

Revival of the Contract Clause

I. INTRODUCTION

Until the adoption of the fourteenth amendment, the contract clause,¹ because of its absolute prohibition of state impairments of contractual obligations, was the most important constitutional restraint on state power.² During the twentieth century, however, the United States Supreme Court softened the clause's rigid prohibition by holding that state legislation may constitutionally impair contractual obligations if the legislation "is addressed to a legitimate end and the measures taken are reasonable and appropriate to that end."³ The Court applied this test with almost complete deference to a state legislature's discretion.⁴

The Supreme Court's recent decision in *United States Trust Co. v. New Jersey*⁵ marks a radical departure from the deferential approach to the contract clause that had prevailed since the 1930's. The *United States Trust* majority⁶ held that a state's impairment of its own contractual obligations will be struck down unless it is both "reasonable and necessary to serve an important public purpose."⁷ Under this test, an impairment may be "reasonable" if it deals with circumstances that were unforeseen at the time of the making of the contract,⁸ and "necessary" if it achieves the state's asserted interest through the least restrictive means.⁹

The standard of review promulgated in *United States Trust* may revitalize the contract clause as an important limitation on state power. It is the purpose of this Case Comment to discuss this new constitutional test and its potential impact on future contract clause litigation.

1. U.S. CONST. art. I, § 10: "No State shall . . . pass any . . . Law impairing the Obligation of Contracts"

2. Until late in the nineteenth century, the Supreme Court dealt more frequently with contract clause issues than with any other constitutional provision except the commerce clause. See B. WRIGHT, *THE CONTRACT CLAUSE OF THE CONSTITUTION* 91-92 (1938).

3. *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 438 (1934).

4. See notes 32-49 and accompanying text *infra*.

5. 431 U.S. 1 (1977).

6. *United States Trust* was a 4-3 decision. Justices Rehnquist and Stevens and Chief Justice Burger joined Justice Blackmun's majority opinion. Justices White and Marshall sided with Justice Brennan's dissenting opinion. The Chief Justice also wrote a brief concurring opinion. Justices Stewart and Powell took no part in the decision.

7. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 25 (1977).

8. *Id.* at 31.

9. *Id.* at 30.

II. JUDICIAL INTERPRETATION OF THE CONTRACT CLAUSE

A. *Early Interpretation of the Clause*

The framers of the Constitution adopted the contract clause primarily to protect creditors from state legislation that enabled debtors to liquidate their private debts by tendering worthless property or depreciated paper money.¹⁰ This express limitation on state action was apparently motivated by the economic self-interest of the framers, most of whom were vested property owners and desired "to shield themselves and their property from the effects of those sudden and strong passions to which men are exposed."¹¹

To carry out the intent of the framers and to encourage the growth of commerce, the Supreme Court in the early nineteenth century construed the contract clause according to its literal meaning.¹² Most of the Justices in *Ogden v. Saunders* adhered to the principle that state legislation may never impair an existing obligation.¹³

While the contract clause prohibited legislative impairment of a contract's "obligation," it was interpreted to permit alteration of the "remedy" for breach of contract.¹⁴ Modification of a remedy was thought to be constitutional because the remedy was merely the means of enforcing an obligation, rather than part of the obligation itself. In *Sturges v. Crowninshield*,¹⁵ for example, the Court found permissible a legislative discharge of a debtor's imprisonment for default upon a debt. Imprisonment, the "remedy" for breach of the loan agreement, was seen as distinct from the "obligation" to repay the principal: "Imprisonment is no part of the contract, and simply to release the prisoner does not impair its obligation."¹⁶ Frequently, however, "remedy" and "obligation" were so intertwined that a stat-

10. See Hale, *The Supreme Court and the Contract Clause*, 57 HARV L. REV 512, 512 (1944). See also THE FEDERALIST No. 44 (J. Madison) (B. Wright ed. 1961) which contains a statement by Madison that the contract clause would help "banish speculations on public measures, inspire a general prudence and industry, and give a regular course to the business of society." *Id.* at 319.

11. *Fletcher v. Peck*, 10 U.S. (6 Cranch) 87, 138 (1810).

12. See *Ogden v. Saunders*, 25 U.S. (12 Wheat.) 213, 354-55 (1827) (Marshall, C.J., dissenting), cited with approval in *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 427-28 (1934). Chief Justice Marshall felt the contract clause was designed to insure the free flow of commerce and the existence of credit. See generally Hale, *supra* note 10, at 12.

13. Although a majority of the *Ogden* Court rejected the idea that the contract clause applies to modifications of contracts formed after the passage of a statute, almost all the Justices agreed that the contract clause absolutely prohibited statutes impairing current obligations. See, e.g., *Ogden v. Saunders*, 25 U.S. (12 Wheat.) 213, 335 (1827) (Marshall, C.J., dissenting): "a State is as entirely forbidden to pass laws impairing the obligation of contracts, as to make treaties, or coin money." Unlike the majority of Justices, however, Chief Justice Marshall wanted this rigid prohibition to be used for prospective impairments of contract.

14. See *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122, 200-01 (1819).

15. *Id.*

16. *Id.* at 201.

ute purporting to modify only the remedy for breach of a contract also impaired the contract's obligation.¹⁷ When the alteration of a remedy diminished the value of a contract, the Court held that an obligation of the contract had also been impaired.¹⁸

During the nineteenth century, the Supreme Court also broadened the class of contracts to which the contract clause applied. Although the framers apparently intended the contract clause to apply only to contracts between private individuals (private contracts),¹⁹ the Court construed the clause expansively to apply to contracts entered into by a state (state contracts). In *Fletcher v. Peck* Chief Justice Marshall, applying the contract clause to a state land grant, stated that the words of the clause "are general, and are applicable to contracts of every description."²⁰

B. *The Reserved Powers Doctrine*

In contrast to the Marshall Court's stringent application of the contract clause, under which many state statutes were invalidated,²¹ the Court in the latter half of the nineteenth century interpreted the clause to permit statutory modifications of contracts under the doctrine that a state could not bargain away certain police powers, such as the power to regulate the public health or morals.²² The notion was not that the obligation of contracts giving up the right to exercise these police powers could be impaired by subsequent legislation, but rather that such contracts were invalid *ab initio*. Thus, the Court in the leading case of *Stone v. Mississippi*²³ held that the state legislature, in outlawing lotteries, did not impermissibly impair a twenty-five year lottery charter granted by its predecessor because no legislature could bind its successor to a contract that bargains away the power, necessarily reserved to the state, to regulate the public morals.

