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INVOLUNTARY BANKRUPTCY FOR AMERICAN STATES

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> *The history [of Congress' bankruptcy power] is one of an expanding concept. It is, however, an expanding concept that has had to fight its way. Almost every change has been hotly denounced in its beginnings as a usurpation of power. Only time or judicial decision has had capacity to silence opposition.*[1]

This essay began as an act of whimsy and provocation. Its central argument—that any bankruptcy regime created for American states should include an involuntary component—is well beyond the scope of current discussions among legal scholars and policymakers who are exploring the possibility of extending bankruptcy law to the States. While various writers and policymakers have recently advocated or considered allowing states to obtain relief in bankruptcy,[2] as one writer puts it, "no one is proposing involuntary bankruptcy for states."[3]

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1. Ashton v. Cameron Cnty. Water Improvement Dist., 298 U.S. 513, 535 (1936) (Cardozo, J., dissenting) (citations omitted).

2. *See generally, e.g.*, Michael W. McConnell, *Extending Bankruptcy Law to States: Is It Constitutional?*, *in* WHEN STATES GO BROKE: ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS (Peter Conti-Brown & David Skeel eds., 2012); Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy"*, 59 UCLA L. REV. 322 (2011); David A. Skeel, Jr., *States of Bankruptcy*, Univ. of Pa. Law School, Public Law Research Paper No. 11–30 (2011), *available at* http://papers.ssrn.com/sol3/papers.cfm? abstract_id=1907774; David Solan, *State Bankruptcy: Surviving a Tenth Amendment Challenge*, 42 GOLDEN GATE U.L. REV. 217 (2012); Lisa Lambert, *State Bankruptcy Bill Imminent, Gingrich Says*, REUTERS (Jan. 21, 2011, 5:57 PM), http://www.reuters.com/article/2011/01/21/us-usa-states-bankruptcy-idUSTRE70K6PI20110121.

3. McConnell, *supra* note 2, at 229. Some writers have discussed the possibility of involuntary bankruptcy for sovereigns. *See, e.g.*, Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured*, 53 EMORY L.J. 763, 786–87 (2004).

Until now. And with inspiration from Justice Cardozo's observation quoted above, what began as whimsy and provocation has become an argument—one that now seems more plausible than it did at the outset of this project. As Part I explains, there is a strong economic justification for an involuntary component of a bankruptcy regime in general. Debtors are predictably inclined to delay or avoid seeking available relief, thereby incurring unnecessary costs and losses that fall upon their creditors and other stakeholders.

Governmental debtors are similar to other debtors in this regard. Part II describes how sovereign governments—motivated by political pressures, concerns over access to credit markets, and optimism about economic improvements—predictably delay or avoid seeking debt relief when they suffer financial distress. Because governments in financial crisis can continue to collect tax revenues to fund their obligations, and because they enjoy broad immunity from suit and from enforcement of judgments against them, they have significant latitude to kick the can down the road until their financial situations become acute or resolve themselves. Meanwhile, their obligations accumulate, diluting each other, and some of their assets may be depleted.

Although American states have averted acute financial distress in the modern era, Part II argues that they would likely delay seeking relief if they were to face an unfolding financial crisis as other governmental debtors have done. If the goal of allowing American states to file for bankruptcy is to reduce the likelihood or the scope of financial support from the federal government, that goal could remain largely unrealized by an exclusively voluntary bankruptcy regime. There is a real possibility that the benefits of allowing states to file for bankruptcy could be slight compared to the costs that states will incur and externalize as a result of their delay in voluntarily seeking relief.

Part III proposes that, if bankruptcy law is extended to states, the federal government be authorized to initiate a bankruptcy case for a state when it is likely to need financial assistance from the federal government or is likely to impose financial costs or harms on the rest of the nation. Once a state is involuntarily placed in the bankruptcy system, however, no other involuntary consequences need follow. Under the model regime described in Part III, the state would be given the option to exit bankruptcy at its discretion after a short period, during which time it would benefit from a stay on actions against it. This protection would be more comprehensive than its

immunity from suit or enforcement. If the state elected, it could utilize the bankruptcy forum to negotiate with stakeholders and propose a plan that, among other things, would bind holdout creditors.

An involuntary procedure would not assure that states obtain relief sooner than they otherwise would. The federal government might itself delay invoking the procedure, perhaps for reasons similar to those that would deter the state from voluntarily seeking relief in bankruptcy. Furthermore, a state forced into bankruptcy might choose to exit without submitting a plan for restructuring if the option to exit were available. Nonetheless, the inclusion of an involuntary procedure in any state bankruptcy regime should at least increase the chances that a state in financial distress would obtain bankruptcy relief and would obtain it somewhat earlier than it otherwise would.

The commentary on extending bankruptcy protection to states assumes, often without inquiry, that an involuntary bankruptcy provision for states would be impermissible under the U.S. Constitution. Two Supreme Court cases from the 1930s that examined the constitutionality of the U.S. municipal bankruptcy regime include dicta supporting this view. Part IV argues that constitutional impediments to a state bankruptcy regime with an involuntary component are much less robust than courts, commentators, and scholars assume. A narrowly drawn bankruptcy regime for states that could be triggered by the federal government only if a state were likely to need financial assistance or threatened domestic financial stability should be able to navigate constitutional doctrines of state sovereignty. American states are not unqualifiedly sovereign, and their sovereignty is not so expansive that it can prevent the federal government from protecting fundamental national economic and financial interests when a state faces financial crisis.

I. INVOLUNTARY BANKRUPTCY

Bankruptcy can serve a variety of important functions. It can increase the overall return for creditors of an insolvent debtor and ensure the timely and equitable allocation and recognition of losses stemming from a failing debtor.[4] Simply by halting a race to collect assets from a debtor in financial distress, a bankruptcy regime can

4. *See, e.g.*, World Bank, *2011 Principles for Effective Insolvency and Creditor/Debtor Regimes*, at 6 (2011), *available at* http://siteresources.worldbank.org/INTGILD/Resources/ICRPrinciples_Jan2011.pdf.

help preserve the value of the debtor's assets for the benefit of all creditors.[5] Bankruptcy can also provide a process and a forum for restructuring the debtor's obligations to increase its value as a going concern for the benefit of its creditors and other stakeholders.[6]

But these functions of bankruptcy often depend on the regime being employed in a timely fashion. The consequences of avoiding or delaying bankruptcy when a debtor is in financial distress can be significant and, in some cases, determinative. Financial distress is itself costly to debtors and to other stakeholders.[7] A debtor's productivity may decline while it is distracted by financial distress, and it will likely incur direct costs in navigating its distress. If it defaults on obligations or delays in payment, its creditors will shift their losses back on the debtor if they are able, causing the debtor to suffer additional distress-related obligations. Debtors in distress will also likely have pressing financing needs and will generally be required to pay more for credit than financially healthy firms. Any new costly financing will further dilute existing claims.[8] Meanwhile, the debtor may be hemorrhaging assets in its effort to stay afloat or due to poor management.

If a private debtor's indebtedness worsens or its assets are depleted, the overall insolvency-state return for creditors tends to decline. If the debtor faces liquidation, there will be less to share among a larger group of claims. If there is initially a chance that the debtor could be successfully reorganized, it may become significantly more challenging to do so as the debtor slides deeper into financial distress. It will have fewer assets to employ as a going concern and greater short- and medium-term financing needs; it may also have squandered commercial opportunities and goodwill that it could more profitably exploit as a restructured entity.

Despite the costs and pitfalls of delay in the face of financial distress, debtors are predictably inclined to avoid or delay voluntarily seeking debt relief for some significant amount of time after it is in their and their creditors' interest to seek relief. Significant numbers of individuals and households in the United States forgo substantial

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5. *See, e.g.*, Adam Feibelman, *Federal Bankruptcy Law and State Sovereign Immunity*, 81 TEX. L. REV. 1381, 1419–20 (2003).

6. *See, e.g.*, World Bank, *supra* note 4, at 6.

7. *See* Adam Feibelman, *Defining the Social Insurance Function of Consumer Bankruptcy*, 13 AM. BANKR. INST. L. REV. 129, 166 (2005) (discussing the costs of financial distress).

8. *See, e.g.*, Bolton & Skeel, *supra* note 3, at 786.

relief available to them under bankruptcy law.[9] Faltering business debtors routinely delay seeking available relief, often needlessly expending resources that would be useful in a reorganization or that would increase the insolvency-state returns of their creditors.[10]

There are numerous interrelated explanations for debtors' delay in seeking debt relief when they experience financial distress. They may be overly optimistic about their future prospects for financial recovery and believe that debt relief will ultimately be unnecessary. They may be uninformed or poorly informed about the relief available to them. They may be deterred by stigma or concerns about reputation. Managers of a corporate debtor may reasonably fear that they will lose their positions if their firm files for bankruptcy.

Because the inclination of debtors to delay or avoid seeking debt relief can frustrate the primary goals of bankruptcy, most bankruptcy regimes around the globe provide that debtors can be forced into bankruptcy involuntarily in at least some circumstances.[11] Under the U.S. Bankruptcy Code, for example, three or more unsecured or under-secured claimholders whose unsecured claims total more than $14,425 can file an involuntary petition in Chapters 11 and 7 against consumer and commercial debtors.[12]

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9. *See generally* Michelle White, *Why Don't More Households File for Bankruptcy?*, 14 J.L. ECON. & ORG. 205 (1998) (noting that a "higher fraction of U.S. households would benefit financially from bankruptcy than actually file").

