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STATE BANKRUPTCY FROM THE GROUND UP

David A. Skeel, Jr.

Introduction

The nineteenth century English poet William Wordsworth famously defined poetry as the “spontaneous overflow of powerful feelings … recollected in tranquility.”¹ By this definition, there is something a little poetic about the current shape of the debate as to whether Congress should enact a bankruptcy law for states. In late 2010, as the extent of the fiscal crisis in many states became clear, a handful of commentators and politicians proposed that Congress enact a bankruptcy law for states.² “If Congress does its part by enacting a new bankruptcy chapter for states,” one advocate concluded with a somewhat hyperbolic flourish, California governor “Jerry Brown will be in a position to do his part by using it.”³ These proposals met immediate, passionate resistance. One law professor denounced state bankruptcy as a “terrible idea.”⁴ “[I]f we in fact create … a state bankruptcy chapter,’ another critic testified to Congress, “I see all sorts of snakes coming out of that pit, as ‘[b]ankruptcy for states could—would cripple bond markets.”⁵

After a brief, high profile debate, the state bankruptcy proposals dropped from sight in Washington, apparently knocked out by a left-right combination: because the proposals were perceived as a tool to punish public employee unions, Democrats opposed them from the

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¹ Wordsworth offered this definition in his preface to the Lyric Ballads. William Wordsworth, Preface, in WILLIAM WORDSWORTH & SAMUEL TAYLOR COLERIDGE, LYRICAL BALLADS, WITH A FEW OTHER POEMS (1800).
³ Skeel, Give States a Way to Go Bankrupt, supra note 2, at 24.
beginning. Many Republicans turned against the proposal after bond market representatives warned that state bankruptcy could hurt the bond markets.⁶

With the debate’s initial passions having cooled, at least for a time, we can now consider state bankruptcy, as well as other responses to states’ fiscal crisis, a bit more quietly and carefully. That is precisely what I hope to do in this chapter. Although my analysis will not be mistaken for poetry, it may benefit from reflection outside the passions of the initial public debate.

I will begin the chapter by briefly outlining a theoretical and practical case for state bankruptcy. Because I have developed these arguments in much more detail in companion work, I will keep the discussion comparatively brief. My particular concern here is, as the title suggests, on developing a bankruptcy framework from the ground up. After briefly discussing what bankruptcy is, and some of the confusion befogging this term, I will argue that state bankruptcy should emphasize five key objectives, an approach I will compare to two possible alternatives. I then will consider six facets of the bankruptcy case: initiation; proposing a reorganization plan; the role of a stay, reachback provisions and confirmation rules; the possibility of “guillotines” or “checks” tailored to the state bankruptcy context; financing; and the structure of the bankruptcy court.

A Case for State Bankruptcy

Scholarly critics of state bankruptcy have argued that state fiscal difficulties are “political,” not “financial.”⁷ The financial predicaments faced by states like California and Illinois can be traced to taxing and spending problems, the reasoning goes, and to a political tendency to borrow to fund current funding without fully considering the long-term costs. Bankruptcy is not designed to address these kinds of problems. Unlike in an ordinary Chapter 11 case, bankruptcy would not shift decision making authority to a new or different decision maker. Moreover, the other standard benefits of bankruptcy—its ability to halt the “grab race” by

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⁶ A key moment in bond-market inspired resistance came when House majority leader Eric Cantor announced that he would not support any state bankruptcy proposal. See, e.g., James Pethokoukis, When States Go Bust, WEEKLY STD, Feb. 14, 2001 (noting that Cantor “brushed off the idea” on January 24, 2011).

⁷ Adam Levitin makes this argument with vigor in his contribution to this volume.
creditors that can dismember an otherwise viable firm—would not apply if the creditor is a state rather than a private entity.

If we shift the frame of reference from corporate to personal bankruptcy, the limits of these objections quickly become clear. Like a state, a consumer debtor cannot be liquidated and the same decision maker—the debtor herself—will remain in this role even after bankruptcy. Although consumers are not biased in precisely the same ways as political decision makers, there are obvious similarities; most importantly, both tend to focus more on the short-term benefits of borrowing than its long-term costs. With both consumers and states, bankruptcy can address the problem of debt overhang—debt that may make it impossible for the debtor to fund even the most promising investments.8 In both contexts, the prospect that debt may be discharged also enlist creditors as monitors, given them an incentive to discourage overborrowing by increasing interest rates or cutting off funding for profligate debtors.9

States differ from consumer debtors in some respects. The question of who will file the bankruptcy petition is more complicated, for instance, and states may need interim financing to fund the bankruptcy case.10 But the similarities suggest a broad analogy between consumer bankruptcy and the potential role of bankruptcy for states.

Even if persuaded that state bankruptcy can be justified in theoretical terms, some still might harbor doubts about its efficacy in practice. Perhaps the most frequent objection is that bankruptcy is unnecessary because states already have the tools to deal with their financial distress. The wave of recent state efforts to scale down their obligations to public employees—quite controversially in Wisconsin but with fewer fireworks in New York—could be seen as initial confirmation of this argument. By reining in spending and/or adjusting taxes, as well as renegotiating problematic agreements, states can address their problems without any bankruptcy option.11 According to critics, state bankruptcy could interfere with these ad hoc adjustments: the bankruptcy alternative might prove too tempting, relieving pressure to fix the state’s finances out of bankruptcy.

