THE YALE LAW JOURNAL

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Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt

ABSTRACT. This Feature considers the debts of quasi-sovereign states in light of proposals to let them file for bankruptcy protection. States that have ceded some but not all sovereign prerogatives to a central government face distinct challenges as debtors. It is unhelpful to analyze these challenges mainly through the bankruptcy lens. State bankruptcy posits an institutional fix for a problem that remains theoretically undefined and empirically contested. I suggest a way of mapping the problem that does not work back from a solution. I highlight the implications of sovereign immunity, immortality, concurrent authority, macroeconomic policy, and democratic accountability for quasi-sovereign debt management. Along with default, fiscal transfers, and ad-hoc renegotiation, bankruptcy is one of several paths to reduce public debt overhang, but not necessarily the best path to state rehabilitation. Bankruptcy centers on coordination failures and contractual liabilities, when neither is especially salient in quasi-sovereign debt. It holds no special advantage against moral hazard from fiscal federalism and sovereign immunity. Even so, recent bankruptcy proposals have started a useful conversation joining previously disparate scholarship about credit market institutions, sovereign debt, fiscal federalism, and local government. The conversation should refocus on the problem of quasi-sovereign debt.

AUTHOR. Professor, American University Washington College of Law. I am deeply grateful to Geoff Walter, Brian Stewart, and Ellen Ostrow for research assistance; to my editors for patience and insight; to William Bratton, Peter Conti-Brown, Adam Feibelman, Clayton Gillette, Mitu Gulati, Melissa Jacoby, Adam Levitin, Stephen Lubben, Richard Schragger, David Skeel, Bruce Spiva, and Stephen Vladeck for help with earlier drafts. This project benefited from presentations and discussions at the Stanford Law School conference, “When States Go Broke: Origins, Context, and Solutions for the American States in Fiscal Crisis.”

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INTRODUCTION

Bankruptcy—a set of legal institutions to manage private debt distress—has long captivated thinkers and politicians solving public debt problems.[1] Adam Smith observed in 1776 that a sovereign state, like an individual, may find it necessary "to declare itself bankrupt," and that "a fair, open, and avowed bankruptcy" was more constructive and honorable than printing money "to cover the disgrace of a real bankruptcy."[2] Yet the intellectual success of sovereign bankruptcy has far outstripped its policy traction: there is no bankruptcy regime for nation-states; examples of subnational bankruptcy are rare and limited to nonsovereign localities.[3] This seems puzzling, because sovereign debt history is replete with examples of distress, default, and messy restructuring.[4]

My Feature considers the puzzle in light of recent proposals to adapt bankruptcy institutions for U.S. states[5] and members of the European Union.[6]

1. Kenneth Rogoff & Jeromin Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001*, 49 IMF STAFF PAPERS 470 (2002).
2. 2 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 930 (R.H. Campbell, Andrew S. Skinner & W.B. Todd eds., Oxford Univ. Press 1976) (1776).
3. Lili Liu & Michael Waibel, *Subnational Insolvency: Cross-Country Experiences and Lessons* (World Bank, Policy Research Working Paper No. 4496, 2008), *available at* http://ssrn.com/abstract=1400640 (surveying subnational insolvency approaches in Albania, Brazil, Bulgaria, Hungary, Romania, South Africa, and the United States). Some scholars and advocates have suggested adapting the U.S. Chapter 9 municipal bankruptcy model to nation-states. *See, e.g.*, Kunibert Raffer, *Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face*, 18 WORLD DEV. 301 (1990). *But see* Daniel K. Tarullo, *Rules, Discretion, and Authority in International Financial Reform*, 4 J. INT'L ECON. L. 613 (2001) (criticizing the Chapter 9 analogy).
4. ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE § 1.2 (1992); CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY 68-138 (2009); Liu & Waibel, *supra* note 3.
5. *E.g.*, Jeb Bush & Newt Gingrich, Op-Ed., *Better Off Bankrupt*, L.A. TIMES, Jan. 27, 2011, http://articles.latimes.com/2011/jan/27/opinion/la-oe-gingrich-bankruptcy-20110127; David Skeel, *Give States a Way To Go Bankrupt*, WKLY. STANDARD, Nov. 29, 2010, http://www.weeklystandard.com/articles/give-states-way-go-bankrupt_518378.html.
6. *See, e.g.*, François Gianviti et al., *A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal* (Bruegel Blueprint Series, No. 10, 2010), *available at* http://www.bruegel.org/download/parent/446-a-european-mechanism-for-sovereign-debt-crisis-resolution-a-proposal/file/928-a-european-mechanism-for-sovereign-debt-crisis-resolution-a-proposal-english; Daniel Gros & Thomas Mayer, *How To Deal with Sovereign Default in Europe: Create the European Monetary Fund Now!* (Ctr. for Eur. Policy Studies, Policy Brief No. 202, 2010), *available at* http://www.ceps.eu/ceps/download/2912.

These public debtors share a quality that sets them apart from the protagonists in earlier bankruptcy debates: they remain sovereign but have ceded important aspects of their sovereignty to a central government in the name of economic and political integration. The fiscal troubles of "quasi-sovereign"[7] states present a distinct economic context for bankruptcy as a public debt management tool, and a constellation of political interests potentially more amenable to trading sovereignty for solvency.

The latest proposals were quickly abandoned, even as public debt problems have continued to dominate the policy agenda on both sides of the Atlantic. Their demise revives an old question: is state bankruptcy a good idea perennially thwarted by bad politics, or a tempting analogy courting problems it cannot solve? Although the answer is probably both, I argue that it is closer to the latter.

In the recent crop of initiatives, even the best had it backwards. They started with a bankruptcy solution, and extrapolated to the state debt problem. To be sure, they have prompted a useful conversation joining previously disparate scholarship about credit market institutions, sovereign debt, fiscal federalism, and local government. But framing the conversation mainly in bankruptcy terms is unhelpful for three reasons. First, starting with bankruptcy flips the logical sequence: it posits an institutional fix for a theoretically undefined and empirically contested problem. As a result, a debate that should be filling gaps in public debt theory yields yet another chapter on the uses of bankruptcy. Second, the bankruptcy label presumptively narrows the inquiry, making creditor collective action problems and the Contracts Clause of the U.S. Constitution play host to broader principles of fiscal policy and democratic governance. That such broad principles arise in response to bankruptcy concerns, not vice versa, is distortive. Third, the bankruptcy label injects the intellectual and political conflicts of bankruptcy into the world of public debt. "Bailout" and "cramdown" are fighting words in both worlds, but such overlaps are misleading. Talking about state debt as "state bankruptcy" sets the stage for replaying entrenched arguments from a different field, and threatens to derail a useful exchange for the wrong reasons.

7. I take the term from Justice Cardozo's dissent in *Ashton v. Cameron County Water Improvement District*, 298 U.S. 513 (1936), where the Court struck down the original U.S. municipal bankruptcy statute. According to Justice Cardozo, "In the public law of the United States a state is sovereign or at least a quasi-sovereign. Not so, a local governmental unit, though the State may have invested it with governmental power." *Id.* at 542 (Cardozo, J., dissenting). "Part-sovereign" may be a more accurate, if less colorful and pedigreed, description.

My Feature is an effort to reframe but continue the conversation. The goal is to refocus on the problem of quasi-sovereign debt, without losing the benefit of the debate that started with state bankruptcy.

Over the past year, supporters have offered a wide range of rationales for state bankruptcy. Writing about U.S. states, David Skeel asks bankruptcy to reduce public debt overhang and moral hazard from bailouts, and to improve fairness and process legitimacy in public finance.[8] Creditor collective action problems loom large for François Gianviti and colleagues in the EU,[9] and for Steven Schwarcz in the United States.[10] For Jeb Bush and Newt Gingrich, bankruptcy is a tool to battle interest groups (here, unionized state workers).[11] Daniel Gros and Thomas Mayer would use bankruptcy elements to overcome structural asymmetries in the design of eurozone institutions.[12]

Diverse ways of framing the problem are at the heart of private bankruptcy theory[13] and are consistent with the history of public bankruptcy initiatives. For

8. David A. Skeel, Jr., *State Bankruptcy from the Ground Up*, *in* WHEN STATES GO BROKE: UNDERSTANDING THE FISCAL AND POLITICAL CRISIS IN THE AMERICAN STATES (David A. Skeel, Jr. & Peter Conti-Brown eds., forthcoming 2012), *available at* http://lsr.nellco.org/upenn_wps/382; David A. Skeel, Jr., *States of Bankruptcy*, 79 U. CHI. L. REV. (forthcoming 2012), *available at* http://ssrn.com/abstract=1907774.

9. Gianviti et al., *supra* note 6.

10. Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy,"* 59 UCLA L. REV. (forthcoming Dec. 2011).

11. Bush & Gingrich, *supra* note 5.

12. Gros & Mayer, *supra* note 6, at 5. The eurozone comprises the subset of EU members that have ceded the right to coin their own currencies and have adopted the euro. They are Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

13. Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 777 (1987), argues that corporate bankruptcy balances competing values to distribute the consequences of default in society, while Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 816 (1987), sees corporate bankruptcy as a discrete system to maximize value for the creditors in response to collective action problems among them. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 907 (1982), first articulated the creditors' bargain theory of bankruptcy as a response to the creditor collective action problem. Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717 (1991), rejected the view of bankruptcy as debt collection in favor of a "value-based account" of bankruptcy as group rehabilitation from financial distress. *See also* Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994) (arguing that community interests should inform personal and corporate bankruptcy systems); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989) (expanding the creditors' bargain model to allow for distributional considerations).

example, the mission of municipal bankruptcy in the United States has gone from neutralizing holdout creditors to comprehensive rehabilitation;[14] elsewhere municipal bankruptcy has served as a vehicle for negotiating federalism;[15] meanwhile, proposals for international sovereign bankruptcy have shifted from targeting holdouts to battling bailouts and moral hazard.[16]

That bankruptcy can promise to solve all of the above problems—and that theorists can debate its mission for decades—testifies to its richness and elasticity. But there is a downside. "Bankruptcy" can become all things to all people, a heuristic for managing debt distress in general that confuses and disappoints when transplanted to a particular new setting. To wit, Adam Smith's place in sovereign bankruptcy debates: eminent advocates have claimed him as an intellectual ancestor,[17] but it is doubtful that his "avowed bankruptcy" would have resembled the collective debt adjustment process at the heart of modern proposals.[18] Much as Smith has brought caché to diverse sovereign bankruptcy proposals, "bankruptcy" is becoming the banner under which good people battle all manner of public debt problems.

With bankruptcy's public debt mission noted (at least in the alternative), the discourse quickly shifts to implementation, constitutional logistics, and transition costs. Which design will clear the state consent requirement in constitutional jurisprudence? Which will win the most votes in today's political climate? Is bond market contagion a danger? Does it follow from enacting

14. Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 355 (2010).

15. *See, e.g.*, Liu & Waibel, *supra* note 3, at 11.

16. *See* Rogoff & Zettelmeyer, *supra* note 1, at 494.

17. The following proposals cite the same passage from Smith, which also opened this Feature, casting him as an eminent early advocate of bankruptcy for states: Ross P. Buckley, *The Bankruptcy of Nations: An Idea Whose Time Has Come*, 43 INT'L LAW. 1189, 1190-91 (2009); Sean Hagan, *Designing a Legal Framework To Restructure Sovereign Debt*, 36 GEO. J. INT'L L. 299, 300 (2005); Jeffrey D. Sachs, *The Roadblock to a Sovereign Bankruptcy Law*, 23 CATO J. 73, 73 (2003); *see also* Rogoff & Zettelmeyer, *supra* note 1, at 471 n.2 (tracing modern sovereign bankruptcy proposals citing Smith).

18. Smith's most-quoted state bankruptcy passage comes in the context of complaints about "pretended payment" in devalued currency, a narrow category of debtor moral hazard. SMITH, *supra* note 2, at 930. Smith does not appear concerned with the problems of disorderly default, creditor collective action, or debtor rehabilitation, which animate today's bankruptcy. In Smith's time, debtors' prisons were the norm, and "bankruptcy" was an involuntary collection proceeding against traders. Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 10 (1995).

bankruptcy, or from invoking it?[19] All these questions become relevant only if bankruptcy does in fact help solve the debt problems of quasi-sovereign states. If it does, its benefits might even outweigh the costs of constitutional or treaty change, and could certainly outweigh the political and market risks of enactment.

Over a year into the debate, the link between quasi-sovereign debt problems and bankruptcy solutions remains tenuous. Debt overhang requires debt relief, not bankruptcy. Relief can come from default, fiscal transfer (bailout), ad-hoc renegotiation, or bankruptcy. Is bankruptcy the best path? Similarly, process problems in quasi-sovereign debt restructuring remain a matter for speculation. The modern history of sovereign debt distress is remarkable for its dearth of collective action problems of the sort that traditionally motivate bankruptcy for private debt.[20] Is it just a matter of time before they appear or are properly diagnosed—and should bankruptcy be adopted preemptively? Bankruptcy's capacity to rehabilitate, and not just

19. *See* Skeel, *State Bankruptcy from the Ground Up*, *supra* note 8, at 2-5 (addressing the leading arguments against state bankruptcy); Skeel, *States of Bankruptcy*, *supra* note 8, at 22-38 (same).

20. This is not to say that sovereign debt relief has been quick and smooth. Rather, the delays and disruptions in the run-up to recent bond restructuring cases, even egregious ones such as Argentina's decade-old default, are more readily attributable to economic and political factors distinct from classic creditor collective action failures (asset grabs, courthouse races). *See* Brad Setser & Anna Gelpern, *Pathways Through Financial Crisis: Argentina*, 12 GLOBAL GOVERNANCE 465 (2006) (describing political factors behind Argentina's delay in addressing its debt overhang). Bond restructuring techniques appear to mitigate private creditor coordination problems once a sovereign decides to seek debt relief. *See* Ran Bi, Marcos Chamon & Jeromin Zettelmeyer, *The Problem that Wasn't: Coordination Failures in Sovereign Debt Restructurings* 7-8 (Int'l Monetary Fund, Working Paper No. 11/265, 2011), *available at* http://www.imf.org/external/pubs/ft/wp/2011/wp11265.pdf (proposing a theory to explain the relatively smooth progression of sovereign debt restructurings beginning in the late 1990s).

In the unfolding government debt crisis in Europe, the biggest challenge has been coordination among potential guarantors and spillover victims—member states of the eurozone that did not start out as creditors of Greece, Ireland, Portugal, Spain, or Italy—not private creditors, which are mostly regulated institutions unusually susceptible to government suasion. *See* EUR. BANKING AUTH., 2011 EU-WIDE STRESS TEST AGGREGATE REPORT 29 (2011), *available at* http://stress-test.eba.europa.eu/pdf/EBA_ST_2011_Summary_Report_v6.pdf (reporting bank holdings of European sovereign debt); Anna Gelpern, *Defies Credulity Eupdate*, CREDIT SLIPS (Aug. 24, 2011, 11:25 PM), http://www.creditslips.org/creditslips/2011/08/defies-credulity-eupdate.html. Early theories of official sector involvement in sovereign debt negotiations with private creditors did not focus on coordination problems within the official sector. Jeremy Bulow & Kenneth Rogoff, *Multilateral Negotiations for Rescheduling Developing Country Debt: A Bargaining Theoretic Framework*, 35 IMF STAFF PAPERS 644, 645 (1988).

deleverage, municipalities and individuals is limited by law; its rehabilitation record is underwhelming. Bankruptcy is at best unproven, and at worst unsuited to overtly political tasks, such as mediating among political interest groups and brokering fiscal federalism.[21] For this and related reasons, municipal bankruptcy in the United States studiously avoids the appearance of political meddling.

Saying that bankruptcy's utility for quasi-sovereign debt is unproven does not foreclose its relevance, or expose it as political subterfuge. A debtor insolvent on account of dysfunctional politics needs debt relief no less than one that has fallen victim to bad luck or mismanagement. If bankruptcy tools can help, they should. And if bankruptcy tools can be adapted or improved for use in public debt, all the better: for example, the answer to bankruptcy's poor municipal rehabilitation record may be to expand its powers,[22] not limit its scope. The challenge is to diagnose the debt problem before evaluating the proposed solution on its merits and in political context.

In what follows, I first map the problem of quasi-sovereign debt distress and restructuring before considering bankruptcy in light of recent proposals. I begin with the distinctive characteristics of quasi-sovereign debtors and their debt problems, and end by asking how bankruptcy might help. With the rich history of quasi-sovereign debt distress,[23] I feel safe in assuming the occasional need for debt relief among this category of debtors. This allows me to steer clear of arguments about the current sustainability of eurozone debt and U.S. state pension commitments, which are tangential to the case for a standing bankruptcy law. Put differently, I assume the possibility of a debt overhang, but not problems with the debt restructuring process, such as coordination failure, where bankruptcy might ultimately hold a special advantage. To the greatest extent possible, I try to generalize from U.S. and other examples. I look for structural flaws in the quasi-sovereign debt management toolkit before considering any bankruptcy tools that might help fix them. Whether the fix should be called bankruptcy and get a part in the U.S. Code or the European treaty complex is a question of implementation beyond the scope of this project.

21. Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. (forthcoming 2012) (manuscript at 3), *available at* http://ssrn.com/abstract=1898775.

22. *See* Clayton P. Gillette, *Political Will and Fiscal Federalism in Municipal Bankruptcy*, 79 U. CHI. L. REV. (forthcoming 2012), *available at* http://lsr.nellco.org/nyu_plltwp/269 (arguing for expanding municipal bankruptcy to authorize tax increases).

23. *See, e.g.*, JOHN V. ORTH, THE JUDICIAL POWER OF THE UNITED STATES: THE ELEVENTH AMENDMENT IN AMERICAN HISTORY (1987); Liu & Waibel, *supra* note 3.

I proceed as follows: Part I describes quasi-sovereign debtors, highlighting the ways in which they differ from private debtors commonly eligible to file for bankruptcy and from other public debtors, especially fully sovereign states and nonsovereign localities. Part II begins with an overview of grounds for quasi-sovereign debt relief and considers gaps in the debt management toolkit. Part III asks how bankruptcy might fill them. I conclude that bankruptcy's likely contributions are limited and often hinge on a set of questionable assumptions. Redirecting the bankruptcy debate to take a fresh look at established alternatives, such as federal funding conditional on policy reform and debt restructuring, promises better answers to quasi-sovereign debt problems—though hardly a cure.

I. QUASI-SOVEREIGNS AND THEIR DEBTS

Public debtors comprise fully sovereign states, states that have partly ceded sovereignty to central governments, local and municipal authorities that are not sovereign but derive their powers from some combination of the sovereign above and the people below,[24] and all manner of public instrumentalities, including commercial firms established or owned by sovereigns, with limited powers deriving from charters and authorizing laws. I focus on the second category: states that have partly ceded sovereignty to central governments. I use the unmodified term "states" to describe entities in either or both of the first two categories, and "quasi-sovereigns" to refer to members of the second category only.

As the name suggests, quasi-sovereigns occupy the middle ground between localities and nation-states. They retain "the self-sufficient source of political power" that was their original endowment, but have ceded certain derived "specific political powers"[25] in a constitutional compromise. The category boundaries are hard to draw: some national laws and most treaties involve ceding sovereignty, but do not make the parties quasi-sovereign in the sense relevant to this discussion. For example, quasi-sovereign U.S. and eurozone states gave up coining their own currency, yet so did fully sovereign Ecuador (by adopting the U.S. dollar as legal tender). The distinction lies in the intent and institutional commitment to pool sovereignty: Ecuador can enact a new

24. AMDURSKY & GILLETTE, *supra* note 4, § 2.1, at 39-40; Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 427 (1993) (describing cities as alternately political subdivisions of sovereign states and agents of private inhabitants).

25. BLACK'S LAW DICTIONARY 1396 (6th ed. 1990).

law to recapture monetary autonomy; the others cannot without breaching treaties or constitutions. The scope of pooling arrangements can vary. At this writing, Europe's union has preserved substantial fiscal autonomy for its members but has been progressively absorbing other economic and regulatory policy prerogatives. Compared to the European Union, the deeply integrated U.S. federal system makes state sovereignty look vestigial, but it remains central to the federal structure and political imagination.[26] The precise content of ceded sovereignty may be uncertain at the outset, to be elaborated and changed over time. For instance, U.S. states found out over a century into their union that they had given up sovereign rights to espouse the claims of their citizens.[27]

Scholarly and policy treatments of subnational debt generally avoid delving into the distinctions between sovereign and nonsovereign borrowers. Some appear to assume that all subnational borrowers are nonsovereign; for others, the distinction makes minimal difference to what they study; yet for others, the causes and consequences of avoiding sovereignty are harder to discern.[28] In contrast, much of this Feature is devoted to the implications of subnational sovereignty for debt management.

Below, I describe the distinct attributes of quasi-sovereigns as debtors. I compare them first to private debtors, individuals, and firms usually eligible for bankruptcy protection. Next, I compare quasi-sovereigns to fully sovereign states, which have no recourse to bankruptcy, and to localities, which can file for protection under Chapter 9 of the U.S. Bankruptcy Code. In the end, I suggest that quasi-sovereigns are different from other public and private debtors in fundamental respects. As a result, the debt problems of quasi-sovereigns do not map neatly either on to bankruptcy or on to established sovereign debt restructuring procedures. I consider the implications of this conclusion in Part II.

26. Some scholars have gone so far as to suggest that "what now passes for federalism in the United States is actually managerial decentralization." MALCOLM M. FEELEY & EDWARD RUBIN, FEDERALISM: POLITICAL IDENTITY AND TRAGIC COMPROMISE, at ix (2008).

27. *See* New Hampshire v. Louisiana, 108 U.S. 76 (1883) (dismissing suits brought by New Hampshire and New York against Louisiana seeking debt repayment to plaintiff states' citizens on the grounds that these suits violated the Eleventh Amendment).

28. *See, e.g.*, AMDURSKY & GILLETTE, *supra* note 4 (focusing on nonsovereign municipal debt); Liu & Waibel, *supra* note 3 (generally avoiding questions of sovereignty); John Petersen, *Financial Market Structure, Regulation, and Operations*, *in* SUBNATIONAL CAPITAL MARKETS IN DEVELOPING COUNTRIES: FROM THEORY TO PRACTICE 126 (Mila Freire et al. eds., 2004) (implicitly treating all subnational debt as nonsovereign).

A. Quasi-Sovereign and Private Debtors

That states are different from private firms and individuals is intuitive. States have distinct forms, functions, institutional structures, and channels of accountability, with no ready analogue to private entities. This Section does not attempt a comprehensive (and pointless) catalogue of differences. I limit the description to quasi-sovereigns as debtors, focusing throughout on attributes relevant to adapting private restructuring and reorganization tools.

1. States Are Immune from Lawsuits on Their Debts and Their Assets Are Immune from Attachment

Perhaps the most salient difference between state and private debt obligations lies in their judicial enforceability. Debt contracts entered into by people and firms are enforceable in court and against the debtor's assets. Immunity doctrines put states and their assets outside judicial purview, unless the state agrees to be sued or an exception applies. Immunity has at least three important implications for debt management. First, it puts the debtor's assets presumptively beyond creditors' reach, altering the traditional concept of a bankruptcy estate beyond recognition. Second, it severely limits the enforcement sanction for debt nonpayment and creates commitment problems that have come to define state borrowing. Third, immunity blunts or eliminates traditional collective action problems that have come to motivate bankruptcy.

The scope of immunity differs among sovereign and quasi-sovereign debtors, a function of internal constitutional arrangements. For example, U.S. states generally enjoy robust immunity from lawsuits for money damages, and they cannot be sued for defaulting on debts without their consent in the United States.[29] This is not a necessary, nor a universal consequence of sovereignty—

29. *See* ORTH, *supra* note 23, at 42-46, 123-26, 132 (discussing the evolution of the Eleventh Amendment bar on suing U.S. states in federal courts in tandem with recurring state debt defaults, the relationship between constitutional and common law sovereign immunity protections, and the emergence of state consent to be sued as a way of overcoming both constitutional and common law concerns); *see also* U.S. CONST. amend. XI (limiting the judicial power of the United States with respect to proceedings against states); Hans v. Louisiana, 134 U.S. 1 (1890) (finding Louisiana immune from suit by one of its own citizens under the Contracts Clause of the U.S. Constitution for amending the state constitution to stop servicing its debt). Although one court construed state immunity narrowly in connection with Arkansas's attempt to restructure its debt unilaterally (suggesting the possibility of an injunction against a state treasurer), the decision remains an outlier. Hubbell v. Leonard, 6 F. Supp. 145, 151 (E.D. Ark. 1934) ("The state is not named as a party other quasi-sovereigns may have agreed to be sued under federal arrangements with no analogue to the Eleventh Amendment to the U.S. Constitution. Under public international and U.S. foreign relations law, foreign sovereigns generally lose their immunity from suit when they engage in "commercial activity,"[30] defined by the U.S. Supreme Court specifically to include public debt issuance.[31] A U.S. state might be more exposed to lawsuits abroad than at home.

to this suit, but, if the state is the real party in interest, and the officer is merely a nominal party, then the suit is in substance one against the state, and cannot be maintained. . . . We cannot, however, agree with counsel for defendant that in considering the question as to whether this is a suit against the state, we should not give attention to the question as to whether the legislative acts, under color of which the defendant claims the right to act, are void as violative of the contract clause of the Constitution. If these acts are unconstitutional, and for that reason void, they furnish no protection for the acts of the officer, and hence a suit to enjoin such acts could not be said to be a suit against the state." (citations omitted)); *see* Clayton P. Gillette, *What States Can Learn from Municipal Insolvency*, *in* WHEN STATES GO BROKE: UNDERSTANDING THE FISCAL AND POLITICAL CRISIS IN THE AMERICAN STATES (David A. Skeel, Jr. & Peter Conti-Brown eds., forthcoming 2012) (manuscript at 19 n.56) (on file with author) (questioning whether *Hubbell* was correctly decided). *See generally* Parden v. Terminal Ry., 377 U.S. 184, 186-87 (1964) ("[In *Hans*,] the action was a contractual one based on state bond coupons, and the plaintiff sought to invoke the federal-question jurisdiction by alleging an impairment of the obligation of contract. Such a suit on state debt obligations without the State's consent was precisely the 'evil' against which both the Eleventh Amendment and the expanded immunity doctrine of the *Hans* case were directed." (footnote omitted)). *Hans* is consistent with the expansive vision of sovereign immunity promulgated by the Supreme Court outside the public debt context in the late 1990s. *See* Alden v. Maine, 527 U.S. 706 (1999); Seminole Tribe v. Florida, 517 U.S. 44 (1996). The Court recognized an exception in *Central Virginia Community College v. Katz*, 546 U.S. 356 (2006), where it permitted a bankruptcy trustee to sue the state to avoid a preferential transfer by the debtor to state agencies. Some of the Court's language in *Katz* is quite broad, potentially pointing to a sweeping bankruptcy exception to sovereign immunity. However, the prevailing reading remains narrow, limited to states' role as creditors in bankruptcy proceedings. According to the National Bankruptcy Conference, "The [*Katz*] decision does not imply that any State waived sovereign immunity with respect to itself as a debtor or that any State, in adopting the Constitution, agreed that another State may be a debtor in a bankruptcy case." *The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter: Hearing Before the Subcomm. on Courts, Commercial & Admin. Law of the H. Comm. on the Judiciary*, 112th Cong. 4 (2011) (statement of the Nat'l Bankr. Conference).

30. Foreign Sovereign Immunities Act of 1976, 28 U.S.C. § 1605(a)(2) (2006). The Act codifies a restrictive theory of sovereign immunity, including the commercial activity exception. *See* Letter from Jack B. Tate, Acting Legal Adviser, to Philip B. Perlman, Acting Att'y Gen. (May 19, 1952), *reproduced in* Alfred Dunhill of London, Inc. v. Cuba, 425 U.S. 682, app. 2 at 711-15 (1976) (describing state practice and U.S. State Department policy with respect to the evolving immunity doctrine); *see also* Verlinden B.V. v. Cent. Bank of Nigeria, 461 U.S. 480, 488 (1983) (discussing federal codification).

31. *See* Republic of Arg. v. Weltover, 504 U.S. 607, 614-17 (1992).

Even if a creditor succeeds in suing a state on a debt contract, the creditor is unlikely to get paid because state property is separately protected from attachment. U.S. states' property is exempt from attachment without the debtor's consent,[32] and foreign sovereigns theoretically exposed to attachment rarely leave attachable property "used for a commercial activity" outside their borders.[33] By comparison, non-sovereign municipalities are not immune from suit;[34] however, they are effectively protected from enforcement against their property in much the same way as sovereign debtors. Courts have held that public property of municipalities cannot be attached to satisfy a debt judgment out of concern not to interfere with municipal functions for the sake of private creditors.[35]

In lieu of attachment, creditors have the state remedy of mandamus: a court order directing a public official to raise taxes to pay debts. However, commentators have observed that both states and municipalities have an impressive record of avoiding mandamus, at the extreme, by having the targeted official resign from office.[36]

Market practice with respect to immunity waivers appears counterintuitive at first blush. U.S. states, which cannot be sued in U.S. courts without their consent, do not usually waive immunity from suit or attachment.[37] On the

32. *See* Watters v. Wash. Metro. Area Transit Auth., 295 F.3d 36, 39 (D.C. Cir. 2002) (holding that the Eleventh Amendment confers immunity to states against the imposition or enforcement of equitable liens and related devices); *see generally* Alden v. Maine, 527 U.S. 706, 712-13 (1999) (holding that states, as sovereigns, have the immunity of any other sovereign).

33. Jonathan I. Blackman & Rahul Mukhi, *The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos, and Other Legal Fauna*, 73 LAW & CONTEMP. PROBS. 47, 59 (2010) ("Not only are judgment creditors faced with a narrow exception to immunity for the foreign state's property under these decisions, but also, in any event, insolvent sovereign debtors rarely have even arguably attachable assets in jurisdictions where execution is possible.").

34. *See, e.g.*, Flushing Nat'l Bank v. Mun. Assistance Corp., 358 N.E.2d 848 (N.Y. 1976) (holding that a moratorium on servicing New York City notes violated the state constitution); *see also* ORTH, *supra* note 23, at 110-20 (contrasting the treatment of states and municipalities under immunity doctrines).

35. AMDURSKY & GILLETTE, *supra* note 4, § 5.4.3.

36. *See, e.g.*, *id.* § 5.4.1.; ORTH, *supra* note 23, at 116 (describing an act of the Dakota Territory legislature enabling county commissioners "to terminate their offices by filing resignations with the county clerk . . . to frustrate federal writs of mandamus").

37. *See, e.g.*, STATE OF N.Y., OFFICIAL STATEMENT ON GENERAL OBLIGATION BONDS 4 (Feb. 25, 2010, as supplemented Mar. 2, 2010), *available at* http://www.osc.state.ny.us/debt/general_oblig_bonds/final_2010abc_official_statement.pdf ("The State Constitution does not provide for the contingency where an appropriation for debt service on bonds has been made but moneys are unavailable on the payment date. . . . Judgments against the State may

other hand, foreign sovereigns, whose consent to be sued is arguably superfluous under U.S. and international law, routinely waive immunity when issuing abroad.[38] An informal review of publicly accessible securities disclosure with respect to the general obligation bonds of U.S. states[39] reveals that ten states either expressly waive immunity or disclose that state law implies consent to be sued in their own state courts.[40] No U.S. state consents to be sued in federal court. Three more states describe partial waiver of immunity.[41] However, even those states that consent to be sued often simultaneously disclose that their assets remain immune from attachment and execution, leaving successful litigants without effective remedy.

Flowing from immunity, it makes little sense to conceive of state debt adjustment in the traditional terms of managing a bankruptcy estate for the

not be enforced by levy and execution against property of the State, and such enforcement is limited to the amount of moneys appropriated by the Legislature and legally available for such purpose. Because the State has never defaulted . . . there has never been any occasion to test a bondholder's remedies in this circumstance.").

38. LEE C. BUCHHEIT, HOW TO NEGOTIATE EUROCURRENCY LOAN AGREEMENTS 140-44 (2004) (describing market practice for waiving foreign sovereign immunity).

39. Fifty-state survey on file with author (based on *Electronic Municipal Market Access*, MUN. SEC. RULEMAKING BD., http://emma.msrb.org (last visited Aug. 29, 2011)).

40. *See* COMMONWEALTH OF MASS., GENERAL OBLIGATION REFUNDING BONDS, at 3 (Mar. 23, 2011), *available at* http://emma.msrb.org/EP515675-EP401847-EP799131.pdf; COMMONWEALTH OF VA., GENERAL OBLIGATION BONDS, at 11 (Oct. 7, 2009), *available at* http://emma.msrb.org/EP333667-EP38346-EP660371.pdf; STATE OF DEL., GENERAL OBLIGATION BONDS, at 5 (Oct. 14, 2009), *available at* http://emma.msrb.org/EP336423-EP38706-EP660738.pdf; STATE OF MINN., GENERAL OBLIGATION STATE BONDS, at 7 (Aug. 19, 2010), *available at* http://emma.msrb.org/EA401804-EA314525-EA710222.pdf; STATE OF NEV., GENERAL OBLIGATION (LIMITED TAX) BONDS, at I-10 (Dec. 8, 2010), *available at* http://emma.msrb.org/EP483256-EP376652-EP773599.pdf; STATE OF N.H., GENERAL OBLIGATION REFUNDING BONDS, at 2 (July 14, 2010), *available at* http://emma.msrb.org/EA390897-EA307175-EA702852.pdf; STATE OF N.J., GENERAL OBLIGATION BONDS, at 4 (Dec. 8, 2009), *available at* http://emma.msrb.org/EP367689-EP288730-EP683994.pdf; STATE OF N.Y., GENERAL OBLIGATION BONDS, at 4 (Mar. 22, 2011), *available at* http://emma.msrb.org/EP516513-EP402775-EP800037.pdf; STATE OF N.C., GENERAL OBLIGATION REFUNDING BONDS, at 2 (Aug. 31, 2010), *available at* http://emma.msrb.org/EP458390-EP358290-EP755324.pdf; STATE OF WASH., VARIOUS PURPOSE GENERAL OBLIGATION BONDS & GENERAL OBLIGATION BONDS, at 15 (Feb. 2, 2011), *available at* http://emma.msrb.org/ER450945-ER351277-ER747565.pdf; *see also* Gillette, *supra* note 29 (manuscript at 18-22) (describing state statutes, constitutional provisions, and jurisprudence relating to state immunity).

