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POLICY BRIEF
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The Difficult Path to State Bankruptcy

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A growing number of state governors are voicing concern about the damage inflicted on their states' budgets—on both the revenue and the expenditure sides—by the COVID-19 pandemic. To allay these concerns, the $2 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act provides $150 billion to state and local governments, a $30 billion education fund, a $45 billion disaster relief fund, and more.[1] But even these massive sums of money are inadequate to stop the massive disruption caused by large-scale business closures, plummeting tax revenues, and new healthcare and unemployment insurance expenses.

The situation is particularly dire for the many states that entered the current crisis with "pre-existing conditions" that render them less able to cope with these challenges owing to repeated failures in addressing their budget issues, particularly heavily underfunded public employee retirement benefits. States that have offered generous retirement benefits to their employees have not funded these benefits in full, partly because the needed money has been spent elsewhere in the budget. Accounting gimmicks as well as high investment returns in the past decade have kept overburdened states afloat. But just as economic catastrophe is driving debt-laden companies such as JC Penney and Hertz into bankruptcy, many states are being forced to confront similar burdens.

It is in this context that the idea has resurfaced of expanding Chapter 9 of US bankruptcy code—which allows cities, counties, and other state municipalities to file for bankruptcy—to allow state governments to file for bankruptcy. Although controversial, political jurisdictions filing for bankruptcy is far from radical; there have been a total of 54 Chapter 9 filings involving cities, counties, towns, and villages since 1980.

Would allowing states to go through the bankruptcy process overcome the political obstacles that legislatures and governors face and finally create the conditions for financially troubled states to rectify their financial conditions? The answer is a guarded maybe.

Ideally, states would try to right their fiscal conditions. Legislatures and governors would make the hard budget adjustments necessary for states to meet their obligations to the public, retirees, and bondholders. But it is apparent, especially for the most financially overburdened states, that doing so is neither politically feasible nor economically possible without severe cuts to public services. Like General Motors and Chrysler a decade ago, both of which descended into bankruptcy after decades of mismanagement, excessive labor and retiree costs, and poor performance, decades of mismanagement and short-term political decision-making by state governments have finally collided with economic reality.

So what are states' options? Their first choice would be to get a federal bailout. But that would provide no incentives to reform the root cause of their problems (overly generous public employee labor compensation) and will encourage states to continue making poor choices.[2] It would also require residents of fiscally prudent states to bail out those that refuse to live within their means, many of which are wealthy. Alternatively, states, as sovereign entities, could simply default on their debts. These defaults are likely to be messy and determined by the dynamics of backroom deals and power politics where public employees are protected at the expense of everyone else.

The political circus that would accompany selective default and debt repudiation would create many new problems and do little to solve current problems. Moreover, many of the most troubled states are constrained by state constitutional provisions that prohibit the flexible options that states need to rectify their balance sheets in a comprehensive way. Most important, many state constitutions contain provisions that have been interpreted by courts to guarantee that state and local employees have a right to pension benefits based on the formula in effect at hire, without reduction, until retirement, essentially rendering these obligations untouchable. Even where modification might be permitted, state courts have set extremely high bars for doing so. As a result, any relief achieved politically will likely be merely temporary and will not address the underlying overspending and underfunding benefit issues that got the states in trouble in the first place.

Extending bankruptcy to states avoids some of these problems. The idea of extending bankruptcy to states is not new. University of Pennsylvania law professor David Skeel, a specialist in corporate finance and bankruptcy, first introduced the idea after the Great Recession of 2007–2009.[3] He argues in academic papers and the popular press that a procedure for bankruptcy could instantly reduce states' unsustainable bond debt, cut wasteful spending, and allow states to rework unsustainable public employee retirement benefit obligations. Duke Law professor Steven Schwarcz even designed a model state bankruptcy law.[4]

Bankruptcy is, admittedly, no panacea to tame countervailing political dynamics. The more recent bankruptcy experiences of larger and more indebted municipalities have exposed the difficulties of keeping the process free of politics.[5] Learning from these cautionary experiences, this policy brief highlights the conditions and commonsense reforms that should be taken before expanding Chapter 9 to make states eligible in order to avoid some of the obstacles that have arisen in the past. For instance, in order to ensure the rule of law in state bankruptcy proceedings, it is crucial that each filing is overseen by a bankruptcy judge, one removed from the politics of the state. Second, creditors must be treated apolitically, with the same priority to which they are entitled in ordinary bankruptcy proceedings.

