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## STATE CONTRACT IMPAIRMENT CLAUSES AND THE VALIDITY OF CHAPTER 9 AUTHORIZATION

### ABSTRACT

*Although chapter 9 bankruptcy provides an opportunity for financially distressed municipalities to escape their debts, it also allows municipalities to impair their contractual obligations. The U.S. Constitution and most state constitutions, though, have a Contract Clause that prohibits states from passing any law impairing the obligation of contracts. The U.S. Supreme Court has foreclosed the argument that chapter 9 bankruptcy violates the federal Contract Clause, but has not foreclosed the argument under the similar clauses of state constitutions. Chapter 9 requires a municipality to have state authorization before filing bankruptcy, and state courts have the authority to determine the constitutionality of a state authorization under their state constitutions.*

*This Comment argues that, except for the rare circumstance where a municipality has absolutely no contractual obligations, state authorization of a municipal bankruptcy under chapter 9 violates a state constitution's contract impairment clause. States have generally applied the U.S. Supreme Court's interpretation of the federal Contract Clause to their own state clauses. However in the last century, the Supreme Court's Contract Clause jurisprudence has become inconsistent with the text, purpose, and original interpretation of the clause. Thus, state courts should abandon this jurisprudence when interpreting their own clauses, and adopt a stricter standard more in line with the Court's earlier decisions. Under such a standard it becomes clear that only municipalities without any contractual obligations should be authorized to file bankruptcy. By authorizing any other municipal bankruptcy filing, states violate their state constitutions' contract impairment clauses.*

## INTRODUCTION

During the Great Depression, Detroit mayor Frank Murphy proclaimed, “This is a great, rich city . . . It never has repudiated an obligation nor defaulted upon a debt—and it never will.”<sup>1</sup> Today, however, the city’s narrative looks quite different. In 2013, Detroit filed the largest municipal bankruptcy in U.S. history.<sup>2</sup> Detroit was facing over 100,000 creditors and \$18 billion of debt, unfunded pensions, and healthcare liabilities.<sup>3</sup> The city turned to the bankruptcy process to escape its financial distress, and ultimately the bankruptcy court accepted a plan that cut Detroit’s financial obligations by \$7 billion.<sup>4</sup> However, Detroit had to overcome more than 100 legal objections to its filing before the bankruptcy process even began.<sup>5</sup> One of these objections arose under the contract impairment clauses of the U.S. Constitution and Michigan’s constitution.<sup>6</sup>

The Contract Clause of the U.S. Constitution states: “No state shall . . . pass any . . . Law impairing the Obligation of Contracts.”<sup>7</sup> Nevertheless, municipal bankruptcies, such as Detroit’s, allow municipalities, acting as subdivisions of the state with state authorization, to impair their contractual obligations.<sup>8</sup> The Supreme Court, though, has foreclosed the argument that chapter 9 violates the Contract Clause of the U.S. Constitution.<sup>9</sup> However, most states have a similar clause that also prohibits the enactment of laws that impair contractual obligations.<sup>10</sup> The Supreme Court has also rejected the argument that chapter 9

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<sup>1</sup> Nathan Boomey & John Gallagher, *How Detroit Went Broke*, DET. FREE PRESS (Sept. 15, 2013, 1:10 AM), <http://archive.freep.com/interactive/article/20130915/NEWS01/130801004/Detroit-Bankruptcy-history-1950-debt-pension-revenue>.

<sup>2</sup> Alexander E.M. Hess et al., *Largest Municipal Bankruptcies in U.S. History*, 24/7 WALL ST. (July 19, 2014 5:43 PM), <http://247wallst.com/special-report/2013/07/19/the-largest-municipal-bankruptcies-in-u-s-history/2/>.

<sup>3</sup> *In re City of Detroit*, 504 B.R. 191, 194 (Bankr. E.D. Mich. 2013); Tom Hals, *Detroit Hits Back Against Opposition to its Bankruptcy*, REUTERS (Sept. 6, 2013, 11:19 PM), <http://www.reuters.com/article/2013/09/07/us-usa-detroit-bankruptcy-idUSBRE98603X20130907>.

<sup>4</sup> See Monica Davey & Mary Williams Walsh, *Plan to Exit Bankruptcy Is Approved for Detroit*, N.Y. TIMES, Nov. 8, 2014, at A11; Mary Williams Walsh, *Detroit Emerges from Bankruptcy, Yet Pension Risks Linger*, N.Y. TIMES, Nov. 12, 2014, at B1 [hereinafter Walsh, *Detroit Emerges*].

<sup>5</sup> See Hals, *supra* note 3 (“To proceed into bankruptcy, Detroit must overcome 109 objections filed in court . . .”).

<sup>6</sup> U.S. CONST. art. I, § 10, cl. 1; MICH. CONST. art. I, § 10; see *City of Detroit*, 504 B.R. at 231.

<sup>7</sup> U.S. CONST. art. I, § 10, cl. 1.

<sup>8</sup> See, e.g., *In re City of Stockton*, 478 B.R. 8, 16 (Bankr. E.D. Cal. 2012).

<sup>9</sup> See, e.g., *United States v. Bekins*, 304 U.S. 27, 52–54 (1938); *City of Stockton*, 478 B.R. at 15–16.

<sup>10</sup> See, e.g., MICH. CONST. art. I, § 10 (“No . . . law impairing the obligation of contract shall be enacted.”).

proceedings violate state constitution contract impairment clauses because of the supremacy of the federal bankruptcy power.<sup>11</sup> Importantly though, the Court has not foreclosed the argument that state *authorization* of a chapter 9 bankruptcy violates these contract impairment clauses.<sup>12</sup> This precise issue arose in the Detroit bankruptcy.

A Michigan trial court held in *Webster v. Michigan* that the law allowing the state’s governor to authorize Detroit’s bankruptcy filing was unconstitutional under Michigan’s constitution.<sup>13</sup> The court held that P.A. 436, the law empowering the governor to authorize a chapter 9 filing, violated the state constitution “to the extent that it permits the Governor to authorize an emergency manager to proceed under chapter 9 in any manner which threatens to diminish or impair accrued pension benefits.”<sup>14</sup>

Michigan’s constitution has both a Contract Clause and a similarly worded Pension Clause.<sup>15</sup> Importantly, Michigan’s Pension Clause is no more powerful than its contract impairment clause.<sup>16</sup> The Pension Clause simply makes clear that pensions are contracts, and, therefore, they have the same protection as all other contracts under the state’s contract impairment clause.<sup>17</sup> Thus, the court’s holding in *Webster* was that the state’s contract impairment clause does not allow the authorization of a chapter 9 filing because it “threatens to diminish or impair” an existing contractual obligation.<sup>18</sup>

However, the federal bankruptcy judge presiding over Detroit’s bankruptcy, Judge Rhodes, gave the Michigan court’s decision essentially no weight in considering the constitutional challenges to the bankruptcy.<sup>19</sup> Judge

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<sup>11</sup> See *Sturges v. Crowninshield*, 17 U.S. 122, 191 (1819); see also *Ass’n of Retired Emp. v. City of Stockton (In re City of Stockton)*, 478 B.R. 8, 15 (Bankr. E.D. Cal. 2012) (rejecting the argument that chapter 9 proceedings violate state constitution contract impairment clauses).

<sup>12</sup> See *City of Detroit*, 504 B.R. 191; *Webster v. Michigan*, No. 13-734, 2013 WL 3815679, at \*1–2 (Mich. Cir. Ct. July 19, 2013).

<sup>13</sup> See *City of Detroit*, 504 B.R. at 256–61; *Webster*, 2013 WL 3815679, at \*1–2.

<sup>14</sup> *City of Detroit*, 504 B.R. at 258; *Webster*, 2013 WL 3815679, at \*1–2.

<sup>15</sup> MICH. CONST. art. I, § 10; MICH. CONST. art. 9 § 24 (“The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby.”).

<sup>16</sup> See *City of Detroit*, 504 B.R. at 244; see also Alexander Volokh, *Pension Protection and the Detroit Bankruptcy*, REASON FOUND. (Apr. 2, 2014), <http://reason.org/news/show/volokh-detroit-pension-protection> [hereinafter Volokh, *Pension Protection*].

<sup>17</sup> See *City of Detroit*, 504 B.R. at 244; see also Volokh, *Pension Protection*, *supra* note 16.

<sup>18</sup> *City of Detroit*, 504 B.R. at 258; *Webster*, 2013 WL 3815679, at \*1–2.

<sup>19</sup> See *City of Detroit*, 504 B.R. at 256–61; see also Alexander Volokh, *Pension Protection*, *supra* note 16.

Rhodes voided the Michigan decision because it was filed after Detroit had filed its bankruptcy petition<sup>20</sup> and held that the “fundamental reason” to void the decision was that the Michigan court lacked jurisdiction.<sup>21</sup> Once a petition has been filed, the bankruptcy court has “exclusive jurisdiction to determine all issues related to the City’s eligibility to be a chapter 9 debtor.”<sup>22</sup>

Judge Rhodes determined that Detroit’s bankruptcy was constitutional under both the U.S. Constitution and Michigan’s constitution.<sup>23</sup> He held that pension rights are contractual rights and that contractual rights could be impaired when the state has consented to chapter 9 bankruptcy.<sup>24</sup> However, he did not independently consider if the state’s authorization violated Michigan’s contract impairment clause.<sup>25</sup> Judge Rhodes’s decision left this very important question unresolved.<sup>26</sup>

This Comment will address head-on the issue that the bankruptcy court in Detroit punted, and show why the Michigan trial court’s opinion that it voided was actually correct. First, this Comment will provide a brief history of municipal bankruptcies and their relevance today. Ultimately, the Analysis section of this Comment will show that state constitutional contract impairment clauses prohibit state authorization of chapter 9 bankruptcy filings, except in the very rare cases of municipalities with absolutely no contractual obligations.<sup>27</sup> Section I of the Analysis will show that state constitutions have the power to prohibit a state from authorizing a chapter 9 filing. Section II will show that state courts should abandon federal Contract Clause jurisprudence and adopt a stricter standard when interpreting state constitutions’ contract impairment clauses. Section III will establish such a standard and apply it to state authorization of chapter 9 bankruptcies. Section IV will argue that from a policy perspective, this constitutional guarantee should trump the potential effectiveness of municipal bankruptcy. The Conclusion of this Comment will discuss the proper course of action for states going forward, including constitutional amendments and alternatives to municipal bankruptcy.

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<sup>20</sup> See *City of Detroit*, 504 B.R. at 258–59.

<sup>21</sup> See *id.*

<sup>22</sup> 28 U.S.C. § 1334(a) (2012); *City of Detroit*, 504 B.R. at 258–59.

<sup>23</sup> See *City of Detroit*, 504 B.R. at 243–61.

<sup>24</sup> *Id.* at 244.

<sup>25</sup> See *id.* at 258–59; see also Volokh, *Pension Protection*, *supra* note 16.

<sup>26</sup> See *City of Detroit*, 504 B.R. at 244.

## I. BACKGROUND

A. *Municipal Bankruptcy Proceedings and Limitations*

Chapter 9 of the Bankruptcy Code allows financially distressed municipalities to seek protection from their creditors while they formulate a plan to adjust their debts.<sup>28</sup> A chapter 9 bankruptcy is similar to a chapter 11 reorganization, but with a few notable distinctions due to limitations imposed on the federal bankruptcy power by the Tenth Amendment's<sup>29</sup> protections of state sovereignty.<sup>30</sup> Municipalities are only "department[s] of the State, and the State may withhold, grant or withdraw powers as it sees fit."<sup>31</sup> Thus, Congress had to accommodate Tenth Amendment limitations in the Bankruptcy Code, which caused chapter 9 to have some unique characteristics.<sup>32</sup>

Unlike chapter 11 debtors, municipalities are not allowed to liquidate their assets in order to satisfy their debts, and, therefore, cannot be forced into a chapter 7 liquidation<sup>33</sup> by the bankruptcy judge.<sup>34</sup> Municipalities also can only enter bankruptcy voluntarily; involuntary petitions are never allowed.<sup>35</sup> Also, very different than chapter 11 bankruptcy, the court's power is highly constrained in a chapter 9 bankruptcy.<sup>36</sup> Without the municipality's consent, the court cannot interfere with any of the municipality's "political or governmental powers," "property or revenues," or "use or enjoyment of any income-producing property."<sup>37</sup> As later discussed in Part C of the Background,

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<sup>28</sup> 6 COLLIER ON BANKRUPTCY ¶ 900.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.) ("The purpose of chapter 9 legislation is to permit a financially distressed public entity to seek protection from its creditors while it formulates and negotiates a plan for adjustment of its debts . . . and to provide the mechanism by which the plan that is acceptable to the majority of creditors can be made binding on a recalcitrant and dissenting minority.").