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8 The classic analysis of debt overhang is Stewart C. Myers, Determinants of Corporate Borrowing, 5 J. Fin. Econ. 147 (1977).
9 See, e.g., Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 249 (1986)(highlighting this effect in the consumer bankruptcy context).
10 In this sense, states resemble the nineteenth century railroads. Although the railroads theoretically could be liquidated, perceived public interest and the interests of every relevant constituency favored reorganization, since railroad track was worth virtually nothing apart from connecting track.
This last concern—bankruptcy as temptation—assumes that states would view bankruptcy as an attractive option, which is highly unlikely. A governor who filed for bankruptcy would be subject to extensive new oversight. Moreover, the moral hazard concern needs to be weighed against the restructuring that can only be done in bankruptcy, and other benefits of bankruptcy such as the added leverage it would give a state to renegotiate many of its obligations outside of bankruptcy.\(^\text{12}\)

Although it may be true that the states currently don’t need the restructuring tools that bankruptcy provides, what if another crisis hits this year or next, rather than twenty years from now? Given the recent turmoil in Greece and elsewhere in Europe, this isn’t out of the question. If there were lessons in the 2008 crisis, surely one was the risk of ignoring the black swan, the remote but potentially devastating possibility.

A second major objection is that enactment of a state bankruptcy option would devastate the market for state bonds, which currently are viewed as safe investments.\(^\text{13}\) As a result of the bond market contagion, the argument goes, even fiscally responsible states would be punished. Contagionists tend to conflate the enactment of a bankruptcy law with an actual default by a state. Simply putting a law in place would not paralyze the bond markets. Indeed, we already have a municipal bankruptcy law, yet these markets continue to function (contrary to the dire, vaguely familiar warnings voiced by critics in the 1930s when it was first enacted).\(^\text{14}\) Current bond prices—which are significantly lower for California and Illinois than for less troubled states—suggest that the markets distinguish between good credit risks and poor ones. Moreover, to the extent a bankruptcy law might lead to slightly lower bond prices and slightly higher interest rates, this would not necessarily be problematic. States currently have too great an incentive to borrow, because the proceeds can be used now while much of the cost will be borne by future taxpayers. Higher borrowing costs might curb this tendency, at least on the margin.

A final objection is that a state’s financial structure is too complex for bankruptcy courts to handle. Nicole Gelasias has pointed out, for instance, that New York state has several hundred

\(^{12}\) These arguments are developed in detail in David A. Skeel, Jr., States of Bankruptcy (unpublished manuscript, July 7, 2011).

\(^{13}\) See supra note 5 and accompanying text.

\(^{14}\) The dissenters from the original 1934 municipal bankruptcy law predicted that “the very novelty of the thing will adversely affect the municipal bond market,” and that “the presence of the law on the statute books would … cost investors and solvent municipalities millions of dollars.” Quoted in Henes & Hessler, supra note 5.
special districts and other entities.\textsuperscript{15} State bankruptcy would indeed call for some adjustments to the bankruptcy process, such as the use of a panel of judges. But this is not due to complexity. Complexity is a familiar feature of many bankruptcy cases. The WorldCom bankruptcy, for instance, involved a large number of entities. The capacity to determine the extent of a debtor’s guarantees and other obligations—and thus to address the complexity—is in fact a signal benefit of bankruptcy. Often this is resolved through negotiation. But the bankruptcy court has the authority to resolve any uncertainties about the parties’ entitlements.\textsuperscript{16}

One of the most attractive features of state bankruptcy is the extent to which its benefits would arise even if no state ever filed for bankruptcy. As already noted, the existence of a bankruptcy option would give a state more leverage to renegotiate its obligations outside of bankruptcy. And bankruptcy’s priority structure would help to clarify nonbankruptcy priorities. Bankruptcy itself would provide other important benefits—not least being a orderly alternative for resolving a state’s financial distress if it did spiral out of control.\textsuperscript{17}

\textbf{What Do We Mean by Bankruptcy?}

Thus far, I have treated the term “bankruptcy” as if it were self explanatory. But of course it isn’t. The warrant for using this particular language can be found in the Constitution itself, which gives Congress the power to make uniform laws on the subject of bankruptcies.\textsuperscript{18} The Supreme Court was frequently called upon to determine just what bankruptcy means in the nineteenth century. Over time, bankruptcy has come to include nearly any reasonably comprehensive framework for adjusting a debtor’s obligations, providing for payment of creditors, and giving the debtor a discharge.\textsuperscript{19}

\textsuperscript{15} Gelinas argues that this complexity would make state bankruptcy implausible. \textit{Hearing on State and Municipal Debt: The Coming Crisis? Before Subcomm. on TARP, Financial Services, and Bailouts of Public and Private Programs of Comm. on Oversight and Government Reform, 113\textsuperscript{th} Cong. 1-2 (prepared statement of Nicole Gelinas, Manhattan Institute)}.


\textsuperscript{17} These benefits are explored in more detail in Skeel, supra note 12, at 9-22.

\textsuperscript{18} CONST. ART. 1, § 8.

The precise label doesn’t matter, of course. Any restructuring framework that has the qualities just described is a bankruptcy law, even if Congress calls it something else. Even experts sometimes get tripped up on this point. In a 2011 hearing, a bankruptcy lawyer condemned state bankruptcy as unworkable, then went on to advocate that Congress consider adopting a framework modeled on the Sovereign Debt Restructuring Mechanism proposed by the International Monetary Fund in the early 2000s. The difference between what he was praising and what he was condemning was not clear. The SDRM proposed a stay on collection under some circumstances, and envisioned that creditors would file claims and vote on a restructuring. Under any ordinary conception of bankruptcy, state SDRM would thus be “state bankruptcy,” even if it did not carry this label.

Given the tendency of many to recoil at the mere mention of the word bankruptcy, there is something to be said for using a different term for any state restructuring framework. My preference might be: State Debt Adjustment Framework. But the framework, at least as I envision it, will be just as much a bankruptcy law as it would be if it bore that label, just as Chapter 9—whose formal title is “Adjustment of Debts of a Municipality”—is bankruptcy.

