup>357</sup> A recent paper by Gamm and Kousser demonstrates that the failure of large cities to obtain legislative authority is due less to hostility from other jurisdictions or to partisan politics than to disagreement within the delegation from the affected locality.<sup>358</sup> Legislators are willing to defer to the preferences of local legislators where those preferences are clear. Where disunity within the local delegation in the state legislature obfuscates the signal about city preferences, other legislators have no one to defer to.<sup>359</sup> If there is unified resistance to state intervention within the delegation from the affected municipality, by contrast, that may be sufficient to quash any effort to impose a government structure. Moreover, to the extent that partisanship explains state interference in local government, it may also explain state inaction. If the distressed municipality is dominated by the same party that dominates the state legislature, the state

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356. See Sheryll D. Cashin, *Localism, Self-Interest and the Tyranny of the Favored Quarter: Addressing the Barriers to New Regionalism*, 88 GEO. L.J. 1985, 2022 (2000); Gerald Gamm & Thad Kousser, *No Strength in Numbers: The Failure of Big-City Bills in American State Legislatures, 1880-2000*, 107 AM. POL. SCI. REV. 663, 664-65 (2013).

357. Scott Allard et al., *Representing Urban Interests: The Local Politics of State Legislatures*, 12 STUD. IN AM. POL. DEV. 267, 294 (1998).

358. Gamm & Kousser, *supra* note 356, at 666-68.

359. *Id.*

legislature may be reluctant to chastise local political leaders by imposing an unwanted governance structure on them.<sup>360</sup>

These results suggest that a locality may have sufficient influence in the legislature to forestall any efforts to impose structural change, even when doing so would enhance fiscal stability. If that is the case, then the argument for bankruptcy court to restructure municipal governance may be stronger because legislative inaction about municipal structure would result from the dominant position of the distressed municipality rather than from the considered judgment of the legislature about the propriety of imposing institutions that could provide fiscal stability.

To be sure, the studies finding that legislatures defer to municipal will may be skewed by their focus on bills introduced by delegates from the affected localities.<sup>361</sup> Legislators from other jurisdictions may be indifferent about autonomous decision making by the affected city, because exercise of the extended authority has few external effects. But if the municipality has fallen into distress, and the distress could have extramural consequences, state legislators' deference could quickly dissipate. In theory, this reasoning could explain states' willingness to enact legislation introduced by local officials under ordinary circumstances, while also suggesting that a state's failure to intervene when a municipality falls into distress reflects considered judgment rather than a political failure that warrants bankruptcy court intervention.

Yet, even if state legislators can be expected to intervene in the event of fiscal distress, they have little incentive to correct dysfunctional governance arrangements. State intervention that reacts to concerns about the external effects of fiscal distress tends to target the immediate crisis. The principal concern is to reassure credit markets that the municipality at issue and other municipalities will not default. Governance reform, by contrast, is intended to generate long-term solutions by addressing the causes of a crisis rather than the imminent consequences of inadequate existing institutions. Centralized decision making, for example, may reduce the size of budgets by eliminating logrolled deals in the future. It will not, however, assure the current payment of debts or assist in the renegotiation of burdensome executory contracts. Nor is restructuring likely to be salient to those who are concerned about the

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360. For discussion of the ambiguous role of partisanship in state interventions into the governance of political subdivisions, see Gillette, *supra* note 31, at 1447-49.

361. One study reported, for instance: "Excluding bills originating in the senate, 93 percent of all big-city bills were introduced by a representative from the city affected by the bill—indeed, in Massachusetts, where legislators often named the person who had petitioned for the introduction of the bill, the mayor of Boston was himself named frequently as the petitioner for Boston-related bills." Allard, *supra* note 357, at 277.

immediate need to address budgetary deficits or to balance the conflicting claims of creditors, public employees, and residents to an insufficient local treasury. Thus, state legislative efforts to address a local fiscal crisis have typically focused on some form of state takeover, either through a receivership or through a control board.<sup>362</sup> Each of these methods has the capacity to exercise substantial authority over budgetary decision making of the distressed municipality. But these forms of intervention are intended to be temporary, to dissolve at the end of the crisis period, and to manage the current crisis rather than to impose longstanding structural changes on the municipality. In the New York City fiscal crisis of the 1970s, for example, Senate Republicans agreed to provide assistance necessary to avoid a default, but the conditions focused on empowering the Municipal Assistance Corporation for the City of New York as a supervisory agency rather than revamping the internal governance of the city.<sup>363</sup>

There is another reason to suspect that a failure by the state to intervene will usually reflect inertia, rather than a considered judgment. We have hypothesized that restructuring often would move in the direction of a more centralized municipal decision-making process. That means that restructuring will confer more authority on mayors and detract from the authority of city-council members. Assuming that mayors would prefer more authority to less, one might initially imagine that the legislature would be motivated to mandate centralization, because the mayor of a major city is likely to have more influence with the state legislature than individual city-council members.<sup>364</sup> If that is true, then, again, one might conclude that the failure of the state legislature to intervene is a consequence of a substantive judgment that such a move is, on balance, undesirable, rather than a consequence of political alignments.

But a period of fiscal distress is not a propitious time for the legislature to confer additional authority on the mayor of a municipality that faces fiscal

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<sup>362</sup>. See Gillette, *supra* note 31, at 1377-78.

<sup>363</sup>. See BAILEY, *supra* note 119, at 26.

