U.S. HOUSE OF REPRESENTATIVES

HOUSE JUDICIARY COMMITTEE'S SUBCOMMITTEE ON COURTS, COMMERCIAL AND ADMINISTRATIVE LAW

HEARING ON THE ROLE OF PUBLIC EMPLOYEE PENSIONS IN CONTRIBUTING TO STATE'S INSOLVENCY AND THE POSSIBILITY OF A STATE BANKRUPTCY CHAPTER.

February 2011

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Thank you for the opportunity to discuss with you the legal and practical concerns presented by the adoption of bankruptcy legislation for the States as a tool for dealing with underfunded State pensions. I am speaking to you from the perspective of someone who has represented clients in connection with financially-challenged situations related to State and local government debt financings, has studied and been involved with municipal bankruptcy for many years and is familiar with the limitations of Chapter 9. Obviously, the analogies are compelling.

A State Bankruptcy Option Would Create Practical Problems and Face Legal Challenges

As States continue to grapple with the issue of burdensome underfunding of public employee pensions, some have recommended the amendment of the existing U.S. Bankruptcy Code, 11 U.S.C. Section 101 *et seq*., to add a Chapter permitting the adjustment of debts of a State. It is respectfully submitted that, while the creation of a vehicle for State bankruptcy may initially appear as an attractive solution to a difficult problem, upon careful consideration, its problems outweigh its benefits. In fact, it appears that State bankruptcy is a less desirable alternative than others that may be available to States. Both practical and constitutional considerations mandate the rejection of a State bankruptcy option in favor of other more surgical approaches to any pension underfunding problem. Further, there is a long, positive history of States meeting their financial obligations to debtholders that would necessarily be affected by the enactment of State bankruptcy legislation. A State bankruptcy risk could, obviously, increase borrowing costs to States and limit easy access to the capital markets at a time when a source of funding is needed. Before legislating a dramatic departure from the sound practices that have characterized States' treatment of creditors in the past, alternative solutions must be explored.

THE MUNICIPAL BANKRUPTCY EXPERIENCE

As you may be aware, of the 620 municipal bankruptcies filed in the United States since the adoption of the authorizing legislation in 1937, few debtors have been major municipalities. Orange County, California in 1994 and Bridgeport, Connecticut in 1991 are recent notable exceptions. For the most part, the 620 Chapter 9 filings have been small municipalities or special tax districts or utilities. Further, in the pending municipal bankruptcy of Vallejo, California, which was filed in 2008, disputes with municipal unions over pensions and benefits have bogged down the proceeding and await final resolution in a confirmed plan. It is safe to say that the availability of a bankruptcy option has not proven to be a "quick fix" to municipalities and is unlikely to be a panacea for States.[i]

LACK OF STATE DEMAND FOR BANKRUPTCY VEHICLE UNDERSTANDABLE

It is interesting to note that the impetus for a State bankruptcy mechanism has not, as a general rule, come from the States themselves.[ii] This reluctance by States to embrace State bankruptcy as the solution to the pension difficulty is undoubtedly a recognition that the existence or even discussion of State bankruptcy risk could quickly raise concerns in the capital markets. Up until now, the threat of a State not honoring in full 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. The existence of a State bankruptcy option could cause a cloud or stigma on State access to the financial markets and increase borrowing costs far beyond any possible benefit the remedy might create for States. In addition, the States likely recognize a bankruptcy would affect all the States' relationships with creditors, including many that are working well and should not be modified. There is an understandable leeriness to jump into the unchartered waters of State bankruptcy when the cause of financial difficulty can be traced to several discreet problems that can be dealt with separately.

Historically, States have been perceived as solid credits, although admittedly some States have been viewed as stronger credits than others. Importantly, though, no State has defaulted in the payment of its general obligation bonds (as opposed to conduit debt where the State is not the actual obligor) 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. States have weathered financial storms, including the Great Depression, without access to a bankruptcy vehicle. Instead, expenditures have been cut, taxes have been increased and additional sources of revenue have been explored. This history of States meeting their financial obligations has permitted States to play an important role in the development and financing of this Country's infrastructure that our citizens rely upon and our industries depend on. Before unfunded pension liabilities bring a State to its knees in a bankruptcy forum, there are other more creative and, ultimately, more appropriate methods of dealing with the resolution of promises made to States employees that may not realistically be able to be fulfilled.[iii]

