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## State Default and Synthetic Bankruptcy

Richard M. Hynes

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# STATE DEFAULT AND SYNTHETIC BANKRUPTCY

Richard M. Hynes \*

*Abstract:* An insolvent state does not need bankruptcy if sovereign immunity would protect it from lawsuits and other collection efforts. To the extent that a state is not judgment-proof and needs bankruptcy, we may not need to modify the Federal Bankruptcy Code to allow it to file. First, a substantial share of state spending flows through their municipalities, and these municipalities have substantial obligations of their own. Unlike states, municipalities can file for bankruptcy under current law, and a state could substantially reduce the cost of accomplishing its own fiscal goals by forcing its municipalities to file. Second, states may be able to create their own synthetic “bankruptcy” mechanisms, or bankruptcy without the federal code. State obligations are creatures of state law; states do not need a federal bankruptcy discharge. Federal law would not preempt a state composition mechanism used to adjust these debts, and any adjustment that would have been confirmed by a bankruptcy court would likely survive a Contract Clause challenge as well. Even if a state does not enact a composition mechanism, it could capture most of the benefits of federal bankruptcy by directly altering the rights of its creditors. A synthetic bankruptcy mechanism created by a state would not precisely replicate a federal bankruptcy chapter for states. Perhaps the best argument for federal bankruptcy is that it could operate with significantly lower transactions costs. In a world without omniscient judges, however, transactions costs can actually increase welfare by enhancing the ability of a state to make credible commitments.

INTRODUCTION .....	658
I. THE NATURE OF A STATE’S FISCAL CRISIS SHOULD DICTATE THE STRUCTURE OF THE RESOLUTION MECHANISM .....	662
A. States and Their Municipalities Resemble Complex Holding Companies .....	663
B. Debt Service Payments Do Not Account for a Large Share of State Budgets .....	665
C. Pension Obligations Constitute a Substantial Burden on States. ....	668
II. NON-BANKRUPTCY LAW MAY PREVENT THE ENFORCEMENT OF STATE OBLIGATIONS .....	671
A. Sovereign Immunity May Prevent Creditors from Suing a State .....	675

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B. State Laws Amending Creditor Rights May Survive a Contract Clause Challenge .....	680
III. AN INSOLVENT STATE COULD USE BANKRUPTCY UNDER EXISTING LAW .....	683
A. States Can Use Municipal Bankruptcy to Reduce Expenses.....	683
B. States Can Create Synthetic Bankruptcy—Bankruptcy Without the Code.....	686
IV. SYNTHETIC BANKRUPTCY MAY BE A GOOD SUBSTITUTE FOR FEDERAL BANKRUPTCY .....	690
A. Minimalist Bankruptcy Is Likely to Be Either Unnecessary or Insufficient.....	690
B. Federal Bankruptcy May Offer No Real Advantages Over Synthetic Bankruptcy .....	694
1. The Contractarian Argument for Synthetic Bankruptcy .....	695
2. Federal Bankruptcy and the Allocation of Power.....	698
3. The Role of Transactions Costs.....	703
CONCLUSION .....	704

## INTRODUCTION

Some scholars and politicians have called for a change in law<sup>1</sup> that would allow states to file for bankruptcy under the federal code.<sup>2</sup> At the moment, states don't need bankruptcy protection. States have relatively little debt, at least if we define debt narrowly to mean liabilities owed to capital markets.<sup>3</sup> More importantly, if a state truly wants to default, there

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1. Although the current bankruptcy code allows municipalities (e.g. Los Angeles County) to file, states (e.g. California) cannot file. *See* 11 U.S.C. § 109(a) (2006) (“[O]nly a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor [in bankruptcy].”). A state is a “governmental unit,” *id.* § 101(a)(27), and therefore not a “person,” *id.* §101(a)(41).

2. *See* Steven L. Schwarcz, *A Minimalist Approach to State “Bankruptcy,”* 59 *UCLA L. REV.* 322 (2011); David A. Skeel, Jr., *States of Bankruptcy,* 79 *U. CHI. L. REV.* 677 (2012); Jeb Bush & Newt Gingrich, *Better Off Bankrupt,* *L.A. TIMES,* Jan. 27, 2011, <http://articles.latimes.com/2011/jan/27/opinion/la-oe-gingrich-bankruptcy-20110127>. Of course, other scholars and politicians oppose a new bankruptcy chapter for states. *See, e.g.,* Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt,* 121 *YALE L.J.* 888 (2012); Adam J. Levitin, *Bankrupt Politics and The Politics of Bankruptcy,* 97 *CORNELL L. REV.* (forthcoming 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1898775](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1898775); *NGA Statement Regarding Bankruptcy Proposals for States,* NAT'L GOVERNORS ASS'N (Jan. 24, 2011), [http://www.nga.org/cms/home/news-room/news-releases/page\\_2011/col2-content/main-content-list/nga-statement-regarding-bankrupt.html](http://www.nga.org/cms/home/news-room/news-releases/page_2011/col2-content/main-content-list/nga-statement-regarding-bankrupt.html).

3. California and Illinois are perhaps the states most frequently mentioned as suffering financial distress, yet they each spend less than 6% of their general fund revenue servicing their debt. *See*

may be very little that its creditors can do to force the state to pay. The Eleventh Amendment prevents nearly all creditors from suing a state in federal court without the state's consent, and sovereign immunity allows the state to prevent most creditors from suing in state court as well.<sup>4</sup> Even if a state's creditors do manage to sue, existing Contract Clause doctrine allows a state to use its financial distress to excuse its non-performance.<sup>5</sup> In other words, non-bankruptcy law can resolve state financial distress tolerably well. It did so both when states defaulted on their bonds in the nineteenth century<sup>6</sup> and when states unilaterally altered their (or their municipalities') collective bargaining agreements in the twentieth and twenty-first centuries.<sup>7</sup>

Although states don't need bankruptcy protection at the moment, we may someday want an insolvent state to use bankruptcy to return to solvency. Payments to bondholders may not currently comprise a significant portion of a state's budget, but this situation could change if a state incurred dramatically more debt and interest rates rose significantly. In addition, states have made substantial commitments to their current and former workers that may be expensive to keep. If some or all of these creditors can sue or exert other pressure on a state, this pressure could create problems that bankruptcy is designed to mitigate.<sup>8</sup> Because bonds and similar debts are unlikely to account for a significant share of an insolvent state's obligations, an effective bankruptcy chapter must constitute more than a minimalist procedure that leaves the rights of current and former workers untouched<sup>9</sup> and does not allow a judge to

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CAL. STATE CONTROLLER'S OFFICE, COMPREHENSIVE ANNUAL FINANCIAL REPORT: FOR THE FISCAL YEAR ENDING JUNE 30, 2011 (2011) (reporting debt service payments of \$5 billion, general fund revenue of \$95 billion, and total revenue of \$192.9 billion), *available at* <http://www.sco.ca.gov/Files-ARD/CAFR/cafr11web.pdf>; STATE OF ILL. COMPTROLLER, BONDED INDEBTEDNESS AND LONG TERM OBLIGATIONS 7 (2010) (claiming that debt service accounted for 3.9% of revenues), *available at* <http://www.ioc.state.il.us/index.cfm/linkservid/51E3FD7F-1CC1-DE6E-2F48F3F5A895A821/>.

4. *See infra* Part II.A.

5. *See infra* Part II.B.

6. *See* William B. English, *Understanding the Cost of Sovereign Default: American State Debts in the 1840s*, 86 AM. ECON. REV. 259 (1996); John V. Orth, *The Interpretation of the Eleventh Amendment, 1798-1908: A Case Study of Judicial Power*, 1983 U. ILL. L. REV. 423 (1983).

7. *See* Stephen F. Befort, *Unilateral Alteration of Public Sector Collective Bargaining Agreements and the Contracts Clause*, 59 BUFF. L. REV. 1 (2011).

8. These problems include a "debt overhang" that prevents beneficial investment and a collective action problem that reduces the aggregate amount collected by all creditors. *See infra* note 85 and accompanying text.

9. *See* Schwarcz, *supra* note 2, at 345 ("On balance, therefore, this Article proposes that the framework not include an explicit right to impair state collective bargaining and pension agreements.").

modify the rights of a class of creditors without their approval.<sup>10</sup>

This Article does not advocate for the modification of states' obligations to their workers or other creditors. One can reasonably argue that a state's taxpayers or the recipients of its discretionary spending should bear the costs of financial distress instead of those to whom the state has made promises.<sup>11</sup> One can also argue that courts should stay out of the matter and leave the resolution to the political process.<sup>12</sup> Rather than engage these debates, this Article argues that if courts are to play a role in deciding whether a state should perform its obligations, states should have access to some version of bankruptcy.

Although states cannot file for protection under the federal bankruptcy code, existing law may still allow them to use bankruptcy to resolve their insolvency. First, a state could substantially reduce its expenses by forcing its municipalities into bankruptcy. The bankruptcy code allows municipalities to file,<sup>13</sup> and the code defines the term "municipality" broadly to mean a "political subdivision or public agency or instrumentality of a State."<sup>14</sup> Grants to localities (a subset of municipalities) account for more than half of some states' spending,<sup>15</sup> and many of the obligations reported as state debts are really municipality debts.<sup>16</sup> If a state can use the federal bankruptcy code to reduce the obligations and expenses of its municipalities, it can reduce the cost of accomplishing its own goals.

Second, state law governs the most significant obligations of a state and its municipalities, including their bonds, pensions, and collective

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10. *Id.* at 335 ("A minimalist framework can nonetheless provide value without [cramdown].").

11. Adam Levitin has characterized the fight over state bankruptcy as a struggle between taxpayers and the beneficiaries of government spending. See Adam J. Levitin, *Fiscal Federalism and the Limits of Bankruptcy*, in *WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS* 214, 216 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012) ("But part of the appeal of a Chapter 9-modeled state bankruptcy regime is clearly as a sword for one side of the tax hike versus service/benefits cut debate, making it a Republican partisan tool."). The interests of the beneficiaries of government spending are not necessarily aligned. For any given level of taxation, the more a state spends on its obligations to its workers and other creditors, the less it has available for transfer payments and discretionary spending.

12. See, e.g., Richard Schragger, *Democracy and Debt*, 121 *YALE L.J.* 860, 883 (2012) ("It is quite difficult on democratic grounds to justify allowing a judge to impose particular fiscal ends unless the political pathologies of the local and state budgeting process are so wide and deep that coercion outside elective politics is required.").

13. 11 U.S.C. § 109 (2006).

14. *Id.* § 101(40). For a good discussion of the meaning of "municipality," see *In re Las Vegas Monorail Co.*, 429 B.R. 770 (Bankr. D. Nev. 2010).

15. See *infra* note 34 and accompanying text.

16. See *infra* note 25 and accompanying text.

bargaining agreements. Accordingly, states can manipulate the rules applicable to their own disputes. Instead of rejecting a collective bargaining agreement or proposing a plan of reorganization in bankruptcy, a state could enact laws that modify the rights of its creditors (including its contractual counter-parties). If sovereign immunity does not prevent their lawsuit, creditors would argue that the state laws violated the Contract Clause. The court would apply a test that is similar to, and perhaps more lenient than, the one it would use in a federal bankruptcy reorganization of a state.<sup>17</sup> The state and its creditors could use aggregate litigation methods to combine the suits in a small number of courts to reduce transactions costs.<sup>18</sup> In the extreme, a state could create its own composition mechanism that would roughly replicate a federal bankruptcy chapter for states.

This Article uses three different definitions of bankruptcy. The general term “bankruptcy” is defined broadly to mean a single proceeding that compels all creditors to accept “some arrangement or disposition of their claims against the bankrupt’s property, whether they agreed to it or not.”<sup>19</sup> The term “federal bankruptcy” shall mean bankruptcy pursuant to the federal bankruptcy code. The term “synthetic bankruptcy” shall mean bankruptcy without the federal bankruptcy code—either a state composition agreement or the direct alteration of the rights of creditors combined with aggregate litigation techniques.

A state-created synthetic bankruptcy process would not precisely replicate a federal bankruptcy chapter for states.<sup>20</sup> First, if we are willing to substantially dilute notions of state sovereignty, federal bankruptcy

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17. See *infra* notes 136–40 and accompanying text.

18. For work discussing the similarity between bankruptcy and aggregate litigation methods (including class actions) used to resolve mass tort litigation, see John C. Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 COLUM. L. REV. 1344 (1995); Troy A. McKenzie, *Toward a Bankruptcy Model for Non-Class Resolution of Aggregate Litigation*, 87 N.Y.U. L. REV. (forthcoming Oct. 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2034388](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2034388).

19. Max Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1, 4 (1940).

20. George Triantis also argues that a state could create its own composition mechanism and that they are better positioned than the federal government to do so because they have the right incentives to contract for the most efficient terms with their creditors. See George Triantis, *Bankruptcy For the States and By the States*, in WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 237, 240 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012) (“This chapter suggests that bankruptcy legislation, however designed, should be encouraged at the state government, rather than federal, level. Indeed, the federal government should refrain from legislating in this area—or should produce a set of default, rather than mandatory, rules—to give states the space and incentive to do so for themselves.”) (citation omitted). It is at least possible, however, that a federal bankruptcy chapter would enhance the ability of a state to contract with their creditors by making it harder for the state to change the resolution procedure at the time of default. See *infra* note 224 and accompanying text.

could reallocate political power in a manner that would allow a more timely response to a fiscal crisis.<sup>21</sup> Second, federal bankruptcy courts have inherent jurisdictional advantages that could allow such courts to return a state to solvency with lower transactions costs.<sup>22</sup> These differences may not be advantages for federal bankruptcy. Good justifications could support strong notions of state sovereignty. If Congress is unwilling or unable to abandon these notions in the federal bankruptcy code, there may be little difference between the political process necessary to respond to a fiscal crisis inside or outside of federal bankruptcy. If judges are likely to approve modifications when the debtor does not “deserve” relief, transactions costs may enhance the state’s ability to make commitments.

To understand the case for a federal bankruptcy chapter for states, we must first understand the nature of a state’s finances and the non-bankruptcy law that would apply if a state were to default. To that end, Part I explores the financial condition of the states and the nature of the obligations that states are struggling to meet. Part II looks to the past and describes the enforcement (or lack thereof) of similar obligations during prior financial crises. Part III argues that existing law would allow a state to use bankruptcy to resolve its insolvency, either by forcing its municipalities to file for bankruptcy under the federal bankruptcy code or by creating a synthetic bankruptcy procedure to adjust its own obligations. Finally, Part IV compares this synthetic bankruptcy approach to a hypothetical new chapter of the federal bankruptcy code designed to address state insolvency.

## I. THE NATURE OF A STATE’S FISCAL CRISIS SHOULD DICTATE THE STRUCTURE OF THE RESOLUTION MECHANISM

This Part offers three basic lessons about state finance so that the remainder of the Article can assess the need for a federal bankruptcy chapter for states. Section A argues that states and their municipalities resemble complex holding companies. Although a state is legally distinct from its municipalities, it relies on these municipalities to accomplish its goals. Section B argues that states do not currently spend a significant

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21. See Skeel, *supra* note 2, at 716 (“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.”).

22. Synthetic bankruptcy is not actually bankruptcy, and it may be unable to bind all creditors in a single proceeding. See *infra* notes 257–60 and accompanying text.

portion of their budgets servicing debts owed to capital markets. Section C argues that states do have significant obligations to their current and former workers.

A. *States and Their Municipalities Resemble Complex Holding Companies*

When speaking of a state, we must be just as precise as we are (or should be) when speaking of a large firm like Citigroup or Exxon. Very large firms are almost never single entities. The largest firms have an average of more than one hundred subsidiaries,<sup>23</sup> each possessing its own legal identity, assets, and debt. The various entities in the corporate structure are not liable for each other's debts unless they are co-borrowers or have issued guarantees. Similarly, states have a large number of sub-agencies or instrumentalities such as university systems, pension funds, unemployment insurance providers, water districts, transit authorities, cities, counties, school districts, etc.<sup>24</sup> Much of the "state" debt reported in the news is actually owed by these sub-entities.<sup>25</sup> Because each of these entities fits the bankruptcy code's definition of "municipality,"<sup>26</sup> this Article will refer to those sub-entities as municipalities. Like parent corporations, states are not liable for their municipalities' debts unless they have issued guarantees. Sometimes,

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23. See Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. CHI. L. REV. 605, 619–20 (2011) ("The 100 largest U.S. public companies by revenues maintained an average of 109 foreign-nation subsidiaries, and . . . within the U.S. they had an average of 62 major subsidiaries outside Delaware (in addition to 74 incorporated in Delaware).").

