

GLOBAL DECENTRALIZATION AND THE SUBNATIONAL DEBT PROBLEM

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ABSTRACT

According to the World Bank, decentralization of government is a pivotal force that will shape global development policy in the twenty-first century. Subnational debt restructuring has emerged as one of decentralization's most difficult problems. Financially troubled municipalities face many of the same concerns, for example, as financially troubled nations: holdout creditors can stymie collective attempts at debt restructuring, and reliance on politically motivated lenders of last resort (the International Monetary Fund in the case of troubled nations, the central government in the case of troubled municipalities) can foster moral hazard. In a prior article, I argued that an international convention for sovereign debt restructuring based on several universal principles of bankruptcy reorganization law can effectively address these concerns for nations. In this Article, I argue

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that similar principles can be applied even more easily to the financial problems of subnational governments. To this end, I propose a model law based on these principles that might form the foundation for national laws, informed by local political and legal culture. Then, using the Japanese municipal crisis as an example, I show that countries enacting such a law can prudently and equitably resolve their subnational debt burdens.

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INTRODUCTION

The World Bank has identified decentralization—meaning the “growing desire of people for a greater say in their government, [which] manifests itself in the assertion of regional identities [and] pushes national governments to reach down to regions and cities as the best way to manage changes affecting domestic politics and patterns of growth”¹—as one of the two forces that will shape world development policy in the twenty-first century.² Even now, governments are shifting numerous public responsibilities to the subnational, or municipal,³ level.⁴

To meet these responsibilities, which often entail the construction of infrastructure and other capital projects, municipalities worldwide are raising funds by issuing debt.⁵ Debt issuance allows a municipality to fund the construction of projects that cannot be managed within the financial resources of a single fiscal year; permits a municipality to “allocat[e] taxes over a period of many years for principal and interest payments on outstanding bonds, [thereby making it] possible to share the burden with future generations which benefit

1. WORLD BANK, ENTERING THE 21ST CENTURY: WORLD DEVELOPMENT REPORT 1999/2000, at 2 (1999) [hereinafter WORLD DEVELOPMENT REPORT].

2. *Id.* (identifying decentralization and globalization as the forces that will shape such development policy).

3. I use the terms “subnational” and “municipal” interchangeably to mean any local governmental subdivision of a sovereign nation. This may include, for example, a city, county, prefecture, state, or province.

4. *See, e.g., id.* at 107 (“[C]ountries everywhere—large and small, rich and poor—are devolving political, fiscal, and administrative powers to subnational tiers of government . . .”); *see also* Elena Okorotchenko & Myriam Fernandez deHeredia, *CEE [Central and East European] Municipalities Need Prudence in Financing Infrastructure Needs*, STANDARD & POOR’S RATINGS DIRECT, Dec. 14, 1999, at 3 (on file with the *Duke Law Journal*) (observing specifically that the governments of Central and Eastern European countries are becoming increasingly decentralized). The World Bank also notes that “[s]trategies to stop decentralization are unlikely to succeed, as the pressures to decentralize are beyond government control.” WORLD DEVELOPMENT REPORT, *supra* note 1, at 124.

5. Okorotchenko & deHeredia, *supra* note 4, at 2 (observing that, “[w]ith a few exceptions, [Central and East European (CEE)] municipalities showed increasing appetite for new debt, as they became increasingly familiar with debt markets,” and that the “[d]irect debt of the majority of CEE municipalities is increasing rapidly”). This, however, reveals only part of the picture: “it [also] is important to consider all guaranteed and revenue-supported debt of municipal companies,” information that “is often very difficult to compile.” *Id.*; *see also* Steven Hochman & Jacqueline McFadyen, *Rating Methodology: Japan’s Local Governments*, MOODY’S INVESTORS SERVICE GLOBAL CREDIT RES., Mar. 1999, at 8 (on file with the *Duke Law Journal*) (discussing the rise of contingent subnational debt in Canada, Australia, Argentina, and Japan).

from the project"; and also can offset temporary shortages in taxes or other financial resources.⁶ Although some of this debt is domestic, much of the debt is being issued in the world's capital markets.⁷

It is becoming increasingly difficult for municipalities to repay all this debt.⁸ Furthermore, because municipalities rarely have the flexibility to substantially reduce expenditures,⁹ a fall in subnational income can lead to a further mushrooming of debt not only in order to finance needed projects but also to refinance the debt of existing projects.¹⁰

As a result, the problem of subnational debt restructuring has become pandemic. The most severe problem today is in Japan, where the overall municipal financial deficit is at the highest level ever seen in the world,¹¹ and matters are only expected to get worse.¹² But Japan is merely the tip of the iceberg. In Central and Eastern European countries, for example, municipal debt financing is leading to

6. Japan Local Bond Ass'n, *Local Bond System in Japan*, in JAPAN MUNICIPAL FINANCE BACKGROUND INFORMATION 1, 16 (Fin. Sec. Assurance, Inc. ed., 1993).

7. There is a "growing presence of subnational governments in world financial markets." Steven Hochman et al., *Moody's Methodology: Japan's Local Governments*, MOODY'S INVESTORS SERVICE, May 1999, at 4; see also Jane Eddy & Monica Richter, *Local Government Ratings in Emerging Markets*, STANDARD & POOR'S CREDITWEEK MUN., Feb. 14, 2000, at 9-10 ("[R]egional and municipal governments [worldwide] are finding the depth and breadth of the international capital markets necessary to provide capital . . ."). My Article covers both domestic and foreign subnational debt. Although some portion of domestic subnational debt may be owed to the central government, "private financing is either already the primary source of subnational credit or is meant to eventually replace central government financing." WORLD DEVELOPMENT REPORT, *supra* note 1, at 118.

8. See, e.g., Hochman et al., *supra* note 7, at 45 (showing the increase of debt-service payments as a percentage of total expenditures for Japanese municipalities).

9. See, e.g., Takashi Miura & Yoko Shimohara, *Municipal Bonds*, GOLDMAN SACHS FIXED INCOME RES., Apr. 12, 2000, at 1 (stating that in Japan, "[t]he annual expenditures of local governments include high proportions of obligatory expenses such as personnel, pension, and public bond expenses" and that "[l]ocal governments have little leeway for cutting such expenses").

10. See *id.* (observing that Japanese subnational debt "will only keep mounting as [municipalities] continue to use municipal bonds and temporary borrowings to fill the gap between their income and expenditures"). These analysts explain that, at least in Japan, this widening gap may be "caused more fundamentally by a structural problem" that the maturation of domestic industries, a decline in capital investment, and a lower birth rate has reduced municipal revenues whereas the increasing need for environmental and social-infrastructure services has "led to an upward trend in total annual expenditures." *Id.*

11. JAPAN RATING & INV. INFO., INC., CHIHOSAI KAKUZUKE [MUNICIPAL BOND RATING], ch. 5 [*Struggle of Financial Reconstruction Bodies*], at 10 (Fin. Sec. Assurance, Inc., trans., Mar. 1999) [hereinafter CHIHOSAI KAKUZUKE].

12. Miura & Shimohara, *supra* note 9, at 1 ("[T]he finances of [Japanese] prefectural and municipal governments ('local governments') [are expected] to continue deteriorating . . .").

“deficits [that] will exceed 10% and deteriorate further” over time.¹³ Russia faces a “significant deterioration of the cities’ and regions’ fiscal and debt positions.”¹⁴ In Brazil, decentralization “has resulted in a prolonged macroeconomic crisis sparked by the growing indebtedness of the [subnational] states.”¹⁵ Existing or potential concerns have arisen in Mexico and Argentina.¹⁶ Indeed, the problem extends to subnational entities in many of the world’s most developed countries. In Switzerland, Italy, Spain, France, Germany, the Nordic countries, and the United Kingdom, for example, “[t]here have been many cases of localities getting into financial distress, even defaulting.”¹⁷ A number of major municipalities have defaulted in the United States.¹⁸ For these reasons, the World Bank has identified subnational debt as “one of the thorniest issues for decentralization.”¹⁹

I. THE DIFFICULTY OF RESTRUCTURING SUBNATIONAL DEBT

There are no easy economic or political answers to the problems of subnational debt restructuring. If central governments were to prohibit the issuance of such debt, that prohibition would only shift the financing burden from subnational to national levels while limiting municipal flexibility to finance locally attractive projects.²⁰ A central government also could attempt to restrict the amount of debt that

13. Okorotchenko & deHeredia, *supra* note 4, at 1.

14. *Id.* at 4; *see also* Elena Okorotchenko & Bram Cartmell, *Russian Regions Look to Improve Transparency and Management*, STANDARD & POOR’S RATINGS DIRECT, May 9, 2000, at 4 (concluding that despite efforts to improve transparency and management, “all [rated] Russian entities are currently in a high-risk rating category”). It stands to reason, then, that unrated Russian entities are likely to be in even worse financial condition.

15. WORLD DEVELOPMENT REPORT, *supra* note 1, at 164.

16. Telephone Interview with Steven Hochman, Moody’s Investors Service (Sept. 19, 2000); *see also* E-mail from Dr. José G. Vargas, Centro Universitario del Sur, Universidad de Guadalajara, Mexico, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Dec. 11, 2000) (on file with the *Duke Law Journal*) (noting that approximately “60% of 1,340 municipalities” in Mexico “have financial problems”).

17. Anders Sars, *Local Governments in Distress: A European Experience*, STANDARD & POOR’S RATINGS DIRECT, June 28, 1999, at 1–2; *see also id.* at 3 (“As illustrated by these cases [discussed therein at 2–3], local governments sometimes do face financial distress despite the strength and stability of the underlying local government system.”).

18. *See, e.g.*, Margarita Tchepournykh & William Simonson, *The Development of the Municipal Bond Market in Russia: The Good, the Bad, and the Ugly*, MUN. FIN. J., Spring 1999, at 20–22 (discussing the history of the American bond market, including defaults by New York City, Cleveland, and Orange County, California).

19. WORLD DEVELOPMENT REPORT, *supra* note 1, at 118.

20. *See, e.g.*, Hochman et al., *supra* note 7, at 4 (arguing that limits on local government autonomy may reduce the local ability to respond to changing conditions).

municipalities can issue, but these types of restrictions cannot always assure that municipalities will be able to pay their debts when such debts come due.²¹ For example, Japanese municipalities are near default even though municipal bonds in that country “are issued according to ordinances and permits in order to maintain the soundness of the financial operations of local public entities . . . [and] [t]he annual amount of local bonds issued is controlled through local bond programs created by the Ministry of Home Affairs.”²²

Municipalities also cannot rely on taxes to solve their debt problems. Although one might assume that a municipality can always generate sufficient tax income to pay its debts,²³ that assumption is problematic. At some point, an increase in the tax rate will cease to raise tax revenues.²⁴ Some citizens and businesses will be unable to pay the tax increase, and even those able to pay may choose instead to leave the municipality, causing economic output to decline.²⁵

Some may argue that central governments should support troubled municipalities. This, however, can create a moral hazard problem:²⁶ municipalities anticipating such support might have less reason

21. See WORLD DEVELOPMENT REPORT, *supra* note 1, at 120 (asserting that “rules and controls [on subnational borrowing] will be ineffective unless accompanied by market discipline and a credible ‘no-bailout’ pledge by the central government”).

22. Japan Local Bond Ass’n, *supra* note 6, at Summary.

23. See, e.g., Miura & Shimohara, *supra* note 9, at 1–3 (arguing that because “local governments can allocate . . . tax revenues to repay their debts, the debts of local governments are always repaid eventually,” but later acknowledging that local governments “cannot collect unlimited taxes”).

24. See Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 466 (1993) (discussing the difficulty of “identifying the tax-maximization point on this implicit ‘Laffer Curve’”). Also, some municipalities have limited taxing authority. See, e.g., Hochman et al., *supra* note 7, at 7 (observing that in Japan, limitations on municipal taxing power result in local governments having limited flexibility and also “[m]ight leave [them] vulnerable to unexpected shifts in the economic or financial environment”).

25. See, e.g., WORLD DEVELOPMENT REPORT, *supra* note 1, at 110 (“A local government with a relatively small tax base cannot compensate by imposing much higher taxes without losing businesses and residents to jurisdictions with lower taxes.”); see also Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418 (1956) (describing communities as competitors for residents who “vote with their feet” by moving to the communities that offer the most ideal mix of goods and services, including the tax levels used to finance those goods and services); *Local Governments Suffer 736 Billion Yen Tax Revenue Shortfall in FY99*, NIHON KEIZAI SHIMBUN (Tokyo), July 30, 2000 (reporting that this shortfall was due to lower-than-expected municipal tax revenues).

26. In this context, the term moral hazard refers to the greater tendency of people who are protected from the consequences of risky behavior to engage in such behavior. See Charles G. Hallinan, *The “Fresh Start” Policy in Consumer Bankruptcy: A Historical Inventory and an In-*

to take a prudent economic course and be less cautious in incurring debt; and their creditors, expecting protection from the consequences of default, might be less prudent in making their credit analysis.²⁷ Therefore, even in Japan, observers believe it is best for municipalities and their investors to be disciplined by market principles.²⁸ Only then will investors focus on a municipality's "economic and demographic characteristics . . . in assessing its credit profile."²⁹

Moreover, central governments themselves may not want, or be able, to support subnational debt. Because of the weak "financial state of the [Japanese] central government," for example, the Japanese Ministry of Finance "is negative on shifting tax resource[s] to local governments."³⁰ Likewise, central governments may be constrained politically from using tax monies to support municipal bailouts.³¹ In some countries, such as those in Central and Eastern

terpretive Theory, 21 U. RICH. L. REV. 49, 84 (1986) (relying on the economic definition of moral hazard: debtors and creditors who are protected from the consequences of default "could be expected to increase both excessive borrowing and excessive resort to bankruptcy"). "Notwithstanding the lack of empirical evidence of the extent, if any, to which the moral hazard risk actually influences the behavior of [governmental entities] or their creditors, the potential for moral hazard figures prominently in the media debate." Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 962 (2000) (citation omitted).

27. See, e.g., WORLD DEVELOPMENT REPORT, *supra* note 1, at 124 (claiming that "[t]he mere possibility of a central government bailout can prompt excess spending and deficit financing at the subnational level"). This is not to say that moral hazard is unrestrained. Even if municipalities anticipate a central government bailout, they may want to avoid the possibility of default, its associated reputational costs, and any reduced autonomy over their local economies that results from the bailout.

28. See Shinji Okabe, *Municipal Bonds*, MORGAN STANLEY DEAN WITTER FIXED INCOME RES.: INVESTMENT GRADE CREDIT RES., June 1999, at 6 (predicting that "the longer trend for local government finances will be toward the application of market principles and the use of market regulation"); CHIHO SAI KAKUZUKE, *supra* note 11, ch. 3 [*Is There No Possibility of Municipal Bonds' Default?*], at 5:

As many specialists in local finance have suggested, the relation between central government and local ones is like that between an overprotecting mother and her children dependent on her. . . . While the parent is rich, there might be no problem. Nevertheless, if the parent fell ill to be unable to support them, they would be at a loss.

29. Hochman et al., *supra* note 7, at 3.

30. CHIHO SAI KAKUZUKE, *supra* note 11, ch. 5, at 10; see also, e.g., Jane Eddy, *Rating Local and Regional Governments in Emerging Markets*, STANDARD & POOR'S CREDITWEEK MUN., Sept. 15, 1997, at 1 ("[C]entral governments historically provided the funding for most local and regional governments' investments. But now, faced with their own fiscal constraints and the discipline of competing in a global economy, sovereign [national] governments have been dedicating less financial resources to municipal projects.").

31. See, e.g., *World Business Briefing, Asia, Second Sogo Suicide*, N.Y. TIMES, Oct. 11, 2000, at W1 (reporting that the "Sogo [Corporation] sought protection from creditors when public pressure forced the government to cancel a debt relief plan for Sogo that would have

Europe, central governments simply will be unable to “offer a high level of support [to municipalities] because of weak equalization systems, both in terms of mechanisms (inefficiencies in distribution of finances) and wealth (size of financial resources).”³²

In the absence of an economic or political solution, municipalities and their creditors will be forced to attempt to restructure their debtor-creditor relationship on a consensual basis. Ad hoc debt restructuring, however, is difficult to achieve. The conflicting interests of the municipality and its creditors make it difficult, and sometimes impossible, to reach agreement on a restructuring plan. This difficulty is exacerbated by the “collective action” problem of reaching agreement *among* creditors—a problem that has worsened in recent years as municipalities have been shifting their borrowing from domestic sources, such as banks, to bond investors in lower cost foreign capital markets.³³ One or more creditors may hold out, hoping that the need to reach an agreement will induce other parties to buy out their claims or pay them a premium.³⁴ Consequently, “[a]t each stage of a financial workout, collective action problems plague the readjustment of debt claims, to the detriment of the creditors as well as the debtor.”³⁵ “Agreement can take years.”³⁶

used taxpayer money”). In a municipal context, such a plan would unfairly shift the burden from the municipal taxpayers that benefit from the spending to the nation’s taxpayers, even those of frugal municipalities.

32. Okorotchenko & deHeredia, *supra* note 4, at 2.

33. See, e.g., William Dillinger & Marianne Fay, *From Centralized to Decentralized Governance*, FIN. & DEV., Dec. 1999, at 19, 21 (“In countries with more developed domestic capital markets or better access to international markets, subnational governments are increasingly turning to the private sector for credit.”); see also *infra* notes 232–36 and accompanying text (explaining that the greater number of capital market investors, as compared to banks, and the relatively smaller amounts of their respective investments decreases the likelihood of obtaining creditor consent). Another collective action problem is that creditors that otherwise may favor a negotiated settlement may be motivated to try to enforce their claims against the municipality because they fear that other creditors will be the first to enforce their claims against assets that are insufficient to pay all claims. I address this problem in the context of discussing an automatic stay *infra* note 153 and accompanying text.

34. Scholars also refer to this situation as a holdout problem. Schwarcz, *supra* note 26, at 960 n.17.

35. Jeffrey D. Sachs, *Do We Need an International Lender of Last Resort*, Frank D. Graham Lecture at Princeton University 6 (Apr. 20, 1995) (unpublished manuscript, on file with the *Duke Law Journal*). See generally Charles Lipson, *Bankers’ Dilemmas: Private Cooperation in Rescheduling Sovereign Debts*, in COOPERATION UNDER ANARCHY 200 (Kenneth A. Oye ed., 1986) (providing an overview of the collective action problem for sovereign debt restructuring).

36. Schwarcz, *supra* note 26, at 961.

In many situations, these economic, political, and ad hoc responses have been inadequate. With the increase in subnational debt burdens, these inadequacies will increase. There is a need for another solution. This Article argues for a legal solution.

At least one country, Japan, has attempted to apply legal solutions to its subnational debt restructuring problems, and the history of these attempts is instructive. In the early 1950s, local finance in Japan was “on the verge of bankruptcy because of an increased financial demand not backed by financial [revenue] sources.”³⁷ In response, the central government enacted a reconstruction law in 1955,³⁸ under which financial rehabilitation bonds were issued at high interest rates, for which the municipalities were subsidized by the central government.³⁹ The proceeds of these bonds apparently were used to cover maturing debt service on existing bonds. As many as 596 municipalities took advantage of this law.⁴⁰ The law’s ultimate success, though, arguably was dependent on “the arrival of high-growth” in the Japanese economy.⁴¹

Memories, however, were short. This new high growth period encouraged municipalities to “improve[] their administrative services [by] including welfare services made free of charge[, to build] such facilities as community centers, libraries, and gymnasiums[, and to increase the pay of municipal workers] more rapidly than [the pay] of central government employees.”⁴² This spurred a new municipal debt crisis in 1975 when “[t]he oil shock and the following depression suddenly acted as a brake on the high growth, but annual expenditures of local governments were unable to be curbed immediately.”⁴³ After as many as 243 municipalities became insolvent, the Japanese central government intervened by issuing new bonds to generate funds to compensate for reduced municipal revenue.⁴⁴ However, an economic upturn again caused municipal revenues to increase, avoiding the need to test this approach.⁴⁵

37. CHIHOSAI KAKUZUKE, *supra* note 11, ch. 5, at 1.

38. *Id.* (referring to this Reconstruction Law as the “Law on Special Measures to Promote Local Public Financial Reconstruction”).

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

In each of these cases, it is noteworthy that the strategy was to place the entire burden on the central government (in the form of loans and subsidies), and none on municipalities or their creditors. The creditors, however, had accepted the credit risk of the municipalities and, presumably, had demanded a rate of interest intended to offset that risk. This strategy, therefore, was not only excessively generous to creditors but also gave rise to moral hazard: municipalities did not have incentives to take disciplined fiscal measures to avoid possible default, and creditors, anticipating a central government bailout, were less prudent in making their credit analysis. Moreover, this strategy could have backfired where the central government, itself facing a financial crisis, either worsens that crisis by subsidizing its municipalities or is simply not prepared to help.⁴⁶

In contrast, since 1956 Japan has tried a somewhat different approach to its municipal debt restructuring problem, referred to as “quasi-financial reconstruction.”⁴⁷ Under this approach, which appears to be directed at reducing municipal moral hazard, a troubled municipality may apply to the Ministry of Home Affairs for a subsidized-rate central government loan.⁴⁸ In return, the municipality is required to prepare a financial reconstruction plan, including a budget approved by the Ministry of Finance.⁴⁹ The municipality then is “put under the absolute control of the central government and [its] independence . . . is completely curtailed.”⁵⁰ The plan is “very severe in content,”⁵¹ typically including higher rentals for public housing, increased charges for the use of public facilities, reduction in local administrative services, curtailing of municipal employee pay raises, and acceptance of early retirement.⁵²

Because the municipality is required to reorganize its services and operations, quasi-financial reconstruction is referred to as “a local government version of corporate reorganization.”⁵³ That refer-

46. *See supra* notes 30–32 and accompanying text (noting that the Japanese Ministry of Finance is now reluctant to shift tax resources to local governments, and that central governments in Central and Eastern Europe may be unable to offer a high level of support to their municipalities).

