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## Do Investors Care about Municipal Debtors' Access to Bankruptcy? Evidence from Bond Disclosures

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# DO INVESTORS CARE ABOUT MUNICIPAL DEBTORS' ACCESS TO BANKRUPTCY? EVIDENCE FROM BOND DISCLOSURES

Mitu Gulati & Richard C. Schragger\*

*A key question in the academic and policy debates over the optimal architecture for sovereign debt has long been whether sovereigns should be given access to bankruptcy or its contractual equivalent. One side of the debate cries moral hazard, saying that the cost of government borrowing will rise if governments have the option to access bankruptcy. Proponents of the other side see bankruptcy as a means to solve a coordination problem and reduce the cost of government borrowing. Using data on disclosures made by issuers of municipal bonds in the United States, this Article attempts to measure the extent to which investors care about access to bankruptcy as an indicator of the level of risk they face in lending. These findings suggest that investors care a lot less than academics and policy makers do.*

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### INTRODUCTION

A central puzzle in the economics of sovereign debt is why investors lend to governments.<sup>1</sup> Governments, after all, cannot be compelled by state force if they refuse to pay their debts. Assuming that there will be circumstances when politicians would rather not pay creditors — such as when voters are unwilling to pay the high taxes needed to repay — it becomes a problem that there is no way to force the government to pay.

One answer to the puzzle is that governments seeking to borrow do find ways to credibly commit to investors that they will not, or at least are less likely to, expropriate from creditors.<sup>2</sup> Over the years, researchers have identified a variety of commitment devices ranging from constitutional promises to independent central banks.<sup>3</sup> The focus of this Article is on one of these commitment devices: the (self-) denial of access to a bankruptcy-type mechanism,<sup>4</sup> which we examine in the context of U.S. sub-sovereign (municipal) debt.

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1. In the sovereign debt literature, this puzzle is often articulated as: “[W]hy do sovereigns ever repay debts?” See LEE C. BUCHHEIT ET AL., *Pathologies in Sovereign Debt*, in REVISITING SOVEREIGN BANKRUPTCY 5 (2013).

2. See Mitu Gulati et al., *When Governments Promise to Prioritize Public Debt: Do Markets Care?*, 6 J. FIN. REGUL. 41, 46 (2019) (describing the theory of credible commitment).

3. See *id.* at 49 (noting a range of credible commitment devices governments have utilized ranging from statutory liens to debt limits and limitations on taxing ability). Cf. Richard M. Hynes, *State Default and Synthetic Bankruptcy*, 87 WASH. L. REV. 657, 679 (2012) (describing nineteenth century Virginia bond commitments).

4. See, e.g., Michelle J. White, *Sovereigns in Distress: Do They Need Bankruptcy?*, 2002 BROOKINGS PAPERS ON ECON. ACTIVITY 287, 307 (2002); David A. Skeel Jr., *Is Bankruptcy the Answer for Troubled States and Cities?*, 50 Hous. L. REV. 1063, 1065 (2013) [hereinafter Skeel, *Is Bankruptcy the Answer?*]. See generally Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract*, 84 WASH. U. L. REV. 1627 (2006); David A. Skeel Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677 (2012) [hereinafter Skeel, *States of Bankruptcy*].

The theory of why access to bankruptcy might matter to investors has to do with incentives. If bankruptcy allows debtors to easily escape their contractual obligations, then access to bankruptcy might cause debtors to irresponsibly overborrow in the first place. Aware of this dynamic, lenders either demand a higher interest rate at the outset or simply refuse to lend. For the government, therefore, tying its hands ex ante by promising not to use the bankruptcy process might be a rational strategy to reduce the cost of borrowing.<sup>5</sup>

The foregoing is especially likely to be the case if, ex post, investors are not able to tell whether a government is genuinely in crisis (in which case creditors might rationally want to give relief) or is opportunistically asking for a debt reduction. Knowing that the costs of government default tend to be high for everyone involved, investors, in the ex post scenario, are going to feel pressure to agree to a renegotiation of the debts so as to avoid the default. To prevent this problem, investors might want to put rules in place to ensure that governments do not too readily seek restructurings.<sup>6</sup> If renegotiation is costly and painful, the theory goes, governments will work hard to avoid ever having to ask for it.<sup>7</sup>

In the literature on sovereign finance, this moral hazard story is often used as an argument for why the process by which governments are able to ask for a restructuring should be made onerous.<sup>8</sup> This can be achieved in two ways. First, government entities can deny themselves the right to utilize a statutory bankruptcy process by refusing to set it up in the first place. Second, the contractual conditions under which a debtor can ask for a renegotiation of its obligations can be made difficult to satisfy. To the extent creditors

5. The classic work on this idea is Douglass North & Barry Weingast, *Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth Century England*, 49 J. ECON. HIST. 803, 806 (1989). See also Michael Breen & Iain McMenamin, *Political Institutions, Credible Commitment, and Sovereign Debt in Advanced Economies*, 57 INT'L STUD. Q. 842, 843 (2013).

6. For discussions of this idea and whether it applies in the real world of government debt, see Patrick Bolton & Olivier Jeanne, *Structuring and Restructuring Sovereign Debt: The Role of a Bankruptcy Regime*, 115 J. POL. ECON. 901 (2007); Andrei Shleifer, *Will the Sovereign Debt Market Survive?*, 93 AMER. ECON. REV. 85 (2003); Michael P. Dooley, *Can Output Losses Following International Financial Crises Be Avoided?* (Nat'l Bureau of Econ. Rsch., Working Paper No. 7531, 2000).

7. For discussion of the relationship between the moral hazard problem in sovereign debt and arguments for and against making bankruptcy procedures available, see Barry Eichengreen, *Restructuring Sovereign Debt*, 17 J. ECON. PERSPS. 75 (2003); Sayantan Ghosal & Marcus Miller, *Co-ordination Failure, Moral Hazard and Sovereign Bankruptcy Procedures*, 113 ECON. J. 276 (2003).

8. Eichengreen, *supra* note 7, at 79 (stating that sovereign reform is used as a rationale for limiting moral hazards).

believe that the foregoing incentives work, governments will get cheaper financing.<sup>9</sup>

But is this frequently told moral hazard story in fact an important determinant of government behavior? Politicians may not actually respond to the hypothesized incentives created by the lack of bankruptcy access.<sup>10</sup> In the real world, some argue, governments default “too little, too late” rather than “too often and too early.”<sup>11</sup>

The question that motivates our project is: How much do investors care about how easy it will be for the government entity to do a debt restructuring? This Article seeks to answer that question by looking at the voluntary disclosures that issuers in the municipal debt market make to investors.

The perspective we take, of looking at voluntary disclosures regarding access to bankruptcy or its contractual equivalent, is different from that of prior researchers. The bulk of the previous research looks at the ex ante cost of capital for entities with and without access to statutory bankruptcy or its contractual equivalents.<sup>12</sup> In the municipal debt context, this research examines the cost of borrowing for different states relative to the presence of core features, such as

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9. See, e.g., Dooley, *supra* note 6, at 5–6; Shleifer, *supra* note 6, at 87. The argument that providing a bankruptcy or restructuring remedy will increase the costs of capital for municipalities or their states is commonplace. For a summary of this literature and a contrary view, see Samir Parikh & Zhaochen He, *Failing Cities and the Red Queen Phenomenon*, 58 B.C. L. REV. 599, 612–13 (2017).

10. See, e.g., Eduardo Borensztein & Ugo Panizza, *The Costs of Sovereign Default*, 56 IMF STAFF PAPERS 683, 716–17 (2009); see also Richard C. Schragger, *Democracy and Debt*, 121 YALE L.J. 860, 874–75 (2012) [hereinafter Schragger, *Democracy and Debt*]; Richard C. Schragger, *Citizens Versus Bondholders*, 39 FORDHAM URB. L.J. 787, 794 (2012) [hereinafter Schragger, *Citizens Versus Bondholders*].

11. This is the theme in TOO LITTLE, TOO LATE: THE QUEST TO RESOLVE SOVEREIGN DEBT CRISES (Martin Guzman, Jose Antonio Ocampo & Joseph Stiglitz eds., 2016). See also IMF Seminar: *Debt Restructuring: Why Too Little Too Late?*, IMF: ANN. MEETINGS 2022 (Oct. 11, 2022), <https://meetings.imf.org/en/2022/Annual/Schedule/2022/10/11/imf-seminar-debt-restructuring-why-too-little-and-too-late> [https://perma.cc/V5CM-CFB8].

12. See generally Pengjie Gao, Chang Lee & Dermot Murphy, *Municipal Borrowing Costs and State Policies for Distressed Municipalities*, 132 J. FIN. ECON. 404 (2019); Tima T. Moldogaziev, Sharon N. Kioko & W. Bartley Hildreth, *Impact of Bankruptcy Eligibility Requirements and Statutory Liens on Bankruptcy Costs*, 37 PUB. BUDGETING & FIN. 47 (2017); Elena Carletti et. al., *The Price of Law: The Case of the Eurozone Collective Action Clauses*, 34 REV. FIN. STUD. 5933 (2021); Parikh & He, *supra* note 9. This question of the impact of bankruptcy features, such as the cram down, has, of course, also received attention in other credit markets. See generally Joshua Goodman & Adam Levitin, *Bankruptcy Law and the Cost of Credit: The Impact of Cramdown on Mortgage Interest Rates*, 57 J.L. & ECON. 139 (2014); Giacomo Rodano, Nicolas Serrano-Velarde & Emanuele Tarantino, *Bankruptcy Law and Bank Financing*, 120 J. FIN. ECON. 363 (2016).

whether the state has passed a statute authorizing its local municipalities to file for bankruptcy, whether the state imposes conditions on those filings, or whether the state has refused to authorize such filings.<sup>13</sup> On its face, this fairly straightforward categorization is tailor-made for an empirical analysis of the cost of capital as a function of what type of bankruptcy access a state allows a municipal issuer of debt. Empirical tests appear to mostly find that bankruptcy availability is disfavored by creditors and therefore issuers pay higher interest rates in those jurisdictions that allow it.<sup>14</sup>

For our part, we instead look at the disclosures made in the bond offering documents regarding access to bankruptcy. If the fact of access to bankruptcy is a crucial determinant of the interest rate that investors will charge government issuers, then investors will want to know the degree of access the entity in question has at the outset of the transaction. Our premise is the following: If the matter is of importance to lenders, those issuers who benefit from releasing that information should, in theory, voluntarily and prominently provide that information in the offering documents for their securities. Other issuers, for whom the information looks bad, should try to explain it away so that investors do not unduly discount their bonds.

