Statement of the

National Bankruptcy Conference

before the

Subcommittee on Courts, Commercial and Administrative Law

of the

House Judiciary Committee

112th Congress, 1st Session

for Hearings on

"The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter"

February 14, 2011

The National Bankruptcy Conference submits this Statement to express its views on some of the legal, policy and practical issues relating to possible legislation that would enable States to seek bankruptcy relief. The Conference is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws. Attached to this statement is a Fact Sheet about the Conference, including a list of Conferees.

Our Statement is divided into three parts, addressing constitutional, policy and practical issues that would be presented by a State bankruptcy act. In our constitutional analysis, while the matter is not free from doubt because there are no direct precedents and only limited indirect precedents, we believe that there are grave doubts that a State bankruptcy act would be constitutional. Even if it were, just because Congress may legislate in an area does not mean that it should. We believe that policy considerations counsel against adoption of a State bankruptcy act. Finally, if Congress nevertheless determines to legislate on this topic, there are practical considerations that must be addressed. We note several of them below but caution that we have had only a short time to consider the entire question of a State bankruptcy act and have not been able to deal with many of the complex issues that are involved. We address whether to specify how a State would authorize a filing, whether to include a threshold insolvency requirement and if so, how it would operate, which court should have jurisdiction over the case and what substantive requirements might be included as conditions for plan confirmation. Another key issue would be the proper role, if any, of a federal court in determining whether a State could or should raise taxes, which we believe is an inherently political issue best tackled by elected representatives.

We encourage further study and analysis before proceeding with State bankruptcy legislation, because of the extraordinary complexity of the topic, the numerous interests that would be affected and the dramatic impact any such law would likely have. We remain available to consult with the Subcommittee on any of these topics.

I. Does the Constitution Authorize or Permit a Law Restructuring State Debts?

A creditor of a State is usually restricted by that State's law from seizing State property.[1] The creditor's traditional remedy in the municipal debt context is by writ of mandamus, ordering the municipality (or, more precisely, the appropriate municipal officer) to pay its debt, in some cases by levying taxes or by devoting first dollars collected to the payment of debt. The first creditor to obtain a writ of mandamus is typically entitled to be paid first.[2] By contrast,a State enjoys sovereign immunity, which prevents a suit against the State or its officers for the State's obligations without its consent and prevents a court from enforcing a judgment against a State's assets.[3] Thus the utility of a State bankruptcy act would lie not in its protection of State assets but rather in allowing a State to obtain federal sanction under the Bankruptcy Clause,[4] to the extent such sanction is needed, to a restructuring of certain pre-existing obligations (reducing payments or extending maturities).

Any such discussion must start with the constitutionality of such an act, which poses several questions. The Bankruptcy Clause provides that Congress shall have the power "to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." Art. I § 8 cl. 4. The first question is whether this power includes the power to enact a State bankruptcy act. If the power exists, does the sovereign character of the States or the Constitution's Contracts Clause impose any limits on the exercise of the power? Finally, are there any other Constitutional provisions or principles that might limit the exercise of such power?

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[1] *See* MCCONNELL & PICKER, WHEN CITIES GO BROKE: A CONCEPTUAL INTRODUCTION TO MUNICIPAL BANKRUPTCY (PLI March 1995) 713 PLI/Comm 35 at *42 – 48 on limitations on seizing municipal property.

[2] John Wittbold & Co. v. City of Ferndale, 281 Mich. 503, 510-511, 275 N.W. 225 (1937).

[3] There is a possible exception to this rule – attachment of out-of-state assets pursuant to a judgment of a court in another state. Struebin v. State of Ill., 421 N.W.2d 874, 875 (Iowa 1988).

[4] Const., Art. I § 8 cl. 4.

The argument for constitutionality is based primarily on the Supreme Court's decision upholding the municipal bankruptcy law, now codified in chapter 9 of the Bankruptcy Code. Under this argument, any concern about impingement on state sovereignty is fully addressed by allowing only fully voluntary state filings.

> In the instant case we have co-operation [between the state and federal governments] to provide a remedy for a serious condition in which the States alone were unable to afford relief. Improvement districts . . . were in distress. Economic disaster had made it impossible for them to meet their obligations. As the owners of property within the boundaries of the district could not pay adequate assessments, the power of taxation was useless. The creditors of the district were helpless. The natural and reasonable remedy through composition of the debts of the district was not available under state law by reason of the restriction imposed by the Federal Constitution upon the impairment of contracts by state legislation. The bankruptcy power is competent to give relief to debtors in such a plight and, if there is any obstacle to its exercise in the case of the districts organized under state law it lies in the right of the State to oppose federal interference. The State steps in to remove that obstacle. The State acts in aid, and not in derogation, of its sovereign powers. It invites the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue. Through its cooperation with the national government the needed relief is given. We see no ground for the conclusion that the Federal Constitution, in the interest of state sovereignty, has reduced both sovereigns to helplessness in such a case.[5]

However, as we explain below, we have grave doubts about whether a State bankruptcy act would be constitutional. There are obviously no direct precedents, so certainty is not possible. As a result, we believe that Congress should tread very carefully, if at all, in this area, and only after serious and thoughtful consideration.

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[5] United States v. Bekins, 304 U.S. 27, 53-54 ("*Bekins*").

A. The Scope of the Bankruptcy Clause

We first consider the scope of the Bankruptcy Clause. If the Bankruptcy Clause does not provide the federal government power to restructure State indebtedness, State "consent" to the exercise of the power is irrelevant.[6]

For over two hundred years, parties have challenged bankruptcy acts as going beyond the authority granted in the Bankruptcy Clause, and such parties have always lost:

> From the beginning, the tendency of legislation and of judicial interpretation has been uniformly in the direction of progressive liberalization in respect of the operation of the bankruptcy power.[7]
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> In no branch of the law is there greater necessity for "adopting legal principles to new and varying exigencies" than in Constitutional law; and nowhere has the Federal Constitution shown its expansive possibilities more frequently and more forcibly than in that clause which vests in Congress the power to pass uniform laws on the subject of bankruptcies.[8]

Thus the Bankruptcy Clause, written at a time when "bankruptcy" was understood to refer only to a proceeding to liquidate the assets of traders and merchants for the benefit of their creditors,[9] has since been expanded to encompass liquidation cases for individuals who are not traders, complete with a discharge,[10] compositions and corporate reorganizations[11] and finally, as noted below, municipal arrangements.[12] In upholding railroad reorganization under Section 77 of the Bankruptcy Act of 1898 as being within the bankruptcy power, *Chicago & Rock Island* gave broad sweep to that power:

[6] The Supreme Court has held that the Bankruptcy Clause contains an implicit waiver of sovereign immunity with respect to preference, fraudulent transfer or other avoidance actions. The Court reasoned that the States had agreed to allow Congress to enact uniform bankruptcy laws and by doing so had waived sovereign immunity to the extent inconsistent with the uniform treatment of private debtors. Central Va. Comm'ty College v. Katz, 546 U.S. 356 (2006) ("*Katz*"). The decision does not imply that any State waived sovereign immunity with respect to itself as a debtor or that any State, in adopting the Constitution, agreed that another State may be a debtor in a bankruptcy case.

[7] Continental Ill. Nat'l Bank & Trust Co. v. Chicago & R.I. & Pac. Ry. Co., 294 U.S. 648, 668 (1935) ("*Chicago & Rock Island*").

[8] C. WARREN, BANKRUPTCY IN UNITED STATES HISTORY 4 (Beard Books 1999)

[9] *Id*.

[10] Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 187 (1902).

[11] *Chicago & Rock Island, supra*.

[12] United States v. Bekins, 304 U.S. 27 (1938).

