THE CONTRACT CLAUSE AS THE GUARDIAN AGAINST LEGISLATIVE IMPAIRMENT OF MUNICIPAL BONDHOLDERS' RIGHTS

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INTRODUCTION

The quality and quantity of public services provided by all levels of government have come under severe attack in recent years. Fiscally burdened state and local governments have been hard pressed to meet demands for more and better services. Recent activities on the part of some state legislatures and courts seeking to remedy inadequacies in public services appear to have diminished or eliminated contractual rights of the holders of bonds issued by governmental bodies to raise funds for a variety of capital improvements.

In New Jersey and many other jurisdictions, funds for providing public education at the elementary and secondary levels have been raised primarily by the impositon of a local real property tax.[1] In *Robinson v. Cahill,*[2] the New Jersey supreme court struck down the present method of financing education within New Jersey's 600 school districts.[3] The court found that the state's constitutional requirement of a "thorough and efficient" free public education was not being satisfied.[4] The supreme court ordered the state

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[1] Robinson v. Cahill, 118 N.J. Super. 223, 229, 287 A.2d 187, 190, *supplemented,* 119 N.J. Super. 40, 289 A.2d 569 (L. Div. 1972), *aff'd as modified,* 62 N.J. 473, 303 A.2d 273, *supplemented,* 63 N.J. 196, 306 A.2d 65, *cert. denied,* 414 U.S. 976 (1973). State and federal assistance has supplemented the local property tax in such areas as transportation, lunch programs, and new building construction. 118 N.J. Super. at 229, 287 A.2d at 190. When *Robinson* was commenced in 1970, the amended State School Aid Law of 1954 was in effect. The provisions of this law comprised a "foundation program" consisting of a minimum base dollar figure supplemented by "formula aid," an equalization aid formula which was computed utilizing a complicated mathematical equation. *See id.* For the text of the amended State School Aid Law see N.J. STAT. ANN. § 18A:58-1 *et seq.* (Supp. 1974-75).

[2] 62 N.J. 473, 303 A.2d 273 (1973), *aff'g as modified* 119 N.J. Super. 40, 289 A.2d 569, *supplementing* 118 N.J. Super. 223, 287 A.2d 187 (L. Div. 1972), *supplemented,* 63 N.J. 196, 306 A.2d 65, *cert. denied,* 414 U.S. 976 (1973).

[3] 118 N.J. Super. at 232, 287 A.2d at 192.

[4] 62 N.J. at 515, 303 A.2d at 295. *See* N.J. CONST. art. 8, § 4, ¶ 1. The court's determination that an education of "thorough and efficient" quality was not being provided

legislature to develop a method of financing the cost of education which meets the constitutional mandate within a period of two years.[5]

A number of new methods for financing the cost of education have been considered, including a plan by which the state would absorb all costs.[6] This program, or a similar proposal, could result in the reduction or elimination of the power of local school districts to impose real property taxes to raise money for school purposes. Since outstanding school bonds are secured by a pledge to impose real property taxes, such action could markedly affect the contract between existing bondholders and school districts.

Recently, the states of New York and New Jersey repealed a statutory pledge—commonly referred to as the 1962 covenant —between the two states and "affected" bondholders of the Port Authority of New York and New Jersey.[7] This covenant was intended to insure the continued high credit rating of the Port Authority by assuring bondholders that it would limit its involvement in fiscally perilous deficit rail operations.[8] The repeal of the

was based on the dollar input per pupil. 62 N.J. at 515-16, 303 A.2d at 295. The validity of the cost-quality relationship in education has been challenged by several commentators. *See, e.g.*, Carrington, *On Egalitarian Overzeal: A Polemic Against the Local School Property Tax Cases*, 1972 U. ILL. L.F. 232, 239-41; Schoettle, *The Equal Protection Clause in Public Education*, 71 COLUM. L. REV. 1355, 1378-81 (1971).

[5] In its supplemental opinion, the supreme court stated that it would

> not disturb the statutory scheme unless the Legislature fails to enact, by December 31, 1974, legislation compatible with our decision in this case and effective no later than July 1, 1975.

63 N.J. at 198, 306 A.2d at 66. The court declined to consider future judicial remedies, if any, should the legislature fail in its task. *Id.*

For an extensive analysis of the *Robinson* decision see Tractenberg, *Reforming School Finance Through State Constitutions: Robinson v. Cahill Points the Way*, 27 RUTGERS L. REV. 365 (1974). *See also* Ruvoldt, *Educational Financing in New Jersey: Robinson v. Cahill and Beyond*, 5 SETON HALL L. REV. 1 (1973).

[6] N.J. Assembly Bill No. 1644 (introduced May 6, 1974). For some of the other tax proposals considered in response to the *Robinson* decision see note 102 *infra*. *See also* NEW JERSEY TAX POLICY COMM., REPORT, Part III, *Service Levels and State Aids* 43-49 (Feb. 23, 1972). This study, completed prior to the supreme court's decision in *Robinson*, recommended "[t]hat the State assume responsibility for all of the operating costs of a standard quality education." *Id.* at 44.

[7] Law of April 30, 1974, ch. 25, 1 N.J. SESS. LAW SERV. 34 (1974), *repealing* Law of Dec. 28, 1972, ch. 208, § 6, [1972] N.J. Laws 801 (codified at N.J. STAT. ANN. § 32:1-35.55a (Supp. 1974-75)) (amendment applicable to prospective buyers not holders of bonds issued between 1962 and 1972), *amending* Law of Feb. 13, 1962, ch. 8, § 6, [1962] N.J. Laws 47 (codified at N.J. STAT. ANN. § 32:1-35.55 (1963)). Law of June 15, 1974, ch. 993, 9 N.Y. SESS. LAW NEWS 1590 (1974), *repealing* Law of May 10, 1973, ch. 318, § 2, [1973] N.Y. Laws 448-49 (codified at N.Y. UNCONSOL. LAWS § 6606 (McKinney Supp. 1973-74)), *amending* Law of March 27, 1962, ch. 209, § 6, [1962] N.Y. Laws 412-27 (codified at N.Y. UNCONSOL. LAWS § 6606 (McKinney 1961)).

[8] *See* notes 138-39 *infra* and accompanying text.

1962 covenant, resulting from pressures to develop improved mass transportation systems, affects the future financial strength of the Port Authority and, thus, its ability to meet its obligations on the outstanding bonds held by investors.

Bondholders may also be affected by other developments in New Jersey. In one instance, a portion of one municipality has successfully severed itself from that entity and annexed itself to another.[9] Additionally, two bills have been introduced which would allow a local school system to withdraw from a regional district.[10] These actions could affect bondholders, since both school and municipal bonds are payable from local ad valorem property taxes. Since severing part of a municipality or school district reduces the property tax base of the original district or municipality by the severed area's share of the ratables, a bondholder might feel that the source of funds for the repayment of his bonds is thereby diminished.

These recent developments in New Jersey could have a significant impact on the future security and viability of bonds issued by the state and its political subdivisions. The possible dilution of bondholders' rights requires testing under the constitutional prohibition of impairment of contract. An examination of these developments reveals that, while most may be navigated successfully through the constitutional channel, some will run aground.

IMPAIRMENT OF CONTRACTS

In placing restrictions on state power, the Framers of the Constitution provided that "[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts."[11] Chief Justice Taft, in

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[9] *See* West Point Island Civic Ass'n v. Township Comm., 54 N.J. 339, 255 A.2d 237 (1969). *See also* note 197 *infra.*

[10] N.J. Assembly Bills Nos. 824 & 825 (introduced Jan. 24, 1974).

[11] U.S. CONST. art. I, § 10. This restriction has been interpreted as being applicable only to state action, and as not binding the actions of federal administrative agencies or acts of Congress arising under any powers specifically granted by the Constitution. *See, e.g.,* Continental Ill. Nat'l Bank v. Chicago R.I. & P. Ry., 294 U.S. 648, 680 (1935); Century Arms, Inc. v. Kennedy, 323 F. Supp. 1002, 1014-15 (D. Vt.), *aff'd mem.,* 449 F.2d 1306 (2d Cir. 1971), *cert. denied,* 405 U.S. 1065 (1972). While the contract clause is not applicable to actions of the federal government, the due process clause of the fifth amendment acts as a limitation on the power of the federal government to impair contracts. Hepburn v. Griswold, 75 U.S. (8 Wall.) 603, 623-24 (1869); Century Arms, Inc. v. Kennedy, 323 F. Supp. at 1014-15.

That the contracts clause is applicable to state legislative action and that no comparable provision operates as a restraint on the legislative powers of Congress, is evidenced by the exclusive power of Congress "[t]o establish . . . uniform Laws on the subject of Bankruptcies

Tidal Oil Co. v. Flanagan,[12] citing "a long line of decisions," stated that the impairment of contract clause "is directed only against impairment by legislation and not by judgment of courts."[13] Prior to *Tidal Oil,* the courts had followed two distinct lines of thought in handling challenges on the issue of impairment of contracts. In *Gelpcke v. City of Dubuque,*[14] the Court had held that a valid contract could not be impaired by any subsequent state court decision which altered the construction of the law existing at the time of the making of the contract.[15] The other approach, taken in *Commercial*

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throughout the United States." U.S. CONST. art. I, § 8. Thus, Congress may discharge bankrupts from pre-existing debts, thereby impairing contract obligations. However, the exercise of this power must be reasonable and is governed by the "just compensation" clause of the fifth amendment. In Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935), the Supreme Court held that subsection (s) added to section 75 of the federal Bankruptcy Act by the Frazier-Lemke Act, Act of June 28, 1934, ch. 869, 48 Stat. 1289, was in violation of the fifth amendment. 295 U.S. at 601-02. The amended Act allowed certain defaulting mortgagors to retain their property thus depriving the mortgagees of the remedy of foreclosure for several years. Although the legislation was proposed to meet the economic plight of the depression, as was the contested statute in Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934), Justice Brandeis distinguished *Blaisdell,* where the legislation was contingent upon the continuation of the emergency, while, by its terms, the Frazier-Lemke Act would allow mortgagors to retain possession and continue in default for several years after the termination of the emergency. 295 U.S. at 597-98.

Holding that the Act had taken from the mortgagees their rights in specific property, Justice Brandeis stated:

> [T]he Fifth Amendment commands that, however great the Nation's need, private property shall not be thus taken even for a wholly public use without just compensation. If the public interest requires, and permits, the taking of property of individual mortgagees in order to relieve the necessities of individual mortgagors, resort must be had to proceedings by eminent domain; so that, through taxation, the burden of the relief afforded in the public interest may be borne by the public.

Id. at 602.

Congress amended the Frazier-Lemke Act in accordance with the Court's opinion. Act of Aug. 28, 1935, ch. 792, 49 Stat. 942. The amended Act was subsequently upheld in Wright v. Vinton Branch of the Mountain Trust Bank, 300 U.S. 440 (1937).

One commentator, in discussing the relationship of fifth amendment due process limitations on the right of the federal government to impair contracts, has stated:

> Although there is no clause expressly forbidding the federal government to pass laws impairing the obligation of contracts, any federal law impairing them in a manner which the Supreme Court deemed unreasonable would doubtless be held to be a deprivation of property without due process, contrary to the Fifth Amendment.

Hale, *The Supreme Court and the Contract Clause,* 57 HARV. L. REV. 852, 890 (1944).

[12] 263 U.S. 444 (1924).

[13] *Id.* at 451. The Chief Justice further stated that the very language of the contract clause "plainly requires such a conclusion." *Id.*

[14] 68 U.S. (1 Wall.) 175 (1863).

[15] *Id.* at 206. The Court relied on the rule as it was articulated by Chief Justice Taney in a separate concurring opinion in Ohio Life Ins. & Trust Co. v. Debolt, 57 U.S. (16 How.) 416 (1853). 68 U.S. (1 Wall.) at 206.

