Hey Uncle Sam, Can You Spare a Couple Billion?: Examining the Constitutionality of a State Bankruptcy Chapter

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Hey Uncle Sam, Can You Spare a Couple Billion? Exploring the Constitutionality of a State Bankruptcy Chapter as a Means of Preventing Bailouts

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During February 2011 the prospect of creating a state bankruptcy chapter burst onto the national conversation. This debate largely centered on the necessity of state bankruptcy as a means of averting state bailouts, while some commentators vaguely invoked the need to tread gingerly on state prerogatives under the 10th Amendment. However, the constitutionality of bankruptcy-for-states demands closer scrutiny given that the Supreme Court’s recent 10th Amendment jurisprudence has evolved in the direction of protecting state sovereignty.

The Article examines a pair of cases from the 1930s that contested the constitutionality of municipal bankruptcy, and argues that the principles handed down from these cases would likely support upholding a state bankruptcy chapter that is carefully drawn to respect state sovereignty. Though highly relevant, these cases are not dispositive because the legal landscape has changed a great deal since the 1930s. The Article argues that even a broad state bankruptcy chapter is constitutional because recent 10th Amendment jurisprudence does not preserve traditional state functions, and the Court has already upheld many similar infringements on state sovereignty, such as the interference with state contractual obligations.

Assuming a state bankruptcy chapter is constitutional, is it a good idea? The Article assesses the main justification expressed for the creation of a state bankruptcy chapter—that is, it is necessary to avoid a massive federal bailout because states, like major financial institutions, are too big to fail—and concludes that the grim logic of bailouts applies to the states because they are significantly interconnected with the financial markets.

Contents
I. Introduction ....................................................................................................................... 2
II. Constitutionality of a State Bankruptcy Chapter................................................................. 5
   A. Constitutional Foundations of the Bankruptcy Clause.................................................... 5
      1. History and text of the Bankruptcy Clause.................................................................. 5
      2. On the Surface, There is No Reason To Exclude Public Debtors ......................... 7
   B. Constitutionality of Municipal Bankruptcy—Early Cases.............................................. 9
      1. Why Are These Municipality Cases Relevant to States? ........................................ 9
      2. Ashton Decision ...................................................................................................... 10
      3. Bekins Decision....................................................................................................... 13
      4. The Application of Ashton and Bekins to State Bankruptcy...................................... 15
   C. 10th Amendment Challenge .......................................................................................... 18
      1. Brief overview of the Court’s evolving 10th Amendment jurisprudence ................. 19
      2. Application of 10th Amendment Decisions to SBR.................................................. 22
III. “Too Big To Fail” and Other Policy Reasons for State Bankruptcy ........................................... 23
   A. Explaining “Too Big To Fail” and the Necessity of the Bank Bailouts ........................................ 24
   B. Are States Also “Too Big To Fail”? .................................................................................................. 24
VI. Conclusion ........................................................................................................................................ 27

When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it
becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the
measure which is both least dishonourable to the debtor, and least hurtful to the creditor.

Adam Smith, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 468
(Edwin Cannan ed., The Univ. of Chi. Press 1976) (1776)

I. Introduction

The great bank bailouts of 2007 have become the most widely detested policy in a
generation. At the time, Congress was warned by Hank Paulson, the Treasury Secretary for the
Bush Administration, that the failure to promptly pass a massive bank bailout would lead to an
imminent collapse of the financial markets.\(^1\) The big banks were so connected with each other
that a failure of one could lead to a failure of all.\(^2\) In other words, the big banks were “too big to
fail.”\(^3\)

Unwilling to risk a second Great Depression for the sake of standing on principle, many
Congressmen held their noses and voted to approve the Troubled Asset Relief Program (TARP).\(^4\)

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\(^1\) Dealbook, Financial Bailout Package Shifts Focus, N.Y. Times, Nov. 13, 2008,
Mr. Paulson went to Congress and urgently pressed for authority to spend as much as $700
billion to unclog the nation’s financial pipelines by buying up unsellable securities from banks
and other financial institutions.”).

\(^2\) Cyrus Sanati, Senator Seeks to Break Up Banks ‘Too Big to Fail’, N.Y. Times, Nov. 6, 2009,

\(^3\) See Sanati, supra note 2.

\(^4\) See Dealbook, supra note 1.
Not soon after, a wave of outrage spread over the nation rooted in utter disgust that the same malefactors whose risky behavior nearly brought the economy crashing down were bailed out, leaving the taxpayers holding the bag. From this foam of outrage a new political power was born. The Tea Party, a loose federation of citizens incensed by the bank bailout, among other outrages, joined forces with the Republican party and swept the Democrats out of power in the 2010 congressional elections. It thus appeared that the regretful era of bailouts had finally come to an end. However, the financial industry is not the only sector of the economy that is “too big to fail.” Worry has grown that some large states, teetering on the brink of insolvency, are also too big to fail.

The states face more than $140 billion in budget deficits in 2012, reports the Center on Budget and Policy Priorities, a Washington research group. Even bleaker are the states’ unfunded pension and health care liabilities, which amount to $3.5 trillion. Moreover, since states’ debt burdens are interconnected with banking institutions, it is plausible that the collapse of a single large state could have very damaging repercussions to the national economy. Against this backdrop, leading policymakers have proposed extending bankruptcy protection to states as a means of ending federal bailouts, once and for all.