10. *See, e.g.*, Susan Block-Lieb, *Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small*, 57 BROOK. L. REV. 803, 835 (1991) (quoting Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong., 1st Sess., pt. I, at 14 (1973), *reprinted in* LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY APP. VOL. 2 (15th ed. 1979) ("[A] major factor explaining the smallness of distributions in business bankruptcies is the delay in the institution of proceedings for liquidation until assets are largely depleted.")).

11. World Bank, *supra* note 4, at 16 ("Both debtors and creditors should be entitled to apply for insolvency proceedings."); UNCITRAL, LEGISLATIVE GUIDE ON INSOLVENCY LAW 54 (2004), *available at* http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf (noting that most jurisdictions allow involuntary proceedings for liquidation but not all jurisdictions allow involuntary reorganization proceedings); Segio Muro, *Deciding on an Efficient Involuntary Bankruptcy Filing Petition Rule*, Cornell Law School Graduate Student Papers, no. 6, at 23 (2003), *available at* http://scholarship.law.cornell.edu/lps_papers/6 ("Whatever the special approach taken by the legal system, bankruptcy laws traditionally maintain that creditors' filings will help to bring recalcitrant, absconding or maybe just overconfident debtors into bankruptcy."). In fact, bankruptcy law originally was exclusively an involuntary creditors' remedy. *See, e.g.*, Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT'L REV. L. ECON. 223, 225 (1991).

12. 11 U.S.C.A. § 303(b)(1) (West 2010). "[I]f there are fewer than 12 such holders . . . one or more of such holders that hold in the aggregate at least $14,425 of such claims" can file an involuntary petition. *Id.* at § 303(b)(2).

Once an involuntary petition is filed under the Code, the debtor has an opportunity to answer and controvert the petition.[13] If the debtor does so, the bankruptcy case can nonetheless proceed if "the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute."[14] If a court dismisses an involuntary petition, the petitioning creditors can be forced to pay the debtor's costs or attorney's fees; if a creditor is found to have acted in bad faith, it can be liable for any losses or costs caused by their action or for punitive damages.[15] Furthermore, "except to the extent that the court orders otherwise, . . . any business of the debtor may continue to operate, and the debtor may continue to use, acquire, or dispose of property as if an involuntary case concerning the debtor had not been commenced."[16]

In theory, the availability of involuntary bankruptcy is an appealing and important component of a bankruptcy system.[17] Unsecured creditors as a group are in a uniquely good position to pull the bankruptcy trigger when it is most beneficial to do so. They generally have fewer reasons than their debtors to delay filing a bankruptcy petition, and they have strong motivations to file an involuntary petition if delay would waste a debtor's assets or its going-concern value. If a debtor becomes insolvent or nears insolvency, then (at least some) unsecured creditors will bear the first loss among creditors. Any diminution in the value of the debtor at that point continues to reduce the unsecured creditors' collective return. On the other hand, if entering bankruptcy would be more costly than beneficial, the unsecured creditors will likely bear those costs. Thus, unsecured creditors as a group should internalize both the costs and benefits of timely filing for bankruptcy more than most or

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13. *Id.* at § 303(d). "If the petition is not timely controverted, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed." *Id.* at § 303(h).

14. *Id.* at § 303(h)(1). An involuntary case can also proceed if "within 120 days before the date of the filing of the petition, a custodian . . . was appointed or took possession." *Id.* at § 303(h)(2).

15. *Id.* at § 303(i). A petitioning creditor can be required to post a bond "to indemnify the debtor for such [damages] as the court may later allow." *Id.* at § 303(e).

16. *Id.* at § 303(f).

17. There is surprisingly little commentary or scholarship on the general approach or on specific provisions of particular bankruptcy regimes. Notable works on the topic include THOMAS JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 193–209 (1986); Baird, *supra* note 11; Block-Lieb, *supra* note 10; Susan Block-Lieb, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case*, 42 AM. U. L. REV. 337 (1993); Muro, *supra* note 11.

all other stakeholders, including the debtor.

The foregoing suggests that creditors would exercise their power to force commercial debtors into bankruptcy with some frequency. As Douglas Baird has noted, "[t]his trigger is so easy for a creditor to pull that it might seem likely that bankruptcy would begin too early rather than too late. Only a few creditors need to get together to invoke the scrutiny of the bankruptcy court and ask if the debtor has a future."[18] In fact, however, involuntary bankruptcy petitions are an extremely small percentage of all bankruptcy filings in the United States.[19]

There are various explanations for this, none of which are mutually exclusive. The requirements for filing an involuntary petition may still be forbidding in some circumstances.[20] The potential liability for filing an involuntary petition that is subsequently dismissed may also discourage some creditors.[21] Perhaps more profoundly, if unsecured creditors are in a good position to internalize the net benefits of an involuntary petition, this is true of creditors in the collective, but not individually. As Baird notes:

> Ordinarily, one can depend upon the party that benefits from a particular legal rule to invoke it. Bankruptcy is different. The beneficiaries of bankruptcy law are the creditors as a whole, not individual creditors within the group. One wants a bankruptcy proceeding to begin when it is in the collective interest of the group, but one must still depend upon someone to initiate it. One must somehow ensure that when a bankruptcy proceeding is in the collective interest of the creditors, it is also in someone's individual interest as well.[22]

Thus, while all of a debtor's creditors might benefit from forcing the debtor into bankruptcy, they will enjoy that benefit only if three (or fewer in certain circumstances) creditors file a petition on their behalf. But any single creditor may not be motivated to join in doing so: it would bear the direct and indirect costs of filing and could face liability if the petition is dismissed.[23] This is a collective action

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18. Baird, *supra* note 11, at 224.

19. Block-Lieb, *supra* note 10, at 803–04 & n.6.

20. *See, e.g.*, *id.* at 806 (exploring the continuing challenges for creditors under § 303); Muro, *supra* note 11, at 25–29 (describing the U.S. bankruptcy regime as "debtor's choice" because of the challenges creditors face in forcing a debtor into bankruptcy).

21. *See, e.g.*, Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 353 (1982).

22. Baird, *supra* note 11, at 223 (citations omitted).

23. *Id.* at 224.

problem: "Because creditors largely lack the incentive to begin the bankruptcy proceeding, American bankruptcy law depends upon those who control the corporate debtor under nonbankruptcy law to start it."[24]

Furthermore, creditors may not have sufficient information to know when to force their debtors into bankruptcy. "Those best positioned to know both the financial condition of the firm and the likelihood that creditors will assert their nonbankruptcy default rights are the managers of the firm. Individual creditors lack a sense of the overall, day-to-day health of the firm."[25] Although creditors can be effective monitors of their debtors, "[c]reditors on the whole . . . tend to specialize"[26] and may not individually have a comprehensive sense of the condition of their common debtor.[27] In any event, creditors often do not need to utilize an involuntary bankruptcy provision to force a debtor into bankruptcy. Creditors can do so by refusing to forbear or provide additional financing or by taking actions to collect upon obligations.[28]

Finally, most creditors resolve issues with their debtors outside of bankruptcy. In some cases, the parties prefer a less adversarial approach, perhaps to preserve relationships or to maintain a reputation for flexibility. In other cases, bankruptcy is simply unnecessary. "[T]he nonbankruptcy world of debt collection [is] a world in which individual creditors can threaten the survival of the firm as a going concern by threatening to seize its assets."[29]

Taken together, these observations underscore an important point: even when given the power to trigger a debtor's bankruptcy, creditors will often themselves delay or avoid forcing their debtor into bankruptcy. This does not mean, however, that a provision for involuntary bankruptcy has no value for commercial creditors and their debtors. First, although they are rare, involuntary filings do happen. In hundreds of cases in the United States each year, creditors

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24. *Id.*
25. *Id.*
26. *Id.*
27. *Id.* at 230–31. Baird notes potential strategies to overcome this information asymmetry, like allowing managers to keep their jobs if they file for bankruptcy at the right time or perhaps compensating them for doing so. *Id.*
28. *See, e.g.*, Block-Lieb, *supra* note 10, at 804 ("The line between voluntary and involuntary filings is an ambiguous one because debtors often file voluntary petitions in reaction to creditors' collection efforts.").
29. Baird, *supra* note 11, at 228.

do in fact force their debtors into bankruptcy sooner than the debtor would have sought relief itself.[30] Second, there is always the chance that creditors of a debtor in financial distress *might* pull the trigger, which may motivate debtors to seek formal relief earlier. Third, and relatedly, the availability of involuntary bankruptcy likely gives creditors some leverage to renegotiate with the debtor to make bankruptcy unnecessary.

II. THE PUBLIC DEBTOR

The potential benefits of exposing government debtors to involuntary bankruptcy are similar to those of private debtors. Like other debtors—perhaps more so—government debtors in financial distress consistently avoid or delay taking steps to restructure their obligations until doing so is unavoidable. In addition to the reasons that private debtors delay or avoid seeking relief noted above, government actors are subject to political constraints and may fear that they will be punished at the ballot box for steering their government into bankruptcy.[31] This Part argues that, in theory, the case for involuntary sovereign bankruptcy is strong and the case for involuntary state bankruptcy is even stronger.