PRINCIPLES OF FEDERALISM AND DUAL SOVEREIGNTY PRECLUDE ANY BANKRUPTCY PROCEEDING WITHOUT A STATE'S CONSENT

The enactment of a bankruptcy vehicle for States would face a number of legal impediments. As a threshold matter, the dual sovereignty of the Federal Government and the States precludes the Federal Government from imposing a mandatory bankruptcy procedure on the States. Dual sovereignty is a defining feature of our Nation's constitutional blueprint.[iv] States, upon ratification of the Constitution, did not consent to become mere appendages of the Federal Government. Rather, they entered the Union "with their sovereignty intact."[v] As noted in the decision of *Federal Maritime Commission v. South Carolina State Ports Authority*, 535 U.S. 743, 152 L. Ed. 2d 962, 122 S. Ct. 1864 (2002) (*"Federal Maritime Commission"*), the U.S. Supreme Court, has applied a presumption -- first explicitly stated in *Hans v. Louisiana*, 134 U.S. 1, 33 L. Ed. 842, 10 S. Ct. 504 (1890) -- that the Constitution was not intended to "raise up" any proceedings against the States that were "anomalous and unheard of when the Constitution was adopted."[vi] In holding that the doctrine of sovereign immunity barred the Federal Maritime Commission from adjudicating a complaint against a State agency that had not consented to be subject to the proceeding, the Court held that it attributed great significance to the fact that States were not subject to private suits in administrative adjudication at the time of the founding of our Nation.[vii] Accordingly, the initial hurdle a State bankruptcy statute would face is a challenge that it fails to afford the States the dignity and respect due sovereign entities. As there was no State bankruptcy procedure in effect at the time of the Nation's beginning, no such process should be "raised up" in the form of Federal legislation to be imposed upon the States at this time. In short, the State as dual sovereign can decide when to pay, what to pay and whether to pay and those decisions by a State cannot be changed by the Federal Government without the State's consent.

THE LESSONS LEARNED FROM CONSTITUTIONAL CHALLENGES TO MUNICIPAL BANKRUPTCY PROVISIONS

The Tenth Amendment to the Constitution explicitly articulates the Constitution's principle of Federalism by providing that powers not granted to the Federal Government nor prohibited to the States by the Constitution of the United States are reserved to the States respectively or to the people. Accordingly, while Article I, Section 8 of the 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. While there may be precedent for the Federal preemption of bankruptcy law for corporations and individuals, there was, at our Nation's founding, no precedent for a dual sovereign passing a law regulating the bankruptcy of the other. This remains the case today. The earliest iterations of statutes providing for municipal debt adjustment (Chapter IX) not unexpectedly resulted in a review of the constitutionality of municipal bankruptcy by the U.S. Supreme Court. As municipalities are instrumentalities of the State or sub-sovereigns, the principles derived from those early decisions with respect to Federalism and the ability of Congress to legislate in the sphere of the States are applicable to the subject at hand.

As you know, the current version of Chapter 9 of the Bankruptcy Code attempts to embrace the concept of sovereignty of States and the limitations imposed by the Tenth Amendment. Section 903 of the Bankruptcy Code specifically reserves a State's power to control municipalities.[viii] In addition, § 904 of the Bankruptcy Code specifically limits the jurisdiction and powers of the Court over the municipality.[ix] As a result, the power of a Bankruptcy Court presiding over a Chapter 9 case is quite limited and cannot interfere with the revenue or government and affairs of the municipality. The jurisdiction of the Bankruptcy Court over the municipality flows from the specific authorization of the State in question to allow the municipality to file. Most States have chosen not to specifically authorize their municipalities to file. In fact, only fifteen States have unconditionally authorized municipalities to file Chapter 9 petitions.[x]

Earlier versions of municipal bankruptcy legislation attempted to deal with these concepts as well. Prior to 1934, Federal bankruptcy legislation did not provide a mechanism for municipal bankruptcy, insolvency, or debt adjustment.[xi] During the period 1929 through 1937, there were 4,700 defaults by governmental bodies in the payment of their obligations.[xii] In 1934, the House and Senate Judiciary Committees estimated that there were over 1,000 municipalities in default on their bonds.[xiii] That was obviously a different stage of financial distress than presently exists today with no State in default of any its general obligation bonds.