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Although some scholars have sketched out how this new bankruptcy chapter might function, they have tended to assume that bankruptcy-for-states would be easily constitutional.\textsuperscript{11} For example, Professor Skeel, whose article, \textit{Give States a Way To Go Bankrupt}, warmed the winter of 2011 with heated debate, said that the “constitutionality of bankruptcy-for-states is beyond serious dispute.”\textsuperscript{12} At the same time, Skeel said that a state bankruptcy chapter (SBC) must “tread[] gingerly on state prerogatives” for it to be constitutional.\textsuperscript{13} Far from easing the worries that SBR would unconstitutionally violate state sovereignty, Skeel has muddied the waters with this pair of contradictory statements. You cannot have it both ways: either a state bankruptcy chapter is easily constitutional, or its constitutionality is questionable, and therefore it must be narrowly drawn to avoid violating state sovereignty. This paradox calls for further explanation to tease out the constitutional problems raised by the creation of a SBC. Given the resurgence of the 10th Amendment in the Supreme Court’s jurisprudence, it is not so clear whether SBR would be found constitutional. After careful analysis, it appears that the constitutionality of SBR is more of a close call than Skeel would have us believe.

All of these concerns must be satisfactorily addressed before it may be determined whether the creation of a SBC would be good policy. Part II will analyze the constitutionality of a SBC. Part III will probe the main justification expressed for the creation of a SBC—that is, it is necessary to avoid a massive federal bailout because states, like major financial institutions, are too big to fail. Part IV concludes that a state bankruptcy chapter would probably be upheld, and sheds some light on the constraints that complying with the constitution may place on drafting choices.

\textsuperscript{11} See Skeel, \textit{supra} note 9.
\textsuperscript{12} \textit{Id.}
\textsuperscript{13} \textit{Id.}
II. Constitutionality of a State Bankruptcy Chapter

A number of newspaper, magazine and internet articles were written in the winter of 2011 exploring the possibility of state bankruptcy. These articles have outlined some of the potential avenues for state debt relief, and some of the political perils. The proponents of a SBC have tended to assume its constitutionality. “[B]ankruptcy-for-states can easily be squared with the Constitution,” said Professor Skeel in the Weekly Standard. At other times, they have suggested that SBR must be narrowly drafted to steer clear of impinging on state sovereignty, and in particular “the Constitution’s protections against federal meddling in state affairs.” These contradictory statements demand a fuller explanation. This Part will do just that by exploring the constitutional framework for providing debt relief to states.

A. Constitutional Foundations of the Bankruptcy Clause

1. History and text of the Bankruptcy Clause

The constitution grants to Congress the power to make “uniform Laws on the subject of Bankruptcies throughout the United States.” Remarkably, the introduction of the bankruptcy clause near the end of the Constitutional Convention elicited little debate. The only recorded comments were those expressed by Governor Morris, who stated, “this [is] an extensive and

15 See Skeel, supra note 9.
16 Id.
17 U.S. Const. art. I, § 8, cl. 4.
18 On August 29, 1787, Pinckney proposed that Congress be given the power “To establish uniform laws upon the subject of bankruptcies, and respecting the damages arising on the protest of foreign bills of exchange.” Farrand, RECORDS OF THE FEDERAL CONVENTION, II, 447.
delicate subject.”¹⁹ The Federalist papers are equally terse, stating only that the bankruptcy power is so intimately connected with the regulation of commerce “that the expediency of it seems not likely to be drawn in question.”²⁰ Notably, while ratifying the Constitution, the New York Convention proposed an amendment that would restrict the scope of the bankruptcy clause to merchants and traders.²¹ The rejection of this proposal suggests that the framers intended the bankruptcy power to embrace an extensive field.

And so it has: the history of the bankruptcy power shows “an expanding concept,” leaving in its wake a “trail . . . strewn with a host of unsuccessful objections based on constitutional grounds against the enactment of various provisions, all of which are now regarded as perfectly orthodox features of a bankruptcy law.”²² Although “[a]lmost every change has been hotly denounced in its beginnings as a usurpation of power,” these objections have receded over time.²³ Moreover, nearly all of these bold expansions have received judicial approval as falling

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¹⁹ See Farrand, supra note 18, at 489. This comment was made in response to Sherman, who objected to granting Congress the power to punish bankrupts by death, as occasionally was the case under the laws of England. No further debate was recorded, and the bankruptcy clause was adopted by a 9-1 margin. Id.; see generally Charles Jordan Tabb, History of the Bankruptcy Laws in the United States, 3 AM. BANKR. INST. L. REV. 5 (1995).
²⁰ No. 42, Madison.
²¹ Elliot’s Debates, I, 330 (“That the power of Congress to pass uniform laws concerning bankruptcy shall only extend to merchants and other traders; and the states, respectively, may pass laws for the relief of other insolvent debtors.”).
²³ Id. (“Thus, it was at first contended that, constitutionally, such a law must be confined to the lines of the English statute; next, that it could not discharge prior contracts; next, that a purely voluntary law would be nonuniform and therefore unconstitutional; next, that any voluntary bankruptcy was unconstitutional; next, that there could be no discharge of debts of any class except traders; next, that a bankruptcy law could not apply to corporations; next, that allowance of State exemptions of property would make a bankruptcy law non-uniform; next, that any composition was unconstitutional; next, that there could be no composition without an adjudication in bankruptcy; next, that there could be no sale of mortgaged property free from the mortgage. All these objections, so hotly and frequently asserted from period to period, were overcome either by public opinion or by the Court.”).
within the scope of the powers granted by the bankruptcy clause of the Constitution. The only momentary hitch in the road to continuous expansion occurred in 1936, when the Supreme Court struck down the Municipal Bankruptcy Act of 1934, a decision effectively overturned only two years later in *United States v. Bekins*.

This history shows that the bankruptcy clause extends to any debtor that is unable to meet his obligations. Expanding bankruptcy relief to the states, therefore, could be the next stage in the evolutionary process, as the bankruptcy clause has adapted to meet new conditions. In this sense, the bankruptcy clause has proven its flexibility in stretching to meet fresh challenges brought by the remarkable growth of American business activities. For example, it has not stood in the way of the country’s transformation from an agrarian economy to an industrial one. Although many expansions of the bankruptcy clause were bold and far-reaching, none have exceeded the limits of congressional power. Instead, they have reflected extensions into new fields with boundaries unseen.

