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When Should Bankruptcy Be an Option (for People, Places or Things)?

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WHEN SHOULD BANKRUPTCY BE AN OPTION (FOR PEOPLE, PLACES, OR THINGS)?

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ABSTRACT

When many people think about bankruptcy, they have a simple left-to-right spectrum of possibilities in mind. The spectrum starts with personal bankruptcy, moves next to corporations and other businesses, and then to municipalities, states, and finally countries. We assume that bankruptcy makes the most sense for individuals; that it makes a great deal of sense for corporations; that it is plausible but a little more suspect for cities; that it would be quite odd for states; and that bankruptcy is unimaginable for a country.

In this Article, I argue that the left-to-right spectrum is sensible but mistaken. After defining "bankruptcy," I outline a series of puzzles for the standard intuitions, such as the absence of personal bankruptcy in many countries and the fact that state bankruptcy is in some respects more defensible than municipal bankruptcy. I then develop and apply a five-factor framework that considers: (1) whether unsustainable debt is a potential problem; (2) the benefits of reshaping decision-making incentives; (3) the risk of premature liquidation; (4) the dignity of the debtor; and (5) spillover effects.

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INTRODUCTION

Since the turn of the twenty-first century, bankruptcy has been proposed as a potential solution for the financial distress of an ever expanding group of entities. Three years ago, at a time when California was projecting annual deficits of more than $10 billion each year and Illinois's pensions were radically underfunded, a handful of U.S. politicians flirted with the idea of proposing a bankruptcy framework for U.S. states.[1] A decade earlier, after Argentina's most recent default, the International Monetary Fund (IMF) proposed, and briefly defended, a statutory framework it dubbed the "Sovereign Debt Restructuring Mechanism."[2] In each case, the proposals were quickly shot down, although neither seems to be entirely dead. As Greece's finances deteriorated in 2009 and 2010, for instance, the architect of the earlier IMF proposal rolled out a new version adapted to the European Union.[3]

At least for those of us in the United States, the fate of these proposals fits perfectly with widespread intuitions about where bankruptcy does and does not make sense. Whether they are bankruptcy experts or lay people, when most people think about bankruptcy, they have a simple left-to-right spectrum of possibilities in mind. The spectrum starts with personal bankruptcy, moves next to corporations and other businesses, and then to municipalities, states, and finally countries. We assume that bankruptcy makes the most sense for individuals; that it makes a great deal of sense for corporations; that it is plausible but a little more suspect for cities;

1. *See, e.g.*, Jeb Bush & Newt Gingrich, *Better Off Bankrupt*, L.A. TIMES, Jan. 27, 2011, at A19 ("This approach begins with a new chapter in the federal Bankruptcy Code that provides for voluntary bankruptcy by states.").

2. Anne Krueger, then First Deputy Managing Director of the International Monetary Fund, announced the initiative in a speech in 2002. Anne Krueger, First Deputy Managing Director, Int'l Monetary Fund, Speech Before Institute for International Economics at the Conference on "Sovereign Debt Workouts: Hopes and Hazards": New Approaches to Sovereign Debt Restructuring (Apr. 1, 2002), *available at* http://www.imf.org/external/np/speeches/2002/040102.htm.

3. FRANÇOIS GIANVITI ET AL., A EUROPEAN MECHANISM FOR SOVEREIGN DEBT CRISIS RESOLUTION: A PROPOSAL vi-vii, 26 (Andrew Fielding ed., 2010), *available at* http://www.bruegel.org/publications/publication-detail/publication/446-a-european-mechanism-for-sovereign-debt-crisis-resolution-a-proposal/#.URUlCo5kJ94.

that it would be quite odd for states; and that bankruptcy is unimaginable for a country.

The left-to-right spectrum also roughly parallels the history of federal bankruptcy law in the United States. The first federal bankruptcy law, enacted in 1800 and repealed several years later, was designed for merchants and traders—that is, individuals in business.[4] Subsequent nineteenth-century bankruptcy laws focused primarily on individuals and small businesses. Congress first added large-scale corporate reorganization to the bankruptcy laws in 1933 and 1934,[5] and it enacted the first municipal bankruptcy law in 1934.[6]

If we are working with this left-to-right spectrum in the back of our mind, the quick demise of proposals for a state or country bankruptcy framework is just what we would expect. The reaction to Detroit's recent bankruptcy filing has also been consistent with the usual intuitions.[7] Municipal bankruptcy is right in the middle of the spectrum, the point at which many observers may get a little queasy about the desirability of bankruptcy. In the past, nearly every municipal bankruptcy filing involved special-purpose entities like a sewage or water district or a small town, not a sizeable city.[8] Bankruptcy seemed harmless enough for these entities. But Detroit is different. It is a major city, and many wonder whether bankruptcy is an acceptable destination for a city.[9]

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4. *See, e.g.*, Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 14-15 (1995) (describing 1800 Act).

5. *See, e.g.*, DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 103-107 (2001) (describing enactment of corporate reorganization provisions for railroads in 1933 and nonrailroad corporations in 1934).

6. The 1934 law was struck down by the Supreme Court as unconstitutional in *Ashton v. Cameron Water Improvement District No. 1*, 298 U.S. 513 (1936), but its 1937 successor was upheld two years later in *United States v. Bekins*, 304 U.S. 27 (1938).

7. Detroit entered bankruptcy on July 18, 2013, filing its petition shortly before a state court judge issued a series of rulings purporting to enjoin Michigan officials from permitting or participating in the bankruptcy. *See, e.g.*, Monica Davey & Mary Williams Walsh, *Billions in Debt, Detroit Tumbles into Insolvency*, N.Y. TIMES, July 19, 2013, at A1; *Detroit Files for Bankruptcy, Setting off Battles with Creditors, Pensions, Unions*, DETROIT FREE PRESS (July 19, 2013, 7:47 AM), http://www.freep.com/article/20130718/NEWS01/307180107.

8. *See, e.g.*, Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 359 & n.43, 360-61 (2010) (describing Chapter 9 as "used by tiny municipalities under peculiar circumstances").

9. *See, e.g.*, Daniel Fisher, *Detroit's Bankruptcy Is Just Politics by Other Means*, FORBES (July 19, 2013, 2:58 PM), http://www.forbes.com/sites/danielfisher/2013/07/19/detroits-

I hope to show in this Article that the standard shorthand for determining when bankruptcy should be an option is simply wrong. Although the intuitions are widespread and perfectly understandable, the left-to-right spectrum turns out to be incoherent. To develop this argument, I will begin by identifying a series of puzzles for the conventional wisdom. Using the left-to-right spectrum as our guide, we would expect, for instance, personal bankruptcy statutes to be ubiquitous, but they are not. Although state bankruptcy's near neighbor on the spectrum is corporate bankruptcy, it has far more in common with personal bankruptcy. State bankruptcy may make more sense, not less, than bankruptcy for municipalities. And bankruptcy is hard to justify for some corporations. At some point, as the anomalies multiply, it is time for another paradigm, or so I will argue.

If we throw out the standard spectrum, what are we left with? My second objective in this Article is to try to develop a more useful framework for considering whether and when bankruptcy makes sense. Drawing liberally from the existing literature, I will offer a five-factor typology for determining whether a bankruptcy framework is appropriate in any given context. The typology does not remove all questions about whether bankruptcy should be an option for any type of individual or entity, but it focuses attention on the key factors and relevant tradeoffs. The typology also helps to explain an odd disconnect in contemporary bankruptcy theory: the sharp differences between the normative justifications for corporate bankruptcy, on the one hand, and for consumer bankruptcy, on the other.[10]

Some may question whether a framework like this is necessary or useful. Why not simply ask, for instance, whether a bankruptcy option would be efficient and would minimize the cost of credit? To this objection, I give two answers. First, the five factors operationalize the efficiency concern by focusing attention on the particular factors that will determine whether bankruptcy is likely to be

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bankruptcy-is-just-politics-by-other-means.

10. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 225 (1986) (characterizing the key issue in business bankruptcy as addressing a common pool problem, but describing the fresh start for consumer debtors as having "nothing to do with the rights of claimants inter se or with the notion that bankruptcy exists to solve a common pool problem").

efficient in any given context. They give content to the efficiency analysis. Second, sometimes we do not want to minimize the cost of credit, as for example in contexts where potential spillover effects come into play. The five-factor framework allows us to account both for non-efficiency concerns and for the full range of efficiency issues.

Before I introduce the puzzles that seem to confound the left-to-right spectrum on bankruptcy, I should first explain what I mean by bankruptcy. I offer a very simple definition in Part I. I turn to the puzzles in Part II, outline the typology in Part III, and offer a series of applications in Part IV. I should note that I will focus entirely on the question of whether some kind of bankruptcy option is desirable, not the particular details of any given bankruptcy framework. I will not be concerned, except incidentally, with key issues such as the optimal priority rules or who should be permitted to initiate bankruptcy.[11]

I. WHAT IS BANKRUPTCY?

For my purposes, bankruptcy has four basic attributes.[12] First, bankruptcy enables a debtor to restructure its obligations. Thus, if the debtor owes $100 to a creditor, bankruptcy provides a way to reduce this obligation, so that it is decreased, say, to $70 or perhaps wiped out altogether. The extent to which the obligation is restructured will generally depend on the debtor's assets, current income,

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11. The distinction between the existence of a bankruptcy framework and its details is, of course, permeable. The ability to create enforceable priorities may be one of the strongest arguments in favor of enacting a bankruptcy law in some contexts. *See, e.g.*, Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework be Structured?*, 53 EMORY L.J. 763, 799 (2004) (describing the absolute priority rule in bankruptcy as counteracting the incentive for sovereigns to overborrow as they near financial distress).