24. See, e.g., CAL. STATE CONTROLLER'S OFFICE, *supra* note 3, at 30 (showing that the major "component units" of the State of California are the University of California, State Compensation Insurance Fund, California Housing Finance Agency, and Public Employees' Benefits Fund). In 2007 there were 89,476 governments in the United States. See Isabel Rodriguez-Tejado & John Joseph Wallis, *Fiscal Institutions and Fiscal Crises*, in WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 9, 26 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012).

25. See, e.g., *State and Municipal Debt: The Coming Crisis?: Hearing Before the Subcomm. on TARP, Fin. Servs., & Bailouts of Pub. & Private Programs, H. Comm. on Oversight and Gov't Reform*, 112th Cong. 1–2 (2011), available at [http://oversight.house.gov/wp-content/uploads/2012/01/gelinas\\_testimony\\_edit\\_2MH.pdf](http://oversight.house.gov/wp-content/uploads/2012/01/gelinas_testimony_edit_2MH.pdf) (testimony of Nicole Gelinas) ("But a state such as New York, for example, with one of the highest per-capita debt burdens in the nation, 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. . . . [I]t is local governments, including cities, towns, and school districts, not the state governments, that owe the bulk of what people think of as 'state' pension benefits.").

26. 11 U.S.C. § 101(40) (2006) ("The term 'municipality' means political subdivision or public agency or instrumentality of a State.").



states also agree to make the repayment of a municipality's debt the "moral obligation" of the state, but such an obligation cannot subject the state to legal liability.<sup>27</sup>

Corporate debt analysts must pay careful attention both to where the firm locates its assets, and where it earns its income. Both the state and its municipalities have some hard assets—such as vehicles, courthouses, schools, prisons, roads, bridges, and other infrastructure.<sup>28</sup> Government entities may also have substantial financial assets, particularly municipalities in charge of government pensions.<sup>29</sup> States and most municipalities have their own sources of income. Water districts and universities charge fees; cities, counties, and states assess taxes.

Although states and municipalities may once have operated as fairly autonomous entities,<sup>30</sup> the modern state government resembles a large firm. Money flows between the different levels (federal, state, local), and the levels work together to accomplish common goals such as providing education and other forms of public assistance. Corporate funds generally flow up, from the subsidiaries to the holding company. By contrast, government funds typically flow down. In 2010, federal grants-in-aid to state and local governments were equal to about 37% of state and local government expenditures from their own sources.<sup>31</sup>

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27. Rhonda Riherd Trautman, *The Impact of State Debt Management on Debt Activity*, PUB. BUDGETING & FIN., June 1995, at 33, 34 ("Moral obligation refers to cases in which a state government has asserted the intent of the legislative body to make appropriations sufficient to make up for any deficiency in monies required to meet debt service for specified bonds. Any actual liability stops at this point in that the legislative body of the state has no legally enforceable obligation to pay off the bond."). If sovereign immunity were absolute, there would be no difference between a moral obligation and a legal liability because creditors could not enforce these legal liabilities. As explained in Part II.A., however, sovereign immunity is not absolute.

28. CAL. STATE CONTROLLER'S OFFICE, *supra* note 3, at 28 (showing that the primary government of the state owns \$109 billion in net capital assets (mostly state highway infrastructure), while the component units own \$25.4 billion of the same (mostly buildings)). As more fully discussed below, most of these assets are exempt from seizure under state law. H.R. REP. NO. 100-1011, at 4 (1988).

29. *See, e.g.*, CALPERS INVS., <http://www.calpers.ca.gov/index.jsp?bc=/investments/home.xml> (last visited Aug. 4, 2012) ("[CalPERS is] the nation's largest public pension fund with assets totaling \$236.8 billion as of April 30, 2012 . . .").

30. In 1902, state aid comprised just 6% of local general revenues, and federal aid comprised just 1% of state and local general revenues. *See* DAVID R. BERMAN, LOCAL GOVERNMENT AND THE STATES: AUTONOMY, POLITICS, AND POLICY 160 app. A (2003).

31. *See* U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES 268 tbl.431 (2012), [hereinafter STATISTICAL ABSTRACT OF THE UNITED STATES], available at <http://www.census.gov/prod/2011pubs/12statab/stlocgov.pdf> (Federal Grants-in-Aid to State and Local Governments: 1990 to 2011); CAL. STATE CONTROLLER'S OFFICE, *supra* note 3, at 36 (showing that \$67.849 billion of California's \$195.337 billion total 2011 revenue came from federal sources).

Intergovernmental revenue (from both the federal and state level) accounted for about 37% of local government's general revenue.<sup>32</sup> A state's grants to its municipalities often comprise a very large share of its own budget. Grants to local governments account for about 30% of the average state's spending,<sup>33</sup> and they account for more than 65% of state expenditures in California and Ohio.<sup>34</sup> Remember that bankruptcy defines "municipality" broadly to include non-local entities such as universities.<sup>35</sup> Thus, these statistics understate the share of state spending that flows through municipalities. State laws also dictate terms of the contracts between a municipality and its workers. California mandates the pension terms for many local employees,<sup>36</sup> and several states have laws that greatly affect teacher pay.<sup>37</sup>

*B. Debt Service Payments Do Not Account for a Large Share of State Budgets*

The classic justification for corporate bankruptcy is that it solves a collective action problem or "race to the assets."<sup>38</sup> Because non-bankruptcy law generally grants priority to the creditor who wins the

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32. See STATISTICAL ABSTRACT OF THE UNITED STATES, *supra* note 31, at 292 tbl.455 (Local Governments—Revenue by State: 2008).

33. See U.S. CENSUS BUREAU, STATE GOVERNMENT FINANCES SUMMARY 2 (2011), available at <http://www2.census.gov/govs/state/10statesummaryreport.pdf> ("During 2010, 30.2% of state general expenditure was in the form of grants and aid to local governments (including independent school district governments), thereby underlining the states' role as a financial resource for their subordinate governments.").

34. *Chart F: Expenditures by Character, All Funds*, CAL. DEPT. FINANCE, [http://www.dof.ca.gov/budgeting/budget\\_faqs/documents/CHART-F.pdf](http://www.dof.ca.gov/budgeting/budget_faqs/documents/CHART-F.pdf) (last visited Aug. 4, 2012) (California has budgeted about \$165 billion in local assistance payments from all sources for the 2012 to 2013 fiscal year out of a total budget of about \$225 billion.); see also Tom Feran, *State Rep. Ron Amstutz Says Most of the State Budget is Spent at the Local Level*, POLITIFACT OHIO (June 22, 2011, 6:00 a.m.), <http://www.politifact.com/ohio/statements/2011/jun/22/ron-amstutz/state-rep-ron-amstutz-says-most-state-budget-spent/> ("fact check" article indicating that 66.6% of Ohio's all-funds budget, and 85.6% of its general fund budget, is made up of local assistance).

35. See *supra* note 14 and the accompanying text.

36. CAL. GOV'T CODE §§ 50800-50927 (West 1983 & Supp. 2011) (authorizing local agencies with police and/or fire departments to establish pension funds having certain required terms); see also COLO. REV. STAT. ANN. § 31-31-401 to -411 (West 2011) (governing statewide defined benefit plan for fire and police personnel hired after 1978); LA. REV. STAT. ANN. §§ 11:3001-3017 and §§ 11:3031-3053 (2006 & Supp. 2011) (providing terms for the retirement systems of the cities of Alexandria and Bogalusa, respectively).

37. See, e.g., HAW. REV. STAT. ANN. § 302A-624 (LexisNexis 2010) (teachers' salary schedule); OHIO REV. CODE ANN. § 3317.13(C) (LexisNexis 2009) (setting minimum salaries for teachers).

38. See Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain*, 91 YALE L.J. 857 (1982) (arguing that bankruptcy can help solve a race to the assets by providing for pro rata distributions to general creditors and thus maximize collections for creditors).

race to the courthouse, each creditor is incentivized to try to collect immediately and in full even when forbearance could maximize aggregate recovery. Consider a simple example. Assume that the debtor owes \$10 to each of ten creditors but can only pay \$50 in the best-case scenario. Assume further that lawsuits or other collection efforts would destroy a substantial amount of value by causing the firm to liquidate immediately. If any creditor tries to collect individually, the debtor can pay a total of just \$10. Although the creditors can maximize their collection if they each reduce their claims to \$5, each will rationally try to collect in full immediately. If only one creditor tries to collect, then that creditor wins the race to the courthouse and is paid in full. If all of the other creditors try to collect, the creditor is again better off racing. If the creditor races, then he or she will win—i.e. receive payment in full—10% of the time. If the creditor does not race, he or she will certainly lose.

Scholars have adapted the collective action justification to municipal bankruptcy as well.<sup>39</sup> Creditors cannot force the liquidation of a municipality, but a successful litigant may be able to force a municipality to impose additional taxes for the litigant's benefit. If too many creditors sue to impose additional taxes, aggregate tax revenue can fall as business and individuals flee to other jurisdictions.<sup>40</sup>

The explanation of bankruptcy as a solution to a collective action problem is far more powerful if the debtor owes a large amount to disorganized trade creditors who lack a non-bankruptcy coordination mechanism that could control this problem. Measured in absolute terms, some states do owe significant amounts to trade creditors. Illinois, for example, delayed payments to Medicare providers and other vendors during its recent financial troubles and owed approximately \$5 billion of trade debt by March 2011.<sup>41</sup>

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39. See Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425 (1993) (arguing that non-bankruptcy law causes individual creditors to seek special taxes beyond the point that maximizes aggregate tax revenue).

40. *Id.* at 448 (“Unusually high rates of taxation also discourage economic activity and create an incentive for business and higher income taxpayers to depart the jurisdiction.”).

41. See Paul Merrion et al., *Illinois Enters a State of Insolvency*, CRAIN'S CHI. BUS. (Jan. 16, 2010), <http://www.chicagobusiness.com/article/20100116/ISSUE01/100032910> (“A record \$5.1 billion in state bills was past due at yearend [sic], almost doubling to 92 days from 48 days a year earlier the average amount of time it takes the state to pay vendors such as doctors, hospitals, non-profit service providers and other contractors.”). California has experienced similar problems. Daniel C. Vock, *Nightmare Scenarios Haunt States*, STATELINE (Dec. 14, 2009), <http://www.pewstates.org/projects/stateline/headlines/nightmare-scenarios-haunt-states-85899384506> (“California's controller in February put a rare 30-day hold on paying most state bills, including

However, states generally owe much more money to their bondholders than to trade creditors. For example, when Illinois owed \$5 billion of trade debt, it owed \$35 billion to bondholders.<sup>42</sup> Most of this debt took the form of general obligation bonds (\$28 billion) or short-term certificates (\$1 billion to \$2 billion). These obligations were backed by the “full faith and credit” of the State and resembled unsecured bonds issued by firms.<sup>43</sup>

Some states have constitutional provisions that grant bondholders special priority. For example, the California Constitution requires that the State pay its bondholders before spending money on anything other than education.<sup>44</sup> Other states provide even stronger protection, not even exempting education from the bondholders’ priority.<sup>45</sup> Unlike large firms, states do not typically issue significant amounts of secured debt.<sup>46</sup> However, they do issue something very similar: revenue bonds. These bonds promise the holder priority with respect to a specific revenue stream (typically a tax).<sup>47</sup> In March 2011, Illinois had about \$5.4 billion in revenue bonds outstanding. The State sales tax backed the majority of those bonds, but some were backed by a hotel tax or other revenue.<sup>48</sup> Other states are less reliant on general obligations. In 2004, states owed about \$754 billion of long-term debt (in 2010, they owed about \$1.1 trillion),<sup>49</sup> but only \$209 billion of the 2004 debt was backed by the full faith and credit of the states.<sup>50</sup>

Bonds are issued pursuant to contracts called indentures, and states could prevent a collective action problem among bondholders by issuing

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personal income tax returns, to guarantee there would be enough cash in the bank to pay schools and bondholders.”).

42. STATE OF ILL., GENERAL OBLIGATION BONDS, TAXABLE SERIES OF FEBRUARY 2011, at 37, 44 (2011), available at <http://emma.msrb.org/EP504139-EP393014-EP790226.pdf>.

43. *Id.* at 36–37.

44. CAL. CONST. art. XVI, §§ 1, 8.

45. *See, e.g.*, N.Y. CONST. art. VII, § 12.

46. H.R. REP. NO. 100-1011, at 4 (1988).

47. Like secured debt, these bonds can be recourse or non-recourse. Revenue bonds receive stronger protection in Chapter 9 than secured debt receives in other bankruptcy chapters. In particular, revenue bonds retain their priority with respect to revenue received after the bankruptcy filing, 11 U.S.C. § 928 (2006), while secured debt only receives priority with respect to after-acquired assets if they are proceeds of other secured assets, *id.* § 552.

48. STATE OF ILL., *supra* note 42, at 44–45.

49. U.S. CENSUS BUREAU, ANNUAL SURVEY OF STATE GOVERNMENT FINANCES (2010), available at <http://www.census.gov/govs/state/1000usst.html>.

50. *See* STATISTICAL ABSTRACT OF THE UNITED STATES, *supra* note 31, at 286 tbl.449 (State Governments—Summary of Finances: 1990 to 2007). 2004 is the last year for which the Census Bureau reports the amount of state debt that is backed by the full faith and credit of the state.

all of their debt pursuant to a single indenture and allowing the majority of bondholders to amend the indenture. However, states do not typically do this. Instead they usually have multiple bond series outstanding, each with its own separate indenture.<sup>51</sup> These indentures may allow the majority to amend some terms, but most insist that a single creditor have the right to sue to enforce a missed payment and require unanimous approval to modify payment terms.<sup>52</sup>

Although state debts are large in absolute terms, the cost of servicing this debt is small relative to the state's revenues and expenses. The complete elimination of a state's capital market debt would only modestly effect the state's cash flow. For example, in 2011, California's debt service payments equaled just 5.3% of its general fund revenues.<sup>53</sup> Nationally, interest payments generally account for 4 to 7% of state and local budgets. Many states and municipalities can only incur debt for capital investment,<sup>54</sup> and the primary state programs (education, social assistance, and corrections) are not very capital intensive.<sup>55</sup>

### C. *Pension Obligations Constitute a Substantial Burden on States*

States may be unable to sustain current or planned spending without raising taxes or cutting other spending, but taxing and spending are political, not legal, questions. Those questions become legal only when a state decides to cut spending by breaking its obligations. Defaulting on the promises that states have made to capital markets would not sharply

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51. See, e.g., *Amended and Restated 2003A Bond Indenture*, CAL. ENERGY COMMISSION, [http://www.energy.ca.gov/efficiency/revenuebonds/official\\_documents/2003A\\_Bond\\_Indenture\\_execution\\_copy.pdf](http://www.energy.ca.gov/efficiency/revenuebonds/official_documents/2003A_Bond_Indenture_execution_copy.pdf); *2005A Bond Indenture*, CAL. ENERGY COMMISSION, [http://www.energy.ca.gov/efficiency/revenuebonds/official\\_documents/2005A\\_Bond\\_Indenture\\_v11\\_execution\\_copy.pdf](http://www.energy.ca.gov/efficiency/revenuebonds/official_documents/2005A_Bond_Indenture_v11_execution_copy.pdf).

52. See Schwarcz, *supra* note 2, at 330 ("Relatively few state bond issues currently include CACs or their equivalent.") The Trust Indenture Act insists that an individual bondholder have the right to sue when it is not paid, but state bonds are not subject to the Trust Indenture Act. 15 U.S.C. § 77ddd(a)(4)(A) (2006).

53. CAL. STATE CONTROLLER'S OFFICE, *supra* note 3, at 36.

54. S. REP. NO. 100-506, at 8 (1988). For a more general discussion of the limitations placed on the issuance of debt by state and local governments, see Rodriguez-Tejado & Wallis, *supra* note 24, at 19-31.

