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What is a Lien? Lessons from Municipal Bankruptcy

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WHAT IS A LIEN? LESSONS FROM MUNICIPAL BANKRUPTCY

*David A. Skeel, Jr.**

This Article considers two related sets of questions that have recently taken center stage in the municipal bankruptcies of Detroit and other cities. First, what is the relationship between liens and lien substitutes, such as priorities and exceptions from bankruptcy's automatic stay? As similar as liens and priorities are, the bankruptcy laws have long drawn a sharp distinction between state-created liens, which are honored in bankruptcy; and state-created priorities, which are not. The second question is the question in the Article's title: what is a lien? Whether a purported lien actually is a lien is not always clear, especially if the lien is created by statute rather than by the parties themselves. The Article attempts to make sense of existing law, advocates a functional approach to liens and priorities, and questions whether courts should honor a statutory lien that lacks the key attributes of a lien.

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I. INTRODUCTION

As the initial shock of Detroit's bankruptcy filing wore off, and the parties attempted to tackle the major issues that stood in the way of a successful adjustment of the city's debts, an unlikely issue kept coming up: what exactly is a lien?[1] In ordinary bankruptcies, this question is not much in dispute. The parties may disagree on the value of the collateral securing the principal lender's security interest, but it generally is clear whether the lender or other creditors do indeed have a property interest or its equivalent.

Not so in Detroit. Some of Detroit's general obligation ("GO") bondholders believed that their bonds could not be restructured due to Detroit's promise to use its "full faith and credit" to assure repayment.[2] Prior to the Detroit bankruptcy filing, as two investment experts at Cumberland Advisors wrote, "the general-obligation pledge was still considered a secured claim and 'sacrosanct'—senior to all other claims against a debtor, requiring the debtor to raise taxes to repay bondholders."[3] Even after it became clear that ordinary GO bonds are simply unsecured claims in bankruptcy, the holders of "unlimited tax" GO bonds insisted that they had a lien on Detroit's *ad valorem* taxes, and that this lien must be recognized in bankruptcy. The beneficiaries of Detroit's two major pensions insisted that they too were fully protected, due to a provision in the Michigan constitution stating that accrued pensions cannot be "diminished or impaired."[4] In 2005, Detroit entered into a swap transaction designed to stabilize the interest rate it paid on bonds that were issued to plug a gap in its pension funding.[5] The swap transaction was restructured three years later to give the counterparties a lien on Detroit's casino revenues.[6] This transaction also raised lien-related issues.[7]

One of the objectives of this Article is simply to sort through these issues and to determine why some of these creditors had liens or lien-like protection and others did not. Answering this question will require an exploration of two related sets of concerns. First, what is the relationship between liens and lien substitutes, such as priorities and exceptions from bankruptcy's automatic stay? As similar as liens and priorities are, the

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1. Through the Article, I use the term "lien" broadly, as the Bankruptcy Code does, to encompass security interests in personal property, mortgages, judicial liens, statutory liens and the like. *See* 11 U.S.C. § 101(37) (2012).

2. David Skeel, *The Education of Detroit's Pension and Bond Creditors*, 2 PENN WHARTON PUB. POL'Y INITIATIVE 1, 3 (2014), *available at* http://publicpolicy.wharton.upenn.edu/live/files/166-a.

3. John Mousseau & Michael Comes, *Detroit Bites Again,* CUMBERLAND COMMENTARIES (Feb. 3, 2014), http://www.cumber.com/commentary.aspx?file=020314.asp.

4. MICH. CONST. art. XI, § 24.

5. Mary Williams Walsh, *Detroit Wins Judge's Nod for Contract Settlement*, N.Y. TIMES, Apr. 11, 2014, http://dealbook.nytimes.com/2014/04/11/judge-approves-pact-to-end-detroit-swap-deal/?_php=true&_type=blogs&_r=0.

6. For a summary of the swaps transaction and Detroit's settlement of the swaps counterparties' claims for $85 million, see *id.*

7. I do not analyze the swaps transaction further in this Article, because the issues are somewhat different than the issues covered here.

bankruptcy laws have long drawn a sharp distinction between state-created liens, which are honored in bankruptcy; and state-created priorities, which are not.[8] We will want to consider why this is so.

The second question is the question in my title: what is a lien? The dictionary defines a lien as "[t]he right to take and hold or sell the property of a debtor as security or payment for a debt."[9] Not a bad definition, but whether a purported lien actually is a lien is not always clear, especially in the municipal context. Shortly before the little town of Central Falls, Rhode Island filed for bankruptcy, the Rhode Island legislature passed a statute giving general obligation bondholders a lien on all of a municipality's *ad valorem* taxes and general revenues—that is, on nearly all of the municipality's revenues.[10] Blanket liens are hardly unheard of; most small businesses and many large ones have lenders who have a security interest in most or all of their assets. Yet despite using the language of liens, the Rhode Island statute seems to function more like a priority rule than a traditional lien. The breadth of the statute raises the question whether a court should decline to honor a statutory lien if it does not serve the functions of a traditional lien.

I lay the groundwork for the Article in Part II, which briefly compares liens and a variety of lien substitutes. In Part III, I recount the history of bankruptcy's statutory lien provision, which honors state liens but not state priorities and requires that the lien be good both in bankruptcy and outside of bankruptcy. In Parts IV and V, I turn to general obligation bonds. My focus in Part IV is the status of general obligation bonds in Detroit, a question which turned out to have different answers for the two different types of Detroit GO bonds. In Part V, I explore Rhode Island's remarkable statute purporting to give a sweeping lien to GO bondholders. I then discuss the question whether pensions can be restructured in bankruptcy in Part VI. I conclude—as did Detroit's bankruptcy judge—that they can, and that the precise status of pension claims turns in large part on bankruptcy's treatment of trusts.

As is no doubt already evident, much of my analysis is descriptive: I am simply trying to determine the treatment of various kinds of creditors. But my answers also will take me well into normative territory, as I consider the implications of protecting, or not protecting, particular kinds of entitlements.

II. LIENS AND LIEN SUBSTITUTES

Although my particular interest in this Article is liens, we cannot talk about liens without considering alternative protections that achieve the same or a similar effect. If I am a creditor whose debtor files for bankruptcy, a lien is one of many different protections that may assure

8. *See* 11 U.S.C. § 545 (2012).
9. THE AMERICAN HERITAGE DICTIONARY 728 (2d College ed. 1982).
10. R.I. GEN. LAWS § 45-12-1(a) (West 2014).

that I receive a higher payout than ordinary unsecured creditors. If my obligation is entitled to a statutory or other priority,[11] this priority also will leapfrog me ahead of ordinary creditors. If my obligation is not subject to the discharge, either because I do not have a claim in the bankruptcy or because my obligation is nondischargeable, this too may ensure that I recover more than an ordinary creditor (so long as the debtor does not disappear as a result of the bankruptcy).[12] The fourth variation on this theme is a trust. If some of the debtor's assets are held in trust for my claim or claims like it, this may give me superior treatment—treatment that is in fact the closest substitute for a lien. A fifth protection is exemption from the automatic stay.[13] If I am not subject to the automatic stay, I can continue insisting on performance from the debtor, which may force the debtor to use unencumbered assets to satisfy its obligations to me rather than to another creditor.

It is worth mentioning one lien substitute that does not protect a creditor in bankruptcy but can be very important outside of bankruptcy: the term of the obligation. If most of the debtor's obligations have a long duration, a creditor can increase the likelihood of repayment by lending to the debtor on a short term basis.[14] An obligation that will be repaid before the debtor's other obligations come due may be nearly as well protected as obligations secured by a lien or entitled to priority. Bankruptcy eliminates this benefit, at least with respect to prebankruptcy obligations, by treating short term and long term obligations the same.

The implications of the existence of numerous mechanisms for ensuring the special treatment of a creditor point in two different directions. To the extent one of the lien substitutes is in fact functionally the same as a lien, it generally should be given the same treatment in bankruptcy.[15] If the lien substitute is not a true substitute for a lien, by contrast, we need to be mindful of the implications of the distinctions. Let me take up each implication in turn.

11. In addition to the formal priorities in 11 U.S.C. § 507 and § 726, critical vendor doctrine creates an informal priority for creditors whose relationship with the debtor is deemed essential. Thanks to the 2005 amendments to the Bankruptcy Code, 11 U.S.C. § 503(b)(9) gives a special priority to creditors who supplied goods to the debtor within twenty days of bankruptcy.

