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The Honorable Rob Bishop, Chairman
U.S. House of Representatives, Committee on Natural Resources
1324 Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 4900, the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA)

Dear Chairman Bishop and Members of the Committee,

Thank you for inviting me to testify on April 13, 2016 on the constitutionality of the new draft of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA). As you know, current federal bankruptcy law does not provide either a voluntary or involuntary debt adjustment process for U.S. states or territories. PROMESA would create such a process for territories. At the hearing, questions were asked about whether a debt adjustment bill similar to PROMESA could be enacted for U.S. state governments. I was asked to submit a letter amplifying my testimony about that topic, in particular focusing on the Contracts Clause of the U.S. Constitution.

As I understood the thrust of several questions, there might be concern about whether a debt adjustment law for territories, such as the current draft of PROMESA, could create a precedent for a bankruptcy bill for states. The constitutional considerations regarding congressionally-authorized debt adjustment for territories, like Puerto Rico, and debt adjustment for U.S. states are starkly different. So different that, in my view, PROMESA would not create constitutional precedent for a debt adjustment statute for states.

Territories and states are fundamentally distinct in our constitutional system. "[U]nder our federal system, the States possess sovereignty concurrent with that of the Federal Government, subject only to limitations imposed by the Supremacy Clause." *Gregory v. Ashcroft*, 501 U.S. 452, 457 (1991) (quotation marks omitted). "[T]he preservation of the States, and the maintenance of their governments, are as much within the design and care of the Constitution as the preservation of the Union and the maintenance of the National government. The Constitution, in all its provisions, looks to an indestructible Union, composed of indestructible States." *Id*. (quoting *Texas v. White*, 7 Wall. 700, 725 (1869)).

State sovereignty limits federal power in a variety of important ways. *See, e.g.,* U.S. Const., art. 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."); *id*. art. XI ("The judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by citizens of another state, or by citizens or subjects of any foreign state."). Congressional power, when legislating for the states of the union, is limited to certain enumerated and implied topics of national concern.

By contrast, the Constitution empowers Congress to "make all needful rules and regulations respecting the territory or other property belonging to the United States." U.S. Const., art. IV, § 3. Unlike U.S. states, territories are not constitutional sovereigns whose existence, structure, and powers are protected from federal infringement by the Constitution. Over a territory or dependency "the nation possesses the sovereign powers of the general government plus the powers of a local or a state government in all cases where legislation is possible." *Cincinnati Soap Co. v. United States*, 301 U.S. 308, 317 (1937). Thus, "[t]he powers vested in Congress by" the Territorial Clause "to govern Territories are broad," *Examining Bd. of Engineers, Architects, & Surveyors v. Flores de Otero*, 426 U.S. 572, 586 n.16 (1976), "plenary," *Binns v. United States*, 194 U.S. 486, 491 (1904), and even "practically unlimited," *Cincinnati Soap Co.*, 301 U.S. at 317.

As my written testimony for the April 13, 2016 hearing indicates, I believe that Congress has authority under Territorial Clause of Article IV to enact the PROMESA bill. But if Congress acting under Article I powers were to amend the bankruptcy code to allow either voluntary or involuntary debt adjustment for U.S. states, very serious questions would be raised about constitutionality. I cannot say definitively that such a statutory scheme would be found unconstitutional—extant Supreme Court case law does not allow that kind of precision, and the membership of the Court will likely be changing in the next year or so—but there is certainly a great risk of unconstitutionality.

The first question would be whether Congress has enumerated or implied power to enact bankruptcy legislation for state governments. The Constitution's Bankruptcy Clause provides that "The Congress shall have power to . . . establish . . . uniform laws on the subject of bankruptcies throughout the United States." U.S. Const., art. I, § 8, cl. 4. The Supreme Court has never been squarely confronted with the question whether this power allows bankruptcy legislation for state governments. Certainly we can say, though, that the members of the Founding generation who drafted and voted to adopt this language did not contemplate that Congress would be legislating with regard to state governments. *See* Emily D. Johnson & Ernest A. Young, *The Constitutional Law of State Debt*, 7 Duke J. Const. L. & Pub. Pol'y 117, 155-56 (2012); Thomas Moers Mayer, *State Sovereignty, State Bankruptcy, and a Reconsideration of Chapter 9*, 85 Am. Bankr. L.J. 363, 367 (2011). But even if the Bankruptcy Clause could not support such legislation, Congress arguably would find sufficient power under the Interstate Commerce and Necessary and Proper Clauses of Article I of the Constitution. *But cf*. *Railway Labor Executives' Ass'n v. Gibbons*, 455 U.S. 457

(1982) (holding that Congress cannot do an end run around the uniformity requirement of the Bankruptcy Clause by legislating under the Commerce Clause).