A. Sovereigns

Few American states have faced acute financial crises in the modern era, but numerous sovereigns have done so and their experiences are illuminating.[32] Although there is no bankruptcy regime or formal debt-restructuring mechanism available to sovereign debtors, there is a familiar *ad hoc* process for sovereign debt restructuring.[33] And while dozens of sovereigns have gone through this process in recent decades, they have consistently triggered the process well after the time that relief would have been most

30. *See, e.g.*, Muro, *supra* note 11, at 26 (quoting David S. Kennedy et al., *The Involuntary Banruptcy Process: A Study of the Relevant Statutory and Procedural Provisions and Related Matters*, 31 U. MEM. L. REV. 1, 3 (2000)).

31. Christoph Trebesch, Delays in Sovereign Debt Restructuring: Should We Really Blame the Creditors? 3 (Mar. 25, 2008) (unpublished paper), *available at* http://ideas.repec.org/p/zbw/gdec08/44.html (reporting evidence "that political risk and government behavior might be a much more important reason for restructuring delays than creditor behavior").

32. *See generally, e.g.*, Adam Feibelman, *American States and Sovereign Debt Restructuring*, *in* WHEN STATES GO BROKE: ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS (Peter Conti-Brown & David Skeel eds., 2012).

33. *See id.* at 158–71 (describing recent sovereign debt restructurings).

beneficial.[34] The recent experience of Greece illuminates the foregoing points. For a variety of reasons, Greece faced fewer formal impediments to restructuring its debt than most sovereigns in a similar financial and economic position.[35] And yet it took two years of acute crisis for the country to restructure any of its obligations.[36]

As the unfolding Greek episode reflects, governments are uniquely able to persist with unsustainable obligations for extended periods of time, in some cases indefinitely. Absent acute crises, sovereigns almost always have access to some revenues that they can use to pay creditors, even at the cost of allocating insufficient resources to the public goods they provide. Furthermore, sovereigns may be especially hesitant to anger private creditors for fear that they will be excluded from credit markets in the future. They may also be hesitant to anger private creditors' home governments or important official creditors for geopolitical reasons.[37]

Thus, sovereign debtors trigger the process of debt restructuring when they reach the point of acute crisis. These crises are occasioned

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34. *See* Bolton & Skeel, *supra* note 3, at 786 (explaining that sovereigns tend to "default too late"); Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt*, 121 YALE L.J. 888, 927 (2012) ("In most cases, the debt restructuring option is invoked too late in hindsight—a problem that sovereign bankruptcy proposals have sought to solve."); ANNE O. KRUEGER, INTERNATIONAL MONETARY FUND, A NEW APPROACH TO SOVEREIGN DEBT RESTRUCTURING 1 (2002), *available at* http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf (noting the "tendency for debtors to delay restructuring until the last possible moment, increasing the likelihood that the process will be associated with substantial uncertainty and loss of asset values, to the detriment of debtors and creditors alike").

35. *See, e.g.*, Lee C. Buchheit & G. Mitu Gulati, *How to Restructure Greek Debt* 4–6 (May 7, 2010) (working paper), *available at* http://ssrn.com/abstract=1603304.

36. In early 2010, it was revealed that Greece had been disguising its financial condition, which was much worse than markets realized. *See* Nelson D. Schwarz et al., *Wall St. Helped to Mask Debt Fueling Europe's Crisis*, N.Y. TIMES (Feb. 13, 2010), *available at* http://www.nytimes.com/2010/02/14/business/global/14debt.html?pagewanted=all. This quickly led to the onset of acute crisis and an initial rescue from the IMF and Eurozone countries. *See* Press Release, International Monetary Fund, IMF Executive Board Approves $30 Billion Stand-By Arrangement for Greece (May 9, 2010), *available at* http://www.imf.org/external/np/sec/pr/2010/pr10187.htm. Greece successfully restructured $206 billion in obligations in March 2012. *See* Richard Milne, *Greek Deal Will Buy Time but Hard Work Lies Ahead*, FIN. TIMES (Mar. 7, 2012, 9:49 PM), http://www.ft.com/intl/cms/s/0/226d36c4-6875-11e1-a6cc-00144feabdc0.html#ax zz1q3A8hk7X.

37. *See generally*, Anna Gelpern, *Odious, Not Debt*, 70 LAW & CONTEMP. PROBS. 101 (2007) (observing the large portion of sovereign debt owed to official creditors and describing the political dimensions of those financial relationships); W. Mark C. Weidemaier, *Contracting for State Intervention: The Origins of Sovereign Debt Arbitration*, 73 LAW & CONTEMP. PROBS. 335 (2010) (exploring how arbitration clauses in sovereign debt contracts historically enabled creditors' home states to intervene in disputes over their private claims against sovereign debtors).

by some combination of familiar if harrowing circumstances: a country's currency collapses, its banking system freezes, there is a flight of foreign investment, the country cannot meet payments coming due, it is effectively excluded from private credit markets.[38] When any combination of these things happens to a sovereign, it must generally impose losses on its creditors, obtain financial support from the official sector (usually lead by the IMF), or both.[39] By the time a sovereign reaches this point, however, the costs of crisis are likely greater than they would have been if the sovereign had acted earlier, perhaps only slightly earlier.

Numerous commentators, policymakers, and market participants have argued, therefore, that the process of sovereign debt restructuring should encourage sovereigns to avoid delay.[40] This is a primary motivation behind a growing list of proposals for a sovereign bankruptcy regime or debt-restructuring mechanism. The literature on sovereign bankruptcy has not satisfactorily addressed, however, how a formal mechanism would actually prod sovereigns to seek relief earlier than they do under the current *ad hoc* approach. Other than making the process of debt relief more manageable and predictable, proposals do not include any measures that would directly alter sovereigns' incentives to delay and avoid reckoning. And the goal of making sovereign debt restructuring easier and more manageable is hardly uncontroversial. Making it easier for sovereigns to obtain debt relief earlier may exacerbate moral hazard.[41]

Although sovereign nations are not likely to accede to any international agreement allowing for involuntary sovereign bankruptcy, at least some writers have observed that an involuntary procedure for sovereigns could be beneficial.[42] It could provide a mechanism for stemming the costs and losses caused by sovereign debt crises, and it might also reduce the incentives that governments have to accumulate unsustainable obligations in the first place.

38. *See, e.g.*, Feibelman, *supra* note 32, at 156–57.
39. *See, e.g.*, *id.* at 169.
40. *See generally, e.g.*, Gelpern, *supra* note 34.
41. *See, e.g.*, Feibelman, *supra* note 32, at 184–85; Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 101, 130–31 (2002) (discussing moral hazard effects of bankruptcy protection).
42. *See, e.g.*, Bolton & Skeel, *supra* note 3, at 786–87 (describing "the greater merit in recommending involuntary bankruptcy than is often appreciated").

The theoretical case for involuntary sovereign bankruptcy may be especially strong for sovereigns that are members of a monetary union. Again, as the situation in Europe illustrates, members of a monetary union have a strong interest in ensuring that every member avoid financial distress and that they stem financial woes before a crisis materializes. The costs of a member's financial crisis will likely be externalized upon the union, and those costs could be magnified within and beyond the union through formal financial linkages and contagion. A union-level involuntary bankruptcy mechanism could give union members a way to protect themselves from this vulnerability, although it is entirely possible that other union members and union institutions might themselves delay forcing a member of the union into debt relief.[43] Recent reforms of the Euro zone's Growth and Stability Pact can be understood as attempting to address this vulnerability *ex ante*.[44]

B. States

Recent financial and economic conditions have raised the specter of one or more American states experiencing some form of financial distress.[45] If that occurred, it would presumably impose external costs and losses on other states and on the federal government, much like a member of a monetary union externalizes costs and losses upon the union.[46] And like sovereigns in monetary unions, those costs and losses may be magnified due to systemic linkages and to contagion.[47]

A state in crisis that delays obtaining debt relief would presumably impose even greater costs and losses on other states and

43. This is especially true if a bankruptcy or restructuring might impose direct, immediate costs or externalities across the union. Union members may at least be inclined to act earlier than a sovereign would act voluntarily, however, and seeking relief even slightly earlier may make a significant difference in this context.

44. *See, e.g.*, Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (Jan. 1, 2012), *available at* http://www.european-council.europa.eu/media/579087/treaty.pdf.

45. *See, e.g.*, Skeel, *supra* note 2, at 2 ("In the past several years, however, the possibility of a state default has begun to look a little less imaginary."); Schwarcz, *supra* note 2, at 324 ("There is a rising consensus, however, that these measures will not be enough, and that states will also need debt relief.").

46. *See, e.g.*, Skeel, *supra* note 2, at 21–22 (discussing the possibility of a federal bailout of a state in financial distress and describing the alternative of state default as "the financial equivalent of a tsunami").

47. *See* Schwarcz, *supra* note 2, at 324 ("[I]f a default by one state undermines investor confidence in all state debt, the broader market in that debt might collapse."); Gelpern, *supra* note 34, at 911 (noting that a state default is "likely to be systemically disruptive").

on the federal government than if it sought relief earlier. And there are good reasons to believe that American states would in fact delay or avoid seeking debt relief as sovereign debtors have historically done—perhaps more so. Compared to sovereigns, financially embattled American states might be more able to avoid seeking relief or addressing underlying financial weaknesses in financial distress because states are less vulnerable to acute financial crises.[48] States tend to be more constrained in their ability incur debt.[49] They also borrow in dollars, so they are not subject to exchange-rate crises. Furthermore, because they are not directly responsible for the stability of the banking system, states are not directly and independently exposed to the threat of a banking crisis. States may also enjoy stronger immunity from suits by creditors, if only because they generally do not waive immunity as sovereigns tend to do, and this may give them more room to maneuver to avoid an acute crisis.[50]

If states in financial distress do delay seeking bankruptcy relief, they would likely undermine the utility of bankruptcy law in helping to avoid or reduce their need for bailouts from the federal government, a primary goal of extending bankruptcy protection to states.[51] Bankruptcy might be more effective than *ad hoc* restructuring in a moment of crisis, but a state that delayed in seeking relief could thereby incur costs that would offset any benefit gained from allowing it to seek relief in bankruptcy in the first place. Furthermore, the availability of a bankruptcy backstop itself might actually make states more comfortable in delaying any effort to restructure their obligations until the need to do so becomes unavoidable. Thus, a purely voluntary bankruptcy scheme for states may fail to achieve its aims and could actually do more harm than good.