12. 11 U.S.C. § 523(a) makes particular debts nondischargeable in cases involving individuals. 11 U.S.C. § 727(a), which applies to debtors of all kinds, withholds the discharge altogether under specified circumstances.

13. The stay is found in 11 U.S.C. § 362(a), and a number of exceptions in 11 U.S.C. § 362(b).

14. In the sovereign debt context, which lacks a bankruptcy regime, a debtor's ability to borrow on an increasingly short-term basis as its financial condition deteriorates creates a serious risk of debt dilution. *See* Patrick Bolton & Olivier Jeanne, *Structuring and Restructuring Sovereign Debt: The Role of Seniority*, 76 REV. ECON. STUD. 879, 895 (2009).

15. To be sure, form is sometimes permitted to prevail over substance, usually in the interests of promoting certainty. A classic example in corporate law is Delaware's rejection of de facto merger doctrine. *See, e.g.*, Ernest L. Folk, III, De Facto *Mergers in Delaware:* Hariton v. ARCO Electronics, Inc., 49 VA. L. REV. 1261 (1963). But permitting the parties to achieve different treatment for functionally similar transactions is an accommodation, not an optimal state of affairs.

Thomas Jackson made the functional similarity point in an early article exploring issues of particular interest for this Article.[16] In the 1980s, courts wrestled with the question whether a constructive trust under state law should be given the same treatment as a statutory lien. In each context, Jackson argued, a creditor or class of creditors has a special claim to assets that are subject to the lien or trust.[17] Given the functional similarity, he concluded, "[n]o section . . . suggests that the decision of nonbankruptcy law to treat something as a constructive trust should be treated with any different respect than the decision of nonbankruptcy law to treat something as a statutory lien."[18]

Courts have often been relatively good at recognizing the functional similarity of liens and lien substitutes. One high profile example was a spate of cases addressing the question whether state or federal environmental regulators are subject to the automatic stay when they seek to enforce environmental obligations after a debtor has filed for bankruptcy.[19] If regulators are permitted to insist on specific performance of the debtor's obligations, the effect is the same as giving regulators a lien on the debtors' unencumbered assets. In the *Kovacs* case, which addressed the closely related question of whether regulatory obligations were discharged by bankruptcy, Justice O'Connor made the point explicit:[20] If state lawmakers wished to ensure that environmental obligations receive special treatment, she said, they can give them a formal lien.[21]

Although liens and lien substitutes are functionally similar, there often are important differences between a lien and any given lien substitute. Even trusts, the closest analogue to a lien, are different than liens in some respects.[22] The differences between a lien, on the one hand, and priority treatment or an exception to the stay, on the other, are much greater. To see this, it may be useful to begin by cataloguing three key attributes of a lien. I then will give a prominent current example of a lien substitute that functions differently than a lien.

The first attribute of a paradigmatic lien is transparency, usually as a result of public notice: it is easy to determine whether the debtor's assets are subject to the lien. In most instances, a security interest in personal property is perfected by recording the interest in a public registry or (less often) by taking possession of the collateral.[23] Statutory liens are a matter of formal state or federal law, and in many instances even people who

16. Thomas H. Jackson, *Statutory Liens and Constructive Trusts in Bankruptcy: Undoing the Confusion*, 61 AM. BANKR. L.J. 287, 288 (1987).

17. *See id.*

18. *Id.* at 294. Jackson notes that section 545, which I discuss in the next Part, may qualify this slightly, but does not change the general point about functional similarity. *Id.*

19. For a very good summary and analysis of the cases, see Kathryn R. Heidt, *The Automatic Stay in Environmental Bankruptcies*, 67 AM. BANKR. L.J. 69 (1993).

20. Ohio v. Kovacs, 469 U.S. 274 (1985) (O'Connor, J., concurring).

21. *Id.* at 286. ("[A] State may protect its interest in the enforcement of its environmental laws by giving cleanup judgments the status of statutory liens or secured claims.").

22. *See infra* Part V (discussing trusts in the pension context).

23. *See, e.g.*, U.C.C. § 9-310(a) (2014) (perfection by filing); § 9-313(a)(perfection by possession).

are not in the habit of reading the lawbooks would not be surprised to learn that a lien is in effect. The handwringing in the caselaw and literature about the evils of "secret liens" is itself evidence of the importance of transparency.

Second, because they are property-based and effective against third parties, liens facilitate asset partitioning, to borrow a concept that has figured prominently in recent literature on corporate law.[24] Although the asset partitioning achieved by liens is not as complete as with the formation of a separate corporate entity, it serves some of the same functions.[25] A lien may facilitate monitoring by enabling the lien creditor to focus its monitoring efforts on a particular type of collateral, or by assuring the lien creditor with a blanket lien that it has first dibs on most or all of the debtor's assets. Like separate incorporation, although to a lesser extent, floating liens also can discourage inefficient liquidation of a debtor's assets. A creditor with a lien on all the debtor's assets is unlikely to permit the debtor's assets to be dismembered in piecemeal fashion if the assets are more valuable as a going concern.[26] Bankruptcy augments the protection against premature liquidation by subjecting lien creditors to the automatic stay.[27] A creditor with a lien on a portion of the debtor's assets cannot simply sell the collateral after the debtor files for bankruptcy. The creditor must first ask the court to lift the stay, which reduces the risk of a collateral sale that destroys going concern value.[28]

A third attribute of a paradigmatic lien is that the property interest it creates is effective both inside and outside of bankruptcy. If I have taken my car to a garage for major engine work, but have not paid for it, the mechanic's lien securing my payment of the obligation will protect my mechanic in bankruptcy if I file for bankruptcy, and outside of bankruptcy if I do not. Some lien substitutes, such as exemption from the automatic stay, have a similar effect; others, such as state law priority rules, may not.

As my use of the term "paradigmatic" to describe the liens I have been discussing suggests, some liens do not have all of the attributes I have just described. This raises the question whether a purported lien is indeed a lien from a doctrinal perspective, and whether it should be a lien from a normative perspective. Lien substitutes raise essentially the same questions.

24. *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000); Henry Hansmann et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333 (2006).

25. As Hansmann and Kraakman recognize in their work on asset partitioning.

26. The general financer's incentives are imperfect, however. If a general financer is oversecured in bankruptcy, it may have too great an incentive to press for liquidation. *See* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 514 (2009) (finding that bankruptcy sales are more likely and traditional reorganization less likely with debtors that have oversecured secured creditors).

27. *See, e.g.*, 11 U.S.C. § 362(a)(4) (2012) (staying enforcement of liens).

28. *See id.* § 362(d)(2) (permitting court to lift stay only if the secured creditor is undersecured and the collateral is not necessary to an effective reorganization).

The most vivid current examples of the distinction between an ordinary lien and a lien substitute are derivatives, repos, and other financial contracts. As is now well known, the counterparty to a derivative is not subject to the preference or constructive fraud rules,[29] is not subject to bankruptcy's anti-*ipso facto* provisions,[30] and is exempt from the automatic stay to the extent the stay would otherwise limit the counterparty's right to effect a set off of its obligations.[31] These rules are sometimes referred to as special "priorities" for derivatives, especially by the financial press.[32] Strictly speaking, they are not priorities. To the extent a derivative is undercollateralized, it is treated as an ordinary unsecured claim. But the derivatives counterparty can receive payments or additional collateral on the eve of bankruptcy without fear that the payments will be retrieved as preferences.[33] The counterparty also can sell any collateral it has at any time, without fear of interference from the court.[34] This special status is neither a priority nor a lien, but it is a substitute for both.

Although the derivatives safe harbors are functionally similar to liens, they are less transparent and provide less protection against liquidation than traditional liens. Derivatives' lack of transparency is magnified by their insulation from preference challenge. By insisting on additional collateral, a counterparty can "feed" its lien at any time, even if a bankruptcy filing is clearly on the horizon.[35] The size of a counterparty's lien is thus less certain (and less transparent) than with other creditors, whose efforts to add collateral on the eve of bankruptcy will be avoided as a preference. Any collateral a derivatives counterparty grabs will not be available for other creditors.

The absence of liquidation protection stems from the right of a derivatives counterparty to terminate its contract and sell collateral at any time. Unlike ordinary lien creditors, who are prevented by the automatic stay from engaging in value destroying asset sales, a derivatives counterparty has complete discretion whether and when to sell its collateral. AIG's inability to prevent counterparties from insisting on additional collateral and threatening to terminate their credit default swaps, even if

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29. *Id.* § 546(e).

30. *See, e.g.*, *id.* § 560 (swap counterparties permitted to terminate contract).

