

## States of Bankruptcy

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*In the past several years, many states' financial condition has been so precarious that some observers have predicted that one or more might default. As the crisis persisted, a very unlikely word crept into these conversations: bankruptcy. Should Congress provide a bankruptcy option for states, or would bankruptcy be a mistake? The goal of this Article is to carefully vet this question, using all of the theoretical, empirical, and historical tools currently available. The discussion is structured as a "case" for bankruptcy rather than an "on the one hand, on the other hand" assessment. But it seeks to be scrupulously fair and reaches several conclusions that veterans of the public and scholarly debate may find surprising.*

*The Article proceeds as follows. Part I briefly develops the theoretical basis for state bankruptcy. Part II explores each of six key benefits of a state-bankruptcy regime. Part III then turns to six principal objections, considering each in detail. After analyzing the response to New York City's 1975 crisis and a number of states' enactment of municipal-oversight boards, Part IV focuses on the possibility of an analogous federal oversight alternative to a more general bankruptcy statute. Although bankruptcy seems superior overall, the oversight strategy would offer some of the same benefits if Congress failed to enact a bankruptcy law before a state crisis materialized.*

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## INTRODUCTION

In the early decades of the Republic, the prospect of an American state defaulting on its obligations was a real and present threat. After the Panic of 1837, and again after the Civil War, states did just that.<sup>1</sup> So notorious were the states that they were lampooned in fiction and verse. To Scrooge, the tightfisted hero of Charles Dickens's *A Christmas Carol*, bills of exchange for which the payment has been delayed were like "a mere United States security."<sup>2</sup> William Wordsworth devoted an entire sonnet to this theme. "All who revere the memory of Penn," the speaker of "To the Pennsylvanians" concludes,

Grieve for the land on whose wild woods his name  
Was fondly grafted with a virtuous aim,  
Renounced, abandoned by degenerate Men  
For state-dishonour black as ever came  
To upper air from Mammon's loathsome den.<sup>3</sup>

<sup>1</sup> The story of these defaults and the bondholders' efforts to collect is told in John Orth's delightful doctrinal history of state sovereign immunity. John V. Orth, *The Judicial Power of the United States: The Eleventh Amendment in American History* 3-5 (Oxford 1987).

<sup>2</sup> Charles Dickens, *A Christmas Carol* 36 (Crowell 1924) (expressing Scrooge's great relief that night had not permanently taken possession of the world, as time-sensitive bills of exchange would be as worthless as US securities "if there were no days to count by"). For a brief discussion of this quote, see Orth, *The Judicial Power of the United States* at 3 (cited in note 1).

<sup>3</sup> William Wordsworth, "To the Pennsylvanians" (1845), in 8 *The Poetical Works of William Wordsworth* 164, 164 (William Paterson 1885) (William Knight, ed).

The offense? Pennsylvania's default on its state debt in 1841.<sup>4</sup>

Until recently, these episodes seemed like relics from a primordial time. The nineteenth-century state defaults that aroused such ire occurred before American markets and industry were fully developed, and many were linked to the peculiar circumstances of the Civil War and its aftermath.<sup>5</sup> In the twentieth century, only a single state defaulted on its debt,<sup>6</sup> and few others threatened to follow suit.<sup>7</sup>

In the past several years, however, the possibility of a state default has begun to look a little less imaginary. Projecting a \$25 billion deficit last year, California Governor Arnold Schwarzenegger proposed to sell the San Francisco Civic Center and other state properties to raise funds.<sup>8</sup> Facing its own large deficit and enormous shortfalls in its public employee pensions, Illinois passed a major tax increase.<sup>9</sup> Both states remain in precarious financial condition, and they have plenty of company.<sup>10</sup>

As the crisis persisted, a very unlikely word crept into conversations about the states' financial predicament: bankruptcy. Starting in late 2010, a few politicians and commentators insisted that state bankruptcy was an idea whose time had now come.<sup>11</sup> So long as the statute was entirely voluntary and did not interfere with governmental decision making, they proposed, it should satisfy any

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<sup>4</sup> See Michael Waibel, *Sovereign Defaults before International Courts and Tribunals* 3–4 (Cambridge 2011).

<sup>5</sup> See, for example, Orth, *The Judicial Power of the United States* at 5 (cited in note 1).

<sup>6</sup> Arkansas defaulted during the Great Depression. See Monica Davey, *The State That Went Bust*, NY Times WK3 (Jan 23, 2011) (analyzing Arkansas's 1933 default).

<sup>7</sup> Probably the last serious discussion of possible state default prior to the recent financial crisis came during New York City's crisis in 1975. Many thought that if New York City collapsed, the state might also default on its obligations. The New York crisis is discussed in Part IV.B.

<sup>8</sup> See, for example, Elizabeth Lesly Stevens, *States Poised to Sell Trophy Buildings to Unidentified Investors*, NY Times A33A (Dec 26, 2010) (projecting sale of state office complexes to raise \$1.3 billion). Governor Jerry Brown later canceled the sales. See Shane Goldmacher, *State's Sale of Buildings is Canceled; Brown Says the Deal, Meant to Help Plug the Budget Gap, Would Have Been Far Too Costly in the Long Run*, LA Times AA1 (Feb 10, 2011).

<sup>9</sup> See Monica Davey, *Questions Persisting as Illinois Raises Taxes*, NY Times A16 (Jan 13, 2011).

<sup>10</sup> See Dave McKinney, *Watchdog Group: State Deficit to Grow to \$5 Billion*, Chi Sun-Times 26 (Sept 26, 2011); Adam Nagourney, *Budget Crisis Is Worse, California Legislators Are Told*, NY Times A29 (Dec 9, 2010).

<sup>11</sup> See, for example, Jeb Bush and Newt Gingrich, *Better Off Bankrupt: States Should Have the Option of Bankruptcy Protection to Deal with Their Budget Crises*, LA Times A19 (Jan 27, 2011); David Skeel, *Give States a Way to Go Bankrupt*, Weekly Standard 11 (Nov 29, 2010); David Skeel, *A Bankruptcy Law—Not Bailouts—for the States*, Wall St J A17 (Jan 18, 2011).

constitutional concerns. After all, municipal bankruptcy has long been deemed constitutional if it satisfies these criteria and gives states the power to forbid their municipalities from invoking the law.<sup>12</sup> Advocates argued that bankruptcy would be preferable to either a complete default or a federal bailout, the two existing options in the event a state's financial distress spiraled out of control.<sup>13</sup>

Not everyone agreed. The Center on Budget and Policy Priorities rushed out a report contending that the crisis was largely just a short-term problem caused by cities' and states' loss of revenue due to the Great Recession. While "states and localities are struggling to maintain needed services," its authors argued, "this is a cyclical problem that ultimately will ease as the economy recovers."<sup>14</sup> A representative of the National Governors Association warned the Senate Budget Committee that "no governor or state is requesting this [ ] authority, and it is also true that such authority will likely increase interest rates, raise the cost of state government, and create more volatility in the financial markets."<sup>15</sup>

Should Congress provide a bankruptcy option for states, or is the idea misguided? The goal of this Article is to carefully vet this question, using all of the theoretical, empirical, and historical tools currently available. The discussion is structured as a "case" for bankruptcy rather than an "on the one hand, on the other hand" assessment. But I will be as scrupulously fair as I can, reaching several conclusions that veterans of the public and scholarly debate may find surprising—such as a conclusion that an ad hoc restructuring similar to the approach used for New York City in 1975 is a plausible though imperfect alternative to a prespecified bankruptcy framework.

Many people recoil at the word "bankruptcy," especially in this context. It is tempting to use a different term, such as a "state debt

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<sup>12</sup> See *United States v Bekins*, 304 US 27, 51–54 (1938). Because cities and other municipalities are subdivisions of a state, federal bankruptcy of a municipality raises the same issues as bankruptcy of a state. Municipal bankruptcy is currently housed in Chapter 9 of the Bankruptcy Code. See 11 USC § 901 et seq.

<sup>13</sup> See, for example, Skeel, *A Bankruptcy Law* at A17 (cited in note 11); Bush and Gingrich, *Better Off Bankrupt* at A19 (cited in note 11).

<sup>14</sup> Iris J. Lav and Elizabeth McNichol, *Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm 1* (Center on Budget and Policy Priorities Jan 20, 2011), online at <http://www.cbpp.org/cms/index.cfm?fa=view&id=3372> (visited Nov 26, 2011).

<sup>15</sup> See Barrie Tabin Berger, *Telling the Truth about State and Local Finance*, 27 *Gov Fin Rev* 79, 80 (Apr 2011), quoting Senate Budget Committee, *The Fiscal Situation 9* (Feb 3, 2011), online at [http://budget.senate.gov/democratic/index.cfm/files/serve?File\\_id=e3f68489-487f-4489-98e6-8e61fa20cae8](http://budget.senate.gov/democratic/index.cfm/files/serve?File_id=e3f68489-487f-4489-98e6-8e61fa20cae8) (visited Nov 24, 2011).

adjustment framework,” to sidestep the negative associations.<sup>16</sup> Altering the terminology also would highlight the distinction between state bankruptcy and other, more familiar forms of bankruptcy; and it might counteract the tendency to envision bankruptcy in monolithic terms, as a single framework rather than a wide range of possible restructuring mechanisms. Despite these benefits, I will use “bankruptcy” throughout the Article. In addition to its familiarity, “bankruptcy” has the added virtue of being the language employed by the US Constitution.<sup>17</sup>

My embrace of the traditional term begs the question of just what bankruptcy is. The Supreme Court has never fully defined its scope, and commentators rarely stop to examine its contours.<sup>18</sup> In its most important early case, *Sturges v Crowninshield*,<sup>19</sup> the Court made clear that the Bankruptcy Clause gives Congress the power to marshal some or all of the debtor’s assets to pay its creditors, and to discharge some or all of the debtor’s obligations.<sup>20</sup> Interestingly, the Court did not state in this case, and has never explicitly held since, that insolvency is a prerequisite for bankruptcy. Over time, bankruptcy has come to include nearly any reasonably comprehensive framework for adjusting a debtor’s obligations, devoting some or all of a debtor’s available assets (if any) to repayment of creditors, and giving the debtor a discharge.<sup>21</sup> A law

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<sup>16</sup> One cannot be sure that the stratagem would work, however. Chapter 9’s official title is “Adjustment of Debts of a Municipality,” but it is universally known as municipal bankruptcy. See 11 USC § 901 et seq.

<sup>17</sup> US Const Art I, § 8, cl 4 gives Congress the power “to establish . . . uniform Laws on the subject of bankruptcies throughout the United States.”

<sup>18</sup> Even experts sometime trip themselves up on the terminology. Bankruptcy lawyer James Spiotto condemned the idea of bankruptcy for states at the outset of his 2011 legislative testimony as a mistake that “would create practical problems and face legal obstacles,” for instance, but then went on to propose that Congress consider adopting a framework similar to the Sovereign Debt Restructuring Mechanism (SDRM) the International Monetary Fund (IMF) proposed for sovereign debt in the early 2000s. *Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter, Hearing before the Subcommittee on Courts, Commercial, and Administrative Law of the House Committee on the Judiciary*, 112th Cong, 1st Sess 57, 69 (2011) (prepared statement of James Spiotto) (“State Insolvency Hearings”). By any ordinary definition of bankruptcy, the SDRM is a bankruptcy framework.

<sup>19</sup> 17 US (4 Wheat) 122 (1819).

<sup>20</sup> *Id.* at 192–96. In *Sturges*, the Court defined bankruptcy to include both bankruptcy laws, which historically had discharged the debtors after their assets were distributed to creditors, and insolvency laws, which released a debtor from prison. *Id.*

<sup>21</sup> For a short and still useful discussion of the Supreme Court’s expanding interpretation of the Bankruptcy Clause, see Frank R. Kennedy, *Bankruptcy and the Constitution*, in *Blessings of Liberty* 131, 137–38 (ALI/ABI 1988) (characterizing the caselaw as “com[ing] close to permitting Congress complete freedom in formulating and enacting bankruptcy legislation”). For the most complete treatment of Congress’s bankruptcy authority, see

authorizing the restructuring of one class of creditors or imposing a moratorium on creditors' rights therefore is not a bankruptcy law. When I speak of state bankruptcy, I thus have a more comprehensive framework in mind.

Although Congress can enact related provisions—such as a moratorium on debt repayment—under its Commerce Clause powers, the question whether a particular law is or is not a “bankruptcy” law is not simply playing with words. Laws that alter the parties' nonbankruptcy entitlements are likely to be subject to more searching scrutiny under the Contracts and Takings Clauses of the Constitution, for instance, if they are not enacted under the Bankruptcy Clause.<sup>22</sup> The Supreme Court has also given Congress more flexibility to “pierce” state sovereign immunity under the Bankruptcy Clause than the Commerce Clause.<sup>23</sup> My focus throughout the Article will be on a framework that is sufficiently comprehensive to constitute a true bankruptcy law.<sup>24</sup>

Because the concept of state bankruptcy is so novel, I will start at the beginning by showing how state bankruptcy might be justified in theoretical terms. For the past three decades, most American bankruptcy scholars have understood bankruptcy as a response to collective action problems, thanks to pioneering work by Douglas Baird and Thomas Jackson.<sup>25</sup> Because creditors cannot effectively coordinate, the reasoning goes, they might dismember an otherwise viable firm as each creditor rushed to collect if bankruptcy did not put a halt to these individual collection efforts.<sup>26</sup> This rationale is a weak fit for states, because it is quite difficult for creditors to coerce

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Jonathan C. Lipson, *Debt and Democracy: Towards a Constitutional Theory of Bankruptcy*, 83 *Notre Dame L Rev* 605, 612–614 (2008).

<sup>22</sup> See, for example, James S. Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship between the Fifth Amendment and the Bankruptcy Clause*, 96 *Harv L Rev* 973, 997–98 (1983).

<sup>23</sup> See, for example, *Central Virginia Community College v Katz*, 546 US 356, 378 (2006).

<sup>24</sup> In other work, I have outlined the terms of such a law in more technical detail. David A. Skeel Jr., *State Bankruptcy from the Ground Up*, in Peter Conti-Brown and David A. Skeel Jr., eds, *When States Go Broke: Origins, Context, and Solutions for the American States in Fiscal Crisis* \*4–8 (forthcoming Cambridge 2012).

<sup>25</sup> See, for example, Thomas H. Jackson, *Bankruptcy, Non-bankruptcy Entitlements, and the Creditors' Bargain*, 91 *Yale L J* 857, 859–71(1982); Douglas G. Baird and Thomas H. Jackson, *Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 *U Chi L Rev* 97, 106 (1984).

<sup>26</sup> Jackson, 91 *Yale L J* at 862 (cited in note 25).

payment from a state.<sup>27</sup> Whatever collective action problems a state faces are quite limited.

To understand the logic of state bankruptcy we need to change categories. The relevant analogy is not corporate bankruptcy so much as *personal* bankruptcy.<sup>28</sup> States are like people. When they find themselves in an insoluble financial predicament, it is often because of systematic distortions in their decision making. Both state politicians and individuals tend to overweight the present and pay insufficient attention to potential future consequences.<sup>29</sup> As with a person, and unlike with a corporation, the decision maker cannot be displaced in bankruptcy. Instead, bankruptcy can restructure an unsustainable debt load that would otherwise have left both the debtor and its creditors worse off. Seen from this perspective, state bankruptcy looks quite different than is commonly assumed.

Having laid the theoretical groundwork, I outline six potential benefits of state bankruptcy, ranging from several that apply even outside bankruptcy—such as increased leverage to restructure a state's obligations—to others that would arise only if the bankruptcy option were invoked. By reducing subsidies for borrowing, among other things, bankruptcy would counteract state politicians' incentives to ignore the long-term costs of fiscal profligacy. It also would assure a more equitable distribution of the pain of financial crisis. Current ad hoc approaches, such as recent reforms in Wisconsin, Ohio, and other states,<sup>30</sup> usually visit the sacrifice on one or two constituencies—often state employees and the recipients of social services. Bankruptcy would bring a broader range of constituencies to the restructuring table.

Although state bankruptcy's benefits are considerable, critics have raised a number of plausible objections, some of which require careful attention. Two of the most powerful are (1) that states

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<sup>27</sup> A state is protected from most creditor litigation by sovereign immunity under the Eleventh Amendment. See US Const Amend XI. See, for example, *Magnolia Venture Capital Corp v Prudential Securities, Inc*, 151 F3d 439, 443 (5th Cir 1998).

<sup>28</sup> I am not the first to observe that sovereigns are similar to individuals for bankruptcy purposes. For a version of this argument in the sovereign debt context, see Robert K. Rasmussen, *Integrating a Theory of the State into Sovereign Debt Restructuring*, 53 Emory L J 1159, 1163–64 (2004).

<sup>29</sup> The decision-making biases of individuals and states are not identical, of course. They differ in that miscalculation figures prominently with individuals, whereas politicians have an incentive to frontload benefits even if they are fully aware of the implications for the future because they are not likely to be the ones who will bear the future costs. See Clayton P. Gillette, *Fiscal Home Rule*, 86 Denver U L Rev 1241, 1256 (2009).

<sup>30</sup> See, for example, Monica Davey and Richard A. Oppel Jr, *Wisconsin Budget Would Slash School and Municipal Aid*, NY Times A16 (Mar 2, 2011); Amy Merrick and Kris Maher, *Ohio Governor Poses Steep Budget Cuts*, Wall St J A4 (Mar 16, 2011).

already have adequate tools to address their financial distress, as evidenced by the measures that have been taken in Wisconsin and other states, and (2) that bankruptcy might create contagion in the bond markets, making it difficult for even fiscally responsible states to borrow money. In each case, I show that the objections are less compelling than they initially appear. The likelihood that most states can muddle through does not justify ignoring the very low probability of a catastrophic failure. And the empirical evidence on bond market contagion suggests that fears of a state bond crisis are greatly overstated. Indeed, they echo the dire warnings that were made when municipal bankruptcy was first proposed in the 1930s, as well as the claims that are regularly made by creditors facing regulation.<sup>31</sup>

Traditional bankruptcy is not the only option for restructuring a state's finances in the event of catastrophic financial distress. In the final part of the Article, I consider an important alternative. In 1975, as New York City fell into financial distress, New York State put a financial control board and other reforms in place and Congress provided \$2.3 billion in loan guarantees. A number of other states have subsequently enacted legislation authorizing intervention by a municipal-control board to oversee financially troubled cities. Although Congress has much less authority over states than states have over their municipalities due to federalism constraints, lawmakers could implement a similar approach so long as the state agreed to the intervention in return for federal funding. This is the model Congress used with New York City, and it is a familiar feature of programs such as Medicaid and welfare. There are a variety of risks to this approach, as with any resolution that is not prespecified, but it is not altogether implausible. To explore these points and complete the analysis of state bankruptcy, I consider the strategic incentives of Congress and a troubled state that seeks federal support under each scenario.