47. CHIHOSEI KAKUZUKE, *supra* note 11, ch. 5, at 1.

48. Because of the current low rate of interest in Japan, the subsidy presently would not apply; it would apply when interest rates again exceed 3.5%. *Id.* at 4.

49. *Id.* at 3.

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

ence, however, misses a central point of corporate reorganization: to motivate not only debtors *but also creditors* to share the debt restructuring burden.⁵⁴ Quasi-financial reconstruction fails to impose any burden on creditors, even though, as discussed, they received compensation in return for assuming the risk of municipal default.⁵⁵

Therefore, although Japan's attempts to craft legal solutions to its municipal debt restructuring problems have resulted in three responses—subsidized financial rehabilitation bonds, a second issuance of bonds in the 1970s, and quasi-financial rehabilitation—each response is inadequate.⁵⁶ They all depend on the central government being willing and able to subsidize its municipalities, a dependence that may backfire.⁵⁷ They all contemplate paying creditors in full, notwithstanding that the creditors have assumed the risk of default and, moreover, that such payment could foster moral hazard on the part of future creditors.⁵⁸ Only one of these responses even attempts to address the problem of moral hazard on the part of municipalities.⁵⁹ And none addresses the collective action problem of debt restructur-

54. Professor Gillette argues that the relative extent to which municipal creditors should share the debt restructuring burden can vary. For example, creditors that invest in municipal "revenue debt in which repayment is limited to revenues from a particular source . . . have taken a more significant risk" than creditors that invest in debt for which the municipality "had pledged all its revenue raising power and faces no constitutional limitation on taxation." E-mail from Clayton P. Gillette, Professor of Law, New York University School of Law, to Steven L. Schwarcz, Professor of Law, Duke University School of Law 2 (Dec. 11, 2000) (on file with the *Duke Law Journal*). Even in the latter case, however, at some point an increase in the tax rate will cease to raise tax revenues. *See supra* note 24 and accompanying text. Thus, even those creditors should share in the debt restructuring burden to some extent.

55. "[Quasi-]financial reconstruction is quite painful for staff members and inhabitants, but may be beneficial to creditors and investors." CHIHOSEI KAKUZUKE, *supra* note 11, ch. 5, at 3 (statement by Japan Rating and Investment Information, Inc.).

56. For a discussion along similar lines of Brazil's attempts to restructure its subnational debt, see WORLD DEVELOPMENT REPORT, *supra* note 1, at 164–66.

57. *See supra* note 46 and accompanying text.

58. That is, that future creditors, anticipating a central government bailout, might be less prudent in making their credit analysis. Creditor moral hazard might even be self-perpetuating absent a strong political will and advance signaling to the contrary. *See, e.g.*, WORLD DEVELOPMENT REPORT, *supra* note 1, at 120 (noting that "where bailouts have occurred in the past," establishing the credibility of a central government's commitment not to intervene may require time); E-mail from Shinsaku Iwahara, Professor of Financial Law, University of Tokyo Faculty of Law, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Nov. 22, 2000) (speculating that, in a subnational debt restructuring in Japan, "the Japanese government might not be able to neglect [the claims of municipal creditors who] believed that the central government would bail out insolvent municipalities under [a] quasi-financial reconstruction scheme" similar to that used in the past).

59. That is, that municipalities will not have incentives to take disciplined fiscal measures to avoid possible default.

ing.⁶⁰ I believe, however, that subnational debt restructuring is well suited to a legal solution, and that a solution can be crafted that surmounts the foregoing inadequacies.

II. A PROPOSED SOLUTION

If a company fails to pay its debts, a system of corporate bankruptcy or insolvency law usually governs the relationship between the debtor-company and its creditors.⁶¹ In contrast, if a municipality fails to pay its debts,⁶² few countries have legal systems that govern the relationship between the municipality and its creditors.

This absence is regrettable because the “pressures and problems that have led to corporate bankruptcy law also operate in the case of a sovereign borrower in financial distress.”⁶³ For example, the principles of bankruptcy reorganization law are designed to “solve such fundamental problems as the ability of holdout creditors to undermine collective action toward a negotiated settlement.”⁶⁴ Furthermore, these principles help to solve the debtor and creditor moral hazard problems that arise when “multilateral governmental institutions . . . act by default as lenders of last resort”⁶⁵—problems similarly faced when a central government, as a last resort, lends to or subsidizes its troubled municipalities. That, in turn, reduces the financial burden on the multilateral governmental institution—or, by analogy to municipalities, the central government—to make the loan or subsidy. I therefore have argued that fundamental principles of bank-

60. That is, the problem of reaching agreement among creditors, that one or more creditors may hold out, hoping that the need to reach an agreement will induce other parties to buy out their claims or pay them a premium. Of course, with creditors being paid in full and no debt actually being restructured, this problem did not arise.

61. The terms “bankruptcy law” and “insolvency law” generally are interchangeable. I will refer to bankruptcy law, because the term is more commonly used in the United States.

62. Municipalities, like companies, often will try to avoid defaulting on their debt because default can adversely affect a municipality’s credit ratings and financial reputation. *But cf.* Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1072 (1997) (recognizing that in spite of what moral hazard analysis would predict, private entities continually lend to national governments). Sometimes, however, default—in the technical sense of “failure of a debtor to make timely payment of interest and principal as they come due,” JOHN DOWNES & JORDAN ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 101 (3d ed. 1991)—cannot be avoided.

63. Sachs, *supra* note 35, at 8.

64. Schwarcz, *supra* note 26, at 956–57.

65. *Id.* at 957.

ruptcy reorganization law, articulated in an international convention, could effectively solve these problems for nations.⁶⁶

In this Article, I extend that analysis to the case of a subnational borrower in financial distress. First, I demonstrate that the pressures and problems that have been the impetus for corporate bankruptcy law also operate in the case of the subnational. Next, I analyze why fundamental principles of bankruptcy reorganization law could effectively solve these problems. I then propose a model law based on these principles.

Implementing this law for subnationals would be easier and more feasible than implementing a legal solution for debt problems of sovereign nations. Whereas the latter ideally would require an international convention,⁶⁷ subnational debt restructuring is an area that is uniquely subject to each nation's internal laws and therefore would require merely the subnational's nation to pass an internal law.⁶⁸

In that context, I argue that the subnational debt restructuring principles proposed in this Article, and the model law based thereon, should have universal application to the internal laws of any nation, irrespective of its subnational structure or its existing approach toward insolvency law. I do not, however, propose that the model law must be adopted uniformly across nations.⁶⁹ Uniformity may not be optimal because political concerns relevant to such a law could vary from nation to nation whereas the external impact of the law would be minimal, affecting only a municipality's foreign creditors. I therefore conceive the model law as a set of provisions that could form the basis of a national law, assuming that the law also will be informed by considerations of the local political and legal culture. In this sense, my Article addresses the subnational debt problems of *all nations*.

66. *Id.*

67. *Id.* at 1011-17.

68. *See infra* Part III.C (illustrating how such an internal law would bind creditors and could be administered, and how disputes thereunder could be adjudicated).

69. *Cf.* U.N. COMM'N ON INT'L TRADE LAW, CROSS-BORDER INSOLVENCY: NEWLY REVISED ARTICLES ON THE DRAFT UNCITRAL MODEL LEGISLATIVE PROVISIONS ON CROSS-BORDER INSOLVENCY 23 (1997) (noting that when incorporating the text of a model law into its legal system, a nation may modify or leave out some of its provisions).

III. ANALYSIS

I begin the analysis by examining the conceptual basis of Chapter 11 of the Bankruptcy Code.⁷⁰ I include in that examination other related chapters of the Code, especially Chapter 9 which focuses on municipal government reorganization.⁷¹ I then analyze how that conceptual basis should be modified to address subnational debt restructuring and its problems, focusing on provisions that reflect universally applicable principles of bankruptcy reorganization law. Finally, I use this modified conceptual basis to formulate rules that might serve as a model law for subnational debt restructuring, informed (as mentioned above) by each nation's political and legal culture. Thus, a nation might enact all, or only certain, of the model law's provisions; and, if other provisions more effectively address the nation's peculiar subnational debt problems, the nation could graft those provisions onto the model law's text.⁷²

The genius of bankruptcy reorganization law is that it provides incentives for debtors and their creditors, notwithstanding their disparate interests, to reach a voluntary agreement on the terms of the restructuring.⁷³ Agreement on a plan of reorganization⁷⁴ is rewarded;⁷⁵

70. 11 U.S.C. §§ 1101–1174 (1994 & Supp. IV 1998). The Bankruptcy Code (hereinafter, the “Code”) governs federal bankruptcy law in the United States and is set forth in full in *id.* §§ 101–1330.

71. *See infra* notes 124–26 and accompanying text. Unless the context otherwise requires, references in this Article to Chapter 11 or to principles of Chapter 11 reorganization also shall include other related chapters of the Code.

72. If, for example, municipal liquidation is politically acceptable in the nation, it could add provisions for determining the desirability of liquidating troubled municipalities or rearranging their political boundaries. *See infra* note 107 and accompanying text; *see also infra* note 269 and accompanying text (suggesting that nations also could adopt a “menu approach” to the model law, making its provisions optional to permit troubled municipalities to pick and choose).

73. A debtor-company's shareholders also may be involved in the reorganization process, but municipalities have no shareholders. I later show, however, that a municipality's residents, the closest equivalent to shareholders, effectively share in the burden of a municipal debt restructuring. *See infra* notes 339–42 and accompanying text (arguing that a successful debt restructuring will require the municipality to cut costs, such as by reducing local municipal services, and generate increased revenues, such as by requiring higher charges for municipal facilities).

74. The plan of reorganization sets forth both how to reorganize the debtor and how to repay the debtor's creditors. *See, e.g.*, 11 U.S.C. § 1129(a) (stating the confirmation requirements of a plan of reorganization).

75. Agreement permits both confirmation of the plan of reorganization and payment of creditors; absent agreement (or a nonconsensual plan, *see infra* note 76), a plan of reorganization cannot be confirmed and therefore creditors cannot be paid, *see* 11 U.S.C. § 1129(a)(8) (requiring acceptance by each class of “impaired” creditor claims for plan confirmation).

failure to agree is penalized.⁷⁶ As a result, most corporate restructurings are consensual.⁷⁷ “The basis of corporate reorganization law’s efficiency rests in the underlying theory of freedom of contract: voluntary contracting maximizes value.”⁷⁸

My analysis does not assume, however, that Chapter 11 is always a perfect system for debt restructuring. Some scholars have criticized Chapter 11, claiming that agency costs make it inefficient by prolonging management and by allowing companies that should liquidate to attempt reorganization.⁷⁹ In place of Chapter 11, they would institute a market solution requiring residual claimants either to cure the defaults of more senior claimants (such as by raising money in the capital markets to repay the company’s debt) or to risk losing their claims to the next-most senior claimants.⁸⁰ Regardless of whether these criticisms are valid in a corporate context,⁸¹ they have little application to subnational debt restructuring where liquidation is not an option.⁸² Further, their proposed market solution also would be inapplicable because municipalities have no residual claimants or owners.⁸³

76. If the parties cannot reach a consensus, the debtor may be liquidated or, if viable, reorganized under a nonconsensual plan that follows the absolute priority rule of liquidation. *Compare* 11 U.S.C. § 1112(b) (granting power to a judge to convert a reorganization case to a liquidation), *with id.* § 1129(b)(2) (granting the power, colloquially called “cramdown,” to confirm a nonconsensual plan only if the plan comports with the absolute priority rule).

77. *See, e.g.*, MARK S. SCARBERRY ET AL., BUSINESS REORGANIZATION IN BANKRUPTCY 839 (1996) (“Most plans are confirmed consensually under section 1129(a) of the Bankruptcy Code.”).

78. Schwarcz, *supra* note 26, at 959.

79. Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1076, 1078 (1992).

80. *Id.* at 1078–86. In effect, their proposal gives residual claimants the option of buying out the senior creditors to retain their residual claim. *Id.* at 1081. The process continues until either a class of residual claimants buys out the senior creditors or the most senior creditors become the residual claimants. *Id.* at 1081–82.

81. *See* Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437, 437–39 (1992) (challenging the Bradley and Rosenzweig thesis). Professor Warren argues, among other things, that the data do not prove Bradley and Rosenzweig’s case and that plausible alternative hypotheses may explain many of their statistical findings. *Id.* at 440–67. She also counters that Bradley and Rosenzweig focus only on bankruptcy’s goal of preserving value for public shareholders and bondholders, thereby omitting its distributional goals. *Id.* at 467–77. She concludes that Congress should not repeal Chapter 11 “[b]ecause thus far, no one has come up with a good substitute.” *Id.* at 478.

82. *See infra* note 107 and accompanying text (explaining that municipal liquidation is not generally politically acceptable).

83. *See supra* note 73 (observing that municipalities have no shareholders).

This Article's methodology nonetheless risks being incomplete in two ways: (1) the conceptual basis of corporate reorganization under one or more foreign insolvency laws, particularly including the insolvency law of the country in which a municipality is located, might be better suited to that municipality's debt restructuring than Chapter 11, or (2) the matters compared might be too dissimilar to be meaningful.⁸⁴ With respect to the first potential shortcoming, my examination of corporate reorganization under several foreign insolvency laws has revealed that the conceptual basis of those laws is remarkably similar to that of Chapter 11.⁸⁵ Four of those countries' laws are actually based on Chapter 11 or its antecedent statute in the United States, and the one law not actually based on Chapter 11 is based on principles that are remarkably similar to those of Chapter 11.⁸⁶ Professor Oliver Hart likewise has found that "[a]lthough there are many different [corporate] bankruptcy procedures around the world, they fall into two main categories: an asset sale (or cash auction) on the one hand"⁸⁷—a category that would not be applicable to subnational debtors⁸⁸—and "structured bargaining on the other hand,"⁸⁹ the

84. See Cass R. Sunstein, Commentary, *On Analogical Reasoning*, 106 HARV. L. REV. 741, 744 (1993) ("For analogical reasoning to work well, we have to say that the relevant, known similarities give us good reason to believe that there are further similarities and thus help to answer an open question.").

85. Schwarcz, *supra* note 26, at 972 & n.102 (discussing this examination and noting that, although not a statistically meaningful sampling, it did sample a range of both civil and common law insolvency laws from countries on different continents).

86. For example, Japan modeled its corporate reorganization law, Law No. 172 of 1952, after Chapter X of the U.S. Bankruptcy Act of 1898 (the predecessor statute to Chapter 11), and Chapter 11 also has been influential on German, Argentine, and Canadian corporate reorganization law. Schwarcz, *supra* note 26, at 973 n.103. Although Israeli reorganization law "is the only one that does not appear to be based on Chapter 11 . . . its principles, as interpreted by the courts, are remarkably similar to those of Chapter 11." *Id.*

87. Oliver Hart, *Different Approaches to Bankruptcy*, Presentation to the Annual World Bank Conference on Development Economics 5 (June 21–23, 1999) (unpublished manuscript, on file with the *Duke Law Journal*).

88. This category is inapplicable because asset sales and auctions are essentially liquidations. *Id.* at 6. Furthermore, even in a corporate bankruptcy context, Professor Hart acknowledges that "there is plenty of indirect evidence suggesting that debtors, creditors and society generally do not trust" cash auctions. *Id.* As far as he knows,

all of the discussion and changes [by countries in the last fifteen years about bankruptcy reform] have been in the direction of introducing a Chapter 11-type structured bargaining procedure . . . none of the movement has been in the direction of cash auctions. In fact, I'm not aware of any group—management, shareholders, creditors, or workers—who is pushing for cash auctions. Thus, it seems to be a fact of life that countries are not prepared to rely on cash auctions as a bankruptcy procedure.

Id. at 7.

89. *Id.* at 5–6.

“leading example” of which is Chapter 11.⁹⁰ These results are consistent with recent scholarship, which predicts that “it [is] highly likely, if not inevitable, that . . . countries [that have market economies will] develop [bankruptcy] reorganization systems that function in essentially the same way [because] [t]he functional aspects of these systems [are] shaped not by culture or politics, but by necessity.”⁹¹

Moreover, even if bankruptcy reorganization systems were not functionally similar, the analogy to Chapter 11 serves only as a starting point for inquiry. Absent an overarching theory of subnational debt restructuring, which may not even exist,⁹² this analogy may suggest a rational legal outcome.⁹³

As for the second potential shortcoming, I believe that the matters being compared under this analogy are indeed similar enough to be meaningful. Municipalities and corporations are fundamentally different entities, but this Article’s analysis takes that into account by

90. *Id.* at 7 & n.6 (observing that “U.K. administration is based on similar ideas [to Chapter 11], as are procedures in France, Germany, and Japan,” and that “[c]ountries in which a Chapter 11-type structured bargaining procedure has been introduced recently include Australia, Indonesia, Thailand and Argentina”). Professor Hart discusses possible alternative approaches to corporate bankruptcy reform that “involve an automatic debt-equity swap,” *id.* at 9, but those approaches would be inapplicable to restructuring the debt of municipalities, which have no equity interests or residual claimants. Professor Hart’s work “deal[s] only with company bankruptcy and not with the bankruptcy of individuals or governments (local, state or national).” *Id.* at 2.

91. Lynn M. LoPucki & George G. Triantis, *A Systems Approach to Comparing U.S. and Canadian Reorganization of Financially Distressed Companies*, 35 HARV. INT’L L.J. 267, 342 (1994). In the context of sovereign debt restructuring, some scholars have asserted that existing differences between national bankruptcy systems could make a uniform approach impractical. Schwarcz, *supra* note 26, at 974 & n.105; Julian R. Franks et al., *A Comparison of US, UK, and German Insolvency Codes*, FIN. MGMT., Autumn 1996, at 86, 93–94. These differences are insignificant, however, when comparing bankruptcy *reorganization* systems. Schwarcz, *supra* note 26, at 974.

92. *See, e.g.*, Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919, 966 (1991) (expressing “distrust of any all-embracing, formal model of bankruptcy law and policy”). Subnational debt restructuring, like sovereign or corporate debt restructuring, ultimately is a matter of contract negotiation, rendering each situation unique. *See, e.g.*, Alfred Mudge, *Sovereign Debt Restructure: A Perspective of Counsel to Agent Banks, Bank Advisory Groups and Servicing Banks*, 23 COLUM. J. TRANSNAT’L L. 59, 60 (1984) (“Each restructure is negotiated separately in its own factual context There are no general rules, and the solution to yesterday’s problem is not the answer to today’s question. . . . Each situation is *unique* . . .”).

93. *See* Sunstein, *supra* note 84, at 767 (arguing that, when there is insufficient information to agree on an overarching theory to deduce the “right” outcome, analogy can help produce a rational legal outcome). *But cf.* RICHARD A. POSNER, *OVERCOMING LAW* 518–22 (1995) (arguing that, although “[a]nalogies can be suggestive, even illuminating,” their use should not exclude attempts to find facts and policies for deciding the case at hand).

also comparing municipal reorganization under Chapter 9 of the Code.⁹⁴

A. *Deriving a Normative Framework for Regulation*

To derive a normative framework for regulation, I examine the conceptual basis of Chapter 11 and then analyze possible modifications that address subnational debt restructuring problems.⁹⁵ The first analysis is complicated, but also universalized, by disagreement on Chapter 11's normative underpinnings.

Traditional scholars ("traditionalists") argue that Chapter 11 attempts to advance two overall goals: to rehabilitate viable debtors and to ensure equality of distribution among creditors.⁹⁶ Other scholars ("free marketers") argue that the only normative goal of bankruptcy reorganization law should be economic efficiency.⁹⁷ These contrasting views represent distinct, and possibly irreconcilable, philosophies of corporate reorganization which arise out of different starting axioms.⁹⁸ Examining the disputes over these axi-

94. See *infra* notes 124–26 and accompanying text.

95. My analysis does not necessarily differentiate between short-term and long-term debt. Although short-term debt might be a greater immediate problem than long-term debt, a default on short-term debt, including a covenant breach, often permits holders of long-term debt to accelerate their maturities. Also, the claims of holders of long-term and short-term debt generally are *pari passu*. Schwarcz, *supra* note 26, at 975 n.114.

96. See Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 542–43 (1999) (describing the bankruptcy policies that are implicated by pre-bankruptcy contracting). A third, lesser, goal is efficient administration of the bankruptcy process. *Id.* at 543. Although other scholars have proposed different articulations of bankruptcy's traditional goals, those other goals are included within the goals of debtor rehabilitation and equality of distribution. *Id.* at 544 n.168.

97. See, e.g., THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 1–6 (1986) ("Bankruptcy law can and should help a firm stay in business when it is worth more to its owners alive than dead."); Barry E. Adler, *Finance's Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. 1107, 1107–11 (1994) (discussing whether prebankruptcy rules are beneficial); Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 411–12 (1990) (arguing that the fundamental goal of a bankruptcy regime should be efficiency); Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159, 1159–65 (1994) (arguing that efficiency should be considered when reviewing each step of the bankruptcy process).