The practical challenges of creating a state bankruptcy regime with an involuntary component may also be less forbidding than the challenges of creating a similar regime for sovereigns. It would likely be easier to design a state bankruptcy regime with an involuntary component than it would be to create one for sovereigns. The

48. *See, e.g.*, Feibelman, *supra* note 32, at 152–56.

49. *See, e.g.*, *id.* at 152–53.

50. *See, e.g.*, *id.* at 152.

51. *See, e.g.*, Schwarcz, *supra* note 2, at 325; David Skeel, *Testimony Before the Subcomm. on TARP, Fin. Servs. and Bailouts of Pub. and Private Programs*, *Comm. on Oversight and Gov't Reform*, 112th Cong. (2011) ("We need a fire department for state fiscal crises that does not depend on using a major federal bailout as a backstop.").

underlying state bankruptcy regime could be created through amendments to the existing Chapter 9[52] and could utilize the existing U.S. bankruptcy court infrastructure. Nonetheless, the political obstacles to state bankruptcy in general, and especially state bankruptcy with an involuntary component, may be insurmountable.

III. DESIGN

This Part addresses, in very general terms, some of the most important issues concerning the design of an involuntary provision in a bankruptcy scheme for states. It proposes a model for involuntary state bankruptcy under which the federal government has the authority to force a state into bankruptcy if the state threatens national financial or economic interests; a state forced into bankruptcy could be given the option to exit bankruptcy after a brief period; the state would enjoy a broad stay of actions against it while in bankruptcy; and it would have the opportunity to propose a restructuring plan that could bind holdout creditors. Thus, entry would be the only involuntary aspect of the regime. To be clear, although this Part proposes some design choices, the discussion below is only intended to sketch a plausible version of involuntary state bankruptcy and thereby make the general idea somewhat harder to dismiss.

A. Who triggers?

If policymakers were interested in adopting an involuntary bankruptcy procedure for government debtors, they would need to address some unique questions of design. While the procedure might be adapted from existing provisions allowing for involuntary bankruptcy, it would presumably reflect some fundamental differences in the nature of commercial and government debtors. Most notably, whereas creditors are relatively well-suited to trigger a private debtor's bankruptcy proceeding, the federal government is the only entity that could plausibly force a state into bankruptcy.

For numerous reasons, creditors of a state are not in a good position to trigger their debtor's involuntary bankruptcy. As an initial matter, like creditors of private firms, individual creditors of a state may not have sufficient incentives to bear the full costs of forcing the state into bankruptcy. Furthermore, creditors of a state may be less likely than creditors of private firms to collectively internalize the

52. *See, e.g.*, Feibelman, *supra* note 32, at 185.

costs and benefits of forcing the state into bankruptcy. Governments (like consumers, to some extent) cannot face liquidation and they generally repay their creditors from revenues.[53] If they delay seeking debt relief, states may deplete some assets that creditors might share upon liquidation, but that risk is probably not as great as it is for creditors of private firms. If not, that removes an opportunity for creditors to increase their insolvency-state returns by forcing the state into bankruptcy earlier than it would enter bankruptcy voluntarily.

Relatedly, a government's creditors may be more likely than creditors of private firms to share their debtor's preference for delaying or avoiding debt restructuring, even in the face of financial distress. Because their government debtor does not face liquidation, and because it may persist with unsustainable levels of indebtedness for a long time, they may have better reason to hope that they will eventually get repaid in full after a present crisis subsides. This is especially true if they expect to take a loss in a debt-restructuring process.

Even more than with consumer debtors, the prospect of a government being forced into bankruptcy raises concerns about dignity, autonomy, and sovereignty. It is a nearly universal principle that private interests are not allowed to direct matters affecting public policy.[54] After all, private actors are politically unaccountable and they are not in a position to balance the interests that a governmental unit must serve.[55] This helps explain why states enjoy robust sovereign immunity from actions of private parties that may affect the state's fiscal or governmental policies.[56] Being forced into a bankruptcy proceeding would represent a meaningful interference with government policy and, potentially, its financial condition. Increasing private creditors' insolvency returns is probably not a sufficient

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53. *See, e.g.*, Gelpern, *supra* note 34, at 926 ("With most sovereign assets inaccessible to creditors, as a practical matter, claims against sovereigns are paid as they come due from the debtor's primary budget surplus."). *But see*, Skeel, *supra* note 2, at 6–7 (noting that states often sell assets to pay creditors when they experience financial distress). In general, the primary risk that creditors of sovereign debtors face is that the debtor will continue to borrow, diluting the value of existing claims. *See* Bolton & Skeel, *supra* note 3, at 788–92.

54. The exceptions to this principle (e.g., industry self-regulation), which are carefully circumscribed and still controversial, tend to prove the general rule.

55. *See* Gelpern, *supra* note 34, at 909–10 (describing American states' "residual responsibility for the welfare of their citizens"); Feibelman, *supra* note 32, at 150 (discussing the role of government in providing public goods).

56. *See*, *e.g.*, Emily D. Johnson & Ernest A. Young, *The Constitutional Law of State Debt*, DUKE J. CONST. L. & PUB. POL'Y 117 (2012).

justification for granting private creditors the authority to force a state government into bankruptcy.

The federal government is in a much better position to trigger a state's involuntary bankruptcy. Because state governments serve crucial functions and cannot be liquidated, they will ultimately be rescued, bailed out, or protected if all else fails, and the federal government will fund and coordinate any necessary rescue on behalf of the nation and other states. And before any rescue or bailout becomes necessary, a state that experiences financial distress will likely externalize many costs upon the nation. In fact, because the federal government does not have the ability to force a state to seek debt relief, states are currently subject to a serious moral hazard.[57] If they believe that the federal government will bail them out if they get into a deep enough hole, they may not try as hard to take the difficult actions necessary to avoid financial distress.

As a result of this structural financial relationship, the federal government would internalize many of the benefits and the costs of forcing a state into bankruptcy if the state is in or approaching serious financial distress.[58] Most obviously, it would enjoy the benefits of the state seeking early bankruptcy relief by reducing the scope—and perhaps the likelihood—of financial support needed from the national government. In other words, the ability to force a state into bankruptcy could, in theory, reduce or eliminate costs to federal taxpayers of a bailout. Perhaps more importantly, if a state's financial distress began to spillover and increase risk of financial distress for other states or for the nation, the federal government would have a useful tool to address the emerging risk. And unlike dispersed private creditors, the federal government would not face a collective action problem in obtaining these benefits.

The federal government would also have to internalize various financial and political costs of triggering a state's bankruptcy. If the federal government acted too precipitously in forcing a state into bankruptcy, for example, it could impose costs on the state that it

57. *See, e.g.*, Schwarcz, *supra* note 2, at 325; Skeel, *supra* note 2, at 27.

58. For sovereigns in a monetary or currency union, other countries in the union and union institutions like a central bank should be in a similar position. For other sovereign nations, international financial institutions—especially the IMF—as well as other countries that likely would take on responsibility for rescuing the government (even if they are not its major creditors) might be able to internalize the costs and benefits of forcing a nation to undergo debt restructuring.

would not otherwise have borne. This could actually hasten a federal bailout and increase the scope of needed support. Even if an involuntary state bankruptcy successfully stabilized the state itself and reduced the federal government's exposure to the state's financial predicament, it could undermine market confidence in other states or the national government.

Forcing a state into bankruptcy could also be politically risky for federal officials. It would be a highly salient, dramatic, and controversial act, even if it were taken in the context of a state's acute financial distress. It would inevitably raise widespread concerns about the legitimacy of the federal role. Setting aside the federalism concerns, an involuntary state bankruptcy could be very unpopular among voters if it causes immediate negative financial and economic effects within the state or beyond. And there would probably not be any short-term political upside for federal officials who forced a state into bankruptcy.

As discussed below, such political concerns might cause federal officials to delay forcing a state into bankruptcy after the point that doing so is appropriate, undermining the purpose of an involuntary component. Thus, although some political concerns will inevitably affect the calculus, the process of deciding whether to force a state into bankruptcy should be insulated from politics to the greatest extent possible. Congress or the Executive might create a dedicated position or entity to exercise this authority. The position could be standing or temporary. Perhaps this authority could be vested in the newly created Financial Stability Oversight Council,[59] the systemic stability regulator created by the Dodd-Frank Act to monitor the stability of the financial system. Its voting members include the heads of the major federal financial regulators.[60] The composition of the voting membership of the Council and the importance of the role of avoiding systemic crises should give the Council some measure of authority and independence from political considerations. But the extent of that authority and independence remains to be seen.