The Article proceeds as follows. Part I briefly develops the theoretical basis for state bankruptcy. In Part II, I explore each of the six key benefits of a state-bankruptcy regime. I then turn in Part III to six principal objections, considering each in detail. Part IV

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<sup>31</sup> When the first municipal bankruptcy law was enacted in 1934, critics claimed that “the very novelty of the thing will adversely affect the municipal bond market’ and ‘would act as a drag on the sale of municipal securities and might demand a higher rate of interest on such securities.’” Jonathan S. Henes and Stephen E. Hessler, *Deja Vu, All over Again*, 245 NY L J S6 (June 27, 2011), quoting *Amend the Bankruptcy Act—Municipal Indebtedness*, HR Rep No 207, 73d Cong, 2d Sess 4, 6 (1933) (minority views) and *To Amend the Bankruptcy Act—Municipal Indebtedness*, S Rep No 407, 73d Cong, 2d Sess 4, 4 (1934) (minority views).

focuses on the Federal Oversight Board alternative to a more general bankruptcy statute. I briefly summarize the analysis in the Conclusion.

### I. THE THEORETICAL FOUNDATION(S)

We begin with bankruptcy theory—and an apparent conundrum. According to its usual theoretical justification, bankruptcy solves a collective action problem.<sup>32</sup> Even if a troubled business is worth more as a going concern, a destructive “grab race” that forces liquidation may nevertheless ensue if the company falls into financial distress.<sup>33</sup> It is rational for a creditor to grab assets, even if this may cause an inefficient liquidation, because the creditor will be even worse off if it refrains but other creditors do not.<sup>34</sup> By putting a halt to collection activities and providing a collective forum for resolving the company’s financial distress, bankruptcy solves this conflict between the incentives of individual creditors, on the one hand, and the collective good, on the other.<sup>35</sup> The contemporary finance literature makes the point in a slightly different way: bankruptcy is justified because creditors may insist on tough contractual terms that may force an inefficient liquidation if the debtor is in financial distress.<sup>36</sup>

The conundrum is this: if bankruptcy’s signal benefit is avoiding an inefficient and ill-advised liquidation, as these theories suggest, then the rationale does not apply to states. Thanks to sovereign immunity, states do not face the same risk of liquidation as corporations. If California or Illinois defaults, its creditors cannot

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<sup>32</sup> Jackson, 91 Yale L J at 859–71 (cited in note 25); Baird and Jackson, 51 U Chi L Rev at 106 (cited in note 25).

<sup>33</sup> The danger of a “race to the courthouse” was already a theme in bankruptcy discussions in the late nineteenth century, but Jackson was the first to incorporate it into a general theory of bankruptcy. See *Davis v Schwartz*, 155 US 631, 636 (1895).

<sup>34</sup> See, for example, Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* 10 (Harvard 1986) (“The basic problem that bankruptcy law is designed to handle, both as a normative matter and as a positive matter, is that the system of individual creditor remedies may be bad for the creditors *as a group* when there are not enough assets to go around.”).

<sup>35</sup> Subsequent scholars questioned the scope of the collective action problem, see, for example, Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U Chi L Rev 645, 678–79 (1992) (arguing that collective action problems can be removed by nimble use of security interests), and proposed a variety of alternatives to the reorganization provisions in Chapter 11, see, for example, Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 Harv L Rev 775, 785 (1988). These debates are tangential to the present discussion, other than to underscore that collective action problems are not the only rationale for bankruptcy.

<sup>36</sup> See, for example, Javier Suarez and Oren Sussman, *Financial Distress, Bankruptcy Law and the Business Cycle*, 3 Annals Fin 5, 6–7 (2007).

seize the capitol building in Sacramento or Springfield, or take over state property in the Sierra Nevadas.<sup>37</sup> We should not get carried away with this point. A state's response to financial distress can look a lot like a liquidation. California was poised to sell \$1.3 billion of its public properties until Governor Jerry Brown called the sales off.<sup>38</sup> Many states have cut back sharply on public libraries and social programs.<sup>39</sup> These cuts may destroy synergies—such as the networks developed in connection with an antipoverty or prison-release program—in ways that echo, at least loosely, the inefficient liquidation of a business.

The obvious distinction between the measures just noted and the grab race of traditional bankruptcy lore is that the states, not their creditors, determine which assets will be sold and which programs cut. A state's creditors have far less ability to seize state assets themselves than the creditors of a private business. Unlike most sovereign debtors, states apparently do not generally waive their sovereign immunity when they issue bonds, and even if they did, it still would be very difficult to pursue the state or its assets in court in the event of a default.<sup>40</sup> While creditors are not altogether bereft of collection options, they cannot march into court, obtain a judgment, and seize assets in the same way as the creditors of a private corporation. The Eleventh Amendment prevents creditors from suing a state in federal court. Although a creditor could sidestep this obstacle by suing an officer of the state in her personal capacity, the creditor would not be entitled to damages if the funds would come from the state treasury, and the officer could evade a mandamus action seeking to compel performance of the contract by simply resigning.<sup>41</sup> Given the obstacles to collection, the most familiar

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<sup>37</sup> See US Const Amend XI. Theoretically, creditors do have remedies in some circumstances. But these remedies generally can be evaded, as discussed below.

<sup>38</sup> See note 8 and accompanying text.

<sup>39</sup> See, for example, Michael Kelley, *In California, All State Funding for Public Libraries Remains in Jeopardy*, *Library J* (July 5, 2011), online at [http://www.libraryjournal.com/lj/home/891201-264/in\\_california\\_all\\_state\\_funding.html.csp](http://www.libraryjournal.com/lj/home/891201-264/in_california_all_state_funding.html.csp) (visited Nov 26, 2011); Michael Kelley and Lynn Blumenstein, *Newsdesk*, *Library J* (Mar 15, 2011), online at [http://www.libraryjournal.com/lj/ljinprintcurrentissue/890115-403/newsdesk\\_may\\_15\\_2011.html.csp](http://www.libraryjournal.com/lj/ljinprintcurrentissue/890115-403/newsdesk_may_15_2011.html.csp) (visited Nov 24, 2011); Erik Eckholm, *States Slashing Social Programs For Vulnerable*, *NY Times A1* (Apr 12, 2009).

<sup>40</sup> See, for example, Steven L. Schwarcz, *A Minimalist Approach to State 'Bankruptcy'*, 59 *UCLA L Rev* 322, 344 n 68 (2011) ("A review of randomly selected state bond indentures and state statutes revealed no effective waivers by states of sovereign immunity in federal court.").

<sup>41</sup> See, for example, Robert S. Amdursky and Clayton P. Gillette, *Municipal Debt Finance Law: Theory and Practice* § 5.4.1 (Little, Brown 1992) (describing states' and municipalities' ability to evade even mandamus actions). See also *City of Grass Valley v Walkinshaw*, 212 P2d 894, 898 (Cal 1949).

justification for bankruptcy thus does not seem to fit states especially well.

Avoiding inefficient liquidation is not the only justification for bankruptcy, however. The standard justification explains one key component of bankruptcy law—the injunction against enforcement by creditors. But bankruptcy may also be necessary to solve a debt overhang problem.<sup>42</sup> A debtor—whether it be an individual, a business, or a state—may find it impossible to borrow funds, even if it has promising future prospects, if it has a large amount of existing debt. Unless a new lender can insist on priority status, its new loan may be soaked up by existing obligations and thus simply subsidize other creditors.<sup>43</sup> If this is the reality, the debtor won't be able to borrow. Bankruptcy can break the impasse by enabling the debtor to scale down its obligations so that it can fund profitable future ventures.

Inefficient liquidation and debt overhang are not simply interchangeable justifications for bankruptcy. Inefficient liquidation may loom large in some contexts—as with farms or financial institutions—while debt overhang is central with others, such as nineteenth-century railroads.<sup>44</sup> This is one reason we see different approaches to financial distress in different countries, or with different industries in the same country.<sup>45</sup> If the liquidation option is *absent*, as with a state, its very absence magnifies the significance of debt overhang. In this sense, a state is more like an *individual* than a corporation. If a corporation makes cars no one wants or books that can be bought more cheaply elsewhere, it can simply be shut down. Not so with a state or a person. State sovereignty and its analogue for individuals, autonomy, imply a presumption—perhaps nearly a

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<sup>42</sup> Indeed, American corporate reorganization arguably developed as a response to precisely this problem. For a classic article examining railroad receivership, the nation's first corporate reorganization framework, in these terms, see Peter Tufano, *Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century*, 71 *Bus Hist Rev* 1, 8–9 (1997).

<sup>43</sup> The classic analysis is Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 *J Fin Econ* 147, 154 (1977).

<sup>44</sup> Inefficient liquidation was less likely with nineteenth-century railroads than with other businesses because every constituency agreed that railroads were worth more as ongoing enterprises than in liquidation. See, for example, David A. Skeel Jr, *Debt's Dominion: A History of Bankruptcy Law in America* 60–63 (Princeton 2001) (identifying this as one of the major factors that spurred the creation of railroad receivership).

<sup>45</sup> See David A. Skeel Jr, *The Law and Finance of Bank and Insurance Insolvency Regulation*, 76 *Tex L Rev* 723, 725 (1998) (contrasting procedures used to resolve bank and insurance company insolvencies to corporate reorganization under Chapter 11).

conclusive one—that debt overhang problems must be solved in order to free up the debtor’s future prospects.<sup>46</sup>

Debt overhang obviously does not arise quite so easily and irreversibly in states as with an individual. Because states, unlike individuals, have evergreen sources of income, thanks to taxes and other revenues, they may be able to handle debt burdens that initially appear to be oppressive.<sup>47</sup> But a state’s capacity to tax is not infinite. Residents can evade high tax burdens by moving to another state, and residents may be tempted to avoid oppressive tax rates illegally.<sup>48</sup> The history of state financial crises in the past,<sup>49</sup> and the more recent analogue in countries’ financial crises, show that debt overhang is a real issue and can have devastating consequences unless it is relieved.<sup>50</sup>

States are like individuals in another respect as well. In each case, systemic decision-making biases often figure prominently in the debtor’s financial distress. More surprising still, the nature of the dysfunction is quite similar. Consumer debtors tend to underestimate the likelihood and magnitude of future costs;<sup>51</sup> politicians have strong incentives to spend in the present and push their repayment to the future.<sup>52</sup> At first glance, bankruptcy does not seem to address either problem. Unlike a corporate bankruptcy, which shifts decision-making authority from a firm’s shareholders to its creditors and often leads to changes in management,<sup>53</sup> personal bankruptcy does

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<sup>46</sup> This is true even though “contracts in general and debt contracts in particular define only a sliver of any state’s constituents,” as Anna Gelpern argues. Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt*, 121 Yale L J 888, 907 (2012).

<sup>47</sup> See, for example, Conor Dougherty, *Higher Taxes Lift State Collections*, Wall St J A4 (June 29, 2011) (suggesting that an increase in tax revenues has counteracted state fiscal crisis to some extent).

<sup>48</sup> See, for example, Andrew Haughwout, et al, *Local Revenue Hills: Evidence from Four U.S. Cities*, 86 Rev Econ & Stat 570, 570–71 (2004).

<sup>49</sup> See, for example, Waibel, *Sovereign Defaults* at 3–4 (cited in note 4).

<sup>50</sup> Greece is the obvious current example. As I initially wrote these words, there were photos on the front pages of the major newspapers of Athens streets engulfed in flames as protesters rioted in response to proposed austerity measures demanded by Europe and the International Monetary Fund. See, for example, Alkman Granitsas, *Greece Erupts over Austerity*, Wall St J A1 (June 29, 2011) (reporting violent protests and general strikes in response to parliamentary debate on \$40 billion in austerity measures).

<sup>51</sup> Tom Jackson was the first to identify decision-making biases as a key reason for personal bankruptcy. Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 Harv L Rev 1393, 1404–05 (1985) (arguing that consumers “systematically fail to pursue their own long-term interests when making decisions”).

<sup>52</sup> See Gillette, *Fiscal Home Rule* at 1256 (cited at note 29).

<sup>53</sup> For an examination of creditors’ enhanced role in corporate governance following bankruptcy, see David A. Skeel Jr, *Corporate Anatomy Lessons*, 113 Yale L J 1519, 1552–58 (2004) (identifying shift in control rights as a major function of corporate bankruptcy).

not and state bankruptcy would not directly remove the dysfunctional decision maker. As we shall see, however, bankruptcy serves as a corrective in two related respects: it gives the debtor's *creditors* an incentive to counteract the debtor's decision-making biases; and it provides insurance against the consequences of decision-making biases by addressing the debt overhang the biases can produce.<sup>54</sup>

## II. WHAT DOES STATE BANKRUPTCY OFFER?

The discussion thus far has identified the reduction of debt overhang as the principal justification for a bankruptcy framework for states, and its effect on dysfunctional decision making as a related but distinct justification. It has also relied on an unlikely analogy: the similarity between states and consumer debtors. In this Part, I move from the general to the specific, exploring the specific benefits that a restructuring framework might offer. Perhaps most remarkably, several of these benefits would come into play even if no state ever took the bankruptcy plunge. I discuss six major benefits in all, moving in roughly chronological sequence from those that would accrue outside bankruptcy to those that arise in bankruptcy itself.

### A. The Shadow of a State-Bankruptcy Law

The first benefit is that a restructuring framework would have a feedback effect, increasing the state's leverage even outside bankruptcy. If the state could more easily restructure its collective bargaining agreements with unionized employees in bankruptcy, for instance, the threat of bankruptcy would shape the parties' prebankruptcy negotiations. Negotiations that might prove impossible in the absence of a bankruptcy law might become feasible in its presence. In similar fashion, bankruptcy might make it easier to restructure bond debt outside bankruptcy. The extent of the effect would depend both on the terms of the bankruptcy law and the credibility of the state's threat to invoke it. A law that gave a state sweeping authority to restructure a particular obligation would provide more prebankruptcy leverage than a law that imposed more conditions. Similarly, a state-bankruptcy law would have greater

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<sup>54</sup> For a discussion of the advantages of a discharge policy in bankruptcy, see Jackson, *The Logic and Limits of Bankruptcy Law* at 249 (cited in note 34) (“[B]y providing for a right of discharge, society enlists creditors in the effort to oversee the individual's credit decisions.”). See also Richard Hynes and Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 *Am L & Econ Rev* 168, 187–88 (2002) (emphasizing the insurance rationale).

effect if it was clear that state officials would be willing to use it. But any state-bankruptcy law that increased the state's restructuring options would enhance the state's prebankruptcy leverage. Like most laws, bankruptcy regulation casts a shadow.<sup>55</sup>

This shadow effect has an important and surprising implication: it suggests that a bankruptcy law could prove beneficial *even if it is never used*. In other contexts, disuse of a law is often cited as grounds that the law is misguided or inappropriate.<sup>56</sup> Perhaps based on this intuition, critics of Chapter 9, the closest analogue to state bankruptcy, sometimes point to its sparing use, and the fact that it has rarely been invoked by a city of any size, as evidence that it is ineffectual.<sup>57</sup> Although Chapter 9 may have other shortcomings,<sup>58</sup> the dearth of major cases is not by itself evidence that the legislation has failed. Quite to the contrary, the shadow benefit may be enormous. Indeed, if the bankruptcy framework enabled even a few states to address debt overhang without actually going through a bankruptcy process, we would have ample justification for a state-bankruptcy law.

## B. Curbing Political Agency Costs

Nearly every state fiscal crisis can be traced, at least in part, to the agency costs of political decision makers—that is, conflicts of interest between the incentives of the decision makers and the constituencies that they ostensibly represent.<sup>59</sup> Most recently, two related distortions have occupied much of the spotlight. The first is lawmakers' temptation to finance current expenditures by borrowing, which enables them to enjoy the benefits of spending

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<sup>55</sup> The "shadow" metaphor was coined in Robert Mnookin and Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 Yale L J 950, 997 (1979).

<sup>56</sup> This intuition even has a name and doctrine: desuetude. See, for example, William J. Stuntz, *The Pathological Politics of Criminal Law*, 100 Mich L Rev 505, 591–94 (2001) (describing desuetude and calling for its expanded use in criminal law).

<sup>57</sup> See, for example, Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 Yale J Reg 351, 359 (2010) ("The chapter is in fact seldom used, and it has almost never been used by a large and important city.").

<sup>58</sup> The most obvious is the phalanx of barriers that must be surmounted before Chapter 9 can be invoked. See, for example, Michael W. McConnell and Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U Chi L Rev 425, 455–61 (1993) (describing and criticizing entry requirements such as prebankruptcy negotiation with creditors and demonstration of insolvency).

<sup>59</sup> Agency cost terminology originated in the economic analysis of corporate governance as an account of the conflict of interest between corporate managers and shareholders. See Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J Fin Econ 303, 308–09 (1976).

while shuffling the costs off to others.<sup>60</sup> The second arises from lawmakers' dependence on the votes of the public employees whose pensions they establish through ostensibly arm's length bargaining with employee representatives.<sup>61</sup> Although it would not eliminate these distortions, a state-bankruptcy framework would curb both.

Start with lawmakers' temptation to fund current spending with borrowed funds. The price of state bonds is buoyed—and thus the cost of borrowing for the state is reduced—by an implicit promise that bondholders will be bailed out if a state falls into financial distress.<sup>62</sup> By decreasing the cost of borrowing, this subsidy increases the allure of credit, thus exacerbating the temptation to use bond financing. By providing a mechanism for restructuring a state's bond obligations in the event of a crisis, bankruptcy would trim this subsidy. If bankruptcy reduced the pressure for a federal bailout, as it likely would,<sup>63</sup> it would assure that the price of bonds more accurately reflected their true social cost, and it would give bondholders an incentive to monitor the state's financial condition. Lawmakers would still be tempted to borrow funds for current spending, but they (and thus the state) would pay a higher price for doing so.

The second distortion—states' pension obligations—is the single greatest threat to states' fiscal stability. Many states have made implausibly generous pension commitments to their employees, and state pension funds are radically underfunded—by roughly \$3 trillion, according to some recent estimates.<sup>64</sup> Political agency costs are a prominent cause of the pension crisis. The lawmakers who

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<sup>60</sup> See Gillette, 86 *Denver U L Rev* at 1256 (cited in note 29) (describing the “incentive to utilize too much debt and to impose a temporal externality on future residents”).

<sup>61</sup> See, for example, Richard Epstein, *The Wisconsin Shoot Out on Public Unions*, *Defining Ideas* (Hoover Institution Feb 22, 2011), online at <http://www.hoover.org/publications/defining-ideas/article/67771> (visited Nov 25, 2011).

