Critique of a Proposal to Allow State Bankruptcy

*By John S. Baker, Jr.**

Note from the Editor:

This article and the article that follows by Michael S. Greve explore various ways to relieve the financial issues that currently confront some states and take diverging views as to the viability of a state bankruptcy option, which would allow a state to declare bankruptcy under federal law. We hope that publishing these articles helps contribute to the debate over the current financial challenges facing these states. The Federalist Society takes no position on particular legal or public policy initiatives. We welcome your responses to these articles; to join the debate, you can e-mail us at info@fed-soc.org.

A proposal by Professor David Skeel of the University of Pennsylvania Law School would change federal bankruptcy law so as to allow states the option of declaring bankruptcy.[1] Professor Skeel, a renowned authority on bankruptcy, has performed an important public service by focusing attention on the "the next frontier in 'too big to fail'" and by prompting consideration of important constitutional issues.

He has written two articles that rest on two essential claims: 1. "the constitutionality of bankruptcy-for-the states is beyond serious dispute"; and 2. Bankruptcy is "the best option we have, if we want to have any chance of avoiding massive federal bailouts of state governments."[2]

Professor Skeel's confidence in the constitutionality of a state-bankruptcy law is questionable. Much would depend on the actual language of the provisions included in proposed legislation. Professor Skeel assumes that making bankruptcy "voluntary" would protect the sovereignty of the states and, therefore, make such a law constitutional. Even if the Supreme Court would eventually uphold such a law, Congress should first give serious consideration to the constitutional question and also to other constitutionally acceptable options to address state insolvency.

Professor Skeel's Approach

Professor Skeel's proposal is based on the assumption that California and other states lack the political will to rein in public-employee unions that have driven up public-employee salaries, benefits, and pensions. It is driven by the fear that California or other large states might default on their debts and thereby plunge the nation into another financial crisis. Such a crisis, of course, could devastate state public employees/retirees whose pension funds have invested in state-government debt. The 1.6 million-member California Public Employees' Retirement System, the country's largest public pension, is already greatly underfunded, with only about 70% of the assets necessary to pay its obligations. Since Professor Skeel put forth his proposal, however, the governors of Wisconsin, Ohio, and New Jersey have demonstrated the power of federalism by exercising the political will to put their own fiscal houses in order.

Professor Skeel's constitutional argument points to existing provisions in the Bankruptcy Code allowing municipalities to declare bankruptcy. He offers the availability of municipal bankruptcy as proof of the constitutionality of a state-bankruptcy provision and as a model which—with some modifications—could basically be extended to the states.[3] He says state sovereignty does not pose a constitutional difficulty because states would be able to choose, but not be forced into, bankruptcy. As he notes, the Bankruptcy Code currently does not allow municipalities to be forced into bankruptcy.

The notion that a federal state-bankruptcy provision would merely be voluntary ignores what has happened to the states under the Spending Clause. In theory, participation in grant programs created by Congress pursuant to the Spending Clause is "voluntary." The theory says that states need not accept grants from Congress, but if they do they are subject to conditions imposed on the grants. Of course, over time, as states become more dependent on particular grants, Congress tends to impose more onerous conditions. Thus, with the health care law's modifications to Medicaid, a number of states have made the claim that the program has become "coercive" and, therefore, unconstitutional. The states are not likely to persuade the Supreme Court that their continued participation in the Medicaid program is being coerced. Although twenty-six states prevailed against Obamacare in the Florida federal court decision on January 31st, the court's opinion holds that the states' continued participation in Medicaid is "voluntary."[4] A federal state-bankruptcy option could also be manipulated legislatively so that the "voluntary" morphs into something very different.

Professor Skeel does not account for the history of Congress's recognition of constitutional protections for states later being interpreted as matters of legislative grace. Consider what happened to states on the minimum wage. Long ago, when it was assumed that the federal government could not constitutionally impose the minimum-wage laws on state governments, Congress exempted states from those laws. When Congress changed its mind, states and municipalities initially prevailed on the constitutional issue in *National League of Cities v. Usery*,[5] on the basis that Congress could not use the Commerce Clause to regulate states "in areas of traditional governmental functions." When Justice Blackmun switched his vote, however, *National League of Cities* was reversed in *Garcia v. San Antonio Metropolitan Transit Authority*.[6] It is not difficult to imagine a scenario in which Congress *de facto* forces states into bankruptcy by using the Spending Clause for a bailout of states on the condition that they "voluntarily" choose to go into bankruptcy.