55. In 2011, California devoted 87% of its general fund to such programs—46% to education, 31% to health and human services, and 10% to corrections. CAL. STATE CONTROLLER'S OFFICE, *supra* note 3, at 18. If we look at government-wide expenditures, these programs still account for 82% of spending. *Id.* at 13. Nationally, education and welfare expenditures alone accounted for about 65% of state spending in 2010. See *State Government Finances Summary*, *supra* note 33, at 10 app. tbl.A-2 (General Expenditures and Education Expenditures of State Governments With U.S. Summary: 2010 and 2009). Highway expenditures (a capital-intensive undertaking) accounted for just 7% of spending. *Id.* at 14.

reduce spending, but the financial commitments that states have made to current and past workers may be more significant. Government employers are not subject to the National Labor Relations Act,<sup>56</sup> so state law governs the rights of state workers, with most states giving at least some employees collective bargaining rights.<sup>57</sup> During fiscal crises, states and municipalities will sometimes resort to unpaid furloughs or otherwise fail to comply with the terms of their collective bargaining agreements.<sup>58</sup>

Pensions and other long-term benefits comprise a significant portion of the compensation of state workers and state pensions, and state pensions exceeded \$3 trillion in 2010.<sup>59</sup> Some of these pensions may not be owed by the states themselves; government pension statistics make it difficult to separate how much is owed by the states and how much is owed by their municipalities.<sup>60</sup> On the other hand, government accounting rules allow states to discount future pension obligations at the rate that they expect to earn on their investments (rather than the much lower rate that reflects the risk that those obligations will not be paid).<sup>61</sup> This method violates basic principles of finance, and the inappropriately low discount rate understates the true value of the pension obligations by trillions of dollars.<sup>62</sup> As long as the Census Bureau estimate is remotely accurate, the amount owed to current and former workers is many times larger than the amount of bonds backed by the full faith and credit of the states.<sup>63</sup> States typically set aside assets

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56. 29 U.S.C. § 152(2) (2006).

57. See Befort, *supra* note 7, at 17 (“Approximately 80% of the states have adopted statutes authorizing collective bargaining for at least some groups of public employees.”).

58. See *id.* at 10 (“Governmental employers have resorted to layoffs, hiring freezes, wage freezes, pay lags, and employee furloughs, among other options during periods of budgetary turmoil.”).

59. See U.S. CENSUS BUREAU, SUMMARY OF THE 2010 ANNUAL SURVEY OF PUBLIC-EMPLOYEE RETIREMENT SYSTEMS: STATE-ADMINISTERED PENSIONS 7 app. tbl.A-1 (Jan. 2012), available at [http://www2.census.gov/govs/retire/2010\\_summary\\_report.pdf](http://www2.census.gov/govs/retire/2010_summary_report.pdf). Non-pension liabilities may be large as well. For example, official estimates of Illinois’ five different pensions total roughly \$125 billion, and Illinois owes another \$24 billion in other retirement benefits (mainly healthcare). *Official Statement, General Obligation Bonds, Taxable Build America Bonds, Series 2010-2*, STATE ILL. 48, 54 (Apr. 12, 2010), <http://emma.msrb.org/EA382562-EA300739-EA696414.pdf>.

60. *Enhancing the Analysis of U.S. State and Local Government Pension Obligations*, FITCH RATINGS 3 (Feb. 17, 2011), [http://www.ncpers.org/Files/2011\\_enhancing\\_the\\_analysis\\_of\\_state\\_local\\_government\\_pension\\_obligations.pdf](http://www.ncpers.org/Files/2011_enhancing_the_analysis_of_state_local_government_pension_obligations.pdf). This difficulty is compounded by the fact that some states guarantee the benefits of these plans. *Id.* at 3–4.

61. See Joshua D. Rauh & Robert Novy-Marx, *Public Pension Promises: How Big Are They and What Are They Worth?*, 66 J. FIN. 1207 (2010).

62. *Id.*

63. See *supra* note 50 and accompanying text.

in special accounts to fund pension obligations, but the amount set aside is often much less than the obligations. In 2008, twenty-one states had funded less than 80% of their pension obligations, and only two states had funded at least half of their health care and other non-pension benefits.<sup>64</sup>

Both the Employee Retirement Income Security Act of 1974 (“ERISA”)<sup>65</sup> and provisions of the Internal Revenue Code that penalize reductions in pension benefits<sup>66</sup> exempt state and municipal pensions from their coverage. As a result, states may be able to alter state and municipal pensions by amending state law. State law treatment of public pensions varies widely.<sup>67</sup> Two states retain the traditional view that public pensions are mere gratuities that can be freely changed by a state.<sup>68</sup> Most states limit the ability of the government to change the terms of a pension in a way that is unfavorable to the employee. One state uses a promissory estoppel theory,<sup>69</sup> and many others use a contract theory.<sup>70</sup> As a result, state laws that modify these obligations could raise Contract Clause issues.<sup>71</sup> A few states view pensions as property interests,<sup>72</sup> and laws altering these pensions could raise due process or takings concerns. Finally, a number of states have constitutional provisions that protect pension obligations.<sup>73</sup> While state constitutions are much easier to amend than the federal constitution, doing so still requires substantial political will.

This Part used an analogy to corporate finance to explain the finances of a state, but David Skeel argues that “the relevant analogy is not corporate bankruptcy so much as *personal* bankruptcy.”<sup>74</sup> In contrast to

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64. While Illinois’ is the most underfunded state pension system in the country, as of 2008, the pension systems of seven other states—Connecticut, Kansas, Kentucky, Massachusetts, Oklahoma, Rhode Island and West Virginia—were underfunded by more than one-third. THE PEW CTR. ON THE STATES, *THE TRILLION DOLLAR GAP: UNDERFUNDED STATE RETIREMENT SYSTEMS AND THE ROAD TO REFORM* 3 (2010), available at [http://www.pewstates.org/uploadedFiles/PCS\\_Assets/2010/Trillion\\_Dollar\\_Gap\\_Underfunded\\_State\\_Retirement\\_Systems\\_and\\_the\\_Roads\\_to\\_Reform.pdf](http://www.pewstates.org/uploadedFiles/PCS_Assets/2010/Trillion_Dollar_Gap_Underfunded_State_Retirement_Systems_and_the_Roads_to_Reform.pdf).

65. 29 U.S.C. § 1003(b)(1) (2000).

66. I.R.C. §§ 411(d)(6), 411(e)(1)(A) (2006).

67. For a review of these laws, see Amy B. Monahan, *Public Pension Plan Reform*, 5 EDUC. FIN. & POL. 617 (2010).

68. See *Ballard v. Bd. of Trs. of Police Pension Fund of Evansville*, 324 N.E.2d 813, 815 (Ind. 1975); *Kunin v. Feofanov*, 69 F.3d 59, 63 (5th Cir. 1995) (Texas).

69. *Christensen v. Minneapolis Mun. Emps. Ret. Bd.*, 331 N.W.2d 740, 747 (Minn. 1983).

70. See Monahan, *supra* note 67.

71. See *infra* Part II.B.

72. See Monahan, *supra* note 67.

73. *Id.*

74. See Skeel, *supra* note 2, at 683. Others have made similar claims. See, e.g., Robert K.

corporate bankruptcy, in individual bankruptcy the decision maker cannot be replaced, and bankruptcy serves to adjust an unsustainable debt load.<sup>75</sup> The same may be true of state bankruptcy; Congress may not allow creditors to wrest control of the political process from the voters.<sup>76</sup> As explained in the next Part, the analogy between the sovereign and the individual is useful for another reason. Poverty and generous non-bankruptcy protections can render many individuals relatively immune from judgment, making bankruptcy unnecessary.<sup>77</sup> Similarly, sovereign immunity and a flexible interpretation of the Contract Clause may make most state obligations legally unenforceable and render the need for bankruptcy unclear.

## II. NON-BANKRUPTCY LAW MAY PREVENT THE ENFORCEMENT OF STATE OBLIGATIONS

Today many debtors use federal bankruptcy to resolve their financial distress, but that has not always been the case. In fact, Americans did not file any federal bankruptcy petitions during most of the nineteenth century. Debtors defaulted on their debts, sometimes at rates that rivaled those of today,<sup>78</sup> but the United States had no federal bankruptcy code under which a debtor could file.<sup>79</sup> Similarly, states may be able to resolve their financial distress without the need of the federal bankruptcy

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Rasmussen, *Integrating a Theory of the State into Sovereign Debt Restructuring*, 53 EMORY L.J. 1159 (2004).

75. See Skeel, *supra* note 2, at 683.

76. See *infra* notes 230–56 and the accompanying text.

77. See, e.g., Richard M. Hynes, *Why (Consumer) Bankruptcy?*, 56 ALA. L. REV. 121 (2004).

78. According to some estimates, the rate at which Americans were sent to debtor's prison around 1833 was roughly equivalent to the rate at which Americans file for consumer bankruptcy today. See CHARLES WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* 52 n.8 (1935) ("As late as 1833, however, it was estimated that 75,000 persons were annually sent to jail for debt . . ."). The United States population was approximately 14,162,000 in 1833, see U.S. CENSUS BUREAU, *HISTORICAL STATISTICS OF THE UNITED STATES, COLONIAL TIMES TO 1970*, at A6-8 (1975), available at <http://www2.census.gov/prod2/statcomp/documents/CT1970p1-01.pdf>, yielding a rate of about one imprisonment for every 200 Americans. In 2010, American consumers filed 1,536,799 non-business bankruptcy petitions, *Bankruptcy Statistics*, UNITED STATES COURTS, <http://www.uscourts.gov/Statistics/BankruptcyStatistics.aspx> (last visited Aug. 6, 2012), and the United States population was 308,745,538, *id.* This also yields a rate of about one bankruptcy filing for every 200 Americans.

79. Prior to 1898, Congress enacted three bankruptcy acts that together lasted less than twenty years. Bankruptcy Act of 1800, ch. 19, 2 Stat. 19, *repealed by* Act of Dec. 19, 1803, ch. 6, 2 Stat. 248; Bankruptcy Act of 1841, ch. 9, 5 Stat. 440, *repealed by* Act of Mar. 3, 1843, ch. 82, 5 Stat. 614. For a history of bankruptcy in the United States, see DAVID A. SKEEL, JR., *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* (2001); Charles Jordan Tabb, *The History of Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5 (1995).



code. Federal bankruptcy may be a useful tool for resolving financial distress, but Congress should ensure that its advantages are relevant for insolvent states before amending the bankruptcy code to allow them to file.

Standard justifications for federal bankruptcy assume that non-bankruptcy law provides creditors with powerful remedies or at least allows them to exert substantial pressure beyond the ability to refuse to extend future credit or report the default to others. If the debtor is an individual, creditors can seize assets and garnish wages.<sup>80</sup> Even when non-bankruptcy law limits legal remedies, creditors can rely on non-judicial measures such as dunning letters and telephone calls that take a psychological toll. If the debt burden is too great, individuals may not make profitable investments or work hard because any amount earned will accrue to their creditors' benefit. The bankruptcy code, therefore, shields individuals from collection efforts and offers a fresh start that reduces the amount that an individual must pay.<sup>81</sup> If the debtor is a firm, senior creditors may liquidate the firm even if it has value as a going concern, and non-bankruptcy law's priority system can cause a destructive race to the assets or prevent the debtor from accessing new capital.<sup>82</sup> Bankruptcy, therefore, offers firms a chance to reorganize their debts or to liquidate in an orderly fashion.<sup>83</sup> Courts do not liquidate municipalities, but non-bankruptcy law may allow the court to order the municipality to adopt special taxes and pay the proceeds to the creditors. If too many creditors seek this remedy, citizens will flee to another jurisdiction, aggregate tax receipts will fall, and creditors as a group will be worse off. Scholars, therefore, use this taxing power to invoke the

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80. See, e.g., Richard M. Hynes, *Broke But Not Bankrupt: Consumer Debt Collection in State Courts*, 60 FLA. L. REV. 1 (2008).

81. See, e.g., Thomas H. Jackson, *The Fresh Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1402 (1985). Individuals can file for bankruptcy under Chapters 7, 11, 13 or, if they are family farmers or fishermen, Chapter 12. 11 U.S.C. § 109 (2006). Nearly all consumers choose Chapters 7 or 13. See *Table F-2: U.S. Bankruptcy Courts—Business and Nonbusiness Cases Commenced, by Chapter of the Bankruptcy Code, During the 12-Month Period Ending September 30, 2011*, UNITED STATES COURTS, [http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2011/0911\\_f2.pdf](http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2011/0911_f2.pdf) (last visited Aug. 6, 2012) (showing that 99.1% of non-business filings were made in Chapters 7 or 13). Chapter 7 offers debtors a discharge in exchange for any non-exempt assets that they may have. See BARRY E. ADLER, DOUGLAS G. BAIRD & THOMAS H. JACKSON, *BANKRUPTCY* 559–620 (4th ed. 2007). Chapter 13 offers debtors a discharge if they complete a repayment plan that usually lasts for three to five years. *Id.* at 620–63.

82. See Jackson, *supra* note 38.

83. Most firms can file under Chapter 7 (liquidation) or Chapter 11 (reorganization). See 11 U.S.C. § 109.

race-to-the-assets story to justify municipal bankruptcy as well.<sup>84</sup>

Traditional theories do not justify a bankruptcy system for sovereign states to the extent that states are (or can make themselves) judgment-proof and relatively immune to pressure. This does not mean that sovereign debtors should always pay in full. Just as a debt overhang can justify a bankruptcy discharge for an individual, it can justify the reduction of sovereign debt.<sup>85</sup> If the sovereign is truly judgment-proof, however, it does not need a legal mechanism to reduce its debt. It can just refuse to pay.

The sovereign's ability to renege on promises represents both power and weakness. Immunity represents power because the sovereign cannot be forced to pay or perform. Immunity also represents weakness because it reduces the sovereign's ability to make promises it can credibly commit to keep. In theory, Congress could adopt a bankruptcy code that enhanced the credibility of a state's promise by granting creditors remedies unavailable outside of bankruptcy and by allowing involuntary petitions. Such an approach is implausible, however, even in light of recent jurisprudence eroding state sovereign immunity in bankruptcy.<sup>86</sup>

A judgment-proof sovereign may repay its debts to develop a reputation for honoring its commitments so that it can obtain more favorable terms from future trading partners.<sup>87</sup> Even if reputation is the only deterrent to default, courts could still play a useful role by adjudicating the reasons for state defaults and helping states bolster their credibility. If there is a report of a state default, potential trading partners may find it very costly to determine whether the state has in fact breached its obligation and whether it did so opportunistically. A state may have a valid reason to refuse payment—a merchant may have

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84. See McConnell & Picker, *supra* note 39. For a longer discussion of this argument, see *supra* notes 39–40 and the accompanying text.

85. See Paul Krugman, *Financing vs. Forgiving a Debt Overhang*, 29 J. DEV. ECON. 253 (1988). A sovereign saddled with too much debt may fail to adopt policies that lead to future growth because the benefits will accrue to its creditors.

86. Cent. Va. Cmty. Coll. v. Katz, 546 U.S. 356, 379 (2006) (holding that sovereign immunity does not bar suits by a bankruptcy trustee to set aside preferential transfers). More generally, Congress has the ability to abrogate sovereign immunity both inside and outside of bankruptcy and thus could enhance the ability of creditors to sue and collect. See LAURENCE H. TRIBE, *AMERICAN CONSTITUTIONAL LAW* 178–89 (2d ed. 1988). I suggest that this move is implausible because proponents of a federal bankruptcy chapter for states seek mechanisms that would reduce rather than enhance the ability of creditors to collect from a state.