Before proceeding, some background on this Article's particular intervention is needed. As noted, municipal borrowers in the United States operate under state-imposed regulatory schemes that determine whether, and under what conditions, they may access federal bankruptcy.<sup>15</sup> These same borrowers also enter into contracts with their lenders that specify the processes by which a renegotiation of their obligations might occur outside of bankruptcy. Put differently, a municipal entity that does not have access to federal bankruptcy can nevertheless enter into a contractual agreement with its creditors regarding how a possible distress situation in the future will be worked

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13. This analysis comes from respected organizations such as non-profits (Pew Charitable Trusts) and major law firms (K&L Gates). K&L GATES, STATE STATUTES AUTHORIZING MUNICIPAL BANKRUPTCY (2015), [https://www.nappa.org/assets/docs/ArchivedConferenceMaterials/2015ConferenceAustin/nappa\\_2015%20friday%20mixon%20municipal%20bankruptcy.pdf](https://www.nappa.org/assets/docs/ArchivedConferenceMaterials/2015ConferenceAustin/nappa_2015%20friday%20mixon%20municipal%20bankruptcy.pdf) [<https://perma.cc/H5KE-K92A>]; NAT'L ASS'N OF BOND LAWS., MUNICIPAL BANKRUPTCY: A GUIDE FOR PUBLIC FINANCE ATTORNEYS 97–102 (3d ed. 2015); PEW CHARITABLE TRS., THE STATE ROLE IN LOCAL GOVERNMENT FINANCIAL DISTRESS (2016), [https://www.pewtrusts.org/~media/assets/2016/04/pew\\_state\\_role\\_in\\_local\\_government\\_financial\\_distress.pdf](https://www.pewtrusts.org/~/media/assets/2016/04/pew_state_role_in_local_government_financial_distress.pdf) [<https://perma.cc/VN9Y-TQ33>].

14. See, e.g., Gao et al., *supra* note 12, at 419–20; Moldogaziev et al., *supra* note 12.

15. See generally ROBERT S. AMDURKSY, CLAYTON P. GILLETTE & G. ALLEN BASS, MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE (Wolters Kluwer Law & Business ed., 2d ed. 2013).

out (i.e., bankruptcy by contract)<sup>16</sup>. Figuring out how easy or difficult it will be for a particular municipal issuer to access either the statutory bankruptcy scheme or use a contractual mechanism to engineer a workout, therefore, requires some legal analysis. That analysis can be done by examining the relevant state statutes, reading the contract terms of the bond issuances, and then determining how they are likely to be interpreted in light of relevant prior case law.

The foregoing is not rocket science. Although the answers are frequently not going to be clear to a lay observer, a specialist municipal finance lawyer should be able to determine the answers with a few hours of time and effort. If, therefore, one is an investor considering whether to buy the bonds of a particular municipal issuer and the ability of that institution to access statutory or contract bankruptcy is a key factor, one should expect meaningful disclosure as to what those chances are. If investors care about something and are willing to pay for it, the theory goes, bond issuers will provide it and pass those costs on to the investors.

To see what kinds of disclosures about the availability of bankruptcy access were provided to investors, our team hand coded nearly six hundred randomly chosen municipal bonds from a major bond database. For each bond offering, we examined what the disclosures were for statutory and contractual access of the issuer to a restructuring process, and specifically access to federal bankruptcy filing under Chapter 9 of the U.S. Bankruptcy Code.<sup>17</sup> Our plan was to then use what we expected to be nuanced answers regarding access to bankruptcy — in either the statutory or contract form — to do our own empirical analysis of the effect of access to bankruptcy on the cost of capital.

What we found was that the vast majority of issuers provided little meaningful information on the issuer's ability to access either statutory bankruptcy or use an alternative contractual workout.<sup>18</sup> Instead, on the statutory bankruptcy front, the majority of offering documents, regardless of credit ratings, provided only vague boilerplate statements about how the issuer might or might not be able to access federal bankruptcy.<sup>19</sup> Vague boilerplate language was provided even when the

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16. Bankruptcy via contract is the solution utilized in the sovereign debt world where there is no statutory scheme available to countries in distressed debt situations. See Lee C. Buchheit & Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317 (2002).

17. 11 U.S.C. §§ 901–46.

18. See *infra* Section II.A.

19. See *id.*

issuing municipality operated under a state law that was relatively clear about the availability or unavailability of bankruptcy — indeed, even in states that explicitly prohibit municipal access to bankruptcy.<sup>20</sup> As for the legal opinions usually appended to the offering documents — the place where bond counsel might tackle especially complex and uncertain matters<sup>21</sup> — not one of the documents contained any indication that special attention had been paid to the question of bankruptcy access or restructuring.

The absence of these disclosures raises a puzzle. Our findings could indicate that investors in this market do not care enough about bankruptcy access to demand disclosure, or do not think it is important — despite empirical findings indicating that bankruptcy access affects the price of debt. Or it could be that investors have access to the information from publicly available sources or that they are hiring their own lawyers or analysts to assess bankruptcy risk. It could also be the case that the relevant information is already incorporated into the price of the debt through some efficient market process.

To understand our findings better, we interviewed thirty-four senior practitioners in the municipal bond industry, including judges, lawyers, ratings agency specialists, and investors.<sup>22</sup>

Our respondents made a number of observations that we report in Part III, but one theme dominated. None of our interviewees thought that the question of access to bankruptcy or its contractual equivalents was important enough to be worth paying attention to as a matter of disclosure. In fact, a number of the lawyers who specialize in local government finance responded to our queries by saying that they likely had little of use to tell us because they did not know very much about federal bankruptcy law. “It just [did] not come up” for them. One of these specialist public finance lawyers explained:

Look, I don’t spend any time trying to figure out the ins and outs of Chapter 9 bankruptcy. It just does not come up. Even when there is a situation of deep distress, and I’ve worked on a few of these, we don’t start talking about federal bankruptcy until very late in the process. It just does not play a role. There are so many other factors

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20. *See infra* Section II.A–B.

21. On legal opinions in securities transactions, see Darrel A. Rice & Marc I. Steinberg, *Legal Opinions in Securities Transactions*, 16 J. CORP. L. 375 (1991).

22. Notes from these anonymous interviews — which took place between approximately January 2022 and February 2023 — are on file with the authors. *See also* Part III.



and considerations that come up prior to thinking about bankruptcy.<sup>23</sup>

Whether investors care about the rules governing debt renegotiation and discharge matters for a number of reasons. If bankruptcy access is unimportant to investors, the policy debates over whether states should be allowed access to a bankruptcy system and whether such access will affect the cost of capital might be pointless.<sup>24</sup> If the primary bond markets do not care about whether the debtor entity has easier or more difficult access to bankruptcy, then the state governments' professed commitment to limit its access to debt relief may be producing unneeded costs, namely the lack of a mechanism that would ameliorate a coordination problem among the creditors.<sup>25</sup>

More broadly, a conventional view of municipal fiscal crises is that they are a product of mismanagement or profligacy; the standard response is to adopt rules that are intended to hold local officials to account as a way of improving their performance.<sup>26</sup> This moralized approach to municipal fiscal crises assumes that institutions can be designed to prevent or correct for local fiscal failure by influencing or changing the behavior of local officials or the local political process.<sup>27</sup> But, as our findings suggest, market participants do not seem particularly attentive to at least one of those key institutions: bankruptcy access.

Part I of this Article describes the legal complications that can arise in determining a municipal issuer's access to bankruptcy.<sup>28</sup> Whether bankruptcy is available to a given issuer is not straightforward; the question can and often does result in litigation. Part II reports our empirical findings.<sup>29</sup> Part III summarizes the results of our interviews

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23. Interview 1 (Nov. 28, 2022) (notes on file with authors).

24. See, e.g., Skeel, *States of Bankruptcy*, *supra* note 4; Skeel, *Is Bankruptcy the Answer?*, *supra* note 4.

25. Cf. Parikh & He, *supra* note 9, at 604.

26. See, e.g., Lew Mandell, *How Detroit Leaders Ignored Causes of Bankruptcy for 65 Years*, PBS NEWSHOUR (Dec. 13, 2013, 1:13 PM), <https://www.pbs.org/newshour/economy/how-detroit-leaders-ignored-signs-of-bankruptcy-for-65-years> [<https://perma.cc/E465-BJCQ>]; Mary Williams Walsh, *In Alabama, a County That Fell Off the Financial Cliff*, N.Y. TIMES (Feb. 18, 2012), <https://www.nytimes.com/2012/02/19/business/jefferson-county-ala-falls-off-the-bankruptcy-cliff.html> [<https://perma.cc/6R5L-FKEU>]. For a discussion of these rules, see generally Schragger, *Democracy and Debt*, *supra* note 10.

27. E.g., Clayton P. Gillette, *Dictatorships for Democracy*, 114 COLUM. L. REV. 1373, 1414 (2014). For a discussion and critique of this approach, see Schragger, *Democracy and Debt*, *supra* note 10, at 863–64.

28. See *infra* Part I.

29. See *infra* Part II.

with market participants.<sup>30</sup> Part IV discusses the implications of our findings and speculates about possible explanations.<sup>31</sup> The Article concludes with a consideration of potential areas of additional research.<sup>32</sup>

## I. THE CHALLENGE OF DETERMINING BANKRUPTCY ELIGIBILITY

This Part provides a brief explanation for why the question of whether a given issuer of municipal debt has access to bankruptcy can be legally complex. Some of the finance literature on the costs of municipal debt suggests that coding for bankruptcy access is relatively straightforward.<sup>33</sup> These studies assume that issuers fall into a small handful of categories defined by the type of access municipal issuers have to bankruptcy.<sup>34</sup> But the law is not always so clear; determining which issuers are “municipalities” at the front end and what forms of debt are dischargeable at the back end can both be fraught inquiries. It is important, therefore, to understand what kinds of legal issues might arise in answering what seems to be a fairly simple question put to a municipal issuer: Can you file for bankruptcy protection?<sup>35</sup>

Bankruptcy is the exclusive province of federal law in the U.S.<sup>36</sup> States and territories are not permitted to adopt their own laws discharging municipal (or other kinds of) debt. But respect for the states’ constitutional status limits access to bankruptcy in the cases of a state’s political subdivisions, public agencies, or instrumentalities to those that have received specific state authorization to file.<sup>37</sup> In other

30. *See infra* Part III.

31. *See infra* Part IV.

32. *See infra* Conclusion.

33. *See, e.g.*, Gao et al., *supra* note 12, at 406–07.

34. *See, e.g., id.* (categorizing states as “Chapter 9 states,” “Proactive states,” and “Neither states”).

35. For a treatment of the complications of municipal bankruptcy eligibility rules, see Laura N. Coordes, *Gatekeepers Gone Wrong: Reforming the Chapter 9 Eligibility Rules*, 94 WASH. U. L. REV. 1191 (2017) [hereinafter Coordes, *Gatekeepers Gone Wrong*] and Laura N. Coordes, *Restructuring Municipal Bankruptcy*, 2016 UTAH L. REV. 307, 308, 313–14 (2016) [hereinafter Coordes, *Restructuring Municipal Bankruptcy*].

36. U.S. CONST. art. I, § 8, cl. 4.

37. M. Heith Frost, *States As Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 819–20 (2015); *see also* Coordes, *Restructuring Municipal Bankruptcy*, *supra* note 35, at 311–13 (noting that federal bankruptcy law developed in response to federalism concerns raised by the Supreme Court in *Ashton v. Cameron County Water District*, which described the Bankruptcy Act as “improperly intruding into the state’s internal, commercial affairs”).

words, state law dictates which municipal entities can file for bankruptcy and under what circumstances they can do so.<sup>38</sup> Importantly, the scope and nature of those permissions varies between the states; moreover, the terms of permissions are subject to judicial interpretation.<sup>39</sup> It is also the case that the remedies available to creditors under state law once a municipal issuer is in bankruptcy will vary.