Chief Justice Taney had stated:

> And the sound and true rule is, that if the contract when made was valid by the laws

Bank of Cincinnati v. Buckingham's Executors,[16] more nearly reflects the position of Chief Justice Taft that the contract clause applies only to state legislative action and not to state judicial determinations.[17] In *Tidal Oil,* Chief Justice Taft reconciled these two approaches to the issue of impairment, indicating that *Gelpcke* and its progeny had not been brought under the contract clause. Instead, he observed, those cases had been decided under article III, which enabled federal courts in diversity of citizenship actions to base their decisions "on the state law as they determined it."[18] If the *Gelpcke* rationale was eroded by *Tidal Oil,* it was entirely washed away by Justice Brandeis in *Erie Railroad Co. v. Tompkins.*[19] The *Erie* doctrine mandates that federal courts in diversity actions are no longer "free to exercise an independent judgment as to what the common law of the State is;"[20] rather, the courts must "apply as their rules of decision the law of the State, unwritten as well as written."[21] As a result, in a *Gelpcke* situation, where a state court has judicially determined that a contract is not valid, the combined effect of *Tidal Oil* and *Erie* would preclude the federal courts from disregarding the state case law and finding an offensive impairment. Thus, in order for the courts to find an unconstitutional impairment of contract, there must be some state legislative action.

The "Obligations of Contract"

"Obligations of Contract" were recognized as early as 1810, when Chief Justice Marshall, in *Fletcher v. Peck,*[22] noted that a state,

> of the State, as then expounded by all the departments of its government, and administered in its courts of justice, its validity and obligation cannot be impaired by any subsequent act of legislature of the State, or decision of its courts, altering the construction of the law.

57 U.S. (16 How.) at 432.

It should be noted that this point of view was not adopted by the majority of the Court at this time. However, within nine years of the *Ohio Life* decision and prior to *Gelpcke,* the Court held that the construction given a state statute by the state's highest court is to be considered part of the statute and is therefore binding on the Supreme Court. Leffingwell v. Warren, 67 U.S. (2 Black) 599, 603 (1862).

[16] 46 U.S. (5 How.) 317 (1846).

[17] *Id.* at 342-43.

[18] 263 U.S. at 451-52. This policy followed the doctrine established in Swift v. Tyson, 41 U.S. (16 Pet.) 1 (1842), which interpreted the Judiciary Act of 1789 as giving federal courts the power to decide questions of general common law even if their decision reverses or overrules a determination of the state court. *Id.* at 18-19.

[19] 304 U.S. 64 (1938).

[20] *Id.* at 71.

[21] *Id.* at 73. Accordingly, the doctrine of Swift v. Tyson, 41 U.S. (16 Pet.) 1 (1842), was expressly overruled. 304 U.S. at 79.

[22] 10 U.S. (6 Cranch) 87 (1810).

as a party to a contract, was bound by the tenets of the contract clause.[23] This phrase was further interpreted in *Ogden v. Saunders,*[24] as "the law which binds the parties to perform their agreement."[25] The "obligations" include more than just the express covenants found on the face of the contract. In the often cited *Von Hoffman v. City of Quincy,*[26] the Court discussed whether other obligations were imposed on the parties to a bond contract:

> [T]he laws which subsist at the time and place of the making of a contract, and where it is to be performed, enter into and form a part of it, as if they were expressly referred to or incorporated in its terms. This principle embraces alike those which affect its validity, construction, discharge, and enforcement.[27]

An essential element of a contractual obligation is a remedy for enforcement in the event of a breach by one of the parties.[28] In the absence of a remedy which is sanctioned and enforced by the law, contracts would be little more than "gentlemen's agreements." Without impairing the obligation, however, the remedy to enforce that obligation may be modified—so long as the particular remedy is not a substantial contractual right.[29] For example, a state may abolish debtor's prison;[30] change procedural methods for the enforcement of contracts;[31] and extend periods of redemption.[32] The test applied to a modification of remedy is that of reasonableness, necessitating the deciding of each case "upon its own cir-

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[23] *Id.* at 137-38.

[24] 25 U.S. (12 Wheat.) 213 (1827).

[25] *Id.* at 257 (citing Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122, 197 (1819)).

[26] 71 U.S. (4 Wall.) 535 (1866).

[27] *Id.* at 550. New Jersey law provides that when a school district issues bonds, those bonds

> shall be a lien upon the real estate situate in the district, the personal estates of the inhabitants of the district and the property of the district, and such estates and property shall be liable for the payment thereof.

N.J. STAT. ANN. § 18A:24-56 (1968). *Accord, id.* § 18A:13-26 (pertaining to regional school districts).

[28] 71 U.S. (4 Wall.) at 554.

[29] *Id.* at 553-54.

[30] Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122, 200-01 (1819), wherein Chief Justice Marshall stated:

> Confinement of the debtor may be a punishment for not performing his contract, or may be allowed as a means of inducing him to perform it. But the State may refuse to inflict this punishment, or may withhold this means, and leave the contract in full force. Imprisonment is no part of the contract, and simply to release the prisoner does not impair its obligation.

[31] Pennsylvania Co. for Ins. of Lives v. Marcus, 89 N.J.L. 633, 638, 99 A. 405, 407 (Ct. Err. & App. 1916); Klorman v. Westcliff Co., 12 N.J. Misc. 266, 271, 170 A. 251, 253 (Sup. Ct. 1934); *see* Antoni v. Greenhow, 107 U.S. 769, 782 (1882).

[32] Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 447 (1934).

cumstances."[33] In deciding whether there has been a legislative impairment, a court will consider whether the remedy sought to be modified was one central to the contract, and therefore one of the primary reasons for either party entering into the contract.[34] When a legislature arbitrarily attempts to reduce the effectiveness of essential remedies, the courts will conclude that there has been an unconstitutional impairment of the contract.

Police Power—The Reserved Power of the State to Validly Impair Contracts

While state legislatures are constitutionally prohibited from impairing contracts, they are also charged with the responsibility of providing for the health, safety, and general welfare of their citizenry. Where the state legislature has been confronted with a fiscal emergency and has chosen a potential solution which has the effect of impairing contractual obligations, how will the courts respond to this exercise of reserved "police power"?

Home Building & Loan Association v. Blaisdell[35] represents one judicial reaction to this dilemma. In 1933 during a duly declared economic emergency, the Minnesota legislature passed a statute which provided that, when a mortgagee sought relief by way of a foreclosure proceeding and execution sales, the "sales may be postponed and periods of redemption may be extended."[36] The effectiveness of the act was limited to " 'the continuance of the emergency and in no event [was to extend] beyond May 1, 1935.' "[37] The enactment was challenged as being an unconstitutional impairment of the obligation of contracts.[38] The Supreme Court, in rejecting this contention, explained that "[t]he economic interests of the State may justify the exercise of its continuing and dominant protective power notwithstanding interference with contracts."[39]

Recognizing that reserved state power had been previously invoked to provide temporary relief from the enforcement of contracts when the public safety was affected by physical causes "such as fire, flood or earthquake," the Court held that this power may

[33] Von Hoffman v. City of Quincy, 71 U.S. (4 Wall.) at 553-54.

[34] *See* City of El Paso v. Simmons, 379 U.S. 497, 514 (1965).

[35] 290 U.S. 398 (1934).

[36] *Id.* at 416.

[37] *Id.* (quoting Act of April 18, 1933, ch. 339, § 8, [1933] Minn. Laws 522).

[38] 290 U.S. at 404. The statute was also challenged as a deprivation of property without due process. *Id.*

[39] *Id.* at 437.

also properly be exercised when relief is demanded from an economic disaster.[40] Thus, the Court upheld the statute primarily because of the act's temporary nature and its being a valid legislative reponse to the emergent economic situation.[41]

Also responding to the emergency of a depression-plagued economy, the New Jersey legislature in 1931 created the Municipal Finance Commission.[42] This act and subsequent legislation empowered the Commission to establish means for satisfying municipal debts,[43] and prevented a municipality's creditor from availing himself of the remedy of mandamus to force the levying of municipal taxes to pay a debt.[44] The constitutionality of the statute and the Commission was challenged in *Hourigan v. North Bergen Township*.[45] Finding that the statute had been enacted "as an emergency measure," the court of errors and appeals held that the interest of the state in using its police power to promote the general good was "paramount to any rights under contracts between individuals."[46] The court relied in part on the *Blaisdell* deci-

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[40] *Id.* at 439-40. The Court stated:

> The reservation of state power appropriate to such extraordinary conditions [the 1930's depression] may be deemed to be as much a part of all contracts, as is the reservation of state power to protect the public interest in the other situations to which we have referred.

Id. at 439.

More recent decisions have relied on the police power theory in less than extraordinary situations, although the public good is still the prime concern. *See, e.g.*, Ruiz v. Economics Laboratory, Inc., 274 F. Supp. 14, 15-16 (D.P.R. 1967), where a statute which was intended to curtail abuse by principals of their franchised dealers was challenged as being unconstitutional partly because it allegedly impaired prior contract obligations between individuals. The court observed:

> "It is the settled law of this court that the interdiction of statutes impairing the obligation of contracts does not prevent the state from exercising such powers as are vested in it for the promotion of the common weal, or are necessary for the general good of the public, though contracts previously entered into between individuals may thereby be affected."

Id. at 17 (quoting from Manigault v. Springs, 199 U.S. 473, 480 (1905)).

[41] 290 U.S. at 447.

[42] Law of April 28, 1931, ch. 340, [1931] N.J. Laws 830, *as amended*, N.J. STAT. ANN. § 52:27-1 *et seq.* (1955).

[43] Law of April 28, 1931, ch. 340, [1931] N.J. Laws 830, *as amended*, Law of June 30, 1931, ch. 384, [1931] N.J. Laws 1212, *as amended*, Law of June 14, 1932, ch. 236, [1932] N.J. Laws 519, *as amended*, Law of June 27, 1933, ch. 330, [1933] N.J. Laws 859, *as amended*, N.J. STAT. ANN. § 52:27-1 *et. seq.* (1955).

[44] *See* Hourigan v. North Bergen Tp., 113 N.J.L. 143, 148, 172 A. 193, 196 (Ct. Err. & App. 1934).

[45] 113 N.J.L. 143, 172 A. 193 (Ct. Err. & App. 1934). In *Hourigan*, the constitutionality of the legislation was challenged as violative of both the federal Constitution and N.J. CONST. art. IV, § VII, ¶ 3 (1844), which forbids the passage of any law impairing contract obligations. 113 N.J.L. at 145, 172 A. at 194-95.

[46] 113 N.J.L. at 148-49, 172 A. at 196.

sion, admitting that the statute in that case was for a fixed and limited period, while the New Jersey law was not so proscribed.[47] Nevertheless, the court declared:

> [I]t is not requisite that the operation of the law be limited to a definite term. It is the actual existence of the emergency solely, and not the limitation of the law's operation to a prescribed period, that gives validity to this exercise of the reserve element of sovereignty called the police power.[48]

While recognizing the existence of possible limits on this power, the court stated that the legislature had "wide discretion . . . in determining what is and what is not necessary—a discretion which courts ordinarily will not interfere with."[49] Although a specified time period was not mandated for the statute's operation, the court noted that its useful life was limited to the duration of the economic emergency which called it forth.[50]

This legislative discretion was soon tested in *Faitoute Iron & Steel Co. v. City of Asbury Park*.[51] The City of Asbury Park had incurred a large municipal bond indebtedness when, in 1935, on application of creditors to the state supreme court, the city was "placed under the control of the Municipal Finance Commission."[52] A proposal for the refunding of the bonded debt was submitted in 1936[53] and approved by the court and the Finance Commission in 1937.[54] The plan was consented to in 1938

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[47] *Id.* at 151, 172 A. at 197.

[48] *Id.*

[49] *Id.* at 149, 172 A. at 196 (citations omitted).

[50] *Id.* at 151-52, 172 A. at 197. The court constructed an implied repealer of the statute:

> When the emergency ceases to exist, the operation of the statute will be arrested, even though the prescribed term of its operation may not then have expired. A law depending upon the existence of an emergency, or other certain state of facts, to uphold it, may cease to operate if the emergency ceases, or the facts change, even though valid when passed. It is always open to judicial inquiry whether the exigency still exists upon which the continued operation of the law depends. The operation of the statute itself could not validly outlast the emergency.

Id. Although the "exigency" which led to the creation of the statute—the depression—has ceased, the Municipal Finance Commission continues in existence. *See* N.J. STAT. ANN. § 52:27-1 *et seq.* (1955). *See also* Schierstead v. City of Brigantine, 20 N.J. 164, 167, 119 A.2d 5, 7 (1955).

[51] 316 U.S. 502 (1942).

