

# Too Big to Fail and Too Big to Pay: States, Their Public-Pension Bills, and the Constitution

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## Introduction

Faced with the most severe budget crises since the Great Depression, many state officials and lawmakers within the United States are desperately trying to pay their bills and balance their budgets. States are anticipating significant budget deficits for the next few years, while tax receipts are slowly recovering from the steep economic downturn in 2008, unemployment rates remain high, and federal stimulus money is running out. Among the states' mounting stacks of unpaid bills are their aggregate unfunded pension liabilities totaling from an estimated \$452 billion to over \$2.54 trillion, depending on what accounting discount rate is used.<sup>1</sup>

State pension plans cover twenty-four million active and retired workers, about eight percent of the United States population of 309

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1. PEW CTR. ON THE STATES, *THE TRILLION DOLLAR GAP: UNDERFUNDING STATE RETIREMENT SYSTEMS AND THE ROADS TO REFORM 3* (2010), [http://downloads.pewcenteronthestates.org/The\\_Trillion\\_Dollar\\_Gap\\_final.pdf](http://downloads.pewcenteronthestates.org/The_Trillion_Dollar_Gap_final.pdf) [hereinafter PEW CTR. ON THE STATES, *THE TRILLION DOLLAR GAP*] (giving lower-end estimate of \$452 billion, an aggregation of fiscal year 2008 funded status taken from the states' own reports and based on governmental accounting principles). Pew Center is a research and lobbying group for state plan managers. Robert Novy-Marx & Joshua D. Rauh, *Policy Options for State Pension Systems and Their Impact on Plan Liabilities* 1 (Nat'l Bureau of Econ. Res., Working Paper No. 16453, 2010), available at <http://www.nber.org/papers/w16453.pdf>. Finance Professors Novy-Marx and Rauh calculate the state-pension shortfall to be \$1.3 trillion if calculated using the Treasury discounting method and \$2.54 trillion if calculated using taxable municipal discounting. *Id.* at 3.

million in 2010.<sup>2</sup> When financial markets plunged in 2008, so did the assets in states' pension systems.<sup>3</sup> Beyond the current pension funding gap, some financial analysts and state officials see pension bills increasing at a rate that is unsustainable in the long run.<sup>4</sup> Assuming no significant changes to the already promised pension benefits to state workers, seven states would have insufficient funds to pay those obligations past the year 2020, even with an optimistic eight-percent return on the assets of state pension systems.<sup>5</sup> According to Finance Professor Joshua D. Rauh, an additional twenty states would run out of funds to cover already accrued pension benefits past 2025.<sup>6</sup> This suggests that substantial contributions will be needed over the next fifteen years to pay for legacy liabilities.<sup>7</sup> Meanwhile, a number of governors are trying to curtail pension and other benefits for new state employees, while financial analysts are recommending increased taxes and more severe budget cutting as

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2. The Bureau of Labor Statistics of the U.S. Department of Labor reports that as of March 2010, state and local governments employ over fifteen percent of the 129 million nonfarmer workers in the United States. U.S. Bureau of Labor Statistics, *A Snapshot of State and Local Government Employee Benefits*, 3 PROGRAM PERSPECTIVES 1 (2011), available at [http://www.bls.gov/opub/perspectives/program\\_perspectives\\_vol3\\_issue1.pdf](http://www.bls.gov/opub/perspectives/program_perspectives_vol3_issue1.pdf). State employees by themselves account for roughly four percent of American nonfarmer workers. *Id.*

3. Michael A. Fletcher, *Governors from Both Parties Plan Painful Cuts Amid Budget Crises Across the U.S.*, WASH. POST, Feb. 8, 2011, at A17, available at <http://www.washingtonpost.com/wp-dyn/content/article/2011/02/07/AR2011020703650.html>.

4. *Id.* Collectively, states have a projected budget deficit of \$175 billion through 2011, which is in addition to the \$230 billion in budget gaps that states filled between fiscal 2009 and 2011. *Id.* For example, the 2011 budget shortfalls for California, New York, and New Jersey were projected at \$25 billion, \$10 billion, and \$11 billion, respectively. *Id.* Ronald Snell, a senior analyst of the National Conference of State Legislatures, observes that public officials, who are feeling pressure to cut spending and not raise taxes, are focusing on pensions. Ron Snell, NAT'L CONF. OF STATE LEGISLATURES, *Pension Reform: Not Easy, But Worth It*, (July–Aug. 2010), <http://www.ncsl.org/?tabid=20716>.

5. *The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter: Hearing Before the H. Subcomm. on Courts, Commercial, and Administrative Law*, 112th Cong. 1 (2011) [hereinafter *Role of Public Employee Pensions*—statement of Joshua Rauh] (statement of Joshua Rauh, Associate Professor of Finance, Northwestern University, Evanston, Ill.), available at [http://judiciary.house.gov/hearings/printers/112th/112-25\\_64585.PDF](http://judiciary.house.gov/hearings/printers/112th/112-25_64585.PDF) at 49.

6. *Id.*

7. In October 2010, Professors Robert Novy-Marx and Joshua D. Rauh raised their estimates of unfunded state-pension liability to almost \$27,000 per American household. In June 2009, they estimated the pension shortfall as high as \$3.23 trillion, which is roughly equivalent to \$21,500 for each of the approximately 150 million households that filed tax returns with the Internal Revenue Service in 2008. Robert Novy-Marx & Joshua D. Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, 23 J. ECON. PERSP. 191, 196 (Fall 2009).

necessary to bring states' long-term obligations such as pensions in line with revenue.<sup>8</sup>

The subject of a state defaulting or repudiating any type of debt has received relatively little attention in the legal literature because until recently, the legal issues concerning state defaults on debt, or in particular defaults on state pension funds, were considered too remote to attract the attention of legal scholars. Yet in recent months, more than a few economists, reporters, academicians, lawyers, and politicians are arguing about legal solutions for pension liabilities that are too big to pay, including possible federal bailouts for states that are deemed "too big to fail."<sup>9</sup>

This note presents the legal limitations that many states face if they were to default on or repudiate any of their pension obligations, and analyzes two proposed solutions to the states' expanding pension liabilities. Section I provides general background on state pension programs and their current financial condition. Section II analyzes how courts within the last few decades have interpreted states' pension obligations, paying particular attention to legal requirements under the Contract Clauses of the federal and state constitutions. Section III describes a modest proposal for a federal government bailout of state pensions through federally subsidized debt obligation bonds conditioned upon states moving from defined-benefit to defined-contribution pensions. Section IV analyzes the more radical and controversial proposal that Congress institute bankruptcy for states, using similar procedures and restrictions found in the bankruptcy code for municipalities. The conclusion suggests that courts would likely find constitutional the two proposed solutions—conditional pension obligations bonds and bankruptcy for states—although each has legal as well as practical and political issues.

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8. Fletcher, *supra* note 3. For example, Michigan Governor Rick Snyder proposed a new state tax on public and private pensions. RICK SNYDER, STATE OF MICHIGAN EXECUTIVE BUDGET: FISCAL YEARS 2012-2013 at 7 (2011), *available at* [http://www.michigan.gov/documents/budget/1\\_345974\\_7.pdf](http://www.michigan.gov/documents/budget/1_345974_7.pdf).

9. GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 13 (Brookings Institution Press 2004) (Representative Stewart McKinney is credited with coining in 1984 the phrase "too big to fail" in connection with the government bailout of Continental Illinois, the seventh largest bank in the United States).

## I. Background on State Pension Programs and Their Current Financial Condition

The diversity of opinions on the size and severity of state pension-fund liability results from disparate underlying assumptions among analysts and interest groups.<sup>10</sup> For example, the two-trillion-dollar difference between the low and high estimates of the state pension liabilities results in large part from the wide range of estimated future rates of return on pension assets from less than one to eight percentage points annually.<sup>11</sup>

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10. Most people agree that states as an aggregate currently have a serious pension-funding problem. Nevertheless, views diverge widely on how severe or extended the problem will be, and what actions, if any, need to be taken to solve the underfunding of state pensions. The current media debates on state pensions reflect the interests of five groups. The first and foremost is the public employees and retirees who expect to be paid the promised pension benefits. The second group is the pension systems themselves with obligations but increasingly limited resources to pay them. The third includes state lawmakers and officials searching for solutions to pension underfunding as well as major state budget deficits. The fourth is the state taxpayers who increasingly resent the possibility of an additional tax load while struggling to fund their own retirements. The last group comprises analysts who among themselves disagree on the severity of pension-funding shortfalls, and whether the problems of those shortfalls are short-term or are more long-term systemic problems.

11. Estimating pension liabilities on the low side are pension advocates who follow the Government Accounting Standards Board and assume returns on assets to calculate pension debts. Jeffrey R. Brown & David W. Wilcox, *Discounting State and Local Pension Liabilities*, 99 AM. ECON. REV.: PAPERS & PROC. 538, 538 (2009) (referencing Novy-Marx & Joshua D. Rauh, *The Intergenerational Transfer of Public Pension Promises* (Nat'l Bureau of Econ. Res., Working Paper No. 14343, 2008)). They assume that the actual return will be identical to the targeted return and do not take into account the risk that if the assets do not return the targeted seven percent or eight percent, the state and ultimately the taxpayers are required to make up the difference. Novy-Marx & Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, *supra* note 7, at 195. As an example of the risk, Novy-Marx and Rauh calculated that Ohio, at its 2009 level of tax collection, would need to dedicate 8.75 years of tax revenue to pension funding to catch up on pension obligations accrued to 2009. *Id.* at 197. This estimate does not include the additional revenue needed to fund new benefits that employees continue to accrue. *Id.* See also Brown & Wilcox, *supra*, at 538. They contend that the value of the pension liability instead should depend on the risk of the stream of cash flow associated with that liability, rather than on the pension assets that back the liability. *Id.*; Novy-Marx & Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, *supra* note 7, at 195. This would suggest a lower discount rate of four percent or five percent, or if taking a very conservative financial position, the "risk-free" discount Treasury rate, which is currently less than one percentage point. Brown & Wilcox, *supra*, at 539. These economists would likely evoke the well-worn financial disclaimer: past performance does not guarantee future results.

### A. Pensions Types: Defined-Benefit and Defined-Contribution Plans

Most states offer defined-benefit rather than defined-contribution types of pension plans to their employees. Pensions can be divided into two major types—the traditional defined-benefit plan<sup>12</sup> and the defined-contribution plan.<sup>13</sup> Defined-benefit plans guarantee a specific retirement benefit, usually an annuitized income, no matter how the underlying securities and assets that back the defined-benefit plans perform.<sup>14</sup> This means that the state as employer takes the financial risk and is obligated to make up the difference between what it has promised to its retirees and what funds are required to meet those promises.<sup>15</sup> Around ninety percent of state public employees have traditional defined-benefit plans and close to eighty percent of them participate in these plans.<sup>16</sup> If the state pension plans are underfunded or do not produce the income needed to cover the required payments to its retirees, the state and ultimately taxpayers have the financial risk to make up the shortfall.<sup>17</sup>

Under often less generous defined-contribution plans, the employer contributes a defined amount to a retirement fund that the

12. See I.R.C. § 414(j) (West 2011); 26 C.F.R. §§ 1.401-1(b)(1)(i), and 1.401(A)-1(b)(1)(i), (iii).

13. See I.R.C. § 414(i) (West 2011). Generally, I.R.C. § 415(b) limits the amount a pensioner can receive from an employer-defined benefit plan to the lesser of a specific “dollar limit” (\$195,000 is the limitation in 2011) or one hundred percent of the participant’s average compensation for his or her three highest years. Government workers, however, are exempted from those limits. I.R.C. § 415(m) (West 2011). State and local governments are allowed to pay benefits in excess of the 415(b) limit by establishing a “qualified excess benefit arrangement” and holding the funds separately from the pension trust. *Id.* For a general overview of the two basic pension types, see Stephen P. McCourt, *Defined Benefit and Defined Contribution Plans: A History, Market Overview and Comparative Analysis*, 43 BENEFITS & COMPENSATION DIG. 1 (2006), <http://www.ifebp.org/PDF/webexclusive/06feb.pdf>.

14. The United States labor force of the 1920s saw the introduction of the traditional defined benefit plan, a plan in which the employer promised to pay to the employee an annual pension, determined in accordance with a predetermined formula. Susan J. Stabile, *Is It Time to Admit the Failure of an Employer-Based Pension System?* 11 LEWIS & CLARK L. REV. 305, 307 (2007).

15. For a discussion on the debate about whether state and local governments should shift away from defined-benefit to defined-contributions plans, see Jonathan Barry Forman, *Public Pensions: Choosing Between Defined Benefit and Defined Contribution Plans*, 1999 MICH. ST. L. REV. 187 (2000).

