

A Minimalist Approach to State “Bankruptcy”

Steven L. Schwarcz



ABSTRACT

Increasingly finding themselves in fiscal straightjackets, states have been turning to austerity measures, tax increases, privatization of services, and renegotiation of collective bargaining agreements. Absent a federal government bailout, however, states will also need debt relief if their debt burden becomes so crushing that reasonable efforts at fiscal reform will fail to avoid default. Some advocate providing this relief by, effectively, extending municipal bankruptcy law to states. That approach brings in excess baggage, however, engendering political opposition and constitutional concerns. There is a simpler solution: Enable states to work out their debt problems with their creditors. Although the main obstacle to consensual debt restructuring is likely to be the creditor-holdout problem, this Article proposes a minimalist legal framework incorporating certain limited bankruptcy protections that would not only help states solve that problem, but would also help address the political and constitutional concerns. The proposed minimalist framework also would enable a state to obtain needed liquidity during the debt-restructuring process. Although the federal government could provide this liquidity, the proposed framework would enable the liquidity source to be privatized.

AUTHOR

Steven L. Schwarcz is Stanley A. Star Professor of Law & Business, Duke University School of Law, and Founding Director of Duke's Global Capital Markets Center.

I thank Clayton P. Gillette, W. Bartley Hildreth, Richard Hynes, Richard C. Schragger, Daniel Schwarcz, and participants in faculty workshops at Syracuse University College of Law and Duke University School of Law for valuable comments and Lucy Chang and Gregory McKay for excellent research assistance.

TABLE OF CONTENTS

INTRODUCTION	324
I. ANALYSIS	327
A. Enabling States to Work Out Their Debt Problems	327
1. Towards a Minimalist Framework	331
2. Operation of the Framework	332
3. Benefits	335
4. Potential Drawbacks	338
5. Certain Complications	343
B. Ensuring Liquidity During the Debt-Restructuring Process	346
CONCLUSION	348
APPENDIX A. MODEL FEDERAL STATUTE FOR STATE DEBT RESTRUCTURING	350
APPENDIX B. FLOWCHART ILLUSTRATING POSSIBLE APPLICATION OF THE FEDERAL STATUTE FOR STATE DEBT RESTRUCTURING	352

INTRODUCTION

In response to “a third year of multi-billion-dollar budget deficits,”¹ U.S. states have been turning to austerity measures, tax increases, privatization of services, and renegotiation of collective bargaining agreements to mitigate their budget shortfalls.² There is a rising consensus, however, that these measures will not be enough, and that states will also need debt relief.³ The goal of debt relief would not be to undermine the responsibility of states to engage in appropriate fiscal reform. Rather, debt relief would be needed if a state’s debt burden becomes—and in some states, like California, the burden soon may be—so crushing that any reasonable efforts at fiscal reform will fail to avoid default absent other measures, most significantly a federal government bailout.

An orderly mechanism for achieving debt relief would benefit residents of financially troubled states otherwise subject to diminished government services and higher taxes. It also would minimize the externalities caused by poorer residents, who depend on essential state services or subsidies, relocating from states cutting services and subsidies to those not faced with massive budget deficits.⁴

Debt relief would also minimize the risk that a state debt default will trigger systemic consequences. For example, if a default by one state undermines investor confidence in all state debt, the broader market in that debt might

-
1. *State and Municipal Debt: The Coming Crisis?: Hearing Before the Subcomm. on TARP, Fin. Servs., and Bailouts of Pub. & Private Programs of the H. Comm. on Oversight and Gov’t Reform*, 112th Cong. (2011) [hereinafter *Hearing*] (testimony of Nicole Gelinas), available at http://www.publicsectorinc.com/psi_articles/2011/02/state-and-municipal-debt-the-coming-crisis.html.
 2. See, e.g., NAT’L GOVERNORS ASS’N & NAT’L ASS’N OF STATE BUDGET OFFICERS, *THE FISCAL SURVEY OF STATES 8* (Fall 2010) (“In fiscal 2010, the actions taken most consistently were targeted cuts [to state budgets], which were put in place by 33 states, as well as across the board cuts, which were utilized by 26 states To eliminate fiscal 2011 budget gaps, 35 states are using specific, targeted cuts [to state budgets], while 25 states have employed across the board cuts. Another method being used by 19 states is to reduce aid to localities while 13 states made use of their rainy day funds.”).
 3. See, e.g., *Hearing*, *supra* note 1 (opening statement of Rep. Patrick McHenry, Chairman, H. Comm. on Oversight & Gov’t Reform) (observing that the “vast majority of states now find themselves in a fiscal straightjacket”).
 4. Cf. HARVEY S. ROSEN & TED GAYER, *PUBLIC FINANCE* 510 (9th ed. 2010) (observing that within the United States, “individuals vote with their feet and locate in the community that offers the bundle of public services and taxes they like best”). Additionally, any subsidies provided by the federal government to the troubled state would indirectly be funded by taxing residents of other states. Borrowing by the federal government to fund these subsidies could also increase the federal budget deficit.

collapse.⁵ That collapse, in turn, might undermine confidence in other debt markets, such as corporate bond markets. This type of contagion occurred in the 2008 financial crisis when investor loss of confidence in rated mortgage-backed securities triggered a broader loss of confidence in all rated-debt securities.⁶ A state debt default might also trigger systemic consequences by causing one or more (of the remaining) monoline insurance companies to fail. These companies, which are thinly capitalized, guarantee payment to investors on a wide range of municipal, state, and corporate bonds.⁷

Perhaps most importantly, the creation of an orderly mechanism for achieving debt relief would reduce the inevitable political pressure on the federal government to bail out defaulting states.⁸ If a federal bailout were to occur, the resulting moral hazard—that a state, anticipating a bailout, would lack incentive to take a prudent fiscal course—and too-big-to-fail dilemma would likely dwarf that of financial institutions, which are at least somewhat disciplined by the threat of being liquidated.⁹

Some commentators, including prominent politicians and bankruptcy scholars, view bankruptcy law—in particular, Chapter 9 of the Federal Bankruptcy Code, which governs municipal (such as city and county) bankruptcy—as a more promising solution to state budget deficits.¹⁰ This viewpoint is not

-
5. Cf. *infra* note 101 (indicating disagreement over the extent to which contagion is likely to result). There are no recent, and few historical, examples of states defaulting. Arkansas defaulted on its debt during the Great Depression, and eight states—Arkansas, Illinois, Indiana, Louisiana, Maryland, Michigan, Mississippi, and Pennsylvania—as well as the then-Territory of Florida defaulted on their debts following the financial panic of 1837. STANDARD & POOR'S, U.S. STATE RATINGS METHODOLOGY 6 (2011).
 6. Iman Anabtawi & Steven L. Schwarcz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. 1349 (2011).
 7. See, e.g., MOODY'S INVESTORS SERV., THE CHANGING BUSINESS OF FINANCIAL GUARANTY INSURANCE 6 (2008); MOODY'S INVESTORS SERV., MOODY'S PORTFOLIO RISK MODEL RESULTS FOR FINANCIAL GUARANTORS 2-3 (2006); SECURITY CAPITAL ASSURANCE, YEAR-END 2007 OPERATING SUPPLEMENT 17 (indicating that, at year-end 2007, 43.1 percent of the obligations guaranteed by Security (now Syncora), one of the largest monoline insurance companies, was municipal and state debt and the balance was corporate and asset-backed debt).
 8. Cf. *Hearing, supra* note 1 (opening statement of Rep. Patrick McHenry, Chairman, H. Comm. on Oversight and Gov't Reform) (observing that “already state and municipal governments are coming to Washington, hat-in-hand, expecting a federal bailout like everyone else”).
 9. *But see* Richard C. Schragger, *Debt, Democracy and the Fiscal Constitution* (May 4, 2011) (unpublished manuscript) (on file with author) (arguing that states and municipalities have “forced austerity requirements” and “cannot tax and spend as they wish”); Email From Richard C. Schragger, Professor of Law, Univ. of Va. Sch. of Law, to author (May 3, 2011) (on file with author) (questioning whether bailouts at the state or municipal level actually foster moral hazard).
 10. See, e.g., Jeb Bush & Newt Gingrich, Op-Ed., *Better Off Bankrupt*, L.A. TIMES, Jan. 27, 2011, at A19; David Skeel, *A Bankruptcy Law—Not Bailouts—for the States*, WALL ST. J., Jan. 18, 2011,

surprising: Bankruptcy law is an obvious mechanism of debt relief, and a bankruptcy scholar naturally looks to the tools of the craft.¹¹

But extending municipal bankruptcy law to states, whether by including states in Chapter 9 or by adding a new Chapter to the Bankruptcy Code to cover states, can bring in a lot of excess baggage. States are very different from municipalities. Being semi-sovereign, states do not necessarily need the protection, for example, of the automatic stay.¹²

The excess baggage can even obscure consideration of potentially useful applications of bankruptcy law. Thus, one scholar argues that state bankruptcy does not fit the traditional rationales for bankruptcy because state assets are not subject to a “grab race” by creditors,¹³ and also because states, unlike municipalities (and, of course, unlike corporations), have unlimited taxing powers and therefore can raise sufficient money to pay their debts.¹⁴ That argument dismisses any application of bankruptcy law to states.¹⁵

That goes too far, however. Certain limited but important bankruptcy law protections can be applied under a minimalist framework to help states consensually solve their debt problems. I begin the analysis by explaining the problems faced by states in attempting to restructure their debt.

at A17; David Skeel, *Give States a Way to Go Bankrupt*, WKLY. STANDARD, Nov. 29, 2010, at 22 [hereinafter Skeel, *Give States a Way to Go Bankrupt*].

