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DEALING WITH AN INEVITABLE CASE OF "I TOLD-YOU-SO": CRAFTING A FRAMEWORK FOR RESOLVING STATE FISCAL DISTRESS POST-PUERTO RICO*

NATHAN A. MOONEY**

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* All statements cited throughout the paper are attributable to the individuals themselves and are not representative of the views of any organization or board that they are professionally associated with.

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INTRODUCTION

When the Commonwealth of Puerto Rico ("Puerto Rico" or "the Commonwealth") filed for bankruptcy protection under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA") on May 3, 2017, it was the first time in modern American history that a U.S. state or territory had taken such extraordinary measures.[1] This was partly by design; under the United States Bankruptcy Code (the "Bankruptcy Code"), neither states nor territories can file for bankruptcy protection.[2] Worryingly, this is also the result of an investor community that has continuously overlooked key structural issues plaguing municipalities, states, and territories, which show few indications of correcting themselves in the future absent significant intervention.

Puerto Rico was largely an agrarian society until the 1950s when new federal tax reform created incentives for labor-intensive and, later, capital-intensive industries to relocate to the Commonwealth.[3] A ten-year phase-out of these tax advantages, enacted in 1996 by the Clinton administration, led to a mass exodus of foreign investment that forced the island to grapple with economic issues that were papered over for decades.[4] On

1. Mary W. Walsh, *Puerto Rico Declares a Form of Bankruptcy*, N.Y. TIMES (May 3, 2014), https://www.nytimes.com/2017/05/03/business/dealbook/puerto-rico-debt.html?_r=0.

2. *See generally* Arthur J. Gonzalez, Senior Fellow, Lecture at N.Y. Univ. Sch. of Law: Puerto Rico in Distress (Sept. 21, 2017); Michael K. Piacentini, *Lights Out for Puerto Rico's Restructuring Law? Puerto Rico's Municipal Bankruptcy Dilemma*, 80 BROOK. L. REV. 1677, 1694 n.140 (2015) (discussing how the definition of "State" was changed in the most recent version of the Bankruptcy Code and no longer allows Puerto Rico to avail itself of Chapter 9 in contrast to other states); 11 U.S.C. § 109(c) (1978) ("An entity may be a debtor under chapter 9 . . . only if such entity is a municipality."); 11 U.S.C. § 101(40) (1978) (defining municipality as a "political subdivision or public agency or instrumentality of a State"); 11 U.S.C. § 101(52) (1978) (defining state as including the "District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9").

3. Gonzalez, *supra* note 2.

4. Dianes L. Dick, *U.S. Tax Imperialism in Puerto Rico*, 65 AM. U. L. REV. 1, 6–7 (2015); Errol Louis, *Puerto Rico: Detroit of the Caribbean*, N.Y. DAILY NEWS (July 17, 2014, 4:30 AM), http://www.nydailynews.com/opinion/puerto-rico-detroit-caribbean-article-1.1869561 (noting how "[t]he economic storm

the one hand, Puerto Rico faces an eroding tax base–unemployment is rampant, labor force participation remains low at 40%, and the commonwealth lost approximately 90,000 citizens to emigration annually between 2010 and 2015, up from 60,000 previously.[5] The trend continues today.[6] On the other hand, it faces increasing demands for government spending:[7] 50% of the population currently receives government assistance, Puerto Rico still grapples with the legacy of a bloated public sector with significant unfunded pension liabilities and a history of pro-labor regulation in the private sector,[8] and demands continue to grow in the wake of the devastation caused by hurricanes Irma and Maria in late-2017.[9] The Commonwealth's inability to repay $125 million of bond and pen-

now engulfing the island began in 1996, when the Clinton administration began a 10-year phaseout of [s]ection 936").

5. Paul Carrillo, Anthony Yezer & Jozefina Kalaj, *Could Austerity Collapse the Economy of Puerto Rico?* 12 (Elliott Sch. of Int'l Affairs, The George Washington Univ., Working Paper Series, 2017), https://www2.gwu.edu/~iiep/assets/docs/papers/2017WP/CarrilloIIEP2017-17.pdf.

6. NAT'L P.R. CHAMBER OF COMMERCE, A BRIEF HISTORY OF REFORMS FROM THE 1980S TO TODAY 5 (2016) (describing how statistics from the U.S. Department of Labor in 2015 found that the unemployment rate was close to 14%, not including the informal sector which accounts for approximately 40% of the population, and labor force participation remained low at only 40%); Isabel Dobrin, *'Get Us Out Of Here': Amid Broken Infrastructure, Puerto Ricans Flee To Florida*, NAT'L PUB. RADIO (Oct. 13, 2017), https://www.npr.org/2017/10/13/557108484/-get-us-out-of-here-amid-broken-infrastructure-puerto-ricans-flee-to-florida.

7. Carrillo, Yezer & Kalaj, *supra* note 5, at 12 (finding that "a program of austerity applied to current expenditure would drive Commonwealth spending and employment significantly below levels that would be expected if it were a similarly situated state").

8. One of the major issues with Puerto Rico beyond its bloated public sector is the pro-labor regulation in the private sector which currently impedes economic growth. For example, current legislation makes it very difficult for employers to fire employees and employees are given a significant number of days for both sick leave and vacation. These laws have resulted in a very unproductive workforce buoyed by tax incentives. Interview with Arthur Gonzalez, Member, PROMESA Oversight Bd. (Apr. 13, 2018); NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 4.

9. Nick Brown, *Hurricane Changes the Game for Puerto Rico Bond Investors*, REUTERS (Nov. 21, 2017, 5:16 PM), https://www.reuters.com/article/us-usa-puertorico-restructuring/hurricane-changes-the-game-for-puerto-rico-bond-investors-idUSKBN1DL2SN (estimating how the damage caused by Hurricane Maria could end up being in the tens of billions of dollars).

sion debt[10] should have been obvious to investors well before the panic that began to engulf the municipal bond market in 2015. The result has been a political, economic, and legal battle that continues to this day, requiring creative thinking in the areas of municipal finance, restructuring, and constitutional law.

U.S. states presently face an eerily similar economic situation to that faced by Puerto Rico. As of the end of 2018, the state of Illinois has $28.8 billion of assets available to satisfy $244.9 billion of outstanding liabilities, including nearly $190 billion of unfunded pension obligations and retiree health care benefits.[11] States such as New Jersey ($25.5 billion vs. $221.0 billion) and Connecticut ($12.1 billion vs. $81.9 billion) are arguably worse off.[12] All the while, U.S. gross domestic product growth, population growth, and interest rates are expected to remain at their current low levels, combined with an aging population.[13] Beyond their unsustainable balance sheets, states, similar to Puerto Rico, face the challenge of forecasting future monetary inflows due to mobile populations

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10. Gonzalez, *supra* note 2.

11. TRUTH IN ACCOUNTING, THE FINANCIAL STATE OF ILLINOIS, https://www.truthinaccounting.org/library/doclib/2017-FSOS-Booklet-.pdf (last visited June 9, 2019).

12. TRUTH IN ACCOUNTING, THE FINANCIAL STATE OF NEW JERSEY, https://www.truthinaccounting.org/library/doclib/2017-FSOS-Booklet-.pdf (last visited June 9, 2019) [hereinafter FINANCIAL STATE OF NEW JERSEY]; TRUTH IN ACCOUNTING, THE FINANCIAL STATE OF CONNECTICUT, https://www.truthinaccounting.org/library/doclib/2017-FSOS-Booklet-.pdf (last visited June 9, 2019) [hereinafter FINANCIAL STATE OF CONNECTICUT].

13. *U.S. Economic Outlook*, FOCUSECONOMICS, https://www.focus-economics.com/countries/united-states (last visited May 19, 2019) (stating that the consensus among leading economists is that GDP growth will stay relatively flat in 2019 at 2.4% before beginning to decline to 1.7% in 2020; Binyamin Appelbaum, *Fed Signals End of Interest Rate Increases*, N.Y. TIMES (Jan. 30, 2019), https://www.nytimes.com/2019/01/30/us/politics/fed-interest-rate.html (Jerome Powell indicated that the case for rising interest rates had weakened given sluggish inflation as well as economic slowdowns in Europe and China. The result is that the Federal Reserve plans to keep interest rates within the current range of 2.25% to 2.5%.); SANDRA L. COLBY & JENNIFER M. ORTMAN, U.S. CENSUS BUREAU, PROJECTIONS OF THE SIZE AND COMPOSITION OF THE U.S. POPULATION: 2014 TO 2060, at 2–5 (2015), https://www.census.gov/content/dam/Census/library/publications/2015/demo/p25-1143.pdf (discussing how the population of the United States is expected to grow at a rate of approximately 0.6% annually until 2060 and the population aged sixty-five and older is expected to increase by 60%).

willing and able to relocate in search of a better quality of life and more social services.[14] Furthermore, the interconnected nature of states risks contagion in the municipal debt markets if there were to be significant unanticipated defaults.[15] Although it may not be politically palatable at the moment, one cannot deny the facts: states will be forced to deal with their fiscal realities. As Puerto Rico has demonstrated, attempting to do so with suboptimal mechanisms in place can be very costly to debtor states, creditors, and most importantly, the affected population.

In this Note, I propose an optimal framework for restructuring insolvent states using the efforts currently underway in Puerto Rico as an important starting point in how one should think about the legal, financial, political, and practical issues involved. Part I will provide an overview of the current situation in Puerto Rico. I will then highlight the key features of the ultimate solution adopted by the Obama administration, PROMESA, which includes both the appointment of a seven-person oversight board and a bankruptcy-esque debt adjustment process overseen by the federal courts.

Part II of my Note provides a synopsis of the worrying fiscal situations faced by many states. Illinois and Connecticut provide interesting case studies of presently distressed states; I undertake a detailed analysis of their balance sheets as well as their future economic prospects to understand the challenges they face in achieving sustainability. Although there are many similarities with the events unfolding in Puerto Rico, no two states or territories are the same and thus I hope to build flexibility into my proposed resolution framework.

Having established that the fiscal situation at the state-level is in need of a resolution mechanism, Part III provides background on the concept of state bankruptcy and the important hurdles that need to be overcome. Scholars, profes-

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14. Gonzalez, *supra* note 2 (describing how states differ from sovereigns in that they cannot as easily restrict the flow of their populations across borders).

15. Vincent S.J. Buccola, *An Ex Ante Approach to Excessive State Debt*, 64 DUKE L.J. 235, 264–269 (2014) (discussing how one of the primary arguments against a state bankruptcy regime is the possibility that one disorderly state filing would lead to contagion in the municipal bond market, creating cascade effects that impaired the ability of all states to borrow in the future, regardless of credit risk).

sionals, and politicians who object to state bankruptcy have instead raised many alternatives and Part IV seeks to explore those options as compared to a more formal process. For example, could these obligations not be restructured out-of-court much in the same way as was done in the sovereign debt cases of Argentina or Greece? Could Chapter 9 of the Bankruptcy Code ("Chapter 9") be used to restructure obligations at the municipal-level and thus avoid having to do so at the state-level? Why can't a sovereign state simply default and refuse to pay? What is the likelihood of a federal government bailout? Upon a thorough review, I contend that all of these options are suboptimal when compared to the PROMESA-based model I propose in Part V.

After having addressed all of these issues, I put forward a state restructuring regime predicated largely on the PROMESA structure. First, I argue that we need to reconceptualize state bankruptcies as more akin to personal bankruptcies rather than the corporate bankruptcies against which they have been traditionally compared. I also advance what I believe should be the standard for determining when a state would be able to avail itself of state insolvency. Part VI follows, arguing that this would be the optimal solution from both debtor states' and creditors' perspective, whether it be institutional bond investors, future pensioners, or distressed hedge funds. Finally, I conclude with some final thoughts on the lessons learned from Puerto Rico thus far, the state of the current debate on state bankruptcies, and highlight some areas for future research.

I.
Puerto Rico's Financial Distress and PROMESA as the Solution

A. *The Legacy of Puerto Rico's Colonial Past*

The Commonwealth of Puerto Rico is an American territory approximately 980 miles off the coast of Florida, acquired by the United States from Spain as a result of the Treaty of Paris which ended the Spanish–American War in 1898.[16] The

16. Robert Kay, *American Cities Closest to Puerto Rico*, USA Today, http://traveltips.usatoday.com/american-cities-closest-puerto-rico-110033.html; Nat'l P.R. Chamber of Commerce, *supra* note 6, at 2–3.

island became an unincorporated territory following the *Insular* Supreme Court of the United States ("SCOTUS") cases, although Puerto Ricans were granted U.S. citizenship in 1917 and became a Commonwealth under their own constitution in 1952, both of which remain today.[17]

Puerto Rico's economic and social history began very similarly to that of many Latin American countries but diverged once it became a colonial possession of the United States.[18] Puerto Rico is required to maintain the federal minimum wage and have the same federally-enacted labor and environmental standards as the mainland states; it cannot negotiate bilateral trade agreements, must adhere to a fiscal policy directed by Congress, and its monetary policy is controlled by the Federal Reserve.[19] Puerto Rico also faces noticeably higher energy and transportation costs as compared to neighboring islands,[20] in addition to local laws and regulations restricting domestic competition and business investment.[21]

The island is largely impacted by external policies enacted by the United States despite its local autonomy. [22] For example, the passing of the Jones Act of 1917 granted Puerto Rico authority over its own local tax policy, but the Merchant Marine Act of 1920 damaged the economy by forcing all ships to go through U.S. ports prior to heading to the island, significantly inflating the cost of goods.[23]

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17. NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 2–3; Juan Torruella, *Ruling America's Colonies: The Insular Cases*, 32 YALE L. & POL'Y REV. 57 (2013) (explaining that the *Insular* cases were a series of opinions by the Supreme Court in 1901 which addressed the question of whether the populations of newly-acquired territories of the United States would automatically become U.S. citizens and held that even if the acquired populations were U.S. citizens, not all constitutional protections would automatically apply to territories in the same way as they did to states).

18. NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 2.

19. *Id.* at 3.

20. ANNE O. KRUEGER, RANJIT TEJA & ANDREW WOLFE, PUERTO RICO — A WAY FORWARD 8 (June 29, 2015), http://www.bgfpr.com/documents/PuertoRicoAWayForward.pdf.

21. *Id.*

22. NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 2.

23. *Id.* at 3.

B. *Adoption and Eventual Repeal of Internal Revenue Code Section 936*

The U.S. Tax Code has historically been a central driver of Puerto Rican growth and various incentives have been used strategically to spur industrialization on the historically agrarian island.[24] Beginning in the 1920s, tax policies were designed with the broader goals of situating Puerto Rico as a lower-cost provider of manufacturing inputs, improving the global competitiveness of U.S. corporations, and lessening the country's dependence on international labor and materials.[25] The 1950s and 1960s were characterized by industrialization, infrastructure development, growing employment and Gross National Product ("GNP").[26] From 1950 to the mid-1970s, output per employee grew by nearly 5% per annum, a rate comparable to the dramatic growth of East Asia at the time.[27] This made Puerto Rico one of Latin America's most developed societies and for many years it had the highest per capital income.[28]

In 1976, Congress enacted *Internal Revenue Code* ("IRC") section 936, which granted U.S. corporations a tax exemption on any income originating from U.S. territories such as Puerto Rico and let U.S. parents receive dividends from Puerto Rican subsidiaries tax-free.[29] This meant that U.S. corporations could set up subsidiaries on the island and so long as the profits were ultimately distributed by way of dividend, they would

24. *Id.*

25. Dick, *supra* note 4, at 54.

26. Gross national product, or GNP, "is an estimate of total value of all the final products and services produced in a given period by the means of production owned by a country's residents." It differs from GDP which focuses on all factors of production within a country's borders, regardless of who owns them. *Gross National Product*, INVESTOPEDIA, https://www.investopedia.com/terms/g/gnp.asp (last visited Jan. 29, 2018).

27. NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 3; J. Thomas Hexner & Glenn P. Jenkins, *Puerto Rico and Section 936: A Costly Dependence*, 10 TAX NOTES INT'L 235 (1995).

28. Davi Dayen, *How Hedge Funds Deepen Puerto Rico's Debt Crisis*, AM. PROSPECT (Dec. 11, 2015), http://prospect.org/article/how-hedge-funds-are-pillaging-puerto-rico.

29. Scott Greenberg & Gavin Ekins, *Tax Policy Helped Create Puerto Rico's Fiscal Crisis*, TAX FOUND. (June 30, 2015), https://taxfoundation.org/tax-policy-helped-create-puerto-rico-s-fiscal-crisis/.

be tax-exempt.[30] This was especially attractive to pharmaceutical companies who could use alternative methods of transportation (e.g., planes) to avoid the substantial shipping costs resulting from the Jones Act.[31]

Although the initial signs were positive, any job-creation benefits came at a substantial cost to both the U.S. Department of the Treasury and native businesses.[32] Corporations received full tax exemption on all income generated, regardless of if it was actually generated using tangible property and/or labor within the territory.[33] Creative companies transferred intangible assets and income streams to its Puerto Rican subsidiaries, resulting in tax credits without any real investment.[34] For example, in the 1980s, pharmaceutical companies received 50% of the total tax benefits under section 936 while only providing approximately 15% of the new jobs created.[35] Furthermore, they received $2.17 in tax credits for each dollar of employee compensation generated.[36]

President Bill Clinton's phase-out of section 936 as part of his efforts to reduce the national deficit clearly had an adverse effect on the fragile Puerto Rican economy.[37] Over the ten-year phase-out period, companies quickly began to exit the island, leading to an erosion in the tax base both at the corporate level and through job losses.[38] At the same time, the closing of military bases post-Cold War further eroded the tax and spending bases.[39] This exposed critical structural issues that had developed over the last eighty years as a result of these self-serving policies. For example, despite the Commonwealth enjoying twenty-eight out of twenty-nine years of economic growth between 1976 and 1996, labor force participation has remained below 50% since 1960 despite continuously climbing

30. *Id.*
31. Gonzalez, *supra* note 2.
32. Hexner & Jenkins, *supra* note 27.
33. *Id.*
34. *Id.*
35. *Id.* at 236.
36. *Id.*
37. *Id.* at 245–46. The phase-out of section 936 was supported by the Puerto Rican government at the time because they believed that this would ultimately be important in their push for statehood. Gonzalez, *supra* note 2.
38. Gonzalez, *supra* note 2.
39. Interview with Arthur Gonzalez, *supra* note 8.

on the mainland.[40] Additionally, the high corporate tax rates on domestic corporations compared to U.S. subsidiaries had skewed the economy towards foreign investment that transferred economic output offshore, rather than fostering domestic entrepreneurship that would create sustainable wealth over time.[41] This was reflected in the fact that national incomes as a percentage of gross domestic product ("GDP") declined over time.[42] So long as the island continued to attract investment, many of these concerns were overlooked. In stark contrast to the prior thirty years, from 2005 to 2015, the island has experienced negative growth in eight out of ten years and GNP fell 10%, partially due to these phase-outs and exacerbated by the Great Recession of 2008.[43]

C. *Debt Financing and the Great Recession of 2008*

The Puerto Rican economy has always been tied to the American business cycle.[44] For example, during the U.S. recessions in the 1970s and 1980s, the Commonwealth suffered from parallel contractions that actually lasted longer than the rest of the country due to its fragile economy kept afloat largely by the tax incentives mentioned previously.[45] Just as the impact of the phase-out of IRC section 936 began to be felt throughout the Commonwealth, the Great Recession of 2008 led to a global economic downturn felt acutely on the island. The combination of an eroding tax base and a growing need to provide critical social services forced the Puerto Rican government to reconsider how it would meet its ballooning fiscal needs.

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40. NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 4; Dayen, *supra* note 28.

41. Dick, *supra* note 4, at 74.

42. Gross domestic production, or GDP, is the "monetary value of all the finished goods and services produced within a country's borders in a specific time period." It is the most commonly-used measurement of a nation's overall economic activity and includes all private and public consumption, government outlays, investments, private inventories, paid-in construction costs and the foreign balance of trade. *Gross Domestic Product*, INVESTOPEDIA, https://www.investopedia.com/terms/g/gdp.asp (last visited Jan. 29, 2018); NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 4.

43. Dayen, *supra* note 28.

44. NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 4.

45. *Id.*

Government authorities ranging from towns, cities, states, federal governments and sovereign states frequently issue debt in the capital markets for a variety of purposes, ranging from building infrastructure projects to simply bridging budgetary gaps between a moment in time and future anticipated tax collection.[46] Investment banks structure, market, and underwrite these bonds, eventually issuing and selling them to a variety of institutional investors.[47] Puerto Rican bonds are "triple tax-exempt," meaning that even if an investor is not a resident of Puerto Rico, it does not need to pay local, state, or federal taxes on any income generated either through interest payments or price appreciation.[48] This has made Puerto Rican debt an extremely attractive investment opportunity and today, over 180 municipal bond funds hold more than 5% of their portfolios in the Commonwealth's bonds.[49] It is not only "foreign" institutions that are exposed to the current fiscal crisis; $12 billion of the debt is held by island residents or institutions as investments or unfunded pension liabilities.[50]

The attractiveness of the bonds allowed the Puerto Rican government to offset its losses on income taxes with debt rather than by raising taxes, improving collection, or tightening the fiscal purse, regardless of how unsustainable the bonds became.[51] The Jones Act initially limited public indebtedness to 7% of the total tax valuation of the island's property but this threshold was consistently manipulated upwards and the Commonwealth's debt doubled from 1980 to 1990, and doubled

46. Isaac Rauch, *How a Little Broke Island Beat the Hedge Funds*, SLATE: MONEYBOX (July 11, 2016, 5:30 PM), http://www.slate.com/articles/business/moneybox/2016/07/how_puerto_rico_beat_the_hedge_funds.html.

