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### Is Bankruptcy the Answer for Troubled Cities and States?

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# ADDRESS

## IS BANKRUPTCY THE ANSWER FOR TROUBLED CITIES AND STATES?

*David A. Skeel, Jr.\**

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## I. INTRODUCTION

The financial crisis that has afflicted America's cities and states for the past decade is far from over. A year ago, California acknowledged a current deficit of almost \$16 billion and the state may be several multiples of this in the red overall,<sup>1</sup> and Illinois recently hinted that it may look to the federal government to help bail out its underfunded pensions.<sup>2</sup> Many cities are in even direr condition, including Detroit,<sup>3</sup> Providence,<sup>4</sup> and San Diego;<sup>5</sup> Philadelphia may not be far behind.<sup>6</sup>

Under existing U.S. law, distressed municipalities can file for bankruptcy if their state permits this, as roughly half do. The states themselves do not have a bankruptcy option, however, no matter how bleak their circumstances may be. In late 2010, a brief debate erupted as to whether Congress should erect some kind of restructuring framework for financially distressed states. Although several prominent politicians threw their weight behind the idea,<sup>7</sup> and at least one senator reportedly began soliciting support for legislation,<sup>8</sup> the campaign quickly fizzled. Both Democrats and Republicans rejected the idea although for quite different reasons.

With the demise of congressional activity, attention has shifted to other venues. The most dramatic developments have come in the handling of municipal distress. According to

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1. Chris Megerian, *Deficit Could Climb, Analyst Reports*, L.A. TIMES, May 19, 2012, at AA1.

2. See, e.g., Editorial, *An Illinois Pension Bailout?*, WALL ST. J., Sept. 21, 2012, at A14 (criticizing suggestion by Illinois governor that he would seek federal guarantees of Illinois pension obligations).

3. Monica Davey, *State May Oversee Detroit's Finances*, N.Y. TIMES, Dec. 6, 2012, at A17 (noting that Detroit is "straining to manage its debts and meet its payroll").

4. Jess Bidgood & Abby Goodnough, *Mayor of Providence Seeks Urgent Steps in City's Financial Crisis*, N.Y. TIMES, Feb. 3, 2012, at A18 (describing Providence as "one player in the municipal crisis gripping the state").

5. Michael Cooper & Mary Williams Walsh, *Leading Way, 2 Cities Pass Pension Cuts*, N.Y. TIMES, June 7, 2012, at A1 (stating that San Diego has "struggled to pay for basic services").

6. Jon Hurdle, *An Ailing School System Sees a Fraught Path to Solvency*, N.Y. TIMES, Dec. 31, 2012, at A10 (reporting that "deep financial problems" have led Philadelphia to consider closing "roughly one out of six public schools").

7. See, e.g., Jeb Bush & Newt Gingrich, Op-Ed., *Better Off Bankrupt*, L.A. TIMES, Jan. 27, 2011, at A19; *Pawlenty: Consider Letting States Have Bankruptcy*, CBS MINN. (Jan. 24, 2011, 8:44 PM), <http://minnesota.cbslocal.com/2011/01/24/pawlenty-consider-letting-states-have-bankruptcy/>.

8. See *House GOP Leader Says No to Federal Bailout of States*, BISMARCK TRIB., Jan. 25, 2011, at 5A ("Kate Dickens, spokesman for Sen. Mark Kirk, R-Ill., said Kirk believes Congress should give states the power to declare bankruptcy and avoid default and is talking to other lawmakers about potential legislation.").

conventional wisdom, Chapter 9, which governs municipal bankruptcy, might be adequate for sewer and water districts or a very small town, but it is irrelevant for real cities and municipalities.<sup>9</sup> A flurry of Chapter 9 filings are now calling this seemingly settled wisdom into question. Jefferson County, Alabama (home of Birmingham) and Stockton and San Bernardino, California have all filed for bankruptcy, and Harrisburg, Pennsylvania has tried.

During this same period, several states have enacted or amended their laws to give the state greater control over the finances of troubled municipalities. In Michigan, sweeping amendments to the state's municipal distress statute now authorize, among other things, the appointment of an emergency manager who can terminate or restructure contracts with the municipality's employees.<sup>10</sup> Emergency managers have already been appointed for several small cities,<sup>11</sup> and Detroit is negotiating with the state over the handling of its longstanding financial distress.<sup>12</sup>

Several other recent developments that might initially seem unrelated may also have important implications for municipal and state distress. The first is *National Federation of Independent Business v. Sebelius*, the Supreme Court's decision upholding the 2010 healthcare legislation.<sup>13</sup> Although much of the excitement surrounding the decision has centered on the Court's validation of the individual mandate, which requires citizens to obtain health insurance or pay a penalty, the Court partially struck down a set of provisions that expand Medicaid.<sup>14</sup> These provisions had authorized the Secretary of Health and Human Services to cut off some or all of the federal contribution to state Medicaid funding if a state declines to expand access to

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9. See, e.g., ROBIN JEWELER, CONG. RESEARCH SERV., RL33924, MUNICIPAL REORGANIZATION: CHAPTER 9 OF THE U.S. BANKRUPTCY CODE 1-2 (2007) (noting that the vast majority of Chapter 9 reorganizations are by small districts); Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 360-61 (2010) (describing Chapter 9 as "used by tiny municipalities under peculiar circumstances").

10. *Michigan: Legislators Pass Law on Emergency Manager Powers*, N.Y. TIMES, Dec. 14, 2012, at A24. After initially being enacted in 2011, the emergency manager provisions were repealed by voters in 2012 but similar provisions were enacted less than two months later.

11. Steven Yaccino, *Michigan Voters Repeal a Financial Law*, N.Y. TIMES, Nov. 8, 2012, at A13.

12. See *id.*

13. Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2608 (2012).

14. *Id.*

Medicaid.<sup>15</sup> The Court called the threat to withhold existing funds an impermissible coercion of the states, thus reinvigorating its jurisprudence on federal “commandeering” of the states and raising important questions about the limits of federal intervention in state and municipal financial distress.<sup>16</sup>

Although the recent crisis in Europe does not directly affect the options for addressing state and municipal distress in the United States, it has important similarities. The European Union’s handling of the travails of Greece, Ireland, Portugal, Spain, and Italy, and recent proposals to move toward “fiscal union” or to enact a restructuring framework, raise questions about the internal dynamics of a federalist framework that also are highly relevant for the U.S. situation.

In this Essay, I propose to take stock of each of these developments, focusing in particular on the lessons they offer about the role of formal restructuring rules in a federal system. I begin, in Part I, by asking why not put a state bankruptcy framework in place and using this question to briefly respond to a handful of the most cogent objections to state bankruptcy.<sup>17</sup> Part II examines the recent municipal filings and Michigan’s expansion of its municipal control provisions, arguing that these developments have significantly expanded the choice set for dealing with municipal distress. Although underfunded pensions are a major reason for many states’ financial distress, Part III argues that Congress cannot realistically intervene in that context without intervening more broadly. Part IV considers the possibility that the Supreme Court’s decision in *National Federation of Independent Business* has increased the likelihood that a state bankruptcy law would be found to interfere with state sovereignty. Part V explores the implications of the crisis in Europe.

## II. WHY NOT A BANKRUPTCY FRAMEWORK FOR STATES?

Two years after the debate first flared, the question whether Congress should enact a bankruptcy law for states is no longer

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15. *Id.*

16. *Id.* at 2602, 2606–08.

17. Because I have argued for state bankruptcy in considerable detail elsewhere, see David A. Skeel, Jr., *State Bankruptcy from the Ground Up*, in WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 191 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012); David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 697–99 (2012) [hereinafter Skeel, *States of Bankruptcy*], I focus in this Essay on concerns that others have raised about the proposal and the implications of a series of key recent developments. The basic case is set forth in the earlier articles.

novel. Most observers know that cities can file for bankruptcy and some know that bankruptcy is sometimes suggested as a solution to the financial distress of countries such as Argentina or Greece.<sup>18</sup> This same period has seen the enactment of a vast new resolution framework for global financial institutions like Citigroup and JPMorgan Chase that are themselves nearly as large as some sovereign economies.<sup>19</sup>

Against this backdrop, it seems appropriate to reverse the usual question. Rather than asking why (or whether) Congress should use its bankruptcy powers to put a resolution framework in place for states, I propose to start with the opposite question: why not enact a state bankruptcy framework? In answering five of the key responses, I attempt not only to address some of the strongest critiques of the state bankruptcy proposal, but also to begin sketching out a few basic principles for thinking about when formal resolution rules are or are not likely to be desirable for addressing the financial distress of sovereign and quasi-sovereign entities.