<sup>29</sup> U.S. CONST. amend. X ("The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.").

<sup>30</sup> 11 U.S.C. § 904 (2012); see also Jonathan J. Spitz, *Federalism, States, and the Power to Regulate Municipal Bankruptcies*, 9 BANKR. DEV. J. 621, 623–26 (1993).

<sup>31</sup> *City of Trenton v. New Jersey*, 262 U.S. 182, 187 (1923); see also Spitz, *supra* note 30, at 630.

<sup>32</sup> See Spitz, *supra* note 30, at 623–27.

<sup>33</sup> See 6 COLLIER ON BANKRUPTCY, *supra* note 28, at ¶ 700.01.

<sup>34</sup> See *id.* at ¶ 900.01 ("Municipal debt adjustment is unlike that for individuals or private corporations. Because of the public nature of the entity experiencing financial difficulties, there is no provision in the law for liquidation of its assets and distribution of the proceeds to creditors.").

<sup>35</sup> See *id.* at ¶ 900.02 ("[A] municipality is not subject to an involuntary petition."); Spitz, *supra* note 30, at 626.

<sup>36</sup> See 11 U.S.C. § 904 (2012); see also Spitz, *supra* note 30, at 626.

<sup>37</sup> 11 U.S.C. § 904; see also Spitz, *supra* note 30, at 626.

the most important distinction for the purposes of this Comment is that a municipality cannot file for bankruptcy without state authorization.<sup>38</sup>

Despite the distinguishing rules, the general purpose of chapter 9 remains essentially the same as reorganization under chapter 11.<sup>39</sup> As the Bankruptcy Court stated in *In re Addison Community Hospital Authority*, “The general policy considerations underlying the municipal debt adjustment plan of Chapter 9 are the same as that of Chapter 11 reorganization: to give the debtor a breathing spell from debt collection efforts and establish a repayment plan with creditors.”<sup>40</sup>

### *B. Relevance of Municipal Bankruptcy*

Municipal bankruptcies are more relevant today than they have been at any other point in U.S. history.<sup>41</sup> Historically, municipal bankruptcies have been quite rare,<sup>42</sup> and many bankruptcy casebooks barely even cover the topic.<sup>43</sup> Recently, though, municipal bankruptcy has become a much more relevant issue. Municipalities filed nearly twice as many chapter 9 bankruptcies in the last five years as in the preceding five years.<sup>44</sup> In 2012, a record number of chapter 9 bankruptcies were filed.<sup>45</sup> More important than the quantity increase, though, is that municipal bankruptcies have become larger than ever.<sup>46</sup> Since 2011, Jefferson County, Alabama; San Bernardino, California; Stockton, California; and Detroit, Michigan, have filed four of the five largest municipal bankruptcies in U.S. history.<sup>47</sup> The bankruptcies of Detroit, Jefferson County, and San Bernardino all exceeded \$1 billion.<sup>48</sup>

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<sup>38</sup> See 11 U.S.C. § 109(c)(2) (“An entity may be a debtor under chapter 9 . . . only if such entity . . . is specifically authorized . . . to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter.”); see also 6 COLLIER ON BANKRUPTCY, *supra* note 28, at ¶ 900.02.

<sup>39</sup> See 175 B.R. 646, 648–49 (Bankr. E.D. Mich. 1994).

<sup>40</sup> *Id.*

<sup>41</sup> See *Chapter 9 Quarterly Filings (1980–2014)*, AM. BANKR. INST. (2014), [http://abi-org.s3.amazonaws.com/Newsroom/Bankruptcy\\_Statistics/Chapter9Filings-Thru2Q2014.pdf](http://abi-org.s3.amazonaws.com/Newsroom/Bankruptcy_Statistics/Chapter9Filings-Thru2Q2014.pdf); Hess et al., *supra* note 2.

<sup>42</sup> See Elizabeth M. Watkins, *In Defense of the Chapter 9 Option*, 39 J. LEGIS. 89, 90 (2013).

<sup>43</sup> See, e.g., ELIZABETH WARREN & JAY L. WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* (6th ed. 2009).

<sup>44</sup> See AM. BANKR. INST., *supra* note 41.

<sup>45</sup> See *id.*

<sup>46</sup> See Hess et al., *supra* note 2.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

As a matter of policy, many of the municipal bankruptcies have been heavily scrutinized.<sup>49</sup> Opponents of chapter 9 bankruptcy filings usually argue that the filing will damage the city's reputation and result in a credit downgrade that will increase the government's future borrowing costs.<sup>50</sup>

The major concern for state officials is that "local credit problems can have a statewide ripple effect."<sup>51</sup> State officials' concerns have led to some heated political battles.<sup>52</sup> In 2011, the governor of Alabama, Robert Bentley, strongly opposed Jefferson County's \$4 billion bankruptcy filing, and became involved in "months of intense settlement negotiations" prior to the filing in order to avoid bankruptcy.<sup>53</sup> After the city filed, Governor Bentley referred to the bankruptcy as an "embarrassing situation," and stated: "[A]t some point, you have to step up and have to be a leader and have to be a statesman and you have to do what's right. Bankruptcy is not right."<sup>54</sup>

Another example arose in Pennsylvania's capital city, Harrisburg.<sup>55</sup> In 2011, the city council of Harrisburg voted to file bankruptcy despite opposition from both the state's governor and the city's mayor.<sup>56</sup> The state went on to pass legislation preventing the city from filing bankruptcy, which ultimately led to the city's case being dismissed by the bankruptcy court.<sup>57</sup>

### C. *The Constitutionality of Municipal Bankruptcy Under the Federal Constitution*

Challenges to municipal bankruptcies have extended beyond the political arena and into courts with several recent bankruptcies being challenged on

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<sup>49</sup> See Mary Williams Walsh, *Alabama Governor Fails to Prevent County's Record \$4 Billion Bankruptcy Filing*, N.Y. TIMES, Nov. 10, 2011, at A16 [hereinafter Walsh, *Alabama Governor*]; Sabrina Tavernise, *Governor Moves to Take Fiscal Control of Pennsylvania's Capital*, N.Y. TIMES, Oct. 21, 2011, at A25; Monica Davey, *Michigan Town Is Left Pleading for Bankruptcy*, N.Y. TIMES, Dec. 28, 2010, at A1.

<sup>50</sup> See John Gramlich, *Municipal Bankruptcy Explained*, PEW CHARITABLE TRUSTS (Nov. 22, 2011), <http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2011/11/22/municipal-bankruptcy-explained-what-it-means-to-file-for-chapter-9>; Tavernise, *supra* note 49.

<sup>51</sup> Gramlich, *supra* note 50.

<sup>52</sup> See Walsh, *Alabama Governor*, *supra* note 49; Tavernise, *supra* note 49; Davey, *supra* note 49.

<sup>53</sup> Dawn Kent Azok, *Jefferson County Bankruptcy Called Disheartening, Inevitable*, AL.COM (Nov. 10, 2011, 8:20 AM), [http://blog.al.com/spotnews/2011/11/jefferson\\_county\\_bankruptcy\\_fi\\_1.html](http://blog.al.com/spotnews/2011/11/jefferson_county_bankruptcy_fi_1.html); see also Walsh, *Alabama Governor*, *supra* note 49 (discussing Jefferson County's \$4 billion bankruptcy filing).

<sup>54</sup> Azok, *supra* note 53.

<sup>55</sup> See Tavernise, *supra* note 49.

<sup>56</sup> See *id.*

<sup>57</sup> See *In re City of Harrisburg*, 465 B.R. 744, 763 (Bankr. M.D. Pa. 2011).

constitutional grounds.<sup>58</sup> Opponents of municipal bankruptcy filings have frequently attempted to make the legal argument that chapter 9 violates the Contract Clause of the U.S. Constitution because the bankruptcy proceedings allow impairment of contractual obligations.<sup>59</sup> However, this argument has very little weight. The Contract Clause by its very terms applies only to *states*, not Congress.<sup>60</sup> Thus, since chapter 9 is part of the Bankruptcy Code passed by Congress, it is clearly consistent with the U.S. Constitution.<sup>61</sup>

Chapter 9 itself may not violate the Contract Clause, but what about state authorization of a chapter 9 filing? Unlike chapter 9, state authorization is a state action, and, therefore, the Contract Clause should be applicable. However, the Supreme Court has foreclosed the argument that states violate the U.S. Constitution by allowing their municipalities to file for bankruptcy.<sup>62</sup> In *United States v. Bekins*, the Supreme Court held that it did not violate the U.S. Constitution for states to authorize a municipal bankruptcy.<sup>63</sup> Prior to *Bekins*, the Court had struck down Congress's original municipal bankruptcy legislation in *Ashton v. Cameron Cty. Water Improvement Dist.* because it improperly interfered with state sovereignty.<sup>64</sup> The Court noted that if states could not manage their own affairs, "the will of Congress" would prevail over them and "the sovereignty of the state, so often declared necessary to the federal system" would not exist.<sup>65</sup> Congress revised the act providing "a modest increase in the protection of states' sovereignty."<sup>66</sup> However, the Court upheld the revised Act in *Bekins*. The Court refused to "hold that the Constitution had rendered both the states and the federal government helpless to alleviate the problem" of the nation's municipal debt crisis, but stressed that municipalities needed state authorization before a court could approve a readjustment plan.<sup>67</sup>

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<sup>58</sup> See, e.g., *In re City of Detroit*, 504 B.R. 191, 194 (Bankr. E.D. Mich. 2013); *Ass'n of Retired Emp. v. City of Stockton (In re City of Stockton)*, 478 B.R. 8, 15–16 (Bankr. E.D. Cal. 2012); *In re City of Vallejo*, 432 B.R. 262, 269 (E.D. Cal. 2010), *aff'g* 403 B.R. 72 (Bankr. E.D. Cal. 2009).

<sup>59</sup> See, e.g., *City of Detroit*, 504 B.R. at 194–95; *City of Stockton*, 478 B.R. at 13–15.

<sup>60</sup> *City of Stockton*, 478 B.R. at 15.

<sup>61</sup> See *id.* See generally Volokh, *Pension Protection*, *supra* note 16.

<sup>62</sup> See *United States v. Bekins*, 304 U.S. 27, 52–54 (1938).

<sup>63</sup> See *id.* at 51–54.

<sup>64</sup> 298 U.S. 513, 530 (1936); see also 6 COLLIER ON BANKRUPTCY, *supra* note 28, at ¶ 900.LH; Spitz, *supra* note 30, at 623 (discussing how Congress's original bankruptcy legislation was struck down).

<sup>65</sup> *Ashton*, 298 U.S. at 530.

<sup>66</sup> 6 COLLIER ON BANKRUPTCY, *supra* note 28, at 900.LH.

<sup>67</sup> *Bekins*, 304 U.S. at 51–54.

Thus, the law is settled that chapter 9 and state authorization are both consistent with the U.S. Constitution, but the issue of whether chapter 9 and state authorization are consistent with *state* constitutions remains unsettled. Importantly, though, federal bankruptcy power under the Bankruptcy Clause<sup>68</sup> of the U.S. Constitution trumps any state constitutional provision because of the Supremacy Clause.<sup>69</sup> In other words, once the municipality has entered into bankruptcy, state constitutions cannot limit the federal bankruptcy power.<sup>70</sup> Therefore, while federal bankruptcy proceedings under chapter 9 are a tool that allows a state to impair contractual obligations, the proceedings themselves are not inconsistent with a state constitution's contract impairment clause because state constitutions cannot invalidate federal law.

