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Give States a Way to Go Bankrupt: It's the Best Option for Avoiding a Massive Federal Bailout

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Anyone who proposed even a decade ago that a state should be permitted to file for bankruptcy would have been dismissed as crazy. But times have changed. As Arnold Schwarzenegger's plea for $7 billion of federal assistance for California early last year made clear, the states are the next frontier in "too big to fail." In the topsy-turvy world we now inhabit, letting states file for bankruptcy to shed some of their obligations could save American taxpayers a great deal of money.

The financial mess that spendthrift states have gotten themselves into is well known. California—recently dubbed the "Lindsay Lohan of states" in the Wall Street Journal—has a deficit that could reach $25.4 billion next year, and Illinois's deficit for the 2011 fiscal year may be in the neighborhood of $15 billion. There is little evidence that either state has a recipe for bringing down its runaway expenses, a large portion of which are wages and benefits owed to public employees. This means we can expect a major push for federal funds to prop up insolvent state governments in 2011, unless some miraculous alternative emerges to save the day. This is where bankruptcy comes in.

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When the possibility is mentioned of creating a new chapter for states in U.S. bankruptcy law (Chapter 8, perhaps, which isn't currently taken), most people have two reactions. First, that bankruptcy might be a great solution for exploding state debt; and second, that it can't possibly be constitutional for Congress to enact such a law. Surprisingly enough, this reaction is exactly backwards. The constitutionality of bankruptcy-for-states is beyond serious dispute. The real question is whether the benefits would be large enough to justify congressional action. The short answer is yes. Although bankruptcy would be an imperfect solution to out-of-control state deficits, it's the best option we have, at least if we want to avoid massive federal bailouts of state governments.

Start with the issue of constitutionality. The main objection to bankruptcy for states is that it would interfere with state sovereignty—the Constitution's protections against federal meddling in state affairs. The best known such barrier is the Tenth Amendment, but the structure of the Constitution as a whole is designed to give the states a great deal of independence. This concern is easily addressed. So long as a state can't be thrown into bankruptcy against its will, and bankruptcy doesn't usurp state lawmaking powers, bankruptcy-for-states can easily be squared with the Constitution. But the solution also creates a second concern. If the bankruptcy framework treads gingerly on state prerogatives, as it must to be constitutional, it may be exceedingly difficult for a bankruptcy court to impose the aggressive measures a state needs to get its fiscal house in order.

Neither of these considerations—state sovereignty or the limited force of a bankruptcy framework that gives wide berth to governmental decisionmakers—is hypothetical. We now have more than 70 years of experience with a special chapter of the bankruptcy code, now called Chapter 9, that permits cities and other municipal entities to file for bankruptcy. For decades, this chapter did not get a great deal of use. But since the successful 1994 filing for bankruptcy by Orange County, California, after the county's bets on derivatives contracts went bad, municipal bankruptcy has become increasingly common. Vallejo, California, is currently in bankruptcy, and Harrisburg, Pennsylvania, is mulling it over. The experience of these municipal bankruptcies shows how bankruptcy-for-states might work, what its limitations are, and why we need it now.

Municipal bankruptcy dates back to the last epic financial crisis, the Great Depression of the 1930s. According to testimony in a 1934 congressional hearing, 2,019 cities and other governmental entities had defaulted on their debt at that time. Back then, the leading advocates of a bankruptcy option for local government were progressives, especially those whose cities were overwhelmed by debt. In 1933, Detroit mayor and future Supreme Court justice

Frank Murphy assured Congress that bankruptcy would be "an orderly and legal way" to assist "the people of these great urban centers that are now simply being crushed out of existence by taxes and by debts." The New Deal Congress obliged by enacting the first municipal bankruptcy law shortly thereafter.