We are not suggesting that any state would be required to file for bankruptcy. Under America's system of constitutional federalism, states as sovereign entities would retain the option to repudiate their debts in whole or in part, subject to their own laws. Unlike Chapter 11 corporate bankruptcy, Chapter 9 provides no option for creditors to initiate involuntary bankruptcy proceedings, nor would such a provision be wise or constitutional. On the other hand, as we discuss later, giving states the option to file for bankruptcy would not only provide them with a workable alternative to outright default, it could also give them leverage to reach consensual adjustments without ever having to resort to an actual bankruptcy filing.

Allowing states to file for bankruptcy will not eliminate the special-interest political influences that brought states to the brink or guarantee that that they will not reoccur in the future. With the right design and stronger constraints, however, it might temper those dynamics. And with additional reforms, allowing states to use a Chapter 9 process might enable troubled ones to get back on their fiscal feet for the benefit of their residents. Without such reforms, however, bankruptcy will fail.

THE ARGUMENT FOR STATE BANKRUPTCY

Many state governments are in dire fiscal shape, and under current conditions, they will never take the steps needed to pay their debts. Indeed, the COVID-19 pandemic has made states' cyclical shortfalls even worse than they were before. Before the crisis, most states faced massive structural shortfalls, owing in part to the excessively generous promises they made to public employees. If states cannot expect to repay their existing debts, they are left with essentially two options.

As sovereign entities under the US Constitution, states could repudiate their debts. Although rare in recent times, state default is not unprecedented. Under this scenario, one should expect that the special-interest dynamics, such as the oversized political powers exercised by public employee unions, that got the states into this financial mess in the first place would continue to work with equal ruthlessness during the debt repudiation process. Based on cases where states have tried to reform their pensions, the predictable result is that states would repudiate the debts of bondholders, most of whom are from out of state, while reaffirming their commitments to public-sector employee unions.[6] The fear is that this outcome could further raise states' costs of future borrowing and thus make state governments even more prone to financial collapse in the future.[7]

In addition to these formidable political realities, provisions in many state constitutions limit the ability of states to tackle the real problem: unsustainable public employee retirement obligations. For example, the Illinois Supreme Court has repeatedly struck down even modest modifications to public employee retirement obligations.[8] But Illinois is not alone in making it effectively impossible or extremely difficult to adjust pension obligations. The burden of these obligations to existing and retired employees has forced substantial cuts to current government services or massive tax hikes that have depressed economic growth and driven people away to other states.

Hopefully, allowing states to declare bankruptcy can provide some semblance of transparency and rule of law as opposed to a political feeding frenzy of selective debt repudiation.

If federal bankruptcy law is invoked, under the Supremacy Clause of the US Constitution, bankruptcy law would preempt state constitutional restrictions that tie the hands of state governments seeking to put retiree benefits on a sustainable financial footing. Chapter 9 of the bankruptcy code requires a municipality to make a specific showing of insolvency before it can file for bankruptcy. Thus, the process can't be used by city officials to simply avoid raising taxes or cutting benefits for city employees in order to obtain the funds necessary to pay creditors in full. In addition, states would later have to show the court that their reorganization plan is "feasible" (i.e., financially sustainable) before emerging from bankruptcy, which, if enforced with real teeth, could force real cuts in spending.

Providing a bankruptcy option with proper safeguards would have another advantage. The specter of bankruptcy can force creditors to the bargaining table to make concessions, thereby making bankruptcy unnecessary. In the corporate context, the threat of filing for bankruptcy and rejecting existing collective bargaining agreements has often led to reworking those plans consensually outside bankruptcy, rather than having a new contract imposed on workers through the bankruptcy process. The threat of states being able to initiate a bankruptcy process during which a judge could order concessions from public employees could likewise create a credible threat to keep public employees from refusing needed concessions. In other words, the specter of bankruptcy provides a bargaining chip for state legislators to resist special-interest pressures for special carve-outs, including pressures from union representatives who may demand benefits that will ultimately prove untenable.

THE ARGUMENT AGAINST STATE BANKRUPTCY

The state bankruptcy argument rests mostly on the assumption that state legislatures facing insolvency would, if allowed, use the process as an opportunity to rework their debts, cut excess spending, rewrite their collective bargaining rules, shift public employee pensions away from a defined benefit to a defined contribution system, and implement other reforms that they have failed to implement through the regular legislative process. However, experience with Chapter 9 to date has demonstrated that bankruptcy is no silver bullet.

Without caution, state bankruptcy could backfire. Although a few Chapter 9 cases have reduced public employee obligations, those cases have been the exception. After some early setbacks, public employee unions have become savvier about avoiding real concessions to their benefits in bankruptcy cases, preserving their benefits while imposing all of the costs on bondholders, many of whom are out-of-state and institutional investors. Under this scenario, bankruptcy would allow states to continue budgeting under the same structure as before, basically giving legislatures a clean slate without providing incentives to change the core source of their financial problems: greater outlays than tax revenues, inadequately funded public pensions and benefits, and a swollen state workforce.