87. See Ugo Panizza et al., *The Economics and Law of Sovereign Debt and Default*, 47 J. ECON. LIT. 651, 662–63 (2009); Kenneth Rogoff & Jeromin Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001* (IMF Working Paper WP/02/133, 2002), available at <http://www.imf.org/external/pubs/ft/staffp/2002/03/pdf/rogoff.pdf>.

delivered defective goods, a contractor's performance may be late, or the state may not have been responsible for a tort victim's injuries. In other cases the state may mistakenly believe that it has a valid excuse and will promptly pay when shown its error. By allowing itself to be sued and complying with judgments entered against it, a state can demonstrate its willingness to fulfill its obligations and thereby obtain better terms from future trading partners.<sup>88</sup>

While transparency and credibility may justify many suits against a state, it is less persuasive when applied to a default due to insolvency or a fiscal crisis. The relevant facts necessary to determine the state's financial condition are likely to be widely disseminated in newspapers and therefore relatively inexpensive for the most significant potential trading partners to gather. Moreover, it is unlikely that future trading partners would rely on a court's or even the current creditors' judgment as to whether the state "should" have paid. Recent developments relating to a different type of sovereign debt provide a graphic example. Banks holding a substantial amount of Greek debt proposed a rollover in an effort to stave off a default under the terms of their contract, but the deal quickly evaporated when Standard & Poor's declared that the plan would itself constitute a default for the purpose of Greece's debt rating.<sup>89</sup> Existing creditors have the right to determine what constitutes a default for the purposes of their contracts, but they do not have the right to determine what constitutes a default for the purposes of the borrower's credit reputation. If they did, the rating agency's decision would have been a non-event.<sup>90</sup>

If bankruptcy is to have a role, it must stop creditor enforcement efforts. We can roughly divide these collection efforts into legal and extra-legal sanctions. In the literature that discusses borrowing by sovereign nations, scholars suggest that creditors may sponsor trade sanctions or even convince their governments to engage in gunboat diplomacy.<sup>91</sup> It is hard to imagine creditors leading a boycott of California wine or an invasion of Illinois, but states may be vulnerable to the extra-legal sanctions commonly used against private firms. Suppliers

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88. States do in fact allow themselves to be sued. See David K. Miller & M. Stephen Turner, *Enforcement of Money Judgments Against the State*, 64 FLA. B. J. 29 (1990).

89. Harry Wilson, *Greek Debt Rollover Amounts to 'Selective Default'*, TELEGRAPH (July 4, 2011, 9:26 PM), <http://www.telegraph.co.uk/finance/economics/gilts/8616659/Greek-debt-rollover-amounts-to-selective-default.html>.

90. Technically a credit rating agency does not have the final say in the determination of the debtor's reputation. Future creditors are free to ignore a credit rating unless these ratings factor into risk-weighted capital calculations as they do for regulated investors like banks or pension funds.

91. See Panizza, *supra* note 87, at 678–79.

who are not paid for deliveries may refuse further business, and workers who are not paid may strike or quit.

The bankruptcy code clearly prohibits the use of extra-legal sanctions to collect debts,<sup>92</sup> and courts can punish creditors who willfully ignore this prohibition.<sup>93</sup> In practice, however, courts recognize that they are unable to thoroughly police this behavior, and this sometimes leads them to authorize deviations from ordinary priority rules. Workers and favored suppliers are frequently paid in full and in cash on the first day of Chapter 11 reorganization, while other holders of unsecured claims must wait until the end of the proceedings and receive pennies on the dollar.<sup>94</sup> If a state wishes to punish the use of these extra-legal sanctions, it does not need the bankruptcy code to do so. For example, a state could pass a law prohibiting its workers from striking. These laws may prove no more effective than federal bankruptcy's prohibition on extra-legal sanctions, and a state may simply give in to the threat of extra-legal sanctions or at least allow their exercise.

Creditors who wish to use the courts to enforce their rights against a state face at least two major hurdles: sovereign immunity (including the Eleventh Amendment) and the courts' flexible interpretation of the Contract Clause. Under existing interpretations of sovereign immunity and the Eleventh Amendment, a state can probably prevent its most significant creditors from suing to collect in either state or federal court. However, a state may be unable to retract a waiver of its sovereign immunity, and creditors may even be able to enforce some covenants. In addition, the Eleventh Amendment will not stop suits brought against a state's localities. Because states use these localities to accomplish many of their goals, these suits could put substantial pressure on state budgets. Bringing suit is, however, only the first step in the process. States may pass laws designed to thwart the creditors' claims, and the validity of these laws would turn on the court's interpretation of the Contract Clause. Some courts have used the flexible interpretation mandated by the Supreme Court to adopt standards that are similar to those that would be used in bankruptcy.

#### A. *Sovereign Immunity May Prevent Creditors from Suing a State*

The Revolutionary War left many of the new states heavily in debt, and creditors sought to use the courts to force them to pay. Creditors

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92. 11 U.S.C. § 362(a)(6) (2006).

93. *Id.* § 362(k).

94. *See* ADLER, BAIRD & JACKSON, *supra* note 81, at 445.

found state courts to be hostile venues, and so they turned to the new federal courts. In *Chisholm v. Georgia*,<sup>95</sup> the Supreme Court ruled that federal courts had jurisdiction to hear suits brought against a state by creditors from another state.<sup>96</sup> The reaction to *Chisholm* was swift. Congress approved the Eleventh Amendment within weeks of the entry of the final judgment in *Chisholm*, and state approval followed about a year later.<sup>97</sup> The Eleventh Amendment states “[t]he Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State.”<sup>98</sup> The Supreme Court has interpreted the Eleventh Amendment to prohibit federal courts from hearing suits against states even if the suit alleged unconstitutional action (e.g. a violation of the Contract Clause), and even if the party bringing the suit were a citizen of the state itself.<sup>99</sup>

The Eleventh Amendment does not render a state completely immune from suit. Its sister states and the federal government can bring suit in federal court.<sup>100</sup> When states defaulted on their bonds in the nineteenth century, creditors asked their own state governments to sue on their behalf and turn over any amounts collected. The Supreme Court ruled that one state could not sue another if it were acting as a mere pass-through or collection agent for its citizens.<sup>101</sup> Later, however, creditors donated their bonds to a state government, and the Supreme Court ruled that a creditor state could sue a debtor state for its own account.<sup>102</sup> If bondholders credibly threaten to sell or give their bonds to a state willing to sue the debtor state, they may be able to extract a settlement. This route would probably be unavailable to a state’s current and former

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95. 2 U.S. (2 Dall.) 419 (1793).

96. *Id.* at 480.

97. See Orth, *supra* note 6, at 428 n.41 (“Because of delays, judgment for *Chisholm* was not entered until February 14, 1794 . . . . By March 4, 1794, Congress by two-thirds majorities in both houses had proposed the amendment, and by February, 1795, the legislatures of three-fourths of the states had ratified it.”).

98. U.S. CONST. amend. XI.

99. *Hans v. Louisiana*, 134 U.S. 1 (1890). For a brief and accessible overview of the Eleventh Amendment, see MICHAEL COLLINS, SECTION 1983 LITIGATION IN A NUTSHELL 127–54 (2001).

100. See *South Dakota v. North Carolina*, 192 U.S. 286 (1904); TRIBE, *supra* note 86, at 175 (“Suits brought by sister states or by the United States are thus not prohibited.”).

101. See *New Hampshire v. Louisiana*, 108 U.S. 76, 91 (1883) (“[O]ne State cannot create a controversy with another State . . . by assuming the prosecution of debts owing by the other State to its citizens.”); Orth, *supra* note 6, at 437.

102. *South Dakota v. North Carolina*, 192 U.S. 286, 321 (1904); Orth, *supra* note 6, at 451–53. However, foreign governments cannot sue a state. *Principality of Monaco v. Mississippi*, 292 U.S. 313, 330 (1934).

workers even if a willing creditor state could be found. ERISA, and its prohibition of the assignment of benefits, does not apply to state pensions.<sup>103</sup> However, the Internal Revenue Code restricts favorable tax treatment to pensions that insist that any assignment be voluntary, revocable, and worth less than 10% of any benefit payment made.<sup>104</sup>

A more common strategy for circumventing the Eleventh Amendment is to sue an officer of the state rather than the state itself. If the officer is not acting pursuant to a valid state law (and the federal Constitution can render a state law invalid), then that officer is no longer cloaked with the mantle of the state and federal courts can enjoin the officer from violating the plaintiff's rights.<sup>105</sup> In 1875, creditors used this strategy to prevent Louisiana from issuing additional bonds on terms that would have violated promises made to existing bondholders.<sup>106</sup> However, eight years later the Supreme Court rejected an attempt to use mandamus to force Louisiana to resume interest payments at the contractual rate.<sup>107</sup> The Supreme Court has subsequently said that "when the action is in essence one for the recovery of money from the state, the state is the real, substantial party in interest and is entitled to invoke its sovereign immunity from suit even though individual officials are nominal defendants."<sup>108</sup> As a result, contract claimants can't use this technique to recover damages for breach.

The Eleventh Amendment does not prevent creditors from suing in state court, but creditors sought access to federal court because they found the state courts to be inhospitable. If a creditor sues a state in its own courts, the state can invoke sovereign immunity or take other steps

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103. 29 U.S.C. § 1003(b)(1) (2006).

104. 26 U.S.C. § 401(a)(13) (2006).

105. See, e.g., *Ex parte Young*, 209 U.S. 123 (1908).

106. *Bd. of Liquidation v. McComb*, 92 U.S. 531, 541 (1875). The bonds at issue in *McComb* were themselves the product of a work-out agreement whereby creditors agreed to exchange old debt for new bonds at sixty cents on the dollar. *Id.* at 534. A district court used a similar strategy to prevent Arkansas from diverting funds that had been pledged to specific bonds. See *Hubbell v. Leonard*, 6 F. Supp. 145 (E.D. Ark. 1934). However, constitutional law scholars question whether modern courts would still reach this result in light of subsequent rulings that find immunity when equitable relief would impact the state treasury. See, e.g., Clayton P. Gillette, *What States Can Learn from Municipal Insolvency*, in *WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS* 99, 112–13 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012).

107. *Louisiana ex rel. Elliott v. Jumel*, 107 U.S. 711, 728 (1883).

108. *Ford Motor Co. v. Dep't of Treasury of Ind.*, 323 U.S. 459, 464 (1945); see also *Edelman v. Jordan*, 415 U.S. 651, 663 (1974) ("[T]he rule has evolved that a suit by private parties seeking to impose a liability which must be paid from public funds in the state treasury is barred by the Eleventh Amendment.").

(change evidentiary rules, etc.) to make the process difficult.<sup>109</sup> Creditors could try to sue a state in the courts of a sister state, but this raises the difficult issue of whether the court must and can obtain personal jurisdiction over the state.<sup>110</sup> Even if successful, the creditor would need to find assets to attach. Most state assets (schools, roads government buildings, etc.) are exempt from attachment,<sup>111</sup> and many of the financial assets (cash, securities, etc.) of a state will actually belong to its municipalities (retirement funds, etc.). A state can also protect itself by keeping its assets out of jurisdictions where creditors can sue.<sup>112</sup>

States can, and sometimes do, waive sovereign immunity in their contracts,<sup>113</sup> and there is some chance that these waivers would be enforced. Language in a nineteenth century Supreme Court opinion suggests that a state could retract such a waiver: “although the state may, at the inception of the contract, have consented as one of its conditions to subject itself to suit, it may subsequently withdraw that consent, and resume its original immunity, without any violation of the obligation of its contract in the constitutional sense.”<sup>114</sup> However, at least one constitutional scholar has seized on some recent Supreme Court language<sup>115</sup> to argue that a state cannot retract a contractual waiver.<sup>116</sup>

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109. See Orth, *supra* note 6, at 439–47.

110. One could argue for personal jurisdiction in a state where a debtor-state marketed its bonds. However, this strategy may be difficult if the debt at issue is owed to current or former workers.

111. See H.R. REP. NO. 100-1011, at 4 (1988).

112. The experience of defaulting nations suggests that creditors will sometimes find assets to attach. The immunity enjoyed by sovereign nations is quite different than that enjoyed by the states. Most notably, sovereign nations are not immune to the extent that they engage in commercial activity, 28 U.S.C. § 1610(a) (2006), and United States courts have held that issuing bonds to the market qualifies as commercial activity. See *Republic of Argentina v. Weltover, Inc.*, 5 U.S. 607 (1992); Panizza, *supra* note 87, at 652–59. Although creditors can sue defaulting nations, these nations have been fairly adept at keeping their assets beyond the reach of the creditors. See, e.g., Mitu Gulati & George Triantis, *Contracts Without Law: Sovereign Versus Corporate Debt*, 75 U. CIN. L. REV. 977, 986 (2007) (“For example, over \$740 million in judgments have been obtained against Argentina on account of its sovereign debt defaults in 2001. Argentina, however, keeps no funds in the U.S. for commercial purposes, and its deposits elsewhere, particularly in Switzerland, are immune from attachment.”). Creditors occasionally find bank accounts that they can attach. See, e.g., *NML Capital, Ltd. v. Republic of Argentina*, 680 F.3d 254 (2d Cir. 2012).

113. Waivers of sovereign immunity in state court are far more common than waivers of the Eleventh Amendment. See Schwarcz, *supra* note 2, at 334 (“[W]aivers [of the Eleventh Amendment] are relatively rare; states typically consent to suit only in their own courts.”).

114. *Ex parte Ayers*, 123 U.S. 443, 505 (1887).

115. *Coll. Sav. Bank v. Fla. Prepaid Postsecondary Educ. Expense Bd.*, 527 U.S. 666, 676 (1999) (“[A] State may, absent any contractual commitment to the contrary, alter the conditions of its waiver and apply those changes to a pending suit.”).

116. See Christina Bohannon, *Beyond Abrogation of Sovereign Immunity: State Waivers, Private Contracts, and Federal Incentives*, 77 N.Y.U. L. REV. 273, 292–303 (2002). The possibility of

Moreover, states can effectively waive sovereign immunity by structuring contracts so that they must initiate the legal action. In the nineteenth century, for example, Virginia issued bonds that gave holders the option to apply the coupon toward their tax bills. When political power in the state shifted, Virginia took steps to prevent bondholders from tendering these coupons in payment of their debts.<sup>117</sup> After several unsuccessful attempts, bondholders finally found a strategy for recovery that worked. They could effectively recover by tendering the coupons in payment of their taxes and then bringing an action in detinue to recover any property taken by the tax collector.<sup>118</sup>

Sovereign immunity does not protect local government entities such as cities or counties, but it does protect the state, its agencies, and other arms.<sup>119</sup> Even where a public entity constitutes a “political subdivision or public agency or instrumentality of a State” and therefore a municipality under the bankruptcy code,<sup>120</sup> it may still be immune from some suits.<sup>121</sup> Consistent with the theory that judgment-proof entities do not need federal bankruptcy protection, it does not appear that any of the municipalities that have ever filed for federal bankruptcy could have claimed sovereign immunity.<sup>122</sup> On the other hand, a large share of state spending flows through localities,<sup>123</sup> and if creditors can enforce their rights against these localities, they can substantially increase the cost that a state must incur to accomplish its goals. Because of this, and because of the other limits on sovereign immunity, it is worth considering plaintiffs’ ability to enforce their claims once they get into court.

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waiving sovereign immunity contrasts with the general inability of entities to waive their right to file for bankruptcy.

117. See Orth, *supra* note 6, at 439–47.

118. *Id.*

119. See Collins, *supra* note 99, at 127 (“Sovereign immunity protects only the state, state agencies, and other arms of the state. Historically, it has not protected cities, counties, and other local government entities.”); Orth, *supra* note 6, at 438–39.

120. 11 U.S.C. § 101(40) (2006).

121. See, e.g., *Leach v. Tex. Tech Univ.*, 335 S.W.3d 386 (Tex. App. 2011).

122. Lists of governments that have filed for bankruptcy can be found in Keren H. Deal, An Examination of Municipal Finance Reform Regarding Municipal Bankruptcies in the United States 313–17 app. II (Aug. 4, 2007) (unpublished Ph.D. dissertation, Auburn University) (on file with author) (listing all Chapter 9 filings between 1971 and 2005), and George H. Hempel, *An Evaluation of Municipal “Bankruptcy” Laws and Procedures*, 28 J. FIN. 1339, 1342–43 (1973) (listing filings between 1938 and 1971). A thorough analysis of whether these entities could have claimed sovereign immunity is beyond the scope of this paper. However, the names of nearly all of these entities suggest a local character.

