THE CONSTITUTIONAL LAW OF STATE DEBT

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State debt crises are an underappreciated driving force in American constitutional history. The Revolutionary War debts of the 1790s gave us *Chisholm v. Georgia*, the Eleventh Amendment, and one of the first great debates over the scope of the national government’s power—Alexander Hamilton’s controversial proposal to assume the states’ debts. The Reconstruction debts gave us a new and improved Eleventh Amendment, reinterpreted to bar federal question claims in *Hans v. Louisiana*, as well as a dress rehearsal for the Court’s freedom of contract cases in the *Lochner* era. And as Michael Greve’s paper for this symposium demonstrates, the way that the central government responds (or doesn’t respond) to state debt crises is a critical factor in determining the practical scope of subnational autonomy in any federal system.

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1. 2 U.S. (2 Dall.) 419 (1793) (holding that the Supreme Court had original jurisdiction of a contract suit by a private citizen against a state).
2. 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.”).
4. 134 U.S. 1 (1890).
6. See Michael S. Greve, Our Federalism is not Europe’s. It’s Becoming Argentina’s, 7 DUKE J. CONST. L. & PUB. POL’Y 17, 39 (2012) [hereinafter Greve, Argentina] (“The fundamental fiscal federalism dilemma is between a credible central commitment against bailouts and central control over subordinate governments’ fiscal affairs.”). We strongly urged our friend Professor Greve to call his paper “Don’t Cry for Me, California,” but to no avail. For development of the argument that the credibility of central government commitments not to
Now we find ourselves in the midst of yet another state debt crisis. This essay explores the constitutional issues that may arise as the states, their creditors, and the national government seek a way out of the current financial tangle. That tangle is complex because states face both near-term and long-term fiscal challenges of differing natures. The near-term challenges largely stem from the most recent recession and can, for the most part, be characterized as financial distress. The long-term challenges arise from pension obligations and healthcare costs and can be characterized as economic distress. These two types of distress call for different kinds of solutions and thus raise different constitutional issues.

Most states do not face immediate fiscal crises—that is, most states can fund their current spending; instead, they face long-term challenges due to pension obligations and rising healthcare costs. A recent study of state debt and future liability, including pension and healthcare obligations, found that “in total, states are in debt for $4.2 trillion.” Focusing on pension funding, the Pew Center has concluded that “[t]hirty-one states were below the 80 percent funded threshold for a well-funded pension system” in fiscal year 2009. These looming liabilities affect not only the security of the pension and healthcare benefits themselves, but the states’ ability to raise money for other purposes. As Olivia Mitchell notes,
financial markets—investors, rating agencies, and insurers—are devoting much more attention than ever before to the financing demands of public sector pension plans when considering whether a state may be able to sustain, and surely to increase, efforts to borrow as a means of smoothing the deleterious impact of the financial crisis.\(^{11}\)

Some states, however, do face current fiscal emergencies. Illinois, for example, has skipped or reduced contributions to pension trust funds and expanded future pension benefits without providing commensurate funding.\(^ {12}\) In 2009, the state issued $3.5 billion of general obligation bonds to help fund its 2010 pension contribution, and the state remains torn by political disagreement about how to deal with public financing.\(^ {13}\) Similarly, in 2009, Connecticut had to sell a seven-year bond to cover its operating budget.\(^ {14}\) And California, dubbed the “Lindsay Lohan of states” by The Wall Street Journal,\(^ {15}\) faces a number of short-term (and long-term) challenges.

When evaluating the challenges facing the states, four categories of state obligations are critical: operating deficits, bond debt, unfunded pension obligations, and other post-employment benefits (largely retiree healthcare benefits).\(^ {16}\) These debts are owed to four different constituencies: citizens, bond investors, employees, and

\(^{11}\) Olivia S. Mitchell, Public Pension Pressures in the United States, in When States Go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis 57 (Peter Conti-Brown & David Skeel eds., 2012) [hereinafter When States Go Broke].


\(^{13}\) For example, the Illinois State Treasurer has threatened to derail a long-term borrowing plan favored by the Governor and members of the legislature by “call[ing] bond houses and financial rating firms to outline how deep the state is in debt.” Josh Barro, Illinois Treasurer: “Don’t Buy My Bonds”, Public Sector Inc. (May 24, 2011, 8:30 AM), http://www.publicsectorinc.com/forum/2011/05/illinois-treasurer-dont-buy-my-bonds.html; see also George F. Will, Illinois is running out of time and money, Wash. Post (Apr. 25, 2012), available at http://www.washingtonpost.com/opinions/illinois-is-running-out-of-time-and-money/2012/04/25/8fQA74kht Story.html (quoting Illinois Governor Pat Quinn to the effect that “our rendezvous with reality has arrived”).

\(^{14}\) Lav & McNichol, supra note 12, at 7; see id. (noting that this also occurred in Louisiana in 1998 and in Connecticut in 1991).

\(^{15}\) Allysia Finley, California: The Lindsay Lohan of States, Wall St. J. (Nov. 8, 2010), http://online.wsj.com/article/SB1000142405274870350690457592612400443370.html.

retirees. Our essay looks to the options available to these constituencies, as well as to the national government, to maximize satisfaction of state obligations in the event that states fail to meet them. We consider five potential “failure” scenarios:

1. **Payment delays and IOUs**: States may simply seek to delay repayment of their obligations without attempting to diminish their ultimate liability, or they may resort—as California and Illinois already have—to paying private businesses, local governments, and others with short-term IOUs rather than real money.

2. **Alterations to Long-Term Obligations**: States in economic distress may decide to alter the terms of long-term agreements with current and former employees to provide pensions and healthcare benefits.

3. **Bailout**: The national government may seek to “bail out” a financially troubled state, much like the International Monetary Fund might bail out a sovereign debtor or a distressed debt lender might lend on an emergency basis to a cash-strapped business. If a bailout occurs, the interesting questions concern what concessions the national government might extract in order to minimize the prospect of recurrence, as well as what long-term effects a bailout might have on the financial independence of the states.

4. **Default**: “Default” may mean a number of things, including a delay in payment or payment in something other than cash (an IOU). For purposes of this essay, however, “default” means failure to pay principal or interest when due with no clear plan of when, if ever, it will be paid.

5. **Bankruptcy**: Though not currently an option for states, scholars and politicians have suggested a voluntary bankruptcy regime for states, and one of our fellow symposium contributors argues for a mandatory regime.

Although many of the constitutional issues raised by these scenarios will overlap, each also raises unique questions of its own.

Part I of this essay describes and analyzes the fiscal challenges currently facing state governments. In the following Parts, we offer a constitutional perspective on each of the five sets of options available to address the states’ fiscal challenges. In Part II, we consider payment delays, IOUs, and alterations to pension and healthcare obligations.
Part III addresses bailouts, and Part IV considers default. In Part V, we describe constitutional concerns raised by proposed state bankruptcy schemes. We cannot hope to offer definitive answers; many of the salient issues have never been considered by the Supreme Court, and others have not been revisited in over a century. We aspire only to flag these questions so that policy discussions may be informed by the relevant constitutional background principles.

I. THE STATES’ FISCAL CHALLENGES

Financially speaking, the states are a mess. Professor Greve wrote last year that “[d]eficits for the current budget cycle are estimated at $175 billion. In some states (Texas, California, Nevada, and Illinois), the shortfall exceeds 30 percent of projected budgets.” The long-term picture is considerably worse: “Unfunded pension obligations are estimated at upwards of $1 trillion and are probably three or four times that amount. Unfunded health care commitments clock in at upwards of a half trillion. Bond debt issued by state and local governments comes in around $2.8 trillion.”

Nor are these problems simply a short-term manifestation of the late economic unpleasantness. The United States Government Accountability Office notes that the “fiscal position of [the states] will steadily decline through 2060 absent any policy changes.” The policy changes required to maintain fiscal balance at the state level—cutting spending and raising taxes—are not politically palatable. And the necessary extent of those policy changes—action taken today and maintained every year equal to a 12.5% reduction in spending or increase in taxes—makes them nearly politically impossible to implement.

In this fiscal landscape, prudent stakeholders should consider how a state may react if (or when) it cannot support its current obligations with revenues or borrowing—that is, if it could not pay its debts as they came due. For a municipality—the only government entity with a bankruptcy option under current law—to be eligible for bankruptcy under Chapter 9, it must be unable to meet its obligations when they become due. 11 U.S.C.A. §109(c) (West 2012).
two kinds of distress. Firms in financial distress are “viable as going concerns, but currently having difficulty repaying debts,” or they “cannot meet [their] debts as they come due, but [have] a positive cash flow from current operations.” Firms in economic distress, on the other hand, have “low or negative operating profitability and have questionable going concern value even in the absence of leverage” or “negative cash flow.” Generally, firms in financial distress are proper candidates for restructuring under Chapter 11 of the Bankruptcy Code. These firms are simply carrying too much debt, which can be written down in a reorganization. When a business is no longer sustainable as a going concern, however, it is in economic distress. These firms are the proper candidates for liquidation under Chapter 7 of the Code. To determine which kind of distress a corporation faces, the Code essentially treats the first day of bankruptcy as the creation of a new firm. The new firm does not carry the debt burdens of its predecessor and must cover all new expenses. If it cannot cover new expenses even without the burden of its predecessor debt, it faces economic distress and is likely a better candidate for liquidation than reorganization.

What kind of distress are states in? Arguably, this question is irrelevant because we cannot liquidate states. The available solutions are either to bail them out or to restructure their obligations by

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23. United Airlines, 416 F.3d at 612–13; Lemmon, Ma & Tashjian, supra note 22, at 1.


25. See, e.g., Anna Gelpern, Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt, 121 YALE L.J. 888, 905–06 (2012). The Constitution does not guarantee the continued existence of any given state in so many words, but numerous provisions seem to foreclose “liquidating” a state of the Union—at least without that state’s consent, and possibly not even with consent. First and foremost, Congress lacks any such enumerated power in Article I. Moreover, Article IV’s statement that “no new State shall be formed or erected within the Jurisdiction of any other State; nor any State be formed by the Junction of two or more States, or Parts of States, without the Consent of the Legislatures of the States concerned,” U.S. CONST. art. IV, § 3, cl. 1, would put a damper on incorporating the territory of a liquidated state within some other more solvent state. Similarly, Article V provides “that no State, without its Consent, shall be deprived of its equal Suffrage in the Senate,” U.S. CONST. art. V, which would certainly be one consequence of liquidation. Finally, the Guarantee Clause obligates “[t]he United States [to] guarantee to every State in this Union a Republican Form of Government,” U.S. CONST. art. IV, § 4, a promise which arguably requires the U.S. to preserve a state’s existence for the benefit of its citizenry, even if the current leadership of a state consents to liquidation.
imposing “haircuts” or extending maturities. But the financial distress versus economic distress distinction helps us understand what kind of restructuring or bailout would be required and if it would be effective. Payment delays, IOUs, bailouts, and defaults can each alleviate financial distress, although each option is more appropriate under certain circumstances and each presents certain side effects. By comparison, only default, alteration of long-term obligations, or a bailout so large that it essentially transfers the liabilities can fix economic distress. In that circumstance, payment delays, IOUs, or a limited bailout will only delay eventual default or federalization of liabilities.

States may experience financial distress for a number of reasons. State receipts—not only from taxes, but also from income on state assets or grants from the federal government—may decline for economic reasons (the recession) or policy reasons (tax reductions, federal grant cutbacks). Likewise, expenditures—including wages and salaries of state employees, health insurance and pension costs, payments of social benefits such as Medicaid and unemployment, and interest payment on financial debt—may increase for a variety of reasons. These include not only deliberate spending increases, but also increases in persons needing public assistance in a recession, natural disasters, population shifts, demographic shifts (e.g., pensioners living longer), and rising healthcare costs.