Regardless of which case—*Usery* or *Garcia*—was correctly decided, it is a mistake to lump states and their municipalities

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together for purposes of the Constitution. Municipalities do not have the residual sovereignty enjoyed by states under the Constitution. In its interpretation of the civil rights statute,[7] for example, the Supreme Court has certainly been affected by the difference. The Court has interpreted the statute to allow recovery of damages under certain circumstances against a municipality because a city is a "person" under 1983,[8] but not against a state (or state agency), which is not a "person" under 1983.[9]

Professor Skeel's statements about the constitutionality of a state bankruptcy rest on one case, a case upholding the constitutionality of municipal bankruptcy, *United States v. Bekins*.[10] He claims that this case on municipal bankruptcy means that "[t]here is little doubt that a federal bankruptcy law for states, based on a similar federal law enabling cities to declare bankruptcy (Chapter 9 of the Bankruptcy Code), would be constitutional." He does not mention more recent developments, namely the Supreme Court's re-invigoration since 1990 of federalism in the Commerce Clause and 11th Amendment/sovereign immunity cases.

On federalism issues since the 1990s, the Court has see-sawed between favoring and not favoring the states in different closely-divided decisions. One of those cases did involve the Bankruptcy Clause, *Central Va. Community College v. Katz*.[11] There, a 5-4 majority upheld Congress's power to allow a trustee in bankruptcy to sue state agencies. This and other cases involving state sovereignty issues have been inconsistent due to a swing vote. That makes a reliable prediction of how a Supreme Court majority might rule on a state-bankruptcy law almost impossible. Professor Skeel is neither an originalist nor a persuasive prognosticator of where the law might be heading.

Professor Skeel's proposal reminded me in some ways of the bankruptcy reform in the 1970s. At the time, I was a research assistant for University of Michigan Law Professor Frank Kennedy, who was executive director of the Commission on Bankruptcy Laws. The Commission eventually proposed bankruptcy legislation to Congress which laid the foundation for the Bankruptcy Reform Act of 1978. Although Congress considered the constitutional issue that would eventually be decided by the Supreme Court, the congressional leadership ultimately ignored the constitutional concerns of many of its members. It may have been that after decades of the Supreme Court acquiescing to its will, the congressional leadership was not that concerned about questions of constitutionality.

In *Northern Pipeline Construction Co. v. Marathon*,[12] the Supreme Court declared it unconstitutional for Congress to give non-Article III bankruptcy judges the power to adjudicate state-law claims. Given the existing cases at the time, the result in *Northern Pipeline* could have gone the other way. That it did not was mainly attributable to Justice Brennan's insistence on protecting the independent federal judiciary in the constitutional structure of separation of powers. While Professor Skeel's proposal is a very different one, he has placed too much weight on a single case and not enough on the basic structure of the Constitution.

An Originalist Approach

Congress has its own distinct role regarding constitutional interpretation. Congress—as demonstrated by the bankruptcy reform addressed in *Northern Pipeline*—should not only look to what particular Supreme Court precedents appear to allow under the Constitution. More importantly, to fulfill its own constitutional responsibility, Congress should be asking whether particular proposals are consistent with the structure of federalism and separation of powers.

As was once assumed, members of Congress have an independent obligation—even if the Court might say that something is constitutional—to determine whether proposed legislation is "necessary and proper." The reason the Court generally upholds exercises of congressional power under the Necessary and Proper Clause is that the Court should not be second-guessing Congress's judgment of what is "necessary and proper." The Court should only declare unconstitutional that legislation which cannot fit within a fair interpretation of one or more of the enumerated powers, including the Necessary and Proper Clause. In other words, Congress is supposed to make the first judgment whether proposed legislation is constitutional. While Congress should not enact legislation that the Court will certainly declare unconstitutional, it is perfectly proper for Congress to decide that proposed legislation is not "necessary and proper" even if the Court would likely uphold the legislation.

State Insolvency in History and the Supreme Court

Insolvency of state governments is not a new issue. Prior to the adoption of the Constitution, a number of the states could not pay their debts. In the 1840s, nine states defaulted on their debts. After the Civil War, a number of southern states—notably Louisiana and North Carolina—could not pay their bills.

Nor is state insolvency a new constitutional issue. A major objection to the Constitution raised during ratification was the claim that states could be sued for their debts in federal court. *Federalist* 81 insisted that the principle of sovereign immunity prevented suits by creditors against the states without their consent. Nevertheless, the Supreme Court's first major decision, *Chisholm v. Georgia*,[13] held exactly to the contrary. The 11th Amendment, whose text nullified *Chisholm* by barring suits against a state by citizens of other states, followed soon thereafter.