2. On the Surface, There is No Reason To Exclude Public Debtors

The text of the bankruptcy clause does not afford strict constructionists any hook to limit the class of debtors that are subject to the bankruptcy power. Indeed, many courts have held

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24 *Id.* at 513.
25 304 U.S. 27, 47 (1938).
26 Erwin Chemerinsky, *Constitutional Law* 286 (2006). Interestingly, when it comes to methods of interpreting the bankruptcy clause, the Court has, in the past, appeared to embrace a hybrid of the “living constitution” view and the strict constructionist view. Continental Illinois Nat’l Bank & Trust Co. of Chicago v. Chicago, R.I. & P. Ry. Co., 294 U.S. 648, 668 (1935). In 1935, the Court remarked that the framers did not intend the powers of congress under the bankruptcy clause to be limited to the English or Colonial law in force when the Constitution was adopted. *Id.* In other words, the framers intended the bankruptcy clause to expand over time to meet new commercial realities.
that congress’s power under the bankruptcy clause is “unrestricted and paramount.”\(^{27}\) The only limitation present is that bankruptcy laws passed by Congress must be “uniform,” which has been interpreted to require only that bankruptcy laws “not be designed to help one debtor in a manner different from how other debtors are treated.”\(^{28}\)

Neither do the Court’s opinions require the exclusion of public debtors. On the contrary, the Court has read the bankruptcy clause to extend to any category of debtors that is unable to meet his obligations.\(^{29}\) For example, as early as 1902, the Court approved Justice Story’s statement, in his Commentaries on the Constitution, that “there is nothing in the nature or reason of such laws to prevent their being applied to any other class of unfortunate and meritorious debtors.”\(^{30}\) On many such occasions, the Court has reaffirmed the broad scope of the bankruptcy powers.

Except for the Ashton decision, the Court has never suggested that the bankruptcy power did not extend to all debtors of every class. Instead, the Court has only required there be a debtor that cannot pay his debts. In sum, it appears that all debtors are subject to the bankruptcy power, regardless of whether the debtor is an individual or an organization, public or private.

\(^{27}\) See e.g., In re Delta Group, 300 B.R. 918 (Bankr. E.D. Wis. 2003), appeal dismissed, 336 B.R. 405 (E.D. Wis. 2004).

\(^{28}\) See Chemerinsky, supra note 27, at 286 (“For example, in the Regional Railroad Reorganization Act Cases, the Court upheld a bankruptcy law that treated railroads in one part of the country differently than other areas. 419 U.S. 102 (1974). The Court explained that the law was “uniform” because all of the railroads covered by the law, and all of the creditors of these railroads were treated the same under the Act.”).

\(^{29}\) Continental Illinois Nat’l Bank & Trust Co. of Chicago v. Chicago, R.I. & P. Ry. Co., 294 U.S. 648, 670 (1935) (“Judge Cowen, in Kunzler v. Kohaus, 5 Hill (N.Y) 317, 321, a decision which was approved by this court in Hanover National Bank v. Moyses, supra, said that the power was the same as though Congress had been authorized ‘to establish uniform laws on the subject of any person’s general inability to pay his debts.’”).

\(^{30}\) Hanover Nat’l Bank v. Moyses, 186 U.S. 181, 185 (1902); see also Sturges v. Crowninshield, 17 U.S. 122 (1819) (J. Marshall) (“[I]t is not easy to say who must be excluded from, or may be included within, this description. It is, like every other part of the subject, one upon which the legislature may exercise an extensive discretion.”).
B. Constitutionality of Municipal Bankruptcy—Early Cases

1. Why Are These Municipality Cases Relevant to States?

The constitutionality of extending bankruptcy protection to municipalities was hotly contested in a pair of Supreme Court cases during the 1930s. To summarize briefly, in the first case, Ashton v. Cameron County Water Improvement Dist. No. 1, the Court struck down the Municipal Bankruptcy Act of 1934.\(^{31}\) In the second case, United States v. Bekins, the Court upheld the constitutionality of a similar law, while declining to overrule Ashton, and instead choosing to distinguish it.\(^{32}\)

These early cases are important to the discussion of whether a state bankruptcy chapter would be constitutional because they implicate the same set of issues—state sovereignty and federal power under the bankruptcy clause. Logically, if municipal bankruptcy was found unconstitutional as infringing on state sovereignty, then state bankruptcy would likewise be unconstitutional because it involves an even greater infringement upon state sovereignty. Although under reigning jurisprudence, municipal bankruptcy, sufficiently circumscribed, is clearly constitutional, it is possible that a SBC could be struck down as an impermissible infringement upon state sovereignty.

But where would the Supreme Court likely draw the line in the sand, if at all? How much of an infringement upon state sovereignty goes too far? Read together, these two cases do not provide clear guidance on whether the Court would uphold a SBC. However, a discussion of Ashton and Bekins helps to reveal the key issues that would likely come up if a SBC was challenged on constitutional grounds.