Chapter 9 proceedings, then, do not violate state constitutional contract impairment clauses, but the inquiry does not end here. Chapter 9 forecloses any proceeding unless the state authorizes the municipal bankruptcy filing, and that authorization could still be inconsistent with the state constitution.<sup>71</sup> The mere fact that Congress has a bankruptcy power does not mandate that states authorize chapter 9 filings; to the contrary, chapter 9 explicitly leaves the decision to the state, and a state can choose not to file either by failing to pass an authorization statute, by passing a statute barring chapter 9 filings, or by tying its hands with its own constitution.<sup>72</sup> *Bekins* closes the door on this argument under the U.S. Constitution, but not under state constitutions.<sup>73</sup> When interpreting a state constitutional provision, Supreme Court precedent does not bind state courts, even if the provisions have exactly the same language.<sup>74</sup>

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<sup>68</sup> U.S. CONST. art. I, § 8, cl. 4 (“To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States.”).

<sup>69</sup> U.S. CONST. art. VI, cl. 2 (“This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.”).

<sup>70</sup> See *County of Orange v. Merrill Lynch & Co.* (*In re County of Orange*), 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996) (“By authorizing the use of chapter 9 by its municipalities, California must accept chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest. The right to discharge is not a benefit without burdens.”).

<sup>71</sup> See 11 U.S.C. § 109(c) (2012).

<sup>72</sup> See *In re City of Vallejo*, 403 B.R. 72, 76 (Bankr. E.D. Cal. 2009), *aff'd*, 432 B.R. 262, 267 (E.D. Cal. 2010) (holding that *after* a state has authorized a municipal bankruptcy filing, the federal bankruptcy power trumps state law).

<sup>73</sup> See 304 U.S. 27, 52–54 (1938).

<sup>74</sup> See *Wilson Banking Co. Liquidating Corp. v. Colvard*, 161 So. 123, 127 (Miss. 1935) (“[D]ecisions of the Supreme Court of the United States construing provisions of the federal Constitution are not binding on a state court construing similar provisions of its own state constitution.”); see also *First Trust Co. of Lincoln v.*

The law is well settled that chapter 9 and state authorization of chapter 9 is consistent with the U.S. Constitution.<sup>75</sup> Furthermore, chapter 9 cannot violate state constitutions because the federal bankruptcy power trumps state law.<sup>76</sup> The federal bankruptcy power, however, does not extend to state authorization, which is a function of state law.<sup>77</sup> The only issue addressed in this Comment, then, is whether state legislation authorizing or permitting the authorization of municipal bankruptcies violates the contract impairment clauses of *state* constitutions.

## II. ANALYSIS

### A. *Power of State Constitutions to Prohibit Authorization of Chapter 9 Filings*

In their role as the “gatekeepers” to chapter 9 bankruptcy, states maintain the power to prohibit municipalities from filing bankruptcy.<sup>78</sup> The metaphorical gates to bankruptcy are opened through authorization by a state or state official.<sup>79</sup> Therefore, a state’s power to prohibit municipalities from filing bankruptcy must also include the power to prohibit authorization of a municipal bankruptcy. This power has been clearly illustrated in the state of Georgia.<sup>80</sup>

The Georgia legislature has expressly forbidden municipalities from filing bankruptcy and state officials from authorizing a municipal bankruptcy.<sup>81</sup> Georgia law prohibits any “county, municipality, school district, authority, division, instrumentality, political subdivision, or public body corporate” from filing “a petition for relief from payments of its debts.”<sup>82</sup> The same statute also prohibits granting any government official, governing body, or organization the power to “authorize . . . any county, municipality, school district, authority, division, instrumentality, political subdivision, or public body corporate

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Smith, 277 N.W. 762, 763 (Neb. 1938); *Commonwealth v. Wilkins*, 138 N.E. 11, 13 (Mass. 1923); *State v. Chin Gim*, 224 P. 798, 800 (Nev. 1924).

<sup>75</sup> See, e.g., *Ass’n of Retired Emp. v. City of Stockton (In re City of Stockton)*, 478 B.R. 8, 15–16 (Bankr. E.D. Cal. 2012).

<sup>76</sup> See, e.g., *City of Vallejo*, 403 B.R. at 76.

<sup>77</sup> See, e.g., *id.*

<sup>78</sup> See *In re City of Vallejo*, 432 B.R. 262, 267 (E.D. Cal. 2010), *aff’g* 403 B.R. 72 (Bankr. E.D. Cal. 2009); see also 11 U.S.C. §§ 903, 904 (2012).

<sup>79</sup> See *City of Vallejo*, 432 B.R. at 267–68.

<sup>80</sup> See GA. CODE ANN. § 36-80-5 (2014).

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

created under the Constitution or laws of this state . . . [from] tak[ing] advantage of any federal statute providing for the adjustment of debts.”<sup>83</sup>

Georgia is not alone in restricting municipalities’ access to chapter 9.<sup>84</sup> Several states have passed legislation authorizing municipalities to file bankruptcy, but only after getting approval from an authorized state official.<sup>85</sup> For example, Kentucky requires approval “by the state local debt officer and the state local finance officer,”<sup>86</sup> and Louisiana requires approval by the governor and the Attorney General before the petition can be filed.<sup>87</sup>

As mentioned in the Background, Pennsylvania has also passed legislative restrictions on chapter 9 access.<sup>88</sup> When the City Council of Harrisburg, Pennsylvania, voted to file bankruptcy over the objections of the mayor and governor, the state took legislative action.<sup>89</sup> The state passed an amendment known as “Act 26” to Pennsylvania’s Fiscal Code.<sup>90</sup> Without the passage of Act 26, the city would have likely had state authorization to file.<sup>91</sup> Act 26, however, provided that “no distressed city may file a petition for relief under [chapter 9] or any other Federal bankruptcy law, and no government agency may authorize the distressed city to become a debtor under [chapter 9] or any other Federal bankruptcy law.”<sup>92</sup> The amendment only applies to “third class” cities, and, therefore, is not nearly as restrictive as the Georgia law. Nevertheless, the law still significantly restricts municipal bankruptcy access, evidenced by the bankruptcy court’s dismissal of Harrisburg’s case.<sup>93</sup>

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<sup>83</sup> *Id.*

<sup>84</sup> See Spitz, *supra* note 30, at 631 (noting that many states have authorized their municipalities to file bankruptcy but are subject to various conditions).

<sup>85</sup> See *id.* at 631–32.

<sup>86</sup> KY. REV. STAT. ANN. § 66.400 (West 2014) (“No county shall file a petition as provided in the Federal Bankruptcy Act unless the proposed plan is first approved by the state local debt officer and the state local finance officer.”).

<sup>87</sup> LA. STAT. ANN. § 39:619 (2014) (“No political subdivision . . . municipality . . . or other taxing district, shall, without the consent, approval and authority of the state through the governor and the Attorney General, file any petition in any court of the United States for confirmation of any plan of readjustment of its debts . . .”).

<sup>88</sup> See *In re City of Harrisburg*, 465 B.R. 744, 763 (Bankr. M.D. Pa. 2011); John J. Ripsardi et al., *A Study in State Law Barriers to Ch. 9*, LAW360 (Jan. 30, 2012, 2:02 PM), <http://www.law360.com/articles/304071/a-study-in-state-law-barriers-to-ch-9>.

<sup>89</sup> See Ripsardi et al., *supra* note 88.

<sup>90</sup> See *City of Harrisburg*, 465 B.R. at 750, 755; Ripsardi et al., *supra* note 88.

<sup>91</sup> See *City of Harrisburg*, 465 B.R. at 750, 755; Ripsardi et al., *supra* note 88.

<sup>92</sup> *City of Harrisburg*, 465 B.R. at 755; Ripsardi et al., *supra* note 88.

<sup>93</sup> *City of Harrisburg*, 465 B.R. at 755; Ripsardi et al., *supra* note 88.

It is clear that states have the power to pass statutes to limit and even completely prohibit filing and authorizing the filing of any chapter 9 bankruptcy.<sup>94</sup> It should be equally as clear, then, that states may also limit and prohibit filing and authorization of chapter 9 bankruptcy through their constitutions. The contract impairment clauses of state constitutions should be read as an implicit exercise of that power.

### *B. State Constitutions' Contract Impairment Clauses Should Be Interpreted Strictly*

The Contract Clause of the U.S. Constitution states, "No State shall . . . pass any . . . Law impairing the Obligation of Contracts."<sup>95</sup> As already established, this clause of the Constitution is consistent with chapter 9 bankruptcy;<sup>96</sup> however, most states have similar clauses in their own constitutions.<sup>97</sup> In general, state courts interpret the contract impairment clause of their state constitutions similarly to the U.S. Supreme Court's interpretation of the federal Contract Clause.<sup>98</sup> State courts should change this practice. They have the ability to adopt a stricter interpretation, and should do so because the Supreme Court's current Contract Clause jurisprudence is no longer consistent with the clause's text, original interpretation, or original purpose.<sup>99</sup>

#### *1. Text of the Contract Clause*

The text of the Contract Clause simply states that states shall pass "no Law impairing the Obligation of Contracts."<sup>100</sup> The current Contract Clause standard allows a state to substantially impair contracts "so long as the impairment is reasonable and necessary."<sup>101</sup> However, the text in both the

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<sup>94</sup> See GA. CODE ANN. § 36-80-5 (2014).

<sup>95</sup> U.S. CONST. art. I, § 10, cl. 1.

<sup>96</sup> See, e.g., *United States v. Bekins*, 304 U.S. 27, 52–54 (1938); *Ass'n of Retired Emp. v. City of Stockton (In re City of Stockton)*, 478 B.R. 8, 15 (Bankr. E.D. Cal. 2012).

<sup>97</sup> See, e.g., MICH. CONST. art. I, § 10 ("No . . . law impairing the obligation of contract shall be enacted."); see also GEORGE D. BRADEN ET AL., *THE CONSTITUTION OF THE STATE OF TEXAS: AN ANNOTATED AND COMPARATIVE ANALYSIS* 62 (1977) (noting thirty-seven other state constitutions had contract impairment clauses).

<sup>98</sup> See, e.g., *Allstate Ins. v. Kim*, 829 A.2d 611, 624 (Md. 2003); see also ALEXANDER VOLOKH, *FEDERALIST SOC'Y, OVERPROTECTING PUBLIC EMPLOYEE PENSIONS* 6 (2013), [http://reason.org/files/overprotecting\\_pensions\\_california\\_rule.pdf](http://reason.org/files/overprotecting_pensions_california_rule.pdf) [hereinafter VOLOKH, *OVERPROTECTING PUBLIC*].

<sup>99</sup> See Richard A. Epstein, *Toward a Revitalization of the Contract Clause*, 51 U. CHI. L. REV. 703 (1984); see also James W. Ely, Jr., *Whatever Happened to the Contract Clause?*, 4 CHARLESTON L. REV. 371 (2009).

<sup>100</sup> U.S. CONST. art. I, § 10, cl. 1.

<sup>101</sup> Eric M. Madiar, *Public Pension Benefits Under Siege*, 27 A.B.A. J. LAB. & EMP. L. 179, 186 (2012).

federal Contract Clause and the similarly worded state contract impairment clauses includes nothing about the reasonableness or the necessity of the law impairing contractual obligations.<sup>102</sup> The clauses also do not include the use of any form of the word “substantial.”<sup>103</sup>

When a law lacks ambiguity, the courts should look no further than the text for interpretation.<sup>104</sup> As the Supreme Court stated in *Connecticut National Bank v. Germain*, “courts must presume that a legislature says in a statute what it means and means in a statute what it says there . . . . When the words of a statute are unambiguous, then, this first canon is also the last: judicial inquiry is complete.”<sup>105</sup> The Contract Clause is quite clear when it states “no Law shall be passed” and, therefore, it would be improper for courts to redefine the clause to read “no unreasonable or unnecessary Law shall be passed.”<sup>106</sup> Even if the courts are going to read more language into the Contract Clause, the absolute language of the text should still demand a strict interpretation. The First Amendment of the U.S. Constitution,<sup>107</sup> for example, has not been read as an absolute bar on laws abridging the freedom of speech or press; however, the Supreme Court has still treated First Amendment protections as fundamental rights.<sup>108</sup> The Contract Clause should be given similar respect.