98. See Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 575, 595–99 (1998) (describing the different set of axioms). Professor Baird concludes that these two philosophies cannot be reconciled by empirical data because the split "is at bottom normative." *Id.* at 596; see also Donald R. Korobkin, *The Role of Normative Theory in Bankruptcy Debates*, 82 IOWA L. REV. 75, 76 (1996) (explaining that "the conflict between these two schools is even deeper than it may first appear").

oms reveals which axioms might apply to subnational debt restructuring.⁹⁹

There are three disputes.¹⁰⁰ The first addresses the rehabilitative role of bankruptcy law and questions the role the law should play in “keeping a firm intact as a going concern.”¹⁰¹ As a general proposition, troubled companies with inherently good businesses may undergo reorganization, but those with inherently bad businesses are often liquidated.¹⁰² However, free marketers contend that bankruptcy law’s *only* role is “determining whether keeping the firm intact makes economic sense.”¹⁰³ A firm with a sound business that is nonetheless likely to fail because of excessive debt should be kept intact,¹⁰⁴ but one with an inherently unsound business should be allowed to fail “to ensure that [its] assets are put to their best use.”¹⁰⁵ Traditionalists, on the other hand, argue that bankruptcy law “serves an important purpose in rehabilitating firms that, but for bankruptcy protection, would fail. Jobs would be lost and communities damaged, economically and otherwise, if the protections that bankruptcy law provides were unavailable.”¹⁰⁶

This dispute over rehabilitation has less application to subnational debt restructuring. At least in the present world order, it generally does not appear to be politically viable to liquidate municipalities.¹⁰⁷ Accordingly, I will assume that there is no need to determine

99. See Schwarcz, *supra* note 26, at 977–80 (engaging in a similar examination).

100. Baird, *supra* note 98, at 576–80.

101. *Id.* at 577.

102. Although a corporate debtor can choose either reorganization or liquidation at the outset of a bankruptcy case, most debtors initially attempt reorganization—a process governed by Chapter 11. See 11 U.S.C. § 706(a) (2000) (permitting the debtor to convert a liquidation into a reorganization). However, the judge has the power to convert the reorganization into a liquidation for various reasons, including that losses are continuing and no “reasonable likelihood of rehabilitation” exists, *id.* § 1112(b)(1), or that the debtor is unable to “effectuate a plan” of reorganization, *id.* § 1112(b)(2).

103. Baird, *supra* note 98, at 577.

104. *Id.* at 580–82.

105. *Id.* at 582.

106. *Id.* at 577.

107. *But see* McConnell & Picker, *supra* note 24, at 472 (challenging the Code’s assumption that municipal debtors should not be dismembered because “[m]erely to give the city a fresh start, but not to address the fundamental causes of its financial problems, may be no favor”); E-mail from Clayton P. Gillette to Steven L. Schwarcz, *supra* note 54, at 1 (suggesting that this assumption might not apply to municipalities that are simply administrative arms of the state for purposes of producing local public goods, lacking any significant responsibilities and political authority). Whether a subnational debt restructuring system *should* allow liquidation of municipalities is a political question beyond this Article’s scope.

whether keeping the municipality intact makes economic sense; reorganization is assumed to be the goal of any municipal debt restructuring. Any subnational debt restructuring scheme therefore should facilitate, or at least not impede, this goal.¹⁰⁸

The second dispute concerns whether bankruptcy law should be a “closed” or an “open” system.¹⁰⁹ Free marketers believe that bankruptcy should be an open system, meaning that its rules should minimally affect the incentives established in the absence of bankruptcy (hereinafter, “prebankruptcy incentives”).¹¹⁰ Traditionalists, on the other hand, believe that “the breathing space that bankruptcy law gives distressed firms and the other costs it imposes on the participants have only a modest effect on how creditors and others behave *ex ante*.”¹¹¹ This dispute appears more directly relevant to subnational debt restructuring. To the extent a municipality’s assets are immune under national law from attachment or other enforcement procedures, the municipality requires less “breathing space” than a corporation, and therefore has less need for special rules.¹¹² On the other hand, to the extent the municipality’s assets are not immune or there is uncertainty regarding immunity,¹¹³ the municipality may require much the same “breathing space” as a corporation. Accordingly, subnational debt restructuring rules should be crafted to balance the need for breathing space with the goal of minimally affecting pre-restructuring incentives.

108. In nations where municipal liquidation *is* a political possibility, one should inquire, however, whether liquidating the municipality, or at least rearranging its political boundaries, would be a more efficient approach. *See, e.g.*, E-mail from Clayton P. Gillette to Steven L. Schwarcz, *supra* note 54, at 1 (“[T]here is ample reason to suggest that problems that lead cities into fiscal distress have to do with [the] inefficiency of their boundaries. If we could overcome the political issues that constrain redrawing of boundaries, it might often make sense to do so.”).

109. Baird, *supra* note 98, at 578.

110. *Id.*; *see also* *Butner v. United States*, 440 U.S. 48, 55 (1979) (“Uniform treatment of property interests [inside and outside bankruptcy] serves to reduce uncertainty, to discourage forum shopping, and to prevent a [debtor] from receiving ‘a windfall merely by reason of the happenstance of bankruptcy.’”) (quoting *Lewis v. Mfrs. Nat’l Bank*, 364 U.S. 603, 609 (1961)).

111. Baird, *supra* note 98, at 578.

112. Indeed, *ex post* modification of creditors’ rights by “[s]ubstantive rules implemented exclusively in bankruptcy” can have adverse effects such as increasing borrowing costs. *Id.*

113. *See, e.g.*, Memorandum from Kazuo Ohtake, Satoshi Inoue, & Tomohiko Iwasaki, Nagashima & Ohno (Japanese law firm), to Ernfred M. Olsen, Financial Security Assurance, Inc. 6–7 (May 26, 1999) (on file with the *Duke Law Journal*) (indicating uncertainty as to whether municipalities have immunity under Japanese law).

The third dispute concerns the implementation of bankruptcy law and focuses on the judge's role in the bankruptcy process.¹¹⁴ Free marketers see the parties making their own decisions and the judge acting simply "to ensure that the biases of the parties are taken into account and all relevant information is gathered and disclosed."¹¹⁵ In contrast, traditionalists believe that "[i]mplementing the goals of bankruptcy requires investing the judge with broad discretion to ensure that bankruptcy's goals are vindicated."¹¹⁶ Free marketers, however, believe that such broad discretion "merely gives the parties more cause for litigation and hence increases the cost of the reorganization without providing any offsetting benefit."¹¹⁷ This dispute is also relevant to subnational debt restructuring because issues of discretion may arise.¹¹⁸ Nonetheless, granting judicial arbiters broad discretion to bind municipalities is likely to be politically unacceptable.¹¹⁹ Accordingly, any framework for subnational debt restructuring should attempt at least to minimize adjudicatory discretion.

Hence, a legal framework for subnational debt restructuring has at least three normative underpinnings: (1) it should foster, or at least not impair, the municipality's ultimate economic rehabilitation; (2) it should balance the need for breathing space with the goal of minimally affecting pre-restructuring incentives; and (3) it should require minimal adjudicatory discretion in its administration. Moreover, any complete framework must address the major problems associated with subnational debt restructuring, such as by placing the burden on the municipality and its creditors, not on the central government (which would foster debtor and creditor moral hazard and also would fail where the central government is unable or unwilling to subsidize

114. Baird, *supra* note 98, at 579.

115. *Id.* Those biases, for example, include the desire of institutional creditors to liquidate the firm and the agency costs of the shareholders. *Id.*

116. *Id.*

117. *Id.* at 595.

118. *See infra* Part III.C.3.

119. Thus, in the United States judicial arbiters do not have the power to interfere with a municipality's political or governmental powers, property or revenues, or use or enjoyment of income-producing property. 11 U.S.C. § 904 (2000); *see also* David L. Dubrow, *Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?*, 24 URB. LAW. 539, 551–52 (1992) (discussing the practical impact of 11 U.S.C. § 904 on creditors' rights); Robert W. Collin, *What the Law Says About Orange County: Creditors' Rights and Remedies on Municipal Default*, MUN. FIN. J., Summer 1995, at 52, 73–74 (examining the difficulties creditors face when attempting to seize municipal property).

the municipality), and by preventing holdout creditors from undermining a collective settlement.

The next Section of this Article attempts to use this framework to fashion rules that might form the basis of a subnational debt restructuring law (the “Model Law”). I begin by identifying the provisions of the Code that might be relevant to subnational debt restructuring and then analyze those provisions in light of the proposed framework.

B. Fashioning Rules for a Model Law

The only provisions of the Code that might be relevant to subnational debt restructuring are in Chapter 11, which governs corporate reorganization,¹²⁰ and in the Code’s related chapters: Chapter 9, which governs adjustment of debts of municipal governments;¹²¹ Chapter 3, which governs administration of the bankruptcy case;¹²² and Chapter 5, which contains provisions concerning the relationship between creditors and the debtor.¹²³ I first considered focusing exclusively on Chapter 9. However, analysis showed that Chapter 9 adds little to the other chapters because it primarily incorporates their provisions by reference¹²⁴ but is not as comprehensive.¹²⁵ I therefore begin the analysis on the most fundamental level by examining the underlying provisions of Chapter 11 and these other chapters. In that context, I also examine how, and why, certain provisions of Chapter 9 differ from related provisions of such other chapters. I then separately examine the few provisions of Chapter 9 that are unrelated to provisions contained in such other chapters.¹²⁶

1. *Commencing the Proceeding.* Sections 301 and 303 of the Code set forth the procedures for commencing a bankruptcy case, which triggers application of the Code’s substantive provisions.¹²⁷ Be-

120. 11 U.S.C. §§ 1101–1146.

121. *Id.* §§ 901–946.

122. *Id.* §§ 301–366.

123. *Id.* §§ 501–560.

124. *Id.* § 901.

125. *See, e.g.,* Bennett J. Murphy, *Address at the National Federation of Municipal Analysts’ 1995 National Conference, in Understanding Municipal Bankruptcy*, MUN. FIN. J., Fall 1995, at 47, 54 (observing that Chapter 9 “includes most of the provisions but not all the provisions of Chapter 11”).

126. *See infra* notes 129–32, 134–38 and accompanying text.

127. 11 U.S.C. §§ 301, 303.

cause subnational debt restructuring does not involve bankruptcy per se, I will refer in that context to commencement of a debt restructuring proceeding to describe the process for triggering the Model Law's substantive provisions.

Under § 301 of the Code, a debtor has the discretion to voluntarily file a bankruptcy petition without being insolvent or meeting other requirements, except those discussed below. The rationale is that a debtor knows best when bankruptcy protection is appropriate.¹²⁸ Curiously, however, § 109(c) of the Code only allows a municipality that is insolvent on a cash flow basis to file a voluntary bankruptcy petition.¹²⁹ This means that the municipality is “generally not paying its debts as they become due [or is] . . . unable to pay its debts as they become due.”¹³⁰ A cash flow insolvency standard, however, is a double-edged sword because it

almost certainly makes both creditors and debtor worse off in those cases actually culminating in bankruptcy [by] postpon[ing] the day of reckoning, while the city continues to pile on new debt at ever-increasing interest rates, further burdening the municipal budget and guaranteeing that each creditor will receive less value in bankruptcy.¹³¹

Nor does there appear to be a viable alternative standard: “the insulation of municipal assets from seizure and sale makes the idea of balance sheet insolvency meaningless, and there is no obvious alternative.”¹³²

128. See, e.g., Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 370 (1993) (arguing that “[t]he debtor is typically the only party with access to full information about its outstanding obligations, future business plans, and income projections,” and is thus “usually best able to assess how successful the business is likely to be in meeting its continuing obligations, and to determine whether bankruptcy provides an opportunity to enhance the value of the business”).

129. 11 U.S.C. § 109(c); see also *id.* § 101(32)(C) (defining insolvency for a municipality).

130. *Id.* § 101(32)(C). This test “reflects the pre-Code common law view, which treated the municipal debtor as having few physical assets available for creditors and instead focused almost exclusively on the ability of the debtor to generate revenues through property taxes.” McConnell & Picker, *supra* note 24, at 456.

131. McConnell & Picker, *supra* note 24, at 456–57.

132. *Id.* at 457; cf. Barry Eichengreen & Richard Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors*, in CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS 3, 14 (Barry Eichengreen & Richard Portes eds., 1995) [hereinafter CRISIS? WHAT CRISIS?] (arguing that a balance-sheet insolvency test for countries would be meaningless because “the solvency of a country is not well defined”).

The only further limitation on voluntary filing is one that is common to both municipal and nonmunicipal filings. Courts have imposed the requirement that a debtor must file any voluntary petition in good faith¹³³ and, in a municipal bankruptcy, § 921(c) of the Code explicitly permits a court to dismiss a bankruptcy petition not filed in good faith.¹³⁴

Involuntarily filings are more restricted. Creditors may file an involuntary bankruptcy case against debtors under § 303 only in limited circumstances, such as when a debtor is generally not paying its debts when due.¹³⁵ This requirement prevents creditors from using the threat of bankruptcy to harass ordinary debtors.¹³⁶ Indeed, in a municipal context, the Code flatly prohibits creditors from filing involuntary bankruptcy cases against municipalities,¹³⁷ although this prohibition may be based on particular aspects of United States constitutional law.¹³⁸

In the context of sovereign debt restructuring, imposing an insolvency or similar requirement for commencing a debt restructuring proceeding appears ill advised for the reasons advanced by Professors McConnell and Picker: such a requirement, if based on cash flow, would make the municipality and its creditors worse off by postponing the day of reckoning and, if based on a balance sheet test, would be meaningless.¹³⁹ Imposing an insolvency requirement also could be counterproductive because it would discourage the use of debt restructuring proceedings by municipalities that wish to avoid being branded as insolvent.¹⁴⁰ Nor does there appear to be a need to impose

133. See 2 COLLIER ON BANKRUPTCY ¶ 301.05[1] (Lawrence P. King et al. eds., 15th ed., rev. 1996) [hereinafter COLLIER] (“[C]ourts have imposed a requirement that the case be commenced in good faith to reflect the intended policies of the Code.”).

134. 11 U.S.C. § 921(c); cf. McConnell & Picker, *supra* note 24, at 460–61 (questioning why the good faith requirement is explicit only for municipal bankruptcy filings).

135. 11 U.S.C. § 303(h).

136. See ROBERT L. JORDAN ET AL., BANKRUPTCY 224 (5th ed. 1999) (asserting that policy considerations, such as the fear of involuntary bankruptcy proceedings being used to harass an honest debtor, prompted limitations of the use of involuntary proceedings).

137. See 11 U.S.C. § 901(a) (omitting § 303 [involuntary bankruptcy] from a list of sections that apply to cases arising under Chapter 9—adjustment of debts of a municipality).

138. See *In re Richmond Unified Sch. Dist.*, 133 B.R. 221, 225 (Bankr. N.D. Cal. 1991) (noting that permitting involuntary filings against municipalities “may constitute an invasion of State sovereignty contrary to the Tenth Amendment, and would constitute bad policy”) (quoting H.R. REP. NO. 95-595, at 321 (1977)).

139. See *supra* notes 128–32 and accompanying text.

140. Indeed, the Model Law does not differentiate between exogenous and endogenous factors that lead to default (except to the limited extent that irrational exogenous factors would

such a requirement; I later argue that only a requirement of good faith, not of insolvency, is needed to prevent strategic manipulation of the Model Law's provisions.¹⁴¹

It likewise appears that creditors should have no right to commence an involuntary debt restructuring proceeding against a municipality. As a matter of national pride, and to avoid harassment of their municipalities and potential political abuse, few countries would want their municipalities to be involuntarily subjected to such a proceeding. The absence of involuntary proceedings should not be troublesome, however, because in situations in which creditors might want to subject a municipality to the Model Law's rules, the municipality itself should have an equal or greater interest in choosing those rules. For example, under the Model Law, the commencement of a debt restructuring proceeding would automatically stay creditors from enforcing their claims against the municipality's assets.¹⁴² The Model Law also would give priority to claims of financiers of the municipality's debt restructuring over claims of other creditors,¹⁴³ and would bind all creditors to a plan of reorganization that is agreed to by supermajority voting of creditors¹⁴⁴ (and, upon such agreement, the Model Law would discharge debts not provided for in the plan).¹⁴⁵ A creditor might want the automatic stay to apply to prevent a grab race by other creditors against the municipality's assets, but the municipality likewise should want to commence a debt restructuring proceeding to prevent *any* creditors from grabbing its assets. A creditor might want financiers' claims to have priority in order to provide liquidity to the municipality. However, if the municipality needs liquidity and cannot obtain it elsewhere, the municipality would want to commence a debt restructuring proceeding. Likewise, a creditor who is frustrated by unanimity requirements in loan agreements might want to bind all creditors to the reorganization plan in order to achieve an overall debt restructuring plan. Similarly, the municipality would be frustrated by its inability to reach such a plan and, there-

justify temporary governmental liquidity to a municipality that is otherwise economically sound, *see infra* notes 185–88 and accompanying text). Differentiation would be counterproductive because municipal leaders who might be blamed for the economic failure would be reluctant to have their municipalities commence a debt restructuring proceeding.

141. *See infra* notes 333–34 and accompanying text.

142. Model Law art. 3(3), *infra* Appendix.

143. Model Law art. 9, *infra* Appendix.

144. Model Law art. 7, *infra* Appendix.

145. Model Law art. 7(1), *infra* Appendix.

fore, would want that rule to apply. These parallel interests of the municipality and its creditors obviate the need for creditors to act as “monitors and instigators of outside intervention.”¹⁴⁶

Thus, the Model Law should empower only the municipality itself, and not its creditors, to commence a debt restructuring proceeding. It should set no requirements on the municipality’s right to commence the proceeding, other than a minimal requirement that the municipality act in good faith. Imposing other requirements would be unnecessary and might prevent the municipality from taking advantage of the proceeding when it needs it the most, thereby harming both the municipality and its creditors.

This approach to commencing a debt restructuring proceeding is consistent with this Article’s conceptual framework for subnational debt restructuring, which contemplates rules that foster, or at least do not impair, the municipality’s ultimate economic rehabilitation; balance the municipality’s need for breathing space with the goal of minimally affecting pre-restructuring incentives; require minimal adjudicatory discretion in their administration; place the burden on the municipality and its creditors, not on the central government;¹⁴⁷ and attempt to minimize the collective action problem.¹⁴⁸ Under this framework, the foregoing approach to commencing a debt restructuring proceeding could, depending on the applicable debt restructuring rules, potentially foster economic rehabilitation and address the collective action problem. Moreover, except in the presumably rare case in which creditors allege a bad faith proceeding, application of this approach does not require adjudicatory discretion.¹⁴⁹ The approach appears neutral from the standpoint of allocation of the burden. The only potential disadvantage to this approach is that rules that operate only in a debt restructuring proceeding could adversely affect pre-restructuring incentives. The magnitude of that effect, however, depends on the substantive nature of the rules, and this Article proposes debt restructuring rules that do not materially ad-

146. McConnell & Picker, *supra* note 24, at 478.

147. Placing the burden on the central government would foster debtor and creditor moral hazard, and also would fail where the central government is unable or unwilling to subsidize the municipality. *See supra* notes 26–32 and accompanying text.

148. *See supra* notes 33–36 and accompanying text.

149. For a discussion of the possibility of disputes arising out of the good faith requirement, see *infra* note 319 and accompanying text.

versely affect pre-restructuring incentives.¹⁵⁰ Thus, the Model Law should provide that the municipality alone may commence the debt restructuring proceeding, subject to a good faith requirement.

2. *Stays.* Section 362 of the Code in a nonmunicipal context, and § 922 in a municipal context, provide that commencement of the bankruptcy case automatically stays, or suspends, the enforcement of all lawsuits and claims against the debtor that arose before commencement of such case, as well as any other actions to obtain possession of the debtor's property.¹⁵¹ Thus, in a subnational debt restructuring context, a stay would, among other things, suspend (until the restructuring proceeding is completed) the rights of creditors to recover on debts owed by the municipality prior to the petition for relief.

Applying this Article's conceptual framework, I propose that the Model Law include a stay. A stay would have a positive effect on the allocation of the burden: by suspending payment of debts, it reduces the municipality's need to look to the central government for funding, and it shifts some of the burden to creditors who now must wait for repayment.¹⁵² Additionally, by preventing an enforcement race among creditors, a stay would reduce that aspect of the collective action problem.¹⁵³ On the other hand, because the stay applies only to pre-

150. Adoption of explicit subnational debt restructuring rules, however, would offset this impact to the extent creditors, *ex ante*, have greater certainty of *ex post* debt restructuring events. See Eichengreen & Portes, *supra* note 132, at 77–78 (discussing the need for a “well-defined structure” for negotiations that will be utilized in case of default).

151. 11 U.S.C. §§ 362, 922 (2000).

152. A stay, therefore, would reduce moral hazard by making creditors more careful when extending credit.

153. In countries in which municipalities enjoy a degree of sovereign immunity, an enforcement race among creditors would be less troublesome in a municipal than a corporate context. Nonetheless, even those municipalities may prefer a stay because, without it, they may be hesitant to suspend payments unilaterally “for fear that they will jeopardize their future credit market access . . . [whereas] a government which received [*de jure*] approval for its standstill would suffer relatively little damage to its reputation.” Eichengreen & Portes, *supra* note 132, at xvii (discussing this issue in the context of sovereign nations). Furthermore, the law in many nations may not grant sovereign immunity to municipalities or may be ambiguous regarding municipal immunity. See, *e.g.*, Memorandum from Kazuo Ohtake et al. to Ernfred M. Olsen, *supra* note 113, at 6:

Although there is no statutory provision that prohibits a person from making compulsory execution [(e.g., compulsory sale)] against a local public entity, some scholars argued in the past that no compulsory execution might be made at all against a local public entity. At present, however, the majority of scholars consider that compulsory execution may be made on any property of a local public entity other than “administrative property”

petition claims, it would not impair a municipality's ability to continue to pay its employees (e.g., police, firefighters, teachers)¹⁵⁴ and to pay for other needed services.