Thus, assuming that the decision to force a state into bankruptcy could be at least partially insulated from direct political

59. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

60. *Id.* at § 111. Non-voting members include representative state financial regulators. *Id.* at § 111(b)(2).

considerations, the federal government is uniquely situated to trigger an involuntary bankruptcy of an American state in financial distress. It is in as good a position as any actor (including the state itself) to trigger a state's bankruptcy if the overall benefits of doing so are greater than the overall costs. In theory, if given the authority, federal officials would only force a state into bankruptcy if they thought they could thereby stem the state's financial deterioration (and thus reduce the federal government's financial exposure to the state) and if they thought this benefit would outweigh the various political and financial costs to the state and to the nation.

Given the salient costs and controversy that would surround a decision to force a state into bankruptcy, the federal government might avoid exercising its authority and, in any event, would probably delay forcing a state to file for bankruptcy for some period beyond the point that bankruptcy would be beneficial. Even with such predictable delay, however, if the federal government forced a state's hand before the state itself would seek relief, then the involuntary trigger could be a valuable policy option. Furthermore, the involuntary option could be valuable even if not exercised if it strengthened the federal government's hand in persuading a state to take actions—perhaps filing for bankruptcy voluntarily or aggressively negotiating with creditors and other stakeholders—that the state would otherwise be hesitant to take.

To press the point further (and to generalize beyond the American context), it is structurally untenable for a government to be ultimately responsible for, or unavoidably subject to, the financial position of its subunits and yet have no way to discipline the financial behavior of those subunits. This is reflected in the fact, for example, that some American states have provided a mechanism by which they can force their municipalities and other subunits into receivership or something similar.[61] Otherwise, states would face responsibility for liabilities incurred by their municipalities and have no way to steer their subunits into a restructuring process. As the European experience now illustrates, federal schemes and monetary unions are vulnerable to the extent that they are unable to discipline members' financial affairs *ex ante* and have limited ability to force subunits to

61. *See, e.g.*, Municipalities Financial Recovery Act, 53 PA. CONS. STAT. ANN. § 11701 (West 2011); Skeel, *supra* note 2, at 41–42.

seek debt relief *ex post*.[62]

To be sure, federal- or union-level government actors will have some leverage over a state or sovereign facing distress even if they have no formal power to force action. When financial support or rescue becomes necessary, for example, the government can condition support on actions that it wants the subunit in question to undertake. This is precisely how many reluctant sovereigns are motivated to seek debt relief under the current *ad hoc* approach to sovereign debt restructuring: an official financial supporter, most often the IMF, essentially conditions financial support on the sovereign debtor obtaining debt relief from private creditors.[63]

Again, the current European crisis provides a case in point, though perhaps it also represents a counterpoint. Germany and other members of the European Monetary Union have expressly conditioned their support for Greece on it obtaining relief from its private creditors.[64] And these countries have ratcheted up the amount of "private involvement" they think is necessary.[65] In some ways, then, union-level actors and other members of the union may have nudged Greece toward more aggressive debt relief. At the same time, however, union-level institutions, the European Central Bank in particular, also appear to have resisted some aggressive approaches to debt restructuring.[66]

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62. As a dramatic reflection of this, German officials recently proposed that an E.U. commission have the power to veto Greek budgetary expenditures. *See, e.g.*, Peter Spiegel and Kerin Hope, *Call for EU to Control Greek Budget*, FIN. TIMES (Jan. 27, 2012, 9:20 PM), http://www.ft.com/intl/cms/s/0/33ab91f0-4913-11e1-88f0-00144feabdc0.html#axzz1p6hPFBAt.

63. *See, e.g.*, Feibelman, *supra* note 32, at 169; Gelpern, *supra* note 34, at 940; *see also infra* note 74.

64. *See, e.g.*, Andrea Thomas, *Germany's Merkel Satisfied with Greek PSI Participation*, WALL ST. J. (Mar. 9, 2012), http://online.wsj.com/article/BT-CO-20120309-705803.html.

65. *See* Jan Strupczewski, *New Greek PSI Haircut Around 30–50 Percent*, REUTERS (Oct. 12, 2011, 6:49 PM), *available at* http://uk.reuters.com/article/2011/10/12/uk-eurozone-greece-haircut-idUKTRE79B3HE20111012 (noting that the expected haircut on Greek debt had increased from 21% to 30–50%); Agustino Fontevecchia, *Greek Debt Deal Will Force Bondholders To Take 'Voluntary' 70% Haircut*, FORBES (Jan. 23, 2012, 5:22 PM), http://www.forbes.com/sites/afontevecchia/2012/01/23/greek-debt-deal-will-force-bondholders-to-take-voluntary-70-haircut/ (reporting the haircut on Greek debt as approaching seventy percent).

66. It is possible, for example, that the European Central Bank's reluctance for Greece to undertake an aggressive approach to debt restructuring delayed that country's efforts to seek meaningful debt relief. *See* Joseph Stiglitz, *Capturing the ECB*, PROJECT SYNDICATE (Feb. 6, 2012), http://www.project-syndicate.org/commentary/capturing-the-ecb (pointing out a number of ways in which the ECB resisted a more aggressive effort to restructure Greek debt).

B. When?

Assuming that some arm of the federal government will have authority to trigger an involuntary bankruptcy provision for states, eligibility will present another threshold challenge. Under what circumstances should a state be subject to involuntary bankruptcy? At the broadest level of generality, eligibility should be a function of the degree of a state's financial distress. The case for involuntary bankruptcy is strongest when it appears likely that the federal government will have to provide substantial or extraordinary financial support to the state. It is also at that point that the federal government will have the most direct stake in forcing the state to resolve its financial distress.

There are a variety of ways to design a test that would help determine when these substantive criteria are met, none of which are ideal. The U.S. Bankruptcy Code provides, for example, that failure to pay debts as they come due is part of the eligibility criteria for involuntary bankruptcy of private debtors.[67] Such a failure can certainly reflect financial distress, but it should probably not be a necessary component of eligibility for government debtors. Given their taxing power, governments can often avoid defaulting on particular obligations even while they are experiencing financial distress.[68]

Perhaps eligibility for involuntary state bankruptcy could hinge on solvency: a state could be subject to involuntary bankruptcy if it became insolvent, a traditional standard for involuntary bankruptcy or insolvency proceedings.[69] But insolvency is a debatable basis for involuntary bankruptcy in general,[70] and it is especially imperfect for government debtors. On the one hand, for example, acute liquidity constraints could require the rescue of a solvent government debtor. On the other hand, a government debtor could have an unsustainable level of debt by some metric but survive indefinitely without the need for financial rescue. Furthermore, insolvency is a notoriously inapt

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67. *See supra* note 12 and accompanying text.

68. *See supra* Part II.A. and accompanying text.

69. *See* Block-Lieb, *supra* note 17, at 367 (noting that under pre-1978 bankruptcy law in the United States it was presumed that only an insolvent party could be subject to involuntary bankruptcy).

70. *See id.* at 374–408 (criticizing insolvency as a standard and discussing JACKSON, *supra* note 17); *see also* McConnell, *supra* note 2, at 235 (suggesting that giving a bankruptcy court the authority to determine whether a state is insolvent might give it some power over the state's sovereign ability to conduct fiscal affairs).

concept for governmental debtors, and questions of solvency in this context are more accurately cast in terms of the relative sustainability of a government's obligations. If sustainability is a better conceptual framework for assessing a government's financial condition, however, it is still very difficult to measure.[71]

Given the functional weakness of available metrics or proxies, it may be best to simply articulate the test for eligibility for involuntary bankruptcy as "likely to need extraordinary financial assistance from the federal government or to threaten stability of the national economy." This would at least underscore the primary justifications for allowing the federal government to force a state into bankruptcy and might focus the inquiry on those justifications. As a practical matter, because the question is not likely to be litigated,[72] whichever actor is given authority to force a state into bankruptcy will have significant discretion to determine when to do so. Given the stakes of triggering an involuntary state bankruptcy, that authority would not be exercised lightly; if it were ever exercised, there would probably not be much question about whether the standard is met. For reasons noted above, there may be greater reason to worry that the federal government would delay in triggering a state bankruptcy beyond when it should do so than there is reason to worry that it would act precipitously.

Anticipating the constitutional concerns discussed below, it might be desirable to grant states the option to exit bankruptcy after a short period of time if the involuntary trigger is employed. This would certainly blunt the involuntary nature of the scheme, and it might also make the involuntary component less controversial in practice. One might assume that any state forced into bankruptcy would decide to exit as soon as it were given the opportunity. There are reasons to believe, however, that officials and citizens of a state in financial distress would quietly or grudgingly approve of being involuntarily subject to bankruptcy, even if they might publicly complain. If states, like other debtors, delay seeking beneficial debt relief until they have no other choice, they may be grateful that someone else has the ability to force the issue at an earlier point in their crisis.

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71. *See, e.g.*, Adam Feibelman, *Contract, Priority, and Odious Debt*, 85 N.C. L. REV. 727, 734 n.25 (2007); *see also* Gelpern, *supra* note 34, at 926–27 (discussing debates over debt sustainability and noting the lack of a solvency metric for sovereigns).

72. *See infra* note 74.

