State Bankruptcy

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Issue

Can a state declare bankruptcy?

The Office of Legislative Research is not authorized to provide legal opinions, and this report should not be considered one.

Summary

States cannot declare bankruptcy for two primary reasons. First, the U.S. Bankruptcy Code does not allow states to do so. Second, the contracts clause of the U.S. Constitution (art. I, § 10, cl. 1) prohibits state governments from "impairing the obligation of contracts," and the U.S. Supreme Court has held that this clause restricts states' ability to relieve their own debt or other financial obligations. For a more detailed discussion, see "3 Questions on State Bankruptcy" from the Council of State Governments.

In addition to the reasons described above, some scholars have argued there are other legal barriers to allowing states to declare bankruptcy. For example, Thomas Moers Mayer argued that, due to the constitutional principle of federalism, Congress may not have the power to pass a law allowing states to declare bankruptcy even with state consent, and that individuals harmed by the law could challenge it on these grounds (*State Sovereignty, State Bankruptcy, and A Reconsideration of Chapter 9*, 85 Am. Bankr. L.J. 363, 365 (2011)).

Federal Bankruptcy Code

The U.S. Constitution explicitly authorizes Congress to establish uniform bankruptcy laws applicable to all states (art. I, § 8, cl. 4). Congress has exercised this authority by, among other things, adopting the U.S. Bankruptcy Code. Under the code, "debtors" eligible to declare bankruptcy include individuals, businesses, and municipalities, but not states (11 U.S.C. § 109). Although Congress has periodically considered allowing states to declare bankruptcy, these proposals have not gained much traction due to concerns about the effects on state borrowing costs and the municipal bond market, among other reasons (see "A Path Is Sought for States to Escape Their Debt Burdens," *New York Times)*.

U.S. Constitution

A state's impairment of a contract may be constitutional if it is reasonable and necessary to serve an important public purpose. But the U.S. Supreme Court has held that when the state is a party to the contract, it is generally inappropriate to defer to the legislature's judgement of reasonableness and necessity (as they would do with impairments of private contracts) because the state's self-interest is at stake.

For example, in *U.S. Trust Company of New York v. State of New Jersey, et al.*, the Court stated that "a state cannot refuse to meet its legitimate financial obligations simply because it would prefer to spend the money to promote the public good rather than the private welfare of its creditors" (97 S. Ct. 1505, 1521 (1977)). In addition, the Court maintained that "a State is not completely free to consider impairing the obligations of its own contracts on par with other policy alternatives. Similarly, a State is not free to impose a drastic impairment when an evident and more moderate course would serve its purposes equally well" (*Id*., at 1522). In its 1983 decision in *Energy Reserves Group, Inc. vs. Kansas Power and Light Co.*, the Court noted that "[w]hen a State itself enters into a contract, it cannot simply walk away from its financial obligations. In almost every case, the Court has held a governmental unit to its contractual obligations when it enters financial or other markets" (103 S. Ct. 697, at 705 n. 14). Thus, even if Congress were to pass a law allowing states to declare bankruptcy, such an action would likely face a contracts clause challenge.

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