

Junk Cities: Resolving Insolvency Crises in Overlapping Municipalities

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What would happen if the City of Chicago, the Chicago Public Schools, and Cook County all became insolvent at the same time? How should policy-makers and courts respond? This Article argues that the pension and budget crises that have left so many local governments deeply in debt have generated another looming problem: the prospect of simultaneous debt crises in overlapping local governments—municipalities, school districts, counties, and other special purpose entities that govern and tax the same territory. These crises will be worse than prior local insolvency crises, as conflicts among overlapping governments will increase the pain suffered by taxpayers, service recipients, and creditors alike. There has been virtually no public discussion of this problem, and as a result, much is still unknown about who would bear the costs of simultaneous insolvency crises and how courts and legislatures would respond.

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This Article explains how collective action problems among overlapping local governments will make addressing simultaneous insolvency crises difficult. Specifically, jurisdictions will hold out against needed restructuring of their obligations in the hopes that another jurisdiction will restructure first, thereby relieving the strain on the shared tax base, or alternatively, they will raise revenues in ways that are individually rational but collectively costly. Existing tools for addressing local governmental insolvency, particularly Chapter 9 bankruptcy, cannot currently address coordination problems among overlapping local governments. Accordingly, this Article proposes several changes to Chapter 9 doctrine and to state laws that would counteract the collective action problems that afflict overlapping local governments during insolvency crises and spread the pain of restructuring.

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INTRODUCTION: WELCOME TO JUNK CITY!

In 2016, the City of Chicago got a new nickname—“Junk City.”¹ Due to both severely underfunded public employee pension systems and a large amount of bonded debt, the credit rating agency Moody’s downgraded the City of Chicago’s general obligation bonds to “Ba1” with a negative outlook, meaning that the bonds were not investment grade or, colloquially, were “junk.”² The rating change meant the City had to pay higher interest rates and forced the City to make payments under swap arrangements it made as part of previous borrowings.³

The City of Chicago’s debt issues, however, represented just one piece of a far larger problem. As bad as the City’s fiscal problems were, Chicago Public Schools (CPS) suffered from far worse.⁴ Although CPS’s territorial jurisdiction

1. Tim Jones, *Five Reasons Chicago Is in Worse Shape Than Detroit*, BLOOMBERG (May 13, 2015), <https://bloom.bg/1F84hWu> [<https://perma.cc/6WR5-BQMR>] (labeling Chicago “Junk City” following downgrades by credit rating agencies); Molly Smith, *Junk City Snapshot: Chicago Taxes Rise, But So Does Pension Debt*, BLOOMBERG (July 15, 2016), <https://bloom.bg/2DeLooU> [<https://perma.cc/VYK4-PJ4F>] (describing Chicago as “Junk City” over a year later).

2. Hal Dardick & Heather Gillers, *Chicago Credit Rating Plummets to Junk Status Following Pension Ruling*, CHI. TRIB. (May 12, 2015), <https://www.chicagotribune.com/ct-chicago-credit-rating-junk-status-met-0513-20150512-story.html> (describing downgrade by Moody’s); Heather Gillers, *New Emphasis on Pension Debt at Moody’s Helped Chicago Fall to Junk Status*, CHI. TRIB. (May 26, 2015), <http://trib.in/2EPd9oo> (same). A court decision invalidating an effort to reform pension systems in Illinois precipitated the downgrade. *Id.* The fiscal picture is staggering: Chicago’s annual budget is roughly \$8.6 billion, and it holds \$8.9 billion in bonded debt and \$25.5 billion in underfunded pension liabilities. CHI. CIVIC FED., CITY OF CHICAGO FY2018 PROPOSED BUDGET: ANALYSIS AND RECOMMENDATIONS 1 (2017).

3. See Hal Dardick & Heather Gillers, *Chicago to Borrow \$674 Million, but Junk Status Adds Millions to Cost*, CHI. TRIB. (May 27, 2015), <http://trib.in/2B9J4O2> (describing the implications of “junk” status for Chicago’s borrowing costs and the “swap” contract arrangements); Melissa Harris, *Chicago’s Junk Status: The Basics*, CHI. TRIB. (May 23, 2015), <http://trib.in/2B9yxCE> (discussing the effect of junk status on borrowing costs and explaining that some institutional investors are forbidden from holding “junk” bonds).

4. Again, the numbers are extremely troubling. CPS has an operating budget of \$5.7 billion and a total budget of \$6.5 billion, but has \$7.3 billion of long-term general obligation debt, \$1.3 billion

is coextensive with the City's, and its Board and Chief Executive are appointed by the Mayor of Chicago, CPS is a separate legal entity with distinct powers, debt obligations, and taxing authority.⁵ CPS had more severe pension and debt problems than the City. Moody's rated the debt at "B3," five steps lower than the City's debt.⁶ In 2016, CPS issued tax-exempt bonds at a shocking 8.5 percent interest rate, a higher spread above the rates paid by "AAA"-rated municipal bond issuers than any other municipal bond offering in recent US history, including bonds sold by the now-insolvent Commonwealth of Puerto Rico.⁷

That was not the full extent of Chicagoland's debt problem, however. There are several other local jurisdictions that overlap with the City of Chicago. The Chicago Park District is yet another separate legal entity from the City, with a large debt burden relative to its revenues, and bonds that Moody's also rated "Ba1," non-investment grade junk.⁸ Cook County, in which Chicago and more than a hundred smaller municipalities are located, had debt rated "A2" by Moody's, a mediocre rating due to underfunded pension liabilities.⁹ Several other overlapping local government units—the Chicago Transit Authority, City Colleges of Chicago, the Cook County Forest Preserve, the Metropolitan Water Reclamation District—are also all separate legal entities with substantial amounts of debt and/or underfunded pension liabilities as well.¹⁰

of short-term debt, and \$9.6 billion of underfunded pension liabilities. CHICAGO PUBLIC SCHOOLS FY2018 PROPOSED BUDGET: ANALYSIS AND RECOMMENDATIONS, CHI. CIVIC FED. 5, 7 (2017).

5. See CHI. CIVIC FED., CHICAGO PUBLIC SCHOOLS BOARD OF EDUCATION GOVERNANCE: A HISTORY AND REVIEW OF OTHER CITIES' PRACTICES 3–5 (2017) (describing the governance structure of Chicago Public Schools). The defining line between an agency of a municipality that issues its own debt backed by special revenues, and a separate local government is, at times, a bit murky. Nonetheless, scholars have developed means for judging this difference. See CHRISTOPHER R. BERRY, IMPERFECT UNION: REPRESENTATION AND TAXATION IN MULTILEVEL GOVERNMENTS 26–29 (2009) (supplying a definition).

6. Yvette Shields, *Chicago Teachers Sign Off on Strike*, BOND BUYER (Sept. 26, 2016), <http://bit.ly/2Dpc6OY> [<https://perma.cc/2XP4-QCNB>] (describing the Moody's downgrade to B3).

7. Karen Pierog & Dave McKinney, *Chicago Schools Slash High-Yielding 'Junk' Bond Deal*, REUTERS (Feb. 3, 2016), <http://reut.rs/2Doofn9> [<https://perma.cc/JR2R-F9QB>]. Even at 8.5 percent interest, CPS could not sell the full amount of bonds it sought to issue. *Id.* A year later, CPS was able to borrow directly from J.P. Morgan at still very high rates of 7.25 to 7.65 percent, depending on maturity. Lauren Fitzpatrick, *CPS Borrows Another \$500 Million at High Interest Rates*, CHI. SUN-TIMES (July 10, 2017), <http://bit.ly/2rhdAWL> [<https://perma.cc/859X-UWPN>].

8. *Chicago Public Schools' and Park District's Debt Downgraded to Junk Status*, CHI. SUN-TIMES (June 24, 2016), <http://bit.ly/2mEYy7C> [<https://perma.cc/LAPE-4B4Y>]. Other bond rating agencies rated (and continue to rate) the Park District at investment grade. See CHI. CIVIC FED., CHICAGO PARK DISTRICT FY2017 BUDGET: ANALYSIS AND RECOMMENDATIONS (2016); see generally CHI. PARK DIST., CHICAGO PARK DISTRICT FY2018 BUDGET SUMMARY (2018). (discussing the legal status and fiscal condition of the Park District)

9. Greg Hinz, *Moody's Strikes Again, Lowering Cook County Debt a Notch*, CRAIN'S CHI. BUS. (June 5, 2015), <http://bit.ly/2FNIwkC> [<https://perma.cc/A67H-BN3X>]. There are 130 municipalities in Cook County. See COOK CTY. GOV., MUNICIPALITIES AND MAPS (2013), <http://bit.ly/2FLiNt1> [<https://perma.cc/6TPW-ZH86>].

10. See CHI. CIVIC FED., LONG-TERM DEBT FOR EIGHT MAJOR CHICAGO GOVERNMENTS RISES BY 59.2% IN 10-YEAR PERIOD (2015).

The biggest of these nesting dolls of debt problems is the State of Illinois, which is saddled with more debt and underfunded pension liabilities as a percentage of own-source revenues than any other state.¹¹ In 2017, the State saw its own credit rating cut to one step above junk by both Standard & Poor's ("BBB-") and Moody's ("Baa3").¹²

In 2018, the short-term fiscal pressure on these governments abated somewhat, following the passage of a state budget and a bunch of new state and local taxes.¹³ But the long-term problems remain. Chicago's local governments will each face difficulties managing their own debt load, but the crisis facing Chicago residents is the cumulative weight of these individual debt loads.

11. See ALICIA H. MUNNELL & JEAN-PIERRE AUBRY, BROOKINGS INST., AN OVERVIEW OF THE PENSION/OPEB LANDSCAPE 6 (2016) (showing Illinois has the highest required debt and pension payments as a percentage of own-source revenues, needing to pay 29 percent of its revenues annually).

12. Elizabeth Campbell, *Illinois Cut Near Junk by Moody's and S&P, Lowest Ever for a U.S. State*, CHI. TRIB. (June 2, 2017), <http://trib.in/2rJj9g9>; Karen Pierog, *Moody's Rating Outlook Revision Pulls Illinois from Edge of Junk*, REUTERS (July 19, 2018), <https://www.reuters.com/article/illinois-moodys/moodys-rating-outlook-revision-pulls-illinois-from-edge-of-junk-idUSL1N1UF237> [<https://perma.cc/3K4A-CP6L>] (noting that Moody's had downgraded Illinois to Baa3, but more recently given it a "stable" rather than "negative" outlook).

13. Illinois passed a budget that raised income and corporate taxes, and a new school funding bill that provided both funds and new taxing authority for CPS. Julie Bosman & Monica Davey, *Illinois Lawmakers Override Budget Veto, Ending Two-Year Stalemate*, N.Y. TIMES. (July 6, 2017), <http://nyti.ms/2Dp3dEV> [<https://perma.cc/2T5Y-77DP>] (describing the budget passage); Osita Nwanvevu, *After Two Years, Illinois Finally Passes a Budget—No Thanks to its Governor*, SLATE (July 7, 2017), <http://slate.me/2uSyW9Z> [<https://perma.cc/FF4W-GE4F>] (same); Rick Pearson & Monique Garcia, *Rauner Win on Schools Bill Comes at a Price*, CHI. TRIB. (Aug. 31, 2017), <http://trib.in/2eLgXfX> (describing CPS funding bill). Illinois also authorized the City to engage in a type of financial engineering that allowed it to borrow money at a lower rate by securitizing its sales tax revenues. Fran Spielman, *Emanuel's \$3 Billion Sales Tax Bonds Get AAA Rating*, CHI. SUN-TIMES (Nov. 2, 2017), <http://bit.ly/2mQpbHt> [<https://perma.cc/7DH2-Y6YA>]; *Chicago Touts New Debt Structure Aimed at Saving Money*, REUTERS (Aug. 9, 2017), <http://reut.rs/2DmT63H> [<https://perma.cc/BC3J-FBTP>]. We discuss the new bonds Chicago was allowed to issue in Part III.C.3. These short-term fixes have not solved these governments' budget problems. Revenue from a number of tax increases by both Cook County and the City of Chicago has been entirely devoted to funding pension systems, despite substantial social needs and a real crime problem. Hal Dardick, *A Taxing Year Ahead: Expect to Pay More for Your Home, Parking, Water and More*, CHI. TRIB. (Dec. 29, 2016), <http://trib.in/2hQTWHS>; Hal Dardick, *Chicago Property Tax Bills Going Up 10 Percent This Year*, CHI. TRIB. (June 13, 2017), <http://trib.in/2rodFY4>; Greg Hinz, *How Cook County Finally Got a New Budget*, CRAIN'S CHI. BUS. (Nov. 21, 2017), <http://bit.ly/2FN6Pz6> [<https://perma.cc/5ZGP-3K9Y>].

Moody's has threatened to downgrade Illinois's debt again, despite its new budget. Matt Egan, *Illinois May Get Downgraded to Junk Despite Budget Deal*, CNN MONEY (July 5, 2017), <https://money.cnn.com/2017/07/05/investing/illinois-downgrade-junk-moodys-budget-deal/index.html> [<https://perma.cc/HUZ5-DPX4>]. It also kept the City of Chicago's general obligation debt rating at "Ba1." Jordyn Holman, *Chicago's Mayor Pushes Moody's to Rescind City's Junk-Bond Rating*, BLOOMBERG (Jan 11, 2017), <https://bloom.bg/2qO9fZR> [<https://perma.cc/HMW7-Z6QZ>]. And while Moody's and Standard & Poor's both upgraded its outlook on CPS debt from "negative" to "stable," they have kept its non-investment grade "junk" rating. Yvette Shields, *Chicago Schools Chief's Resignation Shouldn't Sting District's Finances*, BOND BUYER (Dec. 11, 2017), <http://bit.ly/2knXHae> [<https://perma.cc/QLP8-PK8U>]. Fitch's credit rating agency upgraded CPS, but kept it in the "junk" range. *Id.* These developments have allowed CPS to sell bonds in October of 2017 at substantially lower yields than its previous efforts. *Chicago Schools Sell \$1 Billion Bonds with Lower Market Penalty*, REUTERS (Nov. 16, 2017), <http://reut.rs/2EPKZcO> [<https://perma.cc/5TAE-8RQV>].

Chicago's local governments *all* need to increase revenue and reduce spending to pay their debts. These governments, however, share taxpayers and service recipients who will be squeezed repeatedly by the collective belt tightening. The combined effect of these changes on the local economy and on residents who depend on local services could be massive. In particular, if national economic conditions deteriorate, there is a substantial risk that one or more of Chicago's local governments might become insolvent at the same time.¹⁴

A similar, if less severe, phenomenon is occurring in places across the country. Most urban and suburban territory in the United States is governed by overlapping local governmental jurisdictions.¹⁵ Schools, utilities, jails, hospitals, and transit systems are often provided by a myriad of different local governmental entities other than general-purpose municipalities.¹⁶ Over the past seventy years, the number of these different local governments has been expanding dramatically, all of which are providing services and taking revenue from overlapping constituents. This has made it more likely that overlapping governments will simultaneously face fiscal problems.¹⁷

Crises in overlapping jurisdictions are also likely in part because debt crises are happening in many places. Despite a growing economy and a long bull market that should have buoyed pension funds, a good number of states and localities still face extremely heavy debt burdens due to decades of underfunded pension obligations, built-up debt, and slow revenue growth.¹⁸ These general problems, when combined with the possibility of local economic shocks and failures to coordinate among local governments, mean that there is a growing

14. To be clear, we are not analyzing the capacity of any local government's ability to pay. But, their bond ratings suggest that leading credit analysts believe there is substantial risk of default in many jurisdictions. See MOODY'S, RATING SCALE AND DEFINITIONS 4 (2017), https://www.moodys.com/sites/products/ProductAttachments/AP075378_1_1408_KI.pdf [<https://perma.cc/DRM4-9UPK>] ("Ba" credit ratings mean "speculative elements and are subject to substantial credit risk."). That said, there are certainly those who think Chicago will be fine in the end. See KROLL BOND RATING AGENCY, CHICAGO'S PENSION LIABILITIES: A LOOK BEHIND HEADLINES AND RATIOS (2017), <http://bit.ly/2mQoJJh> [<https://perma.cc/DR9L-XMWJ>] ("[T]he City of Chicago's underlying economy has the ability to absorb and afford the transition needed to fund the city's growing pension and debt burdens. And as discussed previously, city leaders continue to demonstrate commitment to meeting all debt and pension obligations, even while confronting the fiscal challenges related to the state and school district.").

15. See BERRY, *supra* note 5, at 1, 26–27, 31.

16. See *id.* at 31; LYNN A. BAKER, CLAYTON P. GILLETTE & DAVID SCHLEICHER, LOCAL GOVERNMENT LAW: CASES AND MATERIALS 53 (5th ed. 2015).

17. See *infra* note 48 and accompanying text.

18. See DAN COATS & PAT TIBERI, JOINT ECONOMIC COMMITTEE, 114TH CONGRESS, THE LOOMING DEBT CRISIS: A STATE & LOCAL PERSPECTIVE (2016) (discussing continuing state and local debt crises despite long-running economic expansion); DAN WHITE, BERNARD YAROS & BRITTANY MEROLLO, MOODY'S, STRESS-TESTING STATES 1 (2017), <http://bit.ly/2DeVB4y> [<https://perma.cc/KL3A-CKJN>] ("15 states have significantly less funds than they need for the next recession"); MUNNELL & AUBRY, *supra* note 11, at 9–11 (describing huge debt, pension, and other liabilities for many local governments); Barb Rosewicz & Daniel Newman, *Weak Growth in Tax Revenue Persists in 2017*, PEW CHARITABLE TRS. (Oct. 17, 2017), <http://bit.ly/2DcWn2g> [<https://perma.cc/8AXG-99LZ>].

likelihood that there will be simultaneous insolvency crises among multiple overlapping local governments, whether in Chicagoland or elsewhere.¹⁹

The Great Recession created local fiscal problems so substantial that a few mid-sized and large municipalities—most famously Detroit—became insolvent. Yet, municipal financial distress was not widespread because many municipalities went into the Great Recession in comparatively good fiscal shape because of the real estate boom preceding it; higher home prices meant greater property tax revenue. The next recession, whenever it comes, will likely be more problematic for municipalities. They are unlikely to have the benefit of a preceding real estate boom driving up property tax revenues, and underfunded pension and health care obligations are likely to continue to grow, further stressing municipal budgets. On top of this, the next recession will likely be met with local fiscal crises that are more complicated and messier than those that came before because they will take place across overlapping jurisdictions.²⁰ That is, we are likely to see more and more “Junk Cities.”²¹

Neither scholars nor policy-makers have seriously considered the legal challenges posed by simultaneous fiscal crises in overlapping local governments.²² Municipalities can adjust their debts under Chapter 9 of the federal Bankruptcy Code.²³ To date, however, Chapter 9 has been used sparingly and has never been employed to coordinate the insolvencies of multiple overlapping local governments.²⁴ Nor have state legislatures developed alternative responses to overlapping local insolvency crises.

This Article addresses this gap in legal thought, explaining why insolvency crises in overlapping jurisdictions are increasingly likely. It proposes a general framework for thinking about how courts and states should respond, and lays out specific reforms to both Chapter 9 doctrine and state laws that can be applied to facilitate both the prevention and resolution of overlapping municipal fiscal crises.

19. Even recent insolvency crises in Detroit and Puerto Rico are best understood as occurring across multiple overlapping jurisdictions. For a discussion of the multi-jurisdictional natures of the Detroit bankruptcy and the Puerto Rican insolvency, see note 19 and accompanying text.

20. Some of the local fiscal crises of the recent past—most notably Detroit and Puerto Rico—involved problems in many overlapping jurisdictions, although this was not always acknowledged. See *infra* notes 190, 208–10 and accompanying text.

21. To be clear, the city—its residents, economy, culture—isn’t “junk” even if it has multiple governments in fiscal collapse. Rather, “Junk City” is a metonym for the fiscal state of the various governments serving the metropolitan area.

22. As discussed in Part II, there is some scholarship on conflicts among local governments, but none of it addresses the impact of insolvency crises.

23. See Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994). Local governments need specific authorization from states in order to file. 11 U.S.C. § 109(c)(2) (2012).

24. A few bigger local governments have filed for Chapter 9 including Detroit, MI, Stockton, CA, and Jefferson County, AL. See *In re City of Stockton, Cal.*, 542 B.R. 261 (B.A.P. 9th Cir. 2015); *In re City of Detroit, Mich.*, 524 B.R. 147, 213 (Bankr. E.D. Mich. 2014); *In re Jefferson Cty., Ala.*, 474 B.R. 228 (Bankr. N.D. Ala. 2012). But never has more than one government from the same area filed.

The central reason why it is so challenging to address fiscal crises in overlapping jurisdictions is that these jurisdictions are legally independent, but economically intertwined. While these jurisdictions are formally and legally independent, they draw revenue from the same underlying source: local taxpayers. Despite their interdependence, these overlapping governments generally do not coordinate their taxing and spending decisions. Overlapping local governments face a “common pool” problem.²⁵ Each raises revenue from the same local taxpayers, and, in seeking to maximize its cut of the shared pie, creates costs for other governments.

Federal law’s main response to local fiscal crises—Chapter 9 municipal bankruptcy—is likely to be ineffective in this context. Bankruptcy law generally attempts to stop creditors from protecting their own interests in ways that are destructive to their collective interests.²⁶ This Article shows that Chapter 9 as currently applied does not address the inverse problem. Bankruptcy law is designed, *inter alia*, to deal with *creditors’* common pool problem, in which uncoordinated collection attempts by creditors ultimately destroy value through piecemeal liquidation of the debtor. But it lacks formal mechanisms for dealing with *debtors’* common pool problem, where multiple debtors rely on a common revenue base. As outlined below, the tools courts use to address somewhat similar problems among business conglomerates in Chapter 11 bankruptcy—joint administration and substantive consolidation—cannot be readily applied in the context of Chapter 9. Overlapping municipalities lack the common governance structure of corporate affiliates, which makes joint administration unwieldy. They also tend to have clearer divisions of assets and liabilities than corporate affiliates, as well as greater creditor reliance on such separateness, which renders substantive consolidation problematic.

The absence of any method for addressing debtors’ common pool problems renders Chapter 9 a weak mechanism for addressing the proliferating fiscal crises in overlapping local governments. As a result, unless states develop responses that do not rely on debt restructuring, such as bailouts, simultaneous fiscal crises will be subject to increasing amounts of wealth and service-destroying conflict among overlapping municipalities.²⁷ Further, following such inter-local fiscal brawls, someone—an unlucky or politically-disfavored group of creditors, taxpayers, or service recipients—will be left bearing unusually large harms.

25. BERRY, *supra* note 5, at 9–19, 84–86, 98–101. See discussion *infra* Part I.

26. See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 16–17 (1986).

27. Most state responses to local fiscal crises do not involve use of Chapter 9, but instead rely on governance changes at the local level or additional state funds (that is, “bailouts”). See Omer Kimhi, *A Tale of Four Cities—Models of State Intervention in Distressed Localities Fiscal Affairs*, 80 U. CIN. L. REV. 881, 888–90 (2012). However, as the example that is used to introduce the paper suggests, a number of states have little capacity to bailout heavily indebted localities. See MUNNELL & AUBRY, *supra* note 11, at 10, 24 (showing that eight states owe more than 20 percent of their annual budget in required pension, other benefit, and interest payments).

All hope is not lost. Although Chapter 9 does not currently address the problems of overlapping local debt crises, its statutory language is sufficiently capacious and indeterminate that both courts and state legislatures can develop tools to stop local governments from acting in ways that are collectively harmful, even if individually rational, during insolvency crises.

Courts have not yet directly confronted the problem of overlapping insolvent jurisdictions. The default course would be to address each local government that files under Chapter 9 in a vacuum. Such a path would take for granted that a single municipal government is the proper unit of analysis for adjudicating questions like the capacity to raise revenue, the amount of debt, the best interest of creditors, and the feasibility of a plan of adjustment. If courts are going to effectively address the insolvency problems of overlapping local governments, a new approach is required to reflect the reality that overlapping municipal governments regulate a common economy and work together to provide services, despite their partitioned authority and governance.

