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ARTICLE

DISAGGREGATING STATE BANKRUPTCY

MICHAEL A. FRANCUS†

States today face fiscal challenges that they cannot surmount. With trillions in debt and billions in deficits, states are rapidly reaching the point where they cannot satisfy their obligations to pensioners, employees, and residents. This deterioration of state finances has, in turn, revived the debate over whether Congress should expand the Bankruptcy Code to allow states to file for bankruptcy. The debate, though, overlooks how, as a practical matter, bankruptcy is already available to financially

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distressed states. Chapter 9 of the Bankruptcy Code permits a state's political subdivisions, public agencies, and instrumentalities to file for bankruptcy if the state authorizes them to do so. A state can therefore make its own debt bankruptcy-eligible by having a government entity—other than the state itself—owe the debt, and by authorizing all government entities in the state to file for bankruptcy.

This disaggregation—states operating, and taking on debt, through government entities rather than the state itself—is already the norm. In fact, the vast majority of so-called "state debt," some ninety percent, is owed not by states themselves, but by government entities eligible to file for bankruptcy.

The interaction of disaggregated states and Chapter 9 leads to a doctrinal oddity: Debt owed by the state itself is not bankruptcy-eligible, but that same debt, if owed by a state agency or instrumentality, is bankruptcy-eligible. That doctrinal oddity has enormous significance, both theoretical and practical. For theory, disaggregation shows that states can partition liability, confining distress to a particular entity instead of having that entity's liabilities threaten the fiscal stability of the whole state. As for practice, disaggregation offers a superior alternative to adding a state bankruptcy chapter to the Code. Disaggregation is simpler, fairer, and has fewer spillover effects, offering states a good way to address their current, dire, fiscal situations.

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INTRODUCTION

In 1933, Arkansas was broke. Dead broke. The state treasury contained $4.62; the state owed $160 million.[1] After negotiations fell through and efforts to re-fund the state's bonds failed, the state had no choice but default. The consequences were dire: Litigation followed for decades. Creditors leveraged political influence to curtail federal funds to the state.[2] Schools ran out of money.[3] And for decades, Arkansas saw itself frozen out of bond markets, unable to borrow to fund the basic services that states provide.[4]

Arkansas was the last state to default but not the last state to experience a fiscal crisis. Through 2008's Great Recession, state finances deteriorated, leading to calls to amend the Bankruptcy Code to allow states to file.[5] Today,

1 *See* Monica Davey, *The State that Went Bust*, N.Y. TIMES (Jan. 22, 2011), https://www.nytimes.com/2011/01/23/weekinreview/23davey.html [https://perma.cc/87TF-7FPM].

2 *See* O. Emre Ergungor, *Sovereign Default in the US* 8 (Fed. Rsrv. Bank of Cleveland, Working Paper No. 16-09, 2016) (describing how the Public Works Administration suspended all loans to the state).

3 *Id.* at 13.

4 *Id.* at 10.

5 See, e.g., Stephen J. Lubben, Opening Bankruptcy Court to the States, N.Y. TIMES (Dec. 8, 2010, 2:42 PM) https://archive.nytimes.com/dealbook.nytimes.com/2010/12/08/opening-bankruptcy-court-to-the-states [https://perma.cc/263Q-2M6X] ("[The] possibility [of state finances tumbling] raises the question of whether we should amend the Federal Bankruptcy Code to allow states to file for relief . . . .").

in the wake of the COVID-19 recession, state finances are even more dire, leading to renewed calls for state bankruptcy.[6]

The numbers supporting that call are startling. State debt in 2019 totaled $3.05 trillion,[7] compared to $2.39 trillion in 2010.[8] Meanwhile, states' deficits reached $300 billion in 2019,[9] well above the $191 billion they tallied in 2010.[10] Markets too have taken note. States in crisis have seen their bond ratings plummet. Illinois bonds, for example, fell to a BBB- rating (one notch above "junk," the rating that drove Puerto Rico into bankruptcy), echoing the borrowing difficulties once faced by Arkansas.[11] And all that predates the pandemic. Little wonder, then, that the state bankruptcy debate has made its way back into the news and back into the halls of Congress.

But in these debates over allowing states to file for bankruptcy, something has gone unnoticed: As a practical matter, states already can file for bankruptcy.

This Article explores that unnoticed fact, and the consequences it has for the state-bankruptcy-chapter debate. In particular, this Article shows: (1) how states can effect a bankruptcy filing using Chapter 9 of the Bankruptcy Code; (2) how that use of Chapter 9 acts as organizational law for states; and (3) how Chapter 9-based state bankruptcy is a superior alternative to adding a bankruptcy chapter for the states.

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6 See, e.g., David Frum, Why Mitch McConnell Wants States to Go Bankrupt, ATLANTIC (Apr. 25, 2020), https://www.theatlantic.com/ideas/archive/2020/04/why-mitch-mcconnell-wants-states-go-bankrupt/610714 [https://perma.cc/BXP8-KBA2] (quoting Senate Majority Leader Mitch McConnell, stating that states should "use the bankruptcy route" because there is "no good reason for it not to be available"); Ryland Barton, Should States Be Allowed to Declare Bankruptcy?, NPR (May 3, 2020, 8:00 AM), https://www.npr.org/2020/05/03/849732520/should-states-be-allowed-to-declare-bankruptcy [https://perma.cc/6LRC-KDLX] (discussing the same suggestion by the Senate majority leader); David Skeel & Daniel Kane, Should States Declare Bankruptcy?, NAT'L AFFS. (Oct. 4, 2020), https://www.nationalaffairs.com/blog/detail/media/should-states-declare-bankruptcy-with-david-skeel [https://perma.cc/D4QD-9XP4] [hereinafter Skeel & Kane, *Should States Declare Bankruptcy?*] (same).

7 GRANT A. DRIESSEN, CONG. RSCH. SERV., RL11502, STATE AND LOCAL GOVERNMENT DEBT AND COVID-19, at 1 (2020) [hereinafter DRIESSEN, STATE AND LOCAL GOVERNMENT DEBT].

8 STEVEN MAGUIRE, CONG. RSCH. SERV., R41735, STATE AND LOCAL GOVERNMENT DEBT: AN ANALYSIS 5 (2011).

9 See DEIRDRE BAKER, JUSTIN KELLER, RAEMEKA MAYO & KRISTINA MARIE PASQUINO FRATES, U.S. CENSUS BUREAU, ANNUAL SURVEY OF STATE GOVERNMENT FINANCES SUMMARY: 2019, at 1–2 (2020) (noting $2.20 trillion in state general revenue in 2019 and $2.50 trillion in expenditures).

10 PHIL OLIFF, CHRIS MAI & VINCENT PALACIOS, CTR. BUDGET & POL'Y PRIORITIES, STATES CONTINUE TO FEEL RECESSION'S IMPACT 2 fig.2 (2012).

11 Elizabeth Campbell, *S&P, Moody's Downgrade Illinois to Near Junk, Lowest Ever for a U.S. State*, BLOOMBERG (June 1, 2017, 3:23 PM), https://www.bloomberg.com/news/articles/2017-06-01/illinois-bonds-cut-to-one-step-above-junk-by-s-p-over-stalemate [https://perma.cc/GE7K-QNTQ].

Understanding how states can file for bankruptcy requires an understanding of state debt and the government entities that owe it. The key insight here is that states are *disaggregated*, providing services (and taking on debt) through a web of governmental entities rather than through the "state" itself. Disaggregation arises naturally because service provision benefits from specialization. A state Department of Transportation, for instance, specializes in transportation, and is ill-equipped to run a state university. Likewise, regional transit is best run by the region it serves, not a statewide body or a local one. The same holds for cities, which bundle services in a geographic hub and have the local knowledge to best provide those services.

An analysis of Pennsylvania at the close of the Great Recession provides a fuller sense. In 2010, the state owed $10.4 billion in general-obligation bonds.[12] Meanwhile, state agencies owed $32.5 billion in bond debts, school districts owed another $26 billion, other local debts (cities, counties, special districts) tallied $56.5 billion, and unfunded retirement benefits (owed by government pension funds) totaled $65 billion.[13] So of the total $194 billion in "state debt," Pennsylvania itself owed only $10.4 billion, or 5.4%.[14]

That is crucial because the Bankruptcy Code, while forbidding states to file, allows a "municipality" to file.[15] And the Code defines "municipality" as a "political subdivision or public agency or instrumentality of a State."[16] The history of that provision, and current doctrine, reveal that nearly every government entity that owes "state debt" qualifies as a municipality.[17] Hence, nearly all "state debt" is eligible for bankruptcy.

At first glance, this disaggregated bankruptcy seems like legal circumvention. After all, why should debts owed to highway paving contractors be ineligible for bankruptcy when owed by the state, but eligible for bankruptcy when owed by the Department of Transportation, a county, a transportation district, or a city? But circumvention this is not. Instead, the disaggregated bankruptcy permitted by Chapter 9 offers states a way to use organizational law, which has long buoyed private enterprise. And with organizational law, the states enjoy many benefits they could not achieve outside of Chapter 9.

12 Nathan Benefield, *Understanding the Pennsylvania State Budget: Taxing, Borrowing, & Spending*, COMMONWEALTH FOUND. (Mar. 7, 2011), https://www.commonwealthfoundation.org/research/understanding-the-pennsylvania-state-budget [https://perma.cc/Q8Z2-FGSF].

13 *Id.*

14 *Id.* The report limits itself to bond debt, but the same is true of the broader sense of "debt," or as the Bankruptcy Code defines it, "liability on a claim." 11 U.S.C. § 101(12); *see also* discussion *infra* Section I.A.2.

15 11 U.S.C. § 109(c).

16 *Id.* § 101(40).

17 *See* discussion *infra* Section I.B.4.

Organizational law—the law of legal entities like corporations, partnerships, and trusts—gave rise to the modern firm.[18] Scholars of organizational law attribute organizational law's success to a few features, most notably asset partitioning, which separates the entity's assets from the assets of the entity's owners.[19] Thus, for example, a corporation creates owner-shielding (limited liability protects owners of the corporation from the creditors of the corporation) and entity-shielding (the corporation is not responsible to the creditors of its owners).[20]

Partitioning assets yields many benefits, as Henry Hansmann and Richard Squire catalog.[21] Of particular relevance here, the partition reduces creditor monitoring costs (as now creditors need only monitor the entity, not the owners); it brings the cost of capital in line with the risks of the entity (and not risks of the owners of the entity), better reflecting the true cost of capital; and it allows entities with excessive debt to avoid a debt overhang, which occurs when creditors will not lend to an entity—even for projects with expected positive returns—for fear that the rewards will go only to repaying old debt.[22]

Chapter 9 achieves all these benefits for a state. Unlike private entities, though, states achieve these benefits through *liability* partitioning rather than *asset* partitioning. Because states enjoy sovereign immunity, they have no assets that private creditors can reach and thus no assets to partition.[23] Likewise, municipalities almost always receive the protection of anti-attachment laws, which prevent creditors from levying on their assets.[24] Yet

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18 *See* Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1335, 1336 (2006) [hereinafter Hansmann, Kraakman & Squire, *Law and the Rise of the Firm*] (describing organizational law's foundational role for modern business).

19 *Id.* at 1337-39. The seminal paper, which introduced asset partitioning, is Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000).

20 *See* Hansmann, Kraakman & Squire, *Law and the Rise of the Firm*, *supra* note 18, at 1337-39 (defining entity shielding and owner shielding). In *The Essential Role of Organizational Law*, Hansmann and Kraakman used "affirmative asset partitioning" and "defensive asset partitioning," for entity and owner shielding, respectively. *See* Hansmann & Kraakman, *The Essential Role of Organizational Law*, *supra* note 19, at 393. This Article will follow the latter labeling, which is more descriptive.

21 *See* Henry Hansmann & Richard Squire, *External and Internal Asset Partitioning: Corporations and Their Subsidiaries*, *in* OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 253-59 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2017) [hereinafter Hansmann & Squire, *External and Internal Asset Partitioning*] (listing ten benefits).

22 *Id.*

23 *See, e.g.,* Alden v. Maine, 527 U.S. 706, 713 (1999) ("[T]he States' immunity from suit is a fundamental aspect of the sovereignty which the States enjoyed before the ratification of the Constitution, and which they retain today . . . .").

24 *See* Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 647-48 (2008) (describing state laws that prevent creditors from recovering municipal property).

the partitions among public entities, combined with Chapter 9, achieve much of what asset partitions do.

Here is how liability partitioning works. Government entities within a state take on debt. The state implicitly guarantees that debt, either by its history of repaying those debts or by asserting that it will repay the debt.[25] But all those guaranteed debts start to compound as myriad government entities incur debts. So, for example, creditors of a school district must worry if the police pension plan is underfunded by billions of dollars, in part because it weakens the state's implicit insurance of the school district and in part because the state may divert resources from the school district to the pension plan. The result is that the state's implicit guarantee forces every creditor of every government entity in the state to fret about the liabilities of every other government entity in the state. And as the fiscal position of the state deteriorates, this phenomenon accelerates.

But by allowing each government entity access to Chapter 9, the state breaks its implicit guarantees. Allowing for Chapter 9, in essence, informs potential creditors of one government entity that any liabilities for any other government entity will be partitioned and will not affect the potential creditors' lending.

The benefits of Chapter 9's liability partitioning for the state mirror the benefits of asset partitioning for private entities: Creditors benefitting from a liability partition need monitor only the entity that they lend to. Likewise, the state can solve a debt overhang problem by partitioning off entities with excessive liability. And each governmental entity in the state receives an interest rate based on its own fiscal position, not the overall fiscal position of the state.

The benefits of organizational law manifest in a disaggregated bankruptcy. Indeed, a disaggregated bankruptcy is better than a proposed state bankruptcy chapter across the board. Start with the initial motivation for a state bankruptcy chapter––that it is better than the alternatives of default or bailout. Indeed, as David Skeel explained during the Great Recession iteration of the debate, a state's default would sow havoc, affecting not only the state's residents, but also having spillover effects that ripple through the economy.[26] That makes a federal bailout of any state all but inevitable. But a federal bailout has two problems. First, it is unfair to force responsible states to pay for irresponsible ones. Second, a bailout invites moral hazard. Once states know that the federal government will pay for their indebtedness, they have every reason to overspend.

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25 *See* discussion *infra* Section II.A.4.

26 David A. Skeel Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 706 (2012) [hereinafter Skeel, *States of Bankruptcy*].

A state bankruptcy chapter provides an alternative to default and bailout. Instead of the moral hazard of a bailout, bankruptcy internalizes the costs of excess debt so that states have a reason to spend responsibly. Bankruptcy also avoids the chaos of a default by providing a structure—the Bankruptcy Code and a bankruptcy judge. Disaggregation provides those benefits but goes a step further. Through disaggregation, states can solve a debt overhang problem without needing to discharge all liabilities. The specific liabilities causing the overhang can be partitioned, and thus other creditors will be more willing to invest in the state.

A state bankruptcy chapter also offers the benefit of coherent priorities. Outside of bankruptcy, sovereign immunity allows states to pick and choose which debts they repay. Bankruptcy law, though, imposes priorities and demands similar treatment for similar creditors. Disaggregation, by virtue of using Chapter 9, also enjoys the benefits of the Code's priority scheme and equal-treatment rules. But here too it goes further. A state bankruptcy would be massive, and in that bankruptcy, determining which creditors merit similar treatment would be a practical nightmare. Disaggregation, though, forces bankruptcy to operate entity by entity, where similarity of creditors is easier to determine.

One more benefit of a state bankruptcy chapter is its ability to check the political class. Politicians have incentives to spend now and tax never, which leads to well-documented problems of political economy.[27] Those problems are exacerbated by the potential of a bailout, which reduces the need for politicians to pay for their spending. By eliminating bailouts, a state bankruptcy chapter brings politicians' spending more in line with their funding.

Here, too, disaggregated bankruptcy offers more. Like a state bankruptcy chapter, a disaggregated bankruptcy eliminates bailouts and realigns politicians' incentives. But it also allows states to take certain decisions out of political hands, alleviating some of the fiscal federalism concerns that many, led by Adam Levitin, see as lethal to a state bankruptcy chapter.[28] A state bankruptcy would be filed by politicians—some combination of governor and legislature;[29] a municipal bankruptcy can be filed by an apolitical civil servant.

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27 *See* Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. 1399, 1420 (2012) [hereinafter Levitin, *Bankrupt Politics*] ("Politically, however, state legislators have few incentives to pursue fiscal responsibility.").

28 *See id.* at 1402 ("The problems underlying state fiscal distress ultimately concern political structures rather than finances, and they necessitate political, rather than financial, restructuring.").

29 *See* David A. Skeel, Jr., *State Bankruptcy from the Ground Up*, *in* WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 205-06 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012) [hereinafter Skeel, *State Bankruptcy from the Ground Up*] (describing options for how states could trigger bankruptcy).

That matters because politicians are loathe to put their names to a bankruptcy filing, and thus delay filing when bankruptcy would be appropriate. By contrast, a civil servant has fewer reasons to hold off on a much-needed bankruptcy.

Disaggregated bankruptcy also better weathers the criticisms of a state bankruptcy chapter. For example, unlike a state bankruptcy, disaggregation is clearly constitutional.[30] And unlike a state bankruptcy, disaggregation is not overly complex—courts already handle Chapter 9 filings—and is certainly easier than the thousands of governmental entities that would be in court for a statewide bankruptcy.[31] Likewise, disaggregated bankruptcy would do much less to disrupt bond markets. A state bankruptcy sends confusing signals to markets, as it is hard to disentangle the causes of distress with such a large entity.[32] Disaggregation, by placing fewer government entities into bankruptcy, makes it is easier to disentangle why a given entity failed.

Last, and most important, states have reason to use disaggregated bankruptcy, unlike a state bankruptcy chapter. As Vincent Buccola notes, states prefer a bailout to a state bankruptcy chapter because a bailout allows states to spend more and not pay for it, leaving states with little reason to use or support a state bankruptcy chapter.[33] But a disaggregated bankruptcy promises lower interest rates for the state itself, as well as for most of its government entities.[34] And the value of that disaggregated bankruptcy grows as the state grows more distressed, making disaggregation the right solution for today's most indebted states. That states have yet to implement disaggregation may thus be a sign that they have yet to reach the brink and that politicians prefer the implicit subsidy for certain, favored interests.

The remainder of this Article proceeds in four Parts. Part I describes how states can effect a bankruptcy filing using Chapter 9. It details state debt, expounding on the definition of "municipality," and discusses other steps a state would need to take to use Chapter 9 as an alternative to state bankruptcy. Part II turns to organizational law. It explores the mechanisms of

30 *See* discussion *infra* Section III.C.4.

31 *Id.*

32 *See* Jonathan S. Henes & Stephen E. Hessler, *Déjà Vu, All Over Again: Debate Rages Over Allowing States, like Municipalities, to File for Bankruptcy*, N.Y.L.J., June 2011, at 2 (describing the concern of confusion for bond markets and noting that it motivated the National Governors Association and National Conference of State Legislatures to oppose a state bankruptcy chapter).

33 *See* Vincent S.J. Buccola, *An Ex Ante Approach to Excessive State Debt*, 64 DUKE L.J. 235, 277 (2014) [hereinafter Buccola, *An Ex Ante Approach*] ("The threat of contagion turns the federal government into a (partial) guarantor of state debt, which reduces the cost of borrowing.").