The General Framework

To paraphrase a famous line by Felix Frankfurter, saying that state bankruptcy (or a state debt adjustment framework) would be desirable only begins the inquiry. We still need to determine what the framework could or should look like. Given the parallels between state and municipal bankruptcy, one might easily rework Chapter 9 into a state bankruptcy framework, making adjustments as appropriate. This approach has several shortcomings, however. Because Chapter 9 is seriously flawed, it is not the best role model. Starting with a fully formed framework also would obscure many of the key decisions that must be made in determining how

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22 Frankfurter said that determining that someone is a fiduciary “only begins analysis.” S.E.C. v. Chenery Corp., 318 U.S. 80, 85-86 (1943).
to structure the bankruptcy regime. I will begin at a more foundational level, asking what features lie at the heart of an effective state bankruptcy framework. This will enable me to develop a framework from the ground up.

Although a variety of other key features will be discussed below, the edifice rests on five core principles. The first is the recognition of property rights and a coherent priority scheme. Second, similarly situated creditors should receive comparable treatment. Third, the debtor should be given the power to terminate or assume its ongoing (“executory”) contracts. Fourth, the creditors in a particular class should be subject to a restructuring if it is agreed to by an appropriate majority of the claims in the class. Finally, the framework should discharge the debtor’s prebankruptcy obligations.

Start with property rights and other priorities. Not only is recognition of property rights compelled by the Takings Clause of the Constitution, but establishing and honoring priorities brings important benefits even outside of bankruptcy. Well-ordered priorities can reduce credit costs by facilitating monitoring and clarifying creditors’ status in the event of insolvency. This is particularly important for states, because state priorities are quite unclear and can often be subverted outside of bankruptcy. If one class of claims is thought to be entitled to special treatment, for instance, a state can subvert the special status by targeting it but not other claims for restructuring.

A second key principle is that similarly situated creditors should receive comparable treatment. If a state has two similar classes of bonds, it should not be able to promise on class 90% of what they are owed while giving the other only 10%. Similarly, bond holders should not receive 90% while state employees’ contracts are scaled down closer to 10%.

The first two principles are closely related, and together they give rise to an important corollary: the sacrifice entailed in a state’s bankruptcy should be distributed equitably among all constituencies, not just borne by one or two constituencies. A state’s financial distress is a common disaster, as Bob Scott argued about corporate reorganization several decades ago, and

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23 Under existing bankruptcy law, the principal priorities are established in the first instance by 11 U.S.C. § 725 (property rights) and 11 U.S.C. § 726 (other priorities).
24 This benefit is the subject of a long literature. Some years ago, Alan Schwartz proposed first-in-time priority for unsecured debt to obtain some of these benefits even within the class of general unsecured claims. Alan Schwartz, A Theory of Loan Priorities, 18 J. LEG. STUD. 209 (1989).
25 This principle has long been a central objective of American bankruptcy law. It is reflected in the general distribution scheme in a Chapter 7 liquidation, as well as in provisions such as 11 U.S.C. § 1129(b), which forbids “unfair discrimination” in a Chapter 11 cramdown.
the bankruptcy framework should reflect this (even if—perhaps especially if—nonbankruptcy restructuring efforts often do not). 26

Third, bankruptcy should give the state the power to assume or (often more importantly) terminate its executory contracts. 27 This is a feature of personal, corporate and municipal bankruptcy in the United States, and it is particularly important for a financially troubled state. In the 19th century, when state default was last a pervasive concern, executory contracts would not have featured prominently in a state’s distress. Governmental functions were far more limited, and state bond debt was the principal concern. In the current crisis, by contrast, unsustainably generous public employee contracts have been a major component of most troubled states’ woes. Lawmakers have considerable incentives to award generous contacts to state employees, both because state employees are an important voting block and because lawmakers themselves may be direct or indirect beneficiaries of the contracts. The ability to restructure these contracts is an essential component of an effective state bankruptcy framework.

Bankruptcy also should provide for a binding vote of each class of creditors on any proposed restructuring plan. In the absence of voting provisions, holdout creditors might thwart or significantly complicate a state’s restructuring efforts in an effort to secure greater payments for themselves. 28 A binding vote removes this difficulty by compelling dissenting creditors to accept the terms agreed to by a majority of their peers. 29

The holdout problem can be surmounted even without voting provisions. In the late nineteenth century, railroad reorganizers persuaded courts to set an “upset price” that would be paid to dissenting bondholders in the reorganization. If the upset price was low, as it generally was, it discouraged holdouts. 30 More recently, corporations and countries have restructured their

27 To simplify slightly, an executory contract is a contract that has not yet been fully performed by either side. An agreement with a supplier is an executory contract, while bond debt is not (because the investor completes her performance when she pays). Current bankruptcy law addresses executory contracts in 11 U.S.C. § 365.
28 The disruption caused by holdout creditors has been a major concern in the sovereign debt context. Starting with Mexico in 2003, the United States led an effort to persuade sovereign debtors to include voting provisions in the bonds they issue in order to avoid this problem. See, e.g., Anna Gelpern & G. Mitu Gulati, Forward: Of Lawyers, Leaders, and Returning Riddles in Sovereign Debt, 73 L. & CONTEMP. PROB. i, vi (2010)(forward to symposium on “A Modern Legal History of Sovereign Debt”) (describing the intervention).
29 When corporate reorganization was first codified in the United States in 1933 and 1934, providing a binding voting rule was the principal objective of the new statute. See, e.g., Robert T. Swaine, Corporate Reorganization Under the Bankruptcy Power, 19 VA. L. REV. 317 (1933)(emphasizing the need for binding votes).
bonds through exchange offers that included “exit consents” that are designed to punish
bondholders that reject the restructuring.\textsuperscript{31} Although each of these devices is a substitute for
voting provisions, both carry baggage. Paying the upset price to dissenters was quite costly, and
dissenting bondholders are still entitled to full payment, at least in theory, after a contemporary
exchange offer. In the exchange offer, the state might also be forced to limit the extent of its
restructuring to minimize holdouts. Voting provisions avoid these problems, and can facilitate a
more effective restructuring.