A possible negative factor is that a stay could require adjudicatory discretion in deciding what exceptions should be allowed.¹⁵⁵ That, however, must be balanced against the economic rehabilitation fostered by the stay's ability to give the municipality breathing room from claims while attempting to restructure its debt,¹⁵⁶ a process that almost certainly will require the municipality to reduce its costs and attempt to operate more efficiently.¹⁵⁷

The only other negative factor is that the possibility of a stay could adversely affect pre-restructuring incentives. For example, creditors anticipating the possibility of nonpayment during the restructuring period might charge the municipality higher interest rates. On balance, though, this does not appear significant enough to outweigh a stay's rehabilitative benefits.

3. *Reorganization Financing.* Section 364 of the Code outlines a procedure for a debtor to obtain financing for its reorganization from the credit and capital markets.¹⁵⁸ This financing is commonly referred to as debtor-in-possession (DIP) financing. To attract DIP financing, the Code gives priority to lenders and investors that provide such financing.¹⁵⁹ Without this priority, financing likely would be unavailable

Cf. Schwarcz, *supra* note 26, at 984–85 & nn.165–69 (arguing against a stay for sovereign debt restructuring because nations are not subject to the enforcement race except to the extent their creditors could attempt to attach the relatively few assets located in other countries).

154. A municipality might wish, however, to pay all *outstanding* claims of such employees before commencing a debt restructuring proceeding.

155. See DAVID G. EPSTEIN ET AL., BANKRUPTCY § 3-1, at 63 (1993) (discussing stay litigation in corporate bankruptcy).

156. See, e.g., DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 193 (rev. ed. 1993) (describing the stay as a “mechanism to preserve the status quo while we sort out the affairs of the debtor”); James B. Hurlock, *The Way Ahead for Sovereign Debt*, INT’L FIN. L. REV., July 1995, at 10, 10 (arguing that the automatic stay gives “the breathing space needed to return [a debtor] to economic health”).

157. See *infra* notes 180–82 and accompanying text (explaining that the municipality must persuade creditors to agree to the debt restructuring plan).

158. 11 U.S.C. § 364 (2000). The capital markets are “markets where capital funds—debt and equity—are traded. Included are private placement sources of debt and equity as well as organized markets and exchanges.” DOWNES & GOODMAN, *supra* note 62, at 59. The term “credit markets” refers to banks, finance companies, and other traditional institutional lenders. All of these are private, free-market sources of funds.

159. See 11 U.S.C. § 364(a) (“If the trustee is authorized to operate the business of the debtor . . . the trustee may obtain unsecured credit and incur unsecured debt in the ordinary

because the information asymmetry between the debtor and potential financiers may be large (a bankrupt company rarely has full financial transparency)¹⁶⁰ and also because new financiers will not want to be “taxed” by the claims of existing creditors.

The need to grant priority in order to attract credit and capital market financing may be even more compelling in a municipal than a corporate debt restructuring context. In both cases, access to funding is critical to economic rehabilitation: a financially troubled municipality will need “fresh working capital during restructuring, so that critical governmental functions don’t collapse.”¹⁶¹ Without a priority, however, municipalities could not obtain credit and capital market financing for the same reasons such financing would be unavailable in a corporate context: the information asymmetry between the municipality and potential financiers may be large—indeed, there may be even less transparency for municipalities which are not ordinarily subject to the same level of financial reporting as corporations¹⁶²—and

course of business . . . as an administrative expense.”). Moreover, if the priority scheme laid out in § 364(a) is inadequate to attract sufficient financing, the judge may authorize the granting of collateral. *Id.* § 364(c), (d). If necessary, the judge may even authorize the obtaining of credit secured by a senior lien on property already pledged as collateral if the original secured party is adequately protected. *Id.* § 364(d); *see also id.* § 361 (defining adequate protection).

160. Section 1125 of the Code attempts to address this problem for bankrupt companies by replacing the transparency requirement of federal securities law with a more pragmatic standard of “adequate information,” which considers the type and detail of information that is “reasonably practicable in light of the nature and history of the debtor and the condition of the debtor’s books and records.” *Id.* § 1125(a)(1).

161. Sachs, *supra* note 35, at 13 (referring to a financially troubled nation). A financially troubled municipality likewise would need working capital to pay its employees and provide core municipal services.

162. *See* E-mail from W. Bartley Hildreth, Regents Distinguished Professor of Public Finance and Director, Kansas Public Finance Center, Hugo Wall School of Urban and Public Affairs and the W. Frank Barton School of Business, Wichita State University, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Oct. 26, 2000, 15:17 EST) (on file with the *Duke Law Journal*) (stating that “there is no similarity to the reporting practices of corporations and municipalities” in the United States); E-mail from W. Bartley Hildreth, Regents Distinguished Professor of Public Finance and Director, Kansas Public Finance Center, Hugo Wall School of Urban and Public Affairs and the W. Frank Barton School of Business, Wichita State University, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Oct. 26, 2000, 15:03 EST) (on file with the *Duke Law Journal*) (observing that, outside the United States, he has “not found that subnational governments are subject to the same reporting laws” as corporations). There have been attempts to increase government transparency around the world. For example, the International Monetary Fund is seeking to encourage its member countries to implement a “Code of Good Practices on Fiscal Transparency,” which provides, among other things, detailed guidelines on how “[t]he public should be provided with full information on the past, current, and projected fiscal activity of government.” Int’l Monetary Fund, *Code of Good Practices on Fiscal Transparency* § 2.1, available at <http://www.imf.org/>

new financiers will not want to be taxed by existing claims.¹⁶³ Financially troubled municipalities therefore usually can look only to their central governments as lenders of last resort, creating the misallocation of the burden and possible moral hazard described earlier.¹⁶⁴

Shifting the source of funding from the central government to private credit and capital markets would reallocate this burden from the central government to the municipality and its creditors, where the burden belongs.¹⁶⁵ Although the size of the credit and capital markets is clearly large enough to accommodate the legitimate financing needs of restructuring municipalities,¹⁶⁶ a municipality will have no assurance that private credit will be available. This risk of potential default will make the municipality more careful when obtaining credit outside of a debt restructuring proceeding, and arguably more disciplined in its economic planning. Creditors that lend to a municipality outside of such a proceeding will face that same risk of default and, if such a proceeding occurs, will find their claims subordinated even if private credit is available. Therefore, they will lend more carefully.

Granting priority appears neutral from the standpoint of collective action. The adverse effect on pre-restructuring incentives should not be excessive from the standpoint of either the municipality or its creditors. This is because, from the municipality's standpoint, granting priority will not lower the municipality's debt rating and therefore

external/np/fad/trans/code.htm (Mar. 23, 2001). Professor Hildreth observes, however, that “[i]t is unlikely that [even] every American subnational government could pass this test.” Letter from W. Bartley Hildreth, Regents Distinguished Professor of Public Finance and Director, Kansas Public Finance Center, Hugo Wall School of Urban and Public Affairs and the W. Frank Barton School of Business, Wichita State University, to Steven L. Schwarcz, Professor of Law, Duke University School of Law 2 (Oct. 26, 2000) (on file with the *Duke Law Journal*).

163. See Eichengreen & Portes, *supra* note 132, at 15 (arguing that granting a priority prevents underinvestment and therefore “is desirable if the implications for moral hazard can be contained”).

164. See *supra* notes 26–32 and accompanying text (describing these problems). Despite these problems, I later argue that central governments should consider acting as lenders of last resort for certain municipalities. See *infra* notes 184–88 and accompanying text.

165. Professor Sachs additionally argues that this shift would enable debtors to remain in contact with the private markets, thereby enabling them to make a “rapid transition back to market borrowing once the panic had subsided,” and would impose “a market test on each loan . . . (albeit a weak test, since the new loans would be supported by the assignment of . . . priority over existing debts).” Sachs, *supra* note 35, at 12.

166. Schwarcz, *supra* note 26, at 987 (observing that the size of the credit and capital markets is large enough to accommodate the financing needs of restructuring nations; presumably, the size of those markets should be large enough to accommodate the financing needs of restructuring municipalities).

should have a relatively minimal impact on ex ante availability and cost of credit.¹⁶⁷ And, from the creditors' standpoint, granting priority will enable municipalities to borrow new money, thereby reducing their risk of failure¹⁶⁸ and arguably increasing the expected value of creditor claims.¹⁶⁹

Nonetheless, new money priority credit could decrease the value of creditor claims if overinvestment occurs—for example, if the proceeds of the new money credit are invested in a project that is less valuable than the proceeds¹⁷⁰ or otherwise misused.¹⁷¹ In a corporate lending context, I argue elsewhere that monitoring and inherent disincentives limit the risk of overinvestment.¹⁷² Those disincentives would not apply in a municipal or DIP financing context, however, because they arise out of imperfections in the corporate bankruptcy process¹⁷³ that do not affect either of these situations.¹⁷⁴ Nor could creditors rely on the new lender to protect their rights because the new lender's priority claim usually ensures repayment notwithstanding overinvestment. Thus, in a corporate reorganization context, the Code compensates by allowing creditors that are concerned about

167. See *infra* note 361 and accompanying text (referring to discussions with Standard & Poor's, a leading rating agency).

168. The proceeds of the borrowing are needed to pay municipal employees and provide core municipal services. See *supra* note 161.

169. See Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 425 (1997) (arguing that the expected value of unsecured claims increases even though such claims are subordinated to the new money). This article deals with secured lending priorities but its argument applies equally to any set of lending priorities that arise merely by operation of law. *Id.* at 430. The extent to which new money liquidity will reduce the risk of a municipality's, as opposed to a corporation's, economic failure is unclear, however. Because there may be a difference, I caution that the conclusions reached in the text accompanying this note are not free from doubt.

170. Cf. *id.* at 436 & n.45 (discussing misuse of money).

171. See, e.g., Letter from W. Bartley Hildreth to Steven L. Schwarcz, *supra* note 162, at 2 (asking whether "new money [would] help if there are systemic problems with [the municipality's] handling of resources").

172. See Schwarcz, *supra* note 169, at 436–40 (describing the benefits and limitations of monitoring); *id.* at 455–62 (examining disincentives). A rational corporate debtor also is economically motivated to avoid granting priority prematurely because of the costs associated with doing so. *Id.* at 446–49.

173. See *id.* at 456–58 (detailing inherent imperfections in the bankruptcy process).

174. Those imperfections are irrelevant because municipal debt restructuring is not governed by the Code, and DIP financing is governed by special bankruptcy rules that transcend those imperfections. *Id.* at 470–71 & nn.206–07 (discussing DIP financing).

overinvestment to scrutinize and object to an excessive amount of DIP financing and, where appropriate, to monitor its use.¹⁷⁵

Giving creditors in a subnational debt restructuring proceeding a similar right to scrutinize and object to excessive amounts of priority funding may be less valuable, however. Especially where there are foreign or geographically dispersed creditors, it may not be economical to engage in this monitoring. I later examine whether creditors should be represented by a creditors' committee for this purpose but conclude that the cost of committees does not justify their formal appointment in every debt restructuring proceeding.¹⁷⁶ There is, however, an alternative: to prevent overinvestment, a municipal debt restructuring scheme might utilize the central government as a supervisory authority to scrutinize and object to excessive amounts of new funding and to condition and monitor its use when appropriate¹⁷⁷—an approach that I will refer to as conditionality.¹⁷⁸

The foregoing scheme for priority funding would reallocate the debt restructuring burden from the central government to the municipality and its creditors because any loan funding would come from the capital markets, not from the central government.¹⁷⁹ Lenders

175. See 11 U.S.C. §§ 364(c), 1109(b) (2000) (permitting DIP financing only after notice and a hearing at which creditors have the right to appear and be heard). As a practical matter, however, creditors rarely object. See *infra* note 320 and accompanying text.

176. See *infra* notes 222–26 and accompanying text. I nonetheless note that “circumstances sometimes might warrant” the creation of such committees, and therefore suggest that the central government consider creating them on an ad hoc basis. See *infra* note 226 and accompanying text.

177. This scrutiny might be viewed as a quid pro quo for permitting new money funding to have priority over existing claims.

178. In a country debt restructuring context, the term “conditionality” refers only to a multilateral entity, such as the International Monetary Fund, imposing conditions on the disbursement of *its* funding. Schwarcz, *supra* note 26, at 969 & n.72; *id.* at 991 & n.203. I use the term more broadly herein to refer to the central government’s conditioning *even third-party* funding. Thus, conditionality can be used as an economic tool to motivate recalcitrant municipalities to improve their fiscal governance even though the central government does not actually provide the funding.

179. A central government similarly could perform a monitoring and scrutiny role by acting as an intermediary funding source. For example, the central government would borrow funds from the capital markets on a nonrecourse basis—meaning that “the obligation to repay borrowed money is secured by specific assets of the debtor [in this case, the central government’s right to repayment of the loan made to the municipality], but the [capital market] creditor does not have general recourse to the debtor’s [i.e., the central government’s] remaining assets.” Schwarcz, *supra* note 169, at 462–63. Simultaneously, the central government would assign the municipality’s priority loan to the capital market lenders as collateral. As a credit matter, the lenders thus would be in the same position as if they had made the loan directly to the municipality; the lenders are entitled to proceeds of the collateral—the municipality’s promise to repay

could look only to the municipality for repayment. Thus, a municipality's ability to obtain capital market financing and the interest rate thereon would depend entirely on the municipality's credit. The central government also could choose, where appropriate, to shift even more of the burden to the municipality by conditioning the lender's priority on the municipality's agreeing to improve its fiscal responsibility, such as by preparing a financial plan and approved budget, charging more for the use of its public facilities, and reducing its municipal services.¹⁸⁰

This scheme also would be consistent with the remainder of this Article's conceptual framework.¹⁸¹ Nonetheless, it assumes that the central government allows the market to work and avoids acting as a de facto lender of last resort. That creates a risk, though, that even by offering priority, a municipality sometimes might be unable to obtain private market funding at any cost, thereby forcing the municipality into default. Default arguably would be justified where it provides a needed signal to help motivate other municipalities to maintain their fiscal and economic integrity and not to issue debt beyond their ability to repay.¹⁸² Ultimately, however, the matter of a central government bailout of a municipality will be political.¹⁸³

the central government loan on a priority basis—but have no claim against the central government or its assets. Cf. Schwarcz, *supra* note 26, at 990–91 (advocating this structure for sovereign debt restructuring, in which this structure substitutes for the absence of a supernational entity that could enforce monitoring against the borrowing nation). However, structuring the loan in this manner entails slightly higher transaction costs. It therefore appears unnecessary for municipal borrowing, in which the central government could impose its sovereign power to monitor notwithstanding the municipality's borrowing directly from the capital markets.

180. See *infra* notes 339–42 and accompanying text (discussing, in the context of a hypothetical Japanese subnational debt restructuring, the possible imposition of these and other conditions).

181. The central government also could choose to charge its monitoring costs to the municipality.

182. See, e.g., WORLD DEVELOPMENT REPORT, *supra* note 1, at 166 (“The [Brazilian] federal government needs to demonstrate its commitment [not to bail out its subnational state governments] by allowing a state government to default.”); see also *id.* at 124 (arguing that a “hands-off” attitude when subnational governments default on their loans may be more important in controlling debt than the most comprehensive set of regulations and controls”); cf. Schwarcz, *supra* note 26, at 993 (arguing that allowing the possibility of default would reduce moral hazard). In a sovereign debt restructuring context, even the International Monetary Fund now appears to prefer default to a bailout. See *Emerging Market Bonds, A Crash Course in Default*, EUROMONEY, Oct. 10, 1999, at 47, 50 (noting the International Monetary Fund's new policy of permitting the possibility of sovereign debt default).

183. A central government also might wish to consider the effect, if any, that a municipal default would have on its own cost of funds. See, e.g., E-mail from Malcolm Grant, Head, Department of Land Economy, University of Cambridge, to Steven L. Schwarcz, Professor of Law,

On the other hand, there are circumstances in which a central government bailout would appear to be justified. For example, the municipality may be too poor even to attempt to impose austerity measures, or it may be economically and fiscally prudent but the factors causing default are largely exogenous, such as a financial markets panic. The rationale for a bailout in the former case is that the municipality is unable to bear any greater allocation of the burden;¹⁸⁴ the rationale in the latter case is that the central government merely would be providing temporary liquidity which the municipality should be able to repay once the panic subsides.¹⁸⁵ In that latter context, central government liquidity also would help solve the multiple equilibrium problem, that the value of assets in financial markets often depends on market expectations, which in turn depend on asset values.¹⁸⁶ For example, a municipality may be able to pay debt service so long as most investors renew, as expected, their maturing obligations. But if a critical number of investors decide not to renew, other investors may see this as signaling a problem and likewise refuse to renew—the effect being similar to a run on a bank.¹⁸⁷ The municipality, however, may be too illiquid to repay all of the debt then maturing.¹⁸⁸ By assuring investors that a fundamentally healthy municipality

Duke University School of Law (Nov. 19, 2000) (on file with *Duke Law Journal*) (observing that, where, as in the United Kingdom, the central government has “national uniform legislation controlling local government and a national government with a strong economic interest in preventing the occurrence of any default . . . default by any local government [is] liable to increase the costs of borrowing by all”). On the other hand, recent United Kingdom experience with municipal defaults on “huge debts” arising out of nonconventional financial transactions, such as interest rate swaps—where such defaults resulted from court decisions that municipalities are not authorized to enter into such transactions, and therefore their obligations thereunder are “ultra vires and invalid”—only “affected interest rates on local loans.” *Id.*

184. Cf. Schwarcz, *supra* note 26, at 994 n.216 (arguing in a sovereign debt restructuring context that providing assistance to the world’s poorest countries would not increase moral hazard).

185. See HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE 1244 (5th ed. 1998) (“If . . . the contagion were irrational (like a bank run panic), the IMF [International Monetary Fund] should lend funds as international lender of last resort. Once the runs stopped, the loans could be repaid.”); Schwarcz, *supra* note 26, at 995–96 (presenting the same argument for sovereign debt restructuring).

186. Schwarcz, *supra* note 26, at 996.

187. *Id.*

188. Professor Hildreth observes that this “is what happened in Cleveland, Ohio [when] [b]ankers would not roll-over maturing notes,” triggering a default. Letter from W. Bartley Hildreth to Steven L. Schwarcz, *supra* note 162, at 2. As a young attorney, I observed a similar problem. In 1975, the City of New York was close to default, creating general concern in the municipal financial markets. As a result, the county of Monroe, New York, was unable to sell revenue anticipation notes, the proceeds of which were intended to repay maturing notes, and it

will be able to repay them, central government liquidity would help to forestall this panicked response.

4. *Executory Contracts.* Section 365 of the Code permits a debtor to assume or reject certain executory contracts¹⁸⁹ and leases, subject to court approval.¹⁹⁰ This provision fosters debtor rehabilitation by allowing the debtor to choose between continued performance of beneficial contracts and termination of burdensome contracts.¹⁹¹ In the latter case, a debtor that rejects the contract or lease is deemed to breach that contract as of the date immediately preceding the bankruptcy petition.¹⁹² Accordingly, any claim arising out of the breach is treated as a pre-petition, and therefore nonpriority, claim, which is pari passu with other pre-petition claims against the debtor.¹⁹³ The debtor thus may be able to settle that pre-petition claim for a fraction of its face amount.¹⁹⁴

These rights are likely to be less important in a municipal than a corporate debt restructuring context. The first right—to elect to continue performance of beneficial contracts—is unnecessary in a municipal context because nothing in the Model Law would restrict a municipality from continuing to perform its contracts. The second right—to elect to terminate burdensome contracts—is also unnecessary. If a municipality terminates a contract, it typically assumes liability for damages caused by the breach.¹⁹⁵ Because the Model Law

had insufficient funds on hand to pay the maturing notes. The county only narrowly avoided default by persuading investment banks to underwrite a sale of its revenue anticipation notes.

189. A contract is executory where “the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

190. 11 U.S.C. § 365(a) (2000).

191. David S. Kupetz, *The Bankruptcy Code Is Part of Every Contract: Minimizing the Impact of Chapter 11 on the Non-Debtor’s Bargain*, 54 BUS. LAW. 55, 61 (1998).

192. 11 U.S.C. § 365(g)(1).

193. *Id.* (assuming such other claims are unsecured); *see also id.* § 726(a) (describing the order of distribution of claims).

194. “[I]n the United States, general unsecured creditors can expect to receive nothing in bankruptcy 80% of the time and an average of 4–5 cents on the dollar 20% of the time.” Schwarcz, *supra* note 169, at 455 n.130 (quoting Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 886 n.107 (1996)).

195. This result not only obtains under United States law, *see* RESTATEMENT (SECOND) OF CONTRACTS §§ 235, 346 (1981) (setting forth the general principle of breach upon nonperformance of a contract and describing the right to damages), but also under international law principles, *see* UNIDROIT Principles Arts. 7.1.1, 7.4.1 (defining nonperformance and explaining the

does not give priority to such a claim for breach, a municipality's liability for contract breach would be *pari passu* with other nonpriority claims against the municipality. This mirrors the result under § 365, whereby a corporate debtor's liability for contract breach would be *pari passu* with other nonpriority claims against the corporation.¹⁹⁶ Thus, § 365's primary benefit to a corporate debtor—the ability to terminate a burdensome contract without incurring a priority claim—is unnecessary in a municipal debt restructuring context.¹⁹⁷

5. *Discharge.* Sections 524, 727, and 1141 of the Code address the discharge, or nullification, of a corporation's debts.¹⁹⁸ Corporate debtors that are liquidated are not discharged from their debts.¹⁹⁹ The rationale for disallowing discharge is that the corporate form is artificial, and hence assets should be reapplied to their highest uses.²⁰⁰ The Code discharges reorganized corporate debtors, however, from debts

right to damages); OSCAR SCHACHTER, *INTERNATIONAL LAW IN THEORY AND PRACTICE* 311 (1991) ("It can now be said that it is widely agreed that a breach of a contract by a State in itself is not a violation of international law. . . . A private party does not obtain remedies on the international law level against a State that has breached the contract.").