34 *See* Samir D. Parikh & Zhaochen He, *Failing Cities and the Red Queen Phenomenon*, 58 B.C. L. REV. 599, 604 (2017) ("[M]unicipalities with the lowest borrowing costs are those located in states that offer meaningful out-of-court debt adjustment options."); *see also* discussion *infra* Section III.C.4.

organizational law, in particular asset partitions, and details the benefits they bring to legal entities. It then shows how a parallel mechanism, liability partitions, applies to the states and yields similar benefits. Part III returns to the state bankruptcy debate, where the benefits of organizational law are on full display. After cataloguing the arguments for and against a state bankruptcy chapter, Part III shows how a disaggregated bankruptcy proves superior, both yielding more benefits and suffering fewer drawbacks, thus rendering a state bankruptcy chapter unnecessary. Part IV concludes.

I. HOW STATES CAN FILE FOR BANKRUPTCY

This Part shows how states can file for bankruptcy under the current Code. It begins with an overview of state debt—which entities owe the debt and the major categories of that debt. It then turns to a comprehensive analysis of the definition of "municipality" in the Code, showing how the current definition includes nearly every governmental entity that owes state debt. The Part concludes with a description of the minor changes that states would need to implement to make their debt bankruptcy-eligible.

A. *State Debt*

1. Defining State Debt

At the center of state bankruptcy discussions are the state debts to be "adjust[ed]" in bankruptcy.[35] Discussants seldom define "state debt," though. And its meaning differs in public finance and in bankruptcy law, and for purposes of state bankruptcy, a blend of these definitions is most appropriate.

In public finance, "state debt" focuses on general-obligation bonds, as well as future liabilities, like pensions.[36] Often, public finance lumps in debt of all government entities in a state, including bonds owed by, say, the Commonwealth of Pennsylvania, as well as bonds owed by the City of Philadelphia and school-district pensions.[37]

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35 *See* 11 U.S.C. § 901 (codifying the procedures and definitions for the "[a]djustment of [d]ebts of a [m]unicipality").

36 *See, e.g.*, IRIS J. LAV & ELIZABETH MCNICHOL, CTR. BUDGET & POL'Y PRIORITIES, MISUNDERSTANDINGS REGARDING STATE DEBT, PENSIONS, AND RETIREE HEALTH COSTS CREATE UNNECESSARY ALARM 2-5, 7 (2011) (noting that most state debt takes the form of long-term debt, such as bonds and pension obligations, and that some observers exaggerate the risk of state bond debt and pension obligations).

37 *See State and Municipal Debt: The Coming Crisis?: Hearing on H.R. 112-40 Before the Subcomm. on TARP, Fin. Servs. and Bailouts of Pub. & Priv. Programs of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 14 (2011) [hereinafter *Hearing*] ("When many people think of money that a State owes, they think of a State's general obligation bonds . . . . States do not issue only general obligation bonds, though. They issue bonds through hundreds of public authorities.").

Bankruptcy law, by contrast, defines "debt" as "liability on a claim," which encompasses "any right to payment."[38] That includes vendor contracts, tort judgments, intellectual property licensing fees, and general-obligation bonds and pensions. Unlike public finance, bankruptcy is entity-specific, considering debts of *only* the entity that files.[39] So bankruptcy law has a broader definition of debt than does public finance, but a narrower understanding of the state.

For state bankruptcy, taking the broader definition of both the state and its debts is most appropriate. A state bankruptcy chapter would necessarily focus on all "debt" under the Bankruptcy Code's definition, that is, any "liability on a claim."[40] But it would also need to address the state as a constellation of governmental entities. Solving a state's bond and pension problems means little if city, county, and school district pensions loom, with hundreds of billions of dollars in debt threatening the state's fiscal stability.

Congress recognized this too. In the closest legislation to state bankruptcy passed to date, Congress passed a statute to govern Puerto Rico's bankruptcy.[41] That statute draws into the bankruptcy many government entities, including "a territory," and "a covered territorial instrumentality,"[42] and adopts the definition of "claim" from the Bankruptcy Code.[43] And, as one tally reveals, much of "Puerto Rico's" $74 billion in debt is not owed by the "Territory of Puerto Rico," but by: the Public Building Authority (6%); the Highway Transit Authority (6%); PRASA, the sewer authority (6%); PREPA, the public utility (12%); the Government Development Bank and municipal-adjacent debt (15%); the Territory itself (18%); COFINA, a public finance corporation (24%); and a "variety of other instrumentalities" (14%).[44]

A state bankruptcy chapter would look similar. So, for purposes of the state bankruptcy debate, it is best to define state debt as any "liability on a claim" owed by any government entity within the state.

38 11 U.S.C. §§ 101(5), (12).

39 *See* Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1, 4-5 (2013) ("Bankruptcy operates on legal entities, not on firms.").

40 11 U.S.C. § 101(12).

41 Puerto Rico Oversight, Management, and Economic Stability Act, Pub. L. No. 114-187, 130 Stat. 549 (2016) (codified as amended in scattered sections of 48 U.S.C.).

42 48 U.S.C. § 2162.

43 *See id.* § 2161 (adopting term definitions used in Title 11). The Bankruptcy Code defines "claim" as a "right to payment." *See* 11 U.S.C. § 101(5).

44 Aurelia Chaudhury, Adam J. Levitin & David Schleicher, *Junk Cities: Resolving Insolvency Crises in Overlapping Municipalities*, 107 CALIF. L. REV. 459, 507 (2019).

2. State Debts and State Entities

Having defined the state debts to be addressed in a state bankruptcy, this Section describes the major categories of state debt, the government entities within states that owe those debts, and the revenue streams that could be used to satisfy those debts. To do so, it takes state budgets as a proxy, as those budgets reflect approximately the "right[s] to payment" against each government entity.[45] Ultimately, it shows that entities other than the state itself owe the bulk of state debt (about 90%) that a state bankruptcy would address.

State General-Obligation Bonds. State bonds are debt obligations of the state itself.[46] States usually issue these general-obligation bonds to finance long-term capital projects or to refinance old debt. The bonds are backed by the "full faith and credit" of the state, including the state's taxing power.[47] Overall, the dollar value of these debt obligations tends to be high, largely because the obligations are long-term.[48] But as a percentage of state *annual* budgets, only 5% or so is allocated for debt service.[49]

Other Bonds. Other governmental entities, from cities to school districts, likewise issue bonds, and for similar purposes.[50] Debt service on these bonds, like state general-obligation bonds, constitute about 5% of government entities' budgets.[51] Some of these bonds are general-obligation bonds backed by an entity's taxing power (like the City of Philadelphia).[52] Others, known

45 *See* 11 U.S.C. § 101(5)(A) (defining "claim" as a "right to payment").

46 *See, e.g.*, COMMONWEALTH OF PA. OFF. OF BUDGET, GENERAL OBLIGATION BONDS, FIRST REFUNDING SERIES OF 2019, at 1 (2019) ("The Bonds are general obligations of the Commonwealth to which the full faith and credit of the Commonwealth are pledged.").

47 *See id.* at 3-4 ("Security and Source of Payment for Bonds").

48 *See id.* at 1 (issuing $886,875,000 in general-obligation bonds backed by the full faith and credit of the Commonwealth of Pennsylvania).

49 NAT'L GOVERNORS ASS'N, NAT'L CONF. OF STATE LEGISLATURES, COUNCIL OF STATE GOVERNMENTS, NAT'L ASS'N OF CNTYS., NAT'L LEAGUE OF CITIES, U.S. CONF. OF MAYORS, INT'L CITY MGMT. ASS'N, NAT'L ASS'N OF STATE BUDGET OFFICERS, NASACAT, GOV'T FIN. OFFICERS ASS'N & NAT'L ASS'N STATE RET. ADM'RS, STATE & LOCAL FISCAL FACTS—2020, at 3 (2020) [hereinafter NASRA, STATE & LOCAL FISCAL FACTS], https://www.nasra.org/fiscalfacts [https://perma.cc/LAX2-4M7G]. This is consistent with Census Bureau data, which puts state and local debt at approximately 3.3% of expenditures. *See* U.S. CENSUS BUREAU, 2018 STATE & LOCAL GOVERNMENT FINANCE HISTORICAL DATASETS AND TABLES: US SUMMARY & ALABAMA-MISSISSIPPI (2020) [hereinafter HISTORICAL DATASETS], https://www.census.gov/data/datasets/2018/econ/local/public-use-datasets.html [https://perma.cc/E39C-5SU6] (noting state and local interest on debt at $127 billion and total state and local expenditures at $3.8 trillion).

50 *See, e.g.*, CITY OF PHILA., PA., GENERAL OBLIGATION REFUNDING BONDS, SERIES 2019A (2019) (noting the issuance of $188,660,000 in general obligation bonds to, in part, refund other bonds).

51 NASRA, STATE & LOCAL FISCAL FACTS, *supra* note 49, at 3.

52 *Id.* at 5.

as revenue bonds, are backed by revenue generated from the project funded by the bond, like a sewer system bond backed by customer charges.[53] Likewise, a road district might fund its construction with revenue bonds, promising lenders repayment from future tolls that it collects.[54]

Utilities. Utilities are almost always a local government endeavor. States do not spend enough on utilities for them to make the top-line spending categories.[55] But local governments spend billions on these water, power, sewer, electric, gas, and similar districts, making utilities approximately 6% of total "state debt" expenditures.[56] Depending on the type of district, funding might be based on user charges (like water delivery fees) or taxes (like drainage district property taxes).

Transportation. The next-largest category of spending is transportation, which comprises about 8% of annual state budgets.[57] These expenses are both local and statewide, covering roads, airports, public transit, and the like. Transportation funding comes largely from user fees—gas taxes, motor vehicle registration fees, and tolls—rather than from property or income taxes, making funding largely depend on use of the services.[58]

Future Employee Obligations. Employee retirement benefits (pensions and healthcare) are also around 8% of the annual budget that various government entities provide.[59] Like bonds, these are long-term liabilities with large face values. Unlike bonds, though, pension obligations have a habit of ballooning, and some states (notably Illinois, where pensions consumed 26% of last year's

53 *See, e.g.*, MIAMI-DADE CNTY., FLA., WATER & SEWER SYSTEM: WATER & SEWER SYSTEM REVENUE BONDS 561 (2020) (describing bonds backed by the net operating revenues of water and sewer systems).

54 *See* discussion *infra* subsection I.B.3.b.

55 *See* NAT'L ASS'N OF STATE BUDGET OFFICERS, 2020 STATE EXPENDITURE REPORT: FISCAL YEARS 2018-2020, at 10 (2020) [hereinafter NASBO, 2020 STATE REPORT] (breaking down the major categories of state expenditures by funding source).

56 *See* HISTORICAL DATASETS, *supra* note 49 (noting expenditures on sewerage, solid waste management, water, electric, and gas totaling $243 billion).

57 *Id.*

58 Janelle Fritts, *How Are Your State's Roads Funded?*, TAX FOUND. (Sept. 11, 2019), https://taxfoundation.org/states-road-funding-2019 [https://perma.cc/68YM-DZHZ].

59 Based on 2018 pre-pandemic data, states and local governments spent $316 billion of their total $3.8 trillion in expenditure on employee retirement benefits, approximating 8.3%. *See* HISTORICAL DATASETS, *supra* note 49 (presenting Employee Retirement and other pension expenditures).

budget[60]) are distressed because of pensions.[61] Funding for pensions comes from a combination of sources. About a quarter comes from employer (government) contributions.[62] Employees contribute a bit more than ten percent to the fund.[63] The remaining sixty percent or so comes from interest earned on the fund.[64]

Education. The second-largest expense is education, around 30% of the annual budget for states and localities.[65] That includes assistance to public universities, assistance to local governments, and expenses of local school districts. Some education funding comes from federal programs and some from user fees (like college tuition), but funding predominantly derives from state appropriations and local property taxes.[66]

Health. The largest category of annual spending is healthcare, also around 30% of annual state and local budgets.[67] This includes reimbursements under Medicaid (the bulk of health spending), along with payments under the Children's Health Insurance Program and other public health programs.[68]

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60 Adam Schuster, *Illinois Forward 2023: Only Pension, Budget Reform Can Save Taxpayers When Federal Aid Ends*, ILL. POL'Y (2022), https://www.illinoispolicy.org/reports/illinois-forward-2023-only-pension-budget-reform-can-save-taxpayers-when-federal-aid-ends [https://perma.cc/NQ94-S3XZ]. In the 2021 budget, the number increased to 29%. *See* Adam Schuster, *Pensions Set to Consume 29% of Illinois' Budget Amid $7 Billion Debt Increase*, ILL. POL'Y (Dec. 17, 2020) [hereinafter Schuster, *Pensions Set to Consume Budget*], https://www.illinoispolicy.org/pensions-set-to-consume-29-of-illinois-budget-amid-7-billion-debt-increase [https://perma.cc/JD3Q-CJGC].

61 *See* EILEEN NORCROSS & OLIVIA GONZALEZ, GEORGETOWN UNIV., RANKING THE STATES BY FISCAL CONDITION: 2018 EDITION 25, 41 (2018) (identifying Illinois, New Jersey, Kentucky, and Connecticut as four of the five most fiscally distressed states and noting that they each suffer pension woes).

62 NAT'L ASS'N OF STATE RET. ADM'RS, NASRA ISSUE BRIEF: STATE AND LOCAL GOVERNMENT SPENDING ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS 3-4 (2020).

63 *Id.*

64 *Id.*

65 *See* HISTORICAL DATASETS, *supra* note 49 (presenting $3.8 trillion in total expenditures and $1.04 trillion in education spending).

66 *See* REBECCA R. SKINNER, CONG. RSCH. SERV., R4587, STATE AND LOCAL FINANCING OF PUBLIC SCHOOLS 1-2 (2019) (stating that 47% of education spending comes from state governments, 44.8% from localities, and 8.3% from the federal government).

67 NASBO, 2020 STATE REPORT, *supra* note 55, at 10. The census data vary a bit because they classify Medicaid under the "public welfare" category. U.S. CENSUS BUREAU, GOVERNMENT FINANCE AND EMPLOYMENT CLASSIFICATION MANUAL 4-21 (2006), https://www2.census.gov/govs/pubs/classification/2006_classification_manual.pdf [https://perma.cc/KCZ8-GXTB]. Including public welfare as health, which is a bit overinclusive, yields $1.18 trillion in health spending out of $3.8 trillion in total expenditures, or 31%. HISTORICAL DATASETS, *supra* note 49.

68 *See* NASBO, 2020 STATE REPORT, *supra* note 55, at 4-6 (describing the increase in Medicaid payments and the categorization of public health programs under the "all other" category).

Much of the funding here derives from federal grants, though that funding is augmented by state taxes.[69]

Summary. The breakdown of state debt categories reveals just how disaggregated states are. The colloquial "government service" tends to be provided through one of a myriad of government entities, not the state itself: school districts, water districts, cities, a Department of Transportation or Department of Health, and so on. Indeed, of the major categories of "state debt," only state general-obligation bonds (about 5% of annual expenditures) are debts owed by the state itself and issued in the state's name. The remaining "state debts," as relevant for state bankruptcy, are owed instead by these disaggregated entities.

B. *The Bankruptcy Code*

The Bankruptcy Code does not permit states to file for bankruptcy. Yet it does permit the government entities that owe "state debt" to file if they meet five requirements and follow Chapter 9's procedures. This Subpart shows how nearly all entities that owe "state debts," as described in Subpart I.A, are, or easily could become, eligible to file for Chapter 9.

1. States in the Bankruptcy Code

As it stands, the Bankruptcy Code contains no provision allowing states to file for bankruptcy. It never has. The Code allows "persons" and "municipalities" to file, but neither term encompasses a state. The definition of "person" includes an "individual," "partnership," or "corporation," but "does not include [a] governmental unit."[70] The definition of "municipality" is "political subdivision or public agency or instrumentality of a State."[71] So there is no basis for a state to file for bankruptcy and that has long been the understanding of commentators.[72]

2. Municipalities in the Bankruptcy Code

For an entity to file under Chapter 9, it must meet five requirements: (1) being a "municipality"; (2) being "specifically authorized" by state law to file under Chapter 9; (3) being insolvent; (4) desiring to "effect a plan to adjust

69 *See id.* at 11 (breaking down state and federal health payments as a proportion of total spending).

70 11 U.S.C. § 101(41). "Governmental unit," in turn, includes a "State." *Id.* § 101(27).

71 *Id.* § 101(40).

72 *See, e.g.*, Levitin, *Bankrupt Politics*, *supra* note 27, at 1401 ("[T]his option is not available to the states, which at present may not file for bankruptcy." (citing Mary Williams Walsh, *A Path Is Sought for States to Escape Debt Burdens*, N.Y. TIMES, Jan. 21, 2011, at A1)).

such debts"; and (5) having "negotiated in good faith with creditors" or shown that it would be impracticable to do so.[73] (There is no involuntary municipal bankruptcy.[74]) After meeting those requirements, the entity may propose a plan to adjust its debts, and upon court confirmation of that plan,[75] the entity is discharged from its debts.[76]

Eligibility. The most complicated of the eligibility requirements is satisfying the definition of municipality, which is discussed in the next section. The easiest are desiring to effect a plan of debt adjustment and negotiation, which an entity can satisfy in the runup to a filing.

"Specific[] authoriz[ation]" under state law is infrequent.[77] Today, only nine states authorize their municipalities to file without restriction, while six others authorize only specified entities to file, and another eleven impose procedural or substantive conditions to filing.[78] Almost half the states do not authorize their municipalities to file.[79]

On top of showing state authorization, the municipality must show insolvency,[80] meaning that it is "not paying its debts as they become due" or is "unable to pay its debts as they become due."[81] Courts construe the test strictly, much to the chagrin of scholars.[82] The one virtue to the standard is that it limits strategic filings—a government entity may not file for bankruptcy simply to shed debt when it is fiscally sound.[83]

The Plan. Once a government entity qualifies to file under Chapter 9, its plan determines which creditors receive what. Here, the government entity has all the leverage. Only it may propose a plan.[84] The bankruptcy court may not interfere with "political or governmental powers of the debtor," property or revenues of the debtor, or revenue-producing property of the debtor.[85] Those limitations allow the entity to develop a plan that works for the public

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73 11 U.S.C. § 109(c).

74 *See id.* § 901 (not incorporating involuntary bankruptcy provisions of the Code). This restriction is constitutionally required. *See infra* notes 328–30 and accompanying text.

75 *See* 11 U.S.C. § 943 (Confirmation).

76 *See id.* § 944 (Effect of Confirmation).

77 *Id.* § 109(c)(2) (detailing who may be a debtor under Chapter 9).

78 *See* K&L GATES, STATE STATUTES AUTHORIZING MUNICIPAL BANKRUPTCY 1-3 (2015) [hereinafter K&L GATES, STATE STATUTES].

79 *Id.* (listing 22 states that either have no statute or expressly prohibit their municipalities to file).

80 11 U.S.C. § 109(c)(3).

81 *Id.* § 101(32)(C).

82 *See, e.g.*, Skeel, *State Bankruptcy from the Ground Up*, *supra* note 29, at 204 (illustrating the strict application of a court's insolvency test using Bridgeport, Connecticut as an example).

83 *Cf.* Marcus Cole, *Limiting Liability Through Bankruptcy*, 70 U. CIN. L. REV. 1245, 1284-86 (2002) (noting this phenomenon in the retail real-estate context).

84 11 U.S.C. § 941 (stating the debtor's exclusive right to propose a plan).

85 *Id.* § 904 (detailing the limitations on the powers of the bankruptcy court).

and the creditors, while preventing holdout creditors from upending an optimal arrangement.