41. COMMONWEALTH OF PA., GENERAL OBLIGATION BONDS, at 5 (May 19, 2010), *available at* http://emma.msrb.org/EP427869-EP336168-EP732480.pdf; STATE OF MICH., FULL FAITH AND CREDIT GENERAL OBLIGATION NOTES, at 4 (Sep. 30, 2010), *available at* http://emma.msrb.org/EP364902-EP286561-EP681763.pdf; STATE OF TENN., GENERAL OBLIGATION BONDS, at 6 (Oct. 27, 2010), *available at* http://emma.msrb.org/EP462971-EP360341-EP757350.pdf.

benefit of creditors, or even a broader range of constituents. There is no estate, not just for purposes of liquidation, but for any purposes to do with satisfying the collective claims against the bankrupt entity out of its assets.[42] A pool of assets might be allocated for such a purpose with state consent (for example, by special appropriation), but the device does not derive from bankruptcy law or technique.

Another key consequence of immunity is states' limited ability to commit to perform under their contracts, or even their enactments, including statutory and constitutional repayment priorities.[43] The dearth of available commitment devices can push states to risky debt management practices.[44] To reassure creditors, nation-states have issued debt denominated in foreign currencies[45] or indexed to valuable commodities[46] and have progressively shortened the maturities of their debts.[47] U.S. states have paid higher interest rates as economic conditions have worsened and have pledged revenues to secure new borrowing.[48] Inability to commit can be expected to produce unsustainable debt structures prone to distress and default.

Third, immunity appears to blunt certain kinds of collective action problems that have motivated bankruptcy. Immunity acts in important respects like an automatic stay on enforcement, a feature of the U.S. and other bankruptcy regimes, which protects the debtor from lawsuits and protects its

42. There is an analogy to a bankruptcy estate swallowed up by statutory exemptions, particularly common in personal bankruptcy. However, personal bankruptcy exemptions key off the identity of the property, not of the debtor.

43. Jonathan Eaton & Mark Gersovitz, *Debt with Potential Repudiation: Theoretical and Empirical Analysis*, 48 REV. ECON. STUD. 289, 289-90 (1981).

44. *E.g.*, INTER-AM. DEV. BANK, LIVING WITH DEBT: HOW TO LIMIT THE RISKS OF SOVEREIGN FINANCE (2006), *available at* http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=1581016; Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 763 (2004).

45. This technique responds to fears of devaluation and inflation. *See* INTER-AM. DEV. BANK, *supra* note 44, at 245-46.

46. *See* Perry v. United States, 294 U.S. 330 (1935); *see also* Kenneth W. Dam, *From the* Gold Clause Cases *to the Gold Commission: A Half Century of American Monetary Law*, 50 U. CHI. L. REV. 504 (1983) (arguing that indexation is unsustainable).

47. *See* Bolton & Skeel, *supra* note 44, at 793; Jeromin Zettelmeyer, IMF Research Dep't, The Case for an Explicit Seniority Structure in Sovereign Debt (Sept. 29, 2003) (unpublished manuscript) (on file with author); *see, e.g.*, INT'L MONETARY FUND, RUSSIAN FEDERATION: RECENT ECONOMIC DEVELOPMENTS 22 (1999).

48. STEVEN MAGUIRE, CONG. RESEARCH SERV., R41735, STATE AND LOCAL GOVERNMENT DEBT: AN ANALYSIS 5 (2011) (citing data from Thomson Reuters as provided by the Securities Industry and Financial Markets Association).

assets from seizure.[49] Creditors that might ordinarily rush to the courthouse, or to grab the debtor's few possessions, are precluded from doing so where immunity is robust. Even where immunity is incomplete, states enjoy substantial protections from their creditors compared to most debtors outside bankruptcy.

Theories of sovereign debt offer a limited account of the interaction between sovereign immunity and creditor collective action problems. Economic theories emerging out of the developing country debt crisis in the 1980s[50] defined sovereign debt as debt with limited enforcement capacity owing to sovereign immunity.[51] Economists also modeled ways in which sovereign debtors and bank creditors could extract side payments from creditor country taxpayers, who suffered spillover effects of protracted debt default, to help close debt restructuring deals.[52] By the late 1990s, the literature had turned to focus on creditor collective action problems. This shift was motivated by the change in sovereign debt composition. Whereas most of the distressed debt in the 1980s took the form of syndicated loans, at the start of the 1990s, these loans were restructured into tradable bonds,[53] which became the foundation of today's $600 billion emerging market bond market.[54] In the

49. 11 U.S.C. § 362 (2006); *see also* INT'L MONETARY FUND, ORDERLY AND EFFECTIVE INSOLVENCY PROCEDURES (1999), *available at* http://www.imf.org/external/pubs/ft/orderly/index.htm (offering a summary of best practices based on cross-country surveys of corporate insolvency regimes, including the availability of enforcement stays).

50. *See, e.g.*, NANCY BIRDSALL ET AL., DELIVERING ON DEBT RELIEF: FROM IMF GOLD TO A NEW AID ARCHITECTURE 14-15 (2002); WILLIAM R. CLINE, INTERNATIONAL DEBT REEXAMINED 72-79 tbls.2.10, 2.11, & 2.12 (1995).

51. *Compare* Jeremy Bulow & Kenneth Rogoff, *Sovereign Debt: Is To Forgive To Forget?*, 79 AM. ECON. REV. 43, 46-47 (1989) (arguing that reputation sanctions are alone insufficient to support repayment), *with* Harold L. Cole, James Dow & William B. English, *Default, Settlement, and Signalling: Lending Resumption in a Reputational Model of Sovereign Debt*, 36 INT'L ECON. REV. 365, 367-68 (1995) (noting debt repayment as a signal of borrower quality to attract capital inflows), *and* Eaton & Gersovitz, *supra* note 43, at 289-90 (finding debt repayment driven by reputational need to keep borrowing). For a comprehensive review of economic theories of sovereign debt repayment in the legal literature, see William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. 1, 13-17 (2004).

52. *See, e.g.*, Bulow & Rogoff, *supra* note 20, at 644. For an overview and update, see Jeremy Bulow, *First World Governments and Third World Debt*, 2002 BROOKINGS PAPERS ON ECON. ACTIVITY 229, 229-31.

53. *See* ANNE O. KRUEGER, INT'L MONETARY FUND, A NEW APPROACH TO SOVEREIGN DEBT RESTRUCTURING 6-7 (2002), *available at* http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf.

54. BANK OF INT'L SETTLEMENTS, BIS QUARTERLY REVIEW, SEPTEMBER 2011 app. at 117 tbl.12D (2011), *available at* http://www.bis.org/publ/qtrpdf/r_qa1109.pdf.

newer literature and policy analysis, the eventual success of the 1980s restructurings (such as it was) was attributed to debt form and creditor identity, not debtor immunity. Unlike regulated banks, bondholders were expected to rush to the courthouse. Simultaneously, they were expected to hold out in debt restructuring negotiations, free riding on the concessions of others and later litigating for full repayment. As sovereign financing shifted from commercial bank loans to bonds—where creditors were more numerous, diverse, dispersed, and less subject to suasion by regulators—renegotiation appeared to present a virtually insurmountable challenge.[55] In the late 1990s, fearing chaos and contagion, officials in wealthy countries and international financial institutions appeared to be chronically averse to bond restructuring and prone to bailouts.[56] The early 2000s policy response, partly driven by bailout aversion, included heavy official pressure to change foreign sovereign bond contracts to facilitate collective renegotiation,[57] and a failed effort to establish a more robust, treaty-based sovereign debt restructuring mechanism under the auspices of the International Monetary Fund.[58] This response echoes

55. *See, e.g.*, KRUEGER, *supra* note 53, at 6-8. New York law's documentation conventions for sovereign bonds—like the bond contracts of U.S. states—required unanimous consent of the bondholders to amend the financial terms of an obligation. The conventions consequently appeared to give ammunition to individual creditors to hold up restructurings for side payments or to hold out and free-ride on others' concessions. Moreover, bondholders were expected to rush to the courthouse to attach the scant bits of sovereign property abroad not shielded by immunity. *See, e.g.*, BARRY EICHENGREEN & RICHARD PORTES, CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS (1995); GRP. OF TEN, THE RESOLUTION OF SOVEREIGN LIQUIDITY CRISES: A REPORT TO THE MINISTERS AND GOVERNORS PREPARED UNDER THE AUSPICES OF THE DEPUTIES (1996), *available at* http://www.bis.org/publ/gten03.pdf.

56. *See* Bi et al., *supra* note 20, at 5-8 (addressing the gap between pervasive expectations of coordination failure and the relatively smooth restructuring experience since the late 1990s). A proposal by U.S. Under Secretary of the Treasury John Taylor for reforms in sovereign bond contracting made a particularly tight link between coordination problems and bailouts. John B. Taylor, Under Sec'y of the Treasury for Int'l Affairs, Sovereign Debt Restructuring: A US Perspective, Speech at the Institute for International Economics Conference: Sovereign Debt Workouts: Hopes and Hazards (Apr. 2, 2002), *available at* http://www.iie.com/publications/papers/paper.cfm?ResearchID=455.

57. Official pressure helped bring about a wholesale shift in sovereign bond documentation beginning in 2003. Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627 (2006).

58. INT'L MONETARY FUND, PROPOSED FEATURES OF A SOVEREIGN DEBT RESTRUCTURING MECHANISM (2003), *available at* http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf.

the collective action rationale for bankruptcy, including the historical evidence of holdout behavior in municipal bonds in the 1930s.[59]

Experience with debt default and restructuring in the 1990s and 2000s, mostly involving pre-2003 bonds, did not bear out the collective action theories. Although a smattering of high profile lawsuits and holdout settlements took place over the past two decades, on the whole, the period saw a surprisingly smooth progression of sovereign bond restructurings, with default periods shrinking over time.[60] Even under restrictive sovereign immunity with its commercial activity exception, precious few creditors succeeded in disrupting restructurings or secured disproportionate recovery. Bond exchange techniques, including exit consents and minimum participation thresholds, brought relatively quick debt relief for a dozen or so countries.[61]

Although this recent history should give comfort to states, immunity protection is limited: enforcement still bites when states consent to be sued or when a sovereign country has commercial property outside its borders. However, where immunities are robust (as for U.S. states borrowing at home), debtors may find them preferable to an automatic stay in bankruptcy. Unlike a stay, sovereign immunity cannot be lifted by a judge on statutory or equitable grounds. Immunity also reduces the incentive for creditors to hold out for a higher payout in a debt restructuring. Although immunity cannot bind holdouts as bankruptcy might, the holdout has few remedies if the state refuses to pay on the old obligation. However, to the extent a debt restructuring frees up cash flows for payment, some creditors may hold out in hope that a state would choose to repay for reputational or other reasons, even if it cannot be compelled to do so.

2. *States Live Forever*

This is a well-rehearsed distinction with three implications for debt management. First, states cannot be liquidated. Liquidation marks the effective end of life for a firm, terminates the debtor's obligations, and serves as a valuation backstop, a benchmark for what creditors as a group would collect if

59. *See, e.g.*, McConnell & Picker, *supra* note 24, at 450-51 (describing the passage of the first federal municipal bankruptcy statute in response to holdout negotiators).

60. *See* Bi et al., *supra* note 20, at 5-8; Ugo Panizza, Frederico Sturzenegger & Jeromin Zettelmeyer, *The Economics and Law of Sovereign Debt and Default,* 47 J. ECON. LITERATURE 651, 675-76 (2009) (surveying the recent empirical literature on sovereign debt and finding reduced periods of capital market exclusion).

61. *See* Bi et al., *supra* note 20, at 7-8, 14-15 (examining history and developing a theoretical model); Panizza et al., *supra* note 60, at 672-73.

debt adjustment negotiations fail. Nonsovereign municipalities can be dissolved both voluntarily and against their will. In the United States, cities dissolve all the time outside bankruptcy; scholars have also proposed liquidating cities as part of municipal bankruptcy reform.[62] In contrast, liquidation is not available to states, which cannot be extinguished or absorbed into a larger sovereign entity without their consent.

Second, immortality makes it harder to assess solvency. With no prospect of liquidation, there is no good time to value assets less liabilities.[63] State debt is almost never repaid, is usually refinanced, and may be rescheduled in perpetuity under highly malleable growth and tax revenue projections and assumptions about discount rates.[64] States do not normally engage in general purpose borrowing against a stock of assets—which cannot be liquidated—but against growth prospects and revenue streams.[65] In theory, it is possible to determine the present value of all state debts and measure it against cash on hand; in practice, state solvency tends to be measured in cash flow terms, and the term "solvency" is often displaced by the contested concept of debt sustainability.[66]

62. Michelle Wilde Anderson, *Dissolving Cities*, 121 YALE L.J. (forthcoming April 2012), *available at* http://ssrn.com/abstract=1919768 (describing municipal dissolution law and practice); McConnell & Picker, *supra* note 24, at 429-34 (arguing for dissolution and liquidation of municipalities).

63. I address the distinct question of finding state assets available to satisfy liabilities *infra* Subsection I.A.4.

64. Citibank chairman Walter Wriston famously put himself in an awkward spot when Mexico suspended debt payments in 1982, arguing that countries cannot be insolvent, just illiquid. Walter B. Wriston, Op-Ed., *Banking Against Disaster*, N.Y. TIMES, Sept. 14, 1982, at A27, *available at* http://hdl.handle.net/10427/57558. The rapidly evolving argument about Greek and Italian debt sustainability under different growth and interest rate assumptions illustrates the continuing challenge. Gisela Vagnoni & James Morrison, *Italy Under Fire in Widening Euro Debt Crisis*, REUTERS, Aug. 2, 2011, *available at* http://www.reuters.com/article/2011/08/02/us-eurozone-idUSTRE7712HB20110802.

65. *But see* Fano v. Newport Heights Irrigation Dist., 114 F.2d 563, 565-66 (9th Cir. 1940) (rejecting a municipal debt adjustment plan as not serving the creditors' best interests, due to the unencumbered assets owned by the municipality and its capacity to raise taxes). This notion is distinct from the practice of borrowing against dedicated revenue streams and project finance.

66. *See Debt Sustainability Analysis*, INT'L MONETARY FUND, http://www.imf.org/external/pubs/ft/dsa/index.htm (last visited Aug. 29, 2011); *see also* Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructurings*, 53 EMORY L.J. 1115, 1155 (2004) (discussing state insolvency in cash flow terms); *cf. In re* City of Bridgeport, 129 B.R. 332, 338 (Bankr. D. Conn. 1991) (applying the requirement that a municipality be insolvent to file for protection under Chapter 9 of the U.S. Bankruptcy Code, and concluding that Bridgeport was not currently

Third, immortality creates new constituents and time consistency problems. States that issue long-term debt can shift the debt burden to distant generations.[67] This is distinct from similar problems caused by the political cycle, where a government may have the incentive to borrow and spend in the present, knowing that it will not be in office when the debts come due.[68] Future generations may benefit from past borrowing if the proceeds are invested in sound capital projects (for example, public infrastructure) and properly amortized over time; they are unlikely to benefit from ancestral borrowing for current consumption. Whether future generations are owed formal duties is secondary; regardless, they have an economic stake in today's debt management.

3. *A State's Core Constituents Are Noncontractual and Outside Its Capital Structure*

States issue debt and have contractual creditors, much like private firms. However, contracts in general and debt contracts in particular define only a sliver of any state's constituents, which include present and future citizens, residents, property owners, taxpayers, and all manner of contract counterparties. State "management" (government) is ultimately accountable to a diffuse, shifting set of stakeholders, whose economic interests in the public enterprise may vary, but most of whom have no express financial or contractual claim on the government.

In contrast, the capital structure of a private firm reflects contractual tradeoffs of payment priority for management control. It is an important firm governance tool, which determines the identity and incentives of firm constituents to a significant extent. Thus corporate debt is a claim with high distribution priority in bankruptcy and limited management control over a solvent firm. Equity is the reverse. Preferred stock is in the middle. Incentives to monitor, reorganize, liquidate, and gamble for resurrection follow from this

insolvent and could continue to pay its bills for now, though it was likely to lose this capacity soon).

67. MAGUIRE, *supra* note 48, at 9-10 (describing "fiscal illusion" and "debt capitalization" theories). Future corporate shareholders must opt into the firm structure, including the legacy of past borrowing. Future citizens often have no choice.