> Section 77 advances another step in the direction of liberalizing the law on the subject of bankruptcies. Railway corporations had been definitely excluded from the operation of the law in 1910 (c. 412, § 4, 36 Stat. 838, 839), probably because such corporations could not be liquidated in the ordinary way or by a distribution of assets. A railway is a unit; it can not be divided up and disposed of piecemeal like a stock of goods. It must be sold, if sold at all, as a unit and as a going concern. Its activities can not be halted because its continuous, uninterrupted operation is necessary in the public interest; and, for the preservation of that interest, as well as for the protection of the various private interests involved, reorganization was evidently regarded as the most feasible solution whenever the corporation had become "insolvent or unable to meet its debts as they mature." . . . Obviously, § 77 does no more than follow the line of historical and progressive development projected by previous acts.[13]

One can argue that a State is in many instances like the railroad described in *Chicago & Rock Island*. It cannot be liquidated, and its activities cannot be halted because they are in the public interest. Therefore one can argue that a voluntary State bankruptcy act "does no more than follow the line of historical and progressive development projected by previous acts." However, such an argument does not address the fundamental difference between an ordinary commercial corporation, even one invested with a public interest as the railroads were in the 1930's, and a sovereign State in our federal system. The historical record and the Supreme Court's decisions first invalidating and then validating municipality bankruptcy statutes suggest that, because of sovereignty concerns, even a municipal bankruptcy is unlike any commercial bankruptcy.

The opponents of the original Constitution complained that citizens of one State could buy bonds of another State and use the federal courts to enforce the bonds. Alexander Hamilton responded, in Federalist No. 81, that such a lawsuit would be barred by sovereign immunity. However, Hamilton's argument went beyond sovereign immunity to the essence of State sovereignty itself.

> The contracts between a nation and individuals are only binding on the conscience of the sovereign, and have no pretensions to a compulsive force. They confer no right of action, independent of the sovereign will. To what purpose would it be to authorize suits against States for the debts they owe? How could recoveries be enforced? It is evident, it could not be done without waging war against the contracting State; and to ascribe to the federal courts, by

[13] *Chicago & Rock Island,* 294 U.S. at 672.

> mere implication, and in destruction of a pre-existing right of the State governments, a power which would involve such a consequence, would be altogether forced and unwarrantable.

The federal government's lack of power to enforce State obligations does not, of course, necessarily deny the reciprocal power to release or restructure State obligations. However, Hamilton's view of each State as equivalent to a separate country—the dominant view at the time and one that still underlies much jurisprudence—suggests caution in assuming that the latter power exists. As a sovereign, a State is different from a municipality. Although the Supreme Court has held that with proper Congressional authorization, a sovereign State may agree to submit the adjustment of the debts of agencies and instrumentalities that it creates, such as its municipalities, to another sovereign (the federal government), it is far from clear—one may venture to say unheard of in 1787[14] and indeed today—for one sovereign to submit the restructuring of its debts to another, unless in the compact of the Constitution the one sovereign ceded that power to the other.[15]

In fact, the federal government has "restructured" the indebtedness of the States twice—once at par, once at zero. The circumstances of each restructuring also suggest caution in assuming that the Bankruptcy Clause would allow a federal statute to do so.

The first restructuring occurred at the founding of the nation. Hamilton sought to restore public credit by having the federal government assume the indebtedness of the several States by redeeming such indebtedness at par with new federal notes, which would themselves be payable in specie obtained from customs duties and the sale of public lands. The debts of the States were trading at substantial discounts, and James Madison (among others) contended that secondary holders should receive only the prices they had paid for the State indebtedness—in effect implying the imposition, by federal law, of a novation of State indebtedness at a discount. Congress rejected Madison's argument after

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[14] The Framers likely would have been more than surprised at the thought. "[N]either [the Contract Clause] nor any other part of the Constitution has vested the general government with power to interfere with the public securities of any State. I will venture to say that the last thing which the general government will attempt to do will be this. They have nothing to do with it. The clause refers merely to contracts between individuals. . . . When the worthy gentleman comes to consider, he will find that the general government cannot possibly interfere with such securities. How can it? It has no negative clause to that effect. Where is there a negative clause, operating negatively on the States themselves? It cannot operate retrospectively, for this would be repugnant to its own express provisions. It will be left to ourselves to redeem them as we please. We wished we could put it on the shoulders of Congress, but could not." Debate in North Carolina Ratifying Convention, 29 July 1788, Elliot 4:183-85, 190-91.

[15] *See e.g.*, Katz, 546 U.S. 356, and discussion in I.B. *infra*.

Hamilton argued that it would have caused a breach of agreements to pay in full that original noteholders had validly assigned to later purchasers.[16]

The second restructuring occurred after the Civil War. The Confederacy and its constituent States had financed their rebellion by issuing debt. That debt was nullified in Section 4 of the Fourteenth Amendment:

> [N]either the United States nor any State shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States, or any claim for the loss or emancipation of any slave, but all such debts, obligations and claims shall be held illegal and void.

Clearly, Section 4 was adopted as a punitive measure against the defeated States of the Confederacy, but it is worth noting that the invalidation of the debts was done by Constitutional amendment. The arguable implication is that Congress recognized that it could not have voided (or otherwise affected) the obligations of the Confederate States by statute alone,[17] although it is not likely the Bankruptcy Clause was given any consideration at the time as the source of a power to effect that result.

B. Would a State Bankruptcy Act Interfere with State Sovereignty?

The checkered history of constitutional adjudication regarding municipal bankruptcy law advises further caution in passing any voluntary State bankruptcy act because of the potential interference with State sovereignty.

In 1936, the Supreme Court struck down Congress' first attempt to restructure municipal indebtedness (denominated Chapter IX of the Bankruptcy Act of 1898) as violating State sovereignty in *Ashton v. Cameron County Water*

[16] A. HAMILTON, FIRST REPORT ON PUBLIC CREDIT (Jan.9, 1790), communicated to the House of Representatives, January 14, 1790, proceedings of 1st Cong., 2d Sess. at 16-17; *see also* S. ELKINS & E. MCKITTRICK, THE AGE OF FEDERALISM: THE EARLY AMERICAN REPUBLIC, 1788-1800, text at note 81 (Oxford 1993). Congress may also have rejected Madison's argument because some Representatives and Senators had themselves bought State debts at substantial discounts with a view to profiting from the federal assumption of such debts at par, and because certain southern Senators agreed to approve assumption at par, mostly benefiting Northern speculators, in return for the location of the capital in the South. C. BOWERS, HAMILTON & JEFFERSON: THE STRUGGLE FOR DEMOCRACY IN AMERICA 43-48 (1966).

[17] There is very little jurisprudence relating to Section 4 of the 14th Amendment. The Confederate States had to adopt the 13th and 14th Amendments to gain re-admission to the Union, so one could argue that Congress included Section 4 to ensure that a ratifying State was constitutionally estopped from deciding to honor its Confederate war debts.

Improvement District ("Ashton")[18]. Although the Supreme Court later upheld a newly enacted municipal bankruptcy law, it did so by noting its compliance with *Ashton*'s restrictions, rather than by directly overruling *Ashton*, which had been decided only two years before. Thus, the language and reasoning of *Ashton* may still have some force.