A state may also be in financial distress due to a mismatch of maturities or failure of its political leaders to enact budgets in a timely fashion. Payment delays and IOUs can solve these kinds of problems. These modest forms of distress require only modest solutions.

If states are in more substantial financial distress, however, they will need to reduce their leverage—that is, their debt. States may reduce their leverage by reducing their obligations outright or by

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27.  Id.
28.  That is, they expect revenue to come in at a later date than the date on which their bills are due.
29.  Revenue Anticipation Notes and Taxation Anticipation Notes (RANs and TANs) are frequently used cash-management tools that combat mismatched maturities and are not viewed as indicative of distress. However, when an entity cannot rollover its RANs and TANs, a classic liquidity crisis—the epitome of financial distress—follows. This was an issue in New York City’s 1975 fiscal crisis. See generally Donna E. Shalala & Carol Bellamy, A State Saves a City: The New York Case, 1976 DUKE L.J. 1119.
Adding assets. Reducing their obligations requires the states to break or alter promises—for example, by imposing “haircuts” on bondholders, reducing services to constituents, or failing to pay pensions and other benefits as promised to former employees. On the other side of the balance sheet, states have two ways to add assets. The first is austerity. States can cut spending, increase taxes, or both. The second is through some sort of bailout from the federal government, which may provide grants to subsidize particular state activities or funds to pay affected stakeholders like bondholders and pensioners.

Each of these options has important downsides from a policy perspective. A bailout will fix the immediate problem, but potentially create other problems. As we discuss in Part III, the risks are familiar from the bank bailout of 2008, but they actually have a history going back to the dawn of the Republic. These risks include moral hazard—that is, if the federal government is going to pay, why should state politicians quit promising big pensions, healthcare, education, and other vote-winning services and entitlements? Likewise, if federal authorities are going to pay, then bondholders don’t have to price the risk of the state not paying them; rather, they price the risk of the federal government not stepping in to cover the state’s obligations. For nearly two centuries, the federal government has maintained a commitment not to bail out states. If current leaders are tempted to depart from that commitment, they should be mindful of the impact of any such departure on the structure of our federal system.

If the states reduce leverage by breaking promises to various stakeholders, we should expect predictable consequences. If the states break promises to bondholders, tighter capital markets should result. State governments will confront higher interest rates, fewer willing lenders, and possibly different kinds of lenders. Likewise, if the states default on obligations to their employees, employees may decrease their willingness to provide their labor at below-market wages in exchange for promises of a pension and other post-employment benefits. States may have to pay higher wages in order to attract

30. If I have $200 of liabilities and $50 of assets, I am leveraged 4:1 ($200:$50). If I reduce my liabilities to $100 and maintain $50 of assets, I have halved my leverage ratio to 2:1 ($100:$50). Alternatively, if my liabilities remain the same, but I come up with $50 of additional assets, I have also halved my leverage ratio to 2:1 ($200:$100).
31. See infra notes 135–144 and accompanying text.
32. See, e.g., Greve, Argentina, supra note 6, at 19; RODDEN, supra note 6, at 55–67.
desired candidates to public-sector jobs.

If states are in economic distress—that is, accruing liabilities at unsustainable rates—a bailout that adds assets on a one-time or limited basis will only be a band-aid. The obligations will continue to accrue at a rate that the state’s assets cannot cover, and additional assets (more federal dollars) will have to continue to be added over time. A one-time infusion of assets, without corresponding reductions in future liabilities through debt restructuring, revenue increases or expenditure decreases, will only postpone the problem. In other words, a bailout of an economically distressed state will only delay an eventual default or federalization of liabilities, whereas a bailout of a financially distressed state will plug a hole, hopefully enabling the state to become economically self-sufficient again.

State distress poses dilemmas for creditors beyond those ordinarily associated with insolvency in the private sector. States are not corporations; they (currently) cannot file for bankruptcy. Their creditors cannot employ common techniques used in corporate insolvencies to satisfy the creditors’ debts, including equitizing their holdings or liquidating all of the state’s assets. It is unclear what, if any, enforceable remedies a stakeholder has against a state. As one mutual fund advisor recently explained with regard to foreign sovereign debt:

> When a sovereign issuer faces a solvency crisis, the willingness of the government to pay its creditors becomes the key issue. A corporation almost always wants to pay, in order for management to save itself. It will sell prize assets to do so. A country will not. . . . Ultimately, the buyer of sovereign debt is making the leap of faith that the borrower will repay, even when times are tough and even if it is not politically expedient to do so. The owner of corporate debt has to trust their borrower as well, but that trust can be enforced through the lender’s legal claims on the borrower’s assets.

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33. As an example, imagine a state that generates $100 in assets and $300 in liabilities every year. It has a $200 deficit. The federal government bails out the state that cannot pay its bills (and cannot access the bond markets) by giving it $400. In two years, if the state is not generating more assets (revenues), it will have used up the bailout money, but still have a deficit of $200 in the third year (and each year in the future). Even if revenues double to $200, the economically distressed state would have a $100 deficit. The eternally springing hope would be that the bailout would be followed by an economic rebound that would increase tax revenues and plug the hole between assets and liabilities. This is unrealistic given the size of the state budget shortfall. See supra notes 8–10.
We feel safer in that more tangible world of debt investing. Similar insights apply to states as sovereign issuers. The remaining Parts of this essay explore the constitutional issues related to state debt. Although state government debt is generally viewed as a “safe bet,” American public law introduces a maze of complications when times turn bad.

II. PAYMENT DELAYS, IOUS, AND ADJUSTMENTS TO LONG-TERM OBLIGATIONS

We’ll pay you, just not now. A state in financial distress may simply choose to delay payments—on bonds, pensions, public salaries, or other obligations—by a fixed period of time. Cash can be paid as soon as it becomes available without the more complex redemption/payment procedures that are attached to IOUs. This may be an effective remedy when a state faces a mere cash-flow deficit. In February 2009, for example, California delayed payments of approximately four billion dollars for thirty days. The Governor and state legislature had not enacted a budget, and without a budget, California would have been $346 million in the red at the end of February (and $5.2 billion in the red in April). The California state constitution, federal law, and court rulings require California’s available General Fund cash to be used first to make payments related to education, debt service, and certain other General Fund payments; other payments can only be made if those protected creditors’ debts are satisfied. In 2009, when those required payments exhausted the available General Fund assets, non-protected creditors had to accept late payment. The State Controller’s office explained that payment delays were less likely to compromise the state’s access to credit markets than other options, such as issuing IOUs.

36. Id. (“Delaying payments is a more common accounting practice used by many businesses when cash is less than what is needed to immediately meet their obligations. Wall Street recognizes that tactic and can relate the State’s use of it to the private sector.”). The Controller explained, moreover, that “[b]y delaying payments the State can immediately issue payments as soon as cash becomes available. IOUs are more complex, and the redemption process could delay the time it takes to transmit those funds to the recipient.” Id.
Illinois has resorted to payment delays more broadly, on account of a widening gap between expenses and revenues and the state’s chronic unwillingness to confront its long-term structural budget deficit.\footnote{37} Most late payments are owed to school districts, public universities, and other governmental entities. The state pays a one percent “late fee” to nongovernmental payees who receive late payments. As of December 2010, Illinois estimated that approximately $1.5 billion in past-due bills were eligible to receive the one percent fine. In March 2011, Illinois established a Vendor Payment Program that allowed investors to buy vendors’ claims at par and then collect the amount owed (including the one percent fee) from the state.\footnote{38} The purpose of this program is to transfer accounts receivable ownership to investors and away from service providers who may be harmed by late payments and forced to lay off employees or take other measures that may harm the general economic health of the state.\footnote{39} In 2010, Illinois paid roughly thirty million dollars in late payment charges.

When states like California and Illinois delay payments to employees and service providers, they may well find themselves in breach of their contractual obligations. And to the extent that state law cuts off any recourse for such breach, payment delays may raise constitutional questions. If state law effectively changes the payment terms of the state’s contracts, for example, that might well amount to “impairment” under the Contract Clause.\footnote{40} Similarly, the retroactive imposition of such a change on obligations that the state has already undertaken might raise takings and due process concerns under the Fifth and Fourteenth Amendments.\footnote{41} For most creditors whose payments have been delayed, however, litigation is unlikely to be a satisfactory solution. After all, litigation will generally take far longer to achieve any sort of result than the duration of the payment delay itself. Large creditors may find it

\footnote{39.} \textit{Id.} To the extent that these vendor claims are negotiable, they are like IOUs and raise similar problems. \textit{See infra} notes 44–48 and accompanying text.  
\footnote{40.} \textsc{U.S. Const.} art. I, § 10, cl. 1 (“No state shall... pass any... law impairing the obligation of contracts...”).  
\footnote{41.} \textit{See} E. Enters., Inc. v. Apfel, 524 U.S. 498, 536 (1998) (expressing Takings Clause concerns for retroactive legislation); \textit{see also infra} notes 128–133 and accompanying text (discussing \textit{Apfel}).
worthwhile to seek compensation for a fair rate of return on the money owed during the period of the delay. The Court has recognized a doctrine of “temporary takings,” which holds that “where the government’s activities have already worked a taking of all use of property, no subsequent action by the government can relieve it of the duty to provide compensation for the period during which the taking was effective.”42 Under this doctrine, a large creditor—or perhaps a group of small creditors, such as public employees, aggregated into a class action—might seek retrospective relief even after the delay had ended. Alternatively, where a state has institutionalized procedures for late payment—as in Illinois—creditors who can show a likelihood of future late payments might seek prospective relief enjoining the operation of those procedures.43

We’ll pay you, with interest, but for now we’re paying you in fake money. Instead of simply delaying payments, states may choose (and have chosen) to issue IOUs. IOUs are securities issued in place of cash, bearing interest with a short-term maturity.44 California structured its IOUs as a “registered warrant” as opposed to a regular

42. First English Evangelical Lutheran Church of Glendale v. County of Los Angeles, 482 U.S. 304, 321 (1987). The Court rejected an effort to combine First English’s doctrine of temporary takings with the notion that a regulatory taking of all a property’s value requires compensation. See Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg’l Planning Agency, 535 U.S. 302, 332 (2002). But a state’s delay in payment is not a regulatory taking; rather, it is an outright appropriation, for a limited period of time, of the creditor’s property. As such, it strikes us as more analogous to a “physical occupation” of the creditor’s property and therefore subject to far more stringent takings standards. See id. at 323–24.

43. It is not easy to get a court to tell a state it cannot do something before the state has done it. See, e.g., O’Shea v. Littleton, 414 U.S. 488 (1974) (holding that plaintiffs in a civil rights class action seeking to enjoin state and local officials from treating them unfairly in the criminal process had not stated a case or controversy within Article III where the unfair treatment forming the basis of the suit had not yet occurred). The primary doctrinal barrier is ripeness, which requires a plaintiff seeking pre-enforcement review of government action to show that the issues are fit for judicial resolution and that the plaintiff will suffer hardship if required to wait until the law has actually been enforced. See Abbott Labs. v. Gardner, 387 U.S. 136, 148–56 (1967). This is generally not that difficult a burden to meet, but it becomes more difficult when the requested relief involves intrusion into the workings of state government. See O’Shea, 414 U.S. at 499–502.