Until World War II, units of local government were very heavily dependent upon property tax. During the Depression, there was widespread nonpayment of such taxes. Bondholders brought suits for accountings, secured judgments and obtained writs of mandamus for levies of further taxes. The first municipal debt provisions of the Bankruptcy Act of 1898 as amended from time to time (hereinafter the *"Bankruptcy Act"*) were enacted as emergency legislation for the relief of such municipalities. The municipal tax provisions became effective on May 24, 1934.[xiv] These provisions were to be operative for a two-year period from that date, but this period was later extended to January 1, 1940.[xv]

The municipal debt adjustment provisions of the Bankruptcy Act enacted in 1934 reflected an attempt to protect municipalities from debilitating disputes with creditors.[xvi] The 1934 legislation provided a procedure whereby a local governmental unit, if it could obtain acceptances from two-thirds of its creditors, could have a plan of readjustment enforced by the

Federal courts. The 1934 legislation contained language similar to the policy expressed in the current § 904:

> The Judge . . . shall not by any order or decree, in the proceeding or otherwise, interfere with (a) any of the political or governmental powers of the taxing district or (b) any of the property or revenues of the taxing district necessary in the opinion of the Judge for essential governmental purposes or (c) any income producing property, unless the plan of adjustment so provides.

Nevertheless, the Supreme Court determined that, under the 1934 legislation, the court, and to some extent, the creditors through the court, had certain control over the municipality's revenues and governmental affairs. In 1936, the Supreme Court of the United States held, in the case of *Ashton v. Cameron County Water Improvement Dist., No. 1*,[xvii] that the 1934 municipal bankruptcy legislation was unconstitutional because it infringed upon the sovereign powers of the States and potentially permitted too much control by a Federal court and by Federal legislation over municipalities, sub-sovereigns of the sovereign States.

In 1937, new legislation was passed attempting to cure the defects outlined by the Court in *Ashton* and to protect municipalities from the injurious protracted litigation that some were enduring. The 1937 municipal bankruptcy legislation, enacted in response to the *Ashton* decision, required:

(l) no interference with the fiscal or governmental affairs of political subdivisions;

(2) a restriction on the protection of bankruptcy to the taxing agency itself;

(3) no involuntary proceedings;

(4) no judicial control or jurisdiction over property and those revenues of the petitioning agency necessary for essential governmental purposes; and

(5) no impairment of contractual obligations by the States.

This legislation was upheld by the Supreme Court in *United States v. Bekins*,[xviii] where the Supreme Court noted that the statute was carefully drawn so as not to impinge upon the sovereignty of the States. Like the 1934 legislation, language similar to the § 904 concept was included, although references to "the opinion of the Judge" were deleted.

Chapter IX then, while part of the Bankruptcy Act, provided a forum in which a municipality could voluntarily seek an adjustment of indebtedness if authorized by the State to file. A Chapter IX proceeding was not a proceeding to adjudge the city a bankrupt. The court's jurisdiction did not extend to declaring the city bankrupt or to administering its affairs as a bankrupt. The court was limited to approving as a matter of law or carrying out a proposed plan for reorganization of a municipality's debt.[xix]

This birth of municipal debt adjustment must be considered in analyzing possible State bankruptcy legislation. The principles enumerated in *Ashton* and the 1937 legislation are important in understanding the role of a Bankruptcy Court in a Chapter 9 proceeding today.[xx] The Court cannot constitutionally interfere with the revenue, politics, or day-to-day operations of the municipality. The Bankruptcy Court cannot replace, by its rulings or appointments, the City Council or any other elected or appointed official. The limited, but vital, role of the Bankruptcy Court is to supervise the effective and appropriate adjustment of municipal debt in accordance with applicable law. (Obviously, the special limitations on the power of the bankruptcy court in a Chapter 9 case would not be applicable if the city consented to the stay or order of the court which affected its political or governmental powers.[xxi]) Historically, Chapter IX and its successor Chapter 9 were intended to facilitate rather than mandate voluntary municipal debt adjustment, not municipal debt elimination.

The constitutional challenges to Chapter 9 and the resulting Court solicitude for the sovereignty of the States are significant when assessing any attempt to impose Federal bankruptcy legislation on the States. Requiring the applicability of State bankruptcy without the consent of the State would run afoul of the Tenth Amendment to the Constitution articulated by the *Bekins* court. Conversely, a strictly voluntary procedure by which the State consents to a restructuring process is always available to the State as a sovereign and requires no Federal legislation to make it happen.