196. See 11 U.S.C. § 365 (g)(1) (incorporated by reference under 11 U.S.C. § 901(a)) (treating claims of parties whose executory contracts are rejected as pre-petition, and therefore nonpriority, claims). One reviewer has expressed skepticism about this Article's treatment of executory contracts, arguing that "[o]ne of the major issues that faces a locality in distress, at least in the United States, is likely to be the state of its contracts with municipal employees, especially if they are unionized. This was a major issue in the 1970s when Chapter 9 was being rewritten." E-mail from Clayton P. Gillette to Steven L. Schwarcz, *supra* note 54, at 2. However, because the Model Law does not give priority to contract claims, it effectively treats such contracts *the same* as they are treated under Chapter 9—as contracts that can be breached without incurring a priority claim.

197. From the standpoint of the framework I use to test the other Code sections, the right to assume or reject executory contracts does not affect the outcome of the analysis, and therefore is generally neutral. This right could, however, marginally increase the need for adjudicatory discretion. See *Orion Pictures Corp. v. Showtime Networks*, 4 F.3d 1095, 1099 (2d Cir. 1993) ("In reviewing a trustee's or debtor-in-possession's decision to assume an executory contract . . . a bankruptcy court sits as an overseer of the wisdom with which the bankruptcy estate's property is being managed by the trustee or debtor-in-possession . . ."); Warren, *supra* note 128, at 352 (discussing the discretion of bankruptcy courts to decide whether to permit a debtor to assume executory contracts). The right is neutral from the standpoints of the collective action problem and allocating the burden.

198. 11 U.S.C. §§ 524, 727, 1141.

199. See *id.* § 727(a)(1) (prohibiting the discharge of non-individual debtors in liquidation).

200. See, e.g., Douglas G. Baird, *A World Without Bankruptcy*, 50 *LAW & CONTEMP. PROBS.* 173, 182–83 (Spring 1987) (explaining the priority of claims among a corporation's respective stakeholders upon dissolution of the corporation).

that are not provided for in the plan of reorganization.²⁰¹ The rationale is that “the debtor corporation . . . may continue in business after confirmation of the plan. If its debts were not discharged, typically it would immediately be in financial distress.”²⁰² For the same reason, the Code discharges United States municipal governments from all debts except those provided for in the plan of reorganization.²⁰³

By analogy, any proposal for municipal debt restructuring under the Model Law should discharge the municipality—which, after all, does not liquidate—from debts that are not provided for in its restructuring plan. Discharge would be neutral from the standpoint of collective action, and would allocate a greater portion of the restructuring burden to the municipality’s creditors. Discharge also would significantly facilitate a municipality’s economic rehabilitation by permitting a municipality that is greatly overburdened with debt to attempt to cancel at least a portion of those debts.

The arguments against discharge appear to be minor. It might seem that a process of discharge would require adjudicatory discretion,²⁰⁴ but that discretion arises primarily in the case of an individual debtor, not a corporate or municipal one.²⁰⁵ It also might seem that discharge would undermine significantly the pre-restructuring incentives of creditors. Creditors would be protected, however, by the requirement of supermajority voting by classes of claims which, I later show, gives veto power to each voting class, thereby preventing a municipality from devising a plan to harm creditors.²⁰⁶ Indeed, the same

201. See 11 U.S.C. § 1141(d) (discharging only those debts not provided for in the plan of reorganization).

202. SCARBERRY ET AL., *supra* note 77, at 956.

203. 11 U.S.C. § 944(b), (c). Section 901(a) also makes § 524(a)(1) and (a)(2) applicable to municipal bankruptcies by reference. There is a technical difference between corporate discharge and municipal discharge: the former binds all creditors, whereas the latter does not bind creditors that “had neither notice nor actual knowledge of the [bankruptcy] case.” *Id.* § 944(c)(2). I have not found any clear rationale for this distinction, and favor the former result because it fosters economic rehabilitation and provides an incentive for creditors to monitor troubled municipalities.

204. The questions of whether a debtor should apply its assets to payment of creditor claims before discharge and, if so, which assets should be applied, can be controversial. See, e.g., *id.* §§ 522, 523 (listing exemptions and exceptions to discharge).

205. See *id.* § 522(b) (restricting exemptions to individual debtors); *id.* § 523(a) (restricting exceptions to discharge to individual debtors).

206. See *infra* notes 227–41 and accompanying text (discussing supermajority voting by classes of claims). One therefore can view discharge as a corollary of the supermajority voting requirement: there would be no need for this voting requirement if creditors were paid in full. See also 11 U.S.C. § 1126(f) (deeming creditors who are paid in full under a plan to have accepted the plan).

rationale justifies corporate discharge.²⁰⁷ The Model Law therefore should discharge debts not provided for in an approved plan.²⁰⁸

6. *Avoiding Powers.* Sections 547 and 549 of the Code address the avoidance of preferential payments and other transfers under certain circumstances.²⁰⁹ Should preferential payments by troubled municipalities also be subject to avoidance? To analyze this question, one must distinguish between payments made prior to and during the proceeding in question. In a corporate context, payments made prior to the filing of a bankruptcy petition are governed by § 547.²¹⁰ The municipal analogy would be to payments made prior to the commencement of a debt restructuring proceeding. In a corporate context, payments made during the bankruptcy case are governed by § 549.²¹¹ The municipal analogy would be to payments made during the debt restructuring proceeding. In conformity with common corporate bankruptcy usage, I will refer to all such prior payments as pre-petition payments, and to all such later payments as post-petition payments.

The avoidance of *pre-petition* preferential payments would be neutral from the standpoints of allocation of the burden and the collective action problem.²¹² Avoidance could marginally impair economic rehabilitation by reducing the likelihood that a municipality's

207. See SCARBERRY ET AL., *supra* note 77, at 956:

Where the plan does not provide for creditors to be paid 100% of their claims, creditors may initially think that it is unfair for the chapter 11 debtor to receive a discharge of prepetition debts. However, creditors can require that all of the value of the debtor's assets be distributed to them by voting against the plan; if a class of unsecured claims does not accept the plan, then . . . the plan cannot be confirmed . . .

208. Cf. Kordana, *supra* note 62, at 1038–39, 1090, 1096–99 (favoring the discharge of bankrupt municipalities on the basis that investors are wealthier than average municipal citizens and are able to diversify their investments).

209. 11 U.S.C. §§ 547, 549. Section 547(b)(4)(A) avoids payments or other transfers made by an insolvent debtor within ninety days prior to filing for bankruptcy, to the extent that such payments enable a creditor to receive more than it would be entitled to in the event of the debtor's liquidation. Section 549 is designed to avoid unauthorized payments or other transfers the debtor made while in bankruptcy.

210. *Id.* § 547(b)(4)(A).

211. *Id.* § 549(a)(1).

212. Avoidance of pre-petition payments is directed at allocating the burden *among creditors*, to ensure equality of distribution; in contrast, this Article focuses on allocating the burden as between creditors, on the one hand, and the municipality and the central government, on the other hand.

suppliers of goods and services will extend trade credit.²¹³ It also would increase the need for adjudicatory discretion when deciding which pre-petition payments to avoid, and it would impair pre-restructuring incentives by making creditors uncertain about whether they can retain pre-petition payments. Moreover, from a policy standpoint, the need to avoid preferential payments appears less significant in a municipal than in a corporate context. The vast majority of corporate debtors in bankruptcy are liquidated,²¹⁴ in which case unpaid creditors remain unpaid. However, municipalities are not liquidated, and therefore a municipality is more likely to repay its creditors over time.²¹⁵ The Code implicitly recognizes that ultimate repayment of creditors should excuse avoidance of an otherwise preferential payment.²¹⁶ I therefore propose that the Model Law need not avoid pre-petition preferential payments.

The avoidance of *post-petition* preferential payments²¹⁷ would be neutral from the standpoints of allocation of the burden and pre-restructuring incentives. It would marginally reduce the post-petition collective action problem by discouraging creditors from attempting to gain an advantage over other creditors. To that extent, however, such avoidance would marginally impair economic rehabilitation by preventing a municipality from using a divide-and-conquer tactic of paying creditors that agree to the municipality's debt restructuring

213. To address this concern, § 547(c)(2) of the Code provides that preferential pre-petition payments made to corporate debtors in the ordinary course of business, and on ordinary business terms, cannot be avoided. *Id.* § 547(c)(2). This exception, however, is the subject of much litigation. *See, e.g.*, Jeff Bohm & David B. Young, *Preferences and Fraudulent Transfers: A Lender's Perspective*, in 2 18TH ANNUAL CURRENT DEVELOPMENTS IN BANKRUPTCY AND REORGANIZATION 95, 142 (1996) ("One of the most frequently litigated defenses to a preference action is the ordinary course of business exception established by 11 U.S.C. § 547(c)(2)."). Therefore, its adoption would significantly increase the need to exercise adjudicatory discretion.

214. *See* CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* 2 (1997) ("The most common type of bankruptcy case is a liquidation bankruptcy case . . .").

215. Because Article 7(1) of the Model Law permits discharge, there is no assurance that a municipality's creditors always will be repaid. Model Law art. 7(1), *infra* Appendix. Any discount on payment will be subject, however, to supermajority voting of the municipality's creditors. *See infra* notes 238–41 and accompanying text. Thus, creditors always will be repaid unless they *voluntarily* agree, voting on a class by class basis, to a discount (assuming, of course, that any securities exchanged for debt as part of a restructuring plan yield their anticipated value).

216. *See* 11 U.S.C. § 547(b)(3) (allowing a solvent debtor to make preferential payments).

217. Technically, § 549 permits a debtor to avoid any unauthorized post-petition payment, whether or not that payment is preferential. *Id.* § 549. The real goal of that section, however, appears to be to avoid preferential or fraudulent post-petition transfers. *Cf.* 5 COLLIER, *supra* note 133, ¶ 549.02, at 549-5 (stating that the section's purpose is to allow avoidance of transfers that would deplete the estate).

conditions. Furthermore, it would increase the need for adjudicatory discretion when deciding which post-petition payments to avoid.²¹⁸ One can argue that avoiding post-petition preferential payments enhances economic rehabilitation by preventing a municipality from using the proceeds of priority new money credit to repay existing creditors, thereby preventing the transfer of wealth to those creditors at the cost of reducing the municipality's liquidity.²¹⁹ However, a rational municipality would not choose to squander its liquidity by repaying existing creditors.²²⁰ Finally, from a policy standpoint, municipalities are more likely than corporate debtors to repay creditors,²²¹ again making avoidance of post-petition preferential payments less important in a municipal than a corporate context. I therefore conclude that the Model Law need not avoid either pre- or post-petition preferential payments.

7. *Creditors' Committees.* Section 1102 of the Code authorizes the appointment of at least one committee of creditors holding unsecured claims that are "representative of the different kinds of claims to be represented."²²² The costs and expenses of committee members are paid from the debtor's estate.²²³ The purpose of the committees is to make the representation of creditors in the reorganization process economically feasible, because few creditors would have claims large enough to justify the cost of participating on an individual basis.²²⁴

218. See, e.g., 5 COLLIER, *supra* note 133, ¶ 549.05, at 549-11 (discussing protection of post-petition transfers).

219. See *supra* notes 161-69 and accompanying text (discussing the importance of priority new money credit).

220. A municipality might, however, repay creditors if doing so would enable the municipality to meet its remaining commitments over the long term and thereby avoid a liquidity crisis—a strategy that can enhance the municipality's economic rehabilitation. Reputational concerns about the reaction of the unpaid creditors should similarly influence the municipality to avoid selective repayment of existing creditors.

221. See *supra* notes 214-15 and accompanying text (observing that the vast majority of corporate debtors in bankruptcy are liquidated, in which case unpaid creditors will remain unpaid, whereas municipalities are not liquidated, and therefore that creditors are more likely to be repaid over time).

222. 11 U.S.C. § 1102(b)(1) (2000).

223. *Id.* § 503(b)(3)(F) (providing for the payment of the actual and necessary expenses, other than compensation, that committee members incur in the performance of the committee's duties).

224. Because of this role, the committee has the right to retain the expertise of attorneys, accountants, or other agents such as investment bankers. *Id.* § 1103(a). These experts' costs are paid from the debtor's estate. *Id.* § 328(a).

Official creditors' committees do not appear to be as necessary for municipal debt restructuring proceedings. The appointment of a committee would be neutral from the standpoints of collective action and burden allocation and might even foster economic rehabilitation by institutionalizing creditor involvement in the debt restructuring. Such appointment, however, would affect pre-restructuring incentives by increasing administration costs, perhaps significantly,²²⁵ and also would increase the need for adjudicatory discretion in appointing the committee and monitoring the reasonableness of its ongoing costs and expenses. Official committees also would appear unnecessary to the extent that claims against a municipality are sufficiently large that many creditors, or at least a de facto committee of creditors chosen consensually, should find it economically feasible to participate in the restructuring process. Finally, perhaps the most obvious function of a creditors' committee, monitoring of overinvestment, could be effectively performed by the central government.²²⁶

Thus, the Model Law does not provide for the formal appointment of committees. I do not, however, reject out of hand the potential need for these committees, because circumstances sometimes might warrant them. In those cases, the central government could decide to create committees as needed.

8. *Supermajority Voting.* Sections 1123, 1126, and 1129 of the Code govern the contents, acceptance, and court confirmation of the debtor's reorganization plan.²²⁷ Section 1126(c) provides for a form of supermajority voting that supersedes contractual or statutory voting restrictions. For example, loans often are made by groups, or syndicates, of institutional lenders such as banks or insurance companies.²²⁸ These loan agreements typically require unanimous consent of the lenders to alter essential lending terms such as the amount of principal, the rate of interest, or the maturity schedule.²²⁹ Section 1126(c) overcomes this collective action problem by providing that an affirmative vote by creditors holding "at least two-thirds in amount and

225. The debtor typically pays these costs in priority to creditors' claims. *Id.* § 507(a) (granting priority to such claims over general unsecured claims).

226. *See supra* note 177 and accompanying text.

227. 11 U.S.C. §§ 1123, 1126, 1129.

228. *See* Joseph J. Norton, *International Syndicated Lending: The Legal Context for Economic Development in Latin America*, NAFTA: L. & BUS. REV. AM., Summer 1996, at 21, 21-24.

229. Eichengreen & Portes, *supra* note 132, at 26.

more than one-half in number” of the claims binds *all* creditors—even those who vote negatively or fail to vote.²³⁰ In contrast, subnational debt restructurings that change essential lending terms still require unanimous creditor approval,²³¹ which is difficult and sometimes impossible to achieve.

In recent years, this problem has become even more intractable as public bond issues constitute an increasing share of municipal borrowings.²³² Bondholders that invest in a particular municipality tend to have smaller individual investments and to be more numerous than banks that lend to the same municipality.²³³ Bondholders also are less likely than banks to be accommodating in order to maintain a commercial relationship with the municipality.²³⁴ Moreover, because bonds are actively traded, the identity of bondholders constantly changes.²³⁵ All this makes the required unanimous bondholder consent much more difficult to obtain.²³⁶ Solving the collective action

230. 11 U.S.C. § 1126(c); cf. TABB, *supra* note 214, at 7 (observing that “[o]ne primary reason that workouts do not succeed [outside of bankruptcy] is that dissenting creditors cannot be bound to the restructuring agreement”).

231. Although a municipality could attempt to settle with creditors individually notwithstanding their contractual protection of unanimity, that settlement would not bind holdout creditors, who could then sue the municipality on the original claims. See *infra* note 292 (discussing *Allied Bank International v. Banco Credito Agricola de Cartago*, 757 F.2d 516 (2d Cir. 1985), in which a member of a bank syndicate that refused to join a restructuring agreement successfully sued for repayment of its defaulted loan). The right of holdout creditors to recover their original claims could, in turn, undermine the willingness of other creditors to settle their claims.

232. See *supra* note 9.

233. See Ruth Rosauer, *Emerging Market Debt Instruments Play Siren Song for Pension Plans*, 7 MINN. J. GLOBAL TRADE 211, 225 & n.123 (1998). Bondholders therefore will find it more difficult to achieve the type of creditor solidarity that banks sometimes achieve. See Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1193 (1991) (“[B]ank debt restructurings . . . are substantially easier to organize than public debt [i.e., bond] restructurings.”).

234. Cf. Neela Banerjee, *Russian Arrears Deepening on Debts to Foreign Group*, N.Y. TIMES, June 1, 1999, at C3 (discussing, in a sovereign debt context, the conflict of interest between investors who increasingly want to vote to accelerate the debt and bank lenders who “want future business with Russia” and therefore “may be unwilling to pressure the Government on the [debt] arrears”).

235. See, e.g., Enrique R. Carrasco & Randall Thomas, *Encouraging Relational Investment and Controlling Portfolio Investment in Developing Countries in the Aftermath of the Mexican Financial Crisis*, 34 COLUM. J. TRANSNAT’L L. 539, 542 n.3 (1996) (noting the highly volatile nature of portfolio investments).

236. See 15 U.S.C. § 77ppp(b) (2000) (requiring the consent of the holder of an indenture security for changes in payment terms); see also Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 250–51 (1987) (discussing the prohibition of “modification by majority action of any core term of the bond”). Bondholders who are not institutional investors

problem is therefore essential to successful subnational debt restructuring.

Supermajority voting can solve this problem. This voting scheme is neutral from the standpoint of allocation of the burden. It fosters economic rehabilitation to the extent it permits a municipality and its creditors to agree more rationally on a debt restructuring plan. It also can be applied without exercising adjudicatory discretion. The only potential drawback under the framework is that supermajority voting would affect pre-restructuring incentives by modifying voting procedures that require unanimity. However, that impact should be economically insignificant if, as under the Code, the supermajority voting is done by classes of claims that are “substantially similar to the other claims . . . of such class.”²³⁷ Rationally, a supermajority of claimants will not vote for a plan unless they believe that, on balance, the plan benefits their claims; and any plan that benefits their claims should similarly benefit holders of substantially similar claims. Thus, the supermajority vote should benefit all claimants in the class.²³⁸ The Model Law therefore should provide for supermajority voting that binds all parties.

A discussion of how the Model Law should divide claims into classes for supermajority voting purposes is beyond the scope of this Article. I simply note here that courts have interpreted substantial similarity under the Code to mean that claims in a class have the same priority in bankruptcy.²³⁹ Nonetheless, the Code does not require that all claims of the same priority be classed together; it merely prohibits claims from being classed together unless they have the same priority.²⁴⁰ Thus, *pari passu* claims could be classed separately if there were

also may be more willing than banks (which maintain ongoing institutional relationships with each other) to hold out for a special deal.

237. 11 U.S.C. § 1122(a); *see also id.* § 1126(c) (requiring voting by classes of claims).

238. *Cf.* Barbara J. Houser et al., *Plan Issues: Classification, Impairment, Subordination Agreements*, in CHAPTER 11 BUSINESS REORGANIZATIONS 317, 328 (1998) (noting that the proper classification of claims ensures that voting on the plan will result in an equitable distribution among creditors).

239. *See, e.g., In re Bloomingdale Partners*, 170 B.R. 984, 998 (Bankr. N.D. Ill. 1994) (holding that a tort-based claim is substantially similar to a contract-based claim for purposes of plan classification).

240. *See In re Mastercraft Record Plating, Inc.*, 32 B.R. 106, 108 (Bankr. S.D.N.Y. 1983) (“Claims are to be placed in the same class only if the claim is substantially similar to other claims.”), *rev'd on other grounds*, 39 B.R. 654 (S.D.N.Y. 1984).

a rationale for separate classification, but this would give each separate class the ability to veto a plan.²⁴¹

9. *Cramdown*. Finally, § 1129 of the Code sets the standards for confirmation of a restructuring plan.²⁴² Most significantly, it implements the supermajority voting provisions of § 1126 by requiring acceptance of the plan by each class of claims.²⁴³ However, § 1129 also recognizes that a class of claims might sometimes vote to reject the plan, and therefore it provides an exception: the plan still may be confirmed if creditors in each class receive value under the plan equal to the amount of their claims, or if creditors whose claims are junior in priority receive nothing.²⁴⁴ This rule is referred to as “cramdown,”²⁴⁵ and incorporates the principle of absolute priority.²⁴⁶

Cramdown indirectly provides creditors with an incentive to reach agreement on a plan. In order to confirm a cramdown plan, it is necessary to value the debtor as a going concern to ensure that distri-

241. Section 1129 of the Code implements the supermajority voting provisions by requiring acceptance of the plan by *each* class of claims. 11 U.S.C. § 1129(a)(8). A municipality therefore could not prejudice foreign creditors by classifying them separately.

242. *Id.* § 1129.

243. *Id.* § 1129(a)(8). To some extent, § 1129(a)(7)(A) protects objecting creditors whose class has accepted the plan by supermajority voting. This subsection requires that objecting creditors receive value under the plan at least equal to the amount they would receive if the debtor were liquidated and its assets distributed according to the absolute priority rule. Because municipalities are not liquidated and have an indeterminate liquidation value, I do not propose that objecting creditors of municipalities receive the same protection. Rather, they must rely on the fairness of the classification of their claims. *See supra* notes 237–41 and accompanying text (discussing classifications of claims for voting purposes).