16. U.S. Bureau of Labor Statistics, *supra* note 2, at 2. See generally ROBERT L. CLARK, LEE A. CRAIG & JACK W. WILSON, *A HISTORY OF PUBLIC SECTOR PENSIONS IN THE UNITED STATES* (2004). Early in the twentieth century, states began instituting pensions for state employees. *Id.*

17. McCourt, *supra* note 13.

employee uses for retirement income.<sup>18</sup> Defined-contribution plans depend on the value of underlying securities and assets and give no defined guarantee of payment.<sup>19</sup> Some state workers may have an option to participate in a defined-contribution program as well as the defined-benefit program. A small and growing percentage of government workers, like Michigan state employees hired since 1997,<sup>20</sup> have no option to participate in a defined-benefit plan and are enrolled in defined-contribution plans similar to those in the private sector.<sup>21</sup>

Financial analysts and economists have evaluated the current pension-funding rates for the states' defined-benefit plans as well as the projected long-term financial condition of state pensions. While some analysts advocate for radical changes to pension programs for continued financial viability of pension systems, others consider much of the public concern regarding pension funding to be overreactions to relatively short-term problems caused by two severe financial recessions since 2000.<sup>22</sup>

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18. PEW CTR. ON THE STATES, PROMISES WITH A PRICE: PUBLIC SECTOR RETIREMENT BENEFITS 10 (2007), [http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/State\\_policy/pension\\_report.pdf](http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/State_policy/pension_report.pdf) [hereinafter PEW CTR. ON THE STATES, PROMISES WITH A PRICE]. The Internal Revenue Service's definition of a defined-contribution plan is found in I.R.C. § 414(i).

19. Stabile, *Is It Time to Admit the Failure of an Employer-Based Pension System?*, *supra* note 14, at 307. The private pension reforms of the mid-1970s and early 1980s led to a sharp turn away from traditional defined-benefit plans. Sylvia Nasar, *Pensions Covering Lower Percentage of the Work Force*, N.Y. TIMES, Apr. 13, 1992, at A2, <http://query.nytimes.com/gst/fullpage.html?res=9E0CEFD81330F930A25757C0A964958260&pagewanted=2>. Many private-sector employers closed their pension programs and moved their employees to a defined-contribution scheme or employee-funded 401(k) retirement plan. Stabile, *supra* note 14, at 307. The estimated percentage of workers participating in private pension plans in 1991 dropped down to forty-three percent from the peak of forty-nine percent in 1979. Nasar, *supra* note 19, at A1. Many other commentators have discussed the shift from defined-benefit to defined-contribution plans in the private sector. See, e.g., JOHN H. LANGBEIN, SUSAN J. STABILE & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 58-62 (4th ed., Foundation Press 2006); Regina T. Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607, 613 (2000); Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. REV. 71, 74-75 (2002).

20. Richard C. Dreyfuss, Policy Brief, *Michigan's Public-Employee Retirement Benefits: Benchmarking and Managing Benefits and Costs*, MACKINAC CENTER FOR PUBLIC POLICY (Oct. 25, 2010), <http://www.mackinac.org/archives/2010/S2010-05.pdf>.

21. PEW CTR. ON THE STATES, PROMISES WITH A PRICE, *supra* note 18, at 33.

22. Iris J. Law & Elizabeth McNichol, CTR. ON BUDGET & POLICY PRIORITIES, *Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm* 3 (2011), <http://www.cbpp.org/files/1-20-11sfp.pdf>. Law and McNichol argue that proponents overstate current fiscal problems of the states, fail to acknowledge

## B. Uncertainty of Pension Liabilities and Funding Ratios

Divergent assumptions of pension payouts and rates of return on investments help explain why estimates of the unfunded state pension liabilities range widely from \$452 billion to \$2.54 trillion.<sup>23</sup> This makes it difficult for pension administrators and states to determine what the optimal funding level should be to meet future pension obligations. The low estimates of liability are based on the pension funds earning higher expected rates of return from riskier stock and bond portfolios, while the high estimates of pension liability are based on the pension funds earning a riskless rate of return on investments such as Treasury bonds.<sup>24</sup>

In recent years, many state pension plans have assumed a rate of return on assets of eight percent or more, a rate lower than their investments returned in the 1990s, but much higher than their aggregate negative return since 2000.<sup>25</sup> State pension plans have invested in portfolios heavily weighted towards equities, which can result in greater volatility in the value of assets, funding ratios, and unfunded liabilities.<sup>26</sup>

Demographic and lifestyle changes also have increased pension liabilities within the last decade, and the uncertainty of future liabilities in state pension funds.<sup>27</sup> For example, in recent years more public employees took early retirements, sometimes in response to state inducements for early retirement.<sup>28</sup> Additionally retirees are living longer, increasing pension costs per retiree.<sup>29</sup>

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that severe problems concentrate in a few states, and often promote extreme actions rather than more reasonable solutions. *Id.*

23. Novy-Marx & Rauh, *Policy Options for State Pension Systems and Their Impact on Plan Liabilities*, *supra* note 1, at 3; Law & McNichol, *supra* note 22, at 2; PEW CTR. ON THE STATES, THE TRILLION DOLLAR GAP, *supra* note 1, at 3. In part because of these widely divergent estimates, some lawmakers have proposed laws that would force states to change the way they calculate and report their pension liabilities for their pensions to maintain their tax-exempt status. Law & McNichol, *supra* note 22, at 2. *See also* DEAN BAKER, CTR. FOR ECON. & POLICY RES., THE ORIGINS AND SEVERITY OF THE PUBLIC PENSION CRISIS 1 (2011), <http://www.cepr.net/documents/publications/pensions-2011-02.pdf>.

24. Law & McNichol, *supra* note 22, at 3. Historically, pension funds have invested in diversified stock and bond portfolios that have earned average rates of return higher than the riskless rate of a Treasury rate. *Id.*

25. PEW CTR. ON THE STATES, THE TRILLION DOLLAR GAP, *supra* note 1, at 24.

26. *Id.* at 23–24.

27. *Id.* at 18, 31.

28. *Id.* at 18.

29. *Id.* at 24.

As late as 2007, states had funded about eighty-five percent of their pension liability, a level considered healthy by many analysts, including those at the U.S. Government Accountability Office.<sup>30</sup> Since then the rates at which states have funded their pensions have dropped substantially, in some states by as much as thirty to forty percentage points.<sup>31</sup>

## II. Judicial Interpretation of States' Pension Obligations

Most state employees have enjoyed strong legal protections that prevent any significant reductions to their state pensions.<sup>32</sup> This protection comes from the judicial interpretation of state pension obligations as contracts under the Contracts Clause of the United States Constitution, and under similarly worded contract clauses of some state constitutions or specific statutory provisions regarding public pensions.<sup>33</sup> Only a few states have weaker protections for state pensions under the theories of a pension obligation as an implied contract or mere gratuity. Because states have waived their sovereign immunity, state employees have sued states for pension plan changes, and often have been successful in stopping reductions to their pension benefits. Yet it is unclear what would happen if a financially

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30. *Id.* at 16. In 2008, before the major downturn in the securities market had affected pensions' overall assets, states' systems in fiscal year 2008 were eighty-four percent funded. *Id.* The funding ratio equals the actuarial value of assets divided by actuarial accrued liabilities, and provides a fairly good measure of a state's ability to cover its pension obligations. BARRY W. POULSON & ARTHUR P. HALL, AMERICAN LEGISLATIVE EXCHANGE COUNCIL, STATE PENSION FUNDS FALL OFF A CLIFF 5 (2010), [http://www.alec.org/am/pdf/tax/ALEC\\_FINAL\\_pension\\_funds\\_split.pdf](http://www.alec.org/am/pdf/tax/ALEC_FINAL_pension_funds_split.pdf).

31. PEW CTR. ON THE STATES, PROMISES WITH A PRICE, *supra* note 18, at 5. In the 1990s, the aggregate funding rate of the states reached eighty percent, and by 2000, the ratio exceeded one hundred percent, in large part due to the booming economy and strong investment growth through the 1990s. Law & McNichol, *supra* note 22, at 3. In the late 1990s and early 2000s, when half the states' pension plans were fully funded, many states increased pension benefits. PEW CTR. ON THE STATES, PROMISES WITH A PRICE, *supra* note 18, at 5. Since then, the recessions of 2001 and 2008 sliced significant value from pension-fund assets. Law & McNichol, *supra* note 22, at 3.

32. *Simpson v. N.C. Local Gov't Employees' Ret. Sys.*, 363 S.E.2d 90, 91–93 (N.C. Ct. App. 1987) (noting the “kaleidoscope of multifarious and conflicting views” of pension rights, and reviewing five approaches, including the “traditional common law” view that “public employee pensions are gratuities creating no contractual rights until the member satisfies all of his retirement requirements”). For a recent analysis of the Contracts Clause challenges in current public pension litigation, see Paul M. Secunda, *Constitutional Contracts Clause Challenges in Public Pension Litigation*, 29 HOFSTRA LAB. & EMP. L.J. (forthcoming 2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1806018](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1806018).

33. U.S. CONST. art. I, § 10, cl. 1.

distressed state sovereign were to unilaterally change or repudiate terms of its public-pension obligations over court objection.

### A. Pension Obligations under Contract Theory

#### 1. *Is the Pension Obligation a Contract?*

A majority of states' courts have interpreted state pensions to be binding contracts between the state offering public-pension benefits and its employees in return for their services. Assuming public pensions are contracts with public employees, they would be protected by the Contracts Clause of the United States Constitution, which provides that "No State shall . . . pass any . . . Law impairing the Obligation of Contracts."<sup>34</sup> Courts give heightened scrutiny to state contracts and typically enforce terms of a contract if it appears that a state has significantly and unreasonably impaired a contract regarding public pensions or otherwise.<sup>35</sup> In a state where its constitution or statutes guarantee that public-pension benefits cannot be diminished, courts might be expected to apply a high level of scrutiny to any modification of a pension contract.<sup>36</sup>

*United States Trust Co. v. New Jersey* provides the Supreme Court's modern-era Contract Clause interpretation, as applied to the repudiation of public contracts.<sup>37</sup> The Court uses a four-step test to

34. *Id.* For a discussion on the reasons why the Contracts Clause applies only to the states and not the federal government, see Michael W. McConnell, *Contract Rights and Property Rights: a Case Study in the Relationship Between Individual Liberties and Constitutional Structure*, 76 CAL. L. REV. 267 (1988).

35. *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244 (1978).

36. Eight states have constitutional provisions protecting pensions. ARIZ. CONST. art. XXIX § 25, HAW. CONST. art. XVI, § 2; ILL. CONST. art. XIII, § 5; LA. CONST. art. I, § 23; MICH. CONST. art. IX, § 24; N.M. CONST. art. II § 19; N.Y. CONST. art. V, § 7; TEX. CONST. art. I, § 16; and WIS. CONST. art. I § 12. For example, article V, section 7 of the New York Constitution states: "After July first, nineteen hundred forty, membership in any pension or retirement system of the state or of a civil division thereof shall be a contractual relationship, the benefits of which shall not be diminished or impaired." States like Kentucky have general language in their statutes that pension benefits are an inviolable contract. KY. REV. STAT. ANN. § 61.692 (West 2010). Some states statutes have more specific language, such as New Jersey's statute that gives a nonforfeitable right to receive pension benefits upon attainment of five years of service credit. N.J. STAT. ANN. § 43:3C-9.5 (West 2010). A contractual relationship can arise from a statute "when the language and circumstances [of the statute] evince a legislative intent to create private rights of a contractual nature enforceable against the [government]." *Andrews v. Anne Arundel County*, 931 F. Supp. 1255, 1260 (D. Md. 1996), *aff'd without opinion*, 114 F.3d 1175 (4th Cir. 1997) (quoting *United States Trust Co. v. New Jersey*, 431 U.S. 1, 17 n.14 (1977)).

37. *United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977).

determine whether 1) a contract exists, 2) it is substantially impaired, 3) it has a public purpose, and 4) it is reasonable and necessary.<sup>38</sup>

In *United States Trust*, the states of New York and New Jersey borrowed money from the public for the Port Authority and promised in return to not subsidize rail transit.<sup>39</sup> Later, the states repealed the promise and altered the contracts.<sup>40</sup> Under the first step, the Court found that contracts existed between the states and their bondholders and then it analyzed the contract alterations under the last three steps. The Court ultimately struck down the states' actions because the significant impairment of the contracts with the bondholders was not "reasonable [or] necessary to serve an important public purpose."<sup>41</sup>

## 2. *Is the Contract Substantially Impaired?*

Once a court determines that a contract with a state exists under the first step, it will evaluate whether a challenged law or change to the contract operates as a "substantial impairment of the contractual relationship" under the second step of the *United States Trust* test.<sup>42</sup> After determining contract validity of state pension obligations under this step, a court analyzes whether a state has substantially impaired any pension obligations. An impairment occurs if one party of a contract alters any term of a contractual relationship<sup>43</sup> and is substantial "where the right abridged was one that induced the parties to contract in the first place, or where the impaired right was one on which there had been reasonable and especial reliance."<sup>44</sup> If the law operates as only a minimal or no impairment, then it does not violate the contract clause and the judicial inquiry ends.<sup>45</sup>

A judicial dividing line between what constitutes minimal impairment and what constitutes substantial impairment to a state contract is not clear, and where it is drawn varies among jurisdictions. The Fourth Circuit, however, provides an exemplary interpretation.

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38. *Id.* at 17, 23, 25.

39. *Id.* at 10–11.

40. *Id.* at 13–14.

41. *Id.* at 25, 31.

42. *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244 (1978); see *United States Trust*, 431 U.S. at 21.

43. *Allied Structural Steel*, 438 U.S. at 240.

44. *Baltimore Teachers Union v. Mayor of Baltimore*, 6 F.3d 1012, 1017 (4th Cir. 1993).

45. *Allied Structural Steel*, 438 U.S. at 244.