44. When California issued IOUs in 2009, the federal Securities Exchange Commission issued a statement that, in the view of its staff, the IOUs were “‘securities’ under federal securities law.” See U.S. SEC. AND EXCHANGE COMM’N, SEC STAFF STATEMENT ON CALIFORNIA IOUS (July 9, 2009), available at http://www.sec.gov/news/press/2009/2009-154.htm. “As such,” the staff noted, “holders of these IOUs and those who may purchase them are protected by the provisions of the federal securities laws that prohibit fraud in the purchase or sale of securities.” Id. This conclusion suggests that, in addition to the constitutional issues discussed here, federal securities law may also constrain the states’ options when they issue IOUs. The impact of those laws is, alas, beyond the scope of this essay.
warrant, which is how the state’s bills are usually paid. California has used IOUs twice since the Great Depression—in 1992 and 2009.\footnote{See Michael M. Marois & William Selway, California Eyes IOUs for Second Time Since Depression, BLOOMBERG.COM (Dec. 8, 2008, 12:59 PM), http://www.bloomberg.com/apps/news?pid=washingtontory&sid=a2TUhalNFDds. The 1992 IOUs paid 5% interest, and the 2009 IOUs paid 3.75%. By comparison, the prevailing rate on a three-month CD in the secondary market was 3.68% and 0.55% in 1992 and 2009 respectively. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., HISTORICAL DATA, http://www.federalreserve.gov/releases/H15/data.htm (last visited May 16, 2012).} When the state issued $2.6 billion worth of IOUs in 2009, the California comptroller called them a “promise to pay,” and in fact the IOUs were redeemed in relatively short order.\footnote{Issued beginning July 2, 2009, the IOUs were originally to be redeemed three months later, on October 2, 2009, but were in fact redeemed on September 4, 2009. State Controller’s Office Information on Registered Warrants (IOUs) Issued in 2009, CALIFORNIA STATE CONTROLLER’S OFFICE (Nov. 10, 2010), http://www.sco.ca.gov/co_news_registeredwarrants.html.} Prior to redemption, some—but not all—banks were willing to accept the IOUs as deposits. Otherwise, the state paid holders at maturity.\footnote{To the extent that the original payees may have sold their scrip at a discount to speculators, however, they may never have gotten full value. See Peterson & Nadler, supra note 6, at 267 (recounting the experience of Chicago teachers paid in scrip during the Great Depression).}

A variety of legal constraints limit states’ ability to use IOUs. For example, California’s constitution, federal laws, and court orders protected certain payees (education, debt service, state payroll, and pensions). In 1992, for example, California paid its state employee payroll with IOUs, but the Ninth Circuit ultimately ruled that California’s failure to issue paychecks on payday violated the prompt payment requirement under the Fair Labor Standards Act.\footnote{Biggs v. Wilson, 1 F.3d 1537, 1544 (9th Cir. 1993).} In 2009, IOUs went primarily to private businesses, local governments, tax refunds, and owners of unclaimed property.

IOUs raise similar constitutional issues to payment delays—an IOU, after all, is simply a delayed payment that is formally memorialized at the time the original payment was due and that may have value as a negotiable instrument in the interim between the due date and eventual payment. Because the state is offering something else in lieu of the payment that is due, however, the Contract Clause issues are put in stark relief. Bond contracts, for example, typically include a provision prohibiting the modification of interest or principal payments, including extending those payments, without the consent of each holder. Paying with an IOU can be considered a
modification of several terms—the maturity date, the interest rate, and possibly the “currency” of payment. Hence, IOUs may well amount to an “impairment” in violation of the Contract Clause. But because the short-term nature of most IOU payments render litigation relatively unlikely, we hold full consideration of the merits and remedies for such a claim until we have considered a third option—alteration of the states’ long-term obligations to employees and pensioners.

We’ll pay you, but first we need to alter the terms of our long-term obligations to you. Delays and IOUs are helpful tools for dealing with financial stress. States in economic distress, however, may need to alter the terms of their obligations in more fundamental ways. In particular, they may need to alter long-standing agreements to provide pension and healthcare benefits to present and former employees. Many observers have pointed to these sorts of agreements as a basic cause of state fiscal problems, and we have already noted the massive extent of the states’ unfunded pension and healthcare obligations. Unilateral efforts by states to alter these agreements, however, are likely to raise difficult questions under the Contract Clause.

State and local employee benefits plans stand outside the more familiar federal ERISA framework that governs private employers. Crucially, public employee pension and healthcare plans tend to be “defined-benefit” plans, under which the employer pledges to provide a specific benefit at a future time, while private employers have generally moved to “defined-contribution” plans that promise only to contribute certain specified amounts toward those future expenses. Under a defined-benefit plan, “the burden is placed on the employer

49. See David A. Skeel, States of Bankruptcy, 79 U. CHI. L. REV. (forthcoming 2012) (manuscript at 11), available at http://ssrn.com/abstract=1907774 (identifying “states’ pension obligations” as “the single greatest threat to states’ fiscal stability”); see also Miron, supra note 8, at 3 (agreeing that pension problems are significant, but suggesting that healthcare obligations pose the most serious threat to state finances).

50. See supra notes 8–11 and accompanying text.


to contribute funds to the pension plan on an actuarially sound basis so that sufficient funds exist to pay the worker when he or she retires.\textsuperscript{54} The problem, of course, is that many if not most states and localities have failed to meet that burden. As a result, “[s]everal states will surely require substantial new revenue soon, or they will need to institute benefit cuts if they are to return their plans to long-term solvency.”\textsuperscript{55}

Not surprisingly, states are increasingly moving to reduce their obligations. Fourteen states have changed the rules of their plans by increasing the contributions required from the employee.\textsuperscript{56} And at least three states—Colorado, Minnesota, and South Dakota—have sought to restrict cost-of-living adjustments (COLA) to benefits for current retirees.\textsuperscript{57} Contract Clause litigation has ensued in each of these three states over the COLA reductions, as well as in New Hampshire over increases in employee contributions.\textsuperscript{58}

The Contract Clause was included in the Constitution primarily as a constraint on legislative impairment of private contracts—that is, to prevent states from intervening on behalf of private debtors against their creditors.\textsuperscript{59} Beginning with \textit{Fletcher v. Peck},\textsuperscript{60} however, the

\textsuperscript{54.} Id. (internal quotation marks omitted). A defined-benefit plan is “fully funded” if it has, “at any given date, sufficient money to pay all accrued vested benefits.” Mitchell, supra note 11, at 59. As Professor Mitchell explains, though, this concept is “inherently a moving target; Future benefit projections rely on assumptions about wage increases, labor turnover, mortality patterns, inflation, and other factors, and asset returns are also not reliably forecasted.” Id. at 60. Therefore, there are discrepancies in various estimates as to how underfunded the states’ plans actually are. What is not in dispute, however, is that underfunding is a serious problem.

\textsuperscript{55.} Mitchell, supra note 11, at 57.

\textsuperscript{56.} Id. at 69.

\textsuperscript{57.} Id. at 69 n.24; Secunda, supra note 53, at 276; see also Jennifer Staman, Congressional Research Service R41736, \textit{State and Local Pension Plans and Fiscal Distress: A Legal Overview} 1 (2011) (“In 2010 alone, over 20 states introduced or passed legislation aimed to reduce or otherwise modify pension plan benefits for current or future retirees.”).

\textsuperscript{58.} See Secunda, supra note 53, at 276–83 (discussing the Minnesota, South Dakota, and Colorado litigation); Joey Cresta, \textit{Ruling issued in pension suit}, SEACOASTONLINE.COM (Feb. 2, 2012), http://www.seacostonline.com/articles/20120202-NEWS-202020377 (discussing the New Hampshire litigation). We cannot say with confidence that these are the only lawsuits, given the difficulty of identifying early-stage litigation in state courts. Beneficiaries may also challenge alterations to pension and other benefit plans under state constitutional provisions, many of which specifically protect pension benefits. See Cuccinelli, Getchell & Russell, supra note 51, at 534. Although it would be a huge mistake for lawyers and policymakers to neglect these state constitutional protections, they are regretfully outside the scope of this essay.

\textsuperscript{59.} See LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW 613 (2d ed. 1988) (stating that the “common view” of the legislative history underlying the Contract Clause suggests it was added to the Constitution to “protect private contracts from improvident majoritarian impairment”). \textit{But see} James W. Ely, \textit{Whatever Happened to the Contract Clause?},
Supreme Court has made it clear the Contract Clause protects public contracts, too. In the last century, the Court seemed to pull most of the Contract Clause’s teeth in *Home Building and Loan Association v. Blaisdell*, which upheld a Minnesota law that limited the ability of mortgage holders to foreclose on mortgagees. Subsequent cases have indicated, however, that the Clause retains some bite where public contracts are at issue. In *United States Trust Co. v. New Jersey*, the Supreme Court struck down legislation allowing the state to retroactively alter the terms of bond obligations. “Complete deference,” the Court said, “is not appropriate because the State’s self-interest is at stake. . . . If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.” Similarly, in *Allied Structural Steel Co. v. Spannaus*, the Court invalidated legislation that retroactively altered private pension obligations.

These cases suggest serious problems for state measures altering the terms of the states’ own contractual agreements with present and former employees (as well as for IOUs that alter those contracts’ payment terms). A threshold issue in each case will be whether pension benefits and the like are actually contractual rights or merely statutory entitlements that the state may alter without running afoul of the U.S. Constitution. But as the Superior Court’s thorough
discussion in the New Hampshire case suggests, “in more recent years, the majority of state supreme courts have tended to protect pension rights” as contractual in nature. On the federal side, however, the U.S. Court of Appeals for the First Circuit has developed a potentially important impediment to such claims. Although acknowledging that the Contract Clause’s protection extends to “contractual rights against the state created by legislation,” that court has required that “the legislature’s intent to create such rights against the state be unmistakably clear.” We have our doubts about this requirement, but if adopted more broadly it could prove a substantial impediment to Contract Clause claims, at least where the pension benefits in question are created by statute rather than by ordinary contracts.

In states that do create contractual rights to pension and healthcare benefits, the inquiry will shift to whether the state’s law

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70. R.I. Bhd. of Corr. Officers v. Rhode Island, 357 F.3d 42, 45–46 (1st Cir. 2004) (Boudin, J.); see also Parella v. Retirement Bd. of the R.I. Employees’ Retirement Sys., 173 F.3d 46, 59–60 (1st Cir. 1999); Parker, 123 F.3d at 5.

71. Professor Young trembles at the very thought of disagreeing with Judge Boudin, see Rhode Island Brotherhood, 357 F.3d at 45–46, but it is not at all clear to us that the so-called “unmistakability doctrine” applies in this context. As Justice Souter observed in United States v. Winstar, 518 U.S. 839, 879 (1996) (plurality opinion), “[t]he application of the doctrine . . . turns on whether enforcement of the contractual obligation alleged would block the exercise of a sovereign power of the Government.” A suit for damages by a government employee when the government unilaterally alters the terms of an employment or pension contract hardly blocks the exercise of sovereign power—rather, it requires the government to internalize the costs of its change in the law. Certainly the Supreme Court has never applied the unmistakability doctrine in a case like Brand. See supra note 68; see also United Healthcare Ins. Co. v. Davis, 602 F.3d 618, 628 n.7 (5th Cir. 2010) (refusing to apply the unmistakability doctrine in a Contract Clause challenge to a Louisiana law altering the state’s obligations under its contracts with health insurance providers). Moreover, applying the federal unmistakability doctrine to determine whether a contract exists under state law would arguably violate the Erie doctrine. See generally Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938) (holding that federal courts must resolve issues not governed by positive federal law—that is, statutes, treaties, and the Constitution—according to state law); Abbe R. Gluck, Intersystemic Statutory Interpretation: Methodology as “Law” and the Erie Doctrine, 120 YALE L.J. 1898 (2011) (arguing that Erie requires federal courts to apply state rules of statutory construction when interpreting state law).

72. Judge Lynch’s opinion in Parella indicates that the unmistakability requirement may apply only “where a public contract allegedly arises out of statutory language.” Parella, 173 F.3d at 60.