THE U.S. CONSTITUTION DOES NOT PRECLUDE THE STATES THEMSELVES FROM SOLVING THEIR PENSION PROBLEMS

States may pursue changes to pension contracts that are not sustainable and affordable and impair the State's ability to provide essential governmental services. Some have suggested that States are powerless on their own to remedy any unfunded pension issues because the U.S. Constitution forbids States from impairing the obligations of contract.[xxii] In fact, the U.S. Supreme Court has held that an impairment to a contract may be upheld where reasonable and necessary to serve an important public purpose.[xxiii] In *U.S. Trust Company v. New Jersey,* the impaired obligation was a statutory covenant between New York and New Jersey addressing revenues and reserves pledged as security for bonds related to the Port Authority.[xxiv] A New Jersey statute repealed the covenant.[xxv] The Court concluded that New Jersey's action was a contractual impairment and violated the Contract Clause of the U.S. Constitution in the absence of showing that the impairment was necessary and reasonable to serve an important public purpose.[xxvi]

Courts employ a four-part inquiry under the Contract Clause.[xxvii] First, a contractual obligation must be involved. Secondly, the legislation must impair that obligation. Next, the impairment must be substantial. Finally, in order to be valid, the impairment must be "reasonable and necessary to serve an important public purpose."[xxviii] "An impairment rises to the level of substantial when it abridges a right which fundamentally induced the parties to contract initially or when it abridges legitimate expectations which the parties reasonably and heavily relied upon in contracting."[xxix]

Determining that there is an impairment does not end the inquiry. As the Supreme Court in *U.S. Trust* noted:

> The Contract Clause is not an absolute bar to subsequent modification of a state's own financial obligations. 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. [xxx]

In *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942), the court sustained the alteration of a municipal bond contract. In *Faitoute*, the New Jersey Municipal Finance Act provided that a state agency could place a bankrupt local government into receivership. Under the law, similar to a Plan of Adjustment for a Chapter 9 municipal bankruptcy action, the interested parties could devise a plan that would be binding on nonconsenting creditors if a state court decided that the municipality could not otherwise pay its creditors and the plan was in the best interest of all creditors.[xxxi] After certain bondholders dissented, the court determined that the plan helped the city meet its obligations more effectively. "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."[xxxii] The court then found that the plan protected creditors and was not in violation of the Contract Clause.

Similarly, 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 U.S. Contract Clause.[xxxiii] This Contract Clause analysis is significant since it refutes the argument that Federal State bankruptcy legislation must be enacted because the States themselves cannot act to deal with pensions. Obviously, we are not suggesting that a State can reduce its financial obligations whenever it wishes. There is a difference between inability to pay and an unwillingness to pay. Any modification of pension benefits must be tied to being fair to the workers. Benefits can be adjusted to the extent the labor costs or pension obligations prevent the providing of essential governmental services where no further tax increase is possible. Accordingly, 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, the Contract Clause should not bar State action.

POSSIBLE REMEDIES FOR FINANCIALLY TROUBLED STATES

As noted, the Tenth Amendment to the U.S. Constitution, which is part of the Bill of Rights, reflects the sovereign nature of the States and the Constitution's principle of Federalism by providing that powers not granted to the Federal Government nor prohibited to the States by the U.S. Constitution are reserved to the States or to the people. Accordingly, Congress cannot legislate to impose an involuntary debt restructuring procedure on the States. A State is not a municipality within the statutory definition, and hence cannot be a debtor under Chapter 9 of the

Bankruptcy Code. However, that does not mean there are not alternatives available to the States to deal with pension issues.

State Pension Authority

The States themselves can create 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 the light of other requirements of government. The Civic Federation of Chicago has proposed the creation of an Illinois Municipal Pension Protection Authority (*"IMPPA"*) for municipalities to assist units of local government in providing a supervised forum for the determination of what post-employment benefits are affordable and sustainable and should be paid annually, based on the actuarially-required contributions, what cost cutting measures are necessary to achieve affordable and sustainable benefits that do not interfere with the provision of essential governmental services and what contribution increases by both public employers and employees are necessary. A similar authority structure could be devised by and for the individual States where this same type of analysis could take place. Since each State would draft its own unique legislation on a voluntary basis, the sovereign nature of the State would be respected. The pension authority would be a *quasi* judicial body like a special court with specialized expertise and independence. It would only adjudicate labor costs or benefits on an objective, independent basis considering whether those costs were sustainable and affordable and did not interfere with the State providing essential governmental services. The interference with the provision of essential governmental services would create a governmental emergency. Part of the determination would be through the use of uniform standards for calculating pension liabilities (*"Uniform Protocol for Calculation"*). The use of Uniform Protocol for Calculation might prevent a possible criticism that there could be confusion caused by the possibility of fifty separate criteria for dealing with pension problems. Lack of Uniform Protocol for Calculation could result in confusion of the securities markets and make analysis of the soundness of state indebtedness difficult.