If the clause does contain any ambiguities, they are in areas of the text that are either addressed or not at issue in this Comment. Specifically, the words “impairing,” “Obligation,” and “Contracts” are all undefined.<sup>109</sup> The issue of what constitutes a contract has little relevance here. Primarily, this is an issue within a municipal bankruptcy, but could be relevant to the extent that one

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<sup>102</sup> See, e.g., U.S. CONST. art. I, § 10, cl. 1; MICH. CONST. art. I, § 10 (“No . . . law impairing the obligation of contract shall be enacted.”).

<sup>103</sup> See, e.g., U.S. CONST. art. I, § 10, cl. 1; MICH. CONST. art. I, § 10 (“No . . . law impairing the obligation of contract shall be enacted.”).

<sup>104</sup> See, e.g., *Conn. Nat’l Bank v. Germain*, 503 U.S. 249, 253 (1992); *Nat’l Tax Credit Partners v. Havlik*, 20 F.3d 705, 707 (7th Cir. 1994).

<sup>105</sup> 503 U.S. at 253–54 (quotation marks omitted).

<sup>106</sup> See, e.g., U.S. CONST. art. I, § 10, cl. 1; MICH. CONST. art. I, § 10 (“No . . . law impairing the obligation of contract shall be enacted.”); *Germain*, 503 U.S. at 253–54.

<sup>107</sup> U.S. CONST. amend. I (“Congress shall make no law . . . abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances.”).

<sup>108</sup> See, e.g., *Lovell v. City of Griffin*, 303 U.S. 444, 450 (1938) (“Freedom of speech and freedom of the press, which are protected by the First Amendment from infringement by Congress, are among the fundamental personal rights and liberties which are protected by the Fourteenth Amendment from invasion by state action.”).

<sup>109</sup> U.S. CONST. art. I, § 10, cl. 1; see also Epstein, *supra* note 99.

could argue no “Contracts” are impaired through municipal bankruptcies.<sup>110</sup> This argument is addressed in Section III, where it is shown that state courts should presume contract impairment will take place in the bankruptcy proceedings. Thus, Section III also addresses any relevant ambiguity regarding the word “impairing.”<sup>111</sup> For the purposes of municipal bankruptcy, the municipality must have some obligations or it would not be seeking relief through bankruptcy, and, therefore, any ambiguity with the word “Obligation” is not at issue in this Comment.<sup>112</sup>

Thus, the text of the Contract Clause clearly supports a stricter interpretation. Even if a court managed to read some ambiguity into the “no Law shall be passed” language of the clause,<sup>113</sup> the court would still need to resolve the ambiguity.<sup>114</sup> The most appropriate manner of resolving the ambiguity would be to understand the original purpose and intent of the clause.<sup>115</sup> As the following Sections will show, the original interpretations of the Contract Clause and the framers’ purpose and intent also strongly support a strict interpretation of the clause.

## 2. *The Original Interpretation of the Contract Clause*

Until the late nineteenth and early twentieth centuries, the Supreme Court had a very strict interpretation of the Contract Clause.<sup>116</sup> During the 1800’s the Court overturned numerous state statutes that attempted to impair contractual obligations.<sup>117</sup> Then the Supreme Court made a dramatic shift away from earlier precedent, which culminated in a 1934 case allowing Minnesota to impair contractual obligations in order to protect the public in a time of financial emergency.<sup>118</sup>

The Contract Clause was once considered to be “one of the most beneficial provisions of the Federal Constitution.”<sup>119</sup> In an 1877 Supreme Court opinion,

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<sup>110</sup> U.S. CONST. art. I, § 10, cl. 1.

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> *See, e.g., id.* 10 (“No . . . law impairing the obligation of contract shall be enacted.”).

<sup>114</sup> *See Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892); William N. Eskridge, Jr., *The New Textualism*, 37 UCLA L. Rev. 621, 628–29 (1990).

<sup>115</sup> *See Church of the Holy Trinity*, 143 U.S. at 459; Eskridge, Jr., *supra* note 114.

<sup>116</sup> *See Home Bldg. & Loan Ass’n v. Blaisdell*, 290 U.S. 398, 464–83 (1934) (Sutherland, J., dissenting); Ely, Jr., *supra* note 99, at 371–76.

<sup>117</sup> *See Blaisdell*, 290 U.S. at 464–83 (Sutherland, J., dissenting); Ely, Jr., *supra* note 99, at 371–76.

<sup>118</sup> *See Ely, Jr., supra* note 99, at 388–89.

<sup>119</sup> *Wash. Univ. v. Rouse*, 75 U.S. 439, 442 (1869) (Miller, J., dissenting); *see also* Ely, Jr., *supra* note 99, at 375.

Justice William Strong stated: “There is no more important provision in the Federal Constitution than the one which prohibits states from passing laws impairing the obligation of contracts, and it is one of the highest duties of this court to take care the prohibition shall neither be evaded nor frittered away.”<sup>120</sup>

Until 1934, the law was settled that any attempt to shift the “misfortune of the debtor to the shoulders of the creditors” would conflict with the Contract Clause.<sup>121</sup> The Contract Clause did not just extend to private contracts, but applied to contracts between states and individuals as well.<sup>122</sup> Under Justice Marshall in the early nineteenth century, the Supreme Court applied “the provision to tax-exemption agreements, grants of corporate charters, land grants, agreements between states, and state insolvency laws.”<sup>123</sup>

The Supreme Court’s view of the Contract Clause has diminished significantly since that time. In the late nineteenth century, the Court began pulling in the reins on the Contract Clause by ruling that states could not contract away their police and eminent domain powers.<sup>124</sup> The trend of eroding Contract Clause power carried into the twentieth century, which led to the “near-fatal punch” of the *Blaisdell* decision in 1934.<sup>125</sup>

During the Great Depression, the state of Minnesota passed a “statute imposing a two-year moratorium on mortgage foreclosures to stop massive home losses.”<sup>126</sup> In *Blaisdell*, the Supreme Court upheld the state’s statute.<sup>127</sup> The Court’s decision “established the basic standard that a state may substantially impair private contracts so long as the impairment is reasonable and necessary to serve an important public purpose identified by the legislature.”<sup>128</sup> This standard from *Blaisdell* signaled the significant shift in the Supreme Court’s protection of contractual agreements and opened the doors for courts to allow public policy to outweigh contract rights.<sup>129</sup>

Justice Sutherland’s dissent in *Blaisdell* refused to accept the majority’s change of attitude regarding the Contract Clause and explained that the

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<sup>120</sup> Murray v. City of Charleston, 96 U.S. 432, 448 (1877); see also Ely, Jr., *supra* note 99, at 376.

<sup>121</sup> *Blaisdell*, 290 U.S. at 465–72 (Sutherland, J., dissenting).

<sup>122</sup> See Ely, Jr., *supra* note 99, at 374.

<sup>123</sup> *Id.* (internal citations omitted).

<sup>124</sup> See *id.* at 387.

<sup>125</sup> *Id.* at 388; see also VOLOKH, OVERPROTECTING PUBLIC, *supra* note 98.

<sup>126</sup> Madiar, *supra* note 101.

<sup>127</sup> See Home Bldg. & Loan Ass’n v. Blaisdell, 290 U.S. 398, 447–48 (1934); Madiar, *supra* note 101.

<sup>128</sup> Madiar, *supra* note 101, at 186.

<sup>129</sup> See Ely, Jr., *supra* note 99, at 392–94.

majority was disregarding the original understanding of the provision.<sup>130</sup> Justice Sutherland referenced a long line of cases holding invalid similar statutes, including *Bronson v. Kinzie*.<sup>131</sup>

*Kinzie* is an 1843 case in which the Supreme Court invalidated the application of two Illinois statutes to existing mortgages.<sup>132</sup> The statutes extended the period of redemption after a sale and prevented “a sale unless two-thirds of the amount at which the property had been valued by appraisers should be bid therefor.”<sup>133</sup> The Court held those statutes violated the Contract Clause, even though they were passed during a time of substantial financial emergency.<sup>134</sup> The result of the case was quite controversial, and even led to an Illinois senator proposing a constitutional amendment that would prevent the Supreme Court from “declaring void any Act of Congress or any State regulation on the ground that it is contrary to the Constitution of the United States.”<sup>135</sup> Nevertheless, as Charles Warren noted in his book, *The Supreme Court in United States History*, the Court “maintained its firm stand in behalf of high standards of business morale, requiring honest payment of debts and strict performance of contracts.”<sup>136</sup> Justice Sutherland went on to discuss several other cases that followed *Kinzie* and further supported a stricter Contract Clause standard.<sup>137</sup>

Thus, the original interpretations of the Contract Clause were clearly stricter than the Supreme Court’s interpretation today. The Supreme Court acknowledged this fact in *U.S. Trust Co. of New York v. New Jersey* when it noted that in the “early years” the Contract Clause was “regarded as an absolute bar to any impairment.”<sup>138</sup> The Court has undoubtedly come quite a long way from the “early years” to the current “reasonable and necessary”

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<sup>130</sup> See *Blaisdell*, 290 U.S. at 448–83 (Sutherland, J., dissenting); Ely, Jr., *supra* note 99, at 390.

<sup>131</sup> *Blaisdell*, 290 U.S. at 465–72 (1934) (Sutherland, J., dissenting); *Bronson v. Kinzie*, 42 U.S. 311, 311–21 (1843).

<sup>132</sup> *Kinzie*, 42 U.S. at 311–13, 320–21; *Blaisdell*, 290 U.S. at 466 (Sutherland, J., dissenting).

<sup>133</sup> *Blaisdell*, 290 U.S. at 466 (Sutherland, J., dissenting); *Kinzie*, 42 U.S. at 311–13.

<sup>134</sup> *Kinzie*, 42 U.S. at 311–13, 320–21; *Blaisdell*, 290 U.S. at 466 (Sutherland, J., dissenting) (“The opinion of the court says nothing about an emergency; but it is clear that the statute was passed for the purpose of meeting the panic and depression which began in 1837 and continued for some years thereafter.”).

<sup>135</sup> 2 CHARLES WARREN, *THE SUPREME COURT IN UNITED STATES HISTORY* 379 (1922) (quotation marks omitted); see also *Home Bldg. & Loan Ass’n v. Blaisdell*, 290 U.S. 398, 466 (1934) (Sutherland, J., dissenting).

<sup>136</sup> 2 WARREN, *supra* note 135; see also *Blaisdell*, 290 U.S. at 466 (Sutherland, J., dissenting).

<sup>137</sup> See *Blaisdell*, 290 U.S. at 466–72 (Sutherland, J., dissenting).

<sup>138</sup> 431 U.S. 1, 19 n.17 (1977).

standard.<sup>139</sup> State courts should use the early decisions as a guiding light for resolving any ambiguity of the contract impairment clauses as they are one of the best indicators of the provision's purpose.<sup>140</sup>

### 3. *The Framers' Intent and Purpose*

A consideration of the surrounding circumstances along with the opinions expressed by the Framers supports a strict interpretation of the Contract Clause. The Supreme Court correctly noted in *Blaisdell* that the debates at the Constitutional Convention provide "little aid" in determining the Framers' intent, but that does not mean that they should be disregarded.<sup>141</sup> When interpreting a provision of the Constitution, the Framers' intent is often a central focus of the inquiry, and should not be cast aside just because the debates of the Convention have little fruit.<sup>142</sup> The courts should also look to "[t]he necessities which gave rise to the provision, the controversies which preceded, as well as the conflicts of opinion which were settled by its adoption" in considering the intent of the framers.<sup>143</sup>

First, the situation surrounding the adoption of the Contract Clause suggests the Framers intended it to be read strictly. After the Revolutionary War and before the Constitution was adopted, most Americans were financially impoverished.<sup>144</sup> Because of the circumstances, many "incurred indebtedness in the purchase of imported goods and otherwise far beyond their capacity to pay."<sup>145</sup> In response to the situation, states passed a variety of laws, including stay laws, laws limiting access to courts, and laws that discriminated against British creditors.<sup>146</sup> "Debtors, instead of seeking to meet their obligations by painful effort, by industry and economy, began to rest their hopes entirely upon legislative interference."<sup>147</sup>

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<sup>139</sup> *Id.*

<sup>140</sup> See *Blaisdell*, 290 U.S. at 427 ("In the construction of the contract clause, the debates in the Constitutional Convention are of little aid. . . . To ascertain the scope of the constitutional prohibition, we examine the course of judicial decisions in its application.").