244. 11 U.S.C. § 1129(b).

245. *See generally* Steven L. Schwarcz, *Basics of Business Reorganization in Bankruptcy*, J. COM. BANK LENDING, Nov. 1985, at 36, 43–44 (discussing the cramdown valuation costs that parties can avoid by a consensual plan). Professor Baird describes cramdown as the “most important” right in the event that consensual agreement cannot be reached. BAIRD, *supra* note 156, at 18.

246. Absolute priority mandates the distribution of a liquidating debtor’s estate in accordance with the strict priority of claims. *See* 11 U.S.C. § 726 (mandating the order in which “property of the estate” is to be distributed). Confirmation of a plan of reorganization under Chapter 11 does not, however, require absolute priority except to the extent that it is incorporated through cramdown. Absolute priority is dispensed with elsewhere to maximize flexibility when negotiating a plan of reorganization. Increased flexibility makes it easier to reach a successful plan and thereby preserve the debtor’s value as a going concern. *See, e.g., In re Atlas Pipeline Corp.*, 39 F. Supp. 846, 848 (W.D. La. 1941) (“If it is probable that the plan will realize a greater portion of the equity of any class of creditors in the assets of the corporation, then this is a sufficient consideration for the sacrifices that may be made to that end.”).

butions are made in accordance with the absolute priority rule.²⁴⁷ That valuation, however, entails some cost and delay.²⁴⁸ Consequently, senior creditors may be willing to “give something to [junior creditors], enough to gain [their] consent and avoid cramdown.”²⁴⁹ Moreover, “[v]aluation of the company is something that sophisticated participants in any significant chapter 11 reorganization avidly desire to avoid.”²⁵⁰

A cramdown rule may not be appropriate for subnational debt restructuring, however. Notwithstanding its possible benefits,²⁵¹ the rule would be extremely difficult to apply to municipalities.²⁵² Valuation of a corporation as a going concern is complex, but it nonetheless is feasible.²⁵³ However, merely conceiving of a method by which to value a municipality is difficult.²⁵⁴ Any attempted valuation therefore would be inherently speculative and likely to generate costly disputes and protracted litigation. Thus, the threat of invoking cramdown would lack credibility, and creditors would have little incentive to reach a consensual plan solely to avoid that threat.

A potentially simplifying but flawed assumption exists, however, that would make valuation of municipalities possible, and therefore would make cramdown feasible as well. Unlike a corporation, a municipality has the power to tax its citizens. One therefore might assume that a municipality can always generate sufficient tax income in the future to pay its claims over time. That assumption is problematic,

247. Schwarcz, *supra* note 245, at 43; see also Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441, 441–42 (1984) (describing the absolute priority rule and its effect on secured creditors, unsecured creditors, and equity holders).

248. See Broude, *supra* note 247, at 453 (describing some of the “difficulties of valuation”).

249. *Id.*

250. *Id.* at 454.

251. A cramdown rule would minimize the collective action problem and foster economic rehabilitation by creating an incentive for creditors and the municipality to reach agreement on a restructuring plan, in order to avoid a valuation of the municipality.

252. See McConnell & Picker, *supra* note 24, at 464–65 (concluding that the incorporation of cramdown into municipal bankruptcy law is ineffectual).

253. See generally Peter V. Pantaleo & Barry W. Ridings, *Reorganization Value*, 51 BUS. LAW. 419 (1996) (discussing the complexities of valuing companies in cramdowns).

254. Kordana, *supra* note 62, at 1057 (concluding that it is problematic “to apply the absolute priority rule to a bankrupt municipality”). Even the extent to which the valuation should take into account a municipality’s power to tax its citizens is unclear. See McConnell & Picker, *supra* note 24, at 466–67 (discussing the uncertainty of whether, and to what extent, a bankrupt municipality’s valuation should include potential tax revenues).

though, because at some point an increase in the tax rate will cease to raise tax revenues.²⁵⁵

Furthermore, a cramdown rule based on that assumption would invite abuse. The municipality would be able to cram down, over creditor objections, a restructuring plan that pays creditors in full according to debt maturities that are extended over time.²⁵⁶ Such a plan would adversely affect pre-restructuring incentives. This abuse does not occur in a corporate context because cramdown then is a double-edged sword: it harms the corporation's shareholders as well as its creditors.²⁵⁷ Hence, a debtor whose managers often own stock will be reluctant to impose a cramdown plan if there is any realistic chance of a negotiated settlement. This reluctance stems from the fact that, in such a settlement, shareholder claims always receive some recovery in order to induce shareholders to accept the settlement.²⁵⁸ In contrast, a municipality has no true residual claimants who would lose in a cramdown.²⁵⁹

Theoretically, one could minimize the potential for abuse by imposing restrictions on cramdown, such as permitting its use only when the municipality is unable to pay its debts and negotiations to consensually restructure those debts have failed. These restrictions, however, would add considerable uncertainty to the restructuring process and would expand greatly the need to exercise adjudicatory discretion. One also must place the need for a cramdown provision into

255. A tax increase may even reduce economic output. See McConnell & Picker, *supra* note 24, at 466 (discussing the difficulty of "identifying the tax-maximization point on this implicit 'Laffer Curve'").

256. My analysis assumes that debtors will make payments on a present-value basis; otherwise, the adverse impact on creditors will be even greater.

257. If the corporate debtor is insolvent, its shareholders, being the most junior claimants, will receive nothing. In contrast, if the corporate debtor is solvent, potential litigation costs arising out of a cramdown would reduce the recovery to shareholders before affecting any creditors. Schwarcz, *supra* note 245, at 43–44.

258. *Id.*

259. Cf. McConnell & Picker, *supra* note 24, at 465 (concluding that, in a municipal bankruptcy context, "[t]he incorporated Chapter 11 cramdown standard is . . . of cold comfort to unsecured creditors," and asserting that unsecured creditors "would instead look for protection to § 943(b)(7), which requires the court to determine that the plan is in the 'best interests of creditors and is feasible'"). However, even the requirement that objecting creditors receive at least as much from the plan as they would receive in a liquidation of the debtor under Chapter 7 "could not be the standard under Chapter 9 because municipalities are not liquidated in bankruptcy." *Id.* Some courts therefore have reinterpreted the best-interests test to simply require that creditors receive all they could reasonably expect under the circumstances. *Id.* at 465–66. This re-interpretation, "however, leaves considerable room for judicial discretion and municipal gamesmanship." *Id.* at 466.

perspective: the Model Law's goal is not necessarily to eliminate problems inherent in municipal debt restructuring, but to mitigate those problems. From that perspective, even if the absence of a cramdown provision means that consensual agreements cannot always be reached, the Model Law will accomplish its goal if, through supermajority voting, it makes consensual agreements more feasible. Accordingly, I propose that the Model Law not include a cramdown provision.

Proposed Model Law: In summary, I propose that the Model Law comprise the following rules: (1) only a municipality itself, and not its creditors, may commence the debt restructuring proceeding, and it must do so in good faith;²⁶⁰ (2) commencement of such a proceeding automatically stays recovery of all then-existing claims against the municipality,²⁶¹ but (for reasons I discuss in this Article)²⁶² interest will continue to accrue on creditor claims;²⁶³ (3) financiers of the municipality's debt restructuring have priority over claims of other creditors,²⁶⁴ but the central government may scrutinize and object to an excessive amount of new priority financing and condition and monitor its use as appropriate to prevent overinvestment;²⁶⁵ (4) all creditors are bound to a debt restructuring plan that is agreed to by supermajority voting by classes of claims,²⁶⁶ and, upon such agreement, debts not provided for in the plan are discharged;²⁶⁷ and (5) the central government may dismiss the debt restructuring proceeding for cause, such as bad faith or unreasonable delay in reaching a plan.²⁶⁸

Implicit in these rules lies the assumption that the central government will allow the market to work and generally will not act as lender of last resort to the municipality. Nonetheless, the central government might consider acting as a lender of last resort where the municipality either is too poor even to attempt to impose austerity measures or where the municipality has been economically and fis-

260. Model Law art. 3(1)–(2), *infra* Appendix.

261. Model Law art. 3(3), *infra* Appendix.

262. See *infra* note 282 and accompanying text (explaining that interest should continue to accrue to prevent a solvent municipality from using a debt restructuring proceeding simply to save costs).

263. Model Law art. 3(4), *infra* Appendix.

264. Model Law art. 9, *infra* Appendix.

265. Model Law art. 8, *infra* Appendix.

266. Model Law art. 7, *infra* Appendix.

267. Model Law art. 7(1), *infra* Appendix.

268. Model Law arts. 3(2), 7(4), *infra* Appendix.

cally prudent but the factors causing default are largely exogenous, such as a financial markets panic.

In the Appendix, I propose a possible text of this Model Law. I do not claim this model is the only, or even the best, model logically consistent with the framework; it is merely a rational model that exhibits this consistency. Another model, for example, might adopt a “menu approach,” making the rules optional in order to permit the municipality to pick and choose.²⁶⁹ It also should be reiterated that the Model Law is intended only as a set of provisions that might form the basis of a national law, assuming that the law also will be informed by considerations of the local political and legal culture.²⁷⁰ The primary goal of this Article is not to propose definitive rules but, rather, to illustrate the importance of imposing conceptually sound rules on sub-national debt restructuring to address existing problems.

To this end, I next consider how the Model Law could be implemented.

C. *Implementing the Model Law*

Implementing the Model Law raises at least three issues: (1) how the Model Law should bind a municipality’s creditors, (2) how the Model Law should be administered, and (3) how questions arising under the Model Law should be adjudicated.

1. *Binding Creditors.* Enactment of the Model Law into national law would, by definition in at least most national legal systems,²⁷¹ bind a nation’s municipalities and their future domestic creditors. To the extent the municipality’s national law governs contracts

269. Professor Rasmussen partly inspired a menu approach when he first observed, in the context of corporate bankruptcy, that a one-size-fits-all rule is inefficient where bankruptcy covers a wide range of companies and creditors. Robert K. Rasmussen, *Debtor’s Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 66–67 (1992) (arguing that companies should be able to choose from a menu of standardized bankruptcy options at the time they are formed). For example, binding creditors to supermajority voting could anger dissenting creditors whose rights and remedies, but for the law, could not be affected without their consent. A municipality may want the right to decide whether the benefits of this provision outweigh its costs. A menu approach, however, is likely to generate high transaction costs. *See id.* at 100–21 (discussing the menu approach and addressing potential problems with this scheme). For a discussion of how a menu approach might be applied, see Schwarcz, *supra* note 26, at 1010 n.317.

270. *See supra* notes 67–69 and accompanying text.

271. The only exception might occur in a federal law system where national law does not necessarily trump local law.

and instruments under which the municipality incurs debt,²⁷² future foreign creditors also would be bound.²⁷³ An issue might arise, however, whether enactment of the Model Law into national law could be retroactively applied so as to bind existing creditors. This issue is important because any debt restructuring law needs to address existing creditor rights in order to “provide relief to troubled debtors with respect to preexisting obligations.”²⁷⁴

Even where legal retroactivity might appear controversial under a nation’s laws, the nation presumably could decide, subject to any constitutional limitations, to apply a law retroactively to domestic creditors. The more difficult question concerns foreign creditors. Under international law, however, retroactivity is permitted so long as it is neither discriminatory nor arbitrary.²⁷⁵ None of the substantive provisions of the Model Law—the automatic stay, supermajority voting, discharge, and the granting of priority to financiers of the municipal-

272. This would occur where the debt contract states that it is governed by such national law, and even arguably where the debt contract fails to state its governing law. In the latter case, international choice of law principles provide that a sovereign entity “cannot be presumed to have made the substance of its debt and the validity of the obligations accepted by it in respect thereof, subject to any other law than its own.” Concerning the Payment of Various Serbian Loans Issued in France (Fr. v. Serb.), 1929 P.C.I.J. (ser. A) No. 14, at 42 (July 12); Concerning the Payment in Gold of the Brazilian Federal Loans Issued in France (Fr. v. Braz.), 1929 P.C.I.J. (ser. A) No. 15, at 121 (July 12); see also Derek W. Bowett, *Claims Between States and Private Entities: The Twilight Zone of International Law*, 35 CATH. U. L. REV. 929, 931–32 (1986) (noting the difficulty of rebutting the presumption that the law that the contract has the closest connection to is the law of the contracting state party); Rainer Geiger, *The Unilateral Change of Economic Development Agreements*, 23 INT’L & COMP. L.Q. 73, 80 (1974) (referring to contracts between a nation and foreign private investors and observing that if contracting parties do not refer to a particular legal system, “the contract, as a general rule, will be governed by the internal law of the host state”). But cf. Michael E. Dickstein, *Revitalizing the International Law Governing Concession Agreements*, 6 INT’L TAX & BUS. LAW. 54, 65–67 (1988) (asserting that an increasing number of concession contracts have recently been found to be “internationalized,” i.e., not subject to the law of the contracting nation). Noncontractual creditors, such as tort creditors, are likely to be domestic and thus will be bound by national law. And, in a federal system where subnational law is stated to govern a debt contract, this analysis assumes that national law is nonetheless chosen to govern matters of debt restructuring. For an analysis of the case where the municipality’s national law does not govern the debt contract, see *infra* notes 285–93 and accompanying text.

273. Where national law does not govern such debt contracts, see *infra* note 286 and accompanying text.

274. TABB, *supra* note 214, at 680–81 (“It is a familiar canon of statutory construction that statutes normally only operate prospectively. Bankruptcy laws, however, test this canon, because by their very nature such laws usually affect the preexisting rights of creditors . . .”).

275. 1 OPPENHEIM’S INTERNATIONAL LAW 918–21 (Sir Robert Jennings & Sir Arthur Watts eds., 9th ed. 1992) (discussing retroactivity in the context of expropriation and confiscation).

ity's debt restructuring—would fail under this test. None discriminates based on the nationality of the creditors; the rights of nationals and foreigners holding claims would be affected equally. And none is arbitrary because all are essential to a municipality's ability to restructure its debt.

Where retroactivity amounts to expropriation, however, the expropriating government would be liable under international law to compensate the injured parties.²⁷⁶ Nonetheless, lawful government actions “may affect foreign interests considerably without amounting to expropriation.”²⁷⁷ For example, “foreign assets and their use may be subjected to taxation, trade restrictions involving licenses and quotas [may be imposed], or measures of devaluation” may be taken without constituting expropriation.²⁷⁸ Nondiscriminatory “taxation or other fiscal measures” also need not be compensated.²⁷⁹ Indeed, in the context of breaching a contract, only “the situation in which the state exercises its executive or legislative authority to *destroy* the contractual rights as an asset comes within the ambit of expropriation.”²⁸⁰ The rationale excusing compensation appears to be that contracting private parties should be aware of the possibility that a nation may retroactively alter its contracts by changing its national law, and therefore the private party assumes the risk of such changes occurring.²⁸¹

276. In international law, the terms “expropriation” and “confiscation” have “no precise accepted technical meaning. ‘Expropriation’ conveys in a general sense the deprivation of a former property owner of his property, and is equivalent to a ‘taking’ of property; ‘confiscation’ usually connotes an expropriation without compensation . . .” *Id.* at 916 n.9.

277. IAN BROWNLIE, *PRINCIPLES OF PUBLIC INTERNATIONAL LAW* 535 (5th ed. 1998).

278. *Id.*

279. *Id.* at 538.

280. *Id.* at 550 (emphasis added).

281. See SCHACHTER, *supra* note 195, at 311–24 (discussing the wide discretion of the state with regard to economic policy); F.V. Garcia-Amador, *State Responsibility in Case of “Stabilization” Clauses*, 2 J. TRANSNAT’L L. & POL’Y 23, 24, 33–34 (1993) (arguing that, in general, a nation may exercise its sovereign right to alter or repudiate its contractual obligations, possibly subject to constitutional limitations, and that such alteration or repudiation does not automatically constitute a breach of international law unless such a failure is confiscatory or discriminatory in nature). Stabilization clauses—under which a nation “undertakes neither to annul the agreement nor to modify its terms, either by legislation or by administrative measures”—are sometimes included in contracts to respond to this risk. BROWNLIE, *supra* note 277, at 554. However, the “legal significance of such clauses is inevitably controversial,” *id.*, and it is an unsettled question whether they are effective under international law, see, e.g., Thomas W. Waelde & George Ndi, *Stabilizing International Investment Commitments: International Law Versus Contract Interpretation*, 31 TEX. INT’L L.J. 215, 236 (1996) (noting that a stabilization clause is “an attempt to bind the state to a greater extent than a normal contract would seem to do”). In our case, the question only would become relevant as to those debt contracts that contain stabilization clauses.

Imposing the automatic stay and supermajority voting (and its corollary, discharge) and granting priority to financiers of a municipality's debt restructuring are unlikely to destroy the value of the debt claims. The stay only would suspend payment of the debt until the parties agree to the restructuring plan, and interest on that debt would continue to accrue during that period.²⁸² Regarding supermajority voting, any change in the underlying terms of the debt, such as interest rate, maturity, or even principal amount (discharge being merely a change that reduces the principal amount), would be subject to supermajority consent of the creditors.²⁸³ The only contractual right that would be destroyed is an individual creditor's right to hold out for greater gain by threatening to veto a plan desired by other creditors. But legal systems likely would not protect such an unreasonable private expectation.²⁸⁴ In the case of granting priority to financiers of the debt restructuring, I have argued that by increasing the availability of new money credit, such priority may actually increase the expected value of existing claims.²⁸⁵ Accordingly, making the Model Law retroactive would not appear to cause expropriation.

The foregoing analysis assumes that the municipality's national law governs the relevant debt contract, but that may not always be the case. For example, sophisticated foreign creditors often want the law of a major financial center, such as the United States or the United Kingdom, to apply.²⁸⁶ If such other law applies, there remains the ad-

282. I propose that interest not only accrue but that it be compounded—i.e., that creditors also receive an accrual of interest on deferred interest payments. Otherwise, a solvent municipality—and any municipality with taxing power arguably could be viewed as solvent—could use a debt restructuring proceeding simply to save costs even though simple interest continues to accrue. See *infra* notes 331–34 and accompanying text. To the extent my proposal differs from §§ 506(b) and 726(a)(5) of the Code, it is because I regard those sections as inadequate. See, e.g., Chaim Fortgang & Lawrence P. King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. REV. 1148, 1160 (1981) (arguing that, under the aforesaid Code sections, “solvent debtors could begin to use the [Code] strictly for the purpose of reducing their debt service”). In any event, whether post-petition interest ultimately will be *paid* will be a matter of negotiation for the debt restructuring plan.

283. Recall that supermajority voting gives each class of creditors veto power over a plan, and hence over discharge. See *supra* note 238 and accompanying text.

284. See also Schwarcz, *supra* note 26, at 1017 n.350 (similarly arguing that retroactively imposing supermajority voting would not constitute a “taking” under the United States Constitution).

285. See *supra* note 169 and accompanying text.

286. Christopher Greenwood & Hugh Mercer, *Considerations of International Law, in CRISIS? WHAT CRISIS?*, *supra* note 132, at 103, 106. If, of course, all such financial center nations were to enact the Model Law into their own national law, the analysis would be similar to the case where the municipality's national law governs the relevant debt contract.

ditional question of how to bind these foreign creditors to the Model Law's provisions. The answer is both theoretical and pragmatic.

Municipalities, being subnational entities, rarely own assets outside their country. Hence, any foreign creditors attempting to enforce their claims against the municipality would have to do so in the municipality's national jurisdiction. If that nation has enacted the Model Law into national law, the provisions thereof (including the automatic stay and the priority of payment given to financiers of a municipality's debt restructuring) arguably would reflect the nation's fundamental public policy of preserving the integrity of its municipal governments. Indeed, the proposed form of the Model Law explicitly articulates this public policy.²⁸⁷ Under conflict of laws principles common to most national jurisdictions, a nation is not required to apply foreign law that would result in a violation of its fundamental public policy (such as by permitting enforcement to continue notwithstanding the stay or by challenging the priority).²⁸⁸

As a practical matter, of course, foreign creditors could not actually enforce their claims against municipal assets unless the nation acquiesced. National law would impose the automatic stay, suspending the rights of those creditors.²⁸⁹ A nation that wishes to protect its municipality's assets therefore simply could refuse to allow those creditors to pursue their claims, except in accordance with the procedures set forth in the Model Law. The creditors' only remedy would be to sue the municipality. Likewise, if a foreign creditor objects to a plan

287. Model Law pmb., *infra* Appendix; *cf.* DICEY AND MORRIS ON THE CONFLICT OF LAWS 86–87 (Lawrence Collins et al. eds., 2000) [hereinafter DICEY AND MORRIS] (“There is an increasing tendency for statutes in the area of the conflict of laws to provide for the application of public policy.”).

288. *E.g.*, *Oppenheimer v. Cattermole*, [1976] A.C. 249 (H.L.) (appeal taken from Eng.); DICEY AND MORRIS, *supra* note 287, at 81–82 (arguing that “a foreign law, which is otherwise applicable . . . will not be applied or enforced in England if the law, or the result of its application, is contrary to public policy” and that this doctrine of public policy is even more prominent “in the laws of foreign countries”); PETER NORTH & J.J. FAWCETT, *CHESHIRE & NORTH’S PRIVATE INTERNATIONAL LAW* 584 (13th ed. 1999) (“In civil law countries [the concept of] *ordre public* operates as a well established exception to normal choice of law rules, as does public policy in common law jurisdictions.”). Article 16 of the Rome Convention, which establishes uniform choice of law rules for contractual obligations throughout the European Community, explicitly respects this principle, providing that “[t]he application of a rule of the law of any country specified by this Convention may be refused only if such application is manifestly incompatible with the public policy (‘*ordre public*’) of the forum.” Convention on the Law Applicable to Contractual Obligations, art. 16, 1980 O.J. (L 266).

