Forthcoming, *University of Chicago Law Review* (2012)

# STATES OF BANKRUPTCY

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## Introduction

In the early decades of the Republic, the prospect of an American state defaulting on its obligations was a real and present threat. After the Panic of 1837, and again after the Civil War, states did just that.[2] So notorious were the states that they were lampooned in fiction and verse. To Scrooge, the tight-fisted hero of Charles Dickens' *A Christmas Carol*, bills of exchange for which the payment has been delayed were like "a mere United States security."[3] William Woodsworth devoted an entire sonnet to this theme. "All who revere the memory of Penn," the speaker of "To the Pennsylvanians" concludes:

> Grieve for the land on whose wild woods his name
> Was fondly grafted with a virtuous aim,
> Renounced, abandoned by degenerate Men
> For state-dishonour black as ever came
> To upper air from Mammon's loathsome den.[4]

The offense? Pennsylvania's default on its state debt in 1841.

Until recently, these episodes seemed like relics from a primordial time. The nineteenth century state defaults that aroused such ire occurred before American markets and industry were fully developed, and many were linked to the peculiar circumstances of the Civil War and its

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[2] The story of these defaults and the bondholders' efforts to collect is told in *The Judicial Power of the United States,* John Orth's delightful doctrinal history of state sovereign immunity. JOHN V. ORTH, THE JUDICIAL POWER OF THE UNITED STATES: THE ELEVENTH AMENDMENT IN AMERICAN HISTORY (1987).

[3] CHARLES DICKENS, A CHRISTMAS CAROL (1843), quoted and discussed in ORTH, *supra* note 2, at 3.

[4] William Wordsworth, *To the Pennsylvanians*.

aftermath. In the twentieth century, only a single state defaulted on its debt,[5] and few others threatened to follow suit.[6]

In the past several years, however, the possibility of a state default has begun to look a little less imaginary. Projecting a $25 billion deficit last year, then-California Governor Schwarzenegger proposed to sell the San Francisco Civic Center and other state properties to raise funds.[7] Facing its own large deficit and enormous shortfalls in its public employee pensions, Illinois passed a major tax increase. Both states remain in precarious financial condition, and they have plenty of company.

As the crisis persisted, a very unlikely word crept into conversations about the states' financial predicament: bankruptcy. Starting in late 2010, a few politicians and commentators insisted that state bankruptcy was an idea whose time had now come.[8] So long as the statute was entirely voluntary and did not interfere with governmental decision making, they proposed, it should satisfy any constitutional concerns. After all, municipal bankruptcy has long been deemed constitutional if it satisfies these criteria and gives states the power to forbid their municipalities from invoking the law.[9] Advocates argued that bankruptcy would be preferable to either a complete default or a federal bailout, the two existing options in the event a state's financial distress spiraled out of control.

Not everyone agreed. The Center on Budget and Policy Priorities rushed out a report contending the crisis was largely just a short-term problem caused by cities and states' loss of revenue due to the Great Recession. While "states and localities are struggling to maintain needed services," its authors argued, "this is a cyclical problem that ultimately will ease as the economy recovers."[10] A representative of the National Governors Association warned the Senate

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[5] Arkansas defaulted during the Great Depression. *See* Monica Davey, *The State that Went Bust*, N.Y. TIMES, Jan. 23, 2011, Week in Review at 3 (analyzing Arkansas's 1933 default).

[6] Probably the last serious discussion of possible state default prior to the recent financial crisis came during New York City's crisis in 1975. If New York City collapsed, many thought the state might also default on its obligations. The New York crisis is discussed in Part IV(B), *infra*.

[7] *See, e.g.,* Elizabeth Lesly Stevens, *States Poised to Sell Trophy Buildings to Unidentified Investors*, N.Y. TIMES, Dec. 25, 2010 (sales projected to raise $1.3 billion). Governor Jerry Brown later canceled the sales.

[8] *See, e.g.,* Jeb Bush & Newt Gingrich, *Better Off Bankrupt*, L.A. TIMES, Jan. 27, 2011; David Skeel, *Give States a Way to Go Bankrupt*, WEEKLY STD, Nov. 29, 2010, at 22; David Skeel, *Bankruptcy—Not Bailouts—for the States*, WALL ST. J., Jan. 18, 2011, at A17.