Following the Civil War, the Supreme Court again faced the constitutional issue triggered by state insolvency. In *Hans v. Louisiana*,[14] the Supreme Court barred a Louisiana citizen from suing Louisiana despite the fact that the text of the 11th Amendment did not cover the situation. The Court took the position that *The Federalist* was correct and *Chisholm* wrong. The Court reaffirmed that the bar against suing states without their consent is inherent in the principle of sovereign immunity, which was not changed by the Constitution and not dependent solely on the 11th Amendment.

The fact that sovereign immunity protects every state from being sued without its consent means that states have the ability to, and have in the past, defaulted on their debts.

Recognizing that a state has power to avoid paying its debts, however, is not to approve the practice. As Hamilton wrote in *Federalist* 81, states have a moral obligation to pay the debts even though not enforceable by the courts. Moreover, if a state has waived its sovereign immunity, creditors can sue it. Consent by states to be sued varies from state to state depending on its constitution and also on particular contracts which may include waivers.

Even when a state defaults, it suffers consequences. Defaulting affects a state's ability to borrow at reasonable rates. That effect can last a long time. About a decade ago, Mississippi went into the international markets to borrow and was surprised to learn that the state was still blacklisted from its default on Civil War debts. Private lenders and creditors are much less forgiving than government lenders.

State and Federal Alternatives to Federal Bankruptcy

Today, the consequences of a state default on its obligations would not be isolated to one state. A default would affect every pension fund that had invested in what were once thought to be safe assets. Accordingly, Professor Skeel argues that the consequences of a complete default by a state would be "far worse" than reducing its bond debt through a bankruptcy proceeding. Nevertheless, Professor Skeel admits that the bond market was "already beginning to take account of the possibility of a default" by California.

In his first article, Professor Skeel saw "little evidence that either state [California or Illinois] has a recipe for bringing down its runaway expenses, a large portion of which are wages and benefits owed to public employees." Since then, Illinois has substantially increased state taxes. The neighboring states of Wisconsin, Indiana, and Ohio are in the process of cutting expenditures. These different approaches represent competitive federalism in operation. May the state with the best economic public policy win! Citizens of each of the states will be able to "vote with their feet." Corporations apparently are already considering doing so.

<u>Modifying Contracts with Public-Employee Unions</u>:

Professor Skeel is probably correct in saying that California's Governor Brown will not rein in public-employee unions. As other states do so, however, the Supreme Court will be faced with the constitutional question of whether, and to what extent, the Constitution's Contract Clause prevents states from changing contracts with public-employee unions. The federal appellate courts that have faced the constitutional issue have given conflicting answers.[15]

Even if the Contract Clause bars the states from modifying contracts with public-employee unions, Congress has considerable ability to regulate labor relations pursuant to the Commerce Clause. As eventually decided by the Supreme Court during the New Deal, Congress can regulate labor relations on the basis of the effect on interstate commerce. Although specific proposals would need to come from experts in labor law, federal legislation targeting public-employee unions presents a less serious threat to federalism than does a state-bankruptcy law.

<u>Liquidating Non-Governmental State Assets</u>:

In advocating for a state-bankruptcy law, Professor Skeel takes liquidation of state assets off the table because "it seems unlikely that Congress would give bankruptcy judges the power to compel sales in bankruptcy." As an alternative to state bankruptcy, discussed in the next section, Congress might consider blocking and conditioning federal funds.

The reason courts should not be selling state assets is the same reason courts should not be administering any kind of state bankruptcy. First of all, bankruptcy judges are not Article III judges.[16] Even if the legislation provided for federal district judges, Article III judges, to preside over the bankruptcy of a state, the federal judge would be governing much of that state. Such a development may not bother those who favor federal judges administering schools and prisons. State bankruptcy would increase judicial control of state self-government, even if courts were nominally restricted from interfering with a state's legislative process.

The likelihood that Congress would not allow liquidation, as it does not in municipal bankruptcies, means that a major power of a bankruptcy proceeding would not be available. Thus, says Professor Skeel, "the effectiveness of state bankruptcy would depend a great deal on the state's willingness to play hardball with its creditors." Of course, the ability of the state to do so would depend on the trustee appointed by the judge, backed up by the powers of the court. Given that some federal judges have greatly abused their power over the states when administering schools and prisons, something similar is certainly possible under state-bankruptcy administrations.