17. See, e.g., *Bronson v. Kinzie*, 42 U.S. (1 How.) 311 (1843), in which Illinois altered existing remedies for default on mortgage contracts by prohibiting any default sale for less than two-thirds of the property's appraised value. The Court invalidated this statutory provision, holding that it also impaired the contract's obligation. Said the Court: "It is true that this law apparently acts upon the remedy, and not directly upon the contract. Yet its effect is to deprive the party of his preexisting right to foreclose the mortgage by a sale of the premises, and to impose upon him conditions which would frequently render any sale altogether impossible." *Id.* at 320.

18. *Planters' Bank v. Sharp*, 47 U.S. (6 How.) 301 (1848). See also *Von Hoffman v. City of Quincy*, 71 U.S. (4 Wall.) 535, 555 (1867); Hale, *supra* note 10, at 542.

19. See B. WRIGHT, *supra* note 2, at 15-16.

20. 10 U.S. (6 Cranch) 87, 137 (1810). See also *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819). (Corporate charter held to be a contract.)

21. See, e.g., *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819); *New Jersey v. Wilson*, 11 U.S. (7 Cranch) 164 (1812); *Fletcher v. Peck*, 10 U.S. (6 Cranch) 87 (1810).

22. See cases collected in B. WRIGHT, *supra* note 2, at 203-13. Additionally, police power to regulate public safety, public streets, and rivers was inalienable and could not be bargained away. *Id.*

23. 101 U.S. 814 (1880).

A state could, however, permanently bargain away its power to regulate financial matters. The growth of the reserved powers doctrine did not abrogate the Court's earlier holding that a state may grant a permanent tax exemption.²⁴ According to the Court, regulation of the public health and morals was a primary function of state government; taxation, however, was "incident to the exercise of the legitimate functions of government, but nothing more."²⁵

C. *Blaisdell and the Reasonableness Test*

The reserved powers doctrine was arguably consistent with the principle that no legislation may impair an existing obligation; contracts bargaining away the power to regulate the public health or morals were considered to be invalid *ab initio*, and thus not contracts in the constitutional sense. In the twentieth century, however, the Court began to permit certain "reasonable" impairments of contractual obligations. *Home Building & Loan Association v. Blaisdell*,²⁶ a Depression-era case, was the first major decision²⁷ in which the Court expressed this reinterpretation of the contract clause. Appellant in *Blaisdell* had validly foreclosed appellee's mortgage and purchased the mortgaged property at a foreclosure sale. A subsequent Minnesota statute extended the period during which appellee could redeem his land. The Supreme Court held that this legislative alteration of the private contract did not violate the contract clause. The Court did not base its decision on the remedy-obligation distinction, for under that doctrine it had ruled that an act extending the period of redemption impaired the obligation of a contract.²⁸ Rather, the prohibition of the contract clause was judged "not an absolute one and [was] not to be read with literal exactness like a mathematical formula."²⁹

The constitutional standard under which the Minnesota statute in *Blaisdell* was sustained required that the retroactive "legislation [be] addressed to a legitimate end and the measure taken [be] reasonable and appropriate to that end."³⁰ Under this standard, the Court

24. *New Jersey v. Wilson*, 11 U.S. (7 Cranch) 164 (1812).

25. *Stone v. Mississippi*, 101 U.S. 814, 820 (1880).

26. 290 U.S. 398 (1934).

27. *Manigault v. Springs*, 199 U.S. 473, 480 (1905), had hinted nearly thirty years before *Blaisdell* that a valid obligation may be impaired to promote the general welfare. Justice Johnson had been the first member of the Court to espouse the theory that the contract clause prohibition is not absolute. *Fletcher v. Peck*, 10 U.S. (6 Cranch) 87 (1810) (Johnson, J., dissenting).

28. *Bronson v. Kinzie*, 42 U.S. (1 How.) 311 (1843). The Court in *Bronson* invalidated a statutory provision that lengthened the mortgagor's period of equitable redemption by a year. The *Blaisdell* Court did not explicitly overrule *Bronson*, but attempted to distinguish it, stating that the statute struck down in *Bronson* more oppressively abridged mortgagee rights than the statute upheld in *Blaisdell*. *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 432 (1934).

29. 290 U.S. at 429.

30. *Id.* at 438. The Court has used a similar standard of review when examining state

determined the statute's reasonableness by balancing two competing considerations: the strength of the state's interest, and the nature of the private right and the extent of its deprivation.³¹ As it conducted this balancing process the Court paid great deference to the Minnesota legislature's determination of reasonableness.³²

The Court in *Blaisdell* found that the statute served the legitimate public purpose of substantially enhancing the state's economic welfare in a time of emergency, an especially weighty interest.³³ The Court determined that the private right altered was insignificant because most of the main obligations of the mortgage agreement were left intact.³⁴ The obligations to pay interest and to fulfill all other conditions of the contract were unchanged; only the redemption period was affected. The Court further found that the Minnesota statute did minimal damage to the mortgagee's rights.³⁵ A mortgagor who remained in possession was required to pay reasonable rent during the extended redemption period. Moreover, the statute, which expired after two years or the cessation of the emergency, provided merely temporary and conditional relief.³⁶

The Court applied the *Blaisdell* reasonableness test extremely deferentially to validate state statutes that were not enacted under emergency conditions or temporary in nature.³⁷ The Court struck down legislation only if it (1) furthered "no discernible public purpose";³⁸ (2) was neither temporary nor conditional in its effect;³⁹ or (3) deprived the private interest to a degree that undermined "the quality of an acceptable investment for a rational investor."⁴⁰ In *Faitoute Iron & Steel Co. v. City of Asbury Park*,⁴¹ the Court upheld a New Jersey statute, enacted during the Depression, that permitted municipalities

economic legislation under the equal protection and due process clauses. See, e.g., *City of New Orleans v. Duke*, 427 U.S. 297 (1976), upholding an economic regulatory ordinance. The *Dukes* Court stated that its decisions under the equal protection clause "require only that the classification challenged be rationally related to a legitimate state interest." *Id.* at 303.

