Written Testimony of David A. Skeel, Jr.

Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs

Committee on Oversight and Government Reform

United States House of Representatives

February 9, 2011

Thank you for the opportunity to testify about "State and Municipal Debt: The Coming Crisis?" It is a great honor to appear before you today. I will be devoting my remarks to the question of whether Congress should enact a bankruptcy law for states as an option for a state whose financial crisis is otherwise insurmountable.

The financial condition of many states is worse than at any time since the Great Depression of the 1930s. In the past several weeks, a number of state governors have announced plans for aggressive measures to restore some measure of fiscal health.[1] Most states surely can get through the crisis on their own, particularly now that the worst effects of the Great Recession seem to have eased somewhat. Hopefully, even the most troubled states will be able to put their financial houses in order. But some are in such dire financial straits that there is serious and legitimate doubt as to whether they can put their finances on more sustainable footing on their own.

What will happen if the crisis spirals out of control in one or more of these states, or another crisis hits in the future? Currently, there are only two real options. The first is that a state might simply default on some or all of its obligations, declaring itself unable to pay. This has rarely happened in modern American history. No American state has defaulted since Arkansas during the great Depression. But it is no longer unthinkable. The second option is for the Federal government to bail out one or more of the states, much as it bailed out financial

[1] See, for example, Conor Dougherty & Amy Merrick, *Governors Chop Spending*, Wall Street Journal, Feb. 7, 2011, at A1.

institutions like Bear Stearns, Fannie Mae, Freddie Mac and AIG during the recent financial crisis.

In my view, both of these alternatives are deeply problematic. In other contexts, a person or an entity that is in deep financial distress can use bankruptcy to restructure their obligations. I believe that Congress should enact a bankruptcy law for states, to provide a similar option for states as an alternative to a default or a federal bailout in the event that all else fails.

Some have argued that a bankruptcy option is not necessary, because nearly all of the states will be able to muddle their way through their fiscal predicament. This is like saying there's no need for a fire department because most homeowners never have fires in their houses and if one starts they can probably stop it in time. This is true, but we still need fire departments for the rare case where a fire burns out of control.

Others have argued that the "mere mention" of a possible bankruptcy law could cause panic in the bond markets. These concerns are greatly overstated. The critics who issue these dire warnings often predict catastrophe for both state and municipal bonds, for instance, but we already have a bankruptcy law for municipalities. This law has not led to a collapse of municipal credit throughout the nation; a bankruptcy law for states wouldn't either. Indeed, under some circumstances, the possibility of restructuring can actually increase the value of the bonds that are restructured, by putting them on sustainable footing.

Now, more than ever, we need a fire department for state fiscal crises, a solution of last resort that does not depend on using a major federal bailout as a backstop. Although I believe that the concerns that have been raised by critics are exaggerated, they should be addressed by adjusting the bankruptcy law, rather than by foregoing the benefits that bankruptcy offers as a solution of last resort.

In the reminder of my discussion, I'll briefly discuss three key questions with respect to a bankruptcy law for states:

1) What are the benefits of a bankruptcy law for states?
2) Would it be constitutionally permissible?
3) How might the law be tailored to address particular concerns that have been raised?

<u>What are the Benefits</u>?

Enacting a bankruptcy law for states would provide two hugely important benefits. First, it would enable a state to restructure obligations that are difficult or impossible to restructure under ordinary state law. Second, bankruptcy brings every constituency to the table, and ensures that the necessary sacrifices are distributed fairly, rather than visited on one or two disfavored constituencies. Let me describe each of these benefits, especially the first, a little more fully.

