By Jonathan S. Henes and Stephen E. Hessler

The Fiscal Crises of States in the wake of the Great Recession has prompted an extensive and heated discussion about the advisability of Congress adopting a federal solution, such as, most notably, amending the Bankruptcy Code to allow states to file for bankruptcy, as municipalities already are able to do under Chapter 9.

The mere prospect of a state bankruptcy option has generated more opposition than support, and the most oft-repeated criticisms are that it would roil public debt markets and make it prohibitively expensive for states to borrow in the future, as bond investors would require a steep premium for the possibility of a bankruptcy filing.

While there has been a robust debate from a public policy standpoint, what has largely been missing is a proper historical perspective. Importantly, there is an available and instructive analogue to consult.

In the 1930s, Congress enacted the antecedents of today’s Chapter 9, also in response to a financial crisis and also in the midst of fierce objections. This article examines the strikingly parallel criticisms, as well as approximately 75 years of experience under Chapter 9, as a guidepost for whether and to what extent the legislative choice facing Congress today should be informed by this history.

The Great Debate I: Municipalities

Among the victims of the Great Depression were many municipalities unable to service the interest on their public debt.

Voluntary readjustment negotiations frequently were productive, but the all-too-common existence of even a small number of holdout creditors precluded consummation of consensual workouts. Municipalities needed a mechanism to bind all creditors to a majority vote, but Article I, Section 10 of the U.S. Constitution prohibited states from passing any “Law impairing the Obligation of Contracts.”

In May 1934, Congress responded by enacting Chapter IX of the Bankruptcy Act, to allow municipalities to file for bankruptcy, overcome the holdout problem, and facilitate debt readjustment plans. Although the U.S. Supreme Court initially held Chapter IX was unconstitutional, Congress in 1937 passed a modified version that the Court upheld the next year.1

Most relevant for present purposes, however, are the substantive themes that emerged from the debate on the 1934 Act. Both the House and Senate Judiciary Committee reports on the 1934 Act featured impassioned statements by those opposed to the bill.

The broadest line of criticism was that “throwing open the doors of the bankruptcy court to municipal corporations and other political subdivisions of the States” is a “radical departure from the long established practice of the past” for which “no one can foresee the results that may follow.”2

The dissenters predicted, however, “the very novelty of the thing will adversely affect the municipal bond market,”3 and “would act as a drag on the sale of municipal securities and might demand a higher rate of interest on such securities.”4 Granted, some “communities [had] incurred debts out of all proportion to their ability to pay,” “but this [was] due, in most instances, to the extreme severity of the present depression,” and “[w]hile passage of the bill may temporarily aid such communities, it will, in the long run, be detrimental to their credit standing.”5

Moreover, providing relief for the direct benefit of the relatively small number of distressed municipalities that needed reform would have unintended consequences of injuring the vast majority of healthy municipalities that did not.

“The credit of solvent cities will suffer along with those that are insolvent.”6 This would be especially unfortunate, because “[i]n all probability only a comparatively small percent of municipalities will take advantage of the provisions of the bills if enacted, yet the presence of the law on the statute books would...cost investors and solvent municipalities millions of dollars.”7

To that end, it was estimated that “only” approximately 2,000 municipalities were in default on their debt, out of an estimated 250,000 to 400,000 taxing districts, and “[i]n the face of such facts it surely cannot be argued that legislation of this character is universally demanded.”8

Nor were the dire warnings of an unavoidably detrimental impact limited to solely the municipalities.

The New York Law Journal
Corporate Restructuring
And Bankruptcy

Deja Vu, All Over Again

Debate rages over allowing states, like municipalities, to file for bankruptcy.

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"To a very large extent these bonds may be
said to furnish the main support of thousands
and hundreds of thousands of widows, orphans,
and retired elderly people. The principal of the
bonds themselves represent the life savings of
the thrifty middle class of the country."

Accordingly, some of the most eminent mem-
bers of the legal and business establishment
opposed the 1934 Act, including the American
Bar Association, American Bankers Association,
and the Chamber of Commerce of the United
States.10

The Great Debate II: the States

Fast forward three-quarters of a century, to
late 2010: a different era, but a similarly resis-
tive period.

In the aftermath of the worst economic crisis
since the Great Depression, a series of contro-
versial federal government rescues of distressed
private corporations, and an ascendant political
movement intensely focused on public fiscal
responsibility, wary attention turned to the deep-
ening insolvency of certain states, and whether
another round of massively expensive taxpayer-

"The real problem is an actuarial problem
unique to six to eight states...which suffer from
long-term structural imbalances," like “rising
health costs, underfunded pension plans and poor
financial management,” as opposed to short-term
fiscal problems like “a collapse in tax revenues
during the recession” that “will improve as our
economy gets going again.”15

“The municipal bond market is now respond-
ing to legitimate concerns about the long-term
structural imbalances in these six to eight states,
but I believe we’d be correct to distinguish these
bad apples from the 40-some states that have been
relatively well-managed and only have temporary
deficits.”16

“Introducing a bankruptcy statute would force
bondholders to all states to question the legal
regime” that governs repayment rights.17 And
“[w]hile the impact would be greatest on states
perceived to be most likely to file for protection,
like Illinois and California, all states, including
those with well-managed pensions and budgets
would reasonably pay a substantive penalty while
coming to market for new loans.”18