<sup>141</sup> *Id.*

<sup>142</sup> *Id.*

<sup>143</sup> *Id.*

<sup>144</sup> *Id.* at 454 ("Following the Revolution, and prior to the adoption of the Constitution, the American people found themselves in a greatly impoverished condition. Their commerce had been well-nigh annihilated.").

<sup>145</sup> *Id.*

<sup>146</sup> See *id.* at 454–58; Epstein, *supra* note 99, at 706.

<sup>147</sup> *Blaisdell*, 290 U.S. at 455 (Sutherland, J., dissenting).

With that situation in the background, the Framers adopted the Contract Clause.<sup>148</sup> The adoption came over the objections of many who believed it was too restrictive.<sup>149</sup> George Mason expressed concerns that cases would happen “that could not be foreseen where some kind of interference would be essential.”<sup>150</sup> Luther Martin voted against the provision for a similar reason.<sup>151</sup> Martin believed there could “be times of such great public calamity and distress as should render it the duty of a government in some measure to interfere.”<sup>152</sup> Martin said the regulations were necessary in most states “to prevent the wealthy creditor and the moneyed man from totally destroying the poor, though industrious debtor.”<sup>153</sup> He feared that “[s]uch times may again arrive,” and did not think that states should be stripped of their power to give debtors the necessary and desirous “moment’s indulgence.”<sup>154</sup>

The Framers that supported the provision also spoke of it in a manner that suggested a strict and perhaps even an absolute interpretation.<sup>155</sup> James Madison wrote that “[o]ne legislative interference is but the first link of a long chain of repetitions, every subsequent interference being naturally produced by the effects of the preceding.”<sup>156</sup> He declared that the “laws impairing the obligation of contracts, are contrary to the first principles of the social compact, and to every principle of sound legislation.”<sup>157</sup> He further concluded that the Contract Clause was a “constitutional bulwark in favor of personal security and private rights” that would “banish speculations on public measures” and “inspire a general prudence.”<sup>158</sup>

From these opinions and the circumstances prompting the adoption of the Contract Clause, it is quite difficult to imagine the Framers intended it to be interpreted in today’s fashion. The purpose of the clause was undoubtedly

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<sup>148</sup> See *id.* at 459.

<sup>149</sup> See *id.* at 461–62.

<sup>150</sup> *Id.* at 461.

<sup>151</sup> *Id.* at 461–62.

<sup>152</sup> *Id.* at 462.

<sup>153</sup> *Id.*

<sup>154</sup> *Id.* (quotation marks omitted).

<sup>155</sup> See *id.* at 427 (“Randolph declared that the prohibition would be promotive of virtue and justice . . . and the reputation of the people had suffered because of frequent interferences by the state legislature . . . Mr. Davie . . . thought the constitutional provisions were founded on the strongest principles of justice . . . Pinckney . . . said that he considered the section including the clause in question as the soul of the Constitution.”) (quotation marks omitted).

<sup>156</sup> *Id.* at 464.

<sup>157</sup> Ely, Jr., *supra* note 99, at 373.

<sup>158</sup> *Id.*

meant to be much broader. In particular, it is quite clear that the Framers intended for the provision to apply even to “reasonable” laws passed by state legislatures that deemed them “necessary.”<sup>159</sup> The Framers’ intent appears to clearly support a strict reading of the provision, in accordance with the original interpretations of the Contract Clause.<sup>160</sup>

#### 4. *States Should Adopt a Stricter Standard*

State courts should adopt a stricter interpretation of their state constitutions’ contract impairment clauses than the Supreme Court’s current interpretation of the federal Contract Clause. While the Supreme Court’s current Contract Clause jurisprudence has stripped the provision of its power, states with their own contract impairment clauses are not bound to this jurisprudence.<sup>161</sup> When interpreting a state constitution’s clause, a state court is allowed to have a stricter interpretation than the Supreme Court has for the federal clause.<sup>162</sup>

In *State v. Hempele*, the New Jersey Supreme Court stated the well-settled rule that the state supreme court, not the U.S. Supreme Court, is the ultimate interpreter of a state constitution, and thus, is free to adopt a stricter standard.<sup>163</sup>

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<sup>159</sup> See *Blaisdell*, 290 U.S. at 427 (“[T]he clause of the Constitution now under consideration was meant to foreclose state action impairing the obligation of contracts primarily and especially in respect of such action aimed at giving relief to debtors in time of emergency.”).

<sup>160</sup> See *id.* at 456–65; Ely, Jr., *supra* note 99.

<sup>161</sup> See *Wilson Banking Co. Liquidating Corp. v. Colvard*, 161 So. 123, 127 (Miss. 1935) (“[D]ecisions of the Supreme Court of the United States construing provisions of the federal Constitution are not binding on a state court construing similar provisions of its own state constitution.”); see also *First Trust Co. of Lincoln v. Nebraska*, 277 N.W. 762 (Neb. 1938); *Commonwealth v. Wilkins*, 138 N.E. 11 (Mass. 1923); *State v. Chin Gim*, 224 P. 798 (Nev. 1924).

<sup>162</sup> See *Wilson Banking*, 161 So. at 127 (“[D]ecisions of the Supreme Court of the United States construing provisions of the federal Constitution are not binding on a state court construing similar provisions of its own state constitution.”); see also *First Trust Co.*, 277 N.W. 762 (Neb. 1938); *Wilkins*, 138 N.E. 11; *Chin Gim*, 224 P. 798.

<sup>163</sup> See, e.g., 576 A.2d 793, 800 (N.J. 1990); see also *Commonwealth v. Upton*, 476 N.E.2d 548 (Mass. 1985) (applying a standard for probable cause under the Massachusetts constitution that is more strict than the federal Constitution’s standard); Robert F. Williams, *In the Glare of the Supreme Court: Continuing Methodology and Legitimacy Problems in Independent State Constitutional Rights Adjudication*, 72 NOTRE DAME L. REV. 1015, 1016 (1997) (“The idea that state courts may interpret their potentially applicable state constitutional provisions to provide more, or broader, rights protections than are recognized by the United States Supreme Court under the Federal Constitution should no longer be seen as a cute trick or simply flexing a state constitutional muscle. It has now become an accepted . . . feature of our jurisprudence.”) (quotation marks omitted).

In interpreting the New Jersey Constitution, we look for direction to the United States Supreme Court, whose opinions can provide “valuable sources of wisdom for us.” But although that Court may be a polestar that guides us as we navigate the New Jersey Constitution, we bear ultimate responsibility for the safe passage of our ship. Our eyes must not be so fixed on that star that we risk the welfare of our passengers on the shoals of constitutional doctrine. In interpreting the New Jersey Constitution, we must look in front of us as well as above us.<sup>164</sup>

Indeed, several state supreme courts rejected *Blaisdell* shortly after the Supreme Court’s controversial decision.<sup>165</sup> Texas, Nebraska, Oklahoma, and Iowa all struck down mortgage foreclosure moratorium legislation in the 1930s as violations of contract clauses in state constitutions.<sup>166</sup>

The Nebraska Supreme Court’s decision in *First Trust Co. of Lincoln v. Smith* is particularly useful in considering how state courts should interpret their contract impairment clauses.<sup>167</sup> In *First Trust Co.*, the court provided a blueprint for adopting a stricter contract clause standard in striking down a moratorium act similar to the one upheld by the U.S. Supreme Court in *Blaisdell*.<sup>168</sup> The court noted that under the U.S. Constitution the moratorium act would have likely been allowed under the binding precedent of *Blaisdell*, but, unlike an earlier case brought before the Nebraska Supreme Court, the act was also challenged under Nebraska’s own constitution.<sup>169</sup> Specifically, the act was challenged under the contract impairment clause of Nebraska’s constitution, which states, “No law . . . impairing the obligations of contracts . . . shall be passed.”<sup>170</sup>

The court explained that the Nebraska courts are responsible for interpreting state’s constitutional provisions.<sup>171</sup> The court pointed out that the Nebraska Supreme Court’s interpretation of its state constitution has binding

<sup>164</sup> *Hempele*, 576 A.2d at 800 (Pashman, J., concurring) (quoting *State v. Hunt*, 450 A.2d 952 (N.J. 1982)).

<sup>165</sup> See Ely, Jr., *supra* note 99, at 390.

<sup>166</sup> See *First Trust Joint Stock Land Bank of Chi. v. Arp.*, 293 N.W. 441 (Iowa 1939); *First Trust Co.*, 277 N.W. 762; *State ex. rel. Osage Cty. Sav. & Loan Ass’n. v. Worten*, 29 P.2d 1 (Okla. 1934); *Travelers’ Ins. Co. v. Marshall*, 76 S.W.2d 1007 (Tex. 1934).

<sup>167</sup> 277 N.W. at 768–78.

<sup>168</sup> *Id.* at 768–70.

<sup>169</sup> See *id.* (holding that the statute would still fail under *Blaisdell* because an emergency situation did not exist).

<sup>170</sup> NEB. CONST. art. I, § 16; see also *First Trust Co.*, 277 N.W. at 764.

<sup>171</sup> *First Trust Co.*, 277 N.W. at 771–72.

effect on the U.S. Supreme Court, just as the U.S. Supreme Court's interpretation of the federal Constitution is binding on the Nebraska Supreme Court.<sup>172</sup> After the court established this background matter of law, it proceeded to reject the *Blaisdell* standard in its interpretation of the state contract impairment clause.<sup>173</sup>

The court immediately made it clear that the Nebraska contract clause was going to be interpreted more strictly than the federal clause.<sup>174</sup> The analysis began with the court stating that “[a] principal share of the benefit expected from written Constitutions would be lost if the rules they established were so flexible as to bend to circumstances or be modified by public opinion.”<sup>175</sup> The court added: “[A] court or legislature which should allow a change in public sentiment to influence it in giving to a written Constitution a construction not warranted by the intention of its founders, would be justly chargeable with reckless disregard of official oath and public duty.”<sup>176</sup> Thus, the court's goal was to look to the original intent and interpretations of the clause, rather than the current Supreme Court jurisprudence, to interpret the state provision.

After considering the early case precedent on the issue and the history surrounding the adoption of both the federal and state contract impairment clauses, the court determined the act violated the state contract impairment clause.<sup>177</sup> The court held that public policy did not trump a constitutional provision's original intent, and that the clause was not originally intended to allow any emergency exception.<sup>178</sup> The fact that the law impaired contractual obligations was undisputed in the case.<sup>179</sup> The state argued, however, that the legislature had the power to impair contractual obligations during periods of economic crisis.<sup>180</sup> The court rejected the argument, noting that the state's declaration of an emergency did not trigger a police power capable of modifying the “effect of constitutional provisions.”<sup>181</sup> The court further noted

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<sup>172</sup> *Id.* at 772 (“The United States Supreme Court and the Supreme Court of this State are peers. The decisions of the former upon the Federal constitution and laws are binding on the latter: the decisions of the latter upon the constitution and laws of Nebraska are binding on the former.”).

<sup>173</sup> *See id.* at 772–78.

<sup>174</sup> *See id.* at 772–73.

<sup>175</sup> *Id.* at 772.

<sup>176</sup> *Id.*

<sup>177</sup> *See id.* at 772–78.