Having federal courts assist states in pressuring creditors would turn upside down one of the original, most important roles of federal courts vis-à-vis the states. Prior to adoption of the Constitution, a number of states were discriminating against those from other states, notably creditors. In response, the Constitution created diversity jurisdiction for federal courts, established the Privileges and Immunities Clause, and barred states from impairing the obligation of contracts. These provisions were created in large part to protect creditors from debtor-dominated states and, thereby, to move credit into the interior of the country for purposes of economic development.

<u>Checking Irresponsible States</u>:

Rather than encouraging states to "play hardball with creditors," Congress should—if anything—"play hardball with" irresponsible states. This is not a radical idea, but a forgotten dimension of federalism. The state and federal governments are supposed to check each other, rather than either governing the other.[17] When necessary, Congress can check rogue states in order to protect other states.[18]

On occasion, Congress has had to enact legislation whose sole purpose was to restrain the actions of a particular state as a means of protecting other states. Congress did so, for example, in the early 1890s by enacting the Lottery Act in order to block the Louisiana Lottery from undermining the laws of other states. At a time when all states except Louisiana outlawed gambling, the other states could not effectively enforce their own anti-gambling laws because the "Dormant" Commerce Clause prevented them from blocking the flow of goods, including lottery tickets, into their states. The Lottery Act did not outlaw gambling or otherwise change Louisiana law; rather, it simply prevented sending any lottery tickets across state lines into other states. Although the Supreme Court upheld the Lottery Act, the Court's opinion took a much more expansive view than had Congress of its powers under the Commerce Clause.[19]

What might Congress do to isolate the potential consequences of a default by California? Congress could begin with federal oil royalties from drilling on the Outer Continental Shelf (OCS). The OCS is governed by the federal, not state, government. Federal legislation could do for bondholders what federal tax legislation does for the states. The IRS deducts from taxpayer refunds unpaid state taxes which it sends to state treasuries. Similarly, Congress might enact a law setting aside amounts from a state's federal off-shore oil royalties in order to pay bondholders.

California's share of federal oil royalties of over $68 million amounts to no more than a "drop in the bucket" of California's over $6 billion annual debt service. Still, setting aside a state's share of federal oil royalties is an example of legislation which does not impinge on state sovereignty. It would be a start in a new direction of checking a state's irresponsible spending.

Rethinking Federal Spending and Taxing:

Congress could also look at any and all federal spending that goes to the states. In the past, Congress has attached conditions to federal aid that accomplish purposes barely related to the spending.[20] Congress would be more justified to insist on state financial responsibility in programs funded by federal grants.

As Congress considers state insolvency, it is an occasion for fundamentally reconsidering related issues of taxing and spending. The big states in trouble—California, Illinois, and New York— send per capita more taxes to the federal government than they receive in federal aid. Rather than bailing out these states, allowing them to keep more of their own tax dollars would be a more responsible way to improve their balance sheets. Their representatives in Congress should—but likely would not—decide to support federal spending and tax cuts in order to leave more tax dollars in their states.

Professor Skeel has put forth his state bankruptcy proposal as an alternative to pressure from California for a bailout. But consider a bailout for California with certain conditions. As just discussed, all federal aid to the states comes with "strings attached." Any bailout for California should be tied to opening off-shore drilling on the sea bottom within state control. Such an exchange would be consistent with the first federal government bailout of the states, when following ratification of the Constitution the federal government assumed state debts in return for states giving up their claims to Western lands. It is almost a certainty that California's representatives and their allies in the environmental movement would defeat such a proposal. Nevertheless, calls for a California bailout can be countered and effectively defeated by proposing what most of the country would consider a reasonable exchange.

Conclusion: The Essence of Self-Government

Bankruptcy for the states would continue the consolidation of power in the federal government. If this trend continues, the states will be reduced to nothing more than administrative districts, being completely dependent on the federal government. That kind of unitary state, similar to that of France, is exactly the form of government which was anathema to the Founders—both those for and against the Constitution.

State bankruptcy may appear to be a "silver bullet" that would kill off the menacing threat of insolvent states. In reality, it would be yet another bullet into our wounded constitutional system. An essential principle of our Constitution is that the federal government should not govern state governments.[21]

Self-government requires self-discipline. Within our federal system, we have two selves: the state and the federal governments. As James Madison wrote in *Federalist* 51, American liberty depends on the federal and state governments checking the power of each other. Just as the state electorates largely voted in November to force the federal government to put its financial house in order, the federal government must—and can consistent with federalism—force profligate states to make the tough choices necessary to put their financial houses in order.