12. My definition loosely tracks the Supreme Court's interpretation of Congress's constitutional power to enact bankruptcy laws. *See* U.S. CONST. art. I, § 8, cl. 4. Bankruptcy has come to include nearly any reasonably comprehensive framework for adjusting a debtor's obligations, providing for payment of creditors, and giving the debtor a discharge. For a short and still useful discussion, see Frank R. Kennedy, *Bankruptcy and the Constitution*, *in* BLESSINGS OF LIBERTY 131, 137-38 (1988) (characterizing the case law as "com[ing] close to permitting Congress complete freedom in formulating and enacting bankruptcy legislation"). The most complete treatment of Congress's bankruptcy authority is Jonathan C. Lipson, *Debt and Democracy: Towards a Constitutional Theory of Bankruptcy*, 83 NOTRE DAME L. REV. 605, 612-13 (2008) (developing a constitutional theory of bankruptcy).

or both. But the important thing is that the obligation is reduced as a matter of law—the debtor now owes $70 or $0, not $100. The technical term is that part or all of the original obligation is "discharged."[13]

Second, bankruptcy is imposed or facilitated by government or another third party. If a debtor owes $100 to a creditor and cannot pay it all, the debtor and creditor can, of course, agree on their own that the debtor will only pay $70, rather than $100. This is a private restructuring or workout, but it is not bankruptcy.[14] Bankruptcy is not purely private; there is a public role.[15]

Third, it is collective in nature. A bankruptcy framework adjusts the debtor's relationship with most or all of its creditors, not just one.[16] A law that enables a debtor to discharge a particular obligation—say, a law that provided a partial or full tax amnesty to debtors who disclosed previously hidden income—would restructure an important debt, but it would not by itself be a bankruptcy law. Bankruptcy provides a collective forum for resolving financial distress.

Finally, bankruptcy is specific to a particular individual, enterprise, or entity.[17] We could in theory restructure every business in an industry at the same time,[18] but that is not the way bankruptcy ordinarily works. Bankruptcy is specific to a particular debtor.

Those who are familiar with insolvency law may immediately think of examples that do not fit neatly within the description I have just provided. For instance, most states have assignment for

13. In U.S. bankruptcy law, each of the major "chapters" has a discharge provision. *See, e.g.*, 11 U.S.C. §§ 727(b), 944(b), 1141(d), 1328(a) (2012) (providing discharge provisions for chapters 7, 9, 11, and 13).

14. *See* Claire Finkelstein, *Financial Distress as a Noncooperative Game: A Proposal for Overcoming Obstacles to Private Workouts*, 102 YALE L.J. 2205, 2205 (1993) (describing private workouts as non-judicial).

15. In the United States, the formal authority for bankruptcy comes from the Bankruptcy Clause in Article I of the Constitution. U.S. CONST. art. I, § 8, cl. 4.

16. For example, the Bankruptcy Code prevents creditors from continuing to collect on their debts from a debtor who has filed a petition for bankruptcy. *See* 11 U.S.C. § 362(a).

17. *See* 11 U.S.C. § 109 (indicating who may be eligible debtors).

18. Joseph Stiglitz's "super chapter 11" proposal is the best known example of multi-firm bankruptcy. Marcus Miller & Joseph Stiglitz, Bankruptcy Protection Against Macroeconomic Shocks: The Case for a 'Super Chapter 11' 4 (Apr. 16, 1999) (unpublished manuscript) (on file with Univ. of Warwick Ctr. for the Study of Globalisation and Regionalism), *available at* http://www2.warwick.ac.uk/fac/soc/csgr/research/fincrises/milrstig.pdf/.

the benefit of creditors statutes that function very much like our federal bankruptcy laws.[19] Under an assignment law, a trustee takes control of the firm's assets, ordinarily sells them, and distributes the proceeds to creditors.[20] In recent years, many troubled businesses or their creditors have used state assignment laws as an alternative to bankruptcy, often due to the increased costs of a traditional bankruptcy after Congress's 2005 amendments to the bankruptcy laws.[21] State assignment laws have essentially the same effect as bankruptcy. They differ only in that they usually do not formally discharge all of the debtor's obligations. But the absence of a discharge has little significance if the business that is subject to an assignment for the benefit of creditors is a corporation, because limited liability already removes shareholders' personal responsibility for the obligations of the business.[22] Indeed, based on this reasoning, corporations that are liquidated under the bankruptcy laws are not given a discharge.[23] Assignment laws can thus be seen as bankruptcy laws, at least for debtors that have limited liability.

Bank resolution laws, such as the new resolution powers given to bank regulators under the Dodd-Frank Act, are other borderline cases. Many commentators, including this one, distinguish between Dodd-Frank resolution and bankruptcy, usually characterizing Dodd-Frank or other bank insolvency rules as "administrative resolution," in contrast with bankruptcy under the bankruptcy laws.[24] The key difference lies in the fact that regulators control the entire process in an administrative resolution, with little input from

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19. *See, e.g.*, Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?*, 70 N.Y.U. L. REV. 993, 1001-03 (1995).

20. *Id.* at 1005-06.

21. *See, e.g.*, John A.E. Pottow, *Private Liability for Reckless Consumer Lending*, 2007 U. ILL. L. REV. 405, 405-06.

22. The same reasoning also applies to other entities that enjoy limited liability, such as limited liability companies or limited liability partnerships.

23. The exception applies to any "debtor [that] is not an individual." 11 U.S.C. § 727(a)(1) (2012).

24. *See, e.g.*, Thomas H. Jackson & David A. Skeel, Jr., *Dynamic Resolution of Large Financial Institutions*, 2 HARV. BUS. L. REV. 435, 436-37 (2012) (comparing administrative resolution under the Dodd-Frank Act with bankruptcy). The bankruptcy laws do not apply to banks or insurance companies, each of which is handled under their own administrator-run insolvency regimes. 11 U.S.C. § 109(b) (excluding banks and insurance companies from chapter 7).

the parties themselves. Administrative resolution has the virtues of speed, flexibility, and regulatory expertise, while sacrificing transparency and other rule-of-law virtues, such as clear priority rules.[25] Although the distinctions between administrative resolution and traditional bankruptcy are enormously important, administrative resolution has each of the characteristics that define a bankruptcy regime: it is facilitated by the government, collective, specific to an individual debtor, and discharges the debtor's obligations.[26] With the new Dodd-Frank framework and other administrative resolution rules, we are clearly in the realm of bankruptcy.

If administrative resolution and bankruptcy are both bankruptcy for our purposes, some may wonder what responses to financial distress would not qualify as bankruptcy. Non-comprehensive state law collection remedies—such as a creditor's right to foreclose on the property collateralizing its loan—are not bankruptcy. Nor is a central government's decision to provide rescue financing to a troubled bank or business, or a state law putting a financial control board in place to oversee a troubled city's finances. If a debtor simply defaults on one or more of its obligations, this too is an alternative to bankruptcy.

II. A FEW BANKRUPTCY PUZZLES

As I have already mentioned, if we think about bankruptcy as a potential response to the financial distress of individuals, corporations, cities, states, and countries, most of us would assume that the case for bankruptcy is very strong at the start of this list, and it gradually weakens as we go from left to right. Surely we need personal bankruptcy and bankruptcy for corporations, but bankruptcy is a little dubious for cities, crazy for states, really crazy for countries, and utterly absurd for the United States. The bigger the debtor is, in a sense,[27] the less suitable it is for bankruptcy. Many

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25. *See, e.g.*, Jackson & Skeel, *supra* note 24, at 445-46.

26. *See supra* notes 12-18 and accompanying text.

27. I say "in a sense" because some cities and possibly even states are not as large as the largest corporations. Lehman Brothers reported much greater assets than Detroit in its bankruptcy filing, though the numbers may be misleading. *Compare* Matt Hudgins, *Lehman Is Biding Its Time to Market Its Real Estate*, N.Y. TIMES, Sept 12, 2012, at B10, *with* Matthew Dolan, *Record Bankruptcy for Detroit: Motor City 'Is Broke' Governor Says, as It Seeks to*

of us might also note that cities, states, and countries are considered to be sovereign in some respects, and bankruptcy seems unseemly—an assault on the dignity of a sovereign.

These intuitions are widespread, and they also seem to roughly track the way American lawmakers think. But if we pick at them even a little bit, they quickly stop making sense. Here are four puzzles for the standard intuitions.

First, if it is obvious that we need bankruptcy for consumers who are overwhelmed by debt, we would expect consumer bankruptcy law to be ubiquitous. Perhaps some developing countries would be an exception because they are often outliers in economic matters. But we would expect consumer bankruptcy to be as ubiquitous in the laws of developed countries as civil procedure, corporate, or securities laws. Yet this is not what we find at all. Many developed countries do not have any consumer bankruptcy provisions or offer very limited access to bankruptcy. Although Italy has long had a corporate insolvency framework, it did not provide either a collective proceeding or a discharge for consumer debts until 2012.[28] A handful of other European countries still do not have a consumer bankruptcy framework, and those countries that do have consumer bankruptcy generally impose much tighter restrictions on discharge than the United States.[29] This variation raises questions as to whether consumer bankruptcy is as inevitable as the U.S. experience tends to suggest.

Second puzzle. Given that cities and states come right after corporations on the left-right spectrum, we might naturally assume that the best way to explain why cities are—and to decide whether states should be—permitted to file for bankruptcy is to compare municipal or state bankruptcy to corporate bankruptcy. If distressed states face the same issues as distressed corporations, they may

Restructure $18 Billion in Debt, WALL ST. J., July 19, 2013, at A1.

28. *See, e.g.*, Giacomo Rojas Elgueta, The Paradoxical Bankruptcy Discharge: Rereading the Common Law-Civil Law Relationship 11 n.15 (July 25, 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2298486.