123. See *supra* note 34 and accompanying text.



B. *State Laws Amending Creditor Rights May Survive a Contract Clause Challenge*

“No State shall . . . pass any . . . Law impairing the Obligation of Contracts.”<sup>124</sup> Despite the Constitution’s absolutist language, the Supreme Court has held that the Contract Clause does not prohibit legislation impairing private contracts if the legislation is a proper exercise of a state’s police powers. In *Home Building & Loan Ass’n v. Blaisdell*,<sup>125</sup> the Supreme Court upheld a law designed to grant mortgage debtors some relief from their creditors, reasoning that “[the] question is not whether the legislative action affects contracts incidentally, or directly or indirectly, but whether the legislation is addressed to a legitimate end and the measures taken are reasonable and appropriate to that end.”<sup>126</sup>

The framers included the Contract Clause to prevent laws that interfered with the enforcement of contracts between private citizens,<sup>127</sup> but by the early nineteenth century the Supreme Court had applied the Contract Clause to invalidate a state law that interfered with the state’s own contract.<sup>128</sup> Modern Contract Clause doctrine suggests that courts should be less deferential toward a state legislature when the statute impairs contracts in which the state has some interest. In *United States Trust Co. of New York v. New Jersey*,<sup>129</sup> the Supreme Court struck down a New Jersey statute that impaired bondholders’ rights.<sup>130</sup> The Court ruled that although some powers could not be bargained away, “the power [of a state] to enter into effective financial contracts cannot be questioned.”<sup>131</sup> Still, the Supreme Court allowed some flexibility even with respect to financial contracts: “The Contract Clause is not an

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124. U.S. CONST. art. I, § 10, cl. 1.

125. 290 U.S. 398 (1934).

126. *Id.* at 438. Initially the Supreme Court drew a distinction between laws that impaired a contract’s obligation and laws that modified the remedies provided for enforcement. However, the dividing line between remedy and obligation quickly became obscured, and courts focused on the “reasonableness” of the legislation. See TRIBE, *supra* note 86, at 615. This does not mean that the Contract Clause is irrelevant; even after *Blaisdell* the courts have struck down some laws because they interfere with private contracts. See, e.g., *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234 (1978).

127. See TRIBE, *supra* note 86, at 618 (“Particularly since the clause was not intended primarily to protect public contracts . . .”).

128. See, e.g., *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819).

129. 431 U.S. 1 (1977). These bonds were issued by an entity created by an interstate compact between New York and New Jersey. *Id.* at 1.

130. *Id.*

131. *Id.* at 24.

absolute bar to subsequent modification of a State's own financial obligations. As with laws impairing the obligations of private contracts, an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose."<sup>132</sup> The Supreme Court further suggested that courts should exert some scrutiny when the law in question affected the state's own obligations: "complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake."<sup>133</sup>

Courts are not often asked to rule on whether laws altering the rights of bondholders violate the Contract Clause,<sup>134</sup> but courts have applied the Supreme Court's test to unilateral modifications of collective bargaining agreements. State and local governments have suffered a string of financial crises, and they often respond by trying to reduce their labor costs. When these cost-cutting efforts include a unilateral change to a collective bargaining agreement, workers may sue, alleging that the new laws violate the Contract Clause. A recent article by Stephen Befort surveys the cases and concludes that the courts focus on six primary factors when applying the Supreme Court's "reasonable and necessary" test: (i) the severity of the government's fiscal emergency, (ii) the foreseeability of the economic problems that created the crisis, (iii) the severity of the impairment of the workers' rights, (iv) the availability of alternative courses of action, (v) whether the impairment acts prospectively or retrospectively, and (vi) whether the financial pain is shared by similarly situated groups.<sup>135</sup>

Whether to allow an obligor to reject or modify its obligations because of a fiscal emergency is a question commonly associated with bankruptcy,<sup>136</sup> and so it is not surprising that the Contract Clause

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132. *Id.* at 25. An impairment is not "reasonable" if the parties could foresee the changed circumstances that made the impairment necessary, and not "necessary" if there are less drastic alternatives available for safeguarding the public interest. Courts applying state law analogs to the Contract Clause often apply standards that mirror the federal test. *See, e.g.,* *Pierce Cnty. v. State*, 159 Wash. 2d 16, 28, 148 P.3d 1002, 1010 (2006) ("This court uses a three-part test to determine if there has been an impairment of a public contract: (1) does a contractual relationship exist, (2) does the legislation substantially impair the contractual relationship, and (3) if there is substantial impairment, is it reasonable and necessary to serve a legitimate public purpose.").

133. *U.S. Trust Co. of N.Y.*, 431 U.S. at 26.

134. For a notable exception, see *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942) (upholding a state created composition mechanism for municipal debt).

135. *See* Befort, *supra* note 7, at 40–46.

136. *See* 11 U.S.C. §§ 365, 1129 (2006). This power applies to collective bargaining agreements as well. *See* *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 526 (1984). Congress responded to *Bildisco* by enacting a special section for collective bargaining agreements (section 1113), but this section does not apply in municipal bankruptcies. 11 U.S.C. § 901 (2006). The bankruptcy code also

standards reflect basic bankruptcy principles. The Contract Clause principle that an impairment must be substantial or severe is analogous to the bankruptcy principle that creditors cannot block a plan of reorganization if they receive something with a value equal to their claim.<sup>137</sup> The Contract Clause analysis asks whether the severity of the financial distress is sufficiently dire to justify the law and whether alternative courses of action exist; this is similar to the bankruptcy inquiry as to whether a plan is actually in the best interests of creditors or whether the debtor must promise to pay more. Asking whether the financial pain is shared among similarly situated groups (Contract Clause) is effectively the same as asking whether a plan “discriminate[s] unfairly” against a particular group of creditors (bankruptcy).<sup>138</sup> Whether the financial distress was foreseeable is less obviously relevant in the bankruptcy context, but courts have dismissed filings as lacking good faith when they believed that the agreement effectively constituted a settlement designed to resolve the insolvency.<sup>139</sup> The contractual doctrine of mitigation allows a reconciliation of bankruptcy’s approach with the question of whether the modification acts prospectively or retrospectively. If a debtor rejects an executory contract (material performance remaining on each side), the counter-party will receive a claim for damages, but these damages are reduced to the extent that the rejection allows the counter-party to offer performance elsewhere.

The standards applied in both the Contract Clause and federal bankruptcy contexts are sufficiently vague that it is possible that most sets of facts that would satisfy one standard would satisfy the other. But this does not mean that the court would necessarily apply the same analysis in each context. The norm of equitable treatment of creditors may be stronger in bankruptcy, meaning that the Contract Clause analysis would provide the state with greater flexibility. In his survey, Befort suggests that non-bankruptcy courts are too willing to approve a

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requires that a municipality’s plan of reorganization comply with state law, and so courts have struggled when applying *Bildisco* when a municipality files. For example, courts consistently rule that *Bildisco*, and not state law, governs the rejection of a collective bargaining agreement, *Orange Cnty. Emps. Ass’n v. Cnty. of Orange (In re Orange Cnty.)*, 179 B.R. 177, 183 (Bankr. C.D. Cal. 1995); *In re City of Vallejo*, 403 B.R. 72 (Bankr. E.D. Cal. 2009), but consider state law in determining the equities of the rejection or modification. *In re Orange Cnty.*, 179 B.R. at 184 (“In Chapter 9, *Bildisco* does not excuse attempts by the County to comply with the requirements of California law.”). This difficult issue would, however, not arise in a state bankruptcy if the state simultaneously changed the relevant laws.

137. *See, e.g.*, 11 U.S.C. § 1129(b)(2)(A)(II) (2006).

138. *Id.* § 1129(b)(1).

139. *See, e.g., In re Colonial Ford, Inc.*, 24 B.R. 1014 (Bankr. D. Utah 1982).

plan modifying workers' rights, despite the plan not requiring other creditors to sacrifice as well.<sup>140</sup>

### III. AN INSOLVENT STATE COULD USE BANKRUPTCY UNDER EXISTING LAW

Part II explains that states have used non-bankruptcy law to resolve past fiscal crises. In many instances, the states used the political process to raise taxes<sup>141</sup> or cut spending. In the nineteenth century, several states cut spending by defaulting on their bond obligations. However, sovereign immunity and the Eleventh Amendment largely prevented creditors from suing to enforce their claims against the states.<sup>142</sup> More recently, states responded to fiscal crises by unilaterally amending their—or their municipalities'—collective bargaining agreements. Courts resolved these disputes by deciding whether the new state laws violated the Contract Clause.<sup>143</sup>

Part III argues that although states cannot file for federal bankruptcy under existing law, a state could still use bankruptcy to address its fiscal woes. Section A argues that a state could use the federal bankruptcy code to sharply reduce its expenses. Much of a state's spending flows through its municipalities. If a state can use bankruptcy to reduce its municipalities' obligations, it can reduce the cost of achieving its goals. Section B suggests that an insolvent state could construct a synthetic bankruptcy process to resolve its own insolvency without using the federal bankruptcy code.

#### A. *States Can Use Municipal Bankruptcy to Reduce Expenses*

Some commentators have noted that much of the state debt reported in the news is not really state debt at all, but is instead owed by their municipalities.<sup>144</sup> As a legal matter, they are correct. A state's

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140. See Befort, *supra* note 7, at 53–54 (“[C]ourts generally should not uphold a governmental entity’s modification of one of its own contracts unless it is part of a plan that distributes the burden of coping with fiscal crisis broadly and equitably.”).

141. E.g., *Illinois Lawmakers Pass 66 Percent Income Tax Increase*, FOX NEWS (Jan. 12, 2011), <http://www.foxnews.com/politics/2011/01/12/ill-lawmakers-pass-percent-income-tax-increase/#ixzz1TQCYjw1w>.

142. See *supra* Part II.A.

143. See *supra* Part II.B.

144. See, e.g., Iris J. Lav & Elizabeth McNichol, *Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm*, CTR. ON BUDGET & POL. PRIORITIES, 8–9 (2011), <http://www.cbpp.org/cms/index.cfm?fa=view&id=3372>; Steve Liesman, *Why Muni Bond Crisis May Be Exaggerated*, CNBC.COM (Feb. 15, 2011, 9:37 AM),

municipalities (cities, counties, universities, school districts, etc.) have their own bondholders, employees, and retirees. A state is not liable to such creditors unless it is a co-debtor or has issued a guarantee. While grouping state and municipal debt together may be incorrect as a strictly legal matter, so too is consolidating a large firm's debt on the parent company's balance sheet. Some of this debt will be owed by separate legal entities, and the parent company may not have guaranteed this debt. Generally accepted accounting principles ("GAAP") still insist that the parent report the debt of its subsidiaries on its own balance sheet if the parent owns more than half of the subsidiary.<sup>145</sup> GAAP requires consolidation because the firm must pay these debts if it is to continue its current operations. Just as publicly traded corporations rely on their subsidiaries to conduct some business, states rely on their municipalities (universities, school districts, counties, cities, etc.) to accomplish some goals. Larger municipal obligations (bond debt, larger pensions, and collective bargaining agreements with higher salaries) mean that a state must transfer more money to its municipalities to ensure that the state's streets are safe, its children are educated, and its poor receive health and financial assistance. Just as the debts of a corporation's subsidiaries can reduce the money available to pay to shareholders as dividends, municipal debts can increase the taxes that a state's citizens must pay. Thus, while municipal debts may not be state obligations as a legal matter, they are as a practical matter.<sup>146</sup>

Because so much of a state's spending flows through its municipalities,<sup>147</sup> a state could materially reduce its costs by pushing these municipalities into bankruptcy. Clay Gillette has argued that a state cannot force one of its municipalities into bankruptcy.<sup>148</sup> However, this depends on state law. The bankruptcy code insists that a municipality

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[http://www.cnn.com/id/41584517/Why\\_Muni\\_Bond\\_Crisis\\_May\\_Be\\_Exaggerated](http://www.cnn.com/id/41584517/Why_Muni_Bond_Crisis_May_Be_Exaggerated).

145. Consolidation of All Majority-Owned Subsidiaries, Statement of Financial Accounting Standards No. 94, ¶¶ 1, 2, 13 (Fin. Accounting Standards Bd., Oct. 1987).

146. In the nineteenth century Alabama tried a different approach to reduce municipal debt, first dissolving the City of Mobile and then incorporating the Port of Mobile in its place. *See* Gillette, *supra* note 106, at 109. This attempt failed when the Supreme Court ruled that the Port of Mobile was the legal successor of the City of Mobile and was therefore liable for the debts. *See* Port of Mobile v. Watson, 116 U.S. 289, 300 (1886).

147. *See supra* notes 33–34 and accompanying text.

148. *See* Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 283, 299 (2011). Gillette further notes that states may not want their municipalities to file for bankruptcy because the automatic stay could lessen the ability of the state to seize control. *Id.* My argument posits that the state has seized control of the municipality prior to the bankruptcy filing.

file voluntarily,<sup>149</sup> and “desire[] to effect a plan [of reorganization].”<sup>150</sup> If a state’s plenary power allows the state to seize control of a municipality, the state could file on behalf of the municipality and effect a plan. We may soon find out whether this strategy will work. The State of Michigan recently enacted a statute granting itself the authority to appoint a manager with broad authority over a municipality’s finances where the State deems the municipality to be in financial distress.<sup>151</sup> This authority includes the power to reject labor contracts, seize control of pensions, file a bankruptcy petition (with the consent of the governor), and control the bankruptcy process.<sup>152</sup> This law faced substantial opposition from labor unions and other groups, and some citizens have sued claiming that it violates Michigan’s constitution.<sup>153</sup> If this statute is a valid exercise of Michigan’s plenary powers, nothing in the federal bankruptcy code would prevent Michigan from pushing one of its municipalities into bankruptcy.<sup>154</sup>

If a state were to force its municipalities into bankruptcy to resolve its own insolvency, many of the municipal bankruptcies would present similar issues. For example, a state may wish to use bankruptcy to adjust the pensions promised to former teachers from each school district and professors from each state university. A state would incur lower transactions costs and ensure greater consistency in the resolution of the issues if it could consolidate the bankruptcies of its municipalities in a single court, just as businesses consolidate the bankruptcies of their subsidiaries in a single court.<sup>155</sup> Existing law may not allow the administrative consolidation of the bankruptcies of municipalities even if each were controlled by the state. A debtor may file for bankruptcy in a

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149. 11 U.S.C. § 901 (2006) (making § 301 (voluntary filing) applicable in Chapter 9 but excluding § 303 (involuntary filing)).

150. 11 U.S.C. § 109(c)(4).

151. See 2011 Mich. Pub. Acts 4; Caitlin Devitt, *Michigan Bills to Rein in Local Government*, BOND BUYER (Mar. 10, 2011), [http://www.bondbuyer.com/issues/120\\_47/michigan\\_state\\_fiscal\\_law-1024198-1.html](http://www.bondbuyer.com/issues/120_47/michigan_state_fiscal_law-1024198-1.html).

152. See 2011 Mich. Pub. Acts 4 § 19, 23.

153. SUGAR LAW CTR., <http://www.sugarlaw.org/democracy-emergency/> (last visited Aug. 19, 2012).

154. A municipality must also have specific authorization to file, fail to pay, or be unable to pay its debts as they come due and meet one of four tests designed to encourage pre-bankruptcy negotiation between the municipality and its creditors. 11 U.S.C. §§ 109, 101(32(C)). If a state can seize control of a municipality and act on its behalf, it can ensure that each of these tests is met.

155. See, e.g., LYNN M. LOPUCKI, *COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS* 34–37 (2005) (alleging that large firms abuse this right to strategically choose their bankruptcy venue).

district in which an affiliate has filed,<sup>156</sup> and a court may administratively consolidate the two cases.<sup>157</sup> The term “affiliate” does not currently contemplate two municipalities of the same state,<sup>158</sup> but Congress could amend the definition so that it does.

*B. States Can Create Synthetic Bankruptcy—Bankruptcy Without the Code*

Part IV discusses existing proposals for a new federal bankruptcy chapter for states, but there seems to be little political desire to amend the bankruptcy code to allow a state to file.<sup>159</sup> This may change if the financial condition of one or more of the states materially worsens; during the nineteenth century Congress enacted a series of bankruptcy acts during financial crises only to repeal them when economic conditions improved.<sup>160</sup> Even if Congress does not amend the code to allow a state to file, however, courts could use existing law to synthesize a bankruptcy mechanism (a single proceeding that binds all of a debtor’s creditors).<sup>161</sup> This section explores that option.