31. 290 U.S. at 444-47. See generally Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 HARV L. REV 692, 697 (1960).

32. "Whether the legislation is wise or unwise as a matter of policy is a question with which we are not concerned." 290 U.S. at 447-48.

33. *Id.* at 444-45.

34. *Id.* at 445.

35. *Id.*

36. *Id.* at 447.

37. See *Veix v. Sixth Ward Bldg. & Loan Ass'n*, 310 U.S. 33 (1940) (upholding a statute that permanently changed building and loan association withdrawal procedures); *Honeyman v. Jacobs*, 306 U.S. 539 (1939) (sustaining a nonemergency statute that denied mortgagees deficiency judgments); *East New York Bank v. Hahn*, 326 U.S. 230 (1945) (validating legislation that repeatedly suspended a mortgagee's right of foreclosure upon default).

38. *Treigle v. Acme Homestead Ass'n*, 297 U.S. 189, 196 (1936) (invalidating a Louisiana statute that benefited a small number of private building and loan associations).

39. *W.B. Worthen Co. v. Thomas*, 292 U.S. 426, 434 (1934).

40. *W.B. Worthen Co. v. Kavanaugh*, 295 U.S. 56, 60 (1935).

41. 316 U.S. 502 (1942).

permanently to alter the rights of their creditors if creditors representing at least eighty-five percent of the affected indebtedness consented to the modification. Such an arrangement was effected for Asbury Park, an insolvent municipality, when holders of its obligations agreed to exchange their bonds for new bonds that bore a lower interest rate and had a later maturity date. The Court sustained the legislation because the refunding scheme was part of a comprehensive strategy to sustain the insolvent municipality both governmentally and financially.⁴² The new bonds had greater market value than the old bonds.⁴³

In *City of El Paso v. Simmons*,⁴⁴ the most recent contract clause case to reach the Supreme Court prior to *United States Trust*, the Court sustained a Texas statute under the *Blaisdell* reasonableness standard. A prior Texas statute had allowed purchasers of state school land an unlimited time to reinstate their rights to the land if they defaulted in the payment of the purchase price. In 1941 the legislature reduced the reinstatement period to five years, thereby modifying an existing contractual obligation. The Court determined that the statute served a vital state interest because it removed clouds on the title to school lands and thus helped to provide maximum revenue in funding public education.⁴⁵ The *El Paso* Court upheld the 1941 legislation. The Court found little injury to bona fide purchasers of school lands; the unlimited reinstatement provision was not the primary consideration for their agreements to purchase.⁴⁶ Moreover, the statute eliminated unforeseen benefits that had accrued to land speculators.⁴⁷ After substantial mineral wealth was found to exist on much of the school land some purchasers remained in prolonged default until minerals were discovered on their tracts and only then reinstated their rights. The reduced reinstatement period discouraged this speculation without burdening most purchasers because it allowed "defaulting purchasers with a bona fide interest in their lands a reasonable time to reinstate."⁴⁸ The Court said that "[l]aws which restrict a party to those gains reasonably to be expected from the contract are not subject to attack under the Contract Clause."⁴⁹

The Court in the *Blaisdell-El Paso* line of cases departed from the principle that legislation may never impair a contractual obligation. Although the language of its opinions sometimes indicated

42. *Id.* at 513.

43. *Id.* at 504.

44. 379 U.S. 497 (1965).

45. *Id.* at 515.

46. *Id.* at 514.

47. *Id.* at 515.

48. *Id.*

49. *Id.*

otherwise,⁵⁰ the Court applied a deferential reasonableness test under which modifications of both private and state contracts were upheld if they furthered some public welfare objective and did not significantly impinge upon private contract rights. The majority in *United States Trust Co. v. New Jersey*⁵¹ has not totally disallowed impairments of contractual obligations but has fashioned a much more stringent test to determine the constitutionality of such impairments.

III. THE COURT'S DECISION IN *United States Trust*

A. *Facts and Holding*

The controversy in *United States Trust* centered on the alteration of Port Authority bondholders' rights. The Port Authority was created in 1921 by a bi-state compact between New York and New Jersey. Although the compact gave the Authority "full power and authority to purchase, construct, lease and/or operate any terminal or facility within said district,"⁵² a comprehensive plan adopted shortly thereafter directed the Authority to deal solely with the commercial needs of the Port of New York and not with passenger traffic in the Authority's district.⁵³ To finance its projects, the Authority raised funds primarily by issuing bonds to private investors.⁵⁴

After several unsuccessful attempts to involve the Authority in mass transportation, New York and New Jersey determined in 1960 that the Authority should acquire and operate the Hudson & Manhattan Railroad, a bankrupt mass transit link between the two states.⁵⁵ Because the Authority's entrance into mass transportation was expected to be unprofitable and thus discourage investment in bonds, the New York and New Jersey legislatures in 1962 covenanted with each other and with the holders of any affected bonds to limit the subsidization of rail passenger transportation from Authority revenues and reserves.⁵⁶ The Authority was allowed to acquire self-supporting passenger railroad facilities or facilities that would not produce deficits over a permitted amount.⁵⁷ This statutory pledge of fiscal responsibility opened the way for Port Authority involvement in mass transportation.

50. See text accompanying notes 85-87 *infra*.

51. 431 U.S. 1 (1977).

52. Act of Apr. 7, 1921, ch. 151, 1921 N.J. Laws 412; 417 (N.J. STAT. ANN. § 32:1-7 (West 1963)); Act of Apr. 2, 1921, ch. 154, 1921 N.Y. Laws 492, 497 (N.Y. UNCONSOL. LAWS § 6407 (McKinney 1961)).

53. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 5 (1977).

54. *Id.*

55. *Id.* at 9-10.

