Let the American States Design Their Own Restructuring Process

George Triantis[1]

Stanford Law School

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Abstract

In reaction to the fiscal difficulties experienced by state governments over the past three years, several politicians and academics proposed that Congress legislate a new chapter to the Bankruptcy Code under which the financial obligations of a state may be restructured. This essay is forthcoming in an edited volume (Conti-Brown and Skeel, eds., *Confronting Fiscal Crisis in American State Government* (Cambridge U Press)) which is the product of a conference held at Stanford law School in May 2011. This chapter argues that, if a formal bankruptcy process is valuable for states, it should be legislated at the state rather than federal level for the following reasons: (1) state circumstances and political preferences vary, and state-by-state legislation would permit each state to tailor its bankruptcy process; (2) the state would internalize the cost of issuing debt under the bankruptcy regime of its choice and this would reduce the rent-seeking distortions in the legislative process; (3) a state in financial distress is more likely to initiate its own bankruptcy mechanism than one legislated by the federal government and this would reduce the unpredictability of ad hoc unilateral adjustments currently

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implemented by the states; and (4) a state-by-state approach would minimize the pressures for a federal bailout, particularly if combined with federal legislation that expressly sets a default bankruptcy regime from which the states can opt out.

The state bankruptcy statute would be incorporated into all prospectively created obligations of the state. For some period of time, however, it will have a retroactive application that raises some policy and constitutional issues. This chapter suggests that a state bankruptcy regime is likely to survive challenges under either state or federal constitution if (1) the state can invoke the process only in severe and unforeseen distress, (2) the statute provides for the oversight by the state courts, and (3) the regime promotes the usual bankruptcy objective of creating a surplus while ensuring that no creditor is worse off than if it pursued its individual remedies in a world without bankruptcy. These conditions are not difficult to satisfy and, indeed, are also congenial to the design of an effective regime.

Introduction: Bankruptcy For States

The financial crisis of 2008 and the ensuing economic recession imposed considerable stress on the fiscal health of U.S. states. While state governments took steps to control spending, reduce commitments, and raise revenues, some scholars and politicians[2] worried that these steps were insufficient to address the severe challenge facing states such as Illinois and California. These commentators proposed that the U.S. Congress enact a formal debt restructuring or "bankruptcy" process for states, similar to the municipal bankruptcy process governed by Chapter 9 of the U.S. Bankruptcy Code. The proposed state-bankruptcy process would not interfere with state sovereignty because the state government would have sole authority to initiate bankruptcy. Perhaps more importantly, its proponents argued, a statutory state bankruptcy framework would facilitate out-of-court adjustments in its shadow.

Some of the justifications for a state-bankruptcy process echo the familiar goals of bankruptcy law in the commercial context. In particular, bankruptcy clarifies priorities in order to allocate losses in an orderly and reasonably predictable manner. By restoring solvency and financial health, it relieves the overhang of debt that would otherwise drive capital (and taxpayers themselves) out of the jurisdiction. And, it mitigates the problem of hold-outs in restructuring efforts by imposing equitable adjustments—approved by a majority of a class of

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[2] E.g., David Skeel, *Give States a Way to Go Bankrupt*, The Weekly Standard, Nov. 29, 2010, at 22; Grover G. Norquist and Patrick Gleason, *Let States Go Bankrupt*, Politico, Dec. 24, 2010; David Skeel, *A Bankruptcy Law – Not Bailouts – for the States*, Wall St. J., Jan.18, 2011 at A17; Jeb Bush and Newt Gingrich, *Better off bankrupt*, Los Angeles Times, Jan. 27, 2011 (http://articles.latimes.com/print/2011/jan/27/opinion/la-oe-gingrich-bankruptcy-20110127).

creditors—on dissenting claimants. The ideal of bankruptcy law is that, by addressing these goals, the formal process creates a surplus shared among the creditors in a manner that leaves no creditor worse off than if there were no bankruptcy process.

The proponents of a bankruptcy chapter for states add two objectives to this list. First, bankruptcy would give distressed states further power to address the "bloated, broken and underfunded pension system[s]", as well as the "lucrative pay and benefit packages" that they have conceded to the unions of public employees.[3] Second, the availability of bankruptcy would relieve the pressure on Congress to bail out states in dire financial condition. The promise of bailouts undermines states' fiscal discipline (the problem of moral hazard)[4] and shifts the cost of financial rescue, in an ad hoc manner, onto taxpayers outside the state itself. State bankruptcy, in contrast, would ensure that losses are shared in a systematic and predictable manner among the various creditors (such as bondholders or employees) of the distressed state.