To show how this might be done, this Article offers several concrete proposals for how courts and state legislatures can address the problems inherent in the linked fates of overlapping local governments in bankruptcy.²⁸ These proposals would help police collective action problems among overlapping local governments and ensure that pain is spread across their various creditors and counterparties, even if the debts and on-going contractual obligations were incurred by different local governments.²⁹ These proposals would provide Chapter 9 courts with tools that have many of the same benefits as the use of joint administration and substantive consolidation in Chapter 11.

For instance, courts could make Chapter 9 easier to access when there are simultaneous fiscal crises among overlapping local governments by including in the determination of “insolvency” questions about a tax base’s capacity to pay debt across local governments. Courts could also reject any plan of adjustment for exiting bankruptcy as not “feasible” if it would endanger the fiscal soundness of any other local government. State legislatures can pass laws that encourage all heavily-indebted overlapping local governments to file under Chapter 9 simultaneously and force them to consult one another as they proceed through the bankruptcy process, allowing courts to mediate inter-local conflicts. More

28. In this Article, we do not consider how to address situations in which there are multiple fiscal crises in municipalities in a metropolitan area that crosses state lines. These governments clearly would not overlap formally because they are not in the same state, but often share deeply-connected economies because they are in the same metropolitan area. We also do not address the role of entities created by inter-state compacts, which can directly overlap with other local governments and may face fiscal crises of their own. In situations where fiscal crises spiral across state lines inside a metropolitan area, state governments clearly should consider cooperation as a mechanism for effectively and fairly addressing the crisis and avoiding opportunistic but globally inefficient tax competition. But developing mechanisms for doing so are beyond the scope of this Article.

29. Further, overlapping local governments are often created for the purpose of avoiding local debt limits. *See infra* note 92 and accompanying text. This strengthens the case for roping as many local governments into one proceeding, rather than treating them as truly independent entities.

radically, states could make all nearly-insolvent overlapping localities eligible for bankruptcy by removing some local taxing authority and giving it to a new, specially created entity. This entity would be tasked with ensuring that essential services are provided while existing governments, now shorn of some taxing powers and thus potentially insolvent, go through the bankruptcy process.

In identifying and attempting to resolve this emerging problem, this Article innovates in two areas of law: local government law and bankruptcy law. While the collective action problems plaguing the fiscal affairs of overlapping local governments have been discussed, there has been no effort to wrestle with the consequences of inter-local conflict for fiscal crises, nor much effort to develop tools to resolve such conflicts.³⁰ This Article provides both a specific response to a coming crisis and a general approach to addressing the costs created by excessive numbers of overlapping local governments.

The Article also adds to the small but growing literature on Chapter 9 bankruptcy,³¹ which has only begun to grapple with the problem of how a court is supposed to manage a process not simply to restructure financial obligations, but to deal with politically loaded fiscal questions.³² More broadly, the problem of coordination between multiple debtors also relates to an underdeveloped issue in Chapter 11 corporate bankruptcy. The Bankruptcy Code is written for single-entity debtors, but almost all business debtors are part of multi-entity firms—a parent company and various tiers of subsidiaries—while municipalities are

30. The source of many of these debt problems—the public pension crisis—has generated some commentary. *See, e.g.*, Jack M. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3 (2013) (discussing the importance of pensions to state fiscal difficulties); Amy B. Monahan, *Statutes as Contracts? The “California Rule” and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029 (2012) (discussing the legal status of pension promises).

31. *See, e.g.*, Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425 (1993) (discussing the history of municipal bankruptcy and arguing that courts should require municipalities to raise taxes and cut spending before granting access to Chapter 9); Clayton P. Gillette & David A. Skeel, Jr., *Governance Reform and the Judicial Role in Municipal Bankruptcy*, 125 YALE L.J. 1150 (2016) (arguing that municipal bankruptcy must also address governance dysfunction); Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. REG. 55 (2016); Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. REG. 351 (2010) (expressing doubts about bankruptcy’s utility in the municipal context); Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. 1399 (2012) (arguing that bankruptcy problems needed to be addressed in political rather than financial terms). For a collection of scholarly insights on this topic, see PETER CONTI-BROWN, *WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS* (2012). For an analysis of municipal receiverships in bankruptcy, see Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1130–51 (2014).

32. *See, e.g.*, Jacoby, *supra* note 31; Melissa B. Jacoby, *Presiding over Municipal Bankruptcies: Then, Now, and Puerto Rico*, 91 AM. BANKR. L.J. 375, 389–90 (2017); Edward J. Janger, *Towards a Jurisprudence of Public Law Bankruptcy Judging*, 12 BROOK. J. CORP. FIN. & COM. L. 39 (2017). Proposals for bankruptcy for financial institutions raise a related set of politically loaded decisions for bankruptcy courts due to the political nature of systemic risk. *See* Adam J. Levitin, *Bankruptcy’s Lorelei: The Dangerous Allure of Financial Institution Bankruptcy*, 97 N.C. L. REV. 101 (2018); *see also* Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 446–51 (2011) (arguing that systemic risk is a political, rather than an economic description).

usually part of a constellation of overlapping jurisdictions. Surprisingly, the bankruptcy literature has not grappled with the problem of multi-entity firms other than in the context of the extreme and rare remedy of contested substantive consolidation.³³ Instead, Chapter 11 has dealt with multi-entity firms on an informal basis that is not possible to replicate in Chapter 9.³⁴ Irrespective, the Bankruptcy Code remains replete with provisions whose applications are complicated by a serious consideration of multi-entity firms. This Article addresses this issue in the context of Chapter 9, but points toward the need for a broader consideration of the issue in Chapter 11 as well.

This Article proceeds as follows. Part I presents both the theory and evidence that fiscal crises in overlapping jurisdictions will be increasingly prevalent because municipalities in a metropolitan area share common economies, but have different priorities and politics. Part II demonstrates that neither Chapter 9 as currently applied, nor the tools used in Chapter 11 to address corporate conglomerates, provides adequate means for addressing these insolvency crises. Part III outlines our theory of how courts and legislatures should think about insolvency crises in overlapping jurisdictions. It then describes four specific proposals.

I.

OVERLAPPING JURISDICTIONS AND FISCAL CRISES

To the extent people think about local governments, the type of government that comes to mind is usually a general-purpose municipal government—a city or a town. But such governments are a decided minority of the total number of local governments.³⁵ There are about 20,000 municipal governments, and another 16,000 town or township governments.³⁶ In contrast, there are about 50,000 special purpose districts, including almost 13,000 school districts.³⁷ The number of special-purpose local governments, and the size of their spending, has grown tremendously over the last seventy or so years, although growth has halted in recent years, due to an increase in mergers among them.³⁸ There are also another 3,000 or so counties, many of which now have powers traditionally exercised by municipalities.³⁹ The boundaries of these jurisdictions often do not

33. See, e.g., William H. Widen, *Corporate Form and Substantive Consolidation*, 75 GEO. WASH. L. REV. 237 (2007) (providing the most extensive treatment of corporate groups in bankruptcy).

34. See *infra* Section II(b).

35. BAKER ET AL., *supra* note 16, at 53–57.

36. *Id.*

37. *Id.*

38. Conor Clarke, *Merging and Dissolving Special Districts*, 31 YALE J. REG. 493, 494–95 (2014).

39. BAKER ET AL., *supra* note 16, at 54.

follow municipal boundaries. For instance, in most of the country, school district lines are not coterminous with either municipal or county boundaries.⁴⁰

As a result, most Americans live inside the jurisdictions of multiple local governments.⁴¹ We look to our city or town to provide policing and to regulate land use; school districts to provide education; counties to provide prosecutors and jails, record land transfers, and administer federal welfare programs; and to special purpose districts to provide anything from fire protection to hospitals to water to utilities. In theory, such local governments provide voters with targeted policies that fit their preferences, without forcing them to balance these preferences against others.⁴² But as we will see, this vision comes under pressure during periods of fiscal stress.

This Part reviews the literature on the fiscal effects of overlapping local governments and extends it to local government behavior during fiscal crises. It shows that overlapping local governments are increasingly likely to face fiscal crises, and even insolvency, at the same time.⁴³ Even in metropolitan areas with relatively stable economies, a combination of political and legal forces—in particular the decline of local political parties and weakening legal restrictions on local budgeting—has shaped overlapping governments in ways that increase the likelihood of fiscal crises.

A. *The Common Pool Problem of Overlapping Municipal Jurisdictions*

The possibility of concurrent budget crises should not be surprising. If a bunch of local governments depend on taxes from people and firms in the same area, a negative shock to the local economy will result in reduced revenue for all the overlapping governments. There is ample evidence that regional economies

40. WILLIAM A. FISCHER, MAKING THE GRADE: THE ECONOMIC EVOLUTION OF AMERICAN SCHOOL DISTRICTS 198, 209 (2009) (observing that school district boundaries do not match municipal boundaries outside of New England and New Jersey, and largely do not match county boundaries outside of the South).

41. We use the term local governments here and distinguish them sharply from agencies or instrumentalities of local or state governments. However, as Aaron Saiger argues, this distinction is formal, but not particularly substantive—the line between, say, an independent special purpose local government that issues its own bonds with officials appointed by other local governments and a revenue-bond backed local project run by local officials is confusing at best. See Aaron Saiger, *Local Government as a Choice of Agency Form*, 77 OHIO ST. L.J. 423 (2016). All local governments, state agencies, and local agencies are instrumentalities of the state. The decision to create one rather than another can be understood as a weighing of the benefits of specialization, localization, and local democratic legitimacy, respectively. That said, following Christopher Berry's work, we think about local governments in the same way the Census of Governments does. BERRY, *supra* note 5, at 27. The defining factors of a local government are its "existence as an organized entity, governmental character, and substantial autonomy." *Id.*

42. BERRY, *supra* note 5, at 4.

43. These governments are both what the academic literature calls "nested," or one on top of the other (like a city inside a county), and "overlapping," in that they govern both some shared territory and some independent territory (like a school district that covers part of a municipality as well as other areas). For our purposes, we will use the term "overlapping" to refer to both cases and make distinctions where necessary.

have diverged in recent years and particular types of shocks—coming from increased trade competition or technological development—have thrown certain regions into particularly severe local recessions.⁴⁴ In theory, local governments should save for such situations, but such forethought is uncommon.⁴⁵

As a result, when there are local economic shocks, budget problems in all local governments in those regions will likely follow (which in turn can force governments to cut spending and raise taxes, harming the local economy). When this toxic feedback loop is combined with the substantial debt problems plaguing a large and increasing number of local governments across the United States—a result of, among other things, underfunded pension systems and secularly declining revenue from traditional sources like sales taxes on goods—it follows that there will be more overlapping local governments with severe debt problems.⁴⁶

The fiscal problems in overlapping local governments are not limited to places facing economic crashes. After all, even in the example that we use to introduce this Article, the fiscal problems of local governments in the Chicago region are not the result of a disastrous local economy. Chicago has its economic problems, but it is no Detroit.⁴⁷ Shared political and legal systems, as much as shared economic shocks, make overlapping local governments vulnerable to concurrent fiscal crises. There are places all over the country with overlapping jurisdictions that each face severe budget crises.⁴⁸

44. David Schleicher, *Stuck! The Law and Economics of Residential Stagnation*, 127 YALE L.J. 78, 135 (2017).

45. Brian Galle & Kirk J. Stark, *Beyond Bailouts: Federal Tools for Preventing State Budget Crises*, 87 INDIANA L.J. 599, 611–19 (2012) (documenting the failures of states to create and maintain adequate “rainy day funds”).

46. See MARK J. WARSHAWSKY & ROSS A. MARCHAND, MERCATUS CENTER, THE EXTENT AND NATURE OF STATE AND LOCAL GOVERNMENT PENSION PROBLEMS AND A SOLUTION (2016), <http://bit.ly/2ESpecG> [<https://perma.cc/SGM9-TM6G>] (noting the severe fiscal straits of contemporary state and local governments).

47. Melissa Harris, *Chicago Isn't Detroit—and It's Not Going Bankrupt*, CHI. TRIB. (June 20, 2015), <http://trib.in/1fnDyNd>; Reem Nasr, *Municipal Money Matters: Why Chicago Is Not the Next Detroit*, CNBC (May 8, 2015), <http://cnb.cx/2EPgeVs> [<https://perma.cc/2AQR-5V64>].

48. For instance, in Philadelphia, the School District is in very poor fiscal health, with bonds rated below investment grade by Moody's, Ba2. See *Moody's Upgrades Philadelphia School District, PA's Rating to Ba2; Outlook Positive*, MOODY'S (Sept. 8, 2017), https://www.moody.com/research/Moodys-Upgrades-Philadelphia-School-District-PAs-Rating-to-Ba2-Outlook-PR_904190342 [<https://perma.cc/84QJ-EP85>]. The City's debt is solidly investment grade, A2, but is on a negative watch from Moody's, with its pension fund on 43.6 percent funded in 2017. *Rating Action: Moody's Assigns A2 Rating to City of Philadelphia, PA's \$37.8 Million City Agreement Bonds, Series 2018A and 2018B; Outlook Remains Negative*, MOODY'S (Mar. 23, 2018), https://www.phila.gov/investor/PDF/bondRatings/General_Obligation_Bonds/Moodys_0618.pdf [<https://perma.cc/M5JK-P6JR>]; Andrew Coen, *Future Spending Concerns Drive Downgrade of Philadelphia*, BOND BUYER (Mar. 27, 2018), <https://www.bondbuyer.com/news/future-spending-concerns-drive-downgrade-of-philadelphia> [<https://perma.cc/J3T3-FVEG>]. Further, this is not a new phenomenon—the Detroit bankruptcy had interesting inter-local aspects as well. Even though the City of Detroit deleveraged in bankruptcy, Wayne County (in which Detroit is located), the Detroit Public Schools (DPS), and the City of Hamtramck (which is entirely surrounded by the City of Detroit)

While state and federal governments transfer a substantial amount of revenue to local governments, many local governments have capacity to raise “own source” revenue.⁴⁹ That is, they have the power to levy taxes to fund their own operations or impose user fees on the residents that use their services. Overlapping local governments can each be granted different taxing powers; more commonly, they are each granted powers to tax the same things.⁵⁰ For instance, in many places there are a number of local governments that can each tax the same piece of real property. When a resident pays property taxes, the taxes imposed by each government are tacked on top of one another. Take, for example, the variety of entities to which a woman in Wauconda, Illinois, pays taxes as reported by Reuters:

The 53-year-old insurance manager gets a real estate tax bill for 20 different local government authorities and a total payout of about \$7,000 in 2014. They include the Village of Wauconda, the Wauconda Park District, the Township of Wauconda, the Forest Preserve, the Wauconda Area Public Library District, and the Wauconda Fire Protection District. Then there is Wauconda Road and Bridge, not to be confused with Road and Bridge, Wauconda Gravel, or with Wauconda Special Road Improvement and Gravel unit—all three of which have imposed separate taxes on her and the village’s other homeowners.⁵¹

In Chicago, overlapping governments share both property and sales tax revenue. As of 2016, local governments levying property taxes in the city included: the Chicago Public Schools (52 percent of the total paid by city residents), the City (23 percent), the Park District (5 percent), City Colleges (2 percent), Cook County (7 percent), Cook County Forest Preserve (1 percent), and the Metropolitan Water Reclamation District (6 percent).⁵² The overall sales

remained in a fiscally-perilous and service-poor state. DPS ended up receiving a state bailout and remained under state emergency financial management. Wayne County continued to face rough fiscal conditions for many years, only emerging from “junk” ratings in the summer of 2018. Nora Colomer, *Wayne County, Michigan, Is Now Investment Grade Across the Board*, BOND BUYER (June 15, 2018), www.bondbuyer.com/news/upgrade-erases-wayne-countys-last-junk-level-rating [<https://perma.cc/J4LA-8QR3>]. Similarly, Puerto Rico’s fiscal problems implicate several levels of overlapping jurisdictions. *See infra* notes 194–196 and accompanying text.

49. NAT’L LEAGUE OF CITIES, *CITIES AND STATE FISCAL STRUCTURE* 7 (2015), <http://bit.ly/2Drc5tR> [<https://perma.cc/XP6Y-BR5X>] (“On average, U.S. municipalities derive approximately 71% of their general fund revenues from own-source revenues, including 24% from property taxes, 13% from sales taxes, 3% from income taxes and 32% from fees and charges.”).

50. Cities typically collect less than 25 percent of property tax revenue. George Lefcoe, *Competing for the Next Hundred Million Americans: The Uses and Abuses of Tax Increment Financing*, 43 URB. LAW. 427, 457 (2011).

51. Tim Reid & Selam Gebrekidan, *Special Report: Multitude of Local Authorities Soak Illinois Homeowners in Taxes*, REUTERS (Aug 5, 2015), <http://reut.rs/2FNcPaU> [<https://perma.cc/Q25S-753W>].

52. OFFICE OF THE COOK COUNTY CLERK, 2016 COOK COUNTY TAX RATE REPORT, at i (2017), [https://www.cookcountyclerk.com/sites/default/files/pdfs/2016 Tax Rate Report.pdf](https://www.cookcountyclerk.com/sites/default/files/pdfs/2016%20Tax%20Rate%20Report.pdf) [<https://perma.cc/5XJT-RJV7>]. In addition to these local governments, 7 percent of the city’s property tax revenues go to a segregated fund for Chicago Libraries. CITY OF CHI., ANNUAL FINANCIAL ANALYSIS: PROPERTY TAX EXPENDITURES (2017), <http://bit.ly/2mO2nrM> [<https://perma.cc/S6CS-3M3J>].

tax rate is 10.25 percent, shared among the City (1.25 percent rate), the Chicago Transit Authority (CTA) (1 percent and 1.25 percent on certain items), Cook County (1.75 percent), and the State (6.25 percent), which then transfers 20 percent of general state sales taxes and 100 percent of sales taxes on food, drugs, and medical devices to local governments.⁵³ The City, Cook County, the City Colleges, the CTA, and others raise substantial revenues from other taxes: user fees like water charges, fares, tuition, and fines.⁵⁴

The leading scholar on the fiscal effects of overlapping local jurisdictions, Christopher Berry, has argued that, where multiple governments raise taxes from the same territory, there is a natural conflict over revenue. These are generally not formal, legal conflicts.⁵⁵ All jurisdictions can have the undisputed power to

53. ILL. DEP'T OF REVENUE, *LOCALLY IMPOSED SALES TAXES ADMINISTERED BY THE DEPARTMENT OF REVENUE* (2018), <http://www.revenue.state.il.us/Publications/LocalGovernment/ST-62.pdf> [<https://perma.cc/TG29-KWBT>]; *Use Tax and "Local" Use Tax*, ILL. DEP'T OF REVENUE (2018), <http://bit.ly/2DnD0HC> [<https://perma.cc/YEW4-8N3F>] (the state sales tax is 6.25 percent, but the sales tax on food, drugs and medical devices is 1 percent). This is just the general sales tax rate, and does not include other sales taxes. For instance, Chicago has special taxes on liquid nicotine, tires, and bottled water. *Tax List*, CITY OF CHI. (2018), <http://bit.ly/2rhthx2> [<https://perma.cc/R7E7-MEG5>]. Cook County recently passed a tax on sweetened beverages, and it already taxes firearms and ammunition, liquor, hotels, and "amusement," among other things. *Tax Center*, COOK CTY. GOV. (2017), <http://bit.ly/2mP15Nj> [<https://perma.cc/4G79-MJCY>]; *Sweetened Beverage Tax*, COOK CTY. GOV. (2017), <http://bit.ly/2t7rDxK> [<https://perma.cc/5EZX-DDCM>].

54. Fees and fines ranging from the banal to the ridiculous permeate all local governments. *See, e.g., Picnic Grove Permits*, COOK CTY. GOV. (2018), <http://bit.ly/2Bbv8Do> [<https://perma.cc/HW2V-HNDW>] (application and fees for obtaining a license to picnic); *Multi Dwelling Registration*, COOK CTY. GOV. (2018), <https://www.cookcountyil.gov/service/multi-dwelling-units> [<https://perma.cc/C477-FH6L>] (registration fee for buildings with more than four residential units); *Virtual Cemetery*, COOK CTY. GOV. (2018), <http://bit.ly/2mM4YTI> [<https://perma.cc/3QDC-WCT3>] (fee to retrieve cremated remains); *File a Complaint for Unlawful Discrimination or Harassment*, COOK CTY. GOV. (2018), <http://bit.ly/2DnD0HC> [<https://perma.cc/TA9U-LKSB>] (outlining remedies including municipal fines for workplace discrimination).

55. That said, there can be *some* formal, legal conflicts between overlapping local governments over local revenue. Consider school districts and municipally created tax increment financing (TIF) districts. State laws authorize municipalities or other entities to create a TIF district, which then borrows money to fund new infrastructure in the district or even to use eminent domain to take and then resell properties. *See generally* Richard Briffault, *The Most Popular Tool: Tax Increment Financing and the Political Economy of Local Government*, 77 U. CHI. L. REV. 65 (2010) (documenting the proliferation of TIF). The debt is paid back with the "tax increment" or the increased property tax revenue created by the increasing property values that were caused by the new investments.

Theoretically, overlapping jurisdictions that did not create the TIF are not harmed—they continue getting the same property taxes they were before the district was created. But when a TIF is created, increased property tax revenue flows to the municipally controlled TIF district and not to other governments even if property values would have increased anyway, for example, because the investment a TIF district was created to lure was headed to the area anyway. School districts have repeatedly sued TIF districts claiming that municipalities should not be able to capture these tax dollars, but these suits are usually unsuccessful. School districts have also sought and succeeded in getting regulations passed in some places that give them the right to participate in the decision to create TIFs. That said, research has shown that more often than not, TIF districts do not harm school districts. Rachel Weber, Rebecca Hendrik & Jeremy Thompson, *The Effect of Tax Increment Financing on School District Revenues: Regional Variation and Interjurisdictional Competition*, 40 STATE & LOC. GOV'T REV. 27, 37–38 (2008) (finding no effect of TIF density on school district revenues in Chicago or Chicago suburbs, but finding a negative effect in downstate Illinois).

tax property or sales; property owners and customers are simply charged by each. But there is a conflict nonetheless.

Berry has argued that overlapping local governments face a “commons” problem. They draw on the same revenue source(s), but do not make their decisions on how to share these revenues collectively.⁵⁶ Each has incentives to take a greater share of resources for itself. A failure to coordinate can cause overlapping local governments to tax and spend more than is collectively optimal.⁵⁷

This overtaking is particularly onerous because it is frequently on the same tax base—the governments are taxing the same things at higher rates. Economists have discussed the problem in terms of “vertical tax externalities.”⁵⁸ When setting the tax rate, a local government will set its level of taxes at the rate that will maximize its own preferences for revenue, paying no attention to the needs of other governments. Doing so, though, will encourage wasteful tax avoidance activity and destroy some economic activity altogether. Once consumers are taxed at a high enough percentage, they switch away from working more because it is simply not “worth it” from an economic perspective. This reduces the capacity of the other levels of government to raise revenue. As a result, if levels of government pay no attention to the revenue needs of other levels of government, there will be a tragedy of the commons: taxing will be systematically higher than the optimal rate for the jurisdictions as a whole.⁵⁹

A similar problem emerged in New Jersey under a law that allows municipalities to give tax abatements to encourage economic development, effectively taking some properties off property tax rolls for all local governments. But new developments and factories that receive abatements sometimes pay the municipality fees called payments in lieu of taxes (PILOT). N.J. OFF. ST. COMPTROLLER, A PROGRAMMATIC EXAMINATION OF MUNICIPAL TAX ABATEMENTS 4 (2010), <http://bit.ly/2caTvFq> [<https://perma.cc/GLZ7-ZTYQ>]. School districts view this combination as a method for stealing tax revenue, as the property receiving the abatement does not generate tax revenue for schools, but does so for the municipality via the PILOT fees. Jersey City, however, was recently forced to share revenue from PILOT fees with its school district. Terrence T. McDonald, *Jersey City Will Share Tax Abatement Revenue with Schools*, JERSEY J. (Aug 6, 2017), https://www.nj.com/hudson/index.ssf/2017/04/jersey_city_will_share_tax_abatement_revenue_with.html [<https://perma.cc/Q6QV-9T7Y>].