\(^{31}\) 298 U.S. 513 (1936).  
\(^{32}\) 304 U.S. 27 (1938).
2. Ashton Decision

The Great Depression ravaged the balance sheets of municipalities across the country. Congressional hearings at the time revealed that in 1934, 2,019 municipalities, counties, and other governmental units were in default.\[^{33}\] These municipalities could not turn to the states for relief, for the Constitution prohibits the states from passing laws that impair the obligation of existing contracts.\[^{34}\] Therefore, any state insolvency act could not relieve obligations incurred by the debtor before its passage.\[^{35}\]

Unwilling to ignore the plight of municipalities, Congress passed the Municipal Bankruptcy Act of 1934 (MBA). Well aware of the constitutional problems raised by permitting a federal court to exercise jurisdiction over an agency or instrumentality of a state, Congress took care to draft the law to minimize any infringement of state sovereignty.\[^{36}\]

In Ashton, the Court held that the MBA unconstitutionally interfered with state sovereignty.\[^{37}\] Notably, the specter of extending the bankruptcy clause to sovereign states was on the forefront of the Court’s mind.\[^{38}\] For example, the Court asked rhetorically, “If federal bankruptcy laws can be extended to respondent, why not to the state?”\[^{39}\]

In other words, the Court was concerned with the slippery slope leading to bankruptcy-for-states, and decided to nip this project in the bud.\[^{40}\]

\[^{33}\]See Hearing before a Subcommittee of the Senate Committee on the Judiciary on S. 1868 and H.R. 5950, 1934, 73d Cong., 2d Sess.; Hearing before the House Committee on the Judiciary on H.R. 1670, etc., 1933, 73d Cong., 1st Sess.

\[^{34}\]U.S. Const. art. I, § 8.

\[^{35}\]Sturges v. Crowninshield, 17 U.S. 122, 128-29 (1819).


\[^{37}\]Ashton, 298 U.S. at 530.

\[^{38}\]Id.

\[^{39}\]Id.

\[^{40}\]“If the state were proceeding under a statute like the present one, with terms broad enough to include her, apparently the problem would not be materially different. Our special concern is
The Court emphasized the importance of state sovereignty in the federal system, stating “[t]he sovereignty of the state essential to its proper functioning under the Federal Constitution cannot be surrendered; it cannot be taken away by any form of legislation.”

The Court characterized the chief purpose of all bankruptcy legislation as interfering with the contractual relations of the parties by modifying the obligation of their contracts. This purpose, the Court observed, cannot be applied to states or to their political subdivisions:

If obligations of states or their political subdivisions may be subjected to the interference here attempted, they are no longer free to manage their own affairs; the will of Congress prevails over them . . . And really the sovereignty of the state, so often declared necessary to the federal system, does not exist.

Moreover, the Court pointed out that other constitutional provisions, such as the power to lay and collect taxes, had been “impliedly limited by the necessity of preserving independence of the states.” Likewise, the bankruptcy clause, which has neither a higher rank nor more importance than these provisions, must contain the same limitation. Therefore, the Court struck down the Municipal Bankruptcy Act as unconstitutional because it “might materially restrict respondent's control over its fiscal affairs.”

In dissent, Justice Cardozo characterized the question presented in narrow terms: “Is there power in the Congress under the Constitution of the United States to permit local

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41 Id. at 531 (stating that it is impermissible for the federal government to “pass laws inconsistent with the idea of sovereignty”).
42 Id. at 530.
43 Id. at 531.
44 Id. at 530.
45 Id.
46 Id.
governmental units generally, and irrigation or water improvement districts in particular, to become voluntary bankrupts with the consent of their respective states?“

Cardozo started his analysis by tracing the history of the bankruptcy power—noting that although it has steadily expanded over the years, “[a]lmost every change has been hotly denounced in its beginnings as a usurpation of power.” Cardozo stated that the MBA was carefully drafted to avoid interfering with state sovereignty, while conceding for the sake of argument that a more sweeping law might upset the balance between state and federal power. Cardozo emphasized that the MBA does not provide for involuntary bankruptcy; therefore, the critical element of consent is preserved, which prevents the MBA from upsetting the balance of power between the state and the federal government. In other words, it appears that Cardozo would draw the constitutional line at involuntary bankruptcy because such a law would lack the critical element of state consent; thus, municipal bankruptcy would be constitutional as long as it takes place in a voluntary proceeding.

Notably, Cardozo suggested that he would view the extension of the bankruptcy power to the states to be unconstitutional. Cardozo reasoned that under the U.S. public laws, “a state is a sovereign or at least a quasi sovereign. Not so a local governmental unit, though the state may have invested it with governmental power.” In other words, states are considered sovereign—

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47 Id. at 535 (Cardozo, J., dissenting).
48 Id.
49 Id. at 538 (Cardozo, J., dissenting) (“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.”).
50 Id. at 541 (Cardozo, J., dissenting).
51 Id. at 542 (Cardozo, J., dissenting) (“There is room at least for argument that within the meaning of the Constitution the bankruptcy concept does not embrace the states themselves.”).
52 Id. at 541 (Cardozo, J., dissenting).
for example, immunity from suit “belongs to the state alone by virtue of its sovereignty.”\textsuperscript{53} It follows that state sovereignty shields states from the bankruptcy power of the Constitution.

Finally, Cardozo emphasized the practical necessity for the MBA.\textsuperscript{54} Forbidding municipalities from entering into voluntary bankruptcy would mean they are “caught in a vise from which it is impossible to let them out.”\textsuperscript{55} For the contracts clause of the U.S. constitution forbids states from offering a forum to rework contracts, and without the threat of bankruptcy, experience shows that “a small minority of creditors . . . will resist a [fair and reasonable] composition.”\textsuperscript{56}

### 3. Bekins Decision

After Ashton, Congress amended Article IX of the bankruptcy code to comply with the Court’s decision.\textsuperscript{57} The revision provided for a composition procedure that is similar to an agreement between a debtor and a majority of creditors.\textsuperscript{58} Under these proceedings, the jurisdiction of the bankruptcy court was largely limited to determining whether this agreement was fair.\textsuperscript{59}

In Bekins, the Court retreated from its earlier position that state sovereignty presents a barrier to extending bankruptcy to municipalities. Bekins considered “the question of the constitutional validity of the [1937 Act] amending the Bankruptcy Act by adding chapter X