73. Another potentially thorny threshold issue may concern whether the plaintiffs’ benefits have “vested” under state law. See, e.g., Prof’l Firefighters of N.H., supra note 69, at 14–
“operated as a substantial impairment” of the contract, and if so, whether the impairment was “reasonable and necessary to serve an important public purpose.” Courts seem relatively willing to hold that altering employee contributions to pension plans, for example, is a substantial impairment. And although the Supreme Court rejected a Contract Clause challenge in Blaisdell in part on account of the economic emergency posed by the Depression, courts seem likely to treat invocations of emergency more skeptically when made in service of the state’s own self-interest. Hence, as the Massachusetts Supreme Judicial Court observed some decades ago, “[t]hat the maintenance of a retirement plan is heavily burdening a governmental unit has not itself been permitted to serve as justification for a scaling down of benefits figuring in the ‘contract,’ although no case presenting proof of a catastrophic condition of the public finances has been put.

Similar difficulties may await under the Fifth and Fourteenth Amendments’ Takings and Due Process Clauses, which the Supreme Court has interpreted to impose significant constraints on retroactive legislation affecting property rights. The retroactive alterations involved in reducing cost-of-living increases to pension-plan benefits or paying some state obligations by short-term IOUs, however, may well be insufficiently serious to trigger those protections. For that reason, we hold discussion of takings and due process issues until Part III.

23 (dismissing plaintiffs’ claims on the ground that they had not adequately pled that they met the state’s statutory vesting requirements).
75. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 25 (1977); see Secunda, supra note 53, at 284 (discussing two- and three-pronged versions of the test adopted by the lower courts and concluding that they are equivalent in substance).
76. See, e.g., Prof’l Firefighters of N.H., supra note 69, at 21 (“Legislative action increasing the contribution that State employees must pay constitutes an impairment of that [pension] contract.”); Opinion of the Justices, 303 N.E.2d 320, 329 (Mass. 1973) (opining that “[l]egislation which would materially increase present members’ contributions without any increase of the allowances finally payable to those members or any other adjustments carrying advantages to them, appears to be presumptively invalid”) (collecting cases); see also Secunda, supra note 53, at 288 (discussing the impairment standard).
77. See Home Bldg. and Loan Ass’n v. Blaisdell, 290 U.S. 398, 426 (1934) (noting that “[w]hile emergency does not create power, emergency may furnish the occasion for the exercise of power”).
79. U.S. CONST. amend. V (“[N]or shall private property be taken for public use, without just compensation.”); U.S. CONST. amend. XIV, § 1 (“No state shall . . . deprive any person of life, liberty, or property without due process of law . . . .”).
Even if state employees or retirees can establish a Contract Clause violation, tough questions remain concerning the remedy. The litigation arising from the first state debt crisis, in the 1790s, concerned actions by creditors to collect debts from states pursuant to state contract law. *Chisholm v. Georgia*[^80] upheld the federal courts’ jurisdiction to hear such suits under Article III’s citizen-state diversity provisions, but, as Justice Souter has said in another context, “we know what happened.”[^81] The Eleventh Amendment overrode *Chisholm* by providing that

> 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.

[^82] The Eleventh Amendment means that creditors may not sue states for damages under state contract law in federal court, and state law will typically bar such suits in state court as well, absent an applicable waiver of sovereign immunity by the state.[^83]

A claim that state alteration of the debt contract’s payment terms violates the Contract Clause, however, is a federal claim under the Constitution, not a state contract claim. Commentators and judges generally agree that the Eleventh Amendment’s textual bar does not extend to federal question suits.[^84] The post-Reconstruction debt crisis threw up a barrier to such claims in *Hans v. Louisiana,*[^85] which held that state sovereign immunity barred federal courts from hearing Contract Clause challenges to state laws repudiating the states’ bonds.[^86] The primary exception to *Hans* is the principle that federal courts may issue prospective relief—that is, injunctions and declaratory judgments—against state officers who are alleged to be

[^80]: 2 U.S. (2 Dall.) 419 (1793).
[^82]: U.S. CONST. amend. XI.
[^83]: See infra notes 155–161 and accompanying text (discussing waivers).
[^85]: 134 U.S. 1 (1890).
[^86]: Id. at 13, 19.
acting in violation of the U.S. Constitution. This may permit certain challenges to IOUs: a creditor might sue, for instance, to enjoin the issuance of IOUs that arguably impair the obligation of the underlying debt instruments. Similarly, beneficiaries of state pension plans might be able to enjoin changes to the terms of the plan from going into effect. But creditors and beneficiaries will generally remain unable to force actual payment on the original debt or obligation. As one of us has argued elsewhere, the general structure of American state sovereign immunity law is designed to prevent courts from compelling payment on debts that threaten the financial viability of the states.

III. Bailout

We can’t/won’t pay you unless the federal government gives us the money. If anyone is truly “too big to fail,” surely it is a State of the Union. Despite the seeming unpopularity of bailouts in recent years, it would be difficult for national authorities to explain why private banks and car companies warranted rescuing in 2008, but California or Illinois do not. Uber-investor Warren Buffett, for example, has opined that “it would be very hard, in the end, for the federal government to turn away a state that is having extreme financial difficulties when in effect it honored [the debts of] General Motors and various other entities.”

As with the banks and car companies, federal authorities may offer the states bailouts after concluding that the states are not simply too big to fail, but also too interconnected with other aspects of the economy to fail.


89. Some of the states, of course, are not very big at all. But Wyoming is not the state we are worried about in a financial distress scenario.

90. Svea Herbst-Bayliss & Jonathan Stempel, Buffett: US Can Bail Out States, Insurers Pained, REUTERS (May 1, 2010, 4:08 PM), available at http://www.reuters.com/article/2010/05/01/berkshire-buffett-ratings-idUSN0118355720100501; see also Jonathan Rodden, Market Discipline and U.S. Federalism, in WHEN STATES GO BROKE, supra note 11, at 123, 135 (reporting perceptions of Mr. Buffett and other market observers that “the political importance of California and the externalities associated with default are simply too great to imagine a world in which Congress and the president allow it to default,” especially when “the federal government has already revealed its taste for bailouts in the private sector”).
Bailouts involve asset transfers from the federal government to distressed entities. If the federal government chose to bail out a state, the bailout could take the form of unrestricted fiscal assistance, increased funding of existing programs, or new grant or loan programs. A bailout is not the only form that federal assistance might take; as we discuss in Parts IV and V, Congress may legislate options to avoid or deal with a state default that the states probably could not enact on their own. We deal here with the simpler scenario where the national government funds or subsidizes the repayment of the states’ debts.

If such a bailout does occur, it will hardly be the first time. As part of the famous “Compromise of 1790,” southern members of Congress accepted Alexander Hamilton’s proposal that the national government assume the Revolutionary War debts of the states in exchange for an agreement to locate the national capitol on the banks of the Potomac. On the other hand, the national government has resisted outright bailouts of the states since the 1840s, when Congress allowed eight states to default despite considerable pressure from banks and foreign creditors. Ten more states defaulted in the late nineteenth century after Reconstruction, again without federal intervention, and Congress allowed Arkansas to default during the Great Depression. An important school of thought in political economy views this “no bailout” commitment as a pillar of our fiscal federalism.

Congress has nonetheless been willing to provide financial assistance to beleaguered states in less transparent ways. The federal government has given states direct aid in three of the six recessions since 1973. Indeed, the federal government has already bailed out states in this recession by giving them at least $150 billion in direct


93. See, e.g., RODDEN, supra note 6, at 55–63; Peterson & Nadler, supra note 6, at 266.

94. See, e.g., Peterson & Nadler, supra note 6, at 267.

95. See, e.g., RODDEN, supra note 6, at 49–50; Greve, Argentina, supra note 6, at 19–23; Peterson & Nadler, supra note 6, at 271–76.

96. See GENERAL ACCOUNTABILITY OFFICE, supra note 91. In those recessions in which the federal government did not provide direct aid to the states, it did increase spending on unemployment insurance and on grants not administered by state governments. Id.
aid. The United States also provided additional direct payments in the Build America Bonds program, which subsidized state bonds by paying thirty-five percent of the interest cost directly to states.

The constitutional issues raised by a potential federal bailout are of a different order than those we have considered so far, which have focused on the recourse available to individual creditors. We consider two sorts of questions: first, what sort of conditions might Congress wish to impose as a predicate for federal relief, and what—if any—constraints does the Constitution impose on such conditions? After all, “[c]entral governments do not offer a helping hand without at the same time asserting their authority . . . . If they rescue states and localities they will feel more than entitled to take preventative measures designed to preclude future defaults.” Second, to what extent might bailing out the states threaten the fiscal framework of our federal system?

Two types of situations illustrate the kinds of conditions Congress may impose on a state seeking a bailout, and how those conditions may challenge our federal framework. First, imagine that California is Argentina and Congress is the International Monetary Fund. What sort of conditions would the IMF impose on a bailout of California? Next, imagine that California is a corporation in a cash crisis that needs emergency financing, and Congress is a distressed debt lender. What sort of conditions would a distressed debt lender put on a loan to California?

We consider three types of conditions and their impacts on our federal framework: spending and revenue...
requirements, modification of certain obligations (to, for example, public unions), and alteration of the state constitution.

Congress might exert control over a fiscally dysfunctional state by requiring spending cuts and revenue expansion. These spending and revenue requirements could be initial conditions or milestones; that is, Congress could impose them before advancing any funds or could condition future funds on meeting Congress’s spending and revenue benchmarks. These future conditions, or milestones, are typical features of emergency financing because they give lenders control over a borrower. If a borrower fails to meet the lender-specified requirements, the lenders may withhold any remaining commitment amount or call a default. The IMF uses both initial conditions (“ex-ante conditionality”) and milestones (“ex-post conditionality”) as a means to ensure borrower countries are able to repay the IMF.\textsuperscript{101} IMF conditionality, also known as Structural Adjustment Programs, often include currency devaluation, industry privatization, trade liberalization, spending cuts on social services, required deficit reduction, and promotion of exports.\textsuperscript{102}

It is fairly easy to imagine Congress tying its bailout money to spending cuts or revenue generation broadly. Perhaps such conditions would not strike most taxpayers as controversial. If taxpayers are going to lend one state their money, they may expect fiscal discipline to be the price paid for such benefit. A more difficult situation would be if Congress conditioned the bailout funds on specific spending cuts or manners of revenue generation. For example, Congress could require the state to raise taxes on cigarettes, start a lottery, cut spending on specified programs, or sell its state parks.

Congress may also impose structural reforms to serve as a more permanent fix to chronic fiscal imbalances than its spending and revenue milestones can achieve. The IMF’s Structural Adjustment Programs, for example, have often looked to the performance and transparency of a state’s political system in imposing conditions for


IMF assistance. It might, for example, require California to alter some of the dysfunctional aspects of its state constitution, such as the supermajority provisions that make it virtually impossible for California to raise certain kinds of taxes, or even its generous provisions for direct democracy. These sorts of fundamental, politically oriented requirements would raise the most serious constitutional objections.

Both spending and revenue-generation milestones and more fundamental demands that a state alter its constitution can be analyzed as forms of conditional spending: the state does what Congress requires and Congress gives the state money. Such conditions are generally analyzed in two steps. First, we ask whether Congress would have the power to impose the condition directly. If so, we can stop there—the option of declining the money and avoiding the condition hardly makes the requirement more problematic. But Congress often uses conditional spending to elicit results that it could not mandate directly; hence, the second question is whether the condition nonetheless represents a valid exercise of the spending power.

Many conditions that Congress might impose would likely be upheld at the first stage. The Supreme Court has held, however, that state sovereignty constrains Congress’s ability to impose conditions on the states that go to basic decisions of constitutional structure. The Court has never explored the limits of that principle, so it is hard to know whether it would bar, say, a requirement that California


104. See, e.g., Isabel Rodriguez-Tejedo & John Joseph Wallis, Fiscal Institutions and Financial Crises, in WHEN STATES GO BROKE, supra note 11, at 9, 38 (describing how state constitutional requirements of a supermajority to raise taxes, but only a normal majority to borrow, can create strong incentives for excessive borrowing); Andreas Kluth, The People’s Will, THE ECONOMIST (Apr. 20, 2011), available at http://www.economist.com/node/18563638 (arguing that California’s lack of checks on direct democracy “stripped California naked, leaving it unable to respond to external shocks such as the current economic crisis”).