The proposal met quickly with strong criticism from various groups and subsequently drifted from the attention of Congress and the press. Unions were concerned that bankruptcy would increase the power of state governments to terminate collective bargaining agreements

[3] Bush and Gingrich, *supra* note 2.

[4] Skeel, *Give States a Way to Go Bankrupt*, supra note 2 ("The appeal of bankruptcy-for-states is that it would give the federal government a compelling reason to resist the bailout urge."); Bush and Gingrich, *supra* note 2 ("Federal bailouts must come to an end. Federal taxpayers in states that balance their budgets should not have to bail out the irresponsible, pandering politicians who cannot balance their budgets. Congress must allow a safe, orderly way under federal bankruptcy law for states to reorganize their finances").

and compromise the claims of employees in bankruptcy. The Center on Budget and Policy Priorities and the Manhattan Institute for Policy Research each issued a report analyzing the financial condition of states, recommending fiscal reform, and criticizing the state-bankruptcy proposal.[5] Congressional hearings on the subject generated little support for the idea, and the House Majority Leader and the Chairman of the House Judiciary Committee each rejected the proposal.[6]

State government officials were overwhelmingly opposed to the idea. This was perhaps surprising: though states typically react strongly against federal attempts to interfere with their fiscal policy, any federal statutory process for state bankruptcy would necessarily have respected state sovereignty. Most proposed statutory frameworks, for example, would give state governments the sole authority to initiate a bankruptcy proceeding and to propose a restructuring plan and the bankruptcy court no authority over matters of state governance. Nevertheless, the National Governors Association and the Conference of State Legislatures

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[5] Iris J. Lav and Elizabeth McNichol, *Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm Misconceptions Also Divert Attention from Needed Structural Reforms*, Center on Budget and Policy Priorities, Jan. 20, 2011, at http://www.cbpp.org/cms/index.cfm?fa=view&id=3372 (short term budget gaps are not the problem; long-term structural deficits are. Federal bankruptcy is not a solution).

[6] "State and Municipal Debt: The Coming Crisis?", Congressional hearings before the House Oversight and Government Reform subcommittee of TARP, Financial Services and Private Programs. February 9, 2011, at http://oversight.house.gov/index.php?option=com_content&view=article&id=1101%3A2-9-11-qstate-and-municipal-debt-the-coming-crisisq&catid=34&Itemid=39;" State and Municipal Debt: The Coming Crisis? (Part II)", March 15, 2011, at http://oversight.house.gov/index.php?option=com_content&view=article&id=1198%3A3-15-11-qstate-and-municipal-debt-the-coming-crisis-part-iiq&catid=34&Itemid=39.

issued a statement strongly opposed to the idea.[7] The states maintained that a federal bankruptcy chapter for states was unnecessary and counterproductive. They argued that the fresh start promise of bankruptcy would itself be a source of moral hazard and would delay fiscal reforms by states. They claimed that the mere prospect of such legislation would raise their financing costs in capital markets. In light of these sentiments, this chapter proposes a solution likely more amenable to state leaders: that states legislate their own restructuring or bankruptcy regime tailored to their political and economic circumstances.

During the current economic recession, state governments have taken a range of significant measures to narrow their current and future budget deficits: they have laid-off or furloughed public employees, frozen wages, reduced pension benefits, and increased the share of health insurance premiums paid by workers.[8] The federal fiscal stimuli of the past three years, the stabilization of capital markets and the (albeit sputtering) economic recovery have also mitigated the financial distress of states. The risk of default by even the most distressed of states remains low and, for the time being, the need for a formal restructuring process is small.[9]

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[7] *See NGA Statement regarding Bankruptcy Proposals for States* (Jan. 25, 2011) http://www.nga.org/cms/home/news-room/news-releases/page_2011/col2-content/main-content-list/nga-statement-regarding-bankrupt.html; *NGA/NCSL Bankruptcy Letter* (Feb. 3, 2011) http://www.ncsl.org/default.aspx?tabid=22155.

[8] See NGA Center for Best Practices, *State Government Redesign Efforts 2009 and 2010*, October 18, 2010, at http://www.nga.org/files/live/sites/NGA/files/pdf/1010STATEGOVTREDESIGN.PDF.; Pew Ctr. On the States, The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform (2010) (review of pension deficits in states).