11. Cf. ISAAH BERLIN, *THE HEDGEHOG AND THE FOX* 26 (Guernsey Press 1992) (1953) (observing that “to a cobbler there’s nothing like leather”).
12. Municipalities receive this protection under 11 U.S.C. § 922 (2006). I am not claiming that states would not benefit from this protection, merely that the other protections discussed below should be more important to states. Cf. *The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter: Hearing Before the Subcomm. on Courts, Commercial & Admin. Law of the H. Judiciary Comm.*, 112th Cong. 2 (2011) (statement of the Nat’l Bankr. Conf.) [hereinafter Statement of the Nat’l Bankr. Conf.] (observing that “[a] creditor of a State is usually restricted by that State’s law from seizing State property” and also that “a State enjoys sovereign immunity, which prevents a suit against the State”). For a more complete discussion of sovereign immunity, see *infra* notes 62–69 and accompanying text.
13. Adam Levitin, Professor of Law, Georgetown Univ. Law Ctr., Presentation at the 2011 Annual Meeting of Fellows of the American College of Bankruptcy (Mar. 19, 2011) (notes on file with author). A grab race is a type of collective action problem in which creditors who first seize assets recover those assets to the detriment of competing creditors. Nouriel Roubini, *Do We Need a New Bankruptcy Regime?*, BROOKINGS PAPERS ON ECON. ACTIVITY, Fall 2002, at 322–23 (noting a “grab race” problem as “creditors . . . initiat[ing] litigation to recover their claims . . . [by attempting to] seize or attach . . . assets”).
14. Levitin, *supra* note 13.
15. *Id.* Levitin also asserts that applying bankruptcy—a financial and legal solution—to what is essentially a political problem would be a recipe for political instability. *Id.*

I. ANALYSIS

Some traditional rationales for bankruptcy, such as preventing grab races, are not critical in the context of a semi-sovereign state.¹⁶ But the power of a state to tax its residents does not eliminate the importance of at least some bankruptcy protections. A state’s taxing power is not unlimited in practice.¹⁷ At some point, an increase in the tax rate will cease to raise tax revenues.¹⁸ Taxpayers will lose the incentive to earn income, or they will engage in more tax planning to reduce their effective tax rate,¹⁹ or they will move to other states, causing economic output (and tax revenues) of the troubled state to decline further.²⁰

Thus, while the full scope of bankruptcy protections is not needed, states still need a mechanism to work out their debt problems with their creditors.

A. Enabling States to Work Out Their Debt Problems

Debt problems are generally worked out through negotiation between a debtor and its creditors to restructure the terms of the debt. A meaningful debt restructuring usually involves changing such essential payment terms as the amount of principal, the rate of interest, and the maturities.²¹ The overall goal is to reduce debt payments, including the timing of such payments, to levels viewed by the debtor as manageable and by its creditors as realistic given

16. See *supra* note 12 and accompanying text (observing that states do not necessarily need the protection of the automatic stay).

17. Some states’ taxing power is not even unlimited in law. See, e.g., CAL. CONST. art. XIII A, § 3; see also Schragger, *supra* note 9 (observing that “state taxing authority is often limited by state constitutional provisions”).

18. Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 466 (1993) (discussing the difficulty of “identifying the tax-maximization point on this implicit ‘Laffer Curve’”).

19. See, e.g., Robert Carroll, *The Economic Cost of High Tax Rates*, FISCAL FACT, July 2009, at 2, available at <http://www.taxfoundation.org/files/ff182.pdf>.

20. Steven L. Schwarcz, *Global Decentralization and the Subnational Debt Problem*, 51 DUKE L.J. 1179, 1184 (2002) [hereinafter Schwarcz, *Subnational Debt*]; Steven L. Schwarcz, *Subnational Debt Restructuring and the Rule of Law*, 1 J. RESTRUCTURING FIN. 129 (2004); see also Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418 (1956) (describing communities as competitors for residents who “vote with their feet” by moving to the communities that offer the most ideal mix of goods and services, including the tax levels used to finance those goods and services).

21. Schwarcz, *Subnational Debt*, *supra* note 20, at 1219–20.

the debtor's circumstances.²² A debt restructuring between a debtor-state and its creditors should ordinarily follow this pattern.²³

The central problem faced by debtors attempting to restructure their debt—and thus likely to be faced also by debtor-states attempting to restructure their debt—is the “creditor-holdout” problem, a type of collective action problem.²⁴ In any debt restructuring, one or more creditors may strategically hold out from agreeing to a reasonable debt-restructuring plan. The holdouts hope that they either will receive full payment of their claims²⁵ or that the imperative of other creditors to settle will persuade those creditors to allocate to the holdouts more than their fair share of the settlement.²⁶ A holdout may also hope that other creditors will purchase the holdout's claim.²⁷

The creditor-holdout problem can severely impede a debt restructuring.²⁸ Indeed, the very existence of holdouts can undermine the willingness of other creditors to agree to a reasonable restructuring plan.²⁹

The creditor-holdout problem is likely to be especially severe in the context of a state trying to restructure its debt.³⁰ A high percentage of state debt is typically in the form of bonds.³¹ Any meaningful debt restructuring involves changing essential payment terms of the bonds,³² which usually requires

22. *Id.* at 1186.

23. *Cf. id.* at 1186–89 (observing this pattern for debt restructurings between subnational governmental entities and their creditors).

24. *Cf. id.* at 1219–20 (identifying the creditor-holdout problem as the principal debt problem in any subnational debt restructuring).

25. In practice, however, most holdout creditors prefer to seek a settlement rather than to litigate for full payment because of the high cost of litigation. *See* Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59, 60 n.2 (2000). This should especially be the case when the litigation is against a semi-sovereign state. *Cf. infra* notes 62–69 and accompanying text (discussing state Eleventh Amendment immunity from suit). Some judges may be reluctant, as a matter of public policy, to grant judgment to holdout creditors against a state. *Cf. In re LTV Steel Co.*, 274 B.R. 278, 286 (Bankr. N.D. Ohio 2001) (allowing debtor LTV Steel to use cash collateral in violation of its contract with creditors, thereby keeping LTV Steel in business and avoiding the unemployment and regional economic impact that would result from its failure). Moreover, a court might dismiss, as bad faith, a lawsuit brought to pressure other parties to give the litigant more than its fair share of the settlement. *See infra* notes 111–113 and accompanying text.

26. Schwarcz, *Subnational Debt*, *supra* note 20, at 1186.

27. *Id.*

28. *Cf. id.* at 1220 (explaining this in the broad context of any subnational debt restructuring).

29. *Id.* at 1220 n.231.

30. Another reason for this severity, discussed *infra* notes 132–139 and accompanying text, is that states sometimes issue debt through multiple authorities.

31. Chris Edwards, *State and Local Government Debt Is Soaring*, TAX & BUDGET BULL., July 2006, at 1, available at http://www.cato.org/pubs/tbb/tbb_0706-37.pdf (“Most state . . . debt takes the form of long-term bonds.”).

32. *See supra* note 21 and accompanying text.

unanimous bondholder consent.³³ The diversity of bondholders and the fact that their identities constantly change as bonds are publicly traded make it extremely difficult to reach unanimity.³⁴

In an attempt to mitigate a similar creditor–holdout problem in bonds issued by sovereign nations, issuers and underwriters of these bonds sometimes include collective action clauses (CACs) in the bond indentures.³⁵ CACs permit essential payment terms to be amended with the consent of a supermajority, as opposed to all, of the bondholders.³⁶ By analogy, CACs may well be seen as a potential solution to the creditor–holdout problem of states.

There are, however, at least two fundamental limitations to CACs. The first is that CACs are not always included in bond indentures.³⁷ In the recent Greek debt crisis, for example, 90 percent of the total debt was not governed by CACs.³⁸ Indeed, since 2003 there has been a “quiet revival of unanimous consent,” with at least four nations issuing sovereign debt requiring unanimous consent to change certain significant provisions.³⁹

-
33. Schwarcz, *Subnational Debt*, *supra* note 20, at 1220. Even if individual state bond issues were to require less than unanimous consent for these types of changes, there would still be the potential for a creditor–holdout problem across the state’s bond issues. *See infra* notes 48–49 and accompanying text.
34. Schwarcz, *Subnational Debt*, *supra* note 20, at 1220; *cf.* Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1193 (1991) (finding that “bank debt restructurings . . . are substantially easier to organize than public debt [i.e., bond] restructurings”).
35. Steven L. Schwarcz, *Sovereign Debt Restructuring Options: An Analytical Comparison* (Mar. 7, 2011) (work in progress) (manuscript at 11–12) (on file with author). A bond indenture is simply the agreement setting forth the terms and conditions of the bonds—effectively, a type of loan agreement.
36. *Id.*; *see also* BARRY EICHENGREEN, TOWARD A NEW INTERNATIONAL FINANCIAL ARCHITECTURE 65–70 (1999); Buchheit & Gulati, *supra* note 25; Christopher Greenwood & Hugh Mercer, *Considerations of International Law*, in BARRY EICHENGREEN & RICHARD PORTES, CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS 110 (1995).
37. Although an issuer can try to include collective action clauses (CACs) in its bond indentures at a later stage by engaging in exchange offers with exit consents—effectively replacing existing debt claims with debt securities governed by CACs—such an effort would be subject to practical and legal constraints. *See infra* notes 41–46 and accompanying text.
38. Stephen J. Choi, Mitu Gulati & Eric A. Posner, *Pricing Terms in Sovereign Debt Contracts: A Greek Case Study With Implications for the European Crisis Resolution Mechanism* 2, 13–14 (Univ. of Chi. Law & Econ., Olin Working Paper No. 541, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1713914; Mitu Gulati & Lee C. Buchheit, *How to Restructure Greek Debt 2* (Duke Law Scholarship Repository, Working Paper No. 2336, 2010), available at http://scholarship.law.duke.edu/faculty_scholarship/2336.
39. Anna Gelpern & Mitu Gulati, *Innovation After the Revolution: Foreign Sovereign Bond Contracts Since 2003*, 4 CAP. MKTS. L.J. 85, 99 (2008).