56. BERRY, *supra* note 5, at 9–19. For an introduction to the commons metaphor, see generally Garrett Hardin, *The Tragedy of the Commons*, 162 SCI. 1243 (1968).

57. BERRY, *supra* note 5, at 89–128.

58. See David Gamage & Darien Shanske, *Tax Cannibalization and Fiscal Federalism in the United States*, 111 NW. U. L. REV. 295, 297 n.5, 303 n.25 (2017); Michael J. Keen & Christos Kotsogiannis, *Does Federalism Lead to Excessively High Taxes?*, 92 AM. ECON. REV. 363, 363 (2002).

59. Whether the amount raised and spent will be below the socially optimal rate requires an answer to one of the longest-running debates in local taxation: whether inter-jurisdictional competition leads to lower-than-optimal taxes and spending due to races-to-the-bottom, or to the optimal rate due to effective competition and sorting, as in the Tiebout model. See David Schleicher, *The City as a Law and Economic Subject*, 2010 U. ILL. L. REV. 1507, 1508–10 (reviewing the Tiebout model and its discontents). But it is clear that overlapping jurisdictional tax externalities interact with cross-jurisdictional competition in interesting and multiple ways. For instance, David Agrawal found that cities inside a county that are near the county’s borders are likely to have lower sales taxes in order to win shoppers from across the county border. David R. Agrawal, *Local Fiscal Competition: An*

As David Gamage and Darien Shanske have noted with respect to federal and state vertical tax externalities, when multiple governments raise revenue from the exact same tax base, the resulting tax levels can create particularly heavy costs.⁶⁰ One of the fundamental findings in the economic study of taxation is that increasing already high tax rates deters more activity per dollar of new revenue than increasing low rates.⁶¹ Therefore, when governments fail to coordinate in setting rates on a particular tax base, the result can be very high rates on that base and large economic distortions.

The problem worsens at the local level. Overlapping local governments taxing the same base impose *greater* costs on one another than states do on the federal government. Gamage and Shanske have noted that state tax rates reduce the size of their own tax bases in two ways. First, state taxes can reduce economic activity, thus reducing the tax base for the federal government, a vertical tax externality of the type discussed above.⁶² Second, state taxes can encourage firms and people to move elsewhere, what Gamage and Shanske labeled “horizontal distortions.”⁶³

Excessive state and local taxation can destroy a local tax base. When state taxes drive a firm or person to move to another jurisdiction, the federal government can still tax that firm or person (assuming continued US domicile).⁶⁴ But when a local government encourages exit by increasing taxes, all overlapping local governments (and potentially the state government) lose revenue, because the person or firm is no longer located within their collective taxing authority. If a firm moves from Chicago to Texas because the City of Chicago raised taxes, then not only the City, but the State of Illinois, Chicago Public Schools, and Cook County all have a smaller tax base from which to draw revenue.

In the classic Tiebout model of local governments, the threat of exit creates pressure on local governments to provide services and tax at levels desired by mobile residents.⁶⁵ But overlapping governments complicate Tiebout’s theory. Individual local governments do not internalize all of the effects of exit, and

Application to Sales Taxation with Multiple Federations, 91 J. URB. ECON. 122, 136–37 (2016). One effect of this is that, contrary to other findings in the vertical tax externality literature, local sales taxes end up negatively correlated with county sales taxes. Higher county sales taxes lead to lower city taxes, as the city attempts to compete with the nearby county. This does not deny the existence of a vertical tax externality—the county as a whole might set a lower rate than the individual towns would—but rather suggests that cross-border tax competition can dominate vertical tax externalities for certain kinds of taxes and certain kinds of cities.

60. Gamage & Shanske, *supra* note 58, at 335.

61. *Id.*

62. Gamage & Shanske, *supra* note 58, at 302–09.

63. *Id.*

64. The reduced productivity associated with moving from a person or firm’s preferred location harms the federal government. See Schleicher, *Stuck!*, *supra* note 44, at 99–101 (discussing differential productivity rates in different regions).

65. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 424 (1956).

therefore overlapping local governments may collectively raise taxes beyond the optimal rate, at least from the perspective of the overlapping governments as a whole.⁶⁶

So, while these governments are formally independent and can set their own tax rates, the policies pursued by one affect the capacity of all the others to raise revenue. And, in fact, Berry has found that the extent of overlapping local governments is correlated with higher levels of government spending per capita, with no clear effect on government quality.⁶⁷ The interaction of these two literatures suggests that overlapping governments with concurrent taxing powers can create serious welfare losses for residents.

Furthermore, overlapping local governments differ in their political status. Many officials are elected—as is the case with most municipalities, school districts, and counties—but sometimes officials are appointed. Berry’s argument applies most clearly to elected local governments.⁶⁸ But even appointed heads of local governments face different incentives than the officials that appoint them. They generally owe duties to their specific government and their careers are assessed based on how their government does, not the broader set of local governments. More importantly, the interest groups involved with one of many overlapping local governments will feature the same particularized incentives to maximize the revenues of that government, irrespective of whether its officers are elected or appointed. Parents and teachers will lobby both elected and appointed school boards. The power of such interest groups can create the collective action problems Berry discussed.

Berry’s analysis suggests that commons problems lead to greater spending, but also to higher taxes. Higher taxes may not be desirable from the voters’ perspective but would not necessarily cause a fiscal crisis.

The dynamics of local governments’ commons problems can cause fiscal crises in a different way, however. Politicians in overlapping local governments, like all politicians, presumably prefer not to be blamed for raising taxes. The political penalty for raising taxes is surely larger if your special purpose local government does so while others do not, as it becomes easier for voters to assign responsibility. Today’s incumbents in overlapping local governments each want

66. Again, this does not necessarily mean the taxes are below the socially optimal rate. On one view of inter-jurisdictional competition, if say a county set the entire sales tax rate, it could set the rate too low, as it seeks to win sales from neighboring counties. See discussion *supra* note 59 and accompanying text.

67. See BERRY, *supra* note 5, at 126–28. Of course, there is more than one way to understand this finding. Perhaps voters form more special purpose governments when they want more services, thus leading to higher taxes. But findings by Berry and others that the higher taxes associated with large numbers of special districts are not associated with higher levels of services make this understanding questionable. See *id.*; Meghan Rubado, *Local Government Fragmentation Effects on Quality of Service: A Test of Competing Theories Using Data on Fire Response Times* 18–20 (Am. Pol. Sci. Ass’n. Annual Meeting Paper, 2013), <http://bit.ly/2DmJNkX> [<https://perma.cc/W2PP-K7NE>].

68. That said, the power of analysis is much stronger with respect to overlapping elected local governments. One implication that might be drawn is that we elect too many local officials.

to increase spending at the expense of others, but do not want to raise taxes unless others do. Similarly, if there is an external negative economic shock—a recession, say—no one overlapping local government wants to cut its spending first, as doing so would create an opening for others to take “market share” from the general tax base.

Thus, the tragedy of the commons among overlapping local governments can lead to a dangerous game of “chicken” that devolves into fiscal crises. And in fact, we see strong correlations between overlapping local governments and collective debt burdens.⁶⁹ Further, the issuance of local debt increases the borrowing costs for higher levels of government, thus exacerbating collective debt crises.⁷⁰

Whatever the cause of fiscal crises, coordination problems between overlapping governments will make responding to such crises harder for the reasons laid out above.⁷¹ That is, the fight for “market share” and the problem of tax externalities will be part of responses to insolvency crises among overlapping local governments, regardless of why such governments are in crisis. Chapter 9 doctrine and other types of responses thus need to develop solutions that address coordination problems among overlapping local governments.

The increasing number of overlapping governments has by itself increased the likelihood of fiscal crises for such governments. The likelihood is heightened by the decline of two coordinating mechanisms for local governments: local political machines and state laws controlling local indebtedness.

B. Decline of Local Political Machines Removes a Check on the Tragedy of the Commons

The interactions between local governments—whether there is cooperation or conflict—is driven by how politics in a place is organized. In particular, the decline of local party machines that operate across types of local governments in an area removes a key mechanism for coordinating the activities of overlapping local governments.

Just as overlapping local governments draw from the same tax base, they draw authority from the same voters. If elected governments overlap, voters

69. See Dagney Faulk & Larita Killian, *Special Districts and Local Government Debt: An Analysis of “Old Northwest Territory” States*, 37 J. PUB. BUDGETING & FIN. 112 (2016).

70. See Robert A. Greer, *Overlapping Local Government Debt and the Fiscal Common*, 43 PUB. FIN. REV. 762, 762 (2015); see also Nadav Shoked, *Debt Limits’ End*, 102 IOWA L. REV. 1239, 1245 (2017) (arguing that a “valid justification . . . for state-imposed limits on the debt a municipality issues is the desire to control the borrowing costs other municipalities within the state endure”).

71. The existence of these problems does not resolve the long debate over whether special purpose local governments are good or whether we have too many or too few of them. There are certainly some benefits from having lots of local governments. They allow voters to select policy in one area without worrying about whether the people who support that policy also share the rest of their policy agenda. But their likely performance during a crisis is an argument that should be considered when establishing a new special purpose government, and a weight on the scale against establishing more of such governments.

should discipline officials who act against the collective interest of residents. After all, overlapping local governments are all agents of the same principal, the local electorate.

As Berry has demonstrated, however, the structure of contemporary local elections creates and reinforces the commons problem rather than having a disciplining effect.⁷² Turnout in elections for special districts—and in fact, for all local elections—is very low and highly concentrated among groups interested in the outcome.⁷³ Teachers and parents show up for school board elections, transit riders for elections involving transportation special districts, and so on.⁷⁴

The result, as Berry has argued, is that selective participation by interest groups and voters creates the commons problem among local governments. Voters interested in schools vote for school board officials who will spend more on schools, and transit riders vote for transit board officials who will spend more to support transit. The same goes for interest groups and lobbyists. Interest groups focus on the level of government they care about, pushing officials in that government to attempt to seize greater control of the common pool of taxes. Each government responds to interested parties, not to the broad mass of voters and taxpayers, and spends as much as it can get away with on its issues to meet the concerns of its effective constituents. Collectively, government spending is higher than voters would approve if there were one local government making decisions.⁷⁵

This problem is an extreme version of what we see *inside* legislatures. Scholars have long studied how legislatures can fall into what Barry Weingast has called “distributive politics” norms.⁷⁶ Legislators may prefer to reduce spending across the board, but they may care most about protecting projects in their own districts. Each legislator’s concern for his own projects can lead to norms developing in favor of protecting all pork projects, even if it means choosing a level of taxation greater than what legislators would choose if they considered all projects at the same time.⁷⁷

72. BERRY, *supra* note 5, at 63.

73. *Id.* at 65–69.

74. Election laws worsen this phenomenon, particularly those laws that require local elections to be held “off-cycle,” or not on the first Tuesday of an even-numbered year, driving down turnout and increasing interest group influence. See Christopher R. Berry & Jacob E. Gersen, *The Timing of Elections*, 77 U. CHI. L. REV. 37, 38, 62–64 (2010) (examining the interaction between election law and substantive outcomes in special purpose districts); SARAH F. ANZIA, TIMING AND TURNOUT: HOW OFF-CYCLE ELECTIONS FAVOR ORGANIZED GROUPS 2 (2014) (school boards that hold elections off-cycle pay higher teacher salaries because of the greater influence of teachers unions in these elections).

75. Berry & Gersen, *The Timing of Elections*, *supra* note 74, at 45–47 (analyzing this phenomenon).

76. Barry R. Weingast, *A Rational Choice Perspective on Congressional Norms*, 23 AM. J. POL. SCI. 245, 249–53 (1979); JOHN A. FERREJOHN, PORK BARREL POLITICS: RIVERS AND HARBORS LEGISLATION, 1947–1968, at 233–52 (1974).

77. This phenomenon is also a recurrent problem when cities attempt to pass zoning laws. See David Schleicher, *City Unplanning*, 122 YALE L.J. 1670, 1704–07 (2013).

As problematic as distributive politics norms can be inside legislatures, there are procedural rules that try to correct for them.⁷⁸ For example, the requirement that legislators pass budgets, rather than simply *seriatim* appropriations bills, is designed to force a collective decision. It does not always work, but that's the goal.

Across overlapping local governments, however, there is no common budget, leading to greater commons problems.⁷⁹ Also, as discussed above, the low-salience nature of such elections means that it is hard for most voters to track and limit the growth and conflicts of such governments.

In theory, political parties should help voters monitor these governments. In the presence of political parties that project a single brand across different local governments, voters do not need to know which special purpose local government does what, only whether things are going well or poorly. They can then punish the political party in control (they do have to suss out who is in control when power is divided, though).

Berry has found that where there are strong local political parties, they do in fact limit commons problems among overlapping local governments.⁸⁰ Having lots of local governments is associated with higher spending and worse performance, except where there are strong political parties. But local political parties have declined for a variety of reasons.⁸¹ Thus, monitoring problems have become far worse.

The same dynamic of declining party power leading to fiscal profligacy can happen inside cities.⁸² This can help explain what has happened in Chicago. In a

78. See John Ferejohn & Keith Krehbiel, *The Budget Process and the Size of the Budget*, 31 AM. J. POL. SCI. 296, 296–300 (1987).

79. One might ask why this is a greater problem for government provided services than for privately provided ones. After all, we purchase private goods and services *seriatim*, and there is no coordination among service providers to give us one big bill. But voters do not opt into individual government services each time they are provided, or even at the moment of their establishment; individual voters do not have to give approval for the formation of local government, and once governments are established, their decisions are binding on all residents. Further, as Anthony Downs famously found, individual participation in general governmental decision-making, either through voting or lobbying, is individually irrational unless one has a particularized interest in participation, as the cost of information and participation is real and the likely individual impact is low. ANTHONY DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 238–60 (1957).

As a result, voters in general will not consider the collective costs created by revenue-maximizing overlapping special purpose local governments because they know little about these governments and are not forced to make decisions about the way they spend money. But voters and groups who care about the services these governments provide will encourage them to maximize revenue. A collective budget—as we see when a single government allocates revenues across issues—would minimize the information costs for ordinary voters, who could assess the general quality of services against their tax bill, and watch interest groups compete for whatever taxes they are willing to offer in general.

80. See BERRY, *supra* note 5, at 148.

81. See David Schleicher, *Why Is There No Partisan Competition in City Council Elections?: The Role of Election Law*, 23 J.L. & POL. 419, 419–22 (2007).

82. Indeed, theorists of political parties have argued that overcoming such collective action problems inside legislatures is one of the central reasons why political parties exist in the first place. See

classic book examining why Chicago did not have a fiscal crisis in the 1970s when New York did, Ester Fuchs argued that the continuing strength of Mayor Richard J. Daley's political machine allowed the City of Chicago to resist intense political demands to increase spending and lower taxes.⁸³ Individual Aldermen and city departments did not need to make promises to groups to win votes—they'd get reelected and retain power as long as they had Mayor Daley's support and the Daley machine stayed in power. The city's overall successes and failures alternately buoyed and depressed Daley's power, and thus the fates of affiliated politicians. In contrast, the demise of New York's political machines forced local politicians to hustle to get support from blocks of voters and interest groups. To stay in power, politicians had to spend and spend.⁸⁴ According to Fuchs, then, weak political parties cause fiscal crises.

However, while New York created a post-fiscal crisis governmental structure to limit excessive deficits and accounting tricks, Chicago never reformed its government to compensate for the loss of its political party structure.⁸⁵ Mayor Richard J. Daley in Chicago was indirectly succeeded by his son, Richard M. Daley, who then served for twenty-two years, even longer than his father. But Daley the Younger was able to cement control only through actually producing results for intense policy demanders, rather than simply relying on the power of his political organization, particularly later in his tenure. Columnist John Kass of the Chicago Tribune argued, "This is where Richard J. and Richard M. differ. Where the Old Man gave critics the back of his hand, the son buys them."⁸⁶ Following Fuchs, this suggests that Chicago's debt crisis, which took off during Richard M. Daley's last term, as his power ebbed, is a result of his greater responsiveness to intense policy demanders.⁸⁷

The problems of Chicago's multiple local governments may be a product of the same electoral politics. At its height, the Richard J. Daley Machine

GARY W. COX & MATHEW D. MCCUBBINS, *LEGISLATIVE LEVIATHAN: PARTY GOVERNMENT IN THE HOUSE* 1–2 (2d ed. 2007); GARY W. COX & MATHEW D. MCCUBBINS, *SETTING THE AGENDA: RESPONSIBLE PARTY GOVERNMENT IN THE U.S. HOUSE OF REPRESENTATIVES* 1–2 (2005); D. RODERICK KIEWIET & MATHEW D. MCCUBBINS, *THE LOGIC OF DELEGATION: CONGRESSIONAL PARTIES AND THE APPROPRIATIONS PROCESS* 1–4 (1991).

83. See ESTER FUCHS, *MAYORS AND MONEY: FISCAL POLICY IN NEW YORK AND CHICAGO* 5–11 (1992).

84. *Id.* at 78–82.

85. See Kimhi, *A Tale of Four Cities*, *supra* note 27; Editorial, *Welcome to Fear City, Illinois: Lessons from New York's Fiscal Meltdown*, CHI. TRIB. (June 23, 2017), <http://trib.in/2mHS2wH>.

86. David Bernstein, *Daley v. Daley*, CHI. MAG. (Sept. 10, 2008), <https://www.chicagomag.com/Chicago-Magazine/September-2008/Daley-vs-Daley/index.php?cparticle=2&siarticle=1> [<https://perma.cc/R769-HUZE>].

87. See Jason Grotto, Heather Gillers & Patricia Callahan, *Broken Bonds: An Unprecedented Analysis of Bond Spending in Chicago Finds a Pattern of Financial Desperation, Political Expediency, and Little Oversight*, CHI. TRIB. (NOV. 1, 2013), <http://trib.in/2rhon3d> [<https://perma.cc/BEA4-65RG>] (describing the increase in debt during Richard M. Daley's last term as mayor).

controlled elections for all of the local governments in Chicago.⁸⁸ These governments thus had reasons to work together to produce outcomes that were good for the machine as a whole and could therefore avoid collective action problems. That is, the balkanized local governmental structure demands a centralizing and coordinating political force—say, the original Daley Organization. In a world with more open political systems, those with many overlapping local governments will face problems, as intense policy demanders on each issue are able to make demands.

C. Decline of State Law as a Check on the Tragedy of the Commons

The other major potential limit for commons problems among overlapping local governments is state law. Local governments are, after all, creatures of state law. States pass the laws that allow the incorporation of new local governments, grant and limit the power to tax,⁸⁹ require local entities to keep balanced budgets, and regulate local government debt issuance.⁹⁰ In theory, these limits are sufficient to forestall the problem of excessive local indebtedness, at least beyond the comfort level of state governments, which may be asked to bail out the local government units.

These legal limits have weakened over time, making overlapping local governments more likely to face simultaneous fiscal crises. First, states have made it ever easier for new special districts to form by changing incorporation laws over time to encourage the development of special districts.⁹¹ The creation of new special districts is often a way around local debt limits, because they are independent of one another and thus not subject to the same debt limits (and sometimes not to any limit) even if they burden the same tax base.⁹² Consequently, tax and expenditure limits do not do much to reduce the effect of overlapping local governments on taxing and spending behavior.⁹³

Second, state courts have weakened the rules defining debt, allowing more debt to be treated as part of a “special fund” and thus revenue debt that is not counted against local tax and debt limits.⁹⁴ They have also sanctioned local legerdemains to get around debt limits, balanced budget requirements, and imposed tax and expenditure limits, including long-term service contracts or

88. Though, the second Mayor Daley did have lots of connections, including family members serving as officers in County government. See David Bernstein, *Daley vs. Daley*, CHI. MAG. (Sept. 10, 2008), <https://www.chicagomag.com/Chicago-Magazine/September-2008/Daley-vs-Daley> [https://perma.cc/SS9H-XN8T].

89. See Richard Briffault, *Foreword: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 927–38 (2003) (discussing tax and expenditure limits on local governments).

90. See *id.* at 915–27 (discussing local debt limits and procedural rules for the issuance of debt).

91. See BERRY, *supra* note 5, at 28–31. A few states have created commissions for reining in special district growth, but with only middling-levels of success. *Id.* at 87.

92. Shoked, *supra* note 70, at 1254.

93. BERRY, *supra* note 5, at 116.

94. Briffault, *supra* note 89, at 918–19; Shoked, *supra* note 70, at 1253–54.

buy-leaseback arrangements for property that look a great deal like debt.⁹⁵ Third, and most importantly, underfunding local pensions has not traditionally been subject to local debt limits, even though it has become the largest source of local indebtedness in many locales.⁹⁶

The result of legislative chicanery and permissive judicial oversight is that state laws do less than one might think, and less than they once did, to limit the tendency of overlapping local governments to run into collective fiscal problems.

II.

CHAPTER 9 AND OVERLAPPING JURISDICTIONS

When overlapping local governments run into severe collective fiscal problems, one possible response is to turn to the bankruptcy courts. However, Chapter 9, the section of the Bankruptcy Code that applies to municipalities, was not written to address the particular problems of overlapping municipalities. Chapter 9 was explicitly modeled after (and largely incorporates) Chapter 11 bankruptcy, which itself is largely addressed to the problems of single-entity firms. Bankruptcy courts applying Chapter 11 have developed a number of tools for dealing with debtor conglomerates, such as joint administration and consolidation. But because of the ultimately political nature of Chapter 9 municipal bankruptcies, these tools cannot be applied directly to overlapping municipalities. In this Part, we outline why Chapter 9 is difficult to apply to overlapping jurisdictions, and why Chapter 11 tools like joint administration and substantive consolidation cannot be applied directly in Chapter 9.

When insolvent overlapping local jurisdictions face a collective fiscal crisis, what can they or anyone else do to address their situation? State governments have multiple tools for addressing local fiscal problems, from the appointment of emergency managers or emergency financial control boards to the greater provision of state aid.⁹⁷ But once a local government is in a true fiscal crisis and the state has decided it will not bail out the locality, there are fewer options.

Localities can attempt to renegotiate the terms of debt with lenders, but given the large number of holders of debt coordination is difficult and is likely to be plagued by hold-out problems. As a result, voluntary restructuring deals

95. Briffault, *supra* note 89, at 918–25, 927–38.

96. See Beermann, *supra* note 30, at 32 (noting that underfunding pensions does not count against balanced budget requirements); Amy B. Monahan, *When a Promise Is Not a Promise: Chicago-Style Pensions*, 64 UCLA L. REV. 356, 401–11 (2017) (demonstrating that pensions do not usually count against debt limits); Alicia H. Munnell, Jean-Pierre Aubry & Laura Quinby, *The Impact of Pensions on State Borrowing Costs*, 14 CTR. FOR RETIREMENT RES. BOSTON C. 1 (2011), http://crr.bc.edu/wp-content/uploads/2011/02/slp_14-508.pdf [<https://perma.cc/46CF-JUJ3>] (highlighting the relative size of pension obligations and general obligation debt).

97. See Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 664–84 (2008) (describing non-bankruptcy options states have to address local insolvency crises); Kimhi, *A Tale of Four Cities*, *supra* note 27, at 905–20 (same).

can be very difficult or impossible, particularly without the threat of formal bankruptcy. Localities can also simply default on debt, as Cleveland briefly did in 1978, but defaulting does not extinguish legal claims against them.⁹⁸ Under federal law, states cannot set up state-specific municipal bankruptcy laws; federal law expressly preempts any such effort.⁹⁹ So absent a bailout or voluntary restructuring agreement with creditors, an insolvent locality must rely on Chapter 9 of the Bankruptcy Code.