<sup>62</sup> This is similar to the subsidy that bondholders of Citigroup and Bank of America enjoyed in 2008, due to the widespread (correct, as it turned out) assumption the institutions would be protected from default. See Dean Baker and Travis McArthur, *The Value of the “Too Big to Fail” Big Bank Subsidy*, Issue Brief 2 (Center for Economic and Policy Research Sept 2009).

<sup>63</sup> Clay Gillette has argued that the existence of a bankruptcy law could actually be used as a leverage by the state to secure a bailout. See Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 *U Chi L Rev* 281, 302–08 (2011) (noting that contagion effects of state defaults would lead federal government to favor bailouts over bankruptcy). Although Gillette's point about the strategic possibilities is an important one, a state's ability to threaten to simply default already gives the state considerable leverage. Bankruptcy seems likely to decrease pressure for a bailout overall, as discussed later in this Article.

<sup>64</sup> The high-end \$3 trillion estimate comes from Robert Novy-Max and Joshua D. Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, 23 *J Econ Persp* 191, 204 (2009).

negotiate a state's pension promises with the state's employee unions often depend on the votes of those same employees for election, and they may be beneficiaries of the same (or in some cases, even more generous) state pension framework.<sup>65</sup> As a result, bargaining over pensions looks very different than true arm's length bargaining. Because pension accounting is complex, and it is difficult to predict how much the pensions will eventually cost, lawmakers also are tempted to skimp, and do skimp, on the amounts they set aside for future pension payments.<sup>66</sup> Indeed, failing to adequately fund the state's pension has become lawmakers' primary means of circumventing state laws that ostensibly require them to balance the budget each year. "[J]ust as companies have ways of issuing debt off their balance sheets (think of Enron, or for that matter, Merrill Lynch)," as Josh Rauh puts it, "states and localities have ways around the balanced-budget rules. The most pervasive method," he concludes, is "increasing public employees' compensation by promising them larger pensions when they retire."<sup>67</sup> By understating these pension obligations, lawmakers can disguise a de facto deficit.<sup>68</sup>

Here, too, bankruptcy would counteract the political agency costs that have exacerbated states' pension problems. As described more fully below, in bankruptcy, pension beneficiaries' claims might well be protected only up to the amount of funds actually set aside for their payment.<sup>69</sup> If this is correct, unfunded pension promises would be general unsecured claims in a bankruptcy, subject to discharge at less than full payment. A variety of factors would affect the actual amount of restructuring. Union representatives could use

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<sup>65</sup> According to a leading pension treatise, "In 1992 it was reported that the senior member of the Texas state senate could retire with a pension that would exceed final salary by 660 percent. The senior Oklahoma senator was entitled to a pension benefit 172 percent of final salary." John H. Langbein, David A. Pratt, and Susan J. Stabile, *Pension and Employee Benefit Law* 105–06 (Foundation 5th ed 2010), quoting Christine Philip and Rodd Zolkos, *Legislators' Benefits Can Exceed Pay*, *Pensions & Investments* 3 (Aug 3, 1992).

<sup>66</sup> Much of the complexity stems from the final-average formula used in state pension plans to determine the beneficiary's pension payout. Unless an analyst has both actuarial skill and detailed data about the beneficiaries of the plan, she cannot make even an educated guess about the likely liabilities under the plan.

<sup>67</sup> Joshua Rauh, *The Pension Bomb*, *Milken Inst Rev* 26, 28 (First Quarter 2011).

<sup>68</sup> Even the Center on Budget and Policy Priorities, a fervent critic of state bankruptcy, concedes the extent of this problem in Illinois. Lav and McNichol, *Misunderstanding Regarding State Debt* at 21 (cited in note 14):

Because Illinois is chronically short of the revenues it needs to cover its expenses, it has engaged in a number of poor fiscal practices over the years. It has postponed payments to vendors, failed to make adequate pension contributions or borrowed money to make the contributions, securitized or sold assets, and taken other dubious actions.

<sup>69</sup> See Part II.C.

the uncertainty over the legal status of unfunded pension promises to negotiate for partial protection, for instance.<sup>70</sup> But unfunded pension promises would be much more likely to be adjusted than they currently are outside bankruptcy, where states often protect pension promises without regard for whether there is any funding backing them.<sup>71</sup> The prospect of adjustment is not simply hypothetical. In the municipal bankruptcy context, Pritchard, Alabama, restructured its pension obligations to retired as well as current employees in Chapter 9, and Central Falls, Rhode Island, is poised to do so.<sup>72</sup>

The threat that unsustainably generous, unfunded promises would be cut back in bankruptcy would encourage the state employees themselves to push for adequate funding, thus curbing the temptation to underfund. It would not perfectly counteract the parties' distorted bargaining incentives, of course. But at least one of the two parties—the employee representatives themselves—would face some of the consequences of underfunding, because they would be blamed if the state later filed for bankruptcy and the pension was restructured. This prospect would encourage them to consider the sustainability of the promises, especially as a state's finances declined. A greater emphasis on setting adequate funding aside also would expose the true cost of excessively generous pensions, thus putting more pressure on lawmakers to rein them in.<sup>73</sup>

Notice that these benefits, like the effect on the subsidy for bonds, arise in the shadow of bankruptcy. They do not require that any given state actually file for bankruptcy. The message would be

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<sup>70</sup> Bankruptcy's "best interests of the creditors" test could have a similar effect. In Chapter 11, this provision requires that each creditor be given at least as much as they would receive in a liquidation. See 11 USC § 1129(a)(7); *Bank of America National Trust and Savings Association v 203 North LaSalle Street Partnership*, 526 US 434, 441–44 (1999). Because municipalities cannot be liquidated, the provision is construed in Chapter 9 to require that creditors receive more than they would under plausible alternatives. See 11 USC § 943(b)(7); 6 *Collier on Bankruptcy* § 943.03[7][a] at 943-27 (Matthew Bender 15th ed rev 2005). State bankruptcy would (and should) include a similar provision. Under this provision, pension beneficiaries would argue that the most plausible alternative is full payment under state law. The logical counterargument is that the state would default in the absence of bankruptcy, and pension beneficiaries would get no more than the pool of funds actually set aside.

<sup>71</sup> "In practice," as one pension scholar puts it, "public-pension benefits have not been reduced even when governments face severe fiscal distress." Andrew G. Biggs, *The Market Value of Public-Sector Pension Deficits* 4 (American Enterprise Institute Apr 2010), online at <http://www.aei.org/outlook/economics/retirement/the-market-value-of-public-sector-pension-deficits/> (visited Nov 26, 2011).

<sup>72</sup> Neither case has yet given rise to a reported decision addressing the question of the legal entitlements of the beneficiaries of underfunded pensions. For a discussion of Pritchard, see Jeffrey B. Ellum & Daniel J. Merrett, *Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?*, 27 *Emory Bankr Dev J* 365, 411 (2011).

<sup>73</sup> See Novy-Max and Rauh, 23 *J Econ Persp* at 206 (cited in note 64).

still stronger if a state were actually forced to adjust unrealistic pensions in a bankruptcy case. Bankruptcy would bring another benefit in this context as well. Most cases involving state pensions are decided by state judges who are themselves beneficiaries of the state's pension commitments.<sup>74</sup> In bankruptcy, these decisions would be made by a federal judge, thus assuring a more objective decision maker, one who does not have any personal interest in the generosity of the pension promises.

Bankruptcy isn't a cure-all. Lawmakers still would be tempted to borrow, so that they can spend now but defer payment to later, and the distortions in state pensions will not simply disappear. But bankruptcy would reveal the true costs of these distortions and would help to counteract them.

### C. Establishing More Coherent Priorities

Bankruptcy also would establish a more straightforward and coherent priority structure for state obligations. Perhaps in part because they do not anticipate default, states do not provide anything like a complete set of priorities for their obligations, although many purport to create special priorities for some obligations. Though a federal bankruptcy framework might fill in some of the gaps, the incoherence of state priorities is a far more pressing concern. By clarifying priorities, bankruptcy could increase the efficiency of the credit markets, discourage destructive borrowing, and, in doing so, lower states' borrowing costs.

To appreciate the structure of state priorities and the potential benefit of a bankruptcy framework, consider the comparatively robust instructions in California's Constitution.<sup>75</sup> Under one provision, the public school system has first call on the state's revenues as they come in.<sup>76</sup> The Constitution has also been interpreted to protect California's general obligation bond debt—

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<sup>74</sup> See, for example, Sidley Austin LLP, *Illinois' Authority to Reduce the Pension Benefits That Current Employees Will Earn from Future Service* \*1-2, 28 (Apr 27, 2010), online at [http://civiccommittee.org/initiatives/StateFinance/Final%20Pension%20Rebuttal%20Memorandum\\_4\\_27\\_10.pdf](http://civiccommittee.org/initiatives/StateFinance/Final%20Pension%20Rebuttal%20Memorandum_4_27_10.pdf) (visited Nov 25, 2011) (arguing that judges' pensions, unlike other public employees' pensions, are protected by state constitution and cannot be adjusted).

<sup>75</sup> To my knowledge, Anna Gelpern was the first to draw attention to these priorities in the legal literature. Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructurings*, 53 *Emory L J* 1115, 1126-28 (2006) (contrasting these priorities with the absence of priorities for sovereign nations).

<sup>76</sup> Cal Const Art XVI, § 8(a) ("From all state revenues there shall first be set apart the moneys to be applied by the state for support of the public school system and public institutions of higher education.").

that is, bonds that will be repaid from general state revenues rather than a specific source of collateral.<sup>77</sup> Pension benefits also are singled out for special treatment.<sup>78</sup> Other state constitutions provide similar although generally less detailed protections.<sup>79</sup>

Although these priorities appear to be quite straightforward, their effect is ambiguous in two respects. The first problem is that there is very little creditors can do if the state simply fails to pay the obligation. If the state sets aside specific collateral or assigns a designated source of revenue to the obligation, the priority creditor is likely to be protected under all circumstances. But if the promise is just a promise, it can often be subverted in a crisis. When the nation of Ecuador fell into distress in the 1990s, for instance, it undermined the ostensible priority of a class of sovereign bonds by targeting those bonds for restructuring first, despite the promise that they would be protected.<sup>80</sup> A state could subvert priorities even more dramatically by stopping all payments on the priority obligation while continuing to pay other creditors. This ambiguity in priorities—which makes it very difficult for a state credibly to commit to a priority structure in advance—stems from the state’s status as a sovereign entity, which gives it the option of simply refusing to honor its obligations *ex post*.<sup>81</sup>

The second ambiguity is the direct result of states’ manipulation of their finances, most evidently in their treatment of pension obligations. Under the Illinois and New York constitutions, to give a pair of high-profile illustrations, pension promises to public employees cannot be altered in any way.<sup>82</sup> These provisions appear

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<sup>77</sup> See *State Administrative Manual* (Department of General Services July 10, 2007), online at <http://sam.dgs.ca.gov/TOC/6000/6871.htm> (visited Apr 11, 2012) (highlighting the protections affording to general obligation bonds as provided by California’s interpretation of its Constitution).

<sup>78</sup> Cal Const Art XVI, § 17.

<sup>79</sup> In Illinois, pension benefits are singled out for special treatment under a constitutional provision stating that “[m]embership in any pension or retirement system . . . shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.” Ill Const Art XIII, § 5.

<sup>80</sup> Similarly, Pakistan’s 2000 debt restructuring shattered the assumption that Eurobond holders had a higher priority status than other bonds. See Jeromin Zettelmeyer, *The Case for an Explicit Seniority Structure in Sovereign Debt* \*18–20 (IMF Working Paper, Sept 29, 2003).

<sup>81</sup> California bondholders would have the strongest grounds for protection, but it is far from clear that the state constitution provision promising that they will be paid before most other obligations would prevent the bonds from being restructured. More likely, it would require simply that payments go first to bonds, not that the principal amount of the bonds be untouched.

<sup>82</sup> Ill Const Art XIII, § 5; NY Const Art V, § 7. See also Jennifer Staman, *State and Local Pension Plans and Fiscal Distress: A Legal Overview* 5 (Congressional Research Service Mar 31, 2011), online at <http://www.nasra.org/resources/CRS%20state%20and%20local%20legal>

not just to protect benefits that have already been earned but also to assure that an employee's not-yet-earned benefits will not be reduced below their current levels, no matter how generous they are.<sup>83</sup> If Illinois set aside the funds for this promise each year, the commitment would not be particularly problematic; it would look like an ordinary collateralized obligation. But Illinois has dedicated only a small portion of the funds necessary to fulfill the obligation—51 percent, according to the most generous recent estimates.<sup>84</sup> As a result, it is impossible to determine the true content of the guarantee. Are pensions protected up to the full amount of the promise, are they limited to the extent of the funding, or do they have some other content?

A bankruptcy framework could clarify and reinforce the priority framework in each of these areas. Start with the risk of ex post subversion. Bankruptcy would not prevent a state from attempting a priority-distorting restructuring outside bankruptcy. But priorities would be honored in an actual bankruptcy, and the feedback effect of this possibility would shape expectations even outside bankruptcy. With the bankruptcy priorities as a backstop, creditors would have

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%20framework%201104.pdf (visited Nov 25, 2011) (identifying Illinois and New York, as well as Alaska, Arizona, Hawaii, and Michigan, as states with “a constitutional provision that, in general, explicitly provides that membership in, or accrued benefits from, a state’s retirement system creates a contract between the state and its employees that cannot be impaired”).

<sup>83</sup> The precise contours of this promise are, however, a matter of dispute. The law firm Sidley Austin has argued that only the pension fund itself is responsible for payment; the state has not guaranteed any shortfall. Sidley Austin, *Illinois’ Authority* at 50–53 (cited in note 74). For an example of the larger dispute over the legal status of Illinois pension benefits, compare Eric M. Madiar, *Is Welching on Public Pension Promises an Option for Illinois? An Analysis of Article XIII, Section 5 of the Illinois Constitution 2*, online at <http://www.senatedem.ilga.gov/images>

/pensions/D/Pension%20Clause%20Article%20Final.pdf (visited Nov 26, 2011) (arguing that the Illinois General Assembly cannot change pension benefits for current recipients), with Sidley Austin LLP, *The General Assembly’s Authority to Enact Comprehensive Pension Reform Legislation: A Response to Eric Madiar 1* (Apr 11, 2011), online at <http://www.illinoisbroke.com/files/PensionReformMemo041111.pdf> (visited Nov 25, 2011) (reaffirming its position that the General Assembly could reduce benefits not yet earned by current recipients).

Several recent decisions in other states have permitted limited adjustments to existing pensions. In both Colorado and Minnesota, courts upheld new limitations on, among other things, cost of living adjustments. See, for example, Mary Walsh, *Two Rulings Find Cuts in Public Pensions Permissible*, NY Times B1 (June 30, 2011).

<sup>84</sup> As Doug Elliot notes, “Illinois’ pensions . . . are only 51% funded by assets held in the pension plans currently, even using reported figures. Using the most conservative discount rate, the plans would only be 28% funded.” Douglas J. Elliot, *Potential Federal Roles in Dealing with State and Local Pension Problems 3* (Brookings May 12, 2011). This difference stems from the contrast between the state’s own aggressive assumptions about future returns on its assets, which are incorporated into Pew’s pension reports, and the more plausible assumptions used by Rauh. See note 67.

more leverage to resist a restructuring that flouted their priorities.<sup>85</sup> If a state proposed to restructure one class of bonds but not another, arguably lower-priority class of creditors, the bondholders would have an incentive to refuse the restructuring and hold out either for a more equitable restructuring or for bankruptcy.<sup>86</sup> The existence of a nondiscriminatory alternative would make it appreciably more difficult for a state to ignore creditor priorities in a crisis.

Bankruptcy's contribution to incoherent priorities, the second problem under current law, could be even more significant. In the absence of a bankruptcy framework, the status of schizophrenic priorities is almost entirely speculative. Consider once again the status of a state's unfunded pension promises in a state like Illinois whose constitution purports to provide absolute protection for its pension promises.<sup>87</sup> If the state continued to pay all benefits, despite the funding shortfall, the decision could be defended as honoring the state constitution's guaranty of pensions. If state politicians said that continued payment was impossible, on the other hand, the outcome of the litigation that would follow is highly uncertain, given the conflict between the guaranty and the absence of funding to back it.

Bankruptcy would slice through this Gordian knot with two related snips. The bankruptcy framework would fully honor (and give highest priority to) any property right created by state law,<sup>88</sup> but would treat other obligations as general unsecured claims that are subject to restructuring. Because it is federal law, this determination would trump inconsistent state law under the Supremacy Clause.<sup>89</sup> The question with unfunded pension promises is whether any or all

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<sup>85</sup> If involuntary state bankruptcy were possible, creditors would have still more leverage, because they could threaten to throw the state into bankruptcy if it pursued a discriminatory restructuring. But involuntary state bankruptcy would not be constitutional, as we shall see in Part III.A.

<sup>86</sup> If the bondholders were widely scattered, collective action problems might complicate their coordination. But bond ownership is generally concentrated. If the state structured its offer to punish bondholders who did not agree to the exchange offer, on the other hand, bondholders might find it harder to resist. For discussion of these issues with corporate bonds, see Marcel Kahan, *Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights*, 77 NYU L Rev 1040, 1055–56 (2002).

<sup>87</sup> My focus here is on benefits that existing beneficiaries already have ostensibly earned, rather than on the question of whether the formula for benefits that have not yet been earned by current or future employees can be altered. This issue, and states' divergent approaches, is carefully analyzed in Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 Educ Fin & Policy 617, 643–45 (2010) (noting the different implications of contract, property right and annuity approaches).

<sup>88</sup> See, for example, *Butner v United States*, 440 US 48, 54 (1979) (holding that bankruptcy should defer to state law treatment of property rights).

<sup>89</sup> US Const Art VI, cl 2.

of a state's promises creates a first priority property right for the beneficiaries. It is quite likely that a court would conclude that pension beneficiaries do have a property interest, but only to the extent of the funds the state has set aside for payment. The unfunded portions would be treated as general unsecured obligations. This is the way other property interests are treated in bankruptcy; a secured creditor has a secured claim up to the value of its collateral, for instance, and an unsecured claim to the extent it is owed more than the collateral is worth.<sup>90</sup> There is a strong argument for treating partially funded pension promises the same way. This accords, in fact, with the historical significance of the vesting of a pension. Vesting prevents the plan from altering or withdrawing its promise to the beneficiary; it does not guarantee that the funds will be available for payment. The promise rather than the payment priority is protected.<sup>91</sup>

This logic might be challenged under the US Constitution on two grounds. First, beneficiaries might insist that limiting their property interest to the amount of funding actually set aside violates the Takings Clause.<sup>92</sup> Treating the remainder as an unsecured obligation interferes with their investment backed expectations, the reasoning would go, and is impermissible unless the beneficiaries are fully compensated.<sup>93</sup> Second, the bankruptcy treatment violates the Contracts Clause because it impairs promises made under state law. Although the outcome is not altogether free from doubt, neither argument is likely to unsettle the normal bankruptcy treatment. The weakness of the Takings Clause argument lies in the facts that property rights are ordinarily protected only up to the value of the underlying property and that the beneficiary's investment-backed expectations would be limited by the uncertainty as to whether the state could make good on its unfunded promises. Given that the treatment is consistent with the way other property rights have long

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<sup>90</sup> Under 11 USC § 506(a), which applies in both Chapter 9 and Chapter 11, property interests are bifurcated into secured and unsecured portions. See 11 USC § 506(a); 11 USC § 901(a).