[9] Nat'l Governors Ass'n & Nat'l Ass'n of State Budget Officers, *The Fiscal Survey of States* (Spring 2011), at www.nga.org/files/live/sites/NGA/files/pdf/FSS1106.PDF. Testimony of Robin Prunty, Managing Director, Ratings Services, S&P Financial Services, Committee on Oversight and Government Reform, Subcommittee on TARP, March 15, 2011, at

Nevertheless, the events of the past several years alert us to the possibility that states – even the United States as a country -- might become so financially distressed as to prevent economic recovery. A broad financial restructuring of outstanding liabilities may be necessary in the future to address the problem of debt overhang and give the state a fresh start. If such circumstances should arise, the proponents of a bankruptcy regime for states may be justified in arguing for a formal process to mitigate the hold-out problems that impede consensual restructuring.

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—in order to give states the space and incentive to do so for themselves. Of course, state legislation might invite the federal government to play a role as a lender, perhaps even with the type of control it enjoyed as debtor-in-possession lender in the GM or Chrysler bankruptcies. As in those corporate cases, however, the state court with jurisdiction over the case would be required to authorize any such control. States should legislate their own bankruptcy regimes in order to tailor them to their respective economic and financial circumstances, as well as their respective political preferences. States are subject to financial discipline in doing so because they would pay a premium in their contracts to reflect the

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implicit insurance provided by their creditors in their respective bankruptcy regime. In the current as well as past financial crises, states have unilaterally amended many contracts, particularly with employees. Such an ad hoc adjustment of obligations would likely continue even if a federally legislated bankruptcy process were available, because states would be reluctant to file under a federal regime. They would be more likely to invoke their own bankruptcy legislation and this would promote a more structured and predictable restructuring of obligations than the current ad hoc practice.

A state bankruptcy regime would be incorporated implicitly in all future contracts and, in this respect, would not meet significant legal hurdles. To the extent that it modifies contracts existing at the time the law is enacted, bankruptcy's retroactive effect would raise potential political, economic and legal issues. This chapter argues that retroactivity does not impose significant economic costs in this case and that obstacles in the federal and in state constitutions can be overcome by meeting the balancing tests employed in the judicial interpretation of each pertinent constitutional provision. In brief, a state-legislated restructuring process is likely to pass constitutional muster if it satisfies three requirements: (a) the state can invoke the process only under unforeseen and catastrophic conditions, (b) it is subject to judicial oversight, and (c) the court conditions its approval of the adjustment of creditor claims on the finding that the nonconsenting creditors are economically no worse off than if they sought to recover their claims in full from a defaulting state debtor. The second and third requirements are prominent under the existing federal bankruptcy regime for private debtors. The first condition, in contrast, is the product of U.S. Supreme Court jurisprudence indicating that conditions that are either moderate or foreseeable will not justify the impairment of state obligations.

1. State or Federal Legislation (or both)?

The state bankruptcy process should be enacted by state legislation for the following reasons: (1) state circumstances and political preferences vary, and state-by-state legislation would permit each state to tailor its bankruptcy process; (2) the state would internalize the cost of issuing debt under the bankruptcy regime of its choice and this would reduce the rent-seeking distortions in the legislative process; (3) a state is more likely to initiate its own bankruptcy mechanism than one legislated by the federal government and this would reduce the unpredictability of ad hoc unilateral adjustments currently implemented by the states; and (4) a state-by-state approach would minimize the pressures for a federal bailout, particularly if combined with federal legislation that expressly sets a default bankruptcy regime from which the states can opt out.

To most advocates of a state bankruptcy process for sovereign entities, the primary goal is to provide a fresh start for distressed states. The prospect of a fresh start statute effectively adds an insurance provision to each contract of the debtor, which might be efficient if the creditors can better diversify the risk of distress in their portfolios. There are countervailing incentive costs of insurance, particularly moral hazard. However, the moral hazard of debt financing under a fresh start regime may be less severe than the moral hazard, mentioned earlier, that is raised by the prospect of a federal bailout. Moreover, forcing the states to pay for insurance in their debt contracts may be more reliable politically than hoping that state governments refrain from cutting taxes or increasing spending when good economic conditions produce surpluses.