[9] United States v. Bekins, 304 U.S. 27 (1938). Because cities and other municipalities are subdivisions of a state, federal bankruptcy of a municipality raises the same issues as bankruptcy of a state. Municipal bankruptcy is currently houses in Chapter 9 of the Bankruptcy Code, 11 U.S.C. § 901 et sec.

[10] Iris J. Lav & Elizabeth McNichol, *Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm*, CENTER ON BUDGET AND POLICY PRIORITIES 1 (Jan. 20, 2011).

Budget Committee that "no governor or state is requesting this authority, and it is also true that such authority will likely increase interest rates, raise the cost of state government, and create more volatility in the financial markets."[11]

Should Congress provide a bankruptcy option for states, or is the idea misguided? The goal of this Article is to carefully vet this question, using all of the theoretical, empirical and historical tools currently available. The discussion is structured as a "case" for bankruptcy, rather than an "on the one hand, on the other hand" assessment. But I will be as scrupulously fair as I can, reaching several conclusions that veterans of the public and scholarly debate may find surprising—such as a conclusion that an ad hoc restructuring similar to the approach that used for New York City in 1975 is a plausible though imperfect alternative to a pre-specified bankruptcy framework.

Many people recoil at the word "bankruptcy," especially in this context. It is tempting to use a different term, such as a State Debt Adjustment Framework, to sidestep the negative associations.[12] Altering the terminology also would highlight the distinction between state bankruptcy and other, more familiar forms of bankruptcy; and it might counteract the tendency to envision bankruptcy in monolithic terms, as a single framework rather than a wide range of possible restructuring mechanisms. Despite these benefits, I will use "bankruptcy" throughout the Article. By bankruptcy, I mean any legislative framework that provides a mechanism—ordinarily comprehensive in scope—for restructuring and discharging many or all of a state's obligations. In addition to its familiarity, "bankruptcy" has the added virtue of being the language employed by the U.S. Constitution.[13]

Because the concept of state bankruptcy is so novel, I will start at the beginning, by showing how state bankruptcy might be justified in theoretical terms. For the past three decades,

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[11] *See* Barrie Tobin Berger, *Telling the Truth about State and Local Finance*, 27 GOV. FIN. REVIEW, 79, 80 (2011)(quoting testimony of then-National Governors' Association Executive Director Ray Scheppach).

[12] One cannot be sure that the stratagem would work, however. Chapter 9's official title is "Adjustment of Debts of a Municipality," but it is universally known as municipal bankruptcy.

[13] Const., Art. I sec. 8 cl. 4 gives Congress the power "to establish … uniform Laws on the subject of bankruptcies throughout the United States." Even experts sometime trip themselves up on the terminology. Bankruptcy lawyer James Spiotto condemned the idea of bankruptcy for states at the outset of his 2011 legislative testimony as a mistake that "would create practical problems and face legal obstacles," for instance, then went on to propose that Congress consider adopting a framework similar to the Sovereign Debt Restructuring Mechanism (SDRM) the International Monetary Fund proposed for sovereign debt in the early 2000s. *The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter: Hearing of the Subcomm. of Cts, Comm'l, and Adminst Law of the H. Comm. on the Judiciary*, 112th Cong. 1, 13 (2011)(prepared statement of James Spiotto, Partner, Chapman and Cutler LLP). By any ordinary definition of bankruptcy, the SDRM is a bankruptcy framework.

most American bankruptcy scholars have understood bankruptcy as a response to collective action problems, thanks to pioneering work by Douglas Baird and Tom Jackson.[14] Because creditors cannot effectively coordinate, the reasoning goes, they might dismember an otherwise viable firm as each creditor rushed to collect if bankruptcy did not put a halt to these individual collection efforts.[15] This rationale is a weak fit for states, because it is quite difficult for creditors to coerce payment from a state.[16] Whatever collective action problems a state faces are quite limited.