[52] *Id.* at 503, 505. Justice Frankfurter described Asbury Park's crisis as

> present[ing] a familiar picture of optimistic and extravagant municipal expansion caught in the destructive grip of general economic depression: elaborate beachfront improvements, costs in excess of estimates, deficits not annually met by taxation, declining real-estate values, inability to refinance a disproportionately heavy load of short-term obligations, and, inevitably, default.

Id. at 503.

[53] *Id.* at 505.

[54] *Id.* at 506.

by creditors holding 85 percent of the city's debt. Shortly thereafter, the plan went into effect.[55] Faitoute Iron & Steel held bonds and interest coupons of the city which had been issued in 1929 and 1930—prior to the creation of the Municipal Finance Commission.[56] These securities, however, were included in the refinancing plan, which provided for the refunding of $10,750,000 of the outstanding bonds, in exchange for new bonds which carried a lower rate of interest and were to mature at a later date.[57] This plan was subsequently attacked as being violative of the contract clause.[58]

Writing for the Court, Justice Frankfurter went further than did earlier cases in justifying police power on the basis of the emergency doctrine, by stating that

> [t]he necessity compelled by unexpected financial conditions to modify an original arrangement for discharging a city's debt is implied in every such obligation for the very reason that thereby the obligation is discharged, not impaired.[59]

As a result of this refinancing, there was no unconstitutional impairment, for "[i]mpairment of an obligation means refusal to pay an honest debt; it does not mean contriving ways and means for paying it."[60]

The financial problems which faced Asbury Park were analyzed realistically by the Court. In upholding the legislative action, it placed great emphasis on the fact that the law dealt with the solvency of a municipal corporation which could meet its debts only through taxation.[61] The Court recognized that while a city may have unlimited taxing power in theory, it may, in practice, be impossible to exercise this power to such an extent, due to existing

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[55] *Id.* at 506-07.

[56] *Id.* at 507. *See* note 42 *supra* and accompanying text.

[57] 316 U.S. at 507.

[58] The challenge was based on both the federal and New Jersey constitutional guarantees against impairment of contract. The bondholders also contended that the legislation which allowed a municipality to avoid its contractual debts was, in effect, a bankruptcy act, thus usurping Congress' exclusive authority in that area. *Id.* at 507, 509.

[59] *Id.* at 511.

[60] *Id.*

[61] *Id.* at 509-10. The Court further observed:

> The intervention of the State in the fiscal affairs of its cities is plainly an exercise of its essential reserve power to protect the vital interests of its people by sustaining the public credit and maintaining local government. The payment of the creditors was the end to be obtained, but it could be maintained only by saving the resources of the municipality—the goose which lays its golden eggs, namely, the taxes which alone can meet the outstanding claims.

Id. at 512.

economic conditions.[62] Thus, the Court reasoned that the only viable approach for the enforcement of claims against a financially embarrassed municipality was a scheme of public receivership with subordination of individual contractual claims.[63]

A more recent illustration of contractual rights being legislatively diluted in response to an unforeseen exigency is *City of El Paso v. Simmons*.[64] Under the 1876 Texas constitution, more than 42 million acres of state-owned land were designated for sale "to provide revenues for the public school system and to encourage the settlement of the vast public domain."[65] The plan provided that, in the event of forfeiture, the purchaser would be granted the perpetual right of reinstatement.[66] By 1939, many of the owners were in default and, as a result, approximately 600,000 acres of the designated lands lay dormant, having produced no school revenue for more than ten years.[67] The discovery of oil and gas deposits within the state had led to rampant speculation by the owners, many of whom simply forfeited on their purchase contracts with the state, to await the discovery of oil on their land—intending to redeem their property under the existing reinstatement provisions.[68] Consequently, in 1941, the Texas legislature required that the right of reinstatement be exercised within five years of default.[69] Ten years later, it further limited the right to "the last purchaser from the State and his vendees or heirs."[70] In dealing with this legislative action, Justice White, speaking for the Supreme Court, upheld the law as a valid exercise of Texas' police power,

[62] *Id.* at 509.

[63] *Id.* at 510. The Court noted that for a municipality to survive and have its creditors satisfied as well, three essential conditions must be met:

> [I]mpartial, outside control over the finances of the city; concerted action by all the creditors to avoid destructive action by individuals; and rateable distribution.

Id. The Court recognized that prior to the institution of the refinancing plan, the bonds had had little value, but that after the plan was adopted, a large market existed for the new bonds. *Id.* at 513.

[64] 379 U.S. 497 (1965).

[65] *Id.* at 509-10. *See* TEX. CONST., art. 7, § 2.

[66] 379 U.S. at 498-99.

[67] *Id.* at 512.

[68] *Id.* at 511-12.

[69] *Id.* at 499.

[70] *Id.* The plaintiff in *El Paso* sought reinstatement of lands which had been forfeited to the state by reason of non-payment of interest. He tendered the required back payments, but his application was denied because it had not been filed within five years of the date of forfeiture. *Id.* at 500-01. Three years later the land was transferred to the City of El Paso which urgently needed it as a source of water. *Id.* at 516. The major issue, of course, was whether the reduction of the reinstatement period to five years was an unconstitutional impairment of the obligations of the original contract of sale, which had been executed during a time when no such limit was in effect. *See id.* at 501.

since it was "hardly burdensome to the purchaser who wanted to adhere to his contract of purchase, but nonetheless an important one to the State's interest."[71] The Court relied on *Faitoute,* interpreting the impairment of contract clause as intending to protect only " 'substantial' " contractual rights.[72] The Court observed that the state's "promise of reinstatement . . . was not the *central undertaking* of the seller nor the *primary consideration* for the buyer's undertaking."[73] While *El Paso* demonstrates the continued power of the state to alter contractual obligations in emergencies, this last statement of the Court reveals a limit: This police power would apply only to non-essential terms, and terms which had not induced the individuals to enter into the contractual agreement.

Where no emergency exists or the inducement to enter the contract is impaired, legislative action will not be sustained. Thus, the limits of reserved police power were held to have been exceeded in *W. B. Worthen Co. v. Kavanaugh.*[74] In that case the Court considered an Arkansas statute which substantially changed bondholders' remedies. The bonds had been issued by a Municipal Improvement District pursuant to a statutory authorization which also provided for mortgage benefit assessments as security to the purchasers.[75] To secure the issue, the bonds were mortgaged to a firm of bankers which acted as trustees for the bondholders. On the date of the issuance of the bonds, the Arkansas statute gave lot owners thirty days from the date of the required notice for payment of assessments. If payment was not made at the end of the period, the collector was authorized "to add a penalty of twenty per cent, and make immediate return of delinquents to the Board of Commissioners."[76] The Commissioners were required to bring

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[71] *Id.* at 516-17.

[72] *Id.* at 515 (quoting from Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 514 (1942)).

[73] 379 U.S. at 514 (emphasis added). Justice White noted:

> We do not believe that it can seriously be contended that the buyer was substantially induced to enter into these contracts on the basis of a defeasible right to reinstatement in case of his failure to perform, or that he interpreted that right to be of everlasting effect.

Id. Relying on Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934), the Court reaffirmed its position regarding the authority of a state to protect the interests of the public, even if certain contract rights are thereby impaired. 379 U.S. at 508. *See* notes 35-41 *supra* and accompanying text. *See also* Veix v. Sixth Ward Bldg. & Loan Ass'n, 310 U.S. 32, 37-38 (1940) (impairment of contractual rights of investors in building held constitutional in light of importance of financial institutions to New Jersey's statewide credit system).

[74] 295 U.S. 56 (1935).

[75] *Id.* at 57.

[76] *Id.* at 57-58.

foreclosure suits immediately. If the defendant failed to answer within five days of being personally served, a decree was granted adding the twenty percent penalty and attorney's fees to the original assessment. Ten days later, if no payment had been made, "the property was to be sold upon twenty days notice"—the property owner's only remedy being a limited right of redemption.[77]

Three years after the bonds were issued, the Arkansas legislature drastically revised the procedure outlined above. This new legislation extended the time allowed for payment after receiving notice; lessened the penalty from twenty percent to three percent; lengthened the time in which delinquent lists could be returned; extended the time for appearance and answer; changed the time for payment after a decree was granted from ten days to twelve months; and extended, by six months, the waiting period after the entering of a final default before a sale of the property would be allowed.[78] The Court also noted that the new acts failed to provide for reimbursement of court costs and attorney's fees and that it was no longer permissible for the purchaser "to go into possession during the term allowed for redemption and to hold such possession without accountability for rents."[79]

In response to the challenge that the legislation was unconstitutional, the proponents of the statute relied on *Blaisdell* and the emergency doctrine.[80] The Court rejected the contention that a state of emergency justified the new statutes. Justice Cardozo, writing for the Court, noted that the restrictions on the time or extent of impairment which had been part of the legislation attacked in *Blaisdell* were absent from the Arkansas statute.[81] The Arkansas legislature had so grossly reduced the efficacy of the bondholders' statutory lien, which had served as their security, that it took from the contract "the quality of an acceptable investment for a rational investor."[82] The Court further noted:

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[77] *Id.* at 58. The Court stated that the redemption period might have been only two years instead of five. It concluded that the exact length could not be determined since the language of the statutes was unclear. *Id.*

[78] *Id.* at 58-59.

[79] *Id.* at 59.

[80] *Id.* at 63.

[81] *Id.*

[82] *Id.* at 60. Speaking of the dilution of the remedy, the Court found that

> [u]nder the statutes in force at the making of the contract, the property owner was spurred by every motive of self-interest to pay his assessments if he could, and to pay them without delay. Under the present statutes he has every incentive to refuse to pay a dollar, either for interest or for principal.

Id. at 60-61.

> In the books there is much talk about distinctions between changes of the substance of the contract and changes of the remedy. . . . The dividing line is at times obscure. . . . [However] [n]ot even changes of the remedy may be pressed so far as to cut down the security of a mortgage without moderation or reason or in a spirit of oppression. *Even when the public welfare is invoked as an excuse, these bounds must be respected.*[83]

As a result of such cases as *Blaisdell, Hourigan, Faitoute,* and *Worthen,* it appears that legislative action which impairs a bond contract will be permitted under exigent circumstances. However, an emergency will not justify an impairment which destroys the underlying security which had induced the investment or which leaves no reasonable means of contractual enforcement.

The reserved police power of the state must be interpreted harmoniously with limitations rooted in the contract clause. As such, there may be no judicial

> construction which would permit the State to adopt as its policy the repudiation of debts or the destruction of contracts or the denial of means to enforce them.[84]

The New Jersey Constitutional Provision

Before examining how the *Robinson* decision, the repeal of the 1962 covenant, and other recent events may affect the rights of current and future bondholders, the relevant provision of this state's constitution should be mentioned. The New Jersey prohibition against impairment of contract is stated more specifically than that which appears in the federal Constitution. The 1947 New Jersey constitution states:

> The Legislature shall not pass any . . . law impairing the obligation of contracts, or depriving a party of any remedy for enforcing a contract which existed when the contract was made.[85]

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[83] *Id.* at 60 (citation omitted) (emphasis added).

[84] W. B. Worthen Co. v. Thomas, 292 U.S. 426, 433 (1934).

[85] N.J. CONST. art. 4, § 7, ¶ 3. For text of the federal contract clause see text accompanying note 11 *supra.*

The language of the New Jersey constitution of 1947 is the same as that in the prior constitution. *See* N.J. CONST. art. IV, § VII, ¶ 3 (1844). In Baldwin v. Flagg, 43 N.J.L. 495 (Sup. Ct. 1881), the court established a test for determining the constitutionality of legislation impairing or depriving a party of a contract remedy:

> It is perfectly clear that any law which enlarges, abridges, or in any manner changes the intention of the parties, resulting from the stipulations in the contract, necessarily impairs it, and the manner or degree in which this change is effected can in no respect influence the conclusion. Any deviation from its terms, by postponing or accelerating the period of performance which it prescribes, imposing conditions not

Despite the different language in the two clauses, the New Jersey supreme court has characterized them as "parallel guarantees"[86] and the state courts have made no distinction in their application.[87]

THE APPLICATION OF THE IMPAIRMENT OF CONTRACTS CLAUSE TO RECENT EVENTS

The Financing of a Thorough and Efficient Education

Local real property taxes traditionally have provided the primary source of funds for elementary and secondary public education in New Jersey.[88] In *Robinson v. Cahill,*[89] the Supreme Court of New Jersey unanimously held that the method of financing public education in New Jersey did not meet the state's constitutional requirement that every child between the ages of five and eighteen shall receive a "thorough and efficient" free public education.[90] While the court found that the present method of financing public education failed to satisfy the constitutional standard, it did not hold that the imposition of local ad valorem property taxes for educational purposes was per se unconstitutional.[91] The court, however, charged the state legislature with the responsibility of developing a constitutionally acceptable method of providing a "thorough and efficient" education within a period of two years.[92]

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expressed in the contract, or dispensing with the performance of those which are part of the contract, however minute or apparently immaterial in their effect upon it, impairs its obligation.

