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Deja Vu, **All Over Again**

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

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

JONATHAN S. HENES *and* STEPHEN E. HESSLER *are partners in the New York office of Kirkland & Ellis.*

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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.

"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."[9]

Accordingly, some of the most eminent members 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 restive period.

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

Because municipalities are able to seek protection under Chapter 9 of the Bankruptcy Code, some politicians, commentators and practitioners suggested Congress should consider amending the Code to permit states to do so too.[11] This idea, while manifestly logical, was highly controversial. Beyond restructuring professionals, bankruptcy is not well understood, and the prospect of states defaulting on their debt obligations triggered justifiable concerns of drastically cut social services, widespread public employee layoffs and pension reductions, and convulsed public bond markets.

Congress proceeded to hold a series of hearings in early 2011 to examine the viability of a state bankruptcy option. With only limited exceptions, the debate did not particularly focus on whether objections to allowing states to file for bankruptcy echoed the arguments made in the 1930s in opposition to allowing municipalities to do so, but the similarities are evident.

As a matter of both style and substance, critics derided the proposal as too risky, in light of the probable severe impact on states' credit ratings and interest rates.

"[I]f we in fact create…a state bankruptcy chapter, I see all sorts of snakes coming out that pit," as "[b]ankruptcy for states could—would cripple bond markets."[12] Thus, "[w]hat we have to avoid is any rash actions that would contribute new risk factors to the bond market" and "make the [infrastructure project] financing more expensive than it already is."[13] It was estimated that, "were states made able to file for bankruptcy" "municipal bond prices would fall, [and] yields would rise"; specifically, "longer-maturity bond interest rates could easily rise by 10 to 20 percent versus current levels."[14]

Once again, the debate focused on the belief that helping distressed states would have the spillover effect of hurting healthy states, which would be especially inequitable, given the detractors' view that only a few states are probably in bad enough shape even to contemplate a hypothetical bankruptcy filing.

In the **1930s**, Congress enacted the antecedents of today's Chapter 9 (permitting municipalities to file for bankruptcy), **also** in **response** to a **financial crisis** and **also** in the **midst** of **fierce objections**. Should the legislative choice facing Congress today be informed by those **strikingly parallel criticisms**, as well as the approximately **75 years of experience** under Chapter 9?

"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 responding 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 cautioned 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 innocent 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 bankruptcy 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 municipality 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 exacerbate) 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 rights of bondholders actually increased the price of corporate bonds.[21]

Second, and even more important, the availability 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 Chapter 9 since its adoption (i.e., less than an average of 10 annually), and the overwhelming majority 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.

1. See *Ashton v. Cameron Water Improvement Dist. No. 1*, 298 U.S. 513 (1936); *United States v. Bekins*, 304 U.S. 27 (1938).

2. H.R. Rep. No. 207, 73d Cong., 1st Sess. 6 (1933) [hereinafter "1934 Act House Report"].

3. Id.

4. S. Rep. No. 407, 73d Cong., 2d Sess. 4 (1934) [hereinafter "1934 Act Senate Report"].

5. 1934 Act House Report at 7.

6. Id. at 6.

7. 1934 Act Senate Report at 4-5.

8. Id. at 5.

9. 1934 Act House Report at 7.

10. See 1934 Act Senate Report at 5-6.

11. See, e.g., Jonathan S. Henes, "Bankruptcy Works: Why Congress Should Consider Bankruptcy for States," CNBC.com (Jan. 21, 2011), http://www.cnbc.com/id/41194261; Jonathan S. Henes and Stephen E. Hessler, "States of Insolvency," The Deal (Feb. 9, 2011), at 18.

12. "The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter: Hearing of the Courts, Commercial and Administrative Subcommittee of the House Judiciary Committee," 112th Cong. (Feb. 14, 2011), available at LexisNexis, Federal News Service, at 2 [hereinafter "House Judiciary Subcommittee Hearing Transcript"].

13. "State and Municipal Debt: The Coming Crisis: Hearing of the TARP, Financial Services and Bailouts of Public and Private Programs Subcommittee of the House Oversight and Government Reform Committee," 112th Cong. (Feb. 9, 2011), available at LexisNexis, Federal News Service, at 4 [hereinafter "House Oversight Subcommittee Hearing Transcript"].

14. House Judiciary Subcommittee Hearing Transcript at 9.

15. House Oversight Subcommittee Hearing Transcript at 3.

16. Id.

17. Id. at 6.

18. House Oversight Subcommittee Hearing Transcript at 9-10.

19. House Judiciary Subcommittee Hearing Transcript at 3.

20. Joint Letter of National Governors Association and the National Conference of State Legislatures (Feb. 4, 2011), available at http://judiciary.house.gov/hearings/hear_02142011.html.

21. See David Skeel, "A Bankruptcy Law—Not Bailouts—for the States," The Wall Street Journal (Jan. 18, 2011), http://online.wsj.com/article/SB10001424052748703779704576073522930513118.html.

22. House Judiciary Subcommittee Hearing Transcript at 8.

23. See, e.g., Patrick McGee, "Bankruptcy's Bright Side," The Bond Buyer (Feb. 28, 2011), http://www.bondbuyer.com/issues/120_39/bankruptcys-bright-side-1023744-1.html.

24. House Judiciary Subcommittee Hearing Transcript at 8.