#### A. *Bond Contagion*

“By all accounts,” according to a widely circulated defense of the status quo, “the most troubling aspect of the conversation surrounding state bankruptcy legislation has been its potential to disrupt the municipal bond market.”<sup>20</sup> The executive director of the National Governors Association insisted to the Senate Budget Committee that “no governor or state is requesting this [bankruptcy] authority” and warned that the enactment of bankruptcy legislation would “likely increase interest rates, raise the cost of state government and create more volatility in financial markets.”<sup>21</sup> An Illinois legislator warned that a state

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18. In 2002, during the most recent financial crisis in Argentina, Anne Krueger, the First Deputy Managing Director of the International Monetary Fund, called for a formal sovereign restructuring framework that became known as the Sovereign Debt Restructuring Mechanism. Anne Krueger, *New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking*, Speech Before Institute for International Economics at the Conference on “Sovereign Debt Workouts: Hopes and Hazards” (Apr. 1, 2002), available at <http://www.imf.org/external/np/speeches/2002/040102.htm>; see also Steven L. Schwarcz, *Sovereign Debt Restructuring Options: An Analytical Comparison*, 2 HARV. BUS. L. REV. 95, 100 (2012).

19. Title II of the Dodd–Frank Act authorizes bank regulators to intervene and restructure financial institutions that fall into financial distress if their default could cause systemic damage. 12 U.S.C. §§ 5382(a)(1)(A)(iv), 5383(b) (Supp. V 2006).

20. Barrie Tabin Berger, *Telling the Truth About State and Local Finance*, GOV. FIN. REV., Apr. 2011, at 79, 80.

21. *Id.* (alteration in original) (quoting testimony of Raymond Scheppach) (internal quotation marks omitted).

bankruptcy would “so roil financial markets that it would be very destructive to our country’s economy. . . . It would so shake confidence in public investment, it would make it harder for any state to sell bonds.”<sup>22</sup> The fear that state bankruptcy would trigger crippling bond market contagion has been one of the most widely credited arguments against state bankruptcy.<sup>23</sup>

The first thing to note is that no one claims that the enactment of a state bankruptcy law, or even an actual bankruptcy filing by a state, would bring systemically important banks or other holders of state bonds crashing down.<sup>24</sup> Think back to the 2008 crisis. When giant financial institutions like AIG and Citigroup were tottering, regulators feared that a default could cripple their creditors—that AIG’s failure would destabilize Goldman Sachs, for instance, because AIG’s obligations to Goldman were so great. This effect, which is sometimes called “counterparty contagion,”<sup>25</sup> is not present in the state context because systemically fragile institutions are not the major holders of state bonds. The principal holders are mutual funds and wealthy individuals who are residents of the particular state.<sup>26</sup>

Rather than the collapse of a state’s creditors, contagionists focus on the implications of bankruptcy for other states’ access to the bond markets.<sup>27</sup> According to this argument, a bankruptcy filing by one state would cause rates to rise for other states through a fear that the same could happen there. But if bond markets are capable of distinguishing between fiscally troubled states and their more stable peers, the claim that state bankruptcy legislation would torpedo the bond markets seems far-fetched. Before the New York City crisis of the mid-1970s, there was indeed evidence the municipal bond markets were so

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22. Matt Miller, *The World Wonders: Can States Go Bankrupt?*, DEAL MAG., Feb. 18, 2001, at 30, 34 (quoting Illinois House majority leader Barbara Flynn Currie).

23. See Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt*, 121 YALE L.J. 888, 918 (2012) (noting that fear of bond market contagion is “used to justify extraordinary transfers, or bailouts, at the international level”).

24. As discussed below, the financial distress of the U.S. states stands in striking contrast to the European crisis in this regard. In Europe, concerns about the effect of a restructuring on systemically important banks have been a major factor in the crisis response. See *infra* Part VI.

25. See, e.g., Jean Helwege, *Financial Firm Bankruptcy and Systemic Risk*, REGULATION, Summer 2009, at 24, 24.

26. See, e.g., DIV. OF MKT. REGULATION, U.S. SEC. & EXCH. COMM’N, STAFF REPORT ON THE MUNICIPAL SECURITIES MARKET 12–13 (2012), available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf> (observing that individuals and mutual funds are the largest investors in municipal bonds); Skeel, *States of Bankruptcy*, *supra* note 17, at 725.

27. See Skeel, *States of Bankruptcy*, *supra* note 17, at 683–84, 717.

opaque that trouble in a major municipality could have nationwide effects.<sup>28</sup> State and municipal bond markets are still less transparent than one might like, but they appear to distinguish fairly effectively between troubled and less troubled states. Bond yields in California and Illinois have been consistently higher than the yields in less profligate states like Iowa or North Carolina, a trend very much in evidence today.<sup>29</sup>

It is possible that the enactment of state bankruptcy would slightly increase the cost of bonds even in well-run states, either because the bankruptcy option reduced the likelihood of federal bailouts or because, by making restructuring easier, this option increased the likelihood that any given state would fail to pay its obligations in full. The first possibility is grounds more for applause than concern because it suggests that bond prices currently are distorted by the prospect of a federal bailout. The possibility that bond costs might increase because bankruptcy would increase, at least a little, the overall likelihood of a failure to pay in full (even in well run states) is more problematic, but also less likely. Although the risk of nonpayment may rise slightly, the existence of an orderly restructuring mechanism can make bondholders better rather than worse off under some circumstances.<sup>30</sup> Moreover, even if bankruptcy did not increase the value of all bonds, it might increase the value of bonds in well-run states because they are less likely to default and do not benefit from any bailout subsidy. It is hard to know what the net effect of these forces would be. But it is very unlikely that simply enacting a state bankruptcy law would dramatically alter bond prices. Perhaps the best evidence for the law's potential effect is municipal bankruptcy law, which did not at its origin and has not subsequently caused crippling increases in municipal bond costs.

### *B. Singling Out Public Union Employees*

A second answer to the “why not bankruptcy” question is that state bankruptcy seems designed to cripple public employee

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28. See David L. Hoffland, *The “New York City Effect” in the Municipal Bond Market*, FIN. ANALYSTS J., Mar./Apr. 1977, at 36, 36–37.

29. The spread above a triple A benchmark municipal bond was 18 basis points for Iowa and 2 for North Carolina in summer 2012, as compared to 66 for California and 157 for Illinois. Andrew Bary, *State of the States*, BARRON'S, Aug. 27, 2012, at 23, 24.

30. The classic study is Randall Kroszner's analysis of the New Deal era Gold Clause cases. Randall S. Kroszner, *Is It Better to Forgive than to Receive? Repudiation of the Gold Indexation Clause in Long-Term Debt During the Great Depression* (Oct. 1998) (unpublished manuscript), available at <http://faculty.chicagobooth.edu/finance/papers/repudiation11.pdf>.

unions.<sup>31</sup> Proponents of state bankruptcy have fueled this thinking. Jeb Bush and Newt Gingrich speculated that state bankruptcy would prompt a proposition fight over public employee unions in California. The proposition they had in mind “would trigger the cancellation of all state government employee union contracts. Even if the proposition were defeated,” they wrote, “the debate surrounding it would make abundantly clear to the people of California and the rest of the country just how much of a stranglehold government employee unions have on state and federal budgets.”<sup>32</sup>

If state bankruptcy were enacted and a state did in fact file, public employee compensation and pensions almost certainly would be subject to restructuring, as critics fear. The bankruptcy of a state would resemble the bankruptcy of an airline or car company in this regard. In both contexts, the need to address labor costs is central. While states have considerable leeway to rework collective bargaining obligations even without bankruptcy, as controversial reforms in Wisconsin and somewhat less controversial reforms in New York and Connecticut have shown, bankruptcy would enhance a state’s restructuring options, especially with respect to pensions, as we shall see.

Although public employee contracts almost certainly would be subject to restructuring, state bankruptcy proponents’ glee in pointing this out and the predictable outrage of opponents have obscured a surprising benefit of bankruptcy: the sacrifice would almost certainly be distributed more fairly and broadly in bankruptcy, not less. In the absence of bankruptcy, budget cutting sacrifice has been borne almost entirely by two constituencies: public employees and the recipients of public services.<sup>33</sup> Bankruptcy’s “equality of creditors” norm, which requires that

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31. Relatedly, some criticize bankruptcy as making a political choice in favor of spending cuts, and against tax increases, as a solution to states’ financial distress. See Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. 1399, 1450 (2012) (“[A] state bankruptcy regime would be used as a partisan political device to balance state budgets through cuts to employees’ compensation, services, and benefits, and through service cuts, but not through tax increases.”). But a bankruptcy judge can refuse to confirm a reorganization plan that eschews tax increases if the plan does not adequately address a debtor’s financial distress. In the municipal bankruptcy context, Clay Gillette has argued that bankruptcy judges should be given the authority to directly impose tax increases. See Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 295 (2012).

32. Bush & Gingrich, *supra* note 7.

33. See Nicholas Johnson, Phil Oliff & Erica Williams, *An Update on State Budget Cuts*, CTR. ON BUDGET & POLICY PRIORITIES, 1–4 (Feb. 9, 2011), <http://www.cbpp.org/files/3-13-08sfp.pdf> (discussing the impact of state budget cuts on families receiving public services and their cumulative effect upon public employees).

similarly situated creditors receive generally similar treatment,<sup>34</sup> would make it much more likely that other constituencies would share the burden. In the recent Vallejo bankruptcy, for instance, the court held that the city could restructure its collective bargaining agreement but only if other constituencies also were contributing to the restructuring. “While this Court recognizes that contract rejection may have a significant adverse effect on [union] employees,” the district court said in upholding the bankruptcy court’s determination, the complaining union “is not being singled out and all constituencies have or will suffer severe cuts in Vallejo.”<sup>35</sup>

Bankruptcy does not assure that the distribution of sacrifice will be perfectly equal, but equality is a core principle.<sup>36</sup> If we scratch behind one of the principal objections to bankruptcy, we find a surprising benefit instead.