This concern is justified by some of the evidence from the local governments in the 27 states that allow cities to file for Chapter 9 under the federal bankruptcy code.[9]

Advocates of state bankruptcy are quick to point to the "record time, and record efficiency" bankruptcy case of the city of Central Falls, RI,[10] and the city's ability to disregard strong political interests. In 2011, Central Falls entered into bankruptcy.[11] City officials acted swiftly, immediately announcing their intention to put municipal creditors at the head of the line in municipal bankruptcy proceedings and to protect bondholders by repaying them fully (including for any legal fees incurred). City officials' hope was to avoid future interest rate hikes resulting from a default on the city's bonds. The result of this decision was deep budgetary cuts and a property tax hike, but also stringent reforms of public employees' defined benefit plans, with up to a 55 percent cut for some retirees.

While the city's experience was generally perceived as an exemplar for how bankruptcy should be done, one should be careful in interpreting it that way. First, Central Falls is very small, with a population of just over 19,000 living in an area of less than 1.3 square miles, which seems to make a difference in a municipality's ability to resist pressure from politically powerful interest groups. Further, despite all the cuts, relief proved temporary. The city failed to meet even these pared down obligations, so eight years later the city asked state legislators to approve a plan that would give the state control of its local pension system in order to force future mayors and city officials to make their actuarially determined payments each year, something they still fail to do on a regular basis.[12]

Second, even accounting for these flaws, the process put in place in Central Falls is hardly indicative of the way that a majority of local bankruptcies has actually played out elsewhere. Other local jurisdictions, including Stockton, CA, and Vallejo, CA, decided to put their public employee pensions *first* in the repayment hierarchy while not paying bondholders in full.[13] Although this move was politically popular in the short run for current elected officials, this move risked the long-term consequences of raising the cost of borrowing in the future.

The bankruptcy of Vallejo provides a cautionary tale of the costs of caving to public employee demands.[14] In 2008, a bankruptcy judge gave city leaders the authority to void union contracts as those officials sought to reorganize under the crushing load of public-sector compensation. However, city officials didn't use this opportunity, instead going a different route: they cut their annual budget and their staff. They also permanently increased the sales tax by three-quarters of a cent. Yet while in bankruptcy, they refused to take steps to reduce their largest debts and their pensions. Vallejo emerged from bankruptcy in 2011, but today the city's new forecast shows continuing and larger-than-anticipated budget problems, mostly owing to the burden of its public employee benefits.

Detroit, the biggest city to go bankrupt, also made the decision to protect pensions, funding this decision through a legally dubious diversion of the value of one of the city's most valuable assets, the famed art collection of the Detroit Institute of Arts Museum, from general creditors to prop up public employee pensions.[15] The city's failure to significantly address public pension debt and make structural changes to the pension system looms large today. When the city emerged from bankruptcy, its Plan of Adjustment projected a $111 million annual pension payment (11 percent of the city budget) that would start in fiscal year 2024 and decline every subsequent year.[16] In reality, however, pension payments have increased and may consume as much as 24 percent of the city budget as early as July 1, 2023.

The reason for these underwhelming municipal bankruptcy results is that while the process allows for an orderly restructuring of a city's debt, it doesn't prevent political dynamics (i.e., incentives that are not compatible with having to make the hard choices required to attain solvency) from creeping in.

NECESSARY SAFEGUARDS BEFORE ALLOWING FOR STATE BANKRUPTCY

In practice, therefore, municipal bankruptcy has shown that it is not immune to these political pressures. In fact, if bankruptcy is done poorly, it could worsen the fiscal landscape of states that go through this process by raising future borrowing costs while failing to address underlying fiscal problems. Thus, rather than simply advocating an adoption of Chapter 9 as is, this section highlights some of the conditions necessary to make the bankruptcy process more likely to succeed than it has in the past. Fortunately, many of the necessary requirements are currently in place but simply need to be strengthened and applied more rigorously by bankruptcy judges.

Enforcing the Law

One major advantage of allowing states to file for bankruptcy is that the process can, under the Supremacy Clause of the US Constitution, override state constitutional contracts to adjust earned and unearned pension benefits of existing workers and current retirees (and in Illinois, of future employees). On paper, bankruptcy preserves the property right for vested benefits but allows the reworking of all contractual promises, including public employee pension contracts.

Chapter 11 prohibits bankrupt corporations from preferring some creditors over others. Chapter 9, like Chapter 11, requires that any reorganization plan may not "unfairly discriminate" among different groups of creditors that hold the same priority. This means that any claims arising from the repudiation of a contract to pay bond debt must be treated the same as a promise to continue to credit benefits for future work that are at least as generous as in the past.