A second question is whether state bankruptcy legislation would violate the Tenth Amendment and related principles protecting state sovereignty. In the 1930s, the Supreme Court held that a 1934 federal bankruptcy law for municipalities that allowed bankruptcy courts to impair the control of state governments over the fiscal affairs of their municipal subdivisions was not constitutional, *see Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513, 528-29 (1936); *id*. at 539 (Cardozo, J., dissenting), while the 1937 amendment that both required state consent and sufficiently protected state sovereignty was constitutional, *see United States v. Bekins*, 304 U.S. 27, 49-51 (1938).

These two decisions are widely understood to have suggested that, to pass constitutional muster, any federal bankruptcy regime that would apply to states would need to meet two requirements: states would need to consent (the process would need to be entirely voluntary), and the statute would need to prevent federal bankruptcy courts from undermining state autonomy and sovereignty over taxing, spending, and other core sovereign matters. *See, e.g.*, Michael E. McConnell, *Extending Bankruptcy Law to States*, in WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 229, 230 (Peter Conti-Brown & David A. Skeel, Jr., eds., Cambridge Univ. Press 2012); Mayer, *supra*, at 374-75.[1]

Ashton and *Bekins* thus suggest that a mandatory oversight authority for states—akin to that found in PROMESA—could be subject to fatal constitutional objections. *See* David A. Skeel, Jr., *States of Bankruptcy*, 79 U. Chi. L. Rev. 677, 731 (2012). But even a purely voluntary bankruptcy process that attempted to respect state sovereignty could run into constitutional problems under the Tenth Amendment and principles of state sovereignty articulated in *Ashton* and *Bekins.* First, "viewed realistically, state bankruptcy would cut deeply into the inherently sovereign powers of the statute over taxation and expenditure," transferring at least some control over those matters to a bankruptcy court. *See* McConnell, *supra*, at 233-34. In other words, it would be hard to design a process that in fact avoided all interference with a state's core fiscal functions.

Second, more recent Supreme Court case law raises questions about whether state consent could cure Tenth Amendment concerns about federal impairments of state sovereignty via a bankruptcy regime. The "anti-commandeering" case law bars Congress from "require[ing] the States to govern according to Congress' instructions," *New York v.*

[1] Federal bankruptcy for states without state consent might also be unconstitutional under the Eleventh Amendment and principles of state sovereign immunity. The Supreme Court has not directly answered this question, and its case law has given inconsistent signals. *Compare Seminole Tribe v. Florida*, 517 U.S. 44 (1996) (holding that Congress may not abrogate state sovereign immunity under Article I powers) *and Central Virginia Community College v. Katz*, 546 U.S. 356 (2006) (holding that state sovereign immunity did not bar a bankruptcy court from voiding a preferential transfer from a private debtor to a state instrumentality). *See generally* Johnson & Young, *supra*, at 159-60; Mayer, *supra*, at 368.

United States, 505 U.S. 144, 162 (1992), even if the state consents, *see id*. at 180-82. Federal legislation that commands state legislatures to regulate according to federal instructions disrupts the accountability of local officials to their local electorates and hence undermines the constitutional plan. *See id.* at 168-69. The Supreme Court has also reiterated that constitutional limits on federal action arising from federalism concerns and the Tenth Amendment protect structural interests and individual liberty, not just state sovereignty, *see, e.g., id*. at 181-82; *Bond v. United States*, 131 S. Ct. 2355, 2364 (2011), casting further doubt on whether state consent could cure an otherwise unwarranted invasion of state sovereignty. *See* McConnell, *supra*, at 234-35. If state consent is not effective, it is possible that even purely voluntary state bankruptcy would be unconstitutional, to the extent that it impaired the sovereignty and autonomy of state governments.