\textsuperscript{53} Id.
\textsuperscript{54} Id. (“To hold that this purpose must be thwarted by the courts because of a supposed affront to the dignity of a state, though the state disclaims the affront and is doing all it can to keep the law alive, is to make dignity a doubtful blessing. Not by arguments so divorced from the realities of life has the bankruptcy power been brought to the present state of its development during the century and a half of our national existence.”).
\textsuperscript{55} Id.
\textsuperscript{56} Id.
\textsuperscript{58} Giles J. Patterson, Municipal Debt Adjustment Under the Bankruptcy Act, 90 U. PA. L. REV. 520, 525 (1942).
\textsuperscript{59} See Patterson, supra note 58, at 525.
providing for the composition of indebtedness of the taxing agencies or instrumentalities.\textsuperscript{60} The Court held that the act was constitutional, finding that the voluntary composition of debts “was nothing less than ‘the subject of the relations between an insolvent or nonpaying or fraudulent debtor, and his creditors, extending to his and their relief.’”\textsuperscript{61}

The Court reasoned that “[t]he statute is carefully drawn so as not to impinge upon the sovereignty of the State.”\textsuperscript{62} As a result, the Court found that Congress had adequately responded to the concerns raised in Ashton.\textsuperscript{63} First, the state keeps control of its fiscal affairs.\textsuperscript{64} Second, the bankruptcy power is only exercised when the state has given its assent.\textsuperscript{65}

In contrast to the Ashton court’s assertion that “neither consent nor submission by the states can enlarge the powers of Congress,”\textsuperscript{66} the Bekins court concluded that “[i]t is of the essence of sovereignty to be able to make contracts and give consents bearing upon the exertion of governmental power.”\textsuperscript{67} Furthermore, the Tenth Amendment “protected, and did not destroy, [a state’s] right to make contracts and give consents” to limit the exercise of its powers.\textsuperscript{68} The Court drew an analogy to the making of treaties, where “governments yield their freedom of

\textsuperscript{60} United States v. Bekins, 304 U.S. 27, 45 (1938).
\textsuperscript{61} Id. (citing Continental Illinois Nat'l Bank & Trust Co. of Chicago v. Chicago, Rock Island & Pac. Ry. Co., 294 U.S. 648, 672 (1935)).
\textsuperscript{62} Id. at 51.
\textsuperscript{63} Id. at 50 (“In enacting chapter 10 the Congress was especially solicitous to afford no ground for [the Ashton court’s] objection.”).
\textsuperscript{64} Id. at 51.
\textsuperscript{65} Id.
\textsuperscript{66} Ashton v. Cameron County Water Improvement Dist. No. 1, 298 U.S. 513, 531 (1936) (“The sovereignty of the state essential to its proper functioning under the Federal Constitution cannot be surrendered; it cannot be taken away by any form of legislation.”).
\textsuperscript{67} Bekins, 304 U.S. at 51-52 (1938).
\textsuperscript{68} Id. at 52.
action in particular matters in order to gain the benefits which accrue from international accord.”  

Echoing Cardozo’s dissent in Ashton, the Court emphasized the practical necessity of extending bankruptcy to municipalities. The Court stressed that states are obliged to cooperate with the federal government because a “[s]tate itself is powerless to rescue” its municipalities from financial ruin due to the contracts clause. In doing so, “[t]he State acts in aid, and not in derogation, of its sovereign powers.”

4. The Application of Ashton and Bekins to State Bankruptcy

The Court’s shift from Ashton to Bekins is quite striking. In Ashton, the Court issued a sweeping holding that struck down the Municipal Bankruptcy Act on the grounds of protecting state sovereignty. Only two years later, the Court abruptly changed course. In Bekins, the Court largely adopted Justice Cardozo’s dissenting opinion in Ashton.

The analysis presented in Ashton and Bekins would likely play a role in determining the constitutionality of a SBC. To be sure, the portions of the two opinions that discuss the constitutionality of extending bankruptcy protection to states are dicta, since this issue was not before the Court. Accordingly, the Court’s analysis of state sovereignty, though not binding on future courts, is instructive.

The Bekins court articulated a more flexible theory of state sovereignty than the rigid formalism expressed by the Ashton court. Notably, unlike Cardozo’s dissent in Ashton, the

69 Id.
70 Id. at 54 (“We see no ground for the conclusion that the Federal Constitution, in the interest of state sovereignty, has reduced both sovereigns to helplessness in such a case.”).
71 Id.
72 Id.
73 Ashton v. Cameron County Water Improvement Dist. No. 1, 298 U.S. 513 (1936).
74 Bekins, 304 U.S. 27.
Bekins court did not draw a firm line at state sovereignty, and then go on to uphold municipal bankruptcy on the grounds that municipalities are not endowed with sovereignty.\(^75\) In contrast, Justice Cardozo had argued that a local governmental unit is neither a sovereign nor a quasi-sovereign, notwithstanding that the state had invested it with government power.\(^76\) Had the Bekins court adopted Justice Cardozo’s reasoning on this point, the constitutionality of SBC would be thrust into greater doubt. Instead, the Bekins court grounded its reasoning in the idea that a state, like a country that enters into a treaty, has the power to give its consent to limit the exercise of its powers.\(^77\)

Assuming the principles expressed in Bekins are still good law today, how would they apply to the creation of a SBC? Notwithstanding its shift away from protecting state sovereignty, the Bekins Court articulated several guideposts that suggest when municipal bankruptcy might run afoul of the constitution.\(^78\) These standards would likely be relevant in determining the constitutionality of a SBC. The key requirements appear to be that a city cannot be forced to file for bankruptcy against its will, and that the law cannot usurp its political decision making authority.