68. ALBERTO ALESINA, NOURIEL ROUBINI & GERALD D. COHEN, POLITICAL CYCLES AND THE MACROECONOMY (1997) (elaborating the relationship between the political cycle and fiscal and monetary policies).

hierarchy.[69] This is not to say that a firm's stakeholders are limited to its contractual counterparties—for example, Elizabeth Warren's famous vision of bankruptcy policy is based on a vastly broader conception of firm constituents.[70] Yet even hers is an exercise in expanding bankruptcy's remit beyond the contractual core, not upending the implications of firm structure.[71]

For states, the link between repayment and control, or between capital structure and governance, generally fails. The much-remarked absence of equity holders, or residual claimants, is just one symptom of the overall predicament.[72] "Control" for quasi-sovereigns is a function of sovereignty and citizenship, not debt and equity. Citizens exercise some control in a representative democracy, but where the state has ceded part of its sovereignty, its citizens may have lost a measure of control.[73] Governments have very limited capacity to cede public management to creditors in debt contracts. Where they exist, constitutional and contractual debt repayment priorities are conferred unilaterally by the state, without concomitant oversight prerogatives.[74]

69. Changes in corporate reorganization practice that favor creditor control illustrate the way in which contractual counterparties can adapt to the changing business context, even as they continue to use contracts and bankruptcy rules respecting contractual priorities to maximize their advantage. Douglas G. Baird & Robert K. Rasmussen, *Reply: Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003), and David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003), give influential accounts of the change in bankruptcy practice and examine their implications.

70. *See* Warren, *supra* note 13.

71. *See id.*; *see also* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 61-63 (1996) (arguing against the effective subordination of involuntary creditors, such as tort victims).

72. Like states, nonprofit firms have no residual claimants. They owe duties to beneficiaries and, to a lesser extent, to creditors and donors. However, such firms are normally organized for a limited set of purposes and have a much narrower, more stable, and more homogeneous set of contractual beneficiaries. Nonprofit organization reflects a relationship between financial contracts and governance, albeit one different from the relationship underlying for-profit firms. *See* MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS (2004); Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655 (1998); Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631 (1998) (describing the contractual basis for governing nonprofit firms). Nonprofit firm bankruptcy tracks the basic features of corporate reorganization and liquidation. *See, e.g.*, Stephanie Strom, *Charities Now Seek Bankruptcy Protection*, N.Y. TIMES, Feb. 19, 2009, http://www.nytimes.com/2009/02/20/us/20bankrupt.html.

73. *Cf.* Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1057-58 (1997) (illustrating the awkward parallel between the treatment of control and contractual counterparties in municipal and private bankruptcy). Government agency problems are unlike those of a firm, and not nearly as susceptible to contractual solutions.

74. *See infra* notes 120-123 and accompanying text.

The missing link between contracts, capital structure, and governance makes states more like individuals, whose autonomy is a paramount value.[75] In this respect, the state-individual comparison may be fruitful. On the other hand, states have a vastly broader range of constituents than individuals by virtue of their public functions, to which I turn next.

4. *Quasi-Sovereigns Perform General Government Functions*

States' expansive, residual public mandate distinguishes them from all private debtors, state-owned commercial enterprises, and certain special-purpose municipal entities. States have ultimate responsibility for the welfare of their residents and act as "insurers of last resort" against all manner of shocks and economic downturns.[76] This residual responsibility varies among states and over time, but it has become an important feature of the modern welfare state over the course of the 20th century. For example, U.S. states administer essential safety net programs such as Medicaid, mostly but not entirely funded by the federal government.[77] For quasi-sovereigns, the federal compact allocates responsibility for providing public services in normal times, and contingent liability in the event of a shock or a downturn. This allocation is dynamic: when its own budget is stressed, the central government may shift responsibilities on to states; at other times, it may step in to take over local

75. Robert K. Rasmussen, *Integrating a Theory of the State into Sovereign Debt Restructuring*, 53 EMORY L.J. 1159, 1179 (2004) (comparing sovereign and personal bankruptcy, including the "fresh start" objective in U.S. personal bankruptcy); Skeel, *States of Bankruptcy*, *supra* note 8, at 4 (arguing that personal bankruptcy is a more appropriate analogy for a U.S. state regime than corporate bankruptcy).

76. DAVID A. MOSS, WHEN ALL ELSE FAILS: GOVERNMENT AS THE ULTIMATE RISK MANAGER 253-91 (2002). Private firms may assume social safety net obligations by contract, or be assigned responsibilities by law. They are not the default backstop.

77. *Id.* at 289-91; Jonathan Rodden, *Market Discipline and U.S. Federalism*, *in* WHEN STATES GO BROKE: UNDERSTANDING THE FISCAL AND POLITICAL CRISIS IN THE AMERICAN STATES (David A. Skeel, Jr. & Peter Conti-Brown eds., forthcoming 2012) (manuscript at 4, 10, 12) (on file with author); Damon A. Silvers, *Obligations Without the Power to Fund Them—The Origins, Consequences and Possible Solutions to the Fiscal Crisis of the States*, *in* WHEN STATES GO BROKE: UNDERSTANDING THE FISCAL AND POLITICAL CRISIS IN THE AMERICAN STATES (David A. Skeel, Jr. & Peter Conti-Brown eds., forthcoming 2012) (manuscript at 5, 12) (on file with author) ("Prior to the New Deal, what passed for countercyclical spending in the United States was done at the state or local level. . . . [D]ivided responsibility for countercyclical spending has been a feature of the United States' governmental structure since the New Deal.").

functions.[78] However, federalism does not do away with quasi-sovereigns' residual responsibility for the welfare of their citizens. More often than not, this responsibility is concurrent, much like state and federal taxing authority.[79] State insolvency neither cuts off the need for essential services nor automatically displaces their provider.

5. Quasi-Sovereigns Have Distinct Sources of Revenue and Expenditure Constraints

States collect revenues by taxing their constituents, charging fees for public services, and operating state-owned enterprises; they may also receive investment income.[80] In addition, quasi-sovereigns in a fiscal union receive revenues from, and remit revenues to, the central government. Where taxes and fiscal transfers are important, these revenue streams change debtor incentives.

It is usually safe to assume that private debtors will strive to increase revenues; it is not safe to assume the same for states. This is because economic growth and revenue go hand in hand for firms and individuals, but a state needs the intervening step of taxation to turn growth into revenue. That everyone is for growth, but not everyone is for taxes, has implications for debt policy. Private bankruptcy delivers debt relief and, indirectly, a framework for stakeholders to debate how (not whether) to maximize revenues. For public debtors, the debate about revenues goes to the heart of distribution politics, quite apart from economic growth and viability.[81] Neither bankruptcy judges nor contractual creditors have the democratic legitimacy to compel revenue

78. *See* David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2586-91 (2005); Alice M. Rivlin, *Another State Fiscal Crisis: Is There a Better Way?* (Brookings Inst. Policy Brief No. 23, 2002), *available at* http://www.brookings.edu/~/media/Files/rc/papers/2002/12useconomics_rivlin/pb23.pdf (describing cyclical pressures on state budgets and federal response).

79. Super, *supra* note 78, at 2586-88. Super suggests that collaboration and shared responsibility are among the defining characteristics of fiscal federalism, in contrast to regulatory federalism. *Id.*

80. For example, Alaska receives a significant amount of investment revenue through the Alaska Permanent Fund. *See* Press Release, Alaska Permanent Fund Corp., Permanent Fund at $40 Billion, Gains 20.6 Percent in FY11 (Aug. 2, 2011), *available at* http://www.apfc.org/home/Content/home/index.cfm (click "news archive" and then select the 8/02/2011 press release) (reporting that the Alaska Permanent Fund Corp. earned $2.1 billion on its investments in the 2011 fiscal year).

81. *See infra* Section II.A (discussing debt overhang theory).

measures. Maximizing revenues may even be off the table. Bankruptcy can help structure a conversation about debt and growth; it has no power over taxes.[82]

Clayton Gillette has argued for letting federal courts impose tax increases on local authorities seeking protection under Chapter 9 of the U.S. Bankruptcy Code.[83] As he himself suggests, this proposal has limited payoff for states.[84] For municipalities, federal bankruptcy is available alongside state bailouts. This choice of remedy in debt distress distorts incentives. Most importantly, municipalities can threaten to file for bankruptcy to extract more favorable conditions in state bailouts. Letting courts impose tax increases in bankruptcy reduces the appeal of bankruptcy to opportunistic debtors. This should discourage holdup behavior, and ultimately diminish moral hazard from both bankruptcy and bailouts.[85]

Arguments for giving courts the power to force tax increases either fall flat or sound very different for quasi-sovereigns—even without regard to the serious constitutional concerns that would arise from federal judicial interference with the taxing prerogatives of sovereign state legislatures. Gillette suggests (and I agree) that U.S. federal authorities cannot and should not credibly commit never to bail out a constituent state, because the spillover effects from state default are more likely to be systemically disruptive.[86] In contrast, few municipal failures would precipitate systemic risk; many go unnoticed.[87] Where a bailout is plausible, the parallel availability of bankruptcy would create holdup opportunities, giving states bargaining power to weaken federal bailout conditionality. The result contributes to moral hazard in debt

82. *See* Levitin, *supra* note 21, at 35-36.

83. Gillette, *supra* note 22.

84. Gillette, *supra* note 29 (manuscript at 29-30).

85. Gillette's other arguments for tax increases in municipal bankruptcy are less relevant to states. Where localities get poorly targeted subsidies from the blanket federal tax exemption for their debt, letting federal bankruptcy courts have a say over local tax policy may improve targeting and deter overborrowing. Gillette and other scholars have argued that federal courts already have implicit powers to impose tax increases in Chapter 9 bankruptcy, deriving from their ability to find the locality ineligible to file, or to deny approval of its debt adjustment plan. *See* Gillette, *supra* note 22; Kordana, *supra* note 73; McConnell & Picker, *supra* note 24. Because U.S. judges already consider local taxing capacity implicitly (as part of solvency and best interest determinations), asking them to do so explicitly should improve decisionmaking.

86. Gillette, *supra* note 29; Rodden, *supra* note 77 (manuscript at 10-11) (considering spillovers and interconnectedness among grounds for bailouts). Overall, Rodden is optimistic about the U.S. federal government's capacity to commit not to bail out most of the time, although recent crisis response might suggest otherwise going forward. *See id.* at 11-12.

87. Anderson, *supra* note 62; Kimhi, *supra* note 14.

management. Empowering bankruptcy courts to raise state taxes might be a sensible response to moral hazard where bankruptcy exists, but it is not a reason to introduce bankruptcy in the first place.[88] Giving federal courts jurisdiction over state taxes would raise uncomfortable questions of legitimacy and competence. State consent to jurisdiction might allay concerns about the legitimacy of judicial decisions to distribute state taxes and services, but not about judicial competence to distinguish between sovereign inability and unwillingness to pay. In sum, giving bankruptcy courts the power to intervene in state tax matters has fewer advantages and as many, or more, disadvantages than giving courts the same power over municipalities.

Taxes are a peculiar venue of competition among states, with no analogue among private debtors. Where labor and capital are mobile—more likely within a federal union than across international borders—jurisdictions will try to attract them with lower tax rates. The theory is that lower rates support economic activity and thereby boost revenues.[89] However, where taxes are set too low, states may not bear the full cost of a revenue shortfall in a downturn. The more deeply integrated their economies, the more the failure of one state threatens all of the others, and the more leverage each state has to secure a bailout from the others—or from the federal government, in the form of fiscal transfers.[90]

88. Similarly, because courts do not now supervise state debt reorganization, the argument for letting them consider state taxes openly because they already do so quietly does not apply to states.

89. Jude Wanniski, *Taxes, Revenues, and the "Laffer Curve,"* PUB. INT., Winter 1978, at 3-4. A distinct but related view is that local governments compete by adjusting their revenue-expenditure mix to attract perfectly mobile consumers of public services; residents are sorted into optimal communities based on the value they attach to public goods. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956). Lower taxes are not a necessary outcome of this model.

90. *See* Gillette, *supra* note 22; Wallace E. Oates, *Toward a Second-Generation Theory of Fiscal Federalism,* 12 INT'L TAX & PUB. FIN. 349, 360 (2005); Steven B. Webb, *Fiscal Responsibility Laws for Subnational Discipline: The Latin American Experience* 2 (World Bank, Policy Research Working Paper No. 3309, 2004), *available at* http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2004/07/23/000090341_20040723152347/additional/127527322_20041117151057.pdf.

Fiscal transfers are particularly important for quasi-sovereigns.[91] In theory, each level of government must internalize its costs; in practice, "bailouts" are structurally embedded in a fiscal union, and go both ways. Thus, David Super observes that U.S. federal authorities have a wide range of tools at their disposal to support constituent states, including direct transfers, federalizing services, assigning revenue streams, and granting new revenue sources to states.[92] Because money is fungible, all of these tools can do the work of a bailout. Some bailouts are specified ex ante, or as ongoing subsidies, while others come ex post. Even ex post bailouts need not be unexpected; federal intervention may well be presumed in response to spillovers from state failure.[93]

91. Full sovereigns can receive fiscal transfers, too—in the form of foreign aid for budget support, or emergency balance of payments assistance, which, when rolled over multiple times, becomes indistinguishable from budget support. Some countries rely on aid for long periods of time. When they do so, aid becomes a structural component of the sovereign's budget. For quasi-sovereigns in a fiscal union, transfers are embedded in the constitutional compact. See *infra* Subsection I.B.2 for a discussion of embedded bailouts and the distinction between sovereign and quasi-sovereign debtors.

92. Super, *supra* note 78, at 2560-61.

93. *See, e.g.*, Wallace E. Oates, *On the Theory and Practice of Fiscal Decentralization*, *in* INSTITUTIONAL FOUNDATIONS OF PUBLIC FINANCE: ECONOMIC AND LEGAL PERSPECTIVES 165, 176 (Alan J. Auerbach & Daniel N. Shaviro eds., 2008). Europe's recent experience with "no-bailout clauses" illustrates the difficulty of legislating against this structural predicament even in the absence of a formal fiscal union. *See e.g.*, Consolidated Version of the Treaty on the Functioning of the European Union art. 125, Mar. 30, 2010, 2010 O.J. (c 83) 47 ("The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project."). *But see id.* at art. 122(2) ("Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned."). *See generally Default Lines: What Would Happen if a Member of the Euro Area Could No Longer Finance Its Debt?,* ECONOMIST, Dec. 3, 2009, http://www.economist.com/node/15016124 (discussing potential crisis resolutions). At the international level, multilateral financial support of sovereign states offers a limited analogy to federal support of quasi-sovereign constituent states. However, while federal support may be constitutionally and politically embedded, international bailout support—to the extent it is available—is likely case-by-case, conditional, and contingent.

In contrast, private entities are presumptively self-sufficient, even if some (banks and people) are subsidized and insured.[94]

With respect to expenditures, quasi-sovereigns face countercyclical demands as a function of their residual social welfare mandate: at all levels of government, claims on public services increase in a downturn, as tax and other revenues drop.[95] A private debtor's fortunes may, but need not, move with the business cycle; only a few industries enjoy reliably countercyclical demand (gold, guns, and mental health services are classic examples). In the United States, idiosyncratic institutional arrangements limit states' capacity and incentives to meet countercyclical demands. For example, balanced budget requirements across U.S. states can prompt state governments to cut spending in a downturn and, in Oregon, to cut revenues in a boom.[96] Such measures treat governments as if they were private firms; the result is to exacerbate the effects of the economic cycle. Procyclical state laws push against federal macroeconomic policy.[97]

Beyond their relationship to the business cycle, some quasi-sovereign expenditures may be constitutionally protected. When a private firm unilaterally defaults on, or purports to change, its pension contracts, it may be liable on a contract or under federal pension laws. Similarly, when a U.S. state unilaterally changes its pension contracts, it may be liable for violating provisions of the federal and state constitutions.[98] In the past, courts applied the "gratuity approach" to state pension obligations, which allowed states to cut pensions with impunity; more recently, courts have used different constitutional theories to make it much harder for states to walk away when their own pension contracts are at issue.[99]

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94. *See* Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L.J. 951 (1992) (considering the meaning of "bailouts" for private entities).

95. Rodden, *supra* note 77 (manuscript at 11); Silvers, *supra* note 77 (manuscript at 7-10) (describing countercyclical mandates coinciding with declining revenues).

96. *See* Assoc. Press, *Oregon Ready To Send Rebates, Some as High as $100,000*, MAIL TRIB. (Bedford, Or.), Nov. 28, 2007, http://www.mailtribune.com/apps/pbcs.dll/article?AID=/20071128/NEWS07/711280329.

97. *See* Rodden, *supra* note 77 (manuscript at 9); Super, *supra* note 78, at 2559.

98. *See, e.g.*, U.S. CONST. art I, § 10, cl. 1; U.S. Trust Co. v. New Jersey, 431 U.S. 1 (1977); Whitney Cloud, Comment, *State Pension Deficits, the Recession, and a Modern View of the Contracts Clause*, 120 YALE L.J. 2199 (2011). Cloud's treatment of pension obligations stands in partial contrast to market borrowing, such as bond issuance, where unilateral restructuring or default would not normally trigger a Contracts Clause problem, as noted earlier.

99. Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL'Y 617, 622-25 (2010).

6. States Are Few, Firms Are Many

Yet another characteristic of state debtors is the small number of states compared to private debtors. A state bankruptcy chapter in the United States would help at most fifty debtors. A global sovereign bankruptcy regime would help fewer than two hundred. This stands in contrast to the many millions of private debtors and thousands of nonsovereign localities now living "in the shadow" of a bankruptcy regime.[100] Each of the sovereign debtors is "too big to fail"; however, their small numbers make ad hoc, bespoke restructuring feasible. Whether ad hoc intervention is also desirable depends on its merits relative to bankruptcy.