105. See Rumsfeld v. Forum for Academic and Institutional Rights, Inc. (FAIR), 547 U.S. 47, 60 (2006) (“It is clear that a funding condition cannot be unconstitutional if it could be constitutionally imposed directly.”). In FAIR, the Court held that because Congress could mandate that universities allow the military to recruit on campus, the Court need not consider whether such a requirement would be an unconstitutional condition on the grant of federal funds to those universities. Id.

106. See, e.g., Coyle v. Smith, 221 U.S. 559, 580 (1911) (holding that Congress could not require Oklahoma to choose a particular location for its state capital).
change its constitution to facilitate future tax increases. Given the centrality of taxing and spending decisions to democratic governance, however, federal requirements that states alter their constitutional frameworks for fiscal policy would present a serious test of Congress’s authority.

The Court has also suggested—albeit a very long time ago—that the Constitution limits Congress’s power to control state tax policy. Although the Constitution imposed some limits on state collection of imports and exports, the states’ “power of taxation . . . remains entire . . . [and] absolute.” Accordingly, the Court said, state legislatures retain discretion as to “[t]he extent to which it shall be exercised, the subjects upon which it shall be exercised, and the mode in which it shall be exercised.” “That discretion is restrained only by the will of the people expressed in the State constitutions or through elections, and by the condition that it must not be so used as to burden or embarrass the operations of the national government.” In particular, “[t]here is nothing in the Constitution which contemplates or authorizes any direct abridgment of this power by national legislation.” The Court made these statements in 1869, and federal law now interacts with state tax policy in myriad and complex ways. But it is still possible to imagine the Court balking at federal requirements purporting to direct state tax policy.

If Congress lacks power to impose restructuring conditions directly, it may nonetheless do so as a condition on optional grants of federal funds. Contemporary doctrine analyzes this second step under South Dakota v. Dole, which upheld Congress’s requirement that states raise their minimum drinking age to twenty-one as a condition on receiving five percent of their federal highway funds. Dole

107. See, e.g., Adam J. Levitin, Fiscal Federalism and the Limits of Bankruptcy, in WHEN STATES GO BROKE, supra note 11, at 214, 228 (“[T]he long-standing normative choice embodied in the structure of American government and law is that distributional decisions beyond a constitutionally mandated baseline—the ultimate political choice—should be made by electorally responsive bodies.”).
108. See generally Lane County v. Oregon, 74 U.S. (7 Wall.) 71 (1869) (refusing to read federal law as requiring state officials to accept state tax payments in national currency rather than coin).
109. Id. at 77.
110. Id.
111. Id.
112. Id.
required that spending conditions (1) be in pursuit of the “general welfare,” (2) be clearly stated, (3) be “germane” to the purposes of the underlying spending, (4) not require the recipient state to take action that would itself be unconstitutional, and (5) not be coercive. A condition requiring certain revenue or spending milestones, or a state constitutional amendment to remove impediments to revenue increases, would likely encounter difficulty only with the fifth prong: the Court has considered the “general welfare” requirement largely nonjusticiable; the condition could presumably be stated clearly; such a condition would plainly be related to the bailout’s purpose of restoring the state to fiscal health; and it is hardly unconstitutional for a state to raise taxes or cut spending. But the dire financial straits giving rise to the need for a bailout and the likely scale of the federal financial assistance involved would present a far more powerful case for coercion than that in Dole. Nonetheless, the Court has found coercion only once, in New York v. United States, and the circumstances of that case were so odd that it may not provide much guidance in future situations.

115. See id. at 207–08, 211 (outlining the constitutional requirements for spending conditions).

116. 505 U.S. 144 (1992). Coyle also involved a condition on a federal benefit—Oklahoma’s admission to the Union. See Coyle v. Smith, 221 U.S. 559, 563–64 (1911). The Court nonetheless asked only whether the condition could be imposed as a direct mandate, because the “equal footing” doctrine required that Oklahoma be subjected only to requirements that could be imposed on states already admitted to the Union. See id. at 566–68.

117. See, e.g., ELIZABETH PRICE FOLEY, THE TEA PARTY: THREE PRINCIPLES 73–74 (2012) (acknowledging that “[c]oercion claims aren’t getting any traction [in the current healthcare litigation] for the simple reason that the Supreme Court in Dole provided no guidance about how to know when federal strings cross the line from encouragement to coercion”). New York involved the anti-commandeering doctrine, which holds that Congress may not require the states to implement federal law, rather than an effort by Congress to use conditional spending to accomplish an object outside its enumerated powers. See also Printz v. United States, 521 U.S. 898 (1997) (holding that Congress may not require state executive officers to implement federal law). The anti-commandeering doctrine does not forbid voluntary state implementation, and so the question was whether the inducement for the states to implement the Low Level Radioactive Waste Act was so coercive that the statute should be treated as imposing a direct mandate. Under the Act, states choosing not to cooperate in implementing the federal regulatory scheme were obligated to “take title” to all the low level radioactive waste generated within their jurisdiction, and the Court (not surprisingly) held that this was coercive. See New York, 505 U.S. at 174–77. Like we said, it is an odd case.

As this essay goes to press, the Supreme Court is considering a coercion-based challenge to provisions of the federal Patient Protection and Affordable Care Act (PPACA) that expand the states’ obligations under Medicaid. See Greve, Argentina, supra note 6, at 32–34 (discussing these aspects of the PPACA). Although the Spending Clause arguments have generally taken a backseat to the Commerce Clause challenge to the PPACA’s so-called “individual mandate,” see generally Stephen E. Sachs, The Uneasy Case for the Affordable Care Act, 75 L. & CONTEMP. PROBS. 17 (2012) (focusing on the mandate), the Supreme Court devoted a whole hour of
It is also not obvious that anyone would want to challenge the terms of a bailout under *Dole*. The recipient states, after all, will have consented. The persons most likely to complain about such a measure would be taxpayers in more solvent states, but the Court has generally not recognized federal taxpayer standing, and in any event those taxpayers would be asserting the rights of third parties (the recipient states) in challenging the deal. However, the Court has made clear that states accepting conditional federal benefits are not estopped from challenging the conditions imposed if they should later think better of their bargain. This is because the structural federalism principles that limit the spending power benefit not just the state governments themselves but also individual citizens; as a result, states lack the power to waive these protections. A prudent federal official ought to assume that any bailout will have to withstand scrutiny under *Dole*.

A bailout might also require the states to alter some of their obligations to public-sector unions, pension holders, and the like. Here, the question is not the fifth prong of *Dole* (coercion) but rather the fourth—that is, whether the condition would require the state itself to violate the Constitution. And a condition requiring the state to renge might violate that requirement by raising Contract Clause problems that we have already discussed. These problems might be avoided if the federal bailout legislation were to directly preempt the state agreements that Congress wishes to modify, because the Contract Clause by its terms applies only to the states. To be sure, there is strong Supreme Court precedent suggesting that the United States is bound to honor its own contracts in much the same way that

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119. See generally, e.g., *Warth v. Seldin*, 422 U.S. 490 (1975) (holding that prudential standing principles barred plaintiffs from asserting the rights of third parties not before the court).
120. *See New York*, 505 U.S. at 182 (“Where Congress exceeds its authority relative to the States . . . the departure from the constitutional plan cannot be ratified by the ‘consent’ of state officials.”).
121. *See supra* notes 58–78 and accompanying text.
states, under the Contract Clause, are bound to honor theirs. But a federal statute relieving states of certain obligations in their contracts with private parties would not implicate that principle. As the Court explained in Perry v. United States, “[t]here is a clear distinction between the power of the Congress to control or interdict the contracts of private parties when they interfere with the exercise of its constitutional authority, and the power of the Congress to alter or repudiate the substance of its own engagements.” Federal legislation altering the terms of states’ contracts would look a lot more like Blaisdell—that is, a government altering, for public policy reasons, the terms of agreements to which it is not a party.

The more formidable challenge to federal abrogation of state contracts would come from the Takings and Due Process Clauses. The Supreme Court has made clear that retroactive legislation that affects valid property interests raises problems under both these clauses. In Eastern Enterprises v. Apfel, the Court struck down the Coal Act, which imposed retroactive liability for healthcare benefits to coal industry retirees on companies that had employed those retirees in the past. The Court divided over the appropriate theory in that case. Justice O’Connor, writing for a plurality of four Justices, concluded that the Coal Act worked an uncompensated taking of property because it imposed a “considerable financial burden” on Eastern, interfered with Eastern’s “reasonable investment backed expectations,” and unfairly singled out particular companies to bear the burdens imposed by the Act. Most important, Justice O’Connor stressed that “[r]etroactivity is generally disfavored in the law . . . in accordance with ‘fundamental notions of justice’ that have been recognized throughout history.” Any federal bailout legislation

123. See, e.g., Perry v. United States, 294 U.S. 330, 350–54 (1935) (holding that Congress lacked power to override the obligation of a federal bond); cf. United States v. Winstar Corp., 518 U.S. 839, 875–76 (1996) (plurality opinion) (“Although the Contract Clause has no application to acts of the United States, it is clear that the National Government has some capacity to make agreements binding future Congresses by creating vested rights.”).
125. Id. at 350–51.
126. See supra note 63 and accompanying text.
127. See U.S. Const. amend. V (“No person shall . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.”).
129. Id. at 529–37.
130. Id. at 532 (quoting Kaiser Aluminum & Chem. Corp v. Bonjorno, 494 U.S. 827, 855 (1990) (Scalia, J., concurring)). Justice O’Connor cited a wide range of authorities, both ancient
conditioned on altering pension obligations would affect pensioners’ property interests.

Justice Kennedy’s concurrence in Apfel identified a distinct ground for challenging retroactive legislation under the Due Process Clause: “Although we have been hesitant to subject economic legislation to due process scrutiny as a general matter,” he noted, “the Court has given careful scrutiny to due process challenges to legislation with retroactive effects.” Because the Coal Act imposed retroactive liability on Eastern, it violated due process. Similarly, a court may reason that federal bailout legislation imposing retroactive burdens on certain parties—reducing their pension benefits, for example—also violates due process.

What is even more striking about Apfel, however, is that while the four dissenters would have upheld the Coal Act, they all joined Justice Breyer’s opinion insisting that retroactive legislation should be subjected to careful judicial scrutiny under the Due Process Clause. That opinion was quick to disavow claims that all economic legislation should receive great deference from the courts: “Insofar as the plurality avoids reliance on the Due Process Clause for fear of resurrecting Lochner v. New York and related doctrines of substantive due process,” Breyer wrote, “that fear is misplaced. . . . An unfair retroactive assessment of liability upsets settled expectations, and it thereby undermines a basic objective of law itself.” Rather than applying the “rubber stamp” approach with which the Court has traditionally reviewed most economic legislation since the New Deal, the dissenters engaged in a searching analysis

and modern. See id. at 533 (citing 2 Joseph Story, Commentaries on the Constitution § 1398 (5th ed. 1891) (“[R]etro-spective laws are, indeed, generally unjust; and, as has been forcibly said, neither accord with sound legislation nor with the fundamental principles of the social compact.”)).

131. Id. at 547 (Kennedy, J., concurring in the judgment and dissenting in part). Justice Kennedy’s concurrence in Apfel rejected the plurality’s Takings Clause analysis on the ground that the Coal Act did not implicate a specific property interest; Eastern’s liabilities under the Act were to be paid out of general funds, so the Act operated much like any other tax. Id. at 539–47. But that distinction would not apply to a federal bailout condition requiring states to abrogate or restructure their contractual obligations to creditors or pensioners; such a condition would retroactively eliminate specific interests in particular contracts or benefits. One must worry, therefore, that Justice Kennedy would be willing to find a taking in litigation challenging this sort of requirement.