At first cut, one might think it straightforward to distinguish between those states that have given affirmative permission for their municipalities to file under Chapter 9 of the Bankruptcy Code — which governs municipal bankruptcies — and those that do not. But general authorization statutes differ in scope.<sup>40</sup> To the extent there are relatively easy cases, they usually involve cities and towns. The states that have adopted general authorization statutes often use language permitting “municipalities,” “taxing districts,” and/or “political subdivisions” to file.<sup>41</sup> So, too, the Bankruptcy Code itself requires that, for an entity to be eligible for Chapter 9, it needs to fit the definition of a “municipality.” Determining the background law often requires a legal judgment about which entities are allowed by local law to file for bankruptcy as well as an assessment of the nature of the debt being issued. It is not that these determinations cannot be made, but rather that these judgments can and do result in litigation.<sup>42</sup>

Indeed, though towns and cities are usually easy to identify, the overwhelming majority of issuers of municipal debt are neither, but instead are “special purpose entities” or “special districts.”<sup>43</sup> A virtual

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38. 11 U.S.C. § 109(c)(2) (“[I]s specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter.”).

39. *Id.* Some courts have held “that the . . . authorization must be written, ‘exact, plain, and direct with well-defined limits so that nothing is left to inference or implication.’” *In re New York City Off-Track Betting Corp.*, 427 B.R. 256, 267 (Bankr. S.D.N.Y. 2010); *see also In re Jefferson County, Alabama*, 469 B.R. 92 (Bankr. N.D. Ala. 2012).

40. *See* Nuveen, *Municipal Bankruptcy: A Primer on Chapter 9* (Oct. 25, 2022), <https://www.nuveen.com/en-us/insights/municipal-bond-investing/municipal-bankruptcy-a-primer-on-chapter-9> [<https://perma.cc/W3QU-S8KF>].

41. K&L GATES, *supra* note 13; NAT’L ASS’N OF BOND LAWS., *supra* note 13, at 97–102; *see also* Coordes, *Gatekeepers Gone Wrong*, *supra* note 35, at 1225 (“Perhaps no eligibility rule is as daunting as the state authorization requirement.”).

42. *See e.g.*, John A. E. Pottow, *What Bankruptcy Law Can and Cannot Do for Puerto Rico*, 85 REV. JUR. U.P.R. 689, 697 (2016) (making this point in the context of a discussion of Chapter 9).

43. *Cf.* Laura N. Coordes, *What’s So Special About Special Districts?*, SLOGLAW (Dec. 20, 2021), <https://www.sloglaw.org/post/what-s-so-special-about-special-districts>

menagerie of districts has emerged over time. In many cases, these districts have been created to avoid debt limitations that restrict borrowing by general purpose local governments or to circumvent local bond election requirements.<sup>44</sup> The best known of these special purpose entities are school districts, but those are only the tip of the iceberg. Also common are hospital, sanitary, irrigation, public improvement, and housing districts, as well as public utility boards and bridge and highway authorities. In Texas, for example, there are more than fifteen types of special districts solely related to water and wastewater management, at least ten types of districts related to economic and community development, and a handful of types of special districts related to health and safety, agriculture, and transportation.<sup>45</sup>

Questions of statutory interpretation often arise when analyzing bankruptcy eligibility for these types of municipal issuers. The language of general state authorization statutes can be vague about the kinds of entities entitled to file — thus inviting disagreement. For example, Montana permits local entities and irrigation districts to file for bankruptcy but disallows counties.<sup>46</sup> Missouri allows municipalities and political subdivisions to file, raising the question of whether special districts are included.<sup>47</sup> Colorado law authorizes taxing, irrigation, and drainage districts to file for bankruptcy, but what constitutes a taxing district is the subject of legal interpretation.<sup>48</sup>

Importantly, a state's general authorization statute is not the only source of authority for permission to file; one must also investigate the specific state enabling act that authorizes the creation of a particular type of special district. In some cases, that authorization is conditional or co-exists with other potential intervention mechanisms. One example is Arizona, where state law generally authorizes “taxing

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[<https://perma.cc/PME4-HSGB>] (explaining that cities, towns, and counties, also called “general purpose municipalities,” file for bankruptcy at a much lower rate than their special purpose counterparts).

44. See, e.g., Darien Shanske, *Local Fiscal Autonomy Requires Constraints: The Case for Fiscal Menus*, 25 STAN. L. & POL'Y. REV. 9, 23 (2014); C. Robert Morris, *Evading Debt Limitations with Public Building Authorities: The Costly Subversion of State Constitutions*, 68 YALE L.J. 234, 242 (1958).

45. TX. SENATE RSCH. CTR., *INVISIBLE GOVERNMENT: SPECIAL PURPOSE DISTRICTS IN TEXAS* 51 (2014).

46. MONT. CODE ANN. § 7-7-132 (authorizing local entities to file); § 85-7-2041 (authorizing irrigation districts to file); § 7-7-131 (forbidding counties from filing for bankruptcy).

47. MO. REV. STAT. § 427.100.

48. COLO. REV. STAT. § 32-1-1403 (authorizing taxing districts to file); § 37-32-102 (authorizing irrigation and drainage districts to file).

district[s]” to file for bankruptcy.<sup>49</sup> Arizona separately permits school districts to file but also allows the state school board to appoint a receiver in cases of school district insolvency.<sup>50</sup> Conditional authorizations to file, whereby an entity has to receive permission before filing or in which a receiver may be appointed who can in turn file for bankruptcy, are not uncommon.<sup>51</sup> In these instances, bankruptcy is permitted, but only after a state agency gives permission.<sup>52</sup>

The ambiguity of state permissions and the language of Chapter 9 of the Bankruptcy Code, which defines “municipality” as a “political subdivision or public agency or instrumentality of a State,” have generated elaborate judicial analysis of the status of entities seeking bankruptcy protection.<sup>53</sup> In *In re Ellicott School Building Authority*, for example, the bankruptcy court held that an authority established as a non-profit organization under Colorado law solely to issue debt for the construction of a new school was not a municipality for purposes of Chapter 9, and thus ineligible to file under that provision.<sup>54</sup>

Consider also *In re Las Vegas Monorail*, which similarly involved the interpretation of “municipality” in Chapter 9.<sup>55</sup> Despite explicit language in the relevant bond documents identifying the owner of the monorail and issuer of the debt as an “instrumentality of the State of Nevada . . . controlled by the Governor,” the bankruptcy court held that the monorail company was *not* a municipality and was thus free to

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49. ARIZ. REV. STAT. ANN. § 35-603.

50. *Id.* § 15-103(D) (granting “jurisdiction over all petitions requesting that a school district be placed in receivership” in the state board of education).

51. *See, e.g.*, ARIZ. REV. STAT. § 15-103(A)–(D).

52. *See, e.g.*, Lang Yang, *The Impact of State Intervention and Bankruptcy Authorization Laws on Local Government Deficits*, 20 ECONS. OF GOVERNANCE 305, 310–11 (2019).

53. 11 U.S.C. § 101(40); *see also In re Cnty. of Orange*, 183 B.R. 594, 594, 609 (Bankr. C.D. Cal. 1995) (holding that a combined investment pool is not a municipality under the Bankruptcy Code); *In re Westport Transit Dist.*, 165 B.R. 93, 96 (Bankr. D. Conn. 1994) (holding that transit district qualified as a hybrid public agency of both state and town and was therefore a municipality for purposes of Chapter 9 relief); *In re Greene Cnty. Hosp.*, 59 B.R. 388, 389 (Bankr. S.D. Miss. 1986) (holding that county hospital was a municipality for Chapter 9 purposes); *In re City of Cent. Falls*, 468 B.R. 36, 7677 (Bankr. D.R.I. 2012) (holding that a school district was not part of a municipality under Rhode Island law); *In re Las Vegas Monorail Co.*, 429 B.R. 770, 795, 800 (Bankr. D. Nev. 2010) (holding that monorail utility was not a municipality or instrumentality and therefore ineligible for Chapter 9 relief); *In re Northern Marina Islands Retirement Fund*, No. 12-00003, 2012 WL 8654317, at \*3 (D. N. Mar. I. June 13, 2012) (holding that a territorial retirement fund is a governmental unit and thus cannot access Chapter 11).

54. 150 B.R. 261, 262, 264 (Bankr. D. Colo. 1992).

55. 429 B.R. at 795–96.

file for bankruptcy under Chapter 11, the statute for corporate rather than municipal bankruptcies.<sup>56</sup> Importantly, the court held that an entity can be a municipality for tax-exempt purposes, pursuant to the Internal Revenue Service’s definition, yet not be a municipality for bankruptcy purposes.<sup>57</sup> The court also examined state law, observing that Nevada has adopted a system for financially distressed public authorities that does not permit them to access bankruptcy.<sup>58</sup> Entities in that system, the court noted, are “local governments,” however — defined by state law as those entities exercising taxing power.<sup>59</sup> Because the monorail entity did not have the power to tax, the bankruptcy court concluded that Nevada would not consider it a municipality, and thus would have “little interest in whether it files for Chapter 11 or not.”<sup>60</sup>

These cases suggest that whether an entity is a “municipality” for purposes of state and/or federal law will often need to be determined on a case-by-case basis, dependent in many instances on the nature of the entity, its ability to tax, and the level of control exercised by the government over its operations.<sup>61</sup>

Furthermore, despite what the law provides, creditors may fail to challenge any given Chapter 9 filing, permitting it to proceed absent state authorization, as seems to have occurred in some cases in Mississippi<sup>62</sup> and Illinois.<sup>63</sup> Consider also a Florida case involving the Campbellton-Graceville Hospital Corporation, which filed for Chapter 11 bankruptcy in 2017 despite the fact that it was created pursuant to Florida law and had been previously treated as a political subdivision

56. *Id.* at 774, 795.

57. *Id.* at 791–95.

58. *Id.* at 799.

59. *Id.*

60. *Id.*

61. See JONES DAY, AN OVERVIEW OF CHAPTER 9 OF THE BANKRUPTCY CODE: MUNICIPAL DEBT ADJUSTMENTS 4 (2010), <https://www.jonesday.com/en/insights/2010/08/an-overview-of-chapter-9-of-the-bankruptcy-code-municipal-debt-adjustments#:~:text=Chapter%20of%20the%20Bankruptcy%20Code%20expressly%20provides%20protection%20to,fees%20earned%20by%20such%20projects> [https://perma.cc/DZ9S-TKVM] (“[D]emonstrating eligibility under [C]hapter 9 could be a difficult, time-consuming, and hotly contested process that may prove to be too difficult in many instances.”); see also Matthew A. Bruckner, *Special Purpose Municipal Entities and Bankruptcy: The Case of Public Colleges*, 36 EMORY BANKR. DEV. J. 341, 343–82 (2020).

62. JAMES E. SPIOTTO ET AL., MUNICIPALITIES IN DISTRESS?: HOW STATES AND INVESTORS DEAL WITH LOCAL GOVERNMENT FINANCIAL EMERGENCIES 153 (1st ed. 2012).

63. *Id.* at 115.

of the state — which is only eligible for Chapter 9 — in judicial proceedings.<sup>64</sup> The bankruptcy court confirmed a liquidating Chapter 11 plan after one creditor who contested the hospital’s eligibility withdrew its objection.<sup>65</sup>

These examples undermine any straightforward categorization or conclusion regarding a given state’s background legal regime. Even an issuer’s own assertion that it is a state entity may not be determinative of its status for purposes of bankruptcy access. The consequences that follow from a determination of whether an entity is a “municipality” are also important to consider. A ruling that an entity is *not* a municipality, like *In re Las Vegas Monorail*,<sup>66</sup> opens the door to Chapter 11 bankruptcy for certain special purpose entities in a state that does not permit its municipalities otherwise to file under Chapter 9. Some entities will be determined to be municipalities, thus blocking their access to anything other than Chapter 9, but some entities will be determined not to be municipalities, which may allow them to file under Chapter 11.