SOVEREIGN DEBT RESOLUTION MECHANISM

Uniform mechanisms for States, like other sovereigns, to utilize in the event of financial distress could also be considered.[xxxiv] On the global stage, for example, both Greece and Ireland have received emergency funds from the European Financial Stability Facility established by the European Union applying similar principles.[xxxv]

A sovereign debt resolution mechanism (*"SDRM"*) could be explored which could apply to the States in the United States. While a number of structures can be utilized, there are several leading approaches to a SDRM. On the most basic level, provision can be made for an entity to house a composition of creditors. In other words, a legal forum would be provided for creditors to meet to reach consensus, on a voluntary basis, as to what can be paid, to whom and what should be forgiven and provide a mediation forum for such a result.

Future debt financing also can include a "collective action clause," which is meeting with increased approval in European debt financings. The collective action clause would be included in the governing documents of a financing, whereby a majority or super majority of parties (debt holders) to that contract have the power to bind all holders to a debt restructuring and, if need be, forgiveness of debt. This type of provision is not currently acceptable in the U.S. capital markets where the requirement traditionally has been that all holders must consent to the modification of principal or interest on debt outside of a bankruptcy proceeding.[xxxvi]

Another SDRM approach can be the mandatory inclusion of arbitration clauses in State contracts. One shortcoming is that arbitration does not have the transparency and creditor participation that sophisticated institutions in the United States may require. Arbitration in commercial agreements is often avoided by major institutions, and the same could be true of sovereign debt agreements.

In international finance, informal groups of creditors have gathered together to study ways of assisting troubled sovereigns dealing with unsustainable debt. These groups could serve as models for a SDRM. The Paris Club meets periodically in France and is attended by representatives of the world's wealthiest nations, including the United States. The Paris Club considers, on a confidential basis, requests from beleaguered countries, especially those whose debt stems from military conflict or dictatorship. The Paris Club structures a suggested debt rescheduling or debt cancellation as an alternative to default. The decisions are not legally binding but frequently honored. The London Club, composed primarily of major commercial banks, meets on an *ad hoc* basis on request. It shares the goal of the Paris Club of reduced payments rather than defaults. Thus, the London Club is an informal group of private creditors as compared to the Paris Club of public lenders.

Finally, a dispute resolution forum could be created as a SDRM to verify and reconcile claims and possibly act as a sovereign debt restructuring court or sovereign debt tribunal, characterized by independence, expertise, neutrality and predictability. Dispute resolution procedures would include an attempt to reach the agreement of the parties. Any restructuring plan would have the vote of the majority of creditors and the ultimate hammer of a sovereign debt tribunal deciding what the path would be if a restructuring plan cannot be approved.

INDEPENDENT FEDERAL COMMISSION

As another alternative to State bankruptcy, Congress could establish an independent commission -- the State Public Pension Funding Commission -- before which States may voluntarily bring an action to restructure their pension obligations. This Commission, much like courts established under Article I of the U.S. Constitution, would be created pursuant to the bankruptcy clause to hear cases brought by financially-challenged States. To protect the sovereignty of the States, 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 (a governmental emergency) without relief. The authorizing legislation would set forth certain enumerated factors establishing a governmental emergency (which is the functional equivalent of insolvency for a government) that the State would use as a framework to present its case. A guide to consider in establishing the enumerated factors would be those factors set forth by the State of Pennsylvania in establishing the insolvency of a municipality under Act 47, the *Financially Distress Municipalities Act*, or other similar laws adopted by several States to rehabilitate financially troubled municipalities.[xxxvii]

Once a State brings an action before the Commission, the Commission first will consider the threshold issue of the governmental emergency. Evidence could be submitted by the State, a representative designated by those currently receiving pension benefits, and a representative designated by its employees eligible for pension benefits. If the Commission determines that the State is not suffering a governmental emergency and can afford and sustain payment of labor costs and pension obligations without impairing essential governmental services, it would issue a final, appealable decision dismissing the action. Were the Commission to determine that, based on the evidence before it, the State met the definition of governmental emergency, the action would proceed. This is a necessary step because, as discussed, under the Contract Clause of the

U.S. Constitution, as interpreted by the U.S. Supreme Court, a State may only impair its contractual obligations where the impairment is necessary and reasonable to serve an important public purpose.

On a finding of governmental emergency, the Commission could then determine after hearing from the State and the designated representative of the workers what is a sustainable and affordable labor cost and pension benefit achievable without impairing essential governmental services. 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 could restructure present and future promised benefits to current employees and retirees. The decision of the Commission would be appealable by the State, the designated representative of its current pension recipients or the representative of current, pension-eligible employees.