Id. at 503. *Accord,* Klorman v. Westcliff Co., 12 N.J. Misc. 266, 269, 170 A. 251, 253 (Sup. Ct. 1934).

[86] P.T. & L. Constr. Co. v. Commissioner, Dep't of Transp., 60 N.J. 308, 313, 288 A.2d 574, 577 (1972).

[87] *See, e.g.,* New Jersey Highway Auth. v. Sills, 109 N.J. Super. 424, 431, 263 A.2d 498, 501, *supplemented,* 111 N.J. Super. 313, 268 A.2d 308 (Ch. 1970), *aff'd mem.,* 58 N.J. 432, 278 A.2d 489 (1971) (impairment found; police power justification rejected); New Jersey Sports & Exposition Auth. v. McCrane, 119 N.J. Super. 457, 563-64, 292 A.2d 580, 639-40 (L. Div. 1971), *aff'd as modified,* 61 N.J. 1, 292 A.2d 545, *appeal dismissed sub nom.* Borough of E. Rutherford v. New Jersey Sports & Exposition Auth., 409 U.S. 943 (1972), *aff'd on appeal after remand sub nom. In re* Sports Complex, 62 N.J. 248, 300 A.2d 337 (1973) (police power upheld).

[88] Robinson v. Cahill, 118 N.J. Super. 223, 229, 287 A.2d 187, 190 (L. Div. 1972).

[89] 62 N.J. 473, 303 A.2d 273 (1973).

[90] *Id.* at 515, 303 A.2d at 295. The constitutional provision examined by the court declares:

> The Legislature shall provide for the maintenance and support of a thorough and efficient system of free public schools for the instruction of all the children in the State between the ages of five and eighteen years.

N.J. CONST. art. 8, § 4, ¶ 1.

[91] *See* 62 N.J. at 520, 303 A.2d at 297-98.

[92] 63 N.J. at 198, 306 A.2d at 66.

The *Robinson* decision culminates a series of attacks which had been made upon the quality of public education provided through the imposition of local property taxes.[93] In *Serrano v. Priest,*[94] the California supreme court sustained challenges that the state's financing of public schools through the imposition of local property taxes violated the equal protection guarantees of both the federal and state constitutions.[95] Presented with a similar attack upon the Texas system, the Supreme Court of the United States adopted a contrary position in *San Antonio Independent School District v. Rodriguez,*[96] rejecting a claim that federal equal protection was being denied by the funding of public education with local property tax revenues.[97] In New Jersey, while the trial court in *Robinson* had found various violations of federal and state consitutional provisions,[98] the *Rodriguez* decision precluded any further consideration of the federal equal protection question by the state supreme court.[99] Consequently, the New Jersey supreme court's decision in *Robinson* was based solely on the education clause of the New Jersey constitution.[100]

While local real property taxes provide revenues to meet current educational expenditures, they also provide the security for bonds issued by local school districts to obtain funds for capital

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[93] For a thorough analysis of the school financing litigation see Tractenberg, *supra* note 5.

[94] 5 Cal. 3d 584, 487 P.2d 1241, 96 Cal. Rptr. 601 (1971).

[95] *Id.* at 596 n.11, 614-15, 487 P.2d at 1249, 1263, 96 Cal. Rptr. at 609, 623.

[96] 411 U.S. 1 (1973).

[97] *Id.* at 54-55.

[98] 118 N.J. Super. at 279-81, 287 A.2d at 216-17. The lower court found that financing education through local property taxes discriminated against students living in districts with lower tax bases and against taxpayers by exacting an unequal share of the tax burden, resulting in a violation of federal and state guarantees of equal protection. The court also held that the "thorough and efficient" education clause was not met and that the state constitutional provisions on taxation of real property were violated. *Id.* The New Jersey equal protection guarantee is implied in article 1, paragraph 1. *See* Washington Nat'l Ins. Co. v. Board of Review of N.J. Unempl. Comp. Comm'n, 1 N.J. 545, 554, 64 A.2d 443, 447 (1949). Article 8, section 1, paragraph 1 of the 1947 constitution provides for uniformity of taxation. 118 N.J. Super. at 277, 287 A.2d at 215.

[99] 62 N.J. at 486-90, 303 A.2d at 279-82. The New Jersey supreme court had previously rejected a demand for strict equal protection in West Morris Regional Bd. of Educ. v. Sills, 58 N.J. 464, 279 A.2d 609 (1971), noting that

> there is no constitutional fiat that educational expenditures be identical for all students throughout the State. Benefits may indeed depend upon the district of a student's residence.

Id. at 478, 279 A.2d at 616.

[100] *See* 62 N.J. at 513, 515-16, 303 A.2d at 294-95. On the record before it, the court declined to consider the issue of state equal protection demands vis-à-vis public services. *Id.* at 500, 303 A.2d at 287.

improvements. In the event of default on payment of the bonded debt, the bondholders may seek to compel the levy of sufficient taxes to provide funds for payment. Although the supreme court struck down the present method of financing education for failing to meet the "thorough and efficient" standard, Chief Justice Weintraub concluded his opinion by emphatically stating: "Obligations incurred must not be impaired."[101] The New Jersey legislature, acting on the supreme court's mandate to provide a "thorough and efficient education," is currently discussing new methods for school financing, including a plan by which the state would assume the entire cost, with a resulting reduction or elimination of the local districts' financing of education by local ad valorem property taxes.[102] Since the holders of local school district bonds purchased the bonds in reliance on the taxing power of the local districts, the reduction or elimination of this taxing power may cause bondholders to feel that their contract has been impaired.

The importance which the municipal bond industry attaches to the ad valorem tax pledge as security for "general obligation" school bonds cannot be overemphasized. The bond attorney's approving legal opinion accompanying any such issue will include substantially the following language:

> In our opinion, the bonds are valid and legally binding general obligations of the school district and the Board of Education has the power and is obligated to levy ad valorem taxes upon all the taxable real property within the school district without limitation as to rate or amount for the payment of the bonds and interest thereon.[103]

If, for any reason, the bond attorney feels he must qualify his opinion as to the taxing power of the district, investors will usually be unwilling to purchase the bonds at any price. For example, when the California decision of *Serrano v. Priest* was first publicized

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[101] *Id.* at 520, 303 A.2d at 298.

[102] Numerous bills have been introduced to meet the *Robinson* directive. *See, e.g.*, N.J. Assembly Bill No. 1644 (introduced May 6, 1974) (elimination of local property taxes and imposition of statewide property tax); N.J. Assembly Bills Nos. 1815, 1816, 1817 & 1818 (introduced May 16, 1974), N.J. Assembly Con. Res. Nos. 160 & 161 (introduced May 16, 1974) (amendment of sales, business personal property, and corporate taxes along with establishment of statewide property tax and constitutional amendments); N.J. Assembly Bill No. 1863 (introduced June 13, 1974) (local funding with state equalization aid); N.J. Assembly Bill No. 1875 (introduced June 13, 1974) (personal income tax).

[103] Approving Opinion of Kraft & Hughes, Esqs., relating to $4,980,000 bonds of the Board of Education of the Township of Middletown, in the County of Monmouth, New Jersey, issued January 1, 1974.

in 1971, the municipal bond market was shaken by the news.[104] In *Serrano,* the court had held that the very cornerstone for the repayment of billions of dollars in outstanding obligations and millions of dollars in proposed bond issues violated the federal Constitution. A number of bond sales were postponed in order to give bond attorneys the opportunity to properly evaluate the situation and to advise the industry as to the impact of *Serrano* and similar decisions. Without any reassurance from bond attorneys that the unlimited taxing power to satisfy bond obligations remained intact, new issues were simply not marketable. Consequently, the following language was adopted:

> In our opinion the bonds are valid and legally binding general obligations of the school district and, unless paid from other sources, are payable from ad valorem taxes levied upon all the taxable real property within the school district without limitation as to rate or amount.
>
> In expressing such opinion, we have considered the litigation recently instituted in various states, including New Jersey, challenging the constitutionality of present systems of levying taxes and applying funds for public school purposes, and have concluded that, in our opinion, such litigation, whether or not any such system is ultimately held unconstitutional, will not affect the validity or binding obligation of the bonds or modify the rights of holders to ultimate recourse to unlimited ad valorem taxes upon all the taxable real property within the school district for the payment of the bonds if not paid from other sources, and therefore our conclusions stated in the preceding paragraph are not modified or qualified in any respect.[105]

This language was used during the period when the status of the real property taxing power as security for school bonds was being questioned as a result of the *Serrano* line of cases. After the Supreme Court decided *Rodriguez* and the New Jersey supreme court specifically reaffirmed the validity of local school districts' bond debts, bond attorneys reverted to the original language in approving New Jersey school bond issues.

The opinion that the local districts' pledge of their taxing

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[104] Wall St. Journal, Dec. 1, 1971, at 16, col. 3. The doubt was clearly expressed:

> Bond underwriters in recent months have blamed the [*Serrano*] case for creating uncertainty in a market that last year raised more than $3.5 billion for secondary and elementary public schools. The question is whether such bonds are valid and legally binding obligations on school districts that issue them.

Id.

[105] Approving Opinion of Kraft & Hughes, Esqs., relating to $439,000 bonds of the Board of Education of the Buena Regional School District, in the County of Atlantic, New Jersey, issued March 1, 1973.

power to repay school bonds will remain viable, even if the legislature eliminates the local property tax, is based on the constitutional protection of the contract clause. If New Jersey adopts a new system of financing education which dilutes the local property tax levy, the bondholder probably will be paid with money from different sources. There may be a different tax imposed, such as a statewide income or property tax, or payments may be made by the state rather than the local districts. As long as the bondholder is paid, there is no problem. However, if the obligation of the bonds is not satisfied by the new source, the bondholder still has his right to enforce the original pledge of the local school district to levy property taxes sufficient to pay the bonds.

Florida bondholders faced an analogous situation during the early 1930's. The City of Fort Lauderdale in 1926 issued general obligation negotiable bonds in the amount of $2 million for its share of the cost of a harbor project, now known as Port Everglades, which had been jointly undertaken with another municipality.[106] The harbor was subsequently placed under the control of a newly created taxing district, consisting of the two municipalities and additional territory.[107] In place of payment from the city's general taxing power, the legislature provided that the port district would meet bond payments through the imposition of a special assessment tax.[108] The Florida legislature intended "to relieve the cities involved of the payment of their bonds and to assume on the part of the taxing district the primary obligation."[109]

Unfortunately, the new district failed to meet the payments and bondholders sought to compel the city, by a writ of mandamus, to utilize its taxing power to raise sufficient funds to pay the obligations, as had been originally pledged.[110] In *City of Fort Lauderdale v. State ex rel. Elston Bank & Trust Co.*,[111] the Florida supreme court unanimously held that the legislature could not constitutionally release the city from liability, where the city had pledged its unlimited ad valorem property tax revenues for repayment.[112]

The court recognized that, as long as the bond payments were

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[106] City of Fort Lauderdale v. State *ex rel.* Elston Bank & Trust Co., 125 Fla. 89, 91-92, 169 So. 584, 585 (1936).

[107] *Id.* at 92, 169 So. at 585.

[108] *Id.* at 94, 169 So. at 586.

[109] *Id.* at 92, 169 So. at 585.

[110] *Id.* at 92-93, 169 So. at 585.

[111] 125 Fla. 89, 169 So. 584 (1936).