As just mentioned, bankruptcy would enable a troubled state to restructure obligations that could not easily be restructured outside of bankruptcy. The key to understanding this benefit is the Contracts and Bankruptcy Clauses in Article 1, sections 8 and 10 of the Constitution. Under the Contracts Clause, states are prohibited from altering an existing obligation, even if it would be in everyone's interest that the obligation be restructured.[2] This makes it extremely difficult for a state to modify an existing union contract or bond unless the union or bondholder agrees to the restructuring. As a result, there are serious risks that the other parties to state contracts will refuse to alter contracts even if the contractual obligations are unsustainable. These difficulties are magnified by the fact that many states have enacted Constitutional or statutory provisions that make obligations even more difficult to restructure.

The Constitution gives Congress much more authority to provide for the restructuring of a state's obligations. The Bankruptcy Clause authorizes Congress to enact bankruptcy laws. Not

[2] "No State shall … pass any … Law impairing the Obligation of Contracts." Const. Art. 1, sec. 10.

only this, but the Contracts Clause applies only to the states. It does not prevent Congress from providing for the restructuring of existing contracts.[3]

Congress's authority has important implications for key obligations such as public employee contracts (including health benefits), pensions, and bonds. Public employee contracts are not impossible to renegotiate under state law, but it is very difficult to do so. A state often cannot restructure a union contract absent the union's agreement, which unions have often resisted even when the contract's terms were highly unrealistic. Other measures are possible, such as firing large number of workers or passing legislation prohibiting or interfering with unions. But in many states the threat to simply fire large numbers of employees is not credible; in other states, it is credible but would be a draconian response to fiscal problems. In bankruptcy, if the parties fail to reach agreement, the court can terminate the contract. In practice, the threat of termination has encouraged the parties to restructure their contracts to make them more realistic and sustainable.

With pensions, many states now make it nearly impossible to restructure existing pension obligations, no matter how generous, and it is very difficult to restructure even future (that is, not yet earned) obligations to existing employees. Many of the most important protections for pensions would be fully honored in bankruptcy, and rightly so. If a state has set aside funds for its pension obligations, these funds would continue to be available only for the pension obligations. (In technical terms, the pension beneficiaries have a property right in the funds; this property right is likely to be protected by the Fifth Amendment'sTakings Clause). But bankruptcy might provide the authority to restructure the state's obligations to existing employees to make its pension promises more realistic and sustainable.

Even in bankruptcy, it is highly unlikely that any state would severely retrench on its pension promises, even if this were legally permissible. But even a relatively modest restructuring of the state's pension obligations could make the longterm prognosis for its pensions far better.

[3] In addition, the Supremacy Clause gives federal bankruptcy law priority over a conflicting state law. Congress and the courts have long given significant respect to state law—particularly with respect to property rights—but a federal bankruptcy law takes precedence over a conflicting state law.

Under existing state law, a state's general obligation bonds often cannot be adjusted in any way, even though they are simply general obligations of the state. This has the effect of giving a financially troubled state an either/or choice. It can either continue to pay the bonds, even if severe cuts to other constituencies are not enough to stop its crisis, or the state can simply stop paying.[4] Bankruptcy provides an intermediate option. A state's bonds could be restructured along with its other obligations.

This brings us to the other major benefit of bankruptcy. If one benefit of bankruptcy is the ability to restructure obligations that are extremely difficult to restructure in the absence of a bankruptcy option, the other signal benefit is that bankruptcy ensures that most or all of a state's constituencies make sacrifices, not just one or two. Absent a bankruptcy option, much of the sacrifice may be borne by public employees and the beneficiaries of state services, for instance, while other constituencies are protected. Bankruptcy brings every constituency to the table, and makes it much more likely that sacrifices will be distributed more broadly and fairly.

Would Bankruptcy for States be Constitutionally Permissible?

For corporations and private entities, Congress's ability to enact bankruptcy laws is beyond question. But states are different, because they are both public and sovereign. Can Congress enact a bankruptcy law for sovereign entities like states?