State legislatures could tailor their legislation to their economic and political circumstances, while federal legislation would provide one-size for all.[10] Bankruptcy allocates risk and losses among groups of creditors, which is partly a function of political considerations, such as the perceived importance of protecting the contract rights of public employees and pensioners. These considerations may vary by state, and state-specific legislation may be more successful in accounting for these variations. Further, state-specific bankruptcy legislation that is a bargain between the major political influences within a state is likely to be deemed more legitimate by that state, than is a federal bankruptcy regime imposed upon the states. The state regime is accordingly more likely to be invoked than a federal scheme in times of distress. If a formal process for restructuring is valuable, because it increases predictability and mitigates hold-out obstacles, state-legislated bankruptcy is more likely to yield these results in practice.

The political process of legislating bankruptcy is, however, also fraught with rent-seeking, as each constituency strives to shift losses onto the others. Their efforts are largely wasteful and

[10] This alternative has an analog in some scholarly literature that advocates a contractual approach to bankruptcy and debt restructuring. Under this normative approach, a corporation would design, or choose from a menu, its own bankruptcy regime and identify it in its charter. See, e.g., Robert A. Haugen and Lemma W. Senbet, *Bankruptcy and Agency Costs: Their Significance to the Theory of Optimal Capital Structure*, 23 J. Fin. & Qu. Analysis 27, 29-31 (1988); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 Tex. L. Rev. 51 (1992).

can distort the final product in the legislation. Federal legislators would be susceptible to these influences because they can externalize costs to the states and bankruptcy law lacks the salience to bring broad attention or coverage by the news media. After all, their decisions would affect the cost of the states' debt and not the federal debt. 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. This would improve the incentives of state legislators who would seek to minimize the adverse effects of bankruptcy on the cost of capital. To the degree that the legislation granted the state a fresh start, the market would price the implicit insurance written by the bondholders. In the language of scholarship describing the merits of state-level corporate law, this may promote a "race to the top", as each state tries to promote its political objectives while minimizing its cost of capital.

State bankruptcy legislation would also reduce the pressure for a federal bailout. Each state would have access to its own restructuring process, enjoying greater sovereignty in its fiscal affairs and facing market discipline. The markets would compel the states to pay the insurance premiums implicit in their bankruptcy statute. Each state would be encouraged, thereby, to precommit to a narrower set of circumstances under which it can compel the adjustment of its debt. For example, bankruptcy might be limited to cases in which a court rules that the state suffered great distress as a result of unforeseen and dramatic exogenous shocks (e.g. a natural disaster).

As noted earlier, proponents of a federal bankruptcy regime for states argued that federal legislation would mitigate the political pressures on Congress to bail out insolvent states. Yet, a distressed state might hesitate to authorize a filing under a federal bankruptcy process in the hope of receiving federal assistance. This is unlikely to attract much sympathy at the federal level and the federal government might condition assistance on filing. Under a state-legislated bankruptcy regime, the federal government might similarly require a filing under the state-run process. But what if an insolvent state has failed to enact a bankruptcy regime, perhaps strategically, in order to avoid paying the premium to bondholders and to preserve the prospect of a bailout? Proponents of federal legislation might point to this as a weakness of the state-by-state approach, but Congress could anticipate this problem by providing incentives to promote state legislation before the crisis hits. Under one approach, the federal government might enact a bankruptcy regime for states that is expressly a default: that is, states would be authorized to legislate their own statute and could otherwise resort to the federal process. This would ensure that the state's authority to pass its own restructuring legislation would not be preempted, even as a result of the federal government's dormant jurisdiction over bankruptcy.

2. The Policy Implications of Retroactivity

The application of new bankruptcy legislation to prospective liabilities of the state is straightforward: the bankruptcy provisions are simply incorporated in the terms of all new contracts. The legislation is transparent so that future consensual creditors can adjust the price they charge the state. This is not the case with liabilities that are incurred before the enactment of bankruptcy: the laws would have a retroactive effect. Retroactive laws redistribute wealth and raise concerns about fairness of winners and losers. The effect may be small because, to some degree, creditors routinely adjust their prices to anticipate unknown risks of government action, as well as market shocks. Some of those risks impose costs and others create windfalls.[11] Bankruptcy, in particular, is based on a theoretical premise that it promotes collective action to resolve debt overhang, and thereby creates value that is shared among the various creditors. In other words, there may be only winners and no losers.

The U.S. Bankruptcy Code is designed to ensure that no creditor is worse off than if it had exercised its individual enforcement rights in a world without bankruptcy. Bondholders of states have very limited legal remedies if the state chooses not to pay these obligations. Bondholders are unlikely to be able to sue in federal court[12] and will have difficulty enforcing a state law claim. They cannot seize assets or garnish revenues of the state debtor and a mandamus order compelling a state official to collect revenues is of limited effect.[13] Sovereign states typically pay because of concerns about their standing in capital markets rather than legal enforcement. The limited recourse to legal enforcement, however, helps sovereign states wrest consent to reduced debt claims even without bankruptcy.