In *Baltimore Teachers Union v. Mayor of Baltimore*, the Fourth Circuit notes that the Supreme Court has provided little guidance as to what constitutes substantial impairment, but assumes that a substantial impairment occurs “where the right abridged was one that induced the parties to contract in the first place or where the impaired right was on which there had been reasonable and especial reliance.”<sup>46</sup>

An aggrieved party’s reliance on the contractual obligation appears to be “the primary yardstick” by which the Fourth Circuit Court determines the degree of impairment.<sup>47</sup> In *Andrews v. Anne Arundel County, Maryland*, the Fourth Circuit Court found that a pension-benefit reduction was likely more substantially impairing than a salary reduction, after noting the centrality of reliance in an employee’s contractual right for compensation at the contractually specified level.<sup>48</sup> The reason for the greater degree of impairment is “because the individual receiving pension benefits is typically already living on a reduced income as compared to her pre-retirement earnings.”<sup>49</sup>

While a court in the Fourth Circuit likely finds a retroactive diminution of public-pension benefits to be substantial impairment, it might not find substantial impairment of pension terms as long as changes do not adversely affect the benefits, or if adversely affected, are replaced with comparable benefits.<sup>50</sup> Similarly, the Seventh Circuit Court found in analogous private-pension contracts that “[a]n employer is free to move from one legal plan to another, provided that it does not diminish vested interests . . . .”<sup>51</sup> Therefore, unless a

46. *Baltimore Teachers Union*, 6 F.3d at 1017 (internal citations omitted).

47. *Andrews v. Anne Arundel County*, 931 F. Supp. 1255, 1265 (D. Md. 1996), *aff’d without opinion*, 114 F.3d 1175 (4th Cir. 1997) (citing *Baltimore Teachers Union*, 6 F.3d at 1018 n.8).

48. *Andrews*, 931 F. Supp. at 1175 (finding that the county’s retroactive reduction of pension benefits to affect cost-saving was unconstitutional). Courts also have found substantial impairments in temporary changes to contracts such as temporary wage freezes or deferment of salary payments. See *Buffalo Teachers Fed’n v. Tobe*, 464 F.3d 362, 368 (2d Cir. 2006) (confirming the district court’s determination that a “wage freeze substantially impairs the unions’ labor contracts with Buffalo”); *Ass’n of Surrogates and Supreme Court Reporters Within New York v. New York*, 940 F.2d 766, 772 (2d Cir. 1991) (noting that a statute affecting timing of payment of salary substantially impaired public employees’ contract).

49. *Andrews*, 931 F. Supp. at 1175.

50. *City of Frederick v. Quinn*, 371 A.2d 724, 726 (Md. Ct. Spec. App. 1977) (concluding that “the employee must have available substantially the program he bargained for and any diminution thereof must be balanced by other benefits or justified by countervailing equities for the public’s welfare”).

51. *Cooper v. IBM Personal Pension Plan*, 457 F.3d 636, 642 (7th Cir. 2006).

reduction in pension benefits has been replaced by a benefit sufficient to mitigate the impairment, a court following the Fourth Circuit's analysis might conclude that the pension-benefit reduction is a substantial impairment.

Courts might not find substantial impairment where legislation or collective bargaining agreements for pension contract terms operate prospectively. For example, in *Maryland State Teachers Ass'n v. Hughes*<sup>52</sup> and *Howell v. Anne Arundel County, Maryland*<sup>53</sup> the district court explained that the contract clause only protects against retroactive diminution of vested benefits and no contract clause violation occurs when legislation applies prospectively to non-vested plan benefits. In these cases, the court found no impairment because a reduced cost-of-living adjustment to the pension benefits would only apply to benefits earned after the effective date of the legislation.<sup>54</sup>

Recognizing their legal limitations, many states with significant multi-year budget deficits have been trying to reduce pension costs without entangling themselves in impairment issues. For example, some states are offering different contract terms to new employees such as higher retirement-age requirements, longer vesting periods, lower cost-of-living adjustments, and 401(k)-styled defined contribution plans that provide lower costs and benefits when compared to those of their current employees and retirees.<sup>55</sup> Because these contract terms for new employees do not change an existing contract, they do not impair a contract. Yet, when a state tries to introduce similar contract terms to contracts of existing employees that reduce pension benefits, a court may find significant impairment to the pension contract.

### 3. *Does the Impairment Have a Public Purpose?*

If the change to a pension contract operates as a substantial impairment under the second prong of the *United States Trust* test, a court determines whether the impairment has a significant and

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52. *Md. State Teachers Ass'n v. Hughes*, 594 F. Supp. 1353, 1363 n.6 (D. Md. 1984).

53. *Howell v. Anne Arundel County*, 14 F. Supp. 2d 752, 755 (D. Md. 1998).

54. *Md. State Teachers Ass'n* 594 F. Supp. at 1362 (noting that "one legislature can[not] bind subsequent legislatures for work and services to be performed by State employees and teachers in the future"); *Howell*, 14 F. Supp. 2d. at 756.

55. John Keefe, *State Pension Plans Scramble to Avoid Bankruptcy*, INSTITUTIONAL INVESTOR, Feb. 16, 2011, at 1, available at [http://www.cnbc.com/id/41642979/State\\_Pension\\_Plans\\_Scramble\\_to\\_Avoid\\_Bankruptcy](http://www.cnbc.com/id/41642979/State_Pension_Plans_Scramble_to_Avoid_Bankruptcy).

legitimate public purpose under the test's third step.<sup>56</sup> Among a state's important public purposes is to balance its budget and manage taxpayer money in a fiscally sound manner.<sup>57</sup> The court, however, cautions against assuming that a state's financial decisions always are serving a legitimate public purpose: "If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all."<sup>58</sup>

Although not determinative to the judicial outcome, courts might find actions to properly manage and fully fund its pension programs as a legitimate public purpose because "ensuring the financial integrity of the [government] is a significant public purpose."<sup>59</sup> Further, all states except Vermont emphasize the public purpose of their financial soundness by including in constitutional or statutory provisions requirements to balanced their operating budgets,<sup>60</sup> and a number of states have further constitutional protection for pension funding.<sup>61</sup>

#### 4. *Is the Impairment Reasonable and Necessary?*

Assuming the legislation has a significant public purpose under the third step of the *United States Trust* test, a court analyzes under the fourth step whether the impairment to the contract was reasonable and necessary to satisfy that important public purpose.<sup>62</sup> The analysis with this last step often provides the most point and counterpoint to arguments between parties.

In *United States Trust*, the Supreme Court held that "less impairing" means were available to preserve energy and improve rail transit.<sup>63</sup> Reasonable alternatives and less impairing means might

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56. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 27 (1977).

57. *Baltimore Teachers Union v. Mayor of Baltimore*, 6 F.3d 1012, 1019 (4th Cir. 1993).

58. *United States Trust*, 431 U.S. at 26.

59. *Baltimore Teachers Union*, 6 F.3d at 1019.

60. NAT'L CONF. OF STATE LEGISLATURES, NCSL FISCAL BRIEF: STATE BALANCED BUDGET PROVISIONS 2 (2010), <http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf>.

61. For example, around thirty states have constitution pension protections specifically covering educators. NAT'L EDUCATION ASS'N, NEA ISSUE BRIEF ON PENSION PROTECTIONS IN STATE CONSTITUTIONS 3 (2004), <http://www.nea.org/assets/docs/PensionProtectionsinStateConstitutions04.pdf>.

62. *United States Trust*, 431 U.S. at 29–31.

63. *Id.* at 25–26.

have included raising taxes, cutting spending, or selling off assets.<sup>64</sup> Thus, “[a] state may not justify an impairment of its contractual financial obligations to others simply because it would rather spend the money for some other public purpose.”<sup>65</sup> In short, the Court did not find that it was reasonable or necessary for the states to revoke their promise not to subsidize rail transit.<sup>66</sup> The needs for energy preservation and promoting mass transit were foreseeable at the time the states made the promises and nothing had radically changed since then.<sup>67</sup>

In the public-pension context, a state would need to show the court that its impairment to pension obligations was reasonable and necessary. As part of its fact-specific analysis, a court would determine whether more reasonable alternatives were available and whether the state could have foreseen the problems it cites as reasons for needing to change terms of a pension contract.

The question of whether the severity of pension liability in recent years was foreseeable may be debated. From the pension holder’s perspective, the pension underfunding may be the result of mismanagement, reduced state revenue, or some other reason for which a pension holder has no responsibility. Further, the pension holder may argue that the problems with pension funding are overblown, that states have alternatives to solve their financial problems, and that impairing state pensions is not necessary. For example, Dean Baker of the Center for Economic and Policy Research argues that the pension shortfall has been misrepresented in public debates, and the primary reason for the shortfall is the plunge in the stock market from 2007 through 2009.<sup>68</sup> He asserts that the pension shortfall remains manageable because it is less than 0.2 percent of the projected gross state product over the next thirty years in most states.<sup>69</sup> Even the largest shortfalls, he argues, is less than a half percent of projected state product, and some of the shortfall is likely to disappear with more recent stock market growth.<sup>70</sup>

To buttress Dean’s point, some analysts point to the recent pension funding failure as a part of a normal business cycle and

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64. *Id.* at 26.

65. *Id.*

66. *Id.* at 29–30.

67. *Id.* at 32.

68. BAKER, *supra* note 23, at 4, 10, 15.

69. *Id.* at 1.

70. *Id.*

recessionary market decline.<sup>71</sup> Alternatively, even if the Great Recession was not part of a normal business cycle, and instead was a generational market collapse, a significant market downturn is unlikely in the foreseeable future. Advocates for pension holders would urge the court to leave pension contracts untouched because a state can make up the shortfall as its budgets strengthen, and market forces will cover the pension funding gap over time.<sup>72</sup> In short, the pension holder's position may be that any reduction to pensions is unreasonable and unnecessary.

From the perspective of a state such as Illinois, the pension shortfalls are unlikely to be fixed with the passing of time, and it may be necessary to impair pensions to make them sustainable.<sup>73</sup> While many factors may have caused the current state budget crises, economists have pointed to two primary reasons for the possible state default on pension-fund obligations. First, many states over-promised benefits to employees during the financially flush 1990s.<sup>74</sup> Second, many states have projected unrealistic amounts of funding resources or rates of return for current and future pension investments.<sup>75</sup> Also contributing to some of the pension underfunding, states can argue, are systemic structural issues such as early retirements,<sup>76</sup> generous cost-of-living adjustments, past sharing with retirees of excess returns, double-dipping of retirees into more than one pension,<sup>77</sup> and spiking

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71. *Id.* at 1–2. See also Law & McNichol, *supra* note 22, at 2; David Madland & Nick Bunker, CTR FOR AM. PROGRESS ACTION FUND, STATE BUDGET DEFICITS ARE NOT AN EMPLOYEE COMPENSATION PROBLEM 4–5 (2011), <http://www.americanprogressaction.org/issues/2011/03/pdf/statebudgetissuebrief.pdf>.

72. See Law & McNichol, *supra* note 22, at 3; BAKER, *supra* note 23, at 15.

73. Joshua D. Rauh, *Are State Public Pensions Sustainable? Why the Federal Government Should Worry About State Pension Liabilities* (May 15, 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1596679&](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1596679&).

74. PEW CENTER ON THE STATES, PROMISES WITH A PRICE, *supra* note 18, at 8–9.

75. Brown & Wilcox, *supra* note 11, at 538–39.

76. See *Faulkenbury v. Teachers' and State Emp. Ret. Sys. of N.C.*, 483 S.E.2d 422, 429 (N.C. 1997) (concluding that changing a plan that no longer encourages people to take early retirement through disability, because it pays more than a salary, and is not an important public purpose that justifies the impairment of contractual rights).

77. See *Retired Adjunct Professors of the State of R.I. v. Almond*, 690 A.2d 1342, 1347–1348 (R.I. 1997) (“[T]he challenged legislation was both reasonable and necessary to advance the legitimate public purpose of fostering public confidence in the State’s retirement system by restricting the proclivity of some public pensioners to indulge in what is colloquially referred to as “double dipping”—that is, the simultaneous receipt by retired public employees of both a salary for state reemployment and a state pension”); *but see Wiggs v. Edgecombe County*, 632 S.E.2d 249 (N.C. Ct. App. 2006) (concluding that saving taxpayer money, improving retirement system, and correcting inequities—such as “double dipping”—are not valid reasons for impairing contractual rights.).

of final salaries with overtime pay and vacation payouts to increase that factor into calculation of retirement pay.<sup>78</sup> Some states have tried to change contract terms with new employees that address the above-mentioned issues.

States in significant financial distress have either taken or are considering further impairments. Among them are capping of the salary on which public pensions are figured; raising retirement ages; requiring employees to pay into the pension system or requiring additional employee contributions; and requiring a minimum number of hours of work per week before an employee receives pension credit.<sup>79</sup>

States may assert that their severe budget shortfalls were unforeseeable, and any proposed changes to their pension plans are both reasonable and necessary to insure long-term sustainability of their defined-benefit pension funds. Nonetheless, a state court will evaluate a pension contract to determine whether a state had less impairing or reasonable alternatives to its impairing action. The court also will evaluate how necessary impairment is on two levels: 1) whether a less drastic modification could have been implemented; and 2) whether, even without modification, a state could have achieved its stated goals.<sup>80</sup> For example, a court may find a state's impairing action unconstitutional if the court determines that the state's action impairs a contract or burdens the pension holder more than an alternative action that could have been taken.<sup>81</sup> Given decades of judicial rulings that have protected pensions of governmental employees and retirees from impairments, the states have a difficult evidentiary bar to clear before a court will find an impairment to be reasonable or necessary.