<sup>178</sup> *See id.*

<sup>179</sup> *Id.* at 773 (“That the Nebraska moratorium act impairs the ‘obligation of contracts’ . . . This is admitted by appellees, both in their brief and in their argument presented at the bar of this court.”).

<sup>180</sup> *Id.*

<sup>181</sup> *Id.* at 775.

that the contract impairment clause was adopted during a time of a financial emergency; thus, it would not make sense to alter its meaning because of the existence of an emergency.<sup>182</sup>

*First Trust Co.* provides a blueprint for state courts to follow in adopting a stricter standard. The court in *First Trust Co.* did not simply reject the Supreme Court's standard from *Blaisdell* and adopt a stricter interpretation. Importantly, the court made it clear that it had both the authority and precedent to support such an interpretation.<sup>183</sup> First, the court established that *Blaisdell* does not bind state courts in interpreting a state contract impairment clause.<sup>184</sup> Then, the court established a stricter standard based on the original interpretations and intent of the clause.<sup>185</sup>

##### 5. *Government Contracts in Particular Should Have a Stricter Standard*

Although state courts clearly have the ability to establish a stricter standard of interpretation for their own constitutional contract impairment clauses, the courts might still be reluctant to throw out the federally inspired jurisprudence.<sup>186</sup> However, even if the courts are reluctant to adopt a stricter standard in general, they should still adopt one in the context of chapter 9 bankruptcy. Municipal bankruptcies involve contracts made with a government entity. Thus, in authorizing a municipal bankruptcy, a state government effectively allows a division of itself to impair its own contractual obligations. The Supreme Court has established that this kind of self-interest should inspire a heightened level of scrutiny.<sup>187</sup>

The Supreme Court addressed the self-interest concern in 1977 in *U.S. Trust Co. of New York*.<sup>188</sup> Despite the Court's continuing acceptance of the relaxed standard from *Blaisdell*, in *U.S. Trust Co. of New York*, it acknowledged that "some limits remain on state abrogation of contracts."<sup>189</sup> In

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<sup>182</sup> *Id.* at 777 ("The Constitution was adopted in a period of grave emergency. Its grants of power to the federal government and its limitations of the power of the States were determined in the light of emergency, and they are not altered by emergency.") (quoting *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 425 (1934)).

<sup>183</sup> *See id.* at 772–78.

<sup>184</sup> *See id.* at 771–72.

<sup>185</sup> *See id.* at 772–78.

<sup>186</sup> *See First Trust Co.*, 277 N.W. 762; *State v. Hempele*, 576 A.2d 793 (N.J. 1990); *First Trust Joint Stock Land Bank of Chi. v. Arp.*, 293 N.W. 441 (Iowa 1939).

<sup>187</sup> *See U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 25–26 (1977).

<sup>188</sup> *Id.* at 16–32.

<sup>189</sup> *Id.* at 16; VOLOKH, OVERPROTECTING PUBLIC, *supra* note 98.

*U.S. Trust Co.*, the state of New Jersey had repealed a covenant among itself, New York, and “the holders of any affected bonds.”<sup>190</sup> The Court held that the repeal violated the Contract Clause.<sup>191</sup> Importantly, the Court noted the special circumstance of a government impairing its own contractual agreement and chose not to defer to the state legislature as it had in the past.<sup>192</sup> The Court held that “complete deference to a legislative assessment of reasonableness and necessity” would be inappropriate because “the [s]tate’s self-interest [was] at stake.”<sup>193</sup> The Court went on to say: “[i]f a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.”<sup>194</sup>

While the Court did not adopt a particularly strict standard for government impairment of its own contracts in *U.S. Trust Co. of New York*, the case provides a basis for state courts to adopt such a standard.<sup>195</sup> *U.S. Trust Co. of New York* did not overrule *Bekins*, and, therefore, chapter 9 authorization is still considered constitutional under the U.S. Constitution.<sup>196</sup> However, *U.S. Trust Co. of New York* recognizes the need to strictly scrutinize contract impairment by a self-interested government.<sup>197</sup> The case supports the proposition that a “[s]tate 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.”<sup>198</sup>

Thus, state courts should adopt a stricter interpretation of state constitutions’ contract impairment clauses in the context of chapter 9 bankruptcy, even if courts are not willing to adopt a stricter standard more generally. While municipal bankruptcy authorization could potentially be in the best interest of the public, it would come at the cost of creditors of a state’s subdivisions. As the Supreme Court in *U.S. Trust Co. of New York* asserts, a state should not be allowed to dodge its financial obligations to creditors

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<sup>190</sup> *U.S. Trust Co. of N.Y.*, 431 at 17–18.

<sup>191</sup> *Id.* at 32.

<sup>192</sup> *Id.* at 27–28.

<sup>193</sup> *Id.* at 26.

<sup>194</sup> *Id.*

<sup>195</sup> *Id.* at 25–26 (holding the impairment is still constitutional if it is reasonable and necessary to promote a legitimate public purpose, but not giving deference to the legislature on either prong).

<sup>196</sup> *United States v. Bekins*, 304 U.S. 27, 52–54 (1938); *U.S. Trust Co. of N.Y.*, 431 U.S. at 26.

<sup>197</sup> *U.S. Trust Co. of N.Y.*, 431 U.S. at 29–31.

<sup>198</sup> *Id.* at 29.

simply to “promote the public good.”<sup>199</sup> In the words of the Court: “A governmental entity can always find use for extra money, especially when taxes do not have to be raised.”<sup>200</sup>

### *C. Chapter 9 Authorization Is Inconsistent with a Strict Contract Clause Standard*

Now that it has been established that state courts need to adopt a stricter standard for their constitutions’ contract impairment clauses, the next step is to consider exactly what that standard should look like. The early decisions of the Supreme Court provide the best guidance to state courts on how to apply a strict standard.<sup>201</sup> While the early decisions do not create a crystal clear test, they definitively establish that a strict standard would prohibit state chapter 9 authorizations to the extent that they would allow for contract impairment.

#### *1. Establishing a Strict Standard*

As previously discussed, the Supreme Court originally interpreted the Contract Clause quite strictly.<sup>202</sup> State courts, then, can look to the early decisions of the Court to determine what a stricter standard should look like. What should first be noted about the early Supreme Court cases is that “even during its heyday” the Contract Clause “was not read with literal exactness.”<sup>203</sup> Thus, while reading a state’s contract impairment clause as an absolute bar to any contract impairment is certainly a possibility, it is not necessarily what a stricter standard demands.

In his dissent in *Blaisdell*, Justice Sutherland recounted much of the Court’s Contract Clause jurisprudence prior to that decision and the Contract Clause’s original understanding.<sup>204</sup> He came to two very important and clear conclusions: (1) the Contract Clause “was framed to bar the states from granting debtor relief at the expense of creditors in periods of economic distress”; and (2) an emergency could not “justify ignoring the restrictions of the Contract Clause on the states.”<sup>205</sup> Justice Sutherland noted that prior to

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<sup>199</sup> *Id.*

<sup>200</sup> *Id.* at 26.

<sup>201</sup> See *Home Bldg. & Loan Ass’n v. Blaisdell*, 290 U.S. 398, 464–72 (1934) (Sutherland, J., dissenting); Ely, Jr., *supra* note 99, at 376–81.

<sup>202</sup> See *id.* at 455–72; Ely, Jr., *supra* note 99, at 376.

<sup>203</sup> Ely, Jr., *supra* note 99, at 376.

<sup>204</sup> See 290 U.S. at 450–72 (Sutherland, J., dissenting).

<sup>205</sup> Ely, Jr., *supra* note 99, at 390; see also *Blaisdell*, 290 U.S. at 465–72 (Sutherland, J., dissenting).

*Blaisdell* when states had attempted to get around the Contract Clause for either of those reasons, the Court had consistently struck down the legislation.<sup>206</sup> He wrote:

The vital lesson . . . that public or private extravagance, financed by promises to pay, either must end in complete or partial repudiation or the promises be fulfilled by self-denial and painful effort, though constantly taught by bitter experience, seems never to be learned; and the attempt by legislative devices to shift the misfortune of the debtor to the shoulders of the creditor without coming into conflict with the contract impairment clause has been persistent and oft-repeated.<sup>207</sup>

What then would a stricter standard based on the original understanding and Supreme Court interpretations look like? Justice Sutherland’s dissent shows that at the very least it would prohibit a state from passing legislation that impairs contractual obligations in order to relieve the debtors of their liabilities at their creditors’ expense.<sup>208</sup> This Contract Clause protection is not diminished because of the presence of an emergency,<sup>209</sup> and it should only be heightened when the debtor is the government.<sup>210</sup>

Accordingly, the test under a stricter standard should only have two prongs. First, does the state action actually impair a contractual obligation? This is a threshold question that must first be established; otherwise, it would be improper to apply the contract impairment clause in the first place. The strictest standard would end after this threshold question. However, as discussed earlier in this Comment, even in early precedent where the Contract Clause was at its strongest within the courts, the clause was still not necessarily read as absolute.<sup>211</sup> Such a strict textualist approach would have little precedential support and might even be inconsistent with the original interpretations and understanding of the Contract Clause.<sup>212</sup>

Thus, if the courts find impairment of a contractual obligation, the inquiry must probably go a step further. Specifically, the Court’s stricter standard focused on the purpose of the impairment, and its consistency with the original

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<sup>206</sup> *Blaisdell*, 290 U.S. at 464–72 (Sutherland, J., dissenting).

<sup>207</sup> *Id.* at 471–72.

<sup>208</sup> *See id.*

<sup>209</sup> *See id.* at 471–74.

<sup>210</sup> *See* U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 51–56 (1977).

<sup>211</sup> Ely, Jr., *supra* note 99, at 376.

<sup>212</sup> *See id.*

interpretations and understanding of the clause.<sup>213</sup> Thus, the second prong is to establish the purpose of the impairment. If the purpose of the impairment is inconsistent with the purpose of the clause, then it fails the test.

While this test is simple to articulate, it may be much more complicated in application. But it has already been established that a law passed to relieve debtors of their liabilities at their creditors' expense does not serve a valid purpose, and that alone is sufficient to prevent state authorization of most municipal bankruptcies.<sup>214</sup>

## 2. *Applying the Strict Standard to Chapter 9 Authorization*

Application of this standard to chapter 9 authorization, then, requires a two-part inquiry: (1) Does the authorization impair contractual obligations? And (2) what is the purpose of the impairments? If authorizing a municipal bankruptcy impairs contractual obligations, then it must be for an acceptable purpose consistent with the clause's purpose. That purpose cannot be granting relief to debtors at their creditors' expense, even in the case of an emergency, and especially in the case of government contractual obligations.<sup>215</sup>

The first prong of this test is satisfied because courts should either find that authorizing municipal bankruptcies actually impairs contractual obligations or they should presume that it would. By authorizing a municipal bankruptcy, the state is opening the doors for municipalities to impair contractual obligations. With the state's authorization secured, the municipality is free to enter into bankruptcy, assuming it meets the other chapter 9 eligibility requirements.<sup>216</sup> Prior to the authorization, the municipality's creditors have a right to keep their contracts from being impaired.<sup>217</sup> Once the municipality enters into bankruptcy though, it is no longer limited by the contract impairment clause.<sup>218</sup> Thus, after the state authorization, the creditors lose that very important right. Courts could consider such a loss of rights as an impairment derived directly from state authorization of a municipal bankruptcy.

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<sup>213</sup> See *Blaisdell*, 290 U.S. at 464–71 (Sutherland, J., dissenting).

<sup>214</sup> See *id.* at 471–73.

<sup>215</sup> See *id.* at 471–72; *U.S. Trust Co. of N.Y.*, 431 U.S. at 55–56.

<sup>216</sup> See, e.g., *Ass'n of Retired Emp. v. City of Stockton (In re City of Stockton)*, 478 B.R. 8, 16 (Bankr. E.D. Cal. 2012).

<sup>217</sup> See, e.g., U.S. CONST. art. I, § 10, cl. 1; MICH. CONST. art. I, § 10 (“No . . . law impairing the obligation of contract shall be enacted.”).