31. *See, e.g.*, *id.* § 362(b)(17) (exempting swaps). For a more complete overview of the safe harbors for financial contracts, see Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641 (2005).

32. *See, e.g.*, Ellen Brown, *Winner Takes All: The Superpriority Status of Derivatives*, HUFFINGTON POST, (Apr. 11, 2013 2:12 PM), http://www.huffingtonpost.com/ellen-brown/winner-takes-all-the-supe_b_3054522.html.

33. 11 U.S.C. § 546(e).

34. At least if the counterparty does so promptly. In the Lehman bankruptcy, Judge Peck held that counterparties relinquished their immunity from the stay if they waited too long to terminate. *See In re* Lehman Bros. Holding Inc., 445 B.R. 143, 205 (Bankr. S.D.N.Y. 2011).

35. JPMorgan Chase, as Lehman's triparty repo clearing bank, did precisely this on the eve of Lehman's bankruptcy. *See, e.g.*, David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152, 165 (2012).

AIG filed for bankruptcy, was a key feature in its September 2008 collapse.[36]

I have argued elsewhere that the derivatives safe harbors should be removed, and thus that derivatives should be treated more like other contracts in bankruptcy.[37] For present purposes, the more relevant points are simply that liens and lien substitutes are not fully interchangeable, and that departures from the traditional attributes of a lien can prove problematic.

III. STATE PRIORITIES AND LIENS: A BRIEF HISTORY

In my overview of the basic attributes of a lien, I included the fact that liens are ordinarily good for all seasons, valid both inside and outside of bankruptcy. This feature lies at the heart of an important limitation on bankruptcy's recognition of liens: under section 545, a lien is not valid if it first takes effect when the debtor becomes insolvent or files for bankruptcy.[38] This provision has an intriguing and largely forgotten history that underscores several of the points made in the previous Part.[39]

The history of bankruptcy's treatment of statutory liens begins not with liens but with priorities. As originally enacted, the 1898 Act incorporated any nonbankruptcy priorities that were honored under state or federal law.[40] Concerned that there was little or nothing left for general unsecured creditors in most cases after state law priorities were satisfied, lawmakers largely eliminated state law priorities under the Chandler Act of 1938, which made major changes to the 1898 Act.[41] The only state law priority that the Chandler Act retained was any priority for rent owed to a landlord, and this priority was limited to rent that accrued within three months of bankruptcy.[42]

Although ordinary state priorities were no longer enforceable in bankruptcy, the Bankruptcy Act did honor state priorities that looked like liens—that is, state priorities that gave a creditor the right to attach property.[43] As of 1938, the Bankruptcy Act thus distinguished among

36. *See, e.g.*, *id.* at 165–66.

37. *Id.* at 176–80 (repos), 180–92 (swaps); Darrell Duffie & David Skeel, *A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements*, *in* BANKRUPTCY *NOT* BAILOUT: A SPECIAL CHAPTER 14 at 133 (Kenneth E. Scott & John B. Taylor, eds. 2012). Stephen Lubben and Mark Roe also have argued for reform of the safe harbors. *See, e.g.,* Stephen J. Lubben, *Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV. 319 (2010); Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539 (2011).

38. 11 U.S.C. § 545.

39. Not everyone has forgotten the history. *See* Jackson, *supra* note 16, at 294; Richard M. Hynes & Steven D. Walt, *Pensions and Priority Rights in Municipal Bankruptcy* 33 REV. BANKING & FIN. L. 609, 645–47 (2014).

40. Bankruptcy Act of 1898, ch. 541, § 64b(5), 30 Stat. 544, (1898) (prior to Chandler Act of 1938).

41. *See, e.g.*, STAFF OF H. COMM. ON THE JUDICIARY, 74TH CONG., ANALYSIS OF H.R. 12889 at 201 (Comm. Print 1936).

42. Bankruptcy Act, ch. 575, § 64(a)(5), 52 Stat. 840, 874 (1938).

43. *Id.* at 876.

priorities, priorities that looked like liens, and traditional liens.[44] The first was overridden in bankruptcy, while the other two were given effect.[45]

To the extent state lawmakers paid attention to these things, it was not hard for them to reestablish the validity of state created priorities. If they added lien-like attributes that sprang into effect in the event of insolvency or bankruptcy to the basic priority rule, the priority would retain its force in bankruptcy. In the two decades after the Chandler Act was enacted, many states appeared to do just this.[46] In the words of a subsequent Ninth Circuit decision recounting the history, "[c]reditors' groups quickly exerted pressure on state legislatures to preserve their favored position by upgrading their state priorities to the status of liens, thus perpetuating the conflict between state and federal priorities which the Chandler Act had been expected to end."[47]

In 1966, after more than a decade of lobbying by bankruptcy lawyers and others, Congress took another stab at the perceived problem.[48] This amendment, the precursor to current section 545, invalidated state statutory liens that did not take effect prior to a debtor's bankruptcy or insolvency.[49] The amendment was "an attempt to minimize state conflicts with federal priorities by invalidating as against the trustee some of the more obviously spurious liens, those which function more as priorities in bankruptcy than as property interests."[50]

The standard normative justification for the distinction established by the 1966 amendment—which has been retained as section 545 of the Bankruptcy Code[51]—is that limiting statutory liens to those that are valid in all contexts reduces forum shopping. "A creditor enjoying a state-created priority [that is valid only in bankruptcy] . . . may try to initiate a bankruptcy proceeding because bankruptcy serves it well, even though a collective proceeding would not be beneficial to the group of creditors," as Jackson puts it.[52]

It should be noted, however, that the approach that has emerged cannot be fully explained in these terms. If a state enacts a priority that would apply both in a state insolvency proceeding, such as an assignment for the benefit of creditors, and in bankruptcy, the priority will be over-

44. *Id.* at 877.

45. *Compare* Bankruptcy Act, ch. 575, § 64(a)(5), 52 Stat. 840, 874 (1938), *with* Bankruptcy Act, ch. 575, § 67(c), 52 Stat. 840, 877 (1938).

46. *See* Alfred M. Lewis, Inc. v. Holzman (*In re* Telemart Enterprises), 524 F.2d 761, 764 (9th Cir. 1975).

47. *Id.*

48. The U.S. Department of the Treasury apparently was responsible for at least some of the delay, because of concerns about the priority of federal taxes. *See, e.g.*, Frank R. Kennedy, *The Bankruptcy Amendments of 1966*, 1 GA. L. REV. 149, 150 (1967). The concerns that gave rise to the 1966 changes are also discussed in Frank R. Kennedy, *Statutory Liens in Bankruptcy*, 39 MINN. L. REV. 697, 697 (1955); Note, *Vacation in Bankruptcy of Statutory Wage Earners' Priorities Established in Previous State Insolvency Proceedings*, 51 YALE L.J. 863, 867 (1942).

49. Mark S. Dray, *The Bankruptcy Act: Some Effects of the 1966 Amendments to Sections 17(a), 67(c), & 70(c)*, 8 WM. & MARY L. REV. 431, 434 (1967).

50. *In re Telemart Enterprises*, 524 F.2d at 764.

51. *See* 11 U.S.C. § 545 (2012).

52. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 85 (1986).

ridden in bankruptcy. A creditor that is favored in a state law assignment thus has an incentive to press for a state law resolution of financial distress, whereas creditors who fare better in bankruptcy have the opposite incentive.[53] One possible explanation is that the framework is flawed and does not fully achieve its objective. Perhaps Congress made a mistake when it invalidated state law priorities.[54] But there also may be legitimate reasons for having somewhat different rules in place in bankruptcy as opposed to outside of bankruptcy. If this is the case—a possibility I will explore more fully in the next two Parts—Congress may be justified in rejecting the kinds of lien substitutes that alarmed the drafters of section 545.

IV. GENERAL OBLIGATION BONDS IN DETROIT

Nowhere has the status of nonbankruptcy liens and lien substitutes taken on as much urgency as in the recent municipal bankruptcies of Detroit and other cities. In Detroit, many holders of general obligation bonds initially questioned whether their bonds could be restructured in bankruptcy, though it quickly became clear that their optimism was misplaced.[55] A small group of GO bondholders, known as unlimited tax GO bonds, insisted, somewhat more credibly, that their bonds had priority status and were protected by a lien.[56] In the discussion that follows, I consider the treatment of each form of GO bond in turn.