The answer is clearly yes, but any bankruptcy law that Congress enacted would need to respect state sovereignty, which is protected by the Eleventh Amendment, as well as the Tenth Amendment and the overall structure of the Constitution. Two protections are especially important. First, the law must be structured so that it is entirely voluntary: the state would be authorized to invoke bankruptcy, but its creditors could not throw the state into bankruptcy involuntarily. Second, the law must not usurp the state's governmental functions. The state

[4] In theory, there might be a third option: trying to use an exchange offer to restructure the obligations. This faces more practical impediments than a restructuring in bankruptcy.

should be the one to decide whether to cut taxes or raise spending, not a bankruptcy judge or other official.

Fortunately, we already have a template for how this might work. For more than seventy years, we have had a set of bankruptcy provisions—now located in Chapter 9 of the Bankruptcy Code-- for cities and other municipalities. Because cities are instrumentalities of the states, municipal bankruptcy raises the same state sovereignty issues as a new bankruptcy law for states. In 1938, the Supreme Court ruled that a municipal bankruptcy law that had been enacted the year before and was the predecessor of today's Chapter 9 was fully constitutional. A law that "expressly avoids any restriction on the powers of the States or their arms of government," and "is carefully drawn so as not to impinge upon the sovereignty of the states" does not run afoul of states' sovereignty.[5]

How Might the Law Be Tailored to Address Concerns?

It is important to keep in mind that Congress has great flexibility in deciding what kinds of provisions to include in any bankruptcy law. I have just described how the law can be tailored to honor state sovereignty by limiting it to voluntary bankruptcy and expressly preserving the state's governmental powers. Other concerns also can easily be addressed by fine-tuning the bankruptcy law. Let me give three illustrations.

First, some critics worry that bankruptcy would be too tempting an option for a state that has serious financial difficulties. Although I believe that this concern is mistaken, and that states are highly unlikely to use bankruptcy except as an absolute last resort, Congress could reduce any temptation by making it more difficult to file for bankruptcy. This is what Chapter 9 already does for municipal bankruptcy by prohibiting a city or other municipality from filing for bankruptcy unless it is insolvent, has been authorized by the state to file for bankruptcy, and

[5] United States v. Bekins, 304 U.S. 27, 51 (1938). It is worth noting that the Supreme Court has held in other contexts that Congress's powers under the Bankruptcy Clause take priority over state sovereignty concerns. See, for example, Central Virginia Community College v. Katz, 546 U.S. 356 (2006).

satisfies several other requirements.[6] A state bankruptcy law could include similar restrictions. It also could require that both the governor and a majority of legislators approve any bankruptcy filing.

Second, as I noted at the outset, some pundits are now issuing dire warnings about the effect that a bankruptcy law for states would have on the bond markets. Although I think this concern also is greatly overblown, Congress could easily adjust the bankruptcy law to limit the risk of bond market turmoil. Congress could establish a special priority for bonds, or require that any state priority status be honored in bankruptcy. Alternatively, Congress could prohibit a state from restructuring its bond obligations unless the bankruptcy judge or other decision maker determines that the restructuring is not likely to have deleterious effects on the bond markets.

Third, some might worry that the bankruptcy of a state is too large and complex for a single bankruptcy judge to handle. This concern, which I share, can be addressed by providing for state bankruptcy cases to be heard by a panel of judges, rather than a single decision maker. Under one model, decision making authority might be given to a panel of three federal district court judges, chosen at random from a list of district court judges who have financial and bankruptcy expertise.

I list these examples only for illustrative purposes. Congress could easily include other kinds of provisions as well.[7]

Conclusion

I do not mean to suggest that bankruptcy would be a simple, silver bullet solution to a state's travails. It wouldn't be. It would be complicated and messy, and should be used only as a last resort. But, just as we needed to enact a municipal bankruptcy law in the 1930s, we need a bankruptcy law for states now.

---

[6] The requirements are set forth in 11 U.S.C. § 109(c).

[7] I have discussed possible adjustments to union contracts elsewhere, for instance. David Skeel, *A Bankruptcy Law—Not Bailouts—for the States*, Wall Street Journal, Jan. 18, 2011, at A17.