In that case, the state officials would not bear responsibility for pulling the trigger, but the state would obtain the benefits of bankruptcy law in stemming its financial distress and, especially, in enabling it to restructure obligations that might be harder to restructure outside of bankruptcy.[73] Thus, a state forced into bankruptcy might not exercise the discretion to exit; perhaps it would rarely do so. Furthermore, if a state were inclined to exit bankruptcy, and if the federal government deemed a successful restructuring important enough, the federal government might condition federal bailout support on the state's remaining in bankruptcy and seeking relief thereunder.[74]

C. Automatic Stay

Even if a state did exit bankruptcy after, say, a week or two (if the option is available), it might still benefit substantially from its brief, involuntary sojourn in bankruptcy. Bankruptcy law generally provides some form of injunction against nearly all collection efforts and other actions against the debtor upon the initiation of the bankruptcy proceedings.[75] A stay on creditor actions gives the debtor some breathing room, usually in the wake of a period of crisis or near crisis. This respite may enable the debtor to act more deliberately in addressing its financial circumstances. Significant for present purposes, the stay can also force creditors, debtors, and other stakeholders to reassess their respective financial relationships and to recognize the extent of their interrelated fates, which can in turn facilitate negotiated restructuring or settlement. If states and their

73. *See* Skeel, *supra* note 2, at 9–22 (describing the specific benefits of restructuring state debt in bankruptcy).

74. In fact, it is possible that the federal government would have power enough under the Spending Clause to insist that a state voluntarily file for bankruptcy if that were made available. This approach would serve most of the same functions as an involuntary bankruptcy provision. But it would likely be somewhat more constraining—the federal government would presumably have to put money on the table first and then hope that the state needed the offered funds enough to comply. An involuntary bankruptcy approach allows the federal government to withhold a formal offer of financial support until the state is already in the bankruptcy process. The federal government might be able to use its spending power to force a state to make some efforts to restructure obligations outside of bankruptcy. *See, e.g.*, Gelpern, *supra* note 34, at 940. But if the state is attempting to restructure claims outside of bankruptcy, it may run afoul of the Contract Clause. It is worth noting that the Supreme Court is currently considering the scope of the federal government's spending power in its review of the constitutionality of the Patient Protection and Affordable Care Act of 2010. *See generally* U.S. Dep't of Health and Human Servs. v. Florida, No. 11-398 (U.S. argued Mar. 26, 2012).

75. *See, e.g.*, 11 U.S.C.A. § 362 (West 2011) (including the automatic stay provision of U.S. bankruptcy law).

counterparties can successfully negotiate to restructure the state's obligations in the initial period of an involuntary bankruptcy, this would make the other machinery of a bankruptcy unnecessary.

Consistent with existing U.S. bankruptcy law, the stay should not impair or interfere with any exercise of governmental police or regulatory power. Beyond this limitation, however, any stay or injunction should be more extensive than a state's constitutional immunity from suit. Some commentators have proposed that states' immunity may eliminate the need for a stay in bankruptcy,[76] but immunity is subject to various exceptions.[77] Most notably, states can waive immunity *ex ante* and claimants may be able to proceed under Ex parte *Young*[78] for injunctive relief. Furthermore, unlike an automatic stay, immunity does not sanction a party for bringing suit or taking other actions to try to collect an obligation, and such actions can be detrimental to a restructuring process even if they are likely to fail on the merits.

For similar reasons, a state's waiver of immunity from suit should not be construed as a waiver of the stay. Again, a bankruptcy stay is designed to halt even those actions that creditors and other stakeholders are entitled to take outside of bankruptcy. Unlike private debtors, however, a state might be allowed to consent to particular collection efforts after it is forced into bankruptcy, especially if an exception to the stay protected the state's police or regulatory interests.[79]

D. Plan

The inclusion of an involuntary trigger in a state bankruptcy regime might influence the design of the bankruptcy machinery that would apply to states in general. The possibility that a state might enter bankruptcy involuntarily, even if it has the unqualified discretion to exit, might provide some reason to design a state bankruptcy regime that is unobtrusive and otherwise as voluntary as possible (if only to make discretionary exit less likely). Procedurally,

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76. *See, e.g.*, Schwarcz, *supra* note 2, at 326; Gelpern, *supra* note 34, at 902–05.

77. *See, e.g.*, Johnson & Young, *supra* note 56.

78. 209 U.S. 123 (1908).

79. Under U.S. bankruptcy law, debtors are not allowed to waive the automatic stay. *See* Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 524–34 (1999) (discussing doctrinal and scholarly debates over the enforcement of contracting with respect to bankruptcy, especially agreements to waiving the automatic stay).

the regime could be as skeletal as an automatic stay and a forum in which the state can voluntarily negotiate with counterparties. A state might have the authority, but not be required, to submit a plan of restructuring. The plan could provide for impairing claims against the state, presumably with the consent of some percentage of creditors and perhaps with judicial review for fair treatment.[80]

Even if it were not required to do so, there are reasons to believe a state would take the opportunity to submit a restructuring plan once it had been forced into bankruptcy. First, the state may then have a significant amount of leverage over creditors and other stakeholders who are subject to the bankruptcy stay and who now fully realize the extent of the state's financial challenges. Second, the opportunity to submit a plan of restructuring would likely allow the state to restructure obligations in bankruptcy that would be harder to restructure outside of bankruptcy.[81] This is because, among other things, a restructuring of claims against a state under federal bankruptcy law would likely not violate the Contract Clause,[82] while actions by the state itself outside of bankruptcy might do so.

E. Summary

If a bankruptcy regime for states includes an involuntary component, the involuntary trigger should only be given to officials of the federal government, perhaps the Financial Stability Oversight Council. The federal government should have the authority to force a state into bankruptcy only if there is a reasonable chance that the state will need financial support from the federal government or if the state's financial crisis threatens the stability of the national economy. The federal government might delay in forcing a state into bankruptcy, but there is at least some reason to believe that it would pull the trigger sooner than the state. Even if it would not do so, the threat that it might pull the trigger could encourage the state to act sooner than it otherwise might. A state forced into bankruptcy could be given the discretion to exit after a short period of time, during which it would benefit from a stay on all proceedings against it. The

80. This is similar to Steven Schwarcz's proposal for a "minimalist" state bankruptcy regime. *See generally* Schwarcz, *supra* note 2. His model, which would be a free-standing bankruptcy regime for states, would provide for "across-the-board supermajority voting" among creditors that could bind holdouts. *See id.* at 331.

81. *See supra* notes 74–75 and accompanying text.

82. *See, e.g.*, Skeel, *supra* note 2, at 24; McConnell, *supra* note 2, at 234–35.

bankruptcy regime should provide an opportunity for a state to voluntarily propose a plan of restructuring, which, if confirmed, could impair claims against it pursuant to federal law.

Again, the model of involuntary state bankruptcy proposed above is premised on an assumption that, in some circumstances, state officials would not themselves pull the bankruptcy trigger when it would be most beneficial to do so, even when they may want to take advantage of procedural and substantive features of federal bankruptcy law. State officials in such circumstances might exercise the option to exit if forced into bankruptcy. Yet they might complain loudly and then employ the mechanism for obtaining debt relief that federal bankruptcy would afford.

IV. IS IT CONSTITUTIONAL?

This essay has deferred addressing the constitutional issues posed by involuntary bankruptcy for states until this final Part for three reasons. First, it is hopefully useful to have described a particular model of involuntary bankruptcy against which to weigh constitutional concerns. Second, addressing these constitutional issues is only a secondary goal of this essay, which is primarily concerned with evaluating the potential benefits of involuntary state bankruptcy. And third, the analysis of these issues below is tentative and modest. This Part does not argue confidently that an involuntary bankruptcy provision for states would be constitutional. Rather, it argues, contra to nearly universal consensus, that such a provision would not be obviously unconstitutional and that the question is closer than courts and commentators appear to assume.

Thus far, the emerging literature on state bankruptcy includes debate over whether extending a voluntary bankruptcy regime to states would violate the Constitution.[83] Writers on both sides of the debate limit discussion to a voluntary regime, with proponents arguing confidently that allowing states to voluntarily file for bankruptcy should pass constitutional muster.[84] To date, skeptics of this claim are somewhat muted,[85] and thus the weight of commentary seems to lean toward finding a voluntary state bankruptcy regime

83. *See generally, e.g.*, McConnell, *supra* note 2; Skeel, *supra* note 2; Solan, *supra* note 2.

84. *See, e.g.*, Skeel, *supra* note 2, at 23–25.

85. *See, e.g.*, McConnell, *supra* note 2, at 236 (arguing that the answer to whether a state bankruptcy regime would be constitutional “is not obvious either way”).

constitutional. Proponents and skeptics alike avoid discussion of an involuntary regime, strongly suggesting that they believe such a regime would be unconstitutional. And, as discussed below, this view has support in dicta from relevant Supreme Court authority.

This nearly universal view of the constitutionality of involuntary state bankruptcy has not yet been directly and carefully examined, however. This Part proposes that the U.S. Constitution can accommodate a carefully drawn statute that allows the federal government to force a state into a bankruptcy regime that is voluntary in all other respects if a bailout or national financial crisis is eminent. As explained below, the sovereignty of states as reflected in the Tenth Amendment represents the primary obstacle to this proposition.[86]

The Tenth Amendment of the Constitution provides: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."[87] The Amendment has famously been described as a truism.[88] But the scope and meaning of this provision has shifted significantly throughout history. This Part assesses involuntary bankruptcy for states in light of three strands of Tenth Amendment doctrine: cases analyzing the constitutionality of the U.S. municipal bankruptcy regime, cases prohibiting the commandeering of state regulation, and cases articulating a general principle of state sovereignty.