132. Id. at 550.

133. Id. at 557–58 (Breyer, J., dissenting).

134. See generally Ernest A. Young, Sorrell v. IMS Health and the End of the Constitutional Double Standard, 36 Vt. L. Rev. (forthcoming 2012) (discussing the Court’s post-New Deal
of the Coal Act’s impact and objectives. The crucial takeaway from Apfel, then, is that all nine Justices expressed profound concerns about retroactive legislation that upsets investment-backed expectations. Surely state pensioners, who have invested their careers in the state government expecting the pensions the state promised, would have a strong case under this principle if their expectations were to be thwarted by federal legislation.

Federal legislation that seeks to alter the states’ pension and healthcare obligations in order to alleviate the states’ economic distress is thus likely to encounter significant constitutional hurdles. And state laws abrogating or significantly altering those obligations, perhaps enacted as a predicate to a bailout, would encounter the same objections under the Fourteenth Amendment. Without some means of reducing the structural causes of the states’ distress, however, it is hard to see a bailout getting through Congress. No legislator wants to be seen as giving a blank check to fiscally improvident state legislators.

This linkage between federal assistance and federal control highlights the second and more systemic constitutional issue with bailouts: their potential impact on America’s system of fiscal federalism. There are basically two ways to organize spending and borrowing authority in a federation: the central government can exercise hierarchical control over borrowing and spending by the subunits, or it can leave those subunits fiscally sovereign—that is, free to make their own borrowing and spending decisions. If the federation takes the first approach, then the central government will generally be responsible for the subunits’ fiscal health and will guarantee their debts. This is the system that Alexander Hamilton advocated when he sought to use the post-Revolutionary War debt crisis as “an opportunity to centralize fiscal authority” in the new Republic, and it is the situation in most federal systems around the world today.

In the absence of hierarchical controls, however, it is critical that the central government commit not to bail out the subunits. Otherwise, as Jonathan Rodden has demonstrated, the federation

dereference to economic legislation challenged on due process grounds).
135. Rodden, supra note 90, at 124.
136. See Peterson & Nadler, supra note 6, at 255 (“Except in Canada and Switzerland [and the U.S.], state debts in all federal systems in the industrialized countries of the world are implicitly or explicitly guaranteed by the federal government.”).
faces “a basic moral hazard problem”: “When the central and lower-level governments both have authority to tax and spend, individual lower-level governments can harbor the belief that unsustainable fiscal burdens will ultimately be borne by other members of the federation through bailouts.” If markets perceive a bailout as likely, they will continue lending to subnational governments at rates that reflect not the subunit’s solvency, but rather that of the central government. The subunits will thus remain largely free of market discipline, which may further increase incentives for unsustainable policies and compound pressures for a central bailout. Only a credible commitment by the national government not to bail out the subunits can ensure the operation of market-based checks on state fiscal policy.

Ever since Congress allowed several states to default in the 1840s, its “no bailout” commitment has been perceived as highly credible. Professor Rodden’s recent analysis of state bond yields, credit default swaps on state debt, and state credit ratings, for example, demonstrates that financial markets continue to assess the creditworthiness of states individually and have not “priced in” an assumption that the national government would bail states out in the event of a default. Nor have state officials behaved as if they expect such a bailout; rather, “state governments are making serious efforts at reform” rather than “throwing up their hands, staying the course, and placing all of their bets on a federal bailout.”

To be perfectly honest, we find all this continued confidence in the U.S. government’s no-bailout guarantee a bit puzzling. One reason, as already noted, is that Administrations of both parties and Congress have already proven willing to bail out private entities, such as General Motors and various banks. But more fundamentally, the relationship between the national and state governments is profoundly different today than it was in the 1840s. Then, the state and national governments operated in largely separate spheres, and both did relatively little. Nowadays, we live in an era of activist government, and most federal programs incorporate an important implementation role for the states through various “cooperative

137. Rodden, supra note 90, at 124.
138. See id. at 131–33 (arguing that a firm no-bailout commitment increases the spending discipline of states).
139. Id. at 137–40.
140. Id. at 140.
federalism” arrangements.141 Two aspects of these arrangements are critical for present purposes: first, the national government now depends on state governments to achieve its regulatory and social welfare goals;142 and second, much state spending is now driven by federal matching-funds arrangements and other federal requirements.143 These developments both increase the pressure on Congress to bail out state governments and give rise to a plausible argument that it is only fair for Congress to do so.

What to do about this situation is one of the most profound questions of our federalism, and we cannot purport to answer it here. Our point is simply that policymakers considering what to do about state debt should be aware of the way that this particular policy dilemma ties into the more fundamental structural issues. Congress’s commitment not to bail out the states has played a critical role in maintaining the states’ fiscal sovereignty, and that commitment appears to retain significant credibility with both state officials and financial markets. At the same time, surrounding changes in the federal-state relationship have undermined many of the assumptions on which the no-bailout commitment rests. Whether one views a federal bailout as the last nail in the coffin of our federalism or a necessary step to a sounder, more Hamiltonian arrangement, policymakers should heed Sergeant Esterhaus’s famous advice from Hill Street Blues: “[L]et’s be careful out there.”144

IV. DEFAULT AND REPUDIATION

We won’t pay you now, and we may never pay you. It is not hard to imagine a scenario in which the states cannot meet their financial obligations, cannot raise revenue, and no bailout is forthcoming. Since 1840, after all, the national government has generally been willing to let states fail.145 The last state to default on general obligation bonds

142. See id. at 671 (“[B]y the federal government’s own admission, it is almost always unwilling and/or unable to take back the power to implement cooperative federalism programs.”).
143. See Greve, Argentina, supra note 6, at 29–32 (outlining how state spending responds to federal incentives).
145. See generally Rodden, supra note 6, at 57–63 (describing how the federal government resisted calls to bail out the states in the 1830s and 1840s); William B. English, Understanding the Costs of Sovereign Default: American State Debts in the 1840’s, 86 AM. ECON. REV. 259
was Arkansas in 1934, during the Depression. More famously, “[m]ost of the States of the Old Confederacy,” especially Louisiana and our own dear North Carolina, repudiated their Reconstruction-era debt in the late nineteenth century. With a little help from the Supreme Court’s willingness to reinterpret the Eleventh Amendment, they largely got away with it. In light of this history, we must consider the possibility that states may choose to forgo principal and/or interest payments on their bonds, fail to pay pensioners, or even repudiate certain debts outright. Although the consequences of default may pose a greater deterrent today, it would be a mistake to dismiss the possibility of default entirely.

Consider the following scenario: as a state’s financial prospects darken and a default becomes more likely, current holders of state debt are likely to sell their stake to investors with higher risk appetites—that is, “vulture” funds that speculate in distressed assets. It would become politically unattractive to call for austerity and sacrifice on the part of retirees to pay hedge funds at par plus interest when those investors paid pennies on the dollar for the bonds. At some point, the political pendulum might well swing, and voters would call for repudiation.

To be sure, a repudiating state would suffer dire consequences in the capital markets. Its bond rating would plummet, and it might find itself unable to raise further capital for some period of time. But if a state can determine it does not need access to capital markets for some period, it may determine it is politically better to default. For example, Dennis Kucinich presided as mayor over a “default” of Cleveland’s bank debt by letting Cleveland go into bankruptcy instead of selling a public utility—a decision that was politically damaging at the time but now seems to be viewed more favorably


148. See, e.g., id. at 58–89; see also Cuccinelli, Getchell & Russell, supra note 51, at 532–33.

149. See Rodden, supra note 6, at 63 (recounting that, after the defaults of the 1840s, the defaulting state governments were unable to access capital markets for a time); English, supra note 145, at 268 (“Rather than direct sanctions, the cost of default appears to have been loss of access to new loans.”).
Repudiation of a state’s bonds is surely unconstitutional under the Contract Clause. The question is whether bondholders have any prospect of a remedy. As we have already discussed, state sovereign immunity poses a formidable bar to recovery on debt contracts by private plaintiffs. Conventional wisdom holds that such recovery will be virtually impossible in the unfriendly forum of state court. Although two Mississippi courts in the 1840s found that the state was legally and morally bound to the payment of repudiated bonds, that result is certainly the exception and not the rule. Federal court offers a potentially friendlier forum, but the Eleventh Amendment bars state-law suits where federal jurisdiction rests on citizen-state diversity of citizenship, and the Amendment’s “penumbra” bars federal question suits predicated on the Contract Clause.

Two possible avenues might permit federal-court suits in the event of state-bond defaults. The first is waiver. Notwithstanding the wording of the Eleventh Amendment as a constraint on federal subject-matter jurisdiction, which is ordinarily unwaivable, the Supreme Court has long held that states may waive their sovereign immunity from suit. Some state bonds actually include a waiver of sovereign immunity in the bond contract itself. We have found such waivers, for example, in bonds issued by North Carolina.


151. See supra notes 80–88 and accompanying text.

152. See, e.g., English, supra note 145, at 261 (commenting that the state court route “seems unpromising, given the likely unpopularity of the bondholders”). However, to the extent that state bonds are frequently held by a state’s own citizens in the modern era, see Rodden, supra note 90, at 136, the prediction of state-court hostility may be overblown.

153. WILLIAM A. SCOTT, THE REPUDIATION OF STATE DEBTS 39 (1893); English, supra note 145, at 261. As Professor English notes, however, the successful state plaintiffs still found themselves unable to collect on their judgment. See id.

154. See generally, e.g., Hans v. Louisiana, 134 U.S. 1 (1890); see also Alden v. Maine, 527 U.S. 706, 713 (1999) (commenting that the phrase “Eleventh Amendment immunity” is “something of a misnomer, for the sovereign immunity of the States neither derives from nor is limited by the terms of the Eleventh Amendment”).


Massachusetts, and Minnesota. Where such waivers are unavailable, it may be possible to fit a bond suit into a more general waiver of immunity in contract suits, analogous to the general federal waiver in the Tucker Act. The problem with both specific and general waivers is that they will be construed as only applicable to suits in state court unless the waiver specifically says otherwise. They may, in other words, get creditors a hearing, but it will not ordinarily be a hearing in federal court.

Congress may, however, seek to induce states to waive their immunity more broadly for bond suits in federal court, perhaps by conditioning federal financial aid on such waivers. Like other spending conditions, an induced waiver of state sovereign immunity would be analyzed under Dole's five-part test. In general, courts have been unwilling to strike down state immunity waivers under this test. As a result, a Congress that was inclined to help state creditors


158. A recent notice for Minnesota’s general obligation bonds includes the following waiver:
Waiver of Immunity: Under Minnesota Statutes, Section 3.751, the State has waived immunity from suit with respect to the controversies arising out of its debt obligations incurred pursuant to Article XI of the Minnesota Constitution, and has conferred jurisdiction on State District Courts to hear and determine such controversies. Accordingly, if the State fails to pay in full the principal of and interest on the Bonds when due, a holder of a Bond on which principal or interest is past due is entitled to commence an action in the District Court for Ramsey County, Minnesota, to enforce the pledge of the State’s full faith and credit to the payment of such principal and interest.

159. See, e.g., ALASKA STAT. ANN. § 09.50.250 (West 2012) (“A person or corporation having a contract, quasi-contract, or tort claim against the state may bring an action against the state in a state court that has jurisdiction over the claim.”).


161. See supra note 152 and accompanying text (explaining that state courts have generally been viewed as unreceptive to claims by state creditors).


164. See, e.g., Jim C. v. United States, 235 F.3d 1079, 1081 (8th Cir. 2000) (upholding, under Dole, a federal spending condition requiring a waiver of sovereign immunity).
in the event of a state-bond default might well be able to induce states to waive their immunity from suit in federal court in return for federal aid.

The second avenue—statutory abrogation of immunity—would likewise require congressional assistance. In *Fitzpatrick v. Bitzer*, the Supreme Court held that Congress may override or abrogate the states’ sovereign immunity, notwithstanding the Eleventh Amendment, when it acts pursuant to its power to reinforce the Reconstruction Amendments.