<sup>91</sup> "Prior to the passage of ERISA in 1974," as one commentator puts it, "prefunding of pension obligations was almost wholly discretionary on the part of the employer. The lack of collateral exposed employees to the risk of default if the employer went bankrupt or terminated the plan." Eric D. Chason, *Outlawing Pension-Funding Shortfalls*, 26 Va Tax Rev 519, 523 (2007) (citation omitted). The collapse of Studebaker in 1963 drew attention to the underfunding problem and ultimately contributed to the enactment of ERISA. *Id.*, citing John H. Langbein and Bruce A. Wolk, *Pension and Employee Benefit Law* 355 (Foundation 3d ed 2000).

<sup>92</sup> US Const Amend V.

<sup>93</sup> *Penn Central Transportation Co v City of New York*, 438 US 104, 124 (1978).

been treated in bankruptcy, it also does not seem likely to violate the Contracts Clause, under the reasoning discussed earlier.<sup>94</sup> If this is correct, underfunded pensions would have a much clearer status in bankruptcy than they do outside bankruptcy.

Bankruptcy would have a clarifying effect on other state obligations as well. Many state obligations—or ostensible obligations—consist of promises to municipalities or separate projects that are legally distinct from the state. This proliferation of special districts has been fueled in part by states' desire to evade debt limits and balanced budget requirements.<sup>95</sup> The result is a complex network of obligations. Nicole Gelinas notes, for instance, that New York “owes only \$3.5 billion in ‘general obligation’ debt. New York owes the remainder of its \$78.4 billion in debt through hundreds of special ‘authorities,’ including the Transitional Finance Authority, Metropolitan Transportation Authority, the Dormitory Authority, and others.”<sup>96</sup> Bankruptcy has very clear principles for sorting out these obligations.<sup>97</sup> This would enable a state to determine the limits of its obligations in an actual bankruptcy, and the existence of this backstop would add clarity even outside bankruptcy.

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<sup>94</sup> It is possible that a court would distinguish between state constitutional and statutory provisions for the purposes of the Contracts Clause analysis. On this view, overriding a state constitutional provision purporting to protect property rights would be more problematic, since it is more difficult for a state itself to alter its constitution. But it seems more likely that a restructuring facilitated by the Bankruptcy Clause would be upheld in either context.

<sup>95</sup> See, for example, Richard Briffault, *The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 Rutgers L J 907, 920–27 (2003) (describing use of special districts and added cost this entails).

<sup>96</sup> *Hearing on State and Municipal Debt: The Coming Crisis? Before the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs of the House Committee on Oversight and Government Reform*, 112th Cong 1st Sess 1–2 (2011) (statement of Nicole Gelinas, Manhattan Institute), online at [http://oversight.house.gov/images/stories/Testimony/gelinas\\_testimony\\_edit\\_2MH.pdf](http://oversight.house.gov/images/stories/Testimony/gelinas_testimony_edit_2MH.pdf) (visited Nov 25, 2011) (“Gelinas Statement”). Gelinas contends that the complexity in this structure makes state bankruptcy untenable. In reality, this is exactly backwards, as argued in the text that follows. Bankruptcy clarifies the status of otherwise uncertain obligations.

<sup>97</sup> The general rule is that each entity is dealt with separately. Complicated cases are often “substantively consolidated” if the creditors of the respective entities agree to the consolidation. See, for example, William H. Widen, *Report to the American Bankruptcy Institute: Prevalence of Substantive Consolidation in Large Public Company Bankruptcies from 2000 to 2005*, 16 Am Bankr Inst L Rev 1, 6, 8 (2008) (finding substantive consolidation in 178 out of 315 large public company bankruptcies investigated). The leading case is *In re Owens Corning, Inc.*, 419 F3d 195, 211 (3d Cir 2005) (establishing a very restrictive test for substantive consolidation).

Recent cases like *In re Worldcom, Inc.*, 2003 WL 23861928 (Bankr SDNY Oct 31), and *In re Enron Corp.*, 419 F3d 115, 119 (2d Cir 2005), have involved numerous entities, much as a state bankruptcy would.

A final issue stems from the fact that priorities can be created informally by adjusting the maturity date of the repayment obligation. Obligations that must be repaid quickly have de facto priority, even if they are not technically entitled to priority.<sup>98</sup> Suppose, for instance, that much of a state's debt consists of bonds that will mature in ten or fifteen years and which purport to have priority over any subsequent bond issuances. To create de facto priority for new debt, the state need only shorten the repayment period. The ability to circumvent priorities has been shown both to increase a debtor's borrowing costs and to encourage excessive borrowing in the event of a crisis.<sup>99</sup>

Here, too, bankruptcy would help. A state's ability to subvert its existing priorities depends on its ability to credibly commit to the new lenders that they will be repaid. Because the new obligations would lose their de facto priority in the event of bankruptcy, bankruptcy undermines their implicit priority.<sup>100</sup> Investors would need to consider the possibility that the state would file for bankruptcy before repaying the short-term obligations. By interfering with this de facto priority, bankruptcy would discourage the destructive last-minute borrowing that sovereigns are tempted to do in a financial crisis.<sup>101</sup>

A common theme runs through these priority issues. With each, an actual bankruptcy filing under a bankruptcy framework would clarify the parties' priorities and diminish the risk of subversion. Even if the likelihood of any given state filing for bankruptcy were remote, its existence would have a feedback effect on priorities outside bankruptcy. Bankruptcy could not eliminate subversions of priority altogether, of course. States still could attempt to restructure priority obligations first or make unfunded pension promises. But the existence of a bankruptcy alternative would shape the parties'

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<sup>98</sup> States' use of short-term, tax-anticipation notes (TANs) to raise money is a familiar example of this phenomenon. When this borrowing is simply a temporary bridge until expected revenues are received, it is not problematic. But it also can be used as a disguised form of increasing the state's overall debt. See Stewart E. Sterk and Elizabeth S. Goldman, *Controlling Legislative Shortsightedness: The Effectiveness of Constitutional Debt Limitations*, 1991 Wis L Rev 1301, 1314–15 (1991).

<sup>99</sup> The effect—which is produced by the dilution of earlier debt through new borrowing—is modeled in Patrick Bolton and Olivier Jeanne, *Structuring and Restructuring Sovereign Debt: The Role of Seniority*, 76 Rev Econ Stud 879, 890–91 (2009).

<sup>100</sup> This argument is developed in more detail in the sovereign debt context in Patrick Bolton and David A. Skeel Jr, *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 Emory L J 763, 788–800 (2004).

<sup>101</sup> *Id.* at 788–93. Bankruptcy's benefits could be increased still further by adopting a true first-in-time priority rule, under which earlier general debt has priority over subsequently issued debt. *Id.* at 799.

expectations, and the contours of their expectations would more closely track the formal, legitimate priorities.

#### D. Additional Restructuring Tools

Bankruptcy also might enable a state to restructure obligations in ways that would not be possible outside bankruptcy. We saw an important example of this benefit in the last Section: bankruptcy provides more scope for restructuring unfunded pension obligations. Experience in municipal bankruptcy suggests that political pressures would limit the extent to which a state tried to scale down these obligations.<sup>102</sup> But a state would have the legal ability to restructure overly generous, unfunded pension obligations whose status is ambiguous outside bankruptcy, as discussed earlier.<sup>103</sup>

The experience in the Vallejo, California, bankruptcy underscores the benefit of several additional restructuring options.<sup>104</sup> Because of state law restrictions, Vallejo was unable to close nonessential fire stations outside bankruptcy, and it could not terminate its contracts with its public employee unions.<sup>105</sup> Bankruptcy enabled the city to take both steps. Bankruptcy gives a debtor a great deal of flexibility to cancel contracts that could not be adjusted outside bankruptcy, or could be adjusted only at greater cost.

These powers are so important in ordinary corporate bankruptcy that corporations sometimes file for bankruptcy primarily to take advantage of the tools it makes available for restructuring.<sup>106</sup> These same tools would significantly expand a state's ability to restructure if its financial obligations became unsustainable.

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<sup>102</sup> In the Vallejo bankruptcy, for instance, the city did not attempt to restructure its pension obligations. The City concluded after discussion with its attorneys that litigation with CalPERS over pension plan modifications for current retirees or employees would be extremely expensive and could have taken many years. Interview with Robert V. Stout, former financial director of the City of Vallejo and bankruptcy liaison (June 15, 2011) (on file with author).

<sup>103</sup> See notes 87–94 and accompanying text.

<sup>104</sup> Vallejo filed for Chapter 9 in 2008 and has become a lightning rod for debate about the pros and cons of Chapter 9. See generally *In re City of Vallejo*, 408 BR 280 (9th Cir BAP 2009).

<sup>105</sup> See *In re City of Vallejo*, 403 BR 72, 79 (Bankr ED Cal 2009), affd 432 BR 262, 275–76 (ED Cal 2010).

<sup>106</sup> The ability to terminate property leases and treat the damages as general unsecured claims was a major reason that Kmart and many other retailers have filed for bankruptcy. See *In re Kmart Corp.*, 362 BR 361, 384 (Bankr ND Ill 2007). General Motors and Chrysler took advantage of the same provision, 11 USC § 365(a), to terminate unwanted car dealerships. See Lawrence A. Young, et al, *Some Critical Issues in Automobile Dealer Bankruptcies*, 64 Consumer Fin L Q Rep 368, 369 (2010).

### E. Equitable Distribution of Sacrifice

States do not simply stand idly by as they tumble toward financial Armageddon, of course. They take steps to cut costs, in some cases raise taxes, and try to restructure their obligations to existing constituencies. This is precisely what many financially troubled states have done during the recent crisis. Wisconsin was particularly aggressive in this regard, renegotiating its collective bargaining agreements with most of its public employees and passing controversial legislation restricting future collective bargaining rights.<sup>107</sup> Illinois, California, New York, and New Jersey have responded to their financial plight in similar fashion.<sup>108</sup>

There is a logic to these priorities. Like the auto industry and airlines, many states have made implausibly generous promises to their employees.<sup>109</sup> These costs are a major cause of states' financial predicaments and cannot realistically be maintained at current levels. It is both appropriate and understandable that states would take aim at these labor and pension costs.

What is both striking and far more problematic about the states' response to their financial predicaments, however, is that these restructuring initiatives have not been accompanied by similarly assiduous efforts to reduce other kinds of obligations. Two constituencies in particular have been asked to bear a disproportionate percentage of the sacrifice during the recent crisis: the state's public employees and the recipients—especially the poor and lower middle class recipients—of its services. Other, similarly situated creditors such as bondholders have not been expected to bear any of the financial burden.

The recent backlash against efforts to cut back on state employees' collective bargaining rights can be explained in part as resistance by workers and those sympathetic to them to a serious erosion of the power they enjoyed during much of the post-World

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<sup>107</sup> For a discussion of the Wisconsin cuts and of potential constitutional objections, see Paul M. Secunda, *Constitutional Contracts Clause Challenges in Public Pension Litigation* \*28–48 (unpublished manuscript, Apr 2011), online at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1806018](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1806018) (visited Nov 26, 2011).

<sup>108</sup> See, for example, Vauhini Vara and Jacob Gershman, *Why Cuomo Is Sailing and Brown Becalmed—The New Governors of New York and California Have Quite a Few Things in Common; So Far, Success Isn't One of Them*, *Wall St J* A5 (June 30, 2011) (contrasting the success of New York Governor Andrew Cuomo with the difficulties of California Governor Jerry Brown in addressing their states' fiscal crises).

<sup>109</sup> See, for example, John Hood, *The States in Crisis*, 6 *Natl Affrs* 49, 55–56 (2011), online at <http://www.nationalaffairs.com/publications/detail/the-states-in-crisis> (visited Nov 26, 2011) (“High on the list of reckless expenditures and promises are unfunded government pensions.”).

War II era. But it also reflects a perception of unfairness shared by many who would not necessarily identify themselves with labor.

Here, too, a bankruptcy framework would provide an important benefit. Much as admiralty law's "general average" principle requires that every constituency share the costs of measures taken in response to a crisis during the voyage, bankruptcy requires that the sacrifice be borne by everyone, rather than one or two disfavored constituencies.<sup>110</sup> This does not mean that priorities can or should be shuffled willy-nilly. To the contrary, adherence to clear priority rules is a signal benefit of bankruptcy, as we have seen. But all general creditors—a class that includes public employee contracts and most bonds—can be adjusted.<sup>111</sup> Elizabeth Warren made a version of this point in a classic article many years ago. "Bankruptcy," she argued, is "a federal scheme designed to distribute the costs among those at risk."<sup>112</sup>

The assurance of equitable treatment in bankruptcy is far from perfect in practice. Expansive use of critical vendor doctrine, under which debtors pay key suppliers in full, and the debtor's power to assume some contracts while rejecting others, can lead to distortions.<sup>113</sup> But the principle of equal treatment of similarly situated creditors is deeply entrenched, and bankruptcy law is designed to encourage a fair distribution of the sacrifice.

The emphasis on fairness here is important. Although bankruptcy scholars are often hesitant to consider appeals to fairness, it plays a major role in the politically charged context of state and municipal finance, and its prominence is magnified still further in a crisis. In Vallejo's Chapter 9 case, the court conditioned its willingness to permit the city to terminate its collective bargaining agreements on the fact that the burdens of the restructuring were being fairly distributed among Vallejo's general creditors.<sup>114</sup> The prospect of an equitable restructuring that requires a broad range of constituencies to share the sacrifice is a crucially important benefit of

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<sup>110</sup> Bob Scott was the first to apply the "general average" principle to bankruptcy. See, for example, Robert E. Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic*, 53 U Chi L Rev 690, 700–07 (1986).

<sup>111</sup> Even secured creditors may be subject to minor adjustments, such as the cessation of interest payments during bankruptcy if the creditor is undercollateralized. See Thomas H. Jackson and Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 Va L Rev 155, 178–90 (1989).

<sup>112</sup> Elizabeth Warren, *Bankruptcy Policy*, 54 U Chi L Rev 775, 790 (1987).

<sup>113</sup> Critical vendor treatment was questioned in *In the Matter of Kmart Corporation*, 359 F3d 866 (7th Cir 2004), but it has continued largely unabated. A debtor's power to assume and reject contracts is found in 11 USC § 365(a).

<sup>114</sup> *Vallejo*, 403 BR at 77–78, *affd*, 432 BR at 273–75.

a bankruptcy framework, and one that has been almost completely missed in the recent debates over states' fiscal predicament. This objective is not always achieved in bankruptcy,<sup>115</sup> but bankruptcy is much more likely to assure fairness than more ad hoc measures are.

#### F. A Better Catastrophe Option

Prior to the 2008 crisis, the largest commercial and investment banks were earning record profits and derivatives had made the financial markets less risky than ever before, or so it seemed.<sup>116</sup> The "black swan"—the prospect of a complete collapse—seemed too remote to need preparing for.<sup>117</sup> One lesson of 2008 is the danger of ignoring seemingly unlikely but potentially devastating risks.

Consider the existing options in the unlikely-but-far-from-impossible event that a state's financial crisis spirals out of control. A state presently has two main possibilities if it cannot meet its obligations.<sup>118</sup> The first is to turn to the federal government, as the banks did when the banking system threatened to collapse in 2008. The government could offer assistance directly—perhaps through explicit new legislation by Congress or increases in existing outlays such as Medicaid<sup>119</sup>—or indirectly, say, through a Federal Reserve program to guarantee the debt of state institutions.

The normative case for extraordinary federal intervention is extremely weak. Bailouts are most defensible if the issue is

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<sup>115</sup> The Chrysler and General Motors bankruptcies are perceived by many to have been unfair, privileging unionized employees and trade creditors while cutting off senior creditors (in Chrysler) and current tort claimants. See, for example, Mike Spector, *Car Bailouts Left Behind Crash Victims*, Wall St J A1 (May 27, 2011) (describing criticisms of the failure to provide for tort claimants).

<sup>116</sup> See *Corporate Profits by Industry*, table 6.16D (Bureau of Economic Analysis 2011), online at <http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=239&Freq=Qtr&FirstYear=2001&LastYear=2011> (visited Nov 25, 2011).

<sup>117</sup> The popularity of the black swan metaphor in discussions of the recent financial crisis can be traced at least in part to a popular book. Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable* xvii–xviii (Random House 2007) (defining the "black swan" as an improbable event with an extreme impact that is susceptible to the imposition of a fictitious explanatory narrative).

<sup>118</sup> I discuss a third possibility, a more ad hoc federal intervention modeled on state municipal-oversight boards, in Part IV.

<sup>119</sup> Congress recently did just this. Roughly 20 percent of the 2009 stimulus package consisted of funding for states and state programs. See Katherine Bradbury, *State Government Budgets and the Recovery Act* \*12 (Federal Reserve Bank of Boston Public Policy Brief, Feb 2010), online at <http://www.bos.frb.org/economic/ppb/2010/ppb101.pdf> (visited Nov 25, 2011). See generally American Recovery and Reinvestment Act of 2009, Pub L No 111-5, 123 Stat 115.

liquidity—a temporary crisis in funding—rather than insolvency.<sup>120</sup> In 2008, the banks’ plight could plausibly be viewed as a liquidity crisis: their reliance on short-term funding created the risk of a run, and their interconnectedness stoked worries of a system-wide crisis if any one failed.<sup>121</sup> Although liquidity issues do figure in the states’ recent travails—state revenues have dipped due to the recession and will likely rebound as economic conditions improve—the woes of the most troubled states are far more than simply liquidity issues.<sup>122</sup> States also do not depend on the kind of short-term funding that makes bank financing so fragile,<sup>123</sup> and they are not interconnected in the same way as the largest financial institutions were, as discussed more fully below. In each of these respects, the case for intervention is much weaker.