Arguably, since the Bekins court found that the municipal bankruptcy law was drafted in a sufficiently circumscribed way to not impinge upon state sovereignty, the same law, with minor alterations, could be simply transposed onto a new bankruptcy chapter for states. This is the view expressed by Professor Skeel, who stated: “[a] state bankruptcy law that honored [the

\(^{75}\) Ashton, 298 U.S. 542 (Cardozo, J., dissenting).

\(^{76}\) Id.

\(^{77}\) Id. However, this treaty analogy must have some limits. For example, if a state consents to a federal command that it make a certain law, does this make it constitutional?

Bekins principles would be equally sound. But, it is not so clear this is the case, for SBC represents a far greater intrusion into state sovereignty than municipal bankruptcy. The reason is that there are hierarchies of sovereignty—municipalities are endowed with some features of sovereignty, and states possess all aspects of sovereignty that they did not give up when they signed the Constitution.

Furthermore, there is another major wrinkle—the necessity for state bankruptcy today is not present in the same way as it was with municipal bankruptcy in the 1930s. In Bekins, the Court, mirroring Justice Cardozo’s analysis in his Ashton dissent, emphasized that without municipal bankruptcy a “[s]tate . . . is powerless to rescue” its municipalities from financial ruin. This is not the case with states themselves because a state, unlike a municipality, always has the option of defaulting on its debt and refusing to pay its creditors, much like a sovereign country.

On the other hand, there is a kind of “necessity” in both cases. For starters, states are grappling with dire financial troubles. True, states can always raise revenues to dig out of a financial hole, but so can municipalities, and although a fear exists that if a municipality raises taxes, its citizens will move elsewhere, the same fear exists on the state level that citizens may

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79 See Skeel, supra note 9.
80 Bekins, 304 U.S. at 54.
82 See Vekshin, supra note 7.
“vote with their feet” in response to tax hikes. However, arguably there is less justification for this fear on the state level, for it is often more difficult to uproot one’s family and move out of the state than out of the municipality.

In conclusion, the principles expressed in *Bekins* will likely play a role in determining the constitutionality of a SBC. To begin, the prospect of extending bankruptcy protection to states was in the Court’s mind as it shaped the guideposts for when a municipal bankruptcy chapter might violate sovereignty principles. Although instructive, these two cases do not provide clear guidance on whether the Court would uphold a SBC because we must take into account the evolution of the Court’s 10th Amendment jurisprudence over the last 75 years.

**C. 10th Amendment Challenge**

Extending bankruptcy relief to the states may be challenged on Tenth Amendment grounds. It is not altogether clear that you can simply grab the *Ashton* and *Bekins* decisions from the shelf, dust them off, and apply them directly to the constitutionality of SBR, for the legal landscape has changed a great deal since the 1930s. Specifically, the Court’s Tenth Amendment jurisprudence has undergone great change over the past 75 years. Insofar as the Court in the 1930s was still enthralled with the dual sovereignty theory, the Tenth Amendment cases from that period have lost some of their force, for that theory has been long repudiated. Therefore, determining the constitutionality of a SBC requires an analysis of the Court’s Tenth Amendment jurisprudence and how this relates to the bankruptcy clause.

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83 To begin, it is not clear how these Tenth Amendment principles interact with the bankruptcy clause. Presumably, they are generally applicable to all constitutional provisions. However, there may be room for doubt as to whether they extend beyond the commerce clause.

1. Brief overview of the Court’s evolving 10th Amendment jurisprudence

The first question regarding the Tenth Amendment is whether it is a judicially enforceable limit on Congress’s powers? Over the course of American history, the Court has shifted between two different approaches. In the 1990s, the Court revived the Tenth Amendment as a limit on congressional power86 in New York v. United States,87 and Printz v. United States.88

Even so, the Court has long repudiated the nineteenth century notion of dual sovereignty.89 However, in the last few decades, the Supreme Court has not held that the Tenth Amendment reserves a zone of activities for exclusive state control. Instead, these Tenth Amendment decisions have had a narrower focus, establishing that Congress cannot compel state legislative or regulatory activity.90

Under these decisions, a challenge to a potential state bankruptcy chapter on Tenth Amendment grounds must show that the federal government has compelled states to enact laws or regulations or to implement a federal mandate. It is not enough to argue that the management of fiscal affairs are a traditional responsibility of state governments, for under any recent Supreme Court decisions, it is not a violation of the Tenth Amendment for the federal government to assume functions traditionally performed by the states.

89 See e.g., United States v. Comstock, 130 S.Ct. 1949, 1962 (2010); Corwin, The Passing of Dual Federalism, 36 VA. L. REV. 1 (1950). However, some scholars have argued that “the concept of a state sovereignty constitutionally immune from excessive federal impairment has never been wholly abandoned where regulation affects the operations of the state itself rather than merely displacing its authority to regulate private conduct.” Note, Municipal Bankruptcy, the Tenth Amendment and the New Federalism, 89 HARV. L. REV. 1871, 1873 (1976).
90 Specifically, they held that Congress may not “commandeer” states nor coerce them into implementing federal policy.
However, it appears that the Court has revived the “traditional functions” test as at least a factor in determining whether congress has exceeded the scope of its powers. At least, this is how four dissenting justices in *Morrison* characterized the Court’s evolving jurisprudence. In that case, Justice Souter wrote a dissenting opinion, with whom Justices Stevens, Gisburger, and Breyer joined.\(^9^1\) Souter characterized the majority’s opinion as reviving the traditional functions test, which like a good horror monster, is killed numerous times but keeps coming back to life:

The Court finds it relevant that the statute addresses conduct traditionally subject to state prohibition under domestic criminal law, a fact said to have some heightened significance when the violent conduct in question is not itself aimed directly at interstate commerce or its instrumentalities. Again, history seems to be recycling, for the theory of traditional state concern as grounding a limiting principle has been rejected previously, and more than once.