### C. *Bankruptcy Can’t Solve Political Problems*

Although the first two responses to the “why not bankruptcy” question have dominated public discussion, and each is backed by a powerful political constituency, they are quite unpersuasive on inspection. The remaining three responses have not received as much attention but are more compelling.

Perhaps the most important response is that states’ problems are more political than fiscal, and bankruptcy is poorly designed to solve political problems. “The U.S. fiscal federalism arrangement means that economic downturns place

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34. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain*, 91 YALE L.J. 857, 859–68 (1982) (noting that similarly situated creditors are typically treated as equivalently as possible).

35. Int’l Bhd. of Elec. Workers, Local 2376 v. City of Vallejo (*In re City of Vallejo*), 432 B.R. 262, 275 (E.D. Cal. 2010).

36. In his commentary on this Essay, Professor Gillette notes that Rhode Island passed legislation purporting to give bondholders a lien on tax revenues shortly before Central Falls filed for Chapter 9 bankruptcy. Clayton P. Gillette, *Bankruptcy and Its By-Products: A Comment on Skeel*, 50 HOUS. L. REV. 1127, 1137–38 (2013). The legislation does illustrate the possibility that favored creditors will be protected. But it is not altogether clear that the lien would be enforced by a court, as it is quite unusual in form and might be invalidated as an artificial lien under 11 U.S.C. § 545. In her commentary, Professor Gelpert raises a similar issue. She asks whether the omission from Chapter 9 of Chapter 11’s special protections for labor contracts and pensions should “be read as a sign of bankruptcy’s ‘capture’ by capital at the expense of labor” and concludes that both bankruptcy and informal restructuring processes may be subject to capture. Anna Gelpert, *A Skeptic’s Case for Sovereign Bankruptcy*, 50 HOUS. L. REV. 1095, 1115–16 (2013). Although I agree that there is a possibility of capture in both contexts, I suspect that the omission of Chapter 11’s protections was an accident rather than a calculated decision, and sacrifice seems to me to be much more broadly distributed in the bankruptcy context than with more piecemeal approaches in the absence of bankruptcy.

unusual financial strains on the states,” according to one critic of state bankruptcy, “which may be exacerbated by political agency problems—elected official[s] pursuing private benefits, including reelection, rather than the public interest.”<sup>37</sup> “Rather than addressing the causes of state budget crises,” he contends, “proposals for state bankruptcy dangle the false hope of fiscal solutions to political crises.”<sup>38</sup> As a result, state bankruptcy law might invite serial bankruptcy filings without addressing a state’s real problems.<sup>39</sup>

There clearly is an element of truth to this concern. However broad the bankruptcy powers may be, the capacity of Congress or a bankruptcy judge to restructure a state’s governmental operations is limited. Bankruptcy cannot displace state officials or dictate state governmental policy. But this does not mean that bankruptcy would have no effect. Even if the bankruptcy process cannot solve a political crisis, the enactment of a state bankruptcy law could help counteract several key structural problems in state finance.

One obvious political dysfunction is the tendency to over-rely on borrowed funds. Borrowing enables politicians to spend the money in the short term—often on a popular project—while deferring the costs to the future. If bankruptcy increases the likelihood that a state will restructure its obligations and decreases the likelihood of a federal bailout in the event of severe financial distress, as I believe it would, it could counteract politicians’ short-term incentives on the margin. Debt financing would be marginally more costly, which would discourage its use, particularly as a state’s fortunes declined.<sup>40</sup>

The effect on perverse pension politics could be even more powerful. A major reason for states’ enormous unfunded

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37. Adam J. Levitin, *Fiscal Federalism and the Limits of Bankruptcy*, in *WHEN STATES GO BROKE*, *supra* note 17, at 214, 214. This is Levitin’s principal critique of state bankruptcy.

38. *Id.* at 216.

39. A related political objection suggests that the same political stalemates that prevent states from solving their problems outside of bankruptcy could interfere with a bankruptcy solution. See Richard M. Hynes, *State Default and Synthetic Bankruptcy*, 87 WASH. L. REV. 657, 698 (2012). This is in some respects a more compelling objection, but it too does not warrant forgoing bankruptcy. Three reasons: bankruptcy can itself alter the political dynamic (it may be harder to resist change after a state has filed for bankruptcy than before, for instance); bankruptcy offers tools that are not available outside of bankruptcy; and the possibility that bankruptcy might not always solve the state’s problems is not a good reason to forgo bankruptcy.

40. It is possible that states would simply continue to borrow, despite the added cost of debt, and thus that the increased cost could increase a state’s debtload overall. But it seems more likely that the cost would chill borrowing. Indeed, a profligate state might find it hard to borrow at acceptable prices.

pensions is that the pensions are negotiated by state officials, who are themselves often dependent on the votes of the same employees whose pensions they are negotiating.<sup>41</sup> As a result, state officials are much less likely to drive a hard bargain than private employers. In addition, because the funding rules that ERISA imposes on private pensions do not apply to state governments, pension promises can be made today but do not have to be paid for until later. Unless taxpayers are unusually vigilant, this dynamic often leads to excessively generous pension promises.<sup>42</sup>

Still another factor further magnifies the problem: balanced-budget requirements. All but one state impose some form of requirement that state lawmakers balance the budget each year.<sup>43</sup> Underfunded pensions do not count in the budget calculations, which puts great pressure on state politicians to cheat on their pension contributions.<sup>44</sup> At the same time as New Jersey Governor Chris Christie pursued cuts in public employee salaries and benefits, for instance, he deferred making contributions to their pensions.<sup>45</sup>

Outside of bankruptcy, states have very little flexibility to restructure the pension promises they have made to existing and retired employees, no matter how unrealistic those promises might be. In a state bankruptcy regime, by contrast, unrealistic pensions that are not fully funded probably could

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41. See Jeffrey B. Ellman & Daniel J. Merrett, *Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?*, 27 EMORY BANKR. DEV. J. 365, 372–76 (2011) (discussing public pension plans and funding methods); see also Daniel DiSalvo, *The Trouble with Public Sector Unions*, NAT'L AFF., Fall 2010, at 3, 4, 10 (discussing the “hundreds of billions of dollars in unfunded pension liabilities . . . weighing down state and city budgets” and addressing the political clout union members have over legislative negotiations).

42. See, e.g., DiSalvo, *supra* note 41, at 17 (noting that public-sector unions can influence “public policy in directions that neither elected officials nor voters desire”); Willie Brown, *Homeland Security Chief Takes Responsibility*, SFGATE (Jan. 3, 2010, 4:00 AM), <http://www.sfgate.com/bayarea/williesworld/article/Homeland-security-chief-takes-responsibility-3276937.php> (“[W]e politicians, pushed by our friends in labor, gradually expanded pay and benefits to private-sector levels while keeping the job protections and layering on incredibly generous retirement packages that pay ex-workers almost as much as current workers.”).

43. For an overview of state balanced-budget requirements, see NAT'L CONFERENCE OF STATE LEGISLATURES, NCSL FISCAL BRIEF: STATE BALANCED BUDGET PROVISIONS 2 (2010), available at <http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf>.

44. See Joshua Rauh, *The Pension Bomb*, MILKEN INST. REV., First Quarter 2011, at 26, 28 (discussing how government accounting procedures “allow pension plan managers to claim that a pension is fully funded as long as the expected returns on the assets in the pension fund’s portfolio would be adequate to meet the pension obligations”).

45. Lisa Fleisher, *N.J. Deal Could Save Billions*, WALL ST. J., June 17, 2011, at A19.

be restructured. Bankruptcy would protect an employee's pension to the extent of the funding set aside for it, just as it protects an ordinary secured creditor's collateral, but the underfunded portion of a pension would be subject to restructuring.<sup>46</sup>

The implications of this possibility for the perverse politics of state pensions should be obvious. Even if it is unlikely that a state would file for bankruptcy, the representatives of public employees would have far more reason to care not just about the size of the pensions, but also about their funding. Similarly, a decision to defer pension contributions would be seen for what it is—as potentially jeopardizing the pensions. Once again, the enactment of a state bankruptcy framework would not solve the distortions in state politics, but it would provide a welcome countervailing force.

As surprising as this may sound, state bankruptcy would be quite similar to personal bankruptcy in this regard. Like states, consumer debtors tend to overemphasize the short-term benefits of borrowing and to underestimate the long-term costs. Bankruptcy cannot fix these problems; unlike with a corporation, whose managers can be ousted, a bankruptcy judge cannot force a consumer to make better decisions. But it can help them to restructure debt if it becomes completely unsustainable and give the debtor's creditors an incentive to monitor her decisionmaking.