To understand the logic of state bankruptcy we need to change categories. The relevant analogy is not corporate bankruptcy so much as *personal* bankruptcy.[17] States are like people. When they find themselves in an insoluble financial predicament, it is often because of systematic distortions in their decision making. Both state politicians and individuals tend to overweight the present and pay insufficient attention to potential future consequences.[18] As with a person, and unlike with a corporation, the decision maker cannot be displaced in bankruptcy. Instead, bankruptcy can restructure an unsustainable debtload that leaves both the debtor and its creditors worse off. Seen from this perspective, state bankruptcy looks quite different than is commonly assumed.

Having laid the theoretical groundwork, I outline six potential benefits of state bankruptcy, ranging from several that apply even outside of bankruptcy—such as increased leverage to restructure a state's obligations—to others that would arise only if the bankruptcy option were invoked. By reducing subsidies for borrowing, among other things, bankruptcy would counteract state politicians' incentives to ignore the longterm costs of fiscal profligacy. It also would assure a more equitable distribution of the pain of financial crisis. Current ad hoc approaches, such as recent reforms in Wisconsin, Ohio and other states, usually visit the sacrifice

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[14] *See, e.g.,* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982); Thomas H. Jackson & Douglas G. Baird, *Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy* 51 U. CHI. L. REV. 97 (1984).

[15] *Id.*

[16] A state is protected from most creditor litigation by sovereign immunity under the 11th Amendment.

[17] I am not the first to observe that sovereigns are similar to individuals for bankruptcy purposes. For a version of this argument in the sovereign debt context, see Robert K. Rasmussen, *Integrating a Theory of the State into Sovereign Debt* Restructuring, 53 EMORY L.J. 1159 (2004).

[18] The decision making biases of individuals and states are not identical, of course. They differ in that miscalculation figures prominently with individuals, whereas politicians have an incentive to frontload benefits even if they are fully aware of the implications for the future because they are not likely to be the ones who will bear the future costs.

on one or two constituencies—often state employees and the recipients of social services. Bankruptcy would bring a broader range of constituencies to the restructuring table.

Although state bankruptcy's benefits are considerable, critics have raised a number of plausible objections, some of which require careful attention. Two of the most powerful are that states already have adequate tools to address their financial distress, as evidenced by the measures that have been taken in Wisconsin and other states; and that bankruptcy might create contagion in the bond markets, making it difficult even for fiscally responsible states to borrow money. In each case, I show that the objections are less compelling than they initially appear. The likelihood that most states can muddle through does not justify ignoring the very low probably of a catastrophic failure. And the empirical evidence on bond market contagion suggests that fears of a state bond crisis are greatly overstated. Indeed, they echo the dire warnings that were made when municipal bankruptcy was first proposed in the 1930s, as well as the claims that are regularly made by creditors facing regulation.[19]

Traditional bankruptcy is not the only option for restructuring a state's finances in the event of catastrophic financial distress. In the final part of the Article, I consider an important alternative. In 1975, as New York City fell into financial distress, New York state put a financial control board and other reforms in place and Congress provided $2.3 billion in loan guarantees. A number of other states have subsequently enacted legislation authorizing intervention by a municipal control board to oversee financially troubled cities. Although Congress has much less authority over states than states have over their municipalities, due to federalism constraints, lawmakers could implement a similar approach so long as the state agreed to the intervention in return for federal funding. This is the model Congress used with New York City, and it is a familiar feature of programs such as Medicaid and welfare. There are a variety of risks to this approach, as with any resolution that is not pre-specified, but it is not altogether implausible. To explore these points, and complete the analysis of state bankruptcy, I consider the strategic incentives of Congress and a troubled state that seeks federal support under each scenario.

The Article proceeds as follows. Part I briefly develops the theoretical basis for state bankruptcy. In Part II, I explore each of the six key benefits of a state bankruptcy regime. I then

[19] When the first municipal bankruptcy law was enacted in 1934, critics claimed that "the very novelty of the thing will adversely affect the bond market," and that it "would act as a drag on the sale of municipal securities and might demand a higher rate of interest on such securities." Jonathan S. Henes & Stephen E. Hessler, *Déjà Vu, All Over Again*, N.Y.L.J., June 27, 2011 (quoting dissenting views in 1933 House and 1934 Senate Reports).

turn in Part III to six principal objections, considering each in detail. Part IV focuses on the Federal Oversight Board alternative to a more general bankruptcy statute. I briefly summarize the analysis in the conclusion.