

# Michigan Law Review

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Volume 116 | Issue 7

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2018

## Formailzing Chapter 9's Experts

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### Recommended Citation

Laura N. Coordes, *Formailzing Chapter 9's Experts*, 116 MICH. L. REV. 1249 (2018).

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# FORMALIZING CHAPTER 9'S EXPERTS

Laura N. Coordes\*

*Chapter 9 of the U.S. Bankruptcy Code has many shortcomings. One of the most persistent, yet understudied, problems judges face in chapter 9 is also a problem that exists in other areas of bankruptcy law: the sheer difficulty of applying generalized plan confirmation standards to wildly different, highly specialized entities. In practice, judges have turned to experts—individuals well versed in municipal finance, mediation, and the particular debtor community—to help overcome this problem in chapter 9. These experts often perform critical roles in a municipal bankruptcy case, including conducting mediations, investigating the municipality's finances, and even helping to craft the municipality's plan of debt adjustment.*

*Despite the important roles experts play in bankruptcy, their appointment and selection process receives little attention, and the scope of their role is often ill defined. This Article highlights the concerns that arise due to the lack of procedures surrounding experts in municipal bankruptcy. After exploring the benefits and pitfalls associated with using experts in chapter 9 and elsewhere, this Article provides detailed guidance for designing formal procedures for selecting, appointing, and using experts in chapter 9.*

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## INTRODUCTION

“I urge you now not to forget your anger. Your enduring and collective memory of what happened here, and your memory of your anger about it, will be exactly what will prevent this from ever happening again.”<sup>1</sup> When Judge Steven Rhodes spoke these words during Detroit’s chapter 9 plan confirmation proceedings, he acknowledged a fear felt by nearly everyone in the courtroom: the fear that Detroit would not succeed postbankruptcy and would fall back into severe financial distress. This fear persisted years after Detroit exited bankruptcy.<sup>2</sup>

Chapter 9 of the Bankruptcy Code is supposed to assuage this fear. In particular, the standards for confirming a chapter 9 plan of debt adjustment are safeguards designed to ensure that a municipality exits bankruptcy on firmer footing while acting in good faith toward its creditors. Yet, judges tasked with confirming a municipality’s plan of adjustment struggle to apply these standards, which were largely imported from chapter 11 of the Bankruptcy Code and do not easily map onto the particularities of municipal fiscal distress.<sup>3</sup> This struggle produces uncertainty about bankruptcy’s effectiveness for municipalities, which in turn contributes to state and local officials’ reluctance to use (or permit) chapter 9 in the first place. Officials, uncertain whether the process will work and wary of the risk that using it will cut municipalities off from the capital markets, are likely to avoid chapter 9.<sup>4</sup>

1. Nathan Bomey, *Rhodes on Pensioners, DIA, Kevyn Orr and More*, DET. FREE PRESS (Nov. 7, 2014, 8:08 PM) (quoting Transcript of Bench Decision at 66, *In re City of Detroit*, 524 B.R. 147 (Bankr. E.D. Mich. 2014) (No. 13-53846), ECF No. 8257), <http://www.freep.com/story/news/local/detroit-bankruptcy/2014/11/07/rhodes-excerpts-ruling/18677011/> [https://perma.cc/P27S-SUJT].

2. See, e.g., Quinn Klinefelter, *Post-Bankruptcy, a Booming Detroit Is Still Fragile*, NPR (Dec. 12, 2015, 5:06 PM), <http://www.npr.org/2015/12/12/459192004/post-bankruptcy-a-booming-detroit-is-still-fragile> (on file with the *Michigan Law Review*) (describing Detroit as “walking a financial tightrope”); Brian J. O’Connor, *Detroit Facing Challenges One Year After Bankruptcy*, DET. NEWS (Dec. 9, 2015, 6:18 PM), <http://www.detroitnews.com/story/news/local/detroitcity/2015/12/09/detroit-city-finances-one-year-bankruptcy/77063402/> [https://perma.cc/J462-8WRJ] (quoting director of municipal finance research firm who described Detroit’s bankruptcy plan as “fragile”).

3. See Michael J. Deitch, Note, *Time for an Update: A New Framework for Evaluating Chapter 9 Bankruptcies*, 83 FORDHAM L. REV. 2705, 2726–27 (2015) (evaluating the inconsistencies in chapter 9 plan confirmation orders); see also Bill Rochelle & Sherri Toub, *Detroit Judge Steven Rhodes Used Conscience to Approve Plan*, 26 BANKR. L. REP. (BNA) 1600 (2014) (describing how Judge Rhodes dealt with difficult questions during plan confirmation “by looking to his conscience and sense of morality”).

4. Laura Napoli Cordes, *Restructuring Municipal Bankruptcy*, 2016 UTAH L. REV. 307, 329–30 [hereinafter Cordes, *Restructuring*] (“Municipalities may be further discouraged from adjusting debts out of concern that impairing debt may limit their access to capital markets”).

Plan confirmation can be challenging in chapter 9 because municipalities are not autonomous or self-governing. Instead, their actions are shaped by the state in which they are located.<sup>5</sup> Municipal officials must balance payments to creditors and the fulfillment of campaign promises with the immediate needs of the people that live and work within municipal boundaries.<sup>6</sup> The complex nature of municipalities, and notably their intertwined relationship with their state, make it difficult for judges and creditors to understand a municipality's ability to navigate the bankruptcy system.<sup>7</sup> For their part, states, particularly those facing fiscal problems of their own, are often not in a position to actively manage municipal affairs.<sup>8</sup> Further complicating matters, the dearth of chapter 9 precedent makes it nearly impossible to apply the plan confirmation standards in a consistent, straightforward manner—and yet, that is exactly what chapter 9 judges are asked to do.<sup>9</sup>

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and future funding.”); see also Laura N. Coordes, *Gatekeepers Gone Wrong: Reforming the Chapter 9 Eligibility Rules*, 94 WASH. U. L. REV. 1191, 1228–29 (2017) [hereinafter Coordes, *Gatekeepers*] (discussing the rhetoric surrounding municipal bankruptcy as a further source of discouragement of its use).

5. For an in-depth discussion of the myriad ways in which cities and the state in which they are located are intertwined, see GERALD E. FRUG & DAVID J. BARRON, *CITY BOUND: HOW STATES STIFLE URBAN INNOVATION* (2008). Local governments are also shaped by the federal government. See, e.g., LARA MERLING ET AL., CTR. FOR ECON. & POLICY RESEARCH, *LIFE AFTER DEBT IN PUERTO RICO: HOW MANY MORE LOST DECADES?* (2017), <http://cepr.net/images/stories/reports/puerto-rico-2017-07.pdf> [<https://perma.cc/DKQ7-5H3N>] (discussing how Puerto Rico's economic condition was partially a result of decisions made by the federal government).

6. See Rebecca Gosch, Note, *An “Immeasurable Sign of Great Hope”: The Detroit Institute of the Arts, Municipal Bankruptcy and “Cultural Assets”*, 51 WASH U. J.L. & POL'Y 233, 233–34 (2016) (“Due to the important roles citizens play [in municipal bankruptcy], already complex legal issues can be further complicated by the very human concerns of a municipal population.”); Frank Shafroth, *Human Needs & Fiscal Imbalances*, GMU MUN. SUSTAINABILITY PROJECT (May 24, 2017), <https://fiscalbankruptcy.wordpress.com/2017/05/24/human-needs-fiscal-imbalances/> [<https://perma.cc/99XB-GMM6>] (discussing this balancing act in Detroit and Flint, Michigan).

7. See, e.g., FRUG & BARRON, *supra* note 5; see also Laura N. Coordes & Thom Reilly, *Predictors of Municipal Bankruptcies and State Intervention Programs: An Exploratory Study*, 105 KY. L.J. 493, 497 (2017) (“[A] vast array of different state laws impact a municipality's fiscal health.”); Juliet M. Moringiello, *Chapter 9 Plan Confirmation Standards and the Role of State Choices*, 37 CAMPBELL L. REV. 71, 74 (2015) (noting the “scant body of case law applying the [c]hapter 9 confirmation standards”); Samir D. Parikh & Zhaochen He, *Failing Cities and the Red Queen Phenomenon*, 58 B.C. L. REV. 599, 614 (2017) (“[A] municipality's borrowing costs are affected by its state and federal debt-restructuring options.”).

8. See, e.g., Coordes, *Restructuring*, *supra* note 4, at 353–55 (discussing problems with state intervention); Stacie Sherman, *N.J. Budget ‘Imbalanced’ on Partial Pension Payments*, *S&P SAYS*, BLOOMBERG (Mar. 16, 2017, 10:45 AM), <https://www.bloomberg.com/news/articles/2017-03-16/n-j-budget-imbalanced-on-partial-pension-payments-s-p-says> [<https://perma.cc/E9QA-RCNL>] (discussing severe problems with New Jersey's budget and pension funding).

9. Deitch, *supra* note 3, at 2726–45 (evaluating the inconsistencies in judicial opinions with respect to chapter 9 plan confirmations); Moringiello, *supra* note 7, at 74–75 (noting the lack of judicial review surrounding confirmation standards due to the relatively small number of cases).

Uncertainty about chapter 9's efficacy, combined with the cost and resource drain of bankruptcy, discourages municipalities from using chapter 9.<sup>10</sup> With chapter 9 seemingly off the table, officials may instead choose to delay addressing financial problems.<sup>11</sup> As a consequence, although the number of municipal bankruptcies has decreased in recent years, the need to resolve municipal fiscal distress is greater than ever. A well-publicized pension crisis is looming,<sup>12</sup> and in many municipalities, this crisis is exacerbated by other unsustainable obligations.<sup>13</sup> Many smaller cities and towns are struggling in quiet desperation,<sup>14</sup> while large cities—even seemingly wealthy ones—are grappling with more public crises.<sup>15</sup> Budgetary problems also

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10. See Moringiello, *supra* note 7, at 75 (noting that the lack of clarity with respect to confirmation standards is “undesirable from a public policy standpoint” when states are trying to decide whether or not to permit municipalities to file for bankruptcy).

11. Parikh & He, *supra* note 7, at 605 (describing “the reluctance of state officials and policymakers to address” municipal distress).

12. Richard Ciccarone & Jeffrey L. Garceau, *City Pension Plans Take a Surprise Upturn in 2015—Is Improvement a One-Off?*, MUNINET GUIDE (Apr. 13, 2017), <http://muninetguide.com/city-pension-plans-upturn-2015/> [<https://perma.cc/J6V2-M7ES>] (noting that although “[c]ity pension plans improved their funding ratios in 2015,” returns are expected to be lower for 2016 and that the overall trend is a decline in funding ratios); Danica Coto, *Puerto Rico Seeks Court’s Help to Save Public Pension System*, APNEWS.COM (May 22, 2017), <https://apnews.com/c7ae9e5694a44262898af1009935bfc6/Puerto-Rico-seeks-court’s-help-to-save-public-pension-system> [<https://perma.cc/B6XG-HJSC>] (describing how Puerto Rico sought to have court-supervised pension restructuring in light of its debt crisis).

13. See, e.g., Coordes & Reilly, *supra* note 7, at 510 (illustrating how pension problems combine with other factors to contribute to fiscal distress); Scott Pryor, *The Night of the Living Dead Is Coming: America’s Pension Crisis*, PRYOR THOUGHTS (Feb. 22, 2017), <http://pryorthoughts.blogspot.com/2017/02/the-night-of-living-dead-is-coming.html> [<https://perma.cc/JNP4-LUQ8>] (“The combination of subterranean promises to politically favored groups, unrealistic assumptions about rates of return on investments, and the declining middle-class birthrate makes the question of a fiscal cliff not one of if but of when.”).

14. See, e.g., Valerie Bauerlein, *One Tiny North Carolina Town Votes to Disband*, WALL STREET J. (Mar. 5, 2017, 8:00 AM), <https://www.wsj.com/articles/one-tiny-north-carolina-town-votes-to-disband-1488718801> (on file with the *Michigan Law Review*) (statement of David Rusk) (“Wealth has left these little cities to such a degree that they’re basically bankrupt.”) *quoted in* Frank Shafroth, *Breaking up Is Hard to Do.*, GMU MUN. SUSTAINABILITY PROJECT (Mar. 6, 2017), <https://fiscalbankruptcy.wordpress.com/2017/03/06/breaking-up-is-hard-to-do/> [<https://perma.cc/MLJ3-5GU3>]; Rowena Coetsee, *Antioch Will Face Bankruptcy if Half-Cent Sales Tax Expires*, FINANCE OFFICIAL SAYS, E. BAY TIMES (Apr. 26, 2017, 12:32 PM), <http://www.eastbaytimes.com/2017/04/26/antioch-will-face-bankruptcy-if-half-cent-sales-tax-expires-finance-official-says/> [<https://perma.cc/V4RQ-Q4UV>] (describing the financial predicament of the small city of Antioch, California).

15. See, e.g., Parikh & He, *supra* note 7, at 601 (describing Moody’s downgrade of Chicago’s bond rating to junk status and noting that the city is “not alone” in its financial struggles); Romy Varghese, *Even San Francisco, Flush with Tech Wealth, Has Pension Problems*, BLOOMBERG (Mar. 20, 2017, 5:00 AM), <https://www.bloomberg.com/news/articles/2017-03-20/even-san-francisco-flush-with-tech-wealth-has-pension-problems> [<https://perma.cc/SX65-FV83>] (noting that San Francisco’s pension cost is projected to rise three times faster than the city’s revenue).

exist at the state level, constraining states' abilities to assist their municipalities.<sup>16</sup> To address these concerns, Congress has indicated that it will review the bankruptcy system's "responsiveness to the needs of financially troubled" municipalities in the coming year.<sup>17</sup> Indeed, although alternatives to bankruptcy exist, when municipalities are facing debt overhang and the need for breathing space, bankruptcy ought to be a serious consideration.<sup>18</sup>

Recent events have reinforced the importance of critically examining the tools municipalities have at their disposal to resolve fiscal distress. In early May of 2017, Puerto Rico filed the largest government bankruptcy in U.S. history.<sup>19</sup> Other governmental entities, including territories, states, and municipalities, will be closely watching Puerto Rico as it navigates the uncharted waters of its unique bankruptcy proceedings.<sup>20</sup>

Although many scholars have turned to the study of municipal bankruptcy in recent years,<sup>21</sup> a key problem remains understudied in this context: the difficulty judges face when applying bankruptcy's generalized plan confirmation standards to the highly specialized entities that come before them.<sup>22</sup> Municipalities, like other debtor entities, need relief that is tailored to their unique situations; however, bankruptcy is a much more general

16. Parikh & He, *supra* note 7, at 602 ("States have been disengaged from the municipal restructuring process."); Jenna Carlesso, *Hartford Moves Closer to Bankruptcy, Soliciting Proposals from Law Firms*, HARTFORD COURANT (May 9, 2017, 9:10 PM), <http://www.courant.com/community/hartford/hc-hartford-bankruptcy-lawyer-20170509-story.html> [<https://perma.cc/3ZT4-UEFR>] (describing Hartford's need for state assistance to help it avoid financial ruin and Connecticut's estimated \$2 billion budget gap, which necessarily limits the assistance the state can provide to its municipalities); Morgan Lee, *Cash-Strapped New Mexico Reconsiders Savings Strategy*, WASH. TIMES (May 18, 2017), <http://www.washingtontimes.com/news/2017/may/18/cash-strapped-new-mexico-may-overhaul-savings-stra/> [<https://perma.cc/Z6BZ-EF53>] (discussing New Mexico's budget crisis).

17. *Legislative Highlights*, AM. BANKR. INST. J., Mar. 2017, at 10.

18. Coordes, *Gatekeepers*, *supra* note 4, 1212–13 (describing the unique benefits of municipal bankruptcy).

19. Notice of Commencement of Cases Under Title III of PROMESA, Entry of Order for Relief and Related Matters, *In re* The Fin. Oversight & Mgmt. Bd. of P.R., No. 17 BK 3283-LTS (D.P.R. May 3, 2017), ECF No. 243-1; Nick Brown, *Puerto Rico Files for Biggest Ever U.S. Local Government Bankruptcy*, REUTERS (May 3, 2017, 3:34 PM), <https://www.reuters.com/article/us-puertorico-debt-bankruptcy/puerto-rico-files-for-biggest-ever-u-s-local-government-bankruptcy-idUSKBN17Z1UC> [<https://perma.cc/8X5W-9HGA?type=image>].

20. See Kate Smith & Amanda Albright, *Muni-Bond Vultures Rethink Risks Lurking in Market's Junk Yard*, BLOOMBERG (May 30, 2017, 6:00 AM), <https://www.bloomberg.com/news/articles/2017-05-30/muni-bond-vultures-rethink-risks-lurking-in-market-s-junk-yard> [<https://perma.cc/6V7Z-FWH3>] (discussing potential effects of Puerto Rico's bankruptcy-like proceedings on states); see also David R. Doyle, *The Puerto Rico "Bankruptcy": A Cheat Sheet*, AM. BANKR. INST., <https://www.abi.org/feed-item/the-puerto-rico-%E2%80%9Cbankruptcy%E2%80%9D-a-cheat-sheet> [<https://perma.cc/VCX7-RJD7>] ("[A]lthough PROMESA only applies to Puerto Rico, some commentators believe that the Act may provide a statutory framework that could be adapted to address any financial crises facing the nation's states.").

21. For an in-depth discussion of the scholarly literature on municipal bankruptcy, see *infra* Section I.B.

22. See generally Robert F. Salvin, *Student Loans, Bankruptcy, and the Fresh Start Policy: Must Debtors Be Impoverished to Discharge Educational Loans?*, 71 TUL. L. REV. 139 (1996)

toolkit. This problem's seeming simplicity belies its prevalence—this difficulty is present in the insolvency and restructuring context in both the United States and abroad, and is by no means isolated to chapter 9.