The Commission's decision would be appealable to a court established under Article III of the U.S. Constitution, such as the U.S. Court of Appeals for the Federal Circuit. The appellate court would review the Authority's decision and either enforce the decision or set it aside based on whether the decision was in accordance with law and supported by the evidence on the record. This is a necessary step because the members of the Authority, although appointed by the President and confirmed by the Senate, would not have the life tenure enjoyed by Article III judges. Because of the specialized nature of pension obligations and the importance of individuals with independence and expertise in the area reviewing the States' obligations, the Authority would consist of 5 members, appointed for 14 year terms. Limited terms would allow for the turn-over necessary to allow fresh perspectives in balancing the interest of the States and current and prospective State pension recipients.

Once the Commission has issued its final decision and appeals have been exhausted, the State would be required to implement a plan to meet the terms of the Commission's decision. It would be intended that the plan would require annual payments of the actuarially-required contribution (*"ARC"*) for the benefits so ordered by the Commission. If the State fails to take the necessary actions as required by the Commission's order, the Commission would maintain jurisdiction to issue further orders with respect to the enforcement of its decision. For instance, the underlying legislation should provide the Commission with the authority to withhold future federally designated funds to the State if the State fails to tender amounts it was ordered to pay to its pension benefits fund. Other enforcement mechanisms not encroaching on the State's sovereignty would also be advisable.

Although in an ideal world such a Commission would not be necessary, the Commission strikes a balance between a free-for-all bankruptcy proceeding, the rights of those currently receiving pensions, the rights of States employees, and the rights of the residents of the States to receive essential services.

ACCOMPANYING FINANCIAL ASSISTANCE

The legislation creating the Commission could also be accompanied by or could separately provide provisions whereby the Federal Government would back tax exempt bonds issued to restructure pension obligations at the lowest interest rate available for the financing in order to accomplish a real fix to the problem. Sometimes bridge financing is necessary to fix the problem rather than to defer a resolution for lack of funding. It would be the intent that the State's plan would be a solution and not a band-aid so workers, retirees, taxpayers and the State are assured the problem would not resurrect itself again. When the State's pension problem has been dealt with as a real fix, this provision of financing or financial assistance by the Federal Government could be deemed reasonable.

CONCLUSION

State debt financing in the United States has a proud and successful history. With the exception of the default by Arkansas on highway bonds in 1933, which were quickly refinanced, States have not defaulted on their general obligations since the 1800s. In that era, thirteen States repudiated indebtedness that represented, for the most part, unacceptable overspending of a carpetbagger era after the Civil War. This historical fact is no accident. State governments have relied heavily on cheap financing for funding to bridge uneven tax revenues and to provide needed infrastructure and essential governmental services.[xxxviii] Having that financing available and inexpensive has allowed State governments to chart their own destiny and develop infrastructure and essential services to suit their tastes and circumstances. However, individuals and market participants are now questioning whether this historic pattern will continue. The reaffirmation of the historical precedent of paying their obligations is essential for State governments if they are to weather the current storms as well as those that are on the horizon. Similar question and debate as to the dependability of municipal debt existed in the 1930s during the Great Depression and the annihilating lawsuits that municipalities faced for delayed or failed payments due to insufficient tax revenues.[xxxix] That situation brought about Chapter 9, not as a universal remedy, but as a last resort when all else failed.

States have done almost anything to meet their payment obligations and avoid default and repudiation of their obligations. States have not defaulted on their general obligation bonds compared to the over 4,000 defaults in municipal bonds during the Depression that led to the implementation of Chapter 9 of the Bankruptcy Code. Certainly part of the reason has been the need for access to the market and the inexpensive financing. But another motivation has been that, in meeting these obligations, the State is assured that its citizens will continue to receive essential services and there will be steady progress.

The current crises of unfunded pension liabilities, aging infrastructure, increased costs of health, education and safety needs must lead to new, creative ways for States to meet their obligations of providing essential and improving services for a better tomorrow. A less creative and somewhat simplistic approach would be the creation of a bankruptcy court for the States to alleviate the current financial distress. Bankruptcy courts and tribunals do not provide bridge financing or interim provision of essential services. Bankruptcy affects virtually all constituents, taxpayers, government workers, suppliers, essential services and is an expensive, time-consuming, disruptive process that only can be used when there is no feasible alternative - the last resort. As I have indicated, better options need to be considered and put in place before the situation deteriorates. Perhaps the States can consider public pension authorities or similar vehicles if there really is a need to address these issues. As discussed, on the Federal level, the use of a Commission could also be explored. A resolution of the pension problem is conceivably possible at the State level if there is a preliminary determination of a governmental emergency. The use of pension restructuring bonds as part of a permanent fix to the pension problem would be appropriate.