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In sum, quasi-sovereign states as debtors are quite unlike private firms and individuals. They have a robust shield from creditors in the form of sovereign immunity, a perpetual lifespan, a broad spectrum of irreducible public functions and stakeholders, and a peculiar mix of highly cyclical, constitutionally constrained, and politically fraught revenues and expenditures. Adapting private debt restructuring techniques for such debtors would require very different assumptions about the incentives of all the actors involved, as I elaborate further in Part III. Before proceeding to consider debt restructuring, I will briefly compare quasi-sovereigns with other kinds of public debtors.

B. Quasi-Sovereign and Other Public Debtors

The preceding Section described fundamental differences between quasi-sovereigns and private debtors. Quasi-sovereigns are also different from indebted nation-states and localities. Differences between quasi-sovereign and fully sovereign debtors are of degree. They stem from a combination of legal arrangements and economic realities, such as constitutions formally ceding sovereignty, economic and political integration among members of a federation, and the spillover effects of distress in one jurisdiction for the others and for the federation as a whole. On the other hand, differences between quasi-sovereigns and nonsovereign localities come back to sovereignty: one has original authority, autonomy, and immunity, and the other does not.

100. *See, e.g.*, Skeel, *supra* note 8, at 9-10 (observing that the effect of bankruptcy law is not limited to actual filers, because the mere possibility of filing changes the incentives for all potential debtors and creditors).

Some of the key differences between quasi-sovereign and other public entities have appeared earlier in the Feature as asides in my comparison of quasi-sovereigns and private debtors. What follows is a catalogue and elaboration of these points, along with several new ones.

1. *Quasi-Sovereigns Have Countercyclical Responsibilities but Limited Scope for Macroeconomic Policy*

Quasi-sovereign states are in an odd position: on the one hand, they are responsible for cushioning the effects of the economic cycle through spending on welfare, health, and public safety; on the other hand, they have ceded important macroeconomic policy prerogatives to the central government. Fiscal federalism can dampen cyclical pressures with transfers (bailouts) or amplify them with unfunded service mandates to constituent states.[101] Similarly, as noted earlier, quasi-sovereign states may reinforce or push against federal macroeconomic management in response to internal political pressures (for example, cutting taxes in a boom). Each state's bargaining position vis-à-vis the central government is a function of its unique resource endowment and other structural and political factors.[102]

The difference between sovereigns and quasi-sovereigns is even starker in monetary policy. Quasi-sovereigns normally do not print their own money.[103]

101. *See, e.g.*, Super, *supra* note 78; Rivlin, *supra* note 78.

102. *See, e.g.*, Richard C. Schragger, *Decentralization and Development*, 96 VA. L. REV. 1837 (2010) (arguing that distribution of authority between local and central government is more likely to follow than precede economic endowment and development).

103. By "money" here I mean a medium of exchange that serves as mandatory legal tender throughout the federal entity. This is distinct from "scrip," or quasi-money, occasionally issued and honored by subsovereign and private entities. *See generally* INT'L MONETARY FUND, ARGENTINA: STAFF REPORT FOR THE 2002 ARTICLE IV CONSULTATION 34 (IMF Country Report No. 03/226, July 2003), *available at* http://www.imf.org/external/pubs/ft/scr/2003/cr03226.pdf (describing the issuance of quasi-money by Argentine provinces during financial crisis); Stephanie Simon, *Cash-Strapped California's IOUs: Just the Latest Sub for Dollars*, WALL ST. J., Jul. 25, 2009, http://online.wsj.com/article/SB124846739587579877.html (describing Depression-era and modern-day scrip issuance by public and private entities); Loren Gatch, Local Scrip in the USA During the 1930s: Lessons for Today? (Sept. 2006) (unpublished manuscript), *available at* http://www2.socioeco.org/bdf/_docs/local_scrip_in_the_usa-gatch.pdf (describing scrip issuance by states, localities, and firms); Bruce Champ, Fed. Reserve Bank of Cleveland, *Stamp Scrip: Money People Paid To Use*, ECON. COMMENT. (Apr. 2008), *available at* http://www.clevelandfed.org/Research/commentary/2008/0408.pdf (describing municipalities and firms issuing scrip during the Great Depression). Ceding monetary sovereignty as part of a federal arrangement is also distinct from the voluntary adoption by fully sovereign states of another sovereign's currency. For example, a number of smaller economies have adopted the U.S. dollar or the euro as their

In some federal arrangements, including one that has obtained for over a century in the United States, central monopoly over money is an essential attribute of the union, a vehicle for deeper economic integration, and an important policy tool. Giving up monetary policy autonomy means, among other things, that a state cannot increase the money supply to stimulate its economy and cannot print money to pay off its debts. The result is a hard budget constraint, as in a country that can only borrow in foreign currency.[104]

Currency unions are a twist on the idea of monetary sovereignty. For example, members of the eurozone have a domestic currency (the euro) over which they have little control because of the narrow price stability mandate and institutional design of the region's central bank.

2. *"Bailouts" of Quasi-Sovereigns Are Embedded in Fiscal Federalism*

Quasi-sovereign and central authorities operate concurrently and can substitute for one another in many areas; the precise allocation of work between them varies across federal arrangements.[105] The relationship also varies over time: economic or political change can prompt repeated renegotiation over resources and responsibilities.[106] The process and outcome of such negotiations are not always transparent. This view of fiscal federalism as a dynamic negotiation at the extreme implies that the precise boundaries of the quasi-sovereign economy are uncertain. In contrast, fully sovereign states are more plausibly like stand-alone enterprises: it is possible to consider their "consolidated" economies in static isolation for long enough to determine the need for debt adjustment and the prospects for rehabilitation.

Except where the boundary between the sovereign and quasi-sovereign fisc appears to be firmly fixed, bailouts—extraordinary fiscal transfers—are structurally embedded in the federal system. Such transfers may be overt or covert. Especially when they are covert, one would expect more moral hazard among quasi-sovereigns than other debtors. Theory holds that subnational

currency. Such sovereigns can unilaterally recapture monetary sovereignty without violating treaties or constitutions.

104. While instilling discipline in distress, this attribute also takes away a sanction in default: for example, Jeffrey Sachs's classic theory of sovereign debt cites currency runs as a major consequence of sovereign default. *See* Jeffrey Sachs, *The Debt Overhang of Developing Countries*, *in* DEBT, STABILIZATION AND DEVELOPMENT 80 (Guillermo Calvo et al. eds., 1989). *But cf.* Panizza et al., *supra* note 60 (discussing domestic disciplining mechanisms on sovereign default).

105. *See* Super, *supra* note 78.

106. *Id.*; *see* Liu & Waibel, *supra* note 3, at 18-19; Webb, *supra* note 90.

entities know they are "too big to fail" and expect to be bailed out through readily available, but nontransparent, channels.[107] As a result, they overborrow and refuse to adjust (for example, by raising taxes).[108]

One way to counter such incentives is with firm commitments against fiscal transfers, such as Europe's infamous "no-bailout" clause.[109] Such blunt commitment devices are tested in crisis. At this writing, EU treaties have been creatively interpreted to permit bilateral and regional bailout facilities for Greece, Portugal, and Ireland.

Expectations of a bailout also make it easier for quasi-sovereigns to engage in tax competition: the consequences of a revenue shortfall would spill over to the rest of the union, increasing the prospects of a bailout. For their part, private creditors may not discipline subnational debtors where they believe they are lending against central government credit.[110] Tools to counter moral hazard, such as legal debt limits at the quasi-sovereign and local levels, run up against sovereign commitment problems. They are routinely evaded and ignored, and have a terrible record of advancing their stated goal of fiscal probity.[111]

Spillover effects and contagion are also used to justify extraordinary transfers, or bailouts, at the international level. Yet the background

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107. *See* Clayton P. Gillette, *Can Public Debt Enhance Democracy?*, 50 WM. & MARY L. REV. 937, 976-77 (2008); *see also* Gillette, *supra* note 22, at 51-52; John Petersen & Mila Freire, *Political, Legal, and Financial Framework*, *in* SUBNATIONAL CAPITAL MARKETS IN DEVELOPING COUNTRIES, *supra* note 28, at 21 (describing moral hazard from central government bailouts); Rodden, *supra* note 77 (manuscript at 1-2); Webb, *supra* note 90, at 3 (describing agency problems in the subnational-central government relationship, bailout expectations, and the trading of political and fiscal favors between the two levels of government).

108. *See* MARK BALDASSARE, WHEN GOVERNMENT FAILS: THE ORANGE COUNTY BANKRUPTCY 13 (1998) (contending that the origin of Orange County's 1994 default was the passage of Proposition 13 in 1978, which placed strict limitations on property tax increases and effectively crippled local government's ability to increase revenue).

109. Treaty on the Functioning of the European Union, *supra* note 93, art. 125, ¶ 1.

110. Gillette, *supra* note 22 (manuscript at 41).

111. AMDURSKY & GILLETTE, *supra* note 4, § 4 (describing state and municipal evasion of debt limits, among other ways, by redefining capped "debt"); Richard Briffault, *Foreword: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907 (2003) (describing evasion and restrictive interpretation of state fiscal limits, and arguing that they are ineffective); Richard C. Schragger, *Democracy and Debt*, 121 YALE L.J. 860, 868-71 (2012) (describing state fiscal limits as ineffective and undesirable); Mark Tran, *What Is the Stability and Growth Pact?*, GUARDIAN (London), Nov. 27, 2003, http://www.guardian.co.uk/world/2003/nov/27/qanda.business (describing German and French breaches of the fiscal discipline provisions in the treaty framework establishing the Euro); Webb, *supra* note 90, at 16-17 (concluding that statutory debt limits have been ineffective at disciplining subnational borrowing in Latin America).

presumption among governments and market participants alike is reversed where sovereignty is not concurrent, and where economic integration is limited. Procedural barriers to bailouts for full sovereigns are high: the International Monetary Fund cannot quietly pick up Greece's welfare bill any more than the United States can secretly stick Canada with the cost of road construction in Ohio. With economic and financial integration, the outcomes may converge—bailouts for all. However, it is important to recognize that private firms, sovereigns, and quasi-sovereigns arrive at bailouts from very different places.[112]

3. Quasi-Sovereigns Have Distinct Immunities

While amply covered in the preceding Section, this point bears emphasis. Foreign sovereign immunities are grounded in public international law, and are codified in national statutes such as the Foreign Sovereign Immunities Act in the United States, the State Immunity Act in the United Kingdom, and others like them.[113] Quasi-sovereigns' immunities are a function of domestic law. In the United States, they are grounded in state common law, the Eleventh Amendment to the Constitution, and background jurisprudential rules,[114] which together grant more robust protections to U.S. states than they or the U.S. government enjoy as borrowers in the international capital markets. Quasi-sovereigns in different federal arrangements may be in a weaker position at home, which would make bankruptcy protections more valuable to them.

4. Sovereign and Quasi-Sovereign States Face Different Sanctions for Debt Nonpayment

Recent empirical research on the debt of fully sovereign states has cast doubt on the role of creditor collective action problems in sovereign debt restructuring and on the effect of traditional enforcement and reputational sanctions in compelling debt repayment by immune states.[115] As noted earlier, bond restructurings since the 1990s have proceeded relatively smoothly; holdout litigation was minimal; and most restructurings did not cut sovereigns

112. *See* discussion *supra* note 98 and accompanying text for the discussion of bailouts for private firms compared to quasi-sovereigns.

113. Foreign Sovereign Immunities Act of 1976, 28 U.S.C. § 1610 (2006); State Immunity Act, 1978, c. 33 (U.K.), *available at* http://www.legislation.gov.uk/ukpga/1978/33.

114. ORTH, *supra* note 23.

115. *See* Panizza et al., *supra* note 60; discussion *supra* Subsection I.A.1.

off from the capital markets for a significant amount of time.[116] Nevertheless, most countries continued paying their debts over the past two decades. In a survey of empirical studies, Ugo Panizza and colleagues suggest that governments may have been motivated by fear of domestic disruptions from sovereign default: bank runs, capital markets contagion, domestic effects of collapsing currencies, failure of important domestic constituents, and broader social unrest.[117] One implication from the survey is that home bias in the financial system might soften the sovereign budget constraint in distress, but can also be a source of discipline against default.

Domestic sanctions can be diffuse for quasi-sovereigns. They would bite where, for example, financial institutions within the defaulting state have concentrated holdings of its debt, where market contagion disproportionately affects issuers within the state, or where the creditors most directly affected by default also are important constituents of the defaulting government. Put differently, a quasi-sovereign that can regulate or strong-arm local residents into holding its debt might be able to postpone default, but would face a stronger local backlash from it. The disruption and political backlash would be attenuated where local bank and pension fund investments are geographically diversified.

The difference between Europe and the United States in this area is instructive. There is no evidence that banks and pension funds in U.S. states hold dangerous levels of their state government securities.[118] One might even

116. *See* R. Gaston Gelos, Ratna Sahay & Guido Sandleris, *Sovereign Borrowing by Developing Countries: What Determines Market Access?*, 83 J. INT'L ECON. 243 (2011) (failing to detect significant punishment of defaulting countries by the capital markets). *But see* Juan J. Cruces & Christoph Trebesch, *Sovereign Defaults: The Price of Haircuts* (CESifo Grp., Working Paper No. 3604, 2011), *available at* http://www.ifo.de/portal/pls/portal/docs/1/1210242.PDF (arguing that deep sovereign debt reduction is associated with prolonged market exclusion).

117. Panizza et al., *supra* note 60.

118. Over 70% of all state and local debt in the United States is held by individuals and mutual funds. *See Frequently Asked Questions About Municipal Bonds*, INVESTMENT COMPANY INSTITUTE (Mar. 2008), http://www.ici.org/policy/markets/domestic/faqs_muni_bond. State and local debt stands at less than 1% of all capital for federally chartered banks, and a little over 2% for state-chartered banks. *See Statistics on Depository Institutions*, FDIC http://www2.fdic.gov/sdi/index.asp (last visited Dec. 9, 2011) (search for "All Commercial Banks" and "All Savings Institutions" within "Standard Peer Groups" and then generate "Securities" reports in "Percent of Assets" terms); Michael Corkery, *In Muni-Bond Ills, Danger and Hope*, WALL ST. J., Feb. 9, 2011, http://online.wsj.com/article/SB10001424052748703960804576119870629891478.html (describing bank holdings of municipal debt). In contrast, Greek bank holdings of sovereign debt from the eurozone periphery are roughly double their capital. *See* Adrian Blundell-Wignall & Patrick Slovik, *A Market Perspective on the European Sovereign Debt and Banking Crisis*, 2010 OECD JOURNAL: FINANCIAL MARKET TRENDS 1, 16 (Feb. 2011), *available at* http://www.oecd.org/dataoecd/19/

expect a bias away from home-state debt, whose chief attraction is its tax-exempt status, among entities such as U.S. pension funds that benefit from their own tax exemptions. In contrast, eurozone banks show strong bias in favor of home state debt: for example, according to recent examinations by European bank regulators, Greek, Irish, and Portuguese banks were heavily invested in Greek, Irish, and Portuguese government securities, respectively.[119] As a result, the threat of banking sector collapse provides a powerful incentive against sovereign default for Greece, but not Illinois.

5. Quasi-Sovereigns Issue Debt of Varied Repayment Priority

All the debt of fully sovereign states generally ranks *pari passu*; formal sovereign priority structures tend to be extremely flat. Causes may include immune sovereigns' inability to commit, their legal and political inability to trade off repayment priority for enhanced governance, as well as some combination of inertia and network effects in sovereign debt contracts.[120] However, commentators have pointed out that this apparent flatness is misleading: creditors unable to secure credible commitment of priority repayment raise interest rates and shrink maturities.[121]

Against this background, it is puzzling that some U.S. states appear to have constitutional, statutory, administrative, and contractual priority systems for distributing revenues among various claimants. At least six states report apparent hierarchies of repayment priority in their general obligation

9/46970598.pdf. Bank holdings of quasi-sovereign debt vary across countries and federal arrangements. For example, Brazil is more like Europe than the United States: major Brazilian banks were the leading creditors of Brazilian states, and state default would have damaged the banking system. *See* Rodden, *supra* note 76, at 8, 13 (describing the risk of Brazilian state debt to Brazil's banking system, comparing Europe, and contrasting the United States, where banks are minor creditors).

119. EUR. BANKING AUTH., *supra* note 20, at 28-29, *available at* http://stress-test.eba.europa.eu/pdf/EBA_ST_2011_Summary_Report_v6.pdf (reporting that the Greek banks hold 67% of Greek sovereign debt considered in the stress test, with the Irish and Portuguese ratios at 61% and 63%, respectively).

120. *See, e.g.*, Lee C. Buchheit & Jeremiah S. Pam, *The* Pari Passu *Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869, 911-17 (2004); Mark Weidemaier, Robert Scott & Mitu Gulati, *Origin Myths, Contracts, and the Hunt for* Pari Passu, LAW & SOC. INQUIRY (forthcoming 2012), *available at* http://ssrn.com/abstract=1633439.