Because bankruptcy cannot by itself transform state political dysfunction, some critics worry that a profligate state might repeatedly file for bankruptcy if that option were available, embarking on a cycle of excessive borrowing followed by bankruptcy.<sup>47</sup> Once again, consumer bankruptcy provides a useful analogy. To discourage consumers from abusing bankruptcy, current bankruptcy law prohibits them from taking advantage of the bankruptcy discharge for eight years after a prior discharge.<sup>48</sup> Although serial filing by states seems unlikely, putting a waiting period in place, as with consumer bankruptcy, would be a far better response to these concerns than forgoing the benefits of state bankruptcy.

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46. Skeel, *States of Bankruptcy*, *supra* note 17, at 697–99.

47. Levitin, *supra* note 31, at 1446 (“Nothing prevents states from being serial bankruptcy filers . . .”).

48. 11 U.S.C. § 727(a)(8) (2006). The time periods are shorter if the debtor files for Chapter 13, which requires a three-to-five year repayment plan, than in Chapter 7, which gives the debtor an immediate discharge. *See* 11 U.S.C. § 1328(f) (2006).

*D. A State's Capital Structure Is a Small Fraction of its Obligations*

A fourth response is that a state's capital structure is only a small portion of the life of the state.<sup>49</sup> Even the most heavily indebted states devote only a small portion of their income to serving their bond obligations: Illinois devotes about 9.6% of its revenues to debt service and California devotes 5.3%.<sup>50</sup> The contrast to an ordinary corporate debtor (or to Greece or Italy), which is likely to use much more of its income to service debt and other obligations, is quite striking. In addition, many of a state's expenditures could not realistically be adjusted in bankruptcy, such as a state's Medicaid obligations. And large numbers of a state's stakeholders are not creditors; they have nonfinancial interests at stake.<sup>51</sup> Perhaps bankruptcy is a poor fit for a struggling state.

This objection seems to me to make the same category mistake as the previous response: it assumes that a formal resolution mechanism would be ill advised unless state bankruptcy looks like corporate bankruptcy. But personal bankruptcy provides a more revealing comparison. Like states, and unlike corporations, ordinary consumers have a wide range of nonfinancial interests. Creditors are only one of many groups of "stakeholders" in their lives. Most consumers devote the vast majority of their earnings to activities that have no discernible profit-making motive. Yet few would question the value of having bankruptcy laws in place for financially troubled consumers.

Consumer bankruptcy law is based on the conclusion that providing relief from an overwhelming debt burden is in the best interest not just of the consumer, but of her creditors as well. Excessive debt can discourage the consumer from taking steps to address her financial travails and interfere with her pursuit of potential solutions. A similar logic applies to states. A state has more options for addressing its financial woes than a consumer. It can cut back on services and other expenses and has a wide range of taxing options. But if there is even a small possibility that a state may be overwhelmed by debt, the case for having a

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49. See, e.g., Gelpert, *supra* note 23, at 907 ("[C]ontracts in general and debt contracts in particular define only a sliver of any state's constituents . . .").

50. STATE OF ILL. COMPTROLLER, BONDED INDEBTEDNESS AND LONG TERM OBLIGATIONS 8, 13 (2011), available at <http://www.ioc.state.il.us/index.cfm/linkservid/66F97DE1-1CC1-DE6E-2F48D999108D050C/showMeta/0/> (reporting debt service payments of \$3.26 billion and general fund revenue of \$33.8 billion); Hynes, *supra* note 39, at 658 n.3.

51. Gelpert, *supra* note 23, at 907.

formal restructuring mechanism in place is strong. Moreover, much as a consumer's financial distress may impose costs on third parties such as relatives and friends, a state's excessive debt imposes costs on future taxpayers.<sup>52</sup>

In the current environment, many states' balance sheets dramatically understate the extent of their liabilities. Although bond debt is relatively small as a percentage of state GDP, many states' obligations to public employees are considerable, and they have vast unfunded pension liabilities.<sup>53</sup> The problem, as Paul Volcker and Richard Ravitch put it in a recent report, is not simply cyclical; it is structural.<sup>54</sup> It may be that any potential crisis is still a few years off, given that states currently are capable of paying their pension obligations. But it would be a mistake to assume that there is no need to have a restructuring framework in place.

#### *E. The Strategic Dimensions of Fiscal Federalism*

A final pair of responses points to the relationship between the federal government and the states as a basis for eschewing a formal restructuring mechanism. According to the first, states might use the bankruptcy option strategically, as a way to extract a bailout with few strings attached from the federal government.<sup>55</sup> The second argues that state and federal finances are so closely intertwined that federal bailouts are inevitable.<sup>56</sup> While the first is a legitimate concern, the logic of the second strikes me as backwards.<sup>57</sup>

The concern that states might use the prospect of bankruptcy to negotiate a few-strings-attached bailout begins

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52. See, e.g., THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 243–44 (1986) (discussing externalities as a justification for bankruptcy discharge for consumer debtors).

53. See RICHARD RAVITCH ET AL., *REPORT OF THE STATE BUDGET CRISIS TASK FORCE* 2, 3 (2012) (“Unfunded liabilities for health care benefits for state and local government retirees amount to more than \$1 trillion.”).

54. *Id.* at 4.

55. See Gillette, *supra* note 31, at 285–86, 320–22.

56. See Richard C. Schragger, *Democracy and Debt*, 121 *YALE L.J.* 860, 863–65, 877–78 (2012).

57. In his commentary on this Essay, Professor Gillette introduces another set of strategic considerations, arguing that the states might respond to the existence of a state bankruptcy framework by relying more heavily on secured obligations such as revenue bonds. Gillette, *supra* note 36, at 1137. Professor Gillette's emphasis on this and other possible ex ante effects throughout his commentary strikes me as quite important, but states already have a strong incentive to use similar strategies to evade balanced budget requirements. As a result, it seems unlikely that state bankruptcy would prompt a significant shift in state financing techniques. And even if it did, it is not clear the shift would be pernicious.

with a counterintuitive but plausible assumption: because state bankruptcy cannot interfere with the state's governmental functions, state officials might prefer bankruptcy as compared to a federal bailout under some circumstances—in particular, if the bailout came with tough strings attached. If the federal government tries to attach tough conditions to a bailout, the state can threaten to file for bankruptcy. From the federal government's perspective, this threat might have little bite if only the state itself would feel the effects of its bankruptcy. But if the federal government is concerned about potential spillover effects—that California's bankruptcy filing could jolt the markets nationwide—state officials may have the upper hand in a game of chicken with the federal government. Under these circumstances, the state could credibly threaten to file for bankruptcy unless the federal government offered a bailout on attractive terms. The existence of a state bankruptcy option could thus lead to a weaker bailout—that is, a bailout that did not require the state to make serious fiscal reforms—than the federal government could achieve if there were no bankruptcy alternative lurking in the background.

The best evidence for this line of reasoning comes from the municipal bankruptcy context. Nearly half of the states do not authorize their cities to file for bankruptcy, and states that do authorize bankruptcy have sometimes tried to discourage a municipality from filing or have imposed significant preconditions. The state of Alabama discouraged Jefferson County's recent bankruptcy filing, for instance.<sup>58</sup> Michigan does not permit a municipality to file for bankruptcy until after the state has first intervened and appointed an emergency manager, a process Detroit is facing now.<sup>59</sup> These states' reluctance to allow bankruptcy filings, and willingness in some cases to provide financial support if a municipality foregoes bankruptcy, seems to suggest that the existence of a bankruptcy option gives municipalities leverage against the state.

Although strategic considerations like these may sometimes come into play, in my view they do not call state bankruptcy into serious question. Although a significant number of states forbid their municipalities from filing for bankruptcy, many others do not. California, the site of a growing number of important filings, places only minor limits on municipalities' right to file and did

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58. See Mary Williams Walsh & Campbell Robertson, *Just Before Deadline, County in Alabama Delays Bankruptcy Move*, N.Y. TIMES, July 29, 2011, at B1.

59. See Michelle Wilde Anderson, *Democratic Dissolution: Radical Experimentation in State Takeovers of Local Governments*, 39 FORDHAM URB. L.J. 577, 586–89 (2012).

not offer sweetheart bailouts to dissuade Stockton or San Bernardino from filing. Clearly, the existence of a bankruptcy option does not always give municipalities the strategic upper hand.

Moreover, the absence of a state bankruptcy option does not prevent states from playing chicken with the federal government. The state can threaten simply to default on its obligations unless the federal government agrees to provide rescue funding. A state's threat is more credible than a similar threat by a municipality to its state because the federal government has considerably less control over states than the states do over their municipalities. The federal government could not threaten to dissolve a state or give a federal official control over the state's contracts and budget, as states have done with their municipalities. Because states are not creatures of the federal government, as cities are of their state, the federal government would have fewer options if a state carried through on its threat to default.