The Court in *Ashton* noted that "[i]t is plain enough that respondent is a political subdivision of the state, created for the local exercise of her sovereign powers, and that the right to borrow money is essential to its operations. Its fiscal affairs are those of the state, not subject to control or interference by the national government, unless the right so to do is definitely accorded by the Federal Constitution." *Ashton* at 527-28 (internal citations omitted). Because "there [can] be no loss of separate and independent autonomy to the States, through their union under the Constitution," and interference with a state subdivision is equivalent to interfering with a State, *id.* at 528-29, the Court held the Act unconstitutional because it "might materially restrict [a State political subdivision's] control over its fiscal affairs," *id.* at 530. The Court reasoned that:

> If federal bankruptcy laws can be extended to [a State political subdivision], why not to the state? . . .
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> . . . .
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> If obligations of states or their political subdivisions may be subjected to the interference here attempted, they are no longer free to manage their own affairs; the will of Congress prevails over them . . . . And really the sovereignty of the state, so often declared necessary to the federal system, does not exist.
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> . . . .
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> Like any sovereignty, a state may voluntarily consent to be sued; may permit actions against her political subdivisions to enforce their obligations. Such proceedings against these subdivisions have often been entertained in federal courts. But nothing in this tends to support the view that the federal government, acting under the bankruptcy clause, may impose its will and impair state powers—pass laws inconsistent with the idea of sovereignty.

Id. at 531. It added:

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[18] 298 U.S. 513 (1936). In Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 433 n.42 (1946), the Court included *Ashton* in a list of cases that "thus far not overturned", though it acknowledged that *Ashton* "may be said in effect to have been overruled by [*United States v.*] *Bekins*".

> The Constitution was careful to provide that "no State shall * * * pass any * * * Law impairing the Obligation of Contracts." . . . This she may not do under the form of a bankruptcy act or otherwise. . . . Nor do we think she can accomplish the same end by granting any permission necessary to enable Congress so to do.

Id. (alteration in original). Thus, a State was powerless to acquiesce to an intrusion of the core components of its sovereignty, even in case of necessity (i.e., the necessity being that the State could not act alone because the Contract Clause law of the time prevented it from altering its obligations).

Justice Cardozo's dissent, arguing that the statute was valid, specifically noted that it did not address State indebtedness:

> No question is before us now, and no opinion is intimated, as to the power of Congress to enlarge the privilege of bankruptcy by extending it to the States as well as to the local units. Even if the power exists, there has been no attempt to exercise it. There is room at least for argument that within the meaning of the Constitution the bankruptcy concept does not embrace the States themselves. In the public law of the United States a State is a sovereign or at least a quasi-sovereign. Not so, a local governmental unit, though the State may have invested it with governmental power.[19]

Congress passed a virtually identical statute in 1937, initially denominated Chapter X of the Bankruptcy Act of 1898 (later re-numbered Chapter IX). This statute was upheld in *Bekins*, in an opinion authored by the Chief Justice, who had joined the *Ashton* dissent.[20]

Bekins cited *Ashton* without disapproval, *id.* at 50, and upheld the statute primarily because it required a municipality to be authorized by its State to seek bankruptcy relief, which the Court found addressed *Ashton*'s State sovereignty concerns. That is, the new statute complied with the *Ashton* requirements. Thus, applying those requirements, *Bekins* found no bar to having the States seek the aid of the federal bankruptcy power for the relief of their municipalities in the circumstances of the Great Depression. "The statute is carefully drawn so as not to impinge upon the sovereignty of the state." *Id.*

> In the instant case we have cooperation to provide a remedy for a serious condition in which the States alone were unable to afford relief. Improvement districts such as the petitioner were in distress.

[19] Ashton, 298 U.S. at 542 (Cardozo, J., dissenting).

[20] 304 U.S. 27 (1938).

> Economic disaster had made it impossible for them to meet their obligations. As the owners of property within the boundaries of the district could not pay adequate assessments, the power of taxation was useless. The creditors of the district were helpless. The natural and reasonable remedy through composition of the debts of the district was not available under State law by reason of the restriction imposed by the Federal Constitution upon the impairment of contracts by State legislation. The bankruptcy power is competent to give relief to debtors in such a plight and, if there is any obstacle to its exercise in the case of the districts organized under State law it lies in the right of the State to oppose federal interference. The State acts in aid, and not in derogation, of its sovereign powers. It invites the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue. Through its cooperation with the national government the needed relief is given. We see no ground for the conclusion that the Federal Constitution, in the interest of State sovereignty, had reduced both sovereigns to helplessness in such a case.[21]

Bekins might therefore be read to reaffirm the rule that the core of State sovereignty may be neither surrendered nor infringed, while expanding the concept of sovereignty to include a form of State self-determination that allows States to obtain congressional permission to solve their problems. Nevertheless, there is a difference between acting with the sovereign's consent on the sovereign's political agencies, instrumentalities and subdivisions and acting on the sovereign itself. For example, for diversity purposes, federal courts regularly treat political subdivisions as citizens of their States,[22] while treating as noncitizens entities that are sufficiently indistinct from the sovereign to be considered "alter egos" of the State.[23] There can thus be no assurance that a State bankruptcy act would pass constitutional muster on the sovereignty issue.

C. The Interaction of the Bankruptcy Clause and the Contracts Clause

Bekins should also be read to reaffirm the applicability of the Constitution's prohibition of State laws impairing contracts in Article I § 10 (the "Contracts Clause") to prevent a State's abrogation of contractual obligations of private or municipal debtors. Only Congress may authorize such abrogation under the Bankruptcy Clause. In *Bekins*, as in cases that preceded and followed it, the Constitutional limit seems to some degree based on necessity and the absence of any reasonable alternative. For example, four years after deciding *Bekins*, in a

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[21] *Id*. at 53, 53-54.

[22] Illinois v. City of Milwaukee, 406 U.S. 91, 92 (1972).

[23] Moor v. Alameda County, 411 U.S. 693, 717 (1973).

unanimous decision upholding a New Jersey's municipal restructuring statute, the Supreme Court appeared to retreat from the position that the States may not affect municipal obligations. In *Faitoute Iron & Steel Co. v. City of Asbury Park*, ("*Faitoute*"),[24] the Court said:

> [T]he authority to levy a tax is imported into an obligation to pay an unsecured municipal claim, and there is also imported the power of the State to modify the means for exercising the taxing power effectively in order to discharge such obligation, in view of conditions not contemplated when the claims arose. . . . The necessity compelled by unexpected financial conditions to modify an original arrangement for discharging a city's debt is implied in every such obligation for the very reason that thereby the obligation is discharged, not impaired.
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> *　　　*　　　*
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> The real constitutional question is whether the Contract Clause of the Constitution bars the only proven way for assuring payment of unsecured municipal obligations. For, in the light of history, and more particularly on the basis of the recommendations of its expert advisers, the New Jersey legislature was entitled to find that in order to keep its insolvent municipalities going, and at the same time fructify their languishing sources of revenue and thus avoid repudiation, fair and just arrangements by way of compositions, scrutinized and authorized by a court, might be necessary, and that to be efficacious such a composition must bind all, after 85 per cent of the creditors assent, in order to prevent unreasonable minority obstruction. . . .
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> From time to time, ever since *Sturges v. Crowninshield*, it has been stated that a State insolvency act is limited by the Contract Clause of the Constitution in authorizing composition of preexisting debts. So it is, but it all depends on what is affected by such a composition and what State power it brings into play. The dictum from *Sturges v. Crowninshield* is one of those inaccurate generalizations that have gained momentum from uncritical repetition.
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> If a State retains police power with respect to building and loan associations . . . and if it may authorize the reorganization of an insolvent bank upon the approval of a State superintendent of banks and a court, but over the dissent of one-fourth of the

[24] 316 U.S. 502 (1942).

> depositors (except preferred or secured claimants), a State should certainly not be denied a like power for the maintenance of its political subdivisions and for the protection not only of their credit but of all the creditors by an adjustment assented to by at least 85 per cent of the creditors, approved by the commission of the State having oversight of its municipalities, and found wise and just after due hearing by a court.[25]

As in *Bekins*, the element of necessity seems to carry substantial weight.