Further confounding any conclusion regarding access to bankruptcy is the fact that certain obligations under state law may be treated specially even if the issuer is clearly a municipality under Chapter 9 and state law permits it to file. Under Section 922(d) of the Bankruptcy Code, payments to bondholders holding “special revenues” are not stayed and can continue even after the filing of a bankruptcy petition.<sup>67</sup> State law determines what constitutes a special revenue bond.<sup>68</sup> So, too, bondholders holding bonds to which “statutory liens” attach might continue to receive payment on those bonds. Again, state law

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64. Diane Lourdes Dick, *Public Hospital Bankruptcies and an Evolving Functional Interpretation of the Bankruptcy Code*, 39 BANKR. L. LETTER 1, 13 (2019).

65. *Id.*

66. 429 B.R. 770, 795 (Bankr. D. Nev. 2010).

67. *See* 11 U.S.C. § 922(d). *But see* Rick B. Antonoff, “*Application of Pledged Special Revenues Under §922 (d)*,” AM. BANKR. INST. J., DEC. 2019, at 18, 64 (2019) (arguing that 922(d)’s language has been found ambiguous by various courts and that “the statute as drafted does not make . . . clear” that “Congress intended debt payments on special-revenue bonds to be mandatory”).

68. Central Falls, Rhode Island presents an infamous example. After the city “went into receivership, but shortly before it filed for bankruptcy, the Rhode Island legislature gave general obligation bondholders a statutory lien on tax revenues. The effect was that throughout and after its bankruptcy, Central Falls’ bondholders continued to be paid in full, while some retirees saw their pensions cut up to 55%.” Dave Tejas, Comment, *Rethinking Roadblocks to Municipal Bankruptcy*, 38 EMORY BANKR. DEV. J. 277, 290 (2022).

determines the existence of a statutory lien.<sup>69</sup> In these two types of bond issuances, access to bankruptcy arguably matters little to the bondholders, who enjoy favorable treatment even in bankruptcy.

On the other hand, the efficacy of those kinds of commitment devices depends on assumptions about the political economy of debt. Paying bondholders before providing basic services — which a statutory lien may require — is not likely to be politically palatable; elected officials may be wary of putting bondholders before citizens when the provision of basic services is at issue.<sup>70</sup> And once an entity is in bankruptcy, judges exercise equitable discretion to modify and discharge debt even in the face of state law commitment devices.<sup>71</sup>

This leads to a final point. That a state has chosen a particular bankruptcy structure for its municipalities at the time a bond was issued does not, standing alone, constitute a binding promise to keep that structure. If some years down the road, the state feels the need to change the bankruptcy options available to its municipalities, it can do so.<sup>72</sup> If the applicable legal rules can be altered, they are a minimal commitment device. When push comes to shove and fiscal crises hit, states tend to deal with local fiscal emergencies in an ad hoc manner through the legislative adoption of special laws.<sup>73</sup> Those states create rules *ex post*, rather than *ex ante*, even if their interventions might set expectations for future fiscal failures.

In this end, investors who believe that the degree of access to bankruptcy affects the likelihood of payouts on a bond would need to

69. Some states have passed state laws protecting statutory liens, which are intended to extend to the Bankruptcy Code. For example, California's Senate Bill 222, (now Section 15251 of the California Education Code) applies to some school district general obligation bonds, and Michigan's Public Act 17 of 2015 applies to specific home rule city financial recovery bonds. See NAT'L ASS'N OF BOND LAWS., *supra* note 13, at 50 n.171.

70. See Diane Lourdes Dick, *Bondholders v. Retirees: The Political Economy of Chapter 9*, 92 AM. BANKR. L. J. 73, 75–76 (2018); Diane Lourdes Dick, *Recognizing Taxpayers as Stakeholders in Municipal Bankruptcies*, 14 J.L. ECON. & POL'Y 91, 91–92, 105 (2017).

71. See, e.g., Doug Rendleman, *The Triumph of Equity Revisited: The Stages of Equitable Discretion*, 15 NEV. L.J. 1397, 1419 (2015).

72. See, e.g., John Gramlich, *Municipal Bankruptcy Explained: What It Means to File for Chapter 9*, PEW CHARITABLE TRS. (Nov. 22, 2011), <https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2011/11/22/municipal-bankruptcy-explained-what-it-means-to-file-for-chapter-9> [<https://perma.cc/F8Z5-A6ZF>].

73. *Id.* (“Rhode Island was so worried about Wall Street’s reaction to fiscal crisis in some of its municipalities that it approved special legislation guaranteeing that bondholders — not residents of those municipalities — have the first claim to local tax money.”).



analyze bonds by their type and type of issuer and then track and analyze the appropriate state law so as to make a prediction on what is likely to happen in a distress situation. They would also need to consider whether a state might change its access rules in the future. As observed in the Introduction, this is a task that a skilled public finance lawyer can undertake with some minimal effort.<sup>74</sup> The background finance literature suggests that investors care about this information — indeed, that this information can substantially change the cost of capital. Given the foregoing, we might predict clear and straightforward disclosure regarding bankruptcy access,<sup>75</sup> even with the caveats noted above, and especially in light of the fact that the inadequacy of disclosure can subject the issuer to liability for fraud under the securities laws.<sup>76</sup> Therefore, our study asks whether the terms of bankruptcy access or other forms of debt relief are clearly disclosed in the offering documents for municipal bonds in the U.S. Generally, we find that those terms are not.

## II. DATA AND FINDINGS

Our dataset is made up of the disclosure documents (e.g., offering circulars, prospectuses, and prospectus supplements) for approximately 600 municipal bonds sourced from the Filings Expert database.<sup>77</sup> These bonds were selected randomly with an attempt to get an equivalent representation from every state — that is, roughly ten bonds for each of the 50 states. For each bond, we coded a set of five standard legal variables relating to the issuing entity’s ability to utilize either statutory or contractual bankruptcy mechanisms. Not every one

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74. *See supra* Introduction.

75. *Cf.* Michael Bradley & Mitu Gulati, *Collective Action Clauses for the Eurozone*, 18 REV. FIN. 2045 (2014) (describing the effects of Collective Action Clauses on the cost of Eurozone sovereign bonds). Disclosure regarding the equivalent of bankruptcy for bonds is routinely made in the sovereign debt context, where the bulk of issuances operate under an analogous regulatory framework as municipal bonds (i.e., exempt from any sorts of mandatory disclosure requirements). The fact that these disclosures are made in the sovereign context makes it relatively easy to conduct pricing studies as a function of access that issuers have to the equivalent of bankruptcy. *See id.*

76. *See, e.g.*, Marc I. Steinberg, *The Disclosure Regimen of the Federal Securities Laws*, in RETHINKING SECURITIES LAW 13, 14 (2021), <https://academic.oup.com/book/39800/chapter/339906385> [<https://perma.cc/H3MK-8LLC>] (“The objective is to provide investors and the securities markets with accurate disclosure of material information so that informed decisions can be made.”).

77. Filings Expert (now Perfect Information) is an extensive database of documents from financial transactions, including a variety of bond issuances. *See* FILINGS EXPERT, <https://www.filingsexpert.com> [<https://perma.cc/PU4M-CVCL>] (last visited Feb. 23, 2023).

of the documents we accessed was complete on each variable, so we have somewhat fewer than 600 data points on most of the individual variables.<sup>78</sup>

The variables are: (1) access (or lack thereof) to federal statutory bankruptcy; (2) access to the contractual equivalent of bankruptcy via a voting mechanism where a supermajority of creditors can do a “cram down” of dissenting creditors (a so-called “collective action clause” for key payment terms); (3) access to an indirect contract equivalent via modification of non-payment terms (known as the “exit amendment” mechanism); and (4) use of governing law other than the law that the issuing state sovereign controls (a “foreign” governing law).

In Table 1, we report a summary of the bonds we have collected as a function of one of the more well-regarded, albeit simplistic, categorizations of the states into whether they allow or disallow municipal access to federal bankruptcy. The categories reported in the table are borrowed from a fifty-state summary produced by the law firm of K&L Gates.<sup>79</sup> Similar categorizations are used in bond lawyers James Spiotto, Ann Acker, and Laura Appleby’s book, *Municipalities in Distress*, which is the most thoroughgoing collection of state-by-state statutes related to municipal fiscal distress and bankruptcy access.<sup>80</sup> Spiotto’s second, and most recent, edition was published in 2016.<sup>81</sup> A PEW Charitable Trusts study, also last updated in 2016, entitled *The State Role in Local Government Financial Distress*, uses slightly different state-to-state categorizations, but relies heavily on Spiotto for basic statutory information.<sup>82</sup> One could do their own 50 state survey to confirm or complicate these categories. But as explained, the existence of a particular statute or statutory regime in any given state can only tell us part of the access story.

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78. We also have more bonds from California than the other states because we began our collection with a purely random selection method, which resulted in a disproportionate number of bonds from California.

79. K&L GATES, *supra* note 13, at 1–3.

80. *See generally* SPIOTTO, *supra* note 62.

81. *See* JAMES E. SPIOTTO ET AL., *MUNICIPALITIES IN DISTRESS?: HOW STATES AND INVESTORS DEAL WITH LOCAL GOVERNMENT FINANCIAL EMERGENCIES* (2d ed. 2016).

82. PEW CHARITABLE TRS., *supra* note 13, at 7.

**Table 1: Number of Offering Documents Coded by State and Type of Chapter 9 Authorization for that State**

General Authorization	No Statute	Authorization for Specified Entities Only	Conditional Authorization	Express Prohibition	Prohibition with Exceptions	
Alabama	10 Alaska	10 Arizona	10 California	29 Georgia	20 Iowa	20
Arkansas	10 Delaware	10 Colorado	10 Connecticut	10 Total ODs Coded	20 Total ODs Coded	20
Florida	14 Hawaii	10 Idaho	10 Illinois			
Minnesota	10 Indiana	10 Montana	10 Kentucky	10		
Missouri	10 Kansas	10 New York	12 Louisiana	10		
Nebraska	10 Maine	10 Washington	10 Michigan	16		
Oklahoma	10 Maryland	10 Total ODs Coded	62 New Jersey	10		
South Carolina	15 Massachusetts	12	North Carolina	12		
Texas	10 Mississippi	10	Ohio	21		
Oregon	10 Nevada	10	Pennsylvania	18		
Total ODs Coded	109 New Hampshire	10	Rhode Island	10		
	New Mexico	14	Total ODs Coded	156		
	North Dakota	11				
	South Dakota	11				
	Tennessee	12				
	Utah	11				
	Vermont	10				
	Virginia	18				
	West Virginia	11				
	Wisconsin	10				
	Wyoming	10				
	Total ODs Coded	230				

### A. Access to Bankruptcy

A significant majority of the offering documents for the bonds in our sample used similarly vague language to address the question of bankruptcy access. In a boilerplate disclosure statement, usually about a paragraph long, it is reported that the issuer “may” or “might” be able to access federal bankruptcy. That’s it. We found cases of this boilerplate disclosure in every state whether or not that state was one where municipalities formally enjoy full, conditional, or no access to federal municipal bankruptcy.