Some might argue that federal and state finances are so intertwined already that an additional, one-shot federal rescue package could not be criticized. It is just more money, on this view, in a framework that already involves substantial federal financing of state activities.<sup>124</sup> But federal funding initiatives are not interchangeable. Each must be assessed on its own merits. There may be—and in my view, are—good reasons for concern about the structure of Medicaid funding, for instance, but quite different concerns about federal rescue financing. A direct bailout would, among other things, externalize the costs of a state’s profligacy to other states.<sup>125</sup>

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<sup>120</sup> This insight dates back at least to the nineteenth-century British economist Walter Bagehot. See Walter Bagehot, *Lombard Street: A Description of the Money Market* 173 (C. Kegan Paul 7th ed 1878).

<sup>121</sup> For an argument that the TARP legislation was justified based on liquidity concerns but that the ad hoc bailouts of Bear Stearns and other major financial institutions were not, see David A. Skeel Jr, *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences* 132–35 (Wiley 2011).

<sup>122</sup> See, for example, Dougherty, *Higher Taxes*, Wall St J at A4 (cited in note 47) (noting that tax collections have increased since their recession lows, but that serious fiscal problems remain).

<sup>123</sup> The closest analogue to financial institutions’ dependence on repurchase-agreement-based (“repo-based”) financing is states’ use of short-term revenue- or tax-anticipation notes (RANS or TANS) to plug holes in their financing. But repos are often one-day obligations, whereas RANS and TANS are longer and make up a much smaller portion of a state’s funding.

<sup>124</sup> Richard Schragger criticizes this Article’s state bankruptcy proposal on this basis. Richard C. Schragger, *Democracy and Debt*, 121 Yale L J 860, 877 (2012), online at <http://ssrn.com/abstract=1943529> (visited Nov 26, 2011) (intergovernmental “transfers are so significant as to make the worry about a one-time bailout seem odd”).

<sup>125</sup> My focus here is on simple rescue funding. If limited financial support is coupled with a requirement that the state restructure its obligations in important respects, the effect is in many respects similar to bankruptcy. This alternative, which New York State used with New York City in 1975, is discussed in Part IV.

Even if normative objections did not preclude a bailout, the practical obstacles might. Given the lingering hostility to the 2008 bailouts, a large federal intervention on behalf of a troubled state may not be politically plausible.<sup>126</sup> It is also far from clear that the federal government could afford to intervene at the level necessary to rescue a financially troubled state. This dilemma is not unique to the current historical moment. State crises invariably come at times when the federal government also is financially strapped.<sup>127</sup>

The other major option, a state default, would be the financial equivalent of a tsunami. First, default would impose large, sudden losses on the creditors affected. This likely would include bondholders, since other obligations will seem more urgent.<sup>128</sup> Second, the state would have almost complete control over which creditors to pay and which to stop paying, which would create deep uncertainty. This uncertainty would roil the credit markets long before the state actually defaulted. Finally, default would not relieve the state of its obligations. If the state defaulted on its bonds, for instance, it would still be obligated to pay them, which would bring ongoing hassles such as the need to defend against bondholders' efforts to collect.<sup>129</sup> The ugly repercussions of default would linger.

A federal restructuring framework would be far more effective than either of the existing options in the event of a catastrophe. It is likely to be much less costly than a bailout and would avoid the distortions that bailouts create in the credit markets. Moreover, the bailout option may not even be available. In contrast to default, bankruptcy would provide an orderly response to a state's financial distress, and the restructuring would permanently discharge the state's obligations.

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<sup>126</sup> Although the origins of the Tea Party movement are complex, anger at the bailouts clearly was one of the contributing factors. See Ross Douthat, *The Great Bailout Backlash*, NY Times A27 (Oct 25, 2011).

<sup>127</sup> See, for example, See Davey, *The State That Went Bust*, NY Times at WK3 (cited in note 6).

<sup>128</sup> Historically, bondholders have been the principal victim of state defaults. See Orth, *The Judicial Power of the United States* at 44–46 (cited in note 1) (describing bondholder efforts to circumvent sovereign immunity obstacles to recovery). Although bondholders are less likely to be out-of-state residents than in the nineteenth century, states still would be likely to default on bonds before shutting down core governmental functions.

<sup>129</sup> This has been an ongoing headache for Argentina since it restructured its bonds through ad hoc exchange offers in 2003. Bondholders that did not accept the restructuring have continued to pursue their claims by seeking to attach Argentine assets around the world. See *Settling Up*, Economist 48 (Oct 31, 2009).

### III. WHY RESIST A STATE-BANKRUPTCY FRAMEWORK?

Why, given these benefits, has state bankruptcy met such stout resistance? The answer may lie in part in the idiosyncrasies of recent politics. Almost as soon as state bankruptcy was proposed, it was pulled into the vortex of a partisan battle over public employee unions.<sup>130</sup> A second factor is simply that many of the benefits that we have just considered have not been well understood. The perception that bankruptcy would be devastating to public employees, for instance, who are a key source of the political impasse, underappreciates bankruptcy's tendency to distribute sacrifice more broadly than ad hoc restructuring does.

But the resistance to state bankruptcy rests on more than misperceptions and unfortunate political framing alone. Even if these obstacles were removed, additional doubts would remain. In this Part, I take up six of the most important of the objections and argue that they complicate but do not undermine the case for a bankruptcy framework for states.

#### A. State Bankruptcy Would Not Be Constitutional

Some critics question the constitutionality of a state-bankruptcy regime.<sup>131</sup> Even if it were a brilliant solution to states' financial distress, the reasoning goes, state bankruptcy would impermissibly interfere with the state's sovereignty. State bankruptcy might also encounter turbulence under the Contracts Clause, because it would alter existing contracts, which the states themselves ordinarily cannot do.<sup>132</sup>

These issues were hashed out for municipalities in a pair of cases that straddled the Supreme Court's famous "switch in time" in the 1930s. In *Ashton v Cameron County Water Improvement District*

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<sup>130</sup> State bankruptcy was framed in some circles primarily as a tool for punishing public employee unions. As Doug Elliot has noted, this generated some Republican support but assured that "Democrats in Congress [would oppose bankruptcy] virtually unanimously." Elliot, *Potential Federal Roles* at 12 (cited in note 84). Further opposition was prompted by bond market representatives, who persuaded a number of Republican lawmakers to withhold support. See, for example, Michael A. Fletcher, *No Bankruptcy Option for States, Cantor Says*, Wash Post A14 (Jan 25, 2011).

<sup>131</sup> For a nuanced analysis of the issue, viewed through the lens of the Supreme Court's two 1930s municipal bankruptcy cases, see Anna Lund, *State Bankruptcy: Lessons from Ashton and Bekins* \*29–50 (unpublished manuscript, 2011) (on file with author).

<sup>132</sup> The Contracts Clause states that no state may "pass any . . . Law impairing the Obligation of Contracts." US Const Art 1, § 10, cl 1 (listing various restrictions on the powers of the states). It generally forbids the alteration of existing contracts, although it is subject to exceptions under extraordinary circumstances. See Part III.C (discussing Contracts Clause limits on state restructuring statutes).

*No I*,<sup>133</sup> the Court struck down the original 1934 municipal bankruptcy law under both the Tenth Amendment and the Contracts Clause.<sup>134</sup> “If obligations of states or their political subdivisions may be subjected to the interference here attempted,” the majority held, “they are no longer free to manage their own affairs. . . . And really the sovereignty of the state, so often declared necessary to the federal system, does not exist.”<sup>135</sup> Although the Contracts Clause limits the states, not Congress, the majority also held that the bankruptcy statute impermissibly enabled a state to impair contracts “by granting any permission necessary to enable Congress so to do.”<sup>136</sup>

Two years later, the Supreme Court upheld a new municipal bankruptcy framework that differed only in minor details from its ill-fated predecessor.<sup>137</sup> In *United States v Bekins*,<sup>138</sup> the Court quoted with approval the assurance of the language of a congressional report that the framework “avoids any restriction on the powers of the States or their arms of government,” and that “[n]o involuntary proceedings are allowable.”<sup>139</sup> “The statute is carefully drawn so as not to impinge upon the sovereignty of the State,” the Court concluded, and it is authorized by Congress’s powers under the bankruptcy clause.<sup>140</sup>

For over seventy years, the constitutionality of a municipal bankruptcy law with the features just described has been well settled. This strongly suggests that a state-bankruptcy law that could be invoked only by the state itself, and which avoided interference with state decision making, also would adequately safeguard state sovereignty. Such a law would only be struck down on sovereignty grounds under one of two circumstances: the sovereignty concerns of state bankruptcy are different and greater than with municipal bankruptcy, or *Bekins* itself is no longer good law.

The first possibility is implausible. Cities and states are different, of course, but the Court’s analysis of municipal restructuring is

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<sup>133</sup> 298 US 513 (1936).

<sup>134</sup> *Id.* at 531–32.

<sup>135</sup> *Id.* at 531.

<sup>136</sup> *Id.*

<sup>137</sup> *United States v Bekins*, 304 US 27 (1938).

<sup>138</sup> 304 US 27 (1938).

<sup>139</sup> *Id.* at 51 (internal quotes and citations omitted).

<sup>140</sup> *Id.* Although a substantial number of states have enacted legislation authorizing their municipalities to file for Chapter 9, roughly half have not. See Alexander M. Laughlin, *Municipal Insolvencies: A Primer on the Treatment of Municipalities under Chapter 9 of the US Bankruptcy Code* 17–22 (Wiley Rein & Fielding LLP Mar 2005), online at [http://www.abiworld.org/pdfs/municipal\\_primer.pdf](http://www.abiworld.org/pdfs/municipal_primer.pdf) (visited Nov 25, 2011).

premised on municipalities' status as creatures of the state.<sup>141</sup> Federal interference with a city is interference with a state. State bankruptcy would act more directly on the state, of course, but analogous protections seem likely to satisfy sovereignty concerns.

The second potential distinction is not so easily dismissed. State sovereignty has been a preeminent concern for a majority of the justices of the current Supreme Court. In its anticommandeering cases, for instance, the Court has struck down federal legislation that requires the states to address issues that are of concern to Congress.<sup>142</sup> Although the requirement that a state consent to bankruptcy vitiates this objection, the Court has suggested that the state itself is not the only consideration. Sovereign immunity also is designed to protect the federal structure.<sup>143</sup> Under an expansive reading of the Tenth Amendment, the Court might return to pre-*Bekins* conceptions of state sovereignty and strike down not just state bankruptcy but municipal bankruptcy as well on the grounds that the legislation insinuates federal decision makers too deeply into state affairs.

Although this cannot be ruled out, it seems unlikely. The federal government has already inserted itself into state affairs quite intrusively in other areas, imposing Medicaid funding obligations, welfare restrictions, and a wide variety of other constraints.<sup>144</sup> The government's interest is at least as great in the bankruptcy context, given the large subsidy the federal government provides for state debt by exempting it from tax and the pressure for federal assistance if a state falls into distress.<sup>145</sup> Unless the Court is prepared to strike down many of the other programs, a state-bankruptcy law also seems safe. State bankruptcy also would benefit from the wide scope the

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<sup>141</sup> "The State acts in aid, and not in derogation, of its sovereign powers" when it permits it municipalities to file for bankruptcy, the Court wrote in *Bekins*. 304 US at 54. "It invites the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue." *Id.*

<sup>142</sup> See, for example, *New York v United States*, 505 US 144, 188 (1992).

<sup>143</sup> In *Bond v United States*, 131 S Ct 2355, 2364 (2011), the Court emphasized that "[s]tates are not the sole intended beneficiaries of federalism." The (uncertain) implications of the structural dimension of sovereign immunity are discussed in Michael W. McConnell, *Extending Bankruptcy Law to States: Is it Constitutional?*, in Conti-Brown and Skeel, *When States Go Broke* at \*234–35 (cited in note 24).

<sup>144</sup> These federal-state partnerships are discussed in somewhat more detail in Part IV.B. See note 233 and accompanying text.

<sup>145</sup> According to one estimate, the value of the tax exempt status of state and municipal bond interest will be roughly \$161.6 billion between 2010 and 2014. *Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2010–2014*, JCS-3-10, 111th Cong., 2d Sess 51 (Dec 15, 2010), online at <http://www.jct.gov/publications.html?func=startdown&id=3718> (visited Nov 25, 2011).

Court has given to Congress's exercise of authority under the Bankruptcy Clause. In a different bankruptcy context, the Court recently held that the Bankruptcy Clause trumps state sovereignty concerns.<sup>146</sup> Together, these factors bode well for a well-crafted state-bankruptcy law even in an era of heightened concern for state sovereignty.

In the prior cases, the state sovereignty and Contracts Clause analyses have tended to travel in tandem, which suggests that a state-bankruptcy law that successfully ran the state sovereignty gauntlet would likely survive Contracts Clause scrutiny.<sup>147</sup> The two inquiries are not identical, however. The Contracts Clause cases have emphasized that states can impair existing contracts only under dire circumstances and suggest that courts will consider whether creditors' rights are adequately protected. Under current Chapter 9, the "best interests of the creditors" test serves this function by requiring that creditors be treated better than they would under any realistic alternative.<sup>148</sup> If a state-bankruptcy law lacked a protection of this kind, it might be struck down as facilitating a state's violation of the Contracts Clause.<sup>149</sup> So long as the bankruptcy law includes this protection, it should satisfy the Contracts Clause. If a state-bankruptcy law successfully ran the state sovereignty gauntlet, it therefore should also survive Contracts Clause scrutiny.

The constitutional objections to state bankruptcy are far from silly. But it is hard to imagine the Court striking down state-

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<sup>146</sup> *Central Virginia Community College v Katz*, 546 US 356, 378 (2006).

<sup>147</sup> The trend line in cases in which states authorize contractual restructuring has been toward a somewhat more flexible Contracts Clause. See, for example, *United Automobile v Fortuna*, 633 F3d 37, 39 (1st Cir 2011) (affirming the dismissal of a Contracts Clause objection to Puerto Rican legislation suspending public employee collective bargaining agreements). Even if the Supreme Court curtails these developments in the lower courts, it seems much less likely to invalidate a federal restructuring statute as violating the Contracts Clause, given Congress's broad authority under the Bankruptcy Clause.

<sup>148</sup> The best interests of the creditor requirement is housed, but not explained, in 11 USC § 943(b)(7). In the words of one commentary, courts should "apply the test to require a reasonable effort by the municipal debtor that is a better alternative to its creditors than dismissal of the case." 6 *Collier on Bankruptcy* § 943.03(7)(a) at 943-32 (cited in note 70).

<sup>149</sup> For the related argument that the Contracts Clause requires that municipal bankruptcy include "best interests of the creditors" protection, see McConnell and Picker, 60 *U Chi L Rev* at 480 (cited in note 58)

*Faitoute* stands for the proposition that the Contracts Clause is not violated if—as a practical and not a technical matter—the state substitutes a remedy that is as valuable as the one that had been contracted for. In effect, the Contracts Clause allows state municipal bankruptcy laws but constitutionalizes a 'best interest of the creditors' test, preventing the states from adopting debt adjustment programs that benefit the municipal debtor at the expense of the creditors.

bankruptcy legislation that assures that the principal decision-making authority remains securely in state hands.

#### B. The States' Existing Tools Are Enough

According to a second objection, some states may be in a deep fiscal hole, but they will somehow muddle through their difficulties. Some argue that the state fiscal crisis is simply the inevitable consequence of a financial downturn, and that it will ease when economic conditions improve.<sup>150</sup> Others view the current predicament as more dire but contend that the states have adequate mechanisms for responding. Focusing principally on the costs of public employee unions, municipal finance scholar E.J. McMahon insists that “state officials committed to cutting costs already have options for putting the squeeze on their unions.”<sup>151</sup> In addition to layoffs or involuntary furloughs, McMahon argues, states can restrict public employees' collective bargaining rights, a step several states have taken since McMahon wrote.<sup>152</sup> McMahon also suggests that states are better off restructuring their pension problems outside bankruptcy than under the auspices of a federal bankruptcy law.<sup>153</sup>

Each of these is indeed an important option for dealing with unsustainable obligations. But they also have substantial limitations. With the exception of layoffs and furloughs, a state's tools for addressing unsustainable contracts with its public employee unions ordinarily apply only to future contracts. Cutting back on collective bargaining rights may give the state leverage with future collective bargaining agreements, for instance, but the Contracts Clause limits a state's capacity to rework existing contracts.<sup>154</sup>

With pensions, the state's restructuring options differ in different states. In some of the most troubled states, state lawmakers have very little flexibility. Illinois and New York, for instance, prohibit state lawmakers from altering the pensions of current

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<sup>150</sup> This claim is often coupled with a contention that the states' fiscal troubles are not as severe as naysayers claim. See, for example, Lav and McNichol, *Misunderstandings Regarding State Debt* at 1 (cited in note 14) (criticizing the “mistaken impression that drastic and immediate measures are needed to avoid an imminent fiscal meltdown”).

<sup>151</sup> E.J. McMahon, *State Bankruptcy Is a Bad Idea*, Wall St J A17 (Jan 24, 2011).

<sup>152</sup> See, for example, Kris Maher and Ilan Brat, *Wisconsin Curbs Unions—GOP Governor to Quickly Sign Limits on Bargaining Rights as Democrats Fume*, Wall St J A3 (Mar 11, 2011).

<sup>153</sup> *Id.*

<sup>154</sup> Limits but does not remove altogether. Under the exception for emergency conditions, states have some authority to alter existing contracts in the event of a crisis. The classic case is *Faitoute Iron & Steel Co v City of Asbury Park*, 316 US 502 (1942). But *Faitoute* may be shaky in the current Court and is likely to be construed narrowly, as discussed further in Part III.C.

employees.<sup>155</sup> The restriction applies not only to pension rights that an employee has already earned but also to those she has not yet earned. Other states are not so restrictive, but even the smallest adjustments are fiercely and often successfully contested.<sup>156</sup>

The story is similar with bond debt. It is possible for the state to restructure unsustainable bond debt, but very difficult. Most bonds issued by states do not have so-called collective action clauses, under which a majority of bondholders can vote to restructure the bonds.<sup>157</sup> This means that no bondholder can be forced to accept a reduction in his promised payout unless he affirmatively agrees to it. The state could try to achieve a restructuring by making an offer to its bondholders and conditioning the offer on acceptance by a very high percentage of the bonds, a strategy that has been employed in other contexts.<sup>158</sup> This strategy could achieve a restructuring, but the need to persuade a large percentage of the bonds to agree may limit its extent, and the state would remain liable in full to any bondholders who did not sign on.<sup>159</sup>

The analysis thus far suggests that bankruptcy would appreciably expand the toolkit states have for addressing their financial predicaments. This by itself is not grounds enough for dismissing the “states can do it on their own” objection, however. If states have a bankruptcy option, some worry, state legislators won’t work quite so hard to make the hard choices that are necessary to relieve a state’s financial distress.<sup>160</sup>

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<sup>155</sup> See note 82.