The final requirement is discharge. Whatever terms are agreed to or imposed on a
creditor as a result of the bankruptcy should be permanent. As bankruptcy advertisements put it,
the debtor’s obligations should be erased.

These five principles, together with the obligation to marshal value of the state’s assets in
some way for payment to its creditors,\textsuperscript{32} are the foundation for an effective state bankruptcy
framework.

\textbf{A Simpler Alternative?}

One can imagine a much simpler state bankruptcy framework than the one I have begun
to sketch out. Consider two possible alternatives, and the limitations of each.

\textit{An Immediate Discharge}

Under one approach, all of the state’s obligations would be simply be discharged when it
filed for bankruptcy.\textsuperscript{33} This is how Chapter 7 works for consumer debtors. When a debtor files
for bankruptcy, she turns over all over her nonexempt assets so that the trustee can distribute
them to creditors. In practice, the vast majority of consumers do not have any nonexempt

\textsuperscript{31} See, e.g., John C. Coffee, Jr. & William A. Klein, \textit{Bondholder Coercion: The Problem of Constrained Choice in
Debt Tender Offers and Recapitalizations}, 58 U. CHI. L. REV. 1207 (1991)(describing strategies used to pressure
bondholders to participate).
\textsuperscript{32} Marshalling the assets of the debtor for the benefit of creditors was the original focus of Anglo-American
bankruptcy law.
\textsuperscript{33} Barry Adler suggested this approach at a recent conference. State and Municipal Default Workshop, Hoover
As a result, they simply file for bankruptcy and receive an almost immediate discharge. Given that state bankruptcy plays much the same role as consumer bankruptcy, this approach would simply follow the analogy all the way down.

The immediate discharge would not be quite so radical a departure from a traditional bankruptcy as at first appears. Although everything would be discharged--from its collective bargaining agreements to its bonds and its contracts with suppliers--a state no doubt would wish to reaffirm some of these obligations; the state might renegotiate its bonds and collective bargaining agreements, offering to pay something less than the original obligations. With consumer bankruptcy, the statute permits a debtor to reaffirm debts that would otherwise be removed, but requires that the reaffirmation be approved by a court. An analogous provision would be warranted for states, although for a somewhat different purpose. Whereas the court polices consumer reaffirmations to ensure they are voluntary and do not impose an undue hardship on the debtor, the concern with a state is to ensure that the state doesn’t treat similar obligations radically differently.

Notice where this leaves us. Although the discharge is prompt and automatic, a state might well negotiate the terms of a restructuring with many of its creditors, much as it would in a more elaborate restructuring framework. How, then, would it differ from the structure whose core principles were outlined in the last section? The largest distinction might come in the nature of the bargaining. In an ordinary bankruptcy framework, bargaining between the state and a particular group of creditors is a bilateral monopoly: each party may be the other’s only realistic contracting party, which makes the outcome uncertain and may reduce the likelihood of a thoroughgoing restructuring. Immediate discharge would break the impasse by inviting the state to dictate the terms of any bargain. The distinction should not be overstated. Under the principles described earlier for the framework advocated in this chapter, for instance, the state would have leeway to terminate existing contracts, such as collective bargaining agreements with its unions. But an immediate discharge would sharply expand this leverage, and would reduce the need for judicial oversight.

34 See, e.g., Michelle J. White, Abuse or Protection? Economics of Bankruptcy Reform Under BAPCPA, 2007 U. ILL. L. REV. 275, 284 (no non-exempt assets in 96% of consumer Chapter 7 cases).
36 As Barry Adler also has suggested.
The increased restructuring leverage also would bring a potentially serious risk: the prospect that the immediate discharge would prove *too* tempting. In part, this is a standard moral hazard issue. If bankruptcy is especially attractive, a debtor may invoke it even if the debtor is capable of repaying its obligations. This moral hazard would be counteracted by the risk that precipitously filing states would be punished by the credit markets and by pressure against filing from interest groups that would be affected by the state’s bankruptcy. Even if these forces discouraged unnecessary bankruptcy filings under most circumstances, however, they might not prevent state decision makers from triggering bankruptcy on a whim. Suppose that lawmakers threatened to file for bankruptcy unless the state’s public employees agreed to sharp reductions in their collective bargaining agreements. If the negotiations reached an impasse, the state might make good on its threat, despite not needing bankruptcy relief. The odds of a precipitous filing would not be great, but this would be a much larger risk than with a fuller bankruptcy framework.37

Immediate discharge also would not avoid many of the most difficult issues in a bankruptcy case. Absent a settlement, the court would still need to determine just what has in fact been discharged. This would require rulings on whether and to what extent a creditor was protected by a property right, for instance, and what obligations the state had to special districts, pension funds, or local governments whose obligations it may have guaranteed. These determinations would of course be many orders of magnitude more complex than in a consumer bankruptcy case.

Overall, the benefits of the immediate discharge do not seem great enough to justify forgoing the protections of a more elaborate framework. But it is a plausible alternative, and hints at how wide ranging the options for structuring a state bankruptcy framework.

A Simple Voting Framework

Under a second strategy, bankruptcy would center on the fourth of the core objectives, establishing binding voting provisions. “A minimalist legal framework incorporating across-the-board supermajority voting,” as its principal advocate puts it, is all that would be required to help

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37 At the very least, this would call for more stringent restrictions on initiation than I advocate below for the framework developed in this chapter.
states solve the creditor-holdout problem. Such a framework would not need to bring in other bankruptcy baggage.”