A. The Vulnerability of Ordinary GO Bonds

On the eve of Detroit's bankruptcy, many sophisticated municipal bond investors assumed that all GO bonds would be fully protected in bankruptcy.[57] Unlike with a revenue bond—which is secured by a stream of revenue such as water or sewer fees[58]—GO bonds are backed by the "full faith and credit" of the municipality.[59] If the revenues securing a

53. Hynes & Walt make a similar point. Hynes & Walt, *supra* note 39, at 646–47 ("Some states grant priority to state and wage claims in ways that are different than the priority that such claims would receive in bankruptcy.").

54. Jackson notes the puzzle and speculates that bankruptcy and insolvency specific state priorities are rare. JACKSON, *supra* note 52, at 85 n.35. He seems to be right about this, although the increased use of state insolvency proceedings in the past decade has magnified the importance of existing differences.

55. *See generally* Steven Malanga, *Detroit's Message to Investors: There Will be Blood*, CITY J., Spring 2014, *available at* http://www.city-journal.org/2014/24_2_snd-detroit-bankruptcy.html (characterizing the Detroit emergency manager's threat to treat GO bonds as unsecured as "unprecedented").

56. *See, e.g.*, Opposition to Defendants' Motion to Dismiss Plaintiffs' First Amended Complaint for Declaratory Judgment at 47–48, Nat'l. Pub. Fin. Guar. Corp. v. City of Detroit (*In re* City of Detroit), Case No. 13-53846 (Bankr. E.D. Mich. Feb. 11, 2014) (arguing that unlimited tax GO bonds are secured by lien and qualify as revenue bonds) [hereinafter Plaintiffs' Opposition Motion]. For a recent overview of the treatment of GO bonds, informed by bondholders' experience in the Detroit case, see National Association of Bond Lawyers, General Obligation Bonds: State Law, Bankruptcy and Disclosure Considerations (Aug. 2014).

57. *See, e.g.*, Mousseau & Comes, *supra* note 3.

58. The formal definition of revenue bonds is in 11 U.S.C. § 902(2) (2012).

59. Many GO bonds also are approved by municipal voters.

revenue bond fall short, the bondholders have no further recourse. Revenue bonds are somewhat vulnerable as a result. With GO bonds, by contrast, the municipality commits all of its taxing authority to repayment.[60] As New York's highest court put it in a much-cited case arising out of New York City's financial crisis in the 1970s, "an obligation containing a pledge of the city's 'faith and credit' is secured by a promise both to pay and to use in good faith the city's general revenue powers to produce sufficient funds to pay the principal and interest of the obligation as it becomes due."[61] By this reasoning, GO bonds are quite safe, whereas revenue bonds are precarious.

In bankruptcy, this widespread perception turns out to be exactly backwards. Although revenue bondholders do not have further recourse if the revenue stream is not sufficient to ensure repayment, their lien on the revenue stream itself is fully protected. Indeed, revenue bondholders are in some respects treated even more favorably than other lien holders. Congress amended the municipal bankruptcy provisions in 1988 to make clear that the lien continues to attach to postpetition revenues.[62] And revenue bonds are given a major exemption from the automatic stay.[63]

GO bonds do not enjoy any of these protections. A municipality's "full faith and credit" commitment does not by itself create a lien,[64] which means that the claims of GO bondholders are unsecured in bankruptcy, and need not be paid in full. The vulnerability of GO bonds is reflected in the significant writedown they received in the Detroit case.[65]

B. The Special Case of Unlimited Tax GO Bonds

In the Detroit bankruptcy, one group of GO bondholders insisted that their bonds were secured by a fully enforceable lien, even if ordinary

60. Stoyan Bojinov, *Two Types of Bonds: General Obligation vs. Revenue Bonds*, MUNICIPALBONDS.COM (Aug. 20, 2011), http://www.municipalbonds.com/education/read/60/two-types-of-bonds-general-obligation-vs-revenue-bonds.

61. Flushing Nat'l. Bank v. Mun. Assistance Corp. for New York, 358 N.E.2d 848, 851 (N.Y. 1976). Although *Flushing* is routinely cited as evidence of the sanctity of GO bonds, the court actually declined to insist on immediate performance. "Plaintiff and other noteholders of the city are entitled to some judicial relief free of throttling by the moratorium statute," the court held, "but they are not entitled immediately to extraordinary or any particular judicial measures unnecessarily disruptive of the city's delicate financial and economic balance." *Id.* at 855.

62. 11 U.S.C. § 928(a). Under section 552(a), which is incorporated into Chapter 9 by section 901, a prebankruptcy lien does not attach to collateral obtained by the debtor postpetition. Section 928(a) makes clear that this provision does not cut off attachment of a revenue bond to postpetition revenues.

63. *Id.* § 922(d) (stating the stay does not prevent use of pledged revenues to pay revenue bondholders).

64. As the *Flushing* court noted, "[T]he effect of such pledge of 'full faith and credit' is not to create a general or special lien or charge . . . ." *Flushing*, 358 N.E.2d. at 851 (quoting State v. County of Citrus, 157 So. 4, 11 (1934)).

65. *See, e.g.*, Oral Opinion on the Record at 17, *In re* City of Detroit, Case No. 13-53846 (Bankr. E.D. Mich. Nov. 7, 2014) (estimating recovery on limited tax GO bonds at 41 percent); compare Third Amended Disclosure Statement With Respect to Third Amended Plan for the Adjustment of Debts of the City of Detroit at 31, *In re* City of Detroit, Case No. 13-53846, (Bankr. E.D. Mich. Apr. 25, 2014) (earlier proposed plan estimating recovery on limited tax GO bonds at 10-13%) [hereinafter Third Amended Disclosure Statement].

GO bonds were not.[66] Roughly $388 million in amount, these insured Unlimited Tax General Obligation bonds differed from other GO bonds in at least one key respect. In addition to the usual commitment of Detroit's "full faith and credit," the resolutions approving the bond authorized Detroit to levy an additional *ad valorem* tax to generate funds for repaying the bonds.[67] The holders of these bonds argued that they had a lien on the *ad valorem* taxes,[68] and that the nature of this interest transformed their GO bonds into revenue bonds.[69]

In effect, the bondholders claimed that their bonds were both GO bonds and revenue bonds—in effect, they were like revenue bonds that also included recourse against Detroit in the event of any deficiency. Whether the provision for a special *ad valorem* tax did indeed create a valid lien on revenues was hotly disputed during the bankruptcy case.[70] Some observers suspected that the bankruptcy judge would rule against the bondholders if forced to decide.[71] The parties settled the dispute on terms that appear to imply that the bonds were indeed revenue bonds.[72] The important point for present purposes, however, is that the bondholders' comparative success does not imply that GO bondholders are something other than unsecured creditors. The unlimited tax GO bondholders' case for special treatment rested on a claim that they were not simply GO bonds.[73] Both sides assumed that ordinary GO bonds are unsecured claims.

66. Several other classes of GO bonds were secured by revenues that were not in dispute. *See, e.g.*, Third Disclosure Statement with Respect to Third Amended Plan for the Adjustment of Debts of the City of Detroit at 29–30, *In re* City of Detroit, Case No. 13-53846 (Bankr. E.D. Mich. Apr. 25, 2014) (describing secured treatment of GO bonds in classes 2A–2F).

67. *See* Order of the Emergency Manager of the City of Detroit in *id.* at 197.

68. The bondholders argued that their bonds were revenue bonds secured by a lien on special *ad valorem* taxes authorized by Detroit resolutions approving the bonds. According to the bondholders, Michigan Acts 189 and 34 provided statutory authority for the lien, and the Detroit resolutions approving the bonds "confirm that the City has 'pledge[d] to pay the principal of and the interest on the [Unlimited Tax Bonds] from the proceeds of an annual levy of ad valorem taxes on all taxable property in the City.'" Plaintiffs' Opposition Motion, *supra* note 56, at 47.

69. For the bondholders' purposes, it was important that the bonds be found both to be secured by a lien, and to be revenue bonds. If the bondholders had a lien, but the bonds did not qualify as revenue bonds, section 552 would prevent the lien from attaching to postpetition revenues. 11 U.S.C. § 552(a) (2012). This would render the lien essentially useless.

70. *See* Diane Bukowski, *Wall Street Attacks Detroit Bankruptcy Cops Lawsuit*, VOICE OF DETROIT (Feb. 18, 2014), http://www.voiceofdetroit.net/2014/02/18/wall-street-attacks-detroit-bankruptcy-cops-lawsuit/.