Finally, if a state needed short-term funding or loan guarantees to finance its restructuring process, this funding might well need to come from the federal government.<sup>60</sup> The government could attach strings to this funding, much as so-called DIP financiers do in ordinary cases and the International Monetary Fund does as a condition of its lending. The potential need for funding would strengthen the federal government's hand in any negotiations with the state, weakening the state's threat to file for bankruptcy unless it received a few-strings-attached bailout. Overall, a bankruptcy option seems likely to significantly reduce the pressure for a massive federal bailout in the event of dire financial distress.

The other federalism-based response concedes that a bankruptcy option would diminish the likelihood of a federal rescue but questions the wisdom of discouraging bailouts. "Intergovernmental transfers and direct federal outlays to state and local governments and to state and local residents are the norm in our federalism," as one commentator puts it. "Those transfers are so significant as to make the worry about a one-time bailout seem odd."<sup>61</sup> To the extent this reasoning suggests that the greater the fiscal interdependence of federal and state governments, the less need to worry about the states' access to

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60. Given states' access to tax and other revenues, they might not need additional financing in a state bankruptcy, and if they did need financing, it would likely be substantially less than the cost of a bailout.

61. Schragger, *supra* note 56, at 877.

bailouts, it seems to have the logic backwards. Closer fiscal ties imply a greater need to worry about bailouts and to impose clear constraints on federal funding, at least as American fiscal federalism has historically been configured.

To appreciate this point, it is useful to distinguish between hierarchical and market approaches to federalism. In a hierarchical system, the higher-level government directly and pervasively controls the expenditures of the lower-level governments, whereas lower-level governments have more independence in a market-based system.<sup>62</sup> The worst possible federalism strategy is one that does not rely either on markets or hierarchy to constrain fiscal decisionmaking at the subnational level. If the national government is ultimately responsible for most or all services, the government's insistence that it will not step in with a bailout if a negative shock occurs is not credible. Unless the national government closely controls state level borrowing—that is, unless it adopts a hierarchical approach—it is asking for trouble. If they and their creditors know that the higher-level government will be compelled to provide rescue financing in a crisis, states will have an incentive to over-borrow. If states retain substantial independence, on the other hand, under a more market-based approach, the national government can more credibly commit to stand on the sidelines if the state experiences fiscal distress. Markets provide the discipline that comes from strict rules in a hierarchical approach.

Historically, the United States has relied on the market model, in which the federal government commits not to bail out troubled states. The assumption by the federal government of a larger role in American life and the intertwining of federal and state finance, however, has put increasing strain on this approach. If the states were to conclude from this that Congress has no choice but to bail them out if they threaten to collapse, the results could be disastrous, as it was in Argentina and Brazil in the late 1980s and early 1990s.<sup>63</sup>

In theory, the United States could head off these concerns by moving to a more hierarchical approach in which Congress put constraints on state borrowing, while conceding that it would bail out the states if their finances were amiss. But this would

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62. Here and in the discussion that follows, I draw on important recent work by Jonathan Rodden. See, e.g., Jonathan Rodden, *Market Discipline and U.S. Federalism*, in *WHEN STATES GO BROKE*, *supra* note 17, at 123, 129.

63. "The central government could not prevent [the provinces in Argentina and the states in Brazil] from continuing to undertake new borrowing and debt rollovers in the face of very precarious fiscal positions while explicitly waiting for federal bailouts." *Id.* at 129.

require a radical shift from traditional U.S. conceptions of state sovereignty and would face major constitutional obstacles. It is far more plausible to assume that U.S. federalism will remain within some version of the market model. If I am correct about this, it suggests that lawmakers need to be *more* concerned about the effects of a potential federal bailout as the links between Congress and the states increase, not less. The key question is whether enacting a state bankruptcy framework would reduce the pressure for Congress to step in with a federal bailout.<sup>64</sup> In my view, it would.

Similar reasoning applies to arguments that bankruptcy is unnecessary because the states can muddle through their difficulties, in part because it is very difficult for creditors to recover from a recalcitrant state. But the pressure for a federal bailout is much greater if states are left to muddle through, and the drag on growth from financial distress that lingers over a long period of time may be considerable.<sup>65</sup>

### III. THE NEW LANDSCAPE OF MUNICIPAL DISTRESS

When the debate over state bankruptcy began, the conventional wisdom about Chapter 9 was that real municipalities never used it. There were far fewer filings under Chapter 9—roughly 650 since the 1930s—than under any other chapter of the Bankruptcy Code, and the vast majority of these involved water or sewer districts, together with a few small towns.<sup>66</sup> The past few years have seen a drumbeat of significant Chapter 9 filings: Jefferson County, Alabama; Central Falls, Rhode Island; Harrisburg, Pennsylvania (a short-lived filing); Stockton, California; and San Bernardino, California.<sup>67</sup> During

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64. Although some criticize bankruptcy for interfering with democracy, see, for example, Schragger, *supra* note 56, at 883 (criticizing the proposal for state bankruptcy as reflecting “distrust of local, representative democracy”), the criticism seems misplaced for two reasons. First, a bailout with strings attached may intrude more deeply on local decisionmaking than bankruptcy. Second, bankruptcy can reinvigorate democracy in some contexts, as would likely be the effect with pensions, as noted earlier. See *supra* Part II.C.

65. Analogizing to a famous study of an Israeli daycare center, Professor Gillette suggests that a state might be *too* tempted to default on their obligations if they had a bankruptcy option. Gillette, *supra* note 36, at 1143. This is possible, but it seems much more likely that states would be very reluctant to invoke a bankruptcy option. Bankruptcy would have much greater consequences for a state’s governor or other decisionmaker than the decision whether to pay a small fine for picking up one’s child late from daycare.

66. See generally Kimhi, *supra* note 9, at 357, 359 n.43 (discussing paucity of Chapter 9 filings, especially for general-purpose municipalities).

67. Michael Corkery, *Muni Blues Worry Investors: Growing Fear That Cities Will Default—Not Out of Necessity but as a Strategy*, WALL ST. J., July 26, 2012, at C1.

this same period, Michigan, Pennsylvania and several other states have passed legislation tightening their control over financially troubled municipalities. These two developments reflect starkly different—yet consistent—strategies for resolving municipalities’ financial distress.

Start with the second development: states’ tightening of control over financially troubled municipalities. As originally enacted in 2011, the Michigan legislation instructed the “state financial authority,” which for a municipality is the state treasurer, to conduct a preliminary review of any city or other local government that shows symptoms of “municipal financial stress.”<sup>68</sup> If the treasurer’s review concludes that severe financial distress exists, and the Governor reaches the same conclusion, the Governor is required to declare that the city is in receivership.<sup>69</sup> The Governor must then appoint an emergency manager.<sup>70</sup> The emergency manager displaces the city’s governing body and other decisionmakers, and he or she has forty-five days to create a written financial and operating plan for the city.<sup>71</sup> As part of this plan, the emergency manager can reject, modify, or terminate city contracts, including its collective bargaining agreements.<sup>72</sup>

Although the Michigan approach is a substitute for bankruptcy, it takes a very different form than Chapter 9. Whereas Chapter 9 is patterned on ordinary bankruptcy and assumes that the municipality’s existing decisionmakers will remain in place, the Michigan framework temporarily displaces the municipality’s governing body. Not surprisingly, local critics challenged the Michigan reforms as a usurpation of local democracy. In the terms I used at the end of the last Part, Michigan’s stance toward its municipalities still is consistent with a market approach, but by authorizing draconian

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68. MICH. COMP. LAWS ANN. § 141.1512(1)(r) (West Supp. 2012). The Michigan provisions were repealed by voters in November, 2012 and subsequently replaced by provisions that give a troubled municipality a choice between an emergency manager and several other options, but are generally similar to the original provisions. Pennsylvania amended its municipal oversight legislation to prevent Harrisburg from filing for bankruptcy for at least a year. NAT’L ASS’N OF STATE BUDGET OFFICERS, MUNICIPAL BANKRUPTCY & THE ROLE OF THE STATES 3 (2012), available at <http://www.nasbo.org/sites/default/files/pdf/Municipal%20Bankruptcy%20%26%20the%20Role%20of%20the%20States.pdf>.

69. MICH. COMP. LAWS ANN. § 141.1515(4) (West Supp. 2012).

70. *Id.*

71. MICH. COMP. LAWS ANN. §§ 141.1517–.1518 (West Supp. 2012) (listing the powers and responsibilities of the emergency manager).

72. MICH. COMP. LAWS ANN. § 141.1519(1)(j)–(k) (West Supp. 2012) (giving the emergency manager the power to rework or extinguish existing contracts).

intervention into the affairs of a tottering municipality, the state has taken a large step toward hierarchy.