As a safeguard, Chapter 9 subjects court confirmation of the plan to protections familiar from Chapter 11 reorganization plans—best interest of the creditors,[86] good faith,[87] fair and equitable[88]—as well as federalism safeguards.[89] If the plan satisfies Chapter 9's requirements, though, the court must confirm it,[90] and the debtor is discharged of all its debts.[91]

3. State Debt, State Entities, and the "Municipality"

Case law interpreting "municipality" takes a broad view, tracking the statute's origins, purpose, and evolution—all of which sought to expand bankruptcy access to more government entities.[92] The Chapter originated in the Depression, when over 3,000 government entities (of all varieties) went insolvent.[93] Without bankruptcy, they had no way to address their creditors: The Contracts Clause bars states from "impairing the obligation[s] of contract[]," limiting states' ability to rewrite the terms of their debt agreements.[94] Municipalities, as "creature[s] of the [s]tate,"[95] are likewise bound by the clause. Thus, creditors could refuse to negotiate, holding out for full payment, and ultimately drive the governments into default.

In response, Congress created Chapter 9, which allowed municipalities to bind holdout creditors if the municipality could reach an agreement with creditors holding two-thirds of the debt (three-fourths in some cases) for each class of claims voting on its plan.[96] Because the Contracts Clause does not

86 *Id.* § 943(b)(7).

87 *See id.* § 943(b)(1) (incorporating 11 U.S.C. §§ 901, 1129(a)(3) and in turn, incorporating a good faith requirement for plans).

88 *See id.* § 943(b)(1) (incorporating 11 U.S.C. §§ 901, 1129(b)(1) and in turn, incorporating requirements that the confirmation be fair and equitable, with no unfair discrimination requirement for plans).

89 *See id.* § 943(b)(6) (imposing regulatory and electoral approval requirements for plans).

90 *See id.* § 943(b) ("The court shall confirm the plan . . . .").

91 *Id.* § 944(b).

92 For a thorough history of Chapter 9, see Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403, 440-57 (2014).

93 Keren H. Deal, An Examination of Municipal Finance Reform Regarding Municipal Bankruptcies in the United States 92 (Aug. 4, 2007) (Ph.D. dissertation, Auburn University) (on file with author).

94 U.S. CONST. art. I, § 10, cl. 1.

95 City of Trenton v. New Jersey, 262 U.S. 182, 190 (1923) ("The city is the creature of the State." (internal quotation marks omitted) (quoting Worcester v. Worcester Consolidated Street Ry. Co., 196 U.S. 539, 548-49 (1905))).

96 Amendments to Bankruptcy Act of 1898, ch. 345, 48 Stat. 798 (1934) [hereinafter 1934 Act] (detailing conditions to bind holdout creditors).

bind the federal government,[97] federal bankruptcy could rescue the insolvent municipalities.

And Congress took a broad view of municipalities that needed relief, matching the scope of the Depression's devastation. Congress thus extended relief to any "county, city, borough, village, parish, town, or township, unincorporated tax or special assessment district, and any school, drainage, irrigation, reclamation, levee, sewer, or paving, sanitary, port, improvement or other districts . . . ."[98] In 1946, Congress added "incorporated authorities, commissions, or similar public agencies organized for the purpose of constructing, maintaining, and operating revenue-producing enterprises . . . ."[99]

Indeed, few creditors challenge eligibility on this ground: Only twenty Chapter 9 cases out of the roughly seven hundred filed have opinions addressing the issue whether the debtor qualifies as a "municipality."[100] And many of those opinions simply note that the debtor is a municipality, either taking the matter for granted[101] or noting that the parties do not dispute the point.[102] Despite the paucity of case law, three factors have emerged as the test for which entities fall within the definition of "municipality." In addition to showing the breadth of the term "municipality," the factors also provide a guide for states to turn a governmental entity into a municipality should that entity fail to qualify in its current form.

The three factors are analyzed extensively in the leading opinion on defining "municipality," that of now-Professor Bruce Markell in *In re Las Vegas*

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97 U.S. CONST. art. I, § 10, cl. 1 ("No *State* shall . . . impair[] the obligation of contracts . . . .") (emphasis added).

98 1934 Act, *supra* note 96, at 798.

99 Act of July 1, 1946, Pub. L. No. 481, 60 Stat. 409, 409 [hereinafter 1946 Act]. Three decades later, in the interest of brevity, Congress restyled the definition of "municipality," changing it to "agency, instrumentality, or subdivision which has filed under this chapter." Act of Apr. 8, 1976, Pub. L. No. 94-260, 90 Stat. 315, 316. But Congress explained the change was stylistic only, and no narrowing of eligibility was intended. *See* H.R. REP. NO. 94-686, at 16 (1975) (detailing who may accept or reject a plan); *see also* H.R. REP. NO. 94-938, at 15 (1976) (detailing the intent of the Committee for such claims). Thus, the 1946 Act remains the touchstone for interpreting the meaning of "municipality." *See, e.g.*, *In re* Las Vegas Monorail Co., 429 B.R. 770, 780 (Bankr. D. Nev. 2010) (noting the municipality was merely a vehicle to enable bonds to be issued on a tax-exempt basis and reasoning it is not the Code's intent to include such municipalities in Chapter 9 cases).

100 *See* James Spiotto & Jeff Garceau, *Chapter 9 Municipal Bankruptcy Statistics: Use By Number, Type, and Year*, MUNINET GUIDE (June 14, 2018) [hereinafter Spiotto & Garceau, *Chapter 9 Municipal Bankruptcy Statistics*], https://muninetguide.com/municipal-bankruptcy-statistics [https://perma.cc/9L8F-5RDF] ("There have been a total of 680 Chapter 9 filings since 1937.").

101 *See, e.g.*, *In re* Slocum Lake Drainage Dist., 336 B.R. 387, 388 (Bankr. N.D. Ill. 2006) ("The Debtor is an Illinois drainage district and, thus, a 'municipality' as defined in 11 U.S.C. § 101(40).").

102 *See, e.g.*, *In re* Pleasant View Util. Dist., 24 B.R. 632, 635 (Bankr. M.D. Tenn. 1982) ("The parties do not seriously dispute that the [water] [d]istrict is a municipality as defined by the Bankruptcy Code.").

Monorail Co.[103] They are: sovereignty, state purpose and control, and state treatment of the entity.[104]

The first factor is whether the entity enjoys powers associated with sovereignty.[105] If an entity has the authority to tax, to use eminent domain, or sovereign immunity, then it is almost always found to be a "municipality."[106]

The second factor is whether the entity has a public purpose, along with the level of control exercised by the State.[107] The cases do not discuss "public purpose" directly, though a few cases hold entities that act as adjuncts of the state are municipalities. For example, the *In re Westport Transit District* court held that the transportation district was a municipality in part because it "assume[d] all powers of the department of transportation within the district . . . ."[108] Likewise, in *In re Connector 2000 Association*, the court held the entity to be a municipality because it "was formed to assist the [South Carolina Department of Transportation] with the financing, design, construction, and all other aspects of the Southern Connector [interstate]."[109] Perhaps the best explanation of this factor is Markell's, considering "whether [the entity] operates in place of the State . . . ."[110]

More common for this factor is the public control test, which looks at "whether the authority or agency is subject to control by public authority, state or municipal."[111] Mere regulation or oversight does not suffice,[112] but

103 *In re Monorail*, 429 B.R. 770.

104 *Id.* at 788.

105 *Id.*

106 *See id.*; *see also In re* Hosp. Auth., No. 12-50305, 2012 WL 2905796, at *13 (Bankr. S.D. Ga. July 3, 2012) (eminent domain); *In re* Ozark Mountain Solid Waste Dist., No. 3:14-BK-70015, 2014 WL 7494926, at *5-8 (Bankr. W.D. Ark. Aug. 5, 2014) (taxation); *cf. In re* N. & S. Shenango Joint Mun. Auth., 14 B.R. 414, 415, 418 (Bankr. W.D. Pa. 1981) (tap-in charges for sewer and eminent domain).

107 *In re Monorail*, 429 B.R. at 788.

108 *In re* Westport Transit Dist., 165 B.R. 93, 96 (Bankr. D. Conn. 1994).

109 *In re* Connector 2000 Ass'n, Inc., 447 B.R. 752, 758 (Bankr. D.S.C. 2011).

110 *In re Monorail*, 429 B.R. at 797.

111 *Ex parte* York Cnty. Nat. Gas Auth., 238 F. Supp. 964, 976 (W.D.S.C. 1965); *see also In re Westport*, 165 B.R. at 95 (holding expressly that municipal control suffices); *In re* Barnwell Cnty. Hosp., 471 B.R. 849, 859 (Bankr. D.S.C. 2012) (applying the *York* test). Only one court has rejected the view that municipal control suffices. *See In re* Cnty. of Orange, 183 B.R. 594, 603 (Bankr. C.D. Cal. 1995). But this case is an outlier in a few respects. *See* discussion *infra* subsection I.B.4.e.

112 *In re Monorail*, 429 B.R. at 789; *see also In re* Ellicott Sch. Bldg. Auth., 150 B.R. 261, 264 (Bankr. D. Colo. 1992) (holding that the Authority was not a municipality because no state officials were on its board); *In re* Lombard Pub. Facilities Corp., 579 B.R. 493, 497 (Bankr. N.D. Ill. 2017) ("[The corporation] was also not dependent on the Village for its day-to-day project management activities." (quoting Lombard Pub. Facilities Corp. v. Dep't of Revenue, 378 Ill. App. 3d 921, 935 (2008))). *But see In re* Greene Cnty. Hosp., 59 B.R. 388, 389-90 (S.D. Miss. 1986) (finding that a county hospital was subject to public control because the county board of supervisors had ownership of the property and traditional duties of property management, even though the board had no role in day-to-day operations).

control over day-to-day activities usually does—especially if that control angles to protect the public fisc.[113] Typically, if the board of an entity consists of, or is appointed by, government officials, the entity will qualify as a municipality.[114]

The third factor is the state's own designation and treatment of the entity.[115] Here, courts accept a wide range of evidence. For example, if state law creating the entity uses the magic words "body politic and corporate," that suffices.[116] More generally, creation by statute, rather than creation by general incorporation law, renders an entity a municipality.[117] A state supreme court decision will too.[118] As will a general definition under state law.[119]

The breadth of these factors leads to some surprising entities qualifying as municipalities, like gambling establishments. In *In re New York City Off-Track Betting Corporation*, the bankruptcy court found that the corporation, whose business consisted of managing gambling on horse racing, qualified as a municipality.[120] The court reasoned that the corporation was a public-benefit corporation, established by the state for performing functions

113 *See, e.g.*, *In re* Hosp. Auth., No. 12-50305, 2012 WL 2905796, at *7-8 (Bankr. S.D. Ga. July 3, 2012) (finding state control when the Hospital Authority's board was appointed by the county and the county had final say over assets and dissolution); *In re Monorail*, 429 B.R. at 797 (emphasizing control in terms of protecting public finances).

114 *See, e.g.*, *In re Barnwell*, 471 B.R. at 860 (finding the debtor was eligible for bankruptcy in part because the board of directors was comprised of members appointed by the county council and employees of the debtor).

115 *In re Monorail*, 429 B.R. at 788.

116 *Ex parte York*, 238 F. Supp. at 966; *see also In re* Sullivan Cnty. Reg'l Refuse Disposal Dist., 165 B.R. 60, 73 (Bankr. D.N.H. 1994); *In re Westport*, 165 B.R. at 96; *In re Hosp. Auth.*, 2012 WL 2905796 at *8 ("When an entity is created as a 'body corporate and politic,' courts generally find that the entity is a governmental unit." (quoting *In re Westport*, 165 B.R. at 95-96)); *In re Barnwell*, 471 B.R. at 856 (relying on public control even though the entity was created by statute); *In re Monorail*, 429 B.R. at 795 (reasoning that the Monorail's incorporation under general incorporation law, rather than under an act of the Nevada legislature, weighed against finding it to be a municipality).

117 *See, e.g.*, *In re Westport*, 165 B.R. at 94 (finding the establishment of a municipality through creation by statute).

118 *See In re* N. & S. Shenango Joint Mun. Auth., 14 B.R. 414, 418 (Bankr. W.D. Pa. 1981) ("That the petitioner is a municipality and independent public agency and instrumentality of a state within the meaning of the above quoted [s]ections . . . of the Bankruptcy Code . . . was held by the Supreme Court of Pennsylvania . . . .").

119 *See In re* Pleasant View Util. Dist., 24 B.R. 632, 635 (Bankr. M.D. Tenn. 1982) (reasoning that Tennessee law defined utility districts as municipalities and holding that the district thus qualified as a "municipality" under Chapter 9); *cf. In re* Ellicott Sch. Bldg. Auth., 150 B.R. 261, 264 (Bankr. D. Colo. 1992) (finding that the entity was not a municipality, in part because "[n]either Colorado statutes nor the articles of incorporation" accord "any governmental entity the ability to control it").

120 *In re* N.Y.C. Off-Track Betting Corp., 427 B.R. 256, 265 (Bankr. S.D.N.Y. 2010).

"essentially governmental in nature."[121] On top of that, the enterprise served to raise revenue for the state, something contemplated by the 1946 amendments as falling within the purview of Chapter 9.[122]

What holds for New York sports betting holds all the more for traditional government entities. Indeed, as the subsections below show, nearly all the government entities that owe state debt qualify as "municipalities."

a. *State General Obligation Bonds*

State general-obligation bonds are owed by the state itself and issued in its name. Because a state cannot be a "political subdivision or public agency or instrumentality of a State,"[123] these bonds are not eligible for bankruptcy. Nor does anything in the statute's history or case law suggest states could use Chapter 9 themselves to discharge general-obligation bonds.

In theory, states could issue bonds through a state-financing agency, which would be a "public agency . . . of a state," thus making the bonds eligible for bankruptcy.[124] But that might meet investor skepticism, signaling that the state agency exists *only* to file for bankruptcy and stiff creditors. And the maneuver could be invalid as a retroactive measure—if a state transferred its old bonds to the finance agency that filed for bankruptcy, a court might conclude that the filing was in bad faith and dismiss the bankruptcy.[125] So a state probably cannot escape its liabilities on general-obligation bonds.

b. *Other Bonds*

Bonds issued by cities and counties are eligible for bankruptcy because cities and counties are "political subdivision[s]" of the state.[126] Indeed, in every iteration of Chapter 9, such entities have been permitted to file. And

121 *Id.* (quoting Clark-Fitzpatrick, Inc. v. Long Island R.R., 70 N.Y. 2d 382, 386-87 (1987)). The government function involved in gambling, it seems, was raising revenue and purging organized crime from the gambling industry. *Id.* at 261.

122 *Id.* at 266. There is an outlier in the other direction, as well. The court in *In re Lombard Public Facilities Corp.* held that a corporation established by, and controlled by, the Village of Lombard to finance and construct a convention hall and hotel was not a "governmental unit," which includes a "municipality." 579 B.R. 493, 495 (Bankr. N.D. Ill. 2017).

123 11 U.S.C. § 101(40).

124 *See* Buccola, *An Ex Ante Approach*, *supra* note 33, at 274-75 (noting that states, which are ineligible for Chapter 9 bankruptcy, can establish instrumentalities to issue their debts).

125 *See, e.g.*, 11 U.S.C. § 901 (incorporating the good-faith requirement of § 1129(a)(3)); Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919, 928 n.30 (1991) (collecting cases on "new debtor syndrome" that involve transferring distressed property to different entities prior to filing for bankruptcy).

126 *See, e.g.*, *In re* Boise Cnty., 465 B.R. 156, 167 (Bankr. D. Idaho 2011) (citing 11 U.S.C. § 101(40)).

under the *Monorail* factors the question is equally easy—cities and counties have eminent domain power, taxing authority, and are created as political bodies. The absence of case law reflects the straightforwardness of the question, and no case has found that a city, town, or county was ineligible to file on the grounds that it failed to constitute a "municipality."

The other form of bonds, revenue bonds, will be eligible for bankruptcy if the issuer of the bonds is eligible. Given that the vast majority of government entities issuing revenue bonds are eligible (as discussed in the next subsections),[127] revenue bonds will largely be bankruptcy-eligible.

c. *Utilities*

Water and sewer districts form the bulk of Chapter 9 bankruptcies.[128] They were listed in the 1934 Act, which authorized any "drainage, irrigation, reclamation, levee, sewer, or . . . sanitary" districts.[129] The 1937 Act expanded that list to "[d]rainage, drainage and levee, levee, levee and drainage, reclamation, water, irrigation, or other similar districts . . . ."[130] And these districts lie at the heart of Chapter 9's purpose: offering bankruptcy relief to taxing entities (levee districts) or revenue-based entities (sewer charges).

Unsurprisingly, courts find such districts to be municipalities, and seldom comment on it.[131] The *In re Pleasant View Utility District* court, for example, stated simply that "[t]his definition ["municipality"] clearly encompasses a utility district such as the debtor," a waterworks.[132] The *In re Slocum Lake Drainage District* court was equally curt, writing "[t]he Debtor is an Illinois drainage district and, thus, a 'municipality' . . . ."[133] *In re Sullivan County Regional Refuse Disposal District* wrote that it was "beyond dispute" that the solid waste districts there were municipalities.[134] Indeed, the creditor there challenged every eligibility factor *except* the District's qualification as a

127 *See* discussion *infra* subsections I.B.4.c-g.

128 *See* Spiotto & Garceau, *Chapter 9 Municipal Bankruptcy Statistics*, *supra* note 100 (finding that "more than half," or approximately 58%, of "all Chapter 9 filings" between 1980 and 2018 were "filed by utilities and special districts").

129 1934 Act, *supra* note 96, at 798.

130 Act of Aug. 16, 1937, ch. 657, 50 Stat. 653, 654 [hereinafter 1937 Act].

131 I am not aware of any case that held a water or sewage district failed to qualify as a municipality.

132 *In re* Pleasant View Util. Dist., 24 B.R. 632, 635 (Bankr. M.D. Tenn. 1982).

133 *In re* Slocum Lake Drainage Dist., 336 B.R. 387, 388 (Bankr. N.D. Ill. 2006) (citing 11 U.S.C. § 101(40)).

134 *In re* Sullivan Cnty. Reg'l Refuse Disposal Dist., 165 B.R. 60, 73 (Bankr. D.N.H. 1994). Interestingly, the *Sullivan* court tied that determination to the "political subdivision" language, rather than "public agency" or "instrumentality" language. Most courts do not specify which of the terms they are interpreting.

municipality.[135] And it is common for creditors to forgo such challenges altogether.[136]

The only extensive analysis of these districts' eligibility came in *In re North & South Shenango Joint Municipal Authority*, which involved a Pennsylvania sewer district.[137] That Authority was incorporated under Pennsylvania's Municipal Authorities Act, but the sewer was defectively constructed and filed for bankruptcy.[138] The court held the Authority could file for bankruptcy as a "public agency" and an "instrumentality," relying on a Pennsylvania Supreme Court decision that labeled municipal authorities "independent agencies of the Commonwealth, and part of its sovereignty."[139] The court reinforced that conclusion by highlighting the Authority's powers, which included eminent domain and assessing construction costs against the properties benefited.[140] That analysis applies to many water and sewer districts, and debts owed by all such agencies will thus be eligible for bankruptcy.

d. *Transportation*

The 1937 Act granted Chapter 9 eligibility to "local improvement districts such as road, highway, or other similar districts . . . ."[141] This fits the logic of the taxing power and the logic of the 1946 expansion for revenue bonds, both of which are common in transportation funding. Only a handful of transportation districts have used Chapter 9, mostly without incident.[142]

Three contested cases reveal that transportation-related entities usually qualify for Chapter 9. *In re Westport Transit District*, for example, held that a district created under Connecticut's "transit-district enabling statutes," that assumed all powers of the state department of transportation in its region, was a municipality.[143] *In re Connector 2000 Association* was even more generous, holding that a "public benefit corporation" that was formed to

135 *See id.* ("Neither Wheelabrator Claremont Co., L.P., Calvert Municipal Intermediate Funds nor the State of New Hampshire questioned the requirement that the [New Hampshire] debtor or the [Vermont] debtor be shown to be municipalities . . . .").