47. *Id.*

48. 48 U.S.C. § 745 (1961); Greenberg & Ekins, *supra* note 29 (discussing how when Congress established a government in Puerto Rico in 1917 it specified that "all bonds issued by the Government of Puerto Rico, or by its authority, shall be exempt from taxation by the Government of the United States . . . or by any State, Territory, or possession, or by any county, municipality, or other municipal subdivision . . .").

49. *Id.*

50. Michelle Kaske, *Puerto Rico Governor Says Deficit Could Climb to $59 Billion*, BLOOMBERG (Oct. 14, 2016, 3:43 PM), https://www.bloomberg.com/news/articles/2016-10-14/puerto-rico-governor-says-deficit-could-climb-to-59-billion.

51. Greenberg & Ekins, *supra* note 29.

again from 1990 to 2000.[52] They used seventeen different vehicles to issue the debt, linking it to every available revenue source from the Puerto Rico Electric Power Authority ("PREPA") to the Highway and Transportation Authority ("HTA").[53] Public debt increased every year from 2000 onwards, expanding from $25 billion to over $73 billion with one-third of all government revenue going to debt service by the time the Commonwealth filed for Title III in 2017.[54] At the time of filing, Puerto Rico ranked third—behind only New York and California—in terms of borrowing in the United States and would have been one of the most indebted countries in the world given that its debt represented three-quarters of its GNP.[55]

Once the Commonwealth realized that debt service was an issue, it began delaying tax refunds and payments to suppliers, cut back on healthcare and public transportation services, fired 30,000 public-sector workers, closed 100 schools, and increased sales taxes by over 50%.[56] Despite its efforts, the Commonwealth's debt continued to rise. Between 2000 and 2015, its debt rose from 63% of GNP to over 100%, over four times its annual revenue, which itself was less than its annual expenditures.[57] This was significant because in the same year its bonds were downgraded to non-investment grade by the three major credit rating agencies, triggering acceleration clauses in the indentures[58] while also severely impacting their ability to turn to the capital markets as they had in the past.[59] In the

52. NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 7–8.
53. Dayen, *supra* note 28.
54. Greenberg & Ekins, *supra* note 29.
55. Interview with Arthur Gonzalez, *supra* note 8; Mark DeCambre, *Puerto Rico Has More than $70 Billion in Debt Because of This*, MARKETWATCH (Oct. 7, 2017, 3:20 PM), https://www.marketwatch.com/story/why-does-puerto-rico-have-more-than-70-billion-in-debt-2017-10-04.
56. Dayen, *supra* note 28.
57. Greenberg & Ekins, *supra* note 29; *see also* COMMONWEALTH OF P.R., BASIC FINANCIAL STATEMENTS AND REQUIRED SUPPLEMENTARY INFORMATION: FISCAL YEAR ENDED JUNE 30, 2015, at 14 (2015) (reporting that Puerto Rico had about $17.2 billion of revenue for the fiscal year of 2015, which is less than $17.7 billion of expenses).
58. *Fitch Becomes Third Agency to Cut Puerto Rico to Junk*, REUTERS (Feb. 11, 2014, 10:31 AM), http://www.reuters.com/article/munis-puertorico-ratings-idUSWNAB046DO20140211.
59. Puerto Rico v. Franklin Cal. Tax-Free Tr., 136 S. Ct. 1938, 1942 (2016).

end, these austerity measures were both too late and insufficient in light of the ballooning government workforce, shrinking economy, the loss of approximately 300,000 citizens to emigration since 2006, and rising interest rates brought on by credit downgrades.[60]

In mid-2015, the Governor told the world that Puerto Rico would not be able to pay its debts as they came due in the future, leading the market for its debt to dry up immediately.[61] For example, bonds issued in 2014 that were trading as high as 96.6 cents dipped to an average of 66.6 cents after this announcement.[62] Puerto Rico remains locked out of credit markets and the only bonds it has been able to issue since had coupons of up to 11%.[63] The original creditors, who were traditional municipal bond investors like Franklin Templeton and Oppenheimer, began selling their debt as the credit agency downgrades began. In their place, distressed investors like Fir Tree Partners and Aurelius Management, who bought in as low as thirty cents on the dollar, are now pushing for full repayment.[64]

Today, the publicly-traded debt can be classified broadly into three buckets: (1) $40 billion of general obligation debt ("GO bonds"); (2) $30 billion of municipal debt, including that held by utility companies ("Muni Bonds"); and (3) $17.6 billion of Puerto Rico Urgent Interest Fund Corporation bonds with interest payments paid directly out of a first-priority claim on sales tax revenues before they flow to the rest of the Commonwealth ("COFINA bonds").[65] These latter bonds recently came to a restructuring agreement with the support

60. NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 14–19; Carrillo, Yezer & Kalaj, *supra* note 5 (citing a 2017 study that found that between 2010 and 2015, Puerto Rico averaged a net loss of 66,000 citizens annually to the mainland, a trend that has continued and likely intensified post-hurricane); Gonzalez, *supra* note 2 (for example, in 2014, the bonds issued paid an 8% coupon, a huge interest rate given the income was tax-free).

61. Rauch, *supra* note 46.

62. Michelle Kaske, *Puerto Rico Lawsuit Suggesting Split Among Bond Investor Groups*, BLOOMBERG NEWS (June 23, 2016, 10:17 PM), https://www.bloomberg.com/news/articles/2016-06-24/puerto-rico-lawsuit-suggesting-split-among-bond-investor-groups.

63. Dayen, *supra* note 28.

64. *Id.*

65. Gonzalez, *supra* note 2; Hazel Bradford, *First Puerto Rico Debt Restructuring Deal Approved for COFINA*, PENSIONS & INVS. (Feb. 5, 2019), https://

of 46% of holders whereby one third of the principal amount will be wiped out, saving the island $17 billion of principal and interest payments going forward.[66] This is in addition to the approximately $50 billion in underfunded pension liabilities that exist at all levels of government.[67] This question of liabilities far exceeds the approximately $18 billion restructured as part of the Detroit bankruptcy in 2013.[68]

All of this must be considered against the backdrop of a struggling local economy that remains dependent on transfer payments and other public assistance from the federal government. For example, transfer payments were 27% of GDP in 2010, and today more than 50% of the population receives government assistance.[69] Furthermore, the Puerto Rican poverty rate is double that of Mississippi, the poorest state.[70] As of 2015, unemployment is rampant, stagnating around 14% in the formal sector with labor force participation overall remaining around a lowly 40%.[71] The result has been a mass exodus of the island's population towards the United States mainland; Puerto Rico's population is 3.7 million, compared with 4.9 million Puerto Rican citizens living on the mainland, and the U.S. Census Bureau predicts that the population will drop further to 2.3 million by 2050.[72] This population loss is critical to any restructuring effort because it decreases both future tax revenues and the total productivity of the labor force.[73]

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www.pionline.com/article/20190205/ONLINE/190209905/first-puerto-rico-debt-restructuring-deal-approved-for-cofina.

66. Andrew Scurria, *Puerto Rico Wins Approval of $18 Billion Bond Restructuring*, WALL ST. J. (Feb. 4, 2019, 5:32 PM), https://www.wsj.com/articles/puerto-rico-wins-approval-of-18-billion-bond-restructuring-11549319523.

67. Walsh, *supra* note 1.

68. *Id.*

69. NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 5.

70. *Compare* U.S. CENSUS BUREAU, *QuickFacts: Puerto Rico* (July 1, 2018), https://www.census.gov/quickfacts/pr (44.4% poverty rate), *with* U.S. CENSUS BUREAU, *QuickFacts: Mississippi* (July 1, 2018), https://www.census.gov/quickfacts/ms (19.8% poverty rate).

71. NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 5.

72. Francesca Trianni & Ellie Ismailidou, *The Next Financial Catastrophe You Haven't Heard About Yet: Puerto Rico*, TIME (Mar. 12, 2014), http://time.com/20416/the-next-financial-catastrophe-you-havent-heard-about-yet-puerto-rico/.

73. This rests on the assumption that those leaving are the most productive, well-educated workers because they are the most likely to have better

D. *Puerto Rico's Unsuccessful Attempts to Restructure*

1. *Puerto Rico Does Not Qualify for Use of Chapter 9 of the Bankruptcy Code*

Chapter 9 of the Bankruptcy Code allows states to authorize their municipalities to file for bankruptcy in federal courts.[74] Puerto Rico was unable to avail itself of Chapter 9 to restructure its debt because when Congress amended the Bankruptcy Code in 1984, it excluded Puerto Rico in its revised definition of "state" without specifically including it separately.[75] This was confirmed by the Supreme Court's decision in *Puerto Rico v. Franklin Cal. Tax-Free Trust* in 2016.[76] The lack of a debtor-friendly debt restructuring process like Chapter 9, although flawed, gave Governor Padilla little leverage in out-of-court negotiations with creditors and therefore other alternatives were sought.[77]

2. *Failed Attempt at Drafting Bankruptcy-Type Legislation for Puerto Rico*

Given its inability to avail itself of Chapter 9, Puerto Rico believed that it should be entitled to pass its own bankruptcy statute and attempted to do so beginning in 2014. Once drafted, a congressman from Puerto Rico, Robert Pierluisi, introduced the bill titled the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the "Recovery Act"). The Recovery Act, if enacted, would have changed federal law to allow Puerto Rico's struggling municipalities and public corporations (e.g., power authority) to declare bankruptcy, much

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employment opportunities elsewhere. Interview with Arthur Gonzalez, *supra* note 8.

74. 11 U.S.C. § 109(c) (2015).

75. 11 U.S.C. § 109(c) (stating that "[a]n entity may be a debtor under chapter 9 . . . only if such entity . . . is a municipality . . ."); 11 U.S.C. § 101(40) (defining "municipality" as a "political subdivision or public agency or instrumentality of a State"); 11 U.S.C. § 101(52) (defining "State" as including the "District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9").

76. Puerto Rico v. Franklin Cal. Tax-Free Tr., 136 S. Ct. 1938, 1942 (2016).

77. Johnathan Mahler & Nicholas Cofessore, *Inside the Billion-Dollar Battle for Puerto Rico's Future*, N.Y. TIMES (Dec. 19, 2015), https://www.nytimes.com/2015/12/20/us/politics/puerto-rico-money-debt.html.

in the way they could have if eligible for Chapter 9.[78] Doing so would impact one-third of the island's debt and give Puerto Rico the same rights as most states and greater leverage at zero cost to taxpayers.[79] Creditors who opposed the legislation argued that the Bankruptcy Code explicitly pre-empted the Recovery Act because it says that no state can draft their own restructuring statute.[80] On the other side, support for the legislation came from the bondholders who believed that restructuring this debt would free up more money for their own repayment.[81] In *Puerto Rico v. Franklin California Tax-Free Trust*, decided on June 13, 2016, the Supreme Court agreed with the bondholders, finding that the express language of the Bankruptcy Code excluded Puerto Rico from the definition of "state" only for the purpose of determining who could be a debtor under Chapter 9. It remained a state for all other purposes, including the preemption provisions.[82]

Despite the Supreme Court's blow to Puerto Rico's recovery efforts, Chapter 9 was at best an imperfect solution. Being able to file the municipalities would have provided limited relief because a substantial portion of the island's debt was issued by the central government[83] and would have been heavily contested given the lack of an equitable process that spread the losses among creditor groups.[84] Furthermore, many of the public utilities had issued the bulk of their debt as special revenue bonds which some argued were protected from adjustment regardless of whether a bankruptcy filing was possible.[85]

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78. *Id.*

79. *Id.*

80. Gonzalez, *supra* note 2.

81. Mahler & Cofessore, *supra* note 77.

82. Puerto Rico v. Franklin Cal. Tax-Free Trust, 136 S. Ct. 1938, 1942 (2016).

83. *See* D. ANDREW AUSTIN, CONG. RESEARCH SERV., PUERTO RICO'S CURRENT FISCAL CHALLENGES 20 (2016), https://fas.org/sgp/crs/row/R44095.pdf.

84. Larry H. Summers, *Puerto Rico Is a Test of Whether Financial Interests Control Washington*, WASH. POST (Oct. 28, 2015), https://www.washingtonpost.com/news/wonk/wp/2015/10/28/larry-summers-puerto-rico-is-a-test-of-whether-financial-interests-control-washington/?utm_term=.057c2ae110c2.

85. AUSTIN, *supra* note 83, at 23 n.132. It cites to Senate Report 100-506, which states that:

> To eliminate the confusion and to confirm various state laws and constitutional provisions regarding the rights of bondholders to re-

It was clear at this point that Puerto Rico required an alternative restructuring strategy.

E. *Federally-Enacted PROMESA as the Solution*

At the same time as Puerto Rico was awaiting a decision in *Puerto Rico v. Franklin California Tax-Free Trust*, the government or Puerto Rico had been working with members of Congress on a radical solution that took advantage of the Commonwealth's status as a territory rather than a state. Under the Territorial Clause of the U.S. Constitution,[86] Congress was able to enact federal legislation that infringed upon Puerto Rico's sovereignty in a way it would be incapable of doing with a state.[87] PROMESA was introduced in April 2016 and passed by a bipartisan Congress on June 30, 2016. It created a structure for federal oversight over the fiscal affairs of Puerto Rico and any other territory,[88] a bold judgment that a comprehensive plan to resolve all debt was necessary. [89] PROMESA did not provide any federal tax dollars to pay existing debt, nor did it grant a special dispensation that would have allowed the territory to file for Chapter 9.[90] Rather, it added Chapter 20 to Title 48, the title of the United States Code which governs U.S. territories.[91] Chapter 20 created both a framework to restructure the debt of the Commonwealth and all of its municipalities, as well as, similar to the Detroit bankruptcy, an oversight board with significant power meant to place restraints on, and influence

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> ceive revenues pledged to them in payment of their debt obligations of a municipality, a new section is provided in the Amendment to ensure that revenue bondholders receive the benefit of their bargain with the municipal issuer and that they will have unimpaired rights to the project revenues pledged to them.

S. Rep. No. 100-506, at 12 (1988).

86. U.S. Const. art. IV, § 3 ("The Congress shall have power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States; and nothing in this Constitution shall be so construed as to Prejudice any Claims of the United States, or of any particular State.").

87. Gonzalez, *supra* note 2.

88. 48 U.S.C. § 2121 (2016) (creating an oversight board and setting out its role and responsibilities with respect to the territorial restructuring).

89. Summers, *supra* note 84.

90. Summary: H.R. 4900, 114th Cong. (2016), https://www.congress.gov/bill/114th-congress/house-bill/4900.

91. 48 U.S.C. § 2101(a).

the behavior of, Puerto Rico's executive branch. Perhaps most importantly, PROMESA prevents creditors from asking a court to force Puerto Rico to make debt payments ahead of spending on essential government services.[92]

1. *Titles I & II: Oversight Board*

Title I of PROMESA created a seven-person oversight board with an ex-officio member (either the Governor or his/her designee).[93] The members were appointed by President Obama on August 31, 2017 and none would be paid for their service.[94]

The oversight board's stated goal is to "provide a method for a covered territory to achieve fiscal responsibility and access to the capital markets,"[95] clearly hinting that when PROMESA was passed there was doubt over Puerto Rico's ability to do either of those things. The board's primary goal is to negotiate with the island's creditors. To do so, it is charged with classification of creditors and has the power to issue subpoenas, certify voluntary agreements between creditors and debtors, and seek judicial enforcement of its authority.[96]

Title II provides the oversight board with budgetary and financial control over the island.[97] This is important because it allows the board to deal with the underlying problems that caused the fiscal situation, not simply restructure the debt.[98] Its powers include approving fiscal plans set forward by the government of Puerto Rico, budgets, voluntary agreements with bondholders, debt restructuring plans, and critical projects eligible for expedited permitted processes.[99] Puerto Rico is required to develop a new fiscal plan, to develop and enact balanced budgets that conform to the fiscal plan, and to

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92. *Id.* § 2141(b)(1)(B).
93. *Id.* § 2121(e).
94. *Id.* § 2121(g).
95. *Id.* § 2121(a).
96. *Id.* §§ 2124(f), (i), (k).
97. Gonzalez, *supra* note 2.
98. Telephone Interview with David Skeel, Member, PROMESA Oversight Bd. (Oct. 30, 2017).
99. The PROMESA legislation authorizes the oversight board to designate a territory or territorial instrumentality (such as a public corporation, retirement system, etc.) as a "covered entity" and once designated as such, that territory or instrumentality becomes subject to the terms of PROMESA. 48 U.S.C. §§ 2121, 2141, 2142, 2145, 2147.

deliver audited financial results.[100] The fiscal plan must include "adequate" funding of the island's pensions, currently underfunded by more than $40 billion.[101] Additionally, the board is given broad authority to review government contracts, legislative laws, and to approve any new debt issuances.[102] If an entity makes a request to the board to commence a Title III proceeding after good faith negotiations with creditors, the board then has the authority to file for the entity in federal court.[103]

2. *Title III: Debt-Restructuring in Federal Court*

Title III sets up a process for the adjustment of debts in federal court whereby the oversight board acts as representative to the debtor—much like a trustee or Chapter 11 debtor-in-possession.[104] In this capacity, it has the ability to initiate a Title III process (akin to a bankruptcy filing), submit a plan of adjustment for court approval,[105] and bind holdout creditors.[106] The process requires the fair and equitable treatment of creditors,[107] although the treatment of public sector pensions is not addressed explicitly.[108]

A key advantage of a Title III filing is that much like a typical bankruptcy filing, Title III has an automatic stay provision that stops pending litigation, prevents secured creditors from seizing their collateral, and allows the Commonwealth to stop paying principal and interest on its outstanding debt until emergence.[109] In this way, it gives Puerto Rico significant leverage to negotiate with creditors given these traditional "bankruptcy tools."[110]

100. *Id.* §§ 2141–43.
101. *Id.* § 2141(b)(1)(C).
102. *Id.* §§ 2144(b), 2147.
103. *Id.* § 2162.
104. *Id.* § 2162 (stating that a territory may be a debtor under this title if: (1) an oversight board has been established by Congress or it is covered territorial instrumentality; (b) the oversight board has issued a certification under § 2146(b) of this title; and (3) the entity desires to effect a plan to adjust its debts).
105. *Id.* §§ 2164, 2172–73.
106. Walsh, *supra* note 1.
107. *See, e.g.*, 11 U.S.C. § 1129(b)(2) (2015).
108. Rauch, *supra* note 46.
109. *See generally* 11 U.S.C. § 362 (automatic stay); Gonzalez, *supra* note 2.
110. Rauch, *supra* note 46.

On July 1, 2016, a day after PROMESA officially passed, Puerto Rico defaulted on approximately $2 billion in debt payments.[111] As the filing stated, Puerto Rico was "unable to provide its citizens with effective services," a situation that has only worsened following the devastation caused by hurricanes Irma and Maria in fall 2017.[112] Approximately two months later, President Obama appointed the current seven members of the PROMESA oversight board, which had its first official meeting on September 30, 2016.[113] The first economic growth plan presented to the board by Governor Padilla projected a budget gap of approximately $59 billion over the next ten years.[114] During the subsequent election, Governor Padilla was replaced by Ricardo Roselló, who serves as Governor as of publication.[115] May 1 was a lingering date for the oversight board because as of that date, the stay on bondholder litigation would end and the Commonwealth could be sued in federal court.[116] In response to this, on May 3, 2017, the oversight board filed a petition for debt adjustment under Title III, making Puerto Rico the largest "bankruptcy" case in the history of the American public bond market.[117] The board announced that the fiscal solution "had reached a breaking point" and asked for the immediate appointment of a federal judge, leading Chief Justice Roberts to appoint Judge Laura Taylor Swain of the Southern District of New York. [118]

Since the Title III filing almost three years ago, many important battles have been fought. The most significant may be *In re Fin. Oversight & Mgmt. Bd.* in which hedge fund Aurelius

111. Heather Gillers and Nick Timiraos, *Puerto Rico Defaults on Constitutionally Guaranteed Debt*, WALL ST. J. (July 1, 2016, 6:42 PM), https://www.wsj.com/articles/puerto-rico-to-default-on-constitutionally-guaranteed-debt-1467378242.

112. Walsh, *supra* note 1; Brown, *supra* note 9.

113. CUNY HUNTER COLLEGE CTR. FOR PUERTO RICAN STUDIES, PUERTO RICO IN CRISIS: TIMELINE 9 (2017), https://centropr.hunter.cuny.edu/sites/default/files/PDF_Publications/Puerto-Rico-Crisis-Timeline-2017.pdf.