A. Chapter 9 in a Nutshell

Chapter 9 provides a mechanism for the “Adjustment of Debts of a Municipality.” It works as follows. A municipality commences a Chapter 9 case by filing of a simple-form bankruptcy petition. A municipality’s petition may be accepted only if the municipality is insolvent, if the filing is authorized by state law, and if the petition has been negotiated in good faith with any class of creditors whose claims it intends to impair in Chapter 9.¹⁰⁰

When a municipality files for Chapter 9, most collection efforts against the municipality outside of the bankruptcy court are stayed by a federal injunction.¹⁰¹ During the bankruptcy, the municipality continues to manage its assets and affairs. Eventually the municipality will propose “a plan for the adjustment” of its debts.¹⁰² That plan must classify creditors’ claims into separate classes, specify the treatment of the claims, and provide for means of its implementation.¹⁰³ A municipal debt adjustment plan can propose a broad range of things, including paying little or nothing on particular classes of claims, with the collection of any unpaid amounts then permanently enjoined.

Following a court-approved disclosure of plan terms, creditors’ votes may be solicited on the plan of adjustment.¹⁰⁴ A plan may be confirmed if it is supported by the requisite majorities of creditors¹⁰⁵ and comports with other

98. See Amanda Ruggeri, *Three Decades After Cleveland Defaulted on Its Debts, Cities Face Recession Budget Woes*, U.S. NEWS & WORLD REP. (Dec. 15, 2008), <http://bit.ly/2Dgwi2f> (describing Cleveland’s default).

99. See 11 U.S.C. § 903 (2012); *Puerto Rico v. Franklin Cal. Tax-Free Trust*, 136 S. Ct. 1938, 1942 (2016) (barring Puerto Rico from passing its own municipal bankruptcy law under § 903 despite Puerto Rican municipalities not being eligible for Chapter 9 under 11 U.S.C. § 101(52)). Even if federal law did not preempt such efforts, it is unclear whether such a state law allowing for municipal bankruptcy would violate the Contracts Clause of the Constitution. In 1946, the Supreme Court upheld a state municipal bankruptcy law. *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 514–16 (1942). But courts have questioned whether *Faitoute* remains good law. See *In re City of Detroit*, 504 B.R. 191, 238 (Bankr. E.D. Mich. 2013) (“The limited application of *Asbury Park* to its own facts has been repeatedly recognized.”); *In re Jefferson Cty.*, 474 B.R. 228, 279, 279 n.21 (Bankr. N.D. Ala. 2012) (stating that *Asbury Park*’s “precedent status, if any, is dubious”).

100. See 11 U.S.C. § 109(c) (2012).

101. See 11 U.S.C. §§ 362, 901(a), 922 (2012).

102. 11 U.S.C. § 941 (2012).

103. See 11 U.S.C. §§ 502, 901(a), 1123(a) (2012).

104. 11 U.S.C. § 1125 (2012).

105. 11 U.S.C. § 1126 (2012).

various statutory requirements, including that it is “in the best interests of creditors.”¹⁰⁶ If a plan is confirmed, then any debts owed by the municipality are discharged to the extent they are not provided for by the plan.¹⁰⁷ The effect of the discharge is to permanently enjoin attempts to collect the unpaid debts.¹⁰⁸

While Chapter 9 presents a potentially powerful set of tools for reducing a municipality’s indebtedness, Chapter 9 is not designed to address the problem of overlapping municipal jurisdictions with a shared tax base. There are no provisions in Chapter 9 relating to the problems of coordinating the shared revenue base of such jurisdictions or ensuring that the overlapping jurisdictions are all in bankruptcy. Instead, the statutory language about entering Chapter 9 considers filings by individual municipalities, and the steps that follow are all addressed to individual municipalities. Overlapping municipalities facing linked fiscal crises will find Chapter 9, as currently understood, to be a square peg for the round holes in their budgets.

B. Solutions to the Multiple Debtor Problem in Chapter 11

The reason Chapter 9 does not have provisions relating to overlapping municipalities is because it is a derivative procedure from Chapter 11 bankruptcy. Chapter 11 is the chapter of the Bankruptcy Code that is used for corporate reorganizations and liquidations, but is not designed to deal with debtor conglomerates. Because the typical large business filing for Chapter 11 consists of multiple legal entities, courts have developed some de facto methods for handling multi-entity firms. These tools, however, are a poor fit for addressing the problems of overlapping local governments, even if the idea behind them—treating affiliated entities as one for the purposes of bankruptcy—is precisely what is needed when dealing with insolvent overlapping local governments.

1. Legal Entities vs. Economic Firms

When we speak of companies such as Apple or Coca-Cola, we generally refer to them as a firm—an integrated economic unit. A “firm,” however, is typically not just one legal entity. Instead, a “firm” is usually a conglomerate of numerous separate legal entities bound together by a web of property and contract relations: the parent owns the subsidiary, which in turn owns further subsidiaries, etc. The affiliated entities in a firm may also contract with each other for the provision of common services, such as corporate treasury, payroll, information technology, and human resources management, as well as for the use of intellectual property licenses and leases of real property. These structures

106. 11 U.S.C. § 943(b) (2012).

107. 11 U.S.C. § 944 (2012).

108. 11 U.S.C. § 524(a) (2012).

can potentially become quite complex. Enron, for example, had 177 subsidiaries that filed for bankruptcy, but likely several multiples of that which did not.¹⁰⁹

All of this complexity is not without reason. Partitioning a firm into various separate legal entities can benefit the firm overall. Asset partitioning limits exposure to liabilities¹¹⁰ as well as the scope of particular entities' regulatory compliance requirements. Asset partitioning also facilitates asset-based borrowing¹¹¹ and the sale and acquisition of corporate units through stock sales rather than through asset sales.¹¹² Yet, even as firms benefit from corporate separateness, they can also selectively relax their internal legal boundaries through intercompany guaranties of obligations, tax sharing agreements, payments of intercompany dividends, internal contracting, and filing consolidated tax returns and accounting statements.

Although multi-entity structures have been common for large businesses for decades, the federal Bankruptcy Code is drafted as if it was meant for single-entity debtor firms. When the Code was enacted in 1978, only the largest businesses in the United States were structured as holding companies with subsidiaries, and those businesses were not expected to utilize the bankruptcy laws. The Bankruptcy Code was not drafted with the likes of General Motors, Sears, and United Airlines in mind. Instead, the paradigmatic debtor was more likely a small Seventh Avenue *shmate* shop—certainly not a blue-chip company—even though there had been a handful of large bankruptcy filings (particularly railroads) under the previous Bankruptcy Act.¹¹³

The Code also lacks attention to multi-entity firms because multi-entity firms per se have no legal personhood, only their component entities. Creditors and shareholders are specific to particular entities, rather than to the conglomerate as a whole. Therefore, bankruptcy petitions are filed on a per-entity basis, rather than by the firm. Unlike tax, accounting, or banking law, bankruptcy does not recognize the concept of a consolidated group. As a result, the property of the bankruptcy estate is determined in reference to the actual debtor entities, and the protections of bankruptcy law apply only to those entities within a multi-entity structure that actually file bankruptcy petitions. Indeed, sometimes certain entities within a firm are not eligible to file for bankruptcy.

109. Authors' count of cases on the Public Access to Court Electronic Records (PACER) website listed as jointly administered with that of Enron Creditors Recover Corp. PUBLIC ACCESS TO COURT ELECTRONIC RECORDS (2018), <https://www.pacer.gov> [<https://perma.cc/9R9A-FSQ9>].

110. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 390 (2000).

111. *See id.* at 420–21.

112. Morgan Ricks, *Organizational Law as Commitment Device*, 70 VAND. L. REV. 1303, 1303 (2017).

113. Interview with Rich Levin, Partner, Jenner & Block LLP (Feb. 3, 2018). Rich Levin was a staffer on the House Committee for the Judiciary from 1975 to 1978, where he played a substantial role in drafting the Bankruptcy Code and the Bankruptcy Reform Act of 1978.

Thus, the debtor's non-filing affiliates will not get the legal benefits of being in bankruptcy. For example, one key protection of bankruptcy is the automatic stay, which prohibits creditors of the debtor from pursuing collection actions or seizing the debtor's assets without permission of the court during the bankruptcy. If an affiliate of the debtor does not file for bankruptcy, creditors can begin collection actions against the non-debtor affiliate.¹¹⁴ A non-debtor affiliate will also not normally benefit from the discharge injunction.¹¹⁵ Likewise, because bankruptcy courts generally respect the legal separateness of individual corporations within a multi-entity corporate group, it is possible for transfers between such individual corporations to be voided as fraudulent transfers or preferences.¹¹⁶ And bankruptcy does not recognize "triangular setoff" in which debts owed to one affiliate can be offset against the obligations of another affiliate.¹¹⁷

2. Chapter 11 Tools for Dealing with Affiliated Debtors

While firms can benefit in various ways from internally partitioning themselves into separate corporate entities, such partitioning can create substantial confusion during a bankruptcy proceeding. These problems are similar to the problems we see in overlapping local governments, which create a need to treat multiple entities as if they were one in bankruptcy. Corporate affiliates do too. They draw resources from many of the same sources, their governance mechanisms are linked, and they have substantial capacity to transfer resources and responsibilities between entities. This bespeaks a need to address legally separate entities as a unified firm.

While bankruptcy law defers to corporate separateness, it is also a practice area that is nothing if not practical. Courts are very cognizant that there may be going concern value in a firm as a whole that is not readily attributable to any particular entity.¹¹⁸ Take, for example, the case of the Los Angeles Dodgers baseball team. The Dodgers hold their Major League Baseball franchise rights, Dodger Stadium, and the parking lots surrounding the stadium in different legal entities.¹¹⁹ The value of any of these entities without the others is substantially lower: a baseball stadium's value depends on having a team to play there, a sports stadium in Los Angeles is of little value unless there is parking available, and the value of the parking lots is dependent upon the activities at the stadium.

114. *Lyondell Chem. Co. v. Centerpoint Energy Gas Servs. (In re Lyondell Chem. Co.)*, 402 B.R. 571, 582 (Bankr. S.D.N.Y. 2009) (acknowledging the interdependent nature of a debtor and its non-debtor affiliates and enjoining creditors from pursuing redress against non-debtor affiliates).

115. 11 U.S.C. § 1141(d) (2012).

116. *See, e.g., Senior Transeastern Lenders v. Official Comm. of Unsecured Creditors (In re TOUSA, Inc.)*, 680 F.3d 1298, 1311 (11th Cir. 2012).

117. *In re Lehman Bros., Inc.*, 458 B.R. 134, 144 (Bankr. S.D.N.Y. 2011).

118. *In re Nortel Networks, Inc.*, 532 B.R. 494, 560 (Bankr. D. Del. 2015).

119. Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1, 2–3 (2013).

Similarly, most multi-entity firms will have, at the very least, integrated cash management and information technology systems. It is hard for an entity to operate on its own when all of its cash and all of its email servers are actually owned by another entity.¹²⁰ Bankruptcy law has developed two non-statutory tools to address multi-entity firms, even if formally each company is separate: (1) joint administration and (2) substantive consolidation.

a. Joint Administration

Federal Rule of Bankruptcy Procedure 1015 allows for the joint administration of separate bankruptcy cases of affiliated entities.¹²¹ Joint administration is not automatic—affiliated debtors must each file their own separate bankruptcy petition, but those petitions will be accompanied by a “First Day” motion for joint administration. Such motions are virtually never opposed. An order allowing for joint administration means that the associated cases are heard before the same judge in joint hearings. Jointly administered cases also have a common docket, notice list, and schedule of deadlines and hearings. All of this produces certain administrative efficiencies.

Joint administration does not go very far, however, in terms of addressing the economic realities of multi-entity debtors. In Chapter 11, jointly administered debtors would, absent anything further, each be required to have their own individual plans be confirmed. Nothing prevents debtors in jointly administered cases from having a joint plan, but a joint plan would have to be separately confirmed for each entity. Separate confirmation would mean that the creditors and holders of interests in each affiliated debtor would have to be classified separately and vote separately for each plan. Moreover, the requirement that there must be one impaired class accepting the plan, not counting insiders, would have to be satisfied for each individual debtor entity.¹²² This could be problematic for entities with few outside creditors. Likewise, each plan would require distinct findings by the court in order to confirm the plan. Confirmation of one plan could be made contingent upon confirmation of the others, but doing so would give tremendous holdout power to the creditors of every entity.

120. See, e.g., Jennifer Hughes, *Winding Up Lehman Brothers*, FINANCIAL TIMES MAG. (Nov. 7, 2008), <https://www.ft.com/content/e4223c20-aad1-11dd-897c-000077b07658> [<https://perma.cc/5583-ZLAP>] (noting that “[l]ike many global corporations, the bank swept all the cash from its regional operations back to New York each night and released the funds the next day”).

121. FED. R. BANKR. PROC. § 1015(b) (2017).

122. 11 U.S.C. §§ 1129(a)(10) (2012); compare *In re Tribune Co.*, 464 B.R. 126, 180 (Bankr. D. Del. 2011), *on reconsideration*, 464 B.R. 208 (Bankr. D. Del. 2011) (applying section 1129(a)(10) on a per-debtor basis) with *JPMorgan Chase Bank, N.A. v. Charter Commc’ns. Operating, LLC (In re Charter Commc’ns)*, 419 B.R. 221, 266 (Bankr. S.D.N.Y. 2009) (applying section 1129(a)(10) on a per-plan basis).

b. Substantive Consolidation

Beyond joint administration, Chapter 11 bankruptcy practice also addresses multi-entity firms through the equitable doctrine of substantive consolidation. Substantive consolidation means that corporate separateness is disregarded, and the assets and liabilities of separate, substantively consolidated entities are treated as the common assets and liabilities of a single entity. Thus, the claims of creditors of separate entities would all become claims against a single consolidated entity that would hold the assets of all of the separate entities. This has significant distributional consequences.

To illustrate, imagine two related debtors, both with unsecured liabilities of 100 but one with assets of 50 and the other with assets of 90. Absent consolidation, the general unsecured creditors of the first debtor would recover fifty cents on the dollar (as their recoveries are pro rata),¹²³ while those of the second debtor would do much better, getting ninety cents on the dollar. With consolidation, we have a debtor with liabilities of 200, but assets of 140. That means all creditors recover seventy cents on the dollar. The creditors of the first debtor have done much better, while the creditors of the second debtor have done much worse. Presumably, the creditors of the first debtor would support consolidation, while those of the second debtor would oppose it vigorously. Not surprisingly, involuntary substantive consolidation pushed by certain creditors (such as those of the first debtor in the example above) is likely to be litigated, and the judicial standard for approval of an opposed substantive consolidation motion is quite high.¹²⁴

Substantive consolidation also affects intercompany obligations. Suppose the first debtor in the situation above owed the second debtor 20. Thus, 20 of the first debtor's liabilities and 20 of the second debtor's assets are based on this intercompany debt. When consolidated, that intercompany debt simply disappears. The consolidated assets would be not 140, but 120, while the consolidated liabilities would decrease accordingly, from 200 to 180. The pro-rated payout would thus be lowered to sixty-seven cents on the dollar.

The proponent of non-consensual substantive consolidation faces a high hurdle in court, but non-consensual consolidation is rare. Instead, substantive consolidation is usually consensual, and it is in fact the norm, at least in large bankruptcies, but it will not be full substantive consolidation in the sense of the various corporate entities being legally merged together. Instead, the typical substantive consolidation is more limited—it is a deemed consolidation solely for voting and distribution purposes in bankruptcy. This means that corporate separateness is maintained as a legal matter for all other purposes, so that post-bankruptcy the various entities remain separate. Thus, a typical large bankruptcy

123. 11 U.S.C. § 726 (2012).

124. See, e.g., *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp., Inc.)*, 810 F.2d 270, 279 (D.C. Cir. 1987); *Union Savings Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.)*, 860 F.2d 515, 520 (2d Cir. 1988); *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005).

will be both jointly administered and have a joint plan that provides for deemed substantive consolidation solely for voting and distribution purposes.

Such deemed consolidation will, of course, harm some creditors and benefit others, but it is rarely challenged for a simple reason: creditors cannot readily discern if they are better or worse off because of the consolidation. In order to do so, they would need to know what the particular assets and liabilities are of each debtor entity, including inter-affiliate obligations, but such information is often unavailable or unreliable. Corporations frequently transact with their affiliates and internal record-keeping often leaves something to be desired. An invoice might be sent to one affiliate, but paid by another, and there is scant reason for a firm to keep track of separate corporate assets when there is integrated cash management—effectively a routine pooling of assets. The cancellation of intercompany debts (itself common in Chapter 11 plans) addresses some of this problem, but not all, as there can be questions about the ownership of jointly produced assets.

Ultimately, it is often unclear what the assets and liabilities of any particular entity within a firm are, so creditors cannot tell if they are like the creditors of the first debtor or the second debtor in the example above. While these questions can be sorted out through forensic accounting, doing so is costly. Substantive consolidation affects only unsecured claims and equity interests; payment of secured claims and administrative expenses do not depend on which entity owns which assets because the secured claim is secured by a lien on the asset and the administrative expense must be paid in full in Chapter 11.¹²⁵ Any forensic accounting would be an administrative expense of the bankruptcy estate that would be paid before general unsecured creditors.¹²⁶ Additionally, forensic accounting takes time. For example, homebuilder TOUSA's bankruptcy involved bankruptcy filings by thirty-eight different entities, which had engaged in multiple intercompany transactions.¹²⁷ It took four weeks of forensic analysis to sort through just one month of the intercompany transactions.¹²⁸

125. See 11 U.S.C. § 1129(a)(9)(A) (2012).

126. 11 U.S.C. §§ 503(b), 507(a)(2), 726(a), 1129(a)(7) (2012).

127. See, e.g., Notice of Filing of Clean and Blackline Versions of the Disclosure Statement for Amended Joint Plan of Liquidation of TOUSA, Inc. and Its Affiliated Debtors and Debtors in Possession under Chapter 11 of the Bankruptcy Code at 1 n.1, 4, *In re TOUSA, Inc.*, No. 08-10928 (Bankr. S.D. Fla. June 21, 2013) (Docket No. 9246).

128. Disclosure Statement and Amended Joint Plan of Liquidation of TOUSA, Inc. and Its Affiliated Debtors and Debtors in Possession Under Chapter 11 of the Bankruptcy Code at 76–77, *In re TOUSA, Inc.*, No. 08-10928 (Bankr. S.D. Fla. June 21, 2013) (Docket No. 9169). TOUSA did not undertake a deemed consolidation. Amended Joint Plan of Liquidation of TOUSA, Inc. and Its Affiliated Debtors and Debtors in Possession under Chapter 11 of the Bankruptcy Code, June 21, 2013 Version of Proposed Plan, Exhibit 1, at 28, *In re TOUSA, Inc.*, No. 08-10928 (Bankr. S.D. Fla. June 21, 2013) (Docket No. 9245). Instead, TOUSA elected to treat its intercompany transfers as equity interests, which received no distribution in its joint plan of liquidation. *Id.* at 41, 53. This effective cancellation of intercompany obligations is a lesser form of consolidation in which certain intercompany assets and liabilities are cancelled out, but not arm's length obligations to outsider creditors.

Time is money in bankruptcy. Few creditors are willing to wait years for clarity about intercompany finances, both because such clarity might actually reduce their recoveries and because the delay is itself costly. Unsecured creditors are particularly vulnerable to the costs of delay in bankruptcy for several reasons. First, the debtor would generally need financing while in bankruptcy, and that post-petition financing would have priority over the unsecured claims of pre-petition creditors.¹²⁹ The delay necessitated by accounting could thus transfer substantial value from unsecured creditors to the post-petition lender. Second, delay means that even if creditors get paid, they will get paid later. Unsecured creditors do not receive interest in a Chapter 11,¹³⁰ so delay is expensive because there is no compensation for lost time value. Also, there are ordinarily no distributions in a bankruptcy case until a plan has been confirmed and becomes effective, which negatively affects creditors' liquidity. Third, delay could also harm the debtor's prospects of reorganizing because of loss of customer and vendor confidence. Unsecured creditors might thus recover less in a liquidation than if paid out over time from the firm's future earnings.

On top of this, any creditor objecting to a consolidation would bear its own litigation costs, exposing it to free-riding; the standard bankruptcy collective action device of an Official Committee (whose costs are borne by the bankruptcy estate) is unlikely to be available. There is usually one Official Committee of Unsecured Creditors for all jointly administered cases, and the Official Committee would likely be conflicted out of acting because some of its members might benefit from consolidation and others might not.

All of this means that an unsecured creditor would have to expect a substantial improvement in its recovery in bankruptcy as the result of preventing a deemed consolidation in order to make it worthwhile to object to the consolidation. Few unsecured creditors are likely to have such confidence as to object.

The lack of clarity about intercompany assets and liabilities also discourages objections to consolidation because an objection to the deemed consolidation might actually be self-defeating. If a creditor is in fact a beneficiary of substantive consolidation, it will, by definition, mean that another creditor is harmed by it and will have good grounds to object, thereby depriving the first creditor of the benefit of substantive consolidation. In other words, creditors are generally willing to trade the uncertainty of outcomes under separate bankruptcy plans for the speed and certainty of a consolidated bankruptcy plan.

Thus, while *In re Owens Corning*, the leading case on substantive consolidation, declares that the remedy is "one of last resort after considering and rejecting other remedies,"¹³¹ what is rare is for a court to approve a substantive consolidation in the face of an objection. Such objections, however,

129. See 11 U.S.C. § 364(c)–(d) (2012).

130. The exception is in solvent cases. See 11 U.S.C. § 726 (2012).

131. *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005).

are themselves rare; most of the time substantive consolidation goes unchallenged in large bankruptcies.

3. *Chapter 11 Tools Are Unlikely to Work in Chapter 9*

Corporate bankruptcy practice addresses conglomerates largely through non-statutory doctrine like deemed substantive consolidation. The natural differences between corporate and municipal bankruptcy make it difficult to transfer corporate bankruptcy doctrines to a Chapter 9 context. While joint administration and deemed substantive consolidation generally work well enough in corporate bankruptcies, there is reason to doubt how well these tools would work if applied to municipal bankruptcies. That said, the basic idea behind these tools—treating linked entities as one for the purpose of bankruptcy—is exactly what is necessary in the context of insolvent overlapping local governments. While this Part will show that Chapter 11 tools as they currently function would not work in Chapter 9, Part III will provide some doctrinal and statutory reforms that would make them work for insolvent overlapping local governments.

On its face, Federal Rule of Bankruptcy Procedure 1015 has no application to overlapping municipal governments. It only applies to “a debtor and an affiliate,” whose cases are in the same court.¹³² The statutory definition of “affiliate” refers to entities with common equity ownership or control.¹³³ Overlapping municipalities are not “affiliates” under the Bankruptcy Code because they are not under common equity ownership.

Yet the concept of joint administration is completely plausible to apply to Chapter 9, and nothing expressly forbids it.¹³⁴ It is hard to read Rule 1015 as having a negative implication that prohibits joint administration in situations it does not address because ministerial administration is ultimately a matter left to courts’ discretion; Rule 1015 creates no right to joint administration, nor does it provide what joint administration actually means in practice.

132. FED. R. BANKR. PROC. § 1015(a) (2017).

133. *See* FED. R. BANKR. PROC. § 9001 (2017); 11 U.S.C. § 101(2) (2012); FED. R. BANKR. PROC. § 1015 (2017).

134. A special challenge would exist in the limited subset of cases in which overlapping municipalities span multiple judicial districts or even circuits. For example, the Port Authority of New York and New Jersey covers the Southern District of New York, Eastern District of New York, and District of New Jersey. That would in theory allow the Port Authority to choose its restructuring venue, but it also means that fiscal problems in, say New York City, will affect the Port Authority, which will in turn affect New Jersey municipal governments. (It is not clear, however, if the Port Authority is eligible under the current text of the statute, as it is not a municipality but a bi-state compact.) A special challenge would also exist for metropolitan regions that cross judicial districts’ borders. For example, a Chicago fiscal crisis could result in businesses departing the region, which would have a spillover effect on municipal governments in suburban communities in northwest Indiana. While the concept of joint administration is readily adaptable to filings by multiple municipalities in the same district, cross-district joint administration would present an additional, although not insurmountable, procedural challenge that is beyond the scope of this Article.

For joint administration to be possible in any form, however, it is necessary for multiple governments, first, to be given authorization to file and, second, to in fact do so. Creditors cannot force governments into bankruptcy—there is no involuntary municipal bankruptcy. As a result, collective action problems among overlapping jurisdictions, in theory, could lead to one or multiple local governments “holding out.” Governments could refuse to file knowing that a bankruptcy of another overlapping government will result in that government becoming deleveraged, thereby freeing up tax revenue for those government entities that do not file for bankruptcy. In other words, governments may seek to free-ride on other overlapping governments’ bankruptcies.