29. For the range of approaches, see CONSUMER CREDIT, DEBT & BANKRUPTCY—COMPARATIVE AND INTERNATIONAL PERSPECTIVES 3-4 (Johanna Niemi et al. eds., 2009); Rafael Efrat, *Global Trends in Personal Bankruptcy*, 76 AM. BANKR. L.J. 81, 81-82 (2002); Iain Ramsay, *Between Neo-Liberalism and the Social Market: Approaches to Debt Adjustment and Consumer Insolvency in the EU*, 35 J. CONS. POL'Y 421, 421-22 (2012).

need a bankruptcy framework. If not, bankruptcy is unnecessary. This is, in fact, exactly how most scholars think.[30] They start with the standard scholarly explanation for corporate bankruptcy, which emphasizes bankruptcy law's ability to ensure that businesses are not liquidated unnecessarily.[31] When a business is in financial trouble, the reasoning goes, its creditors will rush to get paid before the money runs out. They may, for instance, foreclose on the company's manufacturing plant or its equipment,[32] even though this could destroy an otherwise viable business. Bankruptcy imposes a cease fire, so that the debtor and its creditors can decide whether the business is worth more alive than dead.[33]

When scholars apply this reasoning to states like Illinois or California, they rightly conclude that states are quite different than corporations. Unlike the creditors of a corporation, who can go to court if the corporation refuses to pay, there is not much Illinois's creditors can do. Illinois is immune from most lawsuits because the Eleventh Amendment prohibits litigation against a state.[34] A creditor cannot foreclose on the state house in Springfield or demand the keys to a state park. To be sure, a mandamus remedy is sometimes available, but states can easily avoid its effects if they do not wish to comply.[35] Although some people might wish that a state could be liquidated if it stops paying its bills, this is not going to happen.

This seems to suggest that state bankruptcy is a lousy idea. But there is a small problem with this reasoning—it is based on the wrong analogy. As strange as this sounds, states are actually a lot more like consumer debtors, like you and me, than like

30. These intuitions pervade the critiques of state bankruptcy by Adam Levitin and Anna Gelpern, although each makes other arguments as well. *See, e.g.*, Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt*, 121 YALE L.J. 888, 907 (2012); Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. 1399, 1433 (2012).

31. Levitin, *supra* note 30, at 1433-34.

32. Cunningham v. Sizer Steel Corp., 1 F.2d 653, 653 (W.D.N.Y. 1924).

33. *See* 11 U.S.C. § 362(a) (2012) (setting forth bankruptcy's "automatic stay" provision).

34. U.S. CONST. amend. XI; *see, e.g.*, Levitin, *supra* note 30, at 1434.

35. *See, e.g.*, ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, MUNCIPAL DEBT FINANCE LAW: THEORY AND PRACTICE § 5.4.1 (1992) (describing states' and municipalities' ability to evade mandamus actions); *see also* City of Grass Valley v. Walkinshaw, 212 P.2d 894, 898 (Cal. 1949).

corporations.[36] Why do consumers end up in financial trouble? Usually the first step is that they overborrow, often because consumers have a tendency to focus too much on the short-term benefits of the borrowing and not enough on the long-term costs.[37] If a consumer is overwhelmed by debt, we cannot simply liquidate the consumer.[38] States are very similar in both respects. Like consumers, state lawmakers tend to focus too much on short-term consequences,[39] and they cannot realistically be liquidated.

If state bankruptcy is a good idea, it is because it offers the same kinds of benefits as consumer bankruptcy, not because states are similar to corporations. Once again, our intuitions about the left-right continuum lead us astray. The disjunction would be considerably less startling if the rationales for consumer and corporate bankruptcy were the same. But they are quite different in traditional bankruptcy theory, as reflected in a perplexingly abrupt shift in focus when the classic normative account of bankruptcy completes its analysis of corporate bankruptcy and takes up the consumer discharge.[40]

Third puzzle. Municipalities can file for bankruptcy but states cannot, which accords with our intuitions under the left-right continuum. But the case for municipal bankruptcy is actually weaker than it is for state bankruptcy. A state has extensive control over its municipalities. It can limit their ability to borrow, change their boundaries, and even liquidate them.[41] State control makes municipal bankruptcy less necessary than it would be in the absence of these powers—not unnecessary, to be sure, but less necessary. Because Congress does not have as sweeping powers over

36. For a more extensive discussion of this point, see David A. Skeel, Jr., *Is Bankruptcy the Answer for Troubled Cities and States?*, 50 HOUS. L. REV. 1063, 1074-76 (2013).

37. *Id.* at 1074.

38. Current bankruptcy law protects not only the debtor, but also some of her assets. 11 U.S.C. §§ 522(b)(1), 522(d) (providing exemptions certain debtors may use to protect property).

39. Skeel, *supra* note 36, at 1074.

40. JACKSON, *supra* note 10, at 225-26.

41. *See, e.g.*, Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L REV. 425, 481, 484-85, 487 (1993) (advocating the liquidation of insolvent municipalities under some circumstances); Stewart E. Sterk & Elizabeth S. Goldman, *Controlling Legislative Shortsightedness: The Effectiveness of Constitutional Debt Limitations*, 1991 WIS. L. REV. 1301, 1313 n.72.

states as states have over their municipalities,[42] the benefits of bankruptcy are more pronounced for states than for municipalities.

One final puzzle. Most of us assume it would be an offense to the dignity of a sovereign entity if it could be thrown into bankruptcy;[43] this is one reason that bankruptcy seems odd to many people for cities and unfathomable for states or countries. The further right we go on the left-right continuum, it may seem, the greater an offense bankruptcy would be. The extent of the entity's sovereignty clearly increases as we move from city to state, and from state to nation. The potential offense to the entity's dignity might seem to do likewise.

Yet the sovereign dignity—or, as I will also call it, anti-harassment—concern cuts both ways. If we prohibit a sovereign from being thrown into involuntary bankruptcy, and allow only voluntary bankruptcy—as the municipal bankruptcy laws currently do with cities[44]—bankruptcy actually could enhance the dignity of the sovereign under some circumstances. Argentina is a good example. Argentina restructured much of its external debt through a highly coercive exchange offer with its bondholders in 2005.[45] But because there is no such thing as sovereign bankruptcy—that is, bankruptcy for countries—Argentina could not discharge its obligations to creditors that refused to agree to its restructuring. Although Argentina made clear that it has no intention ever to make any payments to these holdout creditors,[46] its obligations to the holdouts have not disappeared. They still are due and owing. The holdout creditors have been harassing Argentina[47] and grabbing every asset

42. *See* U.S. CONST. art. I, § 8; U.S. CONST. amend. X.

43. Tenn. Student Assistance Corp. v. Hood, 541 U.S. 440, 460 (2004) (Souter, J., concurring).

44. 11 U.S.C. § 109(c)(2) (2012) (state authorization); 11 U.S.C. § 901(a) (incorporating § 301, which provides for voluntary filings, into Chapter 9, but not § 303, which allows involuntary filings).

45. For a brief chronology of Argentina's dealings with its creditors, see Patrick Bolton & David A. Skeel, Jr., *Redesigning the International Lender of Last Resort*, 6 CHI. J. INT'L L. 177, 193-94 (2005).

46. Argentina went so far as to pass a law—known as the Padlock Law—prohibiting the nation from paying holdouts. *See, e.g.*, MITU GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN 128 (2013).

47. *See, e.g.*, Peter Eavis, *Hedge Funds Win Ruling in Argentina Bond Case*, N.Y. TIMES (Aug. 24, 2013), http://dealbook.nytimes.com/2013/08/23/hedge-funds-win-ruling-in-argentina-bond-case/?_r=0.

they can find outside of Argentina. In 2012, for instance, they seized an Argentine ship called Libertad (which means "freedom," ironically enough).[48] In 2013, they won a very surprising victory in the Second Circuit, which held that Argentina cannot pay the bondholders who agreed to have their bonds restructured unless it also pays the holdouts.[49] Even more dramatically, the Second Circuit also suggested that the institutions that handle Argentina's payments, not Argentina alone, may also be responsible for these obligations.[50] Argentina may be able to evade these rulings by routing all of its payments outside of the United States. But the rulings have created a major headache for Argentina.

I personally do not think anyone should cry for Argentina—it behaved badly throughout its financial distress—but an orderly bankruptcy process would have shown more respect for Argentina's sovereignty than the permanent harassment it ended up facing. Absent bankruptcy, Argentina—and any country in a similar predicament—faces the prospect that hedge funds and other investors will pester it all over the world.

It would not be difficult to identify other puzzles, but these four should suffice to demonstrate the shortcomings of the left-to-right continuum. Its flaws are severe enough to justify starting from scratch and developing a different framework for thinking about bankruptcy. For the remainder of this Article, that is what I propose to do.

III. WHEN DOES BANKRUPTCY WORK?: A FRAMEWORK FOR ANALYSIS

In the discussion that follows, I will offer a five-part typology for assessing whether a bankruptcy framework makes sense in any given context. Much of the novelty in this approach comes not from the individual parts of the typology, but from bringing factors that are usually confined to a limited context—some to consumer bankruptcy,

48. *See, e.g.*, *id.*
49. NML Capital, Ltd. v. Republic of Arg., 727 F.3d 230, 237 (2d Cir. 2013).
50. *Id.* at 243 ("[A]mended injunctions simply provide notice to payment system participants that they could become liable through Rule 65 if they assist Argentina in violating the district court's orders.").

others to corporate insolvency or sovereign debt—together into a single framework. For those who like to know where the story is headed, the five factors are: (1) unsustainable debt; (2) the benefits (and costs) of reshaping decision-making incentives; (3) the risk of premature liquidation; (4) the dignity of the debtor; and (5) spillover effects.

A. Unsustainable Debt

The first of the factors, unsustainable debt, is, in a sense, a gatekeeper for the remaining four. If debtors have or may have unsustainable debt, bankruptcy may be an appropriate solution. But if such debt is not an issue, either because debtors have no or limited debt, or because they have a near certain means of repayment, there is no need to continue. We can simply conclude that bankruptcy is unnecessary.