Studying this problem in the larger bankruptcy context reveals a common theme: judges turn to experts to overcome inherent limitations with the plan confirmation standards. In chapter 9, these experts often possess specialized knowledge of mediation, municipal finance, or the municipality itself. These experts investigate financial problems, mediate disputes, assess the positions of disparate parties, and provide information to the judge about the particulars of a debtor's situation.<sup>23</sup> In analyzing the involvement of experts in chapter 9, this Article illuminates a startling fact—despite the importance of experts to these cases, an expert's selection, appointment, and roles are given little forethought. Instead, experts in chapter 9 are handled on a largely ad hoc basis. Often, judges simply appoint a colleague to manage important aspects of a case, giving this newly appointed expert wide-ranging powers and responsibilities that go well beyond what the judge is able to do in the case. After exploring the roles experts play in chapter 9 and beyond, this Article advocates for the establishment of formal procedures for appointing and using experts in the chapter 9 context and provides specific guidance as to what these procedures should look like.

Chapter 9 thus serves as a vehicle to examine the role of experts in bankruptcy. Because of the relative lack of precedent in chapter 9 compared to other chapters of the Bankruptcy Code, experts in chapter 9 can take on a particularly outsized role. Yet, the problems experts are seeking to resolve are present outside of chapter 9 as well, so studying the appointment and use of experts in chapter 9 is beneficial to understanding the ways experts can and should be used throughout bankruptcy.

This Article proceeds in three Parts. Part I provides an overview of municipal bankruptcy, the chapter 9 plan confirmation standards, and the challenges chapter 9 judges face in applying general principles to complex situations. Part II reviews recent chapter 9 confirmation decisions and reveals that judges often turn to experts such as specialists and mediators to facilitate the plan confirmation process. Unfortunately, the current, ad hoc use of experts in these cases raises concerns about experts exercising relatively unchecked power, as well as the structural and constitutional implications of judges unilaterally exercising control over their selection and appointment process. To address these concerns, Part III explores proposals and processes from other areas of bankruptcy law that have been put forward with respect to experts. This Part then proposes formal processes for the selection, appointment, and use of experts in chapter 9, including establishing a pool of vetted experts and defining the experts' role in a hearing at the outset of the case. In addition to discussing the possible roles for the

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(describing a similar difficulty in the student loan context of personal bankruptcies and proposing a model for applying the undue-hardship standard for student loans in a manner consistent with bankruptcy's fresh start policy).

23. For an in-depth discussion of the roles these experts play, see *infra* Section II.A.

expert beyond those currently used on an informal basis, Part III explains how formal procedures will minimize the dangers of ad hoc expert use. Part III concludes by calling for Congress and the states to develop formal procedures for involving experts in chapter 9 and by encouraging further research into how experts are used across the bankruptcy spectrum. Developing procedures will address more concretely problems with applying the plan confirmation standards, make bankruptcy a more palatable option for reluctant debtors who nevertheless need its toolkit, and assuage concerns over the power exercised by both judges and experts. Furthermore, studying the selection, appointment, and use of experts throughout bankruptcy law can draw attention to these entities and their significant ability to shape a case.

### I. THE CHALLENGES OF PLAN CONFIRMATION

This Part begins with an overview of chapter 9 bankruptcy and the standards for confirming a municipal plan of adjustment. Section I.A illustrates the ways in which the plan confirmation standards fall short of achieving their primary purposes. Because these standards are imported from a different chapter of the Bankruptcy Code, they were not designed with municipal debtors in mind. As a result, judges often have difficulty making sense of the standards in the chapter 9 context, and the confirmation standards thus serve as less effective protection, for both debtors and creditors, in chapter 9. Section I.B surveys the scholarly literature on chapter 9 bankruptcy plan confirmation, concluding that a key bankruptcy problem has been understudied in the chapter 9 context: the inherent difficulty of applying generalized standards to particularized situations.

#### A. *Municipal Bankruptcy and Plan Confirmation Standards*

Chapter 9 is the part of the Bankruptcy Code used to address municipal debt. Only municipalities, as defined in the Code, may use chapter 9, and if an entity meets the Code's definition of a municipality, it is not eligible to use any other chapter of the Code.<sup>24</sup> Upon filing for chapter 9, a municipality receives the benefit of the automatic stay, which prohibits creditors from pursuing repayment remedies.<sup>25</sup> After determining that a municipality is eligible for chapter 9, a bankruptcy judge's primary task is to decide whether to confirm a plan of debt adjustment that the municipality submits.<sup>26</sup> This plan may be confirmed over the objection of creditors.<sup>27</sup> To determine whether

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24. 11 U.S.C. §§ 101(40), 109(c) (2012).

25. *Id.* §§ 362(a), 901(a).

26. PETER J. BENVENUTI ET AL., JONES DAY, AN OVERVIEW OF CHAPTER 9 OF THE BANKRUPTCY CODE: MUNICIPAL DEBT ADJUSTMENT (2010), <http://www.jonesday.com/files/Publication/d518067b-5e02-47c5-9768-fc692bb8ccd8/Presentation/PublicationAttachment/55c686be-d108-4786-ae66-de946542d3da/Chapter%209%20Municipal%20Debt.pdf> (on file with the *Michigan Law Review*).

27. *Id.*

the plan should be confirmed, the judge relies on the confirmation standards enumerated in the Bankruptcy Code.<sup>28</sup>

Chapter 9 thus offers municipalities two key tools. First, chapter 9 allows for municipalities to adjust debt on a nonconsensual basis.<sup>29</sup> Second, chapter 9, through the imposition of the automatic stay, provides breathing space so that municipalities can develop a plan to address their debts and put themselves back on a path to fiscal health.<sup>30</sup>

The plan confirmation standards are found in § 943 of the Bankruptcy Code.<sup>31</sup> Among other more technical requirements, the confirmation standards require chapter 9 plans to be proposed in good faith, in the best interests of creditors, feasible, and not be prohibited by law.<sup>32</sup> The bankruptcy judge must independently determine that a plan meets these confirmation requirements, regardless of whether a creditor objects.<sup>33</sup> If a municipality seeks to “cram down” a plan over the objections of a creditor class, it must also demonstrate that the plan does not discriminate unfairly and that it is fair and equitable to creditors.<sup>34</sup>

The chapter 9 plan confirmation standards play an important role in helping municipalities achieve their bankruptcy goals. In addition, the plan confirmation standards are intended to balance the needs of debtors against

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28. *Id.*

29. *See In re City of Detroit*, 524 B.R. 147, 159–60 (Bankr. E.D. Mich. 2014) (“In chapter 9 . . . the federal government offers help to the states in solving a problem that . . . the states cannot solve by themselves. That problem is the adjustment of the debts of an insolvent municipality.”); C. Scott Pryor, *Municipal Bankruptcy: When Doing Less is Doing Best*, 88 AM. BANKR. L.J. 85, 114 (2014) (“Without the Bankruptcy Clause or its consent, the rights of a minority cannot be affected by a majority.”); Francisco Vazquez, *Examining Chapter 9 Municipal Bankruptcy Cases*, in CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS, COUNSELING MUNICIPALITIES, AND ANALYZING RECENT TRENDS AND CASES 173, 177 (Jo Alice Darden ed., 2011) (noting that a state cannot bind nonconsenting creditors to a state-debt adjustment procedure).

30. *In re City of San Bernardino*, 499 B.R. 776, 791 (Bankr. C.D. Cal. 2013) (noting that a purpose of chapter 9 is to provide “a municipality a breathing space . . . and an opportunity to address its long term solvency through an organized process”); Christine Sgarlata Chung, *Municipal Bankruptcy, Essential Municipal Services, and Taxpayers’ Voice*, 24 WIDENER L.J. 43, 55 (2015) (noting that chapter 9 is designed to “foster[ ] the continua[nce] of municipalities rather than their dissolution” because municipalities must continue to provide essential services (quoting *In re Addison Cmty. Hosp. Auth.*, 175 B.R. 646, 648 (Bankr. E.D. Mich. 1994))); Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403, 458 (2014) (noting that chapter 9 gives municipalities breathing room consistent with chapter 9’s goals of a fresh start and rehabilitation).

31. 11 U.S.C. § 943 (2012).

32. *Id.* Section 943(b)(1) provides that a plan must comply with bankruptcy provisions made applicable by § 901. Section 901(a) indicates which of the chapter 11 plan confirmation requirements apply in chapter 9, including, for example, the good faith requirement. *Id.* §§ 901(a), 1129(a)(3).

33. *In re Valley Health Sys.*, 429 B.R. 692, 710 n.45 (Bankr. C.D. Cal. 2010) (“The court has an independent obligation to determine that a proposed plan meets the confirmation requirements . . . notwithstanding creditor approval.”).

34. *BENVENUTTI ET AL.*, *supra* note 26, at 10.

the fair treatment of creditors.<sup>35</sup> Thus, the confirmation standards are also meant to serve a protective function for creditors, helping to ensure that the debtor does not engage in manipulative or bad faith behavior.

Unfortunately, the plan confirmation standards fall short in these respects. One likely reason is that the confirmation standards are imported nearly wholesale from chapter 11 of the Bankruptcy Code, the chapter used primarily to reorganize business debts.<sup>36</sup> Due to the vastly different nature of municipal and business debtors, chapter 11 standards simply cannot be applied in the same way in the chapter 9 context. For example, the best interest of creditors test is applied in chapter 11 by asking what a creditor would receive if the debtor liquidated and comparing that result to one under the debtor's reorganization plan.<sup>37</sup> In chapter 9, no liquidation alternative exists.<sup>38</sup> Instead, courts have generally found the chapter 9 best interests test to require "that a proposed plan provide a better alternative for creditors than what they already have."<sup>39</sup> In practice, this is a much easier test to meet, as for many creditors the only alternative to a debtor's plan is dismissal and resort to largely ineffective state remedies.<sup>40</sup>

As another example, judges have often found the feasibility requirement to be particularly difficult to assess in chapter 9. This is because a municipality's ability to adhere to the proposals in its plan is necessarily constrained by the interplay of state and local laws, customs, and changing voter preferences.<sup>41</sup> Not only are municipalities affected by state and federal law, but municipal failure (and recovery) can impose costs and benefits on the region, state, and nation as well.<sup>42</sup> Thus, although municipalities use bankruptcy in part to put themselves on a path to fiscal health, the plan

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35. See *Ashton v. Cameron Cty. Water Improvement Dist. No. One*, 298 U.S. 513, 543 (1936) (Cardozo, J., dissenting) (highlighting the adjustment of the debtor-creditor relationship as a key goal of bankruptcy law); Moringiello, *supra* note 30, at 482–83 (describing how confirmation encourages cooperation between debtors and creditors).

36. See 11 U.S.C. § 901(a) (importing standards); § 1129(a)(3) (good faith and not forbidden by law); § 1129(a)(7) (best interests); § 1129(a)(11) (feasible); § 1129(b)(1) (fair and equitable and no unfair discrimination).

37. David S. Kupetz, *Standards for Confirming a Chapter 9 Plan of Debt Adjustment: Incorporating and Diverging from Chapter 11 Plan Standards*, 32 CAL. BANKR. J. 289, 313 (2012).

38. *Id.*

39. *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 34 (Bankr. D. Colo. 1999); see also Pryor, *supra* note 29, at 120 ("[C]ontemporary courts generally give little weight to the best interests test . . .").

40. *In re Mount Carbon*, 242 B.R. at 33 ("The only alternative to Chapter 9 is restructuring by the municipality in accordance with state law, which may be difficult and may require voter approval . . .").

41. See, e.g., R. Craig Martin, *Après nous le déluge: Municipal Debt, Sovereign Debt—What's Next?*, INSOL WORLD, Second Quarter 2017, at 19 (comments of Kevyn Orr) (noting that municipalities often have an "existing infrastructure" and considerable legislation with respect to how a municipality must interact with creditors, and that these elements "add complications to the functioning of core governmental services"); Nadav Shoked, *Debt Limits' End*, 102 IOWA L. REV. 1239, 1241 (2017) (noting that "the law . . . treats local governments strikingly differently from" other debtors by placing limits on local government debt).

42. Parikh & He, *supra* note 7, at 606.

confirmation standards, by themselves, do not ensure this result due to the complex, interconnected nature of municipalities and their particular local, state, and federal settings.<sup>43</sup>

The confirmation standards also frequently do not achieve their creditor protection function.<sup>44</sup> The lack of plausible alternatives to chapter 9, combined with ill-defined creditor priorities, makes application of even the most straightforward plan confirmation standards difficult to achieve.<sup>45</sup> For example, the absolute priority rule, part of the fair and equitable test, is applied in chapter 11 to ensure that objecting unsecured creditors get paid before more junior classes of equity holders.<sup>46</sup> In chapter 9, the absolute priority rule does not provide unsecured creditors with similar protection because municipalities do not have equity holders.<sup>47</sup> In addition, the priorities of creditors in chapter 9 are often unclear, due in part to the interplay between state statutory and constitutional law and federal bankruptcy law.<sup>48</sup> For example, if a state has constitutional protections for pensions, those protections may serve to elevate pensioners above bondholders, even though bankruptcy law would treat both creditors equally.<sup>49</sup> Although some judges have held that state law should not influence bankruptcy priorities, the law remains unsettled at this point, making application of the absolute priority rule in chapter 9 less certain than in chapter 11 and opening the door for parties to

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43. Cf. NAT'L BANKR. REVIEW COMM'N, GENERAL ISSUES IN CHAPTER 11, at 85 (1997), Westlaw 1997 WL 985132 ("Even the most carefully crafted plans of reorganization sometimes encounter circumstances that warrant adjustment."). Although this article discusses plan confirmation in the chapter 11 context, the same concerns exist in chapter 9.

44. See Coordes, *Gatekeepers*, *supra* note 4, at 1220 (discussing the confirmation standards' inadequate creditor protections and resulting creditor behavior); Deitch, *supra* note 3, at 2726 ("[C]reditors have limited recourse once the [chapter 9] petition is accepted, as the municipal debtor can spend and borrow without court approval and bind creditors to a confirmed plan.").

45. See Pryor, *supra* note 29, at 120 (describing chapter 9's priority scheme, but noting that some scholars would contest this account and instead argue that "state priorities should control bankruptcy fairness").

46. See generally Morris J. Massel, *A Guide to the Ch. 11 Initiating Process*, LAW360 (Oct. 30, 2013, 4:58 PM), <https://www.law360.com/articles/484695/a-guide-to-the-ch-11-initiating-process> (on file with the *Michigan Law Review*).

47. *In re Corcoran Hosp. Dist.*, 233 B.R. 449, 458 (Bankr. E.D. Cal. 1999) (noting that the absolute priority rule "must be interpreted somewhat differently" in chapter 9).

48. The situation in Puerto Rico is an illustrative parallel to priority problems in chapter 9. Two different classes of bondholders are disputing who should have priority claims to certain money. The priority question in Puerto Rico, like similar questions in chapter 9 proceedings, involves issues of constitutional and statutory interpretation. See Emma Orr & Michelle Kaske, *Puerto Rico Bondholders Deny Legitimacy of Each Other's Debt*, BLOOMBERG (May 25, 2017, 5:59 AM), <https://www.bloomberg.com/news/articles/2017-05-23/puerto-rico-bondholders-say-everybody-and-nobody-has-valid-claim> [<https://perma.cc/SXV9-H8BZ>].

49. See Andrew B. Dawson, *Beyond the Great Divide: Federalism Concerns in Municipal Insolvency*, 11 HARV. L. & POL'Y REV. 31, 35 (2017).

manipulate the system.<sup>50</sup> Lack of clarity with respect to priorities in bankruptcy may also make creditors hesitant to lend to municipalities in the first place.<sup>51</sup>

To further complicate matters, the person tasked with interpreting and applying the confirmation standards—the bankruptcy judge—plays a very limited role in a chapter 9 case.<sup>52</sup> This is due in part to constitutional and statutory constraints on the bankruptcy court; in essence, the court is not able to supervise the municipality's execution of its recovery and cannot mandate a particular path for the municipality to take.<sup>53</sup> Section 904 of the Bankruptcy Code prohibits the judge from taking measures like forcing a municipality to change its governing structure or directing the municipality on how to spend its money or use its property.<sup>54</sup> In contrast, in a chapter 11 case, the debtor must receive court approval to use, sell, or lease its property outside of the ordinary course of business.<sup>55</sup> Furthermore, while a judge in a chapter 11 case may decide to confirm a plan submitted by a creditor or other party in interest, a chapter 9 judge cannot force the municipality to adopt a plan that is not proposed by the municipality itself.<sup>56</sup> Although judges in practice sometimes work around these limitations,<sup>57</sup> on the whole, a judge in chapter 9 does not have the same Code-sanctioned involvement in a case as a chapter 11 judge, who can exercise more debtor oversight by, for example, appointing a trustee or examiner in the case.<sup>58</sup> The judge's relatively limited role in chapter 9 can make it difficult for the judge to

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50. Vincent S.J. Buccola, *Law and Legislation in Municipal Bankruptcy*, 38 CARDOZO L. REV. 1301, 1316 (2017) (noting that, at least in some instances, creditor priorities in chapter 9 are not well established); Andrew Hedlund, *Supremacy's Claws: How Two Judges Are Changing the Pension Debate*, DEAL (Mar. 6, 2015) (on file with the *Michigan Law Review*) (discussing bankruptcy cases where judges stated that constitutionally protected pensions could be cut).

51. Cf. Robert K. Rasmussen & David A. Skeel, Jr., *Governmental Intervention in an Economic Crisis*, 19 U. PA. J. BUS. L. 7, 32 (2016) ("If priorities are not respected, investors will be more reluctant to lend during a crisis to companies that may later be subject to governmental intervention.").