The most direct method of replicating a federal bankruptcy chapter for states would be for a state to create its own composition mechanism.<sup>162</sup> There is some historical precedent for this. Congress first enacted a municipal bankruptcy procedure in 1934,<sup>163</sup> but New Jersey already had a composition mechanism for its municipalities.<sup>164</sup> New Jersey’s composition mechanism loosely resembled modern municipal bankruptcy. A municipality could adjust the rights of dissenting creditors if it received the support of a super-majority vote of creditors and if it

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156. 28 U.S.C. § 1408(2) (2006).

157. FED. R. BANKR. P. 1015.

158. See 11 U.S.C. § 101(2) (defining “affiliate” as a parent, subsidiary, substantial shareholder, etc.).

159. As noted above, the nation’s governors almost uniformly oppose a state bankruptcy mechanism. See NAT’L GOVERNORS ASS’N, *supra* note 2.

160. See SKEEL, *supra* note 79, at 24–25.

161. See *supra* note 18 and accompanying text.

162. George Triantis also notes that a state could make its own composition mechanism. See Triantis, *supra* note 20.

163. Bankruptcy Act of 1934, 11 U.S.C. § 80(k) (1937) (repealed 1978). In 1936 the Supreme Court found this law to be unconstitutional, *Ashton v. Cameron Cnty. Water Improvement Dist. No. 1*, 298 U.S. 513 (1936), and Congress quickly enacted a revised version in 1937. Bankruptcy Act of 1937, § 83(i), former 11 U.S.C. § 403(i) (1940). For the legislative history of municipal bankruptcy, see 6 COLLIER ON BANKRUPTCY ¶ 903.LH (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011) [hereinafter COLLIER ON BANKRUPTCY].

164. See N.J. STAT. ANN. 52:27-1 to -66 (West 2012).

could convince a judge that the adjustments satisfied basic fairness tests.<sup>165</sup> The precise details of New Jersey's or other states' composition mechanisms are unimportant. What is important is that a composition mechanism fits the broad definition of bankruptcy—a single proceeding that binds all creditors or at least those creditors over whom the court can obtain jurisdiction.<sup>166</sup>

If a state created a mechanism to adjust its own debts, creditors could mount two challenges, but neither is likely to succeed. First, creditors could argue that federal law preempts a state composition mechanism. Today, section 903 of the bankruptcy code would expressly preempt New Jersey's composition mechanism for its municipalities.<sup>167</sup> However, the bankruptcy code does not prohibit a state mechanism that adjusts its own debt. Creditors could construct an argument based on implied preemption—either field preemption or conflict preemption. An argument based on field preemption would claim that Congress intended that federal bankruptcy law occupy the entire field of state insolvency.<sup>168</sup> An argument based on conflict preemption would claim that “compliance with both state law and federal law is impossible” or “state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”<sup>169</sup> These arguments are unpersuasive. Given that Congress chose to enact a bankruptcy chapter for municipalities, expressly preempted state municipal bankruptcy mechanisms, and chose to remain silent with respect to state insolvency mechanisms, the better reading of the bankruptcy code is that Congress decided not to address the field of state insolvency at all. Because federal laws governing the rights of bondholders, workers, and retirees expressly exclude obligations owed by states,<sup>170</sup> a state composition mechanism adjusting the rights of these creditors would not conflict with federal law.

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165. See *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 504–05 (1942) (describing the New Jersey mechanism). Unlike New Jersey's composition mechanism, modern Chapter 9 would allow a court to approve a plan over the objection of a class of creditors. See 11 U.S.C. §§ 901, 943 (2006). However, this cramdown power is rarely, if ever, used. See Schwarcz, *supra* note 2, at 335 n.74 (“There does not appear to be any precedent in which municipalities resorted to cramdown under Chapter 9 . . .”).

166. As discussed below, this synthetic mechanism is not truly a bankruptcy mechanism precisely because it would be unable to bind all creditors. See *infra* notes 257–62 and the accompanying text.

167. 11 U.S.C. § 903(1) (2006) (“[A] State law prescribing a method of composition of indebtedness of [a] municipality may not bind any creditor that does not consent to such composition.”).

168. See *California v. ARC Am. Corp.*, 490 U.S. 93, 100 (1989).

169. *Id.* at 100–01.

170. See *supra* notes 56, 65–66 and accompanying text.



Second, creditors could claim that a composition mechanism that applied retroactively would violate the Contract Clause.<sup>171</sup> This objection would also likely fail, however. In *Faitoute Iron & Steel Co. v. City of Asbury Park*,<sup>172</sup> the Supreme Court upheld New Jersey's composition mechanism for pre-existing municipal debt against a Contract Clause challenge, reasoning that the law did not impair the creditors' rights because the creditors received more than they would have had they pursued their largely unenforceable claims individually.<sup>173</sup> Creditors could argue that the Court must overturn *Faitoute* in light of *United States Trust Co. of New York*.<sup>174</sup> However, a court applying the "reasonable and necessary" test of *United States Trust Co.* would still uphold a well-structured composition mechanism if economic circumstances were sufficiently dire. As noted above, the standards that a federal bankruptcy court would apply to a reorganization plan are similar to, and probably more stringent than, those used by courts in a Contract Clause analysis.<sup>175</sup>

States did not create composition mechanisms when they defaulted on their obligations in the nineteenth century; they simply changed their laws to modify the rights of their creditors. States may take the same approach in a future crisis, modifying collective bargaining agreements, adjusting the rights of pension holders and other creditors, and promising new lenders priority over any existing debts. State law governs the rights of a state's creditors. These laws would achieve the same result as a confirmed plan of reorganization if they survived Contract Clause challenges. This piecemeal approach does not directly control creditor conflicts, but it is unclear how significant these conflicts would be given the extreme difficulty of suing a state and attaching its assets.<sup>176</sup>

Moreover, creditors could mitigate these conflicts by employing

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171. Creditors could also claim that the changes violate the state's faith and credit pledge (a matter of state law), but courts generally apply a balancing standard here as well. See Triantis, *supra* note 20, at 246–49.

172. 316 U.S. 502 (1942).

173. *Id.* at 516 ("To call a law so beneficent in its consequences on behalf of the creditor who, having had so much restored to him, now insists on standing on the paper rights that were merely paper before this resuscitating scheme, an impairment of the obligation of contract is indeed to make of the Constitution a code of lifeless forms instead of an enduring framework of government for a dynamic society.").

174. For a discussion of *United States Trust Co. of New York*, see *supra* notes 129–33 and accompanying text.

175. See *supra* note 138 and accompanying text.

176. See *supra* Part II.A.

aggregate litigation techniques such as mandatory class actions<sup>177</sup> in order to prevent individual plaintiffs from pursuing their claims independently before or after the final adjudication of the mandatory class action.<sup>178</sup> Although not as broad as the automatic stay, mandatory class certification provides a reasonably close substitute.<sup>179</sup> Even if a court refuses to certify mandatory class actions,<sup>180</sup> the aggressive use of quasi-class action techniques (the transfer of similar litigation to a single court) could yield the benefits of litigation in a single forum and prevent

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177. FED. R. CIV. P. 23(a) allows the certification of a class if: (i) the class is so numerous that joinder is impractical, (ii) there are common questions of law or fact (does the new legislation satisfy the Contract Clause?), (iii) the claims of the representative party are typical of other class members (are they similarly affected by the legislation?), and (iv) “the representative parties will fairly and adequately protect the interests of the class.” FED. R. CIV. P. 23(a). A court can certify a mandatory class if allowing individual suits could substantially impair the ability of the claimants to protect their interests, *id.* 23(b)(1), and mandatory class actions are commonly used when the defendant does not have enough money to pay all plaintiffs. *See* AM. LAW INST., PRINCIPLES OF THE LAW: AGGREGATE LITIGATION § 2.04, at 118 (2009) (“Indivisible remedies also may arise with regard to the distribution of a limited fund. In this situation, any distribution as to one claimant invariably affects all other claimants’ potential recovery.”).

178. Creditors may be forced to bring a series of class actions because workers, retirees, and bondholders could not be placed in the same class, but these creditors should not be placed in the same class in bankruptcy either. *See infra* notes 197–205 and accompanying text.

179. Class members rarely vote on a settlement offer, but judges will consider the amount of opposition to a settlement of a plan as an important factor in their decision. *See* CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 1797.1, at 106–07 (3d ed. 2005) (“Another important factor for the court to consider is whether there is any opposition to the proposed settlement and, if so, what the objections are.”). Although the views of the majority (or super-majority) of plaintiffs will not bind the judge in a class action, a bankruptcy vote does not fully bind the judge either. Even if a super-majority of creditors within a bankruptcy class approves a plan, a judge can still side with the minority and rule that the plan is not in the “best interests of the creditors.” 11 U.S.C. § 943(b)(7) (2006). If a super-majority rejects the plan, the judge can still approve the plan by cramdown as long as at least one class of impaired creditors votes in favor of the plan. *Id.* § 1129(b).

180. In *Ortiz v. Fibreboard*, 527 U.S. 815 (1999), the Supreme Court limited the use of mandatory class actions to resolve mass tort litigation in part because it feared that this approach could evade creditor protections provided by the bankruptcy code. *Id.* at 860 n.34 (“[I]t is worth noting that if limited fund certification is allowed in a situation where a company provides only a *de minimis* contribution to the ultimate settlement fund . . . [it] significantly undermine[s] the protections for creditors built into the Bankruptcy Code.”). The settlement of a mandatory class action that complied with bankruptcy’s fairness and equal treatment principles would not raise the same concerns, particularly when the debtor (the state) does not have access to bankruptcy. A court may be reluctant to allow a settlement of a mandatory class that binds bondholders as this would effectively serve to modify the bond indenture and conflict with the principle that the Federal Rules of Civil Procedure cannot alter substantive rights. *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 613 (1997). This problem is not insurmountable. First, the amount states owe to bondholders is small relative to the amount they owe to pensioners and other creditors. Second, a settlement between the state and bondholders could take the form of a statute that modified their rights. Rather than approve a settlement that deprived an individual of the right to sue, the judge could rule that the statute did not violate the Contract Clause.

a race to the assets.<sup>181</sup> These techniques would not offer complete finality, however, because they would not preclude claims brought by those not party to the actions.<sup>182</sup> However, this lack of preclusion may not be as significant as it would appear. Assume that the Supreme Court were to uphold a modification of creditors' rights against a state. Creditors who were not party to the litigation would be free to bring their own claim. However, given the binding precedent, these creditors would have very little chance of success unless they had a very different argument.

#### IV. SYNTHETIC BANKRUPTCY MAY BE A GOOD SUBSTITUTE FOR FEDERAL BANKRUPTCY

Part III suggests that a state could use existing law to create a synthetic bankruptcy mechanism to resolve its financial distress. This Part compares the synthetic approach to reform proposals advanced by other scholars. Section A argues that if a state truly needs a bankruptcy mechanism to resolve its financial distress, this mechanism must be more robust than the minimalist mechanism proposed by Professor Schwarcz. Section B asks whether a new bankruptcy mechanism for states should be created as part of the federal bankruptcy code (federal bankruptcy) or created by the states themselves (synthetic bankruptcy).

##### A. *Minimalist Bankruptcy Is Likely to Be Either Unnecessary or Insufficient*

Although the literature on state bankruptcy is relatively new, an extensive literature on borrowing by sovereign nations has generated a number of bankruptcy proposals. Most of the proposals contain some combination of the following elements: (i) the ability to grant post-petition borrowing priority over existing debt, (ii) a collective voting procedure that allows a super-majority of creditors to bind dissenters with similar rights, (iii) a stay that would suspend enforcement efforts by creditors, and (iv) judicial power to approve (or "cramdown") a plan over the objection of a class of dissenting creditors if the plan meets substantive standards.<sup>183</sup> Steven Schwarcz recently proposed a "minimalist" state bankruptcy system that would contain only the first

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181. For a discussion of these techniques, see McKenzie, *supra* note 18.

182. Taylor v. Sturgell, 553 U.S. 880, 894 (2008).

183. See William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. 1, 26 (2004).

two elements; his system would authorize the court to grant post-petition borrowing priority over existing debt and allow a super-majority vote of bondholders to bind dissenters.<sup>184</sup> His proposal would not include an automatic stay or a cramdown mechanism. It also would not include the power to alter collective bargaining agreements, pensions, or other benefits owed to former workers.

Professor Schwarcz makes a strong case for his proposal, but ultimately it may be insufficient or unnecessary. That question depends on one's assumptions about the ability of a creditor to enforce claims against a state outside of bankruptcy and the nature of an insolvent state's balance sheet. Schwarcz argues that his bankruptcy proposal is needed to solve the standard collective action problem among creditors,<sup>185</sup> thus asserting that non-bankruptcy mechanisms cannot control this problem. However, states have relatively little trade-debt, and they issue their bonds pursuant to indentures that determine when an individual creditor can sue or take other enforcement efforts. In theory, a state could avoid the collective action problem among its bondholders by issuing all of its bonds pursuant to a single indenture, requiring a creditor vote before any bondholder can sue, and by allowing a majority or super-majority to consent to the modification of the terms of the loan. Schwarcz argues that bankruptcy is needed because existing bond indentures too often require unanimous consent for some modifications, and because states frequently issue debt pursuant to multiple indentures.<sup>186</sup>

Professor Schwarcz recognizes that sovereign nations have developed a potential non-bankruptcy solution to this problem—the exchange offer with exit consents.<sup>187</sup> Although indentures usually require unanimous consent for some modifications (e.g. a reduction in the amount of principal owed), they allow a super-majority vote to approve other modifications of the indenture.<sup>188</sup> In an exchange offer, the debtor offers

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184. See Schwarcz, *supra* note 2, at 331 (“A minimalist legal framework incorporating across-the-board supermajority voting is all that would be required to help states solve the creditor-holdout problem. . . . It nonetheless would be desirable for the framework to also include a mechanism that enables states to obtain needed liquidity during the debt-restructuring process.”) (footnotes omitted).

185. See *id.* at 328 (“The central problem faced by debtors attempting to restructure their debt—and thus likely to be faced also by debtor-states attempting to restructure their debt—is the ‘creditor-holdout’ problem, a type of collective action problem.”).

186. See *id.* at 330–31.

187. *Id.* at 330. For a more thorough description of the use of exchange offers with exit consents, see Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59 (2000).

188. See Buchheit & Gulati, *supra* note 187, at 65 (“[C]lauses preclude any changes to the

to exchange new bonds, with new terms, for the old, provided that the creditor votes to strip the old bonds of many of the creditor protections such as the waiver of sovereign immunity and a pledge not to grant more favorable terms to subsequent debt.<sup>189</sup> A holdout strategy is now much less attractive as the holdout would be left with a bond with few protections. A state could use an exchange offer to convert its existing bonds into a series of bonds issued pursuant to a single indenture that allowed collective voting. It could thereby replicate the collective decision-making of Schwarcz's minimalist bankruptcy. Schwarcz suggests that this strategy may not succeed because a court may invalidate an exchange offer as unfair to the creditors.<sup>190</sup>

Note that the ability of a dissenting creditor to sue explains both the race to the assets justification for bankruptcy and Schwarcz's explanation for why an exchange offer will fail to control the problem. If we believe that states can use the Eleventh Amendment and sovereign immunity to prevent their bondholders from suing, states would not need even a minimalist bankruptcy.<sup>191</sup> A state could simply refuse to pay the holdout. The creditor could still report a default and damage the state's reputation, but bankruptcy does not generally try to prevent this harm.<sup>192</sup>

If we believe that courts will enforce the promises that states have made, then Schwarcz's proposal does not go far enough.<sup>193</sup> Most critically, he restricts his proposal to bondholders and similar general debt obligations, and he would not allow his minimalist bankruptcy to

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payment terms of the bonds . . . without the consent of each affected bondholder. But any other provision of the bond can be amended with the consent of the issuer and . . . holders representing only 66 2/3 percent of the outstanding amount of the bonds. Many sovereign bonds set this threshold as low as 50 percent.”).

189. *Id.* at 81–82.

190. Schwarcz, *supra* note 2, at 330 (“Even if this strategy otherwise works, however, questions remain of the extent to which it represents unenforceable coercion.”) (footnote omitted).