<sup>156</sup> For an excellent overview of the extent to which pensions can be adjusted, see generally Monahan, 5 *Educ Fin & Policy* 617 (cited in note 87). See also *id.* at 638–39 (providing a chart summarizing pensions protected on a state-by-state basis).

<sup>157</sup> Schwarcz, 59 *UCLA L Rev* at 329–31 (cited in note 40) (“Relatively few state bond issues currently include collective action clauses or their equivalent.”). A collective action clause is a provision that makes a vote to restructure binding on every bondholder if the specified majority of bonds approves the restructuring. The Trust Indenture Act of 1939, Pub L No 111-229, 53 Stat 1149, codified at 15 USC § 77aaa et seq, forbids collective action provisions in corporate debt, but it does not apply to state or sovereign debt. See The Trust Indenture Act of 1939 § 316, codified at 15 USC § 77ppp(b); The Trust Indenture Act of 1939 § 304, codified at 15 USC § 77ddd(a)(4)(A), (a)(6).

<sup>158</sup> See, for example, John C. Coffee Jr and William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 *U Chi L Rev* 1207, 1214–15 (1991) (describing strategies used to pressure bondholders to participate); Lee C. Buchheit and G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 *UCLA L Rev* 59, 65–66 (2000) (proposing this strategy for sovereign debt).

<sup>159</sup> In the corporate bond context, exchange offers are often conditioned on 90 or 95 percent participation. Coffee and Klein, 58 *U Chi L Rev* at 1215 n 26 (cited in note 158).

<sup>160</sup> See, for example, McMahon, *State Bankruptcy* Wall St J at A17 (cited in note 151); Adam Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 *Cornell L Rev* \*5, 38–43 (forthcoming 2012), online at <http://ssrn.com/abstract=1898775> (visited Nov 25, 2011).

This is a legitimate concern. It is a version of the well-known concern that providing a soft landing in bankruptcy will distort prebankruptcy decision-making incentives.<sup>161</sup> But it is premised on the assumption that state decision makers will be tempted by the bankruptcy option. They are far more likely to view it as a last resort. Few state governors will relish being remembered as the governor who put his or her state into bankruptcy. It is more plausible that a state would use the *threat* of filing for bankruptcy to try to persuade the federal government to provide rescue financing on generous terms, as municipalities have sometimes done with states.<sup>162</sup> But the threat would be effective only if it were credible (that is, federal officials believed that the state really might file for bankruptcy), if federal officials believed that a bankruptcy filing would have dangerous spillover effects throughout the economy, and if the federal government were politically and financially capable of funding a bailout. Moreover, states can make a similar threat—the threat to default on their debt—even in the absence of a state-bankruptcy option. State bankruptcy is more likely to defuse the pressure for a federal bailout than to increase it, as we have seen.<sup>163</sup>

### C. State Restructuring Alternatives

Even if a state's existing tools were insufficient, a state might attempt to craft its own restructuring framework. Indeed, they have sometimes done so in the past. At the end of the Great Depression, New Jersey enacted legislation that authorized the restructuring of municipal bonds if two-thirds of the bondholders approved. Although the statute was challenged under the Contracts Clause—the plaintiffs argued that it interfered with the terms of their contract—the Supreme Court upheld it in a 1942 case.<sup>164</sup> Under this approach, a state might tailor its restructuring regime to its own

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<sup>161</sup> See, for example, Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 Cornell L Rev 439, 473–76 (1992); Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 Intl Rev L & Econ 223, 230 (1991).

<sup>162</sup> See Gillette, 79 U Chi L Rev at 325–27 (cited in note 62). Gillette cites Camden, New Jersey's 1999 Chapter 9 filing, Harrisburg's recent negotiations with Pennsylvania, and the New York City rescue in 1975 as examples of the use of bankruptcy or the threat of bankruptcy to limit the scope of state intervention. *Id.* at 324–26.

<sup>163</sup> See Part II.F. The strategic interaction between federal officials and the state is discussed in more detail in Part IV.C.

<sup>164</sup> *Faitoute*, 316 US at 508–09.

circumstances, with some adopting a limited framework or none at all, and others devising a more comprehensive approach.<sup>165</sup>

I confess that I find this objection alluring, not least because I have made somewhat similar proposals in my own work in the past.<sup>166</sup> It is subject to very serious limitations in this context, however. The first difficulty is simply that a state would have limited room to maneuver to the extent it wished to rework existing obligations, rather than solely not-yet-incurred ones. To be sure, states are not barred from making any adjustments to existing contracts. Under current law, a subsequent modification of a state's financial obligations may be constitutional if it is "reasonable and necessary to serve an important public purpose," so long as no less drastic option is available and the state's objective could not be achieved without impairing contractual obligations.<sup>167</sup> In *Faitoute Iron & Steel Co v City of Asbury Park*,<sup>168</sup> the Supreme Court upheld a state statute that provided for a binding vote on the restructuring of a municipality's bonds. But the important public purpose exception has never been broadly construed, and subsequent Supreme Court cases hint at possible retrenchment;<sup>169</sup> the exception may be too slim a reed on which to hang a comprehensive restructuring framework.<sup>170</sup> Even if *Faitoute* remains good law, which is uncertain, states may not be able to enact a more complete restructuring framework. This may mean that only a purely prospective state-enacted law would survive constitutional scrutiny.

The second and perhaps more important limitation is political. In the current environment, state lawmakers who believe that their state would be bailed out in a crisis have little incentive to enact restructuring legislation that might make a bailout less likely and as a

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<sup>165</sup> George Triantis makes this argument in a new article, see generally George T. Triantis, *Let the States Design Their Own Restructuring Process*, in Conti-Brown and Skeel, eds, *When States Go Broke* (cited in note 24), as does Richard Hynes, *State Default and Synthetic Bankruptcy* (unpublished manuscript 2011) (on file with author).

<sup>166</sup> See David A. Skeel Jr, *Rethinking the Line between Corporate Law and Corporate Bankruptcy*, 72 *Tex L Rev* 471, 513–25 (1994) (arguing that the states should regulate corporate bankruptcy, just as they regulate corporate law).

<sup>167</sup> *US Trust Co v New Jersey*, 431 US 1, 25, 30 (1977).

<sup>168</sup> 316 US 502 (1942).

<sup>169</sup> In *Faitoute* itself, the Supreme Court emphasized that a heavy majority of the bondholders favored restructuring, and that the restructuring was necessary to protect the value of the bonds. *Id.* at 506. In *US Trust*, the Court struck down the state statute. 431 US at 32.

<sup>170</sup> At the least, the framework would need to include creditor protections comparable to bankruptcy's "best interests of the creditors" requirement, as discussed earlier. See notes 148–49 and accompanying text.

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result increase their borrowing costs today.<sup>171</sup> The states that currently are most troubled—California, Illinois, New York, New Jersey—are precisely the states that the government is most likely to bail out if their debt becomes unsustainable.

Notice that neither of these points suggests that state legislation is a bad idea—particularly to the extent it has prospective scope and thus addresses the Contracts Clause difficulty. But the possibility of a state framework does not justify forgoing federal legislation for states.

#### D. The Absence of Political Will

According to a fourth objection, the same political impediments that could stymie a state's efforts to address its problems outside bankruptcy would prove just as debilitating in bankruptcy. “[I]f Gov[ernor] Jerry Brown and the California legislature are unwilling to rewrite their collective bargaining rules,” E.J. McMahon has argued, “why assume they would plead with a federal judge to do it for them?”<sup>172</sup> If a governor refuses to make hard choices, or the legislature thwarts him or her, the reasoning goes, bankruptcy will not prove any more effective, because the same politicians will be making the decisions in bankruptcy.

Politics do indeed make state bankruptcy more delicate than ordinary corporate bankruptcy. But the political will argument is flawed in two respects. The first is that political will sometimes may not be the problem. Even if a state has the political will to make changes, lawmakers may not be able to solve the state's problems fully with the tools available outside bankruptcy.<sup>173</sup> Bankruptcy would thus be justified even if some states might lack the political will to use all of the levers at their disposal outside bankruptcy.

Second, bankruptcy could alter the political dynamics in several ways. Lawmakers who would resist cuts to a particular constituency outside bankruptcy might be persuaded to approve bankruptcy if they concluded that the sacrifice would be distributed more evenly, for instance. The absence of political will outside bankruptcy thus will not always translate to a similar absence in bankruptcy. In addition, the bankruptcy law itself can be structured to reduce some of the political

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<sup>171</sup> This surely is at least one reason California Treasurer Bill Lockyer so quickly and stridently condemned the concept bankruptcy for states. See Press Release, *Treasurer Lockyer Criticizes Effort to Let States File for Bankruptcy* (Jan 21, 2011), online at <http://www.treasurer.ca.gov/news/releases/2011/20110121.pdf> (visited Nov 25, 2011).

<sup>172</sup> McMahon, *State Bankruptcy*, Wall St J at A17 (cited in note 151).

<sup>173</sup> The additional tools available in bankruptcy are discussed in Part II.D.

obstacles to an effective restructuring. I have assumed throughout this discussion that any bankruptcy law would have some of the same basic features as corporate and municipal bankruptcy have, such as a vote by creditors on a restructuring plan that was proposed by the debtor's existing decision makers.<sup>174</sup> But Congress could adjust the framework in a wide variety of ways. Consider two possible alternatives.<sup>175</sup>

First, Congress could adopt a simple, severe bankruptcy framework that automatically discharged all of a state's obligations shortly after it filed for bankruptcy.<sup>176</sup> Under this approach, secured creditors would be entitled to their collateral, but all of the state's contracts would be terminated and its obligations to general creditors would be canceled. Chapter 7 currently functions somewhat similarly for consumer debtors: bankruptcy provides an immediate discharge.<sup>177</sup> Under such a system, the only issue for a state would be whether to file or not in the first instance. To be sure, the state would likely wish to reaffirm at least some of its obligations.<sup>178</sup> But the discharge would ensure that debt overhang was dealt with even if state decision makers subsequently reached an impasse.<sup>179</sup>

Second, the bankruptcy process could simplify the decision-making process even under a more traditional restructuring framework. Rather than requiring the governor and both houses of the legislature to propose a restructuring plan, Congress might vest this authority directly in the governor, perhaps together with an obligation for the governor to consult with the legislature. Such a plan presumably could not commit the state to measures, such as a tax increase, that require legislative approval outside bankruptcy.<sup>180</sup> But it could restructure the state's obligations in other respects (and could be made conditional on subsequent legislative approval where necessary). Congress's authority under the Bankruptcy Clause to

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<sup>174</sup> See 11 USC § 1124(a)–(g).

<sup>175</sup> I discuss the mechanics of a possible state bankruptcy law in more detail elsewhere. See generally Skeel, *State Bankruptcy from the Ground Up* (cited in note 24).

<sup>176</sup> The proposal described in this paragraph was suggested by Barry Adler at a recent conference.

<sup>177</sup> In theory, a consumer debtor who files for Chapter 7 must turn over all of her nonexempt assets to the trustee in return for the bankruptcy discharge. But the vast majority of consumer debtors have no nonexempt assets. See Michelle J. White, *Abuse or Protection? Economics of Bankruptcy Reform under BAPCPA*, 2007 U Ill L Rev 275, 284.

<sup>178</sup> Consumer reaffirmation requires court approval under 11 USC § 524(d)(2).

<sup>179</sup> One can imagine objections to this framework, such as the concern that it might be triggered on a whim. Rather than working out the necessary adjustments, my objective here is simply to show that nonbankruptcy political limitations need not impede restructuring in bankruptcy.

<sup>180</sup> See, for example, Hynes, *State Default* at \*51 n 201 (cited in note 165) (emphasizing these concerns).

provide for a bankruptcy discharge thus should enable it to simplify the decision-making process.

In short, political factors would make state bankruptcy more difficult than an ordinary bankruptcy. But they do not undermine the argument for a bankruptcy option; they strengthen it.

#### E. Bond Contagion

The fifth objection focuses on bankruptcy's effect on the municipal bond market. "Just the availability of a bankruptcy option and the potential bond default could severely damage state credit ratings and destroy the trust of bondholders," as New York's comptroller put it. "Our economy cannot withstand another crisis in confidence."<sup>181</sup> "[I]f we in fact create . . . a state bankruptcy chapter," another critic warned, "'I see all sorts of snakes coming out of that pit,' as '[b]ankruptcy for states could—would cripple bond markets.'"<sup>182</sup> Fear of bond market contagion gives pause to many who might otherwise find the arguments for a bankruptcy backstop compelling.<sup>183</sup>

First, a note about confusion in bond terminology. Credit rating agencies and other market participants often use the term "municipal bond" broadly to include debt issued by states as well as debt issued by true municipalities such as cities and counties. When commentators point to recent volatility in the municipal bond markets as evidence of the risk of contagion, the markets in question include both states and municipalities. Yet municipalities have had a bankruptcy option for decades. It is only states that do not. gyrations in the prices of both state and municipal debt thus suggest that the volatility does not stem from the existence or absence of a bankruptcy option. Indeed, a bankruptcy option could decrease volatility rather than increase it, because it would provide an orderly alternative to the possibility of a catastrophic default. This does not require us to dismiss the bond market contagion argument, but it does highlight the need to carefully distinguish the effects of a

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<sup>181</sup> Thomas P. DiNapoli, *Even Talk of Bankruptcy Is a Bad Solution for States*, Wall St J A16 (Jan 24, 2011) (arguing that the creation of a state bankruptcy regime would negatively affect even fiscally responsible states' access to capital markets).

<sup>182</sup> Henes and Hessler, 245 NY L J at S6 (cited in note 31), quoting State Insolvency Hearings (cited in note 18) (statement of Rep Coble).

<sup>183</sup> Some critics who warn of bond market contagion have an obvious self interest in fending off a bankruptcy option, such as officials in troubled states that might find their leverage in negotiations for a federal bailout diminished if a bankruptcy law were passed. But others are more disinterested, and I put motives to the side to focus on the objection's merits.

bankruptcy option from other factors, such as the general risk of default.

It is even more important to define just what contagion “is.” Contagion can take one or more of three forms. The first, information contagion, is a negative shock that stems from information that one entity’s troubles convey about other similar entities.<sup>184</sup> During the 2008 financial crisis, Lehman’s default created information contagion because other major banks held the same kinds of (mortgage-backed) assets as Lehman. The default signaled that these assets were even more problematic than had been thought. The second, related form of contagion is a confidence crisis.<sup>185</sup> If one entity’s collapse creates uncertainty as to the financial health of its peers, the collapse may trigger a sudden, market-wide flight by creditors of the peer entities, even if they do not have the same assets or financial structure. The final form of contagion is counterparty contagion. If counterparties—that is, the entity’s creditors—hold large amounts of the entity’s debt, a failure by the entity to pay may create a financial crisis for the counterparty itself.<sup>186</sup>

Concerns that enactment of state bankruptcy would “cripple the bond markets” have the second form of contagion principally in mind. Unless the enactment were tied directly to one state’s impending default, it would not reveal new information about state finances. The potential effect on the holders of state bonds also appears to be secondary.<sup>187</sup> The real concern is that congressional action would trigger a confidence crisis.

If I am correct about this, the bond market contagion argument rests on two key assumptions. The first is that the bond markets will not differentiate (or will distinguish poorly) between states that are financially sound and those at risk of default. The prospect that financially troubled states might find it more costly to issue bonds would not be troubling; in a properly functioning market, riskier states should find it costlier to issue debt.<sup>188</sup>

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<sup>184</sup> See Jean Helwege, *Financial Firm Bankruptcy and Systemic Risk*, 32 Reg 24, 24 (Summer 2009).

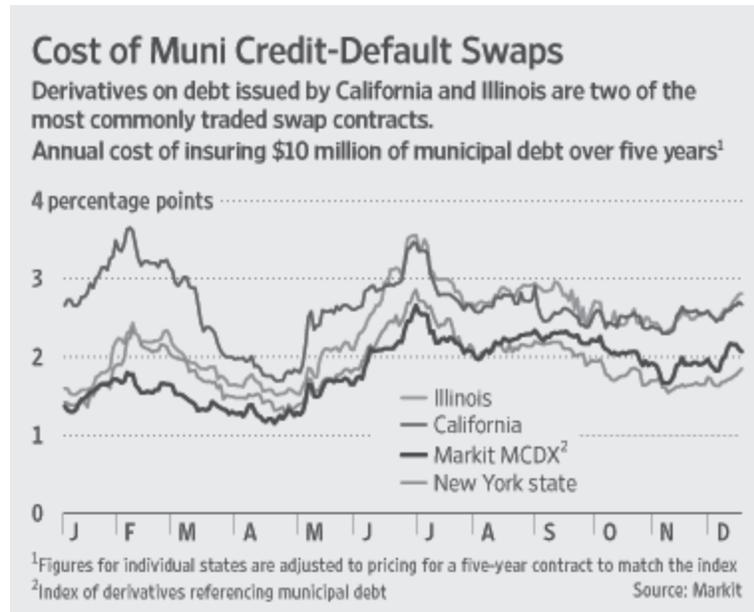
<sup>185</sup> See Kenneth Ayotte and David A. Skeel Jr, *Bankruptcy or Bailouts?*, 35 J Corp L 469, 472 (2010) (discussing crisis of confidence effects in 2008).

<sup>186</sup> See Helwege, 32 Reg at 24 (cited in note 184).

<sup>187</sup> But not irrelevant. The potential adverse effects on bondholders—and the nature of bondholders—are discussed in the next Section. See Part III.F.

<sup>188</sup> This is precisely what we see. The spreads (and thus the cost) of California and Illinois debt have risen considerably during the recent crisis, reflecting their troubled financial condition. See Katy Burne, *Some Banks See Profit in Muni Woes*, Wall St J C1 (Dec 21, 2010) (reporting increased market for credit default swaps that compensate buyers if municipalities miss bond payments). See also James M. Poterba and Kim S. Rueben, *Fiscal News*, *State*

FIGURE 1. COST OF MUNI CREDIT-DEFAULT SWAPS



Source: Katy Burne, *Some Banks See Profit in Muni Woes* Wall St J C1 (Dec 21, 2010).

Contagion is a serious concern only if the markets also punish fiscally sound states. The second assumption is that this punishment would be enduring. Because states have substantial flexibility when to issue bonds, a temporary jump in interest rates when bankruptcy legislation is enacted should not be alarming. The contagion concern thus distills to a claim that enacting a bankruptcy law would impose lasting costs on all states, not just those that are financially troubled.

Because states have never been permitted to file for bankruptcy, we cannot test the contagion hypothesis directly. But we do have a variety of empirical evidence from related contexts. One study, often cited as evidence of contagion, explored the effects of Orange County's municipal bankruptcy filing in 1994.<sup>189</sup> Focusing on bond prices a day after the Orange County filing, the study found a market-wide decrease in municipal prices. Several aspects of the study cast doubt on the claim that it shows that bankruptcy has system-wide effects. First, because municipalities have had a

*Budget Rules, and Tax-Exempt Bond Yields*, 50 J Urb Econ 537, 559–60 (2001) (finding that bond yields increase in response to news that a state's deficit is higher than expected).