Relatively few state bond issues currently include CACs or their equivalent.⁴⁰ Although states responding to a financial crisis could try to insert CACs into their bond indentures, doing so could be difficult.⁴¹ The most viable means of accomplishing this would be for a state to engage in exchange offers with exit consents, in which the state offers its creditors the option of exchanging their debt claims for new debt securities that include CACs.⁴² To try to induce creditors to agree to the exchange, states often employ a variant on the prisoner's dilemma—requiring consenting creditors to waive any covenant protections of the old debt securities that can be waived without unanimous creditor consent, so creditors who do not submit to the exchange will find those covenant protections gone if the number of creditors agreeing to the exchange (which any given creditor will not know in advance) is sufficient to waive those covenants.⁴³ In a sovereign context, for example, Ecuador used this strategy in its 2000 debt restructuring.⁴⁴ Even if this strategy otherwise works, however,⁴⁵ questions remain of the extent to which it represents unenforceable coercion.⁴⁶

-
40. I reviewed several state bond indentures randomly selected by the Duke Law School reference librarian and found that all required unanimous bondholder consent to change essential payment terms. Cf. Nancy A. Peterman, David D. Cleary & Elizabeth J. Sickelka, *Restructuring Challenges of Tax-Exempt Bond Financing for Health Care Facilities*, AM. BANKR. INST. J., Dec. 2010–Jan. 2011, at 18, 72 (discussing when restructuring the terms of state and municipal bonds requires unanimity). Although state bonds are not subject to the Trust Indenture Act's requirement of unanimity (they are exempted by Trust Indenture Act § 304(4)(A)), many state bond indentures are patterned on corporate bond indentures, which, in turn, are governed by the Trust Indenture Act and therefore require unanimity. Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77ppp(b) (2006).
41. Steven L. Schwarcz, *'Idiot's Guide' to Sovereign Debt Restructuring*, 53 EMORY L.J. 1189, 1203 (2004).
42. Buchheit & Gulati, *supra* note 25.
43. *See id.*
44. MOODY'S INVESTORS SERV., SOVEREIGN RESTRUCTURINGS: PUTTING TOO MUCH FAITH IN EXIT CONSENTS (2001).
45. Cf. Stephen J. Lubben, *Why Chapter 11 Cases Are Shrinking*, N.Y. TIMES DEALBOOK, Dec. 27, 2010, <http://dealbook.nytimes.com/2010/12/27/why-chapter-11-cases-are-shrinking> (noting the “conventional wisdom . . . that exchange offers almost never work”). Ecuador's bonds lost about 40 percent of their net present value as a result of Ecuador's exchange offer with exit consents. Schwarcz, *supra* note 41, at 1194 n.25 (referencing the exchange offer described in the text accompanying note 44, *supra*).
46. *See, e.g.*, A. Mechele Dickerson, *A Politically Viable Approach to Sovereign Debt Restructuring*, 53 EMORY L.J. 997, 1015–16 (2004) (observing that “even some supporters of a contractual approach have questioned whether courts would be willing to enforce exit consents that radically altered the nonpayment terms of the bond contract”); Schwarcz, *supra* note 41, at 1191 n.6, 1203 (questioning whether exchange offers with exit consents should be enforceable); Michael M. Chamberlin, Remarks Prepared for the Bear Stearns & EMCA Sovereign Creditors Rights Conference: At the Frontier of Exit Consents (Nov. 8, 2001) (noting that “some bond terms (notably governing law, right of acceleration for non-payment, waiver of sovereign immunity

A second limitation to CACs is that even if all of a state’s bond indentures included CACs, these clauses (being contractual) would most likely work on an agreement-by-agreement basis.⁴⁷ Therefore, any group of bondholders that fails to achieve the requisite supermajority vote would itself be a holdout vis-à-vis other creditors.⁴⁸ It thus is unlikely that CACs, either currently or in the future, could ever completely resolve the creditor-holdout problem in state debt restructuring.⁴⁹

Solving the creditor-holdout problem therefore remains the primary task of any state debt-restructuring mechanism. Solving that problem is also one of the central goals of bankruptcy law.⁵⁰

1. Towards a Minimalist Framework

A minimalist legal framework incorporating across-the-board supermajority voting⁵¹ is all that would be required to help states solve the creditor-holdout problem. Such a framework would not need to bring in other bankruptcy baggage. It nonetheless would be desirable for the framework to also include⁵² a mechanism that enables states to obtain needed liquidity during the debt-restructuring process.⁵³

and submission to jurisdiction) seem so fundamental to a sovereign bondholder’s payment rights that they should not be changed without its consent” and that the likelihood that “courts will uphold such fundamental changes by exit consent as within the intent of the parties is doubtful but remains to be seen”). *But cf.* *Katz v. Oak Indus.*, 508 A.2d 873 (Del. Ch. 1986) (upholding a corporate exchange offer with exit consents).

47. Schwarcz, *supra* note 41, at 1203–05. Although, theoretically, the parties to each bond indenture could agree to a master CAC that operates across all bond indentures, it would almost certainly be difficult, if not impracticable, to obtain agreement from all those parties.

48. *Cf.* Anna Gelpert, *What Bond Markets Can Learn From Argentina*, INT’L FIN. L. REV., Apr. 2005, at 20–21 (stating that when Argentina was trying to negotiate debt-restructuring terms in 2001, several hedge funds, together with groups of individual investors, refused Argentina’s proffered draconian restructuring proposal and litigated, even though 70 percent of bondholders had already agreed to the proposal).

49. *Cf.* Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?*, 37 INT’L LAW. 103, 129 (2003) (concluding that “[t]he insertion of collective action clauses in sovereign bonds is an exercise in futility”).

50. See 11 U.S.C. § 1126(c) (2006) (providing for supermajority voting to attempt to solve the creditor-holdout problem).

51. See *infra* Part I.B (explaining this as, effectively, across-the-board supermajority voting by *pari passu* creditors).

52. See *infra* notes 140–146 and accompanying text (proposing model framework that includes such a mechanism).

53. The focus of the framework on across-the-board supermajority voting to help solve the creditor-holdout problem and on liquidity is inspired by the minimalist sovereign debt restructuring Proposed Model Convention proposed in Appendix I to *Bankruptcy Reorganization Approach*, *infra* note 110. That Convention also inspired both the Sovereign Debt Restructuring

This Article next examines how a minimalist framework could operate. It then compares the framework's benefits and potential drawbacks. Thereafter, the Article examines how the framework could be supplemented to enable states to obtain liquidity during the debt-restructuring process while at the same time protecting existing creditors. Finally, Appendix A to the Article provides possible model language for a federal statute implementing the framework, and Appendix B provides a flowchart illustrating possible application of that statute.

2. Operation of the Framework

Once a state opts to apply the framework,⁵⁴ the state's creditors would be bound to a form of across-the-board supermajority voting on a debt-restructuring plan. Under bankruptcy law, for example, a supermajority is defined as creditors holding at least two-thirds in amount and more than one-half in number of the creditors eligible to vote.⁵⁵ The vote by the applicable supermajority of substantially similar (that is, at least *pari passu*) creditors would legally bind dissenting creditors, including creditors of different bond issues.⁵⁶

Upon application of the framework, the state would have the right to propose a debt-restructuring plan to its creditors, with the goal of obtaining the requisite supermajority agreement of each class of substantially similar creditors whose debt is affected by the plan.⁵⁷ This incentivizes the state to propose a plan that not only eases its debt burdens but also would be regarded as acceptable by its creditors. Reaching a mutually agreeable plan would thus almost certainly involve a reiterative process, including submission of a plan, creditor feedback, submission of a revised plan responding to that feedback, possible creditor feedback on the revised plan, and so forth until the state has designed a mutually agreeable plan.

Convention (SDRC) proposed in the Appendix to *'Idiot's Guide,'* *supra* note 41, and the Sovereign Debt Restructuring Mechanism (SDRM) proposed by the International Monetary Fund (IMF). See *Proposals for a Sovereign Debt Restructuring Mechanism (SDRM)*, INT'L MONETARY FUND (Jan. 2003) <http://www.imf.org/external/np/exr/facts/sdrm.htm>. Neither the SDRM nor the SDRC, nor any other international debt-restructuring convention, has yet been put into force under international law.

54. This Article does not purport to address the internal state governance procedure, which could vary from state to state, by which a state would opt to apply the framework. *Cf.* 11 U.S.C. § 301 (likewise not addressing the internal corporate-governance procedure by which a firm opts to file a voluntary bankruptcy case).

55. *Id.* § 1126(c).

56. See *infra* note 57.

57. This type of voting, in contrast to voting under CACs, see *supra* notes 48–49 and accompanying text, would work across all bond issues whose claims are *pari passu*.

Although there is no assurance that a state and its creditors will be able to reach a mutually agreeable plan, both sides should have incentives to act reasonably.⁵⁸ The state, as mentioned, will want to ease its debt burden. Easing that burden should also help to increase the state’s credit rating,⁵⁹ and states are “enormously concerned with their credit ratings.”⁶⁰ Creditors, on the other hand, will want to reach a resolution that enables them to be paid on a current basis and to avoid the costs and uncertainties of litigating against a semi-sovereign state with limited payment capability.⁶¹ These costs and uncertainties are exacerbated by the Eleventh Amendment,⁶² which generally bars lawsuits against states in federal court.⁶³ It is clear that bondholder and other creditor suits would be included in this bar. The Eleventh Amendment was passed in direct response to a Supreme Court decision that a creditor could sue a state in federal court to collect on Revolutionary War debts,⁶⁴ and in a line of cases resulting from the “Bond Wars” of the late nineteenth century,⁶⁵

-
58. Although public choice theory suggests the potential for state officials’ views of reasonableness to differ from that of their constituents, debt restructuring should offer few opportunities for that divergence in views. Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1090–91 (1997).
 59. *Cf. Screeching to the Precipice: Argentina’s Debt Restructuring*, ECONOMIST, Feb. 26, 2005, at 75 (observing the increase in Argentina’s credit rating after its unilateral debt restructuring). The Contracts Clause of the U.S. Constitution would prohibit a state from engaging in a unilateral debt restructuring (for example, dictating to its creditors how the state’s debt should be discounted and repaid, such as California legislating that it need only pay 75 percent of its outstanding debt). *See infra* note 83 and accompanying text; *cf.* M. DAVID GELFAND, STATE & LOCAL GOVERNMENT DEBT FINANCING § 1:14 (2010) (observing that “[t]he Contract Clause was enacted during an economic depression following the American Revolution to protect creditors whose rights were being abrogated by a flurry of [state] debtor relief legislation”).
 60. Telephone Interview With Alan Hirsch, Policy Dir. for the State of N.C., Chief Policy Advisor for Governor Michael Easley (2001–09), and former Deputy Attorney Gen. of N.C. (Mar. 31, 2011) (notes on file with author). A credit rating is “an assessment of the likelihood of timely payment on [debt] securities.” Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 6.
 61. Among other defenses a state might raise is that the creditor is acting in bad faith. *Cf. infra* notes 111–113 and accompanying text (discussing when bad faith might arise).
 62. U.S. CONST. amend. XI (“The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State.”).
 63. *Coll. Sav. Bank v. Fla. Prepaid*, 527 U.S. 666, 670 (1999).
 64. *See* Thomas E. Plank, *State Sovereignty in Bankruptcy After Katz*, 15 AM. BANKR. INST. L. REV. 59, 68–70 (2007).
 65. “Bond Wars” refers to the efforts by bondholders to seek judgments in federal court to prevent southern states from repudiating war debt. *See* John J. Gibbons, *The Eleventh Amendment and State Sovereign Immunity: A Reinterpretation*, 83 COLUM. L. REV. 1889, 1974 (1983).