Start with the first of the two circumstances in which unsustainable debt is not a serious concern. If an individual or entity cannot borrow, or if its borrowing is strictly limited, bankruptcy is not likely to be necessary or useful. Many of us use this principle with our children—we do not lend them money, or lend the money in such small amounts that repayment is assured. This also explains why many countries do not have personal bankruptcy laws. If it is very difficult to borrow, it will likely be a lot less important that you give consumers a fresh start. In the contemporary world, the principal litmus test is credit cards. If you meet a visitor from a foreign country, and learn—thanks to your audacity or their brashness—that they do not have any credit cards, you can be fairly sure the country they are from either does not provide a discharge for consumer debtors or makes it very hard to get.[51]

Most countries that limit consumer borrowing do not adopt the same attitude with business debt. But in theory they could. Some religious traditions discourage the use of debt, and there have been

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51. Countries with a generous social safety net also tend to restrict the bankruptcy discharge. For a discussion of some of the tradeoffs between bankruptcy and the social safety net, see Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 284-85 (1995).

serious proposals for eliminating or severely curbing debt.[52] The fact that they are nonstarters in the developed world should not blind us to their existence elsewhere. Indeed, a similar impulse has recently entered discussions about regulating systemically important financial institutions. Concerned about the consequences of a giant bank failure, some commentators propose that the biggest banks be required to hold large amounts of equity to reduce the debt in their capital structure.[53] At the levels usually discussed, the banks would be far less likely to fail, but failure would still be possible and a bankruptcy framework still necessary.[54] But if the equity requirement were so stiff that it removed the risk of default, the need for bankruptcy would disappear as well.[55]

Even if an individual or entity can borrow, bankruptcy still will be unnecessary if there is little or no risk that the debtor will not be able to repay. States and countries—and, to a more limited extent, municipalities—may be able to use their taxing authority to generate sufficient funds to pay off even high levels of debt. California is a current illustration. In 2010, in the midst of the recent recession, California's debts appeared to be unsustainable.[56] Since then, the state has imposed higher taxes and has eliminated

52. Scholars associated with the Jubilee Center in Cambridge, England have advocated a radical rethinking of debt. *See, e.g.*, Paul Mills, *The Great Financial Crisis: A Biblical Diagnosis*, JUBILEE CENTRE: CAMBRIDGE PAPERS (Mar. 2011), http://www.jubilee-centre.org/document.php?id=414.

53. The most vocal advocates of this strategy are Anat Admati and Martin Hellwig. ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT 179 (2013).

54. Recall that bankruptcy as I have defined it includes bank resolution. *See supra* Part I.

55. In his writing, Barry Adler has emphasized the possibility of a "world without debt" and explored some of the consequences. Barry E. Adler, *A World Without Debt*, 72 WASH. U. L.Q. 811, 811-12, 815-18 (1994). It is perhaps worth noting that the discussion in the text has taken the conditions of the credit markets as a given and, thus, has assumed that these conditions preceded the question of whether to put bankruptcy laws in place. In reality, it is also possible for the bankruptcy laws to come first and to shape credit decisions and credit markets. In my view, treating credit markets as coming first, and the decision whether to provide a bankruptcy option second, is nevertheless sensible. This has typically been the pattern in practice. For a similar argument about laws protecting minority shareholders in corporate law, see John C. Coffee, Jr., *The Rise of Dispersed Ownership*, 111 YALE L.J. 1, 7 (2001).

56. David A. Skeel, Jr., *Give the States a Way to Go Bankrupt*, WEEKLY STANDARD (Nov. 29, 2010), http://www.weeklystandard.com/articles/give-states-way-go-bankrupt_518378.html?nopager=1.

its annual deficit.[57] Although California still has significant structural deficits, few expect the state to default in the near or intermediate term.[58] In addition to or as an alternative to tax revenues, many countries can simply print money—at least so long as they do not trigger runaway inflation—to pay their debt. This is what the United States has been doing throughout the recent financial crisis. The effectiveness of these solutions is different for different kinds of entities. American states can raise taxes, for instance, but they cannot print money because the Constitution forbids this.[59] The risk that a state will be overwhelmed by its debt is therefore greater than the risk that the United States will be.

The principal cost of unsustainable debt is that it stifles growth.[60] An individual whose debt is overwhelming may lose her incentive to work because any proceeds will go straight to the maws of her creditors. For similar reasons, a business or state may find itself unable to raise the funds it needs to pursue investments that might otherwise benefit both its creditors and itself. Bankruptcy is not necessarily the only solution to these problems. The debtor may be able to negotiate a private restructuring with key creditors, or it may devise ways of raising the necessary funds—such as project finance—that do not require bankruptcy.[61] If these other options are likely to be sufficient, bankruptcy may be unnecessary even for debtors that have unsustainable debt. Indeed, the absence of a bankruptcy option may reshape the debtor's attitude toward borrowing, making it less likely that unsustainable debt will be an issue. Otherwise, the prospect of unsustainable debt will weigh strongly in favor of bankruptcy.

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57. John Avlon, *Jerry Brown Creates California Surplus Miracle, But Can It Last?*, DAILY BEAST (Jan. 15, 2012, 4:45 AM), http://www.thedailybeast.com/articles/2013/01/15/jerry-brown-creates-california-surplus-miracle-but-can-it-last.html.

58. Mary Williams Walsh, *State Debt Woes Grow Too Big to Camouflage*, N.Y. TIMES, Mar. 30, 2010, at A1.

59. U.S. CONST. art. I, § 10, cl. 1 (prohibiting states from coining money).

60. The bankruptcy literature generally describes the dilemma as a "debt overhang" problem. Anat R. Admati, Peter Conti-Brown & Paul Pfleiderer, *Liability Holding Companies*, 59 UCLA L. REV. 852, 868 (2012). The classic analysis is Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 154 (1977).

61. *See generally* STEFANO GATTI, PROJECT FINANCE IN THEORY AND PRACTICE (2007).

B. Reshaping Decision-Making Incentives

A second factor is bankruptcy's effect on the parties' decision-making incentives. Bankruptcy can reshape decision making in two different ways. First, and most obvious, it can shift decision-making authority from one constituency to another. This is most evident with corporations and other business debtors. Prior to bankruptcy, shareholders or other equity holders control the decision-making process.[62] Bankruptcy shifts decision-making authority away from equity holders and puts it in the hands of creditors.[63] Because equity holders' decision-making incentives are distorted when a business is in financial distress, this shift is an important benefit of corporate bankruptcy.[64]

Bankruptcy's second effect on decision making stems from its discharge of a debtor's obligations to general creditors. The prospect that the debtor's obligations will be reduced alters the parties' decision-making incentives in several different ways. Ex post, the prospect of debt reduction may give a debtor too great an incentive to file for bankruptcy—a phenomenon known as moral hazard. The benefits of reducing unsustainable debt therefore must be compared to the potential costs of moral hazard.

The prospect of restructuring has ex ante effects as well. Creditors can be expected to monitor the debtor more carefully and to tighten their credit terms if debtors can discharge some or all of their obligations in bankruptcy. If creditors are good monitors and the risk of moral hazard is low, bankruptcy's effect on decision-making incentives will weigh in favor of bankruptcy. If creditors are poor monitors or moral hazard is a major concern, bankruptcy may be more problematic.

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62. *See, e.g.*, DEL. CODE ANN. tit. 8, § 211(b) (West 2013) (detailing shareholder election of directors at annual meetings); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (describing directors' responsibility to shareholders).

63. In some countries, bankruptcy also displaces the managers of a corporate debtor and puts a government-appointed trustee or other new decision maker in charge. In the United States, managers presumptively remain in place. 11 U.S.C. § 1107 (2012).

64. If the company is insolvent or nearly so, shareholders have an incentive to take even crazy gambles; they are not entitled to anything if the company shuts down, but if the gamble pays off, their stock may be worth something again. *See, e.g.*, Vincent S.J. Buccola, *Beyond Insolvency*, 62 KANSAS L. REV. 1, 3 (2013).

Personal bankruptcy is a good illustration of this second set of decision-making effects. Although the decision maker does not change, bankruptcy gives creditors an incentive to monitor the debtor's borrowing, which puts more of the burden of excessive borrowing on creditors and less on the social safety net.[65] Bankruptcy can (or would) have a somewhat similar effect with a municipality or state, especially with respect to pensions, as I will discuss more fully in the next Part. If such a debtor can restructure its pension obligations in bankruptcy, the beneficiaries and their representatives have an incentive to pay more attention to whether the promises are sustainable. They may put more pressure on politicians to fully fund the pensions than they do in a world where pensions cannot be altered.[66]

C. Preventing Premature Liquidation

As I have already noted, one of the principal benefits of bankruptcy for corporations is that it prevents disorderly liquidation.[67] If we did not have corporate bankruptcy, the creditors of a corporation might destroy its value by forcing the sale of key assets in their race to make sure they got paid before it was too late.[68] Not all insolvent firms should be liquidated; there is a well recognized distinction between economic failure (a firm should be shuttered) and financial failure (liabilities exceed assets).[69] Sometimes, the assets are being used in their highest and best use. It would, therefore, be inefficient to let creditors, lacking a coordination mechanism, pull the firm apart, "saving" a few creditors that are fleet enough to grab assets or payment, but imposing costs on the creditors as a group.[70] By halting creditors' individual efforts to collect what they are owed and providing a collective proceeding for resolving the debtor's financial distress, bankruptcy can prevent

65. JACKSON, *supra* note 10, at 231.

66. *See, e.g.*, David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 701 (2012); Skeel, *supra* note 36, at 1072-74.

67. *See supra* text accompanying notes 31-33.

68. JACKSON, *supra* note 10, at 10-19.

69. *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 313-14 (1993).