136 *See, e.g.*, *In re* Ozark Mountain Solid Waste Dist., No. 3:14-BK-70015, 2014 WL 7494926, at *2 (Bankr. W.D. Ark. Aug. 5, 2014) (noting that the creditor did not question whether the debtor was a municipality); *In re Sullivan*, 165 B.R. at 73 (same).

137 *In re* N. & S. Shenango Joint Mun. Auth., 14 B.R. 414, 418 (Bankr. W.D. Pa. 1981).

138 *Id.* at 415.

139 *Id.* at 418 (quoting Whitemarsh Twp. Auth. v. Elwert, 196 A.2d 843 (1964)).

140 *Id.* at 418-19.

141 1937 Act, *supra* note 130, at 654.

142 Spiotto & Garceau, *Chapter 9 Municipal Bankruptcy Statistics*, *supra* note 100 (finding eight transportation district bankruptcies from 1980 to 2018).

143 *In re* Westport Transit Dist., 165 B.R. 93, 95-96 (Bankr. D. Conn. 1994).

"assist" in financing, acquiring, and constructing transportation projects qualified as a municipality.[144]

The one case to hold that a transportation entity was not a municipality was *In re Las Vegas Monorail*.[145] There, though, the Monorail was incorporated through Nevada's general incorporation laws, had "no power to tax, no power of eminent domain, and no sovereign immunity," and was not treated as a government entity under state law.[146] It was merely subject to extensive government regulation, and thus not a municipality.[147]

All of this suggests that states should have little trouble making their transportation obligations eligible for bankruptcy. A transportation district established by special act or through a transportation-district statute will qualify, as in *In re Westport Transit District*. Even a nonprofit adjunct of the state to assist in the state's transportation functions would qualify, as in *In re Connector 2000 Association*.

A state department of transportation would similarly qualify. For one, it would be a "public agency" within the plain meaning of the statute.[148] Beyond that, the *In re Westport Transit District* court relied on the District's assumption of powers of Connecticut's department of transportation,[149] so *a fortiori* the transportation department itself should qualify. In terms of the factors themselves, the department would have eminent domain and would likely enjoy sovereign immunity.[150] It is also unquestionably controlled by the state—every employee is a state employee, and state employees manage day-to-day operations. Hence every transportation entity in a state likely qualifies as a "municipality."

e. *Future Employee Obligations*

Historically, pension plans have not attempted to file for bankruptcy under Chapter 9. Nor were they contemplated in the 1937 Act or the 1946 Act. That makes pensions a less clear case. That said, the *Monorail* factors,

144 *In re* Connector 2000 Ass'n, Inc., 447 B.R. 752, 752-54 (Bankr. D.S.C. 2011).

145 *In re* Las Vegas Monorail Co., 429 B.R. 770, 800 (Bankr. D. Nev. 2010) ("LVMC does not exhibit any of these [municipality prerequisite] characteristics to the extent required under the Bankruptcy Code or the caselaw interpreting it.").

146 *Id.* at 795.

147 *See id.* at 798 ("The Governor's control, then, while extensive, is not the type of control that historically has caused courts to label entities or enterprises instrumentalities of the State.").

148 11 U.S.C. § 101(40).

149 *In re Westport Transit Dist.*, 165 B.R. 93, 96 (Bankr. D. Conn. 1994).

150 *See* Edelman v. Jordan, 415 U.S. 651, 663 (1974) ("[A] suit by private parties seeking to impose a liability which must be paid from public funds in the state treasury is barred by the Eleventh Amendment.").

and the language of the 1946 Act, strongly suggest that government-entity pension plans are eligible for Chapter 9.[151]

Take Illinois' Teacher Retirement System. It was established by statute.[152] Half of the board members are appointed by the Governor, with advice and consent of the Senate.[153] A reticulated statute governs the System's operation.[154] And a significant portion of the System's funding comes from direct appropriations in Illinois' budget.[155] Courts have also found similar pension plans entitled to sovereign immunity.[156] So Illinois' teacher pension plan enjoys sovereign attributes, is controlled by the state, and is treated as a government entity under state law, satisfying all three *Monorail* factors.

In the same vein, a pension plan is a "revenue-producing enterprise" as contemplated by the 1946 Act. Indeed, in cases where pensions did not file independently but were included in a city's bankruptcy, courts have found their presence in the bankruptcy case proper.[157] Hence, though there is no history of pension plans filing, the doctrine and statute strongly suggest they may file.[158]

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151 One case involved pensions but was not itself about a pension plan. Ky. Emp. Ret. Sys. v. Seven Cntys. Servs., Inc., 901 F.3d 718 (6th Cir. 2018) [hereinafter *KERS*]. In *KERS*, a mental-health center filed for bankruptcy and, as part of the bankruptcy, sought to leave Kentucky's state-employee pension plan for a private one. *Id.* at 721-22. But the issue in the case was whether the retirement system, as a mental-health center, was a "municipality," not whether the pension plan was one. *Id.* at 724.

152 40 ILL. COMP. STAT. 5/16-101 (1939).

153 *Id.* § 5/16-163.

154 *Id.* § 5/16-101 to -206.

155 In fiscal year 2021, the amount funded by Illinois's budget was $5.14 billion. *Annual State Contribution to TRS for FY21*, TEACHERS' RET. SYS. OF THE STATE OF ILL. (July 15, 2020), https://web.archive.org/web/20200913032034/https://www.trsil.org/news-and-events/pension-issues/contribution-2021 [https://perma.cc/68DN-LXEV].

156 *See, e.g.*, Hutto v. S.C. Ret. Sys., 773 F.3d 536, 540 (4th Cir. 2014) ("[T]he pension plans and the Trust are arms of the State of South Carolina and therefore have sovereign immunity."); Gucker v. Mendoza, No. 4-18-0039, 2018 WL 6252887, at *1, *8 (Ill. App. Ct. Nov. 27, 2018) (holding that the Illinois State Employees' Retirement System Board of Trustees had sovereign immunity in a pension case). Sovereign immunity in the pension context plays a dual role. For one, it prevents *pensioners* from suing the pension plan or the state. But it also prevents the *pension plan* itself from suing the state, which would place the liability for pensions on the state itself and thus make a Chapter 9 restructuring of pension plans impossible. States also have significant control of pension funds (through board selection and legislation) and could prevent such lawsuits either by directing the board not to bring them or by codifying that rule by statute.

157 *See, e.g.*, *In re* City of Detroit, 504 B.R. 97, 150 (Bankr. E.D. Mich. 2013) ("For Tenth Amendment and state sovereignty purposes, nothing distinguishes pension debt in a municipal bankruptcy case from any other debt."); *In re* City of Stockton, 526 B.R. 35, 39 (Bankr. E.D. Cal. 2015) ("[T]he City's pension administration contract . . . as well as the City-sponsored pensions themselves, may be adjusted as part of a chapter 9 plan.").

158 *In re County of Orange* muddles the matter a bit. *In re* Cnty. of Orange, 183 B.R. 594 (Bankr. C.D. Cal. 1995). The case involved investment funds of local governments rather than pension funds, which failed when a high-risk investment strategy backfired. *Id.* at 600. The *County of Orange* court held that the fund was ineligible for bankruptcy, though, reasoning that it could not be a "public agency" because it was not formed to "maintain[] or operat[e] a revenue producing enterprise." *Id.*

Because pensions are at the core of state financial distress, it is worth addressing two common arguments that pensions are not eligible for bankruptcy. In particular, attorneys for pensioners have argued that pension plans are protected by state constitutions and that pension obligations give pensioners recourse to the state.

State constitutions typically protect pensions, treating them as contractual obligations.[159] Many include a provision preventing the "impair[ment]" of pension obligations, which gave rise to the argument that Chapter 9 cannot modify pension obligations.[160]

History and doctrine belie the argument though. Historically, government pensions were gratuities—subject to modification at whim.[161] Over time, states saw the flaws in that model and shifted to the current contractual view, which protects pensions from modification at whim through the non-impairment language above.[162] That shift, though, treats pensions like any other contract—the language of the non-impairment clause parallels the states' Contracts Clauses, which prevent modification of contracts generally. So it does not afford pensions special protection beyond what other contracts receive.[163] And contracts can be modified in municipal bankruptcy. That is why courts to date, including the *In re Detroit* and *In re Stockton* courts, have held that Chapter 9 permits the modification of pension plans.[164]

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at 602. Nor did the court find it to be an "instrumentality," reasoning that only instrumentalities of the state, not a county, qualify. *Id.* at 603. Both conclusions have been criticized. *See In re* Las Vegas Monorail Co., 429 B.R. 770, 788 (Bankr. D. Nev. 2010) ("*County of Orange* has been criticized for being overly-precise in creating these definitions . . . ."). Indeed, an investment fund is, by definition, a revenue-producing enterprise. And every other court has held that instrumentalities of a local government qualify. *See* discussion *supra* note 111 and accompanying text.

159 *See* Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL'Y 617, 618 (2010) ("[T]he vast majority of states . . . protect public pensions under contract or property rights theories.").

160 *Id.* at 622-23.

161 *Id.* at 619-20.

162 *Id.*

163 David A. Skeel, Jr., *Can Pensions Be Restructured in (Detroit's) Municipal Bankruptcy?* 5-6 (Inst. for L. & Econ., Research Paper No. 13-33, 2013) [hereinafter Skeel, *Can Pensions Be Restructured?*].

164 *In re* City of Detroit, 504 B.R. 97, 149-50 (Bankr. E.D. Mich. 2013); *In re* City of Stockton, 526 B.R. 35, 39 (Bankr. E.D. Cal. 2015). This is also why decisions like that of the Illinois Supreme Court in *In re Pension Reform Litigation*, holding that prospective pension reductions are unconstitutional, will be superseded by bankruptcy. *See In re* Pension Reform Litig., 32 N.E.3d 1 (Ill. 2015). Incidentally, bankruptcy's modifications tend to favor pensioners over other unsecured creditors. For an argument that this violates the Code's bar on "unfair discrimination," and that pensions not only can be modified but must be treated like other unsecured debt, see Richard M. Hynes & Steven D. Walt, *Pensions and Property in Municipal Bankruptcy*, 33 REV. BANKING & FIN. L. 609, 612-13 (2014).

As for recourse obligations, the question is trickier. Some pension plans are in fact obligations of the state, and thus even if the pension plan itself filed for bankruptcy, the pensioners could seek payment from the state.

However, there are very few such cases. The default rule is that "pension[s] . . . shall not be construed to be a legal obligation or debt of the State."[165] This rule emerges from principles of local government law: For one, local governments may not pledge the state's full faith and credit. On top of that, states must comply with various debt limitations, and debt with recourse to the state (including local recourse debt) is counted toward the debt limit.[166] So states typically cannot afford to pledge their full faith and credit to pension plans at the local level. And those local governments cannot coopt the state's credit on their own. Sticking with Illinois as an example, only five pension plans are *state* plans: the Teachers' Retirement System, the State Employees' Retirement System, the State Universities' Retirement System, the Judges' Retirement System, and the General Assembly Retirement System.[167] The 657 others,[168] including behemoths like Chicago's four plans ($32.9 billion in liabilities[169]) are not, and thus could have their obligations discharged in a Chapter 9 bankruptcy.[170]

f. *Education*

Beginning with the 1934 Act, "any school" was eligible to "file a petition."[171] The 1937 Act specified eligibility for "public-school districts or public-school authorities organized or created for the purpose of constructing, maintaining, and operating public schools or public-school

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165 40 ILL. COMP. STAT. 5/22-403 (1939).

166 *See* ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE § 4.1.1 (2d ed. 1992); *see also* Steven L. Schwarcz, *The Use and Abuse of Special-Purpose Entities in Public Finance*, 97 MINN. L. REV. 369, 379 n.46 (2012) [hereinafter Schwarcz, *The Use and Abuse of Special-Purpose Entities*] (calling state guarantees of local debt "very rare"); *cf.* Skeel, *Can Pensions Be Restructured?*, *supra* note 163, at 17 (rejecting the argument that Michigan's constitution requires the state to guarantee Detroit pensions).

167 COMM'N ON GOV'T FORECASTING & ACCOUNTABILITY, ILLINOIS STATE RETIREMENT SYSTEMS: FINANCIAL CONDITION AS OF JUNE 30, 2014, at 37, 49, 63, 77, 89 (2015).

168 BRUCE RAUNER & ANNE MELISSA DOWLING, ILL. DEP'T OF INS., 2015 BIENNIAL REPORT (2013-2014), at 7 (2015).

169 Heather Cherone, *Chicago's Pension Debt Continues to Rise, Increasing $1.1B in 2020: City Analysis* (July 7, 2021, 9:26 PM), https://news.wttw.com/2021/07/07/chicago-pension-debt-increasing-11-billion-2020-city-analysis [https://perma.cc/2422-BM8A].

170 As a final point, states may be able to discharge *even* their recourse obligations on pensions through a nondebtor release within the pension fund's bankruptcy. While this practice is controversial, and scholars (and litigants) have expressed doubt over its legality, current doctrine often allows for such releases. *See, e.g.*, Lindsey D. Simon, *Bankruptcy Grifters*, 131 YALE L.J. 1154, 1169-76 (2021) (providing an overview of this argument).

171 1934 Act, *supra* note 96, at 798.

facilities . . . ."[172] Few school districts have filed under Chapter 9, and none were challenged for not being municipalities.[173] That makes sense given how school districts raise revenue through taxes to provide a government service.

To date, no state university has filed for Chapter 9.[174] But the same language would apply—Pennsylvania State University is a "school" and also an entity "organized or created for the purpose of constructing, maintaining, and operating public schools." In essence, state universities are equivalent to school districts at the statewide level. And in terms of the *Monorail* factors, a state university would also qualify: It is established by special act,[175] run entirely by state employees and accountable to the state for its budget (and occasionally, for its curriculum), and often can exercise eminent domain.[176] So there should be little doubt that debt owed by state universities, like debt owed by school districts, is eligible for Chapter 9.[177]

Like state universities, no state department of education has filed for bankruptcy. But the *Monorail* factors all suggest that they would qualify as "municipalit[ies]." These, too, are established by special act.[178] They are accountable to politicians, and employees controlling the day-to-day operations are state employees. They likewise enjoy sovereign immunity.[179] And they fit comfortably into the ordinary definition of "public agency." What is more, as the *In re Westport Transit District* court noted, a special district that assumes the powers of the state-level department qualifies as a municipality.[180] So the department itself should unquestionably qualify.

The only education entity held not to qualify as a municipality was one that used municipal bonds, which are tax-exempt, as a cheaper means of

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172 1937 Act, *supra* note 130, at 654.

173 Spiotto & Garceau, *Chapter 9 Municipal Bankruptcy Statistics*, *supra* note 100 (tallying seven from 1980 to 2018).

174 This is likely because the consequences of a university filing for bankruptcy include loss of federal funding. Matthew Bruckner, *Why Can't Colleges Declare Bankruptcy? HBCUs Would Benefit Greatly from Chapter 11 Reorganization*, N.Y. DAILY NEWS (Mar. 30, 2017, 12:19 PM), https://www.nydailynews.com/opinion/colleges-declare-bankruptcy-article-1.3013855 [https://perma.cc/K8A8-NCGH].

175 *See, e.g.*, OR. REV. STAT. § 352.002 (2020) (establishing seven public universities in Oregon). Many special acts also use the magic words "body politic and corporate." Matthew A. Bruckner, *Special Purpose Municipal Entities and Bankruptcy: The Case of Public Colleges*, 36 EMORY BANKR. DEVS. J. 341, 359 (2020) [hereinafter Bruckner, *The Case of Public Colleges*].

176 Bruckner, *The Case of Public Colleges*, *supra* note 175, at 359-60, 365.

177 *Id.* at 367-68.

178 *See, e.g.*, 71 PA. CONS. STAT. § 1037 (2022) ("There is hereby created a Department of Education.").

179 *See* Edelman v. Jordan, 415 U.S. 651, 663 (1974) ("[A] suit by private parties seeking to impose a liability which must be paid from public funds in the state treasury is barred by the Eleventh Amendment." (citing Great N. Life Ins. Co. v. Reed, 332 U.S. 47 (1944))).

180 *In re* Westport Transit Dist., 165 B.R. 93, 96 (Bankr. D. Conn. 1994).

funding an otherwise private endeavor.[181] There, Ellicott School Building Authority was formed to construct a secondary school but barred any government officials from serving on its board.[182] Recognizing the maneuver, the court rejected Ellicott's Chapter 9 filing.[183] *In re Ellicott School Building Authority* thus limits some educational entities. But the main reservoirs of state educational debt—school districts, public universities, and the state department of education—are all eligible for Chapter 9.

g. *Health*

State healthcare expenses make for an interesting bankruptcy category. The 1934 Act makes no mention of healthcare entities of any kind. Nor does the 1937 Act. The 1946 Act does mention "incorporated authorities, commissions, or similar public agencies organized . . . [as] revenue-producing enterprises,"[184] though many government healthcare entities are not designed to produce revenue. Despite this, health-entity Chapter 9s are not uncommon, mostly consisting of public hospitals.[185] Very few of these entities are challenged as not being municipalities, and none of those challenges have succeeded.

In re Greene County Hospital, for example, held that a community hospital formed under Mississippi's "Community Hospitals" code, which gave a county board of supervisors the authority to manage hospital property, was a municipality.[186] *In re Barnwell County Hospital* also found the Hospital to be a municipality because the County Council could create, disband, and appoint members to the hospital's board, and because the City Council could approve the hospital's budget.[187] *In re Hospital Authority* offered detailed analysis of the *Monorail* factors, concluding that the Authority was a "governmental unit."[188] The court reasoned that the Authority was "a creature of specific legislative enactment," with eminent domain and tax-exempt status, so it had many traditional sovereign attributes.[189] The court found state control as well, based on board supervision and the board's power to dissolve the Authority or

181 *In re* Ellicott Sch. Bldg. Auth., 150 B.R. 261, 263-64 (Bankr. D. Colo. 1992).

182 *Id.* at 264.

183 *Id.*

184 1946 Act, *supra* note 99, at 409.

185 Spiotto & Garceau, *Chapter 9 Municipal Bankruptcy Statistics*, *supra* note 100 (tallying sixty-one hospitals or healthcare systems that filed for bankruptcy from 1980 to 2018).

186 *In re* Greene Cnty. Hosp., 59 B.R. 388, 389-90 (S.D. Miss. 1986).

187 *In re* Barnwell Cnty. Hosp., 471 B.R. 849, 860 (Bankr. D.S.C. 2012).

188 *In re* Hosp. Auth., No. 12-50305, 2012 WL 2905796, at *8 (Bankr. S.D. Ga. July 3, 2012). The definition of "governmental unit" includes "municipality," and explains the court's use of the *Monorail* factors. 11 U.S.C. § 101(27).