Of the 598 state-issued bonds, 409 bonds (68.4%) used roughly the same boilerplate language to say that the matter of whether there was bankruptcy access was unclear. A minority (189) of bonds (31.6%) answered the question in the affirmative — that bankruptcy access was clearly permitted. Not one of the bond offering documents delved into the legal (let alone political) complexities of determining whether the entity in question might be able to access federal bankruptcy.

Perhaps unsurprisingly given the foregoing, in none of the bonds did we find any indication of a commitment by the state that the type of Chapter 9 access at the time of issuance would remain in place for the life of the bond.

Digging deeper, we looked more closely at a few categories of bonds. First, we looked at the clear categories represented in Table 1: States where there is either general authorization for the use of Chapter 9 bankruptcy or there is no authorization. For those states, we expected

the bonds to disclose clearly “Yes” or “No” for bankruptcy access. Instead, 66.3% of the bond offering documents in the general authorization category report that it is unclear whether they have access to bankruptcy, and 67.7% of the bonds in the category where there is no statute authorizing bankruptcy also report that it is unclear.

Consider South Carolina, for example. South Carolina falls into the general authorization category, which means that municipal issuers should have bankruptcy access. But out of the 15 South Carolina bonds we coded, 14 (93.3%) indicated that access was unclear (i.e., that municipalities “may” or “might” have access to bankruptcy). As further examples, Georgia and Iowa fall into different categories, but the lack of clarity is similar. Georgia falls into the express prohibition category — a clear category — and yet, 80% of the bonds we coded indicated that access to bankruptcy was unclear. Iowa falls into the conditional prohibition category, and 60% of the bonds we coded for that state indicated that bankruptcy access was unclear.

**Figure 1: Type of Bankruptcy Disclosures (Vague v. Clear)**

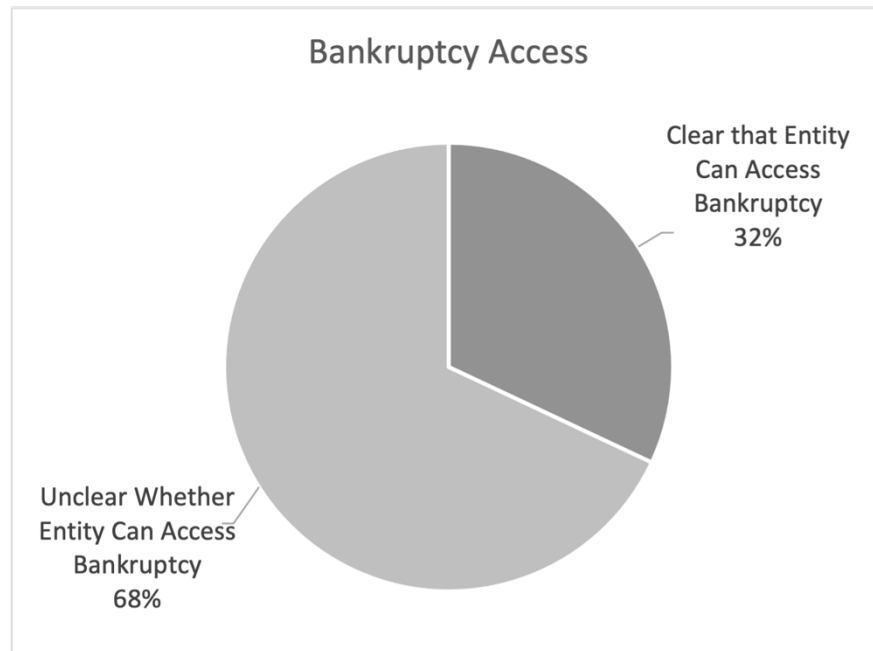
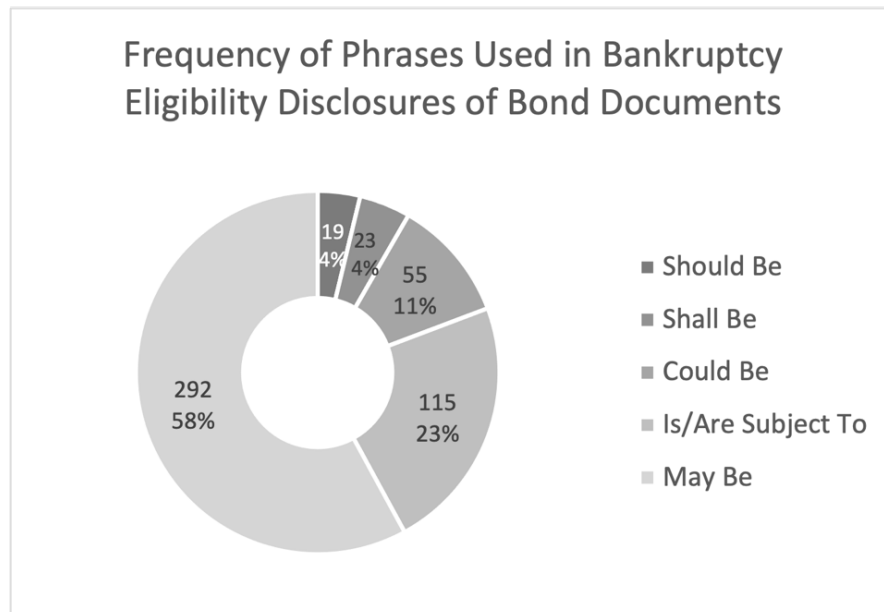


Figure 1 reports the percentage of bonds that are unclear about access to bankruptcy. A majority of bonds in each of the categories of states had vague disclosures regarding the issuer’s access. In Figure 2, looking at the full dataset, we show the different types of wording used

to characterize access to bankruptcy (e.g., a municipality “could” or “may be” able to access a federal bankruptcy process).<sup>83</sup> The dominant category is that the issuer “may be” able to access federal bankruptcy.<sup>84</sup>

**Figure 2: Key Phrases in the Bonds Characterizing Disclosure Regarding Access to Bankruptcy**



Municipal bond issuers could state in no uncertain terms that state law permits or does not permit them to file for bankruptcy. The bond offering documents that we reviewed regularly include bolded, all-caps disclosures that appear on the first page of the offering — often indicating, for example, whether the entity is backed by the “full faith and credit” of the state of issuance. But these bolded disclosures almost

83. *See, e.g.*, Bond issued by Rapid City Area Sch. Dist., S.D. (Apr. 22, 2022) (“The enforceability of the rights and remedies of the owners of Certificates, and the obligations incurred by the District in issuing the Certificates, *could be* subject to . . . the federal Bankruptcy Code and applicable bankruptcy . . . laws.”) (emphasis added).

84. *See, e.g.*, Bond issued by Steilacoom Hist. Sch. Dist. No. 1, Wash. (Mar. 8, 2022) (“Under current Washington law, local governments, such as the District, *may be* able to file for bankruptcy under Chapter 9 of the United States Bankruptcy Code.”) (emphasis added); Bond issued by City of Tullahoma, Tenn. (Nov. 20, 2021) (“It is to be understood that the rights of the owners of the Bonds and the enforceability of the Bonds and the resolution authorizing the Bonds *may be* subject to bankruptcy.”) (emphasis added).

never reported on the issue of bankruptcy access. And even when the offering documents did reference bankruptcy somewhere in the documents, the topic was not readily accessible. To us, the lack of disclosure suggests a lack of importance.

### **B. Payment Terms**

Accessing a statutory bankruptcy scheme is one method of engineering a debt restructuring. An alternate method is bankruptcy by contract: the debt contract includes a set of contractual provisions that basically mimic key features of what would otherwise happen through a bankruptcy system.<sup>85</sup> The missing element is supervision by a federal bankruptcy judge.

Typically, municipal bonds use a trust structure — where a trustee represents the bondholders and the rights of the bondholders are made operational through what is called a trust indenture.<sup>86</sup> To the extent the indenture contract contains provisions that mimic bankruptcy or refuse to, we should see this in the disclosure to investors. In particular, we should see this reported in the discussion of “modification” provisions that tell everyone what sort of creditor vote will allow for a restructuring to occur. If the payment terms (principal, interest rate, maturity date, currency, etc.) cannot be modified without unanimous approval from the creditors, that is akin to saying that the bond cannot be restructured. This is because unanimous approval from a dispersed set of creditors holding a typical bond is impossible to obtain. By contrast, if the payment terms can be modified by some lesser vote such as 75% or 66.67%, that’s more akin to contractual bankruptcy.<sup>87</sup>

There are other bells and whistles that could be included as well to enable an orderly restructuring, but the vote for modifying payment terms is the most crucial term. So, we coded our roughly 600 bonds to capture the vote required to alter payment terms.

Almost 40% of the sales documents that we coded did not disclose anything about the modification process at all. Of the remaining bond offering documents that did report on the amendment process, 42%

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85. See generally BUCHHEIT ET AL., *supra* note 1.

86. This is the standard structure in the bonds we examined. See also Stephen J. Lubben, *Protecting Ma and Pa: Bond Workouts and the Trust Indenture Act in the 21st Century*, 44 *CARDOZO L. REV.* 81, 93–109 (2022) (describing trust indentures and the background legal regime).

87. For a discussion of the evolution of the contractual mechanism in the sovereign context, where there is only the contract option, see Lee C. Buchheit & Mitu Gulati, *The Argentine Collective Action Clause Controversy*, 15 *CAP. MKTS L.J.* 464, 464–69 (2020).

did not tell investors the vote required for altering payment terms. In other words, close to 65% of the sales documents for these bonds said nothing about supposedly crucial contractual restructuring provisions.

When we broke down the bond data by categories such as the states the issuers were from or which industry they were in, we found no meaningful patterns. As with the disclosures about access to federal bankruptcy, disclosures about contractual bankruptcy just do not seem to be considered important.

### C. Non-Payment Terms

The most direct method of doing a debt restructuring is via a vote to modify the payment terms of an instrument. For publicly issued U.S. corporate bonds, however, direct modification via a vote of the creditors is in effect prohibited under the Trust Indenture Act of 1939, which requires unanimous approval of the creditors for a vote-based modification of the payment terms of the debt.<sup>88</sup> This prohibition, however, does not apply to municipal bonds.<sup>89</sup> From what we have been able to tell, however, the basic indenture structure used by municipal issuers appears to be similar to that used by corporate issuers. Specifically, for those municipal bonds where we have been able to discern what the modification vote required for direct alteration of payment terms is, we found that 96% of those bonds require a unanimous vote.

Assuming then that U.S. municipal issuers, for reasons of path dependence, tend to use the standard corporate bond issuance structure, the contract restructuring option available to them would be a technique known as the Exit Amendment.<sup>90</sup> The idea is that the distressed debtor uses the provision that allows for modification of key non-payment terms to threaten dissenting creditors that they will be left with legally weaker instruments (after the modification of the non-payment terms) unless they consent to the offered debt restructuring.<sup>91</sup> What is relevant here — for an investor concerned about the risk that this restructuring technique might be used — is the vote required for changes to key non-payment terms. If that risk is salient, we would expect disclosure of the voting requirement for these terms.

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88. See Buchheit & Gulati, *supra* note 16, at 1328.

89. *Id.* at 1329.