The recent municipal bankruptcies have, in a sense, pushed in the opposite direction, extending the existing market-oriented approach in two respects. First, they have signaled that Chapter 9 is indeed an option—and an alternative to rescue financing. The conventional wisdom that significant municipalities do not file for Chapter 9 is no longer accurate. As Warren Buffett has put it, the stigma is disappearing.<sup>73</sup>

Second, the scope of restructuring has expanded considerably. Before Vallejo filed for bankruptcy, there were significant questions as to whether a Chapter 9 debtor could terminate its collective bargaining agreements. Vallejo answered that question in the affirmative, and the city also adjusted the terms of its bond debt.<sup>74</sup> The only major obligation that Vallejo did not touch was its underfunded pension obligations to its retirees. Vallejo seemed to confirm that pensions cannot be adjusted in bankruptcy. But the bankruptcy of Central Falls, Rhode Island, has offered a very different perspective. Central Falls' reorganization plan will effect a major restructuring of its pensions.<sup>75</sup> Because the city's retirees agreed to the restructuring, the Central Falls case did not test the legal objections to restructuring pensions, but it showed that political opposition to pension adjustments is not insurmountable. Given that underfunded pensions lie at the heart of many municipalities' (and states') financial crises, the legal question of whether the pensions of retirees can be adjusted over their objection may well be addressed soon. There is a strong argument, as I have contended elsewhere, that pensions are entitled to protection to the extent they have been funded, but that the unfunded portion can be restructured in bankruptcy.<sup>76</sup>

For addressing municipalities' financial distress, fiscal control boards and Chapter 9 approaches have different virtues and limitations. Assuming Michigan's emergency manager approach withstands judicial scrutiny, it can more directly address a municipality's political problems than Chapter 9.<sup>77</sup> Yet the scope of

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73. Margaret Collins, *Buffett Says Muni Bankruptcies Set to Climb as Stigma Lifts*, BLOOMBERG (July 13, 2012), <http://www.bloomberg.com/news/2012-07-13/buffett-says-muni-bankruptcies-poised-to-climb-as-stigma-lifts.html>.

74. Int'l Bhd. of Elec. Workers, Local 2376 v. City of Vallejo (*In re City of Vallejo*), 432 B.R. 262, 270, 274–75 (E.D. Cal. 2010).

75. *In re City of Central Falls*, No. 11-13105, 2011 WL 4396953, at \*9–13 (Bankr. D.R.I. Sept. 22, 2011).

76. Skeel, *States of Bankruptcy*, *supra* note 17, at 692.

77. See Clayton P. Gillette, *Fiscal Control Boards and Municipal Fiscal Crises* 4, 6,

possible restructuring is likely to be constrained. Whether an emergency manager can restructure a collective bargaining agreement, as authorized by the statute, is not altogether certain because the Contracts Clause prohibits states from altering contracts.<sup>78</sup> Even if the emergency manager can indeed alter some contracts if a municipality is in crisis, she almost certainly could not be authorized to restructure the municipality's pensions. In Chapter 9, by contrast, the existing decisionmakers retain control, but they probably can restructure a broader range of obligations.<sup>79</sup>

It seems unlikely that other states will rush to emulate Michigan's emergency manager statute, because the Michigan statute owes its existence to a particular confluence of factors: deep crises in a number of municipalities and Republican control of the Governor's mansion and the legislature. Even under these conditions, the statute has been controversial. In more ordinary circumstances, the centralization of authority would prove impossible in most states. Moreover, a permanent shift toward centralization would sacrifice the well-known benefits of local control.

In practice, fiscal control boards may diffuse any hold-up power that a city might otherwise have as a result of the bankruptcy option.<sup>80</sup> From this perspective, it is interesting to note that states generally have not withdrawn the Chapter 9 option when they enacted or revised their fiscal-control-board provisions. Fiscal control boards have supplemented rather than substituted for Chapter 9.

The implications of these developments for the financial distress of states are unclear. Given the constraints of state

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12 (Apr. 5, 2012) (unpublished manuscript) (discussing the broad powers of emergency managers to "advise on, regulate, and frequently direct the fiscal affairs of distressed localities" despite a lack of political experience or aspiration), available at [http://www.law.nyu.edu/ecm\\_dlv4/groups/public/@nyu\\_law\\_website\\_academics\\_colloquia\\_law\\_economics\\_and\\_politics\\_of\\_urban\\_affairs/documents/documents/ecm\\_pro\\_072354.pdf](http://www.law.nyu.edu/ecm_dlv4/groups/public/@nyu_law_website_academics_colloquia_law_economics_and_politics_of_urban_affairs/documents/documents/ecm_pro_072354.pdf). Gillette suggests that fiscal control boards can be justified if they address problems in local interest group politics or limit contagion risks, but he raises questions about their efficacy in practice. *Id.* at 42–44.

78. The prohibition is not complete. The Supreme Court has long permitted some state interference with contracts, particularly in the event of financial crisis. For a brief discussion of the case law, see Stephen F. Befort, *Unilateral Alternation of Public Sector Collective Bargaining Agreements and the Contract Clause*, 59 *BUFF. L. REV.* 1, 22–25 (2011).

79. See Ellman & Merrett, *supra* note 41, at 383–84.

80. Although the risk of contagion seems limited even here, it is possible that a city's bankruptcy filing would have spillover effects for other municipalities in the state (and thus give the troubled city a certain amount of holdup power) to the extent state policies are a contributing factor because other municipalities also will be subject to these policies.

sovereignty, the fiscal-control-board approach may not be a realistic option for troubled states. For state financial distress, the key lesson will come from the new Chapter 9 filings: if Chapter 9 appears to work relatively well, the new cases will underscore the case for giving states a similar option. An important question here is whether at least some municipalities succeed in restructuring their pensions along with other obligations.

Let me suggest a best-case scenario in this regard. In the recent bankruptcy of Stockton, California, several bondholders responded to the city manager's suggestion that he does not plan to touch Stockton's pensions by filing a motion aimed at forcing Stockton to reconsider this stance.<sup>81</sup> If the bankruptcy judge signals that he will take the extent to which sacrifice is evenly distributed into account when he rules on any proposed reorganization plan, and Stockton makes at least some adjustments to its pensions, the Stockton case could show that Chapter 9 has come of age and could serve as evidence of the potential benefits of state bankruptcy.

It is too soon to know whether Stockton or one of the other recent cases will in fact teach these lessons or whether they will provide cautionary tales about the limits of formal restructuring mechanisms. But they are forcing a rethinking of what bankruptcy can and cannot do.

#### IV. WOULD PENSION REFORM BE SUFFICIENT?

The discussion thus far has assumed that the financial distress of states and municipalities is sufficiently complex as to require a comprehensive restructuring strategy, whether it be bankruptcy or a more ad hoc measure. State and municipal distress is indeed complex, but a major piece of the puzzle for many of the most troubled municipalities and states is unsustainable pension promises. (Bond debt, by contrast, is a much smaller portion of municipal and state indebtedness, as noted earlier.) Might pension reform alone be enough?

Certainly if states' pension obligations suddenly disappeared or were suddenly fully funded, their financial picture would look

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81. The motion asks the bankruptcy judge to dismiss the case, due to Stockton's failure to negotiate with Calpers over potential pension cuts prior to bankruptcy. Similar issues have arisen in San Bernardino's Chapter 9 bankruptcy case. See, e.g., Steven Church & James Nash, *Calpers Bankruptcy Strategy Pits Retirees vs. All Others*, BLOOMBERG BUSINESSWEEK (Dec. 12, 2012), <http://www.businessweek.com/news/2012-12-12/calpers-bankruptcy-strategy-pits-retirees-vs-dot-all-others#p1> (discussing Calpers' claim that pension obligations should be given priority treatment).

far less bleak. According to some estimates, state pensions currently are underfunded by more than \$3 trillion.<sup>82</sup> Not only the size but also the nature of the problem makes a laser-like focus on pensions attractive; like private corporations, many states and municipalities are shifting away from traditional defined benefit pensions.<sup>83</sup> The defined contribution alternative poses far less financial risk.

Although targeting pensions is attractive, it has several considerable downsides. The first is that constitutional obstacles likely would prevent either Congress or the states themselves from directly restructuring states' pension obligations to retirees and existing state employees. Pension reform would not be sufficiently comprehensive in scope to constitute an exercise of Congress's Bankruptcy Clause powers. As a result, it would likely be construed as an impermissible interference with state sovereignty to the extent it purported to apply to obligations that predated the reform. Although several states have made minor adjustments to their pension promises, the laws of most states, together with the Contracts Clause of the Constitution, would thwart any effort to alter the states' obligations to retirees.<sup>84</sup> This suggests that any reform could only affect future obligations, not existing ones.

The second issue is fairness. Even if federal or state lawmakers did have the power to restructure state pensions, targeting pensions raises serious fairness issues as compared to a restructuring framework that distributes the sacrifice among a broader range of constituencies, as bankruptcy ordinarily does.

One way to address at least the second of these concerns might be to adopt a framework for protecting state pensions that mirrored the safety net that ERISA provides for the pensions of private corporations.<sup>85</sup> If a corporate pension fund is terminated, the Pension Guaranty Benefit Corporation pays retirees a substantial portion, but not all, of the benefits they would have

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82. Hynes, *supra* note 39, at 669; see also Robert Novy-Marx & Joshua D. Rauh, *Policy Options for State Pension Systems and Their Impact on Plan Liabilities*, 10 J. PENSION ECON. & FIN. 173 (2011).

83. See Steven Greenhouse, *City's Pension Cut Proposal May Set Negotiating Pattern*, N.Y. TIMES, June 6, 2006, at B3; Danny Hakim & Steven Greenhouse, *From Albany, Move to Trim Pension Plans*, N.Y. TIMES, Dec. 17, 2008, at A1.