71. *See id.*

72. Under the terms of the settlement, seventy-four percent ($287.5 million) of the bondholders' claims would be fully reinstated, and the remaining would be used to pay retiree pensions. *See* Statement of Detroit Bankruptcy Mediators, U.S. Dist. Court for the E. Dist. of Mich. (April 9, 2014). Taken literally, this seems to suggest that the bonds are entitled to one-hundred percent payment, but bondholders agreed to "gift" some of their payment to pension recipients.

73. Plaintiffs' Opposition Motion, *supra* note 56, at 35 ("That the Unlimited Tax Bonds are also backed by the 'full faith, credit and resources of the City' does not diminish or obscure the additional, specific pledge of special *ad valorem* tax revenues.").

V. GENERAL OBLIGATION BONDS: THE RHODE ISLAND LIEN STATUTE

One response to the vulnerability of GO bonds is to obtain security for the particular bond issuance. Rhode Island has recently attempted to achieve this effect by statute for all GO bonds.[74]

In 2011, as it became clear that the small Rhode Island town of Central Falls would soon be filing for Chapter 9, bond market participants warned that failure to pay Central Falls' general obligation bonds in full would have a ruinous effect on the bond markets in Rhode Island, and the contagion might spread beyond Rhode Island as well.[75] In response to these warnings, Rhode Island legislators quickly passed a new statute that purported to give bondholders a lien on all of a municipality's revenues.[76] Central Falls did subsequently file for bankruptcy,[77] and the statute ensured that its bondholders emerged unscathed.

Under the Rhode Island statute:

> The faith and credit ad valorem taxes, and general fund revenues of each city, town and district shall be pledged for the payment of the principal of, premium and the interest on, all general obligation bonds and notes of the city or town . . . and shall constitute a first lien on such ad valorem taxes and general fund revenues.[78]

The statute states that the "first lien" status of general obligation bonds does not require a security agreement or perfection under the Uniform Commercial Code, and that the lien is "deemed continuously perfected from the time the bonds or notes or other financing obligations are issued."[79] General obligation bondholders are thus given a first priority lien on essentially all of the city's revenues as of the moment the bonds are issued.

When Central Falls filed for bankruptcy as expected, the new lien statute achieved the desired effect. Although Central Falls significantly restructured its pension obligations, it has continued to make its GO bond payments in full and on time.[80] The statute is quite unusual, but it does not appear to have been challenged in the Central Falls case. Why did the pension recipients, many of whose pensions were cut by fifty-five

74. Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES, Sept. 6, 2012, http://www.nytimes.com/2012/09/07/us/central-falls-ri-to-emerge-from-bankruptcy.html?_r=1&.

75. *See generally* Mary Williams Walsh & Abby Goodnough, *A Small City's Depleted Pension Fund Rattles Rhode Island*, N.Y. TIMES, July 11, 2011, http://www.nytimes.com/2011/07/12/business/central-falls-ri-faces-bankruptcy-over-pension-promises.html (describing contagion concerns).

76. Bidgood*, supra* note 74.

77. Scott Malone, *Rhode Island's Central Falls Files for Bankruptcy*, REUTERS (Aug. 1, 2011, 4:47 PM), http://www.reuters.com/article/2011/08/01/us-rhodeisland-centralfalls-idUSTRE7703ID20110801.

78. R.I. GEN. LAWS § 45-12-1(a) (West 2014).

79. *Id.* at § 45-12-1(b)(1).

80. *See, e.g.*, Dunstan Prial, *In Rhode Island Bankruptcy, Bondholders Came First*, FOX BUSINESS (July 24, 2013), http://www.foxbusiness.com/government/2013/07/24/in-rhode-island-bankrputcy-bondholders-came-first/.

percent, not object to this special protection for GO bonds? The acquiescence appears to be explained by a key feature of Central Falls' GO bonds. Nearly all of the money used for the bond payments comes from Rhode Island itself, rather than from Central Falls. As a result, restructuring the bonds would not have freed up any additional value to pay pension recipients and other Central Falls creditors.[81]

In the discussion that follows, I consider a series of potential objections to the Rhode Island approach. I begin with two possible objections to the lien statute that do not turn on the nature of the lien it creates. I then turn to the question whether the statute is a lien that is or should be enforceable in bankruptcy.

A. Is the Statute a Fraudulent Conveyance?

One possible, though probably unavailing objection is that the lien statute was a fraudulent conveyance.[82] Under bankruptcy's fraudulent conveyance provision, a transfer that occurs on or within two years of a debtor's bankruptcy can be invalidated if the debtor "made such transfer . . . with actual intent to hinter, delay, or defraud" its creditors; or if the debtor "received less than a reasonably equivalent value in exchange" for the transfer and was insolvent or nearly insolvent at the time.[83] The first form of fraudulent conveyance, actual fraud, clearly would not apply to Central Falls or other Rhode Island municipalities. The statute gave Central Falls' bondholders a lien on Central Falls' revenues, which is a transfer of Central Falls property. But the state, not Central Falls, was the entity that effected the transfer. It is hard to imagine how Central Falls could be said to have intentionally defrauded its creditors when the statute was enacted, since Central Falls was a bystander to the enactment.

With the second form of fraudulent conveyance—known as constructive fraud—things get more interesting. On its face, the enactment of the Rhode Island statute does seem to satisfy the requirements for

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81. The discussion in this paragraph is based on a presentation by one of the drafters of the Rhode Island statute, Karen S. D. Grande, Edwards Wildman Palmer LLP, at the "Judicial Symposium on the Law and Economics of Pension Reform" sponsored by the Law & Economic Center of George Mason University School of Law in Charleston, S.C., April 27, 2014.

82. The effect of the Rhode Island statute looks even more like a prebankruptcy preference, but bankruptcy law precludes preference challenges in this context. Ordinarily, a transfer to a creditor in connection with a prior debt can be avoided if it occurs within ninety days of the bankruptcy filing. 11 U.S.C. § 547(b) (2012). The Rhode Island statute transferred a property interest to the Central Falls bondholders shortly before the Central Falls bankruptcy filing, and thus seems vulnerable at first glance. But 11 U.S.C. § 547(c)(6) prohibits the debtor or trustee from challenging "the fixing of a statutory lien" as a preference. Moreover, although municipal bankruptcy law permits the bankruptcy judge to appoint a trustee to bring preference actions that the debtor fails to pursue, 11 U.S.C. § 926(a), the trustee is not permitted to avoid transfers "to or for the benefit of the holder of a bond" under section 547. 11 U.S.C. § 926(b).

83. *See id.* § 548(a)(1). Most states have very similar fraudulent conveyance provisions, often with a longer statute of limitations. The trustee also can invoke these provisions, because 11 U.S.C. § 544(b) authorizes her to use any provision that an existing creditor could have used outside of bankruptcy.

constructive fraud. With constructive fraud, the question is whether Central Falls received reasonably equivalent value when a lien was given to its general obligation bondholders, and whether it was insolvent or nearly so. Central Falls did not receive anything in return for the new lien, and it is quite plausible that Central Falls was insolvent at the time.

The principal obstacle to the fraudulent conveyance argument is that the Bankruptcy Code defines value to include "securing of a present or antecedent debt of the debtor,"[84] which suggests that the original value given by general obligation bondholders when they purchased their bonds counts as value given in return for the lien created by Rhode Island's lien statute. Only if Central Falls' creditors could argue that the original purchase should not count as value for some reason, would they have had a plausible fraudulent conveyance challenge.[85]

B. Does the Statute Violate the Contracts Clause?

A second potential challenge to the Rhode Island statute comes from the Contracts Clause of the U.S. Constitution and a comparable provision in Rhode Island's constitution. Under the Contracts Clause, states are not permitted to "impair" contracts.[86] Although the Contracts Clause has been construed more narrowly when a city or state is in financial distress,[87] it has generally been interpreted to prohibit a state from retroactively impairing contractual obligations.[88] The Rhode Island statute obviously did not impair the obligations of Rhode Island municipal bondholders at all. It increased the likelihood that they would be repaid. But what about pension beneficiaries and other creditors? By giving bondholders a lien on nearly all of a city's revenues, the Rhode Island statute arguably impaired the city's obligations to these other creditors.

It is not clear whether this kind of interference—which is indirect rather than direct—violates the Contracts Clause. Indirect claims pose an obvious slippery slope problem. After all, if indirect impairments violate the Contracts Clause, *any* municipal or state statute that favors a particular creditor or class of creditors could be seen as an impermissible impairment of other creditors. Surely, the Contracts Clause does not sweep

84. *Id.* § 548(d)(2)(A).