189 *In re Hosp. Auth.*, 2012 WL 2905796, at *6.

control its assets.[190] Last, the court noted that the state classified the Authority as a "body corporate and politic," a classification that generally results in the conclusion that the entity is a municipality.[191]

In short, public hospitals, public hospital authorities, and the like are "municipalities." State departments of health have yet to attempt a Chapter 9 filing. But they too would likely be eligible. They are "public agencies," and the same logic as, for example, a department of transportation, would apply.[192] That covers a large swath of states' healthcare debts. It includes hospital expenses, children's health insurance program payments owed to insurers, and Medicaid payments owed to insurers (itself the bulk of state health debts).[193]

Other healthcare debts are eligible for bankruptcy, though for different reasons. Expenses for the healthcare of current employees, for example, is debt owed by the government entity that employs them, like the school district. Those debts are eligible for bankruptcy because school districts may file for bankruptcy.[194] Likewise, healthcare expenses for former employees are debt owed by a pension fund, and will be eligible for bankruptcy because pension funds can file for bankruptcy.[195] Healthcare for correctional facilities should similarly be analyzed as debt owed by the Department of Corrections.[196] All of these, though, should be relatively straightforward cases of eligibility, meaning that the state can make almost all of its healthcare debts eligible for bankruptcy.

C. *Bankruptcy for the Disaggregated State*

For a state to effect a bankruptcy filing, it need only make its "state debt" eligible under Chapter 9. That means ensuring the debt is owed by entities eligible for Chapter 9 under the Chapter's five requirements. Of the requirements, only the "municipality," "specific authorization," and

190 *Id.* at *8.

191 *Id.*

192 *See* discussion *supra* subsection I.B.3.d.

193 Federal regulation requires states to "[s]pecify a single State agency" to administer Medicaid, so Medicaid debts are always owed by an agency, not the state itself. *See* 42 C.F.R. § 431.10(b)(1) (2021).

194 *See* discussion *supra* subsection I.B.3.c.

195 *See* discussion *infra* subsection I.B.3.f.

196 Corrections constitute a small portion of state budgets, so I do not discuss it here. The only wrinkle with corrections healthcare is that states have a constitutional obligation to provide it. *See* Estelle v. Gamble, 429 U.S. 97, 103 (1976). So states can discharge only past debts incurred providing that healthcare, but may not eliminate their future obligations to provide prisoners with healthcare. *Cf.* Douglas G. Baird & Thomas H. Jackson, Comment, Kovacs *and Toxic Wastes in Bankruptcy*, 36 STAN. L. REV. 1199, 1200 (1984) (noting that discharge of debts does not eliminate the obligation to comply with laws regarding future operations of a business).

"insolvency" requirements pose a hurdle. And the first two can be easily overcome.

Municipality. As shown above, much of state debt is already eligible for bankruptcy because north of ninety percent of that debt (essentially everything besides state general-obligation bonds) is owed by entities that qualify as municipalities. Those entities include transportation districts, school districts, public hospitals, water districts, pension plans, and the like. When those services are bundled at the city or county level, those debts too are eligible for bankruptcy. Even when those debts are owed by state-level departments, they are eligible. So states are already in a position where the vast majority of their debts are owed by "municipalities" under Chapter 9.

Even when those debts are not owed by a "municipality," case law shows how a state can transform a government entity into a "municipality." Reforming the entity by legislative act, labeling it a "body corporate and politic," conferring on it the power of eminent domain, or exerting state control over personnel, budgets, and day-to-day operations can transform a government entity into a "municipality."[197]

Specific Authorization. Once the state debt is owed by a "municipality," the state need only grant authorization for municipalities to file. As it stands, half of the states authorize some government entities to file, though many restrict which entities may do so or impose procedural hurdles to filing.[198]

The procedural hurdles matter little for the purposes of this Article. Some, like seeking approval from a particular state official,[199] are unobtrusive and merely identify the government official who will decide that a petition should be filed. Others, like showing financial distress, mirror Chapter 9's requirement of cash-flow insolvency and are thus redundancies.[200] The most intrusive of these procedural impediments are those that require state-level financial involvement, and these could be repealed, or converted into an approval requirement that vests authority in the official whom the state wishes to make such determinations.[201]

On the substantive side, states impose various restrictions, which matter more than the procedural ones. Even among the two dozen states that allow government entities access to Chapter 9, most limit the authorization. For

197 *See* discussion *supra* subsection I.B.3.a.

198 K&L GATES, STATE STATUTES, *supra* note 78, at 1-3.

199 *See, e.g.*, CONN. GEN. STAT. § 7-566 (2019) ("No municipality shall file a petition . . . without the express prior written consent of the Governor.").

200 *Compare* COLO. REV. STAT. § 32-1-1403 (2017) ("Any insolvent taxing district is hereby authorized to file a petition authorized by federal bankruptcy law . . . ."), *with* 11 U.S.C. § 109(c)(3) (codifying the insolvency requirement).

201 *See, e.g.*, 45 R.I. GEN. LAWS § 45-9-7 (2014) (requiring the appointment of a receiver for distressed municipalities, with powers including the filing of a bankruptcy petition).

example, Montana prohibits counties from filing.[202] Arizona limits filing to taxing districts, as defined in the Bankruptcy Code.[203] Iowa focuses on the debt as well as the entity, forbidding a Chapter 9 filing for a "city, county, or other political subdivision" unless the debt was "involuntarily incurred."[204]

These restrictions prevent a state from effecting a bankruptcy filing under Chapter 9. But the fix is simple. A state could repeal any restrictions and enact a statute permitting "any municipality, within the meaning of 11 U.S.C. § 101(40), to be a debtor under Chapter 9 of the Bankruptcy Code."

Insolvency. The one requirement that a state cannot legislate around is insolvency. The Code requires cash-flow insolvency, and courts police that requirement stringently.[205] A state also cannot manufacture insolvency for a municipality (say, by redirecting the municipality's revenues), as that would likely be met with a dismissal on bad-faith grounds.[206]

But the insolvency requirement does not prevent bankruptcy for the disaggregated state. Instead, it *targets* that bankruptcy. Because of the insolvency requirement, the state's fiscally sound municipalities remain untouched and only those municipalities with unsustainable debt file. So unlike a state bankruptcy chapter, a disaggregated bankruptcy leaves unscathed state entities that do not need bankruptcy while allowing bankruptcy for the municipalities that drive the state's distress. The result is that states can still use bankruptcy to solve their debt problems. After all, the states' debt problems manifest in, and stem from, insolvent municipalities. So the insolvency requirement, while limiting state debt that is eligible for bankruptcy, does not prevent the state from using the Code to address its debts. To the contrary, it focuses Chapter 9 on the debts that cause a state's fiscal distress.

To sum up, the Bankruptcy Code bars states from filing a petition for bankruptcy. But the Code makes almost all state debt eligible for bankruptcy because almost all state debt is owed by government entities that qualify as "municipalities" eligible to file for bankruptcy under Chapter 9. To effect a bankruptcy filing, then, a state would need to do little. For the handful of government entities that are not already eligible as "municipalities," a few tweaks can do the trick. After that, the state need only expand its

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202 *See* MONT. CODE ANN. § 7-7-131(2) (2021) (defining local entity to exclude counties); *see also id.* § 7-7-132 (authorizing filing under Chapter 9 for a "local entity").

203 ARIZ. REV. STAT. ANN. § 35-601(2) (2020). The term "taxing district" is not defined in the current Code; Arizona's reference is to the 1934 Act's definition, which excluded revenue-bond districts and other "public agencies." *See* discussion *supra* Section I.B.2.

204 IOWA CODE § 76.16A (2021).

205 *See* Skeel, *State Bankruptcy from the Ground Up*, *supra* note 29, at 203-05 (discussing the standard imposed by *In re City of Bridgeport*, that the municipality have no cash on hand and be unable to borrow) (citing In re City of Bridgeport, 129 B.R. 332, 336-38 (Bankr. D. Conn. 1991)).

206 *See supra* note 125 and accompanying text.

authorization rules, allowing any "municipality" within the meaning of the Code to file.[207] At that point, government entities in the state that suffer from insolvency—namely, those government entities that drive the state's fiscal distress and give rise to the state's need for bankruptcy relief—would be eligible to adjust their debts under Chapter 9. The upshot is the functional equivalent of a state itself filing for bankruptcy.

II. MUNICIPAL BANKRUPTCY AS ORGANIZATIONAL LAW FOR THE STATES

Organizational law—the law of legal entities like corporations, partnerships, and trusts—lies at the foundation of modern commerce. Nearly every transaction today, from downloading apps to buying groceries to donating to a food bank, involves at least one such legal entity. And business-law scholars have expounded on the workings and benefits of organizational law for private enterprises. Yet scholarship on organizational law and public entities is far less developed, on the logic that "states do not need organizational law as much, or in the same ways, as other owners."[208] As it turns out, though, states can use organizational law, and it lies at the core of Chapter 9, which operates as organizational law for the states.

This Part begins with a recap of organizational law in the private context. It first discusses the mechanisms of organizational law (asset partitions and capital lock-in), what those mechanisms achieve (distinct pools of bonding assets for owners and entities), and the benefits that flow from the partitioning of bonding assets. It then turns to the role of temporal partitions, both in organizational law and in bankruptcy law, that extend bonding assets' benefits even after the life of the entity.

From there, this Part explores how states are a poor fit for organizational law as private entities use it. That is so in part because states are not creatures of organizational law—states are formed by constitution, not general-incorporation statute—but primarily because state sovereign immunity ensures that states lack the ability to bond assets.

But states can use organizational law through a different mechanism: liability partitioning. Specifically, by creating distinct government entities that qualify as "municipalities," and allowing them to file for bankruptcy, a state ensures that the outsized liability of one municipality does not threaten

207 A state might even be able to force its municipalities to file, so long as the state's constitutional home-rule provisions allow it to. Even if they do not, though, a state can refuse to bail out the insolvent municipality and thus practically leave it with no choice but to (voluntarily) file.

208 W. Mark C. Weidemaier, *Piercing the (Sovereign) Veil: The Role of Limited Liability in State-Owned Enterprises*, 46 BYU L. REV. 795, 798 (2021) (footnote omitted).

the state itself or threaten any other municipality (whose resources might be diverted to the bankrupt). These liability partitions, in turn, yield many similar benefits as do asset partitions, and thus hold promise for deeply indebted states.

A. *Bonding Assets and Private Entities*

In their seminal paper, *The Essential Role of Organizational Law*,[209] Henry Hansmann and Reinier Kraakman answered one of the burning questions of organizational law: Why does it exist? Corporations, partnerships, trusts, and other legal entities are everywhere, and most successful firms operate as some such entity. Not only that, but before organizational law, firms were smaller, suggesting a connection between organizational law and "the rise of the firm."[210]

The answer, they wrote, lay in asset partitions. Asset partitions separate the assets of an entity from the assets of its owners.[211] They also shield the entity's assets from creditors of the owners (entity shielding), and shield owners' assets from the creditors of the entity (owner shielding).[212] The result is two sets of "bonding assets"—the entity has a designated pool of assets to satisfy its obligations, and the owner has a separate, designated pool of assets to satisfy her personal obligations.[213] By way of example, if an Amazon shareholder owes her friend ten dollars, the friend cannot recover from Amazon; if Amazon owes a customer ten dollars, the customer cannot recover from an Amazon shareholder.

Bonding assets are reinforced by "lock-in," the rule that an owner may not withdraw resources from the entity.[214] Thus, for example, our Amazon shareholder can sell her shares, but cannot withdraw any assets from Amazon, say by taking toys from an Amazon warehouse. That reinforces entity-shielding: not only *creditors* of an owner are barred from reaching the assets of the entity, but the *owners* are too. That results in bonding assets that are distinctly the entity's, which the entity's creditors can rely on to back its obligations.

From the creation of bonding assets, a series of benefits flow to the owners. For one, owners need not monitor every co-owner of their businesses and can be "indifferent to each other's personal fortunes."[215] That same logic

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209 Hansmann & Kraakman, *The Essential Role of Organizational Law*, *supra* note 19.

210 *Id.* at 390; *see also* Hansmann, Kraakman & Squire, *Law and the Rise of the Firm*, at 390-93.

211 Hansmann & Kraakman, *Essential Role of Organizational Law*, *supra* note 19, at 393-94.

212 Hansmann, Kraakman & Squire, *Law and the Rise of the Firm*, *supra* note 18, at 1337-40.

213 Hansmann & Kraakman, *Essential Role of Organizational Law*, *supra* note 19, at 392-93.

214 Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 389, 430 (2003).

215 Hansmann & Squire, *External and Internal Asset Partitioning*, *supra* note 21, at 254.

facilitates transfers of control and share liquidity. Because owners no longer bear liability for firm obligations, new owners need not fear that they will take on outsized liability for the firm.[216]

Markets stand to gain too. Separating the value of shares from the wealth of owners sends a clearer signal through the stock price, as that price reflects *only* the value of the firm.[217] (The value of Netflix, for example, is based on the value of the service provided and not the wealth or indebtedness of Netflix shareholders.) Also, by preventing owners from withdrawing assets from the entity, organizational law preserves going-concern value and prevents premature liquidation.[218]

Creditors stand to gain as well, for their monitoring costs are also reduced. Creditors need only monitor the assets and finances of the entity—not its owners; creditors of an owner need only monitor the owner—not any entities she owns.[219] So, too, bankruptcy becomes a simpler proceeding, and the creditor of an entity (or owner) avoids the tangle of a bankruptcy that includes every creditor of every owner of that entity.[220]

These benefits explain the magic that organizational law worked for private enterprise. Owners could now invest based on the quality of an entity instead of unrelated features (like the wealth of its owners), markets could more easily allocate capital to quality entities, and creditors could lend with lower costs (for monitoring and for a possible bankruptcy).

Organizational law also gave rise to myriad phenomena related to asset partitions. These phenomena are the subject of extensive scholarly treatment, but two—debt overhang and guarantees—are notable here, as they bear on how organizational law works in the public sphere.

Debt Overhang. Debt overhang occurs when an indebted owner or entity has too much debt to fund new projects, even projects with positive expected value. For instance, imagine Cabbage Corporation owns a successful grocery store in Cleveland and wants to expand into Columbus. The expansion requires a $6 million investment and will yield a return of either $15 million (if successful) or $0 (if not), with success and failure being equally likely.[221] If Cabbage Corporation has no debt, it will find investors; the project's expected value is $1.5 million. But suppose Cabbage Corporation carries $5 million in

216 *Id.*

217 *Id.* at 254-55.

218 *Id.* at 256; *see also* Blair, *supra* note 214, at 392.

219 Hansmann & Squire, *External and Internal Asset Partitioning*, *supra* note 21, at 255.

220 *Id.* at 256. There are other uses of organizational law, too. For instance, tax planning and regulatory planning may be achieved through organizational law. *See* Mariana Pargendler, *Veil Peeking: The Corporation as a Nexus for Regulation*, 169 U. PA. L. REV. 717, 720-21, 761 (2021).

221 For further helpful exposition, see Vincent S.J. Buccola, *The Logic and Limits of Municipal Bankruptcy Law*, 86 U. CHI. L. REV. 817, 845-47 (2019). The initial work on debt overhang can be credited to Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977).

debt. Now, if the Columbus expansion succeeds, $5 million will be paid to creditors. The new investors thus receive an upside of only $10 million. In turn, the expected value turns negative (-$1 million), so the expansion will find no investors.

That result is not optimal. There is social value to undertaking projects with positive expected returns, like our grocery store in Columbus. Organizational law, though, solves this debt overhang.[222] By creating a new entity to undertake the Columbus expansion, Cabbage Corporation can shield the project from its other creditors, and thus the investors find themselves in the scenario where the expansion's expected value is $1.5 million. As a result, they invest, and a socially desirable project is undertaken.

Guarantees. Perhaps the strangest phenomenon of organizational law is entities' deliberate nonuse of asset partitions. Large firms tend to have hundreds of subsidiaries, each with its own asset partitions.[223] But the firms often issue a dizzying set of cross-subsidiary guarantees, undermining those partitions.[224]

It remains unclear why firms do this. Richard Squire suggests that firms issue guarantees to achieve lower interest rates.[225] Those lower interest rates, though, hurt nonguaranteed creditors, effectively transferring wealth from nonguaranteed creditors (who lose out in event of insolvency) to shareholders (who benefit from lower interest rates).[226] On Squire's view, though, the entity's owners are insufficiently concerned about insolvency because they receive nothing if the entity goes insolvent.[227]

Anthony Casey offers a more benign explanation. On his view, firms use guarantees to afford creditors tailored enforcement options.[228] Thus, when multiple projects of a firm face partially related risks, like a luxury hotel and a budget hotel, placing the projects into different legal entities with guarantees allows the firm to address the failures either collectively (if hotels generally are in trouble) or individually (if just the luxury hotel is).[229] Whether Casey's view is correct, or Squire's is, or guarantees do some other

222 Hansmann & Squire, *External and Internal Asset Partitioning*, *supra* note 21, at 257.

223 Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. CHI. L. REV. 605, 606, 606 n.1 (2011) [hereinafter Squire, *Strategic Liability*].

224 *Id.* at 606.

225 *Id.* at 607-08.

226 *Id.* at 608.

227 *Id.*

228 Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement*, 124 YALE L.J. 2680, 2683 (2015).

229 *Id.* at 2684-86.

work altogether,[230] the key point remains that entities can use organizational law in conjunction with guarantees to create detailed regimes for pairing assets and liabilities.

B. *Temporal Partitions*

It is also critical to define bonding assets across time. Bankruptcy law does just that, creating a temporal partition by discharging debt.[231] That discharge matters little for liquidating corporations, which dissolve under Chapter 7, and which, by ceasing to exist, need no asset partitioning. But for a reorganizing corporation (which is a successor to the debtor and would thus remain liable on old obligations), bankruptcy provides a discharge.[232] That discharge eliminates the debtor's past liabilities, freeing the debtor's bonding assets going forward. The result is that the entity's new creditors may draw on only one pool of bonding assets (the post-bankruptcy ones) for post-bankruptcy debt, while the old creditors may draw on only another pool of bonding assets (the pre-bankruptcy ones) to satisfy pre-bankruptcy debts.

The same temporal asset partition is critical for human debtors. A person is not dissolved under organizational law or "liquidated" under the Bankruptcy Code. So, absent a discharge, a human debtor would remain liable to pre-bankruptcy creditors. By providing a discharge, bankruptcy partitions assets into pre-bankruptcy and post-bankruptcy bonding assets, as with a reorganizing corporation. That allows the individual to get a fresh start without old creditors hounding her and with a pool of assets that cannot be reached by any but her new creditors.[233]

C. *Private Organizational Law, Bonding Assets, and the State*

At first blush, organizational law seems an odd fit for the state, in many respects. For starters, conceptually, states do not fit the entity-owner model. Doctrinally, too, the fit is an odd one, because state and government entities are not created by entity law like general-incorporation statutes. Most important, the *mechanism* posited by organizational-law theory—creating bonding assets—does not exist for states.

230 Another likely explanation is that subsidiaries are created for regulatory reasons and thus the guarantees ensure sufficient financing for an entity that is not created for asset partition purposes. For further discussion, see generally Pargendler, *supra* note 220.

231 For the classic overview of this phenomenon, and some abuses of bankruptcy's temporal asset partition, see Cole, *supra* note 83, at 1259-60, 1270-84.

232 11 U.S.C. § 524; THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY 190-91 (1986) [hereinafter JACKSON, LOGIC AND LIMITS].

233 *See* JACKSON, LOGIC AND LIMITS, *supra* note 232, at 225 (noting that a "fresh start" is the underlying rationale of individual bankruptcy).