114. *Id.*

115. *Id.* at 10.

116. *Id.* at 13.

117. Walsh, *supra* note 1.

118. Juan Gonzalez, *Puerto Rico's $123 Billion Bankruptcy Is the Cost of U.S. Colonialism*, THE INTERCEPT (May 9, 2017, 9:23 AM), https://theintercept.com/2017/05/09/puerto-ricos-123-billion-bankruptcy-is-the-cost-of-u-s-colonialism/ (internal quotation marks omitted).

Management is challenging the legality of the PROMESA oversight board under the Appointments Clause of the U.S. Constitution.[119] On February 15, 2019, the U.S. Court of Appeals for the First Circuit ruled that members of the oversight board are principal officers of the United States and thus should have been appointed by the President "with the advice and consent of the Senate."[120] The oversight board continues to argue that it is merely an entity within the government of Puerto Rico and will appeal the decision to the Supreme Court. It is unclear at this time what impact this decision will have as reversing all acts done to date would be highly impractical and detrimental to the ongoing process.

F. *Puerto Rico Today*

There is still a long way to go but it is hard to argue that PROMESA has not been critical to the current restructuring process underway in Puerto Rico. So far, the oversight board members have been able to reach a consensus, making the vast majority of their decisions by unanimous vote.[121] Creditors continue to push back and a lot of litigation, both within the Title III process and externally, remains unresolved.[122]

Even if the PROMESA board continues to cut government services and factors in projected revenues from higher taxes and fees, Puerto Rico is expected to generate slightly less than $8 billion in budget surpluses over the next ten years, nowhere near the $35 billion in maturities.[123] In other words, three-quarters of the debt cannot be repaid and bondholders will be forced to take a significant haircut on their principal amounts. The Puerto Rican experience demonstrates that bankruptcy is often critical to properly resolve the issues created by government entities that have borrowed substantially beyond their means.

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119. Aurelius Inv. v. Fin. Oversight & Mgmt. Bd., 915 F.3d 838, 842 (1st Cir. 2019).

120. U.S. CONST. art. II, § 2, cl. 2 (stating that the President "shall nominate, and by and with the Advice and Consent of the Senate, shall appoint . . . all other Officers of the United States").

121. Gonzalez, *supra* note 2.

122. *Id.*

123. Gonzalez, *supra* note 118.

II.
Fiscal Challenges at the State-Level

"If something cannot go on forever, it will stop."

—Herbert Stein (Stein's Law)[124]

A. *Overview of State Fiscal Challenges*

State governments generate and spend approximately $2 trillion annually in order to provide public services that are vital to maintaining GDP growth and ensuring that all Americans live comfortably and are able to advance economically.[125] In doing so, states: (1) support primary, secondary, and post-secondary education; (2) administer public safety, health and income-support programs; (3) build and maintain infrastructure like roads and public buildings; and (4) create a business climate conducive to production and investment.[126] Sound fiscal practices are important to ensure that states can properly fulfill these vital obligations, yet many continue to balance their budgets using deceptive accounting practices that obscure their spending choices.[127] These practices have made "budget trade-offs indecipherable, [led] to poorly-informed policymaking, and weaken[ed]" the state's overall capacity to support the many municipalities for which it is responsible.[128] Worst of all, the lack of transparency has led to irrationality in the municipal bond market with high probability that one day investors may react in the same way as they did in Puerto Rico.

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124. Sometimes formulated as "trends that can't continue, won't," the fiscal situation in Detroit provides a perfect example of Stein's Law that is transferrable to the state context. Detroit could no longer continue to borrow, spend, raise taxes or cut essential government services so it was forced to stop and deal with its economic reality. Charles Krauthammer, *Stein's Law*, Wash. Post (July 25, 2013), https://www.washingtonpost.com/opinions/charles-krauthammer-steins-law/2013/07/25/f45acb30-f567-11e2-aa2e-4088616498b4_story.html?utm_term=.9935847e6fe3.

125. William Glasgall, *New Jersey: Pensions, Promises, and Fiscal Options*, The Volcker All. (Sept. 21, 2016), https://www.volckeralliance.org/publications/new-jersey-pensions-promises-and-fiscal-options.

126. *Id.*; Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 Cornell L. Rev. 956, 957 (2000) (explaining how sovereigns, which can be seen as similar to companies, must borrow money to fund critical projects such as highways and power plants).

127. Glasgall, *supra* note 125.

128. *Id.*

Puerto Rico is not unique in facing significant financial constraints as a result of structural issues that have long been largely ignored. Increasingly, the populace is waking up to the reality that their state has a similarly unsustainable balance sheet as a result of significant borrowing and unfunded pension liabilities. For example, Moody's recently estimated that the unfunded pension liabilities alone at the state and municipal government levels were $3.5 trillion, approximately 20% of the United States' annual GDP,[129] despite the fact that we are currently in the midst of the nation's third-longest economic recovery since 1858.[130] Truth in Accounting has been surveying the state balance sheet situation for years now. They look at the assets and liabilities and determine approximately how much the taxpayer surplus or burden is, with a burden being the amount that each taxpayer would have to contribute in order for the state to be able to meet all of its outstanding liabilities at present.[131] As of 2018, forty-four of the fifty states had taxpayer burdens, with the average across all states being about $10,000 per taxpayer.[132] The numbers range through from New Jersey with the greatest burden per taxpayer at $61,400 to Alaska with a $24,900 surplus.[133]

Weak revenue growth has forced states to begin to reexamine how they will manage their budgets as citizens demand expanded services, including Medicaid, as well as public employee retirement and healthcare benefits. States have managed to live beyond their $2.2 trillion in annual revenues by neglecting necessary investments in critical infrastructure, education, and systemically underfunding public worker pensions and retiree health care, among other contractual obligations.[134] Essentially, they have pushed debts to future generations in order to meet their annual or biennial budgets as

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129. *US Government Pension Shortfall Overshadowed by Social Security, Medicare Gaps*, MOODY'S (Apr. 6, 2016), https://www.moodys.com/research/Moodys-US-government-pension-shortfall-overshadowed-by-Social-Security-Medicare—PR_346878.

130. *Truth and Integrity in State Budgeting: What Is the Reality?*, THE VOLCKER ALL. (Nov. 2, 2017), https://www.volckeralliance.org/publications/truth-and-integrity-state-budgeting-what-is-the-reality.

131. STATE DATA LAB, https://www.statedatalab.org (last visited June 5, 2018).

132. *Id.*

133. *Id.*

134. THE VOLCKER ALL., *supra* note 130.

required by state constitutions, statutes, or traditions.[135] That leaves states with two options: (1) increase taxes or (2) cut spending outright, whether that be through pushing back on the expansion of social services or cutting expenditures in other "discretionary" areas like education and infrastructure.[136]

Neither of these options appears to be a sure-fire solution absent a comprehensive restructuring. On the one hand, there appears to be little appetite across the populations of many states for increases in state taxes. On the other hand, cutting critical social programs is also problematic given the mobility of state populations. Unlike in the case of a sovereign nation, there is very little stopping a resident of one significantly-indebted state from packing their bags and moving to a neighboring state. Although the impact may not be as immediate as when a company is forced to raise prices of an easily-substitutable good, significant changes in tax policy will immediately discourage migration to the given state and over time people will sell houses, switch jobs, and relocate.[137] This presents a unique challenge when dealing with states and territories as compared to sovereigns that the PROMESA board has identified as one of its biggest challenges with Puerto Rico.[138] Such simplified solutions also ignore the fact that as the population of the United States continues to age, we will increasingly require greater spending on social services to support that population.[139] Regardless of how one views the situation, it is clear that change is necessary. The real questions then are not "if" but "how" and "when."

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135. *Id.*

136. *Id.* It is highly debatable that cutting education or infrastructure are truly discretionary expenses, especially given the long-term impacts that these could have on the economic develop of a particular state.

137. Telephone Interview with Ron Bloom, Former Senior Advisor to the Secretary, U.S. Dep't of Treasury, and to President Barack Obama (Mar. 24, 2018) (discussing how the mobility of populations makes raising taxes difficult for local and state governments but the impact is not felt as immediately as in the corporate context. Residents will still be constrained by jobs, property ownership, and social relationships but will begin to migrate over time).

138. Gonzalez, *supra* note 2.

139. Jeffrey R. Brown, Robert Clark & Joshua Rauh, *The Economics of State and Local Pensions* 1–2 (Nat'l Bureau of Econ. Research, Working Paper No. 16792, 2011) (describing the issue of increasing demands by the population of the United States on social services going forward).

1. *Focus on State Pension Liabilities*

There is little debate that the financial demands required to pay the promised future benefits owed to millions of public employees are substantial. Defined benefit plans have been out of vogue in the private sector since the passage of the Employee Retirement Income Security Act of 1974 ("ERISA") and the advent of the 401(k) plan several years later.[140] Despite this, the majority of the public sector continues to have defined benefit plans, making them highly sensitive to changes in their underlying asset portfolio. The credit crisis and subsequent Great Recession of 2008 was particularly tough on pension funding ratios given the sharp decline in asset values combined with the artificially-low interest rates that remain today, which inflated the present discounted value of pension liabilities.[141] Compounding matters is the fact that most retirees rely on these promises as their primary (and often only) source of post-retirement income and unlike corporate pensions, public-sector pensions are not insured by the Pension Benefit Guarantee Corporation.[142] The concern going forward is that funding gaps, combined with rising costs of retirement plans overall, will restrict the ability of governments to adequately fund other priorities.[143] Although there is little controversy over the existence of funding gaps, there is significant debate over the amount by which these pension liabilities are underfunded and the extent to which this can cause issues in the future.[144]

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140. *Id.* at 2.

141. *Id.* at 10 (discussing how the approximately $1 trillion loss to equities held by state and local pension plans as a result of the Great Recession of 2008 had an enormous impact on present funding deficits).

142. Telephone Interview with Bloom, *supra* note 137.

143. Brown, Clark & Rauh, *supra* note 139, at 1–3.

144. *Id.* at 2–3; Telephone Interview with Antonio Weiss, Former Counselor to the Secretary, United States Department of the Treasury (Dec. 6, 2017) (arguing that although some states face fiscal distress, the extent of the problem has been largely overstated and states maintain significant tools of taxation and spending to rectify the situations); Telephone Interview with Bloom, *supra* note 137 (concurring with Antonio Weiss to an extent but acknowledging there is certainly an issue, even though it is hard to make generalizations given different practices around funding, discount rates, forecasted rates of return, appetite for tax hikes, etc. from state to state); Telephone Interview with Josh Rauh, Ormond Family Professor of Finance, Stanford Graduate School of Business (Nov. 8, 2017) (arguing that the current size of unfunded pension liabilities are massive and threaten to worsen

As of fiscal year 2015, the latest year for which complete accounts are available for all cities and states, governments reported unfunded liabilities of $1.4 trillion under recently-implemented governmental accounting standards which assume a 7.5% to 8% annual rate of return.[145] The issue with this logic is that we are currently living in the midst of a unique phenomenon: an amazing bull market in all asset classes.[146] When states are using such high rates of return, they are essentially betting that these artificial and historically-temporary returns will continue indefinitely.[147] This assumption has been subject to substantial criticism.[148] This is the same concern raised by

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given that states have essentially put together portfolios of assets that have a high beta to the general stock market in order to get its current 7.5% returns. The question remains, how will such returns be achieved once we face an inevitable correction? Should we not be factoring this in to our current view of state fiscal health?).

145. *See* JOSH RAUH, HOOVER INST., HIDDEN DEBT, HIDDEN DEFICITS: 2017 EDITION 1–2 (2017) (finding that the average discount rate used by state and local governments was approximately 7.6%); *see also* Matthew J. Belvedere, *Pension pipe dreams put taxpayers on hook: Analysis*, CNBC (Apr. 11, 2016, 1:03 PM), https://www.cnbc.com/2016/04/11/pension-pipe-dreams-put-taxpayers-on-hook-analysis.html (arguing that the assumption by public pension systems across the United States that their assets will generate 7.5% to 8% annually is unrealistic).

146. Belvedere, *supra* note 145.

147. *Id.*

148. *See* Mary Williams Walsh & Danny Hakim, *Public Pensions Faulted for Bets on Rosy Returns*, N.Y. TIMES (May 27, 2012), http://www.nytimes.com/2012/05/28/nyregion/fragile-calculus-in-plans-to-fix-pension-systems.html ("[t]he actuary is supposedly going to lower the assumed reinvestment rate from an absolutely hysterical, laughable 8% to a totally indefensible 7% or 7.5%."); *see also* Adam Summers, *Warren Buffett on Public Pensions*, REASON FOUND.: COMMENTARY (Mar. 26, 2011), https://reason.org/commentary/warren-buffett-on-public-pensions (citing Warren Buffet staying that "[state and local governments] use unrealistic assumptions . . . in determining how much they had to put in the pension funds to meet the obligations. The pension fund assumptions of most municipalities, in my view, are nuts. But there's no incentive to change them. It's much easier to get a friendly actuary than to face an unhappy public."); *see also* John Mauldin, *Someone is Spending Your Pension Money*, MAULDIN ECON. (Oct. 24, 2015), http://www.mauldineconomics.com/frontlinethoughts/someone-is-spending-your-pension-money (arguing that the median plan annual rate of return of 7.9% and 3.0% rate of inflation in the 2013 Public Fund Survey was overly optimistic, especially in light of the average asset allocation. The study found that the average plan was allocated 50.7% equities, 23.3% fixed income, 7.2% real estate, and 15.1% alternatives, with the rest being cash).

Stanford Business School professor Josh Rauh in a recent paper where he argued that if state governments were using proper market valuation techniques, the true unfunded liabilities owed to workers would be close to $3.8 trillion.[149] He premises these calculations on accrued pension promises being modeled as a form of government debt where the government is borrowing from its workers and promising to repay that debt when they retire.[150]

Unlike most investment vehicles, regardless of how the public pension funds perform, the payments to retirees must be made. It is standard in corporate finance to discount a future stream of cash flows by a discount rate that reflects the risk properties of those payments themselves, not the returns expected on the assets as invested. All considered, this implies much lower rate of return assumptions than are currently being used by state governments and instead are much more in line with the realities of today's capital markets.[151]

The discount rate plays an important role in this debate given the long-term nature of the liabilities and thus high duration of the asset portfolio.[152] To observe the impact of

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149. RAUH, *supra* note 145, at 10.

150. *Id.* at 3.

151. For example, Rauh gives the example of "an employee owed a pension that will begin at $100,000 per year in ten years' time and the employer wants to buy the employee out of one year of payments. That is, the employer wants to offer the employee money today to forgo the first payment that one would receive in ten years. The employer announces that since $50,000 can be invested at 7.5% over ten years to pay the first $100,000 payment, it is offering a lump sum payment of $50,000 to the employee in exchange for forgoing the $100,000 payment in ten years. The only circumstance under which this would seem a good deal to the employee is if the employee believed they were unlikely to live for ten years. Otherwise the employee is going to point out that the employer has guaranteed the pension payment of $100,000 in ten years' time, whereas investing in risky securities provides only a hope that such an amount can be obtained. Looking at the roughly 2% rate of return that can be earned on riskless assets over a ten-year horizon, an employee who was sure they would live for ten more years would demand a payment of around $82,034 (= $100,000 / 1.0210) to forgo the first $100,000 payment. This logic does not imply that governments should invest pension money in risk-free assets. It does, however, imply that when measuring the value of the liability, governments should reflect the fact that the liability is a debt that is guaranteed." *Id.* at 5.

152. Duration is a finance term that measures the sensitivity in the change in price of an underlying portfolio of securities (usually in the context of fixed-income instruments like bonds) to a change in the discount rate. A

changing the discount rate, rediscounting the liabilities using the U.S. Treasury yield curve and the duration of each plan results in a liability-weighted average rate of 2.77% and unfunded liabilities of $5.0 trillion.[153] Since not all of these liabilities are accrued, corrections were made on a plan-by-plan basis, generating the $3.8 trillion number mentioned previously.[154] This is approximately three times higher than what governments are currently reporting.

Not only is the magnitude concerning but so too is the continued growth of these deficits.[155] From an *ex-ante* perspective, this implies that the true annual cost of keeping pension liabilities from rising is $289 billion annually, or 18.2% of all state and local government tax revenue.[156] Given the lack of intervention, the $3.8 trillion deficit is an increase of $434 billion from 2014 as realized asset returns fell well short of their targets.[157]

30% of public employees in the United States are not on Social Security, meaning there would be serious legal, practical, and political consequences to any attempt to restructure these liabilities.[158] Despite this, the practices of annual underfunding and buying political goodwill through increasing benefits in "good times" (yet failing to reverse these concessions during subsequent market contractions) may leave state governments with little choice.

portfolio with a high duration means that it is very sensitive to changes in the underlying rate. As a general rule, the longer-term the portfolio, the higher the duration.

153. RAUH, *supra* note 145, at 2.

154. *Id.*

155. According to the Public Fund Survey, at the end of fiscal year 2013, the average public retirement system funding level was 71.8%. That number has been trending steadily downward since the survey began from 100.8% in 2001. Mauldin, *supra* note 148.

156. RAUH, *supra* note 145, at 3. These numbers are similar to those calculated by CNBC's Matthew Belvedere for 2014 in which he found that the true annual cost of keeping pension liabilities from rising would be approximately $261 billion or 17.5 % of state government revenues. Belvedere, *supra* note 145.

157. RAUH, *supra* note 145, at 1.

158. Brown, Clark & Rauh, *supra* note 139, at 7.

2. *Other "Soft" Liabilities*

Although the significance of states' underfunded pension obligations cannot be overstated, most state and local governments also have 'soft' liabilities, which include things such as post-employment benefits to retired public employees, that are also not currently captured on states' balance sheets.[159] According to research done by Novy-Marx and Rauh in 2013, these promises are largely unfunded and have an estimated present value of approximately $630 billion.[160] Much like the discussion on pension liabilities, if the liabilities are to be paid in full, their economic magnitude is currently understated by present government accounting methods.[161] If they are defaultable, their value may be substantially lower given that they are junior to more senior debt (pensions) that are underwater.[162]

B. *Case Studies: Illinois and Connecticut*

In April 2017, a senior official at S&P Global Ratings warned that nearly a dozen states were struggling through "chronic budget stress" that could push them to the brink of default.[163]

For years Illinois has been the poster child for budget shortfalls, pension fund crises, and unpaid bills to public universities, schools, and government vendors.[164] The Volcker Alliance recently released its *2018 Truth and Integrity in State Budgeting* report that grades states' fiscal practices across categories such as budget forecasting, budget maneuvers, legacy costs, reserve funds, and transparency.[165] In 2018, Illinois re-

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159. Robert Novy-Marx & Josh Rauh, *Funding Soft Liabilities*, *in* STATE AND LOCAL HEALTH PLANS FOR ACTIVE AND RETIRED PUBLIC EMPLOYEES 2 (2014).
160. *Id.*
161. *Id.* at 25.
162. *Id.*
163. Eric Pianin, *Could Illinois Be the First State to Go Bankrupt?*, THE FISCAL TIMES (June 12, 2017), http://www.thefiscaltimes.com/2017/06/12/Could-Illinois-Be-First-State-Go-Bankrupt.
164. *Id.*
165. Budget forecasting evaluates the procedures used to develop and present annual budgets, including the extension of reliable revenue and spending estimates over periods beyond the annual budget. Budget maneuvers looks at the state's use of ad hoc, one-off adjustments of revenues and expenditures at the expense of future budgets. "Legacy costs" refers to practices with respect to funding (or failure to fund) pensions and other post-

ceived grades of D, D, D-, D, and B respectively, all of which are trending downward on a three-year basis.[166] This is highlighted by the state's unfunded pension liabilities. The shortfall of the state's five major plans have been attributed to overly optimistic return assumptions, especially during periods of market turmoil such as in 2008 which allowed the state's general assembly to significantly under-contribute while spending the tax money on other priorities.[167] At the same time, the state continues to face a shrinking tax base; Illinois has lost residents on a net basis for three consecutive years leaving its population at its lowest in a decade.[168] There has been little wage growth for those that have remained.[169] Attempted reforms have led to worker unrest as no one wishes to bear the burden of government overpromising.[170]

Much like Illinois, Connecticut is also often held out by the media as an example of poor fiscal management at the

employment benefits for public employees. Reserve funds is the provision for, responsible use, and replenishment of, rainy day funds and other fiscal reserves. Finally, transparency is a measure of the comprehensiveness of state disclosure of budgetary information, including tax expenditures and infrastructure replacement costs. THE VOLCKER ALL., *supra* note 130, at 2.

166. *Truth and Integrity in State Budgeting: Preventing the Next Fiscal Crisis*, THE VOLCKER ALL., 19, 26, 34, 41, 49, (Dec. 12, 2018), http://www.volckeralliance.org/publications/truth-and-integrity-state-budgeting-preventing-next-fiscal-crisis.

167. Aimee Picchi, *Could Illinois Be the First State to File for Bankruptcy?*, CBS NEWS: MONEYWATCH (June 16, 2017, 5:00 AM), https://www.cbsnews.com/news/could-illinois-be-the-first-state-to-file-for-bankruptcy/.