federal judges have mostly refused to hear disputes that could ultimately operate against state treasuries.⁶⁶

Admittedly, the Eleventh Amendment does not completely bar creditor lawsuits against states. A creditor could choose to sue a debtor-state in state court instead of federal court, and also could attempt to procure a state's waiver of its Eleventh Amendment immunity in order to sue in federal court. The option of suing a financially distressed state in its own courts is unattractive, however. And though it appears settled that a waiver by a state of its Eleventh Amendment immunity would be enforceable,⁶⁷ such waivers are relatively rare; states typically consent to suit only in their own courts.⁶⁸ Furthermore, even if a state were to waive its Eleventh Amendment immunity, some legal experts believe such waivers can be revoked.⁶⁹

Creditors therefore should have sufficient incentives to act reasonably under the framework to try to reach a mutually agreeable debt-restructuring plan. The framework nonetheless lacks two additional incentives that, in a corporate bankruptcy, can help a debtor and its creditors reach agreement on a debt-restructuring plan. One incentive motivates the debtor to act reasonably: A debtor that fails to reach a debt-restructuring plan can be liquidated.⁷⁰ The

66. See, e.g., *Edelman v. Jordan*, 415 U.S. 651, 663–65 (1974); *Gibbons*, *supra* note 65, at 2001–04. Although *Central Virginia Community College v. Katz*, 546 U.S. 356, 359 (2006), holds that states cannot raise sovereign immunity as a defense in a preference action instituted by a debtor in bankruptcy, the facts of that decision are easily distinguishable and, even given its facts, that decision has been widely criticized. See, e.g., Jonathan C. Lipson, *Debt and Democracy: Towards a Constitutional Theory of Bankruptcy*, 83 NOTRE DAME L. REV. 605, 644 (2008) (labeling *Katz* as “problematic,” but suggesting that the case indicates that Congress’s bankruptcy powers are not limited by sovereign immunity); Plank, *supra* note 64, at 93–94 (criticizing the reasoning in *Katz*, and suggesting that future encroachments into state sovereign immunity might result in a reconsideration of the Court’s holding in *Katz*).

67. *Coll. Sav. Bank*, 527 U.S. at 675–76 (recognizing that states may waive Eleventh Amendment immunity).

68. A review of randomly selected state bond indentures and state statutes revealed no effective waivers by states of sovereign immunity in federal court. See Memorandum From Greg McKay, Research Assistant, Duke Univ. Sch. of Law, to author (June 6, 2011) (on file with author). Although most states waived sovereign immunity in state court, that immunity is unrelated to the Eleventh Amendment. *Alden v. Maine*, 527 U.S. 706, 745–46 (1999). It is clear that “a state does not consent to suit in federal court merely by consenting to suit in the courts of its own creation.” *Coll. Sav. Bank*, 527 U.S. at 675–76 (also requiring a clear declaration of intent to be sued in federal court for a state to have waived its Eleventh Amendment sovereign immunity).

69. Telephone Interview With Roger L. Davis, Partner & Chair of the Pub. Fin. Dep’t at Orrick, Herrington & Sutcliffe LLP (May 27, 2011) (observing that some bond counsel believe that Eleventh Amendment waivers by states are revocable and that one bond counsel opines that such a waiver is merely “valid,” not “valid and binding”—the latter formulation being the typical generic legal opinion as to validity).

70. 11 U.S.C. § 1112(b) (2006).

other incentive motivates creditors to be realistic in their expectations:⁷¹ A court can potentially cram down a debt-restructuring plan over the objection of a class of creditors.⁷² Neither of these incentives would appear to apply in a meaningful way to state debt restructuring. As a political if not constitutional matter, states cannot be liquidated. Cramdown depends on the ability to value the debtor as a going concern,⁷³ but it is difficult to conceive how to value a state.⁷⁴

A minimalist framework can nonetheless provide value without these incentives.⁷⁵ Even if the framework does not completely solve the creditor-holdout problem, the incentives discussed here should significantly increase the likelihood that a state and its creditors can reach consensual agreement notwithstanding the existence of holdout creditors.⁷⁶

3. Benefits

A minimalist framework could help address political and constitutional concerns about state bankruptcy. The National Governors Association has announced, for example, that the “nation’s governors strongly oppose federal proposals” to institute a Chapter 9–style state bankruptcy law.⁷⁷ And in a recent

71. Schwarcz, *Subnational Debt*, *supra* note 20, at 1222–23.

72. 11 U.S.C. § 1129(b).

73. *See, e.g.*, Peter V. Pantaleo & Barry W. Ridings, *Reorganization Value*, 51 BUS. LAW. 419 (1996) (explaining the relationship between cramdown and valuation).

74. Schwarcz, *Subnational Debt*, *supra* note 20, at 1223. There does not appear to be any precedent in which municipalities resorted to cramdown under Chapter 9, nor are commentators in agreement on how such a cramdown would be applied. *Compare* McConnell & Picker, *supra* note 18, at 464–66 (questioning how municipal-bankruptcy cramdown would address unsecured creditor claims), *with* Richard Maloy, *A Primer on Cramdown—How and Why It Works*, 16 ST. THOMAS L. REV. 1, 55 (2003) (discussing municipal-bankruptcy cramdown, and superficially restating the corporate cramdown language without attempting to apply it in a municipal context).

75. One could conceive of additional debt-restructuring incentives. For example, the federal government could create a pot of money (smaller, of course, than the amount that would be needed for a bailout) to be distributed to a state that successfully restructures its debt within time limits. The pot could even reduce over time to encourage a prompt restructuring. To avoid motivating financially healthy states to restructure their debts to get the rewards, the framework could impose a financial test for restructuring. But that could be hard to measure, and it might be degrading to a state legitimately wishing to use the framework. The federal government also might consider penalty incentives. A powerful penalty incentive, if politically viable, would be limiting the extent that interest on the bonds of a state that fails to negotiate in good faith would be exempt from federal taxation. *Cf.* *South Carolina v. Baker*, 485 U.S. 505, 523–24 (1988) (holding that this tax exemption is not constitutionally required).

76. *See supra* notes 58–69 and accompanying text.

77. Chris Gregoire, Gov. of Wash. and Chair of the Nat’l Govs. Ass’n, & Dave Heineman, Gov. of Neb. and Vice Chair of the Nat’l Govs. Ass’n, NGA Statement Regarding Bankruptcy Proposals for States (Jan. 25, 2011).

congressional hearing, all but one of the testifying experts agreed that “enacting bankruptcy legislation for states has the potential to create more problems than it solves.”⁷⁸

A minimalist framework, in contrast, need not be promulgated as part of the Bankruptcy Code, nor need it use the terms bankruptcy or insolvency.⁷⁹ The framework would thereby mitigate the stigma of bankruptcy, making it more likely to be enacted and more likely that a state needing its protection would use it.⁸⁰

Moreover, a minimalist framework should be less likely to raise federal constitutional issues than a state bankruptcy chapter based on Chapter 9. If, as this Article proposes, the state has the right to decide whether or not to apply the framework,⁸¹ its sovereignty would not be impugned by its choosing to apply the framework.⁸² And, once applied, the framework would modify creditor but not state rights. The framework would therefore not undermine state sovereignty.

Nor should the framework’s modification of creditor rights violate the Contracts Clause of the U.S. Constitution, which prohibits states, subject to certain case law exceptions, from impairing contractual obligations.⁸³ Under these exceptions, only a substantial impairment of contractual obligations would otherwise violate the Contracts Clause.⁸⁴ And even a substantial impairment would not violate the Contracts Clause if “the impairment is both reasonable and necessary to fulfill an important public purpose.”⁸⁵ One could argue that

78. *Congress Hears Testimony on State Bankruptcy Option*, BANKR. CT. DECISIONS, Feb. 22, 2011, at 6 (reporting on the Feb. 9, 2011, hearing before the House Oversight and Government Reform Committee’s subcommittee on TARP, Financial Services, and Private Programs). Professor David Skeel was the only testifying expert who argued in favor of a state bankruptcy option. *Id.*

79. *See infra* notes 92–96 and accompanying text (explaining why federal legislation retroactively imposing supermajority voting should be constitutional).

80. *Cf.* Schwarcz, *Subnational Debt*, *supra* note 20, at 1245 (arguing that “[t]o preserve the dignity of municipalities seeking its protection and to avoid discouraging its use, [the proposed subnational debt-restructuring law] does not speak in terms of bankruptcy or insolvency, nor does it require a municipality to be insolvent to seek protection thereunder or otherwise differentiate between exogenous and endogenous factors that lead to default”).

81. *See supra* note 54 and accompanying text.

82. *Cf.* Skeel, *Give States a Way to Go Bankrupt*, *supra* note 10, at 22 (stating that there is no Tenth Amendment concern “[s]o long as a state can’t be thrown into bankruptcy against its will, and bankruptcy doesn’t usurp state lawmaking powers”).

83. The Contracts Clause provides that “[n]o state shall . . . pass any . . . Law impairing the Obligation of Contracts . . .” U.S. CONST. art. I, § 10, cl. 1.

84. *Energy Reserves Grp., Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 411 (1983) (quoting *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244 (1978)).