<sup>364</sup>. There is some evidence that mayors have greater influence in the state legislature than city councils. During the 1990s, there was a movement away from independent school boards for large cities and toward appointed school boards. During this period, twenty-four states enacted legislation permitting control of school districts by local or state officials. Kenneth K. Wong & Francis X. Shen, *When Mayors Lead Urban Schools: Assessing the Effects of Takeover*, in *BESIEGED: SCHOOL BOARDS AND THE FUTURE OF EDUCATION POLITICS* 81, 83-84 (William G. Howell ed., 2005). Where local officials have been authorized to name some or all members of the school board, the relevant local official has consistently been the mayor, rather than the city council or some combination of mayoral appointment with city-council approval.

distress. The incumbent mayor is likely to have become a focal point of blame for the very distress that additional centralization is intended to alleviate. Even if the absence of centralized control is responsible for the distress, the fact that the crisis materialized on the incumbent's watch makes that official less likely to receive sympathy from the legislature. Instead, the legislature will likely question the competence of the mayors whose cities face local distress, and those mayors are unlikely to enjoy a promising political future, at least in the short term.<sup>365</sup>

Nor is the mayor, even one with influence, likely to advocate any governance reforms, no matter how essential, that would detract from her executive authority. For example, we noted above that the legislation enacted by the government of Michigan required Detroit to appoint a chief financial officer—a rare instance of legislative intervention in municipal governance in the face of fiscal crisis. That requirement was presumably intended to provide centralized decision making insofar as it created a single umbrella for what had been a multi-faceted budgetary process.<sup>366</sup> It is unlikely that a mayor would advocate such a reform in the state legislature. Similarly, as we have indicated above, a requirement that a municipality elect its city council through an at-large system rather than through district elections could facilitate fiscal stability because it would reduce the benefits of district-by-district logrolling. But a mayor may be agnostic about or oppose such a change because it would undermine that official's claim to be the only representative elected by the electorate as a whole.

In summary, the failure of the state to restructure municipal governance in the face of fiscal crisis is not likely to be a consequence of considered legislative

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365. There are exceptions. Marion Barry returned to office as a council member of the District of Columbia, notwithstanding that, as mayor, he had previously presided over a financial crisis and federal bailout. See David Stout, *Marion Barry, Washington's 'Mayor for Life,' Even After Prison, Dies at 78*, N.Y. TIMES (Nov. 23, 2014), <http://www.nytimes.com/2014/11/24/us/politics/marion-s-barry-jr-former-mayor-of-washington-dies-at-78.html> [http://perma.cc/9HSY-DZAN]. Dennis Kucinich was elected to Congress after serving as mayor of Cleveland during its financial crisis in the late 1970s. See Biographical Directory of the United States Congress, Dennis Kucinich, <http://bioguide.congress.gov/scripts/biodisplay.pl?index=k000336> [http://perma.cc/3NLX-LLHQ].

366. See DETROIT CITY CHARTER, art. VIII. Although the chief financial officer is appointed by and reports to the mayor, see H.B. 5567, 97th Leg., Reg. Sess., §§ 4s(1)-(2) (Mich. 2014), the supervisory authority granted to the new official diminishes what had previously been the domain of the mayor, see DETROIT CITY CHARTER, art. VIII. In similar fashion, Congress established a chief financial officer of the District of Columbia when it created a financial control board for the district. District of Columbia Financial Responsibility and Management Assistance Authority Act, Pub. L. No. 104-8, 109 Stat. 97 (1995) (codified as amended at D.C. CODE §§ 47-391.01, 47-393 (2014)).

judgment that should foreclose a bankruptcy court's visitation of the subject. Nor is it likely to emanate from respect for legal doctrines that caution against interference with local autonomy. Instead, legislative inertia is likely to result from political considerations that are disembodied from the optimal allocation of authority between the state and its localities or the optimal design of fiscally stable institutions within the locality. Some political deviations from ideal institutional design must, of course, be tolerated, if for no other reason than the low likelihood that political actors, such as courts, will be able to improve on decisions made in the political market. But where fiscal crisis translates into the inability of the municipality to provide the basic services for which it has been created, the failure of the state to address root causes signals a sufficient gap to warrant some redress. Since bankruptcy courts have been assigned the responsibility of supervising the restructuring of municipal debts and thus addressing the symptoms of a failed system of governance, they seem relatively well positioned to address the causes of that system, at least where the state itself has demonstrated an incapacity to intervene.

## CONCLUSION

According to the conventional wisdom, municipal bankruptcy can only be used to restructure a municipality's debt. Attempting to reform a city's governance would purportedly violate state sovereignty, as well as several key provisions of Chapter 9 that were drafted with state sovereignty in mind. The Detroit bankruptcy largely reflected this conventional wisdom. Although the court-appointed feasibility expert warned about the potential consequences of failing to address Detroit's operational problems, Detroit restructured its debt without addressing the dysfunctional features of its municipal governance.

It would be unfortunate if Chapter 9 were as limited as the conventional wisdom suggests. When a substantial city files for bankruptcy, its excessive debt may only be the external manifestation of problems that run much deeper. Fragmentation and related governance problems are nearly always a key underlying cause of the city's financial distress. If Chapter 9 cannot address these deeper problems, its efficacy may be quite limited.

In this Article, we have argued that Chapter 9 can and should address these deeper problems. Governance reform is a common feature of corporate reorganization in Chapter 11, and it is even more essential for the restructuring of a troubled city, since a city, unlike a corporation, cannot be liquidated or ownership rights transferred from one group of stakeholders to another. Although we acknowledge that governance reform could be challenged on constitutional grounds or as violating one or more provisions of Chapter 9 that are designed to limit the scope of bankruptcy court intervention, we believe

that governance reform would ultimately withstand challenge. If it does, Chapter 9 could prove to be a more effective tool for addressing the financial distress of substantial cities than even its advocates have imagined.