56. Act of Feb. 13, 1962, ch. 8, § 6, 1962 N.J. Laws 35; Act of March 27, 1962, ch. 209, § 6, 1962 N.Y. Laws 980.

57. 431 U.S. at 10-11. The annual estimated deficit, including the debt service, of these facilities could not exceed one-tenth of the Authority's general reserve fund or one percent of the Authority's total bonded debt. *Id.* at 11.

In 1972 the New York and New Jersey legislatures, seeking to increase Port Authority participation in mass transit, made the 1962 covenant inapplicable to bonds issued after the effective date of the 1972 legislation.⁵⁸ During the 1974 energy shortage⁵⁹ the legislatures of both states retroactively repealed the 1962 covenant.⁶⁰ The effect of this action was to remove the protection that the covenant had provided to existing bondholders and allow the Port Authority to purchase mass transit systems that incurred deficits greater than the amounts permitted by the 1962 covenant.

Appellant United States Trust Company, a holder of and trustee for Port Authority bonds, alleged that the 1974 New Jersey legislation violated the contract clause by unconstitutionally impairing the obligation of its covenant with New Jersey. The Superior Court of New Jersey,⁶¹ the New Jersey Supreme Court affirming,⁶² held that the 1974 legislation was a reasonable exercise of the state's police power and did not violate the contract clause. By a four to three vote, the United States Supreme Court reversed, holding that the repeal legislation unconstitutionally interfered with the 1962 covenant because it "was neither necessary to the achievement of the [state's] plan nor reasonable in light of the circumstances."⁶³

Although it conceded that the mass transit, energy conservation, and environmental protection goals of the New Jersey legislation were "important and of legitimate public concern,"⁶⁴ the *United States Trust* majority maintained that total repeal of the 1962 covenant was not the least restrictive way to attain these goals.⁶⁵ The state's objective of "discouraging automobile use and improving mass transit" could have been achieved by a less drastic modification of contract rights or through alternative means that required no impairment of contract rights at all.⁶⁶ The majority hypothesized several less drastic means to achieve New Jersey's mass transit plan. The legislature could have modified the formula for computing "permitted deficits" or relaxed the procedures for obtaining bondholder consent to use Authority revenues for mass transit.⁶⁷ Alternatively, the legislature could have diverted revenues from future increases in bridge and tunnel tolls

58. Act of Dec. 28, 1972, ch. 208, 1972 N.J. Laws 795; Act of June 8, 1972, ch. 1003, 1972 N.Y. Laws 3900 as amended by Act of May 10, 1973, ch. 318, 1973 N.Y. Laws 1121.

59. 431 U.S. at 13-14.

60. Act of April 30, 1974, ch. 25, 1974 N.J. Laws 53; Act of June 15, 1974, ch. 993, 1974 N.Y. Laws 2579.

61. 134 N.J. Super. 124, 338 A.2d 833 (1975).

62. 69 N.J. 253, 353 A.2d 514 (1976).

63. 431 U.S. at 29.

64. *Id.* at 28.

65. *Id.* at 29-30 & nn.28 & 29.

66. *Id.* at 30.

67. *Id.* n.28.

to mass transportation and left the rest of the covenant intact.⁶⁸ Moreover, the state could have accomplished its transportation objectives by legislating gas, parking, and other taxes.⁶⁹ Because the state could have employed these less restrictive alternatives, the majority concluded that repeal of the covenant was not necessary.

The majority also determined that repeal of the 1962 covenant was not reasonable because, unlike the law in *El Paso*, it was not motivated by a desire to address changed circumstances that were unforeseen at the time the contract was formed.⁷⁰ The contemporary need for mass transportation in the New York metropolitan area and concern for the environment and energy conservation were foreseeable: "It was with full knowledge of these concerns that the 1962 covenant was adopted. Indeed, the covenant was specifically intended to protect the pledged revenues and reserves against the possibility that such concerns would lead the Port Authority into greater involvement in deficit mass transit."⁷¹

B. *The Court's Analysis*

The *United States Trust* majority produced a "novel"⁷² standard of review for contract clause cases. Impairments of both private and state contractual obligations must be both reasonable and necessary; that is, the legislation must be (1) addressed to changed circumstances unforeseeable at the time the contract was formed—the reasonableness requirement;⁷³ and (2) the least restrictive means of accomplishing an important state purpose—the necessity requirement.⁷⁴ The majority announced that it would continue to defer to legislative determinations that modifications of private contracts are reasonable and necessary,⁷⁵ but asserted that the Court would not defer to such determinations for state contracts.⁷⁶

68. *Id.*

69. *Id.* at 30 n.29.

70. See text accompanying notes 47-49 *supra*.

71. 431 U.S. at 31-32.

72. See *id.* at 53 (Brennan, J., dissenting).

73. *Id.* at 31.

74. *Id.* at 29-31.

75.

Legislation adjusting the rights and responsibilities of [private] contracting parties must be upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption. . . . As is customary in reviewing economic and social regulation, however, courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure.

Id. at 22-23.

76. "[C]omplete deference to a legislative assessment of reasonableness and necessity is not appropriate [when dealing with state contracts] because the State's self-interest is at stake." *Id.* at 26.

1. *The "Reasonable and Necessary" Test*⁷⁷

In previous constitutional litigation, the use of reasonableness and necessity in the same test would have been redundant because necessity implied the most stringent standard of review of state action,⁷⁸ while reasonableness connoted relaxed judicial scrutiny.⁷⁹ Thus, a statute that satisfied the necessity test was, *a fortiori*, reasonable.⁸⁰ The *United States Trust* majority escaped this redundancy, however, by adopting a new definition of reasonableness.

In *United States Trust* the Court attempted to distinguish earlier cases and to select language from previous opinions to support its new constitutional standard. Although the Court had never used this two-pronged test of constitutionality to decide contract clause litigation, each of the prongs has some support in the prior case law.