The Contract Clause, however, does not prohibit all state actions that impair a contract and in rare cases, a court has ruled an impairment of a pension to be constitutional.<sup>82</sup> After carefully scrutinizing Maryland's actions and its possible alternatives, a Maryland court in 1984 found that state legislation impairing pension

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78. PEW CENTER ON THE STATES, THE TRILLION DOLLAR GAP, *supra* note 1, at 28.

79. Mary Williams Walsh, *In Budget Crisis, States Take Aim at Pension Costs*, N.Y. TIMES, June 19, 2010, <http://www.nytimes.com/2010/06/20/business/20pension.html?scp=2&sq=mary%20williams%20walsh&st=cse>.

80. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 29–30 (1977).

81. *Nev. Employees Ass'n v. Keating*, 903 F.2d 1223, 1227–28 (9th Cir. 1990) (finding that all employees have contract rights “subject to reasonable modification”).

82. *United States Trust*, 431 U.S. at 21.

obligations was constitutional because 1) the law was reasonable and necessary to financially stabilize retirement systems, 2) it spread their cost more equitably across present and future taxpayers, and 3) it helped the state to plan fiscally.<sup>83</sup> In applying the *United States Trust* test, the Court evaluated the extent of the impairment, the possibility of less drastic contract modifications, and the possibility that Maryland could have achieved its stated goals without modifications.<sup>84</sup> The court noted that “[a] pension system need not be actuarially unsound before a legislature may move to change the system and the benefits it provides its members.”<sup>85</sup> In the end, the court found “the impairment to be minimal at worst.”<sup>86</sup>

### **B. Pension Obligations Under Promissory Estoppel Theory**

Like most other courts, Minnesota courts analyze pension obligations under contract law where an actual contract such as a collective bargaining agreement exists, but where a contract does not clearly exist, it relies on the promissory estoppel theory rather than implying a contract.<sup>87</sup> Minnesota’s courts are currently the only state courts that will interpret a vested pension as a property right.<sup>88</sup> Nevertheless, Minnesota courts typically find that employees’ pension rights may not be changed to the employees’ detriment after they have retired because the conditions precedent to the pension obligation has been fulfilled.<sup>89</sup>

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83. *Md. State Teachers Ass’n v. Hughes*, 594 F. Supp. 1353, 1372 (D. Md. 1984).

84. *Id.* at 1362 (citing the Supreme Court). “The extent of impairment is certainly a relevant factor in determining reasonableness.” *United States Trust*, 431 U.S. at 27. Necessity is judged on two levels: 1) whether a less drastic modification could have been implemented; and 2) whether, even without modification, a state could have achieved its stated goals. *Id.* at 29–30.

85. *Md. State Teachers Ass’n*, 594 F. Supp. at 1368.

86. *Id.* at 1370.

87. Amy B. Monahan, *Public Pension Reform 2* (Univ. of Minn. L. Sch. Legal Stud. Res. Paper Series, Res. Paper No. 10-13, 2010), available at <http://lhc.ca.gov/studies/activestudies/pension/UniversityofMinnesota.pdf>.

88. *Id.* at 22. Under the theory of promissory estoppel, once an employee’s service has been performed in reliance on the state’s offer of pay and benefits such as a pension, the state is not free to retroactively change the terms upon which the service was performed. *Christensen v. Minneapolis Mun. Emp. Ret. Bd.*, 331 N.W.2d 740, 748–49 (Minn. 1983) (promissory estoppel may be invoked to enforce a public employer’s promise of pension benefits prescribed by statute).

89. *Christensen*, 331 N.W.2d at 749 (holding that the retiree had a protectable right to be paid a pension when he retired); *Law Enforcement Labor Services, Inc. v. County of Mower*, 483 N.W.2d 696 (Minn. 1992) (holding that upon retirement in reliance on the

### C. Pension Obligations as Mere Gratuity

Early in their history, pensions were considered gratuities that did not vest, which meant that a benefit could be withdrawn or amended at any time.<sup>90</sup> This gratuity theory treats the pension as a gift, and thus most states have rejected it under their laws that ban state gifts to individuals.<sup>91</sup> In the last few decades, only Texas,<sup>92</sup> Indiana<sup>93</sup> and Arkansas<sup>94</sup> have chosen the gratuity approach. While the gratuity approach technically permits benefits to be reduced or eliminated, gratuity states have nonetheless tended to bargain with their labor unions and honor pension promises when an employee has satisfied all eligibility requirements.<sup>95</sup>

### D. Judicial Interpretations on Vesting

Courts are fairly consistent in concluding that once a public employee's right in a pension vests, any modification other than increased benefits may be an unconstitutional impairment. Judicial opinions diverge, however, in how they determine when the employee's contract or property right in a pension vests. Vesting is

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county's promise of pension benefits a retiree's right is vested for the life of the retiree and cannot be altered absent the retiree's express consent).

90. Monahan, *supra* note 87, at 3.

91. See, e.g., *Yeazell v. Copins*, 402 P.2d 541, 543 (Ariz. 1965) (holding that if a state constitution bans state gifts to individuals and pensions are gifts, then paying a pension benefit would be unconstitutional).

92. See, e.g., *Kunin v. Feofanov*, 69 F.3d 59, 63 (5th Cir. 1995) (observing that "Texas law is clear that a person's property right in a public pension is subordinate to the state's power to determine to whom benefits are to be paid, to set conditions for receiving such benefits, to modify benefits paid, or to abolish the pension and accrued benefits altogether").

93. See, e.g., *Haverstock v. State Pub. Employees Ret. Fund*, 490 N.E.2d 357, 360 (Ind. Ct. App. 1986) ("In order for a right to vest or a liability to be incurred it must be immediate, absolute, complete, unconditional, perfect within itself and not dependent upon a contingency. . . . Moreover, it is well settled [that] a mere expectance of a future benefit, or a contingent interest in property founded on anticipated continuance of existing laws, does not constitute a vested right.") (internal citations omitted); *Ballard v. Bd. of Tr. of Police Pension Fund*, 324 N.E.2d 813, 815 (Ind. 1975) (following the gratuity approach with involuntary or compulsory plans, where an employee has no choice on whether to contribute to the pension plan or receive compensation).

94. See, e.g., *Blackwood v. Floyd*, 29 S.W.3d 694, 694 (Ark. 2000) (holding that noncontributory pension benefits are a mere gratuity); cf. *Jones v. Cheney*, 489 S.W.2d 785 (Ark. 1973) (holding that vested pension benefits funded with employee contributions are protected from impairment).

95. Monahan, *supra* note, at 87 n.1 (suggesting the good faith of Texas, which in 2009 left unchanged the benefits of current employees in the Texas Employee Retirement System and only made changes to pension plans for new hires).

when an employee acquires an unconditional entitlement to a share in a pension fund.

In states where pensions are considered contracts, some courts find that public employees acquire unalterable contractual rights at the signing of their employee agreements.<sup>96</sup> Assuming a binding contract is created on an employee's first day of work and remains in effect until the employee ends employment, a court may require a state to protect future benefit accruals as well as benefits already earned. In other states, the rights to a pension vest when the employee joins a pension plan and those vested rights may not be impaired, although a state may reserve the right to revise or amend the public-pension plan.<sup>97</sup> Some state courts interpret a pension contract to include the worker's own pension contribution, so at the point where a worker first contributes funds to his or her own pension plan, the contract cannot be changed.<sup>98</sup> In other states, the statute authorizing the public-pension benefits may say specifically that employee contributions will fluctuate based on the funding needs of the plan.<sup>99</sup>

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96. *See, e.g.,* *Yeazell v. Copins*, 402 P.2d 541, 541 (Ariz. 1965) (holding that public employee had right to rely on terms of legislative enactment relating to pension as it existed at time he began employment, and that subsequent legislation could not be arbitrarily applied retroactively to impair contract); *Calabro v. City of Omaha*, 531 N.W.2d 541, 551 (Neb. 1995) (holding that a "public employee's constitutionally protected right in his or her pension vests upon the acceptance and commencement of employment").

97. *See, e.g.,* *Davis v. Mayor of Annapolis*, 635 A.2d 36 (Md. Ct. Spec. App. 1994) (recognizing that the state follows majority view that pension benefits are contractual, but "under certain circumstances the government may unilaterally modify them so long as the changes do not adversely alter the benefits, or if the benefits are adversely altered, they are replaced with comparable benefits"); *Hansen v. City of Idaho Falls*, 446 P.2d 634 (Idaho 1968) (recognizing that "[t]he rights of the employees in pension plans . . . are vested, subject only to reasonable modification for the purpose of keeping the pension system flexible and maintaining its integrity.)

98. *See, e.g.,* *Jones v. Cheney*, 489 S.W.2d 785, 788 (Ark. 1973) (holding that vested pension benefits funded with employee contributions are protected from impairment); *Swann v. Bd. of Trustees of Joint Mun. Employees' Benefit Sys.*, 360 S.E.2d 395, 398 (Ga. 1987) (holding that where a statute establishes a retirement plan for government employees who contribute toward the benefits and performs services while the statute is in effect, the statute becomes part of the contract of employment so that an attempt to amend the statute violates the impairment clause of the state constitution).

99. *See, e.g.,* *Transport Workers Union of Am., Local 290 v. Se. Pa. Transp. Auth.*, 145 F.3d 619, 624 (3d Cir. 1998) (holding that the Metropolitan Transportation Authorities Act reserving the right to modify the pension contract and might require employees to make contributions did not impair the contractual relationship between employees and authority, and thus did not violate contract clauses of United States and Pennsylvania Constitutions); *Whitely v. N.M. State Pers. Bd.*, 850 P.2d 1011, 1016 (N.M. 1993)

Some courts have held that an employee's inchoate rights to retirement benefits do not vest until an employee has performed all employee obligations and qualifies for retirement.<sup>100</sup> A court may distinguish between limited and absolute vesting rights.<sup>101</sup> Some courts recognize a retiree's vested right at the time a pension benefit is payable at retirement and look to their states' statutes that define the statutorily created vested right at that time.<sup>102</sup>

In state courts that interpret a pension as a property and not a contract interest, a court may determine that the pension does not fully vest until an employee reaches the age necessary to begin receiving benefits.<sup>103</sup> In states where compulsory and noncontributory pensions are treated as a mere gratuity, an employee may not be entitled to vested rights until all eligibility requirements are satisfied.<sup>104</sup> Yet, even in states where courts have not found explicit constitutional or statutory protection for public-pension benefits, they still may provide limited protection for vested pension rights.<sup>105</sup>

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(determining that public employees did not have contractual right to prevent legislative change in the rate of annual leave accrual as an unconstitutional impairment of contract).

100. *See, e.g.,* *Pitts v. City of Richmond*, 366 S.E.2d 56, 58 (Va. 1988) ("Full performance by the employee constitutes acceptance of the offer, and his previously inchoate rights to receive payments under the plan vest and become legally enforceable.").

101. *See, e.g.,* *Nicholas v. State*, 992 P.2d 262, 264-65 (Nev. 2000) ("Until an employee has earned his retirement pay, or until the time arrives when he may retire, his retirement pay is but an inchoate right; but when the conditions are satisfied, at that time retirement pay becomes a vested right of which the person entitled thereto cannot be deprived; it has ripened into a full contractual obligation.").

102. *See, e.g.,* *Herrick v. Lindley*, 391 N.E.2d 729, 732-33 (Ohio 1979) ("[R]etirees have a vested right to receive a retirement allowance or similar benefit at the rate fixed by law when such benefit was conferred. However, neither [statute] grants a vested right to a continuing tax exemption.").

103. *See* *Pierce v. State*, 910 P.2d 288, 305 (N.M. 1995) ("We decline to join those states that find a contractual relationship where one does not clearly and unambiguously exist and that proceed to justify how the legislature may nonetheless unilaterally modify this contract without the consent of the participants."). State constitutions like that of New Mexico recognize that public employees have in their pensions vested property rights, protected by due process but not contractual rights. N.M. CONST. art XX, § 22D. *See also* *Whitely*, 850 P.2d at 1014 (concluding that public employees did not have contractual right to prevent a legislative change in the annual rate of leave accrual as an unconstitutional impairment of contract).

104. *See, e.g.,* *Haverstock v. State Pub. Employees Ret. Fund*, 490 N.E.2d 357, 360 (Ind. Ct. App. 1986).

105. *See, e.g.,* *Singer v. City of Topeka*, 607 P.2d 467, 473 (Kan. 1980) ("A public employee, who over a period of years contributes a portion of his or her salary to a retirement fund created by legislative enactment, who has membership in the plan, and who performs substantial services for the employer, acquires a right or interest in the plan which cannot be whisked away by the stroke of the legislative or executive pen, whether the employee's contribution is voluntary or mandatory.").

### E. Defaults on Pension Obligations and Sovereign Immunity

If a state defaults on public-pension funding or unilaterally changes the terms of a pension contract, its actions raise fundamental issues concerning the state's legal obligations and the immutability of its sovereign immunity. One can ask to what extent a state is legally obligated to fund its public pension when it is functionally insolvent, and how much does its sovereign immunity protect the state from judicial intervention.

Although infrequent, states have defaulted on debts.<sup>106</sup> Bondholders have brought claims against states for violating terms of contracts and not paying debts, and in response, some states claimed sovereign immunity under the Eleventh Amendment of the Constitution.<sup>107</sup> Under the Eleventh Amendment, federal judicial power "shall not extend to suits brought against states by citizens of another states, or by citizens or subjects of any foreign state."<sup>108</sup> In *Hans v. Louisiana*, the Supreme Court extended the doctrine of such sovereign immunity, holding that the Eleventh Amendment barred federal suit even by citizens of that defendant state.<sup>109</sup> The theory is that states, like the federal government, are sovereign and cannot be sued unless they allow themselves to be sued, and then only to the extent they allow themselves to be sued.