Although the voting provisions could take different forms, one approach would follow roughly the pattern of corporate bankruptcy law, allowing the state to group creditors into as few or as many classes as it wishes, so long as the claims in the class are substantially similar.

The voting approach differs from a more complete framework in at least two respects. First, it would omit the third objective, termination of executory contracts. Bankruptcy therefore would not provide a tool to alter collective bargaining agreements and other contracts. This presumably would preclude adjustments to a debtor’s pension obligations, although the implications here are somewhat unclear. If the extent of the pension beneficiaries’ property interests were in doubt, for instance, the court would need to determine what portion should be treated as a priority obligation and what portion would be unsecured.

Second, the voting approach would not explicitly require that similarly situated creditors receive comparable treatment. Creditors could not be lumped with dissimilar creditors, and a class of creditors would be more likely to vote no if a proposed plan treated them worse than a group of seemingly similar creditors. But the debtor would not be precluded from offering radically different treatment to two classes of similar creditors. Indeed, the debtor might restructure one group of creditors but not another.

As with the immediate discharge, the voting framework would appreciably reduce the need for judicial oversight but would not go altogether by itself. Many of the decisions required by a more elaborate framework would also arise with a voting framework, except to the extent the debtor excluded the creditors in question from restructuring. A court would need to estimate or fix the creditor’s claim, for instance, in order to determine how large a vote the creditor had.

The voting framework would resemble a prepackaged corporate bankruptcy in scope. As with a prepackaged bankruptcy, the voting framework would be most beneficial if the

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39 Id. at 14.
40 This was a concern with the IMF’s SDRM, which was similar to, although much more elaborate than, the simple voting framework. See, e.g., Patrick Bolton & David A. Skeel, Jr., Redesigning the International Lender of Last Resort, 6 CHI. J. INT’L L. 177, 184 (2005)(describing danger that priorities can be undermined).
41 In a prepackaged bankruptcy, the debtor files a reorganization plan along with its bankruptcy petition, in the expectation that the plan will be confirmed within the first few weeks of the case.
debtor’s problems can be solved with a simple restructuring of its balance sheet. For states with more complex problems, the voting framework would be less effective.

The Initiation Decision

Under either the more complete framework I advocate in this chapter or either of the alternatives, the terms of initiation are a particularly sensitive issue. If initiation is difficult, bankruptcy’s benefits may be difficult or impossible to achieve. If initiation is easy, bankruptcy may be too tempting—at least under a self-executing framework such as the immediate discharge.

Current municipal bankruptcy law is particularly instructive on this dilemma. To enter Chapter 9, a municipality must show that the state has authorized a filing, that the municipality is insolvent and that it has negotiated in advance with its creditors unless negotiation is impracticable. Chapter 9 also assumes that the filing decision will be made through the ordinary political process, which often means agreement by the mayor and the city council. The stringent preconditions apparently were included primarily to ensure that the Chapter 9 would not be struck down as an unconstitutional interference with state sovereignty. In practice, they have made it very difficult to use Chapter 9.

The most nettlesome requirement is the obligation to show that the municipality is insolvent, which is defined to mean that the municipality is “generally not paying its debts as they become due” or is “unable to pay its debts as they become due.” When Bridgeport, Connecticut filed for bankruptcy several decades ago, the case was eventually tossed out because the court was unpersuaded that Bridgeport had exhausted all of its options for meeting its obligations—it had not yet been cut off by potential lenders, for instance, and had not run out of cash. If the same “unable to pay its debts as they become due” standard applied to state bankruptcy, the interference would be far greater. Because a state can always raise taxes or borrow, objectors would have a plausible challenge to any filing, no matter how dire the state’s

44 In re City of Bridgeport, 129 Bankr. 332, 336-38 (Bankr. D. Conn. 1991). The court’s application of the insolvency standard may have been colored by the state’s staunch resistance to the filing, although the court held that the filing was authorized by state law. Bridgeport’s analysis of the insolvency requirement is pointedly criticized in Michael McConnell & Randal C. Picker, When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy, 60 U. CHI. L. REV. 425, 456 (1993).
financial condition. As McConnell and Picker put it in the municipal bankruptcy context, “[a]t a certain point, raising tax rates ceases to raise tax revenues, but identifying the tax-maximization point on this implicit ‘Laffer Curve’ is not a simple proposition.”

Under the bankruptcy framework advocated in this chapter, there is no need for so stringent an insolvency requirement. It is possible that state bankruptcy could omit this requirement altogether, as corporate bankruptcy does. Given the difficulty of reaching a state’s assets, however, a bankruptcy framework that omitted any insolvency requirement might be challenged as exceeding Congress’s bankruptcy powers. This suggests that, while the insolvency requirement needs to be relaxed, it should not be excluded altogether. One plausible candidate comes from an unlikely source: the Dodd-Frank Act’s resolution rules for systemically important financial institutions. The Dodd-Frank Act’s insolvency requirement focuses on whether the institution is “in default” or “in danger of default.” This standard would satisfy the need for some showing of insolvency, but would be much less stringent than the Chapter 9 insolvency requirement.

Because state bankruptcy would involve an exercise of its bankruptcy powers, Congress should be able to decide which state decision maker would have the authority to initiate a bankruptcy case. Congress would not need to defer to the state, as Chapter 9 does to municipalities. Consider three possible decision makers. First and most obviously, Congress could require a joint decision by the governor and legislature. This, of course, is how ordinary legislation is enacted. Second, Congress could vest the authority in the governor alone. This would simplify the decision making process, and accords with the kind of power an executive in some circumstances. Finally, Congress could authorize the citizens of a state to trigger a bankruptcy filing by referendum, thus relying on direct democracy. The referendum approach is the most radical, but authorizing citizens to make the bankruptcy decision is not dramatically different than the powers they have in referendum states such as California.