In several Depression-era cases⁸¹ the Court applied a foreseeability criterion to uphold legislation favoring mortgagors when unforeseen market conditions resulted in unexpected hardships. More recently, the Court in *El Paso* formally adopted foreseeability as a criterion of reasonableness. In *El Paso*, the Texas legislation altering the rights of purchasers of school lands was upheld partly because it prevented purchasers from acquiring windfall profits. The Court emphasized that laws "restrict[ing] a party to those gains reasonably

77. Before it applied its reasonable and necessary test, the majority in *United States Trust* made a preliminary determination that repeal of the 1962 covenant had impaired a contractual obligation. The Court easily concluded that the covenant constituted a contract among New Jersey, New York, and the holders of the consolidated bonds. *Id.* at 17-18. Moreover, the majority held the contract to be valid when tested under the police power exception, which forbids a state to bargain away such essential attributes of its sovereignty as the power to regulate public health or morals. *Id.* at 23-24. While it realized that formalistic distinctions among the various powers of the state perhaps cannot be dispositive, the Court nonetheless found the 1962 covenant to be valid because it dealt with a financial obligation that "as a threshold matter may not be said automatically to fall within the reserved powers that cannot be contracted away." *Id.* at 23-24. The majority in *United States Trust* also held that repeal of the covenant constituted an impairment of an obligation because an important security provision was eliminated; the bondholders' expectations were seriously disrupted. Without reviving the outdated remedy-obligation distinction, the Court distinguished impairments that upset significant bondholder expectations from impairments that caused no such subversion of expectations. *Id.* at 19 n.17. To make this determination, the majority examined the nature of the impairment: "[a]s a security provision, the covenant was not superfluous; it limited the Port Authority's deficits and thus protected the general reserve fund from depletion." *Id.* at 19. Thus, the impairment provoked scrutiny under the contract clause. The issue of actual financial loss to the bondholders was deemed unimportant since New York and New Jersey had not attempted to compensate them for the taking of the covenant, a form of property. *Id.* at 19.

78. See, e.g., *Shapiro v. Thompson*, 394 U.S. 618, 634 (1969), in which the Court applied a stricter standard of review to state infringements of the right of interstate travel; such legislation is unconstitutional "unless shown to be necessary to promote a *compelling* governmental interest." (emphasis in original).

79. See, e.g., *Williamson v. Lee Optical Co.*, 348 U.S. 483, 487 (1955). The Court applied the rational relation test to an economic regulation: "it is for the legislature, not the courts, to balance the advantages and disadvantages of the . . . requirement."

80. See 431 U.S. 1 at 54-55 n.17 (Brennan, J., dissenting).

81. See *Gelfert v. National City Bank*, 313 U.S. 221 (1941); *Honeyman v. Jacobs*, 306 U.S. 539 (1939).

to be expected from the contract" are immune from contract clause attack.⁸² The *El Paso* Court, however, used foreseeability as only one part of its reasonableness test, which balanced the state interest furthered against the private right denied. The Court also examined the strength of the state interest and inquired whether the provision affected was a "primary consideration for the buyer's undertaking."⁸³ The *United States Trust* majority refused "to engage in a utilitarian comparison of public benefit and private loss."⁸⁴ It looked solely at foreseeability to determine reasonableness as it defined that term. Unlike the *El Paso* test, under which foreseeability is but one aspect of reasonableness, the *United States Trust* test would invalidate a statute impairing a contractual obligation, regardless of the strength of the state's interest, unless the impairment is necessary to deal with unforeseen circumstances.

The Court had previously hinted at a necessity requirement. In *El Paso*, for example, the Court asserted that the reduction of reinstatement rights was "quite clearly necessary" for administration of the school lands⁸⁵ because Texas' previous attempts to attain this objective through other methods had proved unsuccessful.⁸⁶ Although it acknowledged the necessity of legislation to alter reinstatement rights, the Court in *El Paso* did not make necessity a requirement of constitutionality under the contract clause, nor did it inquire into less restrictive means of achieving Texas' public objective. The Court's discovery that the limitation on reinstatement rights was essential merely bolstered the Court's conclusion that the Texas legislation was reasonable.⁸⁷

The *United States Trust* test presents several problems. First, the test does not take into consideration the extent of the damage to the bondholders, but requires only a finding of a "technical impairment" to trigger close scrutiny.⁸⁸ Under this standard, elimination of a single security provision in the 1962 covenant and total destruction of the contract would both be accorded the same protection. The *United States Trust* Court's refusal to examine the extent of the private deprivation clearly assures adequate protection for contract rights; even a *de minimis* invasion of private rights might be struck down under the new standard. The cost of such protection, however,

82. 379 U.S. 497, 515 (1965).

83. *Id.* at 514.

84. 431 U.S. at 29.

85. 379 U.S. at 516.

86. *Id.* at 512-13.

87. The Court found the Texas statute reasonable because "[t]he measure taken to induce defaulting purchasers to comply with their contracts . . . was a mild one indeed, hardly burdensome to the purchaser . . . , but nonetheless an important one to the State's interest." 379 U.S. at 516-17.

88. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 21 (1977).

is an inflexible standard of review that fails to distinguish among different contractual modifications.

Second, the reasonableness standard, by focusing solely on foreseeability, fails adequately to consider emergency conditions. Emergencies, previously held to justify impairments of contract,⁸⁹ are not taken into account in the new test unless they were unforeseeable at the time of the making of the contract. Although the repeal of the 1962 covenant was legislated to help remedy a fuel crisis, the majority in *United States Trust* held the repeal unreasonable because the emergency was, in its view, foreseeable at the time the contract was formed.⁹⁰ Most bond contract impairments could be struck down under the majority's foreseeability criterion because bond interest rates generally reflect the risk that the debtor will default as a result of financial or other difficulties. In *Faitoute*, for example, the 1933 New Jersey statute might have failed to satisfy the *United States Trust* reasonableness standard because the parties to the contract could have foreseen that the municipality would subsequently become insolvent. Only in a rare case like *El Paso*, in which valuable minerals were unexpectedly found on the purchaser's land,⁹¹ will legislation that impairs contract rights treat changes that were completely unforeseeable at the time of contracting.⁹²

A third problem with the majority's test is that the "less restrictive alternative" standard will make it almost impossible for any legislation that impairs contract rights to be sustained.⁹³ The majority

89. See, e.g., *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942); *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934).