84. For a critical analysis of this tendency, see Amy B. Monahan, *Statutes as Contracts? The "California Rule" and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1034–35 (2012).

85. For a similar approach, albeit one that contemplates a bailout of existing obligations, see James P. Allen, Jr. & Richard A. Bales, *ERISA Failures and the Erosion of Workers' Rights: The Urgent Need to Protect Private & Public Workers' Pensions and Benefits*, 75 ALB. L. REV. 449, 456–58 (2011).

received if the fund had not failed.<sup>86</sup> In effect, the benefits are subject to a partial restructuring.

Although the safety net approach is in some respects a very attractive alternative to state bankruptcy, it has several key limitations. First, as already noted, it probably could only handle prospective pension obligations. If federal guarantees are a solution, they are more a solution to future problems than to current ones. A second concern, political pressure to permit states to continue to underfund their pensions, is both an attraction and a limitation of federal pension guarantees. Because federal regulators are removed from state politics, they might be better able to resist pressure to underfund state pensions. Yet the experience of the PGBC, which has been on the brink of financial collapse for some time, is a cautionary tale in this regard, suggesting that federal regulators might themselves be subject to capture by state decisionmakers.<sup>87</sup> Third, to the extent defined contribution plans are a more sustainable approach to public employee pensions, establishing federal pension guarantees might delay a beneficial transition. Finally, pension reform is a less comprehensive approach to states' financial travails than state bankruptcy. Although underfunded pensions are a huge portion of the fiscal problem, states face other financial distresses as well, from their bond debt to employee medical costs.

Federal pension guarantees are an intriguing alternative to the deeply flawed current system. But bankruptcy seems a more promising option.

#### V. IMPLICATIONS OF THE SUPREME COURT'S HEALTHCARE RULING

The relevance of the Michigan reforms and the recent Chapter 9 filings to our discussion was quite obvious. The same cannot be said about another recent development: the Supreme Court's ruling on the Affordable Care Act, the controversial 2010 healthcare legislation.<sup>88</sup> But the last of the key rulings in that case could have significant implications for Congress's intervention in state fiscal affairs.

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86. PENSION BENEFIT GUAR. CORP., <http://www.pbgc.gov> (last visited Mar. 3, 2013).

87. Michael S. Greve, Speech at Boise State University: The State of Our Federalism (Sept. 16, 2011) (transcript available at <http://www.aei.org/files/2011/09/16/State-of-Federalism-Greve.pdf>) ("The bad federalism is the one we have. . . . Cartel federalism is competitive federalism, upside-down: it systematically *suppresses* healthy policy and economic competition among states.").

88. Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2584, 2608 (2012).

The marquee question in the healthcare case was whether the mandate that every American citizen obtains health insurance or pays a penalty is constitutional.<sup>89</sup> Chief Justice Roberts, who provided the deciding vote, said that that it is.<sup>90</sup> Although the mandate could not be justified under the Commerce Clause, its penalty can be construed as a tax.<sup>91</sup> The Court also considered whether the Act's expansion of Medicaid, which authorized the Secretary of Health and Human Services to withhold any or all of a state's existing Medicaid funding unless the state agreed to implement the expansion, constituted an impermissible commandeering of the state.<sup>92</sup> Prior to *National Federation of Independent Business*, the Court seemed to suggest that nearly any program that attached strings to federal funding would withstand constitutional challenge; the inclusion of federal funds and invocation of Congress's authority under the Spending Clause, the reasoning went, would cover a multitude of sins, insulating programs that might otherwise seem problematic to challenge.<sup>93</sup> A seven-justice majority of the Court cast cold water on this perception, striking down the provision in the Act that authorized the withholding of unrelated Medicaid funding from states that declined to expand Medicaid coverage. "The threatened loss of over ten percent of a State's overall budget," the Chief Justice wrote, is impermissible "economic dragooning that leaves the States with no real option but to acquiesce in the Medicaid expansion."<sup>94</sup>

The Court's stiffening up of its commandeering and Spending Clause case law raises two key questions about Congress's options for intervening in state financial distress. The first is whether a rescue-financing program that attaches significant strings might be struck down as commandeering. The Court suggests that a central issue is whether "a State has a legitimate choice whether to accept the federal conditions in exchange for federal funds," and that the question is whether financial inducements constitute "relatively mild encouragement" or "a gun to the head."<sup>95</sup> Federal funding for a troubled state with conditions attached probably would be upheld even under this standard so long as the funds and the conditions were closely

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89. *Id.* at 2577.

90. *Id.* at 2600.

91. *Id.* at 2593, 2600.

92. *Id.* at 2601–02.

93. The leading case is *South Dakota v. Dole*, 483 U.S. 203, 207 & n.2 (1987).

94. *Nat'l Fed'n of Indep. Bus.*, 132 S. Ct. at 2605.

95. *Id.* at 2602–04 (internal quotation marks omitted).

linked. But *National Federation of Independent Business* may suggest that the Court will strike down a funding package that intrudes too deeply into state decisionmaking.

From this perspective, a state bankruptcy framework may stand on firmer constitutional footing than ad hoc federal intervention with conditionalities. State bankruptcy has independent constitutional support because the Bankruptcy Clause explicitly authorizes Congress to make bankruptcy laws,<sup>96</sup> and the bankruptcy process does not interfere as directly with state decisionmaking.

But—and this is the second issue—the Court’s commandeering discussion also hints at potential sovereignty concerns with state bankruptcy. State sovereignty “rests on what might at first seem a counterintuitive insight,” according to Chief Justice Roberts, that “freedom is enhanced by the creation of two governments, not one.”<sup>97</sup> Here, as in another recent case,<sup>98</sup> the Court suggests that state sovereignty is to some extent a matter of individual freedom, not just respect for the interests of the state itself.<sup>99</sup> If individual liberty is a key dimension of state sovereignty, we cannot assume that protecting state consent and noninterference with state decisionmaking is sufficient to assure the constitutionality of a state (or municipal, for that matter) bankruptcy framework. There remains the question whether individual liberty is compromised.

It is hard to predict the implications of the Court’s state sovereignty jurisprudence in the abstract. The Court’s endorsement of municipal bankruptcy in the 1930s<sup>100</sup> and the broad sweep it has given to the Bankruptcy Clause<sup>101</sup> suggest that a state bankruptcy law would likely be upheld. In addition, individual liberty concerns seem strongest when individual rights are at stake, which is much less directly the case with state bankruptcy than in *Bond v. United States*, in which the petitioner sought to challenge her conviction and six-year sentence under the Chemical Weapons Convention Implementation Act of 1998.<sup>102</sup> But the increasing emphasis on

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96. U.S. CONST. art. 1, § 8, cl. 4.

97. *Nat’l Fed’n of Indep. Bus.*, 132 S. Ct. at 2602 (quoting *Bond v. United States*, 131 S. Ct. 2355, 2364 (2011)) (internal quotation marks omitted).

98. *Bond*, 131 S. Ct. at 2364.

99. See *Nat’l Fed’n of Indep. Bus.*, 132 S. Ct. at 2602.

100. *United States v. Bekins*, 304 U.S. 27, 54 (1938) (“[B]ankruptcy power is competent to give relief to [district] debtors in such a plight . . .”).

101. See Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 45–46 (1995).

102. *Bond*, 131 S. Ct. at 2360.

individual liberty has added an important complication.<sup>103</sup> If Congress were simply playing the Supreme Court odds, and concerned only about short-term results, the best option might be to intervene in ad hoc fashion after an actual crisis emerges and a state threatens to default. Even if the ad hoc approach was later struck down as unconstitutional, it might well do its work before the Court intervened.<sup>104</sup> But a state bankruptcy law seems likely to withstand constitutional attack, and it would provide a more predictable and orderly approach to restructuring state obligations.

## VI. A RESTRUCTURING FRAMEWORK FOR EUROPE?

During the same period as the state and municipal crisis has unfolded in the United States, the nations of Southern Europe have faced even direr conditions. The two crises are in many respects closely parallel. The U.S. states and the nations of Europe are sovereign and yet have ceded aspects of their sovereignty—they are quasi-sovereigns, in Professor Gelpern's terms.<sup>105</sup> Because they do not have their own currency, the states and European countries cannot use devaluation to lessen the effect of their fiscal crisis. Given that this leaves federal bailout or straight default as the most likely outcome of a crisis, the case for adopting formal restructuring rules seems particularly strong.<sup>106</sup>

In some respects, the case for a restructuring framework in Europe is even more compelling than for the U.S. states, given

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103. For discussion, see Michael W. McConnell, *Extending Bankruptcy Law to States*, in *WHEN STATES GO BROKE*, *supra* note 17, at 229, 235.

104. For an argument that the initial response to a crisis should be distinguished from ordinary regulation, see Anna Gelpern, *Financial Crisis Containment*, 41 *CONN. L. REV.* 1051, 1063–64 (2009). See also Eric A. Posner & Adrian Vermeule, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008*, 76 *U. CHI. L. REV.* 1613, 1614, 1665 (2009) (arguing that the Congress will accede to the Executive in an emergency, and that the Executive will be constrained only by popular opinion and other “broad political processes”).