52. See Moringiello, *supra* note 7, at 74–75 (addressing the lack of judicial review surrounding confirmation standards in chapter 9 due to the relatively small number of cases).

53. See *In re City of Detroit*, 524 B.R. 147, 163 (Bankr. E.D. Mich. 2014).

54. 11 U.S.C. § 904 (2012).

55. *Id.* § 363.

56. See *id.* § 941; MARC A. LEVINSON ET AL., THOMPSON REUTERS: PRACTICAL LAW, CHAPTER 9 V. CHAPTER 11 COMPARISON CHART (2016), <https://s3.amazonaws.com/cdn.orrick.com/files/Chapter9vChapter11ComparisonChartLevinsonPLB.pdf> [<https://perma.cc/UC28-G2X2>]; see also Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55, 58–59 (2016) (discussing ways judges can work around limitations).

57. See Clayton P. Gillette & David A. Skeel, Jr., *Governance Reform and the Judicial Role in Municipal Bankruptcy*, 125 YALE L.J. 1150, 1206 (2016) (noting that a bankruptcy judge's ability to withhold plan confirmation allows the court to overcome § 904's limitations).

58. § 1104. Limited postbankruptcy oversight is also a problem. For example, the City of San Bernardino, California, recently deviated from its court-approved bankruptcy plan because it did not expect to be able to hire police as fast as its budget calls for. Ryan Hagen, *San Bernardino Budget Proposal Follows Bankruptcy Plan, Except for Police*, SAN BERNARDINO CTY.

understand the parties and the financial issues at stake when a municipality proposes a plan of adjustment.

In sum, the confirmation standards produce uncertainty because they cannot be applied to ensure that a municipality is treating its creditors fairly or producing a fair and feasible plan. Though derived primarily from chapter 11, the tests are much weaker in the chapter 9 context. Even in chapter 11, the confirmation standards do not guarantee success.<sup>59</sup> It is much more difficult to achieve a certain outcome in chapter 9, where the same tests are applied with even less relevance.

Although the chapter 9 plan confirmation standards are difficult to apply and do not themselves put municipalities on a path to fiscal health, changing these standards is daunting for both legal and political reasons. First, chapter 9 strikes a delicate constitutional balance, allowing a federal judge to oversee procedures that necessarily influence the way that municipalities are run as well as the ways in which they interact with their states.<sup>60</sup> Any efforts to formally give the judge more power at plan confirmation risk running afoul of the Tenth Amendment's reservation of powers to the states. Even if a change to the confirmation standards passes legal muster, however, it would likely face steep political obstacles, as both state and local officials are sensitive to perceived attempts to encroach on their powers.<sup>61</sup>

Therefore, despite their limitations, it is unlikely that the plan confirmation standards can be significantly altered. Nevertheless, as Section I.B will illustrate, scholars have not been deterred from making suggestions to improve chapter 9 and its plan confirmation process.

### B. *Proposals for Reform*

The scholarly literature contains many observations about problems with chapter 9, as well as proposals for improvement.<sup>62</sup> Broadly speaking,

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SUN (May 10, 2017, 7:50 PM), <http://www.sbsun.com/2017/05/10/san-bernardino-budget-proposal-follows-bankruptcy-plan-except-for-police/> [https://perma.cc/LZ83-5XAC].

59. See generally Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597 (1993) (discussing chapter 11 "success," defined in various ways, in the context of large public company reorganizations).

60. For a detailed discussion of the constitutional concerns surrounding chapter 9, see David E. Solan, *State Bankruptcy: Surviving a Tenth Amendment Challenge*, 42 GOLDEN GATE U. L. REV. 217 (2012). See also Chung, *supra* note 30, at 57–59 (discussing how the goals of chapter 9 bankruptcy interact with the Tenth Amendment); Dawson, *supra* note 49, at 32 ("While the power to adjust financial operations is squarely within Congress's power to 'enact uniform laws on the subject of bankruptcies,' the states retain the power to govern their municipalities." (quoting U.S. CONST., art. I, § 8, cl. 4)).

61. See Coordes, *Gatekeepers*, *supra* note 4, at 1229–30 (discussing the rhetoric and fear surrounding chapter 9).

62. See, e.g., DANIEL DI SALVO & STEPHEN EIDE, MANHATTAN INST., *WHEN CITIES ARE AT THE FINANCIAL BRINK* (2017) (noting disagreement over how to make chapter 9 more effective); Chung, *supra* note 30, at 61 (providing an overview of when courts have allowed taxpayers to appear as parties-in-interest); Christine Sgarlata Chung, *Zombieland/The Detroit Bankruptcy: Why Debts Associated with Pensions, Benefits, and Municipal Securities Never*

the problems identified fall into three categories. First, many scholars believe the confirmation standards, and chapter 9 more generally, are ineffective because cities emerge from the process and continue to visibly struggle with debt.<sup>63</sup> Second, chapter 9 suffers from an inherently limited scope: due to the constitutional limitations discussed above, municipal bankruptcy can only address financial issues and not governance issues, which are often at the root of financial problems.<sup>64</sup> A related problem is the limited role of the bankruptcy judge and the degree of constitutional limitations on that role.<sup>65</sup> Third, as discussed in more detail above, chapter 9's confirmation standards are difficult to apply in practice because they are both facially unclear and lack relevant precedent.<sup>66</sup>

To address these problems within the chapter 9 context, existing proposals suggest making specific changes to chapter 9 or the plan confirmation

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*Die . . . And How They Are Killing Cities Like Detroit*, 41 *FORDHAM URB. L.J.* 771, 779 (2014) (proposing earlier intervention by state and local governments and a fiduciary standard for public officials and other stakeholders to protect the municipality's long-term best interest); Nathan E. Enfield, *The Logic and Limits of Chapter 9: The Case of Police*, 2016 *U. CHI. LEGAL F.* 739, 740 (discussing the limitations of chapter 9 in addressing police crises); Richard M. Hynes & Steven D. Walt, *Fair and Unfair Discrimination in Municipal Bankruptcy*, 37 *CAMPBELL L. REV.* 25, 28–29 (2015) (arguing that a judge cannot approve a plan that provides retirees and active workers with a greater recovery than other creditors); Jacoby, *supra* note 56, at 58 (studying court oversight in the Detroit bankruptcy); Moringiello, *supra* note 30, at 409 (arguing that an understanding of chapter 9 as an “integrated scheme for municipal financial recovery” is essential to considering changes to chapter 9); Julie A. Roin, *Retroactive Taxation, Unfunded Pensions, and Shadow Bankruptcies*, 102 *IOWA L. REV.* 559, 579–80 (2017) (noting that voters bear some of the blame for continuing to vote for politicians that create poor financial situations and proposing to hold voters partially accountable through retroactive taxation).

63. See, e.g., Buccola, *supra* note 50, at 1337 (describing how uncertainty in chapter 9 is harmful to cities); Karol K. Denniston, *Neutral Evaluation in Chapter 9 Bankruptcies: Mitigating Municipal Distress*, 32 *CAL. BANKR. J.* 261, 263–64 (2012) (noting that chapter 9 may do more harm than good and proposing a neutral evaluation process similar to California's).

64. See, e.g., Dawson, *supra* note 49, at 33–34 (noting that chapter 9 only addresses financial problems and not the root causes of those problems and proposing to move toward a functional approach that recognizes the overlap between debt and governance); Gillette & Skeel, *supra* note 57, at 1153 (noting that chapter 9 does not effectively address governance issues but arguing that it can and should); Andrew Sallway, *Hot Topics—Avoid Being Burnt!*, *INSOL WORLD*, Second Quarter 2017, at 28 (comments of Gaurav Malhotra) (describing a “scoop and toss” approach to insolvency, where financial restructuring occurs without a long-term plan for operational success).

65. But see Jacoby, *supra* note 56, at 72 (discussing how judges might work around these limitations, as well as concerns that might arise when they do).

66. See, e.g., Buccola, *supra* note 50, at 1339–40 (proposing legislative reforms to chapter 9's structure to clarify substantive rights); Deitch, *supra* note 3, at 2726–28 (noting that it is unclear how to determine whether a plan is fair and proposing that courts differentiate between onetime event bankruptcies and structurally imbalanced bankruptcies); John Patrick Hunt, *Taxes and Ability to Pay in Municipal Bankruptcy*, 91 *WASH. L. REV.* 515, 523 (2016) (noting that it is unclear how courts are supposed to look at tax levels and arguing that courts should require a municipality to tax at the top of its peer group as a condition of plan confirmation); Moringiello, *supra* note 7, at 74–75 (noting that confirmation standards are underdeveloped and proposing a clearer role for state choices in the bankruptcy process to help interpret the confirmation standards).

requirements, including expanding the scope of the feasibility requirement and clarifying the unfair discrimination requirement.<sup>67</sup> Other scholars seek to reexamine the federalism questions surrounding chapter 9 with the intention of redefining its scope. For example, Clayton Gillette and David Skeel propose that judges use the feasibility plan confirmation requirement to address governance issues,<sup>68</sup> and John Patrick Hunt argues that Congress could use municipal bankruptcy to constitutionally preempt state constitutional limits on municipal taxes.<sup>69</sup>

Largely absent from the literature is a discussion of an often-observed yet inherent problem: the chapter 9 plan confirmation standards are general principles that are not structured for application to the specific, complex problems that municipalities face.<sup>70</sup> No two municipalities are alike; rather, municipalities are varied in ways too numerous to count. Previous research has established that municipalities differ vastly from one another in terms of structure, governance ability, legal constraints, and much more.<sup>71</sup> The in-depth knowledge needed to assess whether a municipality is complying with the intent of the plan confirmation requirements is therefore significant.

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67. See, e.g., Andrew B. Dawson, *Pensioners, Bondholders, and Unfair Discrimination in Municipal Bankruptcy*, 17 U. PA. J. BUS. L. 1, 3–6 (2014) (noting that unfair discrimination for pensioners vis-à-vis other creditors is unclear and proposing that unfair discrimination mean the same thing it does in chapter 11); 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 how bankruptcy courts can use the confirmation requirements to influence governance); C. Scott Pryor, *Who Pays the Price? The Necessity of Taxpayer Participation in Chapter 9*, 24 WIDENER L.J. 81, 85 (2015) (arguing that courts should use feasibility to take taxpayer interests into account).

68. Gillette & Skeel, *supra* note 57, at 1156.

69. John Patrick Hunt, *Constitutionalized Consent: Preemption of State Tax Limits in Municipal Bankruptcy*, 34 YALE J. ON REG. 391, 394 (2017). There is also substantial literature arguing for increased intervention outside of bankruptcy, for example in the form of oversight or control boards. See, e.g., Clayton P. Gillette, *Dictatorships for Democracy: Takeovers of Financially Failed Cities*, 114 COLUM. L. REV. 1373, 1384 (2014) (advocating expanding the authority of state-run takeover boards); Parikh & He, *supra* note 7, at 605 (suggesting that states should offer meaningful debt-restructuring options both within and outside the bankruptcy context). Yet, as I have argued in previous work, chapter 9 offers distinct, unique benefits as well as targeted relief to address particular problems. Coordes, *Gatekeepers*, *supra* note 4. For this reason, this Article's focus is on improving the chapter 9 system itself; although improvements outside of the chapter 9 context are valuable and desirable, improvements within chapter 9 must also be made so that municipalities can use chapter 9 when they need its distinct tools.

70. See Frank Shafroth, *The Key Lessons Learned After a Decade of Municipal Bankruptcies*, GMU MUN. SUSTAINABILITY PROJECT (Apr. 7, 2017), <https://fiscalbankruptcy.wordpress.com/2017/04/07/the-key-lessons-learned-after-a-decade-of-municipal-bankruptcies/> [https://perma.cc/NB25-54BD] (“Debt adjustment is a process, but a recovery plan is a solution . . . [T]he plan provides additional breathing room so that the municipality . . . may proceed with a recovery plan, reinvest . . . stimulate the economy, create new jobs . . . and raise the level of services and infrastructure to that which is acceptable and attract new business and new citizens.”).

71. See generally Coordes & Reilly, *supra* note 7 (charting these differences through detailed case studies).

Thus, the chapter 9 plan confirmation standards are not tailored to municipalities' specific situations, and applying them to chapter 9 plans requires an understanding of the municipality and its underlying issues that bankruptcy judges often cannot obtain by themselves. The next Part explores the ways in which judges address this problem in practice, as well as concerns raised by the way in which they are proceeding.

## II. OVERCOMING CHAPTER 9'S LIMITATIONS

Difficulties with applying chapter 9's plan confirmation standards arise for three primary reasons. First, there is little relevant precedent, both because of the rarity of municipal bankruptcy and because the entities that have used it differ vastly from one another. Unlike in chapter 11, for example, there is no substantial body of precedent for a judge to draw upon in applying the plan confirmation standards.<sup>72</sup> Second, and relatedly, municipal entities are not self-contained.<sup>73</sup> Even municipalities with so-called "home rule" authority, or the ability to self-govern, often differ substantially from one another in terms of the powers they are able to exercise without requesting state authority or assistance.<sup>74</sup> No municipality exists in a vacuum; each is influenced and directed by federal,<sup>75</sup> state,<sup>76</sup> regional,<sup>77</sup> and local

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72. Transcript of Bench Decision at 16, 49, *In re City of Detroit*, 524 B.R. 147 (Bankr. E.D. Mich. 2014) (No. 13-53846), ECF No. 8257.

73. See *Beauchamp-Velazquez v. Dep't of Educ. of P.R.*, No. 3:17-01419-WGY, 2017 WL 4228047, at \*2 (D.P.R. July 13, 2017) (acknowledging "the difficulties of applying bankruptcy principles to government entities," which "are not capitalist for-profit entities").

74. See generally FRUG & BARRON, *supra* note 5 (detailing limitations on home rule and municipal self-governance).

75. See, e.g., Nick Brown, *Puerto Rico Authorizes Debt Payment Suspension; Obama Signs Rescue Bill*, REUTERS (June 30, 2016, 12:06 AM), <https://www.reuters.com/article/us-puertori-co-debt/puerto-rico-authorizes-debt-payment-suspension-obama-signs-rescue-bill-idUSKC N0ZG09Y> [<https://perma.cc/C7NE-S57E>] (describing how the federal statute PROMESA was designed to aid Puerto Rico in the face of litigation precipitated by default).

76. For an example of a municipality's complex fiscal relationship with its state, see Frank Shafroth, *Perspectives on Municipal Bankruptcy*, GMU MUN. SUSTAINABILITY PROJECT (May 16, 2017), <https://fiscalbankruptcy.wordpress.com/2017/05/16/perspectives-on-municipal-bankruptcy/> [<https://perma.cc/VT59-DYKQ>] (describing the Connecticut governor's proposal to shift teacher pension costs to municipalities, which S&P has noted "may pressure local government finances").

77. See, e.g., FRUG & BARRON, *supra* note 5, at ch. 10 (asserting that central cities' relationships with their neighbors are of critical economic importance).

practices,<sup>78</sup> laws,<sup>79</sup> politics,<sup>80</sup> and customs.<sup>81</sup> Thus, what each municipality needs in order to exit bankruptcy and establish fiscal health will be different in every case, and the judge must understand this complex interplay well enough if he or she is to apply the confirmation standards effectively.

Finally, as previously discussed, the chapter 9 plan confirmation standards do not provide much certainty or clarity. Because chapter 9 is not itself a panacea, a municipality's long-term recovery necessarily exceeds what it can do in bankruptcy.<sup>82</sup> Thus, chapter 9 plan confirmation only provides partial relief to a struggling municipality: the ultimate goal of a financially stable entity cannot be achieved without further efforts.

Despite these shortcomings, chapter 9 cases progress, and judges confirm plans of adjustment. Thus, many of the problems identified in the theoretical literature have been experienced and addressed in practice. In large part, judges turn to experts for help overcoming bankruptcy's inherent shortcomings. Indeed, experts can help all parties to a case maximize bankruptcy's toolkit by solving strategic bargaining problems and revealing hidden information. By providing an informed picture of the municipality's finances and unique situation to the bankruptcy judge, experts can make good use of a municipality's time in bankruptcy. Similarly, experts who take on the role of a mediator can assist with bankruptcy negotiations by providing a neutral sounding board and facilitating settlements.

#### A. Chapter 9 Cases

The following cases illustrate the difficulties judges face when applying the chapter 9 plan confirmation standards, as well as the ways that judges have overcome these difficulties in practice. The Detroit bankruptcy, an enormously complex endeavor indicative of both the problems with chapter 9 bankruptcies and the practical solutions that can be applied to these problems, is the feature of this subsection. Three other examples of general

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78. Many municipal fiscal issues are rooted in years, if not decades, of mistakes and poor management. See, e.g., Martin Z. Braun & Jonathan Levin, *Debt Island: How \$74 Billion in Bonds Bankrupted Puerto Rico*, BLOOMBERG (May 15, 2017, 5:00 AM), <https://www.bloomberg.com/news/articles/2017-05-15/debt-island-how-74-billion-in-bonds-bankrupted-puerto-rico> [<https://perma.cc/3LQQ-NTQL>] (describing Puerto Rico's longstanding fiscal issues and noting that the Commonwealth has not "filed audited financial statements since its 2014 fiscal year").

79. See, e.g., *id.* (noting that Puerto Rico borrowed at a "turbo-charged" rate because its debt was legally exempt from taxation).

80. See, e.g., Keith M. Phaneuf, *Bankruptcy for Hartford May Hinge on CT Tax Debate*, CONN. MIRROR (May 15, 2017), <https://ctmirror.org/2017/05/15/bankruptcy-for-hartford-may-hinge-on-ct-tax-debate/> [<https://perma.cc/RW5J-3EC9>] (noting how the politics of taxation in Connecticut influence the state's strategy toward the struggling city of Hartford).