70. *Id.*

premature liquidation and preserve value. This feature of bankruptcy lies at the heart of the creditors' bargain theory—the classic normative justification for corporate bankruptcy.[71]

The extent to which bankruptcy is needed to prevent premature liquidation is hotly contested in the corporate bankruptcy literature.[72] But this feature is central to the case for corporate bankruptcy—especially in the United States.[73] By contrast, if premature liquidation is not a threat, the case for bankruptcy is weaker.

D. The Dignity of the Debtor

Although bankruptcy experts talk a lot about my first three factors, very few talk about the fourth—dignity, and related anti-humiliation concerns.[74] Perhaps this is because dignity stands in a more ambiguous relationship to efficiency than the prior factors.[75] Or maybe this is because dignity is a less prominent concern in the corporate bankruptcies that garner most scholars' attention than with other financially distressed debtors. But dignity is crucially important to understanding when bankruptcy is, and is not, a good idea.

In the ancient world, dignity was a key theme in laws concerning debtor-creditor relations. In the Bible, Israel's creditors were instructed to release their debtors from servitude every seven years and to forgive all debts every fifty years in the Jubilee.[76] This was one of the world's first bankruptcy laws, and one of its major objectives was to protect the dignity of debtors.[77] Enslavement for

71. *See* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 858-60 (1982) (describing creditors' bargain theory).

72. For arguments that collective action problems are not inevitable, see Adler, *supra* note 69; Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 647-48 (1992).

73. *See* Adler, *supra* note 69, at 311.

74. Anna Gelpern is an exception. Gelpern, *supra* note 30, at 928-30 (discussing autonomy concerns).

75. It is perhaps worth noting that the fresh start in consumer bankruptcy has traditionally been explained in both dignitarian and efficiency terms. It provides relief for the "honest but unfortunate" debtor, while also addressing debt overhang concerns.

76. *Leviticus* 25:1-22.

77. *Id.*

debt was recognized as a great indignity. I think it is no accident that the Thirteenth Amendment abolished involuntary servitude for debt as part of the same amendment that abolished slavery.[78]

To be sure, the extent to which bankruptcy enhances dignity depends on the terms of the bankruptcy law. Harsh bankruptcy laws can actually interfere with a debtor's dignity. This is why, in the United States, debtors were the principal opponents of bankruptcy for most of the nineteenth century.[79] Although Alexander Hamilton favored bankruptcy, Thomas Jefferson hated the idea.[80] But for over a century, and even after the 2005 changes, American bankruptcy has been very generous to debtors and, as a result, promotes, rather than interferes with, dignity.[81]

The contours of the dignity factor are difficult to define precisely. This is in part because conceptions of dignity have evolved in some respects, much as our perceptions of what constitutes "cruel and unusual" punishment have evolved. Dignity also is understood somewhat differently in different countries.[82] In the U.S., constitutional constraints such as the Thirteenth Amendment provide a baseline level of protection. For individuals, the question raised by the dignity factor is whether potentially humiliating circumstances that do not violate the constitution's protections of liberty and equality, such as the long-term effects of unsustainable debt, warrant bankruptcy relief.[83]

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78. *See* U.S. CONST. amend. XIII, § 1; A.O. Scott, *A President Engaged In a Great Civil War*, N.Y. TIMES, Nov. 9, 2012, at C1, C10.

79. *See, e.g.*, DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 26-27 (2001) ("[S]outherners feared that northern creditors would use bankruptcy law as a collective device to displace southern farmers.").

80. Jefferson's antipathy was reflected in his successful campaign to repeal America's first bankruptcy law, the Bankruptcy Act of 1800. *Id.* at 3-4.

81. The initial shift came with the enactment of the Bankruptcy Act of 1898, whose concessions to the concerns of debtors changed the tenor of American bankruptcy law. For a discussion of the political economy of the 1898 Act, see David A. Skeel, Jr., *The Genius of the 1898 Bankruptcy Act*, 15 BANKR. DEV. J. 321, 336-38 (1999).

82. *See, e.g.*, James Q. Whitman, *The Two Western Cultures of Privacy: Dignity Versus Liberty*, 113 YALE L.J. 1151, 1161 (2004) (contrasting German and French concern with image, name, and reputation with American focus on liberty from the state).

83. For an argument that the Supreme Court has become less open to equality-based constitutional law arguments and more welcoming to liberty-based dignitarian claims, see Kenji Yoshino, *The New Equal Protection*, 124 HARV. L. REV. 747 (2011).

For sovereign and quasi-sovereign debtors, the dignity factor is equally subtle. For U.S. municipalities and states, dignity-related concerns are shaped by constitutional protections of state sovereignty such as the Tenth and Eleventh Amendments.[84] For countries, the baseline is set by conceptions of sovereignty. But anti-humiliation concerns can arise even if—perhaps especially if—a country has waived its sovereign immunity with regard to some obligations, such as its bond debt. The prospect that a state or country could be thrown into bankruptcy involuntarily, for instance, would raise significant anti-humiliation concerns. This is one reason almost no one advocates involuntary bankruptcy for cities, states, or countries.[85] Even if only the debtor itself could invoke the bankruptcy provisions, bankruptcy can have negative dignity effects, a point some commentators have made about Detroit's bankruptcy.[86] Yet a bankruptcy framework for countries like Argentina could enhance dignity if it removed the threat of perpetual harassment by unhappy creditors.[87] Dignity has come into play in similarly complicated ways in the recent bankruptcies of Catholic church dioceses in the wake of its clergy misconduct scandals.[88] Filing for bankruptcy had highly negative effects on the dioceses' dignity, yet filing also enabled the dioceses and the clergy misconduct victims to reach settlements.[89]

We cannot, however, simply consider the dignity-enhancing benefits of bankruptcy in isolation. A bankruptcy law that is generous

84. Courts' extreme reluctance to force states to levy taxes to pay bond debts, even in contexts where mandamus would not violate the Tenth or Eleventh Amendment, can be seen as a response to anti-humiliation considerations. For a history of bond defaults and bondholders' efforts to collect, see JOHN V. ORTH, THE JUDICIAL POWER OF THE UNITED STATES: THE ELEVENTH AMENDMENT IN AMERICAN HISTORY (1987).

85. For U.S. cities and states, Tenth Amendment state sovereignty concerns are another reason. But sovereign bankruptcy theoretically could include an involuntary filing option, and at least one commentator advocates involuntary bankruptcy for states. Adam Feibelman, *Involuntary Bankruptcy for American States*, 7 DUKE J. CONST. L. & PUB. POL'Y 81, 81-82, 94-96 (2012).

86. These general dignity concerns are inseparable from concerns about the racial implications of Detroit's bankruptcy filing. *See, e.g.*, Andrew O'Hehir, *Why the Right Hates Detroit*, SALON (July 27, 2013, 12:30 PM), http://www.salon.com/2013/07/27/why_the_right_hates_detroit/.

87. *See supra* notes 43-48 and accompanying text.

88. The most extensive analysis of the church bankruptcies is Jonathan C. Lipson, *When Churches Fail: The Diocesan Debtor Dilemmas*, 79 S. CAL. L. REV. 363 (2006).

89. I discuss church bankruptcy in more detail below. *See infra* Part IV.B.

to debtors, and thus enhances their dignity, may also create moral hazard—the temptation to break financial promises if this can be done with impunity or at little cost—thus creating problematic decision-making incentives. Although it is easiest to see this with consumer debtors, the concern also applies to corporations, especially nonprofits, and even more to cities, states, and countries.[90]

E. Spillover Effects

During the recent 2008 recession, there was a great deal of discussion about the risk that the ordinary bankruptcy process can cause destructive externalities—spillover effects on third parties. If General Motors and Chrysler had not been bailed out, the argument went, all of their suppliers would have also failed, and more than a million jobs would have been lost in the Midwest.[91] Regulators and others have said that if the investment bank, Bear Stearns, or the insurance company, AIG, had filed for bankruptcy, the financial system would have collapsed, to the detriment of every American citizen.[92] Many of these claims were exaggerated, but that is not my concern here. Of greater importance for the purposes of this Article is the general relationship between bankruptcy and spillover effects. If a bankruptcy framework would cause problematic spillovers, this will weigh against creating a bankruptcy option; if bankruptcy reduces or removes these effects, it may be desirable on balance.

The first thing we need to do is determine which spillover effects are caused by bankruptcy and which are not. The "single point of entry" strategy that the FDIC has developed for implementing the Dodd-Frank Act's rules for resolving systemically important financial institutions is a useful avenue into this question.[93] In a

90. Concerns about increased moral hazard were a frequent objection to the IMF's sovereign bankruptcy proposal in the early 2000s. *See, e.g.*, Daniel K. Tarullo, *Neither Order Nor Chaos: The Legal Structure of Sovereign Debt Workouts*, 53 EMORY L.J. 657, 661-63 (2004).

91. *See, e.g.*, Editorial, *A Million Jobs*, N.Y. TIMES, Feb. 26, 2012, at SR10 (crediting the bailouts with creating or saving 1.45 million jobs, based on a study by the Center for Automotive Research).

92. This theme, and the contention that Lehman should not have been permitted to file for bankruptcy, is pervasive in the popular writing about the 2008 crisis. *See, e.g.*, DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC 2-3, 5, 8, 25-26 (2009).