Start with the owner-entity model. States have no owners, so owner-shielding is a meaningless concept for them. A state creditor cannot recover assets from the state's citizens, as she might from a shareholder in a veil-pierced corporation. Nor does entity-shielding apply to states. Citizens of a state do not own shares in the state, and thus it would be nonsensical for a Michigander's creditor to levy on the state's assets to recover a debt owed by that Michigander. So conceptually, it is incongruous to say that states use organizational law as private entities do.

Doctrinally, the fit is equally uncomfortable. States do not resemble the traditional entities of organizational law. Owners of a corporation, for example, form the corporation under general-incorporation statutes.[234] Those corporations may themselves have subsidiaries, which partition assets using the same general-incorporation statutes.[235] They are subject to corporate law, from creation through dissolution.[236] And it is many of those rules—like those locking-in capital—that create bonding assets and the myriad benefits of organizational law.[237]

A state, by contrast, is created by its constitution. State agencies tend to be created by statute.[238] Counties are likewise defined by the legislature.[239] Municipalities are created by municipal-incorporation statutes.[240] All of those differ from general-incorporation statutes, and in ways at the heart of corporate law. For example, state constitutions do not contemplate dissolution, and municipalities do not issue shares. Both states and municipalities can tax; corporations' revenues must come from voluntary transactions. And so on.

The biggest difference, though, is that asset partitions, capital lock-in, and bonding assets do not describe any phenomenon that any public entity engages in. Indeed, in a world where assets cannot be reached by creditors, the concept of bonding assets is inapplicable. And, for at least three reasons, state and municipal assets are unreachable.

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234 *See, e.g.*, DEL. CODE ANN. tit. 8, § 101 (2021).

235 *See* Squire, *Strategic Liability*, *supra* note 223, at 619-20 (noting that the largest 100 public companies in 2010 had an average of 109 foreign subsidiaries and 136 domestic subsidiaries).

236 *See, e.g.*, DEL. CODE ANN. tit. 8, § 275 (2021).

237 Blair, *supra* note 214, at 391-92.

238 *See, e.g.*, 72 PA. STAT. AND CONS. STAT. § 3761-902 (West 2020) (establishing the Pennsylvania Department of Transportation).

239 Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 484 (1993).

240 *See, e.g.*, *In re* Westport Transit Dist., 165 B.R. 93, 95, 97 (Bankr. D. Conn. 1994) (noting that Westport was created under a municipal authority statute for transit district formation).

First, a web of sovereign immunity doctrines typically protects states, so long as they do not consent to suit.[241] Private parties may not sue a state in federal court.[242] Nor may they proceed against a state in federal agencies.[243] So too they may not sue the state in another state's court.[244] And they may not sue the state in its own state court.[245] And though there are some holes in sovereign immunity (like states suing one another), creditors have had limited success with such suits.[246]

Second, even where sovereign immunity may be pierced (or is waived), state assets may not be attached.[247] So a court judgment has little practical value. This protection also extends to municipalities.[248] So even though municipalities enjoy no sovereign immunity, they can frustrate creditors just as the state can, by refusing to pay and relying on their assets being unreachable.[249]

Third, states can allocate assets as they please. The simplest way is through budgeting. A state can divert appropriations from one municipality to another by, for example, shifting future public-health grants from one city to another when annual budgeting happens. A state can also rescind prior budgeting promises, as "one legislature may not bind the legislative authority of its successors."[250] So, for example, a current legislature can rescind a budget promise to buy military equipment for police departments even if the prior legislature enacted that promise. Even more extreme, states may transfer current assets from one municipality to another. Because fraudulent-transfer law does not apply to state legislation, nothing prevents a state from shifting funds among municipalities and rendering one insolvent.[251] Indeed, Pennsylvania has done just that, plunging the Pennsylvania Turnpike into insolvency by forcing it to transfer hundreds of millions of dollars each year

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241 *See* PennEast Pipeline Co. v. New Jersey, 141 S. Ct. 2244, 2258 (2021) (describing doctrine and exceptions).

242 *See* Hans v. Louisiana, 134 U.S. 1, 13 (1890) (preventing suit by a citizen of the same state); *see also* U.S. CONST. amend. XI (preventing suit by a citizen of another state).

243 Fed. Mar. Comm'n v. S.C. Ports Auth., 535 U.S. 743, 760 (2002).

244 Franchise Tax Bd. of Cal. v. Hyatt, 139 S. Ct. 1485, 1490 (2019).

245 Alden v. Maine, 527 U.S. 706, 712 (1999).

246 *See* New Hampshire v. Louisiana, 108 U.S. 76, 88-89, 91 (1883) (holding that bondholders could not sue Louisiana simply by suing in New Hampshire's name and prosecuting the case themselves). *But see* South Dakota v. North Carolina, 192 U.S. 286, 312, 321 (1904) (holding that South Dakota could sue North Carolina because it owned the bonds).

247 Richard M. Hynes, *State Default and Synthetic Bankruptcy*, 87 WASH. L. REV. 657, 678 (2012).

248 *See* McConnell & Picker, *supra* note 239, at 472.

249 *See id.* at 429-34 (tracing the decline of creditors' remedy of taking municipal assets).

250 United States v. Winstar Corp., 518 U.S. 839, 872 (1996) (plurality opinion) (citing 1 WILLIAM BLACKSTONE, COMMENTARIES *90).

251 Many thanks to Vince Buccola for his insight on this point.

to other transit entities instead of allowing the Turnpike to use that money to cover its own costs.[252]

Given all this, states do not create bonding assets. There is no way to partition assets or lock in capital when creditors of a public entity cannot sue to recover those assets and cannot attach those assets. Likewise, when the state can reallocate assets and revenues, there is no ability to lock in capital and no ability to ensure that the assets of an entity will remain *its* bonding assets. Hence, the core mechanism of organizational law is unavailable to states.

D. *Public Organizational Law, Liability Partitions, and the State*

States, however, can use organizational law by partitioning liabilities instead of assets. And that is precisely what Chapter 9 achieves. In doing so, Chapter 9 brings many of the benefits of organizational law, from easier creditor monitoring to clearer market signals to curing debt overhang.

The State as Corporate Group. To see this, start with the common analogy between states and parent corporations.[253] Corporations have many subsidiaries carrying out various lines of business; states have an array of disaggregated public entities providing services. For a corporation, the subsidiaries benefit from the use of asset partitions. For a state, sovereign immunity, anti-attachment laws, and the ability to divert assets prevent the use of asset partitions.

The Problem: Debt Overhang and No Asset Partitions. Creditors of a municipality, then, must always worry about all state debt, including the debt of municipalities other than their debtors. If one municipality, for instance, the Pennsylvania Turnpike, cannot pay its debts, every other creditor in the State—from Philadelphia public-school teachers to retired state policemen to public-hospital vendors to Pennsylvania bondholders—must worry that Pennsylvania will divert funds to the Turnpike, or worse, pay Turnpike debts by repudiating other debt. In short, every creditor of every government entity in the state must worry about every liability of every other government entity because of the state's ability to (and interest in) divert assets to covering those liabilities.

252 *See* Dave Bohman, '*Road to Ruin': Pennsylvania Turnpike Deep in Debt*, WNEP (March 21, 2019, 6:13 PM), https://www.wnep.com/article/news/local/bradford-county/road-to-ruin-pennsylvania-turnpike-deep-in-debt/523-e773272f-3f1b-4092-ba8d-73278bb088b9 [https://perma.cc/U5EJ-A44N] (stating that the turnpike system is on the "brink of financial collapse," as it is in almost $12 billion of debt).

253 *See, e.g.*, Hynes, *supra* note 247, at 663 (contending that states and municipalities are similar to complex holding companies); *see also* Skeel, *State Bankruptcy From the Ground Up*, *supra* note 29, at 196 (comparing states' complex organizational structures with those of large corporations).

Pensions are a prime example of both sides of the phenomenon. Nominally, pension funds pledge a pool of assets to current and future pensioners. Realistically, states underfund pensions, and then raid pension funds regularly, diverting pension assets to present needs in a budget crunch.[254] Conversely, the state budget can achieve the same shell game in favor of pensions. Illinois, for example, spent 29% of its 2020 budget on pensions[255]—money that otherwise could have gone to its commitment to providing, say, public education. Thus, pensioners (like any creditor of a government entity) must fret about the state's other debts and when the fund will be raided to pay those debts. And creditors of other government entities (like public school teachers) must fret about the debt of pensions and when, say, school funding will be curtailed to pay for pensions.

In turn, the concern over the totality of state debt can lead creditors to shy away from even financially sound municipalities. That leaves states with a debt overhang problem.

Exacerbating the Problem: Implicit Guarantees. This concern is doubly strong, as states have long been seen as implicitly guaranteeing the debt of their municipalities, giving states yet more reasons to shuffle assets in ways that disfavor certain municipal creditors. The implicit guarantee is implicit only because states must comply with debt limitations, and an explicit guarantee would qualify as "debt" and thus count toward the limitations.[256]

But that guarantee is robust nonetheless. Indeed, states often, ironically, issue *explicit* implicit guarantees in the form of moral obligation bonds.[257] These "bonds" say that the state will pay "subject to appropriation[s]." [258] Of course, the availability of state funds is always "subject to appropriation," so the bond is a truism and on the same footing as any other potential state appropriation. That leads to the question: Why do states issue such explicit, implicit payment commitments? The answer: they signal to investors that the state will guarantee that municipal debt.[259] And indeed, investors believe these guarantees.[260]

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254 Levitin, *Bankrupt Politics*, *supra* note 27, at 1429.

255 Schuster, *Pensions Set to Consume Budget*, *supra* note 60.

256 AMDURSKY & GILLETTE, *supra* note 166, at § 4.1.1.

257 Janice C. Griffith, *"Moral Obligation" Bonds: Illusion or Security?*, 8 URB. LAW. 54, 54-55 (1976).

258 Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 289 (2012).

259 States could formally guarantee the debt (recourse bonds), but that does not happen often, likely because states have constitutional restraints on debt, and guaranteed debt (depending on the accounting regime) could end up on state books and subject to various state constitutional limits.

260 *Cf.* GAIL RADFORD, THE RISE OF THE PUBLIC AUTHORITY: STATEBUILDING AND ECONOMIC DEVELOPMENT IN TWENTIETH-CENTURY AMERICA 149 (2013) (describing the investment community's perception that a government will stand behind the debt of its agencies).

History also supports the assumption that states will guarantee their municipalities' debts. Typically, as municipalities fail, states step in.[261] For example, when Bridgeport (Connecticut's largest city) encountered fiscal distress, Connecticut's Financial Review Board stepped in to control city finances before the bankruptcy, objected to the bankruptcy, and continued its influence over the city's finances after the bankruptcy filing was dismissed.[262] More generally, municipal bond defaults are rare, with under .05% defaulting, compared to 1.5% for corporate debt, suggesting that states buttress their distressed municipalities.[263]

Practice confirms all this. Ratings agencies seldom factor in a state's bondholder protections in calculating municipal bond ratings,[264] which makes sense only if the state's support is reliable for each municipality and thus the municipalities' bankruptcy regime does not matter. Public finance professionals likewise think of "state debt" as the debt of the state's government entities—not just the state itself—even when there are no guarantees.[265] Congress, too, in designing a bankruptcy law for Puerto Rico, realized it needed to account for the debt of all Puerto Rico's government entities, not just debts of the "Territory of Puerto Rico," as those entities' debts would, practically speaking, be debts of the territory.[266]

A Solution: Chapter 9 as Liability Partition. Putting these phenomena—debt overhang, lack of asset partitions, and implicit guarantees—together shows the challenge states face and how traditional organizational law cannot solve them. But Chapter 9 acts as a different form of organizational law, and can.

By allowing a municipality to file for bankruptcy, the state breaks any implicit guarantee.[267] In organizational-law terms, the state partitions the

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261 *See* Gillette, *supra* note 258, at 308 ("[S]tates have proven to be the providers of relief, either by advancing payments, extending loans, or appointing financial control boards that could exercise municipal authority.").

262 Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEVS. J. 625, 630-35, 638, 641-42 (1994).

263 JAMES E. SPIOTTO, CHAPMAN & CUTLER LLP, THE MYTH AND REALITY OF STATE AND LOCAL GOVERNMENTS DEBT FINANCING IN THE U.S.A. IN TIMES OF FINANCIAL EMERGENCY 8 (2011), https://www.civicfed.org/sites/default/files/7-25-11%20Session%201%20Spiotto.pdf [https://perma.cc/B6RL-VQ3D].

264 Dario Cestau, Not All General Obligation Bonds Are Created Equal: A Commentary 2-3 (June 3, 2021) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3859633 [https://perma.cc/A7DQ-HGF5].

265 *See* discussion *supra* Section I.A.1.

266 *See* discussion *supra* Section I.A.1.

267 Hence liability partitions cannot aid a state's recourse debt, which are a true guarantee and legally obligate the state to repay. Such debts are similar to general-bond obligations, as they are on the state's books and thus cannot be discharged in Chapter 9. The vast majority of municipalities' debt is nonrecourse. *See* note 166 and accompanying text. So this note is more a cautionary one for states going forward (should they become interested in having municipalities issue recourse debt) than a hurdle for states today.

liability of that municipality, walling it off from the state's assets and assuring creditors of *other* municipalities that the distressed municipality's liabilities will not affect them. So, for example, if the Pennsylvania Turnpike can file for bankruptcy, the $12 billion it owes no longer need worry a retired teacher, whose pension fund is no longer at risk of being diverted to pay for the Turnpike.

Liability Partitions vs. Asset Partitions. The comparison to a traditional asset partition is instructive. Chapter 9, unlike an asset partition, does not identify bonding assets that a new entity's creditors will be entitled to. Nor does it shield the entity eligible to file from having its own assets diverted. Instead, Chapter 9 acts as a shield for *other* legal entities—it is a shield not for the entity that may file for Chapter 9 or its creditors (the Turnpike), but a shield *from* that entity and its creditors that benefits every other state entity and its creditors (the pension plan). In essence, then, a liability partition is the inverse of an asset partition: An asset partition shields a corporation's bonding assets for the sake of its creditors; a liability partition shields creditors of *other* municipalities from the bankruptcy-eligible municipality's liabilities.

To see this difference, consider just one of the benefits that both asset partitions and liability partitions yield: lower monitoring costs. A corporation's asset partition separates the assets of owners from the assets of the corporation. The result is that creditors of the corporation need not monitor any person or entity other than the corporation itself. By contrast, a liability partition separates the liabilities of, say, the Turnpike from the pension plan. The result is that the pension plan creditors need not monitor the Turnpike. But they must still monitor every other government entity. That reduces monitoring costs, but minimally (by saving pension plan creditors monitoring of only the Turnpike), leaving pension plan creditors the costs of monitoring the pension plan itself and every other government entity in the state. And the only way to achieve the reduction in monitoring of an asset partition—where creditors of an entity need only monitor *that* entity—is for a state to allow every government entity to file for bankruptcy.

Chapter 9 also acts as a temporal liability partition. By granting a discharge, Chapter 9 limits creditors of a distressed municipality to recovering pre-bankruptcy assets of that municipality.[268] That cordons off what would otherwise be liabilities sought to be collected, indefinitely, against the state. In the Turnpike context, here is how that plays out: Absent a discharge, creditors will continue to return to the Turnpike, and pressure the state indefinitely.[269] That, in turn, would destroy the benefits of the liability

268 11 U.S.C. § 944(b).

269 That is what happened when states defaulted in the 1840s—creditors did not disappear, and eventually most of the defaulting states repaid debts that they had repudiated. *See* William B.

partition, because every other creditor of a Pennsylvania municipality would still need to worry about the diversion of state resources to the Turnpike Commission. With a discharge, those creditors can rest easy, knowing that the Turnpike's liabilities will not affect their municipality's ability to pay.

So Chapter 9 solves a debt overhang problem for states, but not in the traditional way. Instead of partitioning assets in a new entity to create bonding assets for a creditor (creating a pension plan), Chapter 9 partitions liabilities of *other* entities (the Turnpike) to assure creditors that the state will not divert assets from *their* debtor entity (the pension plan) to the entity that can now file for Chapter 9. Allowing every municipality to file for Chapter 9 applies this liability partition to every municipality, ensuring that each municipality will be responsible for its own liabilities and that the state will not need to divert resources from one to another.

Benefits of Public Organizational Law. This use of Chapter 9 yields states some of the traditional benefits of asset partitioning.[270] Foremost, it solves debt overhang, the core concern of state bankruptcy.[271] It also reduces creditor monitoring costs, as, for example, the creditors of the teacher pension plan (teachers) no longer need monitor the Turnpike Commission, let alone the entire state.[272] From the market perspective, these liability partitions align lending with the true cost of capital by eliminating implicit state subsidies that result in overborrowing.

The other benefits of liability partitions track those of asset partitions and operate similarly. Markets can price municipalities' debt more precisely without needing to consider the state's other debts. And bankruptcy is simpler because only the discrete municipality files—not every entity in the state.

But not all the benefits of private organizational law translate to the public context. Most notably, those related to control do not. The transfer of control in a municipality does not happen through stock trades, but through elections. Liquidity of shares does not matter for the same reason. And there is no use of organizational law to lock in capital and thereby facilitate investments.

English, *Understanding the Costs of Sovereign Default: American State Debts in the 1840's*, 86 AM. ECON. REV. 259, 265 (1996).

270 *Cf.* discussion *supra* Section II.A (discussing benefits of asset partitioning).

271 Skeel, *States of Bankruptcy*, *supra* note 26, at 687-88; *see also* Buccola, *An Ex Ante Approach*, *supra* note 33, at 272 ("Chapter 9 is thus oriented toward a singular function—the elimination of debt overhang.").

272 This is especially important in the public sphere given the opacity of state finances. *See* Schwarcz, *The Use and Abuse of Special-Purpose Entities*, *supra* note 166, at 383-85 (discussing consequences of opacity in public finance).

Overall, then, the takeaway is that states can use organizational law, and municipal bankruptcy is a means for them to do so. Because states disaggregate, providing services through myriad distinct public entities, they have the same organizational-law building blocks as does a corporate group. Through Chapter 9, states can partition the liabilities within that group, much like a corporate group partitions assets. In so doing, the state can achieve private organizational law's benefits: curing debt overhang for some municipalities, easing creditor monitoring, and sending clearer signals to the market. Liability partitions do not always mirror asset partitions in *how* they achieve their benefits. But they *do* achieve those benefits. And public organizational law's benefits can make a world of difference, especially when it matters most: when state finances are on the brink.[273]

III. DISAGGREGATION AND THE STATE BANKRUPTCY DEBATE

The benefits of public organizational law manifest in a state's use of disaggregated bankruptcy. Such a bankruptcy would be better than the proposed state bankruptcy chapter and is better than the current landscape for distressed states. This Part therefore explores the arguments advanced by proponents and opponents of state bankruptcy, showing how, for each argument, a disaggregated bankruptcy is preferable.

A. *The Case for State Bankruptcy*

The details of a state bankruptcy regime are not fully fleshed out, but David Skeel's proposal offers a good sketch of what such a chapter would look like.[274] On his view, the major features of a state bankruptcy chapter track other parts of the Code. The chapter would include a list of priorities, the rule that similarly situated creditors be treated similarly, the power to reject contracts, a cramdown option, and a discharge.[275]

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273 *See* discussion *infra* Section III.C.2.