81. See, e.g., Amy Padnani, *Anatomy of Detroit's Decline*, N.Y. TIMES (Aug. 17, 2013), <http://www.nytimes.com/interactive/2013/08/17/us/detroit-decline.html> (on file with the *Michigan Law Review*) (arguing that Detroit's reliance on a single industry was a cause of its financial decline).

82. Shafroth, *supra* note 14.

purpose municipal bankruptcies provide additional insights into the value of mediation and expertise in crafting a chapter 9 plan of adjustment.

### 1. Detroit, Michigan

When Detroit filed for bankruptcy in July of 2013, it was the largest municipal bankruptcy the United States had seen to date.<sup>83</sup> Facing approximately \$18 billion in debt and lawsuits from dozens of unhappy creditors, Detroit was undoubtedly ready for chapter 9 protection.<sup>84</sup> Detroit also exited bankruptcy in about seventeen months, a record time for such a large city.<sup>85</sup>

Two primary factors shaped Detroit's bankruptcy experience. First, the city entered numerous settlements with many key creditor groups.<sup>86</sup> In his confirmation opinion, Judge Rhodes, the bankruptcy judge overseeing the case, praised these settlements as helping the entire bankruptcy process run more smoothly and quickly and called them "ideal" for future restructurings.<sup>87</sup>

Detroit reached these settlements primarily through the mediation process. Indeed, Detroit's most famous settlement, the Grand Bargain, which involved the cooperation of the state of Michigan and several philanthropic organizations, was brokered in mediation, though it was far from the only deal to emerge from the process.<sup>88</sup> Notably, mediation also resulted in a pension settlement that Judge Rhodes deemed "miraculous."<sup>89</sup> In fact, "through court-ordered mediation, the City has achieved settlement with every creditor group that was represented by counsel."<sup>90</sup>

Although Judge Rhodes ordered the mediation, he did not oversee the process himself. Rather, he appointed Chief U.S. District Judge Gerald Rosen to be the case mediator.<sup>91</sup> Judge Rosen and his team of five additional

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83. Nathan Bomey et al., *Detroit Becomes Largest U.S. City to Enter Bankruptcy*, USA TODAY (Dec. 3, 2013, 9:58 AM), <https://www.usatoday.com/story/news/nation/2013/12/03/detroit-bankruptcy-eligibility/3849833/> [<https://perma.cc/NS5T-W6E5>].

84. *Id.*

85. *Detroit on Track to Exit Bankruptcy in Record Time*, GUARDIAN (Aug. 31, 2016, 10:45 AM), <https://www.theguardian.com/world/2014/aug/31/detroit-bankruptcy-record-time-hearing> [<https://perma.cc/8HC4-KEMQ>]; see Christine Ferretti, *Detroit Emerges From Bankruptcy Today*, DET. NEWS (Dec. 10, 2014, 11:29 AM), <http://www.detroitnews.com/story/news/local/wayne-county/2014/12/10/detroit-bankruptcy/20192957/> [<https://perma.cc/C4Q6-VPQV>] (noting that Detroit filed for bankruptcy in July of 2013 and emerged on December 10, 2014).

86. Andrew Scurria, *Detroit Wins Confirmation of \$7B Debt-Cutting Plan*, LAW360 (Nov. 7, 2014, 1:03 PM), <https://www.law360.com/articles/594098/detroit-wins-confirmation-of-7b-debt-cutting-plan> (on file with the *Michigan Law Review*).

87. *Id.* (quoting Transcript of Bench Decision, *supra* note 72, at 29).

88. *Id.* The Grand Bargain enabled Detroit to exit bankruptcy. See *id.*

89. *Id.* (quoting Transcript of Bench Decision, *supra* note 72, at 10).

90. *In re City of Detroit*, 524 B.R. 147, 160 (Bankr. E.D. Mich. 2014).

91. *Id.* at 168.

mediators were given expansive authority to supervise the settlement negotiations between the city and its creditors, a process that the judge characterized as “fundamental to the City’s plan and its revitalization.”<sup>92</sup> In addition to allowing Detroit to avoid litigation, the settlements aided the judge in applying the good faith plan confirmation standard. Judge Rhodes noted that the settlements illustrated the city’s good faith in proposing its plan.<sup>93</sup> The court called the settlement accomplishments “extraordinary in bankruptcy.”<sup>94</sup> Notably, Judge Rosen is widely acknowledged as the “architect” of the Grand Bargain.<sup>95</sup> In all, Judge Rhodes commented that appointing Judge Rosen as mediator was “the smartest thing [he] did in this case.”<sup>96</sup>

The second notable feature of the Detroit bankruptcy was the involvement of specialists. Even before the bankruptcy began, the state of Michigan had selected Kevyn Orr, a prominent bankruptcy attorney, to serve as the city’s emergency manager.<sup>97</sup> Orr’s role was deemed “critical” to the city’s success in bankruptcy; one analysis concluded that Detroit “benefited from an objective, independent subject matter expert who, insulated from ballot box risk, was willing to take politically unpopular but necessary measures.”<sup>98</sup> Additionally, during the bankruptcy itself, Judge Rhodes appointed a feasibility expert to assist him with plan confirmation.<sup>99</sup> Detroit’s plan itself also contemplated continued expert involvement postbankruptcy by creating a financial review commission to supervise the city’s finances after it emerged.<sup>100</sup>

The experts and professionals involved in Detroit’s bankruptcy proved particularly valuable during the plan confirmation process, which was an exercise in sheer information absorption. The court considered testimony from forty-one witnesses at the confirmation hearing, as well as affidavits and declarations included among approximately 2,300 exhibits admitted into evidence.<sup>101</sup> Prior to the hearing, the judge participated in a city tour

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92. *Id.*

93. *Id.* at 248–49.

94. *Id.* at 248.

95. Sean T. Scott et al., *7 Lessons from the Detroit Bankruptcy*, *Law360* (Nov. 11, 2014, 7:44 PM), <https://www.law360.com/articles/595257/7-lessons-from-the-detroit-bankruptcy> (on file with the *Michigan Law Review*).

96. MARK N. BERMAN & ERIK SCHNEIDER, NIXON PEABODY LLP, OBSERVATIONS: CONFIRMATION OF THE CITY OF DETROIT CHAPTER 9 PLAN OF ADJUSTMENT (2014), [https://www.nixonpeabody.com/-/media/Files/Alerts/172296\\_Bankruptcy\\_Alert\\_24NOV2014.ashx](https://www.nixonpeabody.com/-/media/Files/Alerts/172296_Bankruptcy_Alert_24NOV2014.ashx) [<https://perma.cc/9PBW-P58W>].

97. *In re City of Detroit*, 524 B.R. at 189; Monica Davey, *Bankruptcy Lawyer Is Named to Manage an Ailing Detroit*, *N.Y. TIMES* (Mar. 14, 2013), <http://www.nytimes.com/2013/03/15/us/gov-rick-snyder-kevyn-orr-emergency-manager-detroit.html> (on file with the *Michigan Law Review*).

98. Scott, *supra* note 95.

99. *In re City of Detroit*, 524 B.R. at 221.

100. *Id.* at 244.

101. Order Confirming Eighth Amended Plan for the Adjustment of Debts of the City of Detroit at 5–6, *In re City of Detroit*, 524 B.R. 147 (Bankr. E.D. Mich. 2014) (No. 13-53846), ECF No. 8272.

conducted by counsel for Detroit, during which the court observed blight in the city firsthand.<sup>102</sup> The court concluded that the tour was “enlightening and valuable.”<sup>103</sup>

To determine whether the plan was in the best interests of creditors, the court relied on testimony from a tax expert about whether, if creditors resorted to state law, they would be able to collect anything from the city based on a mandamus action.<sup>104</sup> The court also heard testimony from the city’s chief financial officer, mayor, and emergency manager on this issue.<sup>105</sup>

The court also used an independent expert witness to report on the feasibility of the city’s plan.<sup>106</sup> The expert, Martha Kopacz, produced three detailed reports and provided testimony.<sup>107</sup> Kopacz and her team reviewed the plan projections, interviewed relevant parties, pored over thousands of pages of documents, and critiqued the methodology, data, and information used for the projections.<sup>108</sup> The city also retained nine independent professionals to testify with respect to feasibility.<sup>109</sup> Although several creditors objected to portions of Kopacz’s testimony, arguing that she lacked the necessary qualifications to give certain opinions and that her investigations exceeded the scope of her assignment to the court,<sup>110</sup> the judge ultimately overruled these objections.<sup>111</sup>

In his opinion on plan confirmation, Judge Rhodes stated that “the efforts of Ms. Kopacz and her team were essential for the Court to discharge its duty [regarding feasibility].”<sup>112</sup> According to the judge, part of the difficulty with the feasibility analysis was that “several key parts of the plan depend[ed] upon performance by parties who are completely beyond the City’s control.”<sup>113</sup> Thus, the court relied heavily on Kopacz’s reports and testimony to make an informed judgment on whether those parties would perform as projected.

In his confirmation opinion, Judge Rhodes made clear that he understood the problem of applying generalized standards to Detroit’s particularized situation. He rejected all previously adopted standards for determining whether the plan discriminates unfairly against classes of creditors, instead concluding that “determining fairness is a matter of relying upon the judgment of conscience.”<sup>114</sup> In making this statement, Judge Rhodes suggested

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102. *In re City of Detroit*, 524 B.R. at 166–67.

103. *Id.* at 167.

104. *See id.* at 214–15.

105. *See id.* at 223.

106. *Id.* at 221.

107. *Id.*

108. *Id.* at 226.

109. *Id.* at 223.

110. *Id.* at 222.

111. *Id.*

112. *Id.* at 221.

113. *Id.* at 220.

114. *Id.* at 255–56.

that a more flexible standard of unfair discrimination is appropriate for chapter 9 cases.<sup>115</sup> Indeed, Judge Rhodes noted that “the primary focus of the Court’s consideration . . . is on the needs of the City.”<sup>116</sup>

Judge Rhodes similarly took a flexible approach in applying the fair and equitable requirement, which assesses whether the plan complies with bankruptcy priorities. Judge Rhodes determined that the fair and equitable analysis required both the absence of misconduct and an inquiry into “circumstances in the case that suggest to the Court’s conscience that it is fair and equitable to impose the plan on the dissenting creditors against their stated will.”<sup>117</sup> In all, the knowledge Judge Rhodes received from the experts and from his city tour gave him the necessary tools to tailor the confirmation standards to Detroit’s particular situation.

Finally, Judge Rhodes acknowledged the limitations of the role of experts in municipal bankruptcy. Although a fee examiner had been appointed in the case, the court determined that it could not outsource a decision on reasonableness of fees and that it had to make an independent decision regarding fees because this obligation was so closely linked to the fair and equitable plan confirmation requirement.<sup>118</sup>

The aftermath of Detroit’s bankruptcy has not always been smooth, despite the assistance of experts and professionals. In particular, Kevyn Orr was challenged and criticized for many of the decisions he made as emergency manager, and tensions flared when he was perceived as working at cross purposes with local elected officials.<sup>119</sup> Notably, Judge Rhodes ended his opinion on confirmation by stating, “[i]t is now time to restore democracy to the people of the City of Detroit,” suggesting that democracy, on some level, had been supplanted by appointed officials.<sup>120</sup> Nevertheless, the outcome of Detroit’s plan and its flexible, comprehensive nature have proven durable: the city’s finances have significantly improved,<sup>121</sup> and it is “on track to have its oversight board . . . become dormant in 2018.”<sup>122</sup>

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115. *Id.* at 256.

116. *Id.* at 259.

117. *Id.* at 261.

118. *Id.* at 210.

119. See, e.g., Joe Guillen, *Mayor Duggan: Kevyn Orr Hid Pension Plan Details; City May Sue Firm*, DET. FREE PRESS (Feb. 23, 2017, 1:32 PM), <http://www.freep.com/story/news/local/michigan/detroit/2017/02/23/duggan-orr-detroit-bankruptcy-finances/98302920/> [https://perma.cc/GJ4K-4LKF].

120. *In re City of Detroit*, 524 B.R. at 277.

121. Frank Shafroth, *The Roads out of and into Insolvency*, GMU MUN. SUSTAINABILITY PROJECT (May 31, 2017), <https://fiscalbankruptcy.wordpress.com/2017/05/31/the-roads-out-of-and-into-insolvency/> [https://perma.cc/W74E-CJK5] (noting that Detroit ended its 2016 fiscal year with a \$63 million budget surplus, about \$22 million higher than the city projected).

122. Frank Shafroth, *What Lessons Can State & Local Leaders Learn from Unique Fiscal Challenges?*, GMU MUN. SUSTAINABILITY PROJECT (Apr. 25, 2017), <https://fiscalbankruptcy.wordpress.com/2017/04/25/what-lessons-can-state-local-leaders-learn-from-unique-fiscal-challenges/> [https://perma.cc/U7W5-ZAA6].

The mediation process was a cornerstone of Detroit's bankruptcy success.<sup>123</sup> Additionally, experts played a significant role in assisting the judge with applying the plan confirmation standards. Although the judge made independent determinations about plan confirmation, his decisions were greatly facilitated by the experts, as Judge Rhodes himself acknowledged in his confirmation opinion.<sup>124</sup> Judge Rosen as mediator helped take many issues off the table at plan confirmation, and other experts worked to make the confirmation requirements more concrete as they applied to Detroit. Nevertheless, as Detroit's experience with an emergency manager shows, experts can sometimes be viewed as interfering with the democratic process and usurping the roles of elected officials. Similarly, creditor challenges to the feasibility expert's credibility and role illustrate the potential for obstacles when judge-appointed experts are used in chapter 9.

Notably, although Judge Rosen's appointment as mediator undoubtedly helped speed the case to conclusion, Judge Rhodes made the appointment himself, effectively conveying significant authority to an individual who had not been vetted or approved by anyone other than the bankruptcy judge. Thus, although the city's creditors ultimately agreed to a plan, they may have done so only because they perceived that Judge Rosen (and, in turn, Judge Rhodes) would not agree that the Grand Bargain—which Judge Rosen had crafted—was not protective of their rights.<sup>125</sup>

Detroit's bankruptcy also demonstrated the importance of conveying information to Judge Rhodes. The city tour, though perhaps unorthodox, gave the judge firsthand knowledge of aspects of the city he may not have otherwise known and allowed him to use his own knowledge when confirming the city's plan. Indeed, throughout the bankruptcy, Judge Rhodes made clear that Detroit was not divorced from its surroundings, history, or state. This recognition shaped how he applied the plan confirmation standards.

## 2. San Bernardino, California

San Bernardino's bankruptcy process serves as an example of how the absence of nonmediator experts can prove detrimental in chapter 9 cases. Though somewhat different from Detroit's bankruptcy, both cases relied on extensive mediation. San Bernardino's financial predicament did not attract the attention of the outside philanthropic organizations that had flocked to

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123. See BERMAN & SCHNEIDER, *supra* note 96 (noting that “the mediated settlements . . . were one of the bankruptcy court's key considerations in confirming the Plan” and that the judge referred to the settlements in his findings that the plan was proposed in good faith, that it did not discriminate unfairly, and that it was fair and equitable).

124. *E.g.*, *In re City of Detroit*, 524 B.R. at 221.

125. See Nathan Bomey et al., *Judge OKs Bankruptcy Plan; a 'Miraculous' Outcome*, DET. FREE PRESS (Nov. 7, 2014, 12:15 PM), <http://www.freep.com/story/news/local/detroit-bankruptcy/2014/11/07/rhodes-bankruptcy-decision/18648093/> [<https://perma.cc/REH7-Z2J3>] (noting that major financial creditors had argued “repeatedly during the case that the grand bargain was illegal because it favored pensioners over other creditors”).

Detroit.<sup>126</sup> Furthermore, the state of California, unlike Michigan, does not provide for an emergency manager or other state assistance in the event of a municipal fiscal crisis.<sup>127</sup> Although San Bernardino entered bankruptcy in August of 2012, it did not confirm a plan until December of 2016, over four years later.<sup>128</sup>

Despite these differences, San Bernardino and Detroit were similar in that their plans of adjustment both depended on agreements the cities had struck with their various creditors.<sup>129</sup> In particular, San Bernardino's pension bondholders achieved substantial agreement with the city prior to plan confirmation, and their support of the city was crucial to the city's issuance of new debt.<sup>130</sup>

Like in Detroit, the judge in San Bernardino's bankruptcy appointed a colleague to oversee mediation efforts, and after thousands of hours of mediation, all impaired classes of creditors voted to accept the plan of adjustment by wide margins, eliminating the need for San Bernardino to pursue a cram down.<sup>131</sup> Also like Judge Rhodes in the Detroit bankruptcy, Judge Jury in San Bernardino acknowledged that these mediations had influenced her application of the plan confirmation standards.<sup>132</sup> In particular, Judge Jury noted that "[t]he City's almost completely successful effort to replace confrontation with consensus provides ample evidence for this Court to conclude that the Plan was proposed with honesty and good intentions, and in good faith."<sup>133</sup> The settlement agreements that the city reached with its creditors through mediation were also essential to the court's decision that the plan was in the best interests of creditors, as the alternative to confirming the plan (dismissal) would result in the city "being flooded with litigation from [these] creditors."<sup>134</sup>

Just weeks prior to San Bernardino's plan confirmation hearing, Judge Jury continued to order city officials and creditors into mediation. Judge Jury explained that if the parties could agree on a solution, the mediation efforts would ultimately save time, in particular by preventing appeals.<sup>135</sup>

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126. See Ryan Hagen, *San Bernardino Bankruptcy Plan Gets Judge's OK, Clearing Way for Exit*, SAN BERNARDINO SUN (Dec. 6, 2016, 7:20 PM), <http://www.sbsun.com/2016/12/06/san-bernardino-bankruptcy-plan-gets-judges-ok-clearing-way-for-exit/> [https://perma.cc/JC6J-3NWT].