121. *See, e.g.*, EDUARDO BORENZSTEIN ET AL., INT'L MONETARY FUND, OCCASIONAL PAPER NO. 237, SOVEREIGN DEBT STRUCTURE FOR CRISIS PREVENTION 9 (2004); NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS: RESPONDING TO FINANCIAL CRISES IN EMERGING ECONOMIES 305-06 (2004); Bolton & Skeel, *supra* note 44, at 770-72; Zettelmeyer, *supra* note 47.

disclosure documents;[122] priorities range from public education in California, to water bonds in New Jersey, to revenue anticipation notes in New York.[123] Some states, such as California, accord superior legal status to priority obligations; others, like Massachusetts, disclose repayment procedures that accord de facto priority.[124] Like all sovereign undertakings, such quasi-sovereign promises to follow pre-specified payment priorities might be hard to enforce. I know of no studies of state compliance with priority undertakings; however, there have been no reports of U.S. states violating the promised order of repayment.

Quasi-sovereigns are also unlike full sovereigns for using dedicated revenue streams and collateral to secure debt repayment. Secured sovereign debt is negligible to nonexistent at the national level. In contrast, two-thirds of all U.S. state and local government debt issued between 1996 and 2010 was backed by specific revenues, a practice motivated in important part by internal constitutional and legislative restrictions on debt accumulation.[125] The implications of secured public debt are mixed and depend on the terms. On the one hand, a commercial asset or revenue stream pledged to a subset of creditors may be unavailable for urgent public expenditures; some assets also have political salience. (Natural resources and historical relics are often cited as examples of inalienable patrimony.) On the other hand, revenue bonds can offer a form of limited liability and even countercyclical debt management, where recourse is limited to the revenue stream from an investment project, with no separable claim on the state treasury.

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122. *See supra* note 39 and accompanying text (informal fifty-state survey on file with author). Arkansas, California, Massachusetts, New Jersey, New York, and Wisconsin disclose mandatory or expected payment hierarchies among state liabilities in connection with their general obligation bond issues. *See* STATE OF ARK., FEDERAL HIGHWAY GRANT ANTICIPATION AND TAX REVENUE REFUNDING BONDS (GENERAL OBLIGATION), SERIES 2010, at 42-45 (June 1, 2010), *available at* http://emma.msrb.org/EP440411-EP344657-EP741177.pdf (detailing hierarchy of priority payments out of Revenue Fund); STATE OF CALIF., GENERAL OBLIGATION BONDS app. A at A-26 (Nov. 8, 2010), *available at* http://emma.msrb.org/EP478437-EP372944-EP769866.pdf (enumerating the order of priority payments provided under the State Constitution); COMMONWEALTH OF MASS., *supra* note 40, at A-9 (describing order of repayment); STATE OF N.J., *supra* note 40, at 3-4; STATE OF N.Y., *supra* note 40, at 4 (referencing provisions in state law controlling disbursement and payment); STATE OF WIS., GENERAL OBLIGATION BONDS OF 2011, SERIES A, at 2 (Jan. 12, 2011), *available at* http://emma.msrb.org/EP490254-ER348940-ER745185.pdf (disclosing that an appropriation to pay general obligation bonds was made as a "first charge" on state revenues).

123. STATE OF CALIF., *supra* note 122, at A-26; STATE OF N.J., *supra* note 40, at 3-4; STATE OF N.Y., *supra* note 40, at 4-5.

124. COMMONWEALTH OF MASS., *supra* note 122, at A-9.

125. AMDURSKY & GILLETTE, *supra* note 4, at § 1.2.4; MAGUIRE, *supra* note 48, at 5.

The differences between full and quasi-sovereigns in this regard appear to be contingent, a matter of market practice. Both enjoy robust immunities, and nothing in theory prevents fully sovereign states from pledging collateral or adopting priority schemes on the model of U.S. states. In practice, *pari passu* and negative pledge undertakings in existing debt contracts could make a switch difficult for full sovereigns. Moreover, quasi-sovereign priority commitments may be more credible thanks to the expressly political and local content of particular priority schemes (for example, valuing education in California, and clean water in New Jersey). This may be difficult to replicate at the sovereign level.

6. Quasi-Sovereigns Are Sovereign; Localities Are Not

Differences between quasi-sovereign debtors and nonsovereign counties, districts, and municipalities generally come back to the constituent attributes of sovereignty, especially autonomy and immunity. Perhaps most importantly, nonsovereign localities have limited immunities.[126] For example, U.S. courts have held that Eleventh Amendment protections do not extend to municipalities, which may be sued in federal courts; historically, federal authorities have been more open to enforcing judgments against municipal officials.[127] Quasi-sovereign advantage here is partial, because national and state laws can shield nonsovereign governments despite their lack of sovereignty. For example, even though nonsovereign municipalities in the United States may be sued, their public property generally remains protected from attachment.[128] Immunity is presumptive for quasi-sovereigns; for nonsovereigns, its effects must be simulated with other protections. To the extent quasi-sovereigns have stronger immunities, they are more insulated from collective action problems that might interfere with nonsovereign debt management. Chapter 9 municipal bankruptcy in the United States came about partly in response to creditor holdout behavior that blocked municipal debt adjustment, as well as a spate of lawsuits against municipal officials during the Great Depression.[129]

Localities' authority is not concurrent with, but subject to, state sovereign power. Localities need state permission to file for federal bankruptcy

126. ORTH, *supra* note 23, at 110-20.

127. *Id.* at 118.

128. McConnell & Picker, *supra* note 24, at 430-32.

129. *Id.* at 449-50.

protection.[130] Sovereign authority over localities, even where it is exercised to support and protect them, gives quasi-sovereign states tremendous policy leverage in distress: they can demand reform in exchange for protection, threaten dissolution, or simply leave the locality at the mercy of its creditors. Localities' bargaining power comes from the risk and magnitude of spillover effects of local failure for the rest of the state.

As noted earlier, quasi-sovereign states are "indestructible."[131] Nonsovereigns can be dissolved or liquidated without their consent.[132] While liquidation may be extreme, the practice of stripping municipalities of substantially all policy authority is widespread in the form of control and oversight boards.[133]

These differences are important, but they should not be overblown. At least in the United States, nonsovereign localities are still treated as political entities, whose public character entitles them to judicial deference. Chapter 9 prevents federal judges from interfering with political decisionmaking and steers clear of the revenue aspects of municipal management.[134]

* * *

In sum, quasi-sovereigns resemble other public debtors more than they resemble private firms and individuals. However, the similarities are incomplete. Fiscal federalism limits the scope for economic policy at the quasi-sovereign level. The risk of moral hazard for quasi-sovereign debtors may be higher, owing to robust immunities and capacity to extract bailouts in an integrated union. Sovereignty and fiscal federalism thus import a distinct set of debtor incentives. In contrast, municipalities face a higher risk of lawsuits and creditor collective action problems; they are subject to more robust sanctions in the form of sovereign oversight and potential loss of autonomy and therefore,

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130. United States v. Bekins, 304 U.S. 27, 51 (1938) (upholding a revised municipal bankruptcy statute including the requirement of state consent to municipal filing).

131. *Id.* at 53; see *supra* Subsection I.A.2.

132. McConnell & Picker, *supra* note 24, at 483. *See generally* Anderson, *supra* note 62 (describing dissolution practices).

133. *See, e.g.*, Thomas W. Waldron, *House Approves Oversight Board for Bankrupt D.C.*, BALT. SUN, Apr. 4, 1995, http://articles.baltimoresun.com/1995-04-04/news/1995094073_1_oversight-board-oversight-panel-mayor-and-city; *New York City Fiscal Oversight*, OFF. ST. COMPTROLLER, http://www.osc.state.ny.us/osdc/index.htm (last visited Oct. 24, 2011).

134. Gillette, *supra* note 22 (manuscript at 11-12).

at least in theory, should have less trouble committing to repay.[135] The distinctions between sovereign and nonsovereign debtors are particularly consequential for considering bankruptcy.

II. QUASI-SOVEREIGN DEBT: DISTRESS, RELIEF, AND RESTRUCTURING

People, firms, and states alike borrow for two broad reasons: current consumption and investment. They may also borrow to refinance maturing obligations, without net new consumption or investment. Borrowing can smooth fluctuations in consumption and spread the cost (and tax burden) of productive investment over time. Like people and firms, states may run out of funds to service their debt obligations because their revenues fall, their expenses rise, their investments fail, or they cannot refinance their debts in the markets. As with theories of private debt, theories of sovereign debt distress begin with debt overhang—a condition where the debtor has too much debt and cannot engage in productive investment. However, theoretical grounds for sovereign debt relief go beyond debt overhang to include concerns about autonomy and legitimacy. These evoke ideas about fresh start in personal bankruptcy,[136] and equitable sanctions in bankruptcy, corporate, and debtor-creditor law.[137]

My task in Part II is to identify grounds for and obstacles to quasi-sovereign debt relief. Although quasi-sovereigns may evoke some of the same

135. In the past, this view translated into market risk premiums: "In 1889, Wall Streeters ranked municipal bonds second only to federal securities. Because cities and counties could be compelled to pay up if necessary, they enjoyed a high credit rating." ORTH, *supra* note 23, at 118 (citation omitted).

136. *See, e.g.*, Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1393 (1985) ("The principal advantage bankruptcy offers an individual lies in the benefits associated with discharge. Unless he has violated some norm of behavior specified in the bankruptcy laws, an individual who resorts to bankruptcy can obtain a discharge from most of his existing debts in exchange for surrendering either his existing nonexempt assets or, more recently, a portion of his future earnings. Discharge not only releases the debtor from past financial obligations, but also protects him from some of the adverse consequences that might otherwise result from his release. For these reasons, discharge is viewed as granting the debtor a financial 'fresh start.'" (footnotes omitted)).

137. *See, e.g.*, 11 U.S.C. § 510(c)(1) (2006) (giving bankruptcy courts discretion to subordinate a claim, used as a sanction for creditor misbehavior); Lee C. Buchheit, G. Mitu Gulati & Robert B. Thompson, *The Dilemma of Odious Debts*, 56 DUKE L.J. 1201, 1240-51 (2007) (drawing analogies to fraud and corporate misconduct problems); David Gray Carlson, *The Logical Structure of Fraudulent Transfers and Equitable Subordination*, 45 WM. & MARY L. REV. 157 (2003) (discussing equitable subordination of creditors outside bankruptcy).

broad rationales for debt adjustment as firms and people, they face distinct challenges in achieving relief.

A. Public Debt Overhang (Efficiency)

Leading theories of sovereign debt distress start with Paul Krugman's and Jeffrey Sachs's adaptations of the debt overhang theory to sovereigns, arguing that an overindebted government will not be able to attract voluntary new lending for productive investment owing to the confiscatory tax burden required to pay off the debt.[138] In particular, Krugman's model focuses on creditor choices; when he proposed it, private creditors were repeatedly refinancing their loans to Latin American governments suffering from debt overhang. Refinancing preserved an option value for the creditors, on the slight chance the debtor could grow out of its debt burden without debt reduction. The theory hinges on the insight that preserving this option value comes at a cost of distorting the public debtors' incentives, since any benefits of economic reorganization (or adjustment) would go to the creditors.

Showing that there exists a theoretical point of overindebtedness is different from finding that point. 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. When the surplus is not enough, the debtor may be illiquid or insolvent; regardless, the next creditor in line does not get paid. Taxing and borrowing capacity—reflecting politics and market liquidity—obviously affect the threshold; with quasi-sovereign states, fiscal transfers play a prominent role.[139] As a result, quasi-sovereign debt management collapses two important distinctions: between inability and unwillingness to pay, and between illiquidity and insolvency.[140] Debt sustainability methodology attempts to recast the question of sovereign

138. Paul Krugman, *Financing vs. Forgiving a Debt Overhang*, 29 J. DEV. ECON. 253 (1988); Sachs, *supra* note 103, at 80.

139. *See In re* City of Bridgeport, 129 B.R. 332, 336 (Bankr. D. Conn. 1991) (holding that a municipality's ability to pay debts as they become due thanks to fiscal transfers prevents a claim of insolvency until funds run dry).

140. *Cf.* FEDERICO STURZENEGGER & JEROMIN ZETTELMEYER, DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISES 31-47 (2006) (summarizing the literature on inability and unwillingness to pay and emphasizing the thin distinction between the two for sovereigns).

insolvency as a predicate for debt reduction.[141] It is notoriously flawed and fiercely contested;[142] it is also the only game in town.

With no liquidation backstop, no agreed solvency threshold, no higher authority to mandate debt restructuring, and no clear line between inability and unwillingness to pay, the timing of sovereign debt relief is usually fiercely contested. In most cases, the debt restructuring option is invoked too late in hindsight—a problem that sovereign bankruptcy proposals have sought to solve.[143] One pragmatic fix is to condition outside funding to a cash-strapped sovereign on debt restructuring. At this writing, this has been the position of the European Union with respect to Greece since July 2011.[144] The solvency threshold and timing problem can be overcome for quasi-sovereigns by withholding fiscal transfers, which would go to repay debt that should be restructured. The prospect of spillovers from default, discussed at length in Part I, detracts from the utility of this tool for sovereigns and quasi-sovereigns alike.

141. *See, e.g.*, *Debt Sustainability Analysis*, *supra* note 85.

142. *See e.g.*, CARMEN M. REINHART & KENNETH S. ROGOFF, A DECADE OF DEBT 21 (2011) (arguing that a debt stock of over 90% of a country's annual gross domestic product undermines growth, even for wealthy countries); *Heavily Indebted Poor Countries Initiative*, JUBILEE DEBT CAMPAIGN, http://www.jubileedebtcampaign.org.uk/Heavily%20Indebted%20Poor%20Countries%20initiative+97.twl (last visited Nov. 12, 2011) (criticizing the World Bank's and the IMF's sustainability metric for poor countries, set at one and a half times the country's annual exports).

143. *E.g.*, Anne Krueger, First Deputy Managing Dir., Int'l Monetary Fund, International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring, Address at National Economists' Club Annual Members' Dinner (Nov. 26, 2001), *available at* http://www.imf.org/external/np/speeches/2001/112601.htm ("[C]ountries facing severe liquidity problems often go to extraordinary lengths to avoid restructuring their debts to foreign and domestic private creditors. Even an orderly restructuring can impose severe economic costs and devastate the domestic financial system; a disorderly restructuring can block a country's access to private capital for years to come, making an already bad situation even worse."); *see also* INT'L MONETARY FUND, THE DESIGN OF THE SOVEREIGN DEBT RESTRUCTURING MECHANISM—FURTHER CONSIDERATIONS 4 (2002), *available at* https://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf; ANNE O. KRUEGER, A NEW APPROACH TO SOVEREIGN DEBT RESTRUCTURING (2002), *available at* http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf; Hagan, *supra* note 17, at 362 ("[T]he problem to date has been the fact the restructurings are too late rather than too early."); Anne Krueger, First Deputy Managing Dir., Int'l Monetary Fund, Sovereign Debt Restructuring and Dispute Resolution, Address at the Bretton Woods Committee Annual Meeting (June 6, 2002), *available at* http://www.imf.org/external/np/speeches/2002/060602.htm.

144. Jan Strupczewski & Harry Papachristou, *Greek Haircut Under Review, No New Euro Zone Aid Until November*, REUTERS, Oct. 3, 2011, *available at* http://www.reuters.com/article/2011/10/03/us-eurozone-idUSTRE79211720111003.

B. *Jubilee and Odious Debt (Autonomy and Legitimacy)*

The need for debt reduction in Krugman's and Sachs's models comes from inefficiency. Moral and political justifications for government debt relief may point to failings apart from inefficiency, such as the inability to provide for basic human needs or the illegitimate provenance of the debt.

A civil society movement advocating debt relief for the poorest countries in the late 1990s invoked the biblical concept of Jubilee.[145] The accompanying papal proclamation advanced a distinct set of grounds for relief:

> The human race is facing forms of slavery which are new and more subtle than those of the past; and for too many people freedom remains a word without meaning. Some nations, especially the poorer ones, are oppressed by a debt so huge that repayment is practically impossible. . . . The abuses of power which result in some dominating others must stop: such abuses are sinful and unjust.[146]

In this formulation, too much debt is not simply inefficient; it is an immoral abuse of power and denial of human dignity. The Jubilee movement drew on ideas of dignity and fresh start that also underpin personal bankruptcy to support demands for debt reduction for sovereign states.[147] The movement has secured dramatic debt relief for some of the world's poorest countries from bilateral and multilateral creditors; it continues to press for more.[148]

Another rationale for sovereign debt relief steps even further away from the traditional efficiency reasoning, as it does not depend on the amount of debt at issue. The theory of "Odious Debt," found variously in judicial decisions,[149]

145. *Leviticus* 25:8-14 (decreeing every fiftieth year a "jubilee year," and mandating among other things the liberation of slaves); *see The Holy See—Jubilee* 2000, HOLY SEE, http://www.vatican.va/jubilee_2000 (last visited July 11, 2011); Mac Krzyzewski, *15 Years Later: The Jubilee Movement*, BLOG DEBT (Apr. 20, 2011, 2:28 PM), http://jubileeusa.typepad.com/blog_the_debt/2011/04/15-years-later-the-jubilee-movement.html.