Thirty-five years after *Faitoute*, the Supreme Court in *U.S. Trust Co. v. New Jersey ("U.S. Trust")*, ruled that a State may, in some circumstances, restructure its own indebtedness notwithstanding the Contracts Clause.[26] In *U.S. Trust*, the New Jersey legislature had enacted a covenant that assured the holders of Port Authority bonds that Hudson River toll revenues would never be used to fund mass transit. New Jersey subsequently repealed the covenant in order to use toll revenues to fund commuter trains. The bonds' indenture trustee challenged the repeal under the Contracts Clause. The Supreme Court acknowledged that the States had reserved power to modify contracts upon a sufficient showing of necessity,[27] but held that New Jersey could not raid toll revenues to fund PATH merely because it wished to spend money on "the public good rather than its creditors"[28] or when an alternative, such as higher tolls or taxes, was available.[29] The Court thereby effectively reaffirmed necessity as an element of the Constitutional analysis.[30] It also supported its holding by noting that the effect of the impairment was not, as it was in *Faitoute*, to benefit the bondholders.[31]

These decisions show that the States already have the power, despite the Contracts Clause, to adopt legislation restructuring their own obligations if the need is sufficiently dire—if, as *Bekins* would put it, raising taxes (or cutting expenditures on "the public good") would not be sufficient to pay creditors

[25] *Id.* at 510-514. Congress later banned State municipal insolvency laws to make the Bankruptcy Code the sole means of municipal restructuring. 11 U.S.C. § 903.

[26] 431 U.S. 1, 25-28 (1977).

[27] *Id.* at 25 ("As with laws impairing the obligations of private contracts, an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose.").

[28] *Id.* at 29.

[29] *Id.* at 30, n. 28.

[30] The Chief Justice's concurrence in the opinion also makes the point: "In my view, to repeal the 1962 covenant without running afoul of the constitutional prohibition against the impairment of contracts, the State must demonstrate that the impairment was essential to the achievement of an important state purpose. Furthermore, the State must show that it did not know and could not have known the impact of the contract on that state interest at the time that the contract was made. So reading the Court's opinion, I join it." *Id.* at 32.

[31] *Id.* at 28.

because the State economy is imploding, taxpayers are fleeing and property values are dropping. A voluntary State bankruptcy act therefore would serve no purpose unless it gives a State the power to restructure its obligations when the need is *not* sufficiently dire—when it *can* raise taxes or cut expenditures.

But that logic could run a State bankruptcy act afoul of the Contracts Clause. The Bankruptcy Clause permits Congress to enact a bankruptcy law that discharges obligations despite the Contracts Clause, which by its terms does not apply to Congress.[32] But a State bankruptcy act that authorized the State to use the act to discharge its own debts might be the very State impairment that the Contracts Clause prohibits, particularly if it applied when the need was not sufficiently dire. Whatever financial, reputational or other natural disincentives a State might have to authorizing its municipalities or its private citizens to discharge their obligations, "the State's self-interest is at stake" when it authorizes discharge of its own obligations, likely requiring a higher level of constitutional scrutiny and less deference to a State's determination of necessity.[33]

Therefore, although the matter is certainly not free from doubt, it seems likely that a State bankruptcy act that applied to a State that was not *in extremis* would not pass Constitutional muster, and a State bankruptcy act that applied only when a State was *in extremis* would not add anything to the State's existing powers to deal with its debt obligations.[34] Crafting a State bankruptcy act that applied only in such circumstances would be difficult at best, because of the problem of defining what circumstances are sufficiently dire, determined as of the time of filing, to warrant the need for a State bankruptcy. If the act did not limit a filing to such circumstances, then there would be a basis for constitutional challenge; if the statute did so limit a filing, then there would be a basis for a statutory challenge. Either result would prevent the act from being a speedy, efficient procedure to adjust State obligations, even if the act were ultimately upheld.

[32] *See* Ry. Labor Executives' Ass'n v. Gibbons, 455 U.S. 457, 466 (1981) ("'The grant to Congress [under the Bankruptcy Clause] involves the power to impair the obligation of contracts, and this the States were forbidden to do.'" quoting Hanover National Bank v. Moyses, 186 U.S. 181, 188 (1902).)

[33] U.S. Trust, 431 U.S. at 26 (for purposes of limiting the prohibition against impairment of contracts due to financial distress, "complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake.").

[34] We note that State constitutional limitations might prevent a State from adjusting some obligations. A federal bankruptcy act, if constitutional, would overcome any such limitation. *See* Const., Art. VI, cl. 2 (Supremacy Clause).

D. Constitutional Limitations on a State Bankruptcy Act

If the combined operation of the Bankruptcy Clause and the Contract Clause does not prohibit Congress from enacting a State bankruptcy act, *Ashton* and *Bekins* counsel that it must be drawn very carefully. When Congress re-enacted a municipal bankruptcy law after *Ashton*, the House Report enumerated the features of the law that, in its view, supported the law's constitutionality.[35] *Bekins* endorsed the House Report, quoting its list of validating features as follows:

> "Compositions are approvable only when the districts or agencies file voluntary proceedings in courts of bankruptcy, accompanied by plans approved by 51 per cent of all the creditors of the district or agency, and by evidence of good faith. Each proceeding is subject to ample notice to creditors, through hearings, complete investigations, and appeals from interlocutory and final decrees. The plan of composition cannot be confirmed unless accepted in writing by creditors holding at least 66 2/3 percent of the aggregate amount of the indebtedness of the petitioning district or taxing agency, and unless the judge is satisfied that the taxing district is authorized by law to carry out the plan, and until a specific finding by the court that the plan of composition is fair, equitable and for the best interests of the creditors. . . . "[36]

Bekins clearly viewed the requirements that the municipality file voluntarily, that the State consent and that the municipality is authorized by law to carry out the plan as essential to the constitutionality of a municipal bankruptcy statute; it did not indicate which of the other features it listed to justify the statute were (and are) constitutionally required to validate a municipal or State bankruptcy act.

One feature not listed was the requirement in Chapter X (later Chapter IX) that the municipality be "insolvent". *Bekins'* reliance on financial emergency as a justification for the statute might suggest that insolvency or some form of financial distress is constitutionally required for a municipal bankruptcy act, for the reasons noted in the prior section of this Statement. As is discussed in more detail below, section 109(c) of the Bankruptcy Code imposes a requirement for a municipality to be a chapter 9 debtor that it be insolvent—that is, "unable to pay its debts as they mature"[37]—to be eligible to be a chapter 9 debtor. In determining the scope of the Bankruptcy Clause, the Supreme Court has defined bankruptcy as "the subject of the relations between an insolvent or nonpaying or

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[35] H.R. Rep. No. 517, 75th Cong., 1st Sess. (1937).

[36] 304 U.S. at 50 (alterations in original).

[37] 11 U.S.C. §§ 101(32), 109(c)(3); *see* H. Rep. 95-595, 95th Cong. 2d Sess. 319 (1977).

fraudulent debtor and his creditors, extending to his and their relief."[38] Some have argued that some such limitation must be used, or else nothing would prevent Congress from adopting a bankruptcy law for solvent and liquid debtors, including States.[39] The Supreme Court has not explicitly taken so restrictive a view, instead favoring an expansive interpretation: "From the beginning, the tendency of legislation and of judicial interpretation has been uniformly in the direction of progressive liberalization in respect of the operation of the bankruptcy power."[40] Yet the analysis above suggests caution in this area both from a constitutional perspective and from the practical perspective of crafting a workable State bankruptcy act. As noted, extreme need, if not insolvency by some definition,[41] seems to be a constitutional requirement for a law that would involve the States or the federal government in reducing a State's obligations.

The other features listed in *Bekins* do not appear to be of constitutional dimension in and of themselves, other than *Bekins*' requirement of due process—notice, hearing, rights of appeal (at least of final orders). They paint a picture of a considered and complete bankruptcy system, but nothing since that decision imbues any of the additional requirements with more force than that.

