# State Bankruptcy: A viable option or not?

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The topic of the potential for a state bankruptcy capability rose to the top of news releases from statements made by Senator Mitch McConnell yesterday. It has been some time since I have given this topic serious deliberation, but it does surface periodically. The pandemic is driving financial stress in all states but has been much more harmful to a select group of states. The spreading of the virus has been agnostic in terms of all affiliations or labels. Had the awareness of the severity of the virus been raised earlier, we may have taken some of the risk away. Densely populated locales have been more affected than others. Physical proximity has been a real factor as we have learned by taking preventative measures over the last several weeks. Due to the decline in all activities, cash flow for the states is being impaired. We are not certain of the timeline for the pandemic despite an array of opinions out there whether medical or otherwise. The negative financial implications will persist for a time.

The federal financial support that has been targeted to states and large localities and the aid directed to the healthcare sector is valued and is considered very necessary in this environment. There was disappointment that more aid was not included in the recent bill. The push is on for more direct aid for states and localities in Phase 5.

Which brings us to the bankruptcy consideration for states. If financial deterioration deepens to such a point that extraordinary measures need to be taken, should state bankruptcy be an option?

Bankruptcy filing for states is not a feature of present law. The last time that the municipal bankruptcy code was updated in 1988, there were no provisions for such a filing.

The consideration of a state bankruptcy goes to the heart of our system of government. The United States was founded by an affiliation of independent states. Although our federal government has strengthened in its powers in many respects over the years, there is still the concept of States rights. The states have retained sovereign powers that are not granted to the federal level. Our system of federalism over the years has clouded some of the clarity because of the financial interdependence of the different levels of government.

Many of my industry colleagues in the legal community have argued that a state bankruptcy capability may be theoretically possible. There are considerations with the Constitution and the Commerce Clause before this may even be contemplated. I do not believe that granting the right to a state to file for bankruptcy is just a statutory matter that would require an Act by Congress. There may be a need for a Constitutional amendment of some kind, but this consideration is in the realm of the constitutional legal community.

I have worked in the past with states that were under extreme financial duress. One of the examples was Louisiana in the mid 1980’s. Louisiana was and still is an energy and chemical industry dependent state to a degree. At the time, oil declined to $10 per barrel from a much higher level. In addition, the so-called First Use Tax on oil was declared unconstitutional. At the time, the state’s rating was lowered to Baa/BBB category. Cash flow was becoming critical and there was a need for some time to find a way to replace lost revenue from the loss of the First Use Tax. The Louisiana Recovery District bonds were floated to provide the necessary time. A portion of the sales tax was pledged to the repayment of the bonds. There was some conviction that there would be an effort to redeem the bonds as quickly as possible. Looking back, the financing prevented Armageddon. In a relatively short amount of time, the state developed a set of financial practices and principles that set it on a positive course and the state’s rating was raised once again.

California had various imbalances over the years that required a financing solution. At one point, the imbalance was approximately $23 billion. A consortium of banks backstopped a note issuance that provided the solution. Also, recovery bonds were sold that were backed by sales tax. The state found ways to balance its budget by tax increases and spending adjustments and bond ratings ascended in response.

My point with these two examples is that states are resourceful and innovative when they need to be. This time is different due to the exogenous nature of the virus. It would appear only fair that federal aid would prevent the creation of even more dire and systemic financial and economic problems.

Many states have pension challenges. Present market conditions especially equities will be contributing to even more potential underfunding. Even the best asset managers are being tested in the current climate. Most states have pursued pension reforms over the years. In some cases, the courts have not allowed the sought-after changes that would have helped to address the funding shortfall.

There should be some fine distinctions made between the definition of bail out and federal support. We are in an unprecedented predicament in modern times for which there are no easy solutions. We are also talking about support in the near term versus a capacity to pay in the long run. “Ford to City: Drop Dead” that resulted in federal financial support for the City in the end worked out well. New York City repaid the federal government loan ahead of schedule and with interest. It could work out well again.

If there is a conviction that any federal support offered should not be devoted to pensions, then there should be a form of a negotiated stipulation. This condition would be an improvement over the possibility of a state bankruptcy filing.

Bankruptcy creates a raft of its own problems and unintended consequences. Providing for a state bankruptcy capability would change the fundamental risk parameters of the municipal market. This $3.7 Trillion market serves the spectrum of issuers both large and small across the land. Other nations have admiration for our municipal market. We need to think beyond an expedient solution that would bring its own specific set of challenges.