90. 431 U.S. at 31-32.

91. *City of El Paso v. Simmons*, 379 U.S. 497, 511 (1965).

92. Assessing the very factors that the majority failed adequately to consider, the dissenters in *United States Trust* balanced the state's interest against the private right denied and determined that the New Jersey legislation was reasonable. They found that the repeal of the 1962 covenant furthered the goal of expanding mass transit and served the substantial public interest of alleviating the energy crisis and urgent transportation and environmental problems. 431 U.S. at 38 (Brennan, J., dissenting). Recognizing that the repeal might have technically impaired the 1962 covenant, the dissent then looked to the extent of economic injury and concluded that the repeal "occasioned only the most minimal damage on the part of the Authority's bondholders." *Id.* at 41. The bond contracts still required periodic payment of interest and repayment of principal when due; thus, the value of the bonds was little affected by the repeal. *Id.* In addition, the Authority bondholders had two protections against deficit spending for mass transit apart from the 1962 covenant. First, under a "1.3 test" the Authority could not issue new consolidated bonds unless "the best one-year net revenues derived from all of the Authority's facilities at least equal[ed] 130% of the prospective debt service for the calendar year during which the debt service for all outstanding and proposed bonds would be at a maximum." *Id.* at 34. Second, a "section 7 certification" provided that the Authority could not issue bonds unless it certified that the credit standing of the Authority would not be impaired for a specified time period. *Id.* at 34-35.

93. Analysis of the majority's "less restrictive alternative" standard turns on how that standard is defined. Traditionally the standard is that "an economic regulation violates due process . . . if the government can achieve the purposes of the challenged regulation equally effectively by one or more narrower regulations." Struve, *The Less-Restrictive-Alternative Principle and Economic Due Process*, 80 HARV L. REV. 1463, 1463 (1967). State legislation

suggested means less drastic than total repeal of the 1962 covenant to achieve New Jersey's mass transit plan. The Court's suggestions included modifying the formula for computing "permitted deficits" and easing the procedures for obtaining bondholder consent to use Authority revenues for mass transit.⁹⁴ At the same time, however, the Court warned that even these "lesser impairments" could be found unconstitutional under the necessity test.⁹⁵ The majority also suggested that New Jersey's plan could have been met without modification of the 1962 covenant if the legislature had taxed automobile use, gasoline, or parking and applied the revenues to mass transit.⁹⁶ Almost all the statutes that have survived contract clause attack during the past several decades would have been struck down under the majority's new test. In *El Paso*, for example, Texas could either have raised revenues for education by imposing more taxes or compensated purchasers for loss of their unlimited reinstatement rights.⁹⁷

Less restrictive alternative analysis also makes little sense from a standpoint of judicial competence. For forty years the Court has deferred to legislative judgment in the area of socioeconomic regulation, asserting that "it is for the legislature, not the courts, to balance the advantages and disadvantages" of such legislation.⁹⁸ It has been suggested that the legislature as an institution is better equipped than the judiciary to decide matters of socioeconomic regulation because the Court has less ability to collect and synthesize detailed empirical data and experiment with alternative programs.⁹⁹

Adoption of the majority's test would require the very inquiries that the Court usually seeks to avoid. Properly performed, less restrictive alternative analysis would necessitate complex and burdensome economic inquiry to determine whether legislation that modifies contracts is necessary to achieve an important public objective. If,

is seldom invalidated under this standard because "in virtually every case involving real legislation, a more perfect fit involves some added cost." Ely, *Flag Desecration: A Case Study in the Roles of Categorization and Balancing in First Amendment Analysis*, 88 HARV. L. REV. 1482, 1485 (1975). Although the *United States Trust* Court refers to the traditional use of "less restrictive alternative," 431 U.S. at 30, it appears to have adopted a "less restrictive alternative" doctrine that will fall harshly on state legislation. The majority hypothesized means to achieve New Jersey's objectives less drastic than repeal of the 1962 covenant but did not inquire whether the Court's alternatives were as effective or as feasible as repeal. Thus used, "less restrictive alternative" analysis could invalidate almost every state modification of contract rights since the Court can easily postulate a means that is less burdensome to the private contracting party and arguably serves the state's interest.

94. 431 U.S. at 30 n.28.

95. *Id.*

96. *Id.* at 30 n.29.

97. *See id.* at 59 (Brennan, J., dissenting).

98. *Williamson v. Lee Optical Co.*, 348 U.S. 483, 487 (1955).

99. *See Perry, Abortion, the Public Morals, and the Police Power: The Ethical Function of Substantive Due Process*, 23 U.C.L.A. L. REV. 689, 724 (1976).

however, the Court fails to conduct adequate technical inquiries, state legislation will be subject to arbitrary invalidation whenever the Court hypothesizes an arguably less restrictive means.

Moreover, the majority's strict scrutiny of contract impairments—imposed by its necessity test—does not comport with the Court's relaxed scrutiny of state socioeconomic regulation under other provisions of the Constitution. The Court has consistently applied the deferential reasonableness test to socioeconomic cases arising under the equal protection and due process clauses of the fourteenth amendment. Under this test, the Court will sustain any state socioeconomic regulation that has some rational relation to a legitimate state objective.¹⁰⁰

2. *State and Private Contracts: The Role of Deference*

Yet another problem with the majority's test is its different treatment of impairments of state and private contracts.¹⁰¹ The majority indicated that it would defer to legislative determination that a modification of a private contract was reasonable and necessary but not to such a determination about a state contract.¹⁰²

In other areas of constitutional litigation, necessity implies stringent scrutiny of state legislation; deference is shown only where the Court employs reasonableness or rational relationship test.¹⁰³ Under the majority's standard, the Court will require a state to show that it is employing the least drastic means of altering a private contract.¹⁰⁴ But when it examines modifications of private contracts, the Court presumably will accept the state's determination of necessity without further inquiry.