168. *Id.*

169. *Id.* This is consistent with the findings of PwC in their 2016 *State Financial Position Index* which found that states with the greatest need to improve their financial positions, among which the worst were Connecticut, Illinois, Kentucky, and New Jersey, all were currently experiencing negative net migration. Chuck Reed, *Ready to Retire? Avoid These 4 States*, GOVERNING INST. (July 18, 2016, 6:15 AM), http://www.governing.com/gov-institute/voices/col-pension-debt-4-worst-states-to-retire.html.

170. Dick Simpson, a political science professor at the University of Illinois at Chicago, provides the example that because of contractual promises, Chicago Public School teachers pay less into their pension funds than any other workers do in either the public or private sector. Attempts to try to get their union to pay more have simply resulted in strikes. Amanda Robert, *In Illinois, Some Push Bankruptcy as Solution to Troubled Public Budgets*, FORBES (Apr. 19, 2016, 9:46 AM), https://www.forbes.com/sites/legalnewsline/2016/04/19/in-illinois-some-push-bankruptcy-as-solution-to-troubled-public-budgets/#6e3edccd33d2.

state level. In June 2016, the state's credit was downgraded by both Fitch and Standard & Poor citing structural deficits and an overextended credit supply as main drivers of the downgrade.[171] Additionally, employment grew by only half the national average between 2012 and 2015, leading to a drop in the state's median home value[172] and creating property tax implications. None of this was helped by General Electric's decision to relocate their headquarters from Connecticut to Massachusetts. The *2018 Truth and Integrity in State Budgeting* report raised similar issues, rating Connecticut a D in legacy costs and D in related budget maneuvers.[173] At the same time, there may be room for optimism as it received an A rating in budget forecasting and B ratings in both transparency and reserve funds.[174] Connecticut has improved in its financial management but continues to be burdened by significant liabilities that it has been unable to shed.[175] For example, it has used one-time borrowings every year during the three-year study period in order to pay for recurring expenditures and bond premiums for debt service.[176] Connecticut's near-term concern though is its reliance on proceeds from capital gains taxes charged to its residents.[177] Connecticut is ranked seventh nationally in highest effective tax rate and has made a huge jump in rates since their institution in 1991.[178] Raising the tax rate again so soon (the last state tax raise was in 2015) would be very difficult politically, meaning that the state's current restructuring tools are significantly constrained.[179] These trends described above are evident through analysis of both state's balance sheets. As of September 2018, Illinois only has roughly $29 billion in assets available to satisfy $245 billion in liabilities. Of that $245 billion, approximately $40 billion is bond debt, $187 billion are unfunded pension and health care bene-

171. Chase Carmichael, *State Bankruptcy: Will Connecticut Be Next?*, INVESTOPEDIA (June 22, 2016), https://www.investopedia.com/articles/markets-economy/062216/state-bankruptcy-will-connecticut-be-next.asp.

172. *Id.*

173. THE VOLCKER ALL., *supra* note 166, at 11.

174. *Id.*

175. *See id.* at 56.

176. *See id.*

177. *Id.* at 26.

178. Carmichael, *supra* note 171.

179. *Id.*

fits, and the remainder are the various expenses that come along with operating a state government (see *Figure 1*).[180] This funding gap of $216 billion results in a taxpayer burden of approximately $50,800, an amount that has nearly doubled over the last nine years (see *Figure 2*).[181]

Connecticut has $12 billion of available assets to service $82 billion of liabilities (see *Figure 3*).[182] The breakdown is much different than Illinois though, with roughly the same amount of bond debt as unfunded pension liabilities.[183] This is important to keep in mind when putting together a resolution framework because for some troubled states, a system that merely seeks to deal with pension liabilities may be insufficient.[184]

The situation threatens to deteriorate further; a credit downgrade would relegate Illinois to junk-bond status,[185] which would exacerbate the situation by raising borrowing costs in the future for an already cash-constrained state. The one advantage that Illinois has over a state like Connecticut is that it has valuable state-owned property assets that it could potentially consider selling off if the situation deteriorated further.[186] This may lead one to question whether the asset side of both balance sheets is also undervalued.[187] Although this is possible, I propose two responses: (1) the funding gaps in state balance sheets are so large that it is unrealistic to assume that assets are *so* undervalued as to make up the difference, and (2) using market values of assets would require the use of market values of liabilities, and as Rauh has demonstrated, this could significantly inflate the right side of the balance sheet as well, limiting any advantages of boosting the asset side.

C. *Similarities and Differences Between States and Puerto Rico*

At first glance, one may assume that Puerto Rico, as a territory and commonwealth with its own constitution, would be

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180. TRUTH IN ACCOUNTING, *supra* note 11.
181. *See id.*
182. FINANCIAL STATE OF CONNECTICUT, *supra* note 12.
183. *Id.*
184. *Id.*
185. *See* Pianin, *supra* note 163.
186. Telephone Interview with William Glasgall, Director of State/Local Program, The Volcker All. (Nov. 7, 2017).
187. *Id.*

more analogous to a sovereign such as Argentina or Greece rather than a state. Upon further analysis, there are many factors that make Puerto Rico much more similar to a troubled state, including: (a) rising pension costs; (b) crumbling infrastructure; (c) departing taxpayers; and (d) rising borrowing costs from credit downgrades.[188] Thus, the Commonwealth's experience with its current restructuring process is instrumental in informing the ideas of politicians, practitioners, and academics on resolutions of the state-level situation.

At the same time, there are key differences that are relevant to both structuring and implementing a state resolution system. Firstly, states have access to the tools of Chapter 9 in a way that Puerto Rico does not given the constitutional language discussed in Section 2.1. This provides states with one additional alternative that the Commonwealth attempted to use themselves, a restructuring at the municipal-level in an attempt at resolving the fiscal crisis without having to restructure liabilities at the state-level. Secondly, states face federalism issues that were mooted in Puerto Rico given its status as a territory of the United States. It is much more difficult for the federal government, who has exclusive constitutional authority over bankruptcy,[189] to enact measures that may be seen as infringing upon state rights without their explicit or implicit consent. Finally, the structure of the liabilities differs substantially between Puerto Rico and states.[190] In the case of Puerto Rico, approximately 60% of the outstanding debt was bond debt, whereas only approximately 35% of the liabilities at the state and municipal levels are bond debt. It is possible that the 35% is even inflated given the discussion above. This changes the negotiation dynamics as any reductions in pension and health benefits which comprise the majority of the remaining liabilities will have a more direct impact on United States citi-

188. Walsh, *supra* note 1. *See* Carrillo, Yezer & Kalaj, *supra* note 5, at 17 (describing how the Puerto Rican population is aging, creating an increased demand for social services); NAT'L P.R. CHAMBER OF COMMERCE, *supra* note 6, at 15 (arguing that outmigration poses a serious risk to the island's future economic growth by taking away significant labor capital).

189. U.S. CONST. art. I, § 8, cl. 4 ("The Congress shall have the power . . . [t]o establish . . . uniform laws on the subject of bankruptcies throughout the United States.").

190. Interview with David Yermack, Albert Fingerhut Professor of Fin. & Bus. Transformation, N.Y. Univ. Stern Sch. of Bus. (Sep. 26, 2017).

zens as compared to the institutional investors who hold significant bond assets. This is not to imply that citizens will not bear costs from losses to institutional investors, just that cases such as Detroit have demonstrated that dealing with restructuring social benefits is more complicated politically and constitutionally.

The numbers above suggest that regardless of potential optimism around future asset returns, inflation expectations, and interest, future generations will be forced to bear a significant burden when it comes to both government borrowing and the pension benefit promises that have been made to generations of state employees across the United States.[191] Furthermore, the situation may in fact be worse than states currently acknowledge, as has been highlighted by academics such as Novy-Marx, Rauh, and Skeel who all posit that there is vast underfunding of public sector employee pensions.[192]

The tools currently available to state and local governments appear insufficient and although citizens of the most indebted states may attempt to flee to other locales, they cannot avoid the reality. Leaving a dwindling taxpayer base behind to deal with these fiscal issues simply increases the likelihood of a federal taxpayer bailout, imposing costs on taxpayers nationwide.[193] The problem, as described recently by Paul Volcker and Richard Ravitch "is not simply cyclical. It is structural."[194] Much as we saw with Puerto Rico, it is possible for sophisticated investors to ignore a problem for a significant period of time, but eventually both investors and pensioners will demand their promised cash flows. Such an event could be expedited by the onset of another recession, like in 2008. Indeed, many investors believe that a market correction, artifi-

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191. Josh Rauh, *Are State Public Pensions Sustainable?: Why the Federal Government Should Worry About State Pension Liability* 20 (May 15, 2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1596679.

192. *See* RAUH, *supra* note 145, at 1; *see also* Robert Novy-Marx & Joshua Rauh, *The Revenue Demands of Public Employee Pension Promises* 37 (Nat'l Bureau of Econ. Research, Working Paper No. 18489, 2012); David A. Skeel, *Is Bankruptcy the Answer for Troubled Cities and States?*, 50 HOUS. L. REV. 1063, 1085 (2013).

193. Rauh, *supra* note 191, at 19–20.

194. *See* RICHARD RAVITCH & PAUL VOLCKER, REPORT OF THE STATE BUDGET CRISIS TASK FORCE 2, 4 (2012).

cially extended due to significant intervention by central banks globally, is overdue.

All of this means states should begin considering solutions today rather than waiting for the inevitable reality to set in. Although my proposed solution may not have been politically palatable in the past, states have never faced such dire financial conditions, and these conditions risk even further deterioration in the future. It is time to raise the controversial question once more: is a state bankruptcy regime possible and desirable?

III. BACKGROUND ON STATE BANKRUPTCY

A. *States and the Bankruptcy Code*

The concept of state bankruptcy has long been considered unattractive, detrimental, perhaps unconstitutional, and thus undesirable. In late 2010, there was a brief debate in Congress as to whether the federal government should enact some kind of restructuring framework for states, especially in light of the Great Recession.[195] Although several prominent politicians publicly backed the proposal and one senator began soliciting support for the legislation, the campaign quickly fizzled out and was rejected in a partisan effort.[196] Attention quickly shifted to other venues, most importantly developments in municipal bankruptcies.[197] Internationally, we have seen the European Union's movement towards a restructuring framework for indebted sovereigns such as Greece, Ireland, Portugal, Spain, and Italy which seems to implicate many of the same arguments that are raised around bankruptcy within a federal union.[198] The purpose of the following Section is to raise the most common objections to state bankruptcy, as well as discuss how these challenges could be overcome.

195. Skeel, *supra* note 192, at 1064.
196. *Id.*
197. *Id.*
198. *Id.* at 1066.

B. *Key Issues with a State Bankruptcy Filing*

1. *State Sovereignty*

One of the most common critiques of putting states into a federal bankruptcy regime is that it would be an unconstitutional infringement on state sovereignty, protected under the Tenth Amendment of the Constitution.[199] The Tenth Amendment has been interpreted to secure the independence of states by limiting the reach of federal powers that would otherwise overwhelm the sovereign, decentralized units, and undermine the structural principles of federalism and the separation of powers.[200] Chapter 9 resolves these issues of dual sovereignty by making the process completely voluntary.[201] Neither the federal government nor creditors can force a state to file one of its municipalities for bankruptcy. Furthermore, state sovereignty interests are protected through both 11 U.S.C. Sections 901 and 904. Section 901 provides that many sections of other chapters of the Bankruptcy Code do not apply in a Chapter 9 case, limiting the federal bankruptcy court's powers through separating the matters which the judge may consider and those that should be left to the municipality.[202] Section 904 places restrictions on the court's interference with the political or governmental powers of the municipality, as well as their property and revenues.[203]

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199. The Tenth Amendment states that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X; J. Gregg Miller, Nina Varughese & Leon R. Barson, *State Bankruptcy Filings: The Pros and Cons of Allowing States to File for Bankruptcy (Like Municipalities) or "Speak Softly and Carry a Big Stick"*, PEPPER HAMILTON LLP (May 21, 2011), http://www.pepperlaw.com/publications/state-bankruptcy-filings-the-pros-and-cons-of-allowing-states-to-file-for-bankruptcy-like-municipalities-or-speak-softly-and-carry-a-big-sticksup1-sup-2011-03-21; *Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter: Hearing Before the Subcomm. On Courts, Commercial & Admin. Law of the H. Comm. on the Judiciary,* 112th Cong. 61 (2011) [hereinafter *Role of Public Employee Pensions*] (statement of James E. Spiotto, Partner, Chapman and Cutler LLP).

200. Clayton P. Gillette, *Fiscal Federalism as a Constraint on States*, 35 HARV. J. OF L. & PUB. POL'Y 101, 106 (2012); Samir D. Parikh, *A New Fulcrum Point for City Survival*, 57 WM. & MARY L. REV. 221, 242 (2016).

201. *Role of Public Employee Pensions, supra* note 199, at 9.

202. Miller, Varughese & Barson, *supra* note 199, at 2.

203. *Id.* at 2–3.

These issues of sovereignty have been challenged and were decided in the Supreme Court cases *Ashton v. Cameron County Water Improvement District No. One* and *United States v. Bekins*.[204] In *Ashton*, the Court invalidated a 1934 municipal bankruptcy law on the basis that it subjected states to too much interference from the federal bankruptcy courts.[205] A revised municipal bankruptcy framework was later upheld in *Bekins*. The Court held that the new law "avoid[ed] any restriction on the powers of the States or their arms of government . . . [and that] [n]o involuntary proceedings [were] allowable."[206] These two cases suggest that state bankruptcy can only be invoked by the states themselves[207] and federal appointees cannot get too deeply involved in state affairs, infringing on state sovereignty.[208] They do not hold that interference is absolutely prohibited; we have seen the federal government insert itself quite significantly in areas of Medicaid funding obligations, welfare restrictions, etc.[209] The cases also suggest that section 904's noninterference provision could be overcome so long as the debtor consents to the interference.[210]

2. *The Contracts Clause of the United States Constitution*

The second major constitutional issue to overcome is the Constitution's Contracts Clause, which states that "[n]o State

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

205. *Ashton*, 298 U.S. at 531 (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 . . . And really the sovereignty of the state, so often declared necessary to the federal system, does not exist.").

206. *Bekins*, 304 U.S. at 51.

207. Jeb Bush & Newt Gingrich, *Better off Bankrupt*, L.A. TIMES (Jan. 27, 2011), http://articles.latimes.com/print/2011/jan/27/opinion/la-oe-gingrich-bankruptcy-20110127; Clayton P. Gillette & David A. Skeel, Jr., *Governance Reform and the Judicial Role in Municipal Bankruptcy*, 125 YALE L.J. 1150, 1204 (2016).

208. David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. 677, 709 (2012) [hereinafter Skeel, *States of Bankruptcy*]; for example, a federal judge reviewing a state's reorganization plan could not mandate a tax hike or carry out any other governable functions throughout the pendency of the case. Bush & Gingrich, *supra* note 207; David A. Skeel, Jr., *Give States a Way to Go Bankrupt: It's the Best Option for Avoiding a Massive Federal Bailout*, 3 CAL. J. OF POL. & POL'Y 1, 3 (2011) [hereinafter Skeel, *Give States a Way*].

209. Skeel, *States of Bankruptcy*, *supra* note 208, at 709.

210. Gillette & Skeel, *supra* note 207, at 1200–03.

shall . . . pass any . . . Law impairing the Obligation of Contracts . . . ."[211] This has traditionally been understood to prohibit state legislatures from passing any law that would relieve the state government of its own debt obligations, whether that be bond debt, pension debt, or any other contractual liability.[212] A strict interpretation would limit a state's ability to deal with its existing large pension liabilities and be forced to only apply changes prospectively.[213] Since 1934, this clause has been interpreted more flexibly by some courts, allowing some level of state debt relief although "a state cannot refuse to meet its legitimate financial obligations simply because it would prefer to spend the money [on something else]."[214] In certain circumstances, states have been allowed to adjust debts to what is both sustainable and affordable.[215]

The case law has not specifically addressed the Contracts Clause in the context of a state restructuring, but the precedents set in the municipal context are likely to be highly influential. Courts have modified public pensions on the theory that failing to do so would crowd out the state's ability to pay for essential public services, resulting in the number of taxpayers available to fund the desired benefits declining, thus creating a death spiral for the municipality.[216] This balancing of interests dates back to *Homebuilding & Loan Ass'n v. Blaisdell* where the Supreme Court upheld a Minnesota emergency statute providing relief from foreclosures on the basis of the state's police power.[217] The Court reasoned that the Contracts Clause is not an absolute bar to a modification of a state's obligations so long as there is a balancing between individual contractual rights and the public welfare.[218] SCOTUS subsequently applied the *Blaisdell* balancing test in an instance of

211. U.S. CONST. art. I, § 10, cl. 1.
212. Jennifer Burnett, *3 Questions on State Bankruptcy*, THE COUNCIL OF STATE GOV'TS (Aug. 2017), http://www.csg.org/pubs/capitolideas/enews/issue65_3.aspx.
213. Skeel, *States of Bankruptcy*, *supra* note 208, at 711.
214. Burnett, *supra* note 212.
215. James E. Spiotto, *How Municipalities in Financial Distress Should Deal with Unfunded Pension Obligations and Appropriate Funding of Essential Services*, 50 WILLAMETTE L. REV. 515, 518 (2014).
216. *See, e.g.*, Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942); Spiotto, *supra* note 215, at 518.
217. Homebuilding & Loan Ass'n v. Blaisdell, 290 U.S. 398, 440 (1934).
218. *Id.* at 437.

municipal distress in *Faitoute Iron & Steel Co. v. City of Asbury Park, NJ*[219] and refined its analysis in *United States Trust Co. v. New Jersey*,[220] The Court found that that impairment of public contracts may be constitutional if it serves an important public purpose"[221] such as when a municipality is facing a "broad, generalized economic or social problem."[222] Another recession resulting in fiscal distress that threatened the solvency of a state and had potential national knock-on effects, such as the Great Depression did to the municipality in *Asbury Park*, would certainly qualify.[223] An interesting question remains: to what extent does the distress caused by significant pension liabilities meet those characteristics? In the end, we are left with a framework that says that so long as: (1) a contractual obligation is involved; (2) the legislation in question impairs that obligation; (3) the impairment is substantial; and (4) impairment is "reasonable and necessary to serve an important public purpose",[224] there is no violation of the Contracts Clause.[225]

The broader implications of these cases are that if bond and pension obligations are unaffordable and unsustainable, impairment and adjustment to what would be serviceable should be constitutional.[226] Courts have recognized that the crowding out of essential governmental services and infrastructure projects in certain circumstances meets that threshold.[227] For example, in the Detroit bankruptcy the court ruled that the Tenth Amendment does not prohibit the impairment of contract rights and that "nothing distinguishes pension debt from any other debt."[228] Puerto Rico, Illinois, and Rhode Island have also all modified pension rights outside of formal Chapter 9 proceedings.[229]

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219. *Faitoute Iron & Steel Co.*, 316 U.S. at 502.
220. Spiotto, *supra* note 215, at 531–32.
221. *Id.* at 532.
222. Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 250 (1978).
223. Gillette & Skeel, *supra* note 207, at 1225.
224. *See* U.S. Trust Co. v. New Jersey, 431 U.S. 1 (1977).
225. *See Role of Public Employee Pensions*, *supra* note 199.
226. Spiotto, *supra* note 215, at 518.
227. *Id. at* 534.
228. *Id.* at 537.
229. *Id.* at 538.

3. *Prohibitions on Impairment of Pensions under Certain State Constitutions*

A final constitutional barrier to a potential restructuring is the impact of limitations at the state constitutional level.[230] A few states, such as Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, and New York, have state constitutional provisions prohibiting the impairment or diminishment of public employee pensions.[231] There is substantial variability though among the states in the extent to which they protect these promised future benefits.[232] Illinois, for example, is specifically prevented from reducing pension payments at all.[233] So far, the state constitutional argument has been the primary method by which organized labor has fought against the potential restructuring of their pension obligations.[234]

This was evident in the recent Detroit bankruptcy. The Michigan Constitution provides that "[t]he accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby."[235] On its face, it would appear that Michigan would be unable to reduce pension payments or other promises to workers even if there was serious tension between the amount promised and what the state would ultimately be able to pay based on its fiscal situation. In a December 2013 order related to Detroit's eligibility to seek bankruptcy protection, bankruptcy court Judge Steven Rhodes set an important precedent in determining that the Tenth Amendment did not protect the impairment of contract rights otherwise protected by the state constitution.[236] In his decision, Judge Rhodes noted that "nothing distinguishes pension debt in a municipal bankruptcy case from any other debt" and therefore "[if] the Tenth Amendment prohibited[ed] the impairment of pension benefits . . . it would also prohibit the adjustment of any other

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230. Interview with Yermack, *supra* note 190.
231. Spiotto, *supra* note 215, at 527–28.
232. *Id.*
233. Mauldin, *supra* note 148.
234. Telephone interview with Bloom, *supra* note 137.
235. MICH. CONST. art. IX, § 24.
236. *In re* City of Detroit, Mich., 504 B.R. 97, 138 (Bankr. E.D. Mich. 2013) (Opinion Regarding Eligibility).

debt."[237] Pension rights are contractual rights and the court subsequently noted that although "it [would] not lightly or casually exercise the power under federal bankruptcy law to impair pensions," they could be subject to readjustment in the Chapter 9 proceeding regardless of whether or not they were protected by the Michigan Constitution.[238] The court felt that the confirmation requirements would provide adequate protection to pensioners just as it would any other creditors in the bankruptcy proceeding.[239]

The decision in Detroit, though in the context of a municipal bankruptcy, set an important precedent that pensioners should not be given special status as creditors in a bankruptcy proceeding, especially in a situation where their impairment may be necessary for the government's fiscal sustainability. This does not, however, imply that the special nature of pension liabilities should not be a point of consideration when constructing a resolution framework. There are other ways that pensioners can be protected, much in the same way as they were by Judge Rhodes when he made the confirmation of any submitted plan contingent on him being comfortable with the treatment of Detroit's pensioners prior to granting court approval.

