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McConnell Supports Giving States Bankruptcy Access.

Senate Majority Leader favors bankruptcy option over giving states more federal aid as they grapple with coronavirus

Senate Majority Leader Mitch McConnell said Wednesday that he supports the idea of allowing states to use bankruptcy protection to cut their debts instead of supporting them with more federal aid.

Cities and smaller public entities have historically used bankruptcy protection to reduce pension obligations, bond debt and other financial burdens. But bankruptcy is a tool currently off-limits to state leaders. Federal law doesn't give states a bankruptcy option and Congress isn't actively considering any such proposal.

On a syndicated talk radio show, Mr. McConnell, a Republican from Kentucky, floated the idea of opening bankruptcy as a potential option for states that have struggled with pension debt even before the public health crisis caused by the new coronavirus. The pandemic has battered local economies, causing steep declines in sales taxes, transit fees and other sources of municipal revenue.

Bankruptcy protection "saves some cities, and there's no good reason for it not to be available" to states, Mr. McConnell said.

He said he doesn't favor using federal assistance money borrowed "from future generations" to fill in state budget gaps.

Leaders on Capitol Hill are discussing how to help states and municipal governments cope with financial damage caused by the pandemic, which has led to businesses being closed and millions of employees being laid off. The next round of federal stimulus legislation is expected to focus on municipal assistance.

In a letter to Congressional leaders on Tuesday, the National Governors Association asked for $500 billion in direct federal aid to make up for a decline in revenues that pay for state programs related to health care, education, public safety and transportation. The letter didn't mention pension struggles that some states faced before the pandemic.

For years, many states and cities have promised pension benefits to employees based on optimistic investment return projections and have sometimes skimped on annual retirement fund contributions. The shortfalls are particularly severe for New Jersey, Kentucky and Illinois.

Illinois alone is $234 billion short of what it needs to pay promised benefits, according to an estimate by Moody's Investors Service.

Any legislation that enables states to use bankruptcy could give state officials debt-cutting power similar to what some cities have used, though some scholars contend that such tools may not be constitutional. Roughly half of U.S. states enable their cities and other municipal entities to use chapter 9 protection, the type of bankruptcy designed for public bodies.

Many high-income American households invest in the bonds of cities and states because the interest is exempt from federal and state taxes. Those municipal bondholders have taken haircuts in past city bankruptcies.

The municipal bond market largely shrugged off Mr. McConnell's comments Wednesday. Bonds issued by Illinois and New Jersey continued to trade at the same spread to triple-A rated debt as the day before, according to Refinitiv data. Both states already pay elevated interest rates as a result of their high liabilities.

Detroit's $18 billion bankruptcy in 2013 marked the largest filing by a city in U.S. history. The 680,000-resident city blamed tax revenue that fell after the real estate crash and the city's population decline. Its bankruptcy-exit deal cut $7 billion in debt owed to Wall Street firms, city retirees and others.

Puerto Rico filed for bankruptcy in 2017 after Congress passed a law permitting the territory to access bankruptcy protection.

Federal judges in charge of Detroit's case, along with the bankruptcy filing of Stockton, Calif., ruled that worker pensions could be cut as part of the restructuring process. Before those filings, legal experts disagreed on whether city leaders had that power.

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By Katy Stech Ferek and Heather Gillers

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