A feature not listed above but addressed at length in *Bekins* is the court's power over a municipal debtor. The limitations the court approved were part of the 1937 act and have been carried forward in essentially identical terms ever since. They are codified now in section 904 of the Bankruptcy Code:

> **§ 904. Limitation on jurisdiction and powers of court**
>
> Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—
>
> (1) any of the political or governmental powers of the debtor;
>
> (2) any of the property or revenues of the debtor; or
>
> (3) the debtor's use or enjoyment of any income-producing property.[42]

Bekins seems to hold that such limitations are constitutionally required for any governmental bankruptcy act.

[38] Ry. Labor Executives' Ass'n v. Gibbons, *supra*, 455 U.S. at 466.

[39] *See* K. KLEE, BANKRUPTCY AND THE SUPREME COURT 130-31 (LEXIS/NEXIS 2008)

[40] *Chicago & Rock Island*, 294 U.S. at 668.

[41] *Compare* 11 U.S.C. § 101(32)(A) (liabilities greater than fair value of assets) *with id.* §101(32)(C) (generally not paying or inability to pay) *with id.* § 303(h) (1) (generally not paying).

[42] 11 U.S.C. § 904.

II. <u>Policy Considerations</u>

Simply because Congress may exercise a power does not mean that Congress should do so. Besides the Constitutional considerations discussed above, there are policy issues that drive whether Congress should enact a State bankruptcy law.

A. Allocating the Risk of Loss In a State Bankruptcy Act

In determining whether to enact a State bankruptcy act, Congress will necessarily be making decisions about how to allocate the losses that may be engendered when a State is unable to meet all of its obligations based on its current financial profile. There are numerous stakeholders who could suffer direct losses: some or all classes of State creditors (such as bondholders and other lenders, suppliers and contractors, employees and retirees), municipalities and other public agencies within the State. Other stakeholders, such as State taxpayers, other residents or businesses that operate in the State, neighboring States and even the federal government, might suffer indirect losses resulting from higher taxes, higher borrowing costs, reduced services or additional demands to step in to handle functions that a distressed State might abandon.

Instead of enacting a State bankruptcy act, Congress could leave the States to solve their own debt issues, whether by adjusting obligations under current or new State law, by increasing receipts, by reducing expenditures or by a combination of all three.[43] Congress could authorize the federal government to refinance a State's obligations or provide other financial support. Such a solution would ease burdens on creditors and State taxpayers but might invite financially-challenged States to seek federal help for improvident decisions that were not made by other States, whose taxpayers might have to share the funding of any subsidy.

Enacting a State bankruptcy act invites allocation of loss primarily on the State's creditors rather than on taxpayers, residents or businesses. Creditors, because of the nature of credit, take risk. Lenders plan for risk and charge interest accordingly. Some creditors' risk is unplanned and uncompensated by interest or otherwise, for example, the risk of loss assumed by tort creditors or by retirees who are owed future pension or health care benefits. Creditors such as suppliers and contractors may fall in between those two categories.

A State bankruptcy act would also likely allocate cost to taxpayers and users of State services. Chapter 9's legislative history cites to pre-Code cases

[43] Municipalities have fewer options to raise taxes because they are subject to State law over which they have no control. A chapter 9 plan of adjustment for a municipality that seeks to raise taxes must comply with applicable law. *See* 11 U.S.C. §§ 943(b)(4), (6).

requiring a municipality to show that it cannot raise taxes before it may confirm a plan and discharge any part of its obligations.[44] Caselaw has suggested that this feature of municipal bankruptcy law may be constitutionally required.[45] If so, no less would be expected of a State in its bankruptcy case.

However, the absence of a State bankruptcy act would likely impose the same or similar costs on those same taxpayers and users. A State may address its financial distress only by balancing its budget, which would come through any combination of increased receipts, such as taxes, direct aid such as from the federal government, and reduced expenditures, such as lower spending on goods or services or on payments on its preexisting obligations resulting from its creditors' voluntary reduction of their demands. Thus, unless a State exercised its taxing power to the fullest[46] and did all that could be reasonably expected in the circumstances (which would likely be required under a State bankruptcy act)[47] to meet its current and past obligations, loss would not be allocated to creditors, whether or not Congress enacted a State bankruptcy act.

If Congress enacted a State bankruptcy act and a State filed a bankruptcy case based on its inability (not merely its unwillingness) to meet its obligations, the historical Bankruptcy Code treatment of creditor interests should apply, without special loss allocation rules among creditors or others. A State bankruptcy act that placed, or permitted a State to place, inordinate burdens on a particular class of creditors (whether comprised of bondholders, trade creditors, retirees or current employees), would be ill advised, as well as contrary to long-established, fundamental bankruptcy policy. Like its predecessor the Bankruptcy Act, the Bankruptcy Code allocates the risk of loss in a manner that generally tracks the allocation under applicable nonbankruptcy law—secured creditors are entitled to recover the value of their collateral, unsecured creditors (including any undersecured portions of secured claims) are paid from unencumbered assets, subordination agreements are honored and equity takes the remainder. While Congress has established some priorities among unsecured creditors in the Bankruptcy Code, the key provisions establish a priority for the costs of conducting the bankruptcy case and protect involuntary or particularly needy

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[44] 124 Cong, Rec. H 11,100 (Sept. 28, 1978); S 17,417 (Oct. 6, 1978): Chapter 9 plan could not be confirmed without meeting the "fair and equitable" and "best interests" tests, to be applied with reference to Kelley v. Everglades Drainage District, 319 U.S. 415 (1943) (Chapter IX plan could not be confirmed without detailed findings on inability of district to service debt) and Fano v. Newport Heights Irrigation Dist., 114 F.2d 563 (9th Cir. 1940) (Chapter IX plan would not be confirmed where district had ability to raise taxes and repay bonds).

[45] *See* 6 COLLIER ON BANKRUPTCY ¶ 943.03[1][f][i] (16th ed. 2011, A. Resnick & H. Sommers eds.).

[46] *See* Fano v. Newport Heights Irr. Dist., 114 F. 2d 563 (9th Cir. 1940).

[47] *See* Lorber v. Vista Irrigation Dist., 127 F.2d 628, 639 (9th Cir. 1942); 6 COLLIER ON BANKRUPTCY ¶ 943.03[1][f][i][B] (16th ed. 2011, A. Resnick & H. Sommers eds.).

creditors such as tax creditors, workers and the victims of drunk drivers. The allocations among creditors in a chapter 9 case, though not the priorities,[48] are generally consistent, except that there are not equity interests. Creditors holding similar types of claims may be classified separately in a chapter 11 plan or a chapter 9 plan of adjustment.[49] However, unless the class consents, neither type of plan may discriminate unfairly against the class.[50]

Enacting a State bankruptcy act that requires that a plan (or even eligibility for bankruptcy relief) not impair or otherwise protect one or a few favored classes or subclasses of obligations would be contrary to fundamental bankruptcy policy and would establish a dangerous precedent that could have far-reaching consequences with respect to other chapters of the Bankruptcy Code. Similarly, an act that authorized adjustment of only a targeted class or subclass of debt would have similar infirmities. Thus, if Congress were to enact a State bankruptcy act, it should allocate risk of loss according to the existing legal rights that holders of a State's myriad obligations have, as is done in general commercial bankruptcy law.

B. A State Bankruptcy Act's Impact on the States' Ability to Obtain or Cost of Obtaining Credit

Some have suggested that enactment of a State bankruptcy act would adversely affect the State's ability to obtain credit. There is no conclusive evidence as to what impact a bankruptcy option may have on the cost and availability of credit. There is no empirical evidence, and commentators disagree.