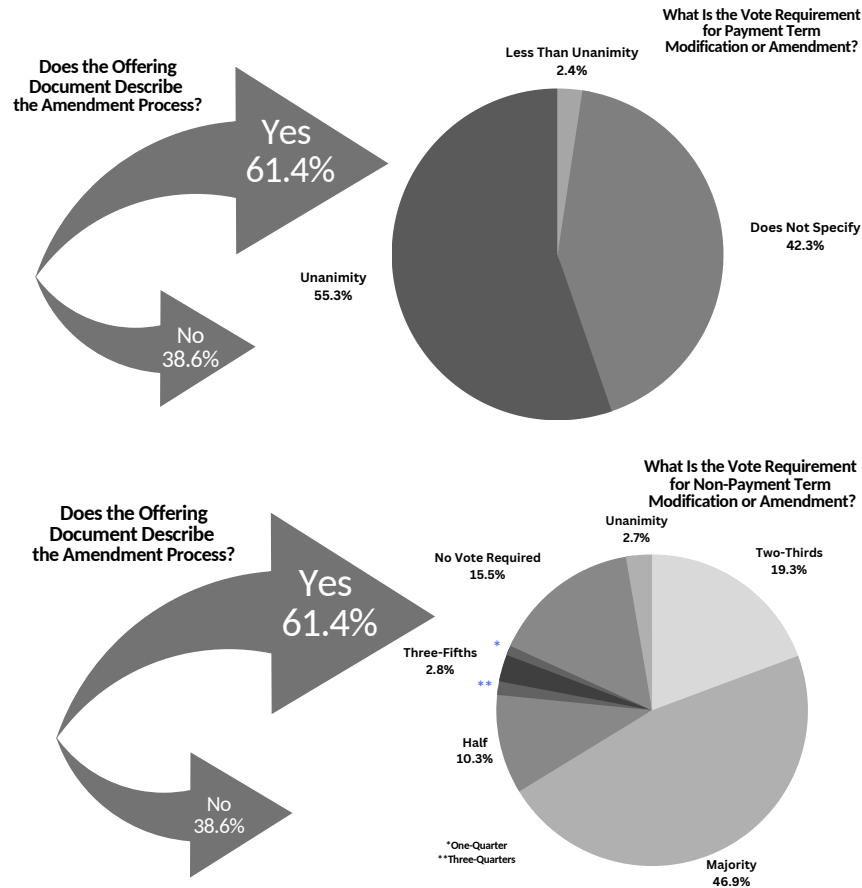
90. See Lee C. Buchheit & Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59, 65–66 (2000).

91. See *id.*

Figure 3 describes what we find for disclosures of the payment and non-payment term variables. As with the payment terms, close to 40% of the documents do not disclose what the required vote is for altering non-payment terms. For the remaining bond offering documents, we do have disclosure and even considerable variation in the voting requirements — indicating that there are differences in preferences operating here.

The key fact, though, is that almost 40% of the bonds do not report the vote requirement. We suspect, as we have conjectured before, that what we are seeing is an indication that investors do not care about this information.

**Figure 3: Disclosures Regarding Contractual Amendment Process for Municipal Bonds in Sample**





#### D. Governing Law

In the literature on government debt, a key commitment variable is thought to be choosing the governing law of the contract to be a law other than that of the state issuing the debt.<sup>92</sup> If the governing law is that of the state that is directly or indirectly, through a municipality, issuing the debt, the state can always change the law *ex post* to advantage itself. And there have been instances of nations doing so: the U.S. government in 1933; Greece in 2012; and so on.<sup>93</sup> This kind of power is particularly potent when the debtor state in question does not have the capacity to inflate the currency — a different method of expropriating value from creditors.<sup>94</sup> Consequently, we would expect to see clear disclosures about the governing law of the contract if commitment to refrain from restructuring opportunistically were important to creditors. Creditors would in turn, under the credible commitment theory, demand higher interest rates for bonds under local state laws and lower rates for those under foreign state laws.

We find, as Figure 4 shows, that almost 50% of the bonds say nothing about the governing law of the bond — that is, they include no “choice of law” provision. And for those that do disclose, there is generally no “governing law” section. Instead, one has to dig through the document to try and find some indication that the bond is governed by a particular jurisdiction’s law. And there, best as we can tell, 100% were to be governed under the state’s local law. Issuers of municipal bonds, whether states, agencies, cities, towns, or special districts, appear not to consider a contractual commitment to having their debt obligations adjudicated out of state important. This pattern is distinct from the sovereign debt context, where nations regularly include choice of law provisions that select for creditor-favorable jurisdictions, often New York or London.<sup>95</sup>

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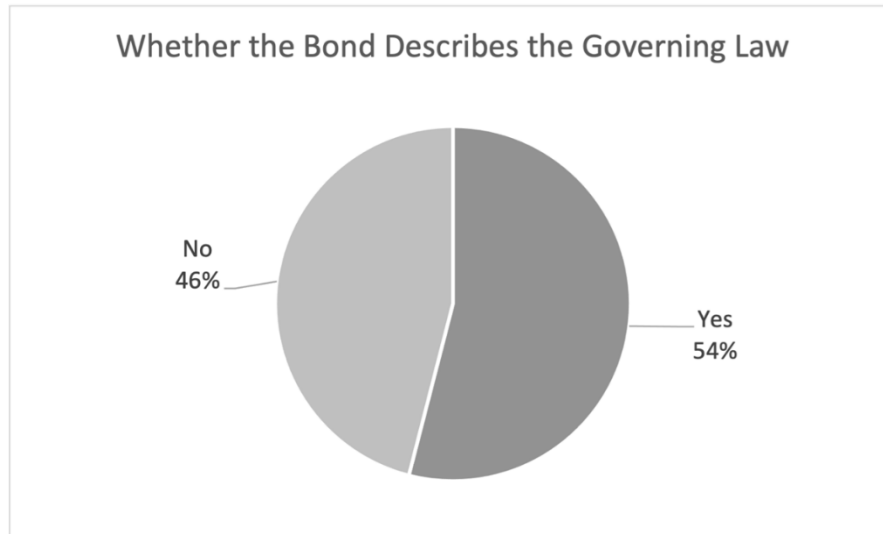
92. See Yannis Manuelides, *Using the Local Law Advantage in Today’s Eurozone*, 14 CAP. MKTS L.J. 469 (2019); Lee C. Buchheit & Mitu Gulati, *Use of the Local Law Advantage in Restructuring of European Sovereign Bonds*, 3 U. BOLOGNA L. REV. 172, 173–74 (2018).

93. See Patrick Bolton, Ugo Panizza & Mitu Gulati, *Legal Air Cover*, 7 J. FIN. REG. 189, 193–94, 207 (2021).

94. *Id.* at 194, 207.

95. See Venetia Argyropoulou, *Sovereign Bond Restructuring from a Contractual Perspective, Caveat Bondholder*, 48 CAL. W. INT’L L.J. 247, 261 (2018).

**Figure 4: Fraction of Bonds in Sample that Disclose the Governing Law**



### III. INTERVIEW FINDINGS

Puzzled by what we were finding in the bond offering documents, we reviewed our results with thirty-four participants in the municipal bond industry. Our primary source of interviewees was through the network of law teachers and alumni at the institutions where we were working during the course of this project. In most cases, if these initial contacts were not able to talk to us, they then suggested further contacts. Our interviewees included lawyers, judges, ratings specialists, issuers, and investors.

In every case, we shared our results with the interviewee as a precursor to our conversation, and, importantly, promised that their conversations with us would be used on a “not for attribution” basis. This Part summarizes the main responses to our findings. These responses are preliminary; we report them to provide additional context for the data and to set the table for future research.

Two caveats are necessary. First, none of our respondents indicated surprise at our results. Second, their responses focused almost exclusively on our findings regarding access to federal bankruptcy. Few respondents found our results regarding the contractual equivalent of bankruptcy or the lack of a specified governing law to be worthy of comment.

### A. Other Things Matter More

A number of our respondents said that we were looking at the wrong features of the bond documents. These respondents were unsurprised by the lack of disclosure about federal bankruptcy access. In their view, bankruptcy access is not one of the key features determining whether an investor is going to get paid in the event of financial distress. As one of our very first interviewees, a senior municipal bond lawyer, explained in response to our interest in whether access to federal bankruptcy affects the cost of capital positively or negatively:

You are looking at the wrong factor. I'm surprised there is this much academic attention for an issue that is not that important. I've never worked on a deal where anyone thought that the access to Chapter 9 impacted anything, let alone being worth basis points. No one ever has talked about this in any deal I can remember. Other factors are a lot more important. Things like whether taxes can be raised to pay the bonds, whether there is a dedicated revenue stream for this bond and maybe whether there is collateral support. Bankruptcy access is far down the chain of things that is important.<sup>96</sup>

Others observed that the municipal bond market was more likely to turn on macro-economic factors and the needs of bond funds for investments; close scrutiny of bond terms was unlikely to occur in this setting. One interviewee, whose particular focus was pricing, explained that when pricing bonds, investors are looking at “macro factors” and bankruptcy does not matter “most of the time.”<sup>97</sup> Another interviewee, a state disclosure counsel, observed that “nobody cares or asks us . . . the market doesn't demand it.”<sup>98</sup>

Indeed, a number of interviewees expressed skepticism of any purported link between interest rates and access to bankruptcy. One indicated that underwriters want to get bonds to the market fast to seize advantageous market windows, as do the other players in the system.<sup>99</sup> We also heard interviewees say that this was a “very permissive market” and so “due diligence shrinks.”<sup>100</sup>

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96. Interview 5 (Nov. 3, 2022) (notes on file with authors). One respondent took the view that since the majority of states (35) restricted access to Chapter 9, only the states that did not restrict access had anything meaningful to disclose. Interview 31 (Jan. 11, 2023) (notes on file with authors). However, we find that the types of disclosures across all of the states are similarly vague when it comes to bankruptcy access.

97. Interview 32 (Nov. 10, 2022) (notes on file with authors).

98. Interview 2 (Dec. 21, 2022) (notes on file with authors).

99. Interview 24 (Mar. 24, 2022) (notes on file with authors); Interview 16 (May 6, 2022) (notes on file with authors).

100. Interview 16, *supra* note 99.

Finally, many of our respondents made the following point: “Bankruptcy [in this market] just hasn’t been frequent enough to be important.”<sup>101</sup>

Given that they thought we were looking at largely irrelevant variables, these respondents were not surprised that we found a failure to meaningfully disclose the terms of bankruptcy. As if to emphasize the point, some respondents asked us: “Have you looked at other categories of bonds? Does *anyone* disclose this stuff?”<sup>102</sup>

These responses raise questions about the academic pricing studies, which report that access to bankruptcy affects the price of credit. The participants in the market report otherwise — indicating that there is a disjuncture between those studies and what actors on the ground say.<sup>103</sup>

### B. Access to Chapter 9 is a Moving Target

Multiple respondents reported that disclosure in the municipal space was uneven, in part because of the lack of regulatory oversight or, in some cases, because disclosure was contingent on recent events.<sup>104</sup> One of our earliest respondents explained:

This stuff is boilerplate and path dependent. You are looking for rationality in a place where there isn’t that much of it. There is no real disclosure regulation in this space. Lawyers tend to repeat what was done in the prior deal. And there is variation. You do see occasions where there is more disclosure. But that can almost always be explained by some idiosyncratic factor — like something happened with that issuer or a big investor got burned. Or regulation changes in a state, like with California school districts. There is no demand

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101. Interview 17 (Nov. 17, 2022) (notes on file with authors).