289. Model Law art. 3(3), *infra* Appendix (describing the automatic stay's effect on creditor claims).

achieved through supermajority voting²⁹⁰ or to another creditor's new money priority, its only remedy would be to sue the municipality.

If a creditor brings the suit before an adjudicatory tribunal of the municipality's nation,²⁹¹ that tribunal simply would adhere to the rules of its national law. The foreign creditor could attempt to bypass that tribunal, perhaps by suing in a foreign court outside the municipality's nation. However, even if the foreign creditor wins that lawsuit,²⁹² its only practical remedy is to attach the municipality's foreign assets, a remedy that is meaningless in most cases. There would be no violation of public international law because the Model Law requires that foreign creditors be treated no worse than domestic creditors.²⁹³

2. *Administration.* At least in a country debt restructuring context, some scholars have assumed that a neutral entity, effectively the

290. Recall that the plan must be approved by each class of claims, including the class that includes the foreign creditor. All such claims, including those of the foreign creditor, then would be deemed modified to the extent provided by the approved plan. *See supra* note 241 and accompanying text.

291. *See infra* Part III.C.3 (arguing that disputes under the Model Law should be adjudicated by national, not international, tribunals).

292. A court might uphold the foreign creditor's claim. For example, in *Allied Bank International v. Banco Credito Agricola de Cartago*, 757 F.2d 516 (2d Cir. 1985), a member of a bank syndicate that refused to join a restructuring agreement between Costa Rican sovereign debtors and other syndicate members sued in the United States for repayment of its defaulted loan. *Id.* at 519. The court granted summary judgment in favor of the objecting bank on the basis that the loan was clearly due and payable, notwithstanding Costa Rica's law suspending its external debt payments. *Id.* at 522–23. The court held that the United States act of state doctrine, which provides that “the courts of one country will not sit in judgment on the acts of the government of another done within its own territory,” was inapplicable; the court found that the situs of the property in question—the objecting bank's right to receive payment from the Costa Rican debtors—was New York, where the debt was payable. *Id.* at 520–21. Costa Rica's suspension of debt payments was “inconsistent with the orderly resolution of international debt problems . . . [and] contrary to the interests of the United States.” *Id.* at 522. This case does not suggest, however, that an objecting creditor always will be able to work mischief. The court might have decided the case differently if the restructuring agreement were reached in accordance with a generally accepted legal approach, such as the Model Law once it is (or laws based on similar principles are) widely adopted by nations. Moreover, courts outside the United States, faced with the same facts, might reach a different outcome.

293. This follows from the Model Law's classification scheme: if foreign creditors are classified with other creditors, the foreign and other creditors *must* be treated alike in the plan; if foreign creditors are not classified with other creditors, the foreign creditors would have veto power over the plan. Model Law arts. 6(3), 7(1), *infra* Appendix. In public international law, this requirement that foreign creditors be treated no worse than domestic creditors, referred to as the principle of “national treatment,” is consistent with international law because of the high standards assured to all creditors under the scheme. *But see* BROWNIE, *supra* note 277, at 526–38 (noting that the principle of national treatment, as customary international law, has been superseded in some areas by the higher “international minimum standard”).

equivalent of a bankruptcy court, is necessary to administer the debt negotiations.²⁹⁴ In that context, however, I have shown that no such entity is needed.²⁹⁵ The experience of corporate debt restructuring confirms that the parties themselves—debtors and their creditors—do the negotiating, and that most United States bankruptcies are largely self-executing.²⁹⁶

Still, these negotiations may be self-executing because they take place in the shadow of bankruptcy law. To what extent, therefore, can we expect subnational debt negotiations to be similarly self-executing, avoiding the need to further involve the central government? To answer this, I compare the incentives for negotiation under the Code with those contemplated by the Model Law. From the debtor's standpoint under the Code,

bankruptcy [law] offers the debtor a number of powerful aids in its negotiations, notably: 1. the automatic stay and the breathing room it brings [and the motivation for creditors to negotiate a plan in order to obtain payment], 2. the possibility of adopting a plan that will legally bind all creditors even though a minority reject it, and 3. the turnover and avoiding powers, which can greatly augment the assets available and provide powerful leverage over certain creditors.²⁹⁷

The Model Law incorporates the first negotiation aid through its automatic stay and the second negotiation aid through supermajority voting. The third aid, which focuses on a bankruptcy trustee's power to avoid preferential payments to creditors and fraudulent transfers, is less important in a subnational than a business context.²⁹⁸ Hence, under the Model Law, a municipality enjoys substantially the same

294. Schwarcz, *supra* note 26, at 1018.

295. *Id.* at 1019–23.

296. Hurlock, *supra* note 156, at 12; *see also* EPSTEIN ET AL., *supra* note 155, § 10-2, at 733–34 (“[I]t would be wrong to think of the Chapter 11 process as primarily a litigated, judge-ruled adversarial process. Plans proposed and adopted in Chapter 11 almost always have been produced by negotiation, not by litigation.”). These negotiations take place in the shadow of bankruptcy law provisions discussed in this Article. *See id.* at 734 (observing that plan “negotiations go on very much in the shadow of bankruptcy law”). My Article later analyzes the phenomenon by comparing incentives for negotiation under the Code with those contemplated by the Model Law. *See infra* notes 297–306 and accompanying text.

297. ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 476 (3d ed. 1996).

298. *See supra* notes 209–21 and accompanying text (discussing §§ 547 and 549 of the Code and avoidance of preferences).

“powerful aids in its negotiations”²⁹⁹ as a corporate debtor enjoys under the Code.

The Code also provides negotiation aids for creditors. First, creditors can threaten the debtor with dismissal of the reorganization case or even liquidation if they do not reach a negotiated plan of reorganization.³⁰⁰ These threats, however—particularly the threat of liquidation—are not always compelling. Under the Code, a judge may dismiss a reorganization case or convert it to a liquidation only “for cause,” such as “continuing loss[es] . . . and [the] absence of a reasonable likelihood of rehabilitation[.]” “inability to effectuate a plan [of reorganization,]” or “unreasonable delay by the debtor that is prejudicial to the creditors.”³⁰¹ The burden of proof for showing “cause” is on the creditor moving for dismissal or conversion, not the debtor.³⁰² Even if the creditor satisfies that burden, the judge ultimately has discretion to decide whether to dismiss the case or convert it to liquidation, and judges are particularly reluctant to do the latter.³⁰³ As a result, the threat of liquidation can be unrealistic, especially for large debtors:

[Liquidation of a large company] would occur only when the bankruptcy system malfunctioned. The ordinary outcome would be for the firm to discharge its . . . debt in bankruptcy while continuing its operations. Empirical evidence shows this to have been universally the case for the past twenty years with regard to large public company bankruptcies.³⁰⁴

Thus, large public debtors, which are most analogous to subnational entities, almost always reach consensual plans in the absence of any

299. WARREN & WESTBROOK, *supra* note 297, at 476.

300. 11 U.S.C. § 1112(b) (2000); *see also* WARREN & WESTBROOK, *supra* note 297, at 477 (observing that creditors can threaten the debtor with liquidation under Chapter 7 of the Code, “even though both [sides] really want to avoid it”). Creditors also can threaten the debtor with a plan of liquidation if the debtor’s exclusive period to file a plan terminates. 11 U.S.C. § 1121(c).

301. 11 U.S.C. §§ 1112(b)(1), (b)(2), (b)(3).

302. 7 COLLIER, *supra* note 133, ¶ 1112.01[2][a], at 1112-7.

303. *Id.*

304. Lynn M. LoPucki, *The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz*, 52 STAN. L. REV. 55, 63 (1999); *see also In re UNR Indus., Inc.*, 72 B.R. 789, 790 (Bankr. N.D. Ill. 1987) (refusing to terminate the debtor’s exclusive right to file a plan of reorganization, which would permit creditors to file a liquidating plan, even though “[n]early five years have passed since the commencement of the UNR bankruptcy case” and “progress toward the confirmation of any plan of reorganization in the UNR bankruptcy is not in sight”); EPSTEIN ET AL., *supra* note 155, § 10-2, at 734 (observing that “the Chapter 11 of a big business usually leads to some form of reorganization”).

realistic liquidation threat, thereby rendering that threat an unnecessary negotiation aid. Accordingly, the absence of a creditor's ability to threaten liquidation of a municipality should not undermine the self-executing nature of debt negotiations under the Model Law.

On the other hand, permitting dismissal of the proceeding "for cause" is a useful negotiation aid that is consistent with this Article's framework for subnational debt restructuring. If the decision to dismiss is made by a neutral party, it should not impair the municipality's economic rehabilitation and even might enhance it by motivating the municipality to formulate a realistic plan. The potential for dismissal also marginally reduces the impact on pre-restructuring incentives because, after dismissal, the parties will be back in their *ex ante* positions. Deciding whether a debt restructuring proceeding actually should be dismissed will require discretion; but dismissal is more likely to be used as a negotiating tool than actually implemented because the potential for dismissal properly shifts the burden to the municipality to come forth with a viable restructuring plan. Dismissal is also neutral from the standpoint of the collective action problem. I therefore propose that the Model Law permit a debt restructuring proceeding to be dismissed for cause.

The other creditor negotiation aid is a senior creditor's threat to cram down a plan of reorganization over a junior creditor's objection.³⁰⁵ Because in a subnational debt restructuring context cramdown not only would be extremely difficult to apply but also would invite abuse, I have proposed that it not be made part of the Model Law.³⁰⁶ If, however, actual experience demonstrates that cramdown is needed to make subnational debt negotiations self-executing, one might reconsider this issue.

Therefore, the Model Law effectively would provide roughly the same incentives for cooperation in subnational debt negotiations that the Code imposes on corporate bankruptcy negotiations. To the extent that corporate bankruptcy negotiations are self-executing, subnational debt negotiations should similarly be self-executing, and the central government would not have to devote significant resources to supervising the process.

Nor would the central government need to devote significant resources to preventing strategic manipulation: the narrowly circumscribed provisions of the Model Law already are designed to prevent

305. See *supra* notes 247–49 and accompanying text.

306. See *supra* notes 259–60 and accompanying text.

that. If, for example, an economically healthy municipality commences a debt restructuring proceeding in an attempt to take opportunistic advantage of its creditors, these creditors could challenge the proceeding as lacking good faith.³⁰⁷ Further, even if the creditors lose their challenge, the municipality would have little ability to manipulate the law unfairly to their disadvantage. Existing creditors would not be harmed if the municipality borrows on a priority basis because the municipality, being economically healthy, would be able to repay all of its creditors.³⁰⁸ (The municipality itself would have little incentive to borrow on a priority basis because granting a priority would be unlikely to reduce borrowing costs in those circumstances.)³⁰⁹ Also, whether economically healthy or not, a municipality would be unable to manipulate the use of loan proceeds because priority loans are monitored under the Model Law to prevent overinvestment.³¹⁰ And the requirement of supermajority voting by classes of claims gives veto power to each voting class, thereby preventing a municipality from devising a plan to harm existing creditors or using the Model Law in an attempt to divide and conquer legitimate creditor opposition.³¹¹ Hence, the central government's administrative role in subnational debt restructuring would be limited in most cases to objecting to excessive amounts of priority funding, and to conditioning and monitoring its use when appropriate.

3. *Adjudication.* The remaining implementation issue is how to adjudicate disputes arising under the Model Law. If municipalities had only domestic creditors, the nation's judiciary could adjudicate these disputes like any other domestic disputes. The problem, however, is that municipalities may have foreign creditors.

307. See *supra* notes 133–34 and accompanying text (discussing the good faith requirement for commencing a debt restructuring proceeding); Model Law arts. 4(2)–(3), 3(2), 7(4), *infra* Appendix.

308. Such creditors also would be entitled to interest accruing during the pendency of the debt restructuring proceeding. See *supra* note 282 and accompanying text.

309. See Schwarcz, *supra* note 169, at 448 (“[T]he debtor often gains no interest rate advantage from a secured [priority] loan if the lender would be comfortable making an unsecured [nonpriority] loan.”).

310. Model Law art. 8, *infra* Appendix; see also *supra* note 177 and accompanying text (discussing prevention of overinvestment). There is some circularity because the central government itself is doing the monitoring, but these monitoring costs should be relatively minor.

311. See *supra* notes 237–41 and accompanying text (discussing supermajority voting by classes of claims).

Relatively little precedent exists for a tribunal to adjudicate disputes between a country, or a subdivision thereof, and its foreign creditors.³¹² Outside of expropriation cases, few disputes arise between governments and foreign private parties.³¹³ Established international courts, such as the International Court of Justice, are only competent to hear disputes between nations.³¹⁴ Although a nation has the right to bring a lawsuit against a foreign nation on behalf of one of its nationals, it may be reluctant to do so for political reasons.³¹⁵

In a subnational debt restructuring context, however, there should be little need for an international tribunal. Unlike expropriation and similar cases, the subnational dispute is between foreign creditors and a municipality, not its nation. Thus, a *national* tribunal, not controlled by the municipal government, would have no direct conflict of interest. Furthermore, the municipality's nation would have a strong economic incentive to adjudicate disputes fairly and with neutrality. If, in a given dispute, it favors a particular municipality over the municipality's creditors, the appearance of bias would discourage future investors and thus adversely affect the availability and cost of credit for all of the nation's other municipalities. Foreign creditors also would be protected against discriminatory recovery on their claims³¹⁶ because, as discussed, the Model Law requires that they

312. See PAUL E. COMEAUX & N. STEPHAN KINSELLA, *PROTECTING FOREIGN INVESTMENT UNDER INTERNATIONAL LAW* 36 (1997) (noting that little precedent exists for a tribunal to adjudicate disputes between a country and its creditors). *But see* ARON BROCHES, *SELECTED ESSAYS: WORLD BANK, ICSID, AND OTHER SUBJECTS OF PUBLIC AND PRIVATE INTERNATIONAL LAW* 198 (1995) (noting situations in which a private party may proceed directly against a country in an international quasi-judicial forum); IGNAZ SEIDL-HOHENVELDERN, *COLLECTED ESSAYS ON INTERNATIONAL INVESTMENTS AND ON INTERNATIONAL ORGANIZATIONS* 374 (1998) (same). In the United States, the bankruptcy court has the power to adjudicate disputes between a municipality and its creditors, whether domestic or foreign, because the Code's definition of "claim" is not limited to domestic creditors. 11 U.S.C. § 101(5) (2000).

313. Schwarcz, *supra* note 26, at 1023.

314. See Eichengreen & Portes, *supra* note 132, at 38–39 (stating that the International Court of Justice may adjudicate cases only between states, not between a state and a private foreign creditor, for example).

315. See Susan Choi, Note, *Judicial Enforcement of Arbitration Awards Under the ICSID and New York Conventions*, 28 N.Y.U. J. INT'L L. & POL. 175, 177 (1995–1996) ("The investor's governments . . . were often reluctant to step into the disputes for political reasons.").

316. Cf. BROCHES, *supra* note 312, at 259 (arguing that "[i]f international disputes [involving nongovernmental foreign nationals] are brought before national courts the 'foreign' party is likely to consider itself to be at a disadvantage on several counts").

be treated no worse than domestic creditors.³¹⁷ An international tribunal therefore appears unnecessary to adjudicate disputes arising under the Model Law.

The cost of establishing an international adjudicatory tribunal also seems unjustified because disputes under the Model Law should be relatively infrequent. The Model Law's rules are narrowly crafted, following the principle that the rules should minimize adjudicatory discretion.³¹⁸ The most likely interpretative disputes would concern either the good faith requirement for commencing a debt restructuring proceeding or the right of creditors to object to an excessive amount of new money financing. Nonetheless, disputes over whether bankruptcy filings are made in good faith are extremely unusual even in a corporate context.³¹⁹ Also, corporate creditors very rarely object to an amount of DIP financing as excessive.³²⁰ Other disputes might include challenges to the retroactive application of the Model Law, the Law's application to foreign creditors, or the automatic stay. Resolution of these disputes, however, would be largely independent of specific fact patterns—the stay, for example, does not permit exceptions.³²¹ Thus,

317. Model Law arts. 7(3), 6(3), *infra* Appendix; *see also supra* note 293 and accompanying text (observing that, if foreign creditors are classified with other creditors, the foreign and other creditors must be treated alike in the debt restructuring plan and that, if foreign creditors are not classified with other creditors, the foreign creditors would have veto power over the plan). If, however, the adjudicatory tribunal *were* part of the subnational government, foreign creditors might be at a disadvantage. Professor Hildreth has observed, for example, that:

the State of Louisiana [had established a debt payment priority system under which] [a]ll taxes flow into a Debt Service Reserve Fund from which debt service is paid first[,] and only to the extent there is something left over . . . is that money transferred to the General Fund. [Unfortunately,] the bond rating agencies did not give the State the appropriate benefit of such an arrangement [under which] Wall Street would get paid before state employees and state service recipients [because] there is no assurance that state court judges would actually let the money flow out of state, and away from their salary accounts, in the event of a major economic crisis.

Letter from W. Bartley Hildreth to Steven L. Schwarcz, *supra* note 162, at 3.

318. *See supra* notes 119–20 and accompanying text. That principle has not, however, made the Model Law's rules inappropriately narrow. A review of this Article's analysis of each Code section reveals that minimizing adjudicatory discretion was only a marginal factor in determining which section's rules should become part of the Model Law.

319. *See* Ponoroff & Knippenberg, *supra* note 92, at 927–42 (observing that bankruptcy filings made by public corporations are never dismissed for lack of good faith, but noting that courts are more likely to dismiss certain filings involving single-asset cases and tax fraud, which would not appear to be as relevant to subnational debt restructuring).

320. Telephone Interview with Lester M. Kirshenbaum, Bankruptcy Partner, Kaye, Scholer, Fierman, Hays & Handler (May 28, 1999).

321. If it did permit exceptions, disputes would be much more likely to arise. *See* EPSTEIN ET AL., *supra* note 155, § 3-1, at 63 (“Every year there are hundreds of reported proceedings

once resolved for a particular proceeding, these disputes should be resolved for all future proceedings. A tribunal therefore would be required to settle disputes only in relatively limited circumstances.

This Article leaves the actual identity of the adjudicatory tribunal to each nation to decide. Some nations may wish their national courts, or certain courts thereof, to take jurisdiction.³²² Others might consider, to the extent appropriate in their governmental structure, giving the central government agency that exercises supervisory authority (hereinafter, the “Supervisory Authority”)³²³ judicial as well as administrative jurisdiction over matters relating to the Model Law. This latter approach, however, might create a conflict where the dispute involves an action of the Supervisory Authority in its administrative capacity.

In summary, implementing the Model Law should be relatively straightforward. Debt negotiations should be largely self-executing, although the central government will need to monitor priority funding. To the limited extent that disputes arise, they could be adjudicated in national courts without the need to establish an international tribunal.

To test the analysis, I next consider how the Model Law might be applied to an actual situation.³²⁴

that implicate [the stay under] section 362 [of the Code]. More often the difficulty is deciding the facts required to apply section 362 rather than construing the law that it states.”).

322. Under Chapter 9, for example, certain national courts—the bankruptcy courts—are given this jurisdiction, subject to appeal to higher national courts.

323. *Cf. supra* Part III.C.2 (discussing the central government’s limited administrative role in subnational debt restructuring). Professor Dan Tarullo suggests that, to some extent, outcomes could depend on the Supervisory Authority’s bias. E-mail from Daniel Tarullo, Visiting Professor, Georgetown University Law Center, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Jan. 22, 2001) (on file with the *Duke Law Journal*). A Supervisory Authority biased toward municipalities might allow a municipality to sit with its old debts tolled, new financing available, and little pressure to come up with a plan, which would have a deleterious medium-term effect on the cost of capital to other municipalities in the same nation. *Id.* On the other hand, a Supervisory Authority that is biased toward creditors might condition borrowing on significant tax increases or spending cuts, which could generate political backlash. *Id.* This Article does not attempt to examine issues of a Supervisory Authority’s bias. I merely note that a Supervisory Authority’s discretion should be limited, and that its actual discretion likely will be influenced by political factors within the relevant nation.

324. References in Part IV to the “Model Law” refer to the proposed Model Law attached as an Appendix to this Article.

IV. APPLICATION

Consider the case of Japan, whose municipal debt problem is among the world's most difficult.³²⁵ Enactment of the Model Law into Japanese national law would bind Japan's municipalities, domestic creditors of those municipalities, and, where Japanese law governs the debt contract, foreign creditors. Existing as well as future creditors would be bound because the Model Law's provisions are retroactive³²⁶ and, under international law, retroactivity is permitted so long as it is neither discriminatory nor arbitrary.³²⁷

Foreign creditors whose debt contracts are governed by non-Japanese law also should be bound to the Model Law's provisions if such provisions reflect a fundamental public policy of preserving the integrity of Japanese municipal governments.³²⁸ The application of these provisions to objecting foreign creditors would not violate public international law because, under the Model Law, foreign creditors cannot be treated worse than Japanese creditors.³²⁹

Each troubled Japanese municipality would have the ability to decide whether to commence a debt restructuring proceeding.³³⁰ A municipality could decide, for example, that its debt problems are not so severe as to justify commencing a proceeding. That would avoid any potential reputational costs.

If a municipality does commence a debt restructuring proceeding, interest will continue to accrue at the contract rate and creditors therefore may be able to avoid writing down their debt.³³¹ Creditors,

325. See *supra* notes 11–12 and accompanying text; see also Editorial, *Local Finances on the Brink of Disaster*, NIHON KEIZAI SHIMBUN (Tokyo), Dec. 28, 2000 (concluding that “Japan’s local finances are on the edge of the abyss”) (on file with the *Duke Law Journal*).