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Although we sense the presence of *Carter Coal, Schechter*, and *Usery* once again, the majority embraces them only at arm's-length. Where such decisions once stood for rules, today's opinion points to considerations by which substantial effects are discounted.\(^9^2\)

While Justice Thomas appears alone in advocating a return to *Usery’s* traditional government functions test,\(^9^3\) which carved out an exclusive zone of state control, Justice Kennedy has

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\(^9^2\) *Id.* at 654.
\(^9^3\) United States v. Lopez, 514 U.S. 549, 585 (1995) (Thomas, J., concurring) ([I]t seems to me that the power to regulate “commerce” can by no means encompass authority over mere gun possession, any more than it empowers the Federal Government to regulate marriage, littering, or cruelty to animals, throughout the 50 States. Our Constitution quite properly leaves such matters to the individual States, notwithstanding these activities' effects on interstate commerce.”).
endorsed the Court’s role in safeguarding areas of traditional state concerns. Under Kennedy’s approach, when the federal government intrudes into an area of traditional state concern, the Court has a “particular duty to ensure that the federal-state balance is not destroyed.”

Moreover, Kennedy has suggested that “the etiquette of federalism has been violated by a formal command from the National Government directing the State . . . to organize its governmental functions in a certain way.”

A recent case, United States v. Comstock, suggests that the Court has doctrinally relaxed its push to bolster state sovereignty. There, the Court held that a federal statute, allowing a district court to order the civil commitment of a sexually dangerous federal prisoner, beyond the date the prisoner would otherwise be released, was constitutional under the Necessary and Proper Clause. The Court rejected the prisoner’s contention that the Act violates the Tenth Amendment merely because it “‘invades the province of state sovereignty’ in an area typically left to state control”—namely, the power to commit persons found to be mentally ill. The Court reasoned that by definition, the powers delegated to the United States by the Constitution are “not powers that the Constitution ‘reserved to the States.’”

Justice Kennedy, in concurrence, faulted the majority’s analysis for not recognizing that the “precepts of federalism embodied in the Constitution inform which powers are properly exercised by the National Government in the first place.” Moreover, Kennedy would consider

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94 Id. at 580 (Kennedy, J., concurring) (“If Congress attempts that extension, then at the least we must inquire whether the exercise of national power seeks to intrude upon an area of traditional state concern.”).
95 Id. at 581 (Kennedy, J., concurring).
96 Id. at 584 (Kennedy, J., concurring).
98 Id. at 1962.
99 Id.
100 Id. at 1967.
the interference with state sovereignty to be “a factor suggesting that the power is not one properly within the reach of federal power.” Likewise, Justice Alito, in concurrence, cited Justice Kennedy’s analysis for his “concern[] about the breadth of the Court's language.” Finally, Justices Thomas and Scalia dissented for similar reasons.

In several cases, the Court has upheld against 10th Amendment challenge federal statutes that interfered with state contractual relationships. These cases are relevant to a discussion of state bankruptcy, which seeks to alter state contractual obligations. In Garcia v. San Antonio Metropolitan Transit Authority, the Court held that a transit authority was not immune from the minimum wage and overtime requirements of the Fair Labor Standards Act. The Court reasoned that the determination of state immunity from federal regulation does not turn on whether a particular governmental function is “traditional.” See also Fry v. United States, 421 U.S. 542 (1975) (upholding the constitutionality of the Economic Stabilization Act, which instituted wage and salary controls to reduce inflation, as applied to state employees).

2. Application of 10th Amendment Decisions to SBR

Is there something in the nature of public debtors that exempts them from the reach of the bankruptcy power? At first blush, it appears that the aspects of sovereignty of state governments are irrelevant to the reach of the bankruptcy power. The Constitution grants Congress “plenary...
power over the whole subject of bankruptcies.”\textsuperscript{105} This power “is unrestricted and paramount,” and therefore acts to set aside both conflicting and nonconflicting state regulation.\textsuperscript{106}

However, the Tenth Amendment likely presents a roadblock to a SBC insofar as the Court reads it to preserve traditional state functions. Importantly, \textit{Garcia} and \textit{Fry} show that the Court has upheld federal laws that interfered with the wages (a form of debt) that a state owes to its employees. In each case, a 10\textsuperscript{th} Amendment challenge was brought on the basis that the government was interfering with traditional state functions, and in each case this argument was rejected. It does not appear that it would be a big stretch to extend these principles to a state bankruptcy chapter, which would also involve interference with state contractual relationships. In other words, the Court has not vigorously defended the aspects of state sovereignty that are arguably threatened by SBC—that is, the exclusive management of its fiscal affairs. To the contrary, the Court has been willing to let the federal government reach into these areas.

\textbf{III. “Too Big To Fail” and Other Policy Reasons for State Bankruptcy}

Much like the last major expansion of the bankruptcy code—its extension to municipalities—that was spurred by the financial troubles of the Great Depression, so too the Great Recession has spurred the need for another expansion of the bankruptcy code—this time, to states. Once thought of as a far-fetched idea, indeed a crazy one, now the creation of a SBC is being taken very seriously by leading policymakers. Times have changed.\textsuperscript{107} Why are the “times a changin’”? The reason why bankruptcy-for-states is being taken seriously now is the growing

\textsuperscript{105} Hanover Nat’l Bank v. Moyses, 186 U.S. 181 (1902).
\textsuperscript{106} International Shoe Co. v. Pinkus, 278 U.S. 261, 265 (1929).
\textsuperscript{107} See Skeel, supra note 9.
desire to avoid another round of massive federal bailouts. This bailout fatigue came to pass as a result of the bank bailouts.