105. Gelpern, *supra* note 23, at 896.

106. Although she remains skeptical about sovereign bankruptcy frameworks, Professor Gelpern notes that the bankruptcy-like elements in European instruments and concludes that “if the European project were to succeed, I would not be surprised to see proto-bankruptcy features emerging as a core part of the federal bargain.” Gelpern, *supra* note 36, at 1126. As will become apparent below, I think she is likely to be right about this. Our principal disagreements concern the extent to which the benefits of bankruptcy can be achieved in sovereign contexts through contract. Professor Gelpern is more optimistic about contract and other sources of priority and less optimistic about formal bankruptcy. Even here, there are points of agreement. See, e.g., Patrick Bolton & David A. Skeel, Jr., *Redesigning the International Lender of Last Resort*, 6 *CHI. J. INT. L.* 177, 198–200 (2005) (arguing that the IMF could function somewhat like a debtor in possession lender in bankruptcy, and that the priority of the loans it facilitated could be enforced by contract-like remedies).

the trajectory of the two crises.<sup>107</sup> Although some U.S. states remain in serious financial trouble, conditions have generally improved since the outset of the crisis. “The fiscal backdrop is better than it was three years ago,” a recent report concluded. “State tax revenues rose for the ninth straight quarter in the first three months of 2012 . . . .”<sup>108</sup> Although there are glimmers of hope in Europe as well, the long-term prognosis remains dire. Over the past four years, European authorities have arranged bailout packages for Greece, Ireland, and Portugal, and have midwived a significant restructuring of Greece’s bond debt.<sup>109</sup> All three remain troubled, as more ominously do Spain and Italy.<sup>110</sup> In addition to their need for financial relief, the countries’ capital structure includes far more bond debt, which is the traditional focus of bankruptcy-style restructuring.<sup>111</sup> Moreover, a European restructuring framework would not interfere with their sovereignty appreciably more than do the current strictures imposed by European authorities.

In one important respect, however, bankruptcy might prove more problematic in Europe than for the U.S. states. Because U.S. state bonds are held primarily by mutual funds and wealthy individuals who live in the state, restructuring them would not jeopardize the financial system. The ownership of European bonds looks quite different. During the crisis, systemically important European banks have held large amounts of Greek and other sovereign debt, as have the banks of the local sovereign.<sup>112</sup> The risk that restructuring would have untoward systemic effects is therefore much greater in Europe, as is the potential for an ongoing drain on growth.<sup>113</sup> (In each case, the

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107. Anne Krueger, the original architect of the IMF’s 2002 proposal for a Sovereign Debt Restructuring Mechanism, has advocated a similar restructuring framework for Europe. FRANÇOIS GIANVITI ET AL., A EUROPEAN MECHANISM FOR SOVEREIGN DEBT CRISIS RESOLUTION: A PROPOSAL 25–34 (2010), available at <http://www.bruegel.org/publications/publication-detail/publication/446-a-european-mechanism-for-sovereign-debt-crisis-resolution-a-proposal/#.URUICo5kJ94>.

108. Bary, *supra* note 29, at 24. Bary also notes, however, that a number of states continue to face severe pension underfunding problems. *Id.* at 26.

109. Landon Thomas, Jr., *In Cyprus Bailout, Questions of Whether Depositors Should Shoulder the Bill*, N.Y. TIMES, Jan. 11, 2013, at B4.

110. Francesca Landini & Julien Toyer, *IMF Urges Aid for Italy, Spain but Rome Baulking*, REUTERS (Oct. 17, 2012, 6:45 PM), <http://www.reuters.com/article/2012/10/17/us-eurozone-idUSBRE89G0NO20121017>.

111. Liz Alderman & Matthew Saltmarsh, *Borrowing Costs Rise for Italy and Spain*, N.Y. TIMES, Aug. 3, 2011, at B1; see also IULIA STANISLAV EMINESCU, STRUCTURE OF GOVERNMENT DEBT IN EUROPE IN 2011 2 (2012).

112. Alderman & Saltmarsh, *supra* note 111.

113. See Patrick Bolton & Olivier Jeanne, *Sovereign Default Risk and Bank Fragility in Financially Integrated Economies* 3, 16–18 (Nat’l Bureau of Econ. Research, Working

bondholding patterns are in part an unintended consequence of legal regulation. Wealthy Californians buy California bonds because they are exempt not just from federal tax but also from California state tax. French and German banks held large amounts of Greek debt at the outset of the crisis because the debt of any European country, regardless how troubled, was treated as risk free for capital purposes.)

In the United States, the relationship between the states and the federal government is sufficiently well defined that we can say with considerable confidence that a state bankruptcy law could enhance states' fiscal stability and diminish the pressure for federal bailouts. That is, it could reinforce the market approach to the federal-state relationship.

With Europe, nearly every dimension of the federalist structure is still up for grabs. A common theme in many recent discussions is the need to increase "fiscal union"—by which commentators mean greater European control over countries' spending decisions.<sup>114</sup> Complete or near complete fiscal union would amount to hierarchical control over EU members' spending decisions. If Europe were to consolidate in this fashion, there would be little need for a formal restructuring framework. Along with centralized control would come an implicit or explicit commitment to provide European rescue financing if a member fell into financial distress. This approach has a great deal to commend it. A more consolidated Europe might be better able to compete in worldwide markets. It also would reduce the likelihood that the response to a crisis would cause system-wide damage to the financial system.

The obvious obstacle to this approach is the deep resistance throughout the EU membership to so fully ceding their sovereignty to European authorities.<sup>115</sup> The current trend appears to be toward greater but limited fiscal consolidation, together with a larger and more flexible bailout fund.<sup>116</sup> The perspective I have advocated in this Essay suggests that this is a highly risky

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Paper No. 16899, 2011), available at <http://www.nber.org/papers/w16899> (modeling effects of a decrease in the value of government debt on lending by banks that hold the debt).

114. James Kanter & Stephen Castle, *Weary of Crisis, but Wary of Change*, N.Y. TIMES, Sept. 13, 2012, at B1; Nick Thompson, *EU Leaders Talk Fiscal Union as Greeks Protest Austerity Cuts*, CNN (Oct. 18, 2012), <http://edition.cnn.com/2012/10/18/business/eu-summit>.

115. Kanter & Castle, *supra* note 114.

116. EU officials have also debated whether to authorize euro bonds guaranteed by the EU as a whole. This would in effect be a form of implicit bailout and has been resisted by Germany. For a description of three recent proposals for addressing the European crisis through euro bonds or adjustments to the bailout fund, see Landon Thomas, Jr., *Pondering the Euro Puzzle*, N.Y. TIMES, Aug. 1, 2012, at B1.

strategy, which risks landing Europe in the intermediate territory between hierarchical and market approaches. If the EU retains only limited control yet is responsible for bailing out troubled countries, its members will have incentives to circumvent EU oversight and to please local constituents at the expense of fiscal stability. In the current crisis, the EU has insisted on major austerity measures as a condition of rescue funding, which in theory could signal that any bailout will require serious reform. But it is not clear that the austerity has been effective, which may make it harder to credibly signal that future bailouts will come with major strings.

A more robust commitment to the market-oriented version of federalism would require Europe to do one of two things: either create a two-track approach to the Euro or put a formal restructuring mechanism in place. Under a two-track Euro, countries whose financial health deteriorated would be temporarily moved off the Euro, which would effectively devalue their currencies.<sup>117</sup> Alternatively, Europe could introduce a bankruptcy framework analogous to the one I have advocated for the American states. Either solution could provide a credible alternative to bailout funding in the event of a crisis.

The U.S. states have fewer options, and there is less uncertainty about the form that American federalism will take. Notwithstanding threats by the occasional Texan to launch a campaign for secession, no state will be kicked off or leave the dollar. Similarly, as tightly interlinked as federal and state finances now are, states will retain extensive sovereignty over their own affairs. Given these realities, together with the lower systemic risk in the event of a restructuring, the case for a formal restructuring framework is far less equivocal for the U.S. states than in Europe.

## VII. CONCLUSION

Sovereign and quasi-sovereign entities can often muddle through their financial distress, not least because it is usually quite difficult for their creditors to insist on repayment. If they have other tools for addressing financial distress, such as currency devaluation, or if a higher level of government is committed to overseeing the entity and providing rescue funding

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117. See generally Charles W. Calomiris, *Exiting the Euro Crisis*, in LIFE IN THE EUROZONE WITH OR WITHOUT SOVEREIGN DEFAULT? 115, 122 (Franklin Allen et al. eds., 2011); *Breaking Up the Euro Area: How to Resign from the Club*, ECONOMIST, Dec. 4, 2010, at 88, 88–89.

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if necessary, formal restructuring rules may not make sense. In a more market-oriented framework, by contrast, as with the U.S. states, bankruptcy can diminish the pressure for bailouts by higher level or outside entities and brings a variety of other benefits as well. In such a context, the case for formal restructuring rules is especially strong.