PERSPECTIVES

Just say ‘no’ to the state bankruptcy option

Given the economic downturn, it is not a surprise that many have expressed concern about lower state revenues and higher state expenses—especially costs of infrastructure, education, healthcare and public safety—combined with the staggering predictions as to unfunded pension costs. However, suggesting as some have that states should declare themselves bankrupt under a federal law can cause unnecessary panic and unwarranted questioning of state and local government debt obligations.

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This is particularly unfortunate since state obligations properly have been viewed as safe investments with little risk of default. Importantly, no state has defaulted in the payment of its general obligation bonds since the late 1800s, and the repudiation of the debt incurred after the Civil War. A notable exception was Arkansas in 1933, which defaulted on its general obligation bonds but later refunded the debt, thus ameliorating the default.

The United States House of Representatives Judiciary Committee, Subcommittee on Courts, recently held a hearing on the possibility of enacting a federal statute that would create a state bankruptcy chapter. During those hearings, while certain testimony tended to argue in favor of the bankruptcy option, most concluded that the bankruptcy court was not a good avenue for troubled states. Expecting a bankruptcy judge, often an individual with little or no experience in public finance, to solve complex fiscal problems is not realistic.

The history of states meeting their financial obligations has permitted them to play an important role in the development and financing of this country's infrastructure. Up until now, the threat of a state not fully honoring its general obligation bonds, but instead "readjusting them" through a bankruptcy, was not considered a possibility. Indeed, currently, the inability of a state to institute a bankruptcy proceeding is an important part of the calculus upon which the cost of state financings are based. Fortunately, there is an understandable leeriness on the part of states to jump into the unchartered waters of bankruptcy when the cause of financial difficulty can be traced to several discreet problems (i.e., pension and other entitlements) that can be dealt with separately without affecting all of the state's relationships.

Constitutional provisions would limit the scope of any state bankruptcy option

The enactment of a bankruptcy vehicle for states would face a number of legal limitations. As a threshold matter, the dual sovereignty of the federal and state governments precludes the former from imposing a mandatory bankruptcy procedure on the latter. While Article I, Section 8 of the US Constitution gives Congress the power to "establish uniform laws on the subject of bankruptcies throughout the United States," that power may not interfere with the power reserved to the states by the Tenth Amendment. The US Supreme Court, in several important decisions,[1] has scrutinized the provisions of the Bankruptcy Code relating to municipal bankruptcy and annunciated principles that likely would apply to any state bankruptcy option. As a consequence, we can assume that bankruptcy could not be imposed without the state's consent. Similarly, we can assume the bankruptcy court could not constitutionally interfere with the revenues, politics or day-to-day operations of the state nor could the court replace, by its rulings or appointments, any elected or appointed officials. Therefore, a constitutional state bankruptcy provision would not permit a bankruptcy judge to take over the reigns of state government and impose the court's views on which jobs should be cut and entitlements eliminated. Thus, the state bankruptcy option would not provide an immediate fix to the pension problem and would not be the panacea suggested by some commentators.

Interestingly, a state currently may pursue changes to contracts that are not sustainable or affordable and which impair its ability to provide essential governmental services. The US Supreme Court has held that an impairment to a contract may be upheld where reasonable and necessary to serve an important public purpose.[2] If a state were able to demonstrate that it was in the impossible situation of choosing between providing essential governmental services and paying pensions and that it could not raise taxes further to fulfill both obligations, a court could find that legislation dealing with and adjusting the pension contracts is valid under the US Constitution's Contract Clause. This refutes the argument that state bankruptcy legislation must be enacted at the federal level because the states themselves cannot act to deal with pensions. Benefits can be adjusted to the extent the labor costs or pension or other contractual obligations prevent the providing of essential governmental services where no further tax increase is possible. Under the right set of facts, where the record demonstrates that the state cannot in good faith marshal any additional revenues or cut any state services without impairing the public welfare, it should be permitted to act without the baggage of federal bankruptcy legislation.