127. See *id.*

128. *Id.*

129. *Id.*

130. *Id.*

131. Order Confirming Third Amended Plan for the Adjustment of Debts of the City of San Bernardino, California (July 29, 2016), as Modified; Findings of Fact & Conclusions of Law in Respect Thereof para. 15.5.3, *In re City of San Bernardino*, 566 B.R. 46 (Bankr. C.D. Cal. 2017) (Case No. 6:12-bk-28006-MJ), ECF No. 2164.

132. *Id.*

133. *Id.*

134. *Id.* para. 18.1.4.

135. Ryan Hagen, *San Bernardino Bankruptcy: Mediation, Then Final Confirmation Scheduled*, SAN BERNARDINO SUN (Nov. 16, 2016, 3:10 AM), <http://www.sbsun.com/government->

Both city officials and creditors in San Bernardino's bankruptcy proceeding credited retired U.S. Bankruptcy Judge Gregg Zive's mediation efforts as responsible for major settlements in the case, including with the city's largest creditor, the California Public Employees' Retirement System.<sup>136</sup>

Because San Bernardino has only recently exited bankruptcy, it is difficult to assess how it has fared under its plan of adjustment. Nevertheless, some indicators suggest that the city will continue to struggle. In 2017, Moody's issued a report suggesting that the city could file for bankruptcy again due to operational challenges and public pension pressures.<sup>137</sup> In fact, Moody's estimated that San Bernardino's adjusted net pension liability will remain at \$904 million, significantly larger than the projected bankruptcy savings of \$350 million.<sup>138</sup> In all, the Moody's report suggested that although San Bernardino's plan of debt adjustment had some positive aspects, such as increased revenues for the city, the larger picture—which includes pension obligations and operational challenges—is much bleaker.<sup>139</sup>

In San Bernardino's case, mediation proved invaluable to the city's bankruptcy exit. Although San Bernardino did not have quite as many resources at its disposal as Detroit, mediation undoubtedly facilitated the bankruptcy process and, in particular, shaped the judge's application of the plan confirmation standards. Missing from the bankruptcy process, however, were other experts, such as those who had so ably assisted the judge in Detroit with assessing other plan requirements, like feasibility. Experts like the ones who helped Judge Rhodes assess the overall fiscal health of Detroit could have performed a similar role in San Bernardino and perhaps could have identified or worked to alleviate some of the concerns expressed in the Moody's report. Notably, a feasibility expert may have been able to help assess whether San Bernardino's plan could overcome the pension-related and operational challenges the city has continued to face since its bankruptcy exit.

### 3. Stockton, California

Like Detroit and San Bernardino, Stockton reached extensive "compromises with virtually all [of] its creditors," although one bondholder did

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and-politics/20161116/san-bernardino-bankruptcy-mediation-then-final-confirmation-scheduled [https://perma.cc/24DP-K5NG].

136. *Id.*

137. Frank Shafroth, *Public Trust, Public Safety, & Municipal Fiscal Sustainability: Has the Nation Experienced the Closing of Its Chapter on Municipal Bankruptcies?*, GMU MUN. SUSTAINABILITY PROJECT (Apr. 20, 2017), <https://fiscalbankruptcy.wordpress.com/2017/04/20/public-trust-public-safety-municipal-fiscal-sustainability-has-the-nation-experienced-the-closing-of-its-chapter-on-municipal-bankruptcies/> [https://perma.cc/LU5Y-8LR7].

138. *Id.*

139. Frank Shafroth, *Disparate Fiscal Solvency Challenges*, GMU MUN. SUSTAINABILITY PROJECT (June 22, 2017), <https://fiscalbankruptcy.wordpress.com/2017/06/22/disparate-fiscal-solvency-challenges/> [https://perma.cc/EVQ2-KLWU].

oppose confirmation.<sup>140</sup> At confirmation, the city's good faith in proposing the plan was the predominant issue, although other issues were ultimately appealed to the Ninth Circuit Bankruptcy Appellate Panel, including whether the plan was in the best interests of creditors.<sup>141</sup>

The bankruptcy judge in Stockton, like his counterparts in Detroit and San Bernardino, appointed another judge to serve as mediator in the case.<sup>142</sup> Yet, even before Stockton entered bankruptcy, another process involving a mediator proved helpful in avoiding litigation. As part of California's bankruptcy eligibility process, municipalities must engage in a "neutral evaluation" with a mediator prior to filing for bankruptcy.<sup>143</sup> During this prefiling process, Stockton reached agreements to modify all of its unexpired collective bargaining agreements and made "substantial progress" on replacing its expired police contract.<sup>144</sup> Still, prebankruptcy mediation did not resolve all of Stockton's outstanding issues with its creditors, and Judge Klein warned at the outset of the case that the city's plan of adjustment would need to be "consensual" in order for Stockton to succeed.<sup>145</sup>

During the bankruptcy itself, Stockton and its creditors engaged in "extensive mediation sessions with Bankruptcy Judge Elizabeth Perris" to resolve "outstanding labor issues" and reach "complex agreements" with all but one capital markets creditor.<sup>146</sup> Through these agreements, Stockton regained the use of facilities that had been taken over by creditors, marking an important step forward in attaining financial viability.<sup>147</sup>

In confirming Stockton's plan of adjustment over a creditor objection, the bankruptcy judge acknowledged the role the mediation had played, stating, "The myriad parties in interest . . . have agreed upon a consensual plan of adjustment that reflects a complex balance achieved through many months of exhaustive mediation."<sup>148</sup> The fact that one party had not reached agreement with the city after extensive mediation, combined with the fact that mediation efforts had been successful with all other parties, seemed to play a role in the court's decision to confirm Stockton's plan over that

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140. John T. Hansen, 3 *Lessons from Stockton's Bankruptcy*, LAW360 (Dec. 18, 2015, 4:25 PM), <https://www.law360.com/articles/738933/3-lessons-from-stockton-s-bankruptcy> (on file with the *Michigan Law Review*).

141. *Id.*

142. *Id.*

143. Alternatively, municipalities may declare a fiscal emergency if they feel they cannot spare the time to comply with the mediation requirement. CAL. GOV'T CODE § 53760 (West 2008).

144. *In re City of Stockton*, 526 B.R. 35, 61 (Bankr. E.D. Cal. 2015).

145. Associated Press, *Stockton Bankruptcy Judge Appoints Mediator, Orders Meeting*, MERCURY NEWS (Jul. 12, 2012, 12:48 PM), <http://www.mercurynews.com/2012/07/12/stockton-bankruptcy-judge-appoints-mediator-orders-meeting/> [<https://perma.cc/CGW6-D3L8>] (statement of Judge Christopher Klein).

146. *In re City of Stockton*, 526 B.R. at 61.

147. *Id.*

148. *Id.* at 62.

party's objection, particularly with respect to the contentious good faith issue.

Postbankruptcy, inflation and payroll slides have hampered Stockton's ability to provide basic services to its citizens.<sup>149</sup> The city's failure to match wages from comparable cities has led to difficulties attracting workers to the police and fire departments.<sup>150</sup> Thus, while mediation played an important role in Stockton's bankruptcy, it was insufficient to ensure stability going forward. Like in San Bernardino, the use of additional experts could have proven valuable during the confirmation process for Stockton's plan of adjustment in order to provide additional assurance that the plan could address more long-term challenges.

#### 4. Central Falls, Rhode Island

Central Falls's bankruptcy was unique in many ways, although like Detroit the state was heavily involved. In Central Falls's case, the Rhode Island legislature passed a law creating preferred status for certain bondholders,<sup>151</sup> and the city entered state receivership the year before it filed for bankruptcy.<sup>152</sup> The state-appointed receiver, former Rhode Island Supreme Court Justice Robert Flanders, led the city through the bankruptcy and ultimately crafted a six-year postbankruptcy plan.<sup>153</sup> Flanders is a "specialist in municipal restructuring" and was appointed by the governor at the time, Lincoln Chaffee.<sup>154</sup> His knowledge of both municipal finance and the particularities of Central Falls's situation proved invaluable to Central Falls's bankruptcy experience—the city's plan has been largely successful, with the city emerging from the plan in 2017.<sup>155</sup>

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149. Roger Phillips, *Stockton's Post-Bankruptcy Recovery Still a Struggle*, RECORDNET.COM (Mar. 26, 2016, 4:00 PM), <http://www.recordnet.com/news/20160326/stocktons-post-bankruptcy-recovery-still-struggle> [https://perma.cc/3JQB-AYJT].

150. *Id.*

151. See Pryor, *supra* note 29, at 107 (discussing the law).

152. Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES (Sept. 6, 2012), <http://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html> (on file with the *Michigan Law Review*).

153. Frank Shafroth, *The Art & Commitment of Municipal Fiscal Recovery*, GMU MUN. SUSTAINABILITY PROJECT (Apr. 11, 2017), <https://fiscalbankruptcy.wordpress.com/2017/04/11/the-art-commitment-of-municipal-fiscal-recovery/> [https://perma.cc/5RDR-N24J].

154. THE PEW CHARITABLE TRS., *THE STATE ROLE IN LOCAL GOVERNMENT FINANCIAL DISTRESS* 18 (2013), [http://www.pewtrusts.org/~media/assets/2013/07/23/pew\\_state\\_role\\_in\\_local\\_government\\_financial\\_distress.pdf](http://www.pewtrusts.org/~media/assets/2013/07/23/pew_state_role_in_local_government_financial_distress.pdf) [https://perma.cc/J73Z-556K].

155. See Jonathan Bissonnette, *Upward Financial Trend Continues for Central Falls*, PAWTUCKET TIMES (May 4, 2017), [http://www.pawtuckettimes.com/news/upward-financial-trend-continues-for-central-falls/article\\_da96b616-3071-11e7-af4d-7f22a19c1bb8.html](http://www.pawtuckettimes.com/news/upward-financial-trend-continues-for-central-falls/article_da96b616-3071-11e7-af4d-7f22a19c1bb8.html) [https://perma.cc/Q2QV-K3DR] (reporting a statement by city officials asserting that "[t]he city has had several years of strong budgetary performance, and has fully adhered to the established post-bankruptcy plan"). Central Falls's confirmation plan officially ended as of June 30, 2017. See Order Confirming Fourth Amended Plan for the Adjustment of Debts of City of Central Falls, R.I. at 6, *In re* City of Central Falls, R.I., No. 11–13105–FJB (Bankr. D.R.I. Sept. 11, 2012), ECF No. 572.

Central Falls's bankruptcy experience demonstrates the value of having a person—in this case, the receiver—involved who has specific expertise about the municipality and what is possible for it. Prior to the bankruptcy, Flanders had already closed Central Falls's community center and library, reduced retired city workers' pensions, voided some contracts, and imposed layoffs.<sup>156</sup> Flanders worked with the community extensively prior to and during the bankruptcy, allowing him to create a sustainable debt adjustment plan.<sup>157</sup> During the bankruptcy, Flanders also took the lead in negotiating agreements with the city's unions and retirees.<sup>158</sup>

Of course, the receiver's involvement was not without its own problems—one observer compared the receiver's role in Central Falls's affairs to the German occupation of Paris.<sup>159</sup> Furthermore, the state's involvement in creating legally preferred status for the bondholders undoubtedly influenced negotiations during the city's bankruptcy.<sup>160</sup>

Overall, Central Falls' experience in bankruptcy illustrates the possibility for increased state involvement in a bankruptcy to provide supplemental expertise. The state-appointed receiver was instrumental in crafting the city's postbankruptcy plan, and his knowledge of the city's position and predicament, combined with his expertise in municipal finance, was essential to creating a plan that would work. Although not all states will be as involved as Rhode Island in their municipalities' bankruptcies or fiscal affairs, Central Falls's case shows that allowing state and federal programs to work together may provide lasting results.<sup>161</sup>

### B. *Themes and Concerns*

Judges relied on mediators and other experts in these cases to help them overcome limitations with chapter 9's plan confirmation standards. In addition, these experts helped maximize bankruptcy's core functions of breathing space and nonconsensual debt adjustment. Judges regularly encouraged parties to work with an independent neutral mediator to settle issues so that they did not have to be resolved at plan confirmation. Additionally, the judges in Detroit and Central Falls relied on experts familiar with the municipality itself and with municipal finance more generally to provide them

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156. Erika Niedowski, *RI City's Receiver Details 5-Year Recovery Plan*, SAN DIEGO UNION-TRIB. (Sept. 22, 2011, 1:22 PM), <http://www.sandiegouniontribune.com/sdut-ri-citys-receiver-details-5-year-recovery-plan-2011sep22-story.html> [https://perma.cc/BT75-FL5X?type=image].

157. *Id.*

158. *Id.*

159. Bidgood, *supra* note 152 (statement of Lawrence Goldberg).

160. *See* Pryor, *supra* note 29, at 107.

161. *See* Coordes & Reilly, *supra* note 7, at 545 (affirming the desirability of state involvement in municipal restructurings); Moringiello, *supra* note 30, at 462 (“It is in the states that require no state involvement in a municipality’s decision to file for bankruptcy that the fear that [c]hapter 9 will do nothing to remedy the conditions that led to a municipality’s financial ills rings most true.”).

with detailed, trusted information about the municipality and its plan of adjustment.

Getting the parties to agree was key to plan confirmation in all four of the above cases, so a critical role for any chapter 9 expert involves reducing contention.<sup>162</sup> The Bankruptcy Code does not provide specific procedures for engaging in mediation or for chapter 9 judges to appoint outside experts.<sup>163</sup> Nevertheless, most of the chapter 9 judges saw fit to simply appoint a separate mediator, usually another judge that they knew, to facilitate this process. By entrusting a mediator to oversee resolution of specific issues, judges can ease the burden on themselves at plan confirmation. As one expert has observed, successful debt adjustment plans nearly always resolve all significant issues with major creditors.<sup>164</sup> Thus, mediation and its resulting settlements are crucial to a smooth bankruptcy exit.

The cases also illustrate the role of the expert in conveying information to the judge about the idiosyncrasies of the municipality at issue. Case mediators became intimately familiar with the parties and the discrete issues they were tasked with resolving. In addition, as seen in Detroit and Central Falls, expertise can take on a larger role: experts familiar with the municipality's financial problems can bring clarity and concreteness to the generalized confirmation standards, allowing the judge to apply them more rigorously. Experts in Detroit were particularly valuable when the judge determined feasibility—whether the plan was likely to succeed on a going-forward basis. As noted above, judges must make an objective evaluation of feasibility regardless of whether creditors accept the plan.<sup>165</sup> This objective evaluation will be difficult, if not impossible, to perform in practice without substantial, detailed information about the municipality's unique situation and limitations. Experts can help distill vast quantities of information down for the judge, allowing him or her to gain this understanding more efficiently.

Thus, using experts in chapter 9 confers several benefits. First, experts can alleviate the need for the judge to have to turn to precedent. As previously discussed, precedent is severely lacking for chapter 9 cases.<sup>166</sup> Relying on experts can give the judge a backstop and increase the judge's confidence that he or she is making the right decision. Second, experts can distill complicated situations, laws, and relationships down for the judge, enabling the judge to receive accurate information quickly. Third, although chapter 9, by itself, is unlikely to ever fully rehabilitate municipalities, experts can help strengthen chapter 9 for its limited purposes. In particular, mediation is helpful with managing politically unpopular measures or bringing difficult

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162. See Pryor, *supra* note 29, at 86 (describing bankruptcy as a process that drives the parties to a settlement).

163. State laws may provide for these procedures in some cases. See, e.g., CAL. GOV'T CODE § 53760 (West 2008) (providing for a neutral evaluation process in California).

164. Shafroth, *supra* note 70 (citing chapter 9 proceedings in Detroit, Vallejo, Jefferson County, and Stockton as examples).

165. See *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 36 (Bankr. D. Colo. 1999).

166. See *supra* note 9 and accompanying text.

or unwilling parties into the fold, a process critical to the functioning of the bankruptcy system. In addition, experts help maximize the breathing room a bankrupt municipality receives courtesy of the automatic stay by focusing on a municipality's key problems and working diligently to resolve them.

Although it is difficult to say for certain whether any of the municipalities discussed above have "succeeded," the plans that have seemed to work thus far were produced using multiple types of experts. Broadly speaking, the experts used in the cases can be classified into three types. First, expert mediators, such as Judge Rosen in Detroit or Judge Zive in San Bernardino, help to settle issues that would have otherwise been litigated and resolve multiparty bargaining problems. Second, experts in municipal finance, such as Judge Flanders in Central Falls or Martha Kopacz, Detroit's feasibility expert, help judges understand the minutiae of the municipality's fiscal situation. Third, experts familiar with the community, such as Judge Flanders in Central Falls, help break down the complexity of the municipality and provide an understanding of what is needed to move forward. All three types of experts provide value to the case, and although expertise need not be centered in one person, one individual may be a source of multiple forms of expertise, as Judge Flanders' example in Rhode Island illustrates.

The cases also provide insights into some of the pitfalls that can occur when using experts. For example, failure to define the scope of an expert's role, or allowing an expert, such as a receiver (in the case of Judge Flanders in Central Falls) or emergency manager (in the case of Kevyn Orr in Detroit), to make decisions relating to governance, can exacerbate tensions with residents and provide fertile ground for creditor objections, slowing down the bankruptcy process. In addition, not every municipality has the resources to fund experts and mediators. Furthermore, to the extent that mediation removes issues from the confirmation discussion, the municipal bankruptcy process as a whole may suffer due to lack of a robust discussion of the confirmation standards and their application. Finally, concerns may arise with respect to who is appointing the experts and how the appointment process works.