93. The single point of entry strategy is described in detail in a report issued by the Bipartisan Policy Center. John F. Bovenzi et al., *Too Big to Fail: The Path to a Solution*,

single point of entry resolution, the FDIC would put only the holding company—the uppermost corporate entity—into resolution.[94] None of the subsidiaries would be put into resolution, except perhaps those that were deeply insolvent.[95] After putting the holding company into resolution, the FDIC would immediately transfer its assets, short-term liabilities, and secured debt to a new bridge institution, leaving the stock and long-term unsecured debt behind in the old entity.[96] The new entity would be a recapitalized version of the old financial institution.[97] The FDIC believes that this approach will minimize the risk of spillover effects, such as a run by the institution's short term lenders in the event a systemically important financial institution falls into distress.[98] As the FDIC sees it, a key advantage as compared to traditional bankruptcy is that the FDIC can act quickly.[99] The FDIC also is not required to focus solely on the troubled institution itself; regulators can take actions, such as pumping capital or assets from the parent corporation to a troubled subsidiary, that would not be permitted in an ordinary bankruptcy case.[100] Finally, the FDIC has access to a great deal of funding, which further reduces the risk of panic runs, and it can step in much more quickly than a bankruptcy court could.[101]

Two of the three factors identified by the FDIC as problematic are features of particular U.S. bankruptcy laws, rather than inherent to bankruptcy. If Congress converted Chapter 11 from a judicial framework to an administrative one and provided access to governmental funding, the bankruptcy system would likely have the same

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BIPARTISAN POL'Y CTR. 58-70 (2013), http://bipartisanpolicy.org/sites/default/files/TooBigToFail.pdf.

94. *Id.* at 63.

95. *Id.*

96. *Id.* at 64.

97. *Id.* at 65.

98. *Id.* at 65-66.

99. *Id.* at 69. This advantage of administrative resolution, and the advantages in the text that follows, are described in Jackson & Skeel, *supra* note 24, at 445.

100. Bovenzi et al., *supra* note 93, at 65.

101. *Id.* at 66. Under Section 210(n) of the Dodd-Frank Act, the FDIC is authorized to borrow up to 10 percent of the book value of the institution as of the time it is taken over and 90 percent of its value in resolution. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(n), 124 Stat. 1376, 1506-09 (2010) (codified at 12 U.S.C. § 5390).

features as FDIC resolution. Indeed, as discussed earlier, FDIC resolution is a form of bankruptcy.[102]

The one factor that does reach closer to the heart of bankruptcy is its focus on maximizing the value of the assets of the debtor—a single individual or entity—rather than on systemic effects. It is quite possible to create a bankruptcy framework that invites the decision maker to consider spillover effects, even when doing so does not maximize the value of the debtor's assets. It also seems clear that an awareness of possible spillover effects influences bankruptcy judges' decision making in particular cases. But these are departures from the bankruptcy paradigm, rather than a traditional feature of bankruptcy.

The other feature of bankruptcy that can cause spillover effects is the cessation of payments to creditors, together with the likelihood that a debtor's general creditors will not be paid in full. It is important to recognize that this effect is not unique to bankruptcy: a debtor that defaults outside of bankruptcy also halts payments and imposes losses. The principal contrast here is to a bailout in which some, or all, of the debtor's shareholders and creditors are protected.[103] If AIG had not been bailed out and had defaulted on its derivatives obligations, regulators have argued, its counterparties would have been destabilized and the confidence crisis of late 2008 would have been far worse.[104] If New York City had filed for bankruptcy in 1975, the municipal bond market would have collapsed and cities all over the country would have been unable to borrow.[105] In each case, a bailout avoided the contagion effects that bankruptcy might have unleashed. If the likelihood of contagion is pervasive, this factor will weigh against putting a bankruptcy framework in place.

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102. *See supra* notes 24-26 and accompanying text.

103. *See* AMDURSKY & GILLETTE, *supra* note 35, at 285.

104. *See, e.g.*, OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, SIGTARP-10-003, FACTORS AFFECTING EFFORTS TO LIMIT PAYMENTS TO AIG COUNTERPARTIES 1 (2009) (describing fears that disorderly AIG bankruptcy would "cause systemic risk to the entire financial system and the American retirement system").

105. *See generally* MARTIN SHEFTER, POLITICAL CRISIS/FISCAL CRISIS: THE COLLAPSE AND REVIVAL OF NEW YORK CITY (1985) (discussing the implications of New York City's financial crisis in the 1970s).

In the contexts we have considered thus far, bankruptcy is—or is thought to be—a source of spillover effects. In other contexts, bankruptcy can have precisely the opposite effect, preventing, rather than causing, spillover effects. By allowing consumers to file for bankruptcy, we reduce the burden that their financial distress may impose on their relatives and friends.[106] In the days of debtors' prisons, these spillovers were welcomed. Creditors hoped that putting a debtor in prison would increase the likelihood that his creditors would be paid because the debtor's destitution put pressure on family and friends to help pay the debtor's obligations.[107] The abolition of debtors' prisons reduced this spillover effect of an individual's financial distress somewhat; the bankruptcy discharge removes it almost entirely.

In the sovereign context, bankruptcy could reduce the burdens that today's borrowing imposes on future generations—what economists call intergenerational wealth transfers.[108] Odious debt doctrine is based on similar principles, removing the responsibility of a country and its citizens for debts that were incurred illegitimately by a prior regime.[109] Sovereign bankruptcy would reduce a future generation's responsibility for debts that were legitimately incurred as well. State bankruptcy could have a somewhat similar effect. If we allowed states to file for bankruptcy, bankruptcy might reduce the burdens that current borrowing imposes on future citizens.

Although state (or sovereign) bankruptcy could remove one source of spillovers, critics worry that it also could create the kinds of contagion problems discussed earlier.[110] State bankruptcy thus

106. *See* JACKSON, *supra* note 10, at 243-44.

107. *See, e.g.*, BRUCE H. MANN, REPUBLIC OF DEBTORS: BANKRUPTCY IN THE AGE OF INDEPENDENCE 78-80 (2002).

108. *See, e.g.*, William G. Gale & Karl Scholz, *Intergenerational Transfers and the Accumulation of Wealth*, 8 J. ECON. PERSP. 145, 145-47 (1994) (discussing wealth transfers and their effect on subsequent generations).

109. I am using the term "doctrine" loosely. Whether odious debt doctrine is indeed doctrine in international law is debatable. For an excellent historical overview and discussion of the doctrine's current status, see Lee C. Buchheit, G. Mitu Gulati & Robert B. Thompson, *The Dilemma of Odious Debts*, 56 DUKE L.J. 1201 (2007).

110. *See, e.g.*, Thomas P. DiNapoli, Letter to the Editor, *Even Talk of Bankruptcy Is a Bad Solution for States*, WALL ST. J., Jan. 24, 2011, at A16 (arguing that the creation of a state bankruptcy regime would negatively affect even a fiscally responsible state's access to capital markets).

promises to reduce one potential spillover effect, but could in theory create a different one. Both effects need to be taken into account in any consideration of whether states should be permitted to file for bankruptcy.

IV. THE FRAMEWORK IN ACTION: THREE APPLICATIONS

My claim, then, is that rather than just assuming that the bigger or more sovereign-like the entity is, the less sense bankruptcy makes, we can reach much more sensible decisions by considering the factors I have just described, and comparing bankruptcy to the other plausible alternatives; this may include private renegotiations, simply defaulting, or a bailout. In the discussion that follows, I will offer three simple applications, each of which illustrates the benefits of the typology outlined in the last Part.

A. City Versus State Bankruptcy

The first application involves the decision whether cities and states should be permitted to file for bankruptcy. Under current law, cities can file for bankruptcy, but states cannot.[111] Most people think this is about right. According to conventional wisdom, bankruptcy is sometimes appropriate for small municipalities, but it is much more problematic for larger public entities.[112] This implies that it is ill-advised for states. Yet the five-factor framework suggests that this conclusion may be backwards, or at the least, that bankruptcy makes even more sense for states than for cities.

The key distinction is that cities are subject to significant control by the state.[113] The state can limit a city's taxing ability and can restrict its ability to take on debt.[114] The state can even dissolve and reconfigure a city.[115] Although states do not usually exercise these powers, they could. Indeed, a conspiracy theory, which made the rounds in some circles after Detroit filed for bankruptcy, speculated

111. 11 U.S.C. § 109(c)(1) (2012) (limiting chapter 9 bankruptcy to municipalities).

112. *See, e.g.*, Kimhi, *supra* note 8, at 360.

113. *See* Skeel, *supra* note 36, at 1078.

114. *See* Richard Briffault, *The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 908-09 (2003).

115. *See* Michelle Wilde Anderson, *Dissolving Cities*, 121 YALE L.J. 1364, 1376-77 (2012).

that Michigan (or less plausibly, the Obama administration) would dissolve the boundaries between Detroit and the wealthy suburbs around it, and thus force the suburbs to help address Detroit's financial distress.[116] Strict state control, especially if it came before any of the state's municipalities fell into distress, would make most of the usual functions of bankruptcy less necessary.

None of this is true if the state itself is in financial distress. The strongest argument against bankruptcy for states is that, even though Congress has much less control over the states than the states have over their cities, a state's ability to cut spending and raise taxes, and to restructure some of its obligations outside of bankruptcy, will enable it to muddle through any financial crisis,[117] as California appears to be doing now.[118] If this is true, states' debt is never truly unsustainable. But the states' ability to tax is far from unlimited. Ever since the Sixteenth Amendment, which authorized a federal income tax, was added to the Constitution in 1913, federal taxation has crowded out state taxation to some extent.[119] This means that states may not always be able to tax their way out of a debt crisis.

If we look at the five factors outlined in the last Part, one of the factors—disorderly liquidation—is not an issue for states because states cannot be liquidated. But each of the other factors favors bankruptcy. The first and third factors—unsustainable debt and bankruptcy's reshaping of decision making—are best illustrated by the public pension crisis that is most severe in Illinois, but is also a looming catastrophe in other states.[120] A number of states, including Illinois, preclude any significant restructuring of the pension benefits of existing employees outside of bankruptcy.[121] Although

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116. For an earlier suggestion that dissolution be considered, see *State Senator Proposes Dissolving City of Detroit*, CBS DETROIT (Nov. 28, 2012, 11:08 AM), http://detroit.cbslocal.com/2012/11/28/state-senator-proposes-dissolving-city-of-detroit/.

117. E.J. McMahon, Opinion, *State Bankruptcy Is a Bad Idea*, WALL ST. J., Jan. 24, 2011, at A17.

118. *See* Avlon, *supra* note 57.