A. Municipal Bankruptcy Cases

Recent analysis of the constitutionality of state bankruptcy rightly focuses on a pair of Supreme Court opinions from the middle of the last century concerning the constitutionality of allowing municipalities to obtain relief under federal bankruptcy law.[89] The first of these cases, *Ashton v. Cameron County Water Improvement District*,[90] struck down an initial municipal bankruptcy regime.[91] It held that the regime, which allowed municipalities to voluntarily file for bankruptcy if state law permitted, violated the Contract Clause[92] and

86. This essay assumes that an involuntary state bankruptcy regime triggered by the federal government would not violate the Eleventh Amendment, which does not prohibit actions against a state by the federal government. *See* U.S. CONST. amend. XI.

87. U.S. CONST. amend. X.

88. United States v. Darby, 312 U.S. 100, 124 (1941).

89. *See generally, e.g.*, Skeel, *supra* note 2; McConnell, *supra* note 2.

90. 298 U.S. 513 (1936).

91. *Id.* at 532.

92. "The Constitution was careful to provide that 'no State shall . . . pass any . . . Law

the Tenth Amendment.[93] Regarding the latter, without much explanation, the Court found that "application of the statutory provisions now before us might materially restrict [a state's] control over its fiscal affairs."[94] In dicta the Court stated: "If federal bankruptcy laws can be extended to respondent, why not to the state? If voluntary proceedings may be permitted, so may involuntary ones . . . ."[95] Assuming (without deciding) that involuntary bankruptcy would be impermissible, the Court thus reasoned that the voluntary regime was unconstitutional.

Dissenting in *Ashton*, Justice Cardozo argued that impairment of contracts under federal law, even if assented to by the states, does not impinge the Contract Clause.[96] He also argued that the statute in question was "framed with sedulous regard to the structure of the federal system," emphasizing the voluntary nature of the provision and the deference to state authorization.[97] Responding to the majority's conflating voluntary and involuntary regimes, he wrote:

> The question is not here whether the statute would be valid if it made provision for involuntary bankruptcy, dispensing with the consent of the state and with that of the bankrupt subdivision. For present purposes, one may assume that there would be in such conditions a dislocation of that balance between the powers of the states and the powers of the central government which is essential to our federal system.[98]

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impairing the Obligation of Contracts.' This she may not do under the form of a bankruptcy act or otherwise. Nor do we think she can accomplish the same end by granting any permission necessary to enable Congress so to do." *Id.* at 531 (citation omitted).

93. "Neither consent nor submission by the states can enlarge the powers of Congress; none can exist except those which are granted. The sovereignty of the state essential to its proper functioning under the Federal Constitution cannot be surrendered; it cannot be taken away by any form of legislation. Like any sovereignty, a state may voluntarily consent to be sued . . . . But nothing in this tends to support the view that the federal government, acting under the bankruptcy clause, may impose its will and impair state powers—pass laws inconsistent with the idea of sovereignty." *Id.* (citation omitted).

94. *Id.* at 530.

95. *Id.* Interestingly, there is now a growing consensus that the first of these statements is actually correct, whereas the latter is not given serious consideration.

96. *Id.* at 542 (Cardozo, J., dissenting).

97. *Id.* at 538.

98. *Id.* "Sufficient reasons do not appear for excluding political subdivisions from the bankruptcy jurisdiction if the jurisdiction is so exerted as to maintain the equilibrium between state and national power." *Id.* at 540.

While Cardozo assumed "for present purposes" that an involuntary provision would be unconstitutional, however, it is not clear whether he was confident that involuntary bankruptcy (or voluntary state bankruptcy, for that matter) would in fact create an improper balance between the states and the federal government.

After *Ashton*, Congress amended the municipal bankruptcy regime to provide explicitly that a bankruptcy court could not interfere with the fiscal affairs of any governmental unit that filed for bankruptcy.[99] The new regime was upheld in *United States v. Bekins*.[100] The Court found that:

> The statute is carefully drawn so as not to impinge upon the sovereignty of the State. The State retains control of its fiscal affairs. The bankruptcy power is exercised in relation to a matter normally within its province, and only in a case where the action of the taxing agency in carrying out a plan of composition approved by the bankruptcy court is authorized by state law.[101]

Again, the Court leaned heavily on the voluntary nature of the municipal bankruptcy regime.[102] But again, any suggestion in that case that an involuntary regime would be unconstitutional is at most dicta.

The basic principle one can derive from *Ashton* and *Bekins* is that there is a constitutional limit on the scope of any bankruptcy regime that extends to state governmental units. These cases strongly suggest that if a regime does not meaningfully interfere with a state's police and regulatory authority and relies on a voluntary trigger, it would be within that constitutional limit. More generally, the fundamental question as framed by Cardozo in *Ashton* and the majority in *Bekins* is whether a scheme upsets the proper "balance between the powers of the states and the powers of the central government,"[103] a balance that should be "to the advantage of the people who are citizens of both."[104]

Although these cases provide a backdrop and reference points for analyzing the constitutionality of a state bankruptcy regime and an involuntary component thereof, they are probably of limited value in that regard. As discussed below, there have been many developments

99. *See, e.g.*, McConnell, *supra* note 2, at 230.
100. 304 U.S. 27 (1938).
101. *Id.* at 51.
102. *Id.* at 51–52.
103. *Ashton*, 298 U.S. at 542 (Cardozo, J., dissenting).
104. *Bekins*, 304 U.S. at 53.

in relevant constitutional doctrines since the 1930s; if the municipal bankruptcy cases provide any guidance, it will presumably be filtered through the lens of more contemporary Tenth Amendment jurisprudence.

B. Anti-Commandeering

One of the enduring principles of contemporary Tenth Amendment jurisprudence is that "Congress may not simply 'commandee[r] the legislative processes of the States by directly compelling them to enact and enforce a federal regulatory program.'"[105] Early cases reflecting this principle include *Coyle v. Smith*,[106] in which the Court held that Congress could not direct where a state located its capitol.[107] *Coyle* drew on prior cases articulating a more general principle that the federal government has limited ability to direct state governmental actions.[108] The Court refined the conceptual contours of this anti-commandeering principle in *Hodel v. Virginia Surface Mining & Reclamation Association*[109] and *FERC v. Mississippi*,[110] cases involving the Surface Mining Control Act of 1977 and the Public Utility Regulatory Policies Act of 1978, respectively. Although aspects of both Acts strongly encouraged states to take particular regulatory actions, the Court held in each case that the act in question did not command or compel the states to take any such actions.

In *New York v. United States*,[111] the Court held that provisions of the Low-Level Radioactive Waste Policy Amendments Act of 1985 contravened the constitutional prohibition on the federal government's commandeering of state governments.[112] That Act was designed to encourage states to dispose of low-level radioactive waste generated within their borders.[113] It employed three strategies:

105. New York v. United States, 505 U.S. 144, 161 (1992) (quoting Hodel v. Va. Surface Mining & Reclamation Ass'n, 452 U.S. 264, 288 (1981)).
106. 221 U.S. 559 (1911).
107. *Id.* at 565.
108. *See generally, e.g.*, Lane County v. Oregon, 74 U.S. 71 (1868); Texas v. White, 74 U.S. 700 (1868); *see also* Printz v. United States, 521 U.S. 898, 905–18 (1997) (reviewing the historical record and finding no evidence from the founding period or from early American history of Congress enacting laws forcing state executive action).
109. 452 U.S. 264 (1981).
110. 456 U.S. 742 (1982).
111. 505 U.S. 144 (1992).
112. *Id.* at 188.
113. *Id.* at 150–51.

providing a set of financial incentives for states to make arrangements for disposal of waste, limiting access of states that did not make satisfactory arrangements with disposal facilities in other states, and requiring states that failed to make arrangements for waste disposal by a target date to "take title" of waste generated within the state.[114] The Court found that the first two strategies were permissible incentives to encourage state governmental action, but it found that the "take title" provision effectively commandeered state governments by forcing them to take responsibility of disposing of waste generated within their borders.[115]

More recently, in *Printz v. United States*,[116] the Court found that interim provisions of the Brady Handgun Violence Prevention Act of 1993 violated the anti-commandeering doctrine under the Tenth Amendment.[117] Provisions of the Act required state law enforcement officers to make efforts to determine within the Act's waiting period whether purchasers were allowed to possess firearms.[118] The Court found these provisions to be unconstitutional commandeering of state executive officers.[119]

If the involuntary bankruptcy scheme proposed above is deemed to be commandeering, then it would likely be prohibited. But the scheme is carefully drawn to avoid running afoul of the anti-commandeering doctrine. It would not allow the federal government to force a state to do anything other than enter bankruptcy. And this probably cannot be construed as "commandeering" the state's regulatory power. The federal government would not be using the state as an instrument for a federal regulatory agency or compelling it to enforce a federal regulatory program; it would be imposing a legal regime upon the state. The appropriate constitutional question, then, is not one about commandeering but whether the federal government has authority to impose its power upon a state in this fashion.

C. General Principles of State Sovereignty

As indicated above, the anti-commandeering doctrine derives from a broader constitutional principle of state sovereignty reflected

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114. *Id.* at 152–54.
115. *Id.* at 174–77.
116. 521 U.S. 898 (1997).
117. *Id.* at 933.
118. *Id.* at 902–04.
119. *Id.* at 933–34.

primarily in the Tenth Amendment. The precise content of this principle, however, is difficult to identify, especially because the Supreme Court has charted an unsteady course in this area.