In my view, the governor should be given the authority to file for bankruptcy, perhaps after mandatory consultation with the leaders of the two legislative branches (or branch, in a unicameral system). Under ordinary corporate bankruptcy, the board of directors makes this

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45 McConnell & Picker, supra note 44, at 466.
46 In a corporate bankruptcy case, insolvency comes in only indirectly, as a possible objection to the good faith of the filing (if the debtor is clearly solvent) or as a possible objection by the debtor to an involuntary case. 11 U.S.C. § 303(h).
decision, not the chief executive. Given the similarity between the board and a state legislature, one could argue that the legislature should have a formal role. But the governor and legislature do not operate as a single coherent team in the way that a chief executive and her corporate board often do. The legislature is also a far more cumbersome decision making body than a corporate board, which generally has less than twenty directors.

The case for making voters the exclusive decision maker is much weaker. If voters triggered a bankruptcy filing over the objections of the state’s governor, the likelihood that the restructuring effort would be pursued with vigor would be relatively small. It is possible, however, that a governor would be prodded into action by the wishes of a majority of the state’s citizens. This suggests that it might be a mistake to exclude the possibility of voter involvement altogether. To leave an opening for voter involvement, Congress could vest the principal authority elsewhere—in the governor, I have argued—but invite the state to enact legislation also giving voters this authority.

The two requirements I have described—a petition by the state’s governor, based on a showing that the state is in default or in danger of default—should be the only prerequisites for initiating a state bankruptcy requirement. The risk of a precipitous bankruptcy filing is exceedingly small, given the consequences to the state of being in bankruptcy.

Proposing a Reorganization Plan

Initiation does not end the tricky political issues posed by state bankruptcy. The other major issue is who should propose a reorganization plan on behalf of the state.

As with initiation, Chapter 9 assumes that the full, ordinary decision making process will apply. Much as the board of directors acts on behalf of a corporate debtor, the municipal council as a whole proposes a plan on behalf of the municipality. The case for adopting a similar approach for state bankruptcy—and thus involving both the governor and the legislature—is stronger in two respects in this context than with initiation. First, time is less likely to be of the essence. In most cases, the reorganization negotiations will have unfolded over a period of

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48 It is interesting to note that this is, in a sense, a practical accommodation of corporate and bankruptcy law to the realities of bankruptcy. Major corporate decisions usually require both directorial approval and a shareholder vote. See, e.g., DEL. CODE ANN. Tit. 8 § 251 (shareholder vote on mergers). Requiring a shareholder vote on bankruptcy would be cumbersome, however, and (more importantly) shareholders’ decision making incentives are suspect when the firm is insolvent.
months, and legislative approval could be included as part of the voting process. Second, a process that provided for full legislative approval could include measures such as tax adjustments that might not otherwise be possible.

Despite these advantages, the more simplified approach proposed for initiation seems appropriate for the plan process as well. Allowing the governor to propose a plan after consultation with legislative leaders would avoid the danger that legislative resistance might derail any proposed plan. To be sure, this would preclude the plan from including provisions like new or different taxes that would require formal legislative approval. But the governor could propose a plan that was made conditional on prompt legislative approval of tax adjustments, or which included a call for specified tax or spending changes.

Other Provisions

Three key provisions provide much of the framework for ordinary corporate reorganization: the automatic stay, which halts creditor collection efforts; the reachback rules that enable the trustee to retrieve prebankruptcy preferences and fraudulent conveyances; and the rules for confirming a reorganization plan.\(^49\) The automatic stay gives the debtor a “breathing space” by preventing creditors from dismembering an otherwise viable corporation, while both the reachback and confirmation rules help, among other things, to ensure the equal treatment of similarly situated creditors.\(^50\)

In contrast to corporate bankruptcy, where the stay and reachback rules are essential, neither is strictly necessary for a state bankruptcy. Because creditors have few mechanisms for forcing a recalcitrant state to pay or attaching its assets, the “grab race” that figures so prominently in corporate bankruptcy is far less important for a state. With few exceptions, the state could simply stop paying its creditors after it filed for bankruptcy. This suggests that, at

\(^{49}\) These rules are found in 11 U.S.C. § 362 (automatic stay), 11 U.S.C. § 547 and 548 (preference and fraudulent conveyance provisions), and 11 U.S.C. § 1129 (plan confirmation requirements).

\(^{50}\) The preference provision requires a creditor that has received preferential payments to disgorge these payments if no safe harbor applies; this restores the creditor (to the extent of the payment) to the same status as other general unsecured creditors. The confirmation rules require equal treatment unless a class of creditors agrees to different treatment.
most, a limited stay would be needed as a part of a state bankruptcy framework. \(^{51}\) The stay could halt litigation against the state, for instance, but not interfere with the state’s creditors in any other way. A stay on litigation would channel any fights over the state’s use of funds during the bankruptcy case into the bankruptcy court, and would prevent creditors from obtaining non-bankruptcy rulings on issues such as the extent of the state’s responsibility for the obligations of special districts and other entities.

While one can imagine a role for reachback rules—states may make preferential transfers to creditors before bankruptcy, just as other debtors do—these rules could be omitted altogether from a state bankruptcy framework. At most, as with the stay, a strictly limited version of the reachback rules would be in order. \(^{52}\) Extensive reachback rules would add significant complexity to the bankruptcy process, and the benefit of pursuing the recipients of preferential payments would likely be limited. With a state, politics is likely to be a more cost effective corrective to favoritism than is the traditional litigation process. And in egregious cases—where state assets are sold to an insider for a pittance—the recipients can be pursued through the criminal process.