This final point is of critical concern in a chapter 9 case because chapter 9 is already, in many ways, something of an antidemocratic process.<sup>167</sup> The appointment of an expert or mediator in a case may perhaps be viewed as an opportunity to provide some democratic legitimacy to this process, as this individual can serve as an intermediary between municipal officials, the judge, and the municipality's citizens. Yet, when a judge, as in Detroit, or a government official, as in Central Falls, appoints a colleague or friend as an expert without engaging in some sort of transparent selection process, this opportunity for democratic legitimacy is threatened.<sup>168</sup> This is especially true

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167. See Gillette, *supra* note 69, at 1376 ("To the extent that the institutions of normal politics are inadequate to redress . . . fiscal distress . . . an alternative decisionmaker less responsive to normal politics may offer a solution.").

168. See Martin, *supra* note 41, at 19 (comments of Kevyn Orr) ("[W]hen people feel their fundamental covenants have not been met by their government, they may decide to resort to violence.").

when the expert is given wide-ranging powers. For example, Judge Rosen, the mediator in Detroit, was given broad authority to design settlements and corral parties.<sup>169</sup> While this authority may be desirable from a bankruptcy perspective, in that it puts further pressure on parties to reach agreement, it may be less desirable from the perspective of democratic legitimacy when an appointee is seen as coercing decisions about a municipality's future.

When a judge or a powerful official appoints an expert to a case, there is also very little room for parties to the case to object to this appointment, even if they feel that the case should proceed differently.<sup>170</sup> Parties may also feel uncomfortable working with an expert they know the judge is close to, particularly if the judge is pressuring the parties to mediate, as nearly every judge in the cases above did. A judge may appoint or rely on an expert in order to pressure the parties to accept the deal the court wants to see. For example, the judge in Stockton's case urged the parties into mediation, warning them that the plan needed to be consensual.<sup>171</sup> Although the judge likely *desired* a consensual plan because it would be easier to confirm, saying that a plan *must* be consensual reflects a judge-made, rather than bankruptcy-imposed, preference. Indeed, bankruptcy is valuable, in part, because a debtor may choose not to reach a consensual plan, instead seeking to cram down a plan over creditor objections.

Using an expert, the judge can exert this pressure without creating a record where his or her comments can be used to challenge rulings.<sup>172</sup> In some cases, then, the expert can act as a surrogate for the judge, enhancing the judge's own power in the case.<sup>173</sup> Thus, the current ad hoc methods of appointing experts in chapter 9 may further weaken democracy and may pressure the parties into reaching suboptimal arrangements. A formal process for appointing and using experts can provide important checks and balances on judicial behavior. These checks and balances may be particularly important in the bankruptcy context, where the Supreme Court has expressed reluctance to give bankruptcy judges, who lack the life tenure and salary protections of Article III judges, much discretion.<sup>174</sup>

In many ways, chapter 9 is a flawed system. Its design and structure lack the flexibility needed to account for the diversity and breadth of debtor and

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169. See *In re City of Detroit*, 524 B.R. 147, 168–71 (Bankr. E.D. Mich. 2014).

170. See Jacoby, *supra* note 56, at 68, 81–83 (discussing how the Detroit bankruptcy court used mediation, along with other procedural devices, to expand its role in the case).

171. Associated Press, *supra* note 145.

172. See Michelle Kaske & Steven Church, *Puerto Rico Bondholders Seek Receivership for Electric Company*, 29 Bankr. L. Rep. (BNA) No. 28, at 818 (July 20, 2017) (describing how the judge in Jefferson County's bankruptcy put pressure on the county to settle by putting off ruling on the bondholders' request for receivership).

173. See Jacoby, *supra* note 56, at 81–82 (“By appointing a chief district judge as a mediator, the bankruptcy judge arguably delegates more power to the mediator than the bankruptcy judge could have exercised himself.”).

174. See Douglas G. Baird & Anthony J. Casey, *Bankruptcy Step Zero*, 2012 SUP. CT. REV. 203, 218 (discussing “a family of cases in which the Court has limited the domain over which the bankruptcy judge may exercise her discretion”).

creditor interests in the municipal context. Nevertheless, as the cases show, courts have used mediation and expertise to help overcome these flaws. Thus far, appointment of experts has been a largely informal process; mediators, receivers, emergency managers, and other experts are not explicitly provided for in the Bankruptcy Code. Use of these entities on an ad hoc basis, without any procedures for vetting experts or defining their role, can raise concerns about legitimacy and democracy. Yet, the cases to date have shown that there is value in having specialized knowledge of municipalities and their financial situations, as well as experienced negotiators to help maximize the use of the bankruptcy toolkit in chapter 9.

Insufficient attention has been paid to the harms of ad hoc expert appointments. As the cases illustrate, experts can be some of the most powerful parties in a bankruptcy case, in some cases even shaping critical pieces of the plan. Indeed, an expert's decisions can shape a municipality for years to come.<sup>175</sup> These experts should not be an afterthought. Rather, they should be recognized for the important players that they are and given the attention they deserve when it comes to defining their role in the case.

### III. USING EXPERTS IN CHAPTER 9

This Part sets out guidelines for the creation of formal procedures for the selection, appointment, and use of experts in chapter 9. Other areas of bankruptcy law, outside of the municipal context, also use experts and can provide guidance on best practices as well as pitfalls. After assessing these areas, this Part advocates for the development of formal procedures with respect to the use of experts in chapter 9, primarily in the form of a hearing on this issue early in the case.

#### A. Experts in Insolvency Law

Although chapter 9 is somewhat unique in the bankruptcy field, chapter 9 judges are not alone in relying on experts for assistance, and the problems of applying general standards to particularized facts are by no means unique to municipal bankruptcy.<sup>176</sup> This Section examines the role of expertise in three other areas of bankruptcy law: other chapters of the U.S. Bankruptcy Code, sovereign debt restructuring, and Puerto Rico. Studying these areas

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175. See *supra* Section II.A (describing Judge Rosen's involvement in Detroit's Grand Bargain and Judge Flanders's involvement in Central Falls's postbankruptcy plan).

176. Expertise is also regularly used outside of the bankruptcy context, although analysis of the use of experts outside of bankruptcy is beyond the scope of this Article. See, e.g., Margaret A. Burt, *The ICWA Expert Witness*, NAT'L CHILD WELFARE RESOURCE CTR. FOR TRIBES (2007), [http://www.nrc4tribes.org/files/ICWA%20Expert%20Witness\\_Margaret%20Burt\\_2007.pdf](http://www.nrc4tribes.org/files/ICWA%20Expert%20Witness_Margaret%20Burt_2007.pdf) [<https://perma.cc/6QST-YPSZ>] (discussing the use and qualifications of expert witnesses under the Indian Child Welfare Act); Randee Fenner, *A River Runs Through It: Buzz Thompson's Stint As a Special Master*, STANFORD LAW. (May 28, 2014), <https://law.stanford.edu/stanford-lawyer/articles/a-river-runs-through-it-buzz-thompsons-stint-as-a-special-master/> [<https://perma.cc/S4W4-MKBU>] (describing the use of "special masters" to collect evidence and provide information in interstate water disputes).

provides guidance about possible ways to develop and formalize the use of experts in chapter 9.

### 1. U.S. Bankruptcy Law

Formal roles for experts are present in nearly every other major area of U.S. bankruptcy law. In other chapters of the Bankruptcy Code, an independent U.S. Trustee provides oversight for the case and offers guidance to the court and the parties about the way the case is proceeding.<sup>177</sup> In a chapter 7 (liquidation) case, an impartial trustee is appointed to administer the case and to liquidate assets.<sup>178</sup> Similarly, in a chapter 13 (individual) case, a trustee reviews and administers the proposed debt repayment plan.<sup>179</sup> Even in a chapter 11 case, where the debtor typically remains in control of the company being reorganized, the court may appoint a trustee or examiner if there are concerns about the debtor in possession's actions.<sup>180</sup> Though rare, examiners, which are neutral parties appointed to investigate and report on claims and issues, have played important roles in some of the most complex chapter 11 cases to date, including that of Lehman Brothers.<sup>181</sup> Indeed, some courts have allowed examiners to have quite expansive roles, including the ability to monitor the debtor's business or file a plan of reorganization.<sup>182</sup>

In other U.S. bankruptcy contexts, other entities, such as the U.S. Trustee, bankruptcy trustees, and examiners, serve critical functions in keeping the debtor on track. Although the U.S. Trustee is involved in chapter 9 cases, the Trustee's involvement is significantly attenuated compared even to a chapter 11 case.<sup>183</sup> Unlike in other chapters of the Code, the U.S. Trustee does not examine the debtor during a meeting of creditors, cannot move to appoint a trustee or examiner in the case, cannot move to convert the case, does not supervise case administration, does not monitor the debtor's financial operations, and does not review professional fees.<sup>184</sup> Thus, relying on an expert in chapter 9 can fill in some of the gaps left by the lack of a more powerful trustee or judge.

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177. 28 U.S.C. § 586(a)(3) (2012).

178. *Chapter 7—Bankruptcy Basics*, U.S. CTS., <http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-7-bankruptcy-basics> [https://perma.cc/857Z-KN6K].

179. *Chapter 13—Bankruptcy Basics*, U.S. CTS., <http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-13-bankruptcy-basics> [https://perma.cc/XK68-JS8G].

180. *See* 11 U.S.C. § 1104 (2012).

181. Katherine Doorley, *ABI Chapter 11 Reform Commission Series: Oversight of the Case (Part I)*, WEIL: BANKR. BLOG (Jan. 8, 2015), <https://business-finance-restructuring.weil.com/abi-reform-commission/abi-chapter-11-reform-commission-series-recommendations-on-oversight-of-the-case-part-i/> [https://perma.cc/5LSC-NJZZ].

182. Paula D. Hunt, Note, *Bankruptcy Examiners Under Section 1104(b): Appointment and Role in Complex Chapter 11 Reorganizations of Failed LBOs*, 70 WASH. U. L.Q. 821, 841–44 (1992) (providing examples of cases where examiners have played expansive roles).

183. *Chapter 9—Bankruptcy Basics*, U.S. CTS., <http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics> [https://perma.cc/ZR3X-UZDU].

184. *See id.*

Recent proposals for improving the U.S. bankruptcy system have also reflected a desire for increased expertise.<sup>185</sup> For example, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (the “Commission”) has proposed using a flexible, court-appointed “estate neutral” in chapter 11 cases.<sup>186</sup> Under the proposed arrangement, the estate neutral would have authority to advise the chapter 11 debtor in possession on operational and financial matters, as well as on the content and negotiation of its plan.<sup>187</sup> The Commission especially recommended the estate neutral for small businesses in chapter 11.<sup>188</sup> The estate neutral would be chosen by the U.S. Trustee and would be subject to court approval.<sup>189</sup>

The Commission’s proposal contemplates that the estate neutral would represent the interests of the estate and would be paid with estate funds.<sup>190</sup> The Commission has sought to ameliorate concerns about the cost of an estate neutral by emphasizing that the appointment of an estate neutral would not be mandatory.<sup>191</sup> The Commission has also stressed the benefits of an estate neutral, such as reducing the potential for diverging interests and self-motivated actions by parties in a case.<sup>192</sup> The proposed estate neutral would thus serve several valuable functions akin to those that chapter 9 experts might serve, including clarifying the parties’ interests in a case and bringing parties to the negotiating table. Furthermore, a chapter 9 expert might perform a similar role to an estate neutral in the small business context by, for example, providing financial advice tailored to the debtor.

The Commission recommended an estate neutral, in essence, to address many of the same problems that arise in chapter 9 cases. The Commission’s focus was on chapter 11, however, and its recommendation therefore extended only to chapter 11 cases.<sup>193</sup> If the Commission is advocating for estate neutrals in the chapter 11 context, it makes sense to have similar mechanisms in place for municipalities given the need for judges in both municipal and reorganization cases to apply the plan confirmation standards coherently and consistently.

Other recent proposals have sought to incorporate more expertise into the bankruptcy process. For example, Congress is currently considering a

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185. See Michelle M. Harner, *The Search for an Unbiased Fiduciary in Corporate Reorganizations*, 86 NOTRE DAME L. REV. 469, 475 (2011) (discussing the benefits a third-party neutral could bring to corporate reorganizations).

186. COMM’N TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., FINAL REPORT AND RECOMMENDATIONS 2012–2014, at 32–38 (2014) [hereinafter ABI COMM’N].

187. See *id.* at 294.

188. See *id.*

189. Doorley, *supra* note 181.

190. See ABI COMM’N, *supra* note 186, at 36–37.

191. See *id.* at 37.

192. *Id.*

193. See *id.* at 4.

bill “that would create a new bankruptcy process for large financial institutions.”<sup>194</sup> The bill contemplates that bankruptcy cases for these entities “would be assigned to a bankruptcy judge picked from a pre-selected pool of judges chosen for their experience, ability and willingness to handle such challenging, fast-paced cases.”<sup>195</sup> Congress has thus recognized the value of expertise in dealing with complex entities whose financial difficulties can have far-reaching impacts. Like financial institutions, municipalities are complicated, multifaceted entities whose distress can create ripple effects extending well beyond the distressed entity itself.<sup>196</sup>

Virtually every other major aspect of U.S. bankruptcy law uses some form of expert, and recent proposals indicate a desire to incorporate even more expertise into the process. In chapter 9, however, no formal mechanisms for the selection and use of experts exist, and no proposals to date have sought to establish a formal avenue or role for these parties. Chapter 9, which deals with some of the most important entities in society, needs these formal mechanisms at least as much as other areas of U.S. bankruptcy law.

## 2. Sovereign Debt

A possible reason for the lack of a formal expert system in chapter 9 may lie in concerns that granting powers to such a party might encroach too much on state sovereignty over municipalities. The current iteration of chapter 9 was carefully designed to limit concerns that the federal government was interfering with municipalities’ contractual obligations, thereby preventing them from overseeing their own financial affairs.<sup>197</sup> However, looking beyond the United States to the sovereign debt context reveals that these concerns may be overcome.

Several years ago, the International Monetary Fund (“IMF”) proposed a Sovereign Debt Restructuring Mechanism (“SDRM”) to better address problems with government debt.<sup>198</sup> As part of this mechanism, the IMF envisioned an efficient, impartial dispute resolution process run by an independent and centralized forum.<sup>199</sup> The forum would decide challenges

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194. Daniel Gill, *Big Bank Bankruptcy Bill Clears U.S. House*, BLOOMBERG BNA (Apr. 6, 2017), <https://www.bna.com/big-bank-bankruptcy-n57982086334/> [<https://perma.cc/FXS4-EU6N>].

195. *Id.*

196. Pengjie Gao et al., *Municipal Borrowing Costs and State Policies for Distressed Municipalities*, SSRN 29 (May 20, 2017), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2845515](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2845515) [<https://perma.cc/TQ7Z-P6NF>] (discussing concerns about negative externalities associated with municipal defaults).

197. See *United States v. Bekins*, 304 U.S. 27, 47–48, 51 (1938) (upholding amended version of chapter 9, which limited the power of the bankruptcy court); *Ashton v. Cameron Cty. Water Improvement Dist. No. One*, 298 U.S. 513, 530–31 (1936) (expressing these concerns about the initial version of chapter 9).

198. See Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, 36 GEO. J. INT’L L. 299, 300–01 (2005).

199. *Id.* at 382; IMF, PROPOSED FEATURES OF A SOVEREIGN DEBT RESTRUCTURING MECHANISM 23 (2003), reprinted in *id.* app. at 395.

brought by parties in interest and perform important administrative functions, but would not resolve economic or political issues.<sup>200</sup> Although the forum would act in some ways like a municipal bankruptcy judge, the forum itself would consist of a panel of judges with carefully prescribed roles.<sup>201</sup> Specifically, the forum's responsibilities would be limited to performing administrative tasks, facilitating dispute resolution, and enjoining specific enforcement actions at the debtor's request.<sup>202</sup> The forum would not be able to challenge decisions made by the IMF nor decide issues relating to sovereign debt sustainability.<sup>203</sup>

To address concerns over encroachment on state sovereignty and to allay fears about certain parties exercising undue influence over the forum, the IMF's proposal included detailed guidance on how the members of the forum would be selected.<sup>204</sup> Under the proposal, a permanent pool of judges would be chosen in advance to serve on the forum, and a panel would be created from the pool when a crisis arose.<sup>205</sup> In this way, the judges would be less likely to be swayed by any particular agenda from the IMF, while also being available quickly in the event of a crisis.<sup>206</sup> Judges would continue to work in their own countries and in their own capacities until they were impeached.<sup>207</sup> To further avoid any concern about undue influence from the IMF, parties outside the IMF would play a role in the selection process, including professional associations of corporate insolvency and debt-restructuring experts.<sup>208</sup>

Although the IMF's SDRM has not come to fruition, it is instructive as a parallel to chapter 9 proceedings because of the attention the IMF has paid to procedures for selecting and appointing experts as well as cabining their roles to avoid political issues. Just as in municipal bankruptcy, adjudicators in the sovereign debt context walk a fine line when it comes to the powers they can exercise. Countries, much like U.S. states, are wary of procedures that encroach upon their sovereign powers. Thus, the selection process for the forum is instructive in thinking about appointment and selection of experts in chapter 9.

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200. Hagan, *supra* note 198, at 383–84.

201. *See id.* at 343 n.114, 346, 388–89 (“The need to fashion a relatively minimalist framework was also dictated by the immovable reality of state sovereignty.”).

202. IMF, PROPOSED FEATURES OF A SOVEREIGN DEBT RESTRUCTURING MECHANISM 28 (2003), *reprinted in id.* app. at 401–02.

203. *Id.* app. at 401.

204. Hagan, *supra* note 198, at 387–88. In addition to these measures, the entire SDRM process could only be activated upon the debtor's initiative. IMF, PROPOSED FEATURES OF A SOVEREIGN DEBT RESTRUCTURING MECHANISM 28 (2003), *reprinted in id.* app. at 397.