Empirical studies that have been conducted on municipality bankruptcies suggest that a bankruptcy option for States may have a negative impact on the cost and availability of credit to a State. For example, one study following the chapter 9 bankruptcy case of Orange County, California, indicates that the bankruptcy case negatively affected the cost and availability of municipal finance generally. However, the study focused on the pricing of municipal bonds during the period following the bankruptcy and not on the costs and availability of credit to municipalities *ex ante*.[51]

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[48] *See*, *e.g.*, In re New York City Off-Track Betting Corp., 434 B.R. 131 (Bankr. S.D.N.Y. 2010) (debtor's operational costs during a chapter 9 case are not entitled to administrative expense priority).

[49] *See* In re Jersey City Med. Ctr., 822 F.2d 52 (3d Cir. 1987).

[50] 11 U.S.C. §§ 901(a), 1122(a), 1129(b)(1).

[51] John M. Halstead, Shantaram Hegde & Linda Schmid Klein, "Orange County Bankruptcy: Financial Contagion in the Municipal Bond and Bank Equity Markets", 39 FIN. REV. 293 (2004); *see also* Dwight V. Denison, "Did Bond Fund Investors Anticipate the Financial Crisis of Orange County?", 21 MUN. FIN. J. 24 (2000).

Commentators disagree as to what impact a bankruptcy option for States would have on the cost and availability of credit for a State. Some suggest that, with the bankruptcy option being a readily available tool for a State to adjust its funded debt in ways that it could not have previously done, investors will feel more at risk and, accordingly, will be less likely to purchase funded debt issued by the State or will charge significantly higher pricing.[52] Other commentators argue that the greater certainty for investors in knowing that the option is available and how it will work will have a stabilizing effect compared to the uncertainty existing on account of the lack of a formal mechanism for a State to adjust its debt.[53]

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[52] Anthony Valeri, LPL Financial, "Bond Market Perspectives: State Bankruptcy Brouhaha" (Jan. 25, 2011), (*available at* http://www.inthemoney.net/files/LPL/Research/RES%202998%200111.pdf) (arguing that rating agencies have factored the historically low default rate of municipal bonds into their ratings, and that a State bankruptcy option likely would lead to "a rash of downgrades" that would "exacerbate price declines among municipal bonds."); Felix Salmon, "Should States Be Able to Go Bankrupt?", *at* http://blogs.reuters.com/felix-salmon/2010/12/07/should-States-be-able-to-go-bankrupt/ ("If [State bankruptcy legislation] were implemented, or if it even looked like it might get implemented, prices of municipal bonds would plunge, and most States would find it pretty much impossible to borrow money… The fact is that there's only one reason to invent a Chapter 8 bankruptcy provision for States—and that's to come up with an efficient and legal way to impose losses on bondholders and other creditors…The creditors, fully aware of this, would immediately cease lending, certainly to the rockier States like California, Illinois, and New York."); *see also* Financial Innovations Lab Report, "Ensuring State and Municipal Solvency," Oct. 2010, at 20, *available at* http://ssrn.com/abstract=1690536 (discussing municipal, rather than State, bankruptcy: "[I]f a streamlined Chapter 9 process were institutionalized, borrowing costs for all municipalities would undoubtedly rise, with investors demanding higher returns to compensate for an increase in the probability of bond defaults.").

[53] *See* Nicole Lapin, "States of Pain: Chapter 8 Bankruptcy Bandage?", CNBC: NetNet with John Carney, *at* http://www.cnbc.com/id/40854030/States_of_Pain_Chapter_8_Bankruptcy_Bandage; *see also* David Skeel, "Give States a Way to Go Bankrupt", THE WEEKLY STANDARD, Nov. 29, 2010, *available at* http://www.weeklystandard.com/articles/give-States-way-go-bankrupt_518378.html?nopager=1 ("The bond market wouldn't be happy with a California bankruptcy, but it is already beginning to take account of the possibility of a default. And bondholders can't pull their funding the way a bank's short-term lenders or derivatives creditors can."). Further, Skeel argues, the possibility of complete default by a State is worse than the possible implications for the bond market if a State bankruptcy option is enacted. *See* David Skeel, "A Bankruptcy Law - Not Bailouts - For the States," WALL STREET JOURNAL, Jan. 18, 2011, available at http://online.wsj.com/article/SB10001424052748703779704576073522930513118.html?KEYWORDS=david+skeel ("While some worry about the implications for bond markets, the alternative for the most highly indebted States—complete default—is far worse… [T]he price of corporate bonds went up during the New Deal when the Supreme Court upheld legislation that reduced payments to bondholders. The reduction increased the prospect that bondholders would get paid. The prospect of State bankruptcy could have a similar effect"). *See also* David Skeel, "Listening to the Bond Market," Jan. 27, 2011, *at* http://www.law.upenn.edu/blogs/dskeel/ ("The standard refrain is that a

We are not economists. We are lawyers, judges and academicians who practice, judge or teach in the bankruptcy field. So our view must be guarded and is limited to our own experiences. Bearing those caveats in mind, our view is that a bankruptcy option will affect the credit assessment of State issuers of funded debt.[54] We believe that the short-term effects on the cost and availability of credit to a State will be negative as investors will view the bankruptcy option as a defensive measure that a State could invoke to impair the terms of funded debt over the objection of some or all investors.

However, if the option is thoughtful and carefully drafted, it is possible that it could have a neutral or positive effect on the cost and availability of credit in the long term. Investors deal continually yet credit is extended and usually at favorable pricing. Our experience has been that credit markets react more favorably when the legal rules are clear and known even if those rules are not always optimal for extenders of credit. The credit market will likely adjust to the

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bankruptcy option would be devastating to the bond markets, and would create chaos for all States, even the financial [*sic*] stable ones. It's possible that a State bankruptcy option would have adverse effects on the bond markets, but I think the effects are greatly overstated. The markets are very good at distinguishing between troubled borrowers and healthier ones; and even troubled borrowers often can quickly return to the markets after a rough patch. (On the international stage, Argentina has shown how this can be done—almost too easily)."). There is anecdotal support for Skeel's argument that the bond market is already incorporating the possibility of a State bankruptcy option, although it is unclear if investors are reacting to this possibility or the increased default risk of specific bonds. *See* Bernard Condon & Daniel Wagner, Associated Press, "First GM, Now States? Pros and Cons of Bankruptcy," Feb. 1, 2011, *at* http://www.washingtonpost.com/wp-dyn/content/article/2011/02/01/AR2011020104802_pf.html ("[Demand for municipal bonds] was already dropping before talk of a bankruptcy option spread. Fearing that towns and cities may default, investors in November and December pulled a record $21 billion from funds that invest in municipal bonds - twice as much as they did at the depths of the 2008 credit crisis, the Investment Company Institute says. Those still buying are demanding higher interest payments to compensate for the risk.").

[54] At least one rating agency has suggested a State bankruptcy option would impact its rating of States, but again it is not clear whether any rating change would be prompted by the availability of bankruptcy rather than the circumstances of a particular State. Standard & Poor's said that "a bankruptcy law would cause it to review they way it judges States." *Id*. *See also* Reuters, "Bankruptcy Seen As Unlikely Option For States: S&P", Jan. 26, 2011, *at* http://www.reuters.com/article/2011/01/26/usa-States-bankruptcy-idUSN2616195220110126 ("Current S&P rating criteria reference the fact that States are not eligible to file for bankruptcy protection under the U.S. bankruptcy code, and that has been fundamental to analysis of the sector, the agency said."). Still, any action by a rating agency would seem to be based on a given State's financial condition rather than the general availability of a bankruptcy option; *see id*. ("'If a State were to file for bankruptcy protection, or we were to become aware of a State considering such a filing, we would likely re-evaluate our credit-worthiness opinion and take ratings actions that we deem appropriate in accordance with the 'overriding factors' of our State rating methodology,' the rating agency said.").

greater certainty created by a thoughtful and carefully drafted bankruptcy option. In the long term, the greater certainty may enable better credit assessments and more considered risk-taking that would favorably affect the cost and availability of credit to States. However, this benefit will likely be mitigated by the uncertainty that would surround any new law for an indefinite time while its contours were tested and settled by the courts. Because it is unlikely that many States, if any at all, would use the law, there could be a substantial delay before there is any meaningful clarity or certainty.