Although the Court has aggressively expanded the scope of state immunity since *Fitzpatrick*, it has repeatedly reaffirmed this principle. The question then becomes whether a state’s repudiation of its debt is a constitutional violation that Congress may remedy under Section Five of the Fourteenth Amendment. The Contract Clause, alas, is neither part of the Fourteenth Amendment nor incorporated therein through subsequent judicial decisions, but the Due Process and Takings Clauses are. To the extent that state repudiation of debt works a retroactive impairment of vested property rights (by, for example, modifying pension obligations), Congress may well have the authority to abrogate state sovereign immunity in private suits challenging such impairments.

At the end of the day, reputational effects—and their concomitant impact on a state’s future access to the capital markets—remain the most significant check on state defaults. Looking back on the state debt defaults and repudiations of the 1840s, William English concludes that “reputation effects appear to have been sufficient to induce most states to repay.” Although this essay focuses on legal structures and remedies—the authors are lawyers, after all—it is well to remember that law is not the only constraint.

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166. *Id.* at 456.
167. See, e.g., *Alden*, 527 U.S. at 756.
We’ll pay you, but less than full value and according to a plan approved by a federal court. The idea of a bankruptcy procedure for sovereign states dates back to Adam Smith, but the States’ recent financial troubles have brought the idea once again to the fore. Academics like David Skeel and Steven Schwarcz, as well as politicians like Jeb Bush and Newt Gingrich, have suggested that Congress should extend the federal bankruptcy regime to offer relief to state governments. A rapidly developing literature assesses these proposals, and we attempt no comprehensive discussion here. Rather, we seek only to flag the most salient issues.

We begin by considering the ways in which the constitutional framework affects the traditional rationales for bankruptcy. Sovereign immunity largely obviates the primary rationale for private-sector bankruptcy—the need to avoid collective-action problems as multiple creditors seek to collect from the debtor. Although some commentators continue to emphasize the need to eliminate holdout problems in renegotiating the terms of state debts, proponents have stressed “the reduction of debt overhang as the principal justification for a bankruptcy framework for states.” These proponents also acknowledge that the continuing institutional autonomy of the state (and its resulting continued accountability to its citizens) must be a principal value in a state bankruptcy process; in valuing the continuing autonomy of the debtor, state bankruptcy is thus more like individual bankruptcy than its more familiar corporate form.

173. In addition to the sources cited in note 171, supra, see also, e.g., Gelpern, supra note 25; Levitin, supra note 107; George G. Triantis, Bankruptcy For the States and By the States, in When States Go Broke, supra note 11, at 237.
174. See, e.g., Gelpern, supra note 25, at 896 (observing that “immunity blunts or eliminates traditional collective action problems that have come to motivate bankruptcy”); Skeel, supra note 49, at 4.
176. Skeel, supra note 49, at 9. “Debt overhang” exists when “[a] debtor . . . find[s] it impossible to borrow funds, even if it has promising future prospects, [because] it has a large amount of existing debt.” Id. at 7.
177. See id. at 8 (“State sovereignty and its analogue for individuals, autonomy, imply a presumption—perhaps nearly a conclusive one—that debt overhang problems must be solved in
A federal bankruptcy scheme appears to offer two primary advantages in reducing a state’s debt overhang. First, like the bailout conditions that we considered in Part III, it provides a federal rule to trump impediments to the adjustment of state debts. Under the Supremacy Clause, federal law would preempt state constitutional provisions guaranteeing various state obligations, and federal requirements would likewise probably avoid the Contract Clause’s constraints on state impairments of state governmental obligations. Unlike a conditional bailout, however, a federal bankruptcy mechanism would presumably not be accompanied by an infusion of federal resources to help pay the creditors; indeed, state bankruptcy proponents frequently present it as a way to forestall the temptation for Congress to bail out the states. Moreover, rather than incorporating adjustments to state obligations in a set of federal statutory conditions accompanying a bailout, a bankruptcy law would create an ongoing process of negotiation and accommodation overseen by a federal court.

The second advantage stems from the suggestion that a bankruptcy procedure might reduce “dysfunctional decision making” that leads to and exacerbates state financial crises. By providing an alternative to federal bailouts, a bankruptcy law would require states to borrow at a rate that reflects the actual risk of default—without any implicit promise of a federal rescue. This, proponents argue, would decrease “lawmakers’ temptation to fund current spending with borrowed funds.” Proponents also hope that “bankruptcy would counteract the political agency costs that have exacerbated

order to free up the debtor’s future prospects.”); see also Gelpern, supra note 25, at 909 (“The missing link between contracts, capital structure, and governance makes states more like individuals, whose autonomy is a paramount value.”).

178. See Michael W. McConnell, Extending Bankruptcy Law to States, in WHEN STATES GO BROKE, supra note 11, at 229 (observing that “[t]he principal advantage of bankruptcy, under current fiscal circumstances” would be to allow governments “to force renegotiation of contractual obligations such as pay, retirement, pensions, and health care”).

179. See supra notes 121–125 and accompanying text.


181. See, e.g., Skeel, supra note 49, at 9; see also Levitin, supra note 107, at 224 (“Bankruptcy could function as a political tool in several ways. It could serve as a political discipline mechanism; provide cover for politically unpopular decisions; serve as a convening mechanism to facilitate negotiations; and facilitate negotiations by setting baseline rules and alternatives.”).

states’ pension problems.”

By moving ultimate adjustment of pension obligations out of the state political process, where beneficiaries of these obligations may exert undue political influence, state bankruptcy might give beneficiaries an incentive to insist that pensions be adequately funded in the first place. Even if these predictions prove accurate, however, it is not clear that bankruptcy would address the root dysfunctions that lead to state financial crises.

Most state bankruptcy proposals have been limited to voluntary participation by state governments, presumably in order to avoid constitutional difficulties. In his contribution to this symposium, however, Adam Feibelman boldly goes where no other scholar has gone before—he proposes a mandatory bankruptcy regime for state governments. The primary virtue of a mandatory regime over a voluntary one, he argues, is that it would prevent states from waiting too long to file. “[T]he benefits of allowing states to file for bankruptcy,” Professor Feibelman argues, “could be slight compared to the costs that states will incur and externalize as a result of their delay in voluntarily seeking relief.” Feibelman’s proposal is “extreme” in a helpful sense because it brings to the fore some constitutional considerations that might otherwise have remained submerged. For that reason, his proposal is a valuable contribution to the ongoing conversation about state debt.

That doesn’t make it constitutional, however. We might begin by asking, what is the enumerated power that authorizes Congress to subject states to bankruptcy proceedings? We doubt it is the bankruptcy power, because sovereign debt has long been understood to raise unique problems outside the purview of bankruptcy; certainly the Founders’ discussions of state debts in the Federalist papers and

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183. See id. at 12.
184. Id. But see Levitin, supra note 107, at 225 (warning that “[i]t is impossible to say . . . whether [taking debt negotiations out of the political process] enables politicians to look out for the commonwealth rather than to be beholden to narrow rent-seeking interests or merely gives politicians the ability to reach deals of personal convenience without regard to their constituents’ interests”).
185. See Levitin, supra note 107, at 219–20 (arguing that the states’ budget problems are structural in nature, arising from a mismatch between the states’ countercyclical spending obligations and state constitutional restrictions on borrowing and budget deficits).
187. Id. at 82.
at the state ratifying conventions would have been different if they thought that the Constitution authorized Congress to establish bankruptcy procedures for states. Congress would most likely have to fall back upon its power to regulate commerce—after all, states sell bonds, purchase services, and engage in other commercial activities in a national market. The question then would be whether the commerce power can be understood to include the power to regulate the states’ own finances.

Our objection at this point begins to sound not so much like a denial of national enumerated power, but rather like an assertion of an immunity from national regulation grounded in some aspect of state sovereignty. This is an underdeveloped area of constitutional law. The Court has suggested at times that the “states as states” retain certain residual rights of sovereignty that the national government may not invade even when acting pursuant to an enumerated power. In *Coyle v. Smith*, for example, the Court held that Congress may not tell a state where to put its capitol. Under current jurisprudence, the anti-commandeering doctrine may be described as protecting a state’s sovereign right to choose what laws it will make and implement. It is not at all clear what other aspects of state governmental independence might also be off-limits to federal intrusion.

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188. *See*, e.g., CLYDE E. JACOBS, THE ELEVENTH AMENDMENT AND SOVEREIGN IMMUNITY 18–40 (1972) (describing the debates at Philadelphia and in the state ratifying conventions over whether the Citizen-State Diversity Clauses of Article III abrogated the states’ sovereign immunity). If Article I’s bankruptcy power had been thought to confer power on Congress to subject states to bankruptcy proceedings, one would think that Anti-Federalists worried about the states being forced to pay their debts would have focused their opposition on Article I, not Article III.

189. One might also question whether a sui generis bankruptcy procedure for states would fall under Article I’s authorization to “establish . . . uniform laws on the subject of bankruptcies,” Art. I, § 8, cl. 4 (emphasis added), although perhaps that stricture is satisfied so long as the rules apply to all state governments “throughout the United States.” *Id.*

190. Even if that power is not enumerated in Article I, it might nonetheless be considered a “necessary and proper” means to some other enumerated end, such as maintaining the general health of the interstate economy. *See* U.S. CONST. art. I, § 8, cl. 18; McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819) (construing the Necessary and Proper Clause very broadly). *But see* United States v. Comstock, 130 S. Ct. 1949, 1967 (2010) (Kennedy, J., concurring in the judgment) (suggesting that there are, in fact, limits on the reach of the “necessary and proper” power).

191. 221 U.S. 559 (1911).

192. *See*, e.g., New York v. United States, 505 U.S. 144, 156 (1992) (suggesting that the doctrine can be understood either as an implicit limit on the enumerated powers or as a part of the states’ residual sovereignty).
Mandatory bankruptcy, however, may well fall within the forbidden zone. The Court’s decisions on municipal bankruptcy—in *Ashton v. Cameron County Water Improvement District No. One* and *United States v. Bekins*—both contain language suggesting that a mandatory provision for states would be problematic. *Ashton* struck down a municipal bankruptcy statute under the Tenth Amendment, stating (without much elaboration) that the law “might materially restrict [a state’s] control over its fiscal affairs.” Two years later, *Bekins* upheld an amended version of the same law, but again stressed the constitutionally sensitive nature of the subject:

The statute is carefully drawn so as not to impinge upon the sovereignty of the State. The State retains control of its fiscal affairs. The bankruptcy power is exercised in relation to a matter normally within its province, and only in a case where the action of the taxing agency in carrying out a plan of composition approved by the bankruptcy court is authorized by state law.

Professor Feibelman points out that all of these statements are arguably dicta, and their vintage—the two cases were decided a year on either side of the Court’s famous 1937 “switch in time”—makes it hard to say how they would fit into contemporary federalism jurisprudence. But requiring states to submit to the jurisdiction of a federal bankruptcy court and conform to a reorganization plan adopted by creditors and approved by the court seems to pose a significant intrusion on state sovereignty. The problem would be still more stark if such a plan required the state to take measures like raising taxes. In particular, the intervention of the bankruptcy court would sever or at least undermine the link between state policy and

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193. 298 U.S. 513 (1936)
194. 304 U.S. 27 (1938).
195. *Ashton*, 298 U.S. at 530. In dissent, Justice Cardozo stressed the voluntary nature of the provision:
The question is not here whether the statute would be valid if it made provision for involuntary bankruptcy, dispensing with the consent of the state and with that of the bankrupt subdivision. For present purposes, one may assume that there would be in such conditions a dislocation of that balance between the powers of the states and the powers of the central government which is essential to our federal system.
*Id.* at 538 (Cardozo, J., dissenting).
198. See McConnell, *supra* note 178, at 234 (concluding that, “viewed realistically, state bankruptcy would cut deeply into the inherently sovereign powers of the state over taxation and expenditure”).
the democratic preferences of the state electorate.\textsuperscript{199}

In assessing these cases, it matters that the Supreme Court has long since abandoned any general prohibition on federal regulation of state governmental functions. The Court had adopted such a prohibition—although a tentative and messy one—in \textit{National League of Cities v. Usery},\textsuperscript{200} but it jettisoned that doctrine a decade later in \textit{Garcia v. San Antonio Metropolitan Transit Authority}.