85. *Seltzer v. Cochrane*, 104 F.3d 234, 236 (9th Cir. 1996) (citing *Energy Reserves Grp.*, 459 U.S. at 411–12).

the framework fits within these exceptions. For example, its supermajority voting should not substantially impair contractual obligations because dissenters would be bound only by the supermajority vote of *pari passu* creditors; and even if such voting does substantially impair contractual obligations, the impairment is both reasonable and necessary to protect state financial integrity.

We do not need to examine the merits of these arguments, however, because implementing the framework under federal law—as this Article proposes—should remove the framework from the scope of the Contracts Clause, which covers only state law impairment of contracts and not impairment that occurs wholly within a federal legal framework. In *In re Stewart*,⁸⁶ for example, the debtors in a Chapter 7 bankruptcy case argued that their tax-exempt savings should be exempt from attachment by creditors pursuant to state law provisions that were incorporated by federal law.⁸⁷ The trustee-in-bankruptcy countered that those savings should not be exempt because the state law provisions violated the Contracts Clause by “retroactively removing certain financial assets from the reach of creditors who relied on such assets when entering into contractual relationships [to extend credit].”⁸⁸ The court ruled that the “Contracts Clause attack is misplaced as a threshold matter” because the “Contracts Clause applies only to state, and not federal, laws.”⁸⁹ Although the state law provisions impaired contractual obligations, they did so “only as modified by *federal* law and only as applied in the *federal* context of bankruptcy.”⁹⁰

This Article’s proposed federal framework may be even more clearly outside the scope of the Contracts Clause. Consistent with *In re Stewart*, any impairment by a state of contractual obligations under the framework would occur only in accordance with federal law and only as applied in the federal context of a debt restructuring contemplated by the framework. Bringing the framework even further outside the scope of the Contracts Clause (which focuses on state law impairment of contract⁹¹), a state would not, as in *In re Stewart*, need to enact state law to use the framework; it merely would choose to do so—although it is not inconceivable that a court might view a state’s making that choice as the de facto equivalent of enacting law.

86. 246 B.R. 134 (Bankr. D.N.H. 2000).

87. *Id.* at 135–36. Federal law, the bankruptcy exemption in 11 U.S.C. § 522(b)(2), incorporated the state (New Hampshire) law provisions.

88. *In re Stewart*, 246 B.R. at 140.

89. *Id.*

90. *Id.*

91. *See supra* note 83.

A final constitutional question is whether the framework's retroactive application to state debt issued before its promulgation under federal law might violate the Fifth Amendment, which provides "some protection against contractual impairment by the federal government."⁹² It is clear that Congress has power under the Bankruptcy Clause of the Constitution to retroactively impair contractual obligations.⁹³ But that power might not be applicable if the framework is promulgated outside of the Bankruptcy Code and does not use the terms bankruptcy or insolvency.⁹⁴ Even without that power, however, the framework's retroactive application should not violate the Fifth Amendment because retroactive federal legislation is constitutional so long as it does not constitute a "taking" by completely destroying property rights in a way that the affected parties could not have anticipated.⁹⁵ The consensual relinquishment of rights under supermajority voting should not constitute complete destruction of creditor rights. The only right that is completely destroyed is an individual creditor's right to be a holdout; that right, however, is an unreasonable private expectation that should not be protected.⁹⁶

4. Potential Drawbacks

Although a minimalist framework could help to solve the creditor-holdout problem, it could have drawbacks. Two potential drawbacks are immediately apparent: first, that the framework could increase financing costs,⁹⁷ and second, that its application could be unfair to dissenting creditors who are bound by the supermajority voting. These drawbacks could be addressed, however, in the design of the framework.

First consider increased financing costs. Creation of the framework might increase state financing costs by making it easier for a state to engage in a

92. GELFAND, *supra* note 59.

93. *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 188 (1902).

94. *See supra* notes 79–80 and accompanying text.

95. *See E. Enters. v. Apfel*, 524 U.S. 498, 528–29 (1998) ("[L]egislation might be unconstitutional if it imposes severe retroactive liability on a limited class of parties that could not have anticipated the liability . . ."); *United States v. Riverside Bay Homes*, 474 U.S. 121, 128 n.5 (1985); *Speckmann v. Paddock Chrysler Plymouth, Inc.*, 565 F. Supp. 469 (E.D. Mo. 1983).

96. *See Jan G. Laitos, Legislative Retroactivity*, 52 WASH. U. J. URB. & CONTEMP. L. 81, 100 (1997); *see also infra* notes 111–113 and accompanying text.

97. *Cf. State Bankruptcy Debate Transfixes Nation*, BANKR. CT. DECISIONS, Feb. 8, 2011, at 4 (reporting that some commentators are concerned that enacting a full-blown Chapter 9–style state bankruptcy law could increase financing costs).

debt restructuring that reduces the value of creditor claims.⁹⁸ Empirical evidence in a related context suggests, however, that any such increase would likely be marginal.⁹⁹ Financially healthy states should not experience even a marginal increase; if an increase does occur, it should primarily impact states facing financial difficulty because only a financially troubled state would have an incentive to apply the framework.¹⁰⁰ Moreover, as explained below, any such increase would only apply prior to a state’s application of the framework (an ex ante cost increase).

Any such increase in financing costs would be offset by the cost decrease of states that actually apply the framework. Such an ex post cost decrease should result from a state’s using the framework to reduce its debt burden, thereby resolving its financial difficulty. Although it is possible, at least for a short period after a debt restructuring under the framework, that a state might face higher financing costs from investors upset about the state’s use of the framework,¹⁰¹ the

-
98. Cf. Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 YALE L.J. 573, 578 (1998) (observing that ex post modification of creditors’ rights by “[s]ubstantive rules implemented exclusively in bankruptcy” can have adverse effects such as increasing borrowing costs).
99. Michael Bradley, James D. Cox & Mitu Gulati, *The Market Reaction to Legal Shocks and Their Antidotes: Lessons From the Sovereign Debt Market*, 39 J. LEGAL STUD. 289, 295–97 (2010) (finding that the inclusion of collective action clauses in sovereign bond indentures, which enable supermajority voting to change essential payment terms, did not measurably increase sovereign borrowing costs). The IMF has argued that observing the impact of collective action clauses on sovereign borrowing costs should be somewhat representative of the impact of its proposed SDRM. See Anne O. Krueger, First Deputy Managing Dir., IMF, *Sovereign Debt Restructuring Mechanism—One Year Later: Address to the European Commission in Brussels, Belgium* (Dec. 10, 2002) (transcript available at <https://www.imf.org/external/np/speeches/2002/121002.htm>) (observing that implementation of the SDRM could even reduce country borrowing costs by facilitating greater incentives for countries to enact sound fiscal policies, a shorter negotiation process, and higher recovery rates for creditors, and suggesting that the cost impact could be measured indirectly through empirical studies of collective action clauses in bond indentures).
100. A financially healthy state that opts to apply the framework would likely find it difficult if not impossible to persuade a supermajority of its creditors to agree to any debt restructuring that impairs essential terms of the debt. Cf. *supra* note 57 and accompanying text (discussing the reiterative process needed for a state and its creditors to reach a mutually agreeable restructuring plan). But by opting to apply the framework, the state would be signaling financial trouble, which would likely raise its financing costs.
101. Compare *Hearing*, *supra* note 1 (statement of David Skeel, Professor of Law, Univ. of Pa.), available at http://www.law.yale.edu/documents/pdf/cbl/Skeel_Congressional_Testimony.pdf (stating that if a state were to declare bankruptcy, “the impact would be very limited” on the borrowing abilities of healthier states), with *id.* (statement by Nicole Gelinas, Fellow, Manhattan Inst.) (disagreeing with Skeel because “[m]arkets can distinguish among states but they cannot do it instantaneously or even in a few weeks or even months”).

state's financing costs will ultimately turn on the credit rating of its bonds.¹⁰² And application of the framework to reduce the state's debt burden should improve that credit rating.¹⁰³

Whether the framework would increase or decrease state financing costs is ultimately an empirical question, depending on whether ex ante cost increases exceed ex post cost decreases.¹⁰⁴ But even if there were a cost increase, it should be viewed with an eye toward the alternative:¹⁰⁵ a state debt default, which would be much more likely to occur absent the framework and which "would make it obscenely expensive for all states to borrow."¹⁰⁶ And the alternative of a federal bailout to prevent default would have its own high costs.¹⁰⁷

-
102. Telephone Interview With Alan Hirsch, *supra* note 60; *cf. Hearing, supra* note 1 (statement of Rep. Mike Quigley) (observing that the low credit rating of Illinois bonds "was costing Illinois taxpayers \$551 million extra per year in interest payments").
103. Schwarcz, *supra* note 60, at 8; *see also supra* notes 59–60 and accompanying text (observing that easing a state's debt burden should help to increase the state's credit rating).
104. This should be a Kaldor-Hicks determination, focusing on overall state costs and not necessarily on individual states. A transaction is Kaldor-Hicks efficient if its aggregate benefits exceed its aggregate costs, considering all affected parties (including third parties). RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 13 (6th ed. 2003).
105. *Cf.* Letter From Richard Levin, Vice Chair, Nat'l Bankr. Conf., to the Subcomm. on Admin. Oversight & the Cts., U.S. Senate (Sept. 15, 2010) (in support of S. 3675, the "Small Business Jobs Preservation Act of 2010") (on file with author) (observing that "any bankruptcy law that permits rehabilitation can raise the price of credit or limit access to it," but it must be balanced against "the gains to society" more generally).
106. *Hearing, supra* note 1 (statement of Rep. Mike Quigley); *cf.* Statement of the Nat'l Bankr. Conf., *supra* note 12, at 18 (indicating that bankruptcy of Orange County, California, "negatively affected the cost and availability of municipal finance generally").
107. *See supra* notes 8–9 and accompanying text (discussing moral hazard and the too-big-to-fail dilemma). The framework theoretically could allow individual states to decide to opt out, thereby signaling to the marketplace (by opting out) that the state has faith in its own financial security. In this vein, some scholars have argued that companies should be able to opt out of the "default rule" of corporate bankruptcy law, enabling them to negotiate contractual provisions that better fit their financial situations. *See, e.g.,* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 *TEX. L. REV.* 51, 53–54 (1992); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 *YALE L.J.* 1807, 1849–50 (1998). Other scholars, however, have countered that such a contractual approach to bankruptcy overstates efficiency and inadequately addresses transaction costs. *See, e.g.,* Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 *HARV. L. REV.* 1197, 1253–54 (2005). In the sovereign nation context, at least one scholar suggests that if there were a debt-restructuring convention, it would be "possible and perhaps desirable to allow for opt-outs." Patrick Bolton, *Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons From Corporate Bankruptcy Practice Around the World*, 50 *IMF STAFF PAPERS* 41, 50 (2003). He later hints, however, that such an opt-out would be solely for political purposes. *Id.* at 66 (referring to this as a possible "compromise with debtor nations that have expressed strong reservations about the proposed new statutory regime by letting them opt out of part or all of the new procedure ex ante"). More attention needs to be given to the question of opting out. In the state context, for example, would opting out by financially healthy states increase costs for less healthy states? If so, would less healthy states then be motivated to

The second drawback is that, by enabling a supermajority of creditors to effectively bind a nonconsenting minority of creditors to a debt-restructuring plan, the framework would prevent holdouts from exercising their contractual rights. Although this type of concern is typical of any majoritarian voting scheme,¹⁰⁸ it is mitigated by the supermajority requirement. Still, the framework should be designed to minimize contractual interference and safeguard against unfairness.