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[11] Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 Harv. L. Rev. 509 (1986)

[12] See *Hans v. State of Louisiana*, 134 U.S. 1 (1890).

[13] Robert S. Amdursky and Clayton P. Gillette, Municipal Debt Finance law: Theory and Practice 1.2 (1992).

Labor unions have expressed concern that a bankruptcy process would enable the states to revise their collective bargaining agreements and to alter the contract rights of their workers and pensioners. However, state governments already have significant capacity to unilaterally modify these contracts even outside of bankruptcy, provided that they do not violate the Contracts Clause of the U.S. Constitution. As noted below, the courts apply a balancing test under which states can demonstrate that the modification is reasonable and necessary to achieve an important public purpose. States have been far more inclined to unilaterally reduce worker entitlements than those of bondholders or other creditors. Therefore, the burden on public employees might be less under a bankruptcy regime that ensures equal treatment of similarly situated creditors. As suggested earlier, a state is more likely to invoke its own bankruptcy regime than one legislated at the federal level. It follows then that public workers may be better off under a state-legislated than federal bankruptcy regime.

In theory, however, no one need be worse off in bankruptcy than without it. Professor Randall Kroszner's study of the market reaction to the government's nullification of the gold clause in contracts is interesting in this respect. In 1933, the U.S. devalued the dollar in order to address the economic depression. Anticipating this possibility, many long-term public and private financial contracts had included a gold clause, which effectively indexed the obligations to the dollar value of gold. Congress acted to nullify such clauses in both public and private contracts, which reduced the nominal value of obligations in these contracts by 69%. The U.S. Supreme Court upheld the legislation in a 5-4 split decision.

Kroszner found that the prices of equity and debt of leveraged corporations rose in response to the decision. "The equity and debt of low rated and heavily-indebted firms experienced the greatest increase in value, thus firms closest to bankruptcy benefited the most from the decision. However, government bonds with the gold clause, where there was little question of the ability to repay… fell in value."[14] Kroszner theorized that the creditors themselves were better off because of the quick coordinated debt forgiveness plan that lifted debt overhang among the most troubled firms, without the uncertainty, delay or cost of complex debt renegotiations. He highlighted the importance of a one-time transparent government action, which was legitimized by a court, in a jurisdiction of strong property rights enforcement.

3. Overcoming Constitutional Obstacles to Retroactive Bankruptcy

Federal and state constitutions constrain some (but not all) types of retroactive legislation. The web of general and specific constitutional provisions at both levels and the related judicial doctrine in this area is complex.[15] Courts are inclined to use a balancing test in applying these

[14]Capital ideas, *Is it Better to Forgive than Receive* (2006), at http://www.chicagobooth.edu/capideas/feb06/4.aspx, summarizing Randall S. Krozsner, Is it Better to Forgive than Receive? Repudiation of the Gold Indexation Clause in Long-Term Debt During the Great Depression (U. Chic. Business Sch. Working paper 1998)

[15] Under the federal constitution, the takings clause of the 5th Amendment and the contracts clause in Article 1, section 10. For the broader range of provisions at the state level, see Morrison & Foerster, LLP & Greeneham doll & McDonald PLLC, Index by States: Extent of Protection of Pension Interests (Sept. 15, 2007) available at http://finance.ky.gov/NR/rdonlyres/275A2978-5DDE-4138-A7F5-AF02D17D7F97/0/statebystatememo10.pdf ; Darryl B. Simko, Of Public Pensions, State Constitutional Protection, and Fiscal Constraint, 69 Temp. L. Rev. 1059 (1996).

provisions, weighing the adverse burden of legislation on existing entitlements against the necessity and reasonableness of the legislation in serving a public interest. By way of example, the following discussion focuses on the constitutional obstacles to a state's restructuring of its general obligation bonds, namely: (A) the requirement in state constitutions (as well as state statutes) that the state pledge its faith and credit to the repayment of the state's debts, which is typically reaffirmed in the legislation authorizing the issuance of debt (as well as the contract itself), and (B) the Contracts Clause of the U.S. Constitution. The legality of unilateral state adjustments to worker entitlements - including job security, wages, pension rights and health benefits – under these provisions is similar.[16]