[112] *Id.* at 94, 169 So. at 586.

made, the state could change boundaries of the taxing district, substitute a new taxing district as the immediate payor, or substitute a new tax as the source for repayment.[113] But, basing its decision on a "well settled" judicial interpretation of the federal and state constitutional prohibitions against impairment of contract, the court stated that "the authority and ability" to levy taxes for payment was "a vital part of the bond contract" and could not be withdrawn by the legislature.[114]

If the New Jersey legislature, responding to the *Robinson* mandate, were to develop a financing program where the state would assume the cost of educational services and make payment on local school district bonds, this would not extinguish the local districts' entire obligation. As in *Fort Lauderdale,* should the state default in its payments, the bondholders will still have the right to compel the local districts to levy taxes.

Even if the bondholders approved the releasing of local school districts and the substituting of the state as obligor, the legislature could not assume all of the local districts' bond debts simply by

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[113] *See id.* at 98, 169 So. at 587. The court stated that

> it is utterly immaterial to a public creditor how he gets his money to discharge his indebtedness so long as he is being paid from some source sufficient to discharge what is his due . . . .

Id.

[114] *Id.* at 96, 169 So. at 587. *See also* Von Hoffman v. City of Quincy, 71 U.S. (4 Wall.) 535, 554 (1866) (by implication).

The plaintiff in *Von Hoffman* held interest coupons on bonds which had been issued by the city. At the time of their issuance, the Illinois legislature had authorized municipalities to levy a tax to pay for the existing debt. *Id.* at 535-36. After the coupons were issued the state legislature placed a taxing ceiling on the amount the municipalities could tax its residents. *See id.* at 536-37. When the coupons became due, the city defaulted and, in compliance with state law, declined to levy a tax which would exceed twenty-eight cents per one-hundred dollars. *Id.* The bondholder petitioned the court to issue a writ of mandamus requiring the city to levy a tax sufficient to pay the existing debt. *Id.* at 536. The Court held that the state law which permitted the city to levy such a tax was still in effect, and that subsequent legislation which had limited its taxing powers was not controlling. *Id.* at 554-55. Emphasizing that the state could not impair the obligation of the city's contract, the Court concluded:

> It is equally clear that where a State has authorized a municipal corporation to contract and to exercise the power of local taxation to the extent necessary to meet its engagements, the power thus given cannot be withdrawn until the contract is satisfied. The State and the corporation, in such cases, are equally bound.

Id.

The decision in *Von Hoffman* could have a substantial impact in New Jersey, should a similar problem arise concerning a bondholder and the taxing power of a local school district. If the New Jersey legislature should pass a law placing a limitation on the local district's power to raise taxes, in conjunction with a statewide tax, the state would not be legally bound to pay the bond debt in the event of default by the local district. *See* notes 115-17 *infra* and accompanying text. As suggested by *Von Hoffman,* if sufficient moneys could not be raised, the bondholder could compel the local district to impose taxes at a rate higher than that mandated by the legislature.

passing a law. The New Jersey constitution contains a "debt limitation clause,"[115] which establishes a specific procedure by which the state may incur a debt of this magnitude: When the debt will exceed one percent of the total general appropriations for that fiscal year, the legislature must enact a statute specifying a "single object or work"; the statute must provide the method by which this debt will be repaid, with discharge of the debt to be within thirty-five years; there can be no repeal of the law until discharge.[116] The constitution further mandates that

> [n]o such law shall take effect until it shall have been submitted to the people at a general election and approved by a majority of the legally qualified voters of the State voting thereon.[117]

At present it seems highly unlikely that the legislature would present such a proposal to the people. The debt limitation clause, however, does not prohibit the state from aiding in the payment of the local school districts' bonds.

There is precedent in New Jersey for the state paying principal and interest on bonds issued for school purposes. Under the Additional State School Building Aid Act of 1970,[118] and the County College Bond Act of 1971,[119] the legislature established a plan by which the state undertakes to pay debt service on bonds issued by school districts and counties for county college purposes as a form of state aid.[120] The County College Bond Act makes it

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[115] N.J. CONST. art. 8, § 2, ¶ 3.

[116] *Id.*

[117] *Id.*

[118] N.J. STAT. ANN. § 18A:58-33.6 *et seq.* (Supp. 1974-75). *See also id.* § 18A:58-21 *et seq.* (School Building Aid Law).

[119] *Id.* § 18A:64A-22.1 *et seq.*

[120] In Holster v. Board of Trustees of Passaic County College, 59 N.J. 60, 279 A.2d 798 (1971), the court construed the County College Bond Act. The court found that the intent of the act was to effect a cost-sharing plan by which the state and any individual county would contribute equally to the financial support of a county college. The bonds issued by the county become, in fact, the state's share of the capital outlay expense, providing, of course, that the state appropriates sufficient funds to meet the bonded indebtedness on principal and interest. *Id.* at 64, 279 A.2d at 800. *See also* New Jersey Turnpike Auth. v. Parsons, 3 N.J. 235, 242-43, 69 A.2d 875, 878-79 (1949) (bond issue of New Jersey Turnpike Authority did not exceed debt limitation clause because public corporations are independent entities and state is not liable for their debts if the state clearly disclaimed liability in the bond authorization statute); City of Passaic v. Consolidated Police & Firemen's Pension Fund Comm'n, 18 N.J. 137, 147, 113 A.2d 22, 27 (1955) (statutory authorization for state contribution to a consolidated pension fund not contrary to debt limitation clause because the statute did not incur debts, but rather provided for annual contributions).

The *Holster* court interpreted these cases as establishing that such "projected or anticipated future legislative appropriation is not a present debt or liability. A future legislature is not bound to make the appropriation." 59 N.J. at 71, 279 A.2d at 804.

clear that the bonds themselves do not constitute obligations or debts of the state of New Jersey.[121] Rather, the bonds are obligations of the counties which issue them and the commitment of the state to pay debt service is one which must be renewed each year through the Annual Appropriation Act.[122] If, in any future year, the state were not to appropriate funds for these payments, it would not violate any contractual obligation to bondholders, who then would have to look to the issuers of the bonds for payment. The constitutionality of this method of annual state aid for school purposes was challenged as being violative of the debt limitation clause in *Holster v. Board of Trustees of Passaic County College.*[123] Finding no binding obligation on the state, the supreme court held that

> both issuing counties and purchasing bondholders are on notice that the faith and credit of the State will not be pledged in respect of bonds issued pursuant to this enactment, but that payment on the part of the State will be dependent upon appropriations provided from time to time. *Lacking such appropriations, recourse can be had only against the county which will have no recourse over against the State.*[124]

If the legislature were to establish a statewide tax to meet the constitutional mandate of *Robinson* and, coupled with that tax, were to curtail the power of local school districts to impose property taxes, the state may be substituted as the primary taxing and paying entity for school bonds. Such a substitution, however, would not bind the state in the future nor would it release the local districts from their validly incurred obligations. In the unlikely event that the state were to follow the procedure prescribed by the debt limitation clause and bind itself to this obligation, it could not force the bondholders to accept the state as their new contractual partner. Not only the state—but also the bondholders—must consent to this new arrangement as a novation of their contract in order to

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[121] N.J. STAT. Ann. § 18A:64A-22.8 (Supp. 1974-75) provides:

> Bonds or notes issued under the provisions of this act shall not be deemed to constitute a debt or liability of the State or a pledge of the faith and credit of the State but are dependent for repayment upon appropriations provided by law from time to time.

Similarly, bonds issued under the Additional State School Building Aid Act of 1970 are not debts of the state, but are solely the obligations of the issuing local district. Although there is no express disclaimer of state liability, the Act does declare that state payments of debt service are "*on behalf* of the school district or municipality issuing such bonds." *Id.* § 18A:58-33.18 (emphasis added).

[122] *Id.* § 18A:64A-22.8.

[123] 59 N.J. 60, 279 A.2d 798 (1971).

[124] *Id.* at 66-67, 279 A.2d at 801 (emphasis added).

release the local districts from their obligations.[125] In all probability, this two-prong test of the debt limitation clause and bilateral consent will not be met. The federal and state impairment of contract clauses will require that ultimate responsibility for the repayment of the school bond debt remain with the local districts and their residents.

The Repeal of the 1962 Statutory Covenant

The Port Authority of New York and New Jersey is an agency created in 1921 by a compact between the two states.[126] The Port Authority district comprises an area of about 1500 square miles in both states, centering upon New York harbor.[127] As required by the Constitution,[128] Congress approved the bi-state compact.[129]

The purpose of the states in establishing the Authority was to provide "terminal, transportation and other facilities of commerce" within the continually expanding port district.[130] To achieve this end, the states have periodically authorized the construction or operation of specific facilities[131] and have empowered the Authority to assess charges for the use of such facilities and to raise capital by issuing bonds or other obligations.[132] The Port Authority, however, has neither the power to tax nor the power to pledge the credit of the two states in support of its activities.[133] It relies solely upon its revenues to meet operational expenses and the principal and interest payments on its bonded indebtedness.

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[125] *See* City of Fort Lauderdale v. State *ex rel.* Elston Bank & Trust Co., 125 Fla. at 95, 169 So. at 586, where the Florida supreme court stated:

> The Legislature cannot constitutionally release an existing municipality from all liability for payment of its validly incurred debts, even though it imposes liability therefore upon another public entity, unless the creditor accepts the new arrangement as a novation amounting to an extinguishment of the pre-existing promise . . . .

[126] N.J. STAT. ANN. § 32:1-1 *et seq.* (1963); N.Y. UNCONSOL. LAWS § 6401 *et seq.* (McKinney 1961).

[127] This area encompasses the cities of New York and Yonkers in New York State, Newark and Jersey City in New Jersey, and more than two hundred other municipalities, including all or part of seventeen counties in the two states. *See* N.J. STAT. ANN. § 32:1-3 (1963); N.Y. UNCONSOL. LAWS § 6403 (McKinney 1961).

[128] U.S. CONST. art. I, § 10.

[129] H.R. Res. 337, 67th Cong., 2d Sess., 42 Stat. 822 (1922); S.J. Res. 88, 67th Cong., 1st Sess., 42 Stat. 174 (1921).

[130] N.J. STAT. ANN. § 32:1-1 (1963); N.Y. UNCONSOL. LAWS § 6401 (McKinney 1961).

[131] N.J. STAT. ANN. § 32:1-8 (1963); *id.* §§ 32:1-25 to -140 *passim;* N.Y. UNCONSOL. LAWS § 6408 (McKinney 1961); *id.* §§ 6451-6778 *passim.*

[132] N.J. STAT. ANN. § 32:1-7 (1963); N.Y. UNCONSOL. LAWS § 6407 (McKinney 1961).

[133] N.J. STAT. ANN. §§ 32:1-8 to -9 (1963); N.Y. UNCONSOL. LAWS §§ 6408-6409 (McKinney 1961).

In the early 1960's New York and New Jersey determined that the Port Authority should undertake the construction of the World Trade Center, a twin-towered office complex in lower Manhattan, and should acquire and operate the Hudson and Manhattan Railroad system—subsequently known as PATH—a bankrupt, mass transit rail link between the two states.[134] For the Port Authority to accomplish this monumental project, massive amounts of additional capital were required. The New Jersey legislature authorized a senate committee, chaired by Senator Frank S. Farley, to investigate the proposed undertaking.[135] During extensive hearings held over a two-year period,[136] the Farley Committee discovered that prospective investors were greatly concerned that the operation of deficit rail systems would sap the Port Authority's financial strength. The recent collapse of many private railroads demonstrates the precarious financial footing of mass rail transit and underscores the concern felt by the prospective Port Authority bond investors. To attract the funds of the very conservative investors who place their money in fixed income "municipals," the Farley Committee reported to the legislature that it was necessary for the state to give these investors a statutory pledge of fiscal responsibility.[137] The need for such an assurance was demonstrated by the testimony of then Vice-Chairman of the Port Authority, James C. Kellogg, III. His testimony indicated that without this pledge, the Authority might not be able to obtain the necessary funds, even at a higher rate of interest. He expressed the unanimous opinion of the Port Authority Commissioners:

> [T]here is no possibility whatsoever of borrowing the money at all without a statutory assurance to investors that any future Port

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[134] *See* N.J. STAT. ANN. § 32:1-35.50 *et seq.* (1963); N.Y. UNCONSOL. LAWS § 6601 *et seq.* (McKinney 1961).