102. Interview 6 (Nov. 3, 2022) (notes on file with authors); Interview 7 (Nov. 3, 2022) (notes on file with authors). One of us has examined this question with sovereign bond contracts. In that context, literally 100% of the random sample of emerging market sovereign bonds examined prominently disclosed details on how a contract-based restructuring and cram down of dissenting creditors could take place. These bonds also prominently disclosed what the governing law was. See Michael Bradley et al., *Pricing Sovereign Debt: Foreign Versus Local Parameters*, 24 EUR. FIN. MGMT 261, 274 (2018). One does not find this disclosure in highly rated sovereign bonds such as those of the US, UK, France, Germany, and Japan because they have no such restructuring provisions.

103. This is not to say that either is wrong. There can sometimes be disjunctions between what people do and what they say are the reasons for what they do, and the reasons for those disjunctions can shed light on what is going on. See generally Gisela Böhm & Hans-Rudiger Pfister, *How People Explain Their Own and Others’ Behavior: A Theory of Lay Causal Explanations*, 6 FRONTIERS PSYCH. 139 (2015).

104. Interview 19 (Feb. 8, 2022) (notes on file with authors); Interview 22 (Aug. 1, 2022) (notes on file with authors); Interview 23 (Aug. 1, 2022) (notes on file with authors).

for higher quality disclosure. And some of the stuff is historical. It was done because of some problem that occurred in the past, so it is still done. Like the legal opinions about whether the bonds were properly authorized. This dates back to the 1800s. Just doesn't come up nowadays. But there is always a legal opinion.<sup>105</sup>

One bond counsel noted that in the aftermath of the Detroit bankruptcy, “we did put some of that in there,” — referring to specific language regarding the potential for municipal issuers to access bankruptcy in his state — but also noted that in “some cases, [bankruptcy access disclosures] came out.”<sup>106</sup>

A subset of our respondents noted that bankruptcy access can change. A state can decide at the point of fiscal distress to authorize bankruptcy even if it had previously denied that ability. Given that ex-post changes to access can be made by state legislatures, our respondents suggested it might make sense for lawyers to hedge on the question of eventual access to bankruptcy, even in states with laws currently clearly denying it. One of our judge respondents explained:

The state can always change the rules it has set up with regards to access to Chapter 9. These are not contractual promises. Maybe lawyers don't want the risk of securities fraud liability — or an obligation to have to update investors on changes in the local rules. And especially not if this [is] something that is both complicated and not particularly important in the first place. If the client [the issuer] won't pay for the legal analysis, then it is best to leave the matter vague. Say nothing meaningful.<sup>107</sup>

This account, however, does not explain the lack of disclosure of the contract mechanisms by which a restructuring can be engineered. We did not push our respondents on this matter, but perhaps the contract mechanisms become unimportant in a context where the state can always opt into or out of bankruptcy after the fact.

### C. It's Complicated

Another explanation provided by a number of respondents — and often the same respondent who observed that legislatures can always change the law — is that determining bankruptcy eligibility is complicated, which might explain why disclosures are equivocal. These respondents observed that there are numerous barriers, both in state and federal law, to a municipal filing, and that predicting whether a

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105. Interview 19, *supra* note 104.

106. Interview 4 (Dec. 21, 2022) (notes on file with authors).

107. Interview 10 (Oct. 31, 2022) (notes on file with authors).

given entity would ultimately be deemed eligible by a court to file for Chapter 9 was often speculative because “bankruptcy is inconsistently applied.”<sup>108</sup> Respondents also noted that there are particular complications with respect to different types of municipal issuers, i.e., that one could not necessarily generalize about access when considering bonds from different sectors.

As noted earlier, some respondents speculated that for a lawyer preparing an offering document, in a market where no one else is providing meaningful disclosure on this matter, the most defensible solution is to follow the crowd and say that it is unclear whether the creditors might find themselves dealing with a federal bankruptcy proceeding. One respondent who had worked specifically on cases involving municipal fiscal distress said, with some frustration:

[It is] easier to do what everyone else is doing. If no one else is willing to state clearly what the access to bankruptcy is, and it is complicated, and a court might decide otherwise, or the state might change its views, [it might be better to] do what everyone else is doing. No one gets into trouble for doing what is the market standard. No liability. Better to go down on the Titanic than in a dinghy. You don’t want to be in the dinghy.<sup>109</sup>

One counsel for a county that had experienced fiscal distress observed that “our boilerplate was bad disclosure” but no one “focused on it” because bankruptcy was “so rare” that “no one paid attention.”<sup>110</sup> This interviewee further observed that bond lawyers “aren’t going to take risks.”<sup>111</sup> Bond lawyers and underwriters, this interviewee suggested, “don’t understand” bankruptcy, and buyers “don’t care.” In light of his experience, this interviewee was “shocked” to learn of studies finding a relationship between interest rates and access to bankruptcy.<sup>112</sup>

Another interviewee observed that “municipal disclosure documents are not very good;” that counsel “don’t understand how bankruptcy works.”<sup>113</sup>

Some respondents also noted that the treatment of debt in bankruptcy was subject to political considerations not present in cases of a corporate restructuring.<sup>114</sup> These respondents observed that

108. Interview 27 (Nov. 17, 2022) (notes on file with authors).

109. Interview 3 (Dec. 21, 2022) (notes on file with authors).

110. *Id.*

111. *Id.*

112. *Id.*

113. Interview 19, *supra* note 104.

114. Interview 33 (Nov. 14, 2022) (notes on file with authors).

judges and state and local political actors would be loath to allow creditor repayment to undermine the provision of basic municipal services or that pension obligations, though falling into the category of unsecured debt, would be difficult as a political matter to cut.

These respondents noted again that access to bankruptcy itself is not all that important compared to other features of a particular issuance. One state disclosure counsel said that “we don’t discuss bankruptcy,” and reported that she was not persuaded that it was necessary.<sup>115</sup> “Even at the point of a borrower not paying, bankruptcy is not that important.”<sup>116</sup>

Once a municipality is in bankruptcy, all bets are off. Because bankruptcy is both a last resort and costly for a municipal debtor to enter, any up-front commitment either to access or not to access bankruptcy is not particularly meaningful.

#### D. Defaults are Rare

Some of our respondents started out with the observation that municipal defaults are rare and that the bonds in our dataset were likely all highly rated issuances. One explained: “[Investors] don’t need to know. The issuers are almost all highly rated. And defaults are extremely rare. Distress is rare and even then bankruptcy is rarely the option that is taken. It is a last resort.”<sup>117</sup>

To be sure, our respondents acknowledged recent prominent municipal debt crises, and in some cases, observed that those crises may have led to changes in how participants viewed the market — at least temporarily. The overall stability of the market, however, was not challenged. A few practitioners who had worked on some distressed debt situations in the municipal bond space noted that even municipalities that had entered bankruptcy, like Detroit, Michigan and Jefferson County, Alabama, were able to access credit markets relatively soon after their respective bankruptcies, and that those entities had garnered respectable credit ratings.<sup>118</sup> Other interviewees emphasized the “short memories” of the bond market.<sup>119</sup>

A few respondents observed that bankruptcy improves the creditworthiness of the debtor, is a useful tool to improve local

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115. Interview 1, *supra* note 23.

116. *Id.*

117. Interview 21 (Apr. 4, 2022) (notes on file with authors).

118. Interview 3, *supra* note 109; Interview 33, *supra* note 114.

119. Interview 34 (Dec. 21, 2022) (notes on file with authors).

finances, and is looked upon favorably by the credit markets.<sup>120</sup> Another observed that “the banks keep lending to insolvent entities,”<sup>121</sup> and that the market is a “very forgiving environment.”<sup>122</sup>

The rarity of municipal default and debt buyers’ relative forgiveness led some of our respondents to doubt the importance of bankruptcy availability *ex ante*. An interviewee who represented fiscally distressed entities observed that “[b]ondholders don’t think Chapter 9 is going to happen.”<sup>123</sup>

In the context of making this point about how bankruptcy access did not matter, multiple respondents asked about whether we had separated out our data by ratings. Perhaps, they asked, the quality of disclosure was correlated to ratings?

This is a topic that we plan to examine further by focusing on the subset of municipal issuers that are unrated or that are rated below investment grade. Our initial examination, however, does not suggest that we will find that ratings are related to disclosure quality. Forty-three percent of the bonds in our dataset had *no rating* from any of the three major ratings agencies, but we did not find any relationship between bankruptcy access disclosure and whether the issuer had a rating. Turning to those with ratings (57%), we again found no meaningful correlation between the type or quality of bankruptcy access disclosure and ratings.

### E. Only Hedge Funds Care

Multiple respondents made the point that the “real money investors,”<sup>124</sup> who tend to buy municipal debt in the primary market, are not going to stick around in the event of a financial crisis. They sell and exit and then distressed debt funds (often hedge funds) enter in the secondary market. The hedge funds may care about legal terms insofar as they are trying to exploit their legal knowledge in

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120. Interview 33, *supra* note 114; Interview 14 (Oct. 26, 2022) (notes on file with authors). We also, however, had one respondent who told us that lore in his state, where municipalities were restricted from access to Chapter 9, was that that state was able to borrow at lower rates because it restricted access to Chapter 9. Interview 2, *supra* note 98.

121. Interview 9 (Oct 21, 2022) (notes on file with authors).

122. Interview 16, *supra* note 99.

123. Interview 6 (Nov. 2, 2022) (notes on file with authors).

124. “Real money investor” is a term of art that usually refers to the big traditional institutional investors who utilize “buy and hold” strategies. See *Definition of Institutional Investor*, BIS, <https://www.bis.org/statistics/glossary.htm?&selection=302&scope=Statistics&c=a&b=ase=term> [https://perma.cc/LX24-J9UR] (last visited Mar. 5, 2023).



anticipation of litigation. One of our pension fund respondents explained:

There is very little of the legalese that I look at. I'm looking at cash flows in particular bonds and comparing across bonds. If there is distress and the legal stuff becomes important, I will have usually sold the instrument to some distressed debt hedge fund who, I'm guessing, has their own in-house lawyers reading the documents and planning what to do. We don't do that.<sup>125</sup>

There is a puzzle about the foregoing, and indeed one that our respondent (who advises distressed debt funds) identified. He noted: "Shouldn't real money investors want to know which of their bonds have better and worse legal terms so that they can better negotiate prices for them with the more informed distressed debt funds?"<sup>126</sup>

The lack of interest in such terms, as reported by our interviewees, complements our data. The terms of any potential restructuring remedy in the event of municipal fiscal distress are rarely disclosed or disclosed only in passing and appear to be uninteresting to bond buyers and the financial markets as a whole. Even practitioners who operate in that market seem unconcerned about the various mechanisms municipal issuers could deploy to make their commitments to repay more credible. Bankruptcy access or its contractual equivalent are simply not considered relevant for these actors.

#### IV. IMPLICATIONS, OPEN QUESTIONS, AND NEXT STEPS

With but a few exceptions, the literature on sovereign and sub-sovereign bankruptcy tells us that access to bankruptcy or a contractual equivalent is important to investors.<sup>127</sup> Our examination of the offering documents for a set of roughly 600 municipal bonds suggests otherwise. Neither issuers nor investors seem to care enough about this matter to have it clearly disclosed in the bond offering documents. The question is why. In this final section, we speculate about the implications of our findings and sketch out some possible extensions of our preliminary inquiry.

##### A. Implications

The most obvious explanation for our findings, which we find support for in our interviews with practitioners in the municipal bond

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125. Interview 30 (Jan. 9, 2023) (notes on file with authors).