The framework attempts to achieve these safeguards in several ways. As mentioned,¹⁰⁹ the state itself would opt for application of the framework. This not only preserves the state’s dignity but also prevents majority creditors from strategically using the framework to bully minority creditors. Under the framework, the state and its creditors would be bound to supermajority voting in which the vote by the overwhelming majority of substantially similar (at least *pari passu*) creditors for a debt-restructuring plan would legally bind both dissenting and majority creditors. This further protects minority creditors by binding them to a plan only if *pari passu* majority creditors agree to the plan; thus, holdouts and dissenters would be affected by the plan in the same way the supermajority is affected.¹¹⁰

A holdout may nonetheless complain that this scheme deprives it of the contractual right to be a holdout. Although, technically, a holdout would be so deprived, it is questionable whether this type of right should be protected by law. The Supreme Court has ruled that a creditor “whose selfish purpose [is] to obstruct a fair and feasible [debt restructuring] in the hope that someone would pay them more than the ratable” share could be viewed as acting in bad faith.¹¹¹ Courts have also found bad faith when a dissenting creditor attempts to block a debt-restructuring plan in order to protect a competing legitimate

opt out, creating somewhat of a Faustian bargain whereby those states might benefit from a short term rate reduction at the risk of being unable to restructure their debts if their financial condition worsens?

108. Marcel Kahan, *Rethinking Corporate Bonds: The Trade-Off Between Individual and Collective Rights*, 77 N.Y.U. L. REV. 1040, 1041–43 (2002).

109. See *supra* note 54 and accompanying text.

110. Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 1006 (2000); cf. David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 489–90 (1992) (suggesting that supermajority voting provides more than adequate protection for nonconsenting minority creditors in Chapter 11 bankruptcy because all creditors of the same class are bound by the majority’s decision).

111. *Young v. Higbee Co.*, 324 U.S. 204, 211 (1945); see also Laitos, *supra* note 96.

interest.¹¹² Bankruptcy law deprives creditors who act in bad faith from even having the right to vote on a debt-restructuring plan.¹¹³

Furthermore, “prepackaged” bankruptcy, which epitomizes supermajority voting, is one of the most widely accepted and admired uses of corporate bankruptcy law.¹¹⁴ Prepackaged bankruptcy is merely the application of bankruptcy law to harness the power of supermajority voting to enable a debtor and its creditors to effectuate a voluntarily negotiated debt-restructuring plan—that is, one negotiated outside of bankruptcy, and thus without the additional incentives discussed above¹¹⁵—on all creditors notwithstanding the objections of holdout creditors.¹¹⁶ The use of a minimalist framework to help solve the creditor-holdout problem would thus be closely analogous to the use of prepackaged bankruptcy.¹¹⁷

The widespread application of prepackaged bankruptcy and the relative paucity of objections to its use¹¹⁸—quite the contrary, some commentators

112. *Figter, Ltd. v. Teachers Ins. & Annuity Assoc.*, 118 F.3d 635 (9th Cir. 1997) (finding that a shareholder acts in bad faith by buying debt claims in order to attempt to block a debt-restructuring plan that, the shareholder believes, treats shareholders unfairly); *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 289–90 (Bankr. W.D. Pa. 1990) (finding that a party acted in bad faith by attempting to gain control of the debtor to block a debt-restructuring plan and substitute that party's own debt-restructuring plan).

113. 11 U.S.C. § 1126(e) (2006).

114. *See, e.g.*, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 840–41 (4th ed. 2001) (observing that proponents of prepackaged bankruptcy regard it as “the best of both worlds” and also that “[t]he use of [prepackaged bankruptcy] has grown with astonishing speed among large companies,” averaging around 10 percent of all bankruptcy cases). I am not claiming that the fact that supermajority voting is widespread and has long been used in bankruptcy law should be dispositive of the normative merits of that type of voting. *Cf.* ALAN SCHWARTZ & ROBERT E. SCOTT, *COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES* 18 (2d ed. 1991) (contending that “oughts’ cannot be derived from what is” (citing G.E. MOORE, *PRINCIPIA ETHICA* 10–14 (1971))). I am merely claiming that this fact provides some evidence of how supermajority voting would be viewed under existing norms. *See infra* notes 118–120 and accompanying text.

115. *See supra* notes 70–74 and accompanying text.

116. *See* CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* § 11.23, at 1130–32 (2d ed. 2009) (discussing prepackaged bankruptcy). A prepackaged bankruptcy is filed under 11 U.S.C. § 1126(b) in order to bind holdout creditors under 11 U.S.C. § 1126(c). TABB, *supra*, at 1130–31.

117. Indeed, prepackaged bankruptcies are “most useful in cases where [as with states] the debtor does not need to revise its business, but simply needs to overhaul its capital structure.” TABB, *supra* note 116, at 1131.

118. The only criticism is qualified. *See* WARREN & WESTBROOK, *supra* note 114, at 842 (observing that although holdout “creditors that are rolled over in a prepackaged [bankruptcy] plan sometimes face a difficult task to fight a steamroller confirmation, much to their consternation,” those consenting to the plan “see it as Chapter 11 at its best”); David A. Skeel, Jr., *Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware*, 1 DEL. L. REV. 1, 28 (1998) (noting that some prepackaged bankruptcies may favor large institutional investors at the expense of scattered general creditors, but arguing that the concern is outweighed by the benefits such as cost savings, time savings, and smaller deviations from absolute priority).

praise it as a “magical device”¹¹⁹—is at least some evidence that supermajority voting under this Article’s proposed framework should not be viewed as unfair under existing norms. The framework’s lack of a mechanism to cram down a debt-restructuring plan over the objections of a class of holdout creditors¹²⁰ should further reinforce that view.

5. Certain Complications

The analysis so far does not specifically address how, if at all, the framework should treat state collective bargaining and pension agreements, nor does it address how the framework should address debt issued not by a state per se but by one of its authorities or other legal entities. I consider these issues in turn.

State-sponsored pension agreements have been calculated to have shortfalls exceeding \$3 trillion,¹²¹ and the Wisconsin legislature recently battled over the elimination of collective bargaining rights for state employees.¹²² These issues are highly politicized, and any inclusion of an explicit right in the framework to impair collective bargaining or pension agreements would almost certainly engender significant opposition.

Bankruptcy law does not even clearly give that right to municipalities. The explicit right to impair collective bargaining agreements is limited in bankruptcy law to corporate reorganizations,¹²³ and even the staunchest scholarly advocate for state bankruptcy admits doubt about bankruptcy law permitting the renegotiation of municipal pension agreements.¹²⁴ A federal district court recently upheld a bankruptcy court’s ruling that a municipality (Vallejo, California) may nonetheless impair its collective bargaining agreements,¹²⁵ but that ruling is

119. TABB, *supra* note 116, at 1130; *see also* DAVID G. EPSTEIN ET AL., *BANKRUPTCY: MATERIALS AND CASES* 343 (3d ed. 2010) (“In some cases, parties have been negotiating long and hard before the bankruptcy case is even filed. A majority of creditors may have agreed to a sensible [debt-restructuring] plan, but some creditors may be ‘holding out,’ trying to use their leverage as holdouts to extract special deals for their particular consent. In such cases, [allowing the holdouts to undermine the debt-restructuring plan] would be economic waste . . .”).

120. *See supra* notes 72–74 and accompanying text.

121. Robert Novy-Marx & Joshua D. Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, 23 J. ECON. PERSP. 191, 192 (2009), *available at* www.kellogg.northwestern.edu/faculty/rauh/research/JEP_Fall2009.pdf.

122. Monica Davey & A.G. Sulzberger, *In Wisconsin Battle on Unions, State Democrats See a Gift*, N.Y. TIMES, Mar. 11, 2011, at A1.

123. *Compare* 11 U.S.C. § 901 (2006) (specifying which provisions of bankruptcy law outside of Chapter 9 also apply in Chapter 9), *with id.* § 1113 (permitting rejection of collective bargaining agreements, which is not specified in 11 U.S.C. § 901).