Our future in part depends on our capacity, not to take the easy path, but to address the real problems directly while not destroying that which has worked and is working. Perhaps the next generation of sovereign debt resolution mechanisms will be tied to increased legislative use of oversight, assistance and refinancing authorities that can transfer certain burdensome services to other entities, provide bridge financing and, if needed, identify appropriate new tax sources and coordinate on a regional or state level to ensure the problem is solved and not transferred to another. The new mechanism should not be an approach that affects all constituents, including those who are not part of the problem. Rather, the mechanism should be focused to deal surgically with the 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.

ENDNOTES

i In fact, not all fifty States permit their municipalities to file for Chapter 9. Only fifteen States specifically authorize municipal bankruptcies. See:

ALA. CODE 1975 § 11-81-3
ARIZ. REV. STAT. ANN. § 35-603
ARK. CODE ANN. § 14-74-103
CAL. GOV'T CODE § 53760
IDAHO CODE ANN. § 67-3903
KY. REV. STAT ANN. § 66.400
MINN. STAT. ANN. § 471.831
MO. ANN. STAT. § 427.100
MONT. CODE ANN. §§ 7-7-132 and 85-7-2041
NEB. REV. ST. § 13-402
N.Y. LOCAL FINANCE LAW § 85.80
OKLA. STAT. ANN. TIT. 62 §§ 281, 283
S.C. CODE ANN. § 6-1-10
TEX. LOC. GOV'T CODE § 140.001
WASH. REV. CODE § 39.64.040

See page 14 of the Background Material for a summary of the State approaches which have been taken with respect to authorizing Chapter 9 filings. Fifteen States specifically authorize municipal bankruptcies. Nine States conditionally authorize municipal bankruptcies. Three States grant municipalities limited authorization, two States prohibit filing but one has an exception and twenty-one remaining States are either unclear or do not have specific authorization to file.

ii The leadership of the National Conference of State Legislatures and the National Governors Association have stated in a joint letter that they "do not support" Federal legislation permitting States to seek bankruptcy protection. The letter is available at http://www.ncsl.org/default.aspx?Tabld=22155.

iii 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.

iv *See Gregory v. Ashcroft*, 501 U.S. 452, 457, 115 L. Ed. 2d 410, 111 S. Ct. 2395 (1991).

v *See Blatchford v. Native Village of Noatak*, 501 U.S. 775, 779, 115 L. Ed. 686, 111 S. Ct. 2578 (1991).

vi *Hans*, 134 U.S. at 18.

vii Federal Maritime Commission, 535 U.S. at 755.

viii "This Chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise . . ." 11 U.S.C. § 903.

ix "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." 11 U.S.C. § 904.

x *See* States listed in Note 1.

xi *See* The Bankruptcy Act of 1800, 2 Stat. 19 (1800); The Bankruptcy Act of 1841, 5 Stat. 440 (1841); The Bankruptcy Act of 1867, 14 Stat. 517 (1867); The Bankruptcy Act of 1898, 30 Stat. 544 (1898). That is not to say that there were no defaults in government obligations in the nineteenth century. Indeed, the 1842 default by the State of Pennsylvania on its bonded debt inspired William Wordsworth to pen the sonnet "To the Pennsylvanians" in which he spoke of "won confidence, now ruthlessly betrayed." It was the defaults of local utility districts and municipalities in the 1800s that tarnished the integrity of the "new frontier's" obligations. George Peabody, an eminent financier, sought to be admitted to polite English Society only to be rebuffed, not due to his lack of social grace, but because his countrymen did not pay their debts. It was the defaults by State governments in the early nineteenth century and municipalities in the late nineteenth century that brought about the procedures which are now taken for granted, including debt limitations on municipal issues, bond counsel, and clearly defined bondholders' rights and State statutory provisions relating thereto.

xii *See* A Commission Report, City Financial Emergencies: The Intergovernmental Dimension (Advisory Commission on Intergovernmental Relations, Washington, D.C., July 1973) (*"ACIR Report"*).

xiii S. Rep. No. 407, 73rd Cong., 2d Sess. (1934).

xiv 48 Stat. 798 (1934).

xv 49 Stat. 1198 (1936).

xvi *See* generally H.R. Rep. No. 207, 73rd Cong., 1st Sess. 103 (1933); H.R. Rep No. 517, 75th Cong., 1st Sess. 3-4 (1937); H.R. Rep. No. 686, 94th Cong., 1st Sess. 541, 542 (1975); H.R. Rep. No. 595, 95th Cong., 1st Sess. 397-398 (1977); S. Rep. No. 95-989, 95th Cong., 2nd Sess. 110 (1978), reprinted in 1978 U.S.C.C.A.N. 5787.