(A) The States' Faith and Credit Pledge

Most states – by constitution as well as by statute -- pledge their faith and credit to the repayment of principal and interest on general obligation bonds. Revenue bonds, in contrast, are payable from funds or revenue streams pledged specifically in the bond contract. Some state constitutions explicitly require the state to pledge its faith and credit to the payment of other contract debts as well. This pledge impedes the adjustment of a debt claim against the state without the creditor's consent. However, constitutional law also prevents states from surrendering future discretion in the exercise of their police power. In enforcing the pledge,

[16] For a recent analysis of Contracts Clause jurisprudence concerning unilateral alteration of collective bargaining agreements, see Stephen F. Befort, Unilateral Alteration of Public Sector Collective Bargaining Agreements and the Contracts Clause, 59 Buff. J. Int'l. L. 1, 9-14 (2011).

therefore, courts balance the faith and credit pledge against the constitutional protection of the state's police power.

Perhaps the best known appellate opinion applying the faith and credit clause arose during New York City's financial distress in the mid-1970s.[17] The City issued and offered new long-term revenue bonds in exchange for its outstanding short-term notes; the bonds and notes had the same principal amount. To encourage the holders of the notes to consent to the exchange, the city imposed a three-year moratorium on enforcement actions against the holders who declined to exchange, even if payment became due. Flushing National Bank held short-term notes and challenged the constitutionality of the moratorium. Under the state constitution of New York, the municipality was required to pledge its faith and credit for the payment of the principal and interest. In its defense, the City argued that the moratorium was a constitutional exercise of its police power under emergency conditions.

The moratorium was upheld in the Special Term and Appellate Division of the New York courts, but this holding was reversed by the Court of Appeals of New York. Writing for a 5-judge majority,[18] Judge Breitel interpreted the constitutional requirement as obliging the city to pay and *in good faith* use its revenue powers to produce funds to make the payments when due. Both the majority and dissent agreed that the good faith standard reflected the constitutional

[17] *Flushing National Bank v. Municipal Assistance Corporation for the City of New York*, 40 N.Y.2d 731 (1976).

[18] Cooke, J., dissented and affirmed the lower court. Judge Cooke interpreted the faith and credit clause as requiring "no more than that the city make a good faith effort to use its resources, credit and powers to pay its indebtedness. This effort must be measured in the light of the city's over-all financial condition and its over-all obligations to its citizens and others… Every step [in the record presented by the City] exhibits the city's good faith." *Id.*, at 747).

balance between the faith and credit pledge, on the one hand, and the power reserved to the sovereign State to secure the health, safety and welfare of its people, on the other. They differed, however, in the standard to be applied and their respective application to the facts of the case.[19] The dissent of Judge Cooke was more deferential to the political decisionmaker and he accepted the City's argument that the City's condition went beyond 'difficult economic circumstances' and had reached "grave public emergency" and "imminent danger… to the health, safety and welfare of [the City's] inhabitants."

Judge Breitel held that the moratorium was unconstitutional because it thrust the burden of resolving the heavy debt of the City on the short-term noteholders, who were being coerced to exchange under a "fugitive recourse to the police power of the State."[20] He thereby left open the possibility that a more equitable allocation of the burden might satisfy the requirement of good faith and comply with the constitutional pledge of faith and credit.

Judge Breitel also noted that this faith and credit pledge requirement is designed to protect debtholder rights in difficult economic circumstances. He found that the difficulties of New

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[19] The dissent suggested that the balancing test is the same for the faith and credit requirement of the state constitution, as for the contracts clause of the federal constitution. So, it relied on the then-leading Supreme Court opinion in *Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934).* "The manner in which the Supreme Court has analyzed the Federal contract clause in similar situations should now serve as a stare decisis precedent to be followed in our analysis in respect to our own State constitutional provisions when those provisions might be interpreted as limiting police power." *Flushing*, supra note --, at 755.

[20] "The city has an enormous debt and one that in its entirety, if honored as portions become due, undoubtedly exceeds the city's present capacity to maintain an effective cash flow. But it is not true that any particular indebtedness of the city, let alone the outstanding temporary notes, is responsible for any allocable insufficiency. In short, what has happened is those responsible have made an expedient selection of the temporary noteholders to bear an extraordinary burden." Id., at 736.