C. Would Any State Authorize a Bankruptcy Filing?

We are in no position to predict whether any State would authorize the filing of a State bankruptcy case. The decision is first and foremost a political one, onto which are layered a number of the legal, policy and practical considerations discussed in this Statement. For example, each State will have to consider the impact on the credit markets that enabling legislation would have on that State's future borrowings. Some have suggested that a State that sought bankruptcy relief and confirmed a plan that imposed discounts on bondholders might suffer in the capital markets in the future and be forced to pay a premium for post-reorganization indebtedness.[55] Moreover, if a State bankruptcy act were to authorize the rejection of collective bargaining agreements or the modification of retiree benefits (whether by incorporation of Bankruptcy Code §§ 365, 1113 or 1114, through modified versions thereof or by entirely new provisions), the impact on the State's labor force, unions and retirees would undoubtedly be subject of intense debate over enabling legislation.

We believe that enactment of a State bankruptcy act would provide little benefit if it were clear that no State would use it other than as a threat to creditor constituencies, because the threat would not be credible. In addition to the political and other considerations discussed in the previous paragraph, we note that 23 States have not enacted legislation authorizing a chapter 9 filing by any of their municipalities, that one State expressly prohibits a municipality bankruptcy filing[56] and that other States condition filings on the satisfaction of various conditions precedent (such as approval of the Governor or by a special board or financial professional).[57] It is questionable whether those States would take the

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[55] Jeb Bush & Newt Gingrich, *Better off bankrupt – States should have the option of bankruptcy protection to deal with their budget crises*, Los Angeles Times, Jan. 27, 2011 ("In a voluntary bankruptcy scenario, states, like municipalities, will have every incentive to file a reorganization plan that protects state bondholder claims and their ultimate recovery. States will evaluate their future access to bond markets and their prospective borrowing rates as they formulate the optimal restructuring plan.").

[56] Ga. Code Ann. §36-80-5.

[57] *See* the Appendix to DABNEY, DARBY, EGAN, LEVINSON AND SOUTH, MUNICIPALITIES IN PERIL: THE ABI GUIDE TO CHAPTER 9 (American Bankruptcy Institute 2010).

more drastic step of enacting legislation enabling the State itself to seek bankruptcy relief. Indeed, were a State bankruptcy act enacted, those States might well follow Georgia's approach to chapter 9 by expressly prohibiting the State from filing for bankruptcy relief.

III. Practical Issues

A. Should a State Bankruptcy Act Specify How a State Consents?

The eligibility requirements for chapter 9 include, among other things, specific State authorization by "State law" or by a governmental officer or organization empowered by "State law,"[58] but does not define that phrase. It is generally assumed that "State law" means legislation enacted by the State legislature and approved by the Governor, but issues of authorization have arisen in chapter 9 cases.[59]

Should Congress determine to enact a State bankruptcy act, specifying the precise nature of State consent would likely reduce the risk of time-consuming litigation that a financially challenged State and its impacted creditors could ill afford to endure. However, we believe that whether a State is authorized to file a bankruptcy case should be determined by State law rather than by the Bankruptcy Code. In commercial bankruptcy cases, whether a juridical entity is authorized to file a bankruptcy petition is determined by its governing law, not by the Bankruptcy Code.[60] Moreover, the Constitutional and sovereignty considerations discussed earlier in this Statement and the Supreme Court cases interpreting them in the bankruptcy context strongly suggest that Congress must defer to the States in determining the form of consent, although Congress may, as it has done for municipal bankruptcy in section 109(c)(2), require that the State have authorized the filing "by State law, or by a governmental officer or organization empowered by State law to authorize" the filing.

B. No Express Insolvency Requirement in a State Bankruptcy Act

We recommend that, if a State bankruptcy act is adopted, it not contain an express threshold eligibility requirement of insolvency. This is in contrast to chapter 9, in which the municipality must be insolvent to be eligible.[61] Insolvency is an elusive concept in the case of a governmental entity, the more so for a sovereign State. Given its taxing power and limited ability to reduce expenses due to statutory and constitutional mandates, a governmental entity

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[58] 11 U.S.C. § 109(c)(2).

[59] *See* In re New York City Off-Track Betting Corp., 427 B.R. 256 (Bankr. S.D.N.Y. 2010).

[60] Price v. Gurney, 324 U.S. 100 (1945).

[61] 11 U.S.C. § 109(c)(3).

stands in an altogether different position than a private individual or corporate entity. Unlike an ordinary debtor who possesses finite resources, a State's ability to pay obligations to creditors is hard to measure at all, let alone with any precision.

Experience with municipality bankruptcies has shown the difficulties that accompany the requirement that the debtor be insolvent. "Insolvent" in the case of a municipality is defined as "generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute" or "unable to pay its debts as they become due."[62] Courts have required municipalities to show not merely that they are in financial distress or that they have obligations that will overwhelm them. Instead, they must demonstrate a present inability to meet obligations. The City of Bridgeport's bankruptcy provides an illustration. The city was running a $16 million annual deficit at the time of its chapter 9 filing, but it had yet to exhaust the proceeds of a special bond issue. The bankruptcy court held that the city was not insolvent because it could not show that "in the near future it will run out of money" nor could it make the showing for as long as the fund was not exhausted. That bankruptcy was a sensible course was irrelevant:

> Bridgeport has demonstrated that its ability to provide even minimal services to its residents is strained . . . and that its financial condition might get worse if drastic steps are not taken soon. The flaw in Bridgeport's argument is that financial difficulties short of insolvency are not a basis for chapter 9 relief.[63]

The court therefore dismissed the petition, observing that the decision of whether to impose a threshold requirement of insolvency lies with Congress, and that an express insolvency requirement is not necessary for a debtor to fall within the ambit of Congress's Constitutional bankruptcy power. Indeed, under current law, there is no requirement that a corporation be insolvent for it to be eligible for relief under chapter 11.

To be sure, Congress's bankruptcy power is not unlimited. Some form of financial distress may be required both as a matter of the Bankruptcy Clause's and the Contract Clause's reach. As the Third Circuit noted in *In re SGL Carbon Corp.*,[64] courts "have consistently dismissed Chapter 11 petitions filed by financially healthy companies with no need to reorganize . . . . Those courts have recognized that if a petitioner has no need to rehabilitate or reorganize, its petition cannot serve the rehabilitative purpose for which Chapter 11 was designed." And the discussion above shows that some form of serious financial

[62] 11 U.S.C. § 101(32)(C).

[63] In re City of Bridgeport, 129 B.R. 332, 339 (Bankr. D. Conn. 1991).

[64] 200 F.3d 154, 165 (3d Cir. 1999).

distress or emergency is likely a Constitutional requirement under the Bankruptcy Clause or the Contract Clause or both for a State to avail itself of either State or federal power to adjust its obligations. But as the Supreme Court explained in *Chicago & Rock Island*,[65] "Those limitations have never been explicitly defined, and any attempt to do so now would result in little more than a paraphrase of the language of the Constitution without advancing far toward its full meaning."