146. Pope John Paul II, *Incarnationis Mysterium: Bull of Indiction of the Great Jubilee of the Year 2000*, § 12 (1998), http://www.vatican.va/jubilee_2000/docs/documents/hf_jp-ii_doc_30111998_bolla-jubilee_en.html.

147. *See, e.g.*, Jackson, *supra* note 136, at 1393.

148. *Factsheet: Debt Relief Under the Heavily Indebted Poor Countries (HIPC) Initiative*, INT'L MONETARY FUND (Sept. 6, 2011), http://www.imf.org/external/np/exr/facts/hipc.htm (noting the Multilateral Debt Relief Initiative); JUBILEE DEBT CAMPAIGN, *supra* note 142.

149. Great Britain v. Costa Rica, 1 R.I.A.A. 375 (1923) (distinguishing state succession from presumption of continuity in government obligations).

treaty history,[150] and the writings of some early twentieth-century scholars,[151] holds that debt incurred by a state without the authority and not in the interests of its people is unenforceable. Policy and academic interest in the theory revived in the mid-2000s, when Iraq sought to renegotiate over $100 billion in debt incurred by Saddam Hussein.[152] Although Iraq ultimately declined to use the theory, Ecuador used a version in 2009 to secure dramatic concessions from creditors threatened with nonpayment on illegitimacy grounds.[153] Because debt relief came at a time when Ecuador was enjoying surplus oil revenues and did not claim unsustainability, some criticized the operation as an instance of pure unwillingness to pay.[154] Because it does not rest on economic necessity, the Odious Debt doctrine would give legal sanction to unwillingness to pay.

Although Odious Debt theory is grounded in state succession and at first blush seems unique to full sovereigns, scholars have found ready parallels in private law.[155] Private debt that has been fraudulently incurred, or whose proceeds were misappropriated with the knowledge of the creditors (much as a dictator might misappropriate the proceeds of a public debt issue into her offshore bank account), may not be enforceable under contract, agency, and corporate law doctrines. The outcomes closely track the goals of Odious Debt.

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150. ERNST H. FEILCHENFELD, PUBLIC DEBTS AND STATE SUCCESSION 337-42 (1931) (describing debt negotiations following the Spanish-American War).

151. A.N. SACK, LES EFFETS DES TRANSFORMATIONS DES ÉTATS SUR LEURS DETTES PUBLIQUES ET AUTRES OBLIGATIONS FINANCIÈRES 157-58 (1927), *quoted in* PATRICIA ADAMS, ODIOUS DEBTS: LOOSE LENDING, CORRUPTION, AND THE THIRD WORLD'S ENVIRONMENTAL LEGACY 165-66 (1991).

152. Scholarship advocating and responding to the revival of Odious Debt doctrines after the fall of Saddam Hussein includes Seema Jayachandran & Michael Kremer, *Odious Debt*, 96 AM. ECON. REV. 82, 83 (2006), which presents a leading economic account of the Odious Debt doctrine, and proposes financial sanctions as a policy response; Symposium, *Odious Debts and State Corruption*, 70 LAW & CONTEMP. PROBS., Summer & Autumn 2007.

153. REPUBLIC OF ECUADOR, NOTEHOLDER CIRCULAR, at iii-iv (Apr. 20, 2009), *available at* http://blogs.reuters.com/felix-salmon/files/2009/04/noteholder-circular-goe-bond-offer.pdf (Letter from the Minister of Finance); *id.* at 18 (Considerations Relating to the Republic).

154. *See, e.g.*, Arturo C. Porzecanski, *When Bad Things Happen to Good Sovereign Debt Contracts: The Case of Ecuador*, 73 LAW & CONTEMP. PROBS. 251, 258 (2010).

155. Buchheit et al., *supra* note 137 (proposing to sanction sovereign debt nonpayment where debt proceeds were misappropriated, on the model of contract, agency, and corporate law applicable to private firms).

Scholars, advocates, and policymakers have articulated three distinct arguments for sovereign debt relief, grounded in efficiency, autonomy, and legitimacy—which map onto theories about debt overhang, fresh start/Jubilee, and Odious Debt. These grounds for relief can easily apply to all public debtors without regard to sovereignty. They have counterparts in private debt.

Although efficiency, autonomy, and legitimacy concerns motivate bankruptcy and debtor-creditor laws, it bears emphasis that none of them requires bankruptcy. Debt overhang, Jubilee, and Odious Debt are all reasons for debt forgiveness. Each may benefit from process legitimacy and coordination techniques found in certain bankruptcy institutions, but that benefit cannot be assumed. Below I turn to consider the process for quasi-sovereign debt restructuring and any gaps that might benefit from bankruptcy's help.

C. Quasi-Sovereign Debt Restructuring

Despite repeated fiscal crises and a rich history of debt defaults throughout the nineteenth century, U.S. states offer few modern-day examples of debt default and restructuring. Arkansas suffered a relatively brief episode of default in 1933, when it tried and failed to replace revenue-backed bonds with faith and credit debt over creditors' objections.[156] Since then, state budget problems have met with a mix of state budget and service cutbacks, federalization of services, and fiscal transfers.[157] Some scholars have argued that the dearth of modern-day state defaults in the United States reflects a learning process going back to nineteenth-century defaults, when the federal government refused to bail out states and municipalities. In this view, states became more prudent borrowers, and their creditors became better risk monitors. In the aftermath of defaults,

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

157. *See, e.g.*, Clayton P. Gillette, *Fiscal Home Rule*, 86 DENV. U. L. REV. 1241, 1241 (2009) (describing states responding to fiscal crises by cutting aid to localities); Super, *supra* note 78, at 2560 (discussing countercyclical federal fiscal transfers). For perspectives on fiscal federalism and responses to municipal debt crises at different times in recent history, see, for example, U.S. GEN. ACCOUNTING OFFICE, HRD-90-34, FEDERAL-STATE-LOCAL RELATIONS: TRENDS OF THE PAST DECADE AND EMERGING ISSUES (1990); U.S. GEN. ACCOUNTING OFFICE, GCD-79-62, REPORT OF THE COMPTROLLER GENERAL: PERSPECTIVES ON INTERGOVERNMENTAL POLICY AND FISCAL RELATIONS (1979); and Rivlin, *supra* note 78. *See also* WILLIAM K. TABB, THE LONG DEFAULT: NEW YORK CITY AND THE URBAN FISCAL CRISIS (1982) (describing the fiscal crisis in New York City, its ramifications for New York State, and the political economy of the federal rescue and restructuring).

states enacted dubious borrowing limitations, but in an effort to circumvent them, tightened the links between debt repayment and revenues.[158] Outside the United States, subnational debt issuance (sovereign or not) is a relatively recent and limited phenomenon.[159] While some countries have begun to experiment with subnational insolvency frameworks,[160] other cases of subnational debt distress have been resolved ad hoc, with a mix of defaults, restructurings, and federal bailouts without recourse to statutory or other standing institutional mechanisms.[161] The lingering crisis in Europe continues to be fertile ground for experimentation. At this writing, members continue to resist large-scale fiscal transfers outside crisis.[162] However, they have committed to temporary and permanent crisis resolution facilities, empowered to lend to distressed member states on strict policy conditions. At the same time, the European Central Bank has been buying member state bonds on the secondary market using its monetary policy authority to counter market disruptions. It

158. Rodden, *supra* note 77 (manuscript at 9-10) (arguing that U.S. states benefit from market discipline following nineteenth-century defaults in the absence of federal bailouts); Isabel Rodriguez-Tejedo & John Joseph Wallis, *Fiscal Institutions and Fiscal Crises*, *in* WHEN STATES GO BROKE: UNDERSTANDING THE FISCAL AND POLITICAL CRISIS IN THE AMERICAN STATES (David A. Skeel, Jr. & Peter Conti-Brown eds., forthcoming 2012) (manuscript at 30) (on file with author) (suggesting that U.S. federal, state, and local governments have adapted in the aftermath of nineteenth-century defaults, to enact constitutions and laws that more closely align borrowing and revenue sources).

159. Liu & Waibel, *supra* note 3, at 2; *see also* WORLD BANK ET AL., CREDIT RATINGS AND BOND ISSUING AT THE SUBNATIONAL LEVEL (1999) (an early-stage training manual for developing countries); Rodriguez-Tejedo & Wallis, *supra* note 158 (manuscript at 3) (noting the enormous size of the U.S. state debt market compared to the rest of the world).

160. Rodriguez-Tejedo & Wallis, *supra* note 158 (manuscript at 4).

161. Argentina offers a high-profile recent example of sub-sovereign debt default and restructuring. Argentina's provinces have borrowed heavily on the international capital markets and in foreign currency. Provincial borrowing stood at 4-6% of GDP in the run-up to the financial crisis of 2001, but rose to 10% of GDP in 2002-04. The central government effectively assumed much of the provincial debt in 2004. In addition, some provinces unilaterally defaulted or restructured their bonds, yet others conducted distressed debt exchanges in the international capital markets. INTER-AM. DEV. BANK, *supra* note 43, at 278-279, *available at* http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=1581016; *see also* Rodrigo Trelles Zabala, *Latin America and the Caribbean: Argentina*, *in* SUBNATIONAL CAPITAL MARKETS IN DEVELOPING COUNTRIES, *supra* note 28, at 231, 238, 258; Moody's, *Why Some Sub-sovereign Ratings in Argentina are Higher than the Sovereign* (Mar. 2010); Standard & Poor's, *A Paradox: Provincial Versus Sovereign Debt Restructuring in Argentina* (Mar. 2004).

162. *Government Analysis: Euro Bonds Would Cost Germany Billions*, SPIEGEL ONLINE INT'L (Aug. 22, 2011), http://www.spiegel.de/international/germany/0,1518,781524,00.html.

has maintained that such operations do not constitute financing for member governments, which is prohibited under its charter and European law.[163]

A cross-country analysis of subnational restructuring experience is an empirical project beyond the scope of this Feature.[164] Instead, this Section draws on the "map" of quasi-sovereign attributes in Part I to consider the likely challenges for managing quasi-sovereign debt distress. These challenges fall under three general themes: debt reduction, economic rehabilitation, and political legitimacy, which I elaborate below. Approaches to debt distress also impact ex ante debt management.

1. Debt Reduction

Quasi-sovereigns have advantages over private debtors and some sovereigns: they are substantially sheltered from litigation and attachment and have a powerful counter to creditor collective action problems in the form of sovereign immunity. As a result, they might be expected to face fewer obstacles on the path to debt relief compared to other debtors, even without bankruptcy. However, reputational, economic-policy, and political constraints may prevent them from pursuing debt reduction at all, in time, or in the optimal amount. To the extent that fiscal federalism creates incentives to externalize debt problems and seek bailouts, it weakens the impetus to seek debt relief. The central challenge of quasi-sovereign debt adjustment then is to help the debtor overcome reputational, economic, and political—not judicial, contractual, or coordination—barriers to restructuring.

163. Decision of the European Central Bank of 14 May 2010 Establishing a Securities Market Programme 2010/281/EU, 2010 O.J. (L 124) 8, *available at* http://www.ecb.int/ecb/legal/pdf/l_12420100520en00080009.pdf; Press Release, Eur. Cent. Bank, Statement by the President of the ECB (Aug. 7, 2011), *available at* http://www.ecb.eu/press/pr/date/2011/html/pr110807.en.html; Press Release, Eur. Comm'n, Treaty Establishing the European Stability Mechanism (ESM) Signed (July 11, 2011), *available at* http://ec.europa.eu/economy_finance/articles/financial_operations/2011-07-11-esm-treaty_en.htm.

164. Liu and Waibel provide valuable recent case studies of subnational debt regulation, and a synthesis of economic theories for regulating subnational debt management. However, they do not address issues of quasi-sovereignty, nor do they offer a comprehensive survey of debt restructuring experiences. *See* Liu & Waibel, *supra* note 3. Similarly, the World Bank volume edited by Freire et al. contains more than a dozen country case studies of subnational borrowing and debt distress, but avoids discussion of sovereignty and its implications. *See* SUBNATIONAL CAPITAL MARKETS IN DEVELOPING COUNTRIES, *supra* note 28.

2. *Rehabilitation*

With respect to rehabilitation, quasi-sovereigns face formidable problems. They may have limited legal, economic, and political capacity to raise revenues from taxation. Statutory and constitutional fiscal limits, however narrow and "disfavored," may still bind at the margin.[165] Raising taxes to pay creditors may be economically inefficient and politically toxic, antagonizing residents and chasing away investors.[166]

On the other hand, immune states have limited capacity to commit to better economic policies, to respect contractual repayment priorities, or even to repay debts going forward. No external power can tell a quasi-sovereign what to do—external commitment is most credible when grounded in dependence on the outside world. This is the crux of conditionality as a vehicle for policy reform, and, on the flipside, the reason why surplus economies can feel insulated from outside policy demands.

Returning a state to viability above all requires internal political support for the mix of public goods provided by the government and revenues it collects going forward, and agreement on loss distribution among taxpayers, service recipients, contractual creditors, and other constituents, including other members of the federal union.

3. *Political Legitimacy*

Political support for quasi-sovereign debt relief and restructuring must go far beyond aligning creditor incentives. All manner of constituents receiving services and paying taxes have to be involved to sustain a restructuring. This bargain must be further coordinated within the federal system, perhaps adjusting the allocation of responsibilities between the quasi-sovereign state and the central government to ensure uninterrupted provision of essential public services. Narrow analogies of taxes to corporate revenues, or of citizens to customers and equity holders, in an effort to replicate "creditors' bargain"

165. *See* sources cited *supra* note 111 and accompanying text.

166. Krugman, *supra* note 138 (grounding sovereign debt overhang theory in the expectation of tax increases for the benefit of creditors). *Compare* Kordana, *supra* note 73 (suggesting that bankruptcy courts have an implied capacity to force tax increases in municipal bankruptcy, and arguing against tax increases), *with* Gillette, *supra* note 22 (arguing that courts should be granted an express power to compel tax increases).

arguments from corporate bankruptcy quickly fail[167]: they miss the core motives, and elevate the marginal attributes, of the protagonists in public debt distress.

Even where all the relevant constituents might agree on a rehabilitation plan, there are no obvious candidates to design it and oversee compliance. Vesting federal courts with design and oversight functions can raise objections on federalism and institutional competence grounds. Such courts may be uniquely ill-equipped to second-guess a constituent sovereign's decisions about distribution of taxes and services. They are not accountable to the people affected and have no fiscal management expertise. Liquidation value and classified voting, which serve as substantive and procedural benchmarks to aid judges in private bankruptcy, are hard to replicate in public debt. The federal executive or an outside creditor, such as an international financial institution, are problematic alternatives. Although such institutions might have more expertise than the courts, their local legitimacy is limited and, with it, the compliance pull. Their conditional funding model might give rise to a presumption of sovereign consent and optimism about compliance: a democratic government voluntarily and specifically agrees to rehabilitation policies in exchange for rescue funds. However, where the debtor is in desperate straits, consent to reforms might be illusory or fragile.

4. Debt Management Incentives

An effective debt restructuring regime should counteract the quasi-sovereign debtor's propensity to overborrow and engage in pro-cyclical fiscal policies in the expectation of federal bailouts, and to compensate for its limited capacity to commit with fragile debt structures. To the extent possible, such a regime should also strive to reduce the time-consistency problems arising both from the state's immortality (such as intergenerational transfers) and the short political horizons of public officials. By implication, a sound restructuring regime would impart better incentives for creditors to monitor quasi-sovereign debt accumulation.

My task in Part III is to consider the extent to which bankruptcy tools might help address these challenges.

167. *See supra* note 13 (citing creditors' bargain scholarship); *cf.* Kordana, *supra* note 73, at 1055-58 (offering a thought experiment transposing the corporate bankruptcy hierarchy on to municipalities).

III. MAPPING TO BANKRUPTCY

Bankruptcy is a historically and culturally contingent set of institutions: bankruptcy in Adam Smith's Scotland shares little with its namesake in today's United States, which in turn only vaguely resembles contemporary bankruptcy in Sweden, Korea, or Brazil. Over time, bankruptcy regimes have negotiated the tension between helping creditors collect and helping debtors get relief and have reduced the spillover effects and deadweight losses of prolonged debt distress.

In the United States, even the essential goals of bankruptcy remain vigorously contested by scholars, despite the fact that its broad remit has been defined by judges. David Skeel observes that after two centuries of U.S. Supreme Court jurisprudence, "bankruptcy has come to include nearly any reasonably comprehensive framework for adjusting a debtor's obligations, providing for payment of creditors, and giving the debtor a discharge."[168]

In the eyes of its supporters and practitioners, bankruptcy gets credit for promoting triage between viable economic actors that should be rehabilitated, and those that are not viable and must be liquidated. Bankruptcy can advance the rule of law by creating a safety valve for modifying unsustainable contracts in an orderly, legitimate process. It can help promote the autonomy and dignity of individual debtors through debt discharge. Theorists have variously imbued bankruptcy with economic efficiency, human dignity, and community values. It is truly a capacious idea.