274 Skeel is the leading proponent of state bankruptcy, making the case in academia, popular press, and Congress. *See, e.g.*, Skeel, *States of Bankruptcy*, *supra* note 26; Skeel & Kane, *Should States Declare Bankruptcy?*, *supra* note 6; *Hearing*, *supra* note 37, at 19-27 (presenting testimony of David Skeel). For that reason, I will follow his model and arguments for state bankruptcy. For a more limited approach to state bankruptcy, see Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy"*, 59 UCLA L. REV. 322, 331-35 (2011) [hereinafter Schwarcz, *A Minimalist Approach*] (proposing a framework with "across-the-board supermajority voting" through which states could bind holdouts upon a supermajority of a class of creditors accepting a debt reduction). Others prefer state bankruptcy to occur under the auspices of state law, akin to the New Jersey composition law in *Faitoute Iron & Steel Company v. City of Asbury Park*. *See, e.g.*, George Triantis, *Bankruptcy For the States and By the States*, *in* WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 240 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012).

275 Skeel, *State Bankruptcy from the Ground Up*, *supra* note 29, at 197.

States, and states alone, could initiate a bankruptcy by showing that they are "in danger of default."[276] The decision to file would rest in the governor's hands, though some legislative participation (consultation or approval) could be mandated.[277] After that, the state would propose a plan of reorganization, and upon sufficient creditor support, the bankruptcy court would approve the plan.[278]

Proponents of state bankruptcy catalog a series of benefits that a state bankruptcy chapter provides that are currently unavailable to states. Broadly speaking, the benefits fall into three categories: (1) providing a better alternative to doing nothing; (2) altering the dynamics of state debt negotiations; and (3) increasing fairness.[279]

1. The Alternatives

Beginning with bankruptcy's advantage over the alternatives, states can face two problems that bankruptcy aids. The first is debt overhang, which hampers states from borrowing for good investments because they carry too much debt. The second is default, when a state cannot pay its debts.

Debt Overhang. States, like individuals, can face a debt overhang when they carry too much debt.[280] And states, like individuals, cannot readily solve debt overhang—they cannot dissolve to eliminate their debt.[281] Nor can states solve a debt overhang by granting new creditors priority, because sovereign immunity prevents creditors from enforcing that priority; thus, at best, creditors have the state's word.[282] Bankruptcy, though, "break[s] the impasse" by reducing a state's debt.[283] Through a discharge, bankruptcy gives individuals a fresh start, and through a discharge, a state bankruptcy chapter would achieve the same.

Default. Bankruptcy can also help when states veer from mere debt overhang into potential collapse. Absent bankruptcy, a state would either need to default or receive a federal bailout, neither of which is desirable.[284] A

276 *See id.* at 204-05 (replacing Chapter 9's insolvency test with the Dodd-Frank test for systemically important financial institutions).

277 *See id.* at 205-06 (preferring consultation).

278 *See id.* at 208-09 (discussing possible rules for creditor approval).

279 *See, e.g.*, Skeel, *States of Bankruptcy*, *supra* note 26, at 689-706; Triantis, *supra* note 274, at 237-38 (noting similar benefits of state bankruptcy); Schwarcz, *A Minimalist Approach*, *supra* note 274, at 324-25.

280 *See* Skeel, *States of Bankruptcy*, *supra* note 26, at 687 (discussing how debt overhang for states is analogous to individuals' debt overhang).

281 Skeel, *State Bankruptcy from the Ground Up*, *supra* note 29, at 194.

282 *See* discussion *supra* Section II.C (discussing sovereign immunity).

283 Skeel, *States of Bankruptcy*, *supra* note 26, at 687.

284 Puerto Rico, though not a state, is an excellent example of this Hobson's choice. Congress excluded Puerto Rico from the Bankruptcy Code in 1978, and the Supreme Court invalidated a

default would have massive spillover effects, rippling through the economies of nearby states.[285] Worse, states would pick and choose which debts to repay, throwing markets into chaos.[286] And a default would not eliminate debt, leaving years of litigation and stiffed creditors continuously returning to the state seeking payment.[287] Indeed, the downsides of default are sufficiently awful that no one expects the federal government to stand for it, and history bears out that expectation—the European Union bailed out Greece, Ireland, and Portugal.[288]

Bailout. But a bailout too causes problems. For one, there is the unfairness in forcing federal taxpayers to subsidize one state's mismanagement. More importantly, the backstop of a bailout creates moral hazard: Once states know that a bailout is forthcoming, they can borrow more, and more riskily, secure in the knowledge that they and their taxpayers will not suffer consequences.[289] A state bankruptcy chapter provides a better alternative, as it minimizes the chaos of state default and erases moral hazard by forcing the state to bear the consequences of its own borrowing.[290]

2. Debt Dynamics

Outside of bankruptcy, the Contracts Clause prohibits states from unilaterally altering their debt contracts.[291] Often state law imposes other

Puerto Rico territorial law that attempted to establish a bankruptcy scheme. *See* Laura N. Coordes, *Bespoke Bankruptcy*, 73 FLA. L. REV. 359, 383 (2021). That meant Puerto Rico (and its municipalities) had no possible access to bankruptcy relief, and Congress faced the choice of bailing out the territory, allowing it to default, or authorizing bankruptcy. *See id.* at 382-84. In a move many have suggested for distressed states, Congress chose the latter, passing the Puerto Rico Oversight, Management, and Economic Stability Act to allow Puerto Rico and its municipalities to file for bankruptcy. *See* Puerto Rico Oversight, Management, and Economic Stability Act, Pub. L. No. 114-187, 130 Stat. 549 (2016) (codified as amended in sections of 48 U.S.C.).

285 *See* Skeel, *States of Bankruptcy*, *supra* note 26, at 706-07 (calling default a "tsunami").

286 *See* discussion *supra* Section III.A.3.

287 English, *supra* note 269, at 259, 265.

288 *See* Anna Gelpern, Essay, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt*, 121 YALE L.J. 888, 917-19 (2011) (describing creative interpretations of the European Union's "no-bailout" clause during crisis).

289 Buccola, *An Ex Ante Approach*, *supra* note 33, at 239. For this reason, states might even oppose the addition of a bankruptcy chapter, as they unanimously did amidst the Great Recession. *See* Letter from Governor Christine O. Gregoire, Governor Dave Heineman, Senator Richard T. Moore & Senator Stephen Morris, to John Boehner, Speaker of the House of Representatives, Nancy Pelosi, Minority Leader of the House, Harry Reid, Majority Leader of the Senate & Mitch McConnell, Minority Leader of the Senate (Feb. 3, 2011) (on file with author) [hereinafter *Letter Opposing State Bankruptcy Chapter*].

290 *See* Buccola, *An Ex Ante Approach*, *supra* note 33, at 239-40.

291 *See* discussion *supra* Section I.B.3 (discussing early municipal bankruptcy cases).

restrictions that cannot be escaped outside bankruptcy, as when the City of Vallejo could not close nonessential fire stations despite being insolvent.[292]

Bankruptcy, as federal law, is not subject to the Contracts Clause.[293] And, as federal law, it preempts state laws to the contrary. So, bankruptcy can rework debt dynamics to favor state resolution of debts. Notably, bankruptcy prevents individual creditors from holding out for a better deal and thus scuttling a state's restructuring, which was the original motivation for Chapter 9.[294]

More important than that is the "shadow of the law" effect.[295] Creditors account for bankruptcy laws, or their absence.[296] So, for instance, negotiations over public pensions will no longer result in politicians and unions agreeing to maximalist positions.[297] After all, if the maximalist position drives a state into bankruptcy, politician and union alike stand to lose.[298] More broadly, politicians would need to temper their instinct to spend now and pay later,[299] as every creditor would have the same concern that excessive state borrowing would backfire.

In the same vein, a state bankruptcy chapter would bring government borrowing more in line with the true cost of capital. As it stands, the implicit guarantee of a bailout allows creditors to charge lower rates and thus allows states to fund projects that would not be funded absent shifting the losses to the federal government.[300] So a state bankruptcy chapter, which would replace bailouts, has this salutary effect as well.

3. Fairness

In a world without state bankruptcy, states select which creditors to repay. They can do so by relying on a web of immunity doctrines, or by shifting the maturity dates of debt.[301] That results in decisions based not on law, but on political favor, and leads to the risks of unfairness and unpredictability.

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292 *See* Skeel, *States of Bankruptcy*, *supra* note 26, at 701.

293 *See* U.S. CONST. art. I, § 10, cl. 2 ("No State shall . . . impair[] the Obligation of Contracts . . . .").

294 *See* discussion *supra* Section I.B.3.

295 *See* Skeel, *States of Bankruptcy*, *supra* note 26, at 689-90.

296 *See id.* at 689 ("Negotiations that might prove impossible in the absence of a bankruptcy law might become feasible in its presence.").

297 *Id.* at 691-93.

298 Unfunded pension promises would be treated as unsecured, giving unions an incentive to monitor the state. *Id.* at 692-93.

299 *See* Levitin, *Bankrupt Politics*, *supra* note 27, at 1420-32 (cataloguing the many reasons for this phenomenon).

300 Skeel, *States of Bankruptcy*, *supra* note 26, at 691.

301 *Id.* at 700.

Bankruptcy offers two means of mitigating these risks. For starters, the Bankruptcy Code contains a detailed list of priorities, which cannot be circumvented through sovereign immunity or through shifting debt maturities.[302] The Code also boasts ample tools to address debtor mischief.[303] Apart from listing priorities, though, the Code's priorities have an eye toward equitable, shared sacrifice.[304] Thus, where states would cut services for the poor and disenfranchised, or redirect pension funds, the Code imposes sacrifices that recognize the shared value in keeping a state afloat. And the Code interposes a bankruptcy judge to enforce that shared sacrifice.

B. *The Case Against State Bankruptcy*

The opponents of state bankruptcy are far more numerous than are the supporters. And they offer a variety of objections. In the main, these objections do not take issue with bankruptcy's role in providing for fair distribution. The objections instead focus on state bankruptcy as a worse alternative (to a bailout[305] or state fiscal discipline[306]), and on the many practical challenges that state bankruptcy would bring.

1. The Alternatives

Critics of state bankruptcy find wanting the rationales of curing debt overhang and better managing a financial collapse. On the former, as Anna Gelpern points out, debt overhang is not a bankruptcy problem.[307] Debt overhang is a debt problem. Bankruptcy *can* cure a debt overhang by discharging debt and thus reducing the debt that future creditors worry about. But debt overhang can also be cured by pumping more money into the debtor (raising taxes, eliciting a federal bailout) or by lowering costs (renegotiating debt, cutting services). So bankruptcy is not necessary, and

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302 *See, e.g.*, 11 U.S.C. § 507 ("Priorities"). Chapter 9 cases have not always comported scrupulously with such priorities, though the requirement of priorities ensures more fairness than the free-for-all of default. *See* Richard M. Hynes & Steven D. Walt, *Fair and Unfair Discrimination in Municipal Bankruptcy*, 37 CAMPBELL L. REV. 25, 44-46 (2015) (discussing how Detroit's bankruptcy favors workers and retirees over other creditors).

303 *See, e.g.*, 11 U.S.C. §§ 547 (recovering preferences), 548 (recovering fraudulent transfers). There are, to be sure, limits to the Code's efficacy in preventing subversion of preferences. *See* David A. Skeel, Jr., *The Empty Idea of "Equality of Creditors"*, 166 U. PA. L. REV. 699, 714-20 (2018). Though, as Skeel's support of state bankruptcy suggests, the circumvention available to states in bankruptcy is far less than the circumvention available to states outside of bankruptcy.

304 *See* Skeel, *States of Bankruptcy*, *supra* note 26, at 703.

305 *See* Gelpern, *supra* note 288, at 940 (suggesting conditional bailouts).

306 *See* Richard C. Schragger, *Democracy and Debt*, 121 YALE L.J. 860, 880-83 (2012) (disfavoring bankruptcy compared to solutions grounded in state and local politics).

307 *See* Gelpern, *supra* note 288, at 894 ("Debt overhang requires debt relief, not bankruptcy.").

proponents must do more to show that bankruptcy is preferable to those alternatives for curing debt overhang.[308]

As for financial collapse, opponents of state bankruptcy tend to recognize the need for a federal bailout. Some, like Clayton Gillette and Anna Gelpern, see danger in having parallel tracks for bankruptcy and bailout. On this view, bankruptcy could create holdup opportunities, with bankruptcy giving states leverage to weaken a federal bailout.[309]

Even worse, a refusal by the federal government to bail out states would not be credible. Indeed, there is a long history of such commitments being broken or circumvented.[310] Nor would such a refusal be desirable, as the spillover effects of a default would be catastrophic.[311] This means that bailouts are "structurally embedded in the federal system,"[312] because states and the federal government both know that the state is too big to fail.[313] Thus, while bankruptcy might sound better than bailouts, the reality of bailouts counsels against state bankruptcy.

2. Debt Dynamics

Though it is true that bankruptcy affords states a way around the Contracts Clause and state law, thus changing debt dynamics, critics tend to view those new debt dynamics negatively. That includes concerns about punishing labor, about the states' desire not to use the new dynamics, and about fiscal federalism.

Punishing Labor. From some critics' perspectives, state bankruptcy is really a cover for punishing labor.[314] And that is certainly how prominent Republican politicians, like Speaker Newt Gingrich and Governor Jeb Bush, sold it. They touted state bankruptcy as a way to "allow states in default or in danger of default to reorganize their finances free from their union contractual obligations," and to potentially "cancel[] . . . all state government

308 *See id.* at 939-40 (noting that bankruptcy cannot solve sovereigns' commitment challenges, rehabilitate sovereigns, or improve their decisionmaking in financial distress).

309 *Id.* at 911; Gillette, *supra* note 258, at 330.

310 *See* Gelpern, *supra* note 288, at 918 (noting the "creative[] interpret[ation]" of the European Union's no-bailout rule for Greece, Ireland, and Portugal).

311 *Id.* at 911-12.

312 *Id.* at 917.

313 This point does result in the moral hazard discussed above, but also suggests that it is unavoidable. *See* discussion *supra* Section III.A.1.

314 Levitin, *Bankrupt Politics*, *supra* note 27, at 1403.

employee union contracts."[315] For supporters of labor, then, state bankruptcy is unappealing.[316]

Use. A deeper challenge to state bankruptcy's debt dynamic is that states might not be inclined to use state bankruptcy, nixing any potential benefits of the new dynamics. That is not farfetched—after the Great Recession, states unanimously opposed the creation of a new state bankruptcy chapter. The National Governors Association sent a letter to Congress, writing that no "state leader has asked for nor would they likely use" state bankruptcy.[317] At the Association's winter conference, Governor Gregoire of Washington said, "[n]ot only do we not want it, we want to stop the discussion . . . . We'd like leaders of Congress to say [i]t's dead."[318] In 2020, governors had much the same reaction.[319] So it seems that state bankruptcy is not popular among the states, and states might refuse to use a state bankruptcy chapter.

As Vince Buccola suggests, states likely oppose bankruptcy because they prefer bailouts.[320] On this view, states would not use a new bankruptcy chapter because it would diminish their power to extract a federal bailout.[321] Nor could they be forced to.[322] The resulting game of chicken, with the federal government refusing funds and demanding the state file for bankruptcy, and the state demanding funds and refusing to file, is as unpredictable as it is undesirable.

Fiscal Federalism. Another foundational challenge to state bankruptcy's debt dynamic is fiscal federalism. On this view, states are doomed to fiscal trouble, and bankruptcy cannot prevent that fate. Adam Levitin, the leading expositor of this view, explains: State budget crises are "inevitable" because states face drains on their budgets in economic downturns, when revenues are

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315 Jeb Bush & Newt Gingrich, *Better Off Bankrupt*, L.A. TIMES (Jan. 27, 2011, 12:00 AM), https://www.latimes.com/opinion/la-xpm-2011-jan-27-la-oe-gingrich-bankruptcy-20110127-story.html [https://perma.cc/U63Q-YVDJ].

316 *See, e.g.*, Catherine Fisk & Brian Olney, *Labor and the States' Fiscal Problems* ("[B]ankruptcy is of dubious utility as a means of modifying or repudiating wage, health benefit, and pension promises."), *in* WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 293 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012).

317 *Letter Opposing State Bankruptcy Chapter*, *supra* note 289, at 2.

318 Sean Cavanagh, *Governors Rip Congress' State Bankruptcy Talk*, EDUC. WEEK (Feb. 28, 2011) (internal quotation marks omitted), https://www.edweek.org/education/governors-rip-congress-state-bankruptcy-talk/2011/02 [https://perma.cc/J5BD-PDB9].

319 Allan Smith, *'Outrageous,' 'Irresponsible': Governors Slam McConnell Over Bankruptcy Comments*, NBC NEWS (Apr. 26, 2020, 12:02 PM), https://www.nbcnews.com/politics/congress/outrageous-irresponsible-governors-slam-mcconnell-over-bankruptcy-comments-n1192916 [https://perma.cc/KC9R-WJH9].

320 Buccola, *An Ex Ante Approach*, *supra* note 33, at 277-78.

321 *Id.*

322 *See* Ashton v. Cameron Cnty. Water Improvement Dist. No. One, 298 U.S. 513, 531 (1936) ("[N]othing . . . tends to support the view that the Federal Government, acting under the bankruptcy clause, may impose its will and impair state powers . . . .").

at their ebb, and have no ability to borrow, print money, or take other steps that close the gap.[323]

Unfunded mandates and state fiscal rules create this trouble. States provide a host of services, many of which are mandated (formally or functionally), by the federal government.[324] Most of these services, like welfare and healthcare, see increasing use, and hence increasing state costs, during economic downturns. At the same time, state revenues decline in times of economic downturn.[325] Federal payments typically do not close the gap and are not countercyclical.[326] But states cannot borrow to close this gap, as nearly all states have a balanced-budget amendment and debt limits.[327] And raising taxes or cutting services would be counterproductive, hurting residents when they need help the most.[328]

In principle, states could save in boom times to pay for the lean years, and states do keep rainy-day funds. But political economy renders these rainy-day funds insufficient.[329] Politicians have many reasons in good economic times to spend the surplus, not save it. The simplest reason is rewarding favorites, be they friends, businesses, or voters. But politicians might also want to bind the hands of future administrations or recognize that voters overvalue short-term benefits and undervalue long-term costs.[330] That this happens regularly suggests that electoral discipline is wanting, and voters will not punish politicians who run up debt enough to deter them.[331]

States, then, on this view, have no good options for preventing fiscal distress. Thus, bankruptcy offers little. Bankruptcy cannot force the federal government to pay for its mandates, eliminate state balanced-budget amendments, or demand that citizens pay more taxes in an economic downturn. These problems are all fundamentally political, and not amenable to a bankruptcy-law solution.[332]

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323 Levitin, *Bankrupt Politics*, *supra* note 27, at 1406-09.

324 *Id.* at 1408.

325 *See* Gelpern, *supra* note 288, at 916 (finding it "odd" that states must provide the most services when they are least able to do so).

326 Levitin, *Bankrupt Politics*, *supra* note 27, at 1414.

327 *Id.* at 1414-15.

328 *Id.* at 1416-17.

329 *See id.* at 1424 ("Functionally, most states maintain rainy day funds at levels that cannot meaningfully cushion even small economic downturns . . . .").

330 *See id.* at 1422-23 (discussing strategic deficits); *see also id.* at 1424-25 (discussing fiscal illusion).

331 *See id.* at 1426-27.

332 *See* Gelpern, *supra* note 288, at 895 ("Bankruptcy is at best unproven, and at worst unsuited to overtly political tasks, such as mediating among political interest groups and brokering fiscal federalism." (footnotes omitted)).