The majority found support for closer scrutiny of state contracts in previous municipal bond cases. In *W.B. Worthen Co. v. Kavanaugh*,¹⁰⁵ for example, a legislative modification affecting the security of municipal bondholders was struck down because the legislation had completely "taken from the mortgage the quality of an acceptable investment for a rational investor."¹⁰⁶ The majority in *United States Trust* correctly recognized that this "total destruc-

100. *Williamson v. Lee Optical Co.*, 348 U.S. 483, 491 (1955). See also *City of New Orleans v. Dukes*, 427 U.S. 297 (1976) (overruling *Morey v. Doud*, 354 U.S. 457 (1957), the only case in the last half century to strike down a wholly economic regulation on equal protection grounds).

101. See *United States Trust Co. v. New Jersey*, 431 U.S. 1, 22-23 (1977).

102. *Id.* at 25-26.

103. See notes 78-79 and accompanying text *supra*.

104. 431 U.S. at 23, 26-27.

105. 295 U.S. 56 (1935).

106. *Id.* at 60.

tion¹⁰⁷ test represents "the outermost limits only";¹⁰⁸ the *Kavanaugh* Court might have invalidated the statute even if there had been less than total impairment of the contractual obligation. The majority in *United States Trust* also pointed out that *Faitoute*, the sole case in which a state's impairment of a bond contract has been upheld in this century, involved only slight alteration of bondholder rights. In that decision, the modification was made with the bondholders' approval and in fact increased the market value of the new bonds.¹⁰⁹

Prior to *United States Trust*, however, the Court had never explicitly differentiated between impairments of state and private contracts under the contract clause. The Court in *Kavanaugh* did not state that its analysis would apply only to modifications of state contracts. The *Blaisdell* Court did not preclude the possibility that its reasonableness test would also apply to alterations of state contracts. Moreover, the modifications of bondholder rights in *Faitoute*, contrary to the assertion of the *United States Trust* majority, involved more than minimal alteration of bondholder rights; the damage was arguably far more substantial than the interference with Authority bondholder rights because "the reorganization plan both extended the maturity date of the city's bonds by some 30 years and reduced the relevant coupon rate."¹¹⁰ The legislation in *Faitoute* did enhance bond value, but the majority itself asserted that valuation is an irrelevant criterion in determining the constitutionality of impairment when the loss of contract rights is not compensated.¹¹¹

The *El Paso* decision¹¹² indicates that the deferential *Blaisdell* test was applicable to alteration of state contracts.¹¹³ In that case, the Court balanced the state interest advanced against the private right deprived when ruling on Texas' unilateral imposition of a limited reinstatement right on land purchasers.¹¹⁴ Justice Black, the lone dissenter in *El Paso*, regarded the Court's decision as "balancing away" the protection of the contract clause: "[T]he Court says that since the State acts out of what this Court thinks are good motives, and has not

107. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 26 (1977).

108. *Id.*

109. See *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 513 (1942). See also Note, *The Constitutionality of The New York Municipal Wage Freeze and Debt Moratorium: Resurrection of the Contract Clause*, 125 U. PA. L. REV. 167, 200-09 (1976), which lends support to the Court's thesis that the case-law gives a special status to modifications of a state contract. Like the *United States Trust* majority, the Note distinguishes *Faitoute* from other bond contract cases because the state in that case did not unilaterally alter its own obligations.

110. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 57 (1977) (Brennan, J., dissenting).

111. *Id.* at 19.

112. See text accompanying notes 44-49 *supra*.

113. Although the Court stated that the Texas statute was essential to achieve the state's goals (see text accompanying note 85-87 *supra*), it proceeded to apply a deferential test.

114. *City of El Paso v. Simmons*, 379 U.S. 497, 514-16 (1965).

repudiated its contract except in a way which this Court thinks is 'reasonable', therefore the State will be allowed to ignore the Contract Clause of the Constitution."¹¹⁵

The "Gold Clause" cases decided under the fifth amendment provide the only historical basis for different treatment of legislative alterations of private and state contracts. The Court upheld the impairment of "gold value" clauses in private bond contracts,¹¹⁶ but subsequently invalidated similar modifications of federal government bonds.¹¹⁷ The Court stated that "[t]here is a clear distinction between the power of the Congress to control or interdict the contracts of private parties . . . and the power of the Congress to alter or repudiate the substance of its own engagements."¹¹⁸ The Court asserted that parties who contract with the United States should always be able to rely on the federal government's solemn pledge of creditworthiness as more than a "vain promise."¹¹⁹ The Court seemed to imply that contracting parties are entitled to place more reliance on the credit of government than on the pledge of a private individual.

The *United States Trust* majority articulated its distinction between alterations of state and of private contracts. The Court maintained that deference to the state legislature's determination of reasonableness and necessity is not appropriate for modifications of state contracts "because the State's self-interest is at stake."¹²⁰ It feared that the contract clause would provide no protection whatever for individuals who contract with a state "[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."¹²¹

This argument for lesser deference to alterations of state contracts has merit. A state government presumably acts as a disinterested referee when it alters the rights of the parties to a private contract. The government, however, cannot be expected to act with such impartiality when its own obligations are at issue; "[t]here is little reason to believe that the state, given the power to alter its own contract obligations unilaterally, will act with more restraint than any individual who is given the opportunity to escape the terms of an onerous contract."¹²²

The potential for abuse of the police power is a legitimate concern but does not justify a distinction between alterations of state and pri-

115. *Id.* at 521 (Black, J., dissenting).

116. *Norman v. Baltimore & Ohio R.R. Co.*, 294 U.S. 240 (1935).

117. *Perry v. United States*, 294 U.S. 330 (1935).

118. *Id.* at 350-51.

119. *Id.* at 351.

120. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 26 (1977).

121. *Id.*

122. Note, *supra* note 109, at 189-90.

vate contracts. The state is motivated by its self-interest when it modifies private as well as public contracts. In *Blaisdell*, for example, the Minnesota legislation that adjusted contract rights between mortgagee and mortgagor was designed to preserve the public fisc. Defaulting mortgagors might have been forced to turn to public assistance; banks, left holding property for which there was no longer a market, might have failed. It has been suggested that "[a]ll economic regulations are promulgated at least in part because the government is reluctant to use more expensive alternative means to effect the same objective."¹²³ Thus, in *Blaisdell* the legislature chose to abrogate the mortgagees' rights rather than to purchase them.