4. *Potential Impact(s) on the Municipal Bond Market*

Finally, beyond constitutional considerations, there is a widespread belief that having state bankruptcy as an option would lead to distortions in the municipal bond markets such as higher interest rates, lower liquidity, and increased volatility as investors would require greater compensation for the greater amount of risk that they would be taking on.[240] Although it is fair to believe that a change in an investment's risk profile would lead to re-pricing in the markets,[241] it is unclear why this would necessarily happen here or that any benefits from doing so would not outweigh additional costs. No one claims that the enactment of a state bankruptcy law or even an actual filing would bring down systemically important financial

237. *Id.* at 150.
238. *Id.* at 154.
239. *Id.* at 141.
240. Skeel, *supra* note 192, at 1067.
241. Miller, Varughese & Barson, *supra* note 199, at 1.

institutions.[242] Counterparty contagion is not present in the state context because these institutions are not the major holders of state bonds, which are the mutual funds and wealthy individuals of a given state.[243]

Contagionists thus focus instead on how a filing by one state could impact another state's access to the capital markets.[244] This theory only holds if we accept that investors are incapable of differentiating between fiscally-distressed states and those that are not.[245] Even though their public statements may be opaque, we know that state fiscal information is available to some extent, as is reflected by differences in bond yields between distressed states such as California and Illinois when compared to those of healthier states like Iowa and North Carolina.[246]

An empirical analysis would expect to find higher interest rates charged and lower credit ratings provided for municipalities in states that permit bankruptcy. Research indicates that this does not appear to be the case.[247] Furthermore, when we discuss the "municipal bond market," we are referring to a market that includes both municipal and state-level debt, one of which has a bankruptcy option and another that does not.[248] Despite the difference, we do not see any unusual premiums charged or greater volatility between municipal and state instruments.[249] This also holds true when you compare across states that permit municipalities to file from bankruptcy versus those that historically have not.[250] When controlled for other factors, interest rates may actually be lower, rather than higher, in states that permit bankruptcy.[251]

Additionally, although having a restructuring framework in place may increase the risk of nonpayment, restructuring mechanisms may make bondholders and pensioners better off

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242. Skeel, *supra* note 192, at 1068.
243. *Id.*
244. *Id.*
245. *Id.* at 1068–69.
246. *Id.* at 1069.
247. CLAYTON P. GILLETTE & DAVID A. SKEEL, INST. FOR L. & ECON., A TWO-STEP PLAN FOR PUERTO RICO 18 (2016).
248. Skeel, *States of Bankruptcy*, *supra* note 208, at 717.
249. *Id.* at 719–21.
250. GILLETTE & SKEEL, *supra* note 247, at 18.
251. *Id.*

in certain circumstances.[252] For example, in a situation where a state is unable to meet its liabilities, having an orderly restructuring mechanism should arguably make bondholders better off than a disorderly default scenario.[253] Furthermore, the potential of a massive federal bailout involving billions of dollars of taxpayer money is much more likely without a proper resolution mechanism.[254] Dissenters appear to be overlooking these important costs.

If this is the final argument to overcome in order to garner support for a state restructuring framework, there are other ways in which these risks can be mitigated. Alternatives include bond market reform and requiring greater information disclosure from the states and their municipalities in the same way as is required for issuers of corporate bonds.[255]

Although there are constitutional barriers, the recent case law leaves open the possibility of a state restructuring process, so long as state rights continue to be properly respected within such a framework. In addition, potential impacts on the municipal bond market are not a valid reason for completely rejecting the idea of a potential solution.

IV.
Proposed Alternatives to State Bankruptcy

A. *What Does One Mean by "Bankruptcy"?*

The current tools available to municipal and state governments are insufficient to address the size, scale, and complexity of the fiscal situation described in Part II. At the same time, the use of federal bankruptcy law as a resolution mechanism seems highly improbable in light of the constitutional concerns raised in Part III, even if fears of contagion appear overblown. A refined solution is necessary. Before proposing a viable framework, it is important to think about what "bankruptcy" means. Many scholars and politicians, such as those that have advocated against federal intervention in state fiscal

252. Skeel, *supra* note 192, at 1069.

253. *Id.*; Skeel, *States of Bankruptcy*, *supra* note 208, at 717 (arguing that the provision of an orderly alternative to a "catastrophic default" should decrease volatility in traded municipal securities); Gillette & Skeel, *supra* note 247, at 18–19.

254. Miller, Varughese & Barson, *supra* note 199, at 1.

255. Skeel, *States of Bankruptcy*, *supra* note 208, at 721.

affairs, see bankruptcy as analogous to the Bankruptcy Code—federal law enforced in federal courts. For the remainder of this Note I want to put forward a broader, more process-oriented definition.

In his article *When Should Bankruptcy Be An Option?*, Professor David Skeel defines bankruptcy as: (1) a process by which a debtor can restructure its obligations (2) in a way that is facilitated by the government or a third party, (3) which is collective in nature, and (4) is specific to a particular individual or entity.[256] Skeel's view of bankruptcy extends beyond the Bankruptcy Code to include instruments such as the resolution powers given to bank regulators under the Dodd–Frank Wall Street Reform and Consumer Protection Act (the "Dodd–Frank Act").[257] Although highly administrative in nature, Dodd–Frank clearly falls within the realm of "bankruptcy" under Skeel's definition.[258] Commentators are too quick to reject any kind of process labeled "bankruptcy" merely because of their associations with Chapter 9 and Chapter 11 procedures. They instead advocate for the following "non-bankruptcy" alternatives. Although many of these substitutes appear viable at first glance, further reflection demonstrates that they are at best suboptimal solutions to state fiscal distress.

B. *Out-of-Court "Solutions"*

An often-proposed alternative to state bankruptcy is a combination of tax hikes, spending cuts, and out-of-court creditor negotiations that would exchange significant face amounts of debt for amounts closer to their current economic value. The rationale for the latter is that the true economic value of the claims held by creditors is really the face amount discounted by the probability of the state's ability or willingness to pay back the full-face amount in the future. A claim held in a state unable to repay all of its liabilities would thus be worth much less than the stated value.

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256. David A. Skeel, *When Should Bankruptcy Be an Option (for People, Places, or Things)?*, 55 WM. & MARY L. REV. 2217, 2222–23 (2014).
257. *Id.* at 2224–25.
258. *Id.* at 2225.

Ever since federal taxation was authorized under the Sixteenth Amendment of the Constitution,[259] it has crowded out state taxation and thus states appear unlikely to be able to tax or cut their way out of their present situations, especially in the most dire of cases.[260] As discussed in Section 2.1, significant investments in social services and infrastructure will only become more critical in light of the United States' aging population, declining GDP growth, and protectionist policies that may discourage foreign investment. Furthermore, residents can evade high tax burdens by moving to other states, illegal tax planning schemes, or simply refusing to pay.[261] This raises doubt as to the effectiveness of any proposed tax hikes or spending cuts absent other intervention.

The biggest issue with an out-of-court process, as we have seen in Greece and Argentina, is the inability of the debtor to use the key provisions of the Bankruptcy Code to gain the leverage necessary to force creditors towards a settlement. For example, it would be very useful for the debtor state to be able to use the automatic stay to suspend litigation and enforcement actions by secured creditors. Furthermore, once a restructuring plan has garnered widespread support, the debtor lacks the ability to use the cram down rules to bind holdouts, giving creditors substantially more influence in the process from day one.

Some tout collective-action-clauses ("CACs") in bonds as the key to resolving the inherent issues discussed above.[262] CACs are clauses in indentures that allow for the alteration of bondholders' legal and economic rights if enough fellow bondholders of the same issue agree (often by majority vote).[263] CACs respond to the fact that municipal and sovereign debt is liquid and thus its holders are constantly in flux

259. U.S. CONST. amend. XVI.

260. Skeel, *supra* note 256, at 2244.

261. Skeel, *States of Bankruptcy*, *supra* note 208, at 687.

262. *See* Stephan Airapetian, *Managing Sovereign Debt: A More Long-Term Debt-Restructuring Solution*, 22 S. CAL. INTERDISC. L.J. 385, 395(2013); *see also* Robert Auray, *In Bonds We Trustee: A New Contractual Mechanism to Improve Sovereign Bond Restructurings*, 82 FORDHAM L. REV. 899, 903 (2013).

263. Antonio J. Pietrantoni, *Collective Action Clauses for Puerto Rican Bonds: Borrowing Costs, Practical Considerations and Lessons from Sovereign Debt*, 84 REV. JUR. U.P.R. 1195, 1203 (2015).

with both differing objectives and levels of sophistication.[264] Bonds without CACs require the unanimous consent of all holders to amend specific terms such as principal or interest payments, whereas CACs allow the debtor to impose haircuts or advantageous terms to the supporting class on the holdout creditors.[265] The result is a change in *ex-ante* incentives that lead to greater cooperation given the advantages of holding out are greatly reduced.

The proposed use of CACs to resolve current state fiscal distress overlooks several key points. Firstly, CACs are a prospective, rather than a retrospective solution—the vast majority of state-level indentures do not currently contain CACs. Secondly, CACs have been much more prevalent and accepted by investors in sovereign debt issuances, rather than municipal debt issuances. Thirdly, even if we looked at it as a prospective solution, policymakers may be reluctant to advocate for their inclusion in future indentures because they may worry that investors will take this as a negative sign of a state's solvency, restricting future market access.[266] Finally, and perhaps most importantly, many of the most indebted states suffer from significant unfunded pension liability where CACs are irrelevant.

CACs themselves are not infallible. For example, a CAC only binds the creditors in a particular issue, meaning an aggregation mechanism is still necessary to loop multiple issues into one restructuring because so long as non-CAC bonds have not matured or been retired, those bondholders will retain their traditional rights.[267] In addition, regardless of whether or not these clauses exist in indentures, as Argentina has shown, litigation will likely still ensue.[268] Litigation is immensely costly, negatively impacting both the local government and its citizens, while detracting time and effort away from the real

264. *Id.* at 1202–03.
265. *Id.* at 1233.
266. *Id.* at 1232.
267. *Id.* at 1238.
268. William W. Bratton, *Pari Passu and a Distressed Sovereign's Rational Choices*, 53 EMORY L.J. 823 (2013) (providing an overview of the litigation spearheaded by Elliott Management in the Argentinian sovereign restructuring raising complicated questions of contractual interpretation surrounding CACs embedded in the indentures. The author goes on to suggest that given the conflicting interests of bondholders *ex-ante* and *ex-post*, that a bankruptcy regime is the optimal solution instead).

issue of solving the underlying structural problems. Clearly an out-of-court restructuring for states through tax increases, spending cuts, and debt exchanges is a lot more problematic than proponents would have one believe.

C. *Chapter 9 of the Bankruptcy Code*

As was attempted in Puerto Rico, another proposed alternative for states is the use of Chapter 9 of the Bankruptcy Code to resolve the fiscal situation at the municipal level, hoping that this would provide necessary breathing space at the state level. Chapter 9 provides a mechanism by which insolvent municipalities,[269] as defined under Section 101(40) of the Bankruptcy Code,[270] can use a court-supervised proceeding to settle disputes with creditors so long as they are authorized to do so by their state[271] and meet several other requirements.[272] Unlike in a Chapter 11 proceeding, municipalities do not have the ability to liquidate their assets to satisfy creditors. The primary purpose of Chapter 9 is to allow the municipality to continue to provide essential services while it adjusts and refinances.[273] In the end, the municipality files a recovery plan that must be accepted by impaired creditors and affirmed by

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269. Insolvency of municipalities is determined on a cash-flow basis as being unable to pay its debts as they come due or past failure to pay outstanding debt. JAMES E. SPIOTTO, ANN E. ACKER & LAURA E. APPLEBY, MUNICIPALITIES IN DISTRESS?: HOW STATES AND INVESTORS DEAL WITH LOCAL GOVERNMENT FINANCIAL EMERGENCIES 130 (Chapman & Cutler LLP, 2d ed. 2016).

270. 11 U.S.C. § 101(40) (2011) (defining "municipality" as a "political subdivision or public agency or instrumentality of a State"). Although not defined in the Bankruptcy Code, "public agency or instrumentality of the State" includes any state-sponsored or controlled entity that raises revenues through taxes or user fees to construct or operate public projects. *An Overview of Chapter 9 of the Bankruptcy Code: Municipal Debt Adjustments*, JONES DAY (Aug. 2010), https://www.jonesday.com/An-Overview-of-Chapter-9-of-the-Bankruptcy-Code-Municipal-Debt-Adjustments-08-15-2010/.

271. *In re* County of Orange, 183 B.R. 594 (Bankr. C.D. Cal. 1995) (holding that the state must provide express written authority).

272. JONES DAY, *supra* note 270 (stating that the municipality must have (1) obtained consent of creditors holding at least a majority in amount of claim in any of the classes that will be impaired; (2) failed to obtain creditor-consent after good faith negotiations; (3) been unable to negotiate with creditors because it was impracticable; or (4) believe that creditors may attempt preference transfers).

273. SPIOTTO, ACKER & APPLEBY, *supra* note 269, at 133.

the bankruptcy judge.[274] The plan must be feasible in the sense that it will allow the government to provide essential services going forward.[275] Sections 903 and 904 of the Bankruptcy Code place significant limitations on the federal bankruptcy court's ability to impose anything on municipalities, consistent with the principles of federalism.[276]

There are several issues with using the Chapter 9 approach. The first is that the magnitude of the state debt makes it unlikely that the most indebted states would be able to resolve their fiscal issues merely by restructuring their municipalities.[277] Relatedly, the thought of having to coordinate numerous Chapter 9 filings simultaneously would both overwhelm the federal bankruptcy courts and lead to a series of long, protracted, and expensive bankruptcies with no promise of a resolution. How would judges coordinate recovery plans across a variety of municipalities within a single state? What if the interests of the different municipalities diverge? Would all cases therefore have to be consolidated before one court? Would one court even have the capacity to take on such an extensive endeavor in light of its current caseload? All of these considerations raise important theoretical and practical limitations of a Chapter 9 alternative, even if a larger portion of the debt could ultimately be adjusted.

Finally, Chapter 9 itself has some key limitations that have led to its use only as a last resort. These include the fact that: (a) the judge's powers are greatly limited;[278] (b) it provides no

274. 11 U.S.C. § 943(b)(7) (2011); SPIOTTO, ACKER & APPLEBY, *supra* note 269, at 157–58.

275. 11 U.S.C. § 943(b)(7) (2011); SPIOTTO, ACKER & APPLEBY, *supra* note 269, at 157–58.

276. SPIOTTO, ACKER & APPLEBY, *supra* note 269, at 133.

277. Interview with Clayton P. Gillette, Max E. Greenberg Professor of Contract Law, N.Y. Univ. Sch. of Law (Oct. 31, 2017). It is estimated by some that there could be more than $5 trillion in debt sitting at the state level. In Puerto Rico, where only about 25% of the debt could have been restructured through the proposed Chapter 9 filing. The massive numbers involved make it unlikely that Chapter 9 alone could be used as a tool to resolve most states' current fiscal issues.

278. Samir D. Parikh, *A Fulcrum Point for City Survival*, 57 WM. & MARY L. REV. 221, 243 (2016) (discussing how Chapter 9 filings are often ineffective because unlike corporate restructurings, the judge's powers are greatly limited because of his or her lack of governance control over the municipal debtor and local officials).

additional revenues or tax sources; (c) it affects all creditors regardless of if they are a problem or not; (d) there is a stigma attached to it; and (e) it involves great cost and complexity that local governments are ill-equipped to deal with.[279] Since Chapter 9 was enacted in 1937, municipalities have only filed 666 Chapter 9 petitions through July 31, 2016 despite there being over 80,000 eligible entities.[280] Since 1954, approximately 60% have been special tax districts and utilities and less than 20% have been cities, towns, villages, and counties.[281] If Chapter 9 was such an effective solution, one would expect its historical use to have been much more widespread.

D. *Federal Bailouts of the Most Severely Distressed States*

The idea of federal bailouts for the most severely distressed states also does not represent a serious alternative to resolving state bankruptcies. On one hand, it creates a moral hazard [282]—states would have perverse incentives to over-promise and spend knowing that they would never be forced to internalize the consequences of their lavish spending nor be able to credibly invoke austerity measures on their citizenry. The result would simply be an externalization of costs on fiscally-responsible states, resulting in a transfer of wealth from one to the other.[283] On the other hand, creditors would have little incentive to act as watchdogs and influence the behavior of their debtors given that their investment would be protected on the downside. Overall this would merely act as a risk-shifting mechanism from debtors and states to the federal gov-

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279. SPIOTTO, ACKER & APPLEBY, *supra* note 269, at 128–29; Judith Elkin, *A "Time Out" for Municipalities: The Recent Workings of Chapter 9 of the Bankruptcy Code*, *in* CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS, COUNSELING MUNICIPALITIES AND ANALYZING RECENT TRENDS AND CASES (2011), 2011 WL 5053638, at *6 (describing how Chapter 9 proceedings involve staggering financial costs "because of the complexity of the issues, and the amount of time and the number of legal, financial and accounting experts needed to reach conclusion.").

280. SPIOTTO, ACKER & APPLEBY, *supra* note 269, at 125–26.

281. *Id.*

282. Stephen L. Schwarcz, *A Minimalist Approach to State "Bankruptcy"*, 59 UCLA L. REV. 322, 325 (2011) (describing moral hazard in the context as an insured actor's propensity to take on supra-optimal risk because the actor will not bear the full costs if that risk were to materialize).

283. Skeel, *States of Bankruptcy*, *supra* note 208, at 705.

ernment, something that makes little sense economically or rationally.

Supporters of the federal bailout option point to the fact that the federal government intervened in the dire financial circumstances during the Great Recession of 2008, but the present landscape is much different. Firstly, the federal government has thus far refused to bail out Puerto Rico based on the rationales discussed above.[284] Secondly, the state municipal debt markets lack the interconnectedness and liquidity issues that were pervasive from late 2007 through 2009.[285] The entire banking system, as well as the automotive industry, were deemed "too big to fail" and few other options existed given their natures as quasi-public goods. As has been highlighted throughout this Note, better alternatives exist for states and thus their situations are not as dire holistically, even if it may appear so financially. Thirdly, the federal government is currently facing significant demands on its resources that must be dealt with before state bailout considerations. In 2016, Moody's estimated that the unfunded pension liabilities of the various federal agencies covering both civilian and military benefits totaled approximately $3.5 trillion, or 20% of the annual GDP of the United States.[286] This pales in comparison to the approximately $16.6 trillion funding gap in Social Security and Medicaid programs nationally.

Even if the federal government did want to help, it has its own pressing priorities to deal with first.[287] Finally, the idea of

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284. Walsh, *supra* note 1 (discussing how President Trump stated on Twitter that there should be no bailout for Puerto Rico on April 26, 2017); Mahler & Cofessore, *supra* note 77 (describing how hedge funds mobilized conservative opposition to proposed legislative action by the Puerto Rican government arguing that it would effectively be akin to the 2008 bailout of the automotive and financial service industries).

285. Skeel, *States of Bankruptcy*, *supra* note 208, at 704–05 (contrasting the need for a federal bailout of financial institutions during 2008–2009 on the basis of the interconnected nature of the market and significant liquidity constraints, neither of which is present in the municipal debt context).

286. Moody's Inv'rs Serv., *US Government Pension Shortfall Overshadowed by Social Security, Medicare Gaps*, MOODY'S (Apr. 6, 2016), https://www.moodys.com/research/Moodys-US-government-pension-shortfall-overshadowed-by-Social-Security-Medicare—PR_346878.

287. *Id.* ("The Social Security funding gap is estimated at $13.4 trillion, or 75% of GDP, while the shortfall from the Hospital Insurance component of the Medicare program amounts $3.2 trillion, or 18% of GDP.").

a federal bailout of a particular state with federal taxpayer money seems highly improbable from a political perspective, especially in light of the harsh criticism levied on the Obama administration as a result of their actions in 2008 and 2009.[288] A more realistic solution may be the provision of federal funds as part of a more comprehensive resolution process, perhaps playing a role similar to that of DIP financing in a Chapter 11 process. This will be explored to a greater extent in Section 5.2.