119. U.S. CONST. amend. XVI.

120. *See* Mary Williams Walsh, *Ratings Service Finds Pension Shortfall*, N.Y. TIMES, June 28, 2013, at B1, B7.

121. *See* Steven Yaccino, *Governor of Illinois Tells Legislators Pension Costs Put State at 'Critical Junction'*, N.Y. TIMES, Feb. 7, 2013, at A16. The best analysis of states' differing levels of protection of pension obligations is Amy B. Monahan, *Public Pension Plan Reform:*

the funded portion might be fully protected in a state bankruptcy framework, the unfunded portions probably would be subject to restructuring.[122] Not only would state bankruptcy provide an alternative to simply defaulting on the state pension if a state is incapable of paying its obligations; but also the prospect that unsustainable obligations could be restructured in bankruptcy would give public employee unions a greater incentive to push for full funding of the state's pension promises and to monitor the state's financial health.[123] The existence of a state bankruptcy framework could thus improve states' handling of their pension obligations.

The final two factors also weigh in favor of state bankruptcy. The bankruptcy discharge would protect a state's dignity interest by cutting off the relentless creditor collection efforts that have made Argentina miserable,[124] and bankruptcy would limit the spillover effects of a state's overborrowing on future generations.[125] Although state bankruptcy theoretically could cause spillover effects in the state bond markets, this seems unlikely given the market's ability to distinguish between financially healthy states and more troubled ones.[126] Indeed, the existence of a state bankruptcy option could even increase the value of bonds issued by healthy states because they are unlikely to default and do not benefit from the implicit bailout subsidy that inflates the value of the bonds of financially troubled states.

B. Corporations

The second application is to corporations. Corporations seem to be the easiest case for a formal bankruptcy option, as the long history of, and highly developed theoretical literature on, corporate

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The Legal Framework, 5 EDUC. FIN. & POLICY 617 (2010).

122. I have analyzed the question of whether public pensions can be restructured in much more detail elsewhere. *See* David A. Skeel, Jr., *Can Pensions be Restructured in (Detroit's) Municipal Bankruptcy?*, FED SOC. WHITE PAPER SERIES (Oct. 2013); Skeel, *supra* note 36, at 1072-74.

123. *Id.*

124. *See supra* notes 45-50 and accompanying text.

125. *See supra* Part III.E.

126. *See, e.g.*, Skeel, *supra* note 36, at 1068-69.

bankruptcy suggests. If a corporation is highly indebted, it may be unable to raise financing even if it has very promising projects.[127] Bankruptcy can address the problem of excessive debt.[128] It also counteracts the decision-making distortions that accompany financial distress by shifting decision making authority from shareholders to creditors.[129] By providing a collective forum for the resolution of financial distress, bankruptcy can also prevent an unnecessary liquidation.[130]

The fourth factor, dignity, is only a little more subtle. For most corporations, bankruptcy does not impose serious dignity costs, especially given that firms that file for bankruptcy are already in financial distress. Although American corporations once had close links to the states that issued their charters, and thus partook of the state's sovereign dignity,[131] they are almost entirely private today.[132] Even when dignity does seem to be at stake, the dignity dimension is often smaller than it might initially seem. As General Motors faltered in 2008 and 2009, there was considerable talk about the consequences to an iconic American business of filing for bankruptcy. These were in part dignitary concerns, but the larger issue was concerns about whether consumers would buy cars from a bankrupt carmaker.[133] These were issues of reputation and viability—how GM was perceived by the marketplace—rather than dignity. With more ordinary corporations, dignity will not be a

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127. *See, e.g.*, Peter Tufano, *Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century*, 71 BUS. HIST. REV. 1, 6-7 (1997).

128. *See, e.g.*, *id.* at 8-9 (describing railroad receivership, the first American reorganization device, as a solution to debt overhang).

129. Baird and Jackson were among the first in the theoretical literature to identify the importance of shifting control. Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 762 & n.58 (1988).

130. JACKSON, *supra* note 10, at 20, 186-88.

131. *See, e.g.*, JOSEPH STANCLIFFE DAVIS, *Eighteenth Century Business Corporations in the U.S.*, *in* 2 ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 3, 149-53, 186-215 (2006) (describing the use of corporations to achieve governmental functions such as building bridges or roads).

132. Frank René López, *Corporate Social Responsibility in a Global Economy After September 11: Profits, Freedom, and Human Rights*, 55 MERCER L. REV. 739, 746 (2004).

133. Indeed, then-CEO Rick Wagoner couched his refusal to file for bankruptcy in these terms, insisting that no one would buy cars from a bankrupt automaker. *See, e.g.*, Bob Sechler, *Wagoner Says GM Won't File for Bankruptcy or Reduce Brands*, WALL ST. J., July 11, 2008, at B10.

major factor, and bankruptcy is as likely to protect dignity as undermine it—not least if it prevents a chaotic liquidation. Finally, spillover effects are rarely a serious concern with a troubled corporation. All five factors thus counsel in favor of a bankruptcy option for corporations.

Yet the case for corporate bankruptcy that I have just outlined assumes that the corporation has lots of creditors and that bankruptcy is needed to shift decision-making authority. If most corporations in a country did not have these characteristics, bankruptcy might not be necessary. At least until recently, Japan was a good illustration. Even large Japanese corporations only had one or a small group of major creditors—usually banks[134]—and the bankruptcy option was extremely limited. It was not hard to imagine simply eliminating bankruptcy because these creditors already had control when a corporation fell into financial distress and they were in a position to prevent an unnecessary or disorderly liquidation.[135]

Churches—and to some extent, other nonprofit corporations—are a different kind of test for the assumption that a bankruptcy option always makes sense for corporations. Churches differ from other corporations in important ways, several of which are closely linked with the dignity factor. The first factor, unsustainable debt, can be seen as weighing in favor of bankruptcy for churches, but less so than with other debtors. A church's borrowing needs tend to be limited,[136] and the consequences of excessive debt usually do not require a bankruptcy solution.[137] With the second factor, reshaping decision-making incentives, we theoretically could create a bankruptcy option that shifted all decision-making authority to creditors or a third party if a church filed for bankruptcy, but this would

134. *See* Justin Wood, *Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany, and Japan*, 26 PENN ST. INT'L L. REV. 139, 159 (2007).

135. Note that Adler has made somewhat similar points about liquidation. *See* Adler, *supra* note 69, at 311, 313-14. If bankruptcy was unnecessary, why does Japan have it? One reason is that the then-current version of U.S. bankruptcy law was imposed after World War II. *See* Wood, *supra* note 134, at 158.

136. Felicia Anne Nadborny, Note, *"Leap of Faith" into Bankruptcy: An Examination of the Issues Surrounding the Valuation of a Catholic Diocese's Bankruptcy Estate*, 13 AM. BANKR. INST. L. REV. 839, 842 (2005).

137. *Id.* at 839.

offend the dignity concerns reflected in the First Amendment religion clauses.[138] The possibility of church bankruptcy can indirectly shape decision making, but this seems less important than with consumer debtors or state politicians, because the decision-making incentives of church leaders are less systematically distorted.[139] The final factor, spillover effects, may weigh slightly in favor of a bankruptcy option. A church's financial distress, for instance, may interfere with the services it provides to the poor. But these spillovers are likely to be relatively minor.

The case for church bankruptcy rests primarily on the third and fourth factors. Although premature liquidation is also less of a risk with churches in most instances, because churches are less dependent on particular assets than ordinary corporations, the recent diocesan bankruptcies demonstrated that premature liquidation can sometimes be a genuine threat. In the absence of bankruptcy, the clergy misconduct victims who sued first might have been paid, leaving little or nothing for those who sued later. The diocesan bankruptcies were unprecedented; premature liquidation is not a serious risk with most churches. But these bankruptcies have made clear that premature liquidation can sometimes be a serious problem, which weighs in favor of a bankruptcy option.

Dignity concerns also weigh in favor of bankruptcy. Although a bankruptcy filing can be seen as interfering with the dignity of a church, by subjecting it to intrusive oversight, it can also protect church dignity by limiting creditor harassment, much as with a country like Argentina.[140] Current U.S. bankruptcy law—which authorizes voluntary bankruptcy filings but does not allow creditors to throw a church into bankruptcy involuntarily[141]—together with

138. The Supreme Court has interpreted the religion clauses to prohibit it from even attempting to interpret church doctrine, much less replacing church decision makers. *See, e.g.*, Jones v. Wolf, 443 U.S. 595, 602 (1979).

139. Church leaders are more likely than politicians to serve for long periods of time, for instance, and most churches do not rely heavily on debt finance.

140. Because most religious organizations do not rely on debt financing nearly as much as countries do, even this factor is relatively unimportant in most cases. The clergy scandals in the Catholic church were thus highly unusual—although this does not justify ignoring the possibility of other catastrophes.

141. *See* 11 U.S.C. § 303(a) (2012); Andrew Stone Mayo, Comment, *For God and Money: The Place of the Megachurch Within the Bankruptcy Code*, 27 EMORY BANKR. DEV. J. 609, 609 (2011).

the First Amendment, minimizes the negative dignity effects of bankruptcy while facilitating the positive ones.

Overall, the case for church bankruptcy is weaker than for other corporations, but the bankruptcy option seems warranted on balance.[142]

C. The Crisis in Europe

The final application is the recent crisis in Europe. Starting with the escalation of Greece's financial crisis four years ago—and continuing as concerns grew about Ireland, Spain, Portugal and Italy—commentators began asking whether Europe needed a sovereign bankruptcy framework.[143] As noted earlier, the architect of the IMF's proposed restructuring framework advocated a variation of her original proposal for Europe.[144] Would such a framework make sense?