Substantive consolidation is more problematic when applied to Chapter 9. First, there is usually little question about the division of assets and liabilities among overlapping municipalities. It is quite clear what the assets and liabilities of the City of Chicago, Cook County, Illinois, and the Chicago Public Schools are. Generally speaking, overlapping municipalities share a tax base, not assets. There might be some inter-entity guaranties, but they are unlikely to muddy the waters enough to produce the uncertainty that leads Chapter 11 creditors to prefer the speed of consolidation over separate plans.

Second, legal separateness is much more prominent with overlapping municipalities than with corporate affiliates. Creditors may not realize which corporate affiliates they are really dealing with: one affiliate is formally liable on a contract, but another pays the invoices. But there is no question about which entity is the counterparty when dealing with municipalities. Moreover, separate municipal governments are much more likely to have neater observance of corporate separateness than affiliated firms. Clear creditor reliance on corporate separateness and debtor observance of such separateness makes it much harder for a court to approve a contested consolidation.

Third, there is unlikely to be serious operational integration among overlapping municipalities.¹³⁵ Municipalities will not share cash management, human resources, or information technology systems, although they occasionally have combined pension systems.

Where municipalities will potentially overlap, however, is in their tax base and in their electorates. But while this is substantively very important, it is not a formal entanglement. Creditors can see which entity is better funded—even if that is simply the result of past taxing decisions that can be reversed by the shared electorate—and are unlikely to accept a consolidation if they own debt in the richer entity.

Deemed consolidation does not easily address this problem as it currently operates. That said, the basic idea is very attractive for overlapping governments.

135. Cf. *Lyondell Chem. Co. v. Centerpoint Energy Gas Servs. (In re Lyondell Chem. Co.)*, 402 B.R. 571, 582 (Bankr. S.D.N.Y. 2009).

For something like consolidation to work, there need to be a variety of statutory and doctrinal changes to Chapter 9.

C. Addressing Overlapping Municipalities in Chapter 9

While Chapter 11's tools for dealing with affiliated debtors are of little use for Chapter 9, it is possible to develop rules within the framework of Chapter 9 that will address the problems of fiscally-distressed overlapping municipalities. Although Chapter 9 explicitly addresses situations where only one municipality is involved, we argue that it has two essential traits that make it possible to address the problems of overlapping jurisdictions.

First, Chapter 9 differs from corporate bankruptcy in the inherently political nature of the court's role. Because a municipality lacks owners or shareholders and cannot be liquidated, the court is not ultimately engaged to maximize the value of the filing entity for creditors or other stakeholders. Instead, the court is engaged in the political task of addressing the problems of excessively indebted municipalities. Courts in Chapter 9 cases are forced to answer irreducibly political questions like how poor public services should be allowed to become before bondholders should be impaired, or how credible the municipal politicians' proposed plan of adjustment is.¹³⁶ This allows, and indeed may require, courts to consider the complications created by overlapping jurisdictions when facing Chapter 9 cases.

Second, Chapter 9 provides a huge degree of flexibility to both the cities that file and the courts that manage cases. Like a Chapter 11 corporate debtor, a municipal debtor files for bankruptcy, operates in bankruptcy for some time behind the shield of the automatic stay while negotiating a plan with creditors, and eventually leaves bankruptcy pursuant to a judicially approved plan. But in Chapter 9, at each stage, creditors are systematically weaker and there is more space for creative policy determinations to be made by both the court and the filing municipality. Given this flexibility, courts, cities, and states have some capacity to take into consideration factors outside of the bounds of Chapter 9's statutory language, including the problems created by overlapping jurisdictions.

An exploration of some of the steps of a Chapter 9 case in the following sections reveals the political nature of the questions being asked and the wide discretion available to courts and filing parties.

1. Entering Bankruptcy

A municipal debtor filing for protection under Chapter 9 must, in order to enter bankruptcy, show that it meets the requirements laid out in the Bankruptcy Code: that it has been specifically authorized to file for bankruptcy by its state government, is insolvent, has a desire to effect a plan to adjust its debts, and has

136. Levitin, *Bankrupt Politics*, *supra* note 31 (describing the inevitably political nature of Chapter 9 decision-making).

attempted to negotiate its debts in good faith with its creditors unless such negotiation is impractical.¹³⁷ This stands in contrast to the corporate debtor, who must only show that it is a person that resides in the United States and is not a prohibited type of financial institution.¹³⁸ In several of these steps, however, there is substantial discretion for bankruptcy courts to determine whether these prerequisites to filing have been satisfied. That discretion creates space for courts to consider the issue of overlapping jurisdictions.

a. Insolvency

The Bankruptcy Code defines insolvency by whether a municipality is “unable to pay its debts as they come due” or “generally not paying its debts as they become due.”¹³⁹ By imposing this requirement, Chapter 9 may lead cautious cities to delay filing for bankruptcy until their financial situation is so dire as to limit the potential options for restructuring, limiting the efficacy of Chapter 9.

In response to this concern, judges have interpreted the insolvency standard flexibly. For example, in the City of Vallejo, California’s bankruptcy, certain creditors challenged the insolvency of the city, arguing that it could have paid its debts as they came due by raiding certain restricted-access funds.¹⁴⁰ The bankruptcy court rejected the creditors’ contention, finding that it would not have been “[p]rudent[t]” to raid those restricted-access funds—essentially drawing a line between acceptable and unacceptable levels of difficulty in making payments on debts as they come due.¹⁴¹ In reviewing the decision, the Ninth Circuit’s Bankruptcy Appellate Panel granted significant deference to the finding by the bankruptcy court because the “insolvency” determination is not as mechanical as the text of the Bankruptcy Code might indicate.¹⁴²

Overlapping local governments make the insolvency determination more difficult. What if a city could meet its burdens only if an overlapping government reduced its taxes, creating fiscal space for the distressed government to increase revenues? What if a decision to raise taxes or reduce services to head off bankruptcy would push another jurisdiction into bankruptcy by eroding the shared tax base by spurring sufficient exit from the area? It is hard to know how courts would address these questions, but the answer may lie in a doctrine created

137. 11 U.S.C. § 109(c) (2012).

138. 11 U.S.C. §§ 109(a), (b), (d). However, a corporate debtor that is not in financial distress might have its petition dismissed for bad faith, under 11 U.S.C. § 1112. *See In re Marshall*, 403 B.R. 668, 690 (C.D. Cal. 2009) (“[T]he potential appellate bond brought the debtors to the brink of insolvency and, thus, their filing was in good faith.”).

139. 11 U.S.C. § 109(c)(3); 11 U.S.C. § 101(32)(B)(i) and (ii).

140. *In re City of Vallejo*, 408 B.R. 280 (B.A.P. 9th Cir. 2009).

141. *Id.* at 293.

142. *See id.* *But see In re City of Bridgeport*, 129 B.R. 332, 335–36 (Bankr. D. Conn. 1991) (rejecting Bridgeport’s Chapter 9 filing because it was not insolvent, despite having a deficit, as it had access to a fund of bond proceeds that allowed it to make payments).

to address the poor fit of the statutory definition of insolvency and larger municipalities.

Traditionally, Chapter 9 was mostly invoked by smaller municipalities that experienced sharp, one-time fiscal shocks: the revenue from an illegal speed-trap on the Interstate would be cut off,¹⁴³ or a tax on topless dancers would be declared unconstitutional.¹⁴⁴ These small municipalities were often unable to make their next scheduled debt payment or even make payroll at the end of the week. But as bigger municipalities facing structural problems have begun to look at Chapter 9, the insolvency requirement has become more constraining. After all, a city like Detroit or Stockton, CA often *could* make its next debt payment by selling assets or firing the entire police force. But doing so would be harmful both for residents and for debt holders in the long run.

Courts have responded to this problem by interpreting the insolvency requirement to encompass “service delivery insolvency.”¹⁴⁵ This doctrine was first introduced in the Chapter 9 case of Stockton, California, where the bankruptcy court pointed out that the municipal government offered residents such a poor set of municipal services that it should be understood to have no ability to pay its bills as they become due. After finding that it could not make its payments, the court noted that “the police department has been decimated,” “the crime rate has soared,” and “[p]olice often respond only to crimes-in-progress.”¹⁴⁶ The court concluded that the concept of service delivery insolvency supported its finding of insolvency.¹⁴⁷ That is, Stockton was “service delivery insolvent.”¹⁴⁸ And “[t]hat it was service delivery insolvent confirms that the cash insolvency was not a mere technical insolvency.”¹⁴⁹

Service delivery insolvency was also central to the most important Chapter 9 eligibility ruling to date—Detroit’s Chapter 9 case. In finding that Detroit suffered from service delivery insolvency, the bankruptcy court discussed in

143. See Tony Thornton & Sheila Stogsdill, *Moffett Seeks Bankruptcy Protection: Town Bears Toll of Designation as a Speed Trap and Debts Incurred by the Late Mayor*, NEWSOK (Feb. 2, 2007), <http://bit.ly/2mID8GT> [<https://perma.cc/6TWA-MFJW>].

144. See Nicholas J.C. Pistor, *Washington Park Files for Bankruptcy Protection*, ST. LOUIS TODAY (July 31, 2009) (describing Washington Park, IL’s repeated bankruptcy filings following successful challenges to topless dancer license fee).

145. See *In re City of Stockton, California*, 493 B.R. 772, 781 (Bankr. E.D. Cal. 2013). Although the court introduced the concept in the Stockton case, it quite clearly drew on the findings in the prior bankruptcy case of Vallejo, CA, in which an appellate court affirmed a bankruptcy court’s determination of insolvency in part on the grounds that “Vallejo could have cut more services, but the court found that it had reduced expenditures to the point that municipal services were underfunded. More importantly, the court found further funding reductions would threaten Vallejo’s ability to provide for the basic health and safety of its citizens.” *In re City of Vallejo*, 408 B.R. 280, 294 (B.A.P. 9th Cir. 2009), *aff’g In re City of Vallejo*, No. 08-26813-A-9, 2008 WL 4180008 (Bankr. E.D. Cal. Sept. 5, 2008).

146. *In re City of Stockton*, 493 B.R. at 789–90.

147. *Id.*

148. The court also found Stockton to be “cash insolvent,” or not paying its debts today, and “budget insolvent,” or unable to meet payments based on expected revenues. *Id.* at 789–91.

149. *Id.* at 791.

great detail how bad local services had become, pointing out the number of streetlights that did not work, the lengthy police response times, and the extent of local blight.¹⁵⁰

In both *Stockton* and *Detroit*, the bankruptcy courts found that the city at issue was unable to pay its debt *and* was service delivery insolvent. As a result, it is unclear whether service delivery insolvency alone can be enough to sustain an insolvency finding. Some cities may test this proposition: the City of East Cleveland, Ohio, for example, continues to pay its debts, but may be unable to maintain basic service provision, and on that basis has sought permission from the state to file for bankruptcy.¹⁵¹

To be sure, even defining the standard for service delivery insolvency will be challenging.¹⁵² The standard may refer to services so bad they actually reduce revenue by encouraging residents to leave the jurisdiction. Alternatively, it may refer to a level of service that falls below some minimum level known only to the judge making the determination.¹⁵³ Or the standard may be something else. Courts have not explained how to judge service delivery insolvency, nor is it clear what law they would draw on to do so.

Overlapping local governments further complicate the problem of defining service delivery insolvency. Which government's services must be sufficient? What if a government can provide sufficient services only by raising revenues to the point that another government cannot provide sufficient services? And so forth.

Service delivery insolvency, as well as our proposal in Part III.B.1 for a tax base insolvency approach, is admittedly the product of the inherently political nature of resolving the insolvency of municipal governments. Moreover, as one of us has argued, Chapter 9 cases are very different from other bankruptcy cases.¹⁵⁴ There is no option to liquidate a city.¹⁵⁵ Furthermore, creditors cannot be given equity in a reorganized city, as there is no such thing as an equity interest in a municipality. Constitutional protections for states mean that federal courts cannot force localities to file for bankruptcy or to accept a court-generated plan of adjustment.¹⁵⁶

150. *In re City of Detroit*, 504 B.R. 191, 214 (Bankr. E.D. Mich. 2013).

151. Emily Bamforth, *East Cleveland Wants to File for Bankruptcy*, CLEVELAND.COM (May 4, 2016), <http://bit.ly/1Y98Vf3> [<https://perma.cc/GVZ2-LL77>].

152. See Anderson, *supra* note 31, 1192–94 (discussing the difficulty of defining service delivery insolvency).

153. What makes this doctrine confusing is that state residents have no general right to municipal services of any level. *Id.* Residents of jurisdictions that have not gone bankrupt (particularly unincorporated areas) often have even worse local services. See Michelle Wilde Anderson, *Mapped Out of Local Democracy*, 62 STAN. L. REV. 931 (2010) (unincorporated areas on the edges of cities often lack basic services).

154. Levitin, Levitin, *Bankrupt Politics*, *supra* note 31.

155. *Id.*

156. Cf. Gillette & Skeel, *supra* note 31, at 1208–16 (discussing constitutional limits on Chapter 9).

A court in a Chapter 9 case has a different role than a court in a traditional corporate bankruptcy case. A Chapter 9 court must inevitably answer questions that, in other contexts, would be considered beyond the scope of the judiciary and best left to political branches. The question of service delivery insolvency highlights this. What seems like a technical inquiry—whether a government can pay its debt now or in the future—ends up devolving into a political question of whether residents have a right to some level of public services.

b. Good Faith

Other aspects of the Chapter 9 eligibility determination allow and indeed require a similar type of judicial involvement in what would otherwise be political questions. Chapter 9 imposes an explicit “good faith” requirement on a debtor seeking protection.¹⁵⁷ As with the insolvency determination, the bankruptcy court has discretion in its determination of whether the municipality has filed for bankruptcy in “good faith.”¹⁵⁸ For example, in *In re Sullivan County Regional Refuse Disposal District*, the bankruptcy court dismissed a petition on the basis of a lack of good faith where the municipality, despite being insolvent, refused to exercise its authority to assess a tax on its tax base.¹⁵⁹ This stands in very sharp conflict with the statutory rule that, once a jurisdiction has entered Chapter 9, the court cannot order it to raise taxes.¹⁶⁰

To the extent that bankruptcy courts judge “good faith” based on the real limitations on local ability to pay, a bankruptcy court could account for the issue of overlapping jurisdictions by noting the extent to which a municipality’s ability to raise tax revenue may be practically constrained by the taxing choices of overlapping jurisdictions. If this inquiry requires understanding the context in which spending and taxing decisions are made, then courts should also consider the external limitations on the decision-making of a government that files under Chapter 9, including the interactions between local governments.

157. 11 U.S.C. § 109(c)(5)(B) (2012). Under section 109(c)(5), a debtor must show one of the following: that the majority of the creditors in each class consent; that it has negotiated with creditors in good faith and failed to come to an agreement; that it is unable to negotiate with creditors; or that a creditor is trying to obtain a preferential transfer of some kind. This requirement is referred to as the “good faith” requirement because the other three ways of meeting the section 109(c)(5)(B) are not relevant in most municipal bankruptcies. The section 109 good faith requirement is distinct from both the statutory good faith plan confirmation requirement of section 1129(a)(3) and the federal common law good faith filing doctrine. See *In re SGL Carbon Corp.*, 200 F.3d 154 (3d Cir. 1999) (discussing the good faith filing doctrine); *Solow v. PPI Enterprises (U.S.), Inc.*, (*In re PPI Enterprises (U.S.), Inc.*), 324 F.3d 197, 210–11 (3d Cir. 2003) (discussing the good faith filing doctrine).

158. 11 U.S.C. § 921(c) (2012).

159. *In re Sullivan County Regional Refuse Disposal Dist.*, 165 B.R. 60, 82–83 (Bankr. D.N.H. 1994).

160. See *Picker & McConnell*, *supra* note 31, at 474, (discussing whether Chapter 9 as written might allow a court to order tax increases under its discretion).

2. *Exiting Bankruptcy*

Between the filing of a municipal bankruptcy and plan confirmation, the court plays a more limited role than it does during a corporate bankruptcy. There is no “bankruptcy estate” created in Chapter 9, unlike in Chapter 11,¹⁶¹ so the debtor’s assets are not in a constructive trust for creditors. Thus, under section 904 of the Bankruptcy Code, “unless the debtor consents or the plan so provides, the court may not . . . interfere with . . . any of the political or governmental powers of the debtor; any of the property or revenues of the debtor; or the debtor’s use or enjoyment of any income-producing property.”¹⁶² Similarly, the municipality does not need the bankruptcy court to approve the use, sale, or lease of assets outside of the ordinary course of business.¹⁶³ The municipal debtor, however, still reaps the protections of the automatic stay,¹⁶⁴ which prevents creditors from suing the municipal debtor to collect on obligations without permission of the bankruptcy court. Further, the protections for secured creditors during municipal bankruptcy are different, and largely weaker, providing much less of a constraint on municipal debtors during bankruptcy.¹⁶⁵ Finally, only the municipality can propose a plan of adjustment to exit bankruptcy.¹⁶⁶ Unlike in a corporate bankruptcy, creditors cannot propose competing plans.¹⁶⁷

During the course of a Chapter 9 proceeding, the bankruptcy court’s power is in approving settlements, appointing mediators, and holding the threat of kicking a municipality out of bankruptcy for unreasonable delay or failure to

161. Section 541 of the Bankruptcy Code creates a new juridical entity, the bankruptcy estate, which accedes to all non-exempt property in which the debtor has an interest. 11 U.S.C. § 541 (2012). Section 901 of the Bankruptcy Code does not make section 541 of the Bankruptcy Code applicable in Chapter 9. 11 U.S.C. § 901 (2012).

162. 11 U.S.C. § 904 (2012).

163. See 11 U.S.C. § 901 (providing that section 363 of the Bankruptcy Code, 11 U.S.C. § 363, does not apply in Chapter 9). See also Picker & McConnell, *supra* note 31, at 462–63 (explaining why municipalities have a greater degree of control in Chapter 9 cases than non-municipal corporate debtors in Chapter 11 cases).

164. See 11 U.S.C. § 901 (incorporating 11 U.S.C. § 362; 11 U.S.C. § 922).

165. A secured creditor can request that the automatic stay be lifted if it is not provided with adequate protection against the depreciation of its collateral. See 11 U.S.C. § 362(d)(1) (2012). In the corporate bankruptcy context, the lifting of the stay would enable a secured creditor to foreclose on its collateral. The lifting of the stay does little to help a secured creditor against a municipality, however, because state law remedies against municipal debtors are highly limited. State courts generally do not authorize the seizure of assets, the garnishment of bank accounts, or other traditional remedies for collecting on a debt owed by a municipality. Picker & McConnell, *supra* note 31, at 427–450 (discussing creditors’ remedies in cases of municipal insolvency prior to the creation of municipal bankruptcy law). The bankruptcy court’s only instrument to protect secured creditors’ power is to make the damages resulting from the automatic stay payable as an administrative expense of the bankruptcy estate. See 11 U.S.C. § 922(c). But because state law remedies against municipal debtors may be highly limited, it would not always be easy for a secured creditor to show that it could have protected the collateral absent the automatic stay, which would limit the impact of this protection.

166. 11 U.S.C. § 941 (2012).

167. See 11 U.S.C. § 1121(b)–(c) (2012).

propose or have a plan accepted within the time set by the court.¹⁶⁸ The court can also exercise influence less formally by delaying rulings or by encouraging settlements through the threat of adverse rulings.¹⁶⁹ In the Detroit bankruptcy, for example, these powers allowed the court to influence how the city operated during bankruptcy as well as the ultimate plan proposed by the city.¹⁷⁰ The bankruptcy court cannot, however, order the debtor to operate in a particular way,¹⁷¹ and unlike in Chapter 11, there is no threat of an appointment of a trustee to discipline the debtor's actions.

The role of the bankruptcy court waxes dramatically, however, during the plan confirmation process. The confirmation process forces the court to make judgments about the proper scope and capacity of municipal governments. The plan confirmation allows courts to consider the problem of overlapping local governments. In particular, courts must make findings about the plan being “feasible” and in the “best interest” of creditors. Both analyses are inevitably affected by the problem of overlapping municipal jurisdictions.

a. Best Interests

To confirm a Chapter 9 plan, the court must find that a plan is “in the best interests” of creditors.¹⁷² This “best interests” test creates room yet again for bankruptcy courts to consider the issue of overlapping jurisdictions. The “best interests” test in Chapter 9 is different from what is often referred to as the “best interests” test in Chapter 11. In Chapter 11, the phrase “best interests” does not appear in the statute, but the phrase is nonetheless used to refer to a requirement that a plan pay all impaired, non-accepting creditors at least as much value as they would receive in a hypothetical Chapter 7 liquidation of the debtor.¹⁷³ The Chapter 11 evaluation therefore requires determining, for each creditor, what a recovery would have been in a hypothetical Chapter 7, and then comparing the Chapter 11 plan to that baseline.

168. 11 U.S.C. §§ 327 (giving the court power to appoint qualified professionals, such as mediators), 363(b) (requiring notice and a hearing before the trustee may use, sell, or lease the property of the debtor outside of the ordinary course of business—a provision that covers settlements), 930 (discussing dismissal of a bankruptcy case); FED. R. BANKR. PROC. § 9019(a) (granting the court power to approve settlements).

169. For example, a judge might announce from the bench that he is generally inclined to rule one way on an issue, but wants to consider it further and is unlikely to produce a final opinion for a week. Such an announcement is effectively a way of telegraphing to parties the relative strengths of their positions and encouraging a voluntary settlement that saves judicial resources and enhances certainty by precluding the possibility of an appeal.

170. Melissa Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. REG. 55, 74–81 (2016).

171. 11 U.S.C. § 904 (2012). Cf. 11 U.S.C. § 363(b) (requiring notice and a hearing before the trustee may use, sell, or lease the property of the debtor outside of the ordinary course of business).

172. 11 U.S.C. § 943(b)(7) (2012).

173. 11 U.S.C. § 1129(a)(7)(A)(ii) (2012). See, e.g., *In re Sierra-Cal*, 210 BR 168 (Bankr. E.D. Cal. 1997).

Chapter 9 actually uses the “best interests” terminology, but in Chapter 9, the evaluation is not done on a creditor-by-creditor basis. Instead, it is done for the creditor community as a whole, which requires a judgment by the bankruptcy court about the relative importance of each creditor class.¹⁷⁴ Because there is no liquidation alternative for municipalities, the Chapter 9 “best interests” test does not compare how creditors fare in the plan to how they would fare in liquidation. Instead, the Chapter 9 “best interests” test compares how creditors fare under the proposed plan to how they would fare without any plan at all.¹⁷⁵ Given the limited remedies available to creditors at state law, when a municipality decides to simply stop paying its debts, this can be a very low bar.

The “best interests” test in Chapter 9 presents another opportunity for bankruptcy courts to consider the issue of overlapping jurisdictions. For example, if there is a shared creditor base (say, pension plans to which multiple governmental entities are supposed to contribute), a plan that pushes an overlapping jurisdiction into insolvency without any plan for reconciling the obligations might be considered not in the “best interests” of the creditors.

b. Feasibility

The Bankruptcy Code also imposes a feasibility requirement on plans of adjustment for municipal debtors.¹⁷⁶ Under Chapter 9, the Bankruptcy Code only says that a plan must be “feasible” but does not further define the term. By contrast, under Chapter 11, the provision that is generally termed the “feasibility” standard requires only that “[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor.”¹⁷⁷

Bankruptcy courts can interpret “feasibility” in a capacious way. For example, courts do not have to look solely at a municipality’s ability to pay debts, but may also consider the municipality’s ability to be a functioning government delivering services at a sustainable level, with a sustainable governance model.¹⁷⁸ This is an overtly political judgment. Courts must determine what services must be provided, for how long the government must show it will be capable of meeting both its debt payments and service provision obligations, and how credible its promises are.