A. Explaining “Too Big To Fail” and the Necessity of the Bank Bailouts

At the time, the bank bailouts were seen as necessary to avert a financial crisis. The Bush Administration argued that if a large financial institution defaulted, then creditors would lead a panicked “run” on the bank, and since the banks are so interconnected with each other, a failure of one could lead to a failure of all, creating an immediate financial crisis. It soon came to pass that these bailouts were viewed with great disgust by the people, themselves struggling during hard economic times to cut back on their personal budgets. In 2010, the Republicans rode a wave of public anger over these bailouts to deliver them control of congress.

B. Are States Also “Too Big To Fail”?

The prospect of bailing out big-spending states is nearly as hated as the decision to bail out the banks. In response to a question addressing the possibility of providing federal assistance to insolvent states, Mitch McConnell, the Senate Republican Minority Leader, declared "There will be no bailouts, I can tell you that. No bailouts." Despite the GOP’s hardline position that “there will be no [state] bailouts,” it is questionable whether the GOP would sit on their hands and watch the economy collapse if a state bailout was necessary to save the economy. This is the problem of institutions that are deemed “too big to fail”—if a default by a large financial institution is guaranteed to bring down the

108 Id.
110 See Sullivan et al., supra note 109.
economy, it is reasonable to bail them out because the alternative is so much worse. At first blush, it appears that the same logic applies to states.

First, it seems that some states are teetering on the edge.\textsuperscript{111} Second, some scholars have suggested that certain states are “too big to fail.” Assuming for the moment that the assets of some states are as interconnected with the economy as the banks, a state bailout might be necessary to avert a financial meltdown, despite its unpopularity. Although Republicans contend that no bailouts will occur on their watch, it is doubtful that they would refuse to bailout a state if economists warned that its default could bring down the economy. In other words, it is one thing to publicly oppose the idea of bailouts in the abstract. But it is quite another to sit by when headlines are declaring that a state’s impending default will send the whole country into a double-dip recession. On the other hand, the debate over raising the debt ceiling shows that Republican leaders are quite willing to engage in a high-stakes game of chicken.

To better understand why some states are considered “too big to fail,” it is instructive to consider a real-world scenario. Say it is November of 2011. The state of California faces a $20 billion shortfall. Under California’s dysfunctional budget system, no taxes may be increased unless a supermajority of votes are obtained. State Republican officials, having signed a no new taxes pledge, and fearing the wrath of the tea party should they vote to increase taxes of any kind, insist that the shortfall must be address purely with spending cuts. State Democratic officials, for their part, insist that state government spending has already been cut to the very bone in previous rounds of budget cuts, and are unwilling to budge from their position.

After weeks of negotiations, the opposing sides dig in and negotiations falter, despite governor Brown’s dire warnings that the state will become insolvent should the legislature fail to

\textsuperscript{111} See Vekshin, supra note 9.
reach an agreement on the budget that ensures timely payment to the state’s municipal bond holders. Despite all-night negotiations on the eve of the deadline, an agreement is not reached, and the state defaults on its obligations.

Throwing up his hands, and pointing the finger at state Republicans, the governor announces that the state’s municipal bondholders must take a haircut. In a news conference, governor Brown lays out a plan whereby each creditor will be paid thirty cents on the dollar. This means that municipal bond creditors face billions of losses. These astounding losses threaten the balance sheets of several big banks. The value of their stock plummets, causing financial analysts to predict their imminent demise.

The financial industry collectively shrieks in horror at this turn of events, and deeply regrets its bad to decision to loan money to the dysfunctional state of California. Hundreds of well-connected banking lobbyists descend on Washington to argue that immediate federal action is necessary to put out this fire before it spreads, causing a conflagration that could bring the country to ruin. The moral of this story is that a state bailout could happen, despite the current anti-bailout sentiment in Washington, due to the gravity of making the wrong choice.

Some scholars have argued that the “too big to fail” problem does not apply to states. First, they argue that bondholders are the states’ most important creditors, and they cannot pull their funding in the same way that a bank’s short-term creditors can. But it seems reasonable to fear that a host of state bond defaults would destabilize the financial markets. To begin, state and municipal debt is widely interconnected with the banks—banks own more than $229 billion

\[112\] See Skeel, supra note 9. Moreover, the bond market is already starting to discount the possibility of a default by California. Id.
in state and municipal bonds.\textsuperscript{113} A state’s default on its debts threatens more than its own ability to borrow at low interest rates; it threatens the banks as well, which hold large amounts of state municipal bonds. Therefore, a state default could mean that banks will suffer huge losses.\textsuperscript{114} Second, there is further potential for a financial crisis because municipal debt is viewed as a “safe” investment. A municipal bond crisis would endanger one of the few “safe” investments out there, and this is particularly troublesome given the fragile state of the economy.\textsuperscript{115}

VI. Conclusion

The leading proponents of a state bankruptcy chapter have tended to assume that bankruptcy-for-states would be easily constitutional, while at the same time, expressing concerns that such a chapter could unconstitutionally infringe state sovereignty. However, given the resurgence of the 10\textsuperscript{th} Amendment in the Supreme Court’s jurisprudence, the constitutionality of a SBC is not crystal clear. After careful analysis, it appears that the Court would likely uphold a state bankruptcy chapter that is narrowly drawn.

The question becomes: would the drafting choices that would be required to avoid constitutional problems reduce the effectiveness of a SBC? Leading scholars have suggested that a SBC must provide for the bankruptcy court to have limited powers; otherwise, it risks running afoul of federalism norms enshrined in the constitution. However, drafting the SBC narrowly might drain the chapter of all its potential benefits. In short, if the constitution places few constraints on the powers of a bankruptcy court, is SBR a still worthwhile? These are the questions that policymakers must face as they decide how to implement a state bankruptcy

\textsuperscript{113} See Pethokoukis, supra note 8.
\textsuperscript{114} Id.
In this paper, I hope that I’ve shed some light on the constitutional foundations for a state bankruptcy chapter. This understanding may aid policymakers that are tasked with drafting its provisions.