I saved the European application for last in the hope that some readers will be prepared by this point to consider the possibility that bankruptcy might make sense for a country, rather than dismissing it out of hand. The first factor is especially important for a country, like Greece or Italy, that falls into financial distress. Before joining the European Union, these countries were less likely to have unsustainable debt because they had the option of devaluing their currency in the event of a crisis.[145] In adopting the euro, they gave up this flexibility[146]—at least so long as Greece does not exit the

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142. I have discussed the church bankruptcy issue in more detail (and have given a more enthusiastic defense than my five-factor analysis leads me to give here) elsewhere. David A. Skeel, Jr., *"Sovereignty" Issues and the Church Bankruptcy Cases*, 29 SETON HALL LEGIS. J. 345, 359-60 (2005); David A. Skeel, Jr., *Avoiding Moral Bankruptcy*, 11 B.C. L. REV. 1181, 1182-83 (2003).

143. *See* Skeel, *supra* note 36, at 1090.

144. *See* GIANVITI ET AL., *supra* note 3, at 1-2.

145. Currency devaluation can "bring an unsustainably negative current account into balance" by encouraging exports and discouraging imports. *See* William C. Gruben, *South American Monetary and Exchange Rate Policies: Their Implications for the FTAA*, 6 NAFTA: L. & BUS. REV. AM. 457, 458 (2000) ("The idea, of course, is for the prices of the home country's products as expressed in dollars to fall enough to increase foreign purchases of these products and for the prices of the foreign country's products as expressed in [for example] pesos to go up correspondingly.").

146. One of the reasons Argentina's crisis in the early 2000s was so severe was that it had limited its devaluation option by issuing a significant amount of debt that required repayment

euro, a possibility I will consider below. Like U.S. states, Euro members cannot print money to deal with a debt crisis. The absence of a money printing option increases the benefits of bankruptcy for dealing with unsustainable debt.

Each of the next three factors also play out very similarly for Greece, other Euro members, and for U.S. states. Although bankruptcy cannot change a country's decision makers, it would reshape decision making by giving creditors a greater incentive to monitor, as consumer bankruptcy does and state bankruptcy would. The third factor—the risk of premature liquidation—weighs against bankruptcy because premature liquidation is not a concern. And the fourth—dignity—is mixed: bankruptcy can be seen as undermining a country's dignity but it also brings an end to creditor harassment.

The principal difference between Greece and a U.S. state is the risk of spillover effects. In both contexts, observers have warned that a bankruptcy option would trigger a contagion effect in bond markets.[147] These fears are almost certainly unfounded, particularly given that we are considering only the enactment of a bankruptcy law, not an actual bankruptcy filing. Contagion is a serious concern only if sovereign debt and state bond markets cannot distinguish profligate countries or states from fiscally responsible ones.[148] But a different kind of spillover effect is a more legitimate issue. Throughout the Greek crisis, large amounts of Greek debt were held by French and German banks that were themselves systemically important, and might have plausibly been destabilized by Greece's failure to pay.[149] The ownership profile of U.S. state debt is quite different—the largest holders are mutual funds and wealthy in-state residents, not systemically important banks.[150] The threat of spillover effects is considerably lower as a result.

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in dollars. *See* PAUL BLUSTEIN, AND THE MONEY KEPT ROLLING IN (AND OUT): WALL STREET, THE IMF, AND THE BANKRUPTING OF ARGENTINA xviii-xix (2005).

147. *See, e.g.*, Skeel, *supra* note 36, at 1067-68 ("The fear that the state bankruptcy would trigger crippling bond market contagion has been one of the most widely credited arguments against state bankruptcy."); Stefan Schultz, *Fears of Euro Zone Domino Effect: Will Greek Contagion Bring Portugal Down?*, SPIEGEL ONLINE (Apr. 30, 2010, 1:43 PM), http://www.spiegel.de/international/europe/fears-of-euro-zone-domino-effect-will-greek-contagion-bring-portugal-down-a-692251.html.

148. For discussion in the context of U.S. states, see Skeel, *supra* note 36, at 1068-69.

149. *Id.* at 1090-91.

150. *Id.* at 1090.

Although spillover concerns are greater in Europe, the problem could be alleviated in two ways. First, European regulatory rules that treated the sovereign debt of all European countries as risk free, and thus gave banks a perverse incentive to buy Greek debt (which offered a high return), could, and clearly should, be changed.[151] In addition, European regulators are working on a resolution framework that is designed to limit fallout in the event a large European bank fails.[152] These developments suggest that a bankruptcy framework could improve Europe's current ad hoc framework, although the case is less robust than it is for U.S. states.

Bankruptcy is not the only alternative to the status quo in Europe, however. When I initially questioned whether Greece's debt and that of other troubled European countries was unsustainable, I assumed that Europe would not alter its existing governance structure. But it could. One much discussed strategy would bring a shift toward "fiscal union"—that is, toward greater European control of the finances of its member states.[153] If Europe moved decisively in this direction, financial failure would be less likely, and Europe would explicitly or implicitly agree to bail out any country that might otherwise be unable to meet its obligations. Alternatively, Europe could adopt a two-track euro, in which countries that are financially unstable would be required to exit the euro until their finances returned to a stable footing.[154] Countries that left the euro would have the option of devaluing their currency in order to meet their obligations. The second option is an imperfect solution—it would need to include a prohibition against issuing debt that could only be paid in euros, for instance, and devaluation could

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151. *See, e.g.*, Daniel Gross, *EZ Banking Union with a Sovereign Virus*, VOX (June 14, 2013), http://www.voxeu.org/article/ez-banking-union-sovereign-virus (noting that sovereign debt holdings still carry a zero weighting).

152. Jim Brunsden & Rebecca Christie, *EU Unveils Bank-Crisis Plan with $55 Billion Euro Fund*, BLOOMBERG (July 10, 2013), http://www.bloomberg.com/news/2013-07-09/eu-steels-for-battle-over-bank-resolution-plans-led-by-germany.html.

153. *See, e.g.*, *Eurozone Crisis Demands One Banking Policy, One Fiscal Policy—and One Voice*, GUARDIAN: ECON. BLOG (Apr. 1, 2013), http://www.theguardian.com/business/economics-blog/2013/apr/01/eurozone-crisis-banking-fiscal-union/print.

154. *See* Charles W. Calomiris, *Exiting the Euro Crisis*, *in* LIFE IN THE EUROZONE WITH OR WITHOUT SOVEREIGN DEFAULT? 115, 121-22 (Franklin Allen et al. eds., 2011); *Breaking Up the Euro Area: How to Resign from the Club*, ECONOMIST, Dec. 4, 2010, at 88.

trigger dangerous levels of inflation. But both are plausible alternatives to bankruptcy.

Some have argued that an informal system of international bankruptcy already exists, with fairly well developed rules of priority.[155] Bonds can be restructured in the event of a financial crisis, whereas ordinary trade debt and the new money provided by the International Monetary Fund or other international institutions are entitled to payment in full.[156] The new European Financial Stability Mechanism (EFSM) that Europe created to provide rescue funding for troubled European Union countries appears to be designed to fit within this or a similar framework.[157] This loosely coordinated framework lacks some of the benefits that a more formal structure could bring, but it can be seen as an emerging bankruptcy system. The principal risk is that the EFSM will provide rescue funding even in the absence of genuine restructuring,[158] and thus that Europe will end up in a no man's land between fiscal union, on the one hand, and an effective bankruptcy framework, on the other.

CONCLUSION

I have argued in this Article that our standard intuitions about bankruptcy are both sensible and wrong. Although it seems obvious that we need personal and corporate bankruptcy, that municipal bankruptcy is problematic but defensible, and that state and national bankruptcy are beyond the pale, there are problems with each part of this left-to-right continuum. Personal bankruptcy is not inevitable, for instance, and state bankruptcy appears to be more necessary than municipal bankruptcy. To determine when bankruptcy is appropriate, we need to start with a different framework.

155. Anne-Marie Slaughter has made this argument in expert reports filed on behalf of Argentina in its litigation over obligations incurred under bilateral investment treaties.

156. Zoe Chace, *Why IMF Loans Always Get Repaid*, NPR (Feb. 3, 2012, 2:16 AM), http://www.npr.org/2012/02/03/146327391/why-imf-loans-always-get-repaid.

157. *European Financial Stabilisation Mechanism (EFSM)*, EUROPEAN COMM'N, http://ec.europa.eu/economy_finance/eu_borrower/efsm (last visited Mar. 25, 2014).

158. For a call for the IMF to require the restructuring of private debt as a condition of its financing, see Douglas G. Baird et al., The Role of the IMF in Future Sovereign Debt Restructurings (Dec. 10, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2360274.

I have advocated a five-factor approach that considers: (1) whether unsustainable debt is a potential problem; (2) the benefits of reshaping decision-making incentives; (3) the risk of premature liquidation; (4) the dignity of the debtor; and (5) spillover effects.

It is important to note, as I did at the outset of this Article, that I have focused solely on the issue of whether to implement a bankruptcy framework. I have not considered, except indirectly, the details of any specific bankruptcy law. Particular features, such as the priority rules or whether the managers of a corporate debtor are ousted at the beginning of the case, can have a crucial effect on how the bankruptcy works. I have set these details to the side and have focused entirely on the question of whether bankruptcy is or is not desirable in any given context.

The framework I have provided does not give simple, permanent answers to the question of when bankruptcy should be an option for each type of debtor that we have considered. Whether bankruptcy makes sense in Europe depends on whether Europe moves toward fiscal union or provides an exit from the euro. Personal bankruptcy is not necessary if consumers do not have access to meaningful amounts of credit. Even corporate bankruptcy is not inevitable. Although we often cannot determine the desirability of bankruptcy in the abstract, the framework has produced several surprising conclusions, even in the handful of applications we considered. The framework suggests that state bankruptcy would function more like bankruptcy for consumers than for corporations, that it makes even more sense than municipal bankruptcy, and that a corporate bankruptcy option is not always necessary. I hope these initial findings suggest that the framework may be worth pursuing.