Finally, whereas opponents of the 1934 Act
cautions the most painful effects would be felt
by the most vulnerable citizens, opponents of
a state bankruptcy option went a step further
and maligned the actual intent of proponents as
“an attack on a group of workers including state
troopers, police officers, firemen, prosecutors,
and teachers,” because they “simply don’t like those
groups,” and bankruptcy would allow states to
“avoid contracts that they have signed through
collective bargaining, a fair process that protects
their employees,” “avoid their obligations to inno-
cent pensioners...and leave those people up the
road, or up the lake with no paddle, in a boat,
subject to the harsh ways of Wall Street.”19

And whereas the 1934 Act was opposed by the
business and legal establishment, a state bank-
ruptcy option is likewise opposed by the political
establishment, namely, the bipartisan National
Governors Association and National Conference
of State Legislatures.20

What’s Past Is Prologue?

To the extent the challenges presently being
levied against a potential state bankruptcy option
mirror those made in the 1930s against a muni-
cipality bankruptcy option, looking to whether the
subsequent impact of Chapter 9 ratified or refuted
these criticisms may prove useful in the ongoing
debate.

First, Chapter 9 did not create (or even exacer-
bate) economic chaos for municipal borrowers.
As an initial matter, lenders having the certainty
of only partial repayment may be more conducive
to stabilizing financial markets than is preserving
the prospect of full repayment. For instance, there
is evidence that Congressional reforms during
the Great Depression that reduced the repayment
erights of bondholders actually increased the price
of corporate bonds.21

Second, and even more important, the avail-
ability of Chapter 9 has not wrecked the borrowing
ability of municipalities because, as predicted,
very few municipalities have availed themselves
of Chapter 9 protection. However, contrary to
predictions, those rare municipalities that have
filed for Chapter 9 have not utilized the process
to impair bondholder recoveries.

There have been only 620 filings under Chap-
ter 9 since its adoption (i.e., less than an average
of 10 annually), and the overwhelming major-
ity involved small municipalities or special-tax
districts.22 And in those few cases, the debtor
municipality, presumably motivated by the need
to maintain future access to the capital markets, has most often opted to continue paying its bondholders. 23

The upshot of this dynamic is that sophisticated investors understand Chapter 9 cases are both rare and not predominantly painful for bondholders, and thus municipalities’ ability to file for bankruptcy is not ruinous to their financial standing.

So why do municipalities file for Chapter 9? To address union contracts, health care obligations, and pension benefits that often cannot be restructured out of court (or at least not without the credible prospect of a bankruptcy proceeding).

And what does this mean for potential state bankruptcies? The ability to file (and maybe even the act of filing) may not materially disrupt credit markets, because the principal focus of a state debtor’s reorganization efforts likely would be on unfunded public pension liabilities and other contractual arrangements, not public bonds. And if public pension liabilities were restructured in a way that made a state stronger fiscally, then bondholders should feel that much more reassured.

But the reality that a state bankruptcy option may impact individuals more than credit markets should not, of course, compel Congress to act with any greater haste or any less care. It should, however, help sharpen the debate appropriately.

For instance:

- The sparing use of Chapter 9 as a tool of last resort indicates it has been a useful mechanism to generate negotiations between municipalities and their stakeholders. Are there persuasive reasons to believe such discussions between states and their beneficiaries would be less productive (for either side)?

- Any personal hardships caused by bankruptcy, and especially those felt by public employees and retirees, are deeply unfortunate. But would alternative outcomes, such as mass layoffs or public pension fund reform without a rational legal process, be less painful, especially if suffered outside the oversight of a federal bankruptcy court applying the creditor protections of federal bankruptcy law?

- Lastly, the fundamental fairness of any bankruptcy regime turns on ensuring similarly-situated creditors receive similar treatment. To that end, is it equitable that a state of California pensioner is exempt from the resolution provisions of the Bankruptcy Code, but not a City of Vallejo, Calif., pensioner, or a General Motors pensioner, both of whom have been subjected to the insolvency resolution framework of Chapters 9 and 11, respectively?

Dissenting from the 1934 Act, certain members of the House Judiciary Committee presciently asked: “[i]f municipal governments may, through the medium of bankruptcy, settle their debts at a discount for so many cents on the dollar on the plea that they have reached the limit of their taxing power, why may not States do likewise; if State governments, why not the National Government?” 24

The latter question (thankfully) is not yet before Congress, but the former is. And thus it would be worthwhile for Congress to revisit specifically the inquiries of its predecessors in enacting Chapter 9, and study whether proceeding to bring states within the auspices of the Bankruptcy Code would have the same effects, on all parties, that it did for municipalities.

3. Id.
6. Id. at 6.
7. 1934 Act Senate Report at 4-5.
8. Id. at 5.
10. See 1934 Act Senate Report at 5-6.
15. House Oversight Subcommittee Hearing Transcript at 3.
16. Id.
17. Id. at 6.
22. House Judiciary Subcommittee Hearing Transcript at 8.
24. House Judiciary Subcommittee Hearing Transcript at 8.

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