205. Hagan, *supra* 198, at 387–88.

206. *Id.* at 388.

207. *Id.*

208. *Id.*

### 3. Puerto Rico

Puerto Rico's fiscal struggles are well documented and well publicized. Although Puerto Rico was deemed ineligible for chapter 9 bankruptcy, Congress created the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA") in 2016 to help the U.S. territory with its financial issues.<sup>209</sup> PROMESA established an oversight board, composed of a group of experts, to guide the territory in managing its finances.<sup>210</sup> President Obama appointed the oversight board's seven members based on Congress's recommendations.<sup>211</sup>

The PROMESA oversight board has extensive powers, and in this respect, Puerto Rico's situation differs in a key way from that of U.S. municipalities.<sup>212</sup> PROMESA gives the oversight board absolute power over the territory's elected officials and finances, reflecting an unprecedented authority to govern.<sup>213</sup> Many Puerto Ricans feel that the oversight board, which directs the Commonwealth's finances and insolvency proceedings, is too powerful.<sup>214</sup> The Oversight Board's actions have been controversial,<sup>215</sup> and some commentators believe they have resulted in "more fiscal harm than good."<sup>216</sup> Recently, the judge in Puerto Rico's Title III proceedings even rejected the board's proposal to appoint agents to advocate for dueling creditors in debt-restructuring talks, lending credence to creditors' claims that the board, which would have had a hand in appointing the agents, could not

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209. Puerto Rico Oversight, Management, and Economic Stability Act, Pub. L. No. 114-187, 130 Stat. 549 (2016) (to be codified at 48 U.S.C. §§ 2101–2241).

210. *Id.* § 101, 130 Stat. at 553–57.

211. Doyle, *supra* note 20. The governor of Puerto Rico also had one appointee on the board to represent his positions. Rebecca Spalding, *Puerto Rico Governor's Appointee on Oversight Board Steps Down*, 29 Bankr. L. Rep. (BNA) No. 29, at 10 (July 20, 2017).

212. *But see* Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 385 (2010) (advocating for state oversight boards as an alternative to chapter 9).

213. Frank Shafroth, *Governance & Fiscal Recovery*, GMU MUN. SUSTAINABILITY PROJECT (Apr. 3, 2017), <https://fiscalbankruptcy.wordpress.com/2017/04/03/governance-fiscal-recovery/> [<https://perma.cc/2LJY-M643>].

214. *See* Mitu Gulati & Robert K. Rasmussen, *Puerto Rico and the Netherworld of Sovereign Debt Restructuring*, in LEGAL STUDIES RESEARCH PAPER SERIES No. 17–11, at 2 (Ctr. for Law & Soc. Sci., Research Paper Series No. CLASS17–13, 2017); Susan Cornwell & Nick Brown, *Puerto Rico Oversight Board Appointed*, REUTERS (Aug. 31, 2016, 12:12PM), <https://www.reuters.com/article/us-puertorico-debt-board/puerto-rico-oversight-board-appointed-idUSKCN11628X> [<https://perma.cc/79A4-NEQQ>].

215. *See, e.g.*, Shafroth, *supra* note 121 (describing the fallout, including student strikes, from the Oversight Board's demands for cuts at the University of Puerto Rico).

216. Frank Shafroth, *Is There a PROMESA of Recovery?*, GMU MUN. SUSTAINABILITY PROJECT (May 5, 2017), <https://fiscalbankruptcy.wordpress.com/2017/05/05/is-there-a-promesa-of-recovery/> [<https://perma.cc/YJ5R-T2Q6>].

be objective.<sup>217</sup> Puerto Rico represents perhaps the outer limits of an expert's influence in the insolvency context.

Expertise will likely continue to play a significant role in resolving Puerto Rico's fiscal distress as the territory proceeds with the in-court restructuring process known as Title III. Although Title III is similar to chapter 9 in many ways, it is a distinct law, and the court overseeing the process will be navigating uncharted waters. In particular, PROMESA's structure raises the potential for tension between the oversight board and the Title III court in deciding whether plan confirmation requirements have been satisfied.<sup>218</sup> "[T]he oversight board's certification of a fiscal plan is nonreviewable."<sup>219</sup> Yet, PROMESA also requires the Title III court to determine that the plan of adjustment is consistent with the oversight board's fiscal plan,<sup>220</sup> "creat[ing] tension with the nonreviewability of the oversight board's certification, and provid[ing] grounds for litigation for creditors . . . ."<sup>221</sup> Concerns about encroachment of power are particularly high given that "the oversight board's certifications are not subject to a notice and comment procedure," and the board's members are not confirmed by the Puerto Rico legislature.<sup>222</sup>

Both the Puerto Rican government and the PROMESA oversight board will have roles in the Title III process. While both the government and the board are likely seeking fiscal recovery, they are unlikely to have similar proposals to achieve this end, setting the stage for a potential clash of interests

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217. Nick Brown, *Puerto Rico Judge Nixes Negotiation Plan in Debt Battle*, REUTERS (June 28, 2017, 11:20 AM), <http://in.reuters.com/article/us-puertorico-debt-bankruptcy/puerto-rico-judge-nixes-negotiation-plan-in-debt-battle-idINKBN19J234> [<https://perma.cc/5NEY-PBVY>].

218. Richard J. Cooper et al., *Issues to Expect in a Title III Puerto Rico Restructuring*, LAW360 (Mar. 8, 2017, 11:07 AM), <https://www.law360.com/articles/898663/issues-to-expect-in-a-title-iii-puerto-rico-restructuring> (on file with the *Michigan Law Review*).

219. *Id.*

220. Puerto Rico Oversight, Management, and Economic Stability Act, Pub. L. No. 114-187, 130 Stat. 583-84 (2016) (to be codified at 48 U.S.C. § 2174).

221. Cooper, *supra* note 218.

222. *Id.*

and confusion over who has the final say in the territory's fiscal governance.<sup>223</sup> This confusion and tension is particularly problematic because Puerto Rico's fiscal distress has a direct effect on its citizens' welfare.<sup>224</sup>

Mediation has also played a role in resolving Puerto Rico's fiscal distress. Former bankruptcy judge Allan Gropper served as a mediator in debt-restructuring talks between the Commonwealth's general obligation bondholders and holders of its COFINA debt, which is backed by sales tax revenue.<sup>225</sup> Shortly after Puerto Rico filed for its bankruptcy proceedings, its main creditors expressed an interest in continuing mediation settlement talks to resolve the unpayable debt.<sup>226</sup> The judge overseeing the Title III process appointed several other judges as mediators in the case.<sup>227</sup> In fact, even the mediation team is seeking to appoint their own expert in the form of an outside financial consultant.<sup>228</sup>

In all, Puerto Rico is an extreme example of a very powerful set of experts. Puerto Rico is also somewhat of a cautionary tale. While the island's situation demonstrates the benefits expertise can bring to the table, it also

223. Frank Shafroth, *The Hard Road to Fiscal Sustainability*, GMU MUN. SUSTAINABILITY PROJECT (June 2, 2017), <https://fiscalbankruptcy.wordpress.com/2017/06/02/the-hard-road-to-fiscal-sustainability/> [<https://perma.cc/X5TA-9TBU>] (describing the budget conflicts—both current and potential—among Puerto Rico's government, the oversight board, and the judge overseeing the bankruptcy process); Frank Shafroth, *The Knife Edges of Municipal Bankruptcy*, GMU MUN. SUSTAINABILITY PROJECT (May 12, 2017), <https://fiscalbankruptcy.wordpress.com/2017/05/12/the-knife-edges-of-municipal-bankruptcy/> [<https://perma.cc/8QPN-N8C8>]. Some of these interest clashes have also caused tensions between the oversight board and Congress. See Frank Shafroth, *Is There a "Right" Structure to Resolve Fiscal Insolvency?*, GMU MUN. SUSTAINABILITY PROJECT (June 19, 2017) [hereinafter Shafroth, "Right" Structure], <https://fiscalbankruptcy.wordpress.com/2017/06/19/is-there-a-right-structure-to-resolve-fiscal-insolvency/> [<https://perma.cc/3CWX-4TPV>] (statement of House Natural Resources Committee Chairman Rob Bishop) ("The oversight board's dilatory tactics run counter to the plain language of PROMESA.").

224. See, e.g., Associated Press, *Puerto Rico Grapples with Foreclosure Crisis as Thousands Lose Homes*, NBC NEWS (June 21, 2017, 8:55 AM), <https://www.nbcnews.com/news/latino/puerto-rico-grapples-foreclosure-crisis-thousands-lose-homes-n775021> [<https://perma.cc/S7FC-DPBE>] (discussing the link between Puerto Rico's foreclosure crisis and its "underlying weak economy" and noting that the foreclosure crisis is harder to resolve because it is tied to the economy as a whole rather than individual bad loans).

225. Nick Brown, *Puerto Rico Board Schedules Mediation in Key Creditor Dispute*, REUTERS (Mar. 31, 2017, 11:11 AM), <https://www.reuters.com/article/puertorico-debt-mediation/puerto-rico-board-schedules-mediation-in-key-creditor-dispute-idUSL2N1H8106> [<https://perma.cc/4R6Y-5WM3>].

226. Nick Brown, *Puerto Rico Creditors Open to Mediation in Bankruptcy Court*, REUTERS (May 17, 2017, 1:25 AM), <https://www.reuters.com/article/us-puertorico-debt-hearing/puerto-rico-creditors-open-to-mediation-in-bankruptcy-court-idUSKCN18D0D9> [<https://perma.cc/R52Y-7YWH>].

227. Associated Press, *Mediation Team Created for Puerto Rico Bankruptcy Cases*, FOX BUS. (Jun. 14, 2017), <http://www.foxbusiness.com/markets/2017/06/14/mediation-team-created-for-puerto-rico-bankruptcy-cases.html> (on file with the *Michigan Law Review*) (noting that five federal judges, including a bankruptcy court judge, have been appointed to the mediation team); Shafroth, "Right" Structure, *supra* note 223.

228. Michelle Kaske, *Puerto Rico's Mediator Is Said to Seek Outside Financial Adviser*, BANKR. L. REP. (BNA) (July 20, 2017) (on file with the *Michigan Law Review*).

highlights the dangers and tensions that can arise when experts are given expansive roles or are perceived as overstepping their bounds. Indeed, in August of 2017, Aurelius Capital, a hedge fund, brought suit in federal court, arguing that the oversight board was unconstitutionally established because its members had been “handpicked by individual members of Congress” without confirmation proceedings.<sup>229</sup> Puerto Rico thus serves as an example of the tensions that can arise when powerful experts are appointed without defined procedures.

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Insolvency proceedings around the world reflect a belief that specialized expertise encourages flexible, creative approaches to addressing complex and unique problems. Chapter 9 is no different. Yet, as Puerto Rico’s situation illustrates, it is important to define and limit the scope of the expert’s role. Open, transparent procedures for selecting and appointing experts may avoid some of the problems the territory has faced with respect to the oversight board’s acceptance by residents and the local government. The following Section explores how experts might be selected and used in chapter 9, as well as the benefits and drawbacks of formalizing the expert’s appointment and role in a chapter 9 case.

### B. *The Expert in Chapter 9*

With some legislative adjustments, formal procedures for selecting and appointing experts could become a part of chapter 9 cases. Through these procedures, all parties to a case will understand the scope and limitations of the expert’s role.

#### 1. Procedures and Role

As discussed, judges are already using mediators and other experts in bankruptcy, and this trend is likely to continue. Yet, judges currently select these experts on an ad hoc basis, with little to no public process or room for discussion. This ad hoc use of experts can result in appointment of an individual with an ill-defined set of duties and may result in the expert interfering with the municipality’s governance procedures. Additionally, municipalities that do not expect the judge to appoint an expert may have trouble funding these entities and their work on the case. All of these problems can be resolved through the development of procedures with respect to experts.

Flexibility in procedures with respect to an expert’s appointment, selection, and role is likely necessary, as each crisis and each municipality is different. The type(s) of expertise needed and the individual(s) best suited to

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229. Mary Williams Walsh, *Hedge Fund Sues to Have Puerto Rico’s Bankruptcy Case Thrown Out*, N.Y. TIMES (Aug. 7, 2017), <https://www.nytimes.com/2017/08/07/business/dealbook/puerto-rico-debt-oversight-board.html> (on file with the *Michigan Law Review*).

provide that expertise will therefore differ from case to case. Nevertheless, careful thought should be given to whether expertise in mediation, municipal finance, or the particular community will be necessary for a case. Proposals and practices across the insolvency spectrum can provide guidance for promoting “transparency, accountability, and predictability” with respect to these experts.<sup>230</sup>

Although chapter 9 is federal law, the formal procedures for determining the selection and scope of chapter 9 experts will also entail involvement from the states. Because chapter 9 requires that states specifically authorize their municipalities to enter bankruptcy,<sup>231</sup> Congress could amend the chapter 9 eligibility rules to require that states adopt procedures for the selection of chapter 9 experts when they provide authorization. Much as states have adopted legislation in response to chapter 9's requirement of specific state authorization, the individual states could then incorporate specific procedures for the selection process into their relevant authorizing statutes, as well as define the outer limits of the roles experts could play in bankruptcy proceedings.

States could draw upon aspects of the IMF's procedure for selecting members of its proposed dispute resolution forum, described above, to avoid concerns about more powerful parties appointing and subsequently influencing experts in chapter 9. When the IMF designed its procedures, its officials tried to ensure that no one entity would have outsize influence over the selection process, including the IMF.<sup>232</sup> Similarly, it will be important for states to establish selection and appointment procedures for chapter 9 experts that do not give too much weight to any one entity or individual.

Applying the IMF's procedures to develop chapter 9 processes might involve state officials working with local bankruptcy professional organizations to identify and establish a pool of vetted experts available to serve in various regions across the state. Experts selected for the pool would be tasked with maintaining knowledge of the municipalities in their region, including their debt issuances, credit ratings, and the legal, financial, and historic frameworks in which they operate. Once a municipality chooses to commence a chapter 9 case, the bankruptcy judge could, with the consent of the municipality, appoint one or more experts from the pool to serve on the case. The number of experts to appoint in each case would depend on several factors, including cost, the complexity of the municipality's finances, and the relationship between the municipality and its creditors.

Regardless of the state's particular selection process, the critical task will be to assemble a pool of experts with extensive familiarity with the three

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230. See Marc J. Heimowitz, *Government as Rescue Financier: Not Just a Private Lender*, 19 U. PA. J. BUS. L. 49, 98 (2016) (noting that “rules of general application can be constructed in light of noncontroversial goals such as transparency, accountability, and predictability” in the context of government bailouts).

231. 11 U.S.C. § 109(c)(2) (2012) (“An entity may be a debtor under chapter 9 . . . if such entity . . . is specifically authorized . . . to be a debtor under such chapter by State law . . .”).

232. See *supra* notes 204–208 and accompanying text.

areas described in Part II: mediation, municipal bankruptcy and finance, and the municipality itself. Like the IMF's proposed procedures, multiple parties should also be involved in the selection process, including—as suggested here—professional organizations. If feasible, getting input from the community through town halls or other types of open forums may be desirable as part of the selection process in order to reduce the potential for community pushback if and when an expert is eventually appointed in a case.

Although assembling a pool of experts would likely be resource intensive, the task is not as daunting as it perhaps first appears. Indeed, procedures for mediator selection are quite common in other contexts. For example, many courts already have well-established local rules on mediation as well as precertified panels of mediators, so there is some precedent for assembling a pool of experts prior to a case commencing.<sup>233</sup> Depending on the state legislation introduced, distressed municipalities could also draw on the pool of experts to assist them prior to filing for bankruptcy. To the extent that states use prebankruptcy planning, oversight, and intervention methods, as many do, experts could play a valuable role in these processes as well.

During the bankruptcy itself, the expert would play a role further defined at the outset of the case. Congress should modify the Federal Rules of Bankruptcy Procedure to provide procedures for the bankruptcy judge to appoint experts in the case. In particular, the judge should hear from state and local officials, residents, and the U.S. Trustee on the role of experts in the case. Ideally, these procedures would take place early in the case, perhaps during the hearing on municipal eligibility. Although the outer limits of the expert's ability would be prescribed by the state, there should be leeway for the judge to consider specific roles for the expert, including overseeing negotiations, mediating, convening voters and residents, investigating discrete aspects of the case and proposed plan of adjustment, and providing information to the judge based on any investigation(s) conducted.

At the eligibility hearing, the bankruptcy judge could review proposals from the parties and the U.S. Trustee on which experts from the pool to appoint, how many are needed, and why each party feels an expert is necessary. In this way, although the appointment of the expert and scope of the expert's role would be ultimately specified by the bankruptcy judge, such determination would take place after a hearing on the issues where multiple parties could be heard. The judge's involvement in the appointment of the expert is important because experts need an ability to be heard in court, as well as the requisite authority to conduct an investigation if one is desired. The addition of a hearing on the experts would also give all parties in the case room to articulate what they believe is necessary for the case as well as who is best qualified to serve. Agreeing upon and setting parameters on the

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233. See, e.g., *Alternative Dispute Resolution Mediation*, U.S. BANKR. CT. DIST. ARIZ., <http://www.azb.uscourts.gov/alternative-dispute-resolution-mediation> [<https://perma.cc/TCE4-9DWF>] (listing approved mediators).

expert's authority at the outset of the case is important, both so that the expert knows when he or she has the freedom to act and so that the judge or other parties can cabin the expert from overstepping his or her role.

Although the expert's role would be subject to some variation depending on the exact needs of each case, previous chapter 9 cases can provide guidance to states on best practices for the use of experts. As discussed previously, experts are primarily valuable for their roles in facilitating settlements and providing information about the municipality, municipal bankruptcy, and municipal finance to the judge so that he or she can make an informed decision regarding plan confirmation. Thus, experts should be used to facilitate settlement proceedings, to help draft the municipality's plan of adjustment by providing both technical, financial expertise and local knowledge, and to investigate particular issues with respect to the debtor or its finances that arise in the case.