A third and final question is whether the Constitution would prohibit the impairment of state government contracts—for example, with bondholders—through a federal debt adjustment process overseen by a bankruptcy court. The Contracts Clause provides that "No State shall . . . pass any . . . law impairing the obligation of contracts." U.S. Const., art. I, § 10, cl. 1. It might be said that no Contracts Clause problem would be posed by a congressional statute authorizing state bankruptcy, *see* Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy,"* 59 U.C.L.A. L. Rev. 322, 337 (2011), because the federal government is not covered by the Contracts Clause, which expressly applies to "State[s]" only, *see Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 188 (1902). But if Tenth Amendment concerns, discussed above, require that the state consent to the federal bankruptcy process and to any court orders stemming from it, then it would not only be Congress but arguably the state also that would be choosing and authorizing actions that impaired state contracts. Thus the Contracts Clause could come into play.

The Supreme Court's 1930s cases about municipal bankruptcy and state sovereignty do not answer all questions about the Contracts Clause as applied to a hypothetical statute authorizing state bankruptcy. The *Ashton* decision, about the 1934 law, suggested that states would violate the Contracts Clause by consenting to a congressional bankruptcy scheme that impaired state contractual obligations. *See* 298 U.S. at 531. But *Bekins*, the subsequent decision about a very similar statute, the 1937 amendment, did not discuss any Contracts Clause issues, perhaps suggesting that the Supreme Court had *sub silentio* reversed itself on the issue.

Under modern Contracts Clause jurisprudence, "impairment of a State's own contracts would face more stringent examination . . . than would laws regulating contractual relationships between private parties." *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 244 n.15 (1978). State laws regulating existing contractual relations must have "a legitimate public purpose. A State could not adopt as its policy the repudiation of debts. . . ." *United States Trust Co. of New York v. New Jersey*, 431 U.S. 1, 22 (1977) (quotation marks omitted). The courts must guard against "the State's self-interest" leading it to abuse contracting partners. *Id*. at 26. Impairments of contract rights must be "reasonable and necessary to serve an important public purpose." *Id*. at 25. The greater and more

permanent the impairment to contract rights, the less likely it is to be constitutional. *See, e.g., Home Building & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 425, 430, 433, 441 (1934). Similarly, if contract rights were more theoretical than real to begin with, a subsequent impairment by the state is less likely to be proscribed by the Constitution. *See Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 510-13 (1942) (holding that bondholders' ability to sue defaulting municipalities under preexisting law was an empty "right to pursue a sterile litigation" and the challenged state law allowing municipal debt restructuring did not violate the Contracts Clause).

It cannot be predicted with certainty how voluntary state bankruptcy allowed by a congressional statute would be treated under the Contracts Clause by the Supreme Court applying the doctrines described above. A lot could depend on details—for instance, did the bankruptcy process impose significant "haircuts" on the principal owed to bondholders, or did it merely extend the payment period by a reasonably short amount of time. The former would be more likely unconstitutional than the latter.

The Supreme Court's case law under the Fifth Amendment also protects against impairment of contract rights. "The Supreme Court has made clear that retroactive legislation that affects valid property interests raises problems under both" the Takings Clause and the Due Process Clause of the Fifth Amendment. Johnson & Young, *supra*, at 144 (discussing *Eastern Enterprises v. Apfel*, 524 U.S. 498 (1998)). As with the Contracts Clause, it is uncertain how a hypothetical congressional statute for state bankruptcy would fare under the Fifth Amendment, and the outcome of judicial review would depend significantly on the particular details of the legislation and any challenged court orders issued pursuant to it.

In sum, a congressional statute allowing state government bankruptcy would raise a number of serious constitutional issues, implicating unsettled areas of Supreme Court doctrine. In my judgment, there is a real risk that either the legislation itself or particular applications of it by bankruptcy courts would be found unconstitutional. By contrast, as my April 13 testimony indicated, I believe that PROMESA rests on a firm constitutional foundation.

Sincerely,

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