Current Supreme Court jurisprudence interprets state immunity to include the protection of a nonconsenting state from suit in state as well as federal courts. In a five-to-four ruling, the Court concluded that Article I of the United States Constitution does not provide Congress with the ability to subject nonconsenting states to private suits for damages in its own courts.<sup>110</sup> Modern-day state constitutions and statutory laws, however, can and often do overcome that

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106. See generally, B. U. RATCHFORD, *AMERICAN STATE DEBTS* (Duke Univ. Press 1941). For more detailed information on states debts in the 1800s, see WILLIAM A. SCOTT, *THE REPUDIATION OF STATE DEBTS* 265–74 (Richard T Ely ed., Thomas Y. Crowell & Co. 1893).

107. *Beers v. Arkansas*, 61 U.S. 527, 529 (1857) ("It is an established principle of jurisprudence in all civilized nations that the sovereign cannot be sued in its own courts, or in any other, without its consent and permission . . .").

108. U.S. CONST. amend. XI.

109. *Hans v. Louisiana*, 134 U.S. 1, 17, 20 (1890).

110. *Alden v. Maine*, 527 U.S. 706, 713 (1999) ("[A]s the Constitution's structure, its history, and the authoritative interpretations by this Court make clear, the States' immunity from suit is a fundamental aspect of the sovereignty which the States enjoyed before the ratification of the Constitution, and which they retain today . . .").

immunity, allowing state employees to sue the state for claims related to public pensions.

Major downturns in the economy of the United States proceeded the times when states have defaulted. Of the twenty-eight states and territories existing in the 1840s, eight states and the territory of Florida defaulted on their debt, with five of them repudiating all or part of their debts in years following the Financial Panic of 1837.<sup>111</sup> In response to these financial fallouts, some states passed constitutional amendments that instituted procedural restrictions on state debts.<sup>112</sup> After the costly and debt-laden years of the Civil War, eight states defaulted to varying degrees in the 1870s and 1880s: Alabama, Arkansas, Florida, Georgia, Louisiana, North Carolina, South Carolina, Tennessee, and West Virginia.<sup>113</sup> This time many states responded by passing repudiation acts between 1870 and 1880.<sup>114</sup> The last time that a state defaulted on its bonds was 1933, when Arkansas defaulted on transportation-related bonds in the aftermath of the Great Depression.<sup>115</sup> Many states have passed debt-limiting and budget-balancing laws that, at least in theory, limit their abilities to accumulate debt and encourage paying current bills such as pension obligations.

States have generally waived their sovereign immunity to allow their employees to sue them on issues of pension obligations. In states where courts have interpreted pension obligations under theories of contract or property rights, public employees as collective bargaining units have come to rely on strong judicial protections against attempts by states to make impairing changes to terms of

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111. John Joseph Wallis, *Sovereign Default and Repudiation: The Emerging Market-Market in United States, 1839-1843*, 2 (Nat'l Bureau of Econ. Res., Working Paper No. 10753, 2004), <http://www.econ.umd.edu/research/papers> (search for "Wallis, Sovereign Default and Repudiation"). The states eventually settled most of these debts, usually with partial payments, after long battles in state legislatures as well as state and federal courts. William B. English, *Understanding the Costs of Sovereign Default: American States Debts in the 1840's*, 86 AM. ECON. REV. 259, 259 (1996). For more detailed information on states debts in the 1800s, see SCOTT, *supra* note 106, at 265–74.

112. John Joseph Wallis & Barry R. Weingast, *Dysfunctional or Optimal Institutions? State Debt Limitations, the Structure of State and Local Governments, and the Finance of American Infrastructure*, in FISCAL CHALLENGES: AN INTERDISCIPLINARY APPROACH TO BUDGET POL'Y 331–656 (Elizabeth Garrett, Elizabeth Graddy, & Howell E. Jackson eds., 2006).

113. RATCHFORD, *supra* note 106, at 183–96.

114. SCOTT, *supra* note 106, at 221.

115. Joe Mysak, *Bond Default Is About Too Much Debt, Too Little Time*, BLOOMBERG, Jul. 20, 2010, <http://www.bloomberg.com/news/2010-07-21/bond-default-means-too-much-debt-too-little-time-commentary-by-joe-mysak.html>.

public pensions. It is unclear how insolvent a state must be before a court might consider any impairment to pension benefits to be reasonable and necessary. Equally unclear is how financially desperate a state would need to be before it declared its sovereign immunity against a court order requiring the state to honor the terms of its pension obligations.

### **III. Solution Using Conditional Bailouts through Tax-Exempt Debt Obligations**

States in financial crisis are seeking financial solutions including federal bailouts to states' current as well as projected long-term pension indebtedness.<sup>116</sup> One proposed solution to the underfunding involves state-issued pension-obligation bonds. The federal government would grant tax-exempt status conditioned on changes to the pensions of new employees.

#### **A. Pension-Obligation Bonds Conditioned on Pension Plan Changes**

The question of whether the federal government should bail out state pensions has sparked fierce debates among media pundits, financial analysts, and lawmakers. Outraged and frustrated by the billions of economic-stimulus dollars already sent to states since 2008, opponents of federal bailouts for state pension funds have declared that "the era of the bailout is over."<sup>117</sup> Other opponents, including lawmakers like House Majority Leader Eric Cantor, suggest that any type of federal bailout will only further delay states from fixing their pension problems.<sup>118</sup> Still others like Jon Shure of the Center on

116. States have fewer legal or practical remedies for debt relief from pension or other liabilities than local and federal levels of government have. They cannot declare bankruptcy as municipalities can. U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq.* (West 2011). The federal bankruptcy statute sets forth the preconditions for a municipality to file bankruptcy, including the requirement of specific state authorization. 11 U.S.C. § 109 (West 2011). The states also cannot print additional money as Congress can under the constitutional power to borrow, coin money, and regulate the value of money. U.S. CONST. art. I, § 8, cl. 5. In February 2011, New Jersey Governor Christie told voters in his State of the State message that "[w]e can't continue to spend money we don't have. We can't print money, and we can't run deficits." Fletcher, *supra* note 3, at A17.

117. Barbara Barrett, 'The Era of the Bailout is Over,' *Rep. McHenry Warns States*, CHARLOTTE OBSERVER, Feb. 10, 2011, <http://www.charlotteobserver.com/2011/02/10/2049471/the-era-of-the-bailout-is-over.html> (reporting the declaration of Rep. Patrick McHenry, who was chairing his first meeting of the House Oversight Committee's subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs on February 9, 2011).

118. Alan Fram, *Lawmakers Oppose Using Federal Money to Bail Out States and Local Govts in Fiscal Trouble*, ABC NEWS, Feb. 9, 2011, <http://abcnews.go.com>

Budget and Policy Priorities assert that the plight of state pension plans is being exaggerated.<sup>119</sup> They believe that the growth of financial markets will eventually solve the underfunding problem, given several years to remedy the shortfalls.<sup>120</sup>

Proponents and opponents of state bailouts at least agree that state pensions are underfunded and states are struggling to balance their budgets. Some states continue to have significant underfunding and it appears that some states might be pressed to request more federal assistance. For example, with his 2012 state budget proposal, Illinois Governor Pat Quinn suggested that his state might seek a federal guarantee for future pension-obligation bond sales, which would allow the state to sell bonds at lower interest rates.<sup>121</sup>

An alternative to Quinn's proposed federal-guaranteed bonds and likely a longer term solution to pension underfunding involves pension-obligation bonds with significant conditions upon a state to receive preferred tax-exempt status for those bonds.<sup>122</sup> Professors Robert Novy-Marx and Joshua Rauh proposed a federal bailout solution where a state issues state bonds that Congress would exempt from federal income tax in exchange for the state agreeing to specific austerity measures.<sup>123</sup> For example, the state could issue tax-subsidized pension funding bonds for a term such as fifteen years, and would close its defined-benefit plan to new hires.<sup>124</sup> The state then would offer new employees a defined-contribution plan similar to a

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/Business/wireStory?id=12875638; Corey Boles & Siobhan Hughes, *No State Bailouts, Lawmaker Says*, WALL ST. J., Jan. 25, 2011, <http://online.wsj.com/article/SB10001424052748703555804576102502825849450.html>.

119. Dan Froomkin, *'Something's Got to Give': Massive Pension Fund Shortfalls Threaten to Bankrupt States*, HUFFINGTON POST, Sept. 15, 2010, [http://www.huffingtonpost.com/2010/04/05/somethings-got-to-give-ma\\_n\\_525860.html](http://www.huffingtonpost.com/2010/04/05/somethings-got-to-give-ma_n_525860.html).

120. *Id.*

121. GOVERNOR PAT QUINN, ILLINOIS STATE BUDGET FISCAL YEAR 2012 29 (2012), available at [http://www2.illinois.gov/budget/Documents/FY%202012/FY12\\_Operating\\_Budget.pdf](http://www2.illinois.gov/budget/Documents/FY%202012/FY12_Operating_Budget.pdf). See Dave McKinney, *Top U.S. House Republican Rejects Federal Guarantee for Ill. Pensions*, CHI. SUN-TIMES, Feb. 23, 2011, <http://www.suntimes.com/news/politics/3959464-418/top-u.s.-house-republican-rejects-federal-guarantee-for-ill.-pensions>.

122. Joshua Rauh & Robert Novy-Marx, *Pension Security Bonds: A New Plan to Address the State Pension Crisis*, 7 ECONOMISTS' VOICE 2 (2010), <http://www.bepress.com/ev/vol7/iss3/art1>.

123. *Id.* Under current federal law, state bonds funding pensions are fully taxable. *Id.* As a result, these bonds are significantly more expensive than municipal bonds qualifying for tax-exempt status. *Id.* See Role of Public Employee Pensions—statement of Joshua Rauh, *supra* note 5, at 10.

124. Rauh & Novy-Marx, *Pension Security Bonds*, *supra* note 122, at 2.

federal thrift savings plan with guaranteed access to social security.<sup>125</sup> Additionally, the state would agree to fund its existing defined-benefit plans on an actuarially sound basis.<sup>126</sup> The advantage to the state is that it could sell pension-obligation bonds at lower interest rates competitive with those of tax-exempt municipal bonds.<sup>127</sup>

### B. Passing the Conditional-Spending Test of *South Dakota v. Dole*

Under the proposed solution of state bonds with federal conditions, Congress would give tax-exempt status to pension-obligation bonds only where a state meets three conditions. First, a state must close its current defined-benefit pension plans to new employees. Second, a state must close its defined-benefit pensions to new employees. Third, a state must guarantee an actuarially sound funding of its current defined-benefit plan. These conditional pension obligation bonds appear to fall within the conditional federal spending power of Congress. Courts have interpreted the almost unlimited spending power of Congress under the Constitution's Spending Power Clause<sup>128</sup> to include conditional federal spending to persuade states to change their laws.

In *South Dakota v. Dole*, the Court adopted a four-prong test against which it assessed the constitutionality of spending conditions such as the ones in the proposal for tax-exempt pension-obligation bonds.<sup>129</sup> First, the spending must be for the "general welfare,"

125. *Id.*

126. Role of Public Employee Pensions—statement of Joshua Rauh, *supra* note 5, at 10. Rauh argues that enrolling state and local workers into Social Security would offset a significant percentage of the federal government's costs from the debt subsidy. *Id.* See also Peter A. Diamond & Peter R. Orszag, *Saving Social Security: The Diamond-Orszag Plan*, 2 *ECONOMISTS' VOICE* 3 (2005), <http://www.bepress.com/ev/vol2/iss1/art8> (suggesting that moving newly hired state government workers into the social security system will help restore social security and move towards all workers bearing their fair share of the nation's legacy generosity to retired workers). *But see* Rowland Davis, *Comment on Rauh and Novy-Marx: The Real Cost to Provide Adequate Retirement Benefits*, 7 *ECONOMISTS' VOICE* 1 (2010), <http://www.bepress.com/ev/vol7/iss4/art1> (asserting that Rauh and Novy-Marx has significantly under-estimated the cost for a replacement defined-contribution plan).

127. Role of Public Employee Pensions—statement of Joshua Rauh, *supra* note 5, at 10.

128. U.S. CONST. art. I, § 8, cl. 1 ("The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States . . .").

129. *South Dakota v. Dole*, 483 U.S. 203, 211 (1987) (holding that receipt of highway funds conditioned on the state establishing a minimum drinking age was constitutional under the spending power of Congress).

although “courts should defer substantially to the judgment of Congress”<sup>130</sup> because “the concept of welfare or the opposite is shaped by Congress.”<sup>131</sup> Second, Congress’s imposed conditions on a state’s receipt of funds must be “unambiguous.”<sup>132</sup> Third, conditions on federal grants must be reasonably related to “the federal interest in particular national projects or programs.”<sup>133</sup> Finally, the legislation should not violate any independent “constitutional provisions . . . [that] provide an independent bar to the conditional grant of federal funds.”<sup>134</sup> In *South Dakota v. Dole*, the Court concluded that conditioned receipt of federal highway funds on a state’s adoption of a twenty-one-year-old drinking age was sufficiently related to the funding program.<sup>135</sup>

Congressional tax expenditure on tax-exempt pension-obligation bonds will likely pass the general-welfare prong of the *South Dakota v. Dole* test because Congress has wide discretion on what constitutes general welfare, and the federal interest in stabilizing public pensions of states seems to meet that low threshold requirement.<sup>136</sup>

Under the lack-of-ambiguity prong, a program imposing conditions upon tax-exempt status for bonds would likely clear the hurdle that conditional spending is free from ambiguity, assuming Congress clearly defines actuarially sound pension-funding levels. The state would need to be able to evaluate the pros and cons of receiving tax-exempt treatment on pension-obligation bonds in exchange for moving their pensions from defined-benefit to defined-

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130. *Id.*

131. *Id.* at 207 (quoting *Helvering v. Davis*, 301 U.S. 619, 640–45 (1937)).