xvii *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513, 80 L. Ed. 1309, 56 S. Ct. 892 (1936), *reh'g denied* 299 U.S. 619, 81 L. Ed. 457, 57 S. Ct. 5 (1936).

xviii *United States v. Bekins*, 304 U.S. 27, 82 L. Ed. 1137, 58 S. Ct. 811 (1938), *reh'g denied* 304 U.S. 589, 82 L. Ed. 1549, 8 S. Ct. 1043 (1938).

xix *Leco Properties, Inc. v. R.E. Crummer & Co*., 128 F.2d 110 (5th Cir. 1942). Further, the court had no jurisdiction to determine the existence the city or boundary disputes in the nature of *quo warranto*. *Green v. City of Stuart*, 135 F.2d 33 (5th Cir. 1943), *cert. denied* 320 U.S. 769, *reh'g denied* 320 U.S. 813, 88 L. Ed. 491, 64 S. Ct. 157 (1943).

xx Upon the adoption of the Bankruptcy Reform Act of 1978, the roman numerals which had previously been used to identify chapters of the Bankruptcy Act were abandoned in favor of arabic numbers. Hence, since the effective date of the Bankruptcy Code, "Chapter IX" has become Chapter 9.

xxi *See, In re Richmond Unified School District,* 133 B.R. 221 (Bankr. N.D.Cal. 1991), (a chapter 9 debtor may voluntarily divest itself by consent of its autonomy rights under § 904 of the Bankruptcy Code.

xxii U.S. CONST., Art. I, § 10.

xxiii *U.S. Trust Company v. New Jersey*, 431 U.S. 1, 52 L. Ed. 2d 92, 97 S. Ct. 1505 (1977).

xxiv *Id*.

xxv *Id*.

xxvi *Id*. at 32.

xxvii For example, *In Royal Liquor Mart, Inc. v. City of Rockford*, the Illinois Second Judicial District identified this test as a three-step test including (1) whether the action in question has operated a substantial impairment of a contractual relationship; (2) if such impairment is found, whether the State can show a significant and legitimate public purpose behind the regulation; and (3) whether the change in rights is based upon reasonable conditions and is of a character appropriate to the public purpose of the regulation. 479 N.E.2d 485, 491, 133 Ill.App.3d 868, 877 (Ill.App.Ct. 1985).

xxviii *Bricklayers Union Local 21 v. Edgar*, 922 F.Supp. 100, 105 (N.D. Ill. 1996) (citing *Energy Reserves Group, Inc. v. Kansas Power & Light Co.,* 459 U.S. 400, 411, 74 L. Ed. 2d 569, 103 S. Ct. 697 (1983)).

xxix *Id*. at 106-07 (citing *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 246, 57 L. Ed. 2d 727, 98 S. Ct. 2716 (1978)).

xxx *U.S. Trust*, 431 U.S. at 25.

xxxi *Faitoute*, 316 U.S. at 504.

xxxii *Id*. at 511.

xxxiii *See Id.* (finding provision altering contracts did not violate the contract clause).

xxxiv The restructuring models utilized by sovereigns is instructive. *See*, Patrick Bolton, "Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World," IMF Staff Papers, (2003), *available at* http://www.imf.org/external/pubs/ft/wp/2003/wp0313.pdf; Randall Dodd, "Sovereign Debt Restructuring," The Financier, (2002), *available at* http://www.financialpolicy.org/dscsovdebt.pdf; John Murray Brown, "Europe Signs up to Irish Rescue," Financial Times (November 21, 2010) available at http://www.FT.com/cms/s/o/9338047c-f5a0-11df-99d6-00144feab49ahtml.

xxxv Jan Strupczewski and Padraic Halpin, "Ireland in aid talks with EU, Rescue Likely," Reuters, November 12, 2010, available at http://www.reuters.com/article/2010/11/13/us-g20-ireland-idUSTRE6AB0P420101113.

xxxvi *See* Trust Indenture Act of 1939, Section 316(b).

xxxvii *See also*:

Rhode Island:	R.I. Gen Laws §§ 45-9-1 to 45-9-17 (Budget Commission);
New York:	N.Y. Local Finance Law §§ 85.00 to 85.90 (Emergency Financial Control Boards) N.Y. Unconsol. Ch. 22, § 5 (New York Financial Control Board).

xxxviii See the accompanying slides which graphically portray this fact.

xxxix *See generally*, ACIR Report at pp. 11-16.