Unfortunately, recent experiences of municipal bankruptcies show that while Chapter 9 is supposed to prohibit discrimination, in practice, bankruptcy courts have been reluctant to enforce this restriction and have allowed preferential treatment of certain creditors. In most cases, as illustrated by the examples of Stockton and Vallejo, enforcing the nondiscrimination requirement reduces preferential treatment of public employee pensions and forces needed reforms that otherwise would not occur.[17] But a rigorous application of the nondiscrimination requirement also protects public employees from being unfairly disadvantaged relative to bondholders, as shown in the Central Falls case.

One reason why the Framers adopted the US Constitution in the first place was to address the tendency under the Articles of Confederation for populist state legislatures to pass legislation at the behest of in-state special interests that disadvantaged out-of-state interests. Protecting out-of-state bondholders from treatment unequal to that of in-state public employees is consistent with that purpose.

Courts should also more rigorously apply the requirement that any plan should be economically feasible, meaning that the plan promises long-term sustainability and not just short-term relief. Failure to clearly address looming unfunded retirement obligations should render any proposed plan infeasible.

Requiring that all claimants share equally in the pain of bankruptcy and that the plan be economically feasible is not only fair, it also creates salutary incentives for all parties in the future by restraining moral hazard and creating incentives to hold state governments accountable. Bailing out bondholders would undermine their incentive to force fiscal discipline on state governments and stop funding their profligacy. For example, Illinois's bonds already trade at near-junk status—with commensurate interest rate returns—reflecting the risk that bondholders recognize of lending to that state. Guaranteeing full payment of those debts would provide a windfall to those investors.

But less appreciated is how state constitutional provisions that guarantee the payment of public employee pensions also create moral hazard by eliminating the responsibility of those creditors to ensure that pensions are properly funded. Raising the possibility that they too might be subject to cuts as part of bankruptcy would create powerful incentives for public employees to accept more realistic benefit promises and then to pressure state governments to fund them adequately. Thus, the threat of bankruptcy and the shared pain it could bring about would provide incentives for both bondholders and public employees to pursue greater public fiscal sustainability going forward.

An Independent Judge

There are about 90 bankruptcy districts across the country, and each one has its own judge. The bankruptcy courts generally have their own clerk's offices. In a regular bankruptcy case, the judge is selected at random by the clerk of the court. In municipal Chapter 9 proceedings, however, the judge is not chosen at random. Instead, the chief judge of the court of appeals chooses a judge from the bankruptcy court where the case is located. According to the legislative history, this provision was intended to ensure that the judge who was selected would have the experience and time to handle these complex, politically fraught cases. But those bankruptcy judges, though federal judges, have to live in the same community as the public employees whose benefits are on the chopping block. Selecting judges from the local community, therefore, creates personal, perhaps subconscious, incentives for the judge to favor public employees over bondholders.

The architects of the 1978 code sought to guarantee that the judge would have sufficient time to dedicate to municipal bankruptcy cases. Experience suggests that these cases are no more complex or time consuming than large Chapter 11 cases. Thus, while selecting a judge from a neighboring district might mean that the judge is occasionally physically unable to be present for an emergency hearing or the like, the advantages of providing some independence from local political pressures and thus treating all parties equally might be an advantage that would outweigh any inconvenience.

At the state level, the same precautions are necessary if America wants state bankruptcy proceedings to have any chance of achieving their longer-term goals of getting states out of debt and setting them on a healthier fiscal path. There are different ways to increase the likelihood that the judge won't be subjected to political pressure. One way is appointing a judge from a neighboring state. Another option is appointing a judge at random. Finally, and probably best, would be assigning the case to a judge from a district other than the one in which the state capitol resides, as it is easy to see how political pressures may be stronger in the state capitol region, which is where the bulk of public employees live. None of these solutions are perfect, but they might mitigate the power of state employees and especially employee unions.

The stakes are high: failing to keep the judge independent would all but assure that state bankruptcy will fail to achieve its goal and that state debt problems and political obstacles in the path of their resolution will persist.

CONCLUSION

Both sides of the state bankruptcy debate have biases. The state bankruptcy advocates tend to ignore political reality and the immense pressures that special-interest groups exert on policymakers and judges to the point of making the process close to useless. State bankruptcy opponents tend to make the perfect the enemy of the good and assume that no reforms can fully remove politics from the process. (That last part is true.) However, it does not follow that some reforms, if strictly enforced, could not make bankruptcy a markedly better alternative than state bailouts or debt repudiation. This brief highlights these reforms. These steps are not as easy as they might seem. Unfortunately, short of these reforms, bankruptcy might not only fail, it could backfire and leave state budgets—and citizens—worse off than they were before.

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NOTES

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