E. *State Defaults*

Finally, nothing prevents a state from simply defaulting on its obligations. A state is merely an administrative body tasked with representing the interests of a diverse group of living, breathing people. There are only so many remedies that can actually be enforced. A state's main incentive to pay their debts when due is the risk that defaulting would impose such huge losses on creditors affected, many of which could be their own populace, that doing so would lead to chaos, negative political implications, and significant litigation. A state default would disproportionately affect those holding instruments with the nearest-term maturities[289] and litigation would stem from the lack of an enforceable priority structure between many of the state's obligations.

Furthermore, no state has defaulted on its obligations since Arkansas in 1933 and thus this would create a significant ripple throughout the capital markets, likely leading to the same cascade effects and increased borrowing costs that anti-state bankruptcy proponents cite as a risk to instituting a bankruptcy framework.[290]

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288. "Federal bailouts must come to an end. Federal taxpayers in states that balance their budgets should not have to bail out the irresponsible, pandering politicians who cannot balance their budgets. Congress must allow a safe, orderly way under federal bankruptcy law for states to reorganize their finances." Bush & Gingrich, *supra* note 207; Skeel, *States of Bankruptcy*, *supra* note 208, at 706 (arguing that given the lingering hostility from the 2008 bailouts, a large federal intervention to rescue fiscally-distressed states "may not be politically plausible").

289. Interview with Richard Ravitch, Former Lieutenant Governor, N.Y. State (Nov. 6, 2017).

290. For example, Detroit's Chapter 9 filing and subsequent default on its public debt raised the cost of borrowing for Michigan's local governments by 50–100 basis points. This was also the case in Puerto Rico, which saw the

Thirdly, in the most extreme scenario, a state could be locked out of the capital markets in the future, which would have devastating consequences. States, like sovereigns or municipal governments, are repeat players. Their purposes are to "provide essential services and infrastructure at a level sufficient to assure the continued economic activities necessary to provide for the health, safety and welfare of citizens."[291] Given this long-term view, the perceived benefits of a near-term default are not sufficient when compared to the adverse effects on the government's ability to fund such services, generate growth, and build a sustainable tax base.[292]

Finally, defaulting does nothing to actually resolve the issues of state fiscal distress; the obligations remain on the state's balance sheet at their full face value. All that is being achieved by a default is a temporary delay in meeting contractual obligations in exchange for undertaking protracted costly litigation.

Given the reasons discussed, although state governments have more leverage than the typical Chapter 11 debtor, a strategic default does little other than buy time; it does not provide a legitimate solution to the resolution of the states' current fiscal predicaments. Neither an out-of-court process, Chapter 9, a federal bailout, nor a strategic default provides a legitimate solution to the present realities of the most distressed states. Thus, I propose the following alternative.

V.
PROPOSING A QUASI-BANKRUPTCY FRAMEWORK FOR RESOLVING FISCALLY-DISTRESSED STATES THAT NAVIGATES THE CONSTITUTIONAL CHALLENGES

"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

yield on its bonds spike to over 12% in October 2015 once creditors began to fear an impending default. SPIOTTO, ACKER & APPLEBY, *supra* note 269, at 3, 18–19.

291. *Id.* at 17–18.

292. *Id.*

is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor."

—Adam Smith[293]

A. *Preliminary Considerations*

As Adam Smith recognized nearly 250 years ago, bankruptcy can be a highly effective tool in resolving complex financial matters. The current crises of unfunded pension liabilities, aging infrastructure, and increased costs of health, education, and safety needs require new, creative ways for states to think about how they will meet their obligations to provide essential services to their citizenry.[294] Doing so will require both short-term actions to reduce the debt obligations, such as increased tax revenues and lower costs, as well as the ability to invest long-term in the government itself, the economy, and the people.[295] To ensure that kind of fiscal flexibility, intervention is imperative.

I believe that the optimal solution is one that builds on the many lessons learned from the present situation in Puerto Rico; I propose a solution (the "Rehabilitation Framework") that borrows many of the successful aspects of PROMESA, while making adjustments necessary to ensure that it is both politically palatable and constitutionally viable at the state level. The Rehabilitation Framework will make use of both an appointed federal oversight board and a quasi-judicial restructuring tribunal to resolve the issues at present and set the stage on the correct course for the future. The oversight board will be tied to federal funding grants and the state will subscribe to the debt restructuring mechanism through its typical state legislative process.

The Rehabilitation Framework has been designed with flexibility in mind; not every state would need to avail itself of both components, if any at all, given that each state faces unique challenges that need to be addressed on a case-by-case

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293. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 468 (Edwin Canaan ed., The Univ. of Chi. Press 1976).

294. *Role of Public Employee Pensions, supra* note 199, at 19.

295. *The Need for the Establishment of a Puerto Rico Financial Stability and Economic Growth Authority: Hearing Before the Subcomm. on Indian, Insular and Alaska Native Affairs of the H. Comm. Nat. Res.*, 115th Cong. 1 (2016) (statement of James E. Spiotto, Partner, Chapman and Cutler LLP).

basis.[296] The framework merely operates as a background default framework that would provide clarity to debtor states, their populations, and creditors as they chart a path forward.

1. *Re-conceptualizing the Process as a Personal Rather than Corporate Bankruptcy*

The first step in conceptualizing the Rehabilitation Framework is understanding the nature of exactly what is being restructured. Many view bankruptcy as fitting a left-to-right spectrum.[297] On the left you have personal bankruptcy, and moving towards the right you have corporate bankruptcy, municipal bankruptcy, and finally sovereign restructurings.[298] As you move from left to right, many argue that the benefits of a formal bankruptcy process decrease.[299] State bankruptcy is currently seen as analogous to sovereign restructurings, leading many to argue that a formal framework, even if constitutionally viable, would represent an inadequate solution.[300] Upon closer analysis, there are fundamental differences between state bankruptcies and sovereign restructurings, a point that prominent scholar David Skeel makes correctly when he argues that state bankruptcy is actually more akin to a Chapter 13 personal bankruptcy. [301] Once viewed through that lens, the need for a formal framework emerges.[302]

There are many parallels between state and sovereign bankruptcies because of their differences with corporate bankruptcies. The key objective of a Chapter 11 reorganization is to maximize enterprise value for the benefit of all stakeholders. This usually involves restructuring the balance sheet and operations of a company so that it can efficiently contribute to the larger economy through providing valuable goods and/or services. If stakeholders can derive more value from breaking up the company, it should thus be liquidated. The process also importantly involves determining who has what claims on that enterprise post-restructuring. In this way, the Chapter 11 pro-

296. Telephone Interview with Antonio Weiss, *supra* note 144.
297. Skeel, *supra* note 256, at 2219–20.
298. *Id.*
299. *Id.*
300. *Id.*
301. Telephone Interview with David Skeel, *supra* note 98.
302. *Id.*

cess acts as a mechanism for efficient reorganization of the enterprise and classification of claims and interests.

A state or sovereign differs from a corporate debtor because, much like an individual, it cannot be "liquidated" and have its assets redistributed for more efficient economic uses.[303] Secondly, a state also differs from a corporation because if New York or California refuse to pay their creditors, there is not much that creditors can do in retaliation despite having legitimate claims on that "enterprise."[304] The Eleventh Amendment precludes most litigation against states and it is unrealistic for a creditor to demand its assets as collateral; no one is receiving the keys to a state park or town hall.[305]

These differences, although important, do not mean that states should be precluded from the use of a formal restructuring framework. States get in trouble much in the same way as consumers do—they over-borrow, focusing on the short-term benefits and deferring the long-term costs to future generations.[306] This over-borrowing leads a state to have to restructure itself because its current fiscal distress precludes it from carrying out its fundamental duty to deliver services for which it is the monopoly provider.[307] Failing to do so results in those who pay taxes in excess of the benefits they receive leaving the state, leading to further balance sheet deterioration.[308] Even if citizens remain, the wealthy will increasingly turn to private service options, leading to stratification in the population between those who can afford to replace those services, even with imperfect substitutes, and those that cannot.[309] In the words of Gillette and Skeel, "[t]he fact that local governments provide public goods otherwise undersupplied due to the market failures means that . . . market solutions cannot remedy government failures."[310]

The constraints faced by states are thus parallel to those of Chapter 13 consumers and an inability to properly restructure will impose significant costs on third parties. In a personal

303. Schwarcz, supra note 126, at 958–59.
304. Skeel, *supra* note 256, at 2227.
305. *Id.*
306. *Id.* at 2228.
307. Gillette & Skeel, *supra* note 207, at 1161.
308. *Id.*
309. *Id.*
310. *Id.*

bankruptcy those third parties are friends and relatives, and in the case of a state, it is current taxpayers, future taxpayers, and the taxpayers of other states.[311] The result of this reconceptualization is that any proposed solution to state fiscal distress must be predicated on providing debtor states with a "fresh start," meaning relief from burdening debt.[312] This is ultimately in the best interest of the debtor, third parties, and creditors.[313] I believe that this necessitates a more formal, rather than out-of-court, process for the reasons I argue in Part VI.

2. *Defining State Insolvency*

A second essential consideration is defining state insolvency. This is important for two reasons. Firstly, it acts as an important guidepost for state legislatures and governors in determining at what point intervention is necessary and when the use of a rehabilitation framework is beneficial. Secondly, it also acts as a necessary condition that a state will need to demonstrate in order to have the quasi-judicial restructuring tribunal accept its filing.

At first glance, this may seem like a simple question but there are many possible definitions of insolvency throughout the law. Is a state insolvent when the book value of its liabilities exceeds the book value of its assets? What if we use market values instead? Who should be calculating these market values and how? Should we instead focus on a liquidity-based test in which a state is deemed to be insolvent when it actually cannot meet its debt payments as they come due? Do the significant unfunded pension liabilities on state balance sheets necessitate a prospective approach where the determination is whether or not a state will be able to fulfill its future obligations, regardless of if it can at present?

SCOTUS has never fully defined the scope of bankruptcy. In *Sturges v. Corwninshield*, one of the earliest and most important cases on the scope of bankruptcy, the court held that the Bankruptcy Clause of the United States Constitution gave Congress the power to marshal the debtor's assets to pay its credi-

311. Skeel, *supra* note 192, at 1076.
312. *Id.* at 1075–76.
313. *Id.*

tors and to discharge some or all of the debtor's obligations.[314] Interestingly, the court never stated, and has never explicitly stated since, whether or not insolvency is a prerequisite to bankruptcy.[315]

When municipalities petition for relief under Chapter 9 they primarily do so because their fiscal distress precludes them from presently delivering the services for which they are relied upon to provide.[316] This has led bankruptcy courts to focus on service delivery, rather than debt service alone, as the measure of whether a municipal debtor is in fact "insolvent" and thus eligible to file.[317] When a municipality ultimately wants to emerge from Chapter 9, it must submit a restructuring plan to the court deemed "feasible" on the basis that it will allow the municipality to provide its government services going forward.[318]

In the corporate context, Section 1112(b) of the Bankruptcy Code enumerates a variety of abuses or failures that can lead to the dismissal of a Chapter 11 case, and courts have consistently found that filing a case "in bad faith," even if not listed, constitutes proper cause.[319] Courts have focused on the debtor's need for Chapter 11 relief, such as the preservation of going concern value or the maximization of the property available to satisfy creditors.[320] If the filing is motivated by something else, such as gaining a tactical litigation advantage, it could be dismissed.[321] Although the debtor's solvency may be relevant to the analysis, it is not determinative.[322]

Skeel argues for the use of the Chapter 11 "good faith" standard in order to avoid the risk of a state's petition being rejected, but I believe that a standard more akin to Chapter 9

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314. U.S. CONST. art. I, § 8, cl. 4; Sturges v. Corwninshield, 17 U.S. 122 (1819); Skeel, *States of Bankruptcy*, *supra* note 208, at 681.

315. Skeel, *States of Bankruptcy*, *supra* note 208, at 681.

316. Gillette & Skeel, *supra* note 207, at 1160.

317. *Id.*

318. *Id.*

319. Paul D. Leake, *Making the Case for a "Good Faith" Chapter 11 Filing*, JONES DAY (Dec. 2004), https://www.jonesday.com/files/Publication/e07e38ed-fd3a-4695-a1e4-d2b90c0b933a/Presentation/PublicationAttachment/b8650228-a690-438c-b453-eb32b96342a4/NYI_2173499_v1_GoodfaithfilingDecember%202004%20BRR.pdf.

320. *Id.* at 3.

321. *Id.*

322. *Id.*

is necessary in light of the Contracts Clause.[323] As interpreted by SCOTUS, a state may only impair its contractual obligations if the impairment is "necessary and reasonable to serve an important public purpose."[324] A standard that provides relief when a state is suffering from a governmental emergency through its incapacity to pay its debts as they mature or provide essential governmental services without relief would appear to satisfy the constitutional obstacle.[325] I would complement the Chapter 9 standard with Chapter 11's focus on a more prospective look. This would allow states to meet the "important public purpose" requirement by demonstrating not only that they cannot meet their contractual obligations but also that they will be clearly unable to do so in the future. This would allow states to file preemptively and resolve inevitable issues today rather than allow them to compound by continuing to defer costs onto future taxpayers.

In conclusion, under my proposed Rehabilitation Framework, the concept of state insolvency would be understood by public officials and the courts as requiring a legitimate threat, either present or future, to the state's ability to fulfill its core functions.

3. *Submitting a State to the Restructuring Framework*

Assuming that reframing state bankruptcy supports a structured resolution process based on a flexible yet constitutional definition of state insolvency, it is unclear exactly who is ultimately responsible for both making and acting on such a determination. I borrow from Jeb Bush and Newt Gingrinch the idea that any framework should provide for a triggering mechanism that "respect[s] the sovereignty of the people of a state."[326] The democratically-elected legislature, acting by a majority vote, along with the consent of the governor, should

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323. This piggybacks off an argument put forward by David Skeel that in putting forward a regime to restructure fiscally distressed states any threshold for filing should mirror the corporate bankruptcy approach of not requiring a formal showing of insolvency and instead focus on the state being "in default or danger of default." Skeel, *States of Bankruptcy*, *supra* note 208, at 714.

324. U.S. Trust Co. v. New Jersey, 431 U.S. 1, 25 (1977).

325. *See generally Role of Public Employee Pensions*, *supra* note 199, at 8.

326. Bush & Gingrich, *supra* note 207, at 2.

be required to initiate any "in-court" process.[327] This would allow the taxpayers, who have perhaps the most significant stake in any state reorganization, to have a voice in the process regardless of whether or not they are creditors, while at the same time avoiding the burden of having to go to them directly through a referendum. The consent of both the legislature and the state governor acts as a system of checks and balances ensuring that the restructuring tribunal is only used in the most extreme and necessary circumstances.

B. *Instituting A State-Appointed Oversight Board Modeled Off PROMESA*

1. *The Concept of an Oversight Board*

The capacity of government officials to impose temporal externalities on their given states is beyond doubt. Self-interest motivates politicians to pursue programs delivering short-term benefits while deferring costs of those same programs into the future in order to attract investment and lobby for electoral success.[328] As a result, the first part of my two-part Rehabilitation Framework for fiscally-distressed states is the appointment of an independent federal government-appointed oversight board (the "Oversight Board") tasked with making fiscal decisions for the state absent self-interest. The Oversight Board will have authority over the states' budgets and related issues, similar in many ways to the PROMESA oversight board currently overseeing the restructuring efforts in Puerto Rico.[329]

One major difference between the PROMESA oversight board and the one proposed here is that this body would be tied to the receipt of federal funding as part of any bank-

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327. *Id.*

328. Gillette notes that "[o]fficials sponsor capital projects that are financed with debt and that can immediately deliver jobs and civic pride, notwithstanding that those projects may turn out to be the white elephants of tomorrow" and "structur[e] compensation for public employees in a manner that provides supracompetitive benefits—such as substantial pensions for members of unions that can offer political backing—the costs of which materialize only once the officials are out of office." Gillette, *supra* note 200, at 107.

329. 48 U.S.C. § 2141 (creating an oversight board and setting out its role and responsibilities with respect to the territorial restructuring).

ruptcy.[330] It is accepted that Congress has substantial power over conditional spending under its Taxing and Spending Clause powers, subject to limited exceptions.[331] Thus, the federal government could require the appointment of an oversight board as a prerequisite for federal financing, mirroring the demands of debtor-in-position lenders ("DIP lenders") in corporate bankruptcies or the International Monetary Fund ("IMF") in their conditions placed upon troubled countries.[332]

The federal government has much greater power to impose an oversight board on a territory like Puerto Rico than it would have over a state so tying it to federal bailout funds would be essential in order to alleviate concerns of interference with the decision-making processes of a state's democratically elected officials.[333] So long as the formation of an oversight board relied on "invitation rather than coercion," it seems that such a framework would be constitutional.[334] The oversight board would thus side-step constitutional issues, respect the integrity of the democratic process, and play an essential role in the rehabilitation of the distressed government.[335]

Among the many advantages of instituting an oversight board is that such a body injects necessary restructuring and fiscal expertise into governments that clearly are lacking such competencies. At the same time, the Board provides credible assurance to the broader capital markets that decision makers are working together towards a resolution.[336]

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330. 48 U.S.C. § 2121 (outlining the structure of the oversight board and its membership).

331. *See* South Dakota v. Dole, 483 U.S. 203 (1987) (upholding the constitutionality of a federal statute that withheld federal funds from states whose legal drinking age did not conform to federal policy); *contra* National Federation of Independent Business v. Sebelius, 567 U.S. 519 (2012) (invalidating a portion of the Affordable Care Act which effectively "coerced" states to either accept the expansion or risk losing their significant existing Medicaid funding upon which they substantially relied).

332. Skeel, *States of Bankruptcy*, *supra* note 208, at 731–32.

333. See *supra* Section I.E.

334. Skeel, *States of Bankruptcy*, *supra* note 208, at 731.

335. GILLETTE & SKEEL, *supra* note 247, at 1.

336. *Id.*

2. *Membership, Appointment, and Termination*

I recommend that the Oversight Board be made up of seven members so that it is both large enough to ensure the representation of all necessary constituencies and expertise while not being so large that it becomes unwieldy.[337] Two of the seven members should be ex-officio members and the remaining five will be nominated by the governor and confirmed by majority vote of the legislature.

The first ex-officio member will be the state governor, providing legitimacy and political accountability.[338] This also allows the governor to benefit from the experience of being surrounded by six experts for a significant period of time,[339] providing an element of learning and continuity once the Oversight Board is ultimately disbanded. Another advantage of having the governor on the Board is that it helps align the interests of all parties. One of the biggest issues in Puerto Rico has been the unwillingness of the governor to enact the measures imposed on the Commonwealth by the oversight board.[340] Allowing him or her to have a voice in the decision-making process could go a long way to resolving the potential gridlock.

The second ex-officio member will be the Treasury Secretary or their designee, ensuring representation of federal interests in the health of the state of the union.[341] Given the Board would only be enacted in situations where the state was seeking significant federal funding as a result of a subsequent restructuring, this would be consistent with concessions given to DIP lenders. Although some may worry about the constitutional implications of federal representatives directing state policy choices, the federal influence would merely represent one of seven votes. At the same time, the federal and state governments have partnered for years on many state issues including unemployment insurance, welfare, and Medicaid, all of which impose extensive constraints on states in exchange for participation;[342] this should be seen as analogous.

337. *Id.* at 5.
338. *Id.*
339. *Id.*
340. Interview with Arthur Gonzalez, *supra* note 8.
341. *Id.*
342. Skeel, *States of Bankruptcy*, *supra* note 208, at 731.

Of the five remaining members, two will be from the distressed state, ensuring that local interests and expertise is infused into the process. Brett Murray, Vice-President at Lazard Frères & Co. who has been actively involved in the restructuring efforts in Puerto Rico through Lazard's representation of a monoline insurance company, highlights the importance of including local interests in the decisionmaking process.[343] Although an oversight board should be composed of actors lacking any self-interest, a lack of connection to the debtor state could lead to radical cancellation of debt through abuse of the restructuring tribunal.[344] Instead of being interested in long-lasting solutions or fears over future access to the capital markets, an oversight board lacking ties to the economic future of the state may succumb to politically and operationally easier solutions to the complex problems faced.[345] In this way, the two "interested" members serve a useful function beyond alleviating constitutional concerns or providing local expertise.

The remaining three members will be external for the opposite reasoning—an external perspective is important, self-interest should be contained, and it is doubtful that all beneficial expertise resides within a particular state.

A final advantage of this structure is that, including the governor, three of the seven members will always be seen as state actors, providing legitimacy to the restructuring efforts in the public eye. At the same time, four members will be uninterested, preventing local interests from overwhelming the process. Of the five non ex-officio members, I recommend that similar to Puerto Rico, at least two and no more than three come from the private sector. It is likely that these individuals would have substantial experience in budgeting, public debt, service delivery, and capital markets, which would provide comfort to both creditors and potential future lenders.[346] At the same time, we are still restructuring a government entity, so those with public sector experience are similarly invaluable.

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343. Telephone Interview with Brett Murray, Vice-President, Lazard Frères & Co. (Mar. 24, 2018).