<sup>218</sup> See, e.g., *City of Stockton*, 478 B.R. at 16.

Even if state courts refuse to accept that the authorization is an actual impairment, they should still presume that authorizing a municipal bankruptcy will impair contractual obligations. Bankruptcy courts have consistently acknowledged that contracts are most likely going to be impaired during a chapter 9 bankruptcy.<sup>219</sup> Bankruptcy courts have also had no problem expressly permitting such impairment to occur.<sup>220</sup> As Judge Klein wrote in his opinion in *In re City of Stockton*, contract impairment has a “starring role” in bankruptcy proceedings.<sup>221</sup> Judge Klein went so far as to claim that “every discharge impairs contracts.”<sup>222</sup> At least one bankruptcy court has even made it a requirement that the municipality’s adjustment of debts impairs or modifies its debts in some way.<sup>223</sup>

Still, most jurisdictions do not require impairment of debts, and it is theoretically possible for a municipality to file bankruptcy and not impair contractual obligations.<sup>224</sup> For example, if after filing for bankruptcy the municipality received a large amount of money from its own debtors, it could have enough to pay all of its creditors. If that were to occur, though, bankruptcy would no longer be necessary for the municipality, and the case would be dismissed, as the municipality would no longer meet the insolvency requirement of chapter 9.<sup>225</sup>

Another theoretical possibility is that a municipality could file bankruptcy without having any contractual obligations. If the municipality has no contractual obligations but has developed significant non-contractual debt, such as a tort judgment, then the bankruptcy proceedings would not be within the scope of any contract impairment clauses. However, for this to be the case the municipality must have absolutely no contractual obligations because even the smallest amount would create a possible impairment and violation of the contract clause. Therefore, state courts should presume that all chapter 9 bankruptcies will impair contractual obligations but allow municipalities an opportunity to rebut this presumption. In the rare event that municipalities have

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<sup>219</sup> See, e.g., *id.*; *In re City of Detroit*, 504 B.R. 191, 247 (Bankr. E.D. Mich. 2013).

<sup>220</sup> See, e.g., *City of Stockton*, 478 B.R. at 16; *City of Detroit*, 504 B.R. at 246–48.

<sup>221</sup> *City of Stockton*, 478 B.R. at 16.

<sup>222</sup> *Id.*

<sup>223</sup> See *In re Town of Westlake*, 211 B.R. 860, 867 (Bankr. N.D. Tex. 1997); see also 6 COLLIER ON BANKRUPTCY, *supra* note 28, at ¶ 900.02.

<sup>224</sup> See 6 COLLIER ON BANKRUPTCY, *supra* note 28, at ¶ 900.02.

<sup>225</sup> See 11 U.S.C. § 109(c)(3) (2012); see also 6 COLLIER ON BANKRUPTCY, *supra* note 28, at ¶ 900.02.

no contractual obligations, state courts could allow the bankruptcy to proceed.<sup>226</sup>

The issue in this Comment, though, is whether the authorization of a chapter 9 bankruptcy will impair contractual obligations, not a chapter 9 bankruptcy itself. Once state courts presume that all chapter 9 bankruptcies will impair contractual obligations, they should also take the next step to presume that chapter 9 *authorization* also impairs contractual obligations. Although the authorization itself may not necessarily impair contractual obligations because it is possible that no municipalities ever actually file for bankruptcy, there is no reason for courts to treat the authorization differently from the filing. It has already been established that courts should presume that all chapter 9 bankruptcies will impair contractual obligations, and, therefore, filing for chapter 9 should be a presumed impairment. If courts make this finding, then chapter 9 authorization by the state is meaningless because municipalities are already barred from filing.

Furthermore, the rationale behind the presumption for filing applies equally to authorization. Once a municipality has filed for bankruptcy under state authorization, federal law trumps the state constitution.<sup>227</sup> As discussed in the Background section of this Comment, the state constitution does not limit federal bankruptcy power.<sup>228</sup> The state court can no longer enforce the state contract impairment clause once the state has authorized the chapter 9 filing, other than by finding the authorization itself as an impairment.<sup>229</sup> If the state court does not presume chapter 9 authorization impairs contractual obligations, the court will simply be allowing the state to sidestep its constitution and, thus, significantly strip it of its power. Again, however unlikely it may be, theoretically a municipality could have no contractual obligations, and its bankruptcy would fall outside the scope of states' contract clauses.<sup>230</sup> Courts, then, must allow states the opportunity to rebut the presumption of impairment by showing the authorization only applies to the municipalities without contractual obligations. Importantly though, while this opportunity to rebut

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<sup>226</sup> See Michael S. Reich, *Ten Guidelines to Municipal Contracts*, ILL. MUN. REV., Jan. 1987, at 7, <http://www.lib.niu.edu/1987/im870107.html> (explaining that in Illinois all municipalities enter into numerous contracts every year).

<sup>227</sup> *County of Orange v. Merrill Lynch & Co. (In re County of Orange)*, 191 B.R. 1005, 1021 (Bankr. C.D. Cal. 1996).

<sup>228</sup> See, e.g., *Ass'n of Retired Emp. v. City of Stockton (In re City of Stockton)*, 478 B.R. 8, 16 (Bankr. E.D. Cal. 2012).

<sup>229</sup> See, e.g., *id.*

<sup>230</sup> See, e.g., MICH. CONST. art. I, § 10 (prohibiting the impairment of *contract* obligations).

must exist, in practice “[e]ven the smallest . . . municipalities enter into scores of contracts each year.”<sup>231</sup>

The threshold question of contractual impairment is satisfied, then, as long as the municipality has any contractual obligations, and the question becomes whether the purpose of the impairment is permissible.<sup>232</sup> This second prong is a two-part process. First, the purpose of the impairment must be established, and only then can the court determine whether the purpose justifies the impairment. Again, the impairment here is the state’s authorization of a municipal bankruptcy, and therefore, the next step is to establish the state’s purpose in authorizing a municipal bankruptcy.

It can be safely assumed that the primary purpose of authorizing a municipal bankruptcy is to allow the municipality to gain the benefits of filing bankruptcy. Thus, the inquiry in this instance should focus predominantly on the purpose of a municipality entering into bankruptcy. *Collier on Bankruptcy* states that the purpose of chapter 9 is “to permit a financially distressed public entity to seek protection from its creditors while it formulates and negotiates a plan for adjustment of its debts.”<sup>233</sup> Importantly though, it also states the purpose is “to provide the mechanism by which the plan that is acceptable to the majority of creditors can be made binding on a recalcitrant and dissenting minority.”<sup>234</sup> The purpose, then, is not only to protect the municipality from creditors while it negotiates with creditors, but also to give the municipality the ability to force creditors to renegotiate and accept contracts.<sup>235</sup>

These two primary purposes stated in *Collier on Bankruptcy* work to do exactly what Justice Sutherland’s dissent made clear would not be acceptable: passing the misfortunes of a debtor onto the shoulders of its creditors.<sup>236</sup> The ability to keep creditors from taking action to recover from the municipality takes away the creditors’ right to recover for the benefit of the indebted municipality. Furthermore, the ability to force creditors to accept a plan, even if they do not wish to accept the agreements, takes away creditors’ freedom to contract because of the municipality’s need to cut its debts.

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<sup>231</sup> Reich, *supra* note 226.

<sup>232</sup> See *Home Bldg. & Loan Ass’n v. Blaisdell*, 290 U.S. 398, 465–72 (1934) (Sutherland, J., dissenting).

<sup>233</sup> 6 COLLIER ON BANKRUPTCY, *supra* note 28, at ¶ 900.01.

<sup>234</sup> *Id.*

<sup>235</sup> See *id.*

<sup>236</sup> See *Blaisdell*, 290 U.S. at 471–72 (Sutherland, J., dissenting); 6 COLLIER ON BANKRUPTCY, *supra* note 28, at ¶ 900.01.

To be fair, one could argue that most contract impairments will benefit one party at the expense of another; however, this standard is not impossible to pass. For example, if a state were to pass a law prohibiting the sale of alcohol and invalidating any contract for such sale, state courts would have little grounds to conclude the law's primary purpose is to pass a debtor's misfortunes onto his creditors. The alcohol contracts would obviously be impaired, in fact destroyed, but prior to the passage of the law, the debtor (the alcohol producer) presumably had no misfortunes to pass to his creditors (the alcohol purchasers). The law would create misfortune. Thus, it would be illogical to argue that the purpose of the law was to pass along the debtor's misfortunes. It is clear, then, that this standard does not create an absolute bar to contract impairment, but it is also clear that the standard presents a bar to municipal bankruptcy authorization.

A look at Detroit's recent bankruptcy provides a real world example of a municipality shifting its misfortunes onto its debtors through the bankruptcy process.<sup>237</sup> At the height of its prosperity in 1952, the city of Detroit produced about half of the world's cars and had approximately 1,850,000 residents.<sup>238</sup> The city's population has now fallen below 700,000 residents, and its employment and revenue levels have dwindled.<sup>239</sup> These circumstances "led to decaying infrastructure, excessive borrowing, mounting crime rates, spreading blight, and a deteriorating quality of life."<sup>240</sup> Detroit lacks the resources to provide "basic police, fire and emergency medical services" to its residents.<sup>241</sup> All of this is to say that Detroit entered bankruptcy dealing with some very serious misfortunes.

Judge Rhodes stated in his opinion that the city needed help from the bankruptcy court to reverse its decline and "reinvigorate itself."<sup>242</sup> By filing for bankruptcy, the city did not just get help with its financial situation; it directly passed its misfortune onto its creditors. Among Detroit's many debts, the city had a \$5.7 billion unsecured debt for the Health and Life Insurance Benefit Plan and the Supplemental Death Benefit Plan and \$3.5 billion of unfunded pension obligations.<sup>243</sup> Under the Michigan constitution, those pension

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<sup>237</sup> See *In re City of Detroit*, 504 B.R. 191, 193–94 (Bankr. E.D. Mich. 2013); Walsh, *Detroit Emerges*, *supra* note 4, at B1.

<sup>238</sup> *City of Detroit*, 504 B.R. at 193.

<sup>239</sup> *Id.* at 194.

<sup>240</sup> *Id.* at 193.

<sup>241</sup> *Id.*

<sup>242</sup> *Id.* at 194.

<sup>243</sup> *Id.*

obligations could not be impaired, but the bankruptcy court made clear that once the city entered into bankruptcy those pensions were no longer protected.<sup>244</sup> Ultimately, the retirees accepted a plan with “reductions to their monthly checks and other cutbacks.”<sup>245</sup> The pensioners lost both their rights and money through the bankruptcy, and yet most considered them to have made out quite well compared to the other creditors.<sup>246</sup> Bondholders, for example, fared much worse in the bankruptcy.<sup>247</sup> With their contracts open to impairment, unlimited-tax general obligation bondholders took a 26% cut and limited-tax general obligation bondholders took a 66% cut.<sup>248</sup>

Bondholders and pensioners both had rights to repayment stripped away through the bankruptcy proceedings and then had to make deals with the city diminishing their rights.<sup>249</sup> The *help* that the bankruptcy provided Detroit was the ability to strip away the bondholders’ and pensioners’ rights as creditors.<sup>250</sup> Bankruptcy courts take away the rights of creditors in order to fulfill the two stated purposes of a municipal bankruptcy from *Collier on Bankruptcy*.<sup>251</sup> The Detroit bankruptcy shows that when these purposes are played out, it becomes quite clear that they violate a stricter standard like the one established in this Comment.

#### *D. Policy of Upholding Constitution Trumps Policy of Supporting Municipal Bankruptcy*

If state courts consider policy in their decisions, then they might be tempted to primarily consider the soundness of a policy in support of municipal bankruptcies; however, while state courts may consider the policy of municipal bankruptcies, that consideration should be given much less weight than the implications of its constitutional interpretation. It is not the place of courts to determine whether authorization of municipal bankruptcies is a sound

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<sup>244</sup> *Id.* at 198.