126. Interview 21, *supra* note 117.

127. See William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. 1, 24–25 (2004).

industry, is that bankruptcy access is not a matter of great importance to market participants, at least not in the primary market where bonds are first sold. To participants in the primary market, other characteristics of the issuer are more important.<sup>128</sup>

There are, of course, other potential explanations for our findings. First, it is possible, despite what our respondents said, that the disclosure documents are not an accurate gauge of what investors consider important. Maybe investors at the kinds of institutions that buy these bonds do their own independent research on key features of the bonds and do not put any weight on what is disclosed in the offering documents. If that is the case, there would be little reason for the issuers to invest resources in providing investors with detailed disclosures on key matters. After all, investors already have that information and do not want to pay for it. In a world where the public disclosures provided to all investors are largely useless, the primary focus of the issuer is likely to be to avoid fraud liability for its statements. This would predict that bond offering documents would include only the most vague and innocuous statements about important matters that could be grounds for a later fraud action. Our interviews did not suggest the foregoing, but it is possible.

Second, it is possible that ratings agencies have access to state-specific information and incorporate it into their ratings, upon which bond buyers rely. Our conversations with those in the industry though, including at ratings agencies, indicate otherwise. In any case, it remains unclear why an issuer would offer vague boilerplate language in offering documents that ratings agencies also read. Furthermore, our understanding is that issuers often make their case for a positive rating directly to the agencies. If the issue of bankruptcy access were as important as academic studies indicate, presumably municipal issuers would be providing that information directly to the agencies or urging their state legislators to change or amend existing laws to be more favorable to creditors.

Our tentative view is that the underlying restructuring regime is either too uncertain or too swamped by other factors that matter more to creditors. The dependability of a given revenue stream, historic default rates, and other kinds of factors are, according to one interviewee, better proxies of the likelihood of repayment.<sup>129</sup>

As noted in the prior section, multiple interviewees expressed surprise when we described the empirical studies that find a

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128. We put those aspects aside for purposes of this article.

129. Interview 27, *supra* note 108.

relationship between bankruptcy access and the cost of debt. A message we heard repeatedly is that buyers of municipal bonds simply do not care about bankruptcy and do not anticipate it.

Additional features of the existing Chapter 9 municipal bankruptcy regime support the practitioners' skepticism. First, a vanishingly small number of municipalities and state instrumentalities actually file for Chapter 9 when they are in distress, even in states that allow it.<sup>130</sup> If the chances of a bankruptcy filing are remote across all municipal issuers, a meaningful difference between the credit worthiness of issuers in permissive states as compared to non-permissive states seems unlikely.

Second, municipal issuers face difficulties in perfecting a Chapter 9 bankruptcy filing even when they have state permission to file. Scholars have observed that the Bankruptcy Code's eligibility criteria present a high hurdle to municipal debt relief; indeed, much of the literature recommends making those criteria less onerous, not more.<sup>131</sup> Aside from proving by a preponderance of the evidence that it is a "municipality" as defined in the Code and authorized to file under state law, a debtor must also fulfill three other requirements: (1) that it is "insolvent"; (2) that it "desires to effect a plan to adjust such debts"; and (3) that it has negotiated in good faith with creditors or that such negotiations would be futile.<sup>132</sup> These criteria present ample opportunities for litigation. Drawn-out eligibility fights deplete a debtor's resources and can force debtors to "capitulate to creditor demands."<sup>133</sup> The costs of eligibility fights only compound the high costs of a Chapter 9 filing. As Laura Coordes writes, "the eligibility requirements are largely unnecessary, as [C]hapter 9 has so many negative consequences and built-in costs that only cities in desperate financial shape will use it."<sup>134</sup> If Chapter 9 is already so onerous and

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130. NUVEEN, MUNICIPAL BANKRUPTCY: A PRIMER ON CHAPTER 9 (2022), <https://documents.nuveen.com/documents/nuveen/default.aspx?uniqueid=28aac556-dca6-48c4-85cd-879b2b5e925a&subid=3%7C7#:~:text=Since%20Congress%20added%20Chapter%2009,in%202022%2C%20one%20has%20filed> [<https://perma.cc/9HFA-4F9D>] ("Since Congress added Chapter 9 to the federal bankruptcy code in the 1930s, there have been approximately 700 filings under Chapter 9. Comparatively, the commercial Chapter 11 filings generally number more than 5,000 per year. Last year, three municipalities filed under Chapter 9.").

131. See, e.g., Coordes, *Gatekeepers Gone Wrong*, *supra* note 35, at 1225; Vincent S.J. Buccola, *The Logic and Limits of Municipal Bankruptcy Law*, 86 U. CHI. L. REV. 817, 864-65 (2019).

132. 11 U.S.C. § 109(c).

133. Coordes, *Gatekeepers Gone Wrong*, *supra* note 35, at 1219.

134. *Id.* at 1196.

underused, any finding that investors favor municipal issuers with or without a restructuring option seems suspect.

These features of the existing bankruptcy regime raise additional questions. First, if buyers do not seem to care about access to bankruptcy, why would states adopt certain rules over others, in some cases permitting bankruptcy and in other cases not? Second, what are the optimal rules for states contemplating the possibility of municipal fiscal distress?

One answer to the first question is that legislatures may *think* buyers care when they do not. State officials sometimes appear to treat the debt markets as more punitive than they are, assuming that any tolerance for municipal default or bankruptcy will raise the costs of debt for all the state's issuers or shut the state and its localities out of the debt markets altogether. The evidence for these effects is limited, however,<sup>135</sup> and many doomsday scenarios have not come to pass.

Political inertia may be another explanation.<sup>136</sup> States respond to specific fiscal crises and tend to adopt legislation in response to historical circumstances and fail to update it, despite evidence that its effect may be minimal or detrimental.<sup>137</sup> Another possibility is that state regulatory regimes are a product of interest group bargaining. Perhaps some interests other than municipal debt buyers have a stake in the state adopting a certain kind of debt resolution machinery, whether permissive or restrictive.

The second question — concerning the optimal rules for managing municipal fiscal distress — is a source of on-going debate.<sup>138</sup> Some argue that moral hazard concerns are overblown in the municipal debt context, but that argument does not tell us the optimal form for state intervention either when or before municipal fiscal distress occurs. Proponents of municipal bankruptcy argue that it should be more widely available and more readily utilized as a means for resolving

135. For a discussion, see Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1074–77 (1997).

136. See Parikh & He, *supra* note 9, at 603 (describing the “paralysis justification”).

137. The “fiscal constitution” in the states, adopted in response to the problem of local and state defaults in the nineteenth century, may be an example. See Schragger, *Democracy and Debt*, *supra* note 10, at 863.

138. See, e.g., Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 357 (2010) (arguing that bankruptcy is not an effective way to address local municipal fiscal distress); Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55, 59 (2016) (describing the “Detroit Blueprint” and how it provides a model of active federal court involvement in municipal bankruptcy that departs from traditional assumptions about the federal courts’ limited role).

municipal debt crises.<sup>139</sup> Some have argued that a bankruptcy option should be extended to the U.S. states as well.<sup>140</sup> Our study has little to say about the pros and cons of those proposals, though we suspect our findings have implications for those debates insofar as bankruptcy does not appear to be a central concern of the municipal bond market.

### B. Extensions

An extension of this research — and one that we hope to consider in subsequent work — is to ask what investors *do* care about. Are bond buyers interested in the remedies available to them in the case of lack of payment or default — whether they can seize assets, seek a writ of mandamus to force tax collections, or rely on statutory liens? Since bankruptcy courts may treat different types of debt differently, the exact type of debt is an important consideration. For some of these remedies, bond buyers might want to know if state statutory or constitutional tax limitations exist, which might prevent increases in local tax rates. These limitations would affect the ability of the local entity to raise revenue.

By the same token, bond buyers might want to know if and how the state regularly intervenes to support distressed entities. The important features of state law in this regard are the availability of emergency financing — extensions of credit, loans, and grants to local entities — and the possibility of restructurings, disincorporation, or renegotiation of labor and other contracts.<sup>141</sup> These kinds of interventions tend to be most relevant in the context of fiscally distressed cities, towns, and school districts, and much less so in the context of most other types of special districts, though generally states have provided limited fiscal support to their distressed local governments, despite options in some states' laws to do so.<sup>142</sup>

Once we have both a fuller set of variables regarding the bonds, and more bonds, we plan to empirically test the relationship between these variables and the cost of capital.

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139. See generally Kordana, *supra* note 135; Coordes, *Gatekeepers Gone Wrong*, *supra* note 35; Buccola, *supra* note 131.

140. See, e.g., Skeel, *Is Bankruptcy the Answer?*, *supra* note 4 (arguing for a state bankruptcy option); Skeel, *States of Bankruptcy*, *supra* note 4. But see Omer Kimhi, *Addressing the Next State Fiscal Crisis: Toward an Ex-Ante Scheme of Federal Assistance to States in Fiscal Distress*, 47 BYU L. REV. 871 (2022) (arguing against).

141. Cf. PEW CHARITABLE TRS., STRATEGIES FOR MANAGING STATE DEBT (2017), [https://www.pewtrusts.org/~media/assets/2017/06/sfh\\_strategies\\_for\\_managing\\_state\\_debt\\_final.pdf](https://www.pewtrusts.org/~media/assets/2017/06/sfh_strategies_for_managing_state_debt_final.pdf) [<https://perma.cc/8FZP-KXC7>].

142. *Id.*

### CONCLUSION

As of the second quarter of 2022, the U.S. municipal debt market was worth approximately \$4 trillion.<sup>143</sup> Municipalities issue over \$400 billion worth of bonds each year.<sup>144</sup> Our scholarly understanding of this market, however, is limited. While there have been numerous studies seeking to quantify the value of legal rules to investors, there has not (as far as we know) yet been a study of the language of the bond offering documents themselves. These documents are meant to set the legal expectations of the parties and to allow buyers to assess the riskiness of a given security. One might have assumed that investors would want, and issuers would provide, a clear explanation of the process by which a municipal debt restructuring can take place in a given jurisdiction. But we do not find evidence that the terms or mechanisms of a restructuring are given much thought by issuers or their counsel beyond standard vague boilerplate.

Academic studies of the municipal bond market suggest that access to bankruptcy or a bankruptcy-like process matters to the capital markets, but our interviewees and the disclosure data seem to indicate otherwise. There are multiple possible explanations for this disjunction, but it is valuable to know which one is operating. If access to bankruptcy does not matter to investors, then it might be in the interest of all the states to embrace rather than avoid it. At this stage of our research we cannot draw definitive conclusions. But we hope to have shown that further investigation into the legal documents upon which the bond market is based and the actual practices of municipal bond market participants can help to gain a fuller understanding.

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143. *US Municipal Bond Statistics*, SIFMA, <https://www.sifma.org/resources/research/us-municipal-bonds-statistics/> [<https://perma.cc/Z3PS-RZ7D>] (last visited Feb. 23, 2023).

144. SIFMA, *SIFMA RESEARCH QUARTERLY – 3Q22: US FIXED INCOME MARKETS – ISSUANCE & TRADING 12* (2022), <https://www.sifma.org/wp-content/uploads/2022/10/US-Research-Quarterly-Fixed-Income-Issuance-Trading-2022-10-19-SIFMA.pdf> [<https://perma.cc/Y2LJ-HQ5F>].