<sup>189</sup> John M. Halstead, Shantaram Hegde, and Linda Schmid Klein, *Orange County Bankruptcy: Financial Contagion in the Municipal Bond and Bank Equity Markets*, 39 Fin Rev 293, 313 (2004).

bankruptcy option since the 1930s, bond prices may have reacted to the fact of Orange County's default, not to the bankruptcy framework as distinct from default. Only if Orange County would have avoided default but for the availability of bankruptcy—which seems very unlikely—can bankruptcy be said to have triggered the price decline. Second, the effect was very short term—one day is far too short to suggest lasting effects. Finally, another study of the Orange County filing found strong evidence that bond funds with a disproportionate exposure to Orange County debt declined more than other bond funds, which suggests that the markets do indeed distinguish between the debt of healthy and troubled municipalities.<sup>190</sup>

A final set of studies explore changes in the sovereign-debt markets. Perhaps the most directly relevant examined the reaction of the sovereign-debt markets to the issuance by Mexico, after arm-twisting by the US, and then other countries of New York denominated bonds that included so-called collective action clauses (CACs) in 2003.<sup>191</sup> The CACs resemble a limited form of bankruptcy because they enable a sovereign debtor to restructure its bond debt by majority vote of its bondholders. A study of sovereign bond offerings over the period from 1986 to 2007 found that the shift to CACs did not have a significant price effect on sovereign debt.<sup>192</sup> We should not read a great deal into this finding, given that sovereign

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<sup>190</sup> See Dwight V. Denison, *Did Bond Fund Investors Anticipate the Financial Crisis of Orange County?*, 21 *Mun Fin J* 24, 32 (1999). For an argument that municipal bond markets began distinguishing between weak and strong municipal bond issuers after the New York City crisis, see David L. Hoffland, *The "New York City Effect" in the Municipal Bond Market*, 33 *Fin Anal J* 36, 36 (Mar–Apr 1977).

<sup>191</sup> The introduction of collective action clauses in most new bond issuances came after a debate over a variety of options for dealing with sovereign financial distress, including an IMF proposal to implement a Sovereign Debt Restructuring Mechanism. See Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?*, 37 *Intl Law* 103, 123–24 (2003). For a discussion of the shift to CACs, see Stephen J. Choi, Mitu Gulati, and Eric A. Posner, *Pricing Terms in Sovereign Debt Contracts: A Greek Case Study with Implications for the European Crisis Resolution Mechanism* \*10–11 (University of Chicago John M. Olin Law and Economics Working Paper No 541, Feb 1, 2011), online at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1713914](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1713914) (visited Nov 26, 2011); Michael Bradley, James D. Cox, and Mitu Gulati, *The Market Reaction to Legal Shocks and Their Antidotes: Lessons from the Sovereign Debt Market*, 39 *J Legal Stud* 289, 295–97 (2010).

<sup>192</sup> Bradley, Cox, and Gulati, 39 *J Legal Stud* at 301 (cited in note 191) (concluding that the introduction of CACs “had little impact on the pricing of sovereign debt”). Bradley et al. were testing the hypothesis that CACs actually would increase the price (and decrease the cost) of sovereign debt by reducing the risk of bondholder holdouts to a restructuring. In a more recent study, Michael Bradley and Mitu Gulati find that “CACs are associated with lower spread for weaker nations” in the post 2002 period. Michael Bradley and Mitu Gulati, *Collective Action Clauses for the Eurozone: An Empirical Analysis* \*50 (Working Paper, Oct 24, 2011), online at <http://ssrn.com/abstract=1948534> (visited Apr 13, 2012).

countries are similar to but not the same as states,<sup>193</sup> and CACs are a more limited form of restructuring than bankruptcy. But the absence of significant price effects suggests that increasing a country's restructuring options need not cause market contagion. Another sovereign debt study found a small premium for a Greek bond without CACs as compared to Greek bonds with CACs, which may imply that the market privileged a bond that was less likely to be restructured, or might not be restructured as much, in a Greek workout.<sup>194</sup> Other studies have examined the market's reaction to a country's default, generally finding that the defaulting country loses access to the bond markets temporarily, but that it can subsequently return to the markets.<sup>195</sup> These studies do not speak directly to the contagion issue, but they do provide further evidence as to the resilience of bond markets.

Although the existing evidence cannot be said to definitively refute the contagion objection, it suggests that contagion concerns are overstated. There is little reason to believe that enactment of a bankruptcy law for states would destabilize the bond markets, and appreciable evidence indicating both that the market differentiates between good and credit risks, and that any effect on bond prices would be muted.

If this conclusion is correct, two important implications follow. First, imperfections in the bond market are best addressed by bond market reforms. The state and municipal debt markets provide considerably less disclosure to investors than the markets for corporate bonds.<sup>196</sup> Not only are state and municipal budgets more opaque than the balance sheets of most corporations (though large financial institutions come close); investors also have less access to current price data than with other bonds. Improving disclosure in the

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<sup>193</sup> States cannot devalue their currency in response to a crisis, for instance, as most countries can. Interestingly, Greece and other Eurozone members have given up this sovereign prerogative by adopting the euro as their common currency, which suggests that many of the arguments for state bankruptcy would also apply to Europe.

<sup>194</sup> Choi, Gulati, and Posner, *Pricing Terms in Sovereign Debt Contracts* at \*25 (cited in note 191) (finding that the yield for English-law-governed Greek bonds, which included CACs, was 212.7 basis points lower than the yield for Greek bonds without CACs at the outset of the Greek crisis).

<sup>195</sup> See, for example, R. Gaston Gelos, Ratna Sahay, and Guido Sandleris, *Sovereign Borrowing by Developing Countries: What Determines Market Access?*, 83 *J Intl Econ* 243, 250 (2011) (finding, among other things, that a default, if resolved quickly, does not reduce significantly the probability of tapping the markets).

<sup>196</sup> See Theresa A. Gabaldon, *Financial Federalism and the Short, Happy Life of Municipal Securities Regulation*, 34 *J Corp L* 739, 742–53 (2009); R. Penny Marquette and Earl R. Wilson, *The Case for Mandatory Municipal Disclosure: Do Seasoned Municipal Bond Yields Impound Publicly Available Information?*, 11 *J Acct & Pub Pol* 181, 184 (1992).

bond markets would be a much more sensible response to these issues than fending off state bankruptcy.<sup>197</sup>

Second, contagion critics tend to assume that any reform that might increase the cost of state bond debt is necessarily pernicious. As we saw earlier, however, this assumption has things backwards.<sup>198</sup> States currently have too great an incentive to issue debt to fund current spending, and the implicit bailout subsidy makes this debt too cheap. If a bankruptcy framework diminished this subsidy and debt costs rose modestly as a result, these consequences should be praised, not condemned.

#### F. The Vulnerable Holders of State Debt?

The final objection focuses once again on the risk of contagion, but the contagion concern is somewhat different. Rather than the effect on states' ability to tap the bond market, this objection worries about counterparty contagion—in this case, the plight of the holders of state debt. According to state and municipal governance scholar Nicole Gelinas, who has frequently raised this concern: “[I]f Congress wants to raise the prospect [of state bankruptcy], it would have to raise the prospect that a large bank or money-market fund, too, could suffer large losses as a result of that default. After all, banks own \$229 billion in state and local debt, and money-market funds own another \$332 billion.” State bankruptcy “could create economic chaos,” she argued, “forcing Congress, in the end, to save the state or the bank.”<sup>199</sup>

It is impossible to consider this objection without casting a glance across the Atlantic to recent developments in Greece and elsewhere in Europe.<sup>200</sup> The identity of the bondholders has figured prominently in the debates over how to address Greece's debt crisis. Much of the debt is held by French and German banks that might be destabilized—or so European leaders feared—by a genuine

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<sup>197</sup> State disclosure concerning their public pensions is even more opaque than state bond disclosure. Legislation introduced in late 2010 would require much more disclosure. See generally Public Employee Pension Transparency Act, HR 6484, 111th Cong, 2d Sess (Dec 2, 2010).

<sup>198</sup> See Part II.B.

<sup>199</sup> Gelinas Statement at 3 (cited in note 96).

<sup>200</sup> In a recent Stanford conference on state financial distress, Felix Salmon explicitly linked the two situations, concluding that the ownership profile made state bankruptcy impossible. Felix Salmon, *When States Go Broke: The Economics and Finance of State Default* (The Arthur and Toni Rembe Rock Center for Corporate Governance and the Stanford Constitutional Law Center May 13, 2011), online at <http://www.youtube.com/watch?v=ePxUCoR3bkQ#t=29m03s> (visited Nov 25, 2011).

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restructuring.<sup>201</sup> Because banks hold a significant percentage of state bonds, the European experience seems to suggest that state bankruptcy raises the same concerns.

As the figures for a small sample of California, Illinois, and New Jersey bonds in Table 1 illustrate, banks, mutual funds, and other financial institutions are indeed large holders of state debt. Vanguard, for instance, is the largest holder of the California bonds, and the Illinois bonds are held by a bank and insurance companies. Yet the bondholders' profile and its implications are quite different with states than with Greece.

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<sup>201</sup> See, for example, Megan Murphy, et al, *Greek Contagion Fears Spread to Other EU Banks*, Fin Times (June 15, 2011), online at <http://www.ft.com/intl/cms/s/0/ac918946-975a-11e0-9c9d-00144feab49a,s01=1.html> (visited Nov 25, 2011) (reporting French bank exposure at \$53 billion, and German bank exposure at \$34 billion). The European Central Bank boxed itself into a corner by announcing that it would not be able to accept Greek bonds as collateral from banks if Greece defaulted. *Id.* The Greek debt is finally being restructured as this Article goes to press. The restructuring has been accompanied by measures, such as funding on generous terms from the European Central Bank, designed to protect the banks.

TABLE 1. LARGEST HOLDERS OF SELECTED STATE BONDS

<b>Symbol</b>	<b>Holder Name</b>	<b>Market Value</b> (in millions of dollars)
California St CUSIP: 13063ACP	Vanguard Group Inc	34.39
California St CUSIP: 13063AAY	Franklin Resources Inc	25.55
California St CUSIP: 13063ACP Illinois St CUSIP: 452151XL Illinois St CUSIP: 452151XW	Blackrock Advisors	8.4
	American Century Co	6.48
	Blackrock Fund Advisers	6.03
	Wells Capital Management	1.47
	Spirit of America Management Corp	0.49
	Phoenix Investment Corp	0.24
	The Pennsylvania Trust Co	0.29
	Bank of New York Mellon Nationwide Indemnity	1.02 2.03
Illinois St CUSIP: 452151XY	Grange Mutual Casualty Group	1.5
Illinois St CUSIP: 4521514J	AGRI General Insurance	1
New Jersey St CUSIP: 646039RB	National Public Finance Guarantee Corp	4.73
New Jersey St CUSIP: 646039PS	QCC Insurance Co	1.18
New Jersey St CUSIP: 646039QH	Putnam Investment Mutual Fund	1.8
New Jersey St CUSIP: 646039QH	American Empire Surplus Lines Insurance Co	1.45

Source: Bloomberg Terminal (Nov 7, 2011).

The first difference is that the banks that hold Greek and other troubled Eurozone debt are systemically important, and their absolute exposure is high—roughly 53 and 34 billion euros for French and German banks in Greece alone, according to recent estimates.<sup>202</sup> Systemically important American banks—the banks that were deemed too big to fail during the recent crisis—do not have nearly so concentrated an exposure to state debt.<sup>203</sup> Second, the debates in Europe have taken place in a context where the financial calamity has already materialized. Absent a massive bailout, Greece would have defaulted long before its recent restructuring. By contrast, if Congress put a state-bankruptcy framework in place, it is unlikely that any state would immediately invoke it. The mere addition of a bankruptcy option would have a much more limited effect on prices than an actual default or bankruptcy filing. The comparison between Greece and state bankruptcy is thus misleading.<sup>204</sup>

In the US context, the more relevant concern may be the potential effect on money market firms that hold state debt. It is possible that the enactment of a state-bankruptcy option would induce money market funds to stop purchasing state debt, but this seems unlikely. After all, money market funds hold municipal debt, despite the fact that municipal debtors already have a bankruptcy option.

The real holders of state bonds, unlike with Greek debt, are wealthy individuals who hold them, either directly or through mutual or money market funds, because of their tax-favored status.<sup>205</sup> State bonds are especially attractive to wealthy individuals who live in the state of issuance, because the holder benefits from the exemption

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<sup>202</sup> Id.

<sup>203</sup> For example, the total fair value of Citigroup's available-for-sale securities held in state and municipal bonds last year was only \$13 billion compared to almost \$100 billion in foreign government debt. Citigroup, *Annual Report 206* (2010), online at [http://www.citigroup.com/citi/fin/data/ar10c\\_en.pdf](http://www.citigroup.com/citi/fin/data/ar10c_en.pdf) (visited Nov 25, 2011).

<sup>204</sup> One important and counterintuitive implication of this analysis is that it suggests that the case for a bankruptcy framework is weaker in Europe than with US states. Because of the potential for counterparty contagion, a European bankruptcy framework could prove problematic, at least to the extent European banks continue to hold large amounts of one another's debt. See generally Patrick Bolton and Olivier Jeanne, *Sovereign Default Risk and Bank Fragility in Financially Integrated Economies* (NBER Working Paper No 16899, Mar 2011), online at <http://www.nber.org/papers/w16899> (visited Nov 25, 2011) (modeling effects of a decrease in the value of government debt on lending by banks that hold the debt).

<sup>205</sup> See Steven Maguire, *State and Local Government Debt: An Analysis 4* (Congressional Research Service Mar 31, 2011), online at <http://www.nasbo.org/LinkClick.aspx?fileticket=4sLYo0HTYI8%3D&tabid... 1> (visited Nov 25, 2011).

from the state's income tax as well as the federal exemption.<sup>206</sup> These holders would be unhappy if state bankruptcy were enacted, given that state bankruptcy could reduce (although probably only slightly) the value of their bonds. But the effect of state bankruptcy on wealthy bondholders would not be likely to have destabilizing effects on American markets.

I do not mean to exaggerate the ease of a state-bankruptcy case. The bankruptcy of a state would be messy and complex. But none of the objections I have considered, either alone or collectively, counsels against its enactment. To the contrary, they suggest that a restructuring option would bring welcome benefits.

#### IV. THE MUNICIPAL CONTROL MODEL: A FEDERAL ALTERNATIVE?

The debate over state bankruptcy has been conducted thus far in strictly binary terms: either a bankruptcy law is enacted or, as critics would have it, Congress leaves states to their own restructuring devices. But these are not the only choices. As we have already seen, a state-bankruptcy framework could take a wide variety of forms. And traditional bankruptcy is not the only strategy Congress might use to facilitate the financial restructuring of a troubled state.

In this part, I explore the possibility of alternative federal mechanisms for assisting an overencumbered state. The template for structured federal assistance already exists: a number of states have established municipal-oversight boards that enable them to intervene in the affairs of their troubled cities. My discussion in this part begins by describing two versions of this approach, the ad hoc restructuring of New York City's finances in 1975 and the statutory frameworks subsequently enacted in many states. I then consider the constitutional limitations on a federal version of this strategy, which prove far less restrictive than might be imagined, before comparing its strengths and weaknesses to bankruptcy.

##### A. The Municipal-Oversight Boards and New York City

Over the past several decades, more than a dozen states have enacted municipal-oversight boards authorizing the state to step in if

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<sup>206</sup> See, for example, Jonathan Rodden, *Market Discipline and U.S. Federalism*, in Conti-Brown and Skeel, eds, *When States Go Broke* \*123, \*136 (cited in note 24).

a city or other municipality is in crisis.<sup>207</sup> Under these frameworks, state officials have access to municipal books and records and have authority over—and sometimes the power to dictate the terms of—a municipality’s plan to restructure its finances.<sup>208</sup>

An inspiration for many of these statutory frameworks was the state and federal intervention in New York City in 1975 and 1976, when New York wobbled toward financial collapse. We begin with New York, then turn to the most recent and dramatic of the restructuring frameworks, Michigan’s new Local Government and School District Fiscal Accountability Act of 2011.<sup>209</sup>

### 1. The New York City crisis.

“Ford to City: Drop Dead.”<sup>210</sup> For Americans of a certain age, this famous *New York Daily News* headline conjures up memories of the looming collapse of New York in the 1970s. As the recession of the mid-1970s worsened, it became increasingly clear that New York’s massive public payroll, expanded public services, and other costs were unsustainable. The Ford administration initially resisted entreaties for help—hence the *Daily News* headline—but the state intervened in dramatic fashion, providing both funding and extensive oversight of the city’s budget.<sup>211</sup>

The state and local intervention proceeded in three steps. First, a group of financial leaders formed the Financial Community Liaison Group (FCLG) with the encouragement of Mayor Abe Beame in late 1974.<sup>212</sup> Intended to consolidate the advice of the financial

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<sup>207</sup> As of 1994, states that had adopted general legislation for distressed municipalities included Colorado, Florida, Illinois, Kentucky, Maine, Michigan, Nevada, New Jersey, North Carolina, Ohio, Pennsylvania, Rhode Island, Tennessee, and Wisconsin. See Anthony G. Cahill, et al, *State Government Responses to Municipal Financial Distress: A Brave New World for State-Local Intergovernmental Relations*, 17 *Pub Prod & Mgmt Rev* 253, 255 (1994). New York, Massachusetts, Connecticut, and Arizona had enacted ad hoc provisions aimed at the financial travails of particular municipalities. *Id.*

<sup>208</sup> Precisely because of these powers, Omer Kimhi has defended municipal-control boards as superior to Chapter 9 bankruptcy. Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 *BU L Rev* 633, 652–54 (2008).

<sup>209</sup> 2011 PA 4, codified at Mich Comp Laws §§ 141.1501 to 141.1531 (2011).

<sup>210</sup> For discussion of the story, which appeared in the *New York Daily News*, see, for example, Seymour P. Lachman and Robert Polner, *The Man Who Saved New York: Hugh Carey and the Great Fiscal Crisis of 1975* 156–57 (SUNY 2010). Ford never actually said “drop dead.” Governor Hugh Carey’s biographer reports that Ford approached a Carey aide in 2001 to emphasize this fact. *Id.* at 157.

<sup>211</sup> Among the best accounts of the drama are Robert W. Bailey, *The Crisis Regime: The MAC, the EFCB, and the Political Impact of the New York City Financial Crisis* 1–12 (SUNY 1984); Martin Shefter, *Political Crisis/Fiscal Crisis: the Collapse and Revival of New York City* xxvii–xxx (Basic 1985); Lachman and Polner, *Hugh Carey* at 75–166 (cited in note 210).