Again, overlapping jurisdictions make this problem harder. What services must be sustainable? Should only the services provided by the government that files be taken into account? How do you address the problem of vertical tax externalities when assessing the likelihood that a jurisdiction will be able to make its payments going forward?

174. *In re City of Stockton, California*, 542 B.R. 261, 283 (B.A.P. 9th Cir. 2015).

175. *See In re City of Detroit*, 524 B.R. 147, 213 (Bankr. E.D. Mich. 2014).

176. *See* 11 U.S.C. § 943(b)(7) (2012).

177. *See id.*; 11 U.S.C. § 1129(a)(11) (2012).

178. *See Gillette & Skeel, supra* note 31, at 1198–1202.

The required Chapter 9 feasibility analysis presents the most obvious opportunity for a bankruptcy court to address the problem of overlapping jurisdictions. If another jurisdiction is financially unstable, a plan of adjustment is unlikely to be feasible in light of the shocks that may come from tax increases or service reductions from that jurisdiction.

While bankruptcy courts have not addressed the issue of overlapping jurisdictions in the small number of Chapter 9 cases to date, the structure of Chapter 9 affords them opportunities to do so throughout the bankruptcy process both when entertaining a municipal debtor's petition for bankruptcy and in the plan confirmation process. Yet, Chapter 9 still does not present a mechanism for coordinated, much less consolidated, plans for overlapping municipalities.

III.

ADDRESSING THE PROBLEMS CREATED BY OVERLAPPING LOCAL GOVERNMENTS

As discussed above, it is increasingly likely that we will see overlapping local governments in fiscal distress.¹⁷⁹ Some local governments in these situations will employ Chapter 9 municipal bankruptcy, either by actually filing or by threatening a filing to convince debtors and contractors to renegotiate and restructure their debt and contracts outside of bankruptcy. But as we have seen, neither existing municipal bankruptcy doctrine nor corporate bankruptcy law provide governments and courts with much guidance about how to resolve conflicts that will inevitably emerge if overlapping local governments employ Chapter 9.

Existing bankruptcy regimes are designed to address common pool problems among creditors, but are not currently well suited to address a common pool problem among debtors. New tools are necessary for Chapter 9 to be a useful process for addressing the problems of debt crises in multiple, overlapping jurisdictions.

This Part proposes several new tools for Chapter 9 and municipal insolvency practice that can address some of the problems created by overlapping jurisdictions. Some of these tools require new laws, but others can be developed by courts using the existing statutory framework.

These tools should be built around three basic principles. First, when insolvency problems occur in overlapping jurisdictions, it is essential to police the inherent conflicts of interest among local governments. Access to bankruptcy remedies should be premised on cooperation, rather than efforts to take advantage of collective action problems. Courts and legislatures should develop rules that counter the incentives of local governments to avoid bankruptcy or retrenchment for as long as possible in hopes that other overlapping local

179. *See infra* Part I.

governments will file for bankruptcy first and, by deleveraging, free up tax base resources to pay the non-filing jurisdictions debts.¹⁸⁰

Second, as much debt and as many ongoing contractual obligations made by a tax base or electorate should be combined into a single bankruptcy proceeding as possible, regardless of how and through which local entity the promises were made. By putting overlapping local governments into one “Big Bankruptcy” proceeding, judges will be able to manage common pool problems among them. Further, Big Bankruptcies will promote fairer treatment among creditors across governments, as long as courts account for the various types of security offered to lenders and the different sources of revenue relied upon by different governments. Most importantly, Big Bankruptcies involving many overlapping local governments will enable better outcomes for residents after bankruptcy. Bankruptcy can only produce a clean slate if it addresses many or all of their excessive debt problems.¹⁸¹

Third, and relatedly, where multiple governments represent the same tax base, losses should be spread among as many creditors as possible. After all, bonds issued by overlapping local governments are just promises made by the same principal—local voters and taxpayers—through different agents, or local governments. Spreading the pain among creditors—a basic bankruptcy principle—means lower losses for each creditor. It also means greater balance in

180. In all sorts of governmental insolvency situations, there is substantial evidence that politicians wait too long to restructure or retrench. This is driven largely by agency problems from leaders who do not want to be in office when the government goes bankrupt or takes unpopular actions. See LEE BUCHHEIT ET AL., BROOKINGS INSTITUTION, REVISITING SOVEREIGN BANKRUPTCY, 10–11 (Oct. 2013), <https://www.brookings.edu/research/revisiting-sovereign-bankruptcy> [<https://perma.cc/W7EE-GB39>]. Waiting too long to file for bankruptcy makes the problem worse, as the steps taken can harm the local economy, leading both to worse outcomes for residents and harsher write-downs for creditors. Common pool problems among overlapping local governments provide yet another reason why a government will take too long to attempt to access Chapter 9 protections. Chapter 9 doctrine and practice should be reformed to push back on this tendency to wait due to conflicts among local governments. *Id.* The authors also suggest that waiting to restructure destroys the political will to adopt austerity measures, as long stretches of bad times anger residents until they are unwilling to accept more cuts and tax increases.

181. Relatedly, efforts by insolvent local governments to strategically shift assets and liabilities among themselves in order to game the bankruptcy process should be policed and limited. Voters and politicians have incentives to either transfer assets, tax streams, or liabilities between local governments in anticipation of filing for bankruptcy. By so doing, one government can save the others, and together they can effectively create priority rules among debtors in ways they cannot do absent such manipulations. See Richard M. Hynes & Stephen D. Walt, *Pensions and Property Rights in Municipal Bankruptcy*, 3 REV. BANKING & FIN. L. 609, 620 (2014) (describing limited capacity of municipalities to create priority among debtors absent giving creditors property rights in municipal assets). This problem is particularly severe in situations where one official or group directly controls several government entities—where, say, the mayor of a city appoints a majority of the school board. If resources or powers are going to be transferred between entities in anticipation of bankruptcy, the entity that does so should be the state government, which has clear authority to do so and, as a formal matter at least, represents the interests overlapping all local authorities. See *infra* note 271 for a discussion regarding the State’s constitutional power to do this and whether these transfers would be prohibited as fraudulent.

whatever spending cuts are necessary, which allows for better provision of municipal services.

There are a number of possible statutory or doctrinal changes that could be used to attempt to achieve these goals. We will explore a few potential changes, in part because they are good ideas, but also in part to make clear why these goals are good ones.

A. *Using Existing Law to Address Common Pool Problems among Overlapping Jurisdictions in Chapter 9*

The leading scholarship about Chapter 9 is premised on the idea that the statutory language of Chapter 9 is sufficiently vague that courts have implicitly been given discretion to make the legal regime more rational and useful. Courts need to determine when a government is insolvent, whether a government has engaged in good faith negotiation with creditors, and if a plan to exit bankruptcy is feasible. The Bankruptcy Code, however, provides scant guidance about what these terms mean.¹⁸² Michael McConnell and Randall Picker have argued that courts should force local governments to cut services and raise taxes if possible, despite clear statutory language that courts have no power to order changes in how municipalities spend, tax, or use property.¹⁸³ More recently, Clayton Gillette and David Skeel have argued that courts should use these same areas of discretion to push for reforms in local governmental structure, even though doing so would raise serious constitutional questions.¹⁸⁴

While courts have not gone as far as these scholars suggest,¹⁸⁵ they have, as discussed above, used areas of discretion in the statutory framework to develop some new law in recent years.¹⁸⁶ The Chapter 9 framework allows courts to have the flexibility to develop tools for addressing a new generation of municipal bankruptcy cases. As fiscal crises in overlapping municipalities become more prevalent and make their way into the legal system, judges should consider using their discretion to address common pool problems among debtors. In this section, we highlight a number of ways courts can deal with the problem of overlapping municipalities.

182. See *supra* notes 98–108 and accompanying text.

183. Picker & McConnell, *supra* note 31, at 472–74 (arguing that bankruptcy courts should be able to force debtors to engage in “politically unpopular reforms,” and suggesting that courts “may have more authority than at first appears,” despite substantial legal barriers).

184. Gillette & Skeel, *supra* note 31, at 1150.

185. For instance, in the Stockton, CA bankruptcy eligibility decision, the court found Stockton insolvent even though city politicians did not ask voters to vote on an increase in taxes. *In re City of Stockton*, 493 B.R. 772, 790 (Bankr. E.D. Cal. 2013). Instead, the court accepted testimony that voters would not approve tax increases until the city’s “fiscal house [was] in order.” *Id.* The court did, however, look to see whether the city had “untapped resources that would make a material difference,” and determining that it did not was essential to finding the city was insolvent. *Id.*

186. See *supra* notes 145–150 and accompanying text.

1. “Tax Base Insolvency”

Just as “service delivery insolvency” fleshed out what is meant by “unable to pay its debts as they come due” in the Chapter 9 statute, so too might another concept that we call “tax base insolvency.”

To determine whether a local government can pay its debts as they come due, a bankruptcy court should not look at that government in isolation, but rather should look at the capacity of its tax base to bear further burdens and service cuts. That is, the court should ask whether the tax base on which the government relies is unable to pay its debts—all of its debts. Doing so would require examining not only the finances of the local government that files, but also the finances of all overlapping governments. Asking whether a tax base is too stretched to pay its debts across all of its local governments can be an alternative mechanism for determining whether any one government is insolvent.¹⁸⁷

A court taking this approach would ask the following questions: Will taxpayers be able to meet debt obligations across all overlapping local governments if the government that files under Chapter 9 is determined not to be insolvent and then takes all necessary steps to meet its debt obligations?¹⁸⁸ Will future actions taken by overlapping local governments negatively affect the capacity of the filing government to meet its own obligations?¹⁸⁹ Will services provided by any overlapping local governments fall beneath the minimum level—*i.e.* create “service delivery insolvency”—if the government that files cannot restructure its debts and has to raise revenue that would otherwise be used by other overlapping local governments? Just as debt payments that cause jurisdictions to fall beneath the level of service delivery insolvency should not be required, actions that would make another government insolvent should not be required either. Further, actions that make service delivery insolvency likely in other jurisdictions should not be required.

187. Importantly, this would not require the court to use its powers in the aggressive way suggested by McConnell and Picker. Instead, the court could—as the court in the *Stockton* case did—examine a city’s existing taxing authority and revenue. *See Stockton*, 493 B.R. at 790. But it would look not only at the filing government, but also at all overlapping local governments. The court should ask if decisions made to make debt payments and balance budgets by other governments will negatively affect the filing government’s capacity to pay its debts as they come due, and whether the filing government’s actions to pay its debts will cause defaults or service delivery insolvency elsewhere.

188. If a municipality in fiscal distress can make debt payments by raising revenue, cutting spending, or selling assets, a court will ordinarily judge it solvent. *Cf. Stockton*, 493 B.R. at 790 (detailing how *Stockton* had no such remedies and was thus insolvent). But if doing so is costly enough, it may generate exit or depress economic activity sufficiently to imperil an overlapping school district or county.

189. Consider Chicago: if Cook County raises sales taxes to meet its debt payments, this will drive some residents to buy goods in Wisconsin or Indiana, depriving the City of Chicago of some revenue. (Anyone who doubts this should consider the effect of Chicago’s strict gun sale laws and ban on firework sales—buyers simply go to Indiana for their guns and fireworks.) As a result, a judge examining the capacity of the City to pay its debts as they come due in a hypothetical bankruptcy case would have to predict the future taxing behavior of the County, particularly if the County will need to raise lots of revenue in the near future.

Parts of such a doctrine already exist *sub rosa*. When economic experts or political figures provide guidance about the capacity of a municipality to pay its debts going forward as part of an insolvency standard, they must make assumptions about the behavior of the state government and overlapping municipalities in order to determine what revenues are or will be available. For instance, Kevyn Orr, the Emergency Manager of Detroit during its bankruptcy, argued that Detroit had “no ability to ameliorate cash losses by raising taxes,” in part because Detroit residents already paid high taxes when taxes to overlapping jurisdictions were taken into account.¹⁹⁰ In analyzing the feasibility of Detroit’s plan to leave bankruptcy, both courts and parties discussed the likelihood of state aid and the quality of state oversight going forward.¹⁹¹ Given the reliance of municipalities on state aid and competition for local resources among overlapping local governments, it would be impossible to do otherwise.

Nevertheless, the focus of such analyses and judicial opinions is on the filing municipality, and not on the tax base as a whole. This is a conceptual mistake. In order to determine the insolvency of a government that has some resources but faces severe structural medium- and longer-term fiscal problems, a court must consider the predicted rates of exit by people and firms as a result of new taxes or service cuts. People and firms do not respond to the actions of one government, but rather to the actions of all governments that tax and provide services to them. And each government will respond to actions taken by other governments, including actions taken in bankruptcy.

Courts should be explicit in requiring the modeling of the behavior of all overlapping local governments and the state. That is, courts and economic experts should examine whether a tax base, and not just the filing local government, cannot pay its debts as they come due.

190. See Declaration of Kevyn D. Orr in Support of City of Detroit, Michigan’s State of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code at 20, *In re City of Detroit, Michigan, Debtor* (Bankr. E.D. Mich. 2013) (No. 13-53846), <http://bit.ly/2ENNKvp> [<https://perma.cc/CY9L-VCMC>].

191. See *In re City of Detroit*, 524 B.R. 147, 224–25, 245 (Bankr. E.D. Mich. 2014) (projecting state revenue sharing numbers for the ten and forty years following the end of bankruptcy, and finding that State’s deal to pay \$195 million in return for pensioners’ release of claims against the State was “a reasonable settlement History will judge the correctness of this finding. It will judge that this finding was correct only if what happened here in Detroit never happens again. The State can sustain that finding in history only by fulfilling its constitutional, legal, and moral obligations to assure that the municipalities in this state adequately fund their pension obligations. If the State fails, history will judge that this Court’s approval of that settlement was a massive mistake.”); Expert Report of Martha E.M. Kopacz Regarding the Feasibility of the City of Detroit Plan of Adjustment at 49–51, *In re City of Detroit, Michigan, Debtor* (Bankr. E.D. Mich. 2014) (No. 13-53846), [https://www.detroitmi.gov/Portals/0/docs/EM/Bankruptcy Information/M. Kopacz Expert Report to Judge Rhodes 071814.pdf](https://www.detroitmi.gov/Portals/0/docs/EM/Bankruptcy%20Information/M.%20Kopacz%20Expert%20Report%20to%20Judge%20Rhodes%20071814.pdf) [<https://perma.cc/4EMD-CJHQ>] (expert opinion basing analysis of feasibility of Detroit’s plan of adjustment in part on assumptions about future state aid); Report of Caroline Sallee, Expert Report and Affidavit at 11, *In re City of Detroit, Michigan, Debtor* (Bankr. E.D. Mich. 2014) (same).

Courts should also ensure that the rejection of a Chapter 9 filing by one local government does not cause another government to have to file under Chapter 9. Doing so will systematically lower the standard for insolvency, as it will remove from localities any responsibility to show that they have the capacity to engage in acts that will help themselves at the expense of other overlapping governments. This is a feature and not a bug.

Evidence from international debt restructuring shows that governments frequently negotiate restructurings that are too small, seeking to reduce conflicts with creditors and to exit restructuring as quickly as possible.¹⁹² This is a result of agency problems between residents and politicians. Ending bankruptcy or restructuring and returning to normalcy is attractive to politicians with short time horizons. But a fast exit from bankruptcy that is not accompanied by a sufficient reduction in debt may not be in the long-term fiscal interest of a jurisdiction. Forcing local governments in bankruptcy to consider the sustainability of debt loads across all overlapping local governments will fight this tendency among insolvent local governments to seek debt restructurings that are too small.

In theory, the existence of overlapping local governments should discourage Chapter 9 filings. One government may seek to save itself on the back of the resources freed up by another government's debt restructuring. If the government that files does not have to raise taxes to pay its debts, other overlapping governments—if they have the legal authority—will be able to raise their taxes and, potentially, save themselves.

Lowering the burden of proving insolvency by using “tax base insolvency” should balance this effect somewhat, making access to Chapter 9 protections easier if there are multiple fiscally distressed overlapping local governments. This should make Chapter 9 filings more likely in exactly the situation when common-pool problems make them less likely.

One caveat is worth mentioning. Using “tax base insolvency” as another mechanism for determining whether a local government is unable to pay its debts as they come due incorporates some of the same problems as “service delivery insolvency.” To start, it directly incorporates the doctrine of service delivery insolvency, as it would ask courts to examine service delivery insolvency across overlapping local governments. Further, it will be difficult for a court to announce a clear rule for proving that a tax base, and not just a government, is prospectively insolvent. All local taxing behavior impacts overlapping local governments, imposing vertical and horizontal tax externalities on overlapping governments. Figuring out the degree to which any revenue-related policy of a filing municipality harms others and attempting to determine the future taxing behaviors of non-parties will be a challenge.

192. Buchheit et al., *supra* note 180, at 13–14. *But see* Juan J. Cruces & Christoph Trebesch, *Sovereign Defaults: The Price of Haircuts*, 85 AM. ECON. J.: MACROECONOMICS 85 (2013) (finding that larger haircuts when sovereigns default on debt lead to higher subsequent bond yields, which spreads and lengthens periods of capital market exclusion).

Nevertheless, it is a challenge worth facing. In situations like Chicago's, no one government has a fiscal situation that is independent of the fiscal position of other local governments. Courts should acknowledge the reality of the interdependence of overlapping local governments.

Puerto Rico's current debt restructuring process offers a real-world test of what a system built around the concept of tax-base insolvency might look like in the context of overlapping jurisdictions. On June 30, 2016, Congress passed the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"), in an effort to deal with the growing fiscal crisis in the Commonwealth of Puerto Rico, America's largest territory.¹⁹³ The statute was enacted exactly a year after the then-governor of Puerto Rico announced that the territory was not capable of paying its debts, and just days before Puerto Rico was due to default on a major debt payment, which would have plunged the territory into an even deeper fiscal crisis.¹⁹⁴

Like Chicago and other cities, Puerto Rico's obligations are split between several different entities. The \$74 billion of debt obligations are owed by the Commonwealth itself (18 percent); COFINA, a special-purpose public corporation to which the Commonwealth transfers sales tax revenues and which issues bonds backed by those tax revenues (24 percent); the Government Development Bank and municipal-related debt (15 percent); PREPA, the public utility (12 percent); PRASA, the sewer authority (6 percent); the Highway Transit Authority (6 percent); the Public Building Authority (6 percent); and a variety of other instrumentalities (14 percent).¹⁹⁵ On top of those obligations, Puerto Rico also faces \$50 billion in unfunded pension obligations, split across at least three distinct entities.¹⁹⁶

Under PROMESA, unlike under Chapter 9, Puerto Rico's territories face no insolvency requirement to enter the bankruptcy-like process established by the statute, termed "Title III." Instead, Congress established an entity to review local budgets, the Fiscal Oversight and Management Board for Puerto Rico.¹⁹⁷ The Oversight Board may designate any territorial instrumentality as a "covered" instrumentality and certify that it should go into a Title III proceeding, regardless

193. Pub. L. No. 114-187, codified at 48 U.S.C. § 2101 (2016).

194. Mike DeBonis & Steven Mufson, *Puerto Rico Rescue Bill Clears Congress Days Before Debt Cliff*, WASH. POST (June 29, 2016), <http://wapo.st/2BaLk7R> [https://perma.cc/MU3D-7X8E]; Mary Williams Walsh, *The Bonds that Broke Puerto Rico*, N.Y. TIMES (June 30, 2015) <https://www.nytimes.com/2015/07/01/business/dealbook/the-bonds-that-broke-puerto-rico.html> [https://perma.cc/WD2U-9HJA].

195. GOV'T OF PUERTO RICO, CERTIFIED CORRECTED COMMONWEALTH FISCAL PLAN 27 (April 18, 2017), http://www.gdb.pr.gov/investors_resources/cofina.html [https://perma.cc/5EWB-ZP5Y] (hereinafter "Certified Corrected Commonwealth Fiscal Plan").

196. Nick Brown, *Puerto Rico Budget to Protect Pension Payments: Governor*, REUTERS (May 31, 2017), <https://www.reuters.com/article/us-puertorico-debt-budget/puerto-rico-budget-to-protect-pension-payments-governor-idUSKBN18R3C8> [https://perma.cc/4AQP-XHAE].

197. 48 U.S.C. § 2121 (2016).

of whether that particular instrumentality is capable of paying its debts.¹⁹⁸ The lack of an insolvency requirement allows the Board to send better-performing instrumentalities into Title III alongside worse-performing ones.

For example, COFINA is a public corporation created by Puerto Rico in 2006 to issue bonds backed by a dedicated portion of sales tax revenue. It was constructed to be better capitalized (and thus issue higher-rated debt) than the Commonwealth as a whole, as its only material liabilities are the bonds it issues.¹⁹⁹ COFINA is essentially a mechanism for securitizing Puerto Rico's sales tax revenue. COFINA's sales tax revenues are projected to exceed its debt service payments over the next decade.²⁰⁰ Nevertheless, the Board certified COFINA to enter Title III, which means that its obligations are also subject to restructuring under PROMESA,²⁰¹ which allows for COFINA's obligations to be addressed together with those of other Puerto Rican government entities.

There is ongoing litigation regarding the extent to which COFINA bondholders have an enforceable security interest in the dedicated sales tax revenue.²⁰² The availability of the dedicated portion of the sales tax claimed by COFINA to Puerto Rico is a critical component of the fiscal plan certified by the Oversight Board. The revenue from the dedicated portion of the sales tax revenue across the ten-year fiscal plan exceeds the total amount the Commonwealth budgeted for debt service²⁰³ prior to Hurricanes Irma and Maria's devastating impact on the island's economy.

Regardless of the ultimate resolution of the COFINA litigation, the incorporation of all of the Commonwealth's relevant creditors into a single proceeding wherein priority claims can be litigated enables a more orderly

198. 48 U.S.C. §§ 2121(d)(1)(A), 2146(a) (2016).

199. See Walsh, *supra* note 194.

200. Compare COMMONWEALTH OF PUERTO RICO, REVISED BASELINE PROJECTIONS 11 (Dec. 20, 2016), <https://centrop.hunter.cuny.edu/events-news/puerto-rico-news/revised-baseline-projections-government-puerto-rico> (Row COFINA Portion of 6% SUT), with Certified Corrected Commonwealth Fiscal Plan, *supra* note 195, at 28 (Row: Total Debt Service: COFINA).

201. Press Release, Financial Oversight and Management Board for Puerto Rico, Oversight Board Certifies COFINA Title III Filing (May 5, 2017), https://drive.google.com/file/d/1QhP_PkamlOXsUga7n331plg28m7xOWGd/view [<https://perma.cc/P46U-2F8S>].

202. Motion of Debtors Pursuant to PROMESA Section 315, *In re the Fiscal Oversight and Mgmt. Bd. for Puerto Rico* (No. 17-BK-3283-LTS), Docket No. 139 (2017) (motion for relief from automatic stay filed by COFINA bondholders seeking immediate certification regarding whether COFINA revenue can be used for general-purpose expenditures if COFINA bondholders are not being paid). While this Article was in the editorial process a settlement was reached in principle that would grant COFINA an ownership interest in over 53 percent of the pledged sale tax revenue, with the residual interest being held free and clear by the Commonwealth of Puerto Rico. See Brian P. Guiney, *Puerto Rico: Commonwealth-COFINA Dispute Nearing Possible Resolution*, PATTERSON BELKNAP BANKR. UPDATE (Nov. 9, 2018), <https://www.pbwt.com/bankruptcy-update-blog/puerto-rico-commonwealth-cofina-dispute-nearing-possible-resolution> [<https://perma.cc/2H5Q-84RK>].

203. Compare Commonwealth of Puerto Rico, Revised Baseline Projections, *supra* note 200, at 11, with Certified Corrected Commonwealth Fiscal Plan, *supra* note 195, at 29 (Row: Cash Flow Available for Debt Service).

process than might occur in a similar context under a strict interpretation of Chapter 9's insolvency requirement. Indeed, this approach is in keeping with the core nature of a bankruptcy proceeding in which all of the debtor's assets are marshaled under the control of a single court and all collection activities are channeled through that court, enabling a fair and orderly distribution among creditors.