132. *Dole*, 483 U.S. at 207.

133. *Id.* (quoting *Massachusetts v. United States*, 435 U.S. 444, 461 (1978) (plurality opinion)). The dissenting Justice O’Connor agreed in principle with the *South Dakota v. Dole* test but disagreed with the Court’s application. *Dole*, 483 U.S. at 212. She thought that the conditioned federal highway grant is unconstitutional because the “establishment of a minimum drinking age of 21 is not sufficiently related to interstate highway construction to justify so conditioning funds appropriated for that purpose.” *Id.* Rather, it was “an attempt to regulate the sale of liquor, an attempt that lies outside Congress’ power to regulate commerce.” *Id.*

134. *Id.* at 208 (citing *Lawrence County v. Lead-Deadwood Sch. Dist.*, 469 U.S. 256, 269–70 (1985); *Buckley v. Valeo*, 424 U.S. 1, 91 (1976) (*per curiam*); *King v. Smith*, 392 U.S. 309, 333, n.34 (1968)).

135. *Dole*, 483 U.S. at 212.

136. In *Helvering v. Davis*, Judge Cardozo explained that this discretion “belongs to Congress, unless the choice is clearly wrong, a display of arbitrary power, not an exercise of judgment.” 301 U.S. 619, 640 (1937). He also suggested that old-age pension with regards to Social Security was a national problem and “separate states cannot deal with it effectively.” *Id.* at 644.

contribution plans. The state would need to evaluate the additional costs to implement a new defined-contribution plan and might determine that the costs of complying with the conditions outweigh the benefits.<sup>137</sup>

Under the reasonably related prong, the conditional federal tax subsidy of pension-obligation bonds appears reasonably related to the federal interest in stabilizing the funding of public-pension programs.<sup>138</sup> Arguably, the federal tax subsidy of pension obligation bonds and public-pension funding are more closely related than highway funds and a state's minimum legal drinking age, which the *South Dakota v. Dole* Court found sufficiently related.

Under the fourth prong, the conditional grant of a tax subsidy fits within the Court's broad interpretation of Congress's power under the Spending Clause,<sup>139</sup> and does not appear to violate any other constitutional rights the states or pensioners might have. Absent evidence of coercion, "Congress may attach conditions on the receipt of federal funds . . . that bear some relationship to the purpose of the federal spending . . ."<sup>140</sup>

Under *South Dakota v. Dole*, tax-exempt pension obligation bonds with federally imposed conditions appear constitutional. This assumes they are unambiguous in their creation and implementation, they promote the general welfare of the country, and they reasonably relate to the federal interest in the nation's overall financial health. Nevertheless, a state might try to argue that strong conditions of closing up defined-contribution plans for new employees in exchange for receiving tax-exempt status for bonds is coercive in nature and impinges upon state autonomy. The counterargument is that states would not be required to participate in a tax-exempt program for bonds, and would be free to issue federally taxed rather than tax-exempt pension-obligation bonds.

The Court recognizes Congress's broad discretion in its spending and conditional spending. Thus, conditional debt obligations for state pensions would likely survive a constitutional challenge because the

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137. Some states such as Michigan and Alaska have closed their defined-benefit plans to new employees and have offered them a defined-contribution plan. RONALD SNELL, NAT'L CONF. OF STATE LEGISLATURES, STATE DEFINED CONTRIBUTION AND HYBRID PENSION PLANS 4 (2010), <http://www.ncsl.org/LinkClick.aspx?fileticket=yGsmFhwoq7E%3D&tabid=18511>.

138. *Dole*, 483 U.S. at 207 (quoting *Massachusetts*, 435 U.S. at 461 (plurality opinion)).

139. U.S. CONST. art. I, § 8, cl. 1.

140. *New York v. United States*, 505 U.S. 144, 167 (1992) (quoting *Dole*, 483 U.S. at 206) (internal quotations omitted).

conditions on the pensions that increase the probability of the state paying the pension-bond obligations seem reasonably related to the preferential tax treatment of the bonds funding those pensions.

#### **IV. Solution Involving Bankruptcy for States**

A more radical and controversial proposal for solving states' budget crises and pension obligations includes bankruptcy relief. Congress could pass laws to allow bankruptcy relief for states. Bankruptcy law already allows local governments such as cities and counties to declare bankruptcy. Arguably, Congress could extend bankruptcy relief to states because the Bankruptcy Clause of the Constitution gives Congress sweeping powers to implement "uniform Laws on the subject of Bankruptcies throughout the United States."<sup>141</sup>

##### **A. Issue of State Autonomy with Bankruptcy for States**

A threshold question is whether the Bankruptcy Clause of the Constitution provides Congress the power to abrogate state sovereign immunity within the bankruptcy context. To some extent, the Bankruptcy Clause may be viewed as a powerful but limited exception to the principles of federalism and state autonomy, which are implied by the structure of the Constitution and expressly stated in the Tenth Amendment. As such, the Bankruptcy Clause permits and sometimes compels exceptions to constitutional provisions like that of the Contract Clause. The exception is available, however, only when the exigencies of financial distress require the federal government to provide a last resort for a debtor.

In principle, bankruptcy for states should be used only as a state's last resort. Proponents of the institution of bankruptcy argue that the proposed bankruptcy law for states would preempt all conflicting state law just as municipal bankruptcy law has. Yet some legal analysts assert that the sovereign immunity of states remains an insurmountable constitutional barrier.<sup>142</sup> Further, they offer more practical warnings about lengthy legal battles, administrative

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141. U.S. CONST. art. I, § 8, cl. 4.

142. See, e.g., *The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter: Hearing Before the H. Subcomm. on Courts, Commercial, and Administrative Law*, 112th Cong. 54 (2011) [hereinafter *Role of Public Employee Pensions*—statement of James E. Spiotto] (statement of James E. Spiotto, Partner of Chapman and Cutler LLP), available at [http://judiciary.house.gov/hearings/printers/112th/112-25\\_64585.PDF](http://judiciary.house.gov/hearings/printers/112th/112-25_64585.PDF).

difficulties, political realities, and the spread of financial-market turmoil.<sup>143</sup>

While the constitutionality of state bankruptcy is fiercely debated, municipal bankruptcy has been accepted as constitutional for over seventy years. In the past seventy years municipalities have been allowed with state consent to *voluntarily* file for bankruptcy. If the proposed bankruptcy law ensures that creditors cannot force a state into bankruptcy and states must voluntarily file, the Supreme Court still would need to determine whether the bankruptcy law impermissibly treads on states' sovereign immunity and whether a limitation on an Article I power protects that "incident of state sovereignty."<sup>144</sup>

Even after two hundred years, debates persist on the scope of power that the United States Constitution gives the federal government. The Supreme Court, in interpreting this scope of power, has set forth limits on federal power, basing them on constitutional text or on the general federalism principle of respecting states' sovereignty implied by the Constitution's structure as a whole. "[T]he Tenth Amendment confirms that the power of the Federal Government is subject to limits that may, in a given instance, reserve power to the States."<sup>145</sup>

The Supreme Court held in *New York v. United States*<sup>146</sup> that Congress cannot compel the states to enact or enforce a particular provision of a federal regulatory program. The Court found in this case that the federal "take-title" provision that made New York liable for damages if the state failed to take possession of low-level radioactive waste was coercive and therefore unconstitutional.<sup>147</sup> The Court analyzed the state's alternatives to either take title to the waste or become liable for damages. It explained, "A choice between two unconstitutionally coercive regulatory techniques is no choice at all."<sup>148</sup>

Under the anti-commandeering doctrine, the federal government cannot impose targeted, affirmative, coercive duties upon state legislators or executive officials. In *Printz v. United States*, Congress had passed interim provisions of the Brady Handgun Violence

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143. *Id.*

144. *New York v. United States*, 505 U.S. at 157.

145. *Id.*

146. *Id.* at 188.

147. *Id.* at 176.

148. *Id.*

Prevention Act that required state and local officers to conduct background checks on prospective handgun purchases and perform certain related tasks.<sup>149</sup> The Court found that these interim provisions were unconstitutional because Congress stepped over the constitutional line when it compelled certain executive actions that should have remained in the purview of the states.<sup>150</sup> The conclusion is that “[t]he Federal Government may neither issue directives requiring the States to address particular problems, nor command the States’ officers . . . to administer or enforce a federal regulatory program.”<sup>151</sup> Thus, if Congress directed a state to declare bankruptcy, it would be unconstitutional coercion under the anti-commandeering doctrine.

In a hypothetical bankruptcy of a state, a federal bankruptcy court still might appear to be directing a state’s actions in violation of the anti-commandeering principle. Any action that Congress could take to direct a state to declare bankruptcy as unconstitutional coercion. The analysis requires determinations on “whether an Act of Congress [such as instituting bankruptcy law for states] is authorized by one of the powers delegated to Congress in Article I of the Constitution [and] whether an Act of Congress invades the province of state sovereignty reserved by the Tenth Amendment.”<sup>152</sup>

The Bankruptcy Clause in Article I of the Constitution gives the Congress broad powers to enact “uniform Laws on the subject of Bankruptcies throughout the United States.”<sup>153</sup> On its face, the Bankruptcy Clause does not preclude the application of federal bankruptcy laws to states. Yet bankruptcy for states opens up the possibility that the federal government could interfere with core state functions and thereby violate a state’s sovereignty under the Tenth Amendment.<sup>154</sup> Further, the structure of the Constitution implies that states possess a degree of autonomy in governing themselves, and their management of their financial affairs would seem to be integral to that autonomy.<sup>155</sup> The proper scope of this autonomous governance can be debated.<sup>156</sup>

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149. *Printz v. United States*, 521 U.S. 898, 902 (1997).

150. *Id.* at 925.

151. *Printz*, 521 U.S. at 935.

152. *New York v. United States*, 505 U.S. at 155.

153. U.S. CONST. art. 1, § 8, cl. 4.

154. U.S. CONST. amend. X.

155. The Constitution’s structure reveals a principle of “dual sovereignty” between the federal and state levels of government. *See, e.g.*, *Gregory v. Ashcroft*, 501 U.S. 452, 457

Competing interests are in play here. On the one hand, the Tenth Amendment guarantees that power is reserved for the states. On the other hand, the Supremacy Clause supports the supremacy of federal bankruptcy. Congress likely would need to include a statutory provision within the proposed bankruptcy law for states similar to, although possibly more limited than, the one for municipalities in Chapter Nine, Section 903 of the Bankruptcy Code.<sup>157</sup> It says, “This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality . . . .”<sup>158</sup>

Assuming that a state wishes to voluntarily declare bankruptcy, the next question is whether the federal government would be commandeering the state’s power to govern itself where the federal bankruptcy court directs the bankruptcy proceedings. While bankruptcy code for states is only hypothetical here, current municipal bankruptcy law and procedures provides a framework for analysis to evaluate the constitutionality of bankruptcy for states and how a bankruptcy court might treat unfunded pension obligations as part of the debts of a bankrupt state.

#### **B. Municipal Bankruptcy as a Model for Proposed State Bankruptcy**

Current municipal bankruptcy law offers a statutory framework upon which a proposed bankruptcy code for states likely would be

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(1991). Similar to the concerns for balance of power on the federal level, the limitations on a state government being sued in its own courts helps prevent the state’s judiciary from having too much power over the legislative and executive branches of the state. If it were otherwise, the legislative and executive branches might be limited in its ability to apportion scarce resources based on the will of its citizens, and to protect the state’s financial integrity.

156. This increasing federal power relative to state power is represented in the growing percentage of the gross national product devoted to federal and states-government expenditures. JOINT ECONOMIC COMMITTEE, OFFICE OF THE CHAIRMAN, U.S. SENATOR CONNIE MACK, *THE U.S. ECONOMY AT THE BEGINNING AND END OF THE 20TH CENTURY 21* (1999), <http://usinfo.org/enus/economy/overview/docs/century.pdf>. The federal government’s expenditures grew four fold, from two to five percent of gross national product (GDP) early in the twentieth century to around twenty percent of GDP early in twenty-first century. *Id.* Meanwhile, the states’ expenditures did not quite double during the same period from five percent of GDP early in the twentieth century to around nine percent of GDP early in the twenty-first century. *Id.*

157. 11 U.S.C. § 903 (West 2011).

158. 11 U.S.C. § 903. See also Ryan Preston Dahl, *Collective Bargaining Agreements and Chapter 9 Bankruptcy*, 81 AM. BANKR. L.J. 295, 329–38 (2007) (noting that “constitutional guarantees of state sovereignty are not violated by a municipal debtor’s independent exercise of bankruptcy-specific rights”).

built. This is because the general structure and debts of municipalities are more analogous to those of local governments than those of individuals or business entities. Further, the court's experience with municipal bankruptcies shows how bankruptcy-for-states might work and what its limitations would be.