344. *Id.*

345. *Id.*

346. GILLETTE & SKEEL, *supra* note 247, at 6.

The termination of the Board will not be effective upon the emergence of the state from the quasi-judicial restructuring process because the Board serves an important independent purpose. The Board will only be disbanded once the U.S. Treasury determined that the governance dysfunction that substantially contributed to the fiscal distress has been addressed and the state affairs are sustainable.[347] This will be true regardless of whether the state chooses to avail itself of the restructuring tribunal or not. Exactly how this will be determined could be the subject of future research, although it should likely comprise a combination of objectives and measures (e.g. economic, income statement, and balance sheet benchmarks) that mirror the goals originally set out by the oversight board in its assessment of the state's fiscal position pre-appointment.

3. *Powers*

The Oversight Board will have a variety of powers analogous to those granted to the PROMESA board. For example, it will have the power to: (a) negotiate with creditors and enter into binding debt adjustment agreements; (b) commission and review audits of financial statements; (c) approve or disapprove annual and 5-year budgets and financial plans (providing benchmarks against which spending could actually be measured and making deviations evident); (d) receive monthly and quarterly revenue and expense reports; (e) approval of substantial contracts for goods and services, including collective bargaining contracts with public unions; (f) approval of debt issuance(s); and (g) imposition of best practices and sanctions for failure to follow.[348] The Oversight Board should not determine the spending priorities within a balanced budget.[349] Although it could use its expertise to make recommendations to state officials, ultimate autonomy should be preserved to those who are democratically elected.

All of the powers described above will give the Oversight Board ample authority to help lead an out-of-court restructuring of the state. The hope is that in the majority of circumstances this is enough to help better manage the presently un-

347. *Id.*
348. 48 U.S.C. §§ 2124, 2141–42, 2145, 2147.
349. GILLETTE & SKEEL, *supra* note 247, at 1–3.

sustainable liabilities, reinvent its fiscal budgeting practices with a view towards the future, and return itself to a place economically where it is able to provide the vital services that all citizens rely on it for. One must be cautious of the constitutional issues lurking in the background when delineating its powers,[350] but the Oversight Board here is much less powerful than the emergency managers instituted in the Washington, D.C. or Detroit bankruptcy cases, which makes it less problematic.[351]

C. *Forming a Quasi-Judicial Debt Restructuring Process*

The United States' federal bankruptcy system is premised on the belief that sometimes out-of-court solutions will not be attainable and thus something "more" is needed to help restructure a given actor or entity. The second part of my two-part rehabilitation framework focuses on that issue and argues for the creation of a quasi-judicial debt restructuring mechanism (the "Restructuring Tribunal") that will play a role similar to Judge Swain's federal district court in Puerto Rico. The Restructuring Tribunal will be a state-level specialized entity staffed by federal bankruptcy judges appointed on a case-by-case basis by the Chief Justice of SCOTUS given the Supreme Court's jurisdiction over all inferior federal courts and their officials under the Constitution.[352] The advantage of staffing this tribunal with federal bankruptcy judges is that they are likely to be the most experienced in dealing with restructuring-related issues, especially given that many elements and legal concepts from the Bankruptcy Code will be imported into legislation for the restructuring tribunals, much in the same way as was done with PROMESA. The use of a federal judge would also be important given his or her lack of self-interest. There will inevitably be a lot of political pressures in these cases given the significant amount of pension debt that may need to be restructured and thus having a party overseeing the process insulated from political influence would be valuable.

The Restructuring Tribunal will oversee the case, make important rulings on decisions as they arise, and ultimately

350. Telephone Interview with Antonio Weiss, *supra* note 144.
351. *Id.*
352. U.S. Const. art. III, § 1 ("The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts . . . .").

help parties towards a negotiated plan of rehabilitation. Upon final submittal and subsequent confirmation of a feasible plan to the Tribunal, the state will emerge and carry through on the negotiated agreement under the continued coordination of the Oversight Board. The following are some of the most important features that would need to be part of the proposed legislation establishing the Restructuring Tribunal.

1. *Commencement of a Case*

Mirroring PROMESA, a state will need to consent to submit itself to the Restructuring Tribunal in order to avoid constitutional issues discussed previously.[353] The state will do so through a majority vote in its legislature, combined with the consent of the governor.

The state's ability to file a petition will be limited. As discussed previously, state insolvency will be defined as a governmental emergency necessitating relief in order for it to provide essential services, whether the threat is present or future.[354] This will give a state in fiscal distress a realistic possibility of using the proposed framework, yet still allow room for creditors' objections to be heard by a neutral third party. The authorizing legislation will set forth certain enumerated factors that will help guide the Tribunal's review of any petition and its decision to reject should be appealable within the federal court system.[355]

This is not the first time that someone has proposed the need for some type of judicial intervention to resolve state fiscal issues. In his 2011 congressional testimony on the issue, James Spiotto proposed the appointment and use of an independent public pension commission, combined with the federal appellate court system, to which states could voluntarily submit themselves in order to restructure their burdensome pension obligations.[356] My concept builds on this idea, but also borrows substantially from the experience in Puerto Rico given that in some states, such as Connecticut, pension liabili-

353. 48 U.S.C. § 2162.
354. *See supra* Section V.B.2.
355. *See generally Role of Public Employee Pensions*, *supra* note 199, at 16 (2011) (statement of James E. Spiotto, Partner, Chapman and Cutler LLP).
356. *Id.* at 15–17.

ties are not the only significant liability in need of restructuring.[357]

2. *The Automatic Stay*

A key feature of bankruptcy law[358] and Title III of PROMESA[359] important to incorporate into the Restructuring Tribunal is the automatic stay. The automatic stay prevents creditors from suing the debtor or taking any other steps to enforce their contractual rights, including collecting what they believe they are owed.[360] There are two rationales for this. The first is the belief that stopping these efforts will lead to a more orderly and even administration of the debtor's financial affairs, ultimately leading to more successful restructuring outcomes.[361] The second is that it prevents a "race to the courthouse" whereby creditors would be able to seize assets in a way that failed to promote equality of distribution.[362] Although one may argue that it is less necessary for a state to have such a tool as compared to a corporate debtor given the limited avenues for creditors to force repayment,[363] the Argentinian sovereign debt crisis provides an interesting case study. There, creditor Elliott Management was able to seize collateral in the form of a military vessel.[364] Beyond this, there are significant time and human capital costs to "unnecessary" litigation filed in courts throughout the United States.[365] For these reasons, incorporating this traditional concept became important.

357. *See supra* Section II.B.

358. 11 U.S.C. § 362(a).

359. 48 U.S.C. § 2194.

360. GILLETTE & SKEEL, *supra* note 247, at 14.

361. Schwarcz, *supra* note 126, at 985 (discussing how one of the important roles of the automatic stay is to "accomplish the orderly and even administration of the debtor's property and financial affairs"); Miller, Varughese & Barson, *supra* note 199, at 1 (describing how the automatic stay importantly provides "breathing space" for the debtor state to negotiate a successful restructuring outcome with its creditors).

362. GILLETTE & SKEEL, *supra* note 247, at 14 (stating that the automatic stay is key in bankruptcy cases given its ability to prevent a "race to the courthouse" that could jeopardize the debtor's restructuring efforts).

363. *Id.*

364. Joe Weisenthal, *A Hedge Fund Has Physically Taken Control Of A Ship Belonging To Argentina's Navy*, BUS. INSIDER (Oct. 4, 2012, 5:28 AM), https://www.businessinsider.com/hedge-fund-elliott-capital-management-seizes-ara-libertad-ship-owned-by-argentina-2012-10.

365. *See* GILLETTE & SKEEL, *supra* note 247, at 14–15.

3. *Debtor-in-Possession Financing*

Another important feature to incorporate into the Restructuring Tribunal's legislation are provisions supporting debtor-in-possession financing ("DIP financing") to allow the debtor state to maintain liquidity throughout the restructuring process. DIP financing is special financing available only to companies that file under Chapter 11 of the Bankruptcy Code and it facilitates reorganization by providing liquidity in exchange for super-priority repayment above all other debt and equity claims.[366] In the context of a state restructuring, the DIP lender will be given payment priority over all existing creditors, whether that be bondholders or pensioners. This may not be necessary in all cases though. For example, if a state is only filing to strategically deal with the strong possibility of a future governmental emergency, liquidity is less likely to be an issue.

Questions may arise about the extent to which the capital markets will be willing or able to meet the DIP financing borrowing requirements of these distressed states. As to the question of willingness, James Spiotto offers an interesting proposal whereby legislation could include a provision by which the federal government would back tax-exempt bonds at the lowest interest rate available in order to further reduce the risk of providing DIP financing.[367] If the question is instead one of availability of capital, the federal government could step in and provide support itself.[368] Unlike the criticisms of a full-on federal government bailout, this Federal government support will simply be restricted to DIP financing facilitating the restructuring process underway, rather than an independent solution to state fiscal distress.

4. *Rejection of Executory Contracts*

The ability to reject executory contracts is a crucial part of many corporate restructurings and is an equally important tool to have in the state context. This allows the debtor to choose between continued performance of beneficial con-

366. *Debtor-in-Possession Financing*, INVESTOPEDIA, https://www.investopedia.com/terms/d/debtorinpossessionfinancing.asp (last visited Feb. 8, 2018).
367. *Role of Public Employee Pensions*, *supra* note 199, at 17 (2011) (statement of James E. Spiotto, Partner, Chapman and Cutler LLP).
368. Skeel, *supra* note 192, at 1078.

tracts and termination or rejection of those deemed to be burdensome.[369] Without this provision, the termination of many contracts is difficult without significant harm caused to the government.[370] Any claim subsequently arising out of the rejection of the contract is treated as a prepetition, unsecured claim *pari passu* with other such claims in the debtor's estate.[371]

This provision does not require the debtor to reject all contracts, and therefore it can pick and choose those that it wishes to continue to perform under and those that it wishes to terminate or renegotiate. For example, the debtor could terminate an expensive contract for an infrastructure project with a private development firm that is no longer a priority in light of the government's stressed fiscal situation. Similarly, many governmental services are provided by private contractors and therefore the government could use this provision to renegotiate or consolidate its service providers. Finally, and perhaps most importantly, this provision will allow a state government to reject and renegotiate labor contracts with public labor unions, especially critical given the enormous unfunded pension liabilities and of continued growth trajectory.[372]

5. *Confirmation Requirements*

The final set of important features to include in the Restructuring Tribunal's legislation are requirements for confirming a plan of rehabilitation. The first is the requirement that the plan be accepted by the creditors themselves. I recommend that voting provisions binding all creditors in a class require only a majority vote of the number of creditors in a given class representing at least two-thirds in amount of the claims to avoid the issues of creditor holdouts that cause significant difficulty in out-of-court restructurings requiring unanimity.[373] This mirrors the development of corporate and municipal bankruptcy law and provides a good balance between protecting individual creditor rights and efficiency.

369. Schwarcz, *supra* note 126, at 997.
370. *See* GILLETTE & SKEEL, *supra* note 247, at 15.
371. Schwarcz, *supra* note 126, at 998.
372. Skeel, *States of Bankruptcy, supra* note 208, at 702.
373. GILLETTE & SKEEL, *supra* note 247, at 15.

The second general confirmation requirement is that there be no unfair discrimination and the plan of rehabilitation be in the best interest of creditors. In requiring that there be no unfair discrimination among creditors, the legislation will ensure that similarly-situated creditors receive comparable treatment in their recoveries.[374] This protects creditors from being able to coerce creditors entitled to the same recoveries into acting adversely towards each other and comports with overall ideals of fairness. For a plan to be in the best interest of creditors in the Chapter 11 context, creditors must recover more under the reorganization than they would if the company were to be liquidated. Given that a state cannot be liquidated, the definition should be modified to require that creditors be given as much under the plan as is reasonably possible, while keeping in mind the government's obligation to provide at least a baseline level of services to its constituents both at present and in the future.[375]

The third and perhaps most important confirmation requirement is that the plan submitted before the court be deemed "feasible." Similar to the municipal context, this requires that the court inquire into whether or not the plan adequately addresses the state's liabilities but also whether it properly reforms the government structures and incentives responsible for generating the fiscal distress in the first place.[376] In this way, the plan should provide for a permanent fix, and not simply a "Band-Aid" solution.[377] This also implicates whether adequate public services can be provided both at the present as well as for the long-term, assuming that the plan is properly instituted.[378] The proposed solution should not focus only on cost-cutting and liability reduction alone. Instead, it should also consider ways in which the government can generate sufficient economic stimulus to create new business opportunities which will increase employment and thus the tax base.[379] Only through combining elements of cost-cutting, new revenue generation, liability relief, and structural changes will the plan of rehabilitation be credibly feasible.

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374. *Id.* at 16.
375. *Id.*
376. *Id.* at 17.
377. Spiotto, *supra* note 215, at 545.
378. *Id.*
379. *Id.*

Although many other elements and provisions will need to be included in legislation surrounding both the Oversight Board as well as the Restructuring Tribunal, I believe that this provides a general overview of those powers and responsibilities necessary to ensure a successful state restructuring process.

VI.
THE PROPOSED FRAMEWORK WOULD BE IN THE BEST INTEREST OF *BOTH* STATES AND CREDITORS

Having put in place the parameters for my two-part rehabilitation framework, the question becomes why would states agree to this? Why would creditors? The restructuring attempts in Puerto Rico highlight how differences in opinion over process among debtors and creditors can have tremendous costs and divert essential resources away from fixing the problems. In speaking with scholars, practitioners, and investors in the field, I believe that the framework I have proposed is beneficial to both debtor and creditor interests in aggregate and thus the proposed legislation should be supported by all.

A. *Mutual Advantages of a Federally-Appointed Oversight Board*

Having an oversight board is critical from the debtor's perspective because it provides the ability to solve the underlying core issues that lead to the state's financial distress in the first place. Professor Clayton Gillette argues that immediate sources of fiscal distress—the legacy costs of pension obligations and debt—are attributable to problems of institutional design, which lead to the systematic distortion of decision-making.[380]

The first of these distortions is the fact that the present system encourages government officials to focus on short-term benefits that help their self-interested goals of re-election at the expense of policies that would maximize the fiscal health of the states that they govern.[381] As a result, they inevitably finance current expenditures through borrowing, often in ex-

380. Clayton P. Gillette, *Can Municipal Political Structure Improve Fiscal Performance?*, 33 REV. BANKING & FIN. L. 571, 572 (2014); Skeel, *States of Bankruptcy*, *supra* note 208, at 683.

381. Gillette, *supra* note 380, at 572; *see generally* Skeel, *States of Bankruptcy*, supra note 208, at 683.

cess of the state's ability to repay, in order to enjoy the benefits at present while passing on the costs to others.[382] The significant pension issues faced by states can be traced to a combination of elected officials' dependence on votes of unionized public employees and the incentive to limit the amount put aside for future pension liabilities, similar to the borrowing concept.[383] Unlike in a corporate bankruptcy, the decision makers cannot be displaced outside of the political processes.[384] The presence of an oversight board imposes discipline on government officials and can put in place policies that will reshape corporate governance practices so that the same pitfalls can be avoided in the future.

The second is a divergence in interests between decision makers and their citizens. It can be useful to think of the situation as akin to a common pool resource given the government's monopoly position as provider of local services.[385] The services represent a common pool where a variety of participants can obtain benefits while ideally sharing the costs.[386] Fiscal policy is decentralized in a way that allows decision makers to make budgetary decisions without internalizing the costs, leading to a tendency to overuse and abuse the common resource.[387] Different branches of the bureaucracy have authority over spending and are inattentive to the manners in which their spending affects the overall state budget.[388] Moreover, different individuals within the government have authority over spending and choose to support different projects for personal benefits.[389] Finally, those with expenditure authority do not coordinate and therefore may duplicate spending or

382. Skeel, *States of Bankruptcy*, *supra* note 208, at 690–91.

383. *Id.* at 691; Gillette, *supra* note 380, at 572 (describing how officials trade higher compensation to public sector employees in the form of increased pension benefits in order to solicit their important electoral support).

384. Skeel, *States of Bankruptcy*, *supra* note 208, at 683.

385. Gillette & Skeel, *supra* note 207, at 1150, 1185.

386. *Id.* at 1185.

387. *Id.*

388. *Id.*; Gillette, *supra* note 380, at 576 (arguing that in the typical government structure there are a variety of avenues to get funds and none of the gatekeepers of those avenues has any reason to be concerned about the larger budget as a whole).

389. Gillette & Skeel, *supra* note 207, at 1186.

do so in ways that conflict with each other.[390] The extent to which government distress is attributable to such temporal misalignment of costs and benefits could be improved through centralizing decision making in an oversight board who puts in place structural reforms to those institutions that exacerbate the externalization of costs to future generations.[391] Monolithic control over the budget prevents different groups within the government from serving the interests of a subset rather than the state as a whole.[392]

Beyond the ability to demand structural changes, the use of an oversight board can also be advantageous for political reasons because it provides political deniability.[393] Many of the actions that would need to be taken (such as returning services to more sustainable levels, cutting pensions, etc.) would be politically unpopular so having an oversight board be responsible for making and implementing these decisions could insulate elected officials from public fallout.[394] This is true not only of state politicians but also the leaders of organized labor. Unions are also political organizations with their officials accountable democratically to the membership base.[395] The argument that a pensioner should give up promised future benefits so that taxpayers can avoid further tax hikes or investment funds can generate higher returns is a hard sell, even if it may reflect a necessary negotiated compromise.[396] Shifting political accountability onto a state oversight board could be an important aspect of reaching necessary compromises around pension liabilities.[397] Finally, an oversight board is preferable to a court or tribunal because it involves politically-accountable

390. *Id.* at 1187.
391. *Id.* at 1193.
392. Gillette, *supra* note 380, at 579.
393. Telephone Interview with James Spiotto, Co-Founder, Chapman Strategic Advisors (Oct. 9, 2017); *See also* Gillette & Skeel, *supra* note 207, at 1195–96.
394. Telephone Interview with Spiotto, *supra* note 393.
395. Telephone Interview with Bloom, *supra* note 137 (arguing that unions themselves are democratic institutions and therefore the most difficult part of a union leader's job is having to deliver bad news to the membership base. Allowing a leader to deflect responsibility of unpopular decisions onto state official or judge can substantially increase the bargaining opportunities available).
396. *Id.*
397. *Id.*

state officials in the decision-making process and a board can act much more expeditiously than a court or tribunal can.[398]

Creditors should similarly favor the implementation of an oversight board because the majority of government restructurings do not result in cash payouts; creditors retain their old securities or receive new securities in the given entity.[399] Creditors are invested in the debtor and have an interest in its successful restructuring so that they can ultimately be repaid. Creditors therefore have a similar interest in permanent structural solutions rather than quick fixes.

B. *Mutual Advantages of an Opt-in Quasi-Judicial Debt Restructuring Process*

The most radical element of my proposed framework is the imposition of a restructuring tribunal, which would operate in many ways like a court in a Chapter 9 municipal proceeding. On the most basic level, a formal restructuring process would serve the important purpose of providing the debtor with a "fresh start."[400] Much like a corporate debtor that avails itself of Chapter 11, the process would allow the state to restructure or shed significant bond and pension liabilities which impair its ability to meet its central function of service delivery to its citizens. At the same time, unsustainable debt causes a debt overhang problem stifling growth through the state's inability to make critical investments.[401] This is exacerbated by the fact that liquidation is not an option.[402] As we have seen in Puerto Rico, the lack of a process can lead to significant costs that further exacerbate what is already a troubled situation, decreasing the likelihood of a successful resolution and depressing creditor recoveries. It is with this in mind that debtors and creditors should evaluate the following benefits.

398. Skeel, *States of Bankruptcy*, *supra* note 208, at 734.
399. Interview with Richard Ravitch, *supra* note 289.
400. Burnett, *supra* note 212.
401. Skeel, *supra* note 256, at 2233; Skeel, *States of Bankruptcy*, *supra* note 208, at 687.
402. Skeel, *States of Bankruptcy*, *supra* note 208, at 687.