2. *Collective "Feasibility"*

Another central area of judicial discretion in Chapter 9 is the power of the court to determine the feasibility of a Chapter 9 plan.²⁰⁴ In making feasibility determinations, courts should also adopt rules to address the problems of fiscally-stressed overlapping local governments.

In order to exit bankruptcy, a local government must file a plan of adjustment that addresses the locality's debt.²⁰⁵ Before it affirms the plan of adjustment, the court must determine that it "is in the best interests of creditors and feasible."²⁰⁶ Importantly for our purposes here, the statute does not clearly define feasibility or specify which factors a court should consider.

Courts interpreting the term "feasible" in this context have looked both at whether the filing local government is likely to be able to make the debt payments suggested in the plan of adjustment, and whether the local government will be able to provide essential municipal services going forward.²⁰⁷ Further, courts have emphasized that the plan must not be a "visionary scheme," but rather must be objectively workable.²⁰⁸ An expert opinion analyzing the feasibility of the plan of adjustment in Detroit summarized the court's standard this way:

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?²⁰⁹

But this leaves open as many questions as it answers, particularly for how many years a government must show that it will be able to make its debt payments and

204. See *supra* notes 176–178 and accompanying text.

205. 11 U.S.C. § 941 (2012).

206. 11 U.S.C. § 943(b)(7) (2012).

207. See *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 35 (Bankr. D. Colo. 1999) (stating that feasibility requires "a practical analysis of whether the debtor can accomplish what the plan proposes and provide governmental services.").

208. *Id.* at 35 (quotation omitted).

209. Kopacz Report, *supra* note 191, at 203.

provide services.²¹⁰ Many jurisdictions have had substantial difficulty providing services even after exiting Chapter 9, suggesting problems with the standard.²¹¹

Less consideration has gone into the feasibility of plans based on the filing government's relationship to other state and local governments.²¹² In Detroit, the court explicitly considered the likelihood that the city would receive expected revenues from the state.²¹³ But it did not ask whether other local governments that provided services to Detroit residents would be in fiscal trouble going forward, or how Detroit's plan of adjustment may affect them. And in fact, Detroit Public Schools remained in a fiscally perilous and service-poor condition after Detroit's bankruptcy, requiring both a state bailout and continued state emergency financial management.²¹⁴ And right after Detroit exited bankruptcy, the State found Wayne County, in which Detroit is located, to be in "financial emergency."²¹⁵

Courts have not yet considered how to address overlapping jurisdictions. However, courts have been creative in how they interpret the term "feasible." For instance, the court in *Detroit* understood the feasibility requirement to require (or at least allow) a substantial amount of money to be spent to improve lives in Detroit, on issues like blight removal and improving transportation.²¹⁶

There are clear reasons to believe that a plan of adjustment that fails to write down debts sufficiently would negatively affect other local governments. After all, if a local government's debts remain too high upon exit from bankruptcy, it will have to skimp on services and raise as much revenue as possible to avoid going into "Chapter 18"—that is, a second Chapter 9 filing.²¹⁷ Raising taxes to exorbitant levels and severely cutting services incentivizes

210. For instance, Martha Kopacz, the feasibility expert in Detroit, judged feasibility over an "indeterminate time period," examining issues with feasibility on a sliding scale based on how far away in time those issues might occur. *Id.* at 17–18.

211. See Laura Napoli Cordes, *Restructuring Municipal Bankruptcy*, 2016 UTAH L. REV. 307, 337–41 (2016) (discussing difficulties that Vallejo, CA, Jefferson County, AL, and Orange County, CA had in providing services even after bankruptcy).

212. One recent law review piece examines the role(s) that states play in Chapter 9 and in feasibility analyses particularly. Juliet Moringiello, *Chapter 9 Plan Confirmation Standards and the Role of State Choices*, 37 CAMPBELL L. REV. 72. Moringiello does not address the considerations below, however.

213. See *supra* note 191.

214. See Jonathan Oosting & Sean D. Lewis, *Snyder Signs \$617M DPS bailout*, DETROIT NEWS (June 21, 2016), <http://detne.ws/28Mwp7Y> [<https://perma.cc/W7EP-7YG6>] (discussing Detroit Schools bailout).

215. Eric D. Lawrence, *Snyder Declares Wayne County Financial Emergency*, DETROIT FREE-PRESS (July 22, 2015), <http://on.freep.com/2mFY6Gg> [<https://perma.cc/QD9S-6MK9>].

216. See *In re City of Detroit*, 524 B.R. 147, 165 (Bankr. E.D. Mich. 2014).

217. See John Knox & Marc Levinson, *Municipal Bankruptcy: Avoiding and Using Chapter 9 in Times of Fiscal Stress* (discussing "Chapter 18"), <https://www.orrick.com/api/content/downloadattachment?id=3eabc58c-a078-4e66-9d80-824c3ab8cf9b> [<https://perma.cc/EGC2-Y339>].

taxpayers to move out of those jurisdictions and imposes vertical tax externalities that would harm other overlapping jurisdictions.²¹⁸

Courts analyzing the feasibility of a plan of adjustment should look to how plans of adjustment will affect public services and debt burdens in all overlapping local governments. That is, plans should be “collectively feasible” for all overlapping local governments. If, say, a plan requires that post-bankruptcy property taxes for a municipality stay sky high, the court should consider rejecting the plan as infeasible if it would reduce revenues for the local school district and thus endanger the municipality’s residents’ capacity to pay off debt or perform contracts made by other local governments. The effect of a plan on the full spectrum of services and debt service paid by residents covered by the plan should be considered, whether those services are provided by the government seeking to exit Chapter 9 or by another.²¹⁹

Analyzing plans for their collective effect would make municipal bankruptcy work better for residents of the government that files. Providing relief from excessive debt for residents with respect to only one set of government obligations does not really address their problems if they continue to receive bad services and face unsustainable debt burdens in other local governments.

One potential complication that arises from considering the collective feasibility of plans is that it would create incentives among overlapping local governments to avoid restructuring for as long as possible. On one hand, this reform would provide a benefit to the entity that went first. It could write down more debt than any overlapping government that filed later, as it would have to save enough to not cause trouble for the greatest number of other entities. This would provide a benefit to filing first. Further, it would provide a hammer to encourage creditors to negotiate outside of bankruptcy, because they would want

218. See *supra* notes 63–65 and accompanying discussion.

219. This broader conception of feasibility may expand the already significant role of the bankruptcy court in making judgment calls—regarding, for example, the minimum required level of service provision or the relative importance of various creditor groups—that are not typically made by a court. To the extent that such an expanded role may raise concerns about the democratic legitimacy of the bankruptcy court’s feasibility determination, that concern is mitigated by the magnitude of the problems raised by the proliferation of government by overlapping districts. As discussed above, *supra* Part I.B, government by overlapping districts challenges voters’ ability to exercise their will through elections. Elections for special purpose districts have lower turnout, less-informed voters, and may be dominated by special interests. See Berry, *supra* note 5, at 64–68 (explaining that special district elections have lower voter turnout and are not representative of general-purpose voters); Schleicher, *supra* note 81, at 457–58 (explaining that party identification is based on national concerns rather than local concerns and that, with limited exceptions, voters generally only know the party identification of candidates in many local elections). Further, it can be questioned whether incumbent officials who allowed a government to fall into insolvency were serving as effective agents of voters’ interests. See generally Clayton P. Gillette, *Dictatorships for Democracy: Takeovers of Financially Failed Cities*, 114 COLUM. L. REV. 1373 (2014) (making this point). Additionally, as explained in Part III.C, *infra*, bankruptcy courts may take cues from the elected officials (or emergency managers appointed by elected officials) in making these judgment calls.

to ensure that the government they lent to did not file first but instead could free-ride on the concessions imposed upon creditors of other local governments in Chapter 9.

On the other hand, providing more complete relief to the first filer among overlapping local governments would reduce pressure on those that do not file. This would make holding out until another government files a more attractive option. That is, it makes holding out and trying to survive without bankruptcy better; but if bankruptcy is inevitable, then it becomes attractive for a jurisdiction to be the first to file.

This tradeoff is unavoidable if only one government at a time files for Chapter 9. This highlights the benefits of forcing multiple overlapping local governments into one proceeding. How that might be accomplished is the focus of the next section.

B. State Legislative Changes to Encourage Coordination Among Insolvent Overlapping Local Governments

Operating through the existing one-municipality-at-a-time Chapter 9 framework—however revised—has substantial limits in the context of overlapping insolvent (or near insolvent) jurisdictions. If only one government files, only that government's debt problems can be addressed. To address the problems of overlapping jurisdictions in fiscal crisis, courts and states should recreate and refashion some of the tools used in corporate bankruptcy to address the problems of multiple-entity firms to the very different context of municipal bankruptcy. Specifically, substantially revised versions of “joint administration” and “deemed substantive consolidation” are necessary for resolving the complex relations between overlapping jurisdictions, their tax bases, and their citizenry. Doing so will require new state legislation or administrative actions.

1. Joint Administration for Overlapping Jurisdictions

As discussed in Section II, the first major tool courts have in dealing with bankruptcies in multiple-entity firms is “joint administration.” Under joint administration, multiple affiliated cases are brought before one judge, with shared hearings and a single docket.²²⁰ This is economical and furthers the capacity of courts to engage in “deemed substantive consolidation,” as will be discussed below. On its own, joint administration does not do very much; separate plans still must be confirmed for each corporate entity, and the rule that one impaired class of debtors must approve a plan applies to each corporate entity and not to the case as a whole.²²¹ But jointly considering related cases forces a single judge to see the relationships between insolvent entities, and the

220. See *supra* Section II.B.2.

221. See 11 U.S.C. § 1129(a)(10) (2012).

ways in which the municipal entities are in fact different agents for the same principle: the voters or tax base.

In the Chapter 9 context, joint administration has not been tried, although there is no obvious statutory reason why it could not be. There is no statutory prohibition on joint administration; at most, the explicit authorization of joint administration in consumer and business bankruptcy cases under Federal Rule of Bankruptcy Procedure 1015 could be read as holding a negative implication of forbidding joint administration in other situations.²²² Yet Rule 1015 is best understood as merely clarifying the possibility of joint administration, rather than precluding a court from otherwise administering its docket in the manner it finds most efficient. Indeed, Rule 1015 says nothing about how joint administration is to proceed; that is left to courts' discretion, which is in keeping with the origins of joint administration in courts' de facto practice.

PROMESA provides an example of what joint administration might look like.²²³ Under that statute, the Financial Control and Oversight Board may send any instrumentality of Puerto Rico into a Title III proceeding, and it can petition the bankruptcy court to jointly administer the various Title III proceedings in Puerto Rico.²²⁴ So far, the Oversight Board has requested and been granted permission to consolidate all of the Title III proceedings filed in Puerto Rico for joint administration before Judge Swain.²²⁵ That joint administration allows Judge Swain to make consistent decisions across cases about issues like timing the certification of questions to state courts, exercising discretion in granting motions for relief from the automatic stay, or timing the appointment and use of mediators across the various disputes.

Chapter 9 cases already do something similar to joint administration. Because cities sometimes have departments that sell their own revenue bonds, courts can spend a lot of time thinking about the relationship between dependent entities and local governments. For instance, in the Detroit bankruptcy, there was a great deal of litigation surrounding the Detroit Water and Sewerage Authority (DWSA).²²⁶ DWSA bondholders were determined to be secured creditors, with

222. See FED. R. BANKR. P. § 1015(b) (2017).

223. See Pub. L. No. 114-187, *codified at* 48 U.S.C. § 2101 (2016).

224. PROMESA defines a “territorial instrumentality” as “any political subdivision, public agency, instrumentality—including any instrumentality that is also a bank—or public corporation of a territory, and this term should be broadly construed to effectuate the purposes of this chapter.” 48 U.S.C. § 2104(19) (2016). The statute also authorizes the Financial Oversight and Management Board to designate any territorial instrumentality as a covered territorial instrumentality. 48 U.S.C. § 2121(d)(1)(A) (2016). The Oversight Board may request joint administration of cases relating to the same territory, which appears to have been granted for each of the separate Title III filings in Puerto Rico. 48 U.S.C. § 2164(g) (2016).

225. Order (A) Pursuant To Promesa Section 304(G) at 1–2, *In re The Financial Oversight and Mgmt. Bd. for Puerto Rico* (No. 17-BK-3283-LTS) (D. P.R. Oct. 10, 2017), <http://bit.ly/2DdAUX0> [<https://perma.cc/P8M8-6BDR>].

226. See *Lyda v. City of Detroit (In re City of Detroit)*, 841 F.3d 684 (6th Cir. 2016) (affirming dismissal of customers' lawsuit that alleged breach of contract and violation of due process for

an interest in the revenues of the department.²²⁷ The court still had to sort out the relationship between the city and DWSA, however. It is this type of work we might imagine joint administration achieving between overlapping jurisdictions.

But outside of PROMESA, with its powerful congressionally-created financial control board, there are substantial problems with using even the limited step of encouraging joint administration for cases in insolvent overlapping local governments in Chapter 9. Because creditors cannot force municipalities into bankruptcy, collective action problems among overlapping municipalities can lead to one or multiple local governments “holding out” by refusing to file on the ground that bankruptcies in overlapping local governments will free up taxing capacity.

But the collective action problem among localities is a product of state law. As discussed above, for a municipality to file for Chapter 9, there must be specific authorization from the state government. States differ in how this authorization is given, if at all. Some states simply allow municipalities to file, while others require case-by-case sign-off from either an administrative agency or the governor, sometimes with substantial conditions.²²⁸ For instance, in Michigan, the governor must approve a municipality’s filing and retains the power to attach conditions to any local effort to file, including the power to appoint a person to act on behalf of the local government throughout the Chapter 9 proceeding.²²⁹

State laws could create conditions on filing that are designed to overcome the collective action problem among overlapping municipalities. A state could authorize a municipality to file on the condition that other overlapping jurisdictions also file and agree to joint administration. No jurisdiction could get the benefit of an overlapping jurisdiction’s filing without filing itself.

Absent substantive consolidation, joint administration can only go so far to resolve the problems of overlapping jurisdictions in Chapter 9. But even without substantive consolidation, joint administration could be an important step if combined with the reforms discussed above—loosening the definition of insolvency when overlapping local governments each face fiscal crises and requiring plans to be feasible for all overlapping local governments. Joint administration would allow courts to see and begin addressing the full set of problems facing a tax base and voters. Overlapping local governments would be

terminating services after non-payment); *In re City of Detroit*, 2014 Bankr. LEXIS 5439 (E.D. Mich. Bank 2016) (holding that City may issue water supply system bonds under Chapter 9).

227. See Mark N. Berman, *What Municipal Bond Investors Can Learn from Detroit*, LAW360 (Nov. 25, 2014), <https://www.law360.com/articles/599587/what-municipal-bond-investors-can-learn-from-detroit> [<https://perma.cc/J395-88CH>] (describing payment in full of water and sewer bondholders due to special revenue pledge.)

228. See M. Heath Frost, *Comment: States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 834–49 (2015) (reviewing different types of authorization given).

229. *Id.* at 843–46.

in the same court, in front of the same judge, and the court would have to consider the effects of plans of adjustment on one another. States should facilitate this with conditional authorizations, and courts should accommodate by approving joint administration.

2. *Substantive Coordination for Plans of Adjustment in Overlapping Jurisdictions and the “Big MAC Combo”*

The biggest tool in the corporate bankruptcy arsenal for dealing with the problems of multiple-entity firms is “deemed substantive consolidation.” Under this court-generated doctrine, related entities are effectively combined during bankruptcy and their creditors treated equally. Once emerging from bankruptcy, the entities become separate again, but during the bankruptcy and for the purposes of a plan of adjustment, all related entities are, in effect, one.

Substantive consolidation as currently used is unlikely to work in the Chapter 9 setting. But state legislatures could fashion strong or weak-form substitutes that would force overlapping jurisdictions in bankruptcy to file plans of adjustment that treat creditors of similar types across jurisdictions similarly. This would facilitate municipal authorities in developing plans that are feasible for all overlapping jurisdictions and that will provide acceptable levels of services for residents.

The reasons why creditors accept substantive consolidation in the corporate context do not exist in the municipal bankruptcy context. The assets and liabilities of overlapping jurisdictions are clearly distinct—no one is really confused about who owns what—so creditors in relatively more solvent jurisdictions will oppose consolidation. Further, there is not much in the way of joint operation of overlapping municipalities, making the need for substantive consolidation as an evidentiary matter less important.

Creditors may thus fight against attempts to substantively consolidate overlapping jurisdictions. The ongoing COFINA litigation in Puerto Rico offers a glimpse into what that type of litigation might look like. Under PROMESA, the Oversight Board is empowered not only to send any territorial instrumentality into its own Title III proceeding with joint administration, but it can also choose to include any territorial instrumentality into the fiscal plan for the Commonwealth. This is akin to substantive consolidation in that the bankruptcy court would approve a single plan of adjustment covering multiple entities.²³⁰ In Puerto Rico, the Oversight Board chose to include COFINA within the fiscal plan for the Commonwealth, and, in drafting the fiscal plan, allocated the COFINA revenues into the general revenue stream, rather than specially separating those revenues out for payment of COFINA obligations.²³¹ The COFINA bondholders, objecting to that treatment, filed a motion for relief from

230. See Section 101(d)(1)(D) of PROMESA.

231. See Certified Corrected Commonwealth Fiscal Plan, *supra* note 200, at 11.

the automatic stay and requested that the bankruptcy court certify to the Supreme Court of Puerto Rico the issue of whether they have an enforceable security interest in COFINA revenue. That request explained that the fiscal plan's inclusion of COFINA revenues into the general revenue pool creates the urgent need for a rapid resolution of that question.²³² The COFINA bondholders and the Commonwealth have, as of the time this Article was in the editorial process, reached a settlement agreement in principle to split the difference, with the COFINA bondholders to receive over 53 percent of the future sales tax revenues and the remainder going to the Commonwealth.²³³ The practical effect of the settlement is not unlike substantive consolidation in that the COFINA bondholders' recovery will be diminished and more assets will be made available for other creditors.

In the Chapter 9 context, while creditors might fight against substantive consolidation, the flexible and equitable nature of that doctrine indicates that they might not always succeed. Creditors are far weaker in Chapter 9 than in Chapter 11. If states wanted to, they could force overlapping jurisdictions in bankruptcy to file plans of adjustment that treat creditors of similar types across jurisdictions similarly, within some limits. And they could do so over the objections of creditors.

What would result would not quite be consolidation but would share some traits with that doctrine. Call it substantive coordination. Here are two possibilities, one more straightforward, and the other more radical, for achieving this end.

a. Legislatively Mandated Coordination in Developing Plans of Adjustment

The relative weakness of creditors, and the role of states in Chapter 9, gives space for state legislative efforts to force cities in overlapping jurisdictions to file coordinated plans of adjustment.

As discussed above, creditors have no power to propose alternative plans in Chapter 9; the debtor has unlimited plan exclusivity, unlike in Chapter 11. Further, the "best interests" test for confirming a plan does not compare how creditors fare in the plan to how they would fare in liquidation, because liquidation is impossible. Instead, it compares how creditors as a whole fare in the plan to how they would fare without any plan at all, a low bar given the weak availability of state law claims against defaulting municipalities.²³⁴

232. See Application and Order for Admission *Pro Hac Vice* at 1–3, *In re* the Fiscal Oversight and Management Board for Puerto Rico, No. 17-BK-3283-LTS (D.P.R. May 15, 2017).

233. See Guiney, *supra* note 202.

234. See *In re* City of Detroit, 524 B.R. 147, 213 (Bankr. E.D. Mich. 2014) (explaining that the "best interests" test, which the court adopts, requires a proposed plan to provide a better alternative for creditors than what they already have).

As a result, creditors do not have much capacity to limit the scope of plans of adjustment. There are constraints: plans of adjustment must be designed to achieve the purposes of bankruptcy; must not “discriminate unfairly, and [be] fair and equitable” in their treatment of creditors; and must be “feasible” going forward.

But even these requirements have not been applied in the same strict way as they are applied in Chapter 11, despite scholarly commentary that they should.²³⁵ Instead, courts have engaged in somewhat free-form equitable balancing, explicitly allowing municipalities to consider all sorts of policy considerations in devising plans of adjustment.

Consider the relative treatment of pensioners and bondholders in municipal bankruptcy. Plans of adjustment in Chapter 11 that seek to cram down some debtors must not engage in unfair discrimination, which means “the plan should not be able to treat one class of creditors substantially better than a similar class of dissenting creditors, unless that treatment comports with pre-bankruptcy expectations or reflects a new value contribution.”²³⁶

This works very differently in Chapter 9, at least. Courts have found that, absent the explicit creation of a statutory lien, neither general obligation bondholders nor pensioners are secured creditors.²³⁷ Chapter 9 contains no explicit priority rules, so if courts applied the Chapter 11 test, these two classes should be treated equally unless doing so would violate pre-bankruptcy expectations or new value contributions. But plans of adjustment have not treated these classes of unsecured creditors equally for policy reasons.

In the *Detroit* Chapter 9 plan of adjustment, pensioners recovered at a higher rate, by most measures, than most classes of unsecured creditors.²³⁸ In upholding the plan, the court noted that fairness and unfairness are matters of conscience and that “determining fairness is a matter of relying upon the judgment of conscience.”²³⁹ It went on to state that paying pensioners a higher return was acceptable for two reasons.

First, doing so would help the city fulfill its “mission . . . to provide municipal services to its residents and visitors to promote their health, welfare and safety,” because “employees and retirees are and were the backbone of the

235. See, e.g., Andrew B. Dawson, *Pensioners, Bondholders, and Unfair Discrimination in Municipal Bankruptcy*, 17 U. PA. J. BUS. L. 1, 38 (2014) (stating that “there is no support for creating a special Chapter 9 unfair discrimination rule”).

236. *Id.* at 36.

237. See Randle B. Pollard, *Feeling Insecure—A State View of Whether Investors in Municipal General Obligation Bonds Have a Mere Promise to Pay or a Binding Obligation*, 24 WIDENER L.J. 19, 32–35 (2015) (discussing cases).

238. See *In re City of Detroit*, 524 B.R. at 257 (explaining why the higher recovery to pensioners is not unfair). The court also allowed “Unlimited Taxation General Obligation Bonds” (and several other classes) to recover at a higher rate than most other unsecured creditors, including “limited taxation general obligation bonds,” which “reflect[s] the strengths and weakness of the creditors’ claims and the City’s defenses, the complexity and expense of possible litigation, and collectability issues.” *Id.* at 258.

239. *Id.* at 256.

structures by which the City fulfills its mission.” It would also “preserv[e] its relationships with its employees, in enhancing their motivation, and in attracting skilled new employees, consistent with its financial resources.”²⁴⁰

Second, Detroit was an “an agency of the State of Michigan,” which has a constitutional provision protecting public pensions.²⁴¹ This constitutional clause stopped the court from finding the city eligible for bankruptcy and from writing down some pension debt. But the clause remained the “considered judgment of the people of the State of Michigan” and was thus “entitled to substantial consideration and deference.”²⁴²

Detroit’s plan did not create formal priority rights or ensure that pensioners get paid in full before others get paid at all. Instead, the court simply accepted the decision of the city to favor pensioners to some degree over other unsecured creditors because it seemed sufficiently fair and a good enough idea not to constitute “unfair discrimination” against other classes of creditors of the same priority.

While the *Detroit* opinion has come under substantial criticism for its open consideration of these factors in justifying unequal treatment among classes of equal priority,²⁴³ other courts have largely followed suit. In *Stockton*, the court accepted a plan of adjustment that did not impair pensions at all because the plan reduced the pay and number of city workers (implicitly limiting future pensions) and because new workers would have less generous pensions.²⁴⁴ The *Stockton* court effectively understood the unfairness in terms of the interests of public employees as whole—rather than in terms of the interests of existing pensioners—presumably because it furthered the interests of the city in finding workers and providing public services.