3. Practical Concerns

Opponents of state bankruptcy also point to a series of practical concerns that might cause bankruptcy to backfire or be ineffective. These include bond contagion, complexity, and constitutionality.

Bond Contagion. The concern of bond contagion posits that if states can file for bankruptcy, their interest rates will soar. This has been the states' lead objection to state bankruptcy.[333] On this view, even healthy states would suffer, with lenders punishing those states merely because they have the option to file, and because lenders have trouble distinguishing among distressed and healthy states.[334] In a world without bankruptcy, bailouts all but guarantee payment for bondholders; with bankruptcy, the possibility of receiving cents on the dollar becomes real.[335] That, apart from concerns over state fiscal discipline, might translate into higher interest rates for states. If it does, then state bankruptcy might backfire, giving states relief on the one hand, but making their borrowing impossible on the other.

Complexity. Another argument points out that state bankruptcy would include an extraordinary amount of debt, spread across hundreds of government entities in the state. That includes the state, its public agencies, counties, cities, and special districts. To get a sense of proportion, the Census Bureau's latest count identifies over 90,000 such entities, or 1,800 entities for the average state.[336] By contrast, the highest-earning Fortune 500 companies average 245 subsidiaries, an order of magnitude less than the average state.[337] Some, like Nicole Gelinas, have therefore argued that the complexities in state structures would render a state bankruptcy nigh impossible.[338]

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333 *Letter Opposing State Bankruptcy Chapter*, *supra* note 289, at 2 ("[T]he mere discussion of legislation, let alone the existence of a law allowing states to declare bankruptcy would only serve to increase interest rates and create more volatility in bond markets.").

334 *See* Henes & Hessler, *supra* note 32, at 2.

335 Gillette, *supra* note 258, at 306-07. Academics focus less on this concern, in part because the evidence of bond contagion is "mixed." *Id.* at 304; *see also* David A. Skeel, Jr., *Is Bankruptcy the Answer for Troubled Cities and States?*, 50 HOUS. L. REV. 1063, 1069 (2013) [hereinafter Skeel, *Is Bankruptcy the Answer?*] (noting that investors may demand higher interest rates from states with bad finances); Parikh & He, *supra* note 34, at 604 (conducting empirical analysis showing that "a municipality's borrowing costs do not increase" based on the fact "that its home state provides meaningful debt restructuring options").

336 *See* U.S. CENSUS BUREAU, FROM MUNICIPALITIES TO SPECIAL DISTRICTS, OFFICIAL COUNT OF EVERY TYPE OF LOCAL GOVERNMENT IN 2017 CENSUS OF GOVERNMENTS 2 (2019) [hereinafter CENSUS OF GOVERNMENTS], https://www.census.gov/content/dam/Census/library/visualizations/2019/econ/from_municipalities_to_special_districts_america_counts_october_2019.pdf [https://perma.cc/66CP-SJEP] (counting 90,126 distinct governments in 2017).

337 Squire, *Strategic Liability*, *supra* note 223, at 606 n.1.

338 *See Hearing*, *supra* note 37, at 14-15 (presenting the statement of Nicole Gelinas).

Constitutionality. Michael McConnell raises the possibility that a state bankruptcy chapter would be unconstitutional.[339] After all, when the Supreme Court struck down the first municipal bankruptcy law in *Ashton*, it pointed to federalism concerns, writing that the law left states "no longer free to manage their own affairs."[340] Congress addressed that concern by clarifying in its 1937 law that states would have complete control over their municipalities, including the taxing power.[341]

But, as McConnell notes, state bankruptcy raises similar issues as those raised in *Ashton*. A bankruptcy court would trench on every aspect of state sovereignty, and the necessary safeguards might prove elusive given the scope of a state bankruptcy.[342] Nor is it clear that states could waive any federalism limitations, especially given recent case law that treats federalism as a protection for individuals as much as for states.[343]

To be sure, McConnell recognizes the question is a close one.[344] Much depends on the details of Congress' handiwork. Other scholars too have argued for the constitutionality of a state bankruptcy chapter, reasoning that it need not intrude on state functions any more than does municipal bankruptcy.[345] So while the constitutional concern does not necessarily defeat a state bankruptcy chapter, it looms, and could minimize the relief Congress may afford the states by using the Bankruptcy Code.

C. *The Case for Disaggregated Bankruptcy*

For every one of these benefits and concerns, bankruptcy through disaggregation works at least as well as the proposals for a state bankruptcy chapter. And in many instances, disaggregation works far better.

1. The Alternatives

Like a state bankruptcy chapter, disaggregation can cure a debt overhang by discharging debt. Unlike state bankruptcy, though, disaggregation can also

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339 Michael W. McConnell, *Extending Bankruptcy Law to States*, *in* WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 229 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012).

340 *Id.* at 230 (quoting Ashton v. Cameron Cnty. Water Improvement Dist. No. One, 298 U.S. 513, 531 (1934)).

341 *Id.*

342 *Id.* at 232-34.

343 *See id.* at 234-35 (discussing New York v. United States, 505 U.S. 144 (1992), and Bond v. United States, 564 U.S. 211 (2011)).

344 *See id.* at 236 (stating state bankruptcy's constitutionality is "not obvious either way").

345 *See* Skeel, *States of Bankruptcy*, *supra* note 26, at 710-11 ("[I]t is hard to imagine the Court striking down state-bankruptcy legislation that assures that the principal decision-making authority remains securely in state hands.").

cure a debt overhang by acting as organizational law and partitioning off liabilities of the government entities that drive a state's debt woes. That allows for precision and affords fiscally sound municipalities a cure to debt overhang without having to go through bankruptcy themselves or participate in a statewide bankruptcy.

As for preventing bailout and default, both state bankruptcy and disaggregation bankruptcy would provide a better alternative to the chaos of default because both offer rules-based proceedings. And both would free the federal government from states that wish to extract bailouts based on the threat of defaulting. Disaggregation offers more, though, as it limits spillover effects. A state's bankruptcy, while better than default, would still send shock waves through the national economy. By contrast, the bankruptcy of a school district, or a department of transportation, would have limited spillover. So compared to state bankruptcy, the targeted nature of disaggregated bankruptcy better contains spillover effects. That also decreases the leverage a distressed state can use to extract favorable bailout terms from the federal government—even when bankruptcy is an option.[346]

2. Debt Dynamics

Like state bankruptcy, disaggregated bankruptcy relies on federal law and thus enables municipalities to escape the Contracts Clause and strictures of state law. In turn, that affects negotiations with creditors (who can no longer hold out and know they will bear the losses of failed projects) and politicians (who would need to account more for expenses). These results are equivalent between the two types of bankruptcy.

Politics. Disaggregation bankruptcy has an extra plus on the political front. A disaggregated bankruptcy could vest the filing decision in an apolitical civil servant, like the head of a water district or the manager of the Turnpike.[347] That would lead to decisions about filing for bankruptcy based on the municipality's finances. By contrast, the decision to file for a state bankruptcy would be vested in the governor or legislature.[348] And no governor wants to sign the petition putting her state in bankruptcy. So states would enter bankruptcy later than they should. In some cases, states that should enter bankruptcy would not, with the political process to blame.

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346 *See, e.g.*, Gillette, *supra* note 258, at 330 (noting that the risks of spillover effects drive a state's ability to extract a federal bailout).

347 *See, e.g.*, 53 PA. STAT. AND CONS. STAT. § 11701.261(a) (West 2020) (allowing the governing body of a municipality to file).

348 *See* Skeel, *State Bankruptcy from the Ground Up*, *supra* note 29, at 205-06 (proposing this mechanism for states to file).

Labor. Disaggregated bankruptcy is better for labor too. States in crisis regularly "sweep" public pensions, taking money from the funds and using them for current needs.[349] This phenomenon is commonplace and results in the chronic underfunding of state pensions.[350] That leaves public pensions between a rock and a hard place: outside of bankruptcy, states underfund; inside a statewide bankruptcy, the debts are caught up with every other debt and are subject to substantial cuts.

Disaggregation helps on this front in three ways. First, it allows other government entities to file for bankruptcy, so a state no longer has reason to raid pension funds. Instead, unsound municipalities file for bankruptcy and there is no "sweeping" money from the pension plan to the unsound municipality. That yields more consistent funding for pensions. Second, in a municipal bankruptcy of some other municipality, the debtor municipality would have no access to pension funds. Hence, unlike a state bankruptcy, where all debts and all assets are lumped together, the pension assets would not be at risk when another municipality files for bankruptcy. Third, if a pension fund itself filed for bankruptcy, pensioners would likely have secured claims on whatever funds were already in the pension and unsecured claims for the balance of what they were owed.[351] That would give pensioners priority claims on the pension funds, placing them first in line.

Fiscal Federalism. Turning to the critique from fiscal federalism, it is true that states' fiscal federalism dilemma is not itself a bankruptcy problem. Bankruptcy cannot repeal balanced-budget amendments, debt limits, or unfunded mandates, and thus cannot guide states out of the Keynesian bind Levitin identifies.

But disaggregation has something to offer. For one, breaking the implicit guarantee of state bailouts forces creditors to lend at the true cost of capital, and they will thus fund fewer suboptimal projects. In turn, that reduces the likelihood of governmental entities failing in an economic downturn. Beyond that, disaggregation changes state budgeting in a downturn. As Levitin notes, in a downturn, state obligations to provide welfare increase.[352] These obligations are drawn from the general fund, meaning that the state will divert general-fund dollars from other sources. As a result, other obligations, like toll roads that produce their own revenues, must be robust against a downturn and can file for bankruptcy if they are not. So projects that are self-sustaining and robust against a downturn survive, and others file for

349 Levitin, *Bankrupt Politics*, *supra* note 27, at 1429.

350 *See* PEW CHARITABLE TRUSTS, THE STATE PENSION FUNDING GAP: 2018, at 4 (2020) (noting that in 2018, only seven states had pensions funded at ninety percent or more).

351 Skeel, *States of Bankruptcy*, *supra* note 26, at 692-93.

352 Levitin, Bankrupt Politics, *supra* note 27, at 1408-09.

bankruptcy, passing a haircut along to creditors.[353] The upshot is more front-end discipline, with creditors ensuring that the state's finances do not get out-of-hand as they do under today's fiscal federalism.

Use. Perhaps the biggest advantage disaggregation has over state bankruptcy is that states have a reason to use it. States oppose a bankruptcy chapter because, absent a state bankruptcy chapter, the federal government must bail them out.[354] And states are strictly better off when they can extract a bailout instead of defaulting or filing under a state bankruptcy chapter.

By contrast, states have a reason to use disaggregation. As it stands, states like Illinois (in poor fiscal condition) pay higher interest rates than states like Iowa (in good fiscal condition).[355] That is so because markets know that the local-level debt will ultimately prove to be the responsibility of the state. Markets therefore evaluate any Illinois government entity's debt (sound or distressed) in light of the massive local debts of Illinois' distressed entities.[356] This means that sound entities (say, a sewer district) pay higher interest rates because of distressed entities (say, a pension plan).

Disaggregation changes that. By allowing the pension plan to file for bankruptcy, disaggregation lowers the risk that Illinois will spend to save the distressed pension plan at expense of the sewer district. In turn, severing the sound sewer district from the distressed pension plan yields lower interest rates for the sewer district (and every other municipality). That benefit extends to the state itself, which will receive lower interest rates on its general-obligation bonds now that bond buyers know that the state will not divert resources to pay for the pension plan. And that benefit multiplies as the state allows *every* entity to file for bankruptcy.

Despite this, no state has used disaggregation, which makes for something of a puzzle. The answer may lie in the states not yet being aware of the possibility—this Article is the first scholarship to show how states can, under current law, file for bankruptcy.

There is another possibility, too. States may want to subsidize their municipalities (including unsound ones that would not otherwise receive credit), either for political reasons or because state officials generally favor governmental undertakings. Providing an implicit guarantee of such debt allows those municipalities to borrow at lower rates, furthering that aim.[357] And as long as the state's debt is manageable, the subsidy is, too.

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353 *See* discussion *supra* Section II.D (describing how liability partitions ensure that credit provision tracks the risks of the particular entity).

354 Gillette, *supra* note 258, at 302-08.

355 See NORCROSS & GONZALEZ, *supra* note 61, at 18.

356 Skeel, *Is Bankruptcy the Answer?*, *supra* note 335, at 1069.

357 *See* Griffith, *supra* note 257, at 60 (describing how implicit guarantees "have had the effect of making an issue of bonds fly which otherwise would not have been marketable").

Likewise, no local official wants her municipality to be eligible for Chapter 9. Local eligibility limits the ability to extract a bailout from the state and is a boon only to *other* municipalities, not the eligible municipality. This concentrated cost likely spurs local officials to oppose disaggregation bankruptcy, even if that disaggregation would benefit the state itself (through lower interest on general-obligation bonds) and would benefit every other municipality in the state (through lower interest rates).

But this logic of implied subsidies and concentrated local costs holds only up to the point that the state can repay creditors in full. If the aggregate of implicitly guaranteed debt exceeds that point, then rates will rise for *every* municipality's debt. Eventually, if fiscal health deteriorates enough, the state slouches into debt overhang and borrowing becomes impossible, as Illinois may soon discover.[358]

Disaggregation, then, might be disfavored by states whose debt load is low enough to reap the benefit of implicitly subsidizing every municipality. And disaggregation is most useful for the most distressed states. In a world where markets cannot trust a state's guarantee, disaggregation allows states (and their sound municipalities) to receive lower interest rates. So, states—and especially distressed states—have reason to use disaggregation, unlike a state bankruptcy chapter, which they view as only a burden depriving them of a federal bailout.

3. Fairness

One marked benefit of state bankruptcy, which opponents do not contest, is its interposition of a bankruptcy judge charged with ensuring the fairness of a plan and compliance with priorities. State bankruptcy enjoys these benefits, and they are one driver for proponents, who worry about the chaos and inequity of a default.

Disaggregation, though, would be even more salutary. In a large bankruptcy, "fairness" is a tough standard to vindicate, and tougher still to vindicate predictably. Countless different creditors are similar and dissimilar, and determining if similarly situated parties are receiving the same treatment becomes a nearly impossible task.[359] For example, are state police pensioners similar to county firefighter pensioners? How do those two compare to teachers in a school district pension plan?

But in a disaggregated bankruptcy, only a handful of distressed municipalities would file. Those municipalities would have more uniform

358 See Campbell, *supra* note 11 (describing Illinois' increased borrowing costs due to underfunded pensions).

359 *See* Gelpern, *supra* note 288, at 937 (noting the difficulty in determining which creditors are "similarly situated" in a state bankruptcy).

creditors. For example, bondholders of a water district are all identically situated. Even for more complicated bankruptcies (say, a school district), the creditors are more uniform: current teachers, retired teachers, administrative staff, and so on. The upshot is that fairness is easier to achieve, and to achieve predictably, as there are fewer opportunities to game the system and the types of creditors are more similar.

4. Practical Concerns

Disaggregation bankruptcy also responds better to the practical concerns raised by opponents of state bankruptcy. That includes bond contagion, complexity, and constitutionality.

Bond Contagion. Start with bond contagion, where disaggregated bankruptcy again bests state bankruptcy. Typically, bond contagion arises when opacity prevents bondholders from knowing what went wrong and what other investments might face similar difficulties. For a state, the failures are usually many and different and political and opaque, so it is hard for investors to know how to re-price risk. Hence, they compensate by increasing prices for every state and every municipality.

But with disaggregation, one municipality alone has failed. Even if that entity's finances are murky, the signal sent by the bankruptcy is far narrower—perhaps sewer districts are in trouble, perhaps a region—than the pall cast by uncertainty over a state's financial distress. So even if there were bond contagion from a disaggregated bankruptcy (which the discussion above casts doubt on),[360] it would be muted compared to a state's bankruptcy.

Complexity. Disaggregation likewise fares better in terms of complexity. The average state has 1,800 municipalities (compared to 245 subsidiaries for a Fortune 500 company) and tens of billions in debt (compared to one billion for a "jumbo" Fortune 500 bankruptcy).[361] In a disaggregated bankruptcy, though, only "insolvent" municipalities would file, reducing the total debt, number of creditors, and complexity of the case.[362] Nor would a bankruptcy court need (or have authority) to substantively consolidate all state entities.[363]

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360 *See* discussion *supra* subsection III.C.2 (discussing why state interest rates might drop in a disaggregated bankruptcy).

361 *Compare* CENSUS OF GOVERNMENTS, *supra* note 336, at 2 (counting 90,126 total governments), *with* DRIESSEN, STATE AND LOCAL GOVERNMENT DEBT, *supra* note 7, at 1 (totaling $3 trillion in state debt), *with* Squire, *Strategic Liability*, *supra* note 223, at 601, 616 n.32 (stating that the average Fortune 500 company has 245 subsidiaries and labeling "jumbo" corporate bankruptcies as those with over $1 billion in assets).

362 11 U.S.C. § 109(c).

363 *See* 11 U.S.C. § 901 (incorporating 11 U.S.C. § 303 and voluntary petitions, but not allowing involuntary petitions). *Ashton v. Cameron County Water Improvement District No. 1* provides the constitutional backstop, barring involuntary bankruptcy. 298 U.S. 513, 530-32 (1936).

Thus, the disaggregated state would have only a handful of its municipalities before a bankruptcy court, and would prove more manageable than a bankruptcy that encompassed the entire state.

Constitutionality. As for constitutionality, whether a bankruptcy chapter for the states would be constitutional remains a live question.[364] By contrast, there is no doubt about the constitutionality of disaggregation. Disaggregation relies on the current Chapter 9, as upheld in *Bekins*.[365] So while *Bekins* remains good law, disaggregation is unquestionably constitutional.[366]

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All in all, then, a disaggregated state bankruptcy holds much promise. It is better than federal bailouts or state defaults. And it improves upon state bankruptcy proposals by harnessing public organizational law. Those improvements include a bankruptcy mechanism that minimizes spillover effects from government failure, better comports with political realities, protects labor, targets only distressed municipalities, maintains fairness across similar creditors, and rewards states that use it with lower interest rates.

CONCLUSION

States have long been in debt, and the manageability of that debt remains a perennial issue. This Article has shown, though, that current law already allows states to avail themselves of the Bankruptcy Code, through Chapter 9 municipal bankruptcy. Doctrine and history alike confirm that nearly every government entity in a state qualifies as a "municipality" eligible to file under Chapter 9. And nearly all "state" debt is in fact owed by these municipalities (not the state itself) making the vast majority of "state" debt eligible for bankruptcy. Put simply, because states are disaggregated—providing services and taking on debt through myriad entities—states can effect a bankruptcy filing by allowing their disaggregated entities to file.

A disaggregated bankruptcy affords states the benefits of organizational law, which spurred the advent and success of private enterprise, but which has been neglected in the realm of public entities. Through the mechanisms of public organizational law, then, states can achieve a bankruptcy that better cures debt overhang, reduces interest rates, protects labor, disciplines

364 *See* discussion *supra* Section II.B (describing McConnell's point of view).

365 United States v. Bekins, 304 U.S. 27, 51 (1938).

366 Even if *Bekins* were narrowed, disaggregation would be in better shape than state bankruptcy, as federalism concerns are heightened when the bankruptcy court acts on the state itself rather than a municipality.

politicians, and is simpler than the proposed state bankruptcy chapter or the current state of play. In short, there is much for scholars and governments alike to explore in public organizational law, and much for states to gain by harnessing that law for better addressing their debt.

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