85. Some bankruptcy courts have in fact concluded that the original extension of credit does not always constitute value for fraudulent conveyance purposes. *See, e.g.*, *In re* Annand, 239 B.R. 511, 518 (N.D. Ill. 1999) (suggesting that the court should consider all relevant facts). One possible analogy here is the invalidation by some courts of leveraged buyout transactions on fraudulent conveyance grounds, despite the fact that the lender extended substantial credit in return for the lien it received. *See, e.g.*, Bay Plastics, Inc. v. BT Commercial Corp. (*In re* Bay Plastics, Inc.), 187 B.R. 315 (Bankr. C.D. Calif. 1995).

86. U.S. CONST. art. I, § 10, cl. 1 ("No State shall . . . impair[] the Obligation of Contracts . . . .").

87. *See, e.g.*, Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 513–16 (1942) (upholding state bond restructuring statute); UAW v. Fortuño, 633 F.3d 37, 40, 47 (1st Cir. 2011) (dismissing Contracts Clause objection to Puerto Rican legislation).

88. Elmer W. Roller, *The Impairment of Contract Obligations and Vested Rights*, 6 MARQ. L. REV. 129, 129 (1922); *see also* Ogden v. Saunders, 25 U.S. 213, 260 (1827) (holding that the Contracts Clause prevents states from passing laws affecting contracts already signed, but that laws affecting future contracts are to be construed as part of the contracts themselves).

so broadly. Probably not, although the effect of the Rhode Island lien statute was far more dramatic than with ordinary municipal or state actions.

C. Does the Rhode Island Statute Create a Genuine Lien?

Thus far, I have considered challenges to the Rhode Island statute that arise from transition issues. Once the statute has been in place for a few years, any fraudulent conveyance concerns will disappear. Similarly, creditors who extend credit to a Rhode Island municipality after the enactment of the statute in 2011 cannot raise Contracts Clause objections, since the Clause prohibits only retroactive impairment.[89] In this Section, I take up a more general objection to the Rhode Island statute: the question of whether the lien it creates is in fact a legitimate lien.

How could a state statute that carefully and explicitly states that it is giving general obligation bondholders a lien on the city's revenues not create a lien? One possible objection is that the lien created by the statute should be invalidated under section 545 because it has little real effect outside of bankruptcy.[90] The second objection is that it is not really a lien at all; it is a state priority rule and should therefore be overridden in bankruptcy.

Start with the first objection. By its terms, the Rhode Island statute is not problematic, since it creates a lien as of the moment a general obligation bond is issued. To challenge the statute, a creditor would need to contend that the lien actually does not have any effect outside of bankruptcy.[91] One can in fact imagine such an argument. It is very difficult for a creditor to enforce an obligation against a municipality outside of bankruptcy, the reasoning might go; a creditor's only realistic option is to seek a mandamus order compelling the municipality to use revenues to pay the credit. Historically, mandamus actions have not fared especially well.[92] Moreover, a Rhode Island bondholder's "lien" would not give it significantly greater rights than bondholders already had under the traditional "full faith and credit" promise included in the bonds. The real effect of the statutory lien is simply to enhance the bondholders' priority in the event of bankruptcy.

The chief limitation of this argument is that the new lien theoretically could have at least some effect outside of bankruptcy. It is possible, for instance, that a court would be slightly more willing to grant mandamus to holders of GO bonds subject to the new statute than it would be in the absence of the statute.

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89. Roller, *supra* note 88, at 129.

90. 11 U.S.C. § 545(1)(A) (2012) (invalidating statutory liens that first become effective "when a case under this title concerning the debtor is commenced").

91. *See id.*

92. *See, e.g.*, Clayton P. Gillette, *Bondholders and Financially Stressed Municipalities*, 39 FORDHAM URB. L.J. 639, 645 (2012) (noting that municipal officers "made a practice of avoiding [writs of mandamus] by resigning office").

The second objection is that the lien is simply not a genuine lien. Traditional liens attach to particular property, such as equipment or a house. Although liens can attach to intangible assets as well, the reasoning might go, a lien on all revenues is too amorphous to constitute a lien. To assess the seriousness of this objection, it is useful to begin by comparing the Rhode Island lien to ordinary security interests under Article 9 of the Uniform Commercial Code. Because Article 9 excludes state-created liens from its scope,[93] it does not regulate the general obligation bonds of Rhode Island or other municipalities. But the analogy may shed light on the nature and permissible scope of liens.

The first thing to note is that the lien created by the Rhode Island statute is most closely analogous to the floating liens authorized by Article 9. A floating lien generally consists of a security interest in all of the debtor's current and after-acquired personal property,[94] and secures the repayment of any current or future loans from the secured creditor.[95] The Rhode Island lien and the floating lien held by the general financer of an ordinary business are, in these respects, somewhat analogous.

If we consider the normative rationales that have been developed to explain the role of floating liens, however, it quickly becomes apparent that floating liens have little in common with the Rhode Island lien. According to the leading normative account, the debtor's general financer serves as the debtor's principal monitor.[96] The blanket lien discourages opportunism by the debtor and solidifies the general financer's status as the principal monitor. This monitoring benefits not just the general financer, but the debtor's other creditors as well. The arrangement also benefits the debtor by reducing its overall cost of credit.

Rhode Island's general obligation bondholders are much less likely to serve as a municipality's principal monitors, for the benefit of all creditors. To the extent general obligation bondholders monitor, they tend to do so indirectly, through the signals sent by bond prices.[97] The Rhode Island lien statute will diminish rather than enhance this benefit, since it

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93. *See, e.g.*, U.C.C. § 9-109(a)(1) (2014) (Article 9 applies to security interests created "by contract").

94. *Id.* § 9-204(a) (authorizing security interests in after-acquired property). The secured creditor must describe the collateral in the security agreement that creates the security interest, and in the financing statement that perfects it, but Article 9 permits very broad descriptions. The security agreement cannot simply say "all personal property," but a reference to different categories of collateral suffices. *Id.* § 9-108(c) (entitled "Supergeneric description not sufficient"); *see, e.g.*, Cahill v. Fruehauf Corp. (*In re* Ass'n. Transp., Inc.), 3 B.R. 124, 134 (Bankr. S.D.N.Y. 1980) (holding that a broad description of collateral that goes on to list specific types of collateral is sufficient). For the financing statement, even "all personal property" is acceptable. U.C.C. § 9-504(2) ("all assets or all personal property" is sufficient).

95. U.C.C. § 9-204(c) (future advances).

96. Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 927 (1986); *see also* Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 169 (1997).

97. For a discussion of monitoring that takes this form, see generally Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993).

assures that the bondholders will be paid even if the municipality is deeply distressed.[98]

The mismatch between the principal normative explanations for the use of a floating lien, and the role of a general obligation bondholder, reinforces the suspicion that the Rhode Island lien really is not a lien at all. It seems to function much more like a priority rule than a genuine lien.

There are additional reasons for concern with the Rhode Island statute. If lenders are fully protected, they will lend even when their lending may be problematic.[99] The prospect of excessive lending seems especially salient in the municipal context. Municipal decision makers already have too great an incentive to borrow because the loan proceeds are available now and repayment is not required until later. Assurance of priority may enable a municipality to continue to borrow even when it is unable to maintain basic services for its citizens. Rather than continuing to borrow, a better solution is for the municipality to restructure its obligations in bankruptcy.

From a doctrinal perspective, my conclusion is a tentative one: courts might plausibly conclude that the "lien" created by the Rhode Island lien statute is not a genuine lien, that it is best characterized as a state's effort to alter bankruptcy priorities, and thus that it is not enforceable in bankruptcy. It is not clear that courts will, but they could. My analysis in this Section suggests that they should, and indeed that lawmakers should consider amending the statutory lien statute to make clear that statutory liens on all revenues are not enforceable in bankruptcy.[100] To be sure, this could create a difference between the treatment of bonds in bankruptcy and their treatment outside bankruptcy, potentially introducing forum shopping concerns. But the invalidity of "all revenues" liens in bankruptcy might discourage other states from adopting such laws (as well as encouraging the parties to secure the GO bonds with more narrowly defined revenue streams if bondholders are concerned about protection). The requirements for filing for Chapter 9 are sufficiently stringent,[101] and the reluctance of cities to file for bankruptcy sufficiently great, that opportunistic use of Chapter 9 to restructure GO bonds seems relatively unlikely.