[135] N.J. Senate Res. No. 7 (1960), reproduced in [1960] N.J. SENATE JOUR. 776, *continued,* N.J. Senate Res. No. 7 (1961), reproduced in [1961] N.J. SENATE JOUR. 41-42.

[136] *Hearings on the Financial Structure and Operations of the Port of New York Authority Before N.J. Sen. Comm'n* (1960-62) [hereinafter cited as *Port Authority Hearings*]. Public hearings were held on Sept. 27-28, 1960, on Jan. 26-27, 1961, on May 5, 1961, and on Aug. 30, 1962.

[137] SPECIAL INVESTIGATING COMM. OF THE N.J. SENATE, REPORT UNDER S. RES. NO. 7, at 23-24 (1963) [hereinafter cited as SPECIAL REPORT]. Characterizing the threat to the Port Authority's credit from the proposed undertaking of deficit rail activities as "a valid and real one," the Committee report stated:

> If the Port Authority were to receive such unrestricted responsibility, there is no question but that its sound credit position would be seriously impared [*sic*], if not destroyed, and it would become impossible for the Authority to continue to move forward either with such a rail program or with other vital transportation and terminal facilities and other facilities of commerce desired by the 2 States in continuing the Port Authority's tradition as a public agency.

Id.

> Authority responsibilities in the field of commuter rail transport over and above the present and existing interstate Hudson and Manhattan railroad system will not involve a pledge of the Port Authority's General Reserve Fund.
>
> . . . [This] simply represents the realities of investment financing and the Port Authority's credit. My business is investment financing and I say to you gentlemen that I could not sell a single Port Authority bond without such an assurance. If my responsibility were on the other side of the table, I would not buy a Port Authority bond that did not contain such an assurance.[138]

After taking testimony, the Committee sponsored legislation designed to assure prospective bondholders that Port Authority revenues would not be eroded by unlimited railroad operations deficits.[139] This statutory pledge, enacted in 1962,[140] did not prohibit the Port Authority from acquiring or engaging in mass rail transit, as long as specified financial conditions were satisfied. The Port Authority could, at any time, acquire a "self-supporting" railroad facility.[141] The proposal also authorized the acquisition and operation of non-self-supporting railroad facilities if the deficits generated were within prescribed limits.[142] A formula involving the Port Authority's equity, reserves, and dollar amount of outstanding bonds, determined if a proposed operation was within the "permitted deficits."[143] The states of New Jersey and New York, in a

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[138] *Port Authority Hearings of Jan. 27, 1961, supra* note 136, at 22. *See also* SPECIAL REPORT, *supra* note 137, at 21-23.

[139] SPECIAL REPORT, *supra* note 137, at 24. The Committee recommended legislation

> [l]imiting by a constitutionally-protected statutory covenant with Port Authority bondholders the extent to which the Port Authority revenues and reserves pledged to such bondholders can in the future be applied to the deficits of possible future Port Authority passenger railroad facilities beyond the original Hudson & Manhattan Railroad system . . . .

Id.

[140] Law of Feb. 13, 1962, ch. 8, § 6, [1962] N.J. Laws 47; Law of March 27, 1962, ch. 209, § 6, [1962] N.Y. Laws 418.

[141] Parallel legislation in New Jersey and New York provided:

> [T]he port authority shall have first certified either that said other railroad facility is self-supporting as hereinafter defined or, if not, that at the end of the preceding calendar year the general reserve fund contained an amount equal to [1/10] of the par value of bonds of the port authority which were outstanding at said year end and which were legal for investment as defined in the general reserve fund statutes and that the group of facilities consisting of such other railroad facility and of all prior other railroad facilities will not produce deficits in excess of permitted deficits as hereinafter defined.

Law of Feb. 13, 1962, ch. 8, § 6, [1962] N.J. Laws 49; Law of March 27, 1962, ch. 209, § 6, [1962] N.Y. Laws 419.

[142] Law of Feb. 13, 1962, ch. 8, § 6, [1962] N.J. Laws 50; Law of March 27, 1962, ch. 209, § 6, [1962] N.Y. Laws 419.

[143] The concurrent statutory sections set out this formula as follows:

> "Permitted deficits" of a group of railroad facilities as used in this section, shall mean deficits as of the time of any certification hereunder which do not exceed (A)

pledge now known as the "1962 covenant," did "covenant and agree with each other and with the holders of any affected bonds"[144] that this formula would be respected. The statute, with the 1962 covenant, passed both houses of the New Jersey legislature on February 13, 1962, without a dissenting vote.[145] Governor Richard Hughes signed the bill on the same day.[146] The New York legislature passed concurrent legislation, which then Governor Nelson Rockefeller signed on March 27, 1962.[147] Emphasizing the size of the investment—$420 million—Governor Rockefeller noted that neither state tax money nor state credit would be used in the project.[148]

After the pledge was enacted by both states, private individuals, in reliance on the covenant, invested over $1 billion in Port Authority bonds at very moderate rates of interest.[149] As a result of the huge investment made by thousands of bondholders since

such amount or amounts of deficits as of the time of any certification hereunder for the payment of which one or both of the [2 States], in connection with the proposed other railroad facility as to which the certification is made and in connection with prior other railroad facilities, has made adequate, secure and effective provision for the duration of the period for which the port authority is liable for such deficits, plus (B) the greater of the following [2] amounts: (1) an amount equal to [1/10] of the amount in the general reserve fund at the end of the preceding calendar year, diminished by an amount equal to [1%] of the principal amount of all bonds of the port authority outstanding at the end of said preceding calendar year the proceeds of which shall have been applied for purposes in connection with the facilities of such group or (2) an amount equal to the sum of [1/10] of the diminished [1/10] amount calculated under clause (1) of this sentence, plus [1%] of the equity, at the end of the said preceding calendar year, of the port authority in its vehicular bridges and tunnels and in all other facilities owned and operated by it (not including railroad cars financed by state-guaranteed bonds) except those of the aforesaid group of railroad facilities.'

Law of Feb. 13, 1962, ch. 8, § 6, [1962] N.J. Laws 50; Law of March 27, 1962, ch. 209, § 6, [1962] N.Y. Laws 419.

[144] Law of Feb. 13, 1962, ch. 8, § 6, [1962] N.J. Laws 47; Law of March 27, 1962, ch. 209, § 6, [1962] N.Y. Laws 418.

[145] [1962] N.J. GEN. ASS'Y MINUTES 240-42; [1962] N.J. SENATE JOUR. 182.

[146] SPECIAL REPORT, *supra* note 137, at 26.

[147] Law of March 27, 1962, ch. 209, [1962] N.Y. Laws 412-27.

[148] Message of the Governor of the State of New York on approving Law of March 27, 1962, ch. 209, [1962] N.Y. Laws 3613. The governor stated:

> According to preliminary estimates, the total cost of this vast port development project [acquiring the Hudson and Manhattan Railroad, and developing the World Trade Center] will be substantially in excess of $420 million. These capital sums will be raised by the Port Authority on its own credit without recourse to the taxing powers or credit of either state or any of their municipalities.
>
> To preserve the Port Authority's credit strength the bill includes a covenant by the two States that additional deficit financing of future railroad projects will only be undertaken within the financial limits set forth in their covenant.

Id. at 3614.

[149] *See* THE PORT AUTHORITY OF NEW YORK AND NEW JERSEY, OFFICIAL STATEMENT ON $100,000,000 CONSOLIDATED BONDS, FORTY-FIRST SERIES, App. I, at 33-34 (1973) [hereinafter cited as OFFICIAL STATEMENT].

1962, the World Trade Center has been completed and PATH now transports its passengers in new, air-conditioned cars at lower fares than were in effect at the time the Port Authority took over the railroad.

Shortly after their enactment, the statutes empowering the Authority to take over the Hudson and Manhattan railroad and to build the World Trade Center were attacked in *Courtesy Sandwich Shop, Inc. v. Port of New York Authority.*[150] The plaintiffs had contended that since no congressional consent had been obtained for the recent bi-state legislation, it violated the compact clause of the Constitution.[151] The Court of Appeals of New York held that no additional consent was necessary, since Congress' approval in 1921 and 1922 of the creation of "the Port Authority expressly contemplated such further co-operative legislation in furtherance of port purposes."[152] The United States Supreme Court dismissed an appeal "for want of a substantial federal question."[153]

In *Kheel v. Port of New York Authority,*[154] the 1962 covenant was specifically attacked.[155] A violation of the compact clause was again alleged, but the district court held that "*Courtesy Sandwich Shop* forecloses the claim."[156] Plaintiffs also argued that the covenant's formula for protecting bondholders effected "a constitutionally impermissible delegation of future legislative authority to provide for mass transit facilities to private persons, the bondholders."[157] The court held that the claim of " 'legislative divestment' " must fail not only legally but also pragmatically since the covenant does not prohibit the states from solving "mass transit problems by other means, e.g. by enactment of subsidy programs."[158] This rendered the constitutional questions "illusory."[159]

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[150] 12 N.Y.2d 379, 190 N.E.2d 402, 240 N.Y.S.2d 1, *appeal dismissed,* 375 U.S. 78 (1963).

[151] 12 N.Y.2d at 391, 190 N.E.2d at 406, 240 N.Y.S.2d at 7. The plaintiffs had also challenged the statutes as effecting a "taking of private property by eminent domain for other than a public use" in violation of the fifth and fourteenth amendments and section 7 of article I of New York's constitution. 12 N.Y.2d at 387, 190 N.E.2d at 404, 240 N.Y.S.2d at 4. Plaintiff's property had been condemned by the Port Authority to make room for construction of the World Trade Center. *Id.*

[152] 12 N.Y.2d at 391, 190 N.E.2d at 406, 240 N.Y.S.2d at 7.

[153] 375 U.S. 78 (1963).

[154] 331 F. Supp. 118 (S.D.N.Y. 1971), *aff'd,* 457 F.2d 46 (2d Cir.), *cert. denied,* 409 U.S. 983 (1972).

[155] 331 F. Supp. at 119.

[156] *Id.* at 121. The court noted that while no consent was given to the new legislation, Congress still retained a veto power. The court also rejected the claim that the 1962 covenant infringed upon Congress' commerce clause powers "[f]or analogous reasons." *Id.*

[157] *Id.* at 119.

[158] *Id.* at 122.

[159] *Id.*

The 1962 covenant is not a "legislative divestment," since the decision of whether to enter the field of mass transit remains with the Port Authority. The covenant simply provides the requisite security to attract and safeguard the necessary investment capital. Although protection of bondholders' interest was afforded by a 1952 bond resolution,[160] the Farley Committee's investigation showed that a more concrete assurance was necessary.[161] The importance of the 1962 covenant to the affected bondholders is that it provides a part of the underlying security for their investment by setting forth an objective test regulating deficits which may be incurred in connection with rail operations.[162] This objective formula acts as a check, in the bondholders' interest, on the discretion of the Port Authority's commissioners.

Following the success of the Port Authority's undertaking of PATH and the World Trade Center, the two states apparently felt that this pledge was no longer needed to attract future investors. Accordingly, in 1972, both states amended the 1962 covenant to provide that neither state would be bound by it as to any future issues of bonds.[163] In enacting the 1972 amendment, however, both states reaffirmed that the holders of more than $1 billion in outstanding bonds could continue to rely on the original covenant.[164] The New Jersey legislature's statement demonstrates their intent:

> The bill is also designed to preclude the application of the 1962 covenant to holders of bonds newly issued after the effective date of this act, *while maintaining in status quo* the rights of the holders of the bonds issued after March 27, 1962 (the effective date of the 1962 covenant legislation) but prior to the effective date of this act.[165]

Within two years, however, both states repealed the solemn legal pledge twice made by statute to the bondholders.[166]

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[160] Consolidated Bond Resolution (adopted Oct. 9, 1952), reproduced in OFFICIAL STATEMENT, *supra* note 149, App. V, at 55-71.

[161] *See* notes 138-40 *supra* and accompanying text.

[162] *See* note 143 *supra*.

[163] Law of Dec. 28, 1972, ch. 208, § 2, [1972] N.J. Laws 801; Law of June 8, 1972, ch. 1003, § 1, [1972] N.Y. Laws 3143.