Unlike stay and reachback provisions, the voting and confirmation rules would be essential to the state bankruptcy process. But here, too, it would be a mistake to simply import the confirmation rules from corporate bankruptcy, as Chapter 9 does. \(^{53}\) Because states do not have owners and cannot be liquidated, the traditional confirmation rules are much more difficult to apply with a state than with a corporation. In particular, it is not clear how to impose a cramdown—that is, a nonconsensual reorganization—in the event that one or more classes of creditors vote against the debtor’s proposed plan. In another context, a co-author and I proposed a two step process to address this problem. \(^{54}\) Creditors would first vote on the extent of the haircut necessary—how much of the debtload needs to be reduced—to give the debtor a more manageable debtload. They then would vote on the debtor’s proposed treatment of each class of

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\(^{51}\) Interestingly, the stay seems less necessary for state bankruptcy than it would be for sovereign bankruptcy. Sovereigns often have assets outside their borders that can potentially be attached. States do not seem to have extraterritorial assets to the same extent.

\(^{52}\) Lawmakers could use a version of the “Hotchpot” rule that applies in some European countries as an alternative to full blown reachback rules. See, e.g., IMF, SDRM DESIGN, supra note 40, at 35-37 (explaining and adopting Hotchpot rule for proposed SDRM). Under the Hotchpot rule, the recipient of a preference is not required to give back the preferential payment, but the amount of the preference is offset against any claim the creditor has.

\(^{53}\) In large part. Chapter 9 incorporates specified subsections of § 1129(a) and (b) pursuant to 11 U.S.C. § 901(a).

\(^{54}\) Patrick Bolton & David A. Skeel, Jr., Inside the Black Box: How Should a Sovereign Bankruptcy Framework be Structured?, 53 EMORY L.J. 763 (2004). The two-step process is outlined in id. at 796-99.
creditors. If each class approved the proposed treatment, this plan would be confirmed. But if one or more classes voted no, the court would automatically the agreed upon haircut, starting with the lowest priority creditors. A voting framework like this would also make sense for a state bankruptcy framework.

Checks and Guillotine Provisions

Under the framework I have outlined, the state would negotiate with its creditors over the terms of a restructuring plan, which would be put to a creditor vote. The state could assume any valuable contracts, and terminate those that are not beneficial. The framework as described does not have any state-specific bells and whistles, but those could easily be added. Two possible approaches—one to ensure adjustments and other to limit them—will illustrate.

Start with the concern to ensure adjustments. One of the most sensitive issues for a financially distressed state is its collective bargaining agreements with its public employees. Renegotiating the state’s collective bargaining agreements may be particularly fraught, as it will usually be imperative to restructure the contracts yet state officials are loathe to simply cancel them.55 Congress could preempt the possibility of an impasse, and also limit the need for a court to decide whether the contracts can be terminated, by providing for automatic adjustments under specified conditions. If the state and its employees failed to reach agreement within six months, for instance, the provisions might automatically reduce wages and benefits by 20%. The automatic adjustment would serve as a guillotine in the event of an impasse.56

Congress also could limit the extent of restructuring by including a provision constraining the depth of permissible cuts. While such a provision sounds counterintuitive—why limit a restructuring?—its relevance became clear during the debates over state bankruptcy. One of the major objections was, as we have seen, a concern that enacting a bankruptcy framework would prompt a devastating bond market run. Although the concern seems overblown,57 it could be assuaged by conditioning any restructuring of the bond debt on a determination by the

55 If there were any doubt about frictions involved, the recent battles over collective bargaining agreements in Wisconsin, Ohio, New Jersey and elsewhere put these questions to rest.
57 See supra notes 13-14 and accompanying text.
bankruptcy court that the restructuring was not likely to have destructive spillover effects in the bond markets.

As I have described them, these examples automatically reduce the state’s collective bargaining obligations and limit the restructuring of its bond debt. But lawmakers could of course do precisely the opposite: they could hardwire automatic adjustments for bond debt into the bankruptcy law, and constraints on the restructuring of public employee contracts. In my view, neither version of these provisions is necessary. But they illustrate the flexibility of the framework I have outlined, and some of the ways it could be tailored to the particular issues raised by a financially troubled state.

Financing the Bankruptcy Process

Through its taxes and other revenues, even the most distressed state has significant sources of income. As a result, a state is appreciably less likely than an ordinary corporation to need fresh financing to fund the bankruptcy process. This is especially so if the state stops paying its debts during the bankruptcy process. Nevertheless, new financing will sometimes be essential, which raises the issue of how financing might be addressed in the bankruptcy framework.

The simplest approach would be to simply borrow the debtor-in-possession financing rules that already apply to corporations and municipalities. Under these rules, a debtor has a series of borrowing options, from borrowing on an unsecured basis, to borrowing that is given administrative expense priority in the case, to borrowing secured by a lien on assets of the debtor. Although loans in a state bankruptcy would likely look different than traditional debtor-in-possession loans—secured lending is more difficult with a state—the range of options is as appropriate for a state as for other debtors in bankruptcy.

This much is straightforward. Things get stickier, however, when we consider the question of who is likely to provide the financing. One likely candidate—perhaps the one likely candidate—is the federal government. Should the federal government be permitted to play this role? In another context, a co-author and I proposed a financing model that would rely more on

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58 11 U.S.C. § 364 (debtor-in-possession financing); § 903 (incorporating § 364(c)-(f) into Chapter 9).
private than public sector funding. In theory, it might be possible to limit federal government involvement by, for instance, permitting federal government funding only if private sector funding is not available. But even if such a restriction were plausible, it might simply push the rescue funding forward in time, inducing the state to refuse to file for bankruptcy until the federal government first agreed to provide pre-bankruptcy funding. If federal funding were permitted in bankruptcy, the federal government could credibly refuse to step in until the state filed for bankruptcy. The government also could impose restrictions on its disbursements, and the prospect of a bankruptcy restructuring would significantly reduce amount of funding needed as compared to a pure bailout. To be sure, there are risks to federal involvement, as reflected in the government’s handling of the Chrysler and GM cases, where it seemed to pick winners and losers. But the government could not realistically be excluded altogether from providing funds.