Bankruptcy has sought to achieve its goals with a distinct set of methods.[169] An automatic stay on debt enforcement can help overcome creditor collective action problems and promote a comprehensive, collective adjustment process.[170] Bankruptcy can offer a framework for collective decisionmaking among the affected stakeholders based on their contractual and statutory endowments, notably including a relatively uniform system of repayment priorities.[171] It can support rehabilitation by allowing debtors to assume or

168. Skeel, *State Bankruptcy from the Ground Up*, *supra* note 8 (manuscript at 5).

169. For a cross-country survey of bankruptcy methods, see LEGAL DEP'T, INT'L MONETARY FUND, ORDERLY AND EFFECTIVE INSOLVENCY PROCEDURES: KEY ISSUES (1999), *available at* http://www.imf.org/external/pubs/ft/orderly/index.htm.

170. *See, e.g.*, 11 U.S.C. § 362 (2006).

171. *See, e.g.*, *id.* §§ 726, 1129(b)(2)(B)(ii). In the United States, uniformity is achieved nationwide by federal statute, under constitutional authority. However, to the extent bankruptcy law respects contractual priorities, it allows for considerable variation within the uniform system.

reject prebankruptcy contracts,[172] and by providing a source of priority interim financing during reorganization.[173] In corporate distress, bankruptcy gets credit for advancing fairness and economic efficiency by ensuring that creditors get no less in a reorganization than they would in liquidation.[174] At its most general, bankruptcy supports orderly debt restructuring and reduces its reputational stigma by extending legal sanction and judicial oversight to the process of discarding otherwise valid contracts. In theory, all these elements together create a background legal regime that supports both out-of-court reorganization ex post and debt management practices ex ante that are consistent with the values of the regime.

What might such a regime hold for quasi-sovereign debtors? David Skeel articulates "core principles" anchoring his state bankruptcy proposal. These are comparable treatment among similarly situated creditors, including a uniform and "coherent" scheme of payment priorities; freedom to modify contracts, including those now protected by state law; capacity of creditor majorities to bind dissenters; and debt discharge to promote a fresh start.[175] In addition, bankruptcy along the lines Skeel describes could help states tap private financial markets during reorganization, reducing the need for public bailouts, and might reduce the stigma of seeking debt relief.

These bankruptcy tools are important. However, more is needed to establish bankruptcy as the preferred solution to quasi-sovereign debt problems. First, a legislature might consider whether these tools would address the core problems with quasi-sovereign debt restructuring; second, whether they would be effective at solving such problems; and third, whether they leave important problems to be solved outside bankruptcy.

Sovereigns and quasi-sovereigns in distress come under pressure to cherry-pick among their constituents, and to alter the prebankruptcy bargain. Their response to such pressure varies with political and economic factors: some may prefer unions or critical service providers, others local banks, yet others foreign bondholders. As Skeel suggests, the practice appears to be unsystematic,[176] as is the range of express contractual and constitutional priorities chosen and announced by the states.

172. *See, e.g.*, *id.* §§ 365, 1113-14.

173. *See, e.g.*, *id.* §§ 364(c)(2), 1129(b).

174. *See id.* § 1129(b).

175. Skeel, *State Bankruptcy from the Ground Up*, *supra* note 8 (manuscript at 7-9).

176. Skeel, *States of Bankruptcy*, *supra* note 8 (manuscript at 13-17) (describing "incoherent" and "schizophrenic" priorities, with "speculative" enforcement prospects).

It is hard to argue with the value of greater predictability and equality in the treatment of similarly situated creditors. Nevertheless, it represents a tradeoff for flexibility in responding to the enormously complex economic and political problems of a few dozen debtors, all too big to fail.[177] "Similarly situated" is hard to define in advance for creditors that wear multiple hats with respect to the state, simultaneously playing banker, customer, and employee.

At a minimum, the diversity of claims, especially noncontractual claims, against a distressed sovereign, would make it harder to structure equal treatment rules. Suppose a state running short of cash faced the choice between paying its retail bondholders, depositors in failed banks, employees, suppliers, pensioners, and hungry children. How might these groups be "classified" for purposes of repayment priority and a bankruptcy reorganization vote? What is the justification for redistributing resources to one or two of the groups at the expense of the others? For private debtors in bankruptcy, these decisions are made primarily by contract and to a lesser extent in background legislation. For sovereigns without bankruptcy, they are often made ad hoc, except in the few cases where constitutional, statutory, or contractual priorities limit sovereign discretion. Of course it is technically possible to devise a classification scheme, and even to put it to a vote. Such a vote would address fundamental questions of distribution and democratic governance; it would be odd to describe it as a bankruptcy matter.

The value of greater uniformity, or coherence, is even less certain. Uniformity is a political choice. For example, unlike many other federal arrangements around the world, U.S. fiscal federalism represents a conscious choice in favor of diversity in economic management,[178] reflected in a small way in some states' apparently scattered decisions to favor education, clean water, or bondholders in their repayment priorities. Although states would presumably have the capacity to opt out of the federal priority system, the content of such a system would be hard to determine, and its utility may be limited, depending on the number of states that choose to opt out.

The ability to assume and reject unperformed contracts can be a valuable tool for debt reduction, but one that raises questions of political legitimacy. With public debtors, unlike private ones, bankruptcy would not just trump private agreements but, more importantly, prior public laws. Where statutory

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177. Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435 (2011); Tarullo, *supra* note 3.

178. *See, e.g.*, Robert D. Behn & Elizabeth K. Keating, *Facing the Fiscal Crises in State Governments: National Problem; National Responsibilities* 2 (Taubman Ctr. for State & Local Gov't, John F. Kennedy Sch. of Gov't, Harvard Univ., Working Paper, 2004), *available at* http://www.hks.harvard.edu/var/ezp_site/storage/fckeditor/file/pdfs/centers-programs/centers/taubman/working_papers/behn_04_fiscalcrisis.pdf.

and constitutional protections for contracts come out of a legitimate political process, they may reflect all manner of values unrelated to debt management or even the daily business of running the government. Put differently, they are not only, and not even primarily, liabilities. It is far from clear that a debate about bankruptcy law is the right forum for arguing about eliminating, changing, or funding such protections.

The need for bankruptcy to bind dissenting creditors ("cramdown"), and even to effect debt discharge, depends on the strength of sovereign immunities. If immunities are robust, creditor collective action problems of all sorts are diffused, because the debtor can simply refuse to pay, extracting concessions from cooperative creditors and ignoring the dissenters. Similarly, discharge is essential where enforcement is a real threat, less so where it is not. The impressive record of sovereign debt restructuring in the 1990s and 2000s, the slim evidence of serious collective action problems among creditors of sovereign or quasi-sovereign debtors, and the fact that some quasi-sovereigns (notably U.S. states) have stronger immunities than full sovereigns all suggest that cramdown and discharge might be less valuable for quasi-sovereigns than they have been for private debtors.

This is not to say that cramdown is worthless for states. Sovereign debtors that have successfully evaded their creditors would no doubt prefer to have no holdouts than to have holdouts barred from collecting by a web of immunities. Defending against creditor lawsuits is expensive, even if you win. Using contractual tools to bind nonconsenting creditors in lieu of bankruptcy can have reputational costs.[179] Even so, cramdown has a very different value for immune debtors than for traditional bankruptcy subjects.

Enforcing priority for new financing would face all the challenges of extracting credible commitment from immune sovereigns. On the one hand, senior private debt financing should reduce bailout demands. On the other hand, where bailouts are conditioned on policy reform, it also limits scant policy leverage. Such priority, which would operate in a state fiscal crisis, may even be perceived as entitled to an implicit federal guarantee, diminishing the anti-bailout effect. Nevertheless, the overall effect may be to reduce federal exposure and introduce a measure of market monitoring—a real benefit.

Finally, the extent to which bankruptcy tools would be effective against reputational barriers to debt restructuring is uncertain. Legal sanction alone is valuable in promoting relief, and a standing bankruptcy regime would certainly provide it. However, reputational factors are also important for sovereign and nonsovereign debtors alike. For quasi-sovereigns, the role of reputation as a

179. Bi et al., *supra* note 20 (discussing exit consents and collective action clauses).

barrier to filing would depend on market and political factors, as well as the terms of the federal arrangement.

In sum, bankruptcy could solve real problems; however, many if not most of these are collateral, and sometimes debatable, impediments to quasi-sovereign debt relief. And for all the virtues of such bankruptcy tools, the list of tools that bankruptcy does *not* bring to the quasi-sovereign restructuring table is impressive.

Bankruptcy would not overcome the quasi-sovereign commitment challenge, which is rooted in sovereign immunity. It adds little to the quasi-sovereign debtor's protections from lawsuits and asset seizures. For private debtors, the bankruptcy shield promotes reorganization. Perversely, if bankruptcy were to fortify states' protection from creditors, it might weaken the incentives for economic adjustment and reform (higher taxes, lower spending, structural change). This effect is in contrast to private debtors, whose stakeholders are presumptively motivated to raise revenues.

Bankruptcy would not perform a triage function by putting poorly managed sovereigns out of commission, while rehabilitating the efficient ones. It has no advantage in creating a constituency for taxes or economic policy reform, although it can help reduce expenditures by making it easier for the debtor to reject problematic contracts. It would not get rid of elected public and politically appointed officials, however inept.

Bankruptcy would not improve quasi-sovereign decisionmaking in distress. A structured, comprehensive, collective process for involving all the necessary constituents in a state debt restructuring must replicate the existing political process at multiple levels of government. This follows from the fact that a quasi-sovereign's set of constituents is not identical to, or even substantially overlapping with, its set of contractual counterparties.

Removing high-pitched political controversy to a more technocratic and bureaucratic venue has its virtues. The ascent of technocratic national unity governments in Greece and Italy illustrates the widespread appeal of technical solutions in political crises. However, if a public debt bankruptcy process is to be truly comprehensive, insulation from political scrutiny is both unrealistic and undesirable. A partial debt adjustment process with respect to a discreet category of debts might be more susceptible to technocratic management. Overhauling core economic structures of the state with a view to rehabilitation is for the political process.

Unless bankruptcy's reputational effect is truly powerful in promoting debt reduction, it would do little to affect quasi-sovereign incentives to demand bailouts and federal incentives to dispense them. As a result, bankruptcy's effect on states' poor ex ante debt management incentives is questionable at best.

It is helpful to consider the benefits of bankruptcy next to a more prosaic alternative, such as federal transfers conditional on policy reform and debt restructuring—"bailouts with strings." This tool is commonly used in federal systems, and internationally by institutions such as the International Monetary Fund and the World Bank, to address crises[180] and promote structural reform.[181] Its record is often criticized.[182] Nevertheless, conditional financing addresses the challenge of comprehensive rehabilitation of quasi-sovereign debtors more directly and transparently than bankruptcy might. Bailouts with strings can leverage existing incentives to provide fiscal transfers in crisis, to achieve substantial policy changes, and perhaps even to help push quasi-sovereign debtors over the tipping point to seek debt restructuring.

Conditional financing faces all the usual sovereign commitment and program design problems. It is often criticized for lack of political legitimacy ("ownership") where the recipient has no choice but to agree to reform in exchange for a financial lifeline. Yet the political legitimacy of conditional federal transfers is more intuitive than that of foreign financing. And even critics acknowledge the occasional capacity of well-designed budget support programs to achieve economic reform in difficult political environments.[183]

CONCLUSION

Quasi-sovereign debtors are a diverse bunch: the scope of their immunities, policy autonomy, and transfer entitlements come from negotiated political compromise, embodied in treaties and constitutional arrangements. Even so, quasi-sovereigns as a group share traits that set them apart from all other debtors. Unlike firms and people, they have public functions and political constituents. Unlike fully sovereign states, they face perverse incentives from

180. *See, e.g.*, INT'L MONETARY FUND, INDEP. EVALUATION OFFICE, EVALUATION REPORT—IMF AND RECENT CAPITAL ACCOUNT CRISES: INDONESIA, KOREA, BRAZIL 41-43 (2003) *available at* http://www.imf.org/external/np/ieo/2003/cac/pdf/all.pdf (describing and criticizing IMF program conditionality); TABB, *supra* note 157, at 28 (describing conditional federal support for New York City).

181. *See, e.g.*, NGAIRE WOODS, THE GLOBALIZERS: THE IMF, THE WORLD BANK, AND THEIR BORROWERS 102-03 (2006) (assessing, for example, the structural adjustment program in Mexico, and the relationship between a sovereign borrower and multilateral creditors).

182. *See, e.g.*, William Easterly, *The Effect of IMF and World Bank Programs on Poverty* (World Bank, Working Paper, 2000), *available at* http://www.imf.org/external/pubs/ft/staffp/2000/00-00/e.pdf. For alternative views, see contributions by Nancy Birdsall, Steven Radelet, and David de Ferranti in CTR. FOR GLOBAL DEV., RESCUING THE WORLD BANK (2006), *available at* http://www.cgdev.org/content/publications/detail/9957.

183. WOODS, *supra* note 181, at 185-86.

fiscal transfers, which can embed and hide bailouts, and let quasi-sovereigns shift the cost of low taxes and high benefits onto the federation. Like sovereign states and unlike nonsovereign localities, they can benefit from immunities that shield them from creditor enforcement and diffuse creditor coordination problems. Such protections create commitment and related moral hazard problems. These and other features can easily make for dysfunctional debt management. This apparent dysfunction seems tailor-made for bankruptcy.

Bankruptcy is a beguiling idea. For private debtors, it variously promises order, efficiency, fairness, dignity, and political legitimacy. State bankruptcy proposals have an impressive pedigree, going back to Adam Smith. Quasi-sovereign debtors face real overindebtedness and incentive problems, as well as formidable legal, economic, and political obstacles to sustainable restructuring and reform.

Nevertheless, bankruptcy's potential contribution to solving quasi-sovereign debt problems is limited. It has no capacity to effect economic policy reform or revenue collection, or to structure broad-based political decisionmaking about economic policy. Where the debtor has robust immunities, bankruptcy does not overcome sovereign commitment problems and adds little to a state's bargaining power against its financial creditors. It may help overcome reputational barriers for quasi-sovereign states seeking debt relief, and it may make debt restructuring by the few eligible debtors more predictable at the margins.

On the cost side of the ledger, a bankruptcy regime would contribute to a narrowing of political space. It can create the illusion of a comprehensive fix, even as it detracts from important debates about distribution and the role and cost of government. This was perhaps the biggest flaw in the International Monetary Fund's proposal for a Sovereign Debt Restructuring Mechanism a decade ago: it was a narrow solution to a narrow set of theoretical collective action problems among the foreign bondholders of a small group of countries. It excluded the vast majority of sovereign debt, such as debt to domestic creditors and debt governed by domestic law. To call such a limited device bankruptcy (still a popular shorthand for the proposal) is to vastly oversell its aspirations while drawing attention away from more fundamental problems of economic management and distribution among the state's many varied constituents.[184] When borrowed, bankruptcy vocabulary is also prone to manipulation: a bailout of a state in a transfer union is neither descriptively nor

184. The Sovereign Debt Restructuring Mechanism proposal is described in Hagan, *supra* note 17. Skeel suggests it fits in the bankruptcy mold in *State Bankruptcy From the Ground Up*, *supra* note 8.

normatively comparable to a bailout of a private bank or manufacturing firm. To be sure, minimal ex ante commitments to a debt restructuring process can be useful;[185] but they should not be confused with cardinal solutions or draw vast resources and political capital for enactment and implementation.

Against the background of a gridlocked political system, debating a process called "bankruptcy," or one structured to advance a set of bankruptcy values blessed with historical pedigree and even constitutional sanction, may give the system a jolt to consider measures that were previously beyond the policy pale. Bankruptcy proposals have already helped start an important conversation about a category of public debt that remains understudied: the debt of quasi-sovereign states. The benefit of proceeding with bankruptcy design, with or without the bankruptcy name, must now be weighed against the cost of further stretching the concept of bankruptcy, and, more importantly, of framing political decisions about autonomy, federalism and economic policy in the narrow terms of debt collection and debt relief.

This Feature has argued against this tradeoff. It is not an argument against bankruptcy values or bankruptcy tools. These can be helpful, especially where coordination problems abound either because immunity is limited, or for other reasons. From this perspective, if Europe were to agree on a debt restructuring and state rehabilitation process, including a regime for fiscal transfers, it might help overcome coordination problems among member states—spillover victims and contingent bailout providers. Bankruptcy could provide some of the vocabulary for negotiating fiscal federalism; however, it neither determines nor displaces the outcome—the result is federalism, not bankruptcy. On the other hand, U.S. states appear to face fewer coordination problems, and to have more tools to secure debt adjustment.

States might benefit from the ability to cram down rehabilitation plans against the will of dissenting creditors, but any such benefit must be weighed against the cost of exacerbating sovereign commitment problems. Bankruptcy techniques might help yet. To make them relevant, the conversation should now refocus on the hard but unavoidable questions about quasi-sovereign debt, with its seemingly intractable problems of commitment, incentives, and legitimacy.

185. George Triantis, *Let the States Design Their Own Restructuring Process*, *in* WHEN STATES GO BROKE: UNDERSTANDING THE FISCAL AND POLITICAL CRISIS IN THE AMERICAN STATES (David A. Skeel, Jr. & Peter Conti-Brown eds., forthcoming 2012) (proposing that U.S. states pre-announce individual debt restructuring systems within the constraints of Contracts Clause jurisprudence).