<sup>245</sup> Walsh, *Detroit Emerges*, *supra* note 4, at B1.

<sup>246</sup> See Caitlin Devitt, *Detroit, Like Stockton, Reveals Growing Tension Between Pensions and Bonds*, BOND BUYER (Nov. 10, 2014, 10:01AM), <http://www.bondbuyer.com/news/regionalnews/detroit-like-stockton-reveals-growing-tension-between-pensions-and-bonds-1067798-1.html>.

<sup>247</sup> See Devitt, *supra* note 246.

<sup>248</sup> *Id.*

<sup>249</sup> *In re City of Detroit*, 504 B.R. 191, 198 (Bankr. E.D. Mich. 2013); see Devitt, *supra* note 246.

<sup>250</sup> See *City of Detroit*, 504 B.R. 191 (allowing the city to impair contractual obligations, including pensions, in its bankruptcy plan).

<sup>251</sup> See, e.g., *id.* at 274; 6 COLLIER ON BANKRUPTCY, *supra* note 28, at ¶ 900.01.

policy.<sup>252</sup> It is the purpose of courts, however, to uphold the constitutions of their respective states.<sup>253</sup> Therefore, this Comment does not attempt to determine the soundness of municipal bankruptcy as a policy decision because it is obviously trumped by the courts' policy of upholding their constitutions.<sup>254</sup> As Justice Sutherland stated, "The only legitimate inquiry we can make is whether it is constitutional. If it is not, its virtues . . . if it have any, cannot save it; if it is, its faults cannot be invoked to accomplish its destruction."<sup>255</sup>

In any event, the wisdom of municipal bankruptcy as a policy matter is far from clear.<sup>256</sup> The history of political battles around municipal bankruptcies shows that it is often a contested policy decision.<sup>257</sup> States have multiple options when it comes to insolvent municipalities. Other than authorizing municipal bankruptcy, a state could also choose to pass other legislation to assist financially troubled municipalities. Importantly, a state could pass legislation that would help an insolvent municipality without confronting its contract impairment clause. States have several legislative options such as bailouts, receiverships, consolidations, and debt limits.<sup>258</sup>

For example, in Georgia where municipalities are not authorized to file for bankruptcy, cities are not left merely to fend for themselves in times of severe financial distress.<sup>259</sup> The state may not be able to authorize a municipal bankruptcy, but it could aid a municipality in other manners such as providing emergency funds.<sup>260</sup> In fact, state bailouts are "the most popular solution to municipal insolvency."<sup>261</sup> Legislatures may also choose to enact receivership or emergency manager statutes that would allow a state or a state-appointed

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<sup>252</sup> See *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 483 (1934) ("Whether the legislation is wise or unwise as a matter of policy is a question with which we are not concerned.").

<sup>253</sup> See *id.*

<sup>254</sup> *Id.*

<sup>255</sup> *Id.*

<sup>256</sup> See *In re City of Vallejo*, 432 B.R. 262, 268 (E.D. Cal. 2010), *aff'g* 403 B.R. 72 (Bankr. E.D. Cal. 2009) ("[A] state's authorization that its municipalities may seek Chapter 9 relief is a declaration of state policy that the benefits of Chapter 9 take precedence over control of its municipalities.").

<sup>257</sup> See Walsh, *Alabama Governor*, *supra* note 49; Tavernise, *supra* note 49; Davey, *supra* note 49.

<sup>258</sup> See MUNICIPAL ASSETS IN DISTRESS TASK FORCE, ALSTON & BIRD LLP, OPTIONS FOR DEALING WITH MUNICIPAL ASSETS IN DISTRESS 3–5 (2011), <http://www.alston.com/files/docs/MAD-TaskForce.pdf> [hereinafter ALSTON & BIRD]; Megan S. Atwell et al., *The State Role in Local Government Financial Distress*, PEW CHARITABLE TRUSTS (July 2013), [http://www.pewtrusts.org/~media/assets/2013/07/23/pew\\_state\\_role\\_in\\_local\\_government\\_financial\\_distress.pdf](http://www.pewtrusts.org/~media/assets/2013/07/23/pew_state_role_in_local_government_financial_distress.pdf).

<sup>259</sup> Gramlich, *supra* note 50.

<sup>260</sup> *Id.*

<sup>261</sup> ALSTON & BIRD, *supra* note 258, at 3–5.

official to take control of municipal finances.<sup>262</sup> The state of Pennsylvania appointed a receiver to run Harrisburg after the city's bankruptcy case was dismissed.<sup>263</sup> Under the control of the receiver, the city negotiated a deal that paid off and restructured its \$600 million of debt.<sup>264</sup> States also have the power to dissolve a municipality and consolidate it with nearby local governments.<sup>265</sup> States could also take proactive action to keep its municipalities out of financial trouble by passing debt limits.<sup>266</sup> By strictly limiting the amount of debt a municipality can hold, a state significantly reduces the chances that any of its municipalities will reach a financial crisis stage.<sup>267</sup>

Thus, it is clear that states have alternatives to municipal bankruptcy authorization.<sup>268</sup> The purpose here is not to argue that these alternatives are more effective means of aiding financially distressed municipalities; the point here is simply that policy decisions should not trump a constitutional provision.<sup>269</sup> The real policy question for courts to consider is whether a policy matter such as municipal bankruptcy should be able to trump the clear meaning of a constitutional provision. State courts are setting a dangerous precedent that significantly devalues their constitutions if they answer that question in the affirmative.

The Nebraska Supreme Court wisely stated in its decision rejecting *Blaisdell* that “a limitation . . . expressed in the terms of a Constitution . . . [is] the exercise of the sovereign power,” and cannot be “modified or in any manner controlled . . . by a state governmental agency . . . if the power it seeks to exercise . . . is in any manner inconsistent with the express terms of the state Constitution.”<sup>270</sup> The ultimate “sovereign power” rests not in the states but in the people who, acting in their collective capacity, create, empower, and limit the government through constitutions.<sup>271</sup> By allowing a state government to

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<sup>262</sup> See *id.*; Atwell et al., *supra* note 258.

<sup>263</sup> See Mary W. Walsh & Jon Hurdle, *Harrisburg Sees Path to Restructuring Debts Without Bankruptcy Filing*, N.Y. TIMES, July 25, 2013, at A12; Emily Prevetti, *Harrisburg to Formally Exit Receivership March 1, Lynch to Step Down*, PENN LIVE (Feb. 26, 2014, 4:22 PM), [http://www.pennlive.com/midstate/index.ssf/2014/02/harrisburg\\_to\\_formally\\_exit\\_re.html](http://www.pennlive.com/midstate/index.ssf/2014/02/harrisburg_to_formally_exit_re.html).

<sup>264</sup> Prevetti, *supra* note 263.

<sup>265</sup> Atwell et al., *supra* note 258.

<sup>266</sup> See ALSTON & BIRD, *supra* note 258, at 3–5.

<sup>267</sup> See *id.*

<sup>268</sup> See *id.*; Atwell et al., *supra* note 258.

<sup>269</sup> See, e.g., *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 483 (1934) (Sutherland, J., dissenting); *First Trust Co. of Lincoln v. Nebraska*, 277 N.W. 762, 777 (Neb. 1938).

<sup>270</sup> *First Trust Co.*, 277 N.W. at 777.

<sup>271</sup> *Id.*

exceed its constitutional limits, courts disrespect the sovereignty of the people of their respective states. State courts should instead respect both the powers and limitations the people have placed on government. Contract impairment clauses are a sovereign exercise of the people, and they were clearly meant to apply in municipal bankruptcy situations. Thus, the correct policy decision for state courts is to respect and uphold their constitutions even if it prohibits a program that many find effective. As Justice Sutherland stated in the final paragraph of his *Blaisdell* dissent, “If the provisions of the Constitution be not upheld when they pinch as well as when they comfort, they may as well be abandoned.”<sup>272</sup>

### CONCLUSION

State courts should not allow the Contract Clause jurisprudence of the Supreme Court to be a tool to devalue their own constitutions. Contract impairment clauses were clearly meant to have a stricter standard than they have today.<sup>273</sup> The Contract Clause and state contract impairment clauses should have never allowed states to enact laws that would relieve the debtors of their debts at the expense of their creditors.<sup>274</sup> Yet, municipal bankruptcy does just that and, in the Supreme Court’s eyes, remains perfectly consistent with the federal Contract Clause.<sup>275</sup> Fortunately, the Court’s precedent does not bind state courts when interpreting their own contract impairment clauses.<sup>276</sup> For the sake of their own constitutions, state courts need to give their contract impairment clauses the interpretation they were intended to have even though that would require them to strike down any law authorizing or permitting the authorization of a chapter 9 bankruptcy filing. State courts would not only rescue their states’ contract impairment clauses from a flawed jurisprudence by holding as such, but they would also uphold the integrity of their states’ constitutions.

Importantly, state courts can accomplish this feat without dooming their states because states with contract impairment clauses in their constitutions

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<sup>272</sup> *Blaisdell*, 290 U.S. at 483 (Sutherland, J., dissenting).

<sup>273</sup> *See id.* at 455–72; Ely, Jr., *supra* note 99.

<sup>274</sup> *See Blaisdell*, 290 U.S. at 471–72 (Sutherland, J., dissenting).

<sup>275</sup> *See United States v. Bekins*, 304 U.S. 27, 52–54 (1938).

<sup>276</sup> *See Wilson Banking Co. Liquidating Corp. v. Colvard*, 161 So. 123, 127 (Miss. 1935) (“[D]ecisions of the Supreme Court of the United States construing provisions of the federal Constitution are not binding on a state court construing similar provisions of its own state constitution.”); *see also First Trust Co. of Lincoln*, 277 N.W. 762; *Commonwealth v. Wilkins*, 138 N.E. 11 (Mass. 1923); *State v. Chin Gim*, 224 P. 798 (Nev. 1924).

have several viable alternatives to authorizing chapter 9 filings. For example, states could appoint emergency managers, establish debt limits, and distribute emergency bailouts.<sup>277</sup> If states determine that those methods will not be sufficient and still wish to open the doors of chapter 9 bankruptcy to their municipalities, there is another simple solution. States can always amend their constitutions to either remove the contract impairment clause or provide an express exemption for chapter 9 bankruptcy.

Unlike the U.S. Constitution, state constitutions are frequently amended.<sup>278</sup> Research has shown that “there have been almost 150 state constitutions, they have been amended roughly 12,000 times, and the text of the constitutions and their amendments comprises about 15,000 pages of text.”<sup>279</sup> Furthermore, almost every state allows its legislature to propose an amendment for ratification.<sup>280</sup> Thus, legislatures do not even have to wait for the citizens of their states to initiate the amendment process; if they want to allow municipalities to have access to chapter 9, they can begin the amendment process themselves. This is not to say that amending state constitutions is necessarily an easy solution, but this is the only approach that would allow states to enact their desired policy without coming into conflict with their contract impairment clauses.

Given recent trends, municipal bankruptcy filings should be expected to grow in both quantity and scale in coming years.<sup>281</sup> The history of municipal bankruptcies also suggests that filings are going to face more and more legal challenges, and although this state contract impairment clause issue has not yet faced many state courts, they will likely face it head on in the near future. In considering the issue, state courts will not only decide a matter of bankruptcy policy; more importantly, they will decide constitutional policy. By striking down laws authorizing or permitting the authorization of chapter 9 bankruptcies under the contract impairment clauses of their constitutions, state

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<sup>277</sup> See ALSTON & BIRD, *supra* note 258, at 3–5; Atwell et al., *supra* note 258.

<sup>278</sup> NAT’L BUREAU ECON. RES. MD. ST. CONST. PROJECT, <http://www.stateconstitutions.umd.edu/index.aspx> (last visited Jan. 23, 2016).

<sup>279</sup> *Id.*

<sup>280</sup> See BRADEN ET AL., *supra* note 97.

<sup>281</sup> See AM. BANKR. INST., *supra* note 41; Hess et al., *supra* note 2.

courts can make an emphatic statement that the clauses still carry the force they were intended to have.

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