When municipalities are unable to pay their bills, they may declare bankruptcy voluntarily under Chapter Nine of the federal Bankruptcy Code.<sup>159</sup> Congress instituted bankruptcy for municipalities after the Great Depression when a number of cities were steeped in debt and needed a vehicle to reorganize that debt.<sup>160</sup> The Supreme Court held the law constitutional and rejected the arguments of municipal bondholders that the bankruptcy law violated the Fifth and Tenth Amendments of the Federal Constitution.<sup>161</sup>

### 1. *Early Constitutional Challenges to Municipal Bankruptcy*

The municipal bankruptcy laws passed in the 1930s met fierce constitutional challenges, and proposed bankruptcy laws for states meet similar opposition. Nevertheless, the Supreme Court might ultimately find bankruptcy law for states constitutional in a severe financial depression, for the same reasons it found the Municipal Bankruptcy Act of 1937<sup>162</sup> constitutional in *Bekins v. Lindsay-Strathmore Irr. Dist.*<sup>163</sup>

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159. 11 U.S.C. §§ 901-946 (West 2011). The law was introduced as Chapter Ten of the Bankruptcy Code but is now Chapter Nine.

160. The first municipal bankruptcy legislation was enacted in 1934 during the Great Depression. Pub. L. No. 73-251, 48 Stat. 798 (1934). Although Congress took care to draft the legislation so as not to interfere with the sovereign powers of the states guaranteed by the Tenth Amendment to the Constitution, the Supreme Court held the 1934 Act unconstitutional as an improper interference with the sovereignty of the states. *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513, 532 (1936). Congress enacted a revised Municipal Bankruptcy Act in 1937, Pub. L. No. 75-302, 50 Stat. 653 (1937), which was upheld by the Supreme Court. *United States v. Bekins*, 304 U.S. 27, 54 (1938), *reh'g. denied*, 304 U.S. 589 (1938).

161. *Bekins*, 304 U.S. at 46.

162. An Act to Amend an Act Entitled "An Act to Establish a Uniform System of Bankruptcy Throughout the United States," Pub. L. No. 75-302, 50 Stat. 653 (1937). The term "Bankruptcy Code" refers to the Bankruptcy Reform Act of 1978. Bankruptcy Act, Pub. L. No. 95-598, 92 Stat. 2549 (1978). Eric W. Lam, *Municipal Bankruptcy: The Problem With Chapter 9 Eligibility—A Proposal to Amend 11 U.S.C. § 109(c)(2)* (1988), 22 ARIZ. ST. L.J. 625, 625 (1990). This enactment became effective October 1, 1979. 92 Stat. at 2682. *Id.* In 1984, a major amendment was made to the Code. Pub. L. No. 98-353, 98 Stat. 333, 364 (1984). *Id.* Another amendment was made in 1986. Pub. L. No. 99-554, 100 Stat. 3088, 3097 (1986). *Id.*

163. *Bekins*, 304 U.S. at 27.

In 1938, the *Bekins* Court gave several key reasons why it found the municipal bankruptcy law to be constitutional. First, municipal bankruptcy like the Lindsay-Strathmore Irrigation District declared was limited in scope to voluntary proceedings on “the composition of debts,” and “it is well settled that a proceeding for composition is in its nature within the federal bankruptcy power.”<sup>164</sup>

Second, the municipality entered into the proceedings voluntarily and with the consent of California, as sufficiently evidenced in a state statute passed in 1934.<sup>165</sup> Third, the bankruptcy proceedings of the District did not “unconstitutional[ly] interfere[e] with the essential independence of the State as preserved by the Constitution.”<sup>166</sup> The Court explained the limited scope of the bankruptcy court’s power: “The bankruptcy power is exercised in relation to a matter normally within its province and only in a case where the action of the [insolvent Lindsay-Strathmore Irrigation District] in carrying out a plan of composition approved by the bankruptcy court is authorized by state law.”<sup>167</sup> The Court also found no merit in the bondholders’ objections under the Takings Clause of the Fifth Amendment bankruptcy because the bankruptcy gave effect to a voluntary arrangement to restructure the municipality’s debt, under which payment is reduced.<sup>168</sup>

In the earlier *Ashton v. Cameron County Water Improvement Dist. No. 1* decision, the Supreme Court also had assumed that the similar Municipal Bankruptcy Act of 1934<sup>169</sup> did not contravene the Fifth Amendment.<sup>170</sup> Nevertheless, it held the Act unconstitutional because the sovereignty of the state and its subdivisions would no longer exist if the Court allowed the federal government to “interfere[e] with the relations between the parties concerned—to change, modify, or impair the obligation of their contracts.”<sup>171</sup>

As a contemporary of the justices deciding *Bekins* and *Ashton*, Professor Reuschlein observed that the *Ashton* Court feared that the

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164. *Id.* at 47.

165. *Id.*

166. *Id.* at 49.

167. *Id.* at 51.

168. *Id.*

169. Municipal Bankruptcy Act of 1934, Pub. L. No. 73-251, 48 Stat. 798 (1934), was substantially similar to the Municipal Bankruptcy Act of 1937, Pub. L. No. 75-302, 50 Stat. 653 (1937), which the Court found constitutional. *Bekins*, 304 U.S. at 51.

170. *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513, 527 (1936).

171. *Id.* at 530.

scope of the Bankruptcy Clause would expand to bankruptcy for states, and thus destroy the sovereignty of states, making them submit to the will of the Congress.<sup>172</sup> In the *Bekins* and *Ashton* cases, the Court was not required to decide on the possibility of state bankruptcy,<sup>173</sup> although Justice James Clark McReynolds cautioned that it was the next logical step. He asks in the *Ashton* opinion, “If federal bankruptcy laws can be extended to [the municipality], why not to the state?”<sup>174</sup>

Professor Reuschlein thought that with the municipal bankruptcy laws the Court’s “fear of vanishing state lines seem[ed] rather unwarranted.”<sup>175</sup> Yet now, some seven decades later, the public concern about federalism, dual sovereignty, and the sovereign immunity of states has reappeared in public debates on whether bankruptcy law should be expanded to states.

To the *Ashton* Court’s concern on the implications of municipal bankruptcy on federalism and state autonomy, the dissenting Justice Cardozo suggested that a state’s consent preserves the equilibrium between national and state power.<sup>176</sup> He concluded that municipal bankruptcy should be constitutional because, assuming it is voluntary and absent coercion, it impedes state autonomy no more than federal taxes do.<sup>177</sup>

## 2. *Current Jurisprudence for Municipal Bankruptcy*

With now more than seventy years of municipal bankruptcy experience, federal bankruptcy courts have developed judicial and procedural standards for municipal bankruptcy that have withstood constitutional challenges. The Supreme Court has concluded that where state law “unduly impede[s] the operation of federal bankruptcy policy, the state law [will] have to yield.”<sup>178</sup> This is because the Supremacy Clause invalidates state laws that “interfere

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172. Harold Gill Reuschlein, *Municipal Debt Readjustment: Present Relief and Future Policy*, 23 CORNELL L.Q. 365, 377 (1938).

173. *Id.* at 377–78.

174. *Ashton*, 298 U.S. at 530. Justice McReynolds postulated that “[i]f the state were proceeding under a [bankruptcy] statute like the present one, with terms broad enough to include her, . . . the problem [of interfering with the sovereignty of the state] would not be materially different.” *Id.*

175. Reuschlein, *supra* note 172, at 377.

176. *Ashton*, 298 U.S. at 540.

177. *Id.* at 540–41.

178. *Perez v. Campbell*, 402 U.S. 637, 649 (1971).

with, or are contrary to the laws of Congress.”<sup>179</sup> Under current jurisprudence, at least at the municipal level, a debtor’s independent exercise of bankruptcy-specific rights does not appear to violate constitutional guarantees of state sovereignty.

The judicial and procedural standards for any proposed provisions for state bankruptcy likely would be challenged on similar grounds to those present in municipality bankruptcy. These standards if applied to the state would require that the state 1) had negotiated unsuccessfully but in good faith with creditors;<sup>180</sup> 2) is insolvent, as defined by cash flow rather than assets and liabilities;<sup>181</sup> 3) has specific law that recognizes the validity of bankruptcy for the state;<sup>182</sup> 4) acts voluntarily and without coercion;<sup>183</sup> 5) remains autonomous in its general governance, politics, and other fiscal affairs throughout the bankruptcy proceedings;<sup>184</sup> and 6) gives final approval to the bankruptcy plan.<sup>185</sup> Underlying these standards are two themes: state autonomy buttressed by constitutional structure and the Tenth Amendment, and good-faith dealing with creditors implied within the Contract Clause.

Assuming that the structure of bankruptcy for states would be similar to that of municipalities, the Bankruptcy Court could not interfere with the revenue, politics, or day-to-day operations of a

179. *Gibbons v. Ogden*, 22 U.S. 1, 211 (1824).

180. 11 U.S.C. § 921(c) (West 2011) (“[T]he court, after notice and a hearing, may dismiss the petition if the debtor did not file the [bankruptcy] petition in good faith.”).

181. 11 U.S.C. § 109(c)(3) (West 2011).

182. 11 U.S.C. § 903(1) (West 2011). The state must “specifically authorize” localities within the state to enter Chapter Nine, with or without conditions. 11 U.S.C. § 109(c)(2) (West 2011). Nevertheless, a general statute that authorizes localities within the state to enter Chapter Nine, with or without conditions, will suffice. *See, e.g., CAL. GOV’T CODE* § 53760 (West 2011).

In 1994, Congress changed the 11 U.S.C. § 109(c)(2) to require that a municipality be “specifically authorized” by its state to file under Chapter Nine from the previous legal requirement that a municipality be “generally authorized.” 11 U.S.C. § 109(c)(2). Daniel J. Freyberg, Comment, *Municipal Bankruptcy and Express State Authorization to be a Chapter 9 Debtor: Current State Approaches to Municipal Insolvency – and What Will States Do Now?*, 23 OHIO N.U. L. REV. 1001 (1997). In *In re County of Orange*, the court noted that the purported state grant of authority “must be exact, plain, and direct with well-defined limits so that nothing is left to inference or implication.” 183 B.R. 594, 604 (Bankr. C.D. Cal. 1995).

183. 11 U.S.C. § 903 (West 2011).

184. 11 U.S.C. § 904 (West 2011) (explicitly barring the court, without the consent of the debtor municipality, from interfering with any of the municipality’s political or governmental powers, any of its property or revenues, or its use or enjoyment of any income-producing properties).

185. 11 U.S.C. § 943(a) (West 2011).

state. In *East St. Louis v. Zebley*,<sup>186</sup> the Supreme Court held that “the question, what expenditures are proper and necessary for the municipal administration, is not judicial; it is confided by law to the discretion of the municipal authorities. No court has the right to control that discretion.”<sup>187</sup> To the Court, the level of expenditures appeared to be an inherently political issue, not susceptible to scientific and disinterested evaluation.<sup>188</sup> In this way, it would violate structural principles of federalism and separation of powers for federal courts to interfere with local democratic decision-making about levels of spending.<sup>189</sup> For the same reason, the Bankruptcy Court could not interfere with the revenue, politics, or day-to-day operations of a state if it were to declare bankruptcy.

### 3. *Public-Pension Obligations in Collective Bargaining Agreements*

Bankruptcy can only be an effective tool against the state’s insolvency if it addresses the liabilities of public pensions, which are becoming a significant portion of many states’ unpaid bills. Public pensions at the state or local level of government are often part of collective bargaining agreements or other types of labor contracts. These agreements between labor unions and states often have additional protections against impairments under state statutory or constitutional law.<sup>190</sup> Consequently, the critical question here becomes whether bankruptcy law for states would allow them to reject collective bargaining agreements related to its public-pension obligations.

Again, using municipal bankruptcy as a model, the municipal bankruptcy code does not specifically address labor contracts or pension obligations as part of those contracts. Yet it allows full access to Chapter Nine bankruptcy relief under 11 U.S.C. § 903,<sup>191</sup> together

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186. *City of East St. Louis v. Zebley*, 110 U.S. 321, 324 (1884).

187. *Id.*

188. *Id.*

189. *Id.*

190. For example, Illinois’s state constitution says “Membership in any pension or retirement system of the State . . . shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.” ILL. CONST. art. XIII, § 5 (1970). A majority of Illinois cases have held that the constitutional provision “prohibits subsequent amendments to the law from decreasing a party’s pension benefits, but allows pension benefits to be enhanced by a subsequent amendment on the theory that a new contract with the increased vested benefits is formed if the party provides additional consideration in the form of continued contributions.” *Hannigan v. Hoffmeister*, 608 N.E.2d 396, 402 (Ill. App. Ct. 1992).

191. 11 U.S.C. § 903 (West 2011).

with 11 U.S.C. § 109(c)(2).<sup>192</sup> Arguably, once the municipality and its state agree to the municipality declaring bankruptcy, the municipality can fully use 11 U.S.C. § 365 to accept or reject its executory contracts.<sup>193</sup>

Collective bargaining agreements and their agreed-upon pension terms by extension, are included in the definition of executory contracts, and thus may be subject to modifications in bankruptcy.<sup>194</sup> In *NLRB v. Bildisco*, the Supreme Court affirmed the bankruptcy's decision that a building supplies distributor had a right to reject a collective bargaining agreement in Chapter Eleven bankruptcy (reorganization) because it had made reasonable efforts to negotiate a voluntary modification of its labor contract prior to bankruptcy.<sup>195</sup> The Court concluded this after it recognized the special nature of the collective bargaining agreement and the consequent "law of the shop," and distinguished the collective agreement from an ordinary executory contract. It applied a somewhat stricter standard than that of "business judgment" to the rejection of the collective bargaining agreement, and found in this case, the employer's rejection of the collective bargaining agreement to be reasonable when the company faced liquidation.<sup>196</sup>

In the end, a bankruptcy court must balance the interests of the debtor, creditors, and employees, and in striking the balance, must consider not only the degree of hardship each party faces, but also any qualitative differences between the types of hardship each may face.<sup>197</sup> That balance in bankruptcy might extend to breaking of a collective bargaining agreement under 11 U.S.C. § 365.