In addition to specifying appropriate roles for experts in chapter 9, state legislation should also impose limitations on these experts. In particular, experts should not assume official capacities within the government that they are assisting. Appointing a chapter 9 expert to a formal role in municipal government may be viewed by residents and officials alike as an encroachment on democracy and may create tensions with residents similar to those seen in Detroit and Puerto Rico.<sup>234</sup> This legislation, by leaving governance matters and final decisionmaking authority with elected municipal officials, could help mitigate tensions among these officials, municipal residents, and the expert and could serve as an important check on the expert's power.

Experts would come with a cost, but the question of who pays for the expert has several possible resolutions. As discussed, states could incorporate a requirement for municipalities to consider engaging the services of one or more experts as part of the authorization process for chapter 9. In the same vein, states could also offer to defray the cost of any experts actually used. At the hearing to approve the expert, the parties could ask the judge to set caps on the expert's fees. Alternatively, states could choose to cabin use of an expert to only certain cases. For example, states may choose to require expertise only in larger (more populous) municipal bankruptcies, where more complications are likely to arise; in cases involving general purpose municipalities, such as cities and towns; or in cases with municipalities with a certain amount of debt. States may also decide that whether an expert is used in a particular case is best decided on an individualized basis.

Because municipal distress's ripple effects can even affect the federal government, it is possible that Congress could establish a fund to help defray the cost of an expert, similar to the existing fund Congress has created for

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234. Cf. Nick Brown & Daniel Bases, *Puerto Rico's Major Bondholders Critical of Fiscal Turnaround Plan*, REUTERS (Mar. 28, 2017, 9:26 AM), <http://www.reuters.com/article/us-puerto-ricos-major-bondholders-critical-of-fiscal-turnaround-plan-idUSKBN16Z1OP> [<https://perma.cc/GW73-GXYB>] (describing how Puerto Rico's major bondholders are critical of the oversight board-approved fiscal turnaround plan).

the U.S. Trustee Program.<sup>235</sup> Finally, similar to professional fees in bankruptcy, an expert's fees should be subject to judicial approval.<sup>236</sup> If possible, funding the expert from a combination of sources may be the most desirable, as such an arrangement would give the expert financial independence from any one entity.

Despite the expert's price tag, using an expert could ultimately be a source of cost savings for the municipality. For example, the expert may expedite the plan confirmation process through dispute resolution, similar to the way the mediator in Detroit played a key role in helping the city exit bankruptcy in record time for a city of Detroit's size. As discussed above, mediators in chapter 9 often help resolve issues that would otherwise be litigated, thus saving the municipality time and money in drawn-out court proceedings. Additionally, by relaying more in-depth information to the bankruptcy judge, the expert could provide greater assurance that a municipality's proposed plan will work as intended, making it less likely that the municipality will need to enter bankruptcy again.

## 2. Benefits of Formalization

Although it is possible, and even desirable, to use experts outside of the chapter 9 process,<sup>237</sup> there are distinct benefits to incorporating the expert into the bankruptcy process itself. Notably, mediation efforts may be more likely to succeed in bankruptcy, as the judge's ability to cram down a plan—or dismiss the case—creates well-documented incentives for parties to strike a bargain.<sup>238</sup> Experts can assist with this process by facilitating greater coordination, information exchange, and overall dialogue within the case, providing a measure of security for creditors who fear inequitable treatment by debtors in bankruptcy.<sup>239</sup> Additionally, as illustrated above, experts can help the judge apply the confirmation requirements to the municipality's plan of adjustment. An expert knowledgeable about the municipality's idiosyncrasies can provide guidance to the judge with respect to how to apply the

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235. *About the Program*, U.S. DEPT. OF JUST. (May 12, 2016), <https://www.justice.gov/ust/about-program> [<https://perma.cc/PEV4-UDHV>] (“[T]he program is funded by the United States Trustee System Fund, which consists primarily of fees paid by parties and businesses invoking Federal bankruptcy protection.”).

236. *See* 11 U.S.C. §§ 327, 328 (2012).

237. Indeed, some states already employ a form of expertise outside of the chapter 9 context. *See* CAL. GOV'T CODE § 53760 (West 2008); *see also* Frank Shafroth, *Addressing Municipal Fiscal Distress*, GMU MUN. SUSTAINABILITY PROJECT (Apr. 5, 2017), <https://fiscalbankruptcy.wordpress.com/2017/04/05/addressing-municipal-fiscal-distress/> [<https://perma.cc/HKY7-8PGA>] (describing a proposal for a similar program in Illinois).

238. *See, e.g.*, Pryor, *supra* note 29, at 122 (noting that bankruptcy “drives stakeholders to compromise or face dismissal”).

239. *See* Hagan, *supra* note 198, at 310 (discussing “pronounced” creditor coordination problems as debt instruments become more complex).

general confirmation standards to the particular debtor. Experts may be especially valuable with respect to the feasibility determination, which is often highly technical and fact based.<sup>240</sup>

Although states are free to use expertise outside of the bankruptcy context,<sup>241</sup> having an expert involved in the chapter 9 process may take some pressure off of the state to devise its own full-fledged relief program.<sup>242</sup> Thus, experts in chapter 9 may be particularly valuable for states that are facing their own financial struggles and do not have the resources to provide robust financial oversight mechanisms for their municipalities outside of bankruptcy.

In bankruptcy, experts will fulfill a role distinct from that of the bankruptcy judge. Although judges do have bankruptcy expertise, they may be less familiar with the particularities of the debtor municipality and its fiscal and operating constraints. The expert, who will have greater specialized competency in the municipality's specific issues, can provide this information to the judge. Additionally, while a bankruptcy judge has a full slate of cases on the docket, experts would be involved in only one case at a time. Scholars have observed that courts, despite their bankruptcy expertise, lack the resources, time, and specialized knowledge necessary to perform many oversight functions.<sup>243</sup> Having a trusted expert available who understands the municipality and the problems it is experiencing will greatly benefit the bankruptcy case while relieving bankruptcy judges of some pressure.<sup>244</sup>

Experts will also fulfill a role distinct from that of the U.S. Trustee. Although increasing the U.S. Trustee's role in a chapter 9 case in lieu of appointing an expert would eliminate the need to design a selection process, U.S. Trustees, like bankruptcy judges, are likely to lack expertise about a given municipality. To return to the example of Judge Flanders's role in Central Falls' bankruptcy, multiple forms of expertise are often needed in a

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240. See, e.g., *In re Jennifer Convertibles, Inc.*, 447 B.R. 713, 725 (Bankr. S.D.N.Y. 2011) (finding plan to be feasible when debtor's monthly operating report showed strong and consistent growth); *In re General Electrodynamics Corp.*, 368 B.R. 543, 555–56 (Bankr. N.D. Tex. 2007) (finding plan to be feasible when debtor had demonstrated access to cash infusions); *In re Rivers End Apartments, Ltd.*, 167 B.R. 470, 476–77 (Bankr. S.D. Ohio 1994) (finding plan to be feasible when debtor's anticipated future economic growth was backed by fact and expert testimony).

241. For example, the Illinois legislature is considering a bill to establish an authority to address local government financial distress. See Shafroth, *supra* note 237.

242. See, e.g., Kimhi, *supra* note 212, at 385 (arguing for state assistance in the form of special boards); Parikh & He, *supra* note 7, at 603 (discussing proposal that states adopt a debt adjustment mechanism).

243. Jennifer Payne, *The Role of the Court in Debt Restructuring*, SSRN 11–12 (Jan. 20, 2017), <https://ssrn.com/abstract=2902528> [<https://perma.cc/4HDDH-RGMG>].

244. See Stefano Rossi & Hayong Yun, *What Drives Financial Reform? Economics and Politics of the State-Level Adoption of Municipal Bankruptcy Laws*, SSRN 34 (Dec. 4, 2015), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2698665](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2698665) [<https://perma.cc/4GHD-UDJB>] (“[Financial reforms] are significantly shaped . . . by the efficiency of courts . . . [E]nabling courts to enforce the complex legislation of financial markets is one of the main challenges of globalization.”).

chapter 9 case. Judge Flanders had expertise about bankruptcy and municipal restructuring, as well as expertise about the particular municipal debtor. Judge Flanders was thus able to devise a working plan of adjustment for Central Falls not just because of his experience with municipal bankruptcy, but also because of his familiarity with the city. Furthermore, although both U.S. Trustees and judges have extensive bankruptcy expertise, neither of these entities are likely to have seen many chapter 9 cases in their careers. An expert with experience in the municipal restructuring process can thus be very valuable.

Above all, experts can help tailor the generalized bankruptcy process to more effectively address debtors' individualized problems. In chapter 9, they can help to ensure that municipalities are getting the most out of the process and are using bankruptcy's toolkit in a way that will work for them. Formalizing the selection and role of experts will add an element of trustworthiness and allow these important individuals to perform their roles more effectively.

Notably, depending on the needs of the case and the requests of the parties, the judge may find it beneficial to appoint several individuals to fulfill the expert role or to assign specific tasks to separate individuals. The key difference from the status quo in chapter 9 is that these decisions will be made after a process has taken place, one that involves the state, residents, and parties to the case, rather than merely the judge.

Subjecting experts to a rigorous selection and approval process legitimates the expert and may reduce challenges to the expert's credibility during the bankruptcy, such as those seen in Detroit. Additionally, articulating the role and scope of the expert's functions within the bankruptcy allows parties to understand this role and even to have a say in defining desired limitations. Furthermore, providing a clear role for an expert in chapter 9 may encourage municipalities who need bankruptcy relief to enter the process sooner rather than engage in potentially costly, harmful delay tactics.<sup>245</sup> This is because the expert may provide more certainty about what the municipality can expect in chapter 9. Creditors, for their part, might be reassured that an expert is present to help protect their rights. Increased certainty can be beneficial in the borrowing context, so it is also possible that municipalities who rely on experts in bankruptcy will be able to reenter the debt markets more quickly than if they had not.<sup>246</sup> Formal procedures can also assist in speeding up a bankruptcy case, as preselected, vetted experts would be available and ready to assist with a case as soon as it is filed. Having a system in

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245. See Desmond Lachman, *Time Is of the Essence: Puerto Rico Needs Bankruptcy Protection Now*, THE HILL (Apr. 27, 2017, 12:00 PM), <http://thehill.com/blogs/pundits-blog/economy-budget/330840-time-is-of-the-essence-puerto-rico-needs-bankruptcy> [https://perma.cc/UC2Y-73Z4] (puzzling over "why Puerto Rico's governor and its Oversight Board have not already availed themselves of . . . bankruptcy" and noting that "[b]y orderly restructuring its debt, the island would reduce the investor uncertainty from which it now suffers as a result of a debt level that everyone knows it cannot afford to pay").

246. See Parikh & He, *supra* note 7, at 629–30 (discussing certainty in the underwriting process).

place for chapter 9's experts will reduce the cost and time necessary to seek out an expert once a case begins.

Recent chapter 9 cases demonstrate the importance of the expert's perceived legitimacy. Formal, transparent procedures for selecting and employing an expert can assuage concerns that the expert might dominate the negotiation process by imposing her own or the judge's will on the parties. This concern is particularly salient in the municipal context because experts, unlike municipal officials, are not democratically elected. The current ad hoc method of judges appointing experts similarly raises concerns because bankruptcy judges are also not democratically elected. Open procedures that allow parties to articulate the reasons for appointing an expert, such as those proposed above, increase transparency and accountability on the part of both the judge and the expert.<sup>247</sup> Involving parties other than the judge in the appointment and selection process also decreases the risk that the judge will be seen as overstepping the boundaries of his or her role in the case.

Formalizing procedures regarding experts in chapter 9 also allows for a vetting process and protects parties from having to work with someone who is perceived as being too close to the judge or to powerful parties, such as creditors. For example, recently the district judge overseeing Puerto Rico's bankruptcy rejected a proposal from the oversight board and suggested that the board and creditors resume negotiations using her selected team of mediators.<sup>248</sup> Although the judge's decision assuaged some creditors who believed the oversight board was exercising too much influence,<sup>249</sup> nudging the parties into mediation with the judge's hand-selected mediators raises concerns about judicial influence and may be no less problematic. In addition to providing legitimacy, a transparent selection process allows for multiple stakeholders to play a role in defining the expert's powers and prevents the judge from selecting someone based on the judge's sole perception of who is qualified. Having multiple parties involved in the expert's selection and appointment also minimizes the risk that the expert will simply impose the judge's preferences on creditors or other parties.<sup>250</sup>

Open discussion about the experts that are needed for a particular case is also valuable because different types of expertise are needed in different cases. One salient criticism of the oversight board for Puerto Rico is that its plan did not adequately address the unique causes and consequences of Puerto Rico's fiscal crisis.<sup>251</sup> Although the oversight board is comprised of financial experts, this criticism shows that the right mix of financial, community, and bankruptcy experts may be lacking. Open discussion of

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247. See Rasmussen & Skeel, *supra* note 51, at 12 (describing the need for transparency to promote political accountability).

248. Steven Church, *Puerto Rico Told to Revamp Plan for Sales-Tax Agency Advocate*, *Bankr. L. Rep. (BNA)*, at 1 (July 13, 2017).

249. *Id.*

250. See Rasmussen & Skeel, *supra* note 51, at 33 (discussing concerns that a single actor will not act to maximize the value of an entity or its interest).

251. MERLING ET AL., *supra* note 5, at 3.

experts, their qualifications, and the roles they need to play in the case can help ensure that the type of expertise that is needed in a case can be found.

As previously discussed, experts could optimize the bankruptcy experience for municipalities by reducing the need for litigation, overcoming the resource constraints of the bankruptcy judge, providing avenues for participation by creditors and other parties in interest, and creating incentives for parties who need it to use the bankruptcy process. One concern with encouraging use of bankruptcy is that it increases the risk of moral hazard, including frivolous filings. The expert's role in facilitating more rigorous application of the confirmation standards should, however, make frivolous filings less likely to occur, as municipalities that do not stand to gain from bankruptcy would not use the system. Over time, using experts on a regular basis to clarify application of the plan confirmation standards may also enable municipalities to see in advance what they can accomplish by filing for bankruptcy, and thus allow municipal officials to make a more informed decision about whether bankruptcy is a productive path forward.

A drawback to using experts is already evident in the current chapter 9 process: if experts take issues off the table at plan confirmation through encouraging settlement, they necessarily minimize the number of judicial opinions on key legal issues and contribute to the perpetuation of the lack of relevant precedent in chapter 9.<sup>252</sup> Discomfort with this outcome may be minimized, however, if the parties can trust that the experts are doing a good job. Chapter 9 procedures that institute a formal process for these experts can increase that trust.

A final benefit of establishing formal procedures for use of experts is that these procedures will separate the expert from the judge and reduce the appearance of impropriety or undue influence. A side effect to this benefit is that parties may be less inclined to negotiate if they feel that the judge is not creating this pressure. After all, the judge holds significant power at the chapter 9 plan confirmation stage. On balance, however, the bankruptcy process itself still provides significant incentives to negotiate,<sup>253</sup> and concerns over abuse and manipulation through retention of the status quo likely outweigh any minor disincentive to negotiate that may result from imposing procedures for an expert.

Implementing formal procedures for experts in chapter 9 will require resources, foresight, and time. In addition, state and local officials will have to contemplate bankruptcy, a topic that is disfavored among most public officials. Despite these obstacles, state and local governments will benefit from putting in the effort now to identify and select experts. As discussed, these experts could also assist financially distressed municipalities prior to their entry into chapter 9. If and when a municipality files for bankruptcy, experts could quickly assume their designated roles and work to expedite the

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252. See BERMAN & SCHNEIDER, *supra* note 96.

253. See Pryor, *supra* note 29, at 122 (discussing these incentives).

municipality's bankruptcy exit. Parties to the case, including citizens, municipal officials, and creditors, could also feel more confident about working with experts that they have had a role in choosing.

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In all, a carefully planned selection process, combined with a defined scope and role for experts to play, will be key to ensuring that the expert is not beholden to the interests of any one party in a municipal bankruptcy. Although the procedures described here should be subject to further scrutiny and refinement, they are intended to serve as a starting point for further inquiry into the critical goal of paying more attention to experts, parties who—despite the substantial powers they can wield in a case—have largely flown under the radar. As courts continue to struggle with the question of what rights a debtor has to exit bankruptcy on its own terms, providing a formal, defined role for experts in the chapter 9 bankruptcy process can help all parties, including the judge, ascertain what a municipality's interests are, and what those terms should look like. Although regular use of chapter 9 experts will require work on the part of Congress and the states, the consistency with which the expert proposal has arisen across the bankruptcy and insolvency spectrum suggests that there is much to be gained by doing the work necessary to make experts a more permanent and deliberate part of chapter 9.

#### CONCLUSION

In many cases, both within chapter 9 and the larger insolvency context, judges have sought guidance in the form of outside expertise to help them overcome difficulties with assessing whether a proposed debt restructuring is feasible and fair. To assist judges with applying the chapter 9 confirmation standards to struggling municipalities, as well as to better protect debtors and creditors in chapter 9, this Article advocates for the regular, formalized use of experts in municipal bankruptcy proceedings. To lend legitimacy to these experts, transparency to the selection process, and clarity to the parties, this Article further proposes that states, in conjunction with Congress, develop concrete procedures for the selection, appointment, and performance of the chapter 9 expert.

Although no one procedure can guarantee that a debtor will exit bankruptcy on stronger financial footing than when it entered, experts can do many things to ensure that the bankruptcy process stays on track. There is thus good reason to give serious consideration to the formalized use of expertise in chapter 9 and in bankruptcy more generally.