124. Skeel, *Give States a Way to Go Bankrupt*, *supra* note 10, at 24.

125. *In re City of Vallejo*, 432 B.R. 262 (E.D. Cal. 2010), *affg* 403 B.R. 72 (Bankr. E.D. Cal. 2009) (holding that because Chapter 9 does not incorporate 11 U.S.C. § 1113, municipalities have

controversial. The ruling inadequately addressed bankruptcy law's explicit limitation on impairing collective bargaining agreements.¹²⁶ And the City of Vallejo ultimately decided not to impair its collective bargaining agreements due to the likely political backlash.¹²⁷

Furthermore, the common portrayal of state pension debt, such as the \$3 trillion figure mentioned,¹²⁸ is misleading. Although "state governments often run large pension funds through state trusts . . . , it is local governments, including cities, towns, and school districts, not the state governments, that owe the bulk of what people think of as 'state' pension benefits."¹²⁹ A prominent rating agency recently reported, for example, that

[s]tates are often one of many contributing participants in [pension] systems that they manage, with no clear obligation for the portion of the liability that is not associated with their own employees. In some cases, even though the state controls the system, no state employees are covered under the plan and the state does not contribute to the plan¹³⁰

Similarly, when rating a state's creditworthiness, that rating agency confirmed that it "generally focus[es] on the portion [of pension liability] that is the state's responsibility."¹³¹

the right to reject collective bargaining agreements under 11 U.S.C. § 365, which generally permits contract breach, as interpreted by prior case law before 11 U.S.C. § 1113 was enacted).

126. The *In re City of Vallejo* opinions do not adequately address how their holdings square with 11 U.S.C. § 1113(f), which provides that "[n]o provision of this title [11] shall be construed to permit a [party in bankruptcy] to unilaterally terminate or alter any provisions of a collective bargaining agreement prior to compliance with the provisions of this section." Title 11 includes all of federal bankruptcy law, including municipal bankruptcy under Chapter 9.

127. See, e.g., Dennis J. Drebsky & Ann E. Chernicoff, *Extending Chapter 9 to States Would Present Hurdles*, NAT'L L.J., Feb. 21, 2011, at 12 (observing that, notwithstanding the court decisions in *In re City of Vallejo*, "the city delayed rejection in favor of continued negotiations with its major unions" and that invocation of this "nuclear option" could have "devastating" effects on state services).

128. See text accompanying note 121, *supra*.

129. *Hearing, supra* note 1 (testimony of Nicole Gelinas).

130. Douglas Offerman et al., *Enhancing the Analysis of U.S. State and Local Government Pension Obligations*, FITCH RATINGS, Feb. 17, 2011, at 3 (although also observing that "many states contribute to the pensions of employees [such as teachers] of lower levels of government to varying degrees"). Some states do not contribute as an employer to state-run pension plans that cover municipal employees but nonetheless guarantee the benefit. *Id.* at 3–4.

131. Telephone Interview With Laura Porter, Managing Dir. of Fitch, Inc., and head of Fitch's States Grp. (May 11, 2011) (notes on file with author); see also Offerman et al., *supra* note 130, at 1–2 ("Fitch believes that allocating the entire unfunded [pension] liability of a multiemployer system to a state just because it manages the system would overstate the burden on the state and understate the commitments of the participating local governments that are actually responsible for unfunded obligations of the system.").

On balance, therefore, this Article proposes that the framework not include an explicit right to impair state collective bargaining and pension agreements.

Consider next how the framework should address the complication of debt issued not by a state *per se*, but by one of its authorities or other legal entities. For example, some

states have made their commitments to creditors not through single “state” entities that could go before a bankruptcy judge with one voice, but through hundreds, in some cases thousands, of legal entities. Each of these legal entities has its own pre-existing agreements with bondholders and other creditors, set out in individual contracts and in state laws. An illustration: When many people think of state bond obligations, they think of “general obligation” debt—that is, debt for which states have obliged their “full faith and credit” to pay. But a state such as New York, for example, with one of the highest per-capita debt burdens in the nation, owes only \$3.5 billion in “general obligation” debt. New York owes the remainder of its \$78.4 billion in debt through hundreds of special “authorities,” including the Transitional Finance Authority, Metropolitan Transportation Authority, the Dormitory Authority, and others.¹³²

This arrangement would exacerbate the creditor-holdout problem if the issuing authority’s debt is state debt that is not *pari passu* with other debt of the state.¹³³ Holders of the authority’s debt could then have the right to vote as a separate class under the framework, enabling them (if they choose) to be holdouts *vis-à-vis* the other state debt treated in the plan.¹³⁴

Nonetheless, the framework’s across-the-board supermajority voting could still be powerfully applied. For example, all state guarantees of debt issued by state authorities and all other state debt could be voted as a single class, so long as those guarantees and other debt claims are *pari passu*. If those guarantees and other debt claims are backed by the state’s full faith and credit, they would almost certainly be *pari passu*.¹³⁵

Furthermore, to the extent politically and economically feasible, a state could even use the framework to restructure its full-faith-and-credit debt in a

132. *Hearing, supra* note 1 (testimony of Nicole Gelinias).

133. To the extent that a state is not itself obligated to pay authority debt, see *infra* notes 137–139 and accompanying text.

134. See *supra* notes 47–48 and accompanying text.

135. As a parallel, for example, where (as is common in my experience) the debt of various issuers in a corporate group is guaranteed by the strongest member of the group, a single debt-restructuring plan for the strongest member’s debt would modify all such guaranty claims, such claims being in substance *pari passu* with debt issued directly by that member.

plan that excludes debt whose recourse is solely to individual state authorities.¹³⁶ Although an individual state authority could separately use the framework to try to restructure its own debt,¹³⁷ the state would not need to participate in that effort. If the authority fails to restructure its debt, the consequences to the state of the authority's default may be limited.¹³⁸ And if the consequences are likely to be significant, such as where the authority engages in an important public function (for example, running transportation), the state could reconstitute a new authority to perform that function.¹³⁹ The state could even give that new authority credibility by backing it with its full faith and credit.

B. Ensuring Liquidity During the Debt-Restructuring Process

Even if the framework achieves its debt-restructuring goals perfectly, a state may need to borrow to pay current expenses, such as employee wages and energy costs, during the debt-restructuring process. A financially troubled state, however, will have difficulty borrowing new money unless the lender is given priority over the state's existing claims.¹⁴⁰

-
136. Cf. Email From Richard C. Schragger, *supra* note 9 (“Why shouldn’t those . . . authorities stand or fall on their own? Why treat those entities as having ‘state’ debt at all [since] many are created to avoid state debt limitations in the first place?”).
137. A state authority, if it qualifies for Chapter 9 bankruptcy, might instead opt to restructure its debts that way. Cf. *In re Las Vegas Monorail Corp.*, 429 B.R. 770, 788–90 (Bankr. C.D. Nev. 2010) (examining whether a governmental entity falls within the definition of a municipality eligible for Chapter 9 bankruptcy by considering whether the entity has “sovereign” powers such as taxation or eminent domain, whether the entity operates for the public purpose, the degree of state control, and whether the state designates or treats the entity as an instrumentality of the state).
138. See, e.g., Richard Williamson, *Texas Sports Agency Flirting With Default*, BOND BUYER, Aug. 31, 2010, http://www.bondbuyer.com/issues/119_416/texas-agency-flirting-with-default-1016658-1.html (discussing the likely default by the Harris County–Houston Sports Authority on \$988 million of debt, which was used to construct three professional sports stadiums). *But cf.* Steven L. Schwarcz, *The Use and Abuse of Special-Purpose Entities in Public Finance* (work in progress) (on file with author) (examining, among other things, the extent to which a state is likely to try to prevent default by a state authority on debt for which the state itself is not legally obligated); Email From W. Bartley Hildreth, Professor of Pub. Mgmt. & Pol’y, Ga. State Univ. Andrew Young Sch. of Pol’y Studies, to author (Apr. 25, 2011) (on file with author) (observing that, in 1984, the State of Ohio stood behind its water development authority’s debt in order to reduce rating-agency scrutiny of a technical default on that debt).
139. To enable a state to allow an authority to default, the framework should provide that such default will not trigger a cross-default in any other debt of the state or its authorities.
140. Cf. Patrick Bolton & David A. Skeel, Jr., *Redesigning the International Lender of Last Resort*, 6 CHI. J. INT’L L. 177, 186–87 (2005) (explaining this difficulty in the context of a nation trying to obtain financing during a debt restructuring); Schwarcz, *Subnational Debt*, *supra* note 20, at 1206–07 (explaining this difficulty in the context of a subnational governmental entity trying to obtain financing during a debt restructuring).

If the federal government were to provide this liquidity, it could designate its own priority. But it may be preferable politically to privatize this funding. To achieve this, there should be a mechanism to give priority to new-money lenders, while protecting existing creditors (who become subordinated to the new-money loans).

Although a state could legislate a priority under its own laws, new-money lenders might find that insufficient. They might worry, for example, that the priority may not be enforceable against out-of-state creditors, or that a politicized state legislature could later change the priority to the lenders’ disadvantage. Existing creditors might also worry that a priority created by a state under pressure to borrow will not give them sufficient notice and opportunity to block a new-money loan if, for example, they believe its amount is too high—creating a risk of overinvestment—or its terms are onerous to the state (and thus indirectly onerous to the state’s creditors). A priority borrowing mechanism promulgated under federal law in the manner described below should be more attractive to both new-money lenders and existing creditors.¹⁴¹

Bankruptcy law provides helpful precedent on how a debtor can attract new-money loans while protecting existing creditors. New-money lenders are granted a priority under an auction arrangement, in which lenders bid to make the loan and the debtor chooses the loan with the most attractive terms.¹⁴² Existing creditors are protected by having the right to object to a new-money loan.¹⁴³ Existing creditors are further protected because a debtor that abuses new-money lending privileges would likely face difficulty receiving supermajority creditor approval for a debt-restructuring plan.

141. Cf. Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425 (1997) (showing that new-money secured loans are generally efficient and fair).

142. 11 U.S.C. § 364(a)–(d) (2006).

143. *Id.* § 364(b)–(d) (requiring notice and a hearing for all new-money borrowings other than unsecured debt incurred in the ordinary course). As discussed *supra* notes 140–141 and accompanying text, existing creditors may object that the amount of the new-money loan is too high or its terms are too onerous. Although identifying a supervisory authority to hear and adjudicate objections in the state context is ultimately a political choice, any such authority should ideally be neutral while not raising concerns over state sovereignty. For example, the authority could be a body of prominent members of respected institutions (such as the American College of Bankruptcy). The authority also might be modeled on the mechanism for resolving disputes between investors and sovereigns in the North American Free Trade Agreement, under which bondholders and a state would each unilaterally appoint a member to a three-member committee, with the third member chosen by mutual agreement. See Daniel M. Price, *An Overview of the NAFTA Investment Chapter: Substantive Rules and Investor-State Dispute Settlement*, 27 INT’L LAW. 727, 731–33 (1993).