The contours of any such emergency requirement will undoubtedly be subject to litigation in any State bankruptcy case. But imposing an express statutory insolvency eligibility requirement invites litigation at the outset that could hold up a State bankruptcy case. The City of Bridgeport's experience is proof that inquiries into solvency are necessarily messy. Given a State's taxing power and its power to curtail services, there would always be ways to argue that a particular State was not insolvent as it has the ability to raise revenue from taxing or asset sales in a way that a distressed private debtor does not.[66]

Because it is highly unlikely that a State would initiate a bankruptcy case absent severe financial distress, there seems little chance of abuse. Stated another way, if a State were willing to shoulder the arduous burden, cost, distraction and embarrassment of filing a bankruptcy case, negotiating a plan and then fighting to confirm the plan, it likely would try to achieve the same result without bankruptcy if at all possible**.** Moreover, the ability that courts have shown to police the use of chapter 11 and dismiss cases that do not belong there shows that they would able to monitor and take action on whatever abuses might occur. The legitimate concerns about what rights could be modified by a State in a bankruptcy case are best left to substantive provisions themselves, which would then be addressed in the context of plan confirmation rather than eligibility.[67] They are not, by their nature, suitable for resolution at the very outset of a case before any record or plan for debt adjustment is developed.

C. Which Court Should Have Jurisdiction?

Congress has granted the United States district courts exclusive original jurisdiction over bankruptcy cases, 28 U.S.C. § 1334(a), but authorized the district courts to refer bankruptcy cases to the bankruptcy courts, 28 U.S.C. § 157(a). All

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[65] 294 U.S. at 669-70.

[66] "If Bridgeport is able to and does raise taxes and/or reduce spending enough to balance its budget, it will be able to pay its bills as they become due …[this] scenario is a self evident statement of solvency." In re City of Bridgeport, 132 B.R. 85, 92 (Bankr. D. Conn. 1991).

[67] Such an approach might suggest that affecting substantive rights before plan confirmation, such as by rejecting a collective bargaining agreement or any other contract, be subject to the same sort of insolvency determination that might otherwise occur at plan confirmation.

94 district courts have done so. However, the bankruptcy courts are not courts established, and vested with the full "judicial Power of the United States", under Article III, sec. 1 of the Constitution, because the judges do not have life tenure "during good Behaviour".[68] Some bankruptcy court determinations are thus subject to de novo review in the district courts.[69]

Any State bankruptcy act could use the same jurisdictional system as the existing bankruptcy system does for consumer, commercial and municipal bankruptcy cases. The bankruptcy courts have extensive, valuable experience and expertise in the legal and financial issues that would be a central part of any State bankruptcy case. However, Congress should consider whether it is appropriate to allow the district courts to refer to a non-Article III tribunal the power to adjust the debts of a sovereign State. There is not likely any Constitutional dimension to such a decision. In *Katz*, the Supreme Court upheld the exercise of the bankruptcy power by the current bankruptcy courts against a State over the State's sovereign immunity objection. However, comity between sovereigns might suggest that a statute should not permit such referrals.

There is, however, a Constitutional dimension to the jurisdictional question. Article III, sec. 2 provides, "In all Cases . . . in which a State shall be a Party, the supreme Court shall have original Jurisdiction." Thus, whether or not Congress grants original jurisdiction over a State bankruptcy case to the Supreme Court, a State would likely be able to bring the case there, rather than in the district court or bankruptcy court. Such a filing would likely result in the Supreme Court referring the case to a special master, such as a United States District Judge.

D. What Financial Standard Should Apply to Confirmation of a Plan To Adjust a State's Debts?

To confirm a municipal debt adjustment plan under chapter 9, a court must find that the plan "is in the best interests of creditors".[70] The courts have construed "best interests" in this context as requiring a "reasonable effort by the municipal debtor that is a better alternative to its creditors than dismissal of the case".[71] In addition, if any class of creditors does not accept the plan, then the court may confirm the plan only if the plan is all that can reasonably be expected

[68] 28 U.S.C. § 151 (fourteen-year terms); *see* Northern Pipeline Construction Co. v. Marathon Pipeline Co., 458 U.S. 50 (1982).

[69] 28 U.S.C. § 158(c)(1).

[70] 11 U.S.C. § 943(b)(7).

[71] 6 COLLIER ON BANKRUPTCY ¶ 943.03[7][a] (16th ed. 2011, A. Resnick & H. Sommers eds.).

under the circumstances.[72] The substantive content of the standards "best interests" and "fair and equitable" differ dramatically from the substantive content of those standards in commercial bankruptcy, and appropriately so. A governmental entity generally cannot be liquidated to satisfy claims against it, and there is neither a priority ladder of claims in most circumstances nor of equity interests in any circumstances to which the commercial meaning of those terms would apply. Finally, a municipal debt adjustment plan must be "feasible".[73]

We believe that something similar to the chapter 9 confirmation standards would be appropriate in a State bankruptcy act. A requirement of "sustainability" of the restructured obligations could address all three of the municipal plan confirmation standards of best interest, fair and equitable and feasible. Sustainability is the point where necessary services can be reduced no further and practical limits on what the citizens can bear in taxes have been reached, and the State will be able to pay its restructured obligations. It is similar to the "fair and equitable" test in a municipal bankruptcy. There is no bright line, however. It is a political judgment, but the court ruling on whether to confirm the plan would have to determine whether the plan is sustainable. Therein lies some of the difficulty and danger of a State bankruptcy act—requiring a court to decide a complex economic, financial and political question that might be better left to both the political system and financial markets.

E. The State Should Have an Absolute Right to Dismiss the Case

We believe that a State, having voluntarily filed a bankruptcy case, should have the unqualified right to dismiss it at any time.[74] This differs from the treatment of dismissal in chapter 11, where the bankruptcy court may dismiss the case or to convert it to a liquidation under chapter 7.[75] The latter course provides a remedy for creditors, namely liquidation of the debtor's assets by a trustee. Constitutional as well as practical problems make any such alternative unavailable in the context of a State bankruptcy.[76] Were such an alternative possible, it is safe to say that no State would risk it by filing a bankruptcy case.

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[72] *See* 6 COLLIER ON BANKRUPTCY ¶ 943.03[1][f][i] (16th ed. 2011, A. Resnick & H. Sommers eds.).

[73] 11 U.S.C. § 943(b)(7).

[74] This right should apply without any good faith limitation, such as was engrafted into chapter 13 is Marrama v. Citizens Bank, 549 U.S. 365 (2006).

[75] 11 U.S.C. 1112(b).

[76] *See* Footnote 1, *supra*.

We note that chapter 9 does not specifically provide a debtor municipality with an absolute right to dismiss its case, but we believe that the Tenth Amendment as well as Bankruptcy Code sections 903 and 904 dictate such a result, and the courts have so ruled.[77] A federal court may not dictate to a municipality or State which obligations to pay—thus the exclusion from chapter 9 of Bankruptcy Code sections 326 *et seq*., 363 and 541. Moreover, the court lacks the power to compel a chapter 9 municipal debtor to file a plan of adjustment[78] or to confirm a plan that includes provisions by which the debtor would take actions prohibited by law[79] or that contemplates raising revenue or the debtor taking other actions without complying with applicable State electoral and regulatory laws.[80] Thus, an involuntary continuation of a chapter 9 case, and by extension a State bankruptcy case (assuming the incorporation of those or similar provisions, which we believe would be Constitutionally required), would be a futile exercise.

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Due to the short time we had to prepare this Statement, we have not attempted to discuss or even list many of the features that we would suggest be included in a State bankruptcy act. We would be pleased to do so, but such an undertaking will require a great deal of thought, and thus time, as our Conferees will need to consider what aspects of current chapters 9 and 11 to discard, incorporate or modify as well as what new provisions ought to be crafted.

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[77] In re New York City Off-Track Betting Corp., Case No. 09-17121-MG (S.D.N.Y. Jan. 26, 2011); In re Richmond Unified Sch. Dist., 133 B.R. 221, 224 (Bankr. N.D. Cal. 1991).

[78] 11 U.S.C. § 941

[79] 11 U.S.C. § 943(b)(4)

[80] 11 U.S.C. § 943(b)(6)