1. *Primary Advantages to the Debtor State*

a. Restructuring Incentives Through Imposing Necessary Governance

In addition to having a centralized authority tasked with reform, the debt resolution process plays a critical role as well. Firstly, the process creates political opportunities that did not previously exist.[403] In the same way as an oversight board with "outsiders" incorporates elements of political deniability, so too does the restructuring tribunal staffed with unelected federal bankruptcy judges.[404] In the event that there had to be significant cuts to public sector pensions, increases in taxes, or lost services, it would be natural to direct attention towards the judge who imposed those changes.[405] The plan confirmation process requires that the proposed plan of rehabilitation be feasible, which in the context of a distressed state would require changes to the political structure that lead to insolvency in the first place.[406] This requirement ensures that there is a focus on long-term financial solvency and is not simply about deferring or eliminating payments at present.[407] It also encourages state officials to bring forward recommendations without judicial prompting once it is apparent that the court has the legal authority to demand such changes, leading to cooperation and improved solutions. [408]

b. Resolving Crippling Collective Action Problems

A formal process also helps facilitate the necessary cooperation between debtor and creditor, as well as within the creditor pool itself.[409] Unlike bank lenders who are often heavily involved in corporate restructurings, bondholders are less likely to act like repeat players given the liquid secondary market which anonymously aggregates investors with vastly diver-

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403. Gillette & Skeel, *supra* note 207, at 1195.
404. Skeel, *Give States a Way*, *supra* note 208, at 5 (discussing how a governor may find it useful to be able to shift blame for a state's new frugality onto a bankruptcy judge that "made him do it").
405. Telephone Interview with Bloom, *supra* note 137.
406. Gillette & Skeel, *supra* note 207, at 1197.
407. *Id.* at 1199–200.
408. *Id.* at 1199.
409. James M. Hays, II, *The Sovereign Debt Dilemma*, 75 BROOK. L. REV. 905, 917 (2010).

gent short-term and long-term goals.[410] The lack of a common purpose means that it is especially difficult to foster cooperation and holdouts can have a disproportionate impact on a restructuring effort.[411] The influential writings of Thomas Jackson and Douglas Baird have led to a conceptualization of a formal bankruptcy process as a response to collective action problems that impose significant costs on the debtor and are ultimately born by the creditors themselves through their recoveries.[412]

The proposed Restructuring Tribunal provides a solution to issues raised above. The majority voting requirements and power of the Restructuring Tribunal to impose a solution on a group of nonconsenting creditors resolves those collective action issues while influencing *ex-ante* incentives to cooperate.[413]

Nowhere is this clearer than in the case of organized labor.[414] States such as Illinois have amounts of unfunded pension liabilities that dwarf any other creditor claim.[415] It is clear that a resolution of Illinois' problems will require some concessions on the part of labor. Pensioners from the outset have a very simple mindset—they want the money they have been promised.[416] The lack of a formal process has led organized labor groups to refuse to bargain and instead litigate endlessly knowing that the state and other creditors have few other alternatives. My restructuring framework, even if never enacted by a state, at least changes these *ex-ante* incentives because there always exists the possibility that the state will submit itself

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410. *Id.*

411. *Id.*; Skeel, *Give States a Way*, *supra* note 208, at 5 (arguing that any state bankruptcy process is dependent on the state's ability to play hardball with its creditors and thus should include the ability for the state to "cram down" nonconsenting creditors in order to eliminate the holdout problem).

412. Skeel, *States of Bankruptcy*, *supra* note 208, at 682 n.25 (first citing Thomas H. Jackson, *Bankruptcy, Non-bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 859–71(1982); and then citing Douglas G. Baird and Thomas H. Jackson, *Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 106 (1984)).

413. Telephone Interview with Bloom, *supra* note 137; Miller, Varughese & Barson, *supra* note 199.

414. Telephone Interview with Bloom, *supra* note 137 (describing a formal restructuring framework as "very important" to the kinds of bargains that involve organized labor).

415. *See supra* Section II.B.

416. Telephone Interview with Bloom, *supra* note 137.

to the framework and a judge will decide that pensions need to be substantially impaired. Even if the possibility is remote, it is still a possibility. The presence of a framework that is currently lacking in the realm of state fiscal policy thus "provides some logic as to why one ought to be bargaining in the first place."[417]

c. Fostering Expediency to Minimize Further Deterioration of the Estate

The lack of a formal restructuring framework also risks further deterioration of the state much as we saw in sovereign debt cases over the past decade like Greece and Argentina. A formal process will expedite a restructuring for a variety of reasons. Firstly, the fact that a process is in place will allow groups to prepare their proposed solutions in advance through a combination of understanding what is required and past precedent from other state filings or comparable Chapter 9 cases. Secondly, the judge will have the ability to impose and enforce deadlines, such as a deadline for the debtor's plan of rehabilitation. Finally, aggregation of all claims into one common forum reduces duplicity of effort litigating particular issues and helps the debtor better understand its creditor constituent(s). Taken together, all of these aspects should minimize the amount of time that the debtor state is undergoing a restructuring, limiting deterioration of the estate and imposing effective solutions earlier in the process. This is advantageous to creditors as well given the impact it could have on recoveries and the fact that distressed investors are particularly time-sensitive when evaluating the risk/reward profile of potential investment opportunities.

d. A Formal Framework Provides the Critical Legitimacy and Respect for the State

An objection to state bankruptcy is the risk of sovereign humiliation.[418] The argument is that subjecting a state to a bankruptcy-type framework not only interferes with its sovereign immunity but is harmful optically. This is misguided for two reasons. Firstly, the proposed framework is completely voluntary and thus no one would be "forcing" a state to partici-

417. *Id.*
418. Skeel, *supra* note 256, at 2238.

pate. Secondly, an orderly process would have shown more respect for a country like Argentina's sovereignty than the permanent harassment that went on for years by its creditors.[419] The lack of a process invites investors to seek remedies from a state until they receive what they believe they are entitled to.[420] This hardly seems less humiliating than a voluntary process which has the benefit of providing legitimacy in the eyes of both its creditors and its citizens. Therefore, this argument should not be overstated.

2. *Primary Advantages to Various Creditor Constituencies*

a. A Formal Avenue to Enforce Creditors' Contractual Rights

Perhaps the most important advantage of a restructuring process to creditors is that it offers them the highest likelihood of actually being able to enforce their contractual rights. This was cited specifically by Lee Grinberg when asked what creditors like his fund find important when assessing a distressed opportunity and was one of the thrusts behind the legislative initiatives enacted in Puerto Rico, culminating with PROMESA.[421] Since SCOTUS's decision in *Alden v. Maine* in 1999, Congress is barred from subjecting nonconsenting states to private suits for damages in their own courts.[422] States are thus free to simply refuse to grant its creditors a forum for recovery.[423] This lack of coercive power to enforce a debt owed may not be completely eliminated by the imposition of a restructuring tribunal but it at least increases the likelihood given that the state would be voluntarily subjecting itself to the process.[424]

419. *Id.*
420. *Id.*
421. Telephone Interview with Murray, *supra* note 343; Telephone Interview with Lee Grinberg, Portfolio Manager, Elliott Mgmt. (Apr. 11, 2018).
422. *See* Alden v. Maine, 527 U.S. 706 (1999) (holding that the United States Congress may not use its Article I powers to abrogate a state's sovereign immunity from suits in its own courts, thereby allowing citizens to sue a state in state court without the state's consent); Buccola, *supra* note 15, at 245.
423. Buccola, *supra* note 15, at 245.
424. *See id.*

b. Certainty is Tremendously Valuable to All

One of the major advantages for creditors of a formalized process is the fact that it provides a framework for allocating value and thus significantly reduces the ambiguity of the negotiation process, which impairs a creditor's ability to predict its ultimate recovery. Distressed investors interviewed specifically mentioned this as the greatest advantage of a formal restructuring process as it would aid them in their investment decisions to be able to understand their likelihood of repayment.[425] When assessing potential opportunities, investors are focused on understanding contractual rights, their likelihood of enforceability, the timeframe to do so, and what a reasonable negotiated outcome that gets the issuer back on track looks like.[426] Putting in place a more structured resolution mechanism should reduce uncertainty around all of those points of consideration. These considerations are also important to financial creditors more broadly such as mutual funds and insurance companies who need to understand their changing investment profiles.[427] Absent a formal process, the state would essentially have complete control over which creditors it chooses to repay and which it does not.[428] This uncertainty demonstrates that the current lack of process impacts credit markets well before any state has actually defaulted.

The current out-of-court structure fails to provide clarity around priority of repayment between different types of creditors. States rarely provide priority structures for their obligations but many questions have been raised about the potential treatment of different claims.[429] Should pension liabilities, based on a public policy rationale, be given payment priority ahead of typical bondholders? Can a state, mirroring the COFINA bonds issued by Puerto Rico, establish payment priorities ahead of traditional bondholders? How should we think about the need to fund crucial infrastructure projects that would not technically result in official "claims" but are clearly

425. Interview with Stuart Kovensky, Co-Founder & Director, Onex Credit (Oct. 5, 2017); Telephone Interview with Murray, *supra* note 343; Telephone Interview with Lee Grinberg, *supra* note 420.

426. Telephone Interview with Grinberg, *supra* note 421.

427. Telephone Interview with Murray, *supra* note 343.

428. Skeel, *States of Bankruptcy*, *supra* note 208, at 706.

429. *Id.* at 694.

necessary to foster economic growth? Regardless of what the decisions are, clarification around the process would increase the efficiency of the credit markets and discourage destructive borrowing on the part of the debtor through priority distorting mechanisms.[430]

c. Minimizing the Risk of Moral Hazard

All of the advantages discussed above must be weighed against the moral hazard costs created by providing states with a "bankruptcy" option.[431] The source of moral hazard that exists within my resolution framework is not entirely unique to that present in a typical Chapter 11 bankruptcy. Broadly, the risk is that states will use the framework as a strategic tool to simply rid themselves of burdensome liabilities once they decide they no longer want to be left on the hook.[432] This will encourage state politicians, motivated by short-term political rather than economic and legal incentives, to borrow excessively knowing that it would not seriously threaten the long-term viability of the state. This source of moral hazard is usually limited in the Chapter 11 context by the fact that equity holders maintain a financial interest in staying out of bankruptcy both because of the burdensome (and sometimes embarrassing) disclosure requirements as well as the financial incentive to avoid having their ownership interest significantly diluted and/or transferred to creditors.[433] States do not have equity holders and thus lack a key defense mechanism. I believe that the incentives created by the restructuring process actually work to minimize the moral hazard risk although perhaps in different ways.

Although the presence of a formal restructuring process creates strategic opportunities, it also ensures that creditors have an increased stake in the fiscal health of a state and thus influences the actions creditors will take *ex-ante* to adequately protect themselves. Creditors are aware of the incentives of

430. *Id.* at 696.

431. Telephone Interview with Bloom, *supra* note 137 (discussing how any framework needs to be conscious of moral hazard problems that may result if states are able to discharge their promises, especially to organized labor, too easily); Skeel, *supra* note 256, at 2234.

432. Telephone Interview with Bloom, *supra* note 137; Skeel, *supra* note 256, at 2234.

433. Telephone Interview with Bloom, *supra* note 137.

state politicians; the potential for their investment to later be restructured at a significant loss means that they will be more diligent in monitoring the debtor state and tighten credit terms for those states deemed higher risk.[434] This creates pressure for state governments to ensure that they properly manage their finances, much like any personal or corporate debtor must.[435] This applies not only to large investors in state bonds but also especially to state pensioners who, out of personal interest, would be incentivized to put political pressure on politicians to fully fund their pension liabilities and ensure that the benefits they do promise are actually sustainable.[436]

A second key check on moral hazard risk that has been specifically integrated into my framework is the requirement of state insolvency to avail oneself of the debt resolution framework. Unlike the more flexible filing standard for Chapter 11 limited only by the debtor's bad faith, any filing before the tribunal would require that the state demonstrate that there was a legitimate threat, either present or future, that the state as currently operating would be in danger of defaulting on its contractual obligations and therefore be unable to fulfill its core functions.[437] Regardless of whether there is an official framework in place, states, given their powers of sovereign immunity and the lack of coercion mechanisms, will always be free to refuse to fulfil their obligations. I believe that the framework I have proposed actually limits the threat of moral hazard as compared to an out-of-court process or at the very least provides key structural barriers to prevent states from simply using it strategically to disadvantage core creditor groups.

d. Ensuring That All Those Who Took on Risk Share in the Downside

A formal process will also provide an element of fairness among creditors, which should be highly valued by citizens given the significant pension liabilities. If a state were to make

434. Skeel, *supra* note 256, at 2234.

435. *Id.* at 2235.

436. *Id.*

437. *See supra* Section V.A.2 (setting forth a definition of state insolvency relevant to determining whether or not a state would be eligible to file a petition and have its case heard before the restructuring tribunal).

use of the process, public employee compensation and pensions would almost certainly need to be restructured.[438] Similar to airline or automotive corporate bankruptcies over the last several decades, the need to address labor costs would be central.[439] Historically, such restructuring efforts of states have resulted in a burden born largely by public employees and recipients of governmental services, such as the poor and middle class.[440] A formal process with judicial oversight would ensure that the costs be distributed fairly and broadly among creditors.[441] To quote Elizabeth Warren, "[b]ankruptcy is a federal scheme designed to distribute the costs among those at risk."[442] The state would not be forced to succumb to the loudest and best organized voices at the table (which are likely to be financial investors given typical collective action problems among large, dispersed groups) ensuring that citizens will not bear all of the costs as they traditionally have in Chapter 9 cases.[443] For example, in the recent Vallejo, California municipal bankruptcy, the court held that the city could restructure its collective bargaining agreement but only if other constituencies were also contributing to the restructuring.[444] Drawing on his substantial experience representing unions in restructuring negotiations, Ron Bloom highlights the difficult discussion in these cases where the government is essentially asking public sector employees promised certain benefits to give them up in order to enhance the returns to financial interests or limit tax increases on the general population.[445] The presence of a tribunal can help find a balance between these interests that none may love but all can live with.[446]

In this way, the presence of a formal process with a clear priority structure would prevent a state from subverting the

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438. Skeel, *supra* note 192, at 1082.

439. *Id.* at 1070; Telephone Interview with Bloom, *supra* note 137.

440. Skeel, *States of Bankruptcy*, *supra* note 208, at 702.

441. Skeel, *supra* note 192, at 1085 (raising the concern that the need to target pensions in a potential state restructuring implicates serious fairness issues if done out-of-court as compared to a court-led process).

442. Skeel, *States of Bankruptcy*, *supra* note 208, at 703 (quoting Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 790 (1987)).

443. Skeel, *States of Bankruptcy*, supra note 208, at 682, 702.

444. *Id.* at 1082.

445. Telephone Interview with Bloom, *supra* note 137.

446. *Id.*

existing priority structure by merely accelerating the maturity of debt.[447] This is beneficial to institutional investors who are most likely to take losses in the event of a large, sudden default given that other state obligations will be framed as more urgent or preferable for political reasons.[448] All should agree that a formal process ensures greater fairness in the ultimate resolution of claims and distribution of losses.

Conclusion

In this Note, I have sought to put forward a bankruptcy-esque framework to resolve the crippling fiscal issues present at the state level that have largely been ignored. Although many of the liabilities are long-term, deficits continue to grow and most agree it is not really a question of "if" but "when."[449] The situation currently unfolding in Puerto Rico should serve as a wake-up call. Structural deficiencies and poor fiscal budgeting practices, covered up and exacerbated by unique tax legislation, has left the Commonwealth and its investors in a rough spot. We are witnessing what happens when no framework exists to resolve such a situation; it is imperative that we learn from our mistakes and be proactive.[450] The imposition of the Oversight Board would help facilitate out-of-court restructurings, provide credibility, help overcome practical political hurdles, and ensure that underlying structural issues are addressed. The Restructuring Tribunal would give the debtor state access to important tools to help right-size its balance sheet, provide creditors with expediency and certainty, and create an overall sense of legitimacy around the process.

447. Skeel, *States of Bankruptcy*, *supra* note 208, at 700.

448. *Id.* at 706. Telephone Interview with Grinberg, *supra* note 421.

449. *See supra* Section II.A; Interview with Yermack, *supra* note 190; Telephone Interview with Skeel, *supra* note 98; Telephone Interview with Rauh, *supra* note 144; Interview with Ravitch, *supra* note 289; Telephone Interview with Glasgall, *supra* note 186; Telephone Interview with Grinberg, *supra* note 421; *but see* Telephone Interview with Weiss, supra note 144 (discussing how he believes that outside of a select few states such as Illinois, the fiscal issues at the state level are largely overblown).

450. Telephone Interview with Murray, *supra* note 343 (discussing how waiting for the PROMESA solution to come in caused a material delay in the proceedings as all actors were hesitant to take any action that would later be reversed, leading to continued decline of the territory).

At the end of the day, any solution requires that we overcome the practical limitations oft-cited with state bankruptcies, namely the lack of political will to enact such legislation and the need to overcome constitutional challenges. As to the latter point, although there is significant favorable precedent stemming from municipal and corporate bankruptcies, the issues surrounding the constitutionality of state bankruptcies and the mechanisms I have proposed have never been considered in this context. This does not mean that we should jump to conclusions that nothing can be done; creativity is required.

This Note leaves open areas for future research, some of which include the ultimate result of Puerto Rico's Title III restructuring process and how its outcome compares to traditional sovereign debt restructurings. This could be instructive in deciding whether or not to enact a state framework and what features are most important to fair and value-maximizing outcomes. As is the case with Puerto Rico, this framework leaves open the question of priorities in bankruptcy. Should pensioners receive a super-priority claim above all other state creditors? Does it make sense to treat the funded portion only as a secured claim rather than the unfunded portion as well?

Another interesting area of research would be the extent to which certain states' fiscal issues could be resolved using only Chapter 9. It is possible that in less-indebted states than Connecticut and Illinois resolving the many municipalities could create enough breathing room for the state to continue to operate without a substantial restructuring (although one may question if this is only a temporary, rather than structural solution). Finally, and perhaps the most ambitious, would be research into whether one may align the incentives of debtor states and pensioners in state restructurings through the creation of equity-like instruments. One of the key aspects of the automotive restructurings was the ability to offer pensioners significant equity interests in the emerging companies in exchange for reductions in benefits owed. This is not currently an option in state restructurings. The idea would be to provide an instrument like a tax participation certificate that returns money to pensioners in the event that real estate values in the state increase and generate greater revenue for the state as a result of their individual sacrifices.[451]

451. Telephone Interview with Bloom, *supra* note 137.

Regardless of the situation playing out in Puerto Rico, state inaction will continue to defer issues of excessive borrowing and unfunded pension liabilities to future generations so long as governments continue to meet the payments at present and point to "the many tools" available to them such as budget cuts, increases in taxation, higher returns on invested assets, as the ultimate solution to this dilemma. Such an approach by the states ignores the practical reality that we find ourselves in in 2019. Financial markets have done extremely well over the past ten years, driven by practices of quantitative easing, artificially-low interest rates, and government-driven incentives for spending. At some point the markets will correct themselves and the issues surrounding the trillions of dollars in asset shortfalls will be thrust into the public light, exactly at the same time as citizens will require more of the services they have come to rely on their states to provide. When that happens, many will look back, much as they have in Puerto Rico, and wonder why all of the warning signs were missed or ignored. At that point, the minority of scholars and practitioners that have advocated for intervention much in the same way as I have throughout this Note will only be able to sit there and say "I told you so."

APPENDIX A: FISCAL SNAPSHOT OF ILLINOIS

Figure 1

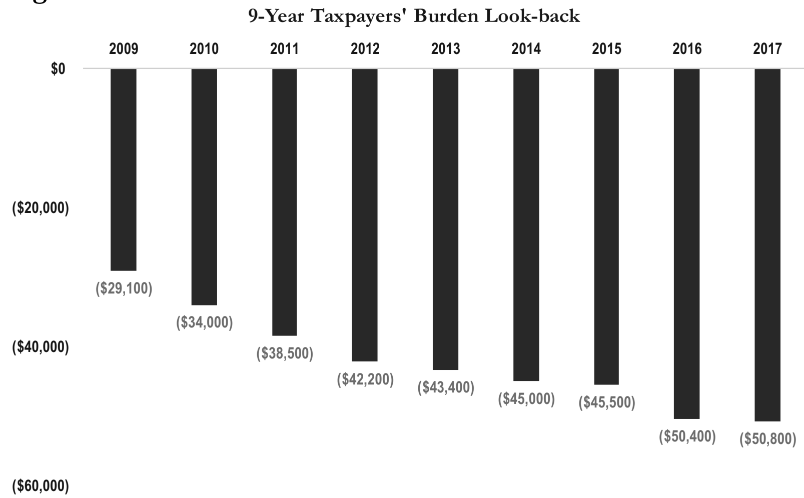
Snapshot of Illinois's Current Fiscal Resources (2017)			
ASSETS*		**LIABILITIES***	
Total Assets	$80.8	State Bonds	$38.4
Capital Assets	(37.5)	Other Liabilities	35.2
Restricted Assets	(14.5)	Debt Related to Capital Assets	(15.6)
		Unfunded Pension Benefits	134.4
		Unfunded Retirees' Health Care Benefits	52.5
Assets Available for Servicing Liabilities	**$28.8**	**Total Liabilities to be Serviced**	**$244.9**

Funding Gap*	**($216.1)**
Taxpayers' Burden	**($50,800)**

*in Billions

Source: State Data Lab

Figure 2



Appendix B: Fiscal Snapshot of Connecticut

Figure 3

Snapshot of Connecticut's Current Fiscal Resources (2017)

ASSETS*		LIABILITIES*	
Total Assets	$38.2	State Bonds	$31.7
Capital Assets	(20.5)	Other Liabilities	5.9
Restricted Assets	(5.5)	Debt Related to Capital Assets	(11.4)
		Unfunded Pension Benefits	34.8
		Unfunded Retirees' Health Care Benefits	20.9
Assets Available for Servicing Liabilities	**$12.2**	**Total Liabilities to be Serviced**	**$81.9**

Funding Gap*	**($69.7)**
Taxpayers' Burden	**($53,400)**

*in Billions

Source: State Data Lab

Figure 4