The likely explanation for courts’ acceptance of these plans is an underlying deference to state policy. While Chapter 9 does not require federal bankruptcy courts to accept formal claims of priority created by state law, it does allow cities (or state governments) to govern during the course of bankruptcy. Thus, Juliet Moringiello has argued that there is a broad respect for the role of the state in supervising a city during bankruptcy.²⁴⁵

240. *Id.* at 257. In theory, this could be understood as “reflecting a new value contribution,” namely workers agreeing not to strike or work harder in return for a higher return. See Dawson, *supra* note 235, at 38. But the court did not explain itself in these terms, nor was the amount of new value contribution weighed against the greater recovery. Further, it is not clear that helping retirees is a particularly effective way to encourage current workers to exert greater effort (compared to just giving them more money).

241. *In re City of Detroit*, 524 B.R. at 257.

242. *Id.* The Court also noted that pensioners’ expectations of recovery were higher due to the constitutional protection, an echo of the Chapter 11 unfair discrimination test.

243. See Dawson, *supra* note 235, at 36–39 (arguing that the unfair discrimination rule in municipal bankruptcy law should mean the same as it does in Chapter 11, namely that the plan should not treat one class of creditors substantially better).

244. See *In re City of Stockton, California*, 542 B.R. 261, 283 (B.A.P. 9th Cir. 2015).

245. See Moringiello, *supra* note 212, at 75.

Chapter 9 leaves debtor governance to the states . . . Perhaps the omission of priorities from Chapter 9 means that a bankruptcy court should defer to a state's choice in prioritizing creditors if the state makes that choice in connection with the bankruptcy case after considering the rehabilitation needs of the municipality.²⁴⁶

After all, Moringiello notes, state governments have incentives to care about the treatment of bondholders because they want to ensure that other jurisdictions in the state continue to be able to receive credit. Thus, states have the power to make determinations about who should benefit or lose in plans of adjustment, even if they cannot create formal priority rules.

As a result, Chapter 9 gives cities or states a great deal of leeway to propose plans that discriminate between classes of creditors of equal priority based on policy and the commitments of state law. Deference will likely be particularly strong when state governments are directly involved, as in Detroit, when the state of Michigan had appointed an emergency manager to govern the city directly.

State governments can and should take advantage of this deference to shape the behavior of overlapping jurisdictions in municipal bankruptcy. When a state gives a municipality authority to file, it can attach substantive conditions. Through legislation surrounding authorization, the state can order municipal officials to coordinate their activities during bankruptcy.

If overlapping jurisdictions file under Chapter 9, the legislation should order municipal authorities (or emergency managers) in these jurisdictions to coordinate their plans of adjustment with experts from the state government. These committees of municipalities may be purely advisory, or the state could require collective sign-off (or state governmental sign-off) before presenting a plan to the court.²⁴⁷ If local officials have been replaced by state-appointed emergency managers, coordination will be relatively straight-forward. The state would simply be ordering state officials to work together towards a common project. Even where local officials are allowed to remain in place, the state gives overlapping jurisdictions a formal say in a local government's plan of adjustment in order to limit intra-jurisdictional externalities. Further, municipal officials could use these negotiations to coordinate their plans of adjustment and to try to develop economies of scale through cooperation.²⁴⁸

246. *Id.* at 102.

247. Such a committee should not be able to force any individual city to present a plan of adjustment. That type of rule might lead to a majority of municipalities asking an official of one municipality to do something that is not in that municipality's best interest or inconsistent with its legal obligations in court. However, some voting rule should be created to allow officials of overlapping local governments to stop any city from presenting a plan of adjustment that harms the other jurisdictions.

248. That is, presuming they want to stay independent. The Civic Federation of Chicago has called the consideration of a plan for Chicago Public Schools to be dissolved and merged with the City of Chicago if it remains in fiscal distress, as doing so would give it access to the City's broader taxing powers. *See* CIVIC FED'N, CHICAGO PUBLIC SCHOOLS FY2018 PROPOSED BUDGET: ANALYSIS AND RECOMMENDATION 5, 22–23 (2017), <http://bit.ly/2DGuH6K> [<https://perma.cc/R8NY-8S95>]. Such coordinated plans of adjustment would provide a mechanism for doing so.

Beyond process, actual coordination in terms of plans of adjustment should be encouraged. Municipal authorities should seek to develop plans that are feasible for all overlapping jurisdictions, and that will provide acceptable levels of services for residents. Statutory language should discourage plans that increase costs for other jurisdictions in fiscal distress. Further, to the extent allowed by law, municipal officials in overlapping jurisdictions should attempt to come to common understandings with similar types of creditors, acknowledging that overlapping governments are simply agents of the same principal: the local tax base and electorate. This would not mean that all creditors across all local governments should be treated the same—the sources of revenue each government has at its disposal should be considered, as should their relative economic position. But, plans of adjustment should recognize that treating creditors of different, overlapping local governments separately would allow local residents to create what amount to unjustifiable priority rules among creditors.

States could also follow the approach set by PROMESA and appoint a single emergency manager across entities, so that the single emergency manager could make decisions and propose plans of adjustment with an eye toward the collective, rather than individual, goals of the instrumentalities. The Oversight Board in PROMESA is effectively a single emergency manager across all of the territorial instrumentalities it seeks to exercise jurisdiction over; as such, it can avoid decisions that would be individually optimal for a single instrumentality but collectively suboptimal. For example, in 2015, before the Oversight Board was appointed, PREPA, the public utility, negotiated a consensual deal with its creditors wherein PREPA creditors would take a 15 percent haircut in exchange for higher-rated bonds financed by an increase in electricity rates.²⁴⁹ In June 2017, however, the Oversight Board rejected the consensual deal that PREPA had reached with its creditors and sent PREPA into Title III.²⁵⁰ The Board rejected the deal because it reasoned that the rate increases called for by the deal would harm the overall economic outlook for Puerto Rico—a territory with higher electricity costs than the rest of the nation, and for which rate increases might meaningfully suppress economic activity.²⁵¹ The Board was specifically concerned about a provision in the deal that would allow a surcharge to grow to the level needed to guarantee repayment of the debt, without regard to the

249. Nick Brown, *Puerto Rico Utility PREPA, Creditors Working on New Debt Deal*, REUTERS (Mar. 29, 2017), <https://www.reuters.com/article/puertorico-debt-prepa/puerto-rico-utility-prepa-creditors-working-on-new-debt-deal-idUSL2N1H621Z> [<https://perma.cc/FX8R-ZSW5>]; Nick Brown, *Puerto Rico's PREPA, Bondholders Agree to New Debt Deal*, REUTERS (Apr. 6, 2017), <https://www.reuters.com/article/us-puertorico-debt-prepa/puerto-ricos-prepa-bondholders-agree-to-new-debt-deal-idUSKBN1782CD> [<https://perma.cc/ST2T-W9SZ>].

250. Cara Salvatore, *Puerto Rico Board Rejects Utility Debt Restructuring Deal*, LAW360 (June 28, 2017), <http://bit.ly/2DfyxCK> [<https://perma.cc/8PUY-8EEM>].

251. See Andrew G. Biggs et al., *Privatize Puerto Rico's Power*, WALL ST. J. (June 29, 2017), <http://bit.ly/2BayBSC> [<https://perma.cc/NZU7-ALTS>].

surcharge on the overall economy.²⁵² The sustainability of the governance of Puerto Rico writ large was taken into account, and not simply PREPA's sustainability. A single emergency manager appointed by the state across jurisdictions could play a similar role in ensuring a coordinated approach to adjusting debts in the framework of jointly administered Chapter 9 cases.

Localities should be ordered to coordinate, but not to consolidate. Overlapping jurisdictions often do not represent identical tax bases and electorates—counties are bigger than cities, school districts straddle across multiple jurisdictional lines. Thus, combining their debts would involve shifting obligations to groups of people who were not involved in incurring them. Further, voters cannot fully decide which government should receive tax revenues, as state laws limit which government can tax what and at what levels, which creditors understand when making lending decisions. As a result, it would not make sense to fully consolidate them for the purpose of bankruptcy.

That said, the range of policy considerations that municipal officials should consider when figuring out what rates of recovery to offer to debtors should be broader when multiple jurisdictions are in fiscal distress. Cities should be forced to consider the interests of overlapping jurisdictions. Doing so would further the purposes of Chapter 9, better protect the welfare of residents, and provide fairer treatment for creditors across jurisdictions.

However, coordination among cities in Chapter 9 will not help address the problem of overlapping jurisdictions that are not yet in bankruptcy. The next section addresses this problem.

b. The “Big MAC Combo” Solution for Fiscal Crises in Overlapping Jurisdictions

When New York City's fiscal crisis hit, one of the first steps New York State took was to create a special borrowing entity, the Municipal Assistance Corporation (known as the “Big MAC”).²⁵³ The structure borrowed the approach Richard Ravitch used when the New York State Urban Development Corporation (UDC) ran aground a few years earlier.²⁵⁴

252. *See id.*

253. *See* RICHARD RAVITCH, SO MUCH TO DO: A FULL LIFE OF BUSINESS, POLITICS, AND CONFRONTING FISCAL CRISES 85–100 (2014); ANNUAL REPORT OF THE MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY OF NEW YORK 34 (1976), https://www.baruch.cuny.edu/library/alumni/online_exhibits/amfl/mac/pdf_files/Ann_Reports/1976.pdf [<https://perma.cc/B9CT-Q6DG>] [hereinafter MAC REPORT]; Jeff Nussbaum, *The Night New York Saved Itself from Bankruptcy*, NEW YORKER (Oct. 16, 2015), <http://bit.ly/2EQ0PEn> [<https://perma.cc/PA9M-F5L5>] (“Governor Hugh Carey was willing to advance state funds to allow the city to pay its bills under the condition that the city turn over its financial management to the state. This led to the creation of the Municipal Assistance Corporation, which was authorized to sell bonds to meet the city's borrowing needs. (Its detractors referred to it as “BIG MAC,” because of its authority to overrule city spending decisions.)”).

254. *See* RAVITCH, *supra* note 253, at 46–84 (discussing the UDC and its relationship to the fiscal crisis).

The basic structure involves the creation of a new entity that receives some of the revenue and assumes some of the responsibilities of the heavily indebted government. In the case of the UDC, federal subsidies for building affordable housing that were supposed to go to the UDC were instead transferred to a new agency that then funded UDC projects.²⁵⁵ The new agency can issue debt, backed by the revenue stream, while the indebted government loses access to the revenues.²⁵⁶ Although the existing government loses access to some revenues, the new entity bears some of the costs of governing. The structure is designed to overcome a liquidity crisis. Investors, who had been unwilling to lend, receive security that they will be paid back ahead of prior investors because they are lending to a legally distinct entity.

When lenders refused to refinance New York City's short-term debt in 1975, New York State stepped in and created Big MAC.²⁵⁷ Big MAC received first claim on city sales and stock transfer taxes, as well as all per capita state aid (and implicit state backing).²⁵⁸ Big MAC then provided interim financing for the city.²⁵⁹ Later, the state enacted a moratorium on claims for payment on short-term city debt and gave bondholders the option to roll their bonds over into long-term MAC debt, but the Court of Appeals of New York held that this violated the state constitution.²⁶⁰

The idea behind Big MAC was that it could bridge the city's short-term funding gap by giving new bondholders (many of them city unions) confidence that they would be protected in the case of a default.²⁶¹ And Big MAC would keep the city running. Combined with other tools—federal and state loans, and a state-dominated Emergency Financial Control Board that was given substantial control over city spending—Big MAC helped New York City stay out of bankruptcy.²⁶²

Recently, similar plans have been implemented *without* a higher level of government creating a separate agency, and they have been used to reduce borrowing costs, rather than to address short-term liquidity crises. In Puerto Rico, as discussed above, the Commonwealth sold "COFINA" debt backed by a putative security interest in a bank account into which the Commonwealth is required to deposit part of its sales tax revenue. This revenue would otherwise

255. *Id.* at 50 (discussing the structure of the UDC); MAC REPORT, *supra* note 253, at 11 (describing the structure of the MAC); Donna E. Shalala & Carol Bellamy, *A State Saves a City: The New York Case*, 1976 DUKE L.J. 1119, 1127–31 (1976) (same).

256. *See* MAC REPORT, *supra* note 253, at 11–19; Shalala, *supra* note 253, at 1127–28.

257. *See* MAC REPORT, *supra* note 253, at 11–15.

258. *See id.*

259. *See id.*

260. *See Flushing Nat'l Bank v. Muni. Assistance Corp.*, 40 N.Y. 2d 731, 731–35 (1976).

261. Union officials were persuaded to support MAC bonds as a way of keeping the city afloat. *See* RAVITCH, *supra* note 253, at 70.

262. *See* Shalala, *supra* note 255, at 1128–29; MAC REPORT, *supra* note 253, at 19, 32 (describing the Emergency Financial Control Board and loans from the federal government).

have been used to pay back other obligations of the government.²⁶³ General obligation bondholders have challenged this, arguing that the Commonwealth's constitution requires general obligation bonds to be paid before any other debt.²⁶⁴

Illinois recently gave cities the power to set up bankruptcy-remote, special purpose issuance entities and to transfer the cities' tax revenues to those entities.²⁶⁵ The special purpose issuance entities would then issue bonds backed by those tax revenues, which is basically a securitization of the tax revenues. The proceeds of the bond issuance are then given to the city. The idea is that the special purpose entity has a better risk profile than the city, resulting in lower financing costs. Chicago has issued these bonds (jokingly called "Chifinas") that will carry a lower interest rate because they provide buyers with a secured interest in the case of bankruptcy.²⁶⁶ Credit rating agency Fitch recently gave the bond "AAA" rating, and Standard & Poor's gave it an "AA" rating.²⁶⁷ Chicago will use the proceeds to pay off existing debt, reducing the city's interest expenses.²⁶⁸

While these types of bonds theoretically protect investors in case of bankruptcy, it is unclear how courts would treat them.²⁶⁹

That said, state governments could consider creating an even bigger version of the Big MAC structure for situations involving fiscal distress in multiple overlapping local governments. The goal would be very different, though, than that in a plain Big MAC structure. Rather than using the structure to bridge a liquidity crisis, this new version, which we term a "Big MAC Combo," would be designed to stop localities from inefficient strategic interactions, and in extremis to *create* such a crisis across all nearly-insolvent jurisdictions in a metropolitan area while still maintaining essential services.

Faced with overlapping fiscal crises, the state could reassign the power to tax certain things from a variety of governments to a new purpose-built agency that would provide the governments with funding for essential government services. Debt issued by this new cross-local jurisdictional structure—the Big

263. See Mary Williams Walsh, *Puerto Rico's Second Cut to Junk Debt*, N.Y. TIMES (Feb. 7, 2014), <http://nyti.ms/2DeHuME> [<https://perma.cc/DH34-J8YC>]; *Puerto Rico Sales Tax Refinancing Corporation (COFINA)*, GOV'T OF PUERTO RICO (Dec. 26, 2017), <http://bit.ly/2EPI4kr> [<https://perma.cc/5EWB-ZP5Y>].

264. See generally Nick Brown, *Puerto Rico's Biggest Creditors Envision Resolving Key Dispute This Year*, REUTERS (Aug. 9, 2017), <http://reut.rs/2FLIQ4v> [<https://perma.cc/SR4Q-EZXR>] (describing the conflict).

265. See Karen Pierog, *New Chicago Debt Structure Wins Initial Approval*, REUTERS (Oct. 5, 2017), <http://reut.rs/2DJTBCo> [<https://perma.cc/76GY-XY3P>].

266. See Spielman, *supra* note 13; Martin Z. Braun, *Bondholders Fret Over Alchemy that Turns Chicago's Junk to Gold*, BLOOMBERG (Nov. 10, 2017), <https://bloom.bg/2B9Hmwg> [<https://perma.cc/Y2MH-Y3U9>].

267. See Braun, *supra* note 266.

268. See Spielman, *supra* note 13.

269. For instance, the question of whether making payments on the COFINAs illegally removes a source of revenue that had been pledged to general obligation bondholders will turn on the peculiarities of the Puerto Rican constitution.

MAC Combo—would presumably be rated well, because it would have the first claim on a number of revenue sources. Although the existing creditors of the underlying local governments may be harmed by the diversion of revenue sources to the Big MAC Combo, the new entity will, in theory, borrow at cheaper rates and be able to use the money to fund local services, leaving the underlying municipalities no worse off.

But states are not bound by their municipalities' promises, and cities cannot limit the power of state government to assign taxing power to different or new local governments. In some states, the state legislature's ability to reassign taxing and other powers may be constrained by state constitutions.²⁷⁰ But the general American rule is that states can create, modify, and destroy local governments, so such a structure would presumptively be legal.

The creation of a Big MAC Combo structure would allow the state to ensure the provision of a set of essential services even while local governments face fiscal crises. It would also allow the state legislature to police two types of abuses of the bankruptcy process by insolvent overlapping local governments.

The first abuse is strategic assignment of revenues in advance of bankruptcy. If, say, it becomes clear that both the City and Chicago Public Schools cannot stay solvent, city officials have an incentive to do whatever they can to plow revenues into one and not the other, keeping one local government out of bankruptcy while making the other worse off. This does not make much sense as a policy matter—spreading the harm across more debtors would be better—but may be in the myopic interests of city officials.

Shifting revenues across local governments might also allow local officials to pick winners and losers among similar classes of debtors for political reasons (*e.g.*, teacher pensions versus police pensions). Keeping revenues in the City or even reducing any transfers from the City to the School District would not be a fraudulent transfer; tax revenues are not assets. But it would be problematic nonetheless. The Big MAC Combo structure would remove the capacity to do this from local officials and voters by stripping the local government of revenues to shift. Instead, the Big MAC Combo would directly fund local services.

Second, the Big MAC Combo could also police deviations from cooperative solutions between municipalities. As discussed above, officials in overlapping local governments have incentives to avoid bankruptcy for as long as possible, hoping that other governments will go first and therefore free up access to revenues. A Big MAC Combo could be designed to make all relevant local governments eligible to file for bankruptcy, while also ensuring that essential local services are provided.

Further, and most importantly, the Big MAC Combo would achieve the ends of coordination across local government. Through the Big Mac Combo, the

270. See BAKER, *supra* note 16, at 256–364 (discussing the variety of types of limitations on the ability of state governments to reorganize local governments under state constitutions).

state would step in and take control not only over the operations of local government, but also of their capacity to pay their existing debt. That is, a Big Mac Combo could be designed to force all nearly-insolvent local governments to become entirely insolvent, and thus to all file for bankruptcy.²⁷¹ States would

271. This raises big questions about whether a state law that intentionally plunged a municipality into bankruptcy would violate the Contracts Clause or whether the transfer of tax revenues to a new entity would be treated as a fraudulent transfer. We do not think the answer to either of these questions is yes, but they are open questions.

Most Contracts Clause cases involving public contracts are challenges to laws passed by the government that entered into the contract or that offered “statutory covenants” which were then incorporated into public contracts. *See U.S. Trust Co. v. New Jersey*, 431 U.S. 1 (1977) (finding that a statutory covenant entered into and then renounced by the New Jersey state legislature violated the Contract Clause). The Supreme Court makes a sharp distinction between state laws that affect contracts generally, and those that affect contracts the state itself enters into, with the former subject to much less scrutiny. *See id.* at 22 (comparing the Big MAC Combo would not change any contract that the state government entered into. A city’s contract can hardly be said to impair the ability of the state to transfer revenues; otherwise all municipal bonds would contain clauses that protected all of the extant powers, and state governments could never preempt local actions.); *Hudson Water Co. v. McCarter*, 209 U.S. 349, 357 (1908) (“One whose rights, such as they are, are subject to state restriction, cannot remove them from the power of the State by making a contract about them.”). And there is a quite clear “legitimate public purpose” for transferring resources to the new entity: ensuring the continued provision of those public services that matter to the region and state as a whole. *Cf. U.S. Trust*, 431 U.S. at 22 (describing required justification for regulations of private contracts).

The complication, though, is that the state law would be designed at least in part to open the door for local governments to file for bankruptcy. Actions by states to create new municipalities explicitly to avoid debt have been frustrated in the past. When Alabama dissolved the city of Mobile, replacing it with a new municipal corporation of almost identical proportion and powers, the Supreme Court found that the new government was liable for the debt of the old one. *Port of Mobile v. Watson*, 116 U.S. 289, 290–91 (1886). However, the basis for this decision is less than clear; the Court never explained the legal basis for its decision and does not cite the Contract Clause—thus its current validity as precedent is dubious. Further, a well-designed Big MAC Combo would only remove some revenue raising capacity from each local government and would not be a “successor” in any meaningful sense.

Still, these are uncharted waters. The state would have a pretty strong argument, particularly to the extent the new entity was designed largely to ensure the continued provision of services important to the state as a whole.

Fraudulent transfer arguments would not help the city’s creditors in this context, either. Since Elizabethan times, fraudulent transfer statutes have enabled creditors to unwind the transfers of assets or the incurrence of obligations that are either made with actual intent to hinder, delay, or defraud creditors or made by insolvent debtors for less than reasonably equivalent value. 13 Eliz. 1, c 5. Conceptually, the fraudulent transfer doctrine would seem to prevent states from stripping municipalities of valuable taxation rights.

But fraudulent transfer law has only ever existed as a matter of statute, and statutory language therefore controls the scope of fraudulent transfer law. Fraudulent transfer law is currently codified in two primary places: the federal Bankruptcy Code and state law. The statutory provisions, as they currently exist, are unlikely to apply to the transfer of taxation rights from a municipality. Specifically, the Bankruptcy Code’s fraudulent transfer provision requires a transfer “of an interest of the debtor in property” or the incurrence of an obligation by the debtor. 11 U.S.C. § 548(a)(1).

State fraudulent transfer statutes, which are generally based on the Uniform Fraudulent Transfer Act (UFTA), may be invoked by a debtor-in-possession. *See* 11 U.S.C. § 544(b)(1). State fraudulent transfer statutes too require a “transfer.” Under the UFTA, “transfer” is defined as “disposing or parting with an asset or an interest in an asset,” which is in turn defined as “property of the debtor.” UFTA §§ 4, 5. Because fraudulent transfer law is keyed to concepts of “assets” or “interest . . . in property,” it does not cover transfers of valuable non-property interests, such as a right to levy a tax. *See* UFTA § 1(16). To be sure, a right to tax could be conceived of as a type of license, but licenses are not

be hesitant to use such a huge cudgel, as it would harm the state's reputation in credit markets and increase borrowing costs in other jurisdictions. But desperate times often call for desperate measures; this is the type of break-glass-in-case-of-emergency tool that states might consider if there is a real insolvency crisis across governments in a major metropolitan area.

By adjusting the services provided and the revenue sources assigned to the new entity, the state could spread out the costs of local insolvency across the full set of creditors and services. The state could provide money or loan guarantees to the Big MAC Combo knowing that it would not simply be paying debtors or financing inter-local conflict, but instead directly providing services. The state could use the Big MAC Combo to facilitate the creation of a new larger government after bankruptcy, but it need not.

The original Big MAC structure and its successors provided solutions to several problems: short-term liquidity problems and a lack of resources available to fund essential services during a crisis. Arguably, it has been abused in recent years, as a way to cover up declining finances rather than to mitigate a short-term crisis. But a Big MAC Combo could allow the same tool to serve a new purpose: policing strategic conflicts among overlapping jurisdictions that delay needed restructuring and that inappropriately favor certain creditors.

CONCLUSION

Several major metropolitan areas in the United States face the prospect of simultaneous fiscal crises for overlapping local governments as part of the broader problem of underfunded pension and retiree benefits. The existing legal mechanisms for dealing with local governments' financial distresses lack the tools to coordinate separate governmental entities' debt restructurings, yet such coordination is essential because of the shared revenue base of overlapping municipalities. This Article identifies this pending problem and proposes a number of concrete solutions that would facilitate coordination among financially distressed local governments.

consistently treated as property in bankruptcy. *See, e.g., In re David Burgess*, 234 B.R. 793 (D. Nev. 1999). Licenses that are not transferred as a matter of common practice, such as medical licenses or law licenses, are generally not treated as property for bankruptcy purposes, while licenses that are commonly transferred, such as FAA gate licenses or cab medallions, are treated as property for bankruptcy purposes. A right to tax would seem to clearly fall in the former category—it is not in the least bit alienable by a municipality.

What this means is that current fraudulent transfer law is not up to the task of preventing states from stripping away taxation rights.