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INSIGHT: Bankruptcy for States? Yes, But Don’t Forget the Constitution.

With Covid-19 causing states to face rising expenditures and growing shortfalls in tax revenues, some policymakers and pundits have suggested making federal bankruptcy laws available to state governments. Susheel Kirpalani, partner at Quinn Emanuel, says Congress should act with precision and not haste, or it will increase the cost of borrowing in all 50 states and destabilize the multitrillion-dollar municipal bond market.

The U.S. bankruptcy laws are a foundational pillar of the world’s most envied capital markets for one reason: they provide a reliable set of rules that lead to predictable outcomes. When states seek to access the $3.9 trillion municipal finance market, investors take comfort in the fact that the Constitution makes it very hard for a state to break its contractual commitments based on changed circumstances—even if doing so would free up money for good uses.

Now that Covid-19 is causing states to face rising expenditures and growing shortfalls in tax revenues, some policymakers and pundits have suggested it’s time to consider making federal bankruptcy laws available to state governments. These voices are quick to note that municipalities and state-level instrumentalities can already file under Chapter 9 of the Bankruptcy Code.

While opponents ponder whether subjecting states to federal court orders represents an affront to the 10th Amendment, any such law would be optional for states to use. The U.S. Supreme Court already cleared the way for this framework in 1938. The bigger constitutional concern is the continuing role of the Contracts Clause, which is the part of the Constitution that prevents states from reneging on their contracts at will.

How It Could Work
Any constitutional bankruptcy law for the states should reserve power to the courts to permit states to impair obligations to the extent justified, but only to that extent. Otherwise, the law would subvert the Constitution, confound judges, and lead to unpredictable and politicized outcomes for markets.

Prospective bill sponsors and relevant committees of jurisdiction would be well served to assess the checks and balances provided by the courts in Chapter 11 before simply incorporating a subset of bankruptcy provisions for states as it did with Chapter 9. In the corporate context, courts can remedy abuses of creditor rights by authorizing a creditor-sponsored plan, the appointment of a trustee, or even liquidation. None of these features is available in Chapter 9 due to state sovereignty, but that should not be the end of the analysis.

Lawmakers should consider that when a state seeks to break its own contractual commitment today, it must demonstrate in a court of law that the impairment is both reasonable and necessary—terms that have an established body of jurisprudence. Even if an impairment is necessary, its reasonableness may depend on the specific commitment made and the context in which it was made.

For example, a public employee union that already provided concessions due to a state’s recent financial distress should continue to be protected from a second bite at the apple in bankruptcy unless there is truly no other viable alternative. Similarly, a non-impairment commitment expressly provided by statute to induce lending, or the state's vesting of property interests in future benefits or revenues, should be considered superior on a relative basis to other claims in bankruptcy that enjoy no such protection.

As such, to the extent Congress considers a state-level bankruptcy law, lawmakers should be careful to ensure that a court retains the power to evaluate the policy decisions underlying a proposed bankruptcy plan in a manner consistent with the Contracts Clause. Furthermore, respecting state-law commitments and priorities given to creditors on a relative basis would be the best way to respect state sovereignty.

In this way, Congress can afford states bankruptcy relief to promote collective action to bind hold-outs while still safeguarding settled constitutional expectations. This can be done without offending state sovereignty because the state is already constrained by the Constitution in the absence of a new bankruptcy law.

If a state could demonstrate an impairment were reasonable and necessary, and the requisite creditor votes for the plan were obtained, the court would grant the federal discharge. But if it could not make the showing, the court would deny confirmation of that particular plan and the state would need to either formulate a better one or dismiss its bankruptcy case and revert to the status quo—no sovereign-bad feelings.

But if state-level bankruptcy law is drawn up in a way that gives states the unchecked right to impair their debt obligations, it will turn the Constitution on its head. And while creditors could try and invoke the protection of the Contracts Clause even if it were not codified in the new statute, this approach would create much greater uncertainty than if the law spelled out the constitutional obligations in the first place.

This is why Congress must act with precision rather than haste. Lawmakers must not be hypnotized by the mantra of state sovereignty without pausing to consider what constitutional protections constrain the states when they transact with private parties.

Should Congress opt for a quick fix, it will increase the cost of borrowing in all 50 states and destabilize the multi-trillion-dollar municipal bond market. There is a way to aid states, but it's not by passing legislation that inadvertently writes the Contracts Clause out of the Constitution entirely.

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