Even if a state is more likely to abuse the police power when it modifies its own contracts, close judicial scrutiny is not necessary to prevent such abuse. The dissenters in *United States Trust* believed that since the states' "credibility in the credit market obviously is highly dependent on exercising their vast law-making powers with self-restraint and discipline . . . few if any jurisdictions would choose to use their authority 'so foolish[ly] as to kill a goose that lays golden eggs for them.'"¹²⁴ States rely on private investment for many of their projects; thus, they seek to preserve adequate bondholder rights in order to encourage future investment. The political processes of a state also reduce the probability that a state will abuse its police power. As the dissenters noted, the bondholders of some \$300,000,000 in assets are neither "discrete" nor "insular" and are capable of protecting their interests before the state legislature.¹²⁵

Moreover, the majority's restrictive standard of review will limit the scope of future state legislative action.¹²⁶ The framers, who apparently intended the contract clause to apply only to private contracts,¹²⁷ perhaps anticipated that successive generations of legislators ought to be allowed sufficient discretion to respond to contemporary needs.¹²⁸

IV. FUTURE IMPACT

Until the *United States Trust* decision, the Supreme Court had not used the contract clause to invalidate an impairment of a state contract since the 1940's.¹²⁹ The majority's stringent scrutiny of the legislative alteration of state contracts suggests renewed vitality for the

123. *The Supreme Court, 1976 Term*, 91 HARV. L. REV. 70, 90 (1977).

124. 431 U.S. 1, 61 (Brennan, J., dissenting) (quoting *Eric R.R. Co. v. Bd. of Pub. Util. Comm'rs*, 254 U.S. 394, 410 (1921)).

125. 431 U.S. at 62 n.18 (Brennan, J., dissenting).

126. See text accompanying notes 132-35 *infra*.

127. See B. WRIGHT, *supra* note 2 at 15-16.

128. See 431 U.S. at 45 (Brennan, J., dissenting).

129. *Wood v. Lovett*, 313 U.S. 362 (1941) (striking down legislation that altered contracts between Arkansas and purchasers of public land).

clause. A state will have to show that its legislation is "reasonable and necessary to serve an important public purpose."¹³⁰ A majority of the full Court, however, has not yet accepted the *United States Trust* analysis. Had Justices Powell and Stewart participated in the decision, they might well have joined the dissenters to comprise a majority that would have maintained a deferential philosophy toward legislative alterations of all contracts.¹³¹

The majority's standard, if it is not reexamined, will greatly diminish the flexibility of state and city governments¹³² to combat financial and other crises by modifications of obligations to investors.¹³³ During New York's recent financial crisis, the city council and the state legislature each passed legislation designed to ease the crisis. The city council authorized Mayor Beame to freeze the wages of municipal employees, although union contracts called for cost-of-living increases. The state legislature passed the Emergency Moratorium Act that provided for a conditional three-year moratorium on the enforcement of short-term obligations.¹³⁴ The New York lower state courts employed the *Blaisdell* standard to uphold these legislative impairments of contracts used to safeguard public welfare during an emergency.¹³⁵

The *United States Trust* majority might have invalidated both the wage freeze and the debt moratorium. As a preliminary matter, the majority would have little trouble finding impairments of contracts in both pieces of legislation. Both modifications of contract rights were probably unreasonable under the *United States Trust* standard because New York City's fiscal plight was arguably foreseeable and the modifications conferred no unexpected advantages on the bondholders or municipal employees. The wage freeze and debt moratorium might have failed to satisfy the *United States Trust* necessity test; although both laws furthered the public welfare, they were not the least restrictive means to achieve the state's objectives. Rather than impair the obligations of municipal bonds, New York City could have discharged city employees. The state legislature could have used its taxing power to provide additional funds for New York

130. 431 U.S. at 25.

131. Justice Stewart was a member of the *El Paso* majority, which employed the deferential reasonableness standard to validate the modification of a state obligation.

132. The contract clause also applies to modifications by municipal ordinance. See *Atlantic Coast Line R.R. Co. v. City of Goldsboro*, 232 U.S. 548 (1914).

133. See, e.g., *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942).

134. See Note, *supra* note 109, at 167-68, for discussion of both the wage freeze and the debt moratorium.

135. *Flushing Nat'l Bank v. Municipal Assistance Corp.*, 84 Misc. 2d 976, 379 N.Y.S.2d 978 (Sup. Ct. 1975), *aff'd* 52 App. Div. 2d 84, 382 N.Y.S.2d 764 (1976), *rev'd on other grounds*, 40 N.Y.2d 731, 358 N.E.2d 848, 390 N.Y.S.2d 22 (1976); *Subway Surface Supervisors Ass'n v. Transit Auth.*, 85 Misc. 2d 695, 381 N.Y.S.2d 186 (Sup. Ct. 1976) *aff'd*, 56 App. Div. 2d, 392 N.Y.S.2d 460 (1977).

City and avoided a debt moratorium. The majority's standard of review, moreover, would fail to take account of the existence of emergency conditions or the actual extent of the deprivation of private contractual rights. Had the *United States Trust* standard of review been in effect, New York City might arguably have been forced into bankruptcy because the only less restrictive alternatives to the wage freeze and the bond moratorium would not have been economically or politically feasible.

V. CONCLUSION

The majority in *United States Trust* constructed its stringent "reasonable and necessary" test to ensure that a state would not renege on its financial obligations "simply because it would prefer to spend the money to promote the public good rather than the private welfare of its creditors."¹³⁶ The test derives little support from previous contract clause decisions and is not dictated by considerations of judicial competence. Most critically, the majority's test could interfere with effective operation of state and local government. New York City weathered a potentially disastrous financial crisis because it was able to alter contractual obligations with municipal bondholders and employees. The ability of cities and states to cope with future emergencies will be greatly limited if the Court does not reconsider its decision in *United States Trust*.

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136. 431 U.S. at 29.