In *National League of Cities v. Usery*,[120] the Court articulated a robust doctrine of state sovereignty.[121] In that case, the Court considered the constitutionality of provisions of the Fair Labor Standards Act that imposed minimum wage and maximum hour regulations on state employees.[122] Drawing upon the same line of cases that supported the holding in *Coyle*,[123] the Court found that the principle of state sovereignty reflected in the Tenth Amendment prohibited Congress from imposing such requirements on state governments.[124] It held that "insofar as the challenged amendments operate to directly displace the States' freedom to structure integral operations in areas of traditional governmental functions, they are not within the authority granted Congress by Art. I, s 8, cl. 3."[125] Quoting *Coyle*, the majority opinion reasoned, "[i]f Congress may withdraw from the States the authority to make those fundamental employment decisions upon which their systems for performance of these functions must rest, we think there would be little left of the States' 'separate and independent existence.'"[126]

Noteworthy for present purposes, the Court reconciled its holding with that of *Fry v. United States*,[127] which upheld provisions of the Economic Stabilization Act of 1970 that imposed wage freezes on state and local government employees.[128] The general provisions of the FLSA under attack in *National League of Cities* and the wage freezes in *Fry* were different, the Court reasoned, because the latter was a measured response to a national economic emergency. In distinguishing *Fry*, the *National League of Cities* Court stated: "The limits imposed upon the commerce power when Congress seeks to apply it to the States are not so inflexible as to preclude temporary enactments tailored to combat a national emergency."[129]

120. 426 U.S. 833 (1976).
121. *Id.* at 849–50.
122. *Id.* at 845–46.
123. *Id.* at 844–45.
124. *Id.* at 851–52.
125. *Id.* at 851.
126. *Id.* (quoting Coyle v. Smith, 221 U.S. 559, 580 (1911)).
127. 421 U.S. 542 (1975).
128. *National League of Cities*, 426 U.S. at 852–53.
129. *Id.* at 853 (quoting *Fry*, 421 U.S. at 548).

> The enactment at issue [in *Fry*] was occasioned by an extremely serious problem which endangered the well-being of all the component parts of our federal system and which only collective action by the National Government might forestall. The means selected were carefully drafted so as not to interfere with the States' freedom beyond a very limited, specific period of time. The effect of the across-the-board freeze authorized by that Act, moreover, displaced no state choices as to how governmental operations should be structured, nor did it force the States to remake such choices themselves. . . . Finally, the Economic Stabilization Act operated to reduce the pressures upon state budgets rather than increase them.[130]

The limitation on Congress's Article I powers under *National League of Cities* was subsequently characterized as applying where these four components obtained: Congress regulates "states as states"; the statute in question touches upon matters that are "indisputably 'attributes of state sovereignty'"; the statute impairs states' "traditional governmental functions"; and the federal interest does not "justif[y] state submission."[131]

Shortly thereafter, however, the Court swept aside this doctrinal formulation and overruled *National League of Cities*. In *Garcia v. San Antonio Metropolitan Transit Authority*,[132] the Court reconsidered the constitutionality of the provisions of the FLSA that it had invalidated in *National League of Cities*.[133] Noting the difficulty lower courts were having in assessing whether federal statutes impaired "traditional governmental functions" under the existing doctrine, the Court effectively reconceptualized the underlying constitutional issue at hand.[134] As the majority opinion stated, "the fact that the States remain sovereign as to all powers not vested in Congress or denied them by the Constitution offers no guidance about where the frontier between state and federal power lies."[135] Thus, "we have no license to employ freestanding conceptions of state sovereignty when measuring congressional authority under the Commerce Clause."[136] Rather than employ such conceptions, the Court held:

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130. *Id.*

131. Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528, 537 (1985) (quoting Hodel v. Va. Surface Mining & Reclamation Ass'n, 452 U.S. 264, 287–88 (1981)).

132. *Id.*

133. *Id.* at 536.

134. *Id.* at 538.

135. *Id.* at 550.

136. *Id.*

> Apart from the limitation on federal authority inherent in the delegated nature of Congress' Article I powers, the principal means chosen by the Framers to ensure the role of the States in the federal system lies in the structure of the Federal Government itself. . . . State sovereign interests, then, are more properly protected by procedural safeguards inherent in the structure of the federal system than by judicially created limitations on federal power.[137]

This articulation of state sovereignty has survived since *Garcia*. It is noteworthy, however, that the composition of the Court has changed since then in ways that might give reason to question the viability of *Garcia* in years to come. Thus, it seems prudent to assess the constitutionality of a provision for involuntary state bankruptcy under both *Garcia* as well as *National League of Cities*.

Under *Garcia*, forcing a state into bankruptcy should not violate the Tenth Amendment unless there is some reason to believe that the underlying structure of the federal government has not protected the state's interest. If the provision were enacted pursuant to conventional legislative procedures, it seems hard to imagine how an objection could be framed pursuant to the concept of state sovereignty under *Garcia*.

Considering the scheme in light of *National League Cities* presents a much harder question. On the one hand, it is clear that forcing a state into bankruptcy is a significant intrusion upon the state's sovereignty. And it would likely cause the state to experience some financial and political disruptions. On the other hand, the *National League of Cities* doctrine recognized that such an intrusion was only one factor in the relevant analysis.[138] That doctrine considered the federal interest that occasioned treading upon states' sovereignty and expressly recognized that the federal government could breach state sovereignty to avert a national emergency or address a threat to "the well-being of all the component parts of our federal system."[139] An involuntary bankruptcy scheme for states as modeled above would be narrowly tailored to protect such a national interest. It would impose upon states' sovereignty by forcing them into bankruptcy only if they threatened national financial or economic stability, and it would include no other involuntary measures.

137. *Id.* at 550–52.
138. *See supra* note 131 and accompanying text.
139. Nat'l League of Cities v. Usery, 426 U.S. 833, 853 (1976).

D. Summary

The basic constitutional principle common to these three strands of Tenth Amendment doctrine is that American states enjoy some meaningful degree of sovereignty within our federal system, but this degree of sovereignty is far from complete. The Constitution envisions that states are only quasi-sovereign.[140] The structure of American government envisions, for example, that states' power to regulate most commercial activity is subject to federal override pursuant to the Commerce Clause.[141] The federal government controls many activities that would be governed by fully sovereign states, including immigration, foreign policy, defense, and monetary policy.

As explained above, a state bankruptcy regime with an involuntary component can be designed to almost completely avoid interfering with states' governmental policies or functions. It is clear, however, that the threshold involuntary component itself would be a significant interference with a state government policy—whether to seek bankruptcy protection. But this only begins the constitutional analysis. Would this necessarily upset the appropriate balance of power between the state and federal governments? If the premise of the provision is that it could only be triggered if the state threatened financial harm to the national government or to other states, then the question seems to be a difficult one. The imposition on the state is real, but it presupposes a looming national threat stemming from the state. If one considers the real and significant dangers that a state in acute financial crisis could pose to the nation, the case for interference with state power does not seem clearly implausible.[142] At the very least, the issue seems close enough that the constitutional question cannot be brushed aside, and, arguably, the burden lies with those who would argue against allowing the federal government to force a state into bankruptcy if that became necessary to avoid a national crisis.

140. *See* Gelpern, *supra* note 34, at 896–925 (describing quasi-sovereigns and comparing them to private debtors and other types of public debtors).

141. U.S. CONST. art. I, § 8, cl. 3.

142. *See* Solan, *supra* note 2, at 238–40 (making a similar point with respect to allowing states to voluntarily file for bankruptcy).

V. CONCLUSION

Like private debtors, sovereign nations predictably delay or avoid seeking debt relief well beyond the point that such relief would be beneficial to them and to other stakeholders. If an American state in financial distress behaved similarly, the costs of its delay could substantially increase the likelihood, and the likely scope, of a federal bailout. If so, a purely voluntary bankruptcy regime for American states would fail to meet its primary objectives. And if the availability of bankruptcy relief increases states' moral hazard, a voluntary regime could end up doing more harm than good.

If bankruptcy law is extended to American states, it should include an involuntary component. This essay describes a minimalist model of involuntary bankruptcy that would allow the federal government to force a state into bankruptcy if the state is likely to need substantial financial support or if it is threatening the nation's financial and economic stability. Beyond this, every other aspect of the regime as modeled would be voluntary. A state forced into bankruptcy would have the option to exit after a very brief period of time. If it did not exit, it would have the ability to propose a restructuring plan that could bind objecting holdouts without violating the Contract Clause. The federal government might delay in forcing a state into bankruptcy, but the availability of an involuntary trigger could at least increase the chances of a more timely bankruptcy proceeding. This in turn could encourage states to be more careful to avoid financial distress *ex ante* and motivate other stakeholders to renegotiate their claims *ex post* if a state experiences financial distress.

An involuntary bankruptcy regime designed in this fashion might withstand constitutional scrutiny. To be sure, forcing a state into bankruptcy would interfere with the state's sovereignty and raise constitutional concerns. But if the regime were otherwise voluntary, this interference would be limited to the state's entry into the bankruptcy system. And, in any event, American states' constitutional sovereignty is qualified by existential needs of the nation. Like a sovereign state in a monetary union, an American state would inevitably externalize its financial distress upon the larger governmental unit, potentially destabilizing the national economy. Tenth Amendment doctrine allows for emergency intrusions upon states' sovereignty, and an involuntary state bankruptcy regime that could be triggered only if a state is threatening the financial or economic welfare or stability of the nation should meet this test.