The Bankruptcy Court

State bankruptcy would put a great deal of pressure on the bankruptcy court, given the magnitude of the issues and the state’s status as a party in interest. The framework outlined in this chapter would remove much of the pressure by relying on negotiations between the state and its creditors to resolve most issues, enabling the court to serve more as umpire than as decision maker. But on some issues, such as a proposal by the state to terminate its collective bargaining agreements, the court would be the principal decision maker.

The bankruptcy of a state introduces another ticklish issue as well: where should the case be held? If a state were analogous to other debtors, the logical locale would be the state itself. But holding the case in the state would be awkward. The judge or judges would not be officials of the state itself; they would be federal judges. But a more neutral location would be preferable.

59 Bolton and I proposed that the IMF coordinate and approve bankruptcy funding, rather than serving as its sole source. Patrick Bolton & David A. Skeel, Jr., Redesigning the International Lender of Last Resort, 6 CHI. J. INT’L L. 177, 196-99 (2005).
60 This proposal is made for systemically important financial institutions in a white paper authored by Tom Jackson for a Hoover Institution working group. Resolution Project Subgroup of Working Group on Economic Policy, Hoover Institution, Bankruptcy Code Chapter 14: A Proposal (April, 2011), at 14 [hereinafter cited as Chapter 14 Proposal]. I am a member of the subgroup.
61 There is in fact precedent for federal involvement on something like these terms. During New York City’s financial crisis in 1975, Congress agreed (after President Ford initially refused) to make $1.5 billion in “seasonal loans” to New York, with each new installment conditioned on evidence of progress in New York’s restructuring. See, e.g., SEYMOUR P. LACHMAN & ROBERT POLNER, THE MAN WHO SAVED NEW YORK: HUGH CAREY AND THE GREAT FISCAL CRISIS OF 1975 at 164-65 (describing enactment of the rescue package).
Given the stakes and the distinctive posture of the case, state bankruptcy cases should not simply be funneled into the judicial framework that applies to other bankruptcy debtors. This would put enormous pressure on a single bankruptcy judge in the state itself. It would also mean vesting oversight in a non-Article III judge, which would limit the jurisdictional reach of the court in ways that might complicate the case.62

Under one possible approach for addressing these concerns, each Circuit Court would designate a small number of Article III district court judges who have bankruptcy expertise, and these judges would be included on a nation-wide panel of judges. If a state filed for bankruptcy, a three judge panel would be randomly selected to oversee the case. The logical venue for the case would be the District Court for the District of Columbia. This framework, which echoes other existing or proposed special courts in important respects,63 would distribute the pressure of the case across three shoulders rather than one; it would provide a logical venue; and it would give full Article III scope to the proceedings.

The most obvious concern is the distance of the court from many of the state’s creditors and other parties in interest. During a controversy over venue in the 1990s, critics of the corporate bankruptcy venue rules objected strongly to venue outside the debtor’s domicile on these grounds.64 The importance of geographical convenience was debatable, for the simple reason that the vast majority of small creditors do not participate in the case, and distance is not a problem for large creditors. But some small creditors might be more inclined to press an issue in a bankruptcy involving a state. The best solution to this concern is to make it as simple as possible to participate. The court could allow participation by video link in major hearings, for instance, and broadcast court sessions on CNN or the internet.

Conclusion

62 The jurisdictional limitations of the bankruptcy court were recently underscored by a major Supreme Court decision. Stern v. Marshall, __ U.S. __ (June 23, 2011).

63 The special court established by the Foreign Intelligence Surveillance Act of 1978 (FISA) is picked from a panel of district and circuit court judges appointed for seven year terms by the Chief Justice of the Supreme Court. The Chapter 14 proposal drafted by Tom Jackson for a Hoover Institution working group would assign systemically important financial institution bankruptcies to a judge (one of a group pre-selected by the Chief Justice of the Supreme Court based on financial institution expertise) in the Second or DC Circuit. Chapter 14 Proposal, supra note 60, at 6-7.

64 The debate centered on Delaware, which was the venue of choice for many of the largest corporate bankruptcy cases in the 1990s. A Federal Judicial Center report raised the inconvenience issue. Federal Judicial Center, Report to the Committee on the Administration of the Bankruptcy System, Chapter 11 Venue Choice by Large Public Companies (Jan. 9-10, 1997).
In this chapter, I have sought to make a case for state bankruptcy, to identify its core objectives, and then to construct a possible framework from the ground up. State bankruptcy would involve political decision makers, rather than simply private actors. As a result, it raises a number of issues that are not present, or are less ticklish, in ordinary bankruptcy cases. In answer to the questions of who should initiate the case and who should be given authority to propose a reorganization plan, I argued that these decisions should be made by the governor in consultation with state legislative leaders. The framework I outlined would include only a limited stay, would not have reachback rules, and would use a streamlined confirmation process. I also argued that the federal government should be permitted to help finance the process, and that a three-judge court should be assembled from a panel of district court judges in the event of a state bankruptcy filing.

There are of course other provisions that one might want to include. But the framework is likely to work best if it is as simple as possible, and is tightly focused on the core objectives outlined at the beginning of the chapter.

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65 I have not stopped to discuss the procedures for filing claims, for instance, but the framework obviously should provide for this.