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## States Need Bankruptcy-Like Options for Leverage: Commentary

Commentary by Jonathan Henes | April 20, 2011 12:00AM ET

(Bloomberg) -- The business community is watching the states' dire fiscal situation closely, and they have reason to be concerned. Many states are insolvent: 44 state governments and the District of Columbia are running budget deficits, many are late on their payables to vendors, and the unfunded liabilities of public pension plans are enormous.

If the states were corporations, they would be headed for a financial restructuring and, very likely, a bankruptcy filing to implement the restructuring transaction.

Unlike corporations, states lack the tools and legal authority to restructure their fiscal balance sheets and operations. Some members of Congress have floated the idea of a bankruptcy law for states, but politicians don't like the word "bankruptcy." Perhaps we can find another word.

As it is, many states constitutionally guarantee pension and retiree obligations as contractual relationships. And the Contracts Clause of the U.S. Constitution may preclude a state from impairing any of its contracts with stakeholders. To the extent the leadership of a state is willing to take on these difficult negotiations, there are no rules to go by.

A corporation facing this scenario would hire legal and financial experts to work with management to determine the best approach to the restructuring. They would analyze the operations and balance sheet, focus on the core business and jettison non-core businesses and assets. They would engage in hard-nosed, good-faith negotiations to achieve a restructuring plan to put the corporation on firm financial footing.

Many promises that were made to stakeholders would be modified because the company doesn't have enough cash to fulfill all of its promises.

### Bankruptcy Protections

The stakeholders, despite the risk of impairment, have the protections of the U.S. Bankruptcy Code to understand their priority and potential for getting paid. And, with a vibrant and liquid market for selling claims to investors, stakeholders who want to cash out, even if at a discount, may do so.

Today, states don't have enough cash to pay all of their bills. Forty-nine states are required constitutionally to balance their budgets. This requires states to focus on short-term fiscal fixes. They balance budgets through borrowing and financial legerdemain, which does nothing to help fix the states' long-term problems.

States need to start acting more like corporations and develop long-term, comprehensive plans to regain strong fiscal footing. They need to be honest and declare that they can't meet all of their obligations to stakeholders.

### Playing Politics

To have credibility, states need to stop playing politics, with Democrats protecting unions and Republicans attacking them. Rather, states should disclose their unfunded pension liabilities, identify the unnecessary and wasteful spending to be cut, disclose the revenues being generated from taxes and which income earners are paying taxes, and disclose off-balance-sheet debts and the amount of delinquent payables to vendors. Once all of this information is available and presented in a straight-forward way, meaningful negotiations can take place.

Why is this important? Because as long as states focus on short-term budget balancing and merely kick the can down the road, creating ever-growing liabilities, their core business suffers. This impacts the business environment, slowing job growth and harming the citizens' welfare.

While a comprehensive restructuring may result in short-term pain and require ingenuity to help those stakeholders, including retirees and public workers close to retirement age who won't get paid what they were promised, it will also result in long-term gain for everyone.

It takes true leadership and political will to face these issues. Management teams of distressed corporations understand this. It's psychologically difficult for a management team to face the reality of a company falling into the abyss, and once accepting reality, a management team is thrust into a world it isn't used to.

### Crisis Management

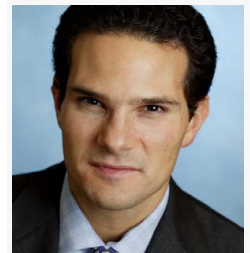
Management teams are skilled at growing companies through good times; they aren't experienced in operating a business through a major corporate restructuring or bankruptcy, out in the open with frustrated stakeholders clamoring for a fight. This requires courage, the ability to accept advice from experts and straight talk with employees, vendors, customers and other stakeholders.

It's even harder for governmental leaders. They need to deal with special interest groups, television commercials, rival parties throwing stones, providing critical services to their citizens, and their next election.

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#### About the Author



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The lack of restructuring tools and rules adds another hurdle. Because pension obligations of public employees and retirees are constitutionally protected as contractual obligations in some states, it's incredibly difficult to negotiate a fair arrangement with unions to achieve real reform. Corporate management teams aren't faced with the same obstacle.

#### Avoiding Court Judgment

The process for corporations and unions is fairer than what's taking place in states across the nation. In Chapter 11, a company may impair or negate obligations under a collective bargaining agreement only after going through a detailed and laborious process.

For instance, a company needs to make a proposal for modifications to the union, provide the union with all relevant and available information and make itself available for negotiations. If a deal can't be reached, then a collective bargaining agreement can be rejected, but only if the court finds that the modifications proposed are clearly necessary to permit the company to reorganize, the union refused to accept the proposal without good cause, and the equities favor the rejection.

These rules lead to good-faith negotiations, and because the rules enable both the company and the union to see the risk involved should a judge get to decide the issue, consensual arrangements usually result.

#### Process Becomes Political

States and the public unions don't have such rules and are unable to gauge their downsides, so the process becomes more political than rational. And rather than sitting down to negotiate, union members protest, legislators flee the state and governors take to the airwaves.

The current fiscal crisis facing states screams for political leadership and rational, rather than political, decision-making. A complete analysis of the states' fiscal situation should be the first order of business and, thereafter, all sides should engage in good-faith negotiations to achieve a complete restructuring.

States and their stakeholders need new tools and rules to make this happen, which may well require a change in federal law. It's time for business leaders and politicians to come together to provide a rational forum for fiscal stability and economic health.

(Jonathan Henes is a partner in the Restructuring Group of the law firm of Kirkland & Ellis LLP. He represents debtors, creditors' committees and distressed investors in acquisitions, restructurings and bankruptcy cases. The opinions expressed are his own.)

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