VI. THE STATUS OF PUBLIC PENSION OBLIGATIONS

The status of public pension beneficiaries in municipal bankruptcy raises an analogous set of issues about liens and lien substitutes. The is-

98. *See* R.I. GEN. LAWS § 45-12-1(a) (West 2014).

99. *See, e.g.*, George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 925 (1993) (noting that priority status solves underinvestment concerns but can create an overinvestment problem).

100. It is worth noting that if Rhode Island is worried about bond contagion in the event its bond statute were not honored in a municipal bankruptcy, it has the option of refusing to permit its municipalities to file for Chapter 9. 11 U.S.C. § 109(c)(2) (2012) (requirement of state consent).

101. A municipal debtor must demonstrate that the municipality is insolvent and must meet several other requirements that do not apply to other types of bankruptcy filings. *Id.* § 109(c).

sues were especially subtle in the Detroit bankruptcy, due to a provision in the Michigan Constitution stating that a public pension cannot be diminished or impaired.[102] In this Part, I begin by exploring the issue whether the pension protection in the Michigan Constitution precludes restructuring. After concluding that the Detroit bankruptcy judge rightly determined it does not, I turn to the question whether pension beneficiaries are protected by a lien or lien substitute.

A. Does Michigan's Constitution Preclude Restructuring?[103]

In June, 2013, shortly before Detroit filed for bankruptcy, Emergency Manager Kevyn Orr filed a report that served as a rude awakening for many of Detroit's creditors, including its pension beneficiaries.[104] Orr had been appointed at the end of March, 2013, pursuant to controversial state provisions that permit the governor to select an emergency manager who would largely displace the mayor and city council if a city is in financial distress.[105] Contrary to the trustees of Detroit's two major pension funds, who claimed that the pensions were adequately funded, Orr's report estimated that they were underfunded by $3.5 billion.[106] Even more radically, Orr also insisted that the pensions would need to be reduced, a step that pension beneficiaries insisted is impossible under Michigan law.[107]

The key to the standoff between Detroit's emergency manager and the pension beneficiaries was a provision that was added to Michigan's Constitution in 1963. This provision states that accrued pension benefits "shall not be diminished or impaired."[108] To pension beneficiaries, the provision sounded like a trump card assuring that their pensions could not be touched. Outside of bankruptcy, they may have been right.[109] And properly funded pensions are probably protected even in bankruptcy. But if a city has failed to fully fund its pensions, the unfunded portion of the pension may be subject to restructuring in bankruptcy.

How can this conclusion be reconciled with Michigan's Constitution, with its very clear promise that pension benefits "shall not be dimin-

102. MICH. CONST. art. IX, § 24 ("The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby.").

103. Parts of this Section draw on the discussion in Skeel, *supra* note 2.

104. CITY OF DETROIT: PROPOSAL FOR CREDITORS (2013), *available at* http://www.detroitmi.gov/Portals/0/docs/EM/Reports/City%20of%20Detroit%20Proposal%20for%20Creditors1.pdf.

105. MICH. COMP. LAWS ANN. § 141.1549 (West 2014).

106. CITY OF DETROIT: PROPOSAL FOR CREDITORS, *supra* note 104, at 109.

107. I discuss many of the issues in this Section more fully in a white paper released a few weeks before the Detroit bankruptcy judge's ruling eligibility ruling. David A. Skeel Jr., *Can Pensions be Restructured in (Detroit's) Municipal Bankruptcy*, FEDERALIST SOC'Y WHITE PAPER (Oct. 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2360302.

108. MICH. CONST. ART. XXIV, sec. 9.

109. Even outside of bankruptcy, Detroit may have had some ability to adjust its pensions given the city's financial distress. The Supreme Court has long construed the Contracts Clause more flexibly in the context of a financial crisis. *See, e.g.*, Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942).

ished or impaired"? The simple answer is that federal law takes precedence over state law—even state constitutional law—under the Supremacy Clause of the U.S. Constitution.[110] Because the U.S. Constitution authorizes Congress to enact bankruptcy laws, and the municipal bankruptcy law that Congress has enacted permits a city to restructure its ordinary debts, the unfunded portion of a pension can be restructured even if state law seems to say pensions are sacrosanct.[111]

Although I have described bankruptcy as overriding Michigan's Constitution, this actually is an exaggeration. Michigan's prohibition against impairing pensions was not added with bankruptcy in mind at all. Prior to 1963, a pension promise was simply a "gratuity" in Michigan, as in many other states.[112] A city like Detroit could withdraw the promise at any time, even after a school teacher or fireman had worked for the city for decades and was about to retire. Michigan lawmakers wanted to put pension promises on sounder footing, by making them enforceable contractual obligations. This does not mean that the obligation could never be restructured, even in bankruptcy; it means that a city like Detroit cannot simply decide to withdraw its promise. Michigan lawmakers could have gone further, and forbidden even the most financially distressed city from filing for bankruptcy if they had wished to do so. Cities can only file for bankruptcy if their state consents to municipal bankruptcy filings.[113] This gave Michigan the power to just say no. But Michigan has permitted cities to file for bankruptcy since 1939, shortly after the first permanent municipal bankruptcy law was enacted.[114] Indeed, not only did Michigan authorize municipal bankruptcy, but Michigan lawmakers such as Frank Murphy—the mayor of Detroit, later governor, and then a U.S. Supreme Court justice—were among the most vigorous advocates for municipal bankruptcy in the 1930s.[115]

There also are strong normative grounds for the conclusion that pensions can be restructured, at least under some circumstances. One of the chief benefits of bankruptcy is that it distributes the sacrifice of financial distress more broadly and equitably than is the case if a city is left to its own devices. If pensions could never be restructured, the cost of paying beneficiaries in cities that have made unsustainable pension promises would be borne by other constituencies, such as service recipients.

The prospect of restructuring also may alter some of the perverse political incentives that have contributed to many cities' financial dis-

110. The Supremacy Clause states that the "Constitution, and the Laws of the United States . . . shall be the supreme Law of the Land." U.S. CONST. art. VI, § 2.

111. U.S. CONST. art. I, § 8, cl. 4; 11 U.S.C. § 109(c) (2012).

112. Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL'Y 617 (2012).

113. 11 U.S.C. § 109(c)(2).

114. MICH. COMP. LAWS § 141.201 (1948).

115. *See, e.g.*, *To Amend the Bankruptcy Act: Municipal and Private Corporations, Hearing Before the H. Comm. on the Judiciary*, 73d Cong. 84–92 (1933) (testimony of Hon. Frank Murphy, Mayor of the City of Detroit, Mich.).

tress. Although there are a variety of reasons for the current pension crisis, one of the biggest problems in many cities has been the absence of genuine bargaining over the terms of pension promises. Public employees obviously would prefer a giant pension to a modest one, but so too would the politicians who ostensibly bargain with them. In some cases, politicians are part of the same pension system; even if they are not, they often depend on the votes of employees who are.[116] Moreover, pension promises are commitments that can be made today but need not be paid until later. If an unsustainably generous pension can be restructured in bankruptcy, this gives employees much more of an interest in making sure that the pension promises are realistic, and that pensions are properly funded.

B. Do Pension Beneficiaries Have a Lien or Lien Substitute?

In the Detroit eligibility decision, Judge Steven Rhodes suggested that Detroit's pension beneficiaries do not have a security interest or other property interest and thus are simply unsecured claimants in the Detroit bankruptcy.[117] Strictly speaking, this statement seems accurate. But Detroit's pension beneficiaries were protected to the extent that funds were set aside by them or by Detroit for their pensions.[118]

Suppose that Detroit has promised $1000 in pension benefits to its pension beneficiaries, and that the beneficiaries and Detroit set aside $600 to fund these benefits, as of the date of Detroit's bankruptcy filing. They contributed these funds to Detroit's two major pension plans, the General Retirement System and the police and firefighters fund.[119] The pension beneficiaries might wish to claim that they have a security interest in the $600 in funds. The problem with this claim is that they have not taken any evident steps to create and perfect a security interest, and no Detroit or Michigan statute purports to give them a security interest in the funds or anything else.[120] It is possible that a court would conclude that the common law could create a lien on the funds, but Judge Rhodes' skepticism appears to be well-founded.

116. *See, e.g.*, Edward L. Glaeser & Giacomo A. M. Ponzetto, *Shrouded Costs of Government: The Political Economy of State and Local Public Pensions* 7–25 (Nat'l Bureau of Econ. Research Working Paper No. 18976, 2013), *available at* http://www.nber.org/papers/w18976 (model of political dynamics where public employees appreciate the value of pension benefits and ordinary voters do not).