326. Model Law art. 11(1), *infra* Appendix.

327. Neither should be the case under the Model Law. See *supra* note 275 and accompanying text. Nor would Japan be liable under international law to compensate impaired foreign creditors. See *supra* notes 276–85 and accompanying text.

328. See *supra* note 288 and accompanying text (stating that, under conflict of laws principles common to most national jurisdictions, a nation is not required to apply foreign law that would result in a violation of its fundamental public policy). Even if objecting foreign creditors sued the municipality outside of Japan and won, their only practical remedy would be to attach the municipality’s foreign assets, which may not exist. See *supra* notes 291–92 and accompanying text.

329. See *supra* note 293 and accompanying text.

330. Model Law art. 3(1), *infra* Appendix.

331. Model Law art. 3(4), *infra* Appendix (including interest on interest payments suspended by the stay).

however, are stayed from attempting to enforce their claims.³³² This affords the municipality a breathing space during which it can formulate a restructuring plan and apply cash, which otherwise would be needed for debt service payment, to pay its employees and provide core municipal services.

A municipality has little incentive to take unfair advantage of the stay to the detriment of creditors. As mentioned, interest will continue to accrue, so a solvent municipality will have no cost saving and, on a present value basis, creditors ultimately would be paid in full. On the other hand, the municipality would have to pay the transactional costs associated with the proceeding. Furthermore, when it adopts the Model Law, Japan would designate an agency or other instrumentality of the national government to serve as the Supervisory Authority.³³³ This Supervisory Authority has the power to dismiss any petition invoking the Model Law's application that is not filed in good faith.³³⁴

Unless the petition is dismissed, creditors will be notified of the debt restructuring proceeding.³³⁵ Concerned creditors can request the Japanese Supervisory Authority to take whatever steps they believe are necessary or appropriate to further the purposes of the Model Law.³³⁶ The Supervisory Authority may take any such steps, but is not obligated to do so.³³⁷ Any disputes arising during the course of the proceeding would be adjudicated in the Japanese courts or, alternatively, by a Japanese tribunal specifically given jurisdiction over such disputes.³³⁸ Nonetheless, disputes should be adjudicated fairly and with neutrality because the appearance of bias would discourage future investors and thus adversely affect the availability and cost of credit for other Japanese municipalities.

During the pendency of the debt restructuring proceeding, the Japanese municipality could choose to borrow money to pay municipal expenses. To attract funding, the municipality may grant new

332. Model Law art. 3(3), *infra* Appendix.

333. Model Law art. 2(5), *infra* Appendix.

334. Model Law art. 3(2), *infra* Appendix.

335. Model Law art. 4(1), *infra* Appendix.

336. Model Law art. 4(2), *infra* Appendix.

337. Model Law art. 4(3), *infra* Appendix.

338. Model Law art. 10(1), *infra* Appendix. To the extent appropriate under Japanese law, the Supervisory Authority might even be assigned to adjudicate these disputes, although that creates a potential for conflicts of interest. *See supra* note 323 and accompanying text.

money lenders a priority claim for repayment.³³⁹ To protect against overinvestment, however, the Supervisory Authority would have the right to object to excessive amounts of priority funding and, when appropriate, to condition and monitor the use of such funding.³⁴⁰ This might include imposing the same types of conditions that have been imposed in Japanese quasi-financial reconstruction proceedings, such as requiring the municipality to prepare a financial reconstruction plan including a budget approved by the Supervisory Authority, and requiring higher rentals for public housing, increased charges for the use of public facilities, reduction in local administrative services, curtailment of municipal employee pay raises and acceptance of early retirement.³⁴¹ Even without a Supervisory Authority, however, the municipality itself has an incentive to self-impose constraints in order to ultimately persuade its creditors to vote for a debt restructuring plan.³⁴²

The municipality would continue operating during the debt restructuring proceeding until it is ready to submit its debt restructuring plan.³⁴³ To avoid disruption, and on the theory that the municipality itself should be in the best position to judge how its debt should be restructured, only the municipality may formulate and submit a plan.³⁴⁴ A plan must designate classes of creditors and propose the treatment of each such class.³⁴⁵ Creditors within each class, whether domestic or foreign, must be treated alike.³⁴⁶

Once a plan is submitted, it is up to the municipality's creditors to decide whether the plan is acceptable. They do this by voting on the plan. For a plan to become effective, each class of claims must agree to it by supermajority voting.³⁴⁷ This requirement protects creditors from being treated unfairly vis-à-vis the municipality or other creditors; if creditors in a class believe they are being treated unfairly,

339. Model Law art. 9, *infra* Appendix.

340. Model Law art. 8, *infra* Appendix.

341. *See supra* notes 49–52 and accompanying text.

342. *See infra* note 238 and accompanying text.

343. Model Law arts. 5(1), 2(4), *infra* Appendix.

344. Model Law art. 5, *infra* Appendix.

345. Model Law art. 6(1)–(2), *infra* Appendix.

346. Model Law art. 6(3), *infra* Appendix. A plan could separate domestic and foreign creditors into separate classes, but then foreign creditors as a class would have the power, if they chose, to veto acceptance of the plan. *See* Model Law art. 7(1), *infra* Appendix (requiring acceptance by each class of claims).

347. Model Law art. 7(1)–(3), *infra* Appendix.

they simply can vote to reject the plan, thereby vetoing it.³⁴⁸ On the other hand, supermajority voting permits creditors to agree to a debt restructuring plan without facing the holdout problems that stem from unanimity requirements.³⁴⁹

If each class of creditors approves the plan by supermajority voting, the Japanese municipality is discharged from its existing debts except to the extent set forth in the plan.³⁵⁰ The automatic stay also terminates,³⁵¹ allowing the municipality's creditors to enforce their restructured claims. Creditors, whether domestic or foreign, share in the burden to the extent their debt is restructured or discharged. They may, for example, agree to a plan that provides a realistic scenario for paying their remaining claims, even though it stretches their debt maturities or reduces the interest rate thereon. This is fair because creditors, by their act of extending credit, had taken the credit risk of the municipality and, presumably, had demanded a rate of interest intended to offset that risk. The Japanese municipality also shares in the burden, however. It has to formulate and submit a plan for which it believes the creditors are willing to vote. This may require the municipality to exercise greater fiscal responsibility, such as by cutting unnecessary or extravagant costs by reducing local municipal services and generating increased revenue by requiring higher charges for municipal facilities or housing. This will make creditors comfortable not only that their restructured debt will be paid when due but also that they are not the only ones making a sacrifice.

The Japanese central government only monitors to ensure the fairness of the proceeding, and neither subsidizes nor supports the municipality. This minimizes the moral hazard problem that the Japanese municipalities that anticipate central government support might have less reason to take a prudent economic course and be less cautious in incurring debt and that its creditors that expect protection from the consequences of default might be less prudent in making their credit analysis. It also avoids the problem that Japan may not want, or may be fiscally or politically unable, to support all of its sub-national debt.

348. Model Law art. 7(1)–(3), *infra* Appendix.

349. See *supra* notes 236–41 and accompanying text.

350. Model Law art. 7(1), *infra* Appendix.

351. Model Law art. 7(1), *infra* Appendix.

This approach is not perfect. A municipality might delay unreasonably in submitting a plan or might submit a plan in bad faith. In practice, however, the presence of the Japanese Supervisory Authority, with its power to dismiss the debt restructuring proceeding in these instances, should lessen this imperfection.³⁵² Another imperfection is that the municipality and its creditors may be unable to reasonably agree on a plan. This is unlikely, however. The Model Law provides roughly the same incentives for cooperation that the Code imposes on corporate bankruptcy negotiations.³⁵³ For example, the Japanese Supervisory Authority (as before) can motivate the municipality to seek agreement by threatening to dismiss the debt restructuring proceeding.³⁵⁴ This threat should be real because the municipality's domestic and foreign creditors would be impaired equally by failure to reach a plan, and also because a perceived bias towards municipalities would discourage future municipal funding in Japan. Therefore, negotiations between a Japanese municipality and its creditors should be as self-executing as bankruptcy negotiations.

Thus, imperfect as this approach might be, it realistically and equitably allocates the debt restructuring burden and also addresses the other serious problems that Japan faced under its "reconstruction" and "quasi-financial reconstruction" approaches.³⁵⁵ Whether this approach ultimately would be politically acceptable in Japan or other countries will depend on factors, however, that are beyond the scope of this Article.³⁵⁶

352. Model Law art. 7(4), *infra* Appendix.

353. *See supra* notes 73–76 and accompanying text.

354. Model Law art. 7(4), *infra* Appendix.

355. *See supra* notes 38–55 and accompanying text.

356. Professor Iwahara, for example, comments that although this Article's "proposed subnational debt restructuring scheme sounds very useful [and] could be a very desirable scheme for many countries[,] [t]here might be a problem . . . in introducing such a scheme to Japan." E-mail from Shinsaku Iwahara to Steven L. Schwarcz, *supra* note 58. His rationale is that a significant amount of municipal debt is

held by [Japanese] financial institutions whose financial soundness is very weak. If the proposed subnational debt restructuring scheme is introduced and municipalities' creditors are forced to share the debt restructuring burden, many Japanese financial institutions will face . . . serious financial trouble and, thus, the Japanese central government will have to bail [them out] in order to avoid . . . financial panic. Therefore, the Japanese government might think that it is better to continue [a] quasi-financial reconstruction scheme.

Id. Compare WORLD DEVELOPMENT REPORT, *supra* note 1, at 120 (asserting that "[e]stablishing [the credibility of the central government's commitment not to intervene] requires avoiding situations in which the central government would be forced to intervene—for example, where a default threatens the national banking system," and suggesting that "regula-

CONCLUSION

Subnational debt restructuring currently gives rise to a host of problems. The conflicting interests of the municipality and its creditors, as well as the collective action problem among creditors, make it difficult to reach agreement on a restructuring plan. The increasing shift from bank to bond financing exacerbates this difficulty. Central government efforts to help troubled municipalities often end up placing the entire burden on the central government instead of the municipality or its creditors. That, in turn, undermines the incentives of the municipality to take a prudent economic course and of its creditors to be cautious when extending credit. This Article has examined whether legal regulation based on universally recognized principles of bankruptcy reorganization law could effectively address these and similar problems.

Although regulation should have normative underpinnings, no existing scholarship purports to offer a normative legal theory of subnational debt restructuring. I have attempted to do so by examining how the conceptual basis of bankruptcy reorganization law can be adapted to subnational debt restructuring. Disputes over the conceptual basis of bankruptcy reorganization law complicate, but at the same time universalize, my examination. Some scholars argue that bankruptcy reorganization law should advance traditional goals; other scholars argue that the only goal of bankruptcy reorganization law should be economic efficiency. The disputes reflect the different initial axioms scholars use.

First, this Article analyzed these disputes in an attempt to understand which axioms should apply to subnational debt restructuring. Next, it used those axioms to derive a normative framework for regulation. The Article then completed this framework by accounting for the previously identified problems of subnational debt restructuring and used the framework to model a simple but arguably effective system of rules for a model law on subnational debt restructuring.

tion [presumably limiting the amount that banks can lend to domestic municipalities] can help prevent such situations”), with E-mail from Ernfred Olsen, Shinsei Bank, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Jan. 18, 2001) (on file with the *Duke Law Journal*):

The fact that the Japanese banks can't absorb the losses and that the relative strength of the banks today varies greatly . . . [creates] impediments to their working out a consensual arrangement outside the framework of something such as the Model Law [proposed by this Article]. The Model Law would provide a critical tool to those municipalities who wish to take responsible action to address their problems.

The Appendix sets forth a proposed text of the Model Law based on universal principles of bankruptcy reorganization law.³⁵⁷ This model need not be enacted uniformly across nations. It is intended, rather, to constitute a foundation for a national law which itself is informed by local political and legal culture.³⁵⁸

Under the proposed Model Law, an automatic stay would suspend payment of the municipality's debt until a restructuring plan is agreed to.³⁵⁹ Financiers of the municipality's debt restructuring would have priority over claims of other creditors. Also, the Model Law would bind all creditors to a restructuring plan that classes of claims agree to by supermajority voting and, upon such agreement, would discharge debts not provided for in the plan. This benefits municipalities by providing incentives for new credit and by minimizing the collective action problem. Nations with subnational debt problems therefore should find it in their interest to enact the Model Law into their national laws.

To preserve the dignity of municipalities seeking its protection and to avoid discouraging its use, the Model Law does not speak in terms of bankruptcy or insolvency, nor does it require a municipality to be insolvent to seek protection thereunder or otherwise differentiate between exogenous and endogenous factors that lead to default.³⁶⁰ Although this construction increases the potential for strategic manipulation, the Model Law's provisions are narrowly circumscribed to prevent opportunistic behavior.

It also appears unlikely that enacting the Model Law into national law would decrease the availability of municipal credit or make it more expensive. Although the ultimate effect of the Model Law on availability and cost of credit is an empirical determination, that effect should be minimal as long as enactment of the Model Law does not lower the rating of the municipality's debt securities. Discussions with Standard & Poor's Ratings Services, a leading rating agency, suggest

357. See *supra* notes 85–91 and accompanying text.

358. Thus, the Model Law is not intended to be, and I believe is *not in fact*, United States-centric.

359. Model Law art. 3(3), *infra* Appendix. Interest on that debt would continue, however, to accrue during that period. Model Law art. 3(4), *infra* Appendix; see *supra* note 282 and accompanying text.

360. An exception is the limited extent that irrational exogenous factors could justify central government funding for maintenance of temporary liquidity.

that ratification would not lower these ratings.³⁶¹ There also is indirect empirical evidence to this effect. When Chapter 9—which is conceptually similar to the Model Law³⁶²—was enacted into law in the United States, there was no adverse effect on municipal debt ratings resulting from such enactment.³⁶³ Nor should an adverse effect be expected: the availability of a subnational debt restructuring law arguably *increases* the ex ante value of investor claims by making it easier for all parties to reach negotiated settlements.

361. Telephone Interview with Joanne W. Rose, Senior Managing Director, General Counsel, and Chair of the Ratings Policy Board, Standard & Poor's Ratings Services (June 10, 1999). Ms. Rose said that ratification of a sovereign debt restructuring convention, which (like the Model Law) contemplates supermajority voting and priority lending, should not affect Standard & Poor's ratings—which are based on the likelihood of default and not on the amount of recovery expected in default—because the convention would not affect the likelihood of default. *Id.* Thus, a nation whose debt was rated investment grade would not experience a ratings change as a result of ratifying the convention. Ms. Rose suggested, however, that a sovereign debt analyst might be tempted to reduce slightly the rating of a financially troubled nation that had ratified the convention, such as from “B” to “B-.” *Id.* Unlike this convention, however, the Model Law also contemplates an automatic stay, the application of which would suspend payment of a municipality's debt. Nonetheless, a municipality that invokes application of the Model Law may well be at the point of defaulting on its debt anyway.

362. Chapter 9, like the Model Law, includes supermajority voting, priority lending, *and* an automatic stay. *See* 11 U.S.C. § 1126(c) (2000) (incorporated into Chapter 9 by 11 U.S.C. § 901) (supermajority voting); Model Law art. 7(2), *infra* Appendix (same); 11 U.S.C. § 364 (relevant parts of which are incorporated into Chapter 9 by 11 U.S.C. § 901) (priority lending); Model Law art. 9, *infra* Appendix (same); 11 U.S.C. § 362 (incorporated into Chapter 9 by 11 U.S.C. § 901) (automatic stay); Model Law art. 3(3), *infra* Appendix (same).

363. E-mail from Colleen Woodell, Managing Director, Public Finance, Standard & Poor's Ratings Services, to Steven L. Schwarcz, Professor of Law, Duke University School of Law (Oct. 22, 2001) (on file with the *Duke Law Journal*).

APPENDIX
PROPOSED MODEL LAW³⁶⁴

This Law is intended to preserve the integrity of this Nation's municipal governments. Its provisions therefore articulate matters that are fundamental to this Nation's public policy.

Chapter I: Scope, and Use of Terms

ARTICLE 1: SCOPE

This Law applies to debt restructurings between municipalities and their creditors.

ARTICLE 2: USE OF TERMS

For purposes of this Law:

- (1) "municipality" means a political subdivision or public agency or instrumentality of this Nation;
- (2) "creditor" means an entity that has a claim for payment against a municipality;
- (3) "debtor-municipality" means a municipality that has commenced a proceeding for relief under this Law;
- (4) "Plan" means a debt restructuring plan;
- (5) "Supervisory Authority" means the [specify appropriate national entity].

Chapter II: Invoking the Law, and Automatic Stay

ARTICLE 3: PETITION FOR RELIEF

- (1) A municipality may invoke application of this Law by filing a voluntary petition for relief with the Supervisory Authority.
- (2) Immediately after such a petition for relief has been filed, and so long as such filing has not been dismissed by the Supervisory Authority for lack of good faith, the provisions of this Law shall apply to the relationship between the municipality and its creditors.
- (3) Thereupon, all persons and entities shall be stayed from taking any act, directly or indirectly, to recover on claims against the debtor-municipality outstanding, or resulting from debts, contracts, or other

364. The author intends this Model Law to be illustrative rather than definitive—a set of provisions that might form the basis of a national law. Therefore, I have simplified its provisions and omitted technical matters such as approval of claims, voting disclosure, or possible exceptions to the automatic stay.

transactions in existence, prior to the filing of the petition for relief, including the enforcement or continuation of lawsuits or the pursuit of any other actions to obtain possession of the debtor-municipality's property in satisfaction of such claims.

(4) Notwithstanding the foregoing stay, interest, including interest on interest payments suspended by the stay, shall accrue at the contract rate (or, absent a contract, at the legal rate) on all claims.

ARTICLE 4: NOTIFICATION OF CREDITORS AND RIGHT TO BE HEARD

(1) Within 30 days after filing its petition for relief, the debtor-municipality shall notify all of its known creditors thereof and of its intention to negotiate a Plan.

(2) Any creditor may raise and be heard before the Supervisory Authority on any matters arising under this Law.

(3) Without limiting the foregoing, any creditor may request the Supervisory Authority to take whatever steps the creditor deems necessary or appropriate to further the purposes of this Law, provided that the Supervisory Authority shall not be obligated to take any such steps.

Chapter III: The Debt Restructuring Plan

ARTICLE 5: SUBMISSION OF PLAN

(1) The debtor-municipality may submit a Plan to its creditors at any time, and may submit alternative Plans from time to time.

(2) No other person or entity may submit a Plan.

ARTICLE 6: CONTENTS OF PLAN

A Plan shall:

(1) designate classes of claims in accordance with Article 7(3);

(2) specify the proposed treatment of each class of claims; and

(3) provide the same treatment for each claim of a particular class, unless the holder of a claim agrees to a less favorable treatment.

ARTICLE 7: VOTING ON THE PLAN

(1) A Plan shall become effective and binding on the debtor-municipality and its creditors when it has been submitted by the debtor-municipality and agreed to by each class of such creditors' claims. Thereupon, the debtor-municipality shall be discharged from

any claim then in existence,³⁶⁵ except as provided in the Plan, and the automatic stay of Article 3(3) shall terminate.

(2) A class of claims has agreed to a Plan if creditors holding at least [two-thirds] in amount and more than [one-half] in number of the claims of such class [voting on such Plan]³⁶⁶ [entitled to vote on such Plan] agree to the Plan.

(3) Each class of claims shall consist of claims against the debtor-municipality that are pari passu in priority, provided that pari passu claims need not all be included in the same class.

(4) If a debtor-municipality unreasonably delays submitting a Plan or submits a Plan in bad faith, or if the debtor-municipality and its creditors cannot reasonably agree on a plan in accordance with this Article 7, the Supervisory Authority may dismiss the debt restructuring proceeding under this Law, whereupon the automatic stay of Article 3(3) shall terminate.

Chapter IV: Financing the Restructuring

ARTICLE 8: TERMS AND CONDITIONS OF LENDING

(1) The Supervisory Authority shall have the right to set terms and conditions for any loans made hereunder and to monitor the debtor-municipality's use of the loan proceeds.

(2) Such conditions may include a requirement that the debtor-municipality take whatever steps the Supervisory Authority deems necessary or appropriate to improve the debtor-municipality's financial governance and fiscal responsibility.

ARTICLE 9: PRIORITY OF REPAYMENT

(1) To finance their operations during the restructuring period, debtor-municipalities may borrow by granting priority of payment to lenders. Any such priority loans must be repaid in full prior to the debtor-municipality paying any other claims.

(2) Such priority of payment shall extend to any assignee of a priority loan.

365. Alternatively, the Law could except discharge of claims owed to entities that neither had notice nor actual knowledge of the Plan.

366. The Plan can be approved more easily if this alternative is selected, but reliable notice to creditors then becomes more important.

Chapter V: Adjudication of Disputes

ARTICLE 10: ADJUDICATION

- (1) Any disputes arising under this Law shall be adjudicated by [specify adjudicatory tribunal].³⁶⁷
- (2) Such [adjudicatory tribunal] shall have exclusive and final jurisdiction over all such disputes.

Chapter VI: Enactment

ARTICLE 11: RETROACTIVE EFFECT

- (1) This Law shall be binding on each debtor-municipality and on each creditor thereof, irrespective of contractual provisions that are inconsistent with the provisions of this Law or the date that a creditor's claim against a debtor-municipality arose.

367. Alternative: Any disputes arising under this Law shall be adjudicated by the courts of this Nation.