In a hypothetical state bankruptcy, public pensions as part of collective bargaining agreements would be subject to modification under 11 U.S.C. § 365. The bankruptcy likely would apply the *Bildisco* standard to any public-pension contract a state wants to modify. That means the state could reject a pension contract with state employees and retirees only if the agreement significantly

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192. 11 U.S.C. § 109(c)(2) (West 2011).

193. 11 U.S.C. § 901 (West 2011) (making § 365 fully applicable to municipality cases).

194. *NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 523 n.6 (1984).

195. *Id.* See also Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 *YALE J. ON REG.* 351, 360 (2010). In response to the *Bildisco* decision, Congress added explicit protections for labor contracts into Chapter Eleven, which governs reorganization of businesses but not for Chapter Nine, which governs municipal bankruptcies. *Id.*

196. *Bildisco*, 465 U.S. at 525–26.

197. *Id.* at 526–27.

burdened the state and the state was able show that it made reasonable efforts to negotiate a voluntary modification to the agreement without a satisfactory result. Under this standard, the state might also apply greater pressure on their employees to make concessions to pension contracts before deciding to declare bankruptcy.

Bankruptcy brings all debts under the bankruptcy court's scrutiny, and at least one creditor from every "impaired" class must approve the bankruptcy plan voluntarily before any involuntary losses or cuts (often called "cram downs") can be imposed.<sup>198</sup> Moreover, once a debtor files and is deemed eligible for bankruptcy, any state law or constitutional provision that limits the provisions of the Bankruptcy Code is preempted.<sup>199</sup>

In the case of a state declaring bankruptcy, the state presumably could not target pension benefits for cuts without also imposing losses on other unsecured creditors under the structure of current bankruptcy law. Conversely, the state likely could not exempt pension benefits from cuts just because of additional state statutory or constitutional provisions that protect pension contracts from impairment. As a result, the "impaired" pension holders could experience at least some financial loss. Additionally, their bargaining unit or labor union would be required as one of the creditors to approve the state's bankruptcy plan, which might include impairment a pension contract.

#### 4. *The Best-Interest Standard for Bankruptcy Plans*

Bankruptcy courts generally require that the municipal debtor is unable to cover liabilities with available revenue before filing bankruptcy, and that the municipality had tried to negotiate with its creditors in good faith before filing bankruptcy. Again, assuming that state bankruptcy code would follow the framework of municipal bankruptcy code, the code would require a state to act fair and equitably with the best interest of the creditors and the court would

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198. 11 U.S.C. § 1129(b) (West 2011) (outlining the requirements for judicial approval of a plan).

199. As the court noted in the bankruptcy of the city of Vallejo, "[B]y authorizing the use of Chapter 9 by its municipalities, California must accept Chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest. *In re City of Vallejo*, 403 B.R. 72, 76 (Bankr. E.D. Cal. 2009) (citing *In re County of Orange*, 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996)).

need to confirm that the state's bankruptcy plan complies with the "fair and equitable" test and is in the best interests of the creditors.<sup>200</sup>

Some courts interpret the "best interests" or "fair and equitable" to mean that they can reject confirmation proposals that do not include feasible tax increases with reasonable possibility of increased revenue. In 1940, for example, a federal appeals court rejected a bankruptcy petition filed by Orange County's Newport Heights Irrigation District on the grounds that the District had sufficient assets and could have raised taxes to pay the interest due on its bonds.<sup>201</sup> The court concluded that it was "unable to find any reason why the tax rate should not have been increased sufficiently to meet the District's obligations or why it can be said that the [bankruptcy] plan is 'equitable' and 'fair' and for the 'best interest of the creditors' with no sufficient showing that the taxing power was inadequate to raise the taxes to pay them."<sup>202</sup>

In contrast, a bankruptcy court concluded that a plan was proposed in good faith where the debtor hospital demonstrated that it could not raise taxes sufficient to pay more to creditors.<sup>203</sup> After facts-and-circumstances analysis, the court determined that a hospital district had no obligation to raise taxes to pay unsecured claims in full to demonstrate that its bankruptcy plan was proposed in good faith and fair and equitable.<sup>204</sup> Additionally, the court recognized no existing authority where the court could require a debtor to raise taxes if the evidence indicated that not raising taxes would be inequitable and unfair.<sup>205</sup>

A state bankruptcy code that follows the framework of municipal bankruptcy code would require a state to act fairly and equitably with the best interest of *all* of its creditors—not just its employees and retirees with pensions. Decades of judicial rulings under Contract-Clause analysis have protected most pensions of governmental employees and retirees from reductions. Nevertheless, a bankruptcy court might come to a different conclusion about what is fair and

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200. The Revision and Legislative Reports following 11 U.S.C. § 943 suggest that a court's confirmation of a bankruptcy plan should be guided by standards of "fair and equitable" and the "best interest of creditors," as set forth in *Kelley v. Everglades Drainage Dist.*, 319 U.S. 415 (1943) and *Fano v. Newport Heights Irrigation Dist.*, 114 F.2d 563 (9th Cir. 1940). 11 U.S.C. § 943 (West 2011).

201. *Fano*, 114 F.2d at 565–66.

202. *Id.*

203. *In re Corcoran Hosp. Dist.*, 233 B.R. 449, 459 (Bankr. E.D. Cal. 1999).

204. *Id.* at 459–60.

205. *Id.* at 460 (citing *Fano*, 114 F.2d at 566).

equitable for public-pension holders after a fact-and-circumstances analysis of a state's overall financial health including the state's budget deficit and its projected revenue and expenditures.

### C. Issue of Greater Federal Interference with Bankruptcy for States

What will not be discussed here in any detail is how bankruptcy for states implicates greater interference with their sovereignty than municipal bankruptcy does because states ultimately control whether the municipality can declare bankruptcy. Even today, not all states grant municipalities the right to declare bankruptcy under Chapter Nine.<sup>206</sup>

Those who question the constitutionality of bankruptcy for states argue that no matter how narrowly the bankruptcy law is drafted to prevent federal interference with state governance, such law ultimately would strip the states of the “dignity and respect due sovereign entities.”<sup>207</sup> Arguably, states could become “mere appendages of the federal government.”<sup>208</sup> Additionally, if the state legislature would declare bankruptcy or enter into a long-term contract, it might bind future legislatures. A legislature should not be able to bind its successors with contracts that the successor determines is harmful to the public's safety, health or comfort, or are not useful or necessary. The Supreme Court made clear in *Stone v. Mississippi* that the “legislature cannot bargain away the police power of a State.”<sup>209</sup>

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206. Role of Public Employee Pensions—statement of James E. Spiotto, *supra*, note 142 at 4. Fifteen states have unconditionally authorized municipalities by statute to file Chapter Nine petitions: ALA. CODE § 11-81-3 (West 2011); ARIZ. REV. STAT. ANN. § 35-603 (West 2011); ARK. CODE ANN. § 14-74-103 (West 2011); CAL. GOV'T CODE § 53760 (West 2011); IDAHO CODE ANN. § 67-3903 (West 2011); KY. REV. STAT. ANN. § 66.400 (West 2011); MINN. STAT. ANN. § 471.831 (West 2011); MO. ANN. STAT. § 427.100 (West 2011); MONT. CODE ANN. §§ 7-7-132 and 85-7-2041 (West 2011); NEB. REV. STAT. § 13-402 (West 2011); N.Y. LOCAL FIN. LAW § 85.80 (West 2011); OKLA. STAT. ANN. tit. 62 §§ 281, 283 (West 2011); S.C. CODE ANN. § 6-1-10 (West 2011); TEX. LOC. GOV'T CODE ANN. § 140.00 (West 2011); WASH. REV. CODE § 39.64.040 (West 2011). *Id.* Twenty-six states do not allow their municipalities to file for bankruptcy under Chapter Nine. John Knox & Marc Levinson, MUNICIPAL BANKRUPTCY: AVOIDING AND USING CHAPTER 9 IN TIMES OF FISCAL STRESS 17 (Orrick, Herrington & Sutcliffe LLP 2009), available at <http://www.orrick.com/fileupload/1736.pdf>.

207. *Fed. Mar. Comm'n v. S.C. State Ports Auth.*, 535 U.S. 743, 769 (2002).

208. *Fed. Maritime Comm'n*, 535 U.S. at 751.

209. *Stone v. Mississippi*, 101 U.S. 814, 817 (1879) (upholding a Mississippi statute outlawing lotteries even though a prior legislature had granted to a private party the right to run a lottery).

Further, opponents of state bankruptcy law suggest that before unfunded pension liabilities bring a state “to its knees in a bankruptcy forum,” more appropriate methods still exist for resolving problems with states’ potentially unrealistic promises made to state employees and retirees.<sup>210</sup> These differences between municipal bankruptcy and the proposed bankruptcy for states could be significant enough for the Supreme Court to find that bankruptcy for states is untenable.

#### **D. Practical Rather than Constitutional Limitations to Bankruptcy**

Even if Congress establishes a new chapter of bankruptcy for states and the Supreme Court finds it constitutional, states may determine that on a practical level, declaring bankruptcy creates more social, political and other economic problems than it solves. At a fundamental economic level, bankruptcy provides debt relief. Yet a state bankruptcy declaration could affect financial-market volatility and an already weakened bond market, further damaging state credit ratings and bondholder trust.<sup>211</sup> So while bankruptcy may provide the most financially troubled states with a new form of relief,<sup>212</sup> many state officials see more harm than good.<sup>213</sup>

Any state pursuing bankruptcy likely would be caught up in lengthy and costly constitutional challenges of pension holders and other interested parties. It is because of this legal uncertainty as well as practical issues that bankruptcy may remain an unattractive option for states. Thus, a state would only file bankruptcy in response to an overwhelming liquidity crisis and as a last resort option when everything else fails.

### **Conclusion**

Whether the funding gap of state public pensions is \$452 billion, \$2.54 trillion or somewhere in between, states’ abilities to pay for retirement benefits promised to public-sector workers may run up against the reality of limited resources. Many states have been

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210. Role of Public Employee Pensions—statement of James E. Spiotto, *supra*, note 142, at 4.

211. Joan Gralla, Jim Christie, Michael Connor & Lisa Lambert, *Factbox: Big U.S. States Spurn Bankruptcy Bill*, REUTERS, Jan. 21, 2011, <http://www.reuters.com/article/2011/01/21/us-usa-states-bankruptcy-reaction-idUSTRE70K78P20110121>.

212. David Skeel, *A Bankruptcy Law—Not Bailouts—for the States*, WALL ST. J., Jan. 18, 2011, at A17, available at <http://online.wsj.com/article/SB10001424052748703779704576073522930513118.html>.

213. John Gramlich, ‘No Thanks,’ States Say to Bankruptcy Idea, STATELINE, Jan. 25, 2011, <http://www.stateline.org/live/details/story?contentId=544565>.

running budget deficits for multiple years, even though most states have statutory or constitutional provisions requiring some form of a balanced budget. Thus, a state may be tempted to default on or repudiate at least some of the current pension obligations.

Beyond the protections of the Constitution's Contract Clause, state constitutional or statutory laws provide additional legal protections against states unilaterally reducing pension benefits. A financially strapped state likely will face stiff legal challenges to any state action significantly impairing its public pensions. Somehow the state would need to convince a court that its budget deficits and public-pension underfunding are so severe that no reasonable alternatives exist to impairing public pensions.

Of the two proposed solutions for the state pension liabilities, bonds would face fewer legal challenges than bankruptcy and might be seen modest but practical. The bonds are a limited federal bailout where Congress would exempt from tax a state's pension-obligation bonds in exchange for a state agreeing to specific austerity measures. Because courts have recognized Congress's broad discretion in its spending, conditional debt obligations for state pensions would likely survive a constitutional challenge. These conditions on the pensions increase the probability of the state paying the pension-bond obligations and seem reasonably related to the preferential tax treatment of the bonds funding those pensions.

Bankruptcy for states, the second and more speculative solution, would face many more legal, practical and political challenges. Arguably the Bankruptcy Clause of the Constitution is worded broadly enough to allow voluntary bankruptcy for states, and would preempt contradictory state law under the Supremacy Clause. Yet, even if Congress were to establish a new chapter of bankruptcy for states and the Supreme Court found it constitutional, states may in the end determine that on a practical level declaring bankruptcy creates more social, political, and other economic problems than it solves. At a fundamental economic level, bankruptcy provides debt relief. The first state to declare bankruptcy, however, might anticipate a long, hard and expensive legal battle through the federal court system to establish the constitutionality of bankruptcy for states. A state's declaration of bankruptcy might result in other unintended consequences such as increased volatility in financial markets, damage to the state's credit rating, lack of bondholder trust, and increased political turmoil. Because of these significant and potential risks, a state would file bankruptcy only in response to an

overwhelming liquidity crisis and as a last resort option when every other option fails.

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