York City were "envisioned" at the time the notes were issued.[21] Therefore, the state's faith and credit pledge prevented it from justifying the moratorium on the grounds of difficulties that were (or ought to have been) anticipated at the time of the creation of the indebtedness. This approach is reminiscent of the contract law doctrine of commercial impracticability, which hinges on factual findings as to the severity of the intervening occurrence and its unforeseeability.[22]

After finding the moratorium to be unconstitutional, however, the majority declined to award any remedy to the noteholders. It left to the legislature the task of rectifying the violation. Judge Breitel wrote:

> In order to minimize market and governmental disruptions which might ensue it would be injudicious at this time to allow the extraordinary remedies in the nature of injunction and preemptory mandamus sought by plaintiff. Plaintiff and other noteholders of the city are entitled to some judicial relief free of throttling by the moratorium statute, but they are not entitled immediately to extraordinary or any particular judicial measures unnecessarily disruptive of the city's delicate financial and economic balance."

Indeed, as noted earlier, the enforcement rights of creditors against sovereign states are of questionable value. As a result, the practical value of debt claims against the state may be much less than their face amount. Therefore, bankruptcy restructuring that adjusts the face value does

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[21] Id., at 736.

[22] E.g., Restatement Contracts (2d) ; Uniform Commercial Code 315. It should be noted that excuse for impracticability does not apply to debt contracts.

not necessarily compromise the expected value. The effect would be a question of fact for a court to determine.

(B) The Contracts Clause

The Contracts Clause of the U.S. Constitution prohibits states from impairing their contractual obligations.[23] Similar clauses are present in a subset of state constitutions as well. In this limited respect, the federal government has an advantage in enacting a restructuring regime under its bankruptcy power. Nevertheless, there is a good deal of case law interpreting the contracts clause. Although there is some variation among the treatment of the state constitution clauses among the states and of the federal clause by the U.S. Supreme Court,[24] two of the leading Supreme Court cases in the modern era suggest how states might enact bankruptcy legislation for their own debt without running afoul of the Clause. The prevailing test asks whether the challenged legislation imposes a substantial impairment on a contractual obligation and if so, whether the legislation is reasonable and necessary to serve an important public purpose.[25] The judicial deference to legislation is lower when the affected contract is an obligation of the state.[26] As in the application of the faith and credit provisions of state

[23] U.S. CONST.art I, §10, cl.1.

[24] See Comment, State Pension Deficits, the Recession, and a Modern View of the Contracts Clause, 120 Yale L.J. 2199, 2203-6 (2011).

[25] *US Trust Company of New York v. State of New Jersey*, 431 U.S. 975 (1977).

[26] Id.

constitutions, the Contracts Clause doctrine applies a standard that looks to the parties' understanding at the time of contracting, the intervening circumstances that prompted the challenged modification, and the necessity of the modification in light of these circumstances.

Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934), is a leading case establishing that the standard for Contracts Clause violations balances the constitutional protection of contracts and the sovereign power of the states to safeguard the welfare of their citizens. The Court upheld modifications to home loan agreements to provide relief from foreclosure because they addressed the financial crisis of the Great Depression. The majority opinion in the modern case of *U.S. Trust Company of New York v. State of New Jersey*, 431 U.S. 975 (1977) was less deferential to the judgment of the state government, largely because the modified contracts were obligations of the state itself.[27]

In *U.S. Trust*, an investor in Port Authority bonds challenged legislation in New York and New Jersey that repealed a covenant in the bonds that had been created by earlier statutes in each of the two states. The covenants had restricted the ability of the Port Authority to subsidize rail passenger transportation from revenues and reserves of the Authority (from which the bonds obligations were being paid). The Supreme Court reiterated the settled law that the Contracts Clause does not prohibit the states from repealing or amending the terms of its own contracts, if it is exercising an essential attribute of its sovereignty. Justices Brennan, White,

[27] *U.S. Trust*, supra note --, at 26 ("a complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake").

and Marshall, in dissent, found that the purpose in this case—promoting rail transit—was a lawful exercise of the state's police powers and would have been more inclined to defer to legislative policy decisions.

The majority held that the laws impairing the contract must be "reasonable and necessary to serve an important public purpose," and that court must conduct its own inquiry beyond the state legislature's pronounced purposes. The majority further held that the repeal of the covenant was neither necessary nor reasonable because a less severe modification would have been effective. The court found that the conditions were not sufficiently dire or extreme to justify the repeal of the covenants in question. Moreover, in holding that the repeal was also not reasonable the court noted that the need to support mass transportation was well known at the time of the statutory covenant. It was neither unforeseen nor unintended. Indeed, Chief Justice Burger also observed in a concurring opinion, the covenant was intended to protect the reserves against the possibility that they might be used for such purposes. This focus on the foreseeability of the event creating the need for modification is similar to that used in the good faith test under the constitutional pledge of faith and credit of states, as well as the doctrine of impracticability in commercial law.