This same type of auction arrangement could be applied equally well in a state context. Because most state debt is unsecured,¹⁴⁴ it should be sufficient to give new-money lenders priority over unsecured creditors only.¹⁴⁵ That would avoid any concern that subordinating claims of secured creditors against their collateral could raise issues under the Fifth Amendment's Takings Clause.¹⁴⁶

Finally, whatever the funding source or mechanism, a new-money lender might wish to impose conditionality—conditioning the lending on the state's agreeing to adopt more fiscally responsible measures (such as balancing the state budget).¹⁴⁷ Although the federal government is more likely than a private lender to wish to impose conditionality, the framework could effectuate both by funneling private lending through the federal government in a back-to-back lending structure.¹⁴⁸ There would appear to be little, if any, constitutional impediment to imposing conditionality.¹⁴⁹ States, however, may oppose a framework that allows conditionality, preferring instead a federal government bailout. The federal government could address this perverse incentive by signaling that it will not engage in bailouts or by signaling its intent to impose more severe conditionality on any bailout it might consider.

CONCLUSION

In response to massive budget deficits, states have been turning to austerity measures, tax increases, privatization of services, and renegotiation of collective bargaining agreements. But states will also need debt relief if their debt burden

144. Edwards, *supra* note 31 (observing that most bonds are backed by full faith and credit).

145. Even in a corporate bankruptcy context, new-money lenders almost never get priority over secured creditors. 11 U.S.C. § 364(d).

146. A security interest is considered a property right, namely, the right to have the value of the collateral applied to payment of the secured creditor's claim. Julia Patterson Forrester, *Bankruptcy Takings*, 51 FLA. L. REV. 851, 876–77 (1999) (citing *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273, 278–79 (1940); *John Hancock Mut. Life Ins. Co. v. Bartels*, 308 U.S. 180, 186–87 (1939)).

147. *Cf.* Schwarcz, *supra* note 110, at 963 (discussing conditionality imposed in a sovereign debt-restructuring context by the IMF).

148. *Id.* at 990–91 (examining the potential, in a sovereign debt-restructuring context, for the IMF to continue to impose conditionality through a back-to-back lending structure even when funding has been privatized). Back-to-back lending occurs when A lends money to B, who then lends that money to C.

149. *South Dakota v. Dole*, 483 U.S. 203, 207–08 (1987) (explaining Congress's broad ability to attach conditions to federal funding under the taxing and spending powers of Article I of the U.S. Constitution so long as the conditions are for the "general welfare," clear and unambiguous, related to the program for which they are provided, and not otherwise unconstitutional).

is so crushing that reasonable efforts at fiscal reform will fail to avoid default without a federal government bailout.¹⁵⁰

Some advocate solving state debt problems by, effectively, extending municipal bankruptcy law to states. That approach, however, brings in excess baggage, engendering political opposition and constitutional concerns, which in turn can obscure consideration of potentially useful applications of bankruptcy law.

A simpler solution is available: Enable states to work out their debt problems with their creditors. The main obstacle to achieving a debt restructuring is likely to be the creditor-holdout problem. Although contractual responses (such as collective action clauses) to the creditor-holdout problem are seriously limited, a minimalist legal framework incorporating certain limited bankruptcy protections would not only help states solve that problem but would also help to address the political and constitutional concerns. By being consensual and avoiding the stigma of bankruptcy, such a framework would preserve state sovereignty and have a higher likelihood of being enacted and used by a state needing its protection. Potential drawbacks of a minimalist framework could be addressed through design of the framework.

A minimalist framework also can enable a state to obtain needed liquidity during the debt-restructuring process. Although the federal government could provide this liquidity, the framework would enable the liquidity source to be privatized.

150. *Cf. supra* notes 3–8 and accompanying text (arguing that state debt relief could help to mitigate the suffering of residents of financially troubled states, minimize externalities that go beyond troubled states, reduce moral hazard, and prevent state debt defaults from possibly triggering systemic consequences).

APPENDIX A. MODEL FEDERAL STATUTE
FOR STATE DEBT RESTRUCTURING

Chapter I—Scope, and Use of Terms

§ 1. SCOPE

This statute applies to debt restructurings between States and their creditors.

§ 2. USE OF TERMS

For purposes of this statute:

- (1) “Consenting State” means a State that has invoked application of this statute in accordance with its terms;
- (2) “creditor” means an entity that has a claim for payment against a Consenting State;
- (3) “Plan” means a debt restructuring plan;
- (4) “Supervisory Authority” means _____.¹⁵¹

Chapter II—Invoking Application of the Statute

§ 3. PETITION FOR RELIEF

(1) A State may invoke application of this statute by filing a petition for relief with the Supervisory Authority.

(2) Immediately after such a petition for relief has been filed, the provisions of this statute shall apply to the relationship between the Consenting State and its creditors.

§ 4. NOTIFICATION OF CREDITORS

Within 30 days after filing its petition for relief, the Consenting State shall notify its known creditors of its intention to negotiate a Plan under this statute.

Chapter III—The Debt Restructuring Plan

§ 5. SUBMISSION OF PLAN

(1) The Consenting State may submit a Plan to its creditors at any time, and may submit alternative Plans from time to time.

(2) No other person or entity may submit a Plan.

§ 6. CONTENTS OF PLAN

A Plan shall:

- (1) designate classes of claims in accordance with § 7(3);

151. The model statute does not purport to choose the Supervisory Authority. For a discussion about how that choice might be made, see *supra* note 143.

- (2) specify the proposed treatment of each class of claims; and
- (3) provide the same treatment for each claim of a particular class, unless the holder of a claim agrees to a less favorable treatment.

§ 7. VOTING ON THE PLAN

(1) A Plan shall become effective and binding on the Consenting State and its creditors when it has been submitted by the Consenting State and agreed to by each class of such creditors’ claims. Thereupon, the Consenting State shall be discharged from any debt encompassed by the Plan, except to the extent provided in the Plan.

(2) A class of claims has agreed to a Plan if creditors holding at least [two-thirds] in amount and more than [one-half] in number of the claims of such class [voting on such Plan¹⁵²] [entitled to vote on such Plan] agree to the Plan.

(3) Each class of claims shall consist of claims against the Consenting State that are *pari passu* in priority, provided that *pari passu* claims need not all be included in the same class.

Chapter IV—Financing the Restructuring

§ 8. TERMS OF LENDING

(1) The Supervisory Authority shall have the right, but not the obligation, to lend money to a Consenting State on such terms and conditions as the Supervisory Authority deems appropriate,¹⁵³ taking into account the Consenting State’s use of the loan proceeds and any objections raised by creditors pursuant to § 8(2).

(2) Any loan by the Supervisory Authority under § 8(1) shall be made only after notice to the State’s known creditors of the intention to make such loan and the proposed terms and conditions thereof, and a hearing at which those creditors shall have the right to object to the loan.

§ 9. PRIORITY OF REPAYMENT

(1) Consenting States must repay loans made by the Supervisory Authority prior to paying any other claims.

(2) Such priority of payment shall extend to any assignee of such loans.

§ 10. NONRECOURSE BORROWING BY SUPERVISORY AUTHORITY

(1) To finance its lending to a Consenting State, the Supervisory Authority may borrow on such terms and conditions as it may negotiate, provided that

152. The Plan can be more easily approved if this alternative is selected, but then reliable notice to creditors becomes more important.

153. Chapter IV of the model statute, including § 8(1), would enable the Supervisory Authority to impose conditionality pursuant to a back-to-back lending structure, as discussed *supra* notes 147–148 and accompanying text.

neither the Supervisory Authority nor its assets shall be liable, contingently or otherwise, for repayment of such borrowing except to the extent the Supervisory Authority specifically agrees.

(2) As collateral for a borrowing, the Supervisory Authority may assign as security its right to payment under the loan made from the proceeds of such borrowing.

**APPENDIX B. FLOWCHART ILLUSTRATING POSSIBLE APPLICATION
OF THE FEDERAL STATUTE FOR STATE DEBT RESTRUCTURING**

See next page for a highly simplified example of how the Statute might work. The numbers used in this example are intended to be explanatory only and are not necessarily realistic.

Issue. Notwithstanding diligent efforts to raise taxes, reduce costs, and otherwise engage in fiscal reform, State X faces a budget shortfall that would prevent it from paying principal and interest on its debt and still maintain essential government services.

Invoking Application of the Statute for State Debt Restructuring. State X files a petition for relief with the Supervisory Authority.

Notification. Within 30 days of filing the petition, State X notifies its known creditors of its intention to negotiate a Plan under the Statute.

The Plan. State X submits a Plan to its creditors designating (*pari passu*) classes of claims and proposed repayment terms for each class:

Class 1: Maturity dates extended 2 years.

Class 2: Maturity dates extended 1 year and interest rates reduced by 2 percent.

Class 3: Principal amounts reduced 10 percent.

Vote. Classes 1 and 2 vote to approve, but Class 3 disapproves (i.e., less than the requisite supermajority of Class 3 creditors vote for approval).

Updated Plan. State X revises and resubmits Plan to creditors.

Class 1: Maturity dates extended 2 years.

Class 2: Maturity dates extended 1 year and interest rates reduced by 2 percent.

Class 3: Maturity dates extended 4 years and interest rates reduced by 1.5 percent.

Agreement. Requisite supermajority of creditors in each Class vote for approval. The Updated Plan becomes binding on all creditors (i.e., Classes 1, 2, and 3).

Financing. After discussions between Supervisory Authority and State X, Supervisory Authority proposes to lend \$Y billion to State X to help it pay its current expenses during the debt-restructuring process.

Supervisory Authority notifies the State’s known creditors of its intention to make the loan and the proposed terms and conditions thereof.

Supervisory Authority holds a hearing, at which creditors have the right to object to the loan.

Taking those objections into account, Supervisory Authority decides to renegotiate certain terms of the proposed loan.

Supervisory Authority borrows \$Y billion on a nonrecourse basis from private lenders, on-lends the loan proceeds to State X, and pledges its first-priority right to payment from State X as collateral to the private lenders.