<sup>212</sup> Bailey, *Crisis Regime* at 19–20 (cited in note 211).

community, the FCLG had no formal authority and a perceived lack of democratic accountability, and proved ineffectual as a result.<sup>213</sup> In early 1975, the state legislature established the Municipal Assistance Corporation (MAC), whose members included Lazard Freres partner Felix Rohatyn and Columbia Teachers College professor Donna Shalala, who would later serve as secretary of education in the Clinton Administration.<sup>214</sup> The MAC was given control over New York's sales tax and securities fees, as backing for its issuance of new bonds. This gave the MAC significant funding authority—and thus valuable carrots to entice reform—but relatively little direct oversight power.<sup>215</sup> That came with the third intervention, the state's enactment of the Financial Emergency Act,<sup>216</sup> which created the Emergency Financial Control Board (EFCB).<sup>217</sup> In addition to launching the EFCB, the legislation provided for \$750 million in state rescue funding as part of a \$2.3 billion rescue package, codified a recent New York City wage freeze, and established a special deputy comptroller for the city, to report to State Comptroller Arthur Levitt. Under the terms of its enactment, the EFCB was authorized to devise and approve a three-year budget to return the city to solvency, to exercise veto power over city borrowing, supervise the use of all city revenues, file for bankruptcy and propose a reorganization plan, and implement the wage freeze.<sup>218</sup>

Throughout 1975, the Ford administration resisted the entreaties of New York Governor Hugh Carey, a former six-term congressman, for federal help. The Ford speech that prompted the “Drop Dead” headline (what Ford actually said was “I am prepared to veto any bill that has as its purpose a bailout of New York City to prevent a default”), which Carey first saw during a late dinner with Rohatyn at Elaine's, actually triggered a shift in public sympathy to New York.<sup>219</sup> According to Carey's biographer, New York's

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<sup>213</sup> *Id.* at 23 (noting that the FCLG's “absence of legal formality was matched by a narrowness of political base”).

<sup>214</sup> For a lengthy description of the MAC and its powers, see *id.* at 23–36.

<sup>215</sup> Bailey characterizes the MAC as “deal[ing] increasingly in symbolic politics” and “breaking apart a stable, if inadequate policy-making process.” *Id.* at 35.

<sup>216</sup> New York State Financial Emergency Act for The City of New York, 1975 NY Sess Laws 1408–44.

<sup>217</sup> For an overview of the EFCB and its powers, see Bailey, *Crisis Regime* at 36–43 (cited in note 211) (noting that the EFCB was invested with even broader powers than the MAC).

<sup>218</sup> *Id.* at 41–43. New York City's public employees came under enormous pressure to acquire city bonds for the unions' pension funds as part of the overall plan, and they eventually agreed to do so. See Daniel Fischel and John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U Chi L Rev 1105, 1144–46 (1988).

<sup>219</sup> Lachman and Polner, *Hugh Carey* at 156–57 (cited in note 210) (describing the background behind the famous newspaper headline).

subsequent enactment of a moratorium law that pressured bondholders to trade their New York bonds for bonds with lower payment terms persuaded Ford that New York City had indeed defaulted and was facing up to its need to restructure.<sup>220</sup> In late November 1975, Congress passed and, on December 9, Ford signed legislation authorizing \$2.3 billion in loans to New York over the next three years. The federal loans essentially implemented the package outlined in the state's Financial Emergency Act and enabled New York to avoid a municipal bankruptcy filing.<sup>221</sup>

## 2. The 2011 Michigan framework.

Michigan's amendments to its municipal-oversight statute are the most recent, and arguably most sweeping, addition to the statutory oversight frameworks that a number of states have adopted.<sup>222</sup>

The handiwork of a Republican governor and legislature, the legislation authorizes the "state financial authority," which for a municipality is the state treasurer, to conduct a preliminary review of any city or other local government if, among other things, she concludes that there are "facts or circumstances . . . indicative of municipal financial stress."<sup>223</sup> If the treasurer's review concludes that severe financial distress exists, and the governor reaches the same conclusion, the governor is required to declare that the city is in receivership. The governor is then instructed to appoint an emergency manager.<sup>224</sup> The emergency manager displaces the city's governing body and other decision makers, and he or she has forty-five days to create a written financial and operating plan for the city.<sup>225</sup> As part of this plan, the emergency manager can reject,

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<sup>220</sup> See *id.* at 162 (describing the enactment of Moratorium Act); *id.* at 164 (describing the contentions of the Ford administration "that the Moratorium Act was tantamount to a declaration of voluntary default, and added that the state and city were jointly facing up to their years of fiscal responsibility"). The Moratorium Act was struck down as violating the New York Constitution, but by this time the New York City rescue was in place. See *Flushing National Bank v Municipal Assistance Corp for City of New York*, 358 NE2d 848, 851-52 (NY 1976).

<sup>221</sup> During the Carter administration, Congress added \$1.5 billion in loan guarantees to its earlier support. Lachman and Polner, *Hugh Carey* at 187 (cited in note 210).

<sup>222</sup> Local Government and School District Fiscal Accountability Act, Mich Comp Laws §§ 141.1501-141.1531 (2011).

<sup>223</sup> Mich Comp Laws § 141.1512(1)(r).

<sup>224</sup> Mich Comp Laws § 141.1515(d)(4).

<sup>225</sup> Mich Comp Laws §§ 141.1517 to 141.1518.

modify, or terminate city contracts, including its collective bargaining agreements.<sup>226</sup>

The power to terminate collective bargaining agreements and other contracts is the framework's most radical intervention. On its face, this provision seems to violate the Contracts Clause by authorizing the emergency manager to undo existing contracts, not just prospective obligations. Anticipating this objection, the legislation requires that the emergency manager determine that rejecting the terms of a collective bargaining agreement "is a legitimate exercise of the state's sovereign [police] powers," because the "financial emergency . . . has created a circumstance in which it is reasonable and necessary for the state to intercede" and the adjustments are "reasonable and necessary to deal with a broad, generalized economic problem."<sup>227</sup> Whether these conditions, which echo the language of the Supreme Court cases,<sup>228</sup> can withstand a Contracts Clause challenge is far from clear. But the powers to create and implement a written financial and operating plan are less controversial and nearly as sweeping.<sup>229</sup> The question is whether Congress could borrow aspects of this approach for its dealings with financially troubled states.

#### B. Would Federal Oversight Boards Be Constitutional?

The municipal-control board analogy offers two general strategies that Congress might borrow to help states manage their financial crisis. Under the ad hoc approach used in New York, Congress would wait until a crisis emerged before acting and at that point would legislate as circumstances appeared to dictate. Under the Michigan strategy, Congress would legislate more generally and in advance of a specific crisis.<sup>230</sup> As will already be evident, a framework modeled on the Michigan approach would essentially be

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<sup>226</sup> Mich Comp Laws § 141.1519(j).

<sup>227</sup> Mich Comp Laws § 141.1519(k).

<sup>228</sup> See, for example, *Faitoute*, 316 US at 512.

<sup>229</sup> Less controversial but hardly uncontroversial. The legislation has already been challenged as a usurpation of local decision making in contravention of the Michigan state constitution. See generally Complaint for Declaratory and Injunctive Relief, *Brown v Snyder*, No 11-685-CZ (Circuit Court of Ingham County, filed July 2011), online at <http://www.sugarlaw.org/wp-content/uploads/2011/06/Sugar-Law-Complaint-Brown-v.-Snyder-PA4.pdf> (visited Nov 25, 2011).

<sup>230</sup> For this reason, a Michigan-style framework for handling municipal bankruptcy might be challenged on preemption grounds if it included provisions providing for a vote to restructure the claims of bonds or other creditors. 11 USC § 903 invalidates such "composition" provisions in Chapter 9. Whether this Chapter 9 provision would have a preclusive effect even outside Chapter 9 is not altogether clear. See 11 USC § 903.

a state-bankruptcy law, which has been my focus throughout the Article. I therefore will place primary emphasis on the ad hoc, New York approach in the discussion that follows.

Congress's relationship to the states is different from that of a state to its municipalities, of course. It is hard to imagine the Supreme Court upholding a federal analogue to the Michigan provision that prohibits municipal decision makers from exercising their governmental authority once an emergency manager has been appointed, for instance, and authorizes the emergency manager to devise and implement a financial plan for the municipality. The affront to state sovereignty would be too direct. As the Court said in *New York v United States*:<sup>231</sup> "While Congress has substantial powers to govern the Nation directly, including in areas of intimate concern to the States, the Constitution has never been understood to confer upon Congress the ability to require the States to govern according to Congress' instructions."<sup>232</sup>

It is just as clear, however, that Congress has considerable scope for intervention before it runs up against the state sovereignty constraints. Congress has for many years partnered with the states under terms set by Congress on issues such as unemployment insurance, welfare, and Medicaid.<sup>233</sup> Although these programs do not explicitly mandate state participation, they impose extensive constraints on the states that participate, and their financial structure makes it very difficult for states to opt out. Relying on the same principles—financial invitation rather than coercion—lawmakers could adopt either ad hoc, New York-style legislation or a more general framework.

In practice, particularly with ad hoc intervention, the federal oversight board would amount to a structured bailout of the troubled state. In return for federal financing, the state would agree to restructure its finances under the watchful eye of Congress. Although Congress could not displace the governor or legislators, it could condition financing on structural change by the state.<sup>234</sup> Congress presumably could survey a proposed budget and determine whether it was acceptable, for instance, so long as Congress did not put the budget in place itself. The intervention would be primarily

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<sup>231</sup> 505 US 144 (1992).

<sup>232</sup> *Id.* at 162.

<sup>233</sup> See generally Roderick M. Hills Jr, *The Political Economy of Cooperative Federalism: Why State Autonomy Makes Sense and "Dual Sovereignty" Doesn't*, 96 Mich L Rev 813 (1998) (describing and critically assessing federal-state partnerships).

<sup>234</sup> See *South Dakota v Dole*, 483 US 203, 207 (1987).

forward looking, as the New York intervention was. But it also might provide for the restructuring of some existing obligations, particularly if it were framed as an exercise of Congress's Bankruptcy Clause authority.<sup>235</sup>

In addition to its similarity to Medicaid and welfare, Congress's role in a federal oversight board would echo another existing practice: the role of the lender—known as a debtor-in-possession (DIP) financier—in an ordinary corporate bankruptcy case. DIP financiers often use the terms of their financing agreements to shape the progression of the case.<sup>236</sup> Similarly, when the International Monetary Fund lends money to a financially troubled country, it nearly always imposes “conditionalities” as a requirement of the loan.<sup>237</sup> A federal oversight board would function in the same way, providing emergency funding in exchange for structural reform in the state's finances. Although the issue is not altogether free from doubt, this approach seems comfortably constitutional.

### C. Better Than Bankruptcy?

If a federal oversight board would survive constitutional challenge, as I believe it would, how does this alternative compare to bankruptcy? The two mechanisms overlap in some respects. But there are important distinctions between the two.

Start with funding. As we have seen, to provide the hydraulic pressure Congress needs without violating state sovereignty, a federal oversight board would need to link its reforms with rescue funding. Congress could not simply instruct a state to revamp its finances, because this would constitute an unconstitutional commandeering of the state. The federal oversight approach would therefore require that Congress also commit to rescue funding. It is unclear how sharply this would differ from a bankruptcy framework in practice, because it is possible and perhaps likely that the federal government would provide funding even in bankruptcy, serving as

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<sup>235</sup> If the legislation specified a particular state, it would not qualify as “uniform” and would therefore fall outside the Bankruptcy Clause. US Const Art I, § 8, cl 4. Lawmakers could avoid this difficulty by framing the legislation in general terms, even if it were clearly aimed at a single state.

<sup>236</sup> See Douglas G. Baird and Robert K. Rasmussen, *The End of Bankruptcy*, 55 *Stan L Rev* 751, 784–85 (2002); David A. Skeel Jr, *Creditors' Ball: The “New” New Corporate Governance in Chapter 11*, 152 *U Pa L Rev* 917, 923–26 (2003).

<sup>237</sup> For a discussion of the IMF's use of conditionalities, see Nouriel Roubini and Brad Setser, *Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies* 305 (Institute for International Economics 2004). See Factsheet, *IMF Conditionality* \*1–2 (Sept 2011), online at <http://www.imf.org/external/np/exr/facts/pdf/conditio.pdf> (visited on Nov 25, 2011).

the DIP financier.<sup>238</sup> But the scope of any rescue financing may be lower in bankruptcy. Because there is greater capacity for restructuring in bankruptcy, the federal funds could be used for current operating purposes and would be less necessary for debt service.

The second difference is that a federal oversight board would carry a greater risk of ad hoc preferences among the state's creditors. The federal oversight board would be less constrained by formal priorities and the obligation that similarly situated creditors receive comparable treatment. If the board appeared to pick winners and losers, the differential treatment could create market distortions in future financial crises.<sup>239</sup> If the brunt of a restructuring were borne by bondholders, while other creditors were protected, troubled states might face prohibitive costs in issuing long-term debt, which could tempt them to rely on short-term borrowing instead. Other benefits of bankruptcy might also be more difficult to achieve under an ad hoc approach. The shadow effects would be less pronounced in the absence of a formal framework, for instance, and the federal oversight board would be much less likely to clarify entitlements and help create a coherent priority scheme.

A federal oversight board does, however, have several attractive qualities as compared with bankruptcy. With a federal oversight board, Congress—or more precisely, the members of the oversight board—would be the principal nonstate decision maker.<sup>240</sup> In bankruptcy, by contrast, the judge would play this role. From this perspective, a federal oversight board could be seen as offering

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<sup>238</sup> DIP financing is authorized by 11 USC § 364. Although a state might have somewhat less need for new financing than a corporate debtor, due to taxes and other revenues, some financing would likely be necessary. This could come either from private lenders or from the federal government.

<sup>239</sup> The Chrysler and General Motors bankruptcies were overseen by what amounted to a federal oversight board in this regard. The terms were dictated by the President and his auto task force, and the transactions were accomplished through a “sale” rather than the traditional reorganization process. For the General Motors bankruptcy, see *In re General Motors Corp*, 407 BR 463, 476–79 (Bankr SDNY 2009). In the Chrysler bankruptcy, the benefits to favored constituencies may have come at the expense of senior creditors. See Mark J. Roe and David Skeel, *Assessing the Chrysler Bankruptcy*, 108 Mich L Rev 727, 729 (2010).

<sup>240</sup> Because municipal-control boards often have direct decision-making authority, the inclusion of elected officials can raise separation of powers issues. *Actions Taken by Five Cities to Restore Their Financial Health*, Subcommittee on the District of Columbia of the Committee on Government Reform and Oversight, 104th Cong, 1st Sess 17 (Mar 2, 1995) (statement of Jan B. Montgomery). Because the federal oversight board would not be exercising direct decision-making authority over the state, this seems less likely to pose constitutional problems. Elected officials like Governor Hugh Carey (designated as ex officio, along with New York Mayor Abe Beame and the state comptroller) figured prominently on New York's oversight board in the 1970s. See Bailey, *Crisis Regime* at 43 (cited in note 210).

greater democratic legitimacy—at least to the extent its membership included politically accountable officials.

In addition, a federal oversight board could act much more quickly than an ordinary bankruptcy proceeding. Because it would not require the approval either of creditors or of a bankruptcy judge, the board could operate much more expeditiously.

To fully assess the distinctions between the two approaches, we need to consider one final factor: the strategic implications of each for negotiations between state and federal officials in the event a state threatened to default. If a bankruptcy framework were in place, and the federal government feared that a state filing would have spillover effects outside of the state, perhaps unleashing turmoil in the bond markets, state officials might threaten to file for bankruptcy unless the federal government provided rescue financing with few or no strings attached.<sup>241</sup> Municipalities have sometimes used the threat of bankruptcy as leverage in negotiations for state assistance, although different factors seem to drive the interactions in different states.<sup>242</sup> The ad hoc oversight-board approach might be less susceptible to this gamesmanship. Yet state officials would still have a card to play, even if there were no bankruptcy framework in place: they could threaten simply to default if they weren't given a generous federal funding package. This threat seems as credible as a threat to file for bankruptcy.

Moreover, the ad hoc approach places intense pressure on lawmakers' ability to craft a response after the crisis has already materialized. If Congress failed to put a funds-and-oversight package in place, either because of an impasse in its negotiations with state officials or because of resistance within Congress itself, the only alternative might be an outright default by the state. The contrast between the New York City crisis of 1975 and more recent negotiations to avert potentially devastating debt crises is quite

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<sup>241</sup> See Gillette, 79 U Chi L Rev at 285–86 (cited in note 62). To curb municipalities' ability to use the threat of bankruptcy to extract concessions from the state, Gillette proposes that Congress amend Chapter 9 to authorize bankruptcy judges to require the municipality to raise taxes. *Id.* at 295.

<sup>242</sup> See note 162 and accompanying text (describing the strategic use of Chapter 9). Georgia does not permit its municipalities to file for bankruptcy, see Ga Code Ann § 36-80-5, for instance, and legislation has recently been enacted in California to make it slightly more difficult for municipalities to use Chapter 9. Act of Sept 9, 2011, 2011 Cal Stat 675, to be codified at Cal Gov Code § 53760 et seq. The political dynamics in the two states are very different, however. The California legislation has been promoted by supporters of public employee unions who are unhappy about Vallejo's restructuring of its collective bankruptcy agreements in Chapter 9.

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worrisome in this regard. They underscore the benefits of putting a restructuring framework in place before a default is imminent.

While these strategic considerations suggest that the bankruptcy option is preferable to relying on an ad hoc restructuring framework, it is important to recognize that the use of a federal oversight board is available as an option if no bankruptcy framework is put in place. While federal oversight might seem difficult to reconcile with traditional conceptions of state sovereignty, it is no more intrusive than the federal mandates that are now ubiquitous in American regulation.

#### CONCLUSION

Despite the confident assertions of advocates on both sides of the state-bankruptcy debate,<sup>243</sup> there are strong and plausible arguments both for and against. This Article has assessed the six principal benefits of a state-bankruptcy option and six of the major objections. Although several of the objections complicate the case for state bankruptcy, the analysis has suggested that bankruptcy would significantly improve on the existing strategies for dealing with a state's financial collapse. The Article also considered a somewhat analogous alternative, the use of a federal oversight board modeled on the strategies put in place by a number of states for their municipalities. Although bankruptcy seems superior overall, the oversight strategy would offer some of the same benefits as bankruptcy if Congress failed to enact a bankruptcy law before a state crisis materialized.

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<sup>243</sup> A tendency to which I myself have not been immune. See sources cited in note 11.