U.S. Trust cited approvingly the earlier case *Faitoute Iron & Steel v. City of Asbury Park*, 316 U.S. 1129 (1942), which is worth noting because the state action in *Faitoute* was a restructuring of bond debt and directly pertinent to the constitutionality of a state-legislated bankruptcy regime. New Jersey passed a statute in the early 1930s to authorize state control over insolvent municipalities. The statute allowed a plan for adjustment of the non-principal claims of creditors against an insolvent municipality to be made binding on all creditors. If 85% of the creditors, the municipality and the relevant state commission approved of the plan, and a court reviewed the plan to ensure, inter alia , that it was in the best interest of all creditors, then it would be binding. Bondholders challenged the statute under the Contracts Clause.

The Supreme Court recognized that states had the power to restructure their debt to address unforeseen financial distress, and it upheld the New Jersey statute.[28] The Court identified several other features that were significant in their finding of constitutionality. First, the statute required that the plan be scrutinized and authorized by the state court before it could be imposed on a nonconsensual creditor. Second, the Court found that the restructuring plan did not leave the bondholders worse off. This criterion is reminiscent of the best interests test under the current Bankruptcy Code. In finding that the bondholders were not harmed by the adjustment, the Court stated that "the practical value of an unsecured claim against the city is inseparable from its reliance upon the effectiveness of the city's taxing power. The only remedy for the enforcement of such a claim is mandamus to compel the levying of authorized taxes. The experience of the two modern periods of municipal defaults, after the depressions of '73 and '93, shows that the right to enforce claims against the city through mandamus is the empty right to litigate."[29] It is interesting to compare this statement with the NY state appellate

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[28]The holding in *Faitoute* was reversed by Congress' amendment to Chapter 9.

[29] Faitoute, supra note --, at 1133.

court's opinion in *Flushing National Bank* discussed above, which gave judgment to the challenging bondholders but no remedy.

While the Supreme Court focused on the constitutionality of contract modifications in this case and others, it also invoked from time to time a contractual approach that considers the implied terms of the bargain. This was implicit in the courts' attention to foreseeability in the two other cases discussed here (*US Trust* and *Flushing National Bank*). The Court also referred to it in *Faitoute*. One of the reasons given by the court to hold that the practical value of the debtholder's remedy was limited is that the states could withdraw the authority of a municipality to levy taxes even to pay debts, particularly in the face of unforeseen conditions. "The necessity compelled by unexpected financial conditions to modify an original arrangement for discharging a city's debt is implied in every such obligation for the very reason that thereby the obligation is discharged, not impaired."[30]

In sum, the constitutionality of a state-legislated bankruptcy process is a transitional issue. As obligations are satisfied, replaced, renewed or refinanced, the bankruptcy regime will be incorporated into the state's contracts that follow. In the short term, however, existing creditors might challenge the retroactive effect of the legislation when it is enacted, if the enactment leads to a decrease in the value of their rights or claims against the state (such as a drop in the

[30] Id. At 1134.

market price of the state's bonds). The foregoing analysis suggests that a state's bankruptcy regime can survive such challenges under either state or federal constitution if the state can invoke the process only in severe and unforeseen distress, the statute provides for the oversight by the state courts, and the regime promotes the usual bankruptcy objective of creating a surplus while ensuring that no creditor is worse off than if it pursued its individual remedies in a world without bankruptcy. These conditions are not difficult to satisfy and, indeed, they are also congenial to the design of an effective regime. The political and economic benefits of state-enacted bankruptcy over a federal regime that are raised earlier in this chapter might provide further justification for upholding the state bankruptcy regime.

4. Conclusion

Inspired by the recent debate over a proposed federal bankruptcy statute for states, this chapter argues in favor of allowing states to legislate their own bankruptcy regimes. Economic and political considerations militate strongly in favor of enactment at the state level. Either federal or state efforts to legislate a state bankruptcy regime would face a distinct set of constitutional obstacles. Under the preliminary analysis presented in this chapter, a state-enacted statute could be designed to survive constitutional challenge. To the extent that the debate over the merits of a bankruptcy process for states continues, the alternative of legislation by states should be seriously considered.