\textit{Garcia}'s reasoning is nonetheless instructive for Professor Feibelman's proposal. The \textit{Garcia} majority rejected \textit{National League of Cities}' implicit constitutional protection for state sovereignty on the ground that the constitutional structure protects states through their representation in Congress.\textsuperscript{202} Hence, when Congress acts, it is with the consent of the states' representatives.\textsuperscript{203} \textit{Garcia} thus ushered in an era of “process federalism,” under which judicial review eschews substantive line-drawing in favor of reinforcing the “political safeguards” of federalism.\textsuperscript{204}

A mandatory state bankruptcy scheme is problematic from this standpoint, because rather than having Congress regulate the states directly—as the federal law upheld in \textit{Garcia} did, and as a conditional bailout might—it would delegate authority to restructure state finances to a federal court. While the states are represented in Congress, they have no analogous representation within the federal judiciary. Indeed, the Eleventh Amendment and two centuries of state sovereign immunity doctrine rest in large part on the view that federal courts are unfriendly to state governments, especially when they are sued on their debts. Although \textit{Garcia} allows Congress to regulate the states’ governmental operations, it is not nearly so clear that Congress may turn over control of state financial decisions to

\begin{itemize}
\item \textsuperscript{199} Cf. \textit{New York v. United States}, 505 U.S. 144, 169 (1992) (“Accountability is . . . diminished when, due to federal coercion, elected state officials cannot regulate in accordance with the views of the local electorate in matters not pre-empted by federal regulation.”).
\item \textsuperscript{200} 426 U.S. 833 (1976) (holding that Congress could not regulate the traditional governmental functions of the states).
\item \textsuperscript{201} See \textit{469 U.S. 528, 532 (1985) (overruling National League of Cities).}
\item \textsuperscript{202} \textit{Id.} at 546–47.
\item \textsuperscript{203} See, e.g., Herbert Wechsler, \textit{The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government}, 54 \textit{COLUM. L. REV.} 543, 559 (1954).
\item \textsuperscript{204} See generally Ernest A. Young, \textit{Two Cheers for Process Federalism}, 46 \textit{VILL. L. REV.} 1349 (2001) (examining whether the protection of federalism should be a subject of judicial review or of political processes).
\end{itemize}
federal judges.\textsuperscript{205}

Finally, there is the small matter of state sovereign immunity. Any mandatory state bankruptcy scheme would involve an abrogation of state sovereign immunity and therefore encounter problems under \textit{Seminole Tribe v. Florida},\textsuperscript{206} which held that Congress generally may not override state immunity when acting pursuant to its Article I powers. The Supreme Court did step back from \textit{Seminole} in \textit{Central Virginia Community College v. Katz},\textsuperscript{207} which held that the states may be subjected to federal damages liability, notwithstanding the Eleventh Amendment, in bankruptcy cases.\textsuperscript{208} In that case, however, the state had been made a party to a bankruptcy proceeding involving a private business, on the ground that the state community college had received a preferential transfer of money in the debtor’s estate.\textsuperscript{209} Subjecting the state itself to bankruptcy would involve a far greater incursion on state sovereignty.\textsuperscript{210} Moreover, it is hard to know how seriously to take \textit{Katz}, given how hard it is to square with \textit{Seminole}, \textit{Alden v. Maine},\textsuperscript{211} and the Court’s other immunity precedents. Now that Justice O’Connor—the only member of the \textit{Seminole} and \textit{Alden}...
majorities to join *Katz*—has left the Court, it is not clear that *Katz* would be followed, much less extended, today.\(^\text{212}\)

The likelihood that mandatory bankruptcy for states is unconstitutional leaves, of course, the possibility of *voluntary* bankruptcy as proposed by Professor Skeel, Messrs. Bush and Gingrich, and others.\(^\text{213}\) Voluntary state participation may obviate many or even all of the arguments we have considered in this Part,\(^\text{214}\) but only if we consider the states’ sovereign interests to be waivable. As Michael McConnell has explained, the answer depends on what we consider federalism to be for:

> If federalism protects states’ rights, then it follows that an entity that has rights ought to be able to waive those rights . . .

Alternatively, if federalism diffuses power and thus provides a check against tyranny and oppressive centralized authority, then the state should not be able to waive this central structural aspect of federal constitutionalism.\(^\text{215}\)

Although some aspects of state sovereignty—like sovereign immunity—remain waivable,\(^\text{216}\) the Court has increasingly suggested that others may not be. In *New York v. United States*,\(^\text{217}\) for instance, the Court held that while states may voluntarily agree to implement federal law, their earlier acquiescence could not waive their right to challenge such laws under the anti-commandeering doctrine.\(^\text{218}\) And last term, in *Bond v. United States*,\(^\text{219}\) the Court held that individuals have standing to raise Tenth Amendment challenges to federal laws because “[t]he limitations that federalism entails are not . . . a matter of rights belonging only to the States.”\(^\text{220}\)

This question may not have a categorical answer; rather, the validity of a voluntary state bankruptcy scheme may well turn on the

\(^{212}\) Cf. Coleman v. Court of Appeals of Maryland, 132 S. Ct. 1327 (2012) (refusing to extend the rationale of *Hibbs* and holding that Congress did not successfully abrogate the states’ sovereign immunity with respect to the self-care provisions of the Family Medical Leave Act).

\(^{213}\) See supra notes 171–173 and accompanying text.

\(^{214}\) But see Philip Hamburger, *Unconstitutional Conditions: The Irrelevance of Consent*, 98 VA. L. REV. (forthcoming 2012) (arguing that consent cannot empower the government to do things it would otherwise lack power to do).

\(^{215}\) McConnell, supra note 178, at 234.

\(^{216}\) See supra note 155 and accompanying text.


\(^{218}\) See id. at 181–82 (holding that because “federalism secures to citizens the liberties that derive from the diffusion of sovereign power,” it followed that state officials “cannot consent to the enlargement of the powers of Congress beyond those enumerated in the Constitution”).

\(^{219}\) 131 S. Ct. 2355 (2011).

\(^{220}\) Id. at 2364.
institutional details of how it operates.\textsuperscript{221} From a pragmatic standpoint, as Professor McConnell points out, “the sovereign interests of the public might . . . be better served by breaking the stranglehold of old contracts, even at the cost of submission to the scrutiny of federal bankruptcy judges.”\textsuperscript{222} That it might be constitutional for a state to submit to bankruptcy jurisdiction, however, would not necessarily mean that, by so consent ing, the state could delegate its taxing and spending authority to the bankruptcy court.\textsuperscript{223} Taxing and spending do not necessarily lie outside the constitutional limits of judicial power \textit{per se}.\textsuperscript{224} Nonetheless, federal municipal bankruptcy law has traditionally denied those sensitive powers to the bankruptcy court,\textsuperscript{225} and including them in an already-intrusive state bankruptcy regime might push any such scheme over the constitutional line.\textsuperscript{226} Moreover, even if the overall scheme is valid, some orders that a bankruptcy court could issue—such as a “haircut” for state creditors—might implicate the Contract Clause and/or Takings Clause issues that we have discussed earlier.\textsuperscript{227}

\begin{itemize}
\item \textsuperscript{221} Moreover, in analyzing the validity and scope of state consent, one would need to look not only to the federal but to the state constitution, because a state can hardly consent to something that its own constitution forbids.
\item \textsuperscript{222} McConnell, supra note 178, at 235.
\item \textsuperscript{223} See Gelpern, supra note 25, at 910–11 ("Neither bankruptcy judges nor contractual creditors have the democratic legitimacy to compel revenue measures."); McConnell, supra note 178, at 236 (suggesting that any valid state bankruptcy scheme “must ensure . . . that the democratic process and not the judiciary retains control over the states’ fundamental taxing and spending decisions”).
\item \textsuperscript{224} See, e.g., Missouri v. Jenkins, 495 U.S. 33, 55 (1990) ("[A] court order directing a local government body to levy its own taxes is plainly a judicial act within the power of a federal court."). Jenkins cited "a long and venerable line of cases in which this Court held that federal courts could issue the writ of mandamus to compel local governmental bodies to levy taxes adequate to satisfy their debt obligations." Id. at 55–56 (citing Louisiana \textit{ex rel.} Hubert v. Mayor and Council of New Orleans, 215 U.S. 170 (1909); Graham \textit{v.} Folsom, 200 U.S. 248 (1906); Wolff \textit{v.} New Orleans, 103 U.S. 358 (1881); United States \textit{v.} New Orleans, 98 U.S. 381 (1879); Heine \textit{v.} Levee Comm’rs, 86 U.S. (19 Wall.) 655, 657 (1874); City of Galena \textit{v.} Amy, 72 U.S. (5 Wall.) 705 (1867); Von Hoffman \textit{v.} City of Quincy, 71 U.S. (4 Wall.) 535 (1867); Bd. of Comm’rs of Knox Cnty. \textit{v.} Aspinwall, 65 U.S. (24 How.) 376 (1861)).
\item \textsuperscript{225} See Levitin, supra note 107, at 226 ("Traditionally, bankruptcy courts have not had the power to order tax increases or even rate increases for public utilities.").
\item \textsuperscript{226} A preferable approach might be to empower the bankruptcy court to enjoin the operation of state laws that \textit{prevent} necessary taxing or spending, while leaving the actual execution of the tax or spending to state authorities. \textit{Cf.} Jenkins, 495 U.S. at 51–52 (holding that the district court should have pursued this course in a desegregation case rather than imposing a tax increase by its own order). Such an injunction would remain an extraordinary exercise of federal power, particularly if the enjoined state tax or spending limits are not themselves unconstitutional.
\item \textsuperscript{227} See supra notes 121–133 and accompanying text.
\end{itemize}
Our final point is that, while many of the constitutional impediments to state bankruptcy that we have discussed are quite formal in nature, they may well make good functional sense. As Anna Gelpern observes, “[b]ankruptcy is at best unproven, and at worst unsuited to overtly political tasks, such as mediating among political interest groups and brokering fiscal federalism.”

Sovereignty-based protections for state governments are, at bottom, meant to guarantee that the political organs of state governments decide important questions affecting the lives of their constituents—and that those constituents can hold state government democratically accountable for those decisions. As dysfunctional as state governments may sometimes seem, it is far from clear that unelected generalists on the federal bench can make superior financial decisions, much less that those decisions will be perceived as legitimate by affected state citizens.

VI. CONCLUSION

Students of federal jurisdiction who care about state governance and finances are at risk of living out the famous Chinese curse: “May you live in interesting times.” In this essay, we have sought to identify some of the key constitutional issues that will complicate any effort to deal with the burgeoning crisis of state debt. As in much of the law of federal jurisdiction, the law rarely cuts off all remedies or precludes all meaningful reform, but it repays attention to history and doctrinal detail. Many of these issues are far too complex to permit any sort of definitive treatment here, and on some agreement remains elusive even among specialists. We hope simply to have sketched out a map for lawyers and policymakers who must pick their way through this maze.

228. Gelpern, supra note 25, at 895; see also Levitin, supra note 107, at 224 (concluding that “[b]ankruptcy cannot fix the underlying cyclical structural problem in states’ budgets”).

229. See Young, Its Hour Come Round, supra note 88, at 620–21 (explaining how sovereign immunity “implicate[s] the States’ capacity to exercise self-governance”).