As with much New Deal legislation, the early history of municipal bankruptcy law was rocky. The Supreme Court struck down the original law in 1936, concluding that it would infringe on state authority, even if the state vigorously welcomed the law. (One reason for rejecting municipal bankruptcy, according to Justice James Clark McReynolds, whose opinion was and is widely criticized but who was perhaps prescient, was that state bankruptcy might be next.) Two years later, after the famous "switch in time" from its earlier pattern of striking down New Deal legislation, the High Court gave its blessing to a 1937 version of the law. Congress's revisions to the municipal bankruptcy legislation were slight, but the Court was ready to uphold it. Because the law was "carefully drawn so as not to impinge upon the sovereignty of the State," the Court concluded, and made sure that the state "retains control of its fiscal affairs," it now passed constitutional muster.

Municipal bankruptcy differs in a few key respects from the law applying to nongovernmental entities. Unlike corporations, a city's creditors are not permitted to throw the city into bankruptcy. A law that allowed for involuntary bankruptcy could not be reconciled with anyone's interpretation of state sovereign immunity. A city must therefore avail itself of bankruptcy voluntarily; no one else, no matter how irate, can trigger a bankruptcy filing. And when municipalities do file for bankruptcy, the court is strictly forbidden from meddling with the reins of government.

Current law explicitly affirms state authority over a municipality that is in bankruptcy and prohibits the bankruptcy court from interfering with any of the municipality's political or governmental powers. A court cannot force a bankrupt city to raise taxes or cut expenses, for instance. Such protections have long since quieted concerns that municipal bankruptcy intrudes on the rights of the states, and they would similarly assure the constitutionality of a bankruptcy chapter for states.

One can imagine other constitutional concerns coming into play. If a municipal or state bankruptcy law allowed the court to ignore the property interests of creditors who had been promised specific state tax revenues or had been given other collateral, it might violate the Takings Clause of the Fifth Amendment. But the current chapter for municipal bankruptcy respects these entitlements (as does current corporate bankruptcy), and a chapter for states could easily be structured to do the same.

In the decades since the constitutionality of municipal bankruptcy was affirmed by the Supreme Court, the most serious obstacle in practice has been the rule that only insolvent municipalities can file for bankruptcy. Because a struggling city theoretically can raise taxes or slash programs, it often isn't clear if even the most bedraggled city needs to be in bankruptcy. In 1991, a court concluded that Bridgeport, Connecticut—which wasn't anyone's idea of a healthy city—had not demonstrated that it was insolvent, and rejected Bridgeport's bankruptcy filing.

To avoid this risk, without making bankruptcy too easy for states, Congress would do well to consider a somewhat softer entrance requirement if it enacts bankruptcy-for-states legislation. Current corporate bankruptcy does not require a showing of insolvency, and the new financial reforms allow regulators to take over large banks that are "in default or in danger of default." Although these reforms are in other ways deeply flawed, the "in default or danger of default" standard would work well for states.

Given that a new bankruptcy chapter for states would clearly be constitutional, and the entrance hurdles could easily be adjusted, the ultimate question is whether its benefits would be great enough to justify the innovation. They would, although a bankruptcy chapter for states would not be nearly so smooth as an ordinary corporate reorganization. When a business files for bankruptcy, the threat to liquidate the company's assets—that is, to simply sell everything in pieces and shut the business down—has the same effect on creditors that Samuel Johnson attributed to the hangman's noose: It concentrates the mind wonderfully. Because creditors are likely to be worse off if the company is simply liquidated, they tend to be more flexible, and more willing to renegotiate what they are owed.

One can imagine something like a liquidation sale for cities and even states. Indeed, in the early 1990s, professors Michael McConnell and Randal Picker proposed that Congress amend the existing municipal bankruptcy chapter to allow just that. They argued that many of a city's commercial, nongovernmental properties could be sold in a municipal bankruptcy, and the proceeds simply distributed to creditors. They also suggested that municipal boundaries could be dissolved, with a bankrupt city being absorbed by the surrounding county.

Although California has taken small steps in this direction on its own—it recently contracted to sell the San Francisco Civic Center and other public buildings to a Texas investment company for $2.33 billion—it seems unlikely that Congress would give bankruptcy judges the power to compel sales in bankruptcy. Nor could it do so with respect to any property that serves a public purpose. Liquidation simply isn't a realistic option for a city or state. The same limitation applies to nation-states like Ireland and Greece, whose financial travails have reinvigorated debate about whether there should be a bankruptcy-like international framework for countries.