117. Judge Rhodes pointed out that Michigan could have given pension beneficiaries a property interest or a security interest, or could have guaranteed the obligations, but did not. *In re* City of Detroit, 504 B.R. 97, 127 (Bankr. E.D. Mich. 2013).

118. This distinction is reflected in Detroit's reorganization plan, which addressed only the unfunded portion of pension beneficiaries' claims. *See* Third Amended Disclosure Statement, *supra* note 65, at 34–38 (including only the unfunded portion of the accrued benefits of the two pensions in classes 10 and 11 of the proposed plan).

119. RETIREMENT SYSTEMS OF THE CITY OF DETROIT, http://www.rscd.org (last visited Oct. 14, 2014).

120. Third Amended Disclosure Statement, *supra* note 65, at 34–38.

Even if there is no security interest, however, Detroit's pension beneficiaries' interest in the funds is protected in very similar fashion.[121] Detroit and its employees make their pension contributions to the two funds, which manage the money separately from Detroit's finances. The structure of the funds is defined by the Detroit city charter, which requires that the funds be overseen by trustees appointed by the city.[122] Under these circumstances, the funds are treated as being held in trust for the pension recipients.[123] Indeed, even if the structure did not qualify as a statutory trust, a court would likely conclude that Detroit and its creditors do not have any interest in the moneys contributed to the funds.[124] This is in fact precisely how Detroit handled the pensions in its debt adjustment plan: only the unfunded portion of the pensions was restructured.

An explicit trust is the most lien-like of the lien substitutes. Like a lien, it is relatively transparent; trust assets are partitioned from a debtor's other assets, and trust status has bite both inside and outside of bankruptcy. Yet even trusts differ from liens in several respects. Because the trust assets are owned by the beneficiary, not by the debtor, for instance, they are not subject to the automatic stay.[125] In theory, this means that the beneficiaries have complete access to the assets, even in bankruptcy.[126]

It is important to emphasize that the status of funds contributed by a city and its pension recipients will depend on how the pension is struc-

121. In earlier writing on pensions in bankruptcy, I analogized pension beneficiaries' interest in the funded portion of their pensions to a security interest. *See* David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 692 (2012). As the text suggests, in the absence of state law creating a statutory or common law lien, I think it more likely that the funds will be treated as property held in trust for the beneficiaries.

122. CHARTER OF THE CITY OF DETROIT, art. 11, § 11-103.

123. As noted earlier, Detroit's reorganization plan was consistent with this intuition. *See supra* note 118.

124. In cases involving funds set aside in similar fashion in Chapter 11 cases, courts have held that the funds are not property of the estate. For instance, courts have enforced restrictions on grants to nonprofit hospitals and other charitable organizations. *See, e.g.*, *In re* Joliet-Will Cnty. Cmty. Action Agency, 847 F.2d 430, 434–35 (7th Cir. 1988) (restricted grants made by federal and state agencies were not property of the debtor's estate); Hunter v. St. Vincent Med. Ctr. (*In re Parkview Hospital*), 211 B.R. 619 (Bankr. N.D. Ohio 1997) (funds donated to hospital for a particular purpose were not property of the hospital's bankruptcy estate).

125. Hynes and Walt point out several additional distinctions: when a secured creditor's collateral is worth more than the creditor is owed, the creditor is nevertheless only entitled to the amount it is owed. The excess value belongs to the debtor. With a trust, the assets belong entirely to the beneficiaries. Hynes & Walt, *supra* note 39, at 651. In addition, trust assets are not subject to the automatic stay, *id.* at 652, and the grounds for avoidance of liens and trusts by a bankruptcy trustee are somewhat different. *Id.* at 657–59.

126. In contrast to an express trust, which is quite similar to a lien, constructive trusts are considerably less transparent. A debtor's other creditors often have no reason to be aware that some of the debtor's property is subject to a constructive trust for a particular creditor or other party. Courts tend to view constructive trust claims with skepticism. *See, e.g.*, XL/Datacomp, Inc., v. Wilson (*In re* Omegas Group, Inc.), 16 F.3d 1443, 1452 (6th Cir. 1994) ("Constructive trusts are anathema to the equities of bankruptcy since they take from the estate, and thus directly from competing creditors, not from the offending debtor."). *But see In re* Mississippi Valley Livestock, Inc., 745 F.3d 299, 305–08 (7th Cir. 2014) (criticizing *Omegas* and suggesting it may sometimes be appropriate to impose a constructive trust).

tured. If the pension contributions are not separated from a municipality's general funds in any way, they may not be treated as subject to a trust. And even if commingled contributions are found to be held in trust, courts often require that the funds be traced.[127]

Other pension arrangements raise still other kinds of issues. California is especially interesting in this regard. Most California cities—including San Bernardino and Stockton, each of which is currently in bankruptcy—are part of the statewide CalPERS system. CalPERS insists that these pensions cannot be restructured, even though Detroit could and did restructure its pensions, because CalPERS is an arm of the California government.[128] In the Stockton case, the bankruptcy judge rejected CalPERS's arguments, stating from the bench and then in a written opinion that Stockton could restructure its obligations to the pension beneficiaries. But Stockton nevertheless declined to adjust the pensions, arguing that the city would incur steep costs if it did.[129]

VII. CONCLUSION

Municipal liens are in some respects quite different than liens in other contexts. In a traditional lending relationship, loans are secured by a lien on hard assets such as equipment and real estate. Municipal creditors, by contrast, are usually given liens on revenues of various kinds. Most do not take lien on hard assets, in part because the lien would not be enforceable against any property that has a public function.

Although some might suspect that these differences limit the relevance of municipal lien issues, in my view quite the opposite is the case. The variations in the nature of liens offer valuable insights into the role that liens and lien substitutes play, and the choices the parties make when they are structuring their transactions. Given the emphasis on revenues rather than hard assets, for instance, it is not surprising that municipal creditors often rely on trust arrangements rather than traditional liens.

I have devoted much of my attention in this Article to the status of general obligation bonds and of pensions, each of which has been the

127. *See, e.g.*, Cnty. of Orange v. Merrill Lynch & Co. (*In re* Cnty. of Orange), 191 B.R. 1005, 1016 (Bankr. C.D. Cal. 1996) (holding that tracing obligation applies to express as well as constructive trusts, and that this "is necessary to further the Bankruptcy Code's policy of equal distribution among similarl[y] situated creditors").

128. *See, e.g.*, Peter Mixon, Summary of CalPERS Legal Position in Municipal Bankruptcies ¶ 6 (Sept. 12, 2012) ("The relationship between CalPERS and a municipal employer is not a mere commercial contract between a creditor and a debtor. Instead, it is an aspect of the State's control over a municipality that is protected from interference under constitutional principles and federal bankruptcy law."); David B. Brandolph & Florence Olsen, *Detroit Bankruptcy Filing Raises Constitutional Issues, Could Affect Other Plans*, BLOOMBERG BNA PENSION & BENEFITS DAILY (Aug. 12, 2013), http://www.ncpers.org/files/BBNA%20DETROIT%20STORY.pdf (discussing comparisons between Detroit's restructuring plan and CalPERS's stance on the federal court's ability to preempt state law protecting CalPERS beneficiaries).

129. *See, e.g.*, Dale Kasler, *Appeal Threatens Stockton Bankruptcy Ruling on* Pensions, SACRAMENTO BEE, Nov. 14, 2014, http://www.sacbee.com/news/business/article3932965.html; *In re* City of Stockton, California, Case No. 12-32118 (Bankr. E.D. Cal. Feb. 4, 2015).

subject of considerable uncertainty in recent municipal bankruptcy cases. Much of the analysis has been descriptive. I concluded that traditional GO bondholders are simply general creditors, despite the municipal debtor's "pledge" of its "full faith and credit" to support the bonds. I also concluded that pensions can be restructured in bankruptcy, even if the state constitution protects them, but that pension beneficiaries may be entitled to the funds that have been set aside on their behalf.

While drawing these descriptive conclusions, I also suggested a variety of normative implications. I argued the unsecured status of traditional GO bonds and the susceptibility of pensions to at least some restructuring can have beneficial normative effects. At least on the margin, each counteracts problematic political incentives. The vulnerability of GO bonds may discourage excessive borrowing, and the prospect of pension restructuring may lead to pressure for more realistic funding of pensions. I also defended a functional approach to the treatment of liens and lien substitutes, and argued that it is appropriate to have somewhat different rules in bankruptcy than apply outside of bankruptcy in the contexts I have considered.