The Constitutional limits on municipal bankruptcy have contributed to the infrequent exercise of this remedy by units of local government. There have been only 623 municipal bankruptcies filed in the US since the adoption of

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the authorizing legislation in 1937, and only 252 Chapter 9 cases filed since 1980, compared to over 11,000 Chapter 11 cases instituted by corporate debtors in 2010. For the most part, Chapter 9 filings have been by small municipalities or special tax districts or utilities rather than major municipalities. In other words, Chapter 9 has been used essentially to terminate a vehicle that has outlived its usefulness. Thus, investors can also take comfort from the fact that, even where a bankruptcy option exists, it has been seldom utilized by municipalities. Further, statutory liens and special revenues have continued to be protected by the courts even in the face of a municipal bankruptcy filing.

State pension authority

As an alternative to the bankruptcy option, the states themselves can create state authorities established to: 1) examine the state's pension obligations and the resources available to meet them; and 2) if necessary, adjust the pension obligations to an affordable level in light of the other requirements of government. An authority structure could be devised by and for the individual states, thus respecting their sovereign nature. The state pension authority would be a quasi-judicial body, like a court with specialized expertise and independence that would have the power to compel the state and its unions to settle pension disputes. It would adjudicate labor costs or benefits on an objective, independent basis considering whether those costs were sustainable and affordable, and would not interfere with the state providing essential governmental services or determining whether the costs created a governmental emergency. Thus, successful relationships with creditors and others would not be upset.

Independent federal commission

As another alternative to state bankruptcy, Congress could establish an independent body—for example, the State Public Pension Funding Commission—before which states could voluntarily bring an action to restructure their pension obligations. This commission, much like courts established under Article I of the US Constitution, would be created pursuant to the bankruptcy clause to hear cases brought by financially challenged states. The commission would be composed of experienced, qualified and independent professionals. To protect state sovereignty, only a state could bring an action before the commission. To bring an action before the commission, a state would be required to establish that it is incapable of paying its debts as they mature and provide essential governmental services (i.e., a governmental emergency) without relief. On a finding of governmental emergency, the commission could then determine after hearing from the state and the designated representative of the workers what sustainable and affordable labor cost and pension benefit is achievable without impairing essential governmental services. Once this question is determined, it would be clear whether the state would make the existing payments or would have to adjust them. The commission could then issue an order restructuring the state's pension benefits and other post-employment benefits to a level that would allow the state to continue to provide essential state services while making manageable payments to its pension fund. The commission's decision would be appealable to a court established under Article III of the US Constitution, such as the US Court of Appeals for the Federal Circuit.

Conclusion

The current crises of unfunded pension liabilities, aging infrastructure and increased costs of health, education and safety needs must lead to new, creative ways for states to meet their obligations to provide essential and improving services for a better tomorrow. Bankruptcy courts and tribunals do not provide bridge financing or interim provision of essential services. Bankruptcy affects virtually all constituents—taxpayers, government workers and suppliers—as well as essential services. It is an expensive, time-consuming, disruptive process that can only be used as a last resort when no feasible alternative exists. Better options need to be considered and put in place before the situation deteriorates. In the past, our country has relied on "blue ribbon" panels to help resolve difficult issues. A state or federal commission dedicated to examining the sustainability of existing pension obligations on an impartial basis is far preferable to the cumbersome and inappropriate bankruptcy option. The mechanism ultimately selected should be designed to deal surgically with the pension or other financial problem in a discreet method that does not adversely affect that which works. This will lead to a new, effective mechanism that is less expensive, less intrusive and more focused on precisely what is broken.

If history is a guide, the states will again weather the storm and find creative ways to deal with the reality of less revenue and increased demand for public services. Unless we embark upon a radical departure from who and what we are, state and local governments will do whatever it takes to meet their public debt obligations to ensure for this and future generations their ability to have access to the municipal bond markets at a low cost. In this way, they will continue to be able to determine locally the level of infrastructure and services desired by their constituents rather than, as exists in virtually all other countries, having such policy dictated from on high.

For a more extensive discussion of these topics, please see the presentation by the author, "Unfunded Pension Obligations: Is Chapter 9 the Ultimate Remedy? Is there a Better Resolution Mechanism?" and "Historical and Legal Strengths of State and Local Government Debt Financing," both of which are available at www.chapman.com/publications.php.