With liquidation off the table, the effectiveness of state bankruptcy would depend a great deal on the state's willingness to play hardball with its creditors. The principal candidates for restructuring in states like California or Illinois are the state's bonds and its contracts with public employees. Ideally, bondholders would vote to approve a restructuring. But if they dug in their heels and resisted proposals to restructure their debt, a bankruptcy chapter for states should allow (as municipal bankruptcy already does) for a proposal to be "crammed down" over their objections under certain circumstances. This eliminates the hold-out problem—the refusal of a minority of bondholders to agree to the terms of a restructuring—that can foil efforts to restructure outside of bankruptcy.

The bankruptcy law should give debtor states even more power to rewrite union contracts, if the court approves. Interestingly, it is easier to renegotiate a burdensome union contract in municipal bankruptcy than in a corporate bankruptcy. Vallejo has used this power in its bankruptcy case, which was filed in 2008. It is possible that a state could even renegotiate existing pension benefits in bankruptcy, although this is much less clear and less likely than the power to renegotiate an ongoing contract.

Whether states like California or Illinois would fully take advantage of such powers is of course open to question. During his recent campaign, Governor-elect Jerry Brown promised to take a hard look at California's out-of-control pension costs. But it is difficult to imagine Brown taking a tough stance with the unions. Even in his reincarnation as a sensible politician who has left his Governor Moonbeam days behind, Brown depends heavily on labor support. He doesn't seem likely to bring the gravy train to an end, or even to slow it down much.

But as Voltaire warned, we mustn't make the perfect the enemy of the good. The risk that politicians won't make as much use of their bankruptcy options as they should does not mean that bankruptcy is a bad idea. For all its limitations, it would give a resolute state a new, more effective tool for paring down the state's debts. And many a governor might find alluring the possibility of shifting blame for a new frugality onto a bankruptcy court that "made him do it" rather than take direct responsibility for tough choices.

This brings us back to the issue of federal bailouts. When taxpayer-funded bailouts are inserted into the equation, the case for a new bankruptcy chapter becomes overwhelming. And it's a case for Congress to move now on the creation of a state bankruptcy law.

With the presidential election just two years away, the pressure to bail out California, Illinois, and perhaps other states is about to become irresistible. As we learned in 2008 and 2009, it is impossible to stop a bailout once the government decides to go this route. The rescue of Bear Stearns in 2008 was achieved through a "lockup" of its sale to JPMorgan Chase that flagrantly violated corporate merger law. To bail out Chrysler and General Motors, the government used funds that were only authorized for "financial institutions," and illegally commandeered the bankruptcy process to give the car companies a helping hand. There is, in short, no law that will stop the federal government from bailing out profligate state governments like those in California or Illinois if it chooses to do so.

The appeal of bankruptcy-for-states is that it would give the federal government a compelling reason to resist the bailout urge. President Obama is no doubt grateful to California for bucking the national trend in the election this month, but even he might resist bailing the state out if there were a credible, less costly, and more effective alternative. That's what bankruptcy would offer.

Indeed, even those who still believe (quite mistakenly, in my view) that the 2008 bailouts were an unfortunate necessity for big financial institutions like Bear Stearns and AIG, and that bankruptcy wasn't a realistic alternative, should agree on the superiority of bankruptcy for states. The case for bailing out financial institutions rested on a concern that their creditors would "run" if the bank defaulted, and that the big banks are so interconnected that the failure of one could have devastating spillover effects on the entire market.

With states, none of these factors applies in anything like the same way. California's most important creditors are its bondholders and its unionized public employees. 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. As for California's public employees, there is little reason to suspect they will be running anywhere.

Bankruptcy isn't perfect, but it's far superior to any of the alternatives currently on the table. If Congress does its part by enacting a new bankruptcy chapter for states, Jerry Brown will be in a position to do his part by using it.