191. If sovereign immunity prevents all enforcement, it makes no sense to speak of legal priority for post-petition lending. However, this does not mean that distressed lenders cannot be given effective priority. For example, the International Monetary Fund (“IMF”) serves as a lender of last resort for sovereign nations, and nations almost always repay the IMF in full. See Kenneth S. Rogoff, *Moral Hazard in IMF Loans: How Big a Concern?*, FIN. & DEV., Sept. 2002, available at <http://www.imf.org/external/pubs/ft/fandd/2002/09/rogoff.htm#author> (“[T]he actual realized historical default rate [on IMF loans] is virtually nil.”).

192. If the debtor is a consumer, other laws may try to limit the damage that a filing does to the debtor's reputation. Most importantly, the Fair Credit Reporting Act will limit the period in which a bankruptcy or other default can appear on a credit report. Fair Credit Reporting Act, 15 U.S.C. §§ 1681–91 (2006).

193. I am assuming that courts would not allow the bondholders to sue and refuse to allow other creditors to sue.

adjust the rights of current or former workers.<sup>194</sup> One could argue that, as a matter of policy, courts should force bondholders to forgive some of their debts before they adjust workers' rights.<sup>195</sup> However, debt service (as traditionally defined) accounts for a rather insignificant share (3% to 6%) of existing state budgets.<sup>196</sup> Unless the nature of state liabilities changes radically, bankruptcy must address the rights of current and former workers if it is to have a meaningful effect on a state's finances.

A voting mechanism may help solve the collective action problem among former workers (pensioners). Unions already serve to mitigate the collective action problem among current workers. But bankruptcy still needs some mechanism to address the holdout problem among the various groups of creditors. Federal bankruptcy allows a super-majority vote to bind the minority,<sup>197</sup> but only if the interests of the majority and minority are (or ought to be) aligned. In existing federal bankruptcy reorganization procedures, voting is done by class, and either all classes must approve a plan or a plan must be approved by cramdown.<sup>198</sup> All claims in a class must be "substantially similar"<sup>199</sup> and must receive equal (not merely equivalent) treatment.<sup>200</sup> Bondholders, current workers, and pensioners could not be placed in a single class and thus could not vote as a single group. These various creditors may have legally similar claims if non-bankruptcy law does not give any of them special priority. A judge could address any unique issues for each creditor (e.g. valuing each pensioner's future stream of payments) when allowing their claim,<sup>201</sup> and could address the collective bargaining

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194. See Schwarcz, *supra* note 2, at 345 ("On balance, therefore, this Article proposes that the framework not include an explicit right to impair state collective bargaining and pension agreements.").

195. States seem to be moving in the opposite direction; Rhode Island recently passed a statute giving municipal bondholders priority over all other creditors, including workers. See Michael McDonald, David McLaughlin & Laura Keeley, *Central Falls Bankruptcy Casts Shadow Over Rhode Island Pensions*, BLOOMBERG.COM (Aug. 2, 2011, 8:50 AM), <http://www.bloomberg.com/news/2011-08-02/central-falls-bankruptcy-driven-by-pensions-casts-shadow-over-rhode-island.html>.

196. See *supra* notes 3, 53 and accompanying text.

197. 11 U.S.C. § 1126(c) (2006) (requiring the affirmative vote of more than one-half of the number of claims in a class and two-thirds of the value of the claims in a class).

198. *Id.* § 1129(a)(10), (b). These sections are imported into Chapter 9 by Section 901. *Id.* § 901(a). Creditors do not vote at all in the individual reorganization procedure (Chapter 13) or the procedure designed for family farmers (Chapter 12).

199. *Id.* § 1122.

200. *Id.* § 1123(a)(4).

201. *Id.* § 502.

agreements prior to the adoption of the plan of reorganization.<sup>202</sup> A bankruptcy mechanism that did this would be far from minimalist. The valuation of pensions would demand the exercise of substantial discretion,<sup>203</sup> and judicial approval of the rejection of a collective bargaining agreement requires the implementation of a difficult balancing test that resembles cramdown.<sup>204</sup> More seriously, bankruptcy insists that members of a single class receive equal treatment. A state bankruptcy could not place pensioners and bondholders in the same class unless it would give new bonds to the former, or pensions to the latter.<sup>205</sup>

If each group of creditors must consent to an adjustment of their rights, the collective action problem returns. The bondholders, current workers, and pensioners each have an incentive to refuse a modification and hope that the others will bear the burden of keeping the state solvent. Courts can mitigate this collective action problem by forcing a dissenting group to accept a modification.<sup>206</sup> This is the power of cramdown.

*B. Federal Bankruptcy May Offer No Real Advantages Over Synthetic Bankruptcy*

Part III suggests that a state could synthesize its own “bankruptcy” mechanism if the federal government does not add a bankruptcy chapter under which a state could file. This subsection asks whether the federal government should add such a chapter, or if, as George Triantis argues, it should step back and let the states create their own composition mechanisms.<sup>207</sup> The crux of his argument is that states should be allowed to choose their own resolution method as part of a contract with their

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202. *Id.* § 364; *In re City of Vallejo*, 403 B.R. 177 (Bankr. E.D. Cal. 2009).

203. The workers’ pensions are contingent claims; their value depends on how long the workers will live. A bankruptcy court can estimate the value of these claims, but doing so requires substantial discretion. The current bankruptcy code provides the court with very little guidance as to how it should conduct this analysis. *See* 11 U.S.C. § 502.

204. *See supra* note 136 and the accompanying text.

205. A state bankruptcy may even need multiple classes of pensions and workers. Judges, teachers, firefighters, police officers, and lifeguards do not generally share collective bargaining agreements or pensions. Indeed, states often have different pensions for the same types of workers depending on when they were hired.

206. The cramdown power should play a far more important role in Chapter 11. If capital markets are liquid, a court supervising a Chapter 11 reorganization can effectively grant senior creditors control over the process if junior claimants fail to redeem the senior claims. *See* Richard M. Hynes, *Reorganization as Redemption*, 6 VA. L. & BUS. REV. 183 (2011). This approach will not work in a state or municipal bankruptcy because senior creditors cannot take control of the process.

207. *See* Triantis, *supra* note 20.

creditors,<sup>208</sup> but a federal bankruptcy chapter for insolvent states may actually enhance the state's ability to contract. David Skeel, on the other hand, argues for a federal bankruptcy chapter applicable to states.<sup>209</sup> His argument is based in part on federal bankruptcy's ability to solve misallocations of power that can prevent a timely reorganization.<sup>210</sup> However, a bankruptcy chapter that significantly reallocates power within a state would likely be held unconstitutional. The case for a federal bankruptcy chapter for states must ultimately rest on the likelihood that it would resolve a state's insolvency at a lower cost than a mechanism created by the state itself. However, in a world of imperfect judges, larger transactions costs can increase efficiency ex ante by enhancing the ability of a state to make credible commitments.

### 1. *The Contractarian Argument for Synthetic Bankruptcy*

A number of scholars have argued that the law should allow businesses<sup>211</sup> or individuals<sup>212</sup> to contract in advance for the resolution mechanism that will apply after default. These arguments suggest that the debtor is in a better position to balance the need to reorganize after a fiscal shock against the increased cost of capital caused by generous debt relief terms. George Triantis extends this contractarian argument to the states, arguing that the federal government should step back and let each state choose its own resolution mechanism.<sup>213</sup>

Many reject the contractarian approach to bankruptcy. In fact, few, if any, scholars advocate for a strictly contractarian approach to individual bankruptcy. Individuals may suffer from cognitive failures (e.g. they

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208. *Id.* at 243 (“State legislators, in contrast, would internalize the cost of bankruptcy legislation borne by some constituencies because the market for state debt, as well as for workers, would ‘price’ each state’s bankruptcy choice.”).

209. *See* Skeel, *supra* note 2.

210. *Id.* at 715 (“[B]ankruptcy could alter the political dynamics in several ways.”).

211. *See, e.g.*, Robert K. Rasmussen, *Free Contracting in Bankruptcy at Home and Abroad*, in *THE FALL AND RISE OF FREEDOM OF CONTRACT* 311, 319–20 (F.H. Buckley ed., 1999); Robert K. Rasmussen, *Debtor’s Choice: A Menu Approach to Corporate Bankruptcy*, 71 *TEX. L. REV.* 51, 53–54 (1992) [hereinafter Rasmussen, *Debtor’s Choice*]; Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 *AM. BANKR. INST. L. REV.* 85, 96–101 (1995); Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 *TEX. L. REV.* 515, 529–34 (1999) (reviewing the literature); Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 *YALE L.J.* 343 (1999); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 *YALE L.J.* 1807, 1836–38 (1998); Alan Schwartz, *Contracting About Bankruptcy*, 13 *J. L. ECON. ORG.* 127, 129 (1997).

212. *See, e.g.*, Jackson, *supra* note 38 (questioning whether individuals should be able to waive the right to file for bankruptcy).

213. *See* Triantis, *supra* note 20, at 240.



may fail to properly discount future values) that prevent them from choosing the correct resolution mechanism.<sup>214</sup> State politicians may suffer from these failures as well, but shifting the responsibility for choosing a bankruptcy mechanism to the federal level just replaces one set of politicians with another.

Eric Posner offers a different justification for mandatory bankruptcy rules for individuals.<sup>215</sup> According to his theory, the non-waivable right to seek a discharge, and similar laws, helps solve a version of the Samaritan's dilemma. The government cannot commit to withhold assistance from those in need, and this may cause citizens to engage in behavior (such as excessive borrowing) that makes financial need more likely.<sup>216</sup> The government can mitigate this problem by mandating generous terms of debt relief as this shifts some of the cost to the citizen's creditors and thus makes borrowing more expensive.<sup>217</sup> Similarly, the federal government may be unable to commit to withhold assistance to a state in financial distress. The federal government can mitigate the moral hazard created by the prospect of a federal bailout by mandating generous terms of debt relief and shifting some of the cost of financial collapse to the state's creditors. In doing so, the federal government exploits an inconsistency in the state's preferences across time. At the time of borrowing, the state would like to credibly grant the creditors strong collection rights and thereby obtain better credit terms. If the federal government creates a bankruptcy chapter for states or allows the state to retract waivers of sovereign immunity, it can prevent the state from making these credible commitments. Once the credit has been extended and the state enters financial distress, it has an incentive to go back on its prior commitments and choose the most beneficial resolution terms available.

The argument most commonly raised against a contractarian approach to business bankruptcy is that such schemes will harm trade creditors and tort victims. Critics argue that firms will grant senior creditors unduly strong collection rights because the senior creditors' increased recoveries will come at the expense of tort victims and trade creditors,

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214. See Jackson, *supra* note 81.

215. Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283 (1995).

216. *Id.* at 283 ("The provision of welfare in a free market produces perverse incentives to take credit risks, which both drive up the cost of the welfare system and undermine its goal of poverty reduction.").

217. *Id.* at 293 ("One approach to this policy is simply the nonenforcement of contracts extending high-risk credit to the poor.").

who cannot adjust their credit terms to reflect this fact.<sup>218</sup> One can debate the empirical importance of this argument in the context of firms,<sup>219</sup> but states have little trade debt and few tort claims.<sup>220</sup> States do owe substantial amounts to current and former workers, but these workers are well represented by unions who can, and do, monitor state laws that can affect the rights of their members.

The contractarian argument assumes that a state can commit to use a particular resolution mechanism in a future financial crisis. To the extent that a state can create a new mechanism just before default and apply its terms to existing debts, the state is unable to make this commitment. Creditors will not reward a state for choosing creditor-friendly resolution terms (no composition mechanism) because the state could change to a less creditor-friendly mechanism (composition mechanism) when the crisis actually occurs. The Contract Clause may place some limit on the retroactive application of a state composition mechanism, but the Depression-era Supreme Court has already upheld a composition mechanism for pre-existing municipal debt.<sup>221</sup> A modern court may be more reluctant to uphold a retroactive composition mechanism for the state's own debt, but given that it has been more than 100 years since a state has defaulted on its bonds,<sup>222</sup> this is very hard to predict. A court may well conclude that a future fiscal crisis is sufficiently severe and unexpected to make a retroactive mechanism "reasonable and necessary," and thus permissible under *United States Trust Co. of New York v. New Jersey*.<sup>223</sup>

A federal bankruptcy chapter may actually enhance a state's ability to contract for debt relief (by preempting state resolution mechanisms) and still leave the states with substantial discretion to choose the terms of their own resolution. A state bankruptcy chapter could follow the

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218. See, e.g., Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999); Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197 (2005).

219. See Yair Litsokin, *Is Secured Debt Used to Redistribute Value from Tort Claimants in Bankruptcy? An Empirical Analysis*, 57 DUKE L.J. 1037 (2008).

220. Tort victims have, however, played an important role in municipal bankruptcy. See Gillette, *supra* note 106, at 100 ("The precipitating cause of bankruptcy has tended to be . . . one-off events such as tort damage awards that have constituted a substantial percentage of the insolvent municipality's budget."). Note that Gillette offers this fact as a reason for why municipal bankruptcy may offer limited guidance for a state bankruptcy. *Id.*

221. See *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 508–09 (1942) (upholding a state created composition mechanism that applied to pre-existing municipal debt).

222. See English, *supra* note 6 (discussing state defaults in the nineteenth century).

223. 431 U.S. 1, 25 (1977).

example of municipal bankruptcy (Chapter 9) and respect the priority of revenue bonds,<sup>224</sup> allowing the state to balance its need for debt relief against the cost of capital. It could also go much further, allowing the state to choose among a menu of procedural options.<sup>225</sup> Federal preemption of state composition mechanisms would not completely solve the state's commitment problem; the state could still claim sovereign immunity or use statutes to amend the rights of its creditors and defend itself against Contract Clause challenges. But these strategies could be costly. At least one scholar has argued that the Supreme Court would uphold a contractual waiver of sovereign immunity,<sup>226</sup> and the nineteenth-century experience demonstrates that a state can effectively waive this immunity if it is sufficiently creative when designing its bonds.<sup>227</sup> Even if a state does not successfully waive its sovereign immunity, invoking this immunity could be quite costly in terms of reputational and transaction costs.<sup>228</sup> Congress could draft a preemption provision to make it more difficult for a state to change its creditors' rights by statute. Even without such a provision, courts may be more reluctant to find such statutes to be a "reasonable and necessary" response to a financial crisis if a bankruptcy chapter is available.<sup>229</sup>

## 2. *Federal Bankruptcy and the Allocation of Power*

Substantial political hurdles may prevent a state from creating its own composition mechanism or changing non-bankruptcy laws to modify creditors' rights. Most of these changes would require the enactment of state statutes, and either the governor or members of the legislature may oppose the legislation. Still other changes would require amendments to the state constitution, which in turn might require the vote of a skeptical electorate. The structure of some state governments may be too dysfunctional to allow the timely enactment of these changes during a financial crisis. Unfortunately, the process of proposing a plan of reorganization within a federal bankruptcy system may prove just as difficult unless federal bankruptcy reallocates power within a state.

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224. 11 U.S.C. § 928 (2006).

225. For a menu approach to corporate bankruptcy, see Rasmussen, *Debtor's Choice*, *supra* note 211.

226. *See supra* note 116 and accompanying text.

227. *See supra* notes 117–18 and accompanying text.

228. After its default, the State of Mississippi faced litigation over the extent of its sovereign immunity for nearly 100 years. *See supra* note 102 and accompanying text.

229. *See United States Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 25 (1977).

David Skeel has proposed a new bankruptcy mechanism that would do just this, vesting the authority to file for bankruptcy and propose a plan of reorganization to the state's governor, giving the legislature at most the right to consult.<sup>230</sup> His mechanism may not survive a constitutional challenge for precisely this reason.<sup>231</sup>

An improper allocation of power can also inhibit the prompt resolution of a financially distressed firm. Bankruptcy solves this problem by reallocating control. Outside of bankruptcy, managers enjoy substantial control, but their power has limits. A manager cannot sell substantially all of a firm's assets without shareholder approval.<sup>232</sup> Many firms enter bankruptcy because of a failed business model, and the best option is to sell the assets to someone who can put the assets to better use. Shareholders of an insolvent firm may oppose a quick sale because absolute priority requires that they receive none of the proceeds. If the firm continues to operate, there is at least some chance that the firm could return to solvency and the shareholders will receive something. There may be a greater chance that the firm's insolvency will deepen, but once the firm is insolvent this loss is borne by the creditors.

