PERSPECTIVES

REGARDING STATE BANKRUPTCY

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By Adam Stern

As reported by *The Wall Street Journal* on Wednesday, April 22, Senate Majority Leader Mitch McConnell (R-KY) hinted that, in exchange for more federal aid, he supports the idea of allowing states to file for bankruptcy protection.

Breckinridge's Co-Head of Research Adam Stern believes McConnell's statements, while likely made in good faith, are best understood as political gamesmanship.

Like other observers in our market, we believe it is highly unlikely that Congress enacts a bankruptcy chapter for states or that a state would ever avail itself of a bankruptcy statute. This is true for several reasons:

First, there is no need for a state bankruptcy code. As sovereign entities in our federal system, states already have the legal authority to abrogate a contract (for bonds, pensions, or other contracts), when necessary. States' contracts may be broken if doing so is reasonable (an emergency exists, for example) and necessary (no other choice exists but to renege on the contract). A state will undoubtedly be sued if it fails to pay debt service, pension payments, or make good on other obligations, and courts will generally not defer to state determinations of "necessity" as states' own financial interests are at stake. But the law is clear that all state obligations have a limit. If a state has, in good faith, exhausted its fiscal options, it can legally subordinate its financial obligations to the public welfare.

Second, the current public health emergency is likely not a sufficient legal basis for a state bankruptcy filing. In parallel to the idea that state contracts can be broken only when absolutely necessary, any federal bankruptcy law for states would require a showing by the state that it is 'insolvent' and is acting in good faith when it claims it cannot meet its debts. Based on traditional understandings of the meaning of 'insolvent' in Chapter 9 (as well as in PROMESA, the Puerto Rico bankruptcy law), no state is insolvent right now, probably not even Illinois. Illinois can certainly *choose* to default on its debt obligations, but it likely cannot establish that it is 'insolvent' for the purposes of bankruptcy law.

Third, as a political matter, it makes little sense for states to file for bankruptcy. Inside a bankruptcy court, a federal judge would influence all manner of policymaking issues for entire states. Governors and state legislators would cede significant control over the policymaking function. This would be an unforced error on their part: as mentioned above, lawmakers *already* have the ability to restructure contracts, if needed, in order to address an emergency.

Fourth, Congress has recently debated this issue, and legislation has moved nowhere. During the discussion over Puerto Rico's bankruptcy bill, many lawmakers sought to clarify that the Puerto Rico bankruptcy law would never apply to a state; that it was appropriate for Puerto Rico because the Commonwealth is a territory and lacks a state's sovereign power. This kind of thinking would likely prevail in the current Congress, as well. States are facing a fiscal challenge but not a credit emergency. Most would likely not want their credit reputations tarnished with the possibility that they might one day file for bankruptcy.