Endnotes

1 *See* David Skeel, *A Bankruptcy Law—Not Bailouts—for the States*, Wall St. J., Jan. 18, 2011, *available at* http://online.wsj.com/article/SB10001424052748703779704576073522930513118.html; David Skeel, *Give States a Way to Go Bankrupt*, Wkly. Standard, Nov. 29, 2010, *available at* http://www.weeklystandard.com/articles/give-states-way-go-bankrupt_518378.html.

2 Skeel, *A Bankruptcy Law—Not Bailouts—for the States*, *supra* note 1; Skeel, *Give States a Way to Go Bankrupt*, *supra* note 1.

3 Skeel, *A Bankruptcy Law—Not Bailouts—for the States*, *supra* note 1; Skeel, *Give States a Way to Go Bankrupt*, *supra* note 1.

4 Florida v. U.S. Dept. of Health & Human Servs., No. 3:10-cv-91-RV (N.D. Fla. 2011) (unpublished decision). A three-judge panel of the Eleventh Circuit affirmed the district court's holding that the states' participation in the Medicaid program was voluntary. Florida v. U.S. Dept. of Health & Human Servs., No. 3:10-cv-91-RV-EMT (11th Cir. 2011).

5 426 U.S. 833 (1976).

6 469 U.S. 528 (1985).

7 42 U.S.C. § 1983.

8 Monell v. Dept. of Soc. Servs., 436 U.S. 658 (1978).

9 Will v. Michigan Dept. of State Police, 491 U.S. 58 (1989).

10 304 U.S. 27 (1938).

11 546 U.S. 356 (2006).

12 458 U.S. 50 (1982). Last Term, the Supreme Court upheld its decision in *Northern Pipeline*, concluding that a bankruptcy court lacked the authority under Article III to make a judgment on a state-law counterclaim. Stern v. Marshall, 2011 U.S. LEXIS 4791 (June 23, 2011). A majority of the Court, in an opinion written by Chief Justice Roberts, followed the reasoning of Justice Brennan's plurality opinion in *Northern Pipeline*. *Id.*

13 2 U.S. (2 Dall.) 419 (1793).

14 134 U.S. 1 (1890).

15 Fraternal Order of Police Lodge No. 89 v. Prince George's County, 608 F.3d 183 (4th Cir. 2010) (upholding county's implementation of public employee furlough plan); Buffalo Teachers Fed'n v. Tobe, 464 F.3d 362 (2d Cir. 2006) (upholding public employee wage freeze); Balt. Teachers Union v. Mayor of Balt., 6 F.3d 1012 (4th Cir. 1993) (upholding salary reduction for city employees); Local Div. 589, Amalgamated Transit Union v. Massachusetts, 666 F.2d 618 (1st Cir. 1981) (upholding state law instituting different arbitration procedures from original public employee contract). *Contra* Am.

Fed'n of State, County & Mun. Employees, Local 2957 v. City of Benton, 513 F.3d 874 (8th Cir. 2008) (requiring city to continue paying retiree health insurance premiums); Univ. of Haw. Prof'l Assembly v. Cayetano, 183 F.3d 1096 (1999) (affirming preliminary injunction against state salary deferral program for public employees); Condell v. Bress, 983 F.2d 415 (2d Cir. 1993) (striking down state salary deferral program for public employees); Ass'n of Surrogates & Supreme Court Reporters v. New York, 940 F.2d 766 (2d Cir. 1991) (same).

16 *See supra* note 10.

17 *See* The Federalist No. 51 (James Madison).

18 See *Federalist* 9 and 10 for a discussion of how the federal system avoids the corruption of one state spreading to others.

19 *See* Champion v. Ames, 188 U.S. 321 (1903).

20 *See, e.g.,* South Dakota v. Dole, 483 U.S. 203 (1987) (upholding Congress's conditioning of five percent of federal highway funds on a state having a law prohibiting the sale of alcohol to persons under twenty-one years of age).

21 *See* The Federalist No. 15 (Alexander Hamilton) ("The great and radical vice, in the construction of the existing confederation, is in the principle of LEGISISLATION for STATES or GOVERNMENTS, in their CORPORATE or COLLECTIVE CAPACITIES, and as contradistinguished from the INDIVIDUALS of whom they consist."); s*ee also* Printz v. United States, 521 U.S. 898 (1997) (declaring an act of Congress unconstitutional because it legislated that state officials take certain actions); New York v. United States, 505 U.S. 144 (1992) (same).