Bankruptcy can solve the misallocation of power within a firm through a reorganization that eliminates the old shareholders and allows new shareholders (the former creditors) to vote on the sale. The reorganization process takes time, and the value of the firm's assets could drop sharply during the delay. Bankruptcy, therefore, reallocates power to allow managers to sell all of the assets of their firms without any investor or creditor consent as long as they convince a judge that there is a valid business reason to do so.<sup>233</sup> Many high-profile bankruptcies, such as those of Chrysler and General Motors, resolve the firm with a sale of substantially all of the firm's assets, and these sales are typically justified by the argument that rapid depreciation makes such sales a necessity.<sup>234</sup>

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230. See Skeel, *supra* note 2, at 716 ("Congress might vest this authority directly in the governor, perhaps together with an obligation for the governor to consult with the legislature.").

231. Michael McConnell questions whether any state bankruptcy mechanism would survive a constitutional challenge that argued that state sovereignty is designed to protect the individual and therefore cannot be waived by a state government. See Michael W. McConnell, *Extending Bankruptcy Law to States*, in *WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS* 229, 234–35 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012).

232. See, e.g., *Hollinger Inc. v. Hollinger Int'l, Inc.*, 858 A.2d 342 (Del. Ch. 2004), *appeal denied*, 871 A.2d 1128 (Del. Super. Ct. 2004).

233. 11 U.S.C. § 363 (2006); *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983).

234. See, e.g., *In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009), *vacated sub nom.* Ind. State

One could adapt this argument for states. State law can allocate power in a way that prevents a prompt response to a fiscal crisis. State law may, for example, require a super-majority vote to raise taxes<sup>235</sup> or require a change in the state constitution to alter the rights of bondholders or workers.<sup>236</sup> While a state's executive, legislature, and electorate could make these changes, they may be unable to do so with sufficient speed. Moreover, their failure to act could impose costs on the rest of the nation through financial contagion. Because of the risk of this contagion, central governments cannot credibly commit to refuse a bailout of local governments, and this creates a moral hazard by reducing the incentive that local governments have to avoid financial distress.<sup>237</sup>

States have used these external costs to justify the seizure of broad fiscal authority over financially troubled municipalities.<sup>238</sup> Clay Gillette recently used the moral hazard argument to advocate for greater federal control (through a bankruptcy judge) of a municipality's finances.<sup>239</sup> These externality and moral hazard arguments are not unique to municipalities; they could also be used to justify federal control over a state's finances.<sup>240</sup> David Skeel does in fact make this argument in a recent article, and proposes mechanisms by which the federal government could exert control over the states.<sup>241</sup> One of the proposed mechanisms is a structured non-bankruptcy workout in which Congress procures the cooperation of state political actors by conditioning federal aid on various changes, much as Congress conditions federal aid on a state's participation in programs like Medicare.<sup>242</sup> This proposal is not a bankruptcy mechanism,<sup>243</sup> but Skeel's other two proposals are. One is a

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Police Pension Trust v. Chrysler LLC, \_\_ U.S. \_\_, 130 S. Ct. 1015 (2009) (vacating as moot).

235. See *supra* Part I.

236. CAL. CONST. art. XIII A, § 3(a).

237. See, e.g., Robert P. Inman, *Transfers and Bailouts: Enforcing Local Fiscal Discipline with Lessons from U.S. Federalism*, in FISCAL DECENTRALIZATION AND THE CHALLENGE OF HARD BUDGET CONSTRAINTS 35 (Jonathan A. Rodden et al. eds., 2003).

238. See, e.g., David M. Halbfinger, *New York State Seizes Finances of Nassau County*, N.Y. TIMES, Jan. 26, 2011, at A1, available at

[http://www.nytimes.com/2011/01/27/nyregion/27nassau.html?\\_r=1&partner=rss&emc=rss](http://www.nytimes.com/2011/01/27/nyregion/27nassau.html?_r=1&partner=rss&emc=rss).

239. See Gillette, *supra* note 148, at 283 ("In this article, I suggest that allowing bankruptcy courts to impose resource adjustments serves to neutralize the strategic behavior of local officials and thus encourages localities to internalize the costs of their activities in a manner more consistent with the tenets of fiscal federalism."). Gillette defines resource adjustments to mean higher taxes or reduced services. *Id.*

240. *Id.* at 329–30.

241. See Skeel, *supra* note 2.

242. *Id.* at 726–35.

243. To the extent that the aid offered to the state takes the form of a bailout, it creates a moral

simplified version of bankruptcy modeled after a consumer Chapter 7 filing that would automatically discharge all of a state's obligations except those that the state explicitly reaffirms.<sup>244</sup> This proposal is designed to shift the burden away from a default rule of payment toward a default rule of non-payment. The same groups that had the power to prevent a state from adopting non-bankruptcy code solutions to the crisis may be able to prevent the state from filing for bankruptcy. Alternatively, political stasis could prevent the state from reaffirming *any* of its obligations, thereby making bankruptcy much less attractive. As discussed above, Skeel's third alternative addresses this issue by substantially reallocating decision-making authority within the state. Under his proposal, Congress would vest the power to file for bankruptcy and propose a restructuring plan with the governor, giving the legislature at most the right to consult.<sup>245</sup>

While Skeel's proposals reallocate political power within the bankrupt political entity, the existing chapter for municipal bankruptcy tries to minimize the role of the judge and the reallocation of control. Unlike other bankrupt debtors, municipalities do not need judicial approval of their borrowing or spending,<sup>246</sup> and section 904 prohibits the court from interfering with "any of the political or governmental powers of the debtor."<sup>247</sup> Section 943(b)(6) requires a bankrupt municipality to obtain the regulatory or electoral approval that non-bankruptcy requires, in order to carry out its reorganization plan.<sup>248</sup> Congress included this provision to preserve "[s]tate and local financial and political controls [and to avoid] constitutional issues as to the scope of the bankruptcy power."<sup>249</sup>

Some reallocation of power in bankruptcy is inevitable,<sup>250</sup> but the

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hazard that makes insolvency more likely.

244. *Id.* at 716 ("First, Congress could adopt a simple, severe bankruptcy framework that automatically discharged all of a state's obligations shortly after it filed for bankruptcy.").

245. *Id.* ("Congress might vest this authority directly in the governor, perhaps together with an obligation for the governor to consult with the legislature.").

246. Section 363(b)(1) requires notice and a hearing before the debtor may use property outside of the ordinary course of business, and section 363(c)(1) allows the judge to prohibit the debtor from entering transactions in the ordinary course of business. 11 U.S.C. § 364 (2006). Similarly, section 364 requires notice and a hearing before the debtor can incur obligations outside the ordinary course of business and allows the judge to prohibit the debtor from incurring debt in the ordinary course of business. *Id.* However, the relevant portions of these sections do not apply in Chapter 9. *See* 11 U.S.C. § 901 (2006).

247. *Id.* § 904(1).

248. *Id.* § 943(b)(6).

249. S. REP. NO. 100-506, at 11 (1988).

250. Section 943(b)(4) states that the court cannot confirm a plan if "the debtor is . . . prohibited

reallocation that occurs in Chapter 9 is consistent with the plenary power that states enjoy over their municipalities. As noted above, a state can use these powers to seize control over insolvent municipalities outside of bankruptcy.<sup>251</sup> States must specifically authorize the filing of bankruptcy petitions by their municipalities.<sup>252</sup> One could argue that by doing so they are exercising their right to change the political dynamic within the municipality.

The use of a federal law to reallocate power within a state would generate much more serious opposition because the federal government does not enjoy plenary power over the states.<sup>253</sup> States are not creations of the federal government, and the federal government's seizure of control of a state due to fiscal crisis could be viewed as a violation of state sovereignty. This approach would be very different from programs like Medicare or unemployment insurance that procure state cooperation through conditional grants. Although federal law sets the conditions for a state's participation, state law determines which state actors decide whether to accept the federal funds.<sup>254</sup> This principle is illustrated by the dispute between the governor and legislature of South Carolina in 2009 over whether to accept stimulus money. Although the Stimulus Act purported to determine which political branch of a state government could apply for the funds (allowing the legislature to apply for the funds if the governor refused),<sup>255</sup> the Supreme Court of South Carolina was

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by law from taking any action necessary to carry out the plan." 11 U.S.C. § 943(b)(4) (2006). Read broadly, this provision would prevent a bankruptcy court from impairing any creditor's claims as long as they are enforceable outside of bankruptcy. Courts have refused to adopt this reading, however, and have instead interpreted the language to limit the ability of the bankruptcy court to exempt the municipality from complying with state law in the future. *See In re Sanitary & Improvement Dist. No. 7*, 98 B.R. 970 (Bankr. D. Neb. 1989); COLLIER ON BANKRUPTCY, *supra* note 163, at ¶ 943.03[4]. This contrasts with Chapter 11 that allows a bankruptcy plan to override applicable state laws even after the debtor emerges from bankruptcy. 11 U.S.C. 1142(a) (2006).

251. *See supra* notes 148–54 and accompanying text (describing a Michigan statute granting the state the authority to seize control of insolvent municipalities).

252. 11 U.S.C. § 109 (2006).

253. The Reconstruction era provides some precedent for congressional control over state government. Congress removed the existing civilian governments, created military governments, and conducted elections, citing their obligation to ensure a republican form of government. *See, e.g.*, Arthur E. Bonfield, *The Guarantee Clause of Article IV, Section 4: A Study in Constitutional Desuetude*, 46 MINN. L. REV. 513, 540–42 (1962).

254. *See* D. Cody Huffaker, *A New Type of Commandeering: The Bypass Clause of the American Recovery and Reinvestment Act of 2009 (Stimulus Package)*, 42 ARIZ. ST. L.J. 1055, 1056 ("The power to accept federal funds is a question of state law, and the state executive is usually the entity empowered to accept such funds.") (footnote omitted).

255. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111–5, § 1607(b), 123 Stat. 115, 304 (2009).

able to avoid “grave and doubtful constitutional questions”<sup>256</sup> by adopting an interpretation of the statute that left the decision to state law.

### 3. *The Role of Transactions Costs*

If bankruptcy takes a robust view of state sovereignty, the case for amending the code to allow a state to file rests on transactions costs. A state composition mechanism cannot bind out-of-state creditors who do not subject themselves to the court’s jurisdiction.<sup>257</sup> If the state did not adopt a composition mechanism, the transactions costs could be much higher because courts may not be able to combine all suits in a single forum. Most suits would not raise federal questions under the well-pleaded complaint rule.<sup>258</sup> While suits by some types of plaintiffs (bondholders, perhaps pensioners) may satisfy diversity requirements, suits by other types of plaintiffs (current workers) probably would not. By contrast, state courts may lack the ability to bind out-of-state plaintiffs within a single class without giving class members the chance to opt out.<sup>259</sup> Courts have sometimes overcome these obstacles through mutual cooperation in the mass torts context,<sup>260</sup> but there is no guarantee that they will cooperate during a state insolvency.

Proceeding under the bankruptcy code would also provide access to specialized courts that are well suited to this litigation. Regular courts may not have experience resolving insolvent governments and thus may not have specific knowledge about the relevant substantive issues. However, bankruptcy courts regularly manage reorganizations with competing classes. Moreover, if a state were truly insolvent, many of its municipalities would likely be insolvent as well. The resolution of these

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256. *Edwards v. State*, 278 S.E.2d 412, 417 (S.C. 2009).

257. *See Ogden v. Saunders*, 25 U.S. (12 Wheat.) 213, 358, 368–69 (1827) (holding that debts held by out-of-state creditors who had not voluntarily appeared in a state insolvency proceeding could not be discharged); *see also Baldwin v. Hale*, 98 U.S. (1 Wall.) 223, 227, 234 (1863) (holding that a state insolvency proceeding could not bind out-of-state creditors even when the contract was originally made in that state and would be enforced in that state); *id.* at 234 (indicating that legal notice cannot be given to the out-of-state creditor), discussed in Hollis R. Bailey, *A Discharge in Insolvency, and its Effect on Non-Residents*, 6 HARV. L. REV. 349, 352, 358 (1893) (taking issue with the general doctrine that a discharge would not bind a nonresident creditor unless he were personally served or voluntarily appeared).

258. *See, e.g.*, 13D CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 3566 (3d ed. 2008).

259. *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 812 (1985) (“Additionally, we hold that due process requires at a minimum that an absent plaintiff be provided with an opportunity to remove himself from the class by executing and returning an ‘opt out’ or ‘request for exclusion’ form to the court.”).

260. *See McKenzie*, *supra* note 18.



entities would present common questions and thus it would make some sense to consolidate the litigation (at least as an administrative matter). Bankruptcy courts regularly manage the insolvency of related entities such as parent corporations and their subsidiaries.

The fact that a federal bankruptcy chapter may operate with lower transactions costs does not necessarily imply that we should change the code to allow states to file. In a world of omniscient judges, transactions costs are to be avoided. As long as a judge approves plans only when they are in the “best interests of creditors,”<sup>261</sup> we should make it as easy as possible for an insolvent state to modify its obligations. The judge will only let the state modify its obligations to the extent that it “deserves” to do so. If, however, judges are not omniscient, they may grant relief when they should not. Society may want to impose transactions costs (such as enhanced political costs from additional suits) to raise the cost of default and thereby enhance the state’s ability to make credible binding commitments. Large transactions costs may reduce efficiency *ex post* after default, but conversely they may raise efficiency *ex ante*.

## CONCLUSION

Bankruptcy is neither necessary nor sufficient to resolve a state fiscal crisis, but that does not mean that it should be avoided. Bankruptcy is not sufficient because it will almost certainly fail to address the structural problems (too much spending or too little taxation) that led to financial distress. However, the same is true of bankruptcy more generally. Bankruptcy judges do not find consumer debtors better jobs, heal their illnesses, or change their long-term spending habits. If bankruptcy can solve a collective action problem and provide struggling states a “fresh start” by freeing them of some of their obligations, it can facilitate a state’s recovery.

Several factors may combine to make a state bankruptcy mechanism unnecessary. First, sovereign immunity and the Eleventh Amendment may prevent creditors from suing the state to enforce their claims.<sup>262</sup> Second, much of the “state” debt is really owed by its municipalities, and existing law allows a state to force its municipalities into bankruptcy to reduce its expenses. Congress could facilitate the use of municipal bankruptcy to resolve a state’s insolvency by amending the definition of

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261. *See* 11 U.S.C. §§ 943(b)(7), 1129(a)(7) (2006).

262. *See supra* Part II.A.

“affiliate” to make it easier for a state to use this approach.<sup>263</sup> Third, a state can create a close substitute for bankruptcy reorganization by enacting laws that modify the rights of its creditors and then using aggregate litigation methods to resolve the resulting Contract Clause disputes. At the extreme, a state could even create its own composition mechanism.<sup>264</sup>

Significant differences would exist between a synthetic bankruptcy procedure created by a state and a new federal bankruptcy chapter, but it is not clear which approach we should prefer. George Triantis argues that states should be allowed effectively to contract with their creditors for the most efficient mechanism,<sup>265</sup> but the existing interpretation of the Contract Clause may undermine the ability of states to credibly commit to a particular mechanism by allowing new laws to apply to existing debts.<sup>266</sup> A federal bankruptcy chapter may enhance the ability of a state to contract with its creditors by limiting the state’s ability to change its laws in a time of financial crisis.<sup>267</sup> David Skeel argues that a federal bankruptcy mechanism could reallocate power within a state in a manner that would allow for a more timely response to a budget crisis.<sup>268</sup> Unfortunately, this approach raises concerns over state sovereignty and may not survive a constitutional challenge. The best argument for a state federal bankruptcy chapter may rest on transactions costs. A federal bankruptcy court can more easily address all claims against the state in a single forum. However, in a world without omniscient judges, transactions costs can actually improve efficiency *ex ante* by allowing a state to make credible commitments.

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263. *See supra* note 158 and accompanying text.

264. *See supra* Part III.B.

265. *See supra* Part IV.B.1.

266. *See, e.g.,* *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942) (upholding a state-created composition mechanism that applied to pre-existing municipal debt).

267. *Id.*

268. *See supra* Part IV.B.2.