[164] Law of Dec. 28, 1972, ch. 208, § 3, [1972] N.J. Laws 802; Law of May 10, 1973, ch. 318, § 2, [1973] N.Y. Laws 448. In its 1972 amendment, the New York legislature had attempted to repeal the protection of the 1962 covenant completely; however, the New Jersey legislature refused to enact such an amendment. Since the New York statute required concurrent legislation in New Jersey, the complete repeal was not accomplished in 1972.

[165] N.J. Assembly Bill No. 1565 (introduced Nov. 16, 1972) (emphasis added).

[166] Law of April 30, 1974, ch. 25, 1 N.J. SESS. LAW SERV. 34 (1974); Law of June 15, 1974, ch. 993, 9 N.Y. SESS. LAW NEWS 1590 (1974).

The constitutionality of the repeal has been questioned from the moment of its inception. Governor Malcolm Wilson of New York recognized the existence of the controversy when he signed the repeal into law on June 15, 1974, stating:

> It is with great reluctance that I approve a bill that overturns a solemn pledge of the State. I take this extraordinary step only because it will lead to an end of the existing controversy over the validity of the statutory covenant, a controversy that can only have an adverse effect upon the administration and financing of the Port Authority, and because it will lead to a speedy resolution by the courts of the questions and issues concerning the validity of the statutory covenant.[167]

The bondholders' trustee has subsequently instituted suit, challenging the repeal as an unconstitutional impairment of contract.[168]

The action of the two states in repealing the covenant is far more offensive than are other instances in which the impairment of contract issue has been raised. In most other cases, state legislative action has affected contractual rights where the state itself was not a party, such as those between a mortgagor and a mortgagee or a bondholder and a municipality. In this situation, however, the states of New York and New Jersey are parties to the contract and each has sought to repudiate its own solemn contractual covenant unilaterally.

By repealing the covenant, the states have not simply modified the bondholders' remedy or changed a procedural means of enforcement, so that there would be no impairment of the obligation.[169] Consequently, the validity of the repeal must rest upon the police power exception. Perceiving a mass transit emergency, the legislatures deemed this repeal a valid exercise of that police power.[170] While a state's police power can, of course,

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[167] Memorandum of the Governor of the State of New York on approving Law of June 15, 1974, ch. 993, 9 N.Y. SESS. LAW NEWS A-362 (1974).

[168] Complaint, United States Trust Co. v. New Jersey, No. L-26861-73 (N.J. Super. Ct., L. Div., April 30, 1974). Plaintiff is the trustee for the fortieth and forty-first series of Port Authority bonds, as well as a bondholder, and brought suit in its capacity as trustee to protect and act on behalf of the individual bondholders. *Id.* at 2-3. The complaint alleges that the retroactive repeal of the 1962 covenant constituted an impairment of the bondholders' contracts in violation of the New Jersey and federal constitutions. *Id.* at 16. In addition, it alleges that the repeal constituted a taking of the bondholders' property without just compensation in violation of the fifth and fourteenth amendments and of the state constitution. *Id.* at 17. Plaintiff seeks a declaratory judgment that the repeal is void. *Id.* at 18.

[169] *See* notes 28-32 *supra* and accompanying text.

[170] Answer and Counterclaim at 6, United States Trust Co. v. New Jersey, No. L-26861-73 (N.J. Super. Ct., L. Div., July 15, 1974). As one of their defenses, the defendants pleaded:

never be "bargain[ed] away,"[171] it can only be exercised within constitutional limits.

This recent legislative action should be compared with the statutes considered in *New Jersey Highway Authority v. Sills,*[172] which, in 1970, reaffirmed the proposition that bondholders' contract rights vis-à-vis the state are constitutionally protected from unilateral legislative impairment. In *Sills,* the trial court examined two 1968 statutes which attempted to exempt national guardsmen and military reservists from paying tolls on bridges, ferries, or toll roads while going to or returning from duty.[173] The Highway Authority had previously issued revenue bonds to finance construction. The payment of principal and interest was to be made primarily from tolls.[174] The proposed exemption was in contravention of a statutory pledge made by the state to the holders of the Highway Authority bonds that the Authority and not the state would have the sole power to set and collect tolls.[175] The yearly loss of revenue resulting from the exemption only would have amounted to approximately $27,300 of total revenues in excess of $46 million.[176] The exemption was struck down as an unconstitutional impairment of contract.[177] In a supplemental opinion, the court rejected the claim that the police power of the state could be invoked to justify the statutory exemption.[178]

The use of the police power to impair contracts has been sustained when legislatures have responded to real emergencies through temporary measures.[179] Unlike the statute upheld in *Blaisdell,* the repeal of the 1962 covenant is not a suspension of contract rights. Instead, it purports to permanently deprive bond-

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> The 1974 Act constitutes a reasonable exercise of the police powers of the State of New Jersey to protect the health, safety and welfare of its citizens. These police powers are fundamental to the sovereignty of the State and cannot be abdicated.

Id. The Attorney General of New Jersey is not actively defending the suit. Instead, Michael I. Sovern, a member of the New York bar and dean of the Columbia University School of Law, has been retained as special counsel for the state.

[171] *See, e.g.,* Stone v. Mississippi, 101 U.S. 814, 817 (1879).

[172] 109 N.J. Super. 424, 263 A.2d 498, *supplemented,* 111 N.J. Super. 313, 268 A.2d 308 (Ch. 1970), *aff'd mem.,* 58 N.J. 432, 278 A.2d 489 (1971).

[173] 109 N.J. Super. at 426, 263 A.2d at 499 (citing Law of Jan. 14, 1969, ch. 414, [1968] N.J. Laws 1431; Law of Nov. 25, 1968, ch. 352, [1968] N.J. Laws 1162).

[174] 109 N.J. Super. at 426-27, 263 A.2d at 499.

[175] *Id.* at 427-28, 263 A.2d at 499-500 (citing N.J. STAT. ANN. §§ 27:12B-9, -14 (1966)).

[176] 111 N.J. Super. at 315, 268 A.2d at 309.

[177] 109 N.J. Super. at 431, 263 A.2d at 501. The court reaffirmed this conclusion in its supplemental opinion. 111 N.J. Super. at 322, 268 A.2d at 313.

[178] 111 N.J. Super. at 319-20, 268 A.2d at 312.

[179] *See* notes 35-63 *supra* and accompanying text.

holders of the protection afforded by the 1962 covenant. The supposed repeal is not "limited to the exigency which called it forth,"[180] nor is there any benefit to the bondholders. In contrast to the decision in *Faitoute,* where the Supreme Court emphasized that the challenged legislation benefited both the municipality and bondholders, the repeal at issue here favors only one party to the contract. In *Faitoute,* the legislation increased the likelihood of repayment, while the removal of the 1962 covenant's protection, with possible dilution of Port Authority revenues, increases the chances of non-payment.

In examining a legislature's alleged exercise of police power, a court will look to see if the right impaired was a "primary consideration for the buyer's undertaking."[181] In 1962, when the states sought to have the Port Authority undertake the World Trade Center and PATH projects, it was as much in their interest as the bondholders' to provide the statutory protection of the covenant.[182] As testimony before the Farley Committee established, the Authority, without this pledge, "could not sell a single Port Authority bond."[183]

A bond investor is willing to take a relatively fixed risk in exchange for a fixed return. The type of risk is then utilized in determining the amount of interest he will require for the use of his capital. The 1962 covenant was enacted in order to attract large sums of capital by setting limits on the risk which the Port Authority could undertake in the precarious area of deficit rail operations. Since the Port Authority lacks the power to tax or to pledge the credit of either state, the covenant was designed to protect the only source for payment of expenses and over $1 billion in bond obligations—the Authority's revenues. To remove this protection is to take from the bond contract "the quality of an acceptable investment for a rational investor," of which Justice Cardozo spoke in *W. B. Worthen Co. v. Kavanaugh.*[184] The Port Authority bondholders were given no opportunity to renegotiate the rate of interest in relationship to the increased risk. As was stated in *Worthen,*

[180] Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 447 (1934). For further discussion see notes 35-41 *supra* and accompanying text.

[181] City of El Paso v. Simmons, 379 U.S. 497, 514 (1965). For further discussion see notes 64-73 *supra* and accompanying text.

[182] *See* notes 137-38 *supra* and accompanying text.

[183] *Port Authority Hearings of Jan. 27, 1961, supra* note 136, at 22. *See* note 138 *supra* and accompanying text.

[184] 295 U.S. 56, 60 (1935). For further discussion see notes 74-83 *supra* and accompanying text.

"[e]ven when the public welfare is invoked as an excuse,"[185] the security of an investment cannot be restricted to such an unreasonable extent.

The full financial impact of the repeal has not yet been felt as the Port Authority has not issued any new bonds since the two states acted to repeal the covenant. There is considerable sentiment in the investment and banking community that, because of the repeal of the covenant, the Port Authority will find it difficult or impossible to market any major new issues of bonds. The ultimate penalty of this action, however, is that the repeal will weaken investor confidence not only in the Authority, but also in the integrity of the states of New Jersey and New York.

Investor confidence takes on greater significance when a state agency attempts to issue bonds secured not by a legal pledge but solely through the state's "moral pledge." The moral pledge is a euphemism which is utilized to describe provisions in statutes creating various state agencies with the power to issue revenue bonds. These provisions generally declare that, in the event revenue-producing operations of the state agency do not generate sufficient funds to pay debt service and operating costs and to maintain reserves, the state will appropriate and pay over to the agency sufficient moneys to meet the deficit. This moral pledge, however, does not create a legally binding obligation on the legislature to make future payments. The pledge must be legally non-binding; otherwise the debt limitation clause of the state constitution would be violated.[186] As in the Additional State School Building Aid Act[187] and the County College Bond Act,[188] each future legislature is free to appropriate or not appropriate any necessary funds.[189] Future legislatures are subject only to the "moral pressure" of the statutory provisions and the reality that investors had purchased the agency's bond with the expectation that this moral pledge would be honored.

More than $6 billion in bonds have been "secured" by moral pledges enacted by eleven states.[190] New York and New Jersey are

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[185] 295 U.S. at 60.

[186] *See* notes 115-17 *supra* and accompanying text.

[187] N.J. STAT. ANN. § 18A:58-33.6 *et seq.* (Supp. 1974-75). *See* notes 118-24 *supra* and accompanying text.

[188] N.J. STAT. ANN. § 18A:64A-22.1 *et seq.* (Supp. 1974-75). *See* notes 119-24 *supra* and accompanying text.

[189] *See* notes 120 & 125 *supra* and accompanying text.

[190] 66 MOODY'S BOND SURVEY 771 (1974).

"prominent among these issuers."[191] Recently, for example, the New Jersey Sports and Exposition Authority issued more than $300 million of bonds "backed" by the moral peldge of the State of New Jersey.[192] The practical importance of the pledge was recognized by Justice Francis, speaking for the majority of the New Jersey supreme court, in *New Jersey Sports & Exposition Authority v. McCrane*:[193]

> [I]f the constitutionally acceptable device of modern day progressive government, *i.e.*, the financially independent authority, is to succeed in the expeditious accomplishment of public purpose projects, and in persuading investors to buy the authority's bonds, the good faith covenant of the Legislature for itself and its successors to refrain from adopting later enactments which will materially impair the obligation of the authority's bonds must be respected. Otherwise the device becomes an empty formula.[194]

The New York and New Jersey legislatures, in repealing the 1962 covenant, have impaired a constitutionally protected obligation. The practical repercussions of this repudiation—not of a moral pledge but of a solemn legal pledge—were recently noted in *Moody's Bond Survey*:

> What does the repeal of a legal obligation, the basis for the Port Authority's covenants, imply with respect to moral obligations? If the States are willing to repeal a legal obligation used as the basis for selling bonds without regard for possible litigation and uncertainty, what chance does a moral obligation have in a period when sufficient political pressures arise? Or, to phrase another question: When or under what circumstances would a State legislature find it expedient not to make a contribution to a capital reserve fund? The answer, if the Port Authority example provides one, is when it may be politically expedient.[195]

The repeal of the covenant, if *Moody's* is an indication, has already significantly undermined investor confidence in the trustworthiness of the two states. This erosion can result in higher interest rates for New Jersey's public authorities and agencies seeking to finance their public projects. Is this a price worth paying

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[191] *Id.*

[192] *See* THE NEW JERSEY SPORTS AND EXPOSITION AUTHORITY, OFFICIAL STATEMENT ON $302,000,000 SPORTS COMPLEX BONDS, 1974 SERIES (1974).

[193] 61 N.J. 1, 292 A.2d 545, *appeal dismissed sub nom.* Borough of E. Rutherford v. New Jersey Sports & Exposition Auth., 409 U.S. 943 (1972).

[194] 61 N.J. at 29, 292 A.2d at 559. A bill has been introduced to repeal the state's "moral pledge." N.J. Assembly Bill No. 808 (introduced Jan. 15, 1974).

[195] 66 MOODY'S BOND SURVEY 772 (1974).

—especially when repeal of the covenant does not insure that the Port Authority will, in fact, be able to undertake any additional deficit rail operations?[196] The confidence of the banking and investment community in the two states would be restored by a clear judicial expression that the repeal of the 1962 covenant violates the impairment of contracts clause, is not a proper exercise of police power, and, therefore, is unconstitutional.

Other Developments

Bondholder rights also may be affected by other developments in New Jersey. In 1969, the New Jersey supreme court upheld the right of a portion of a municipality to secede and annex itself to another municipality.[197] Recently, legislation has been introduced

[196] *See* Memorandum of the Governor of the State of New York on approving Law of June 15, 1974, ch. 993, 9 N.Y. SESS. LAW NEWS A-363 (1974). After noting that "the Port Authority is solidly committed to providing mass transportation," Governor Wilson expressed doubt as to the ability of the Authority to undertake further mass transit activities:

> In response to my inquiry, the Chairman has also advised me that, because of the heavy long-term capital commitments for the PATH facilities and the Kennedy Rail Link, the Authority has no significant capacity to contribute funds for operating subsidies for commuter railroads. Hence, the plain and simple fact of the matter appears to be that the Authority has virtually no excess funds that could be channeled into operating subsidies for mass transportation facilities in the New York metropolitan area. Even if such funds were available, existing bond indenture provisions which survive despite repeal of the statutory covenant would prohibit their use except in relation to facilities owned, leased or operated by the Port Authority.
>
> For these reasons, my approval of the bill should not be considered as a criticism of the efforts which the Port Authority has made to provide effective transportation services, including mass transportation services, to the people of the New York metropolitan area, nor a panacea for the mass transportation problems plaguing the New York metropolitan area.

Id. at A-362 to -63.

[197] West Point Island Civic Ass'n v. Township Comm., 54 N.J. 339, 349-50, 255 A.2d 237, 242 (1969) (construing N.J. STAT. ANN. § 40:43-26 (1967)). Comprising an area of "one-half mile square," West Point Island had 1.737 percent of Dover Township's tax ratables. The island residents wanted to secede from the township and join the Borough of Lavallette, to which the island was adjacent. The township's business center was seven and a half miles away from the island and it was necessary to drive through Lavallette to get there. 54 N.J. at 344-45, 255 A.2d at 239. Pursuant to N.J. STAT. ANN. § 40:43-26 (1967), the islanders petitioned the governing bodies of the two municipalities to allow the island to detach itself from Dover Township and become annexed to Lavallette. The Dover Township Committee refused to consent to the "deannexation." 54 N.J. at 342-43, 255 A.2d at 238-39. The supreme court overruled the refusal to consent as being without "reasonable grounds," finding that the township was not "economically or socially injured by the deannexation, and the geography is so pointedly in favor of allowing it." *Id.* at 350, 255 A.2d at 242.

Recently, in Ryan v. Mayor & Council, 64 N.J. 593, 319 A.2d 442 (1974), the supreme court again considered a petition for severance. An area consisting of an exclusive residential development sought to withdraw from the Borough of Demarest and attach itself to the adjacent Borough of Alpine. Part of the development was also located in Alpine. The Demarest mayor and council refused their consent to the deannexation petition on the

which would allow part of a school district to withdraw from a regional system.[198] These events may have a significant impact on the holders of bonds issued by the respective entities.

A bondholder purchases a bond from a municipality or school district in reliance on the taxing power and credit-worthiness of the entity as a whole. When the legislature allows a portion of the entity to sever itself, the original area's taxing potential is reduced. In authorizing the secession of part of a school district, the New Jersey legislature has provided for the apportionment of school district debt between the new and old districts.[199] If either of the districts cannot meet its share, does the bondholder have the right to proceed against the non-defaulting district for payment?

The Florida supreme court faced a similar question in *Humphreys v. State ex rel. Palm Beach Co.*[200] Seven years after issuing

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ground that the interest and welfare of the municipality would be harmed. *Id.* at 596-97, 319 A.2d at 444. Although the development constituted only sixteen of the municipality's 1547 homes, it provided 2.11 percent of the total tax ratables, residential and commercial, in the borough. The development's residents were socially and politically active in the Demarest community. *Id.* at 598-99, 319 A.2d at 445. Despite evidence that the borough's tax revenues would be decreased while its operating expenses in providing public services would remain the same, the trial court ordered the governing body to consent. It concluded that the social and economic detriments to the municipality were "insignificant." *Id.* at 599-600, 319 A.2d at 445-46. The supreme court reversed. *Id.* at 606, 319 A.2d at 449. The court held that the borough had met its burden of producing evidence of substantial social or economic injury to the municipality, and that the burden of proving the unreasonable withholding of consent had not been satisfied by the plaintiffs. *Id.* at 602, 319 A.2d at 447. Speaking of the economic injury that would result from deannexation, Justice Clifford wrote:

> [I]t is certain that the owners of these exclusive and expensive homes contributed substantially more to the Borough than they cost in services. (What is clearly inferable from the record . . . is that plaintiffs sought deannexation primarily because it would save them considerable money, the property tax rate in Alpine being significantly lower than in Demarest, where they feared an additional burden because of sewer installation.) The municipal fathers quite properly considered the amount of both the long term and the short term loss of revenue in determining that the proposed deannexation would mean economic injury to the Borough.

Id. at 603, 319 A.2d at 448. Justice Pashman, concurring in the result, dissented to the distribution of burdens of proof. Concluding that any deannexation results in loss of tax ratables or in disruption of the social character of a municipality, he stated: "It must always fall, therefore, to the potential seccessionists to prove that in fact the economic or social consequences of deannexation will be *de minimis*." *Id.* at 607, 319 A.2d at 450. Rather than attempting to show no social or economic harm, "a task in which they can never succeed," plaintiffs seeking deannexation should show that the benefits to the seceding area outweighed any harm to the remainder of the municipality. *Id.*

[198] N.J. Assembly Bill No. 824 (introduced Jan. 24, 1974) (withdrawal from all-purpose regional school district); N.J. Assembly Bill No. 825 (introduced Jan. 24, 1974) (withdrawal from limited purpose regional school district). *See also* N.J. STAT. ANN. § 18A:8-4 *et seq.* (1968) (division of school district on division of municipality).

[199] N.J. STAT. ANN. § 18A:8-7 (1968); *cf.* N.J. Assembly Bill No. 825, § 3 (introduced Jan. 24, 1974).

[200] 108 Fla. 92, 145 So. 858 (1933).

bonds, the Town of Boynton was divided by the legislature into the towns of Boynton and Boynton Beach. The legislature also provided that each of the new towns should assume fifty percent of the indebtedness of the original town.[201] Subsequently, the bonds were in default, and the bondholders sought to have the towns, jointly or severally, levy sufficient taxes for payment—without regard to the fifty percent legislative apportionment.[202] The court held that although the legislature had the power to divide municipal corporations,[203] it could not "take away taxes necessary to meet the payments pledged to be made therefrom when the bonds were sold."[204] If precluded from this recourse, the bondholders would be substantially without a remedy.

Holders of New Jersey governmental bonds may face such a threat from legislation allowing severance. Were the legislature permitted to release the seceding portions from the entire obligation, the dire consequences are apparent. If the "richer" areas of school districts or municipalities containing most of the ratables felt that their tax burden was too great in relation to the amount of services received, they might seek to have their burden lightened by severing themselves from the rest of the area. The legislature has provided that on division of a school district, the new districts will assume that portion of the entire debt which relates to the amount of school property within their boundaries.[205] This division may create the following situation: One new district may have fifty percent of the school property and a significantly greater percentage of the tax ratables, while the other new district, not so generously endowed with ratables, will nevertheless be responsible for fifty percent of the debt. In the not unlikely event of a default by the poorer district, the bondholder must have the right to

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[201] *Id.* at 94-98, 145 So. at 859-61.

[202] *Id.* at 94-95, 145 So. at 860.

[203] *Id.* at 108, 145 So. at 864.

[204] *Id.* at 103, 145 So. at 862.

[205] N.J. STAT. ANN. § 18A:8-7 (1968). This method of apportionment departs from the formula followed in the predecessor statute which had been based on the ratio of tax ratables in the new district. Law of April 27, 1931, ch. 270, [1931] N.J. Laws 680. The older method was examined in Board of Educ. v. Board of Educ., 8 N.J. Super. 124, 73 A.2d 600 (App. Div. 1950). The court noted that the statute made "more equitable the distribution of liabilities on the bonded indebtedness" than a division determined by the location of school property. *Id.* at 129, 73 A.2d at 602.

The proposed bills in the Assembly follow the approach of N.J. STAT. ANN. § 18A:8-7 (1968). *See* N.J. Assembly Bill No. 824, § 1 (introduced Jan. 24, 1974); N.J. Assembly Bill No. 825, § 3 (introduced Jan. 24, 1974). Is it not more equitable to take into consideration the ability to pay, *i.e.*, the tax ratables, as well as the amount of school property situated in each district?

proceed against the richer district, otherwise he will have lost a substantial remedy inherent in his original contract.[206] While the legislature can sever an area and apportion primary responsibility for the debt, this apportionment must imply secondary liability for the entire debt. Since the bondholder relied on the taxing power of the entire school district or municipality, the impairment of contracts clause requires that the legislature not release either area from ultimate responsibility for repayment of the original debt.

CONCLUSION

The foregoing analysis demonstrates that some legislative acts which appear to violate the impairment of contract clause, in fact, do not do so. The courts can construe such actions as leaving intact the original undertaking of the contracting parties. This category includes revamping the method of financing public education and rearranging the boundaries of municipalities, school districts, and other taxing districts. A second category of cases involves legislative modifications of existing contractual rights which the courts determined had not constituted the central undertaking of one party nor the primary consideration of the other party to the contract. This group is exemplified by the *El Paso* case where the Supreme Court permitted modifications of contractual rights in a manner "hardly burdensome" to the party whose rights were affected. It should be noted, however, that the contractual rights of the holders of bonds issued by governmental units rarely, if ever, fall into this category. For example, in the *Sills* case, the revenue loss resulting from the legislative act permitting reservists and guardsmen to use the Garden State Parkway toll-free was de minimis. Yet, the New Jersey supreme court refused to permit this legislative modification of bondholders' rights. When the legislature responds to the *Robinson v. Cahill* mandate, its actions will be judged by these principles.

The final category of impairment cases presents the question whether an act of a state legislature which impairs important, even essential, contract rights should be upheld as a valid exercise of the state's reserved police power. Such a result sustaining the police power requires a showing of grave physical or economic crisis which threatens the public welfare. This is the only argument which might validate the repeal of the 1962 covenant in the face of

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[206] *See* Humphreys v. State *ex rel.* Palm Beach Co., 108 Fla. at 102-03, 145 So. at 862.

overwhelming evidence that the existence of the covenant was of primary concern to the bondholders. The Supreme Court in *Worthen* has indicated that the courts are loathe to accept modifications of bondholders' rights, even if an economic crisis exists. In fact, legislative impairment of bondholders' rights because of the economic crisis has been permitted only when any other result would lead to total fiscal collapse of the bond issuer and the impossibility of payment of the bonds. Such is not the case of the Port Authority. Any emergency which may exist in the field of mass transit is not caused by the covenant, might or might not be alleviated by its repeal, and certainly may be solved by other, constitutionally inoffensive methods.

The fiscal impact of the repeal on the states is a reality. If the two states wish to restore credibility to their legal and moral commitments and thus maintain borrowing costs at a minimum, they should abandon their ever more frequent attempts to renege on these covenants and pledges after substantial sums have been invested in reliance on them. In